# The Financial Market in Norway 2004: Risk Outlook



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

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# Introduction

The stability of the financial system has received much attention in recent years. Many countries, including most Nordic countries, have seen serious problems in their financial sectors, with substantial costs for society. The financial system redistributes capital and risk and attends to payment and settlement functions. Solid financial institutions and smoothly functioning financial and securities markets are needed if these functions are to be discharged in a satisfactory manner. Should confidence in the financial system fail, there could be substantial negative consequences for other sectors of the economy.

The experiences of a number of countries, including the Nordic countries, show that a combination of persistent, vigorous credit market expansion and rising prices in asset markets, in which real estate and securities markets are at centre-stage, makes the financial system more vulnerable to possible macroeconomic shocks. Imbalances, which are just as likely to accumulate in periods of low and stable inflation as otherwise, may be difficult to identify. The presence of solid financial institutions reduces the risk of macroeconomic shocks leading to serious problems in the financial system.

Since 1994 Kredittilsynet has analysed and assessed potential stability problems in the Norwegian financial industry in the light of developments in the Norwegian and international economy. This is a necessary supplement to Kredittilsynet's ongoing supervision of individual institutions, since significant aspects 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. Kredittilsynet publishes annually its view of the state of the financial market and of the various categories of institutions.

## Highlights

Based on a review of the results reported by financial institutions and investment firms and an analysis of the economic prospects, the situation in the Norwegian financial market can be summarised as follows:

- Banks' results in 2004 were a significant improvement on 2003, and the best since 2000. The cyclical upturn since the summer of 2003, along with very low interest rates, meant that banks recorded virtually no loan losses in 2004. Banks' pre-loss results were approximately unchanged from the preceding year. Increased sales of products generating revenues in the form of charges and commissions, together with somewhat lower costs, improved results in 2004, whereas banks' interest margins remained under pressure. Banks' net interest revenues continued to fall in 2004. The banking sector's overall financial position remains satisfactory.

- Extremely low interest rates appreciably ease borrowers' debt-servicing burden. Continuing growth in household indebtedness, strong growth in house prices and high loan-to-value ratios on new home loans will heighten the risk of problems for households and banks once interest rates start to climb from their current abnormally low level. A low volume of fixed interest borrowing increases households' vulnerability. Should many households experience debt-servicing problems and need to reduce their consumption, there could be spillover effects to real estate markets and the business sector, reinforcing the banks' credit risk. Financial stability considerations call for a gradual increase in interest rates, an increase which should not be put off for too long.

- Bank deposits showed strong growth in 2004, despite a vigorous upturn in Norwegian share markets and low interest rates on bank deposits. Even so, higher lending growth meant that deposits as a share of lending fell somewhat in 2004. Most banks expanded their other long-term funding, in part by issuing bonds. Banks' overall liquidity risk is lower than at the turn of the year 2002/2003 when some banks experienced problems with both short- and long-term funding. Banks appeared in general to have sharpened their awareness of liquidity risk and liquidity management.

- Somewhat reduced losses improved finance companies' results in 2004. Whereas net interest revenues fell in the case of finance companies as a whole, they rose in the case of companies engaged in consumer finance. Finance companies and mortgage companies expanded vigorously in 2004.

- Life insurance companies posted good results in 2004, albeit slightly weaker than in 2003. Low equity holdings, of which foreign shares account for about two thirds, meant that the impact of the vigorous upturn on Oslo Børs (the Oslo Stock Exchange) on companies' results was limited. Low interest rates make it difficult for life insurers do build up sufficient capital buffers and risk-bearing capacity. To improve prospects of higher return and assure sound long-term return on assets under management, the companies' risk-bearing capacity needs to be strengthened. The good results achieved in 2004 gave life insurers an opportunity to increase their buffer capital. Although buffer capital should preferably be increasing more rapidly than appears to be the case, life insurers are equipped to meet their obligations in the years immediately ahead.

- Pension companies achieved a somewhat higher return on capital in 2004 than life insurance companies although, for them too, returns were lower than in 2003. Pension funds have benefited from the upturn in share markets to a larger degree than life insurers.

- Non-life insurance companies posted strong results in 2004, as in 2003. Technical accounts continue to improve on the back of premium increases and a stable cost trend. Overall results were weaker in 2004 than in 2003 due to lower financial revenues. No general increase in premiums appears to be needed ahead.

- The strong trend in share prices and trading of shares quoted on Oslo Børs brought a steep increase in revenues for investment firms in 2004, particularly non-banks. Investment firms operating as banks – which earn much of their revenues from trading in currencies, currency derivatives and fixed income instruments – showed little change in their earnings from 2003 to 2004.

## Summary

The global economy showed strong growth in the first half of 2004, with the US and China leading the field. The strong recovery in China has given a significant impetus to other countries in Asia. Despite relatively strong growth in exports, the euro area remains on a weak trend and shows almost no growth in domestic demand. During the autumn there were several indications that global growth is coming to a halt, and the cyclical peak appears to be behind us. The major forecasting institutes expect declining, albeit still relatively high, global growth in 2005. Given the large imbalances in the US economy and continued high oil prices, likely developments ahead are uncertain. The possibility that these imbalances will trigger further falls in the dollar, with ensuing effects on the real economy and securities markets, cannot be ruled out.

The steep rise in share market prices in 2003, which continued into the first quarter of 2004, was succeeded from March onwards by an uneven trend in international share markets in which a short-lived downturn was followed by a slight upturn. In the past two years Oslo Børs has shown a considerably larger upturn than the international bourses, and in 2004 Oslo Børs's benchmark index climbed about 38 per cent. This development should be seen in light of the fact that the Norwegian market is dominated by shipping companies that are benefiting from increased international trade, along with oil companies and other major exporters that are profiting from the high commodity prices. In the international arena, long interest rates rose somewhat towards the summer of 2004. The upturn was reversed during the autumn as signs of weaker growth and lower-than-expected inflation became evident. Norwegian long rates have largely shadowed their American counterparts. In the euro area, sluggish growth and absence of inflationary pressures contributed to a slight increase during the summer and somewhat lower rates during autumn. At the end of 2004, long US rates were roughly on a par with the level at the start of the year, while rates in the euro area and in Norway fell about 0.5 percentage points over the year. Long rates were still falling early in 2005.

Since the summer of 2003 the Norwegian economy has seen a cyclical upturn, driven by substantial monetary policy stimuli and an international recovery. Private consumption has long been the principal driving force, but in 2004 was accompanied by a moderate rise in investment. Hence moderate wage

settlements, depreciation of the Norwegian currency through 2003, an international boom and high commodity prices appear to have kindled a more positive development for business and industry than has been seen in the Norwegian economy in recent years. Enterprises' credit growth is once again positive at 3.7 per cent at end-2004, compared with a negative 1.5 per cent at end-2003. A somewhat more favourable labour market is instilling increased optimism among households, and, supported by record-low interest rates, house prices rose by just over 10 per cent at end-2004. The buoyant housing market is largely reflected in the credit market where households are continuing to increase their indebtedness. Growth in credit to households has been very high over the past five years, reaching 11.4 per cent at end-2004. Continued strong consumer demand combined with a somewhat more favourable trend among enterprises has had a positive impact on the market for commercial real estate, which was on a weak trend during the downturn. Office vacancies remain high, while rental prices appear to have bottomed out in the past year after falling sharply for several years.

Large financial groupings predominate in the Norwegian financial industry, particularly in banking and life insurance. Foreign actors have gained increasing influence in recent years through the establishment of branches and subsidiaries. Even after the establishment of DnB NOR, Norway's largest financial conglomerate is far smaller than its largest Nordic counterparts, and credit market concentration in Norway falls short of levels elsewhere in the Nordic region.

The improved performance of Norwegian banks from 2002 to 2003 continued in 2004. The main contributor is a reduction in losses. Low interest rates and a favourable economic climate are enabling a continued fall in the volume of non-performing loans, and the banking sector as a whole recorded virtually no losses in 2004. Banks' net interest revenues, which continued to fall in 2004, remain under pressure, whereas charges and commissions showed a slight increase. Banks' overall lending growth quickened in 2004, reaching about 10 per cent by year-end. As in 2003, growth in lending to the retail market was particularly strong, whereas lending to the enterprise sector rose from a low initial level. The spread in results between individual banks and groups of banks narrowed in 2004. Nordea Bank Norway, in particular, has now come into line with the others, after a weak performance in 2003. DnB NOR looms large in the Norwegian financial system, and the DnB NOR Group reported a clearly improved performance in 2004. The two largest banks also expanded strongly in the retail market in 2004. Three small banks reported accounting losses in 2004, compared with nine in 2003. Financial strength remains satisfactory for the banking sector as a whole, and tier 1 capital adequacy at end-2004 was approximately on a par with end-2003. Norwegian banks' liquidity risk has receded since the turn of the year 2002/2003, and all categories of banks have increased their long-term funding over the past two years.

A more favourable economic climate, somewhat lower joblessness, and very low interest rates – making it easier for borrowers to service debt – have reduced Norwegian banks' short-term credit risk. Banks face larger challenges in the somewhat longer term in the shape of risk associated with persistent strong growth in credit and housing markets. Lending to households has been growing steeply for some time, driven above all by developments in the housing market. Credit has grown far more rapidly than incomes, resulting in a sharp increase in the debt burden. The interest burden has however diminished dramatically due to the fall in interest rates in 2003 and 2004. If the impression sets in that the current low interest rates will persist, it may prompt further debt incurrence. Over the past five years the debt burden has risen most among households in the lowest income and age groups, which are the groups most vulnerable to interest rate hikes. Moreover, these groups generally have less financial assets to serve as a buffer when debt becomes difficult to service. Calculations commissioned by Kredittilsynet show that almost half a million Norwegian households might have to spend more than 20 per cent of their income on interest payments if interest rates return to their 2001 level.

Since the bulk of bank's lending growth is in the form of home mortgage loans, banks' financial position increasingly depends on households' situation and the housing markets. Hence the orientation of the tax system is of major significance. Continued interest deductibility combined with reduced housing tax could encourage over-investment in the housing market. Kredittilsynet's survey of bank lending secured on homes, carried out in November 2004, shows that while lending with a high loan-to-value ratio has declined somewhat, it still accounts for a very large share of new lending. In the period covered by the survey almost 40 per cent of new home loans had a loan-to-value ratio above 80 per cent. Hence a key challenge ahead is to instil an understanding among borrowers and lenders alike that mortgages taken out at current interest rates will also have to be repaid in the event of a substantial rate increase, and that the housing market could weaken significantly compared with 2004. A survey carried out for Kredittilsynet shows that many customers fail to grasp crucial information on interest rate and borrowing terms and the repercussions of interest rate increases on personal finances. In the interest of financial stability, interest rates must not be allowed to remain low for too long and rates should be increased on a gradual basis.

Enterprises' debt burden has diminished considerably in recent years due to improved earnings combined with very weak, and at times negative, debt growth. Slower debt growth and lower interest rates have been accompanied by a sharp fall in the interest rate burden. All in all, credit risk vis-à-vis the enterprise sector has declined of late. A survey, carried out in the autumn of 2004, of banks' exposure to selected industries also underpins the impression of lower credit risk in the enterprise sector as a whole. However, there are some uncertainties ahead. Persistent high oil prices and a sharper-than-expected brake on growth in the US and China may dampen the international cyclical recovery by a significantly wider margin than anticipated, with negative consequences for Norwegian exporters. Any strengthening of the Norwegian currency resulting from continued high oil prices will pull in the same direction. It will, however, take time for an adverse economic trend to translate into defaults and losses on banks' corporate lending. Should a large number of households be prompted to reduce their consumption by higher interest rates, there may be spill over effects to real estate markets and parts of the business sector that are dependent on vigorous consumption growth. This is unlikely in 2005, but the longer indebtedness continues to grow the greater the risk that such problems will arise and assume major proportions.

After several years of weak performances, life insurance companies saw a considerable improvement in 2003, thanks in part to capital gains on fixed-income portfolios and the recovery in Norwegian and foreign share markets. Life insurers' results in 2004 were also good, but less so than in 2003. Total premium income rose sharply in 2004, partly due to a cut in the guaranteed interest rate from 4 to 3 per cent and partly to a substantial increase in endowment insurance. Life insurers entered 2004 with a low share component in their balance sheets, and only limitedly increased this component in 2004. Since the bulk of their shareholdings is invested in foreign shares, they have gained little from the steep upturn on Oslo Børs, at the same time as low interest rates yielded low revenues on money market instruments and bonds held as current assets. After a substantial increase in the portion of bonds classified for accounting purposes as "held to maturity", this type of investment tapered in 2004 to 32.5 per cent of life insurers' total balance sheet by year-end. Interest rates on this part of the portfolio average 5.6 per cent, and 70 per cent mature after 2007. Just over a third of bonds held to maturity are foreign. By investing such a large portion of their total assets in bonds held to maturity at relatively high interest rates, life insurers are assured a stable yield for some years ahead. However, the low interest rates are making it difficult for them to accumulate sufficient buffers, and thereby risk-bearing capacity, while at the same time honouring the interest rate guarantee to their customers.

# 1 Markets and economic trends

The strong growth witnessed in the second half of 2003 continued in first half of 2004. Between mid-2003 and mid-2004 the global economy grew by about 5 per cent. While growth was on a broad footing, countries in Asia performed particularly well. In the autumn and winter 2004/2005 growth has slowed somewhat, albeit at varying rates between regions. For the full year 2004 the World Bank puts overall global growth at 4 per cent, despite an extremely high oil price. The high oil price, prospects of further interest-rate increases and uncertainty associated with international imbalances dampen the prospects for growth. The major international forecasting institutes expect somewhat weaker, but still relatively high, growth in 2005 and 2006.

The US economy is the locomotive for growth in the global economy. Recent years' growth in the US has been stimulated by a highly expansionary monetary policy and sizeable tax reliefs. Household sector demand, which accounts for two-thirds of demand in the economy, has been high. Low interest rates have stimulated demand for loans and increased housing investments, at the same time as saving has been restrained. US household sector indebtedness has accordingly risen, rendering the economy more vulnerable to interest rate increases. Since early June 2004 the Federal Reserve Bank has raised its key rate from 1.0 per cent to 2.5 per cent. Higher oil prices have spurred inflation, making room for a higher interest rate. Capacity utilisation in the US remains low, however, although business investment has risen of late. Imbalances in the US economy were reinforced in 2004. Government budget deficits are substantial. Up to 2004 the dollar was little affected by the weak external account, but inasmuch as foreign investors' willingness to fund the growing deficit diminished, the dollar tumbled towards year-end. However, in February the Bush administration presented a tighter-than-expected budget bill for 2005, kindling some appreciation of the dollar. The dollar's path ahead largely depends on market actors' perception of the risk associated with the US imbalances and the Federal Reserve's interest rate policy. If US growth ahead remains stronger than among its trading partners, the trade deficit will continue to deepen, pointing to an uncertain dollar exchange rate.

Table 1.1 Growth forecast

| | US | | Euro area | | Japan | | Norway | |
|---|---|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 | 2004 | 2005 | 2004 | 2005 |
| GDP* | 4.4 | 3.6 | 1.8 | 1.7 | 2.9 | 1.1 | 3.5 | 3.6 |
| Inflation | 2.7 | 2.5 | 2.1 | 1.8 | -0.1 | 0.0 | 0.4 | 1.2 |
| Unemployment | 5.5 | 5.3 | 8.9 | 8.8 | 4.8 | 4.6 | 4.4 | 4.0 |

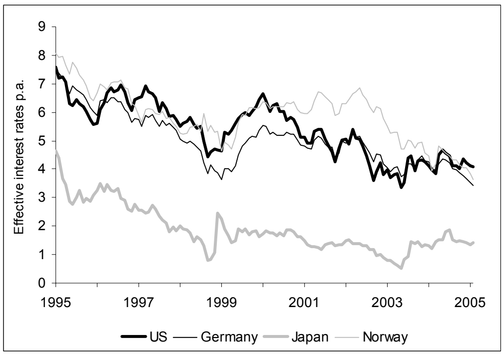
Sources: Consensus Forecasts, January 10, 2005, Economic Survey 4/2004, Statistics Norway
* Mainland Norway (i.e. the non-oil sector)

Recent years' economic upturn has been driven by US household demand and Chinese corporate investment. The US has imported goods from China, which in turn has spent part of its saving on financing the US trade deficit. China has thereby contributed to keeping the dollar up and US long rates down. Through their fixed-exchange-rate policy vis-à-vis the dollar, the Chinese have concurrently imported the expansionary US monetary policy. While monetary policy in China has boosted corporate investment, in the US it has stimulated household demand, particularly for housing.

China's significance for the world economy became clear in 2004. China's GDP grew more than 9 per cent over the year. Rapid Chinese growth has created an Asian domestic market, providing good export opportunities for other countries in Asia. Concurrently China's rapid export growth has contributed to weak inflationary impulses, and thereby to low key rates, in much of the world. Moreover, highly commodity-intensive Chinese growth has lifted international commodity prices. However, over-investment in the steel and cement industry, among others, has prompted the authorities to initiate tightening measures, and somewhat lower growth is expected ahead. China will nonetheless be among the fastest growing countries in the world, above all due to its large supply of cheap labour.

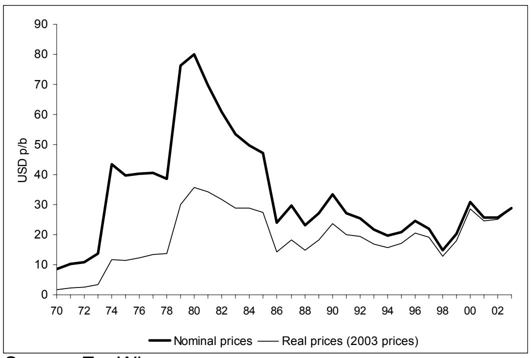
The foreign exchange market in 2004 reflected the structural imbalances in the international economy. In the year's fourth quarter the dollar dropped to its lowest value against the European currency area since 1992. A higher focus on risk and uncertainty about China's future exchange rate policy were contributors. The current stability of international financial markets is in part politically founded, and the dollar's fall is an indication of the risk inherent in the international imbalances. The low saving rate in the US, both public and private, is a substantial risk factor. The trade deficit funding structure, in which Asian central banks buy US government bonds, adds to the risk of rapidly rising long interest rates and further falls in the dollar. How central banks and market actors react to further falls in the dollar will be crucial to the impacts on the world economy. Heavy demand for government bonds, along with weaker growth and inflationary expectations, has pushed down long rates. In the US and Europe alike, long rates are on a falling trend and are at very low levels. Norwegian long rates have also fallen, in the winter of 2005 to their lowest level for 50 years.

Chart 1.1 Long interest rates




Source: EcoWin

Chart 1.2 Real and nominal oil prices



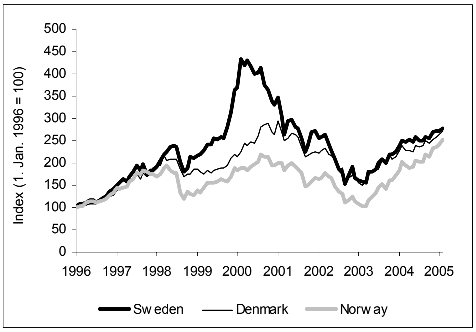

Source: EcoWin

The dollar fell by 8 per cent against the euro and by about 5 per cent against the yen in 2004. Trade-weighted, the dollar has fallen more than 30 per cent since the summer of 2001. While a weaker dollar means a concurrent strengthening of the other main currencies, thereby impeding these countries' export opportunities, the depreciation of the trade-weighted dollar is curbed by China's fixed-exchange-rate policy. The oil market was also turbulent in 2004. Both spot and forward prices rose considerably, fuelled by high growth in oil demand and little idle production capacity. The effect of a long-lasting high oil price on the world economy is uncertain. Although high in nominal terms, the price is considerably lower in real terms than during the oil crises in the 1970s. Effects could also vary between regions.

Growth in the euro area is weak. GDP growth from 2003 to 2004 was 2.0 per cent. The appreciation of the euro inhibited exports through the autumn. Concurrently a jobless rate close to 10 per cent signifies a poor trend in household incomes, making for weak domestic demand. The biggest countries in particular are struggling. Germany was in recession in 2003 and showed little improvement in 2004. More than 5 million Germans are out of work. In France growth fell in the autumn of 2004 after a good start to the year. Although some of the smaller countries in the euro area display higher growth, the overall picture is gloomy. Japan has performed somewhat better in the past couple of years, but after negative growth in the last three quarters of 2004 the country ended the year in recession. Japan still has deflationary tendencies and a zero-interest-rate policy.

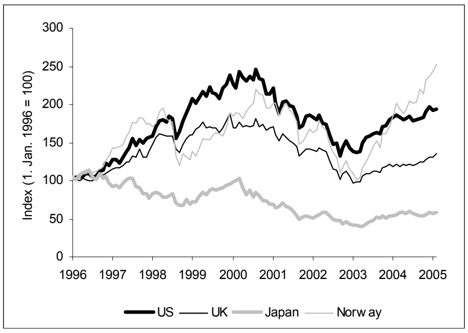
The cyclical upturn in Sweden was considerably stronger in 2004 than in the euro area. Consumption growth and broad-based investment growth both contributed. Export growth was also good, particularly in telecommunications and the car industry, and GDP growth in 2004 was about 3.5 per cent. The central bank's key rate stands at 2.0 per cent at the start of 2005. In Denmark too, domestic demand was high in 2004. The housing market in particular was on a positive trend, partly thanks to the interest-only mortgage loans introduced in 2003. GDP growth in 2004 is put at just over 2 per cent. In Finland, GDP growth is expected to be somewhat lower in 2005 than in 2004 when growth was an estimated 3 per cent. Iceland's central bank raised its key rate to 8.75 per cent at the start of 2005. The Icelandic share market climbed 53 per cent in 2004, i.e. more than its counterparts in either Sweden or Denmark.

Chart 1.3 Scandinavian share markets




Source: EcoWin

Chart 1.4 International share markets

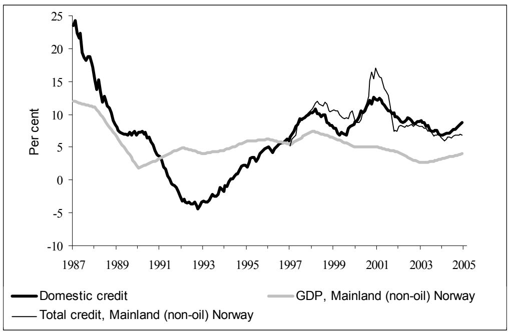



Source: EcoWin

International share markets were on a moderately positive trend in 2004. The major indices moved sluggishly in the first half of 2004, despite relatively good corporate results. The markets picked up in the autumn, however, and composite benchmark indices in the US and the UK rose by 9 and 7.5 per cent respectively. The upswing has continued into 2005 and the tsunami that hit South-East Asia had little effect on the markets. Share markets are buttressed by the expansionary monetary policy pursued in the international economy. Low interest rates and sound growth have concurrently contributed to low volatility in financial markets. In 2004 Oslo Børs climbed more than 38 per cent, far more than its counterparts elsewhere. Since the trough in February 2003, the Oslo Børs benchmark index has risen more than 157 per cent. In 2004 it was the industrials index that rose furthest. The market upswing, specific to Norway, is ascribable to a high oil price, healthy earnings for exports-oriented businesses and low interest rates. At the start of 2005 the central bank's key rate stands at 1.75 per cent. Despite the fact that money market rates were stable at 2 per cent in 2004, the krone exchange rate has been affected by movements of the main currencies. The trade-weighted index strengthened by 2.5 per cent in 2004.

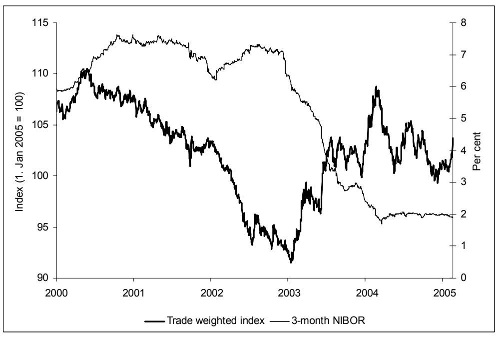
The Norwegian economy is now in the midst of a cyclical recovery which has lasted one and a half years. Low interest rates continue to fuel growth in household consumption and investment, at the same time as a high oil price has lifted oil-related investment. The Norwegian economy seems set to enter a period of strong economic expansion in the first half of 2005. The exceptionally strong nominal stimuli to which the Norwegian economy has been subject have made the downturn in 2002-2003 one of the most moderate since the 1970s. Forecasts suggest GDP growth of 3.6 per cent for Mainland Norway (i.e. the non-oil sector) in 2005.

Chart 1.5 Growth in GDP and credit




Sources: Statistics Norway and Norges bank

Chart 1.6 Krone exchange rate and 3-month NIBOR




Source: EcoWin

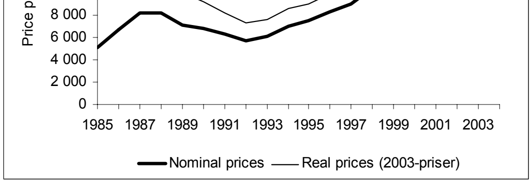
Rapid growth in households' real disposable income means that private consumption remains a growth factor in the mainland economy. Despite high growth in consumption, the household sector appears to be maintaining a high saving rate. Housing investment above all has been high, and looks set to remain high in 2005. Low interest rates have also stimulated investment in other sectors. The outlook for a continued high oil price has spurred oil investment in particular, and Statistics Norway's estimate for 2005 indicates an increase of 23 per cent over 2004. High international commodity prices, together with domestic capacity enlargements, have stimulated parts of Norway's traditional export industry. At the same time vigorous growth in consumption and a high import share in production have spurred substantial import growth. In the first three quarters of 2004 imports grew at an annual rate close to 18 per cent. China in particular has increased its market shares in Norway in recent years. Rapid growth in imports means that demand growth has so far had a moderate effect on the labour market, where unemployment at end-2004 measured 4.4 per cent. However, high growth in consumption has lifted employment in the retail trade sector, whereas local government finances put a brake on employment growth in the public sector. Cheap imports from China, together with a number of domestic factors, provided weak inflationary impulses, with consumer prices rising by a mere 0.4 per cent in 2004.

Low price inflation has kept the central bank's key rate down, in turn spurring household debt incurrence. Credit expansion in the household sector has been stable at 10-11 per cent over the past five years, which is far higher than this sector’s rate of income growth. In December 2004 household credit growth was 11.4 per cent. Non-financial enterprises debt growth at that point was 3.7 per cent, after negative growth in parts of 2004. Growth in credit from domestic sources (C2) was 8.8 per cent at the end of 2004, while growth in overall credit (C3), which includes credit from foreign sources, in November was 6.6 per cent. In 2004 192 new bonds were admitted to trading on Oslo Børs, 32 more than in the previous record year of 2003. Companies with bonds quoted on Oslo Børs brought in a total of NOK 92 billion in 2004, about the same as in 2003. The savings bank sector accounted for much issue activity in 2004, funding parts of its lending growth in the bond market.

An improved economic climate and low interest rates appear to have stabilised the market for commercial real estate, which has seen a sluggish trend for several years. Vacancy rates remain high, however, despite having fallen in 2004. There appear to be wide differences in vacancy rates between different types of premises. OPAK's calculations of rental prices for office premises in Oslo show that prices for the lowest-quality premises fell during 2004, while better-quality premises showed rising price tendencies. Office premise values have been on a negative trend since 2000, in both nominal and real terms. Prices (values) of office buildings in Oslo are now significantly lower than at the end of the 1980s. In nominal terms prices are 30 per cent lower than in the previous peak year. Little new construction of commercial property is in evidence. Low interest rates have spurred interest in real estate as an investment medium, and turnover in 2004 was high. Property funds and pure syndication companies alike have been active,  especially in the market for property with long rental contracts. However, the increased interest in real estate may have pushed down investment returns.

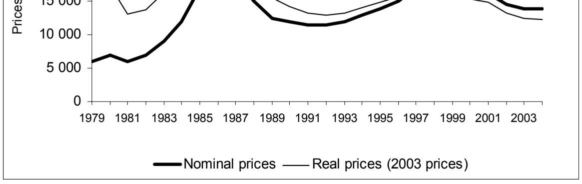
The steep growth in household credit is related to many years' rapid growth in house prices. According to the Norwegian Association of Real Estate Agents (NEF) and Econ, house prices rose 12 per cent from 2003 to 2004, the largest increase since 2000. In January 2005, house prices were nominally 129 per cent higher than in the previous peak year of 1987. In real terms prices were 45 per cent higher. Concurrently turnover, and not least housing starts, have been very high. In 2004 housing starts were 31 per cent higher than the previous year. Housing starts appear to be particularly high in Oslo where 2004 saw the largest number of starts since 1967. Any over-investment in the housing markets could reinforce a weakening price trend in the wake of higher interest rates.

Chart 1.7 Housing prices (NOK)




Sources: NEF, EFF, Finn.no and ECON

Chart 1.8 Price of office premises in Oslo (NOK)




Sources: OPAK and Kredittilsynet

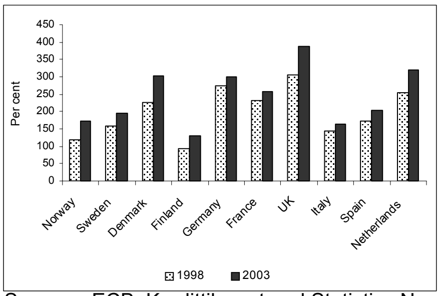
# 2 Financial institutions

Financial institutions' financial position needs to be assessed in light of the trend in economic conditions and markets, discussed in Chapter 1. This chapter starts by briefly describing important features of the financial market structure. It then summarises results reported in 2004 by financial institutions: banks; mortgage companies and finance companies; life insurance companies; pension funds; non-life insurance companies, as well as investment firms and management companies for securities funds. Interest margins in Norway and other Nordic countries are also shown and, in conclusion, a brief survey is given of the situation of the largest Nordic financial conglomerates.

## Financial market structure

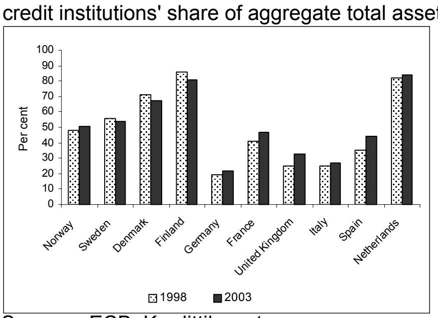
The Nordic and international financial markets have undergone major changes in the past 10-20 years. Deregulation of financial markets, liberalisation of capital markets, along with technological and demographic changes have substantially altered the financial institutions' environment. Cross-border establishments and cross-border operations have grown in scope, bringing national financial markets closer together. This fuels competition, both within and across the traditional segments of the financial industry. Competition has intensified on both the savings front and when it comes to financing businesses and households.

Chart 2.1 Credit institutions' total assets in relation to GDP




Sources: ECB, Kredittilsynet and Statistics Norway

Chart 2.2 Concentration in the credit market. Five largest credit institutions' share of aggregate total assets



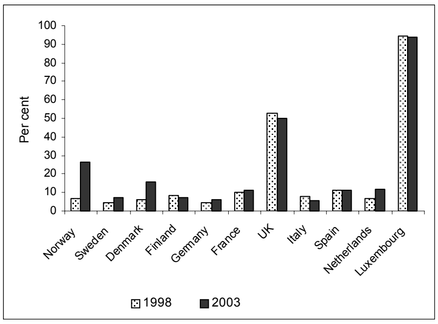

Sources: ECB, Kredittilsynet

Credit institutions' assets as a share of GDP have increased in the past five years in all countries, although there are wide differences in terms of level. Concentration in the credit market, measured by the five largest institutions' share of aggregate total assets, declined in most Nordic countries from 1998 to 2003 whereas it has risen in the largest European countries. At the end of 2003 credit market concentration was highest in the Netherlands where the five largest credit institutions accounted for 84 per cent of the total market. Concentration was lowest in Germany at 22 per cent. In Norway the five largest credit institutions accounted for 51 per cent of aggregate total assets at the end of 2003. Concentration in the Norwegian market increased somewhat with the merger of DnB and Gjensidige NOR. There are wide differences between European countries in terms of the number of credit institutions. In Germany there were 2 225 such institutions in 2003 as compared with 426 in the United Kingdom. In Norway the figure was 213. Both branch numbers and staff numbers have fallen in recent years.

Foreign actors have acquired increasing influence in the credit markets of most countries. In the Nordic countries, subsidiaries and branches of foreign credit institutions increased their market shares from 1998 to 2003; the credit institutions in question are mainly Nordic. Several Nordic conglomerates regard the Nordic region as their domestic market. Of the Nordic countries, Norway has the highest share of foreign branches and subsidiaries. Foreign actors accounted for 26 per cent of aggregate total assets in the Norwegian credit market at the end of 2003, and 27 per cent at the end of 2004, of which Nordea Bank Norway accounted for about half. In Europe, only Luxembourg and the United Kingdom of the EU-15 member countries have higher foreign shares.

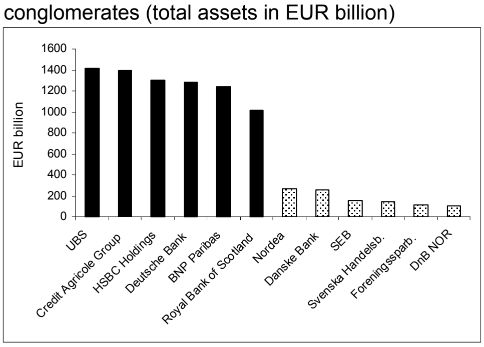
Despite mergers and acquisitions, Nordic credit institutions remain small in the European context. The largest European financial conglomerate, UBS, had total assets of EUR 1 400 billion in 2003 compared with EUR 262 billion for the largest Nordic conglomerate, Nordea.

Chart 2.3 Foreign branches and subsidiaries as % of credit institutions' aggregate total assets




Sources: ECB, Kredittilsynet

Chart 2.4 The largest European and Nordic financial conglomerates (total assets in EUR billion)




Sources: The Banker / Annual reports

The Norwegian financial market is dominated by five large financial groups engaged in both financing and insurance business, but with their heaviest focus on banking and life insurance. With the merger of DnB and Gjensidige NOR the merged entity, DnB NOR, acquired a substantial share of the banking, securities funds and life insurance markets alike. The sale of Elcon Finans to Spain's Santander Group reduced DnB NOR's share of finance companies' overall capital. The two large collaborative groupings in Norway, the SpareBank 1 Group and the Terra Group, encompass a total of 100 banks. For 16 banks the collaboration agreements with the former Gjensidige NOR were continued within the DnB NOR Group, albeit in a looser form than previously. Few banks opt for complete independence in the Norwegian banking market.

In the life insurance segment, only six companies are engaged in traditional life insurance business. The three largest – Vital, Storebrand and KLP – account for 85 per cent of managed assets. The non-life insurance market is dominated by three large non-life groups – Gjensidige NOR Forsikring, If (a branch of the Finnish Sampo) and Vesta Forsikring (wholly-owned subsidiary of Tryg Forsikring) – whose overall market share in terms of gross premium income comes to 68 per cent.

Table 2.1 Structure of the Norwegian financial market at end-2004

| | Banking market<br>Per cent of total assets | Finance & mortgage company market<br>Per cent of total assets | Life insurance market<br>Per cent of total assets | Non-life insurance market<br>Per cent of gross premium |
|---|---|---|---|---|
| DnB NOR (incl. Nordlandsbanken)* | 38.8 | 7.6 | 32.9 | 29.3 |
| Nordea Bank Norge | 13.6 | 5.6 | 5.6 | 0.0 |
| SpareBank 1 Group** | 11.6 | 0.7 | 2.9 | 7.4 |
| Storebrand | 1.4 | 0.0 | 26.1 | 0.2 |
| Terra Group** | 6.3 | 0.1 | 0.0 | 0.5 |
| Total financial groups | 71.6 | 14.0 | 67.4 | 36.9 |
| Other companies | 28.4 | 86.0 | 32.6 | 63.1 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| - of which foreign branches in Norway | 9.6 | 8.4 | 0.0 | 29.3 |
| - of which foreign subsidiaries | 17.1 | 20.6 | 5.0 | 15.7 |

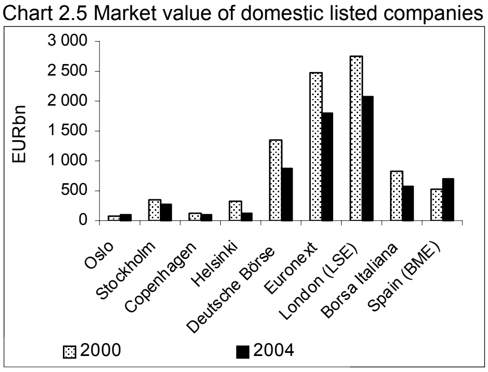
* The DnB NOR Group has no non-life insurance arm as such. Gjensidige NOR Forsikring, an independent mutual non-life insurer, has a strategic collaboration agreement with DnB NOR. **For the SpareBank 1 Group and the Terra Group, market shares include the owner banks.

Foreign branches' and subsidiaries' shares of the Norwegian financial market have risen appreciably in recent years. Foreign actors have a particularly high share of finance companies (68 per cent of total assets), and non-life insurance (45 per cent of premium income). The Ministry of Finance approved Íslandsbanki's acquisition of Kredittbanken in November 2004. Íslandsbanki's application for permission to acquire BN Bank is still being considered. The acquisition of Kredittbanken, and in the event BN Bank, further increases the foreign share of the Norwegian banking market.

## Securities markets

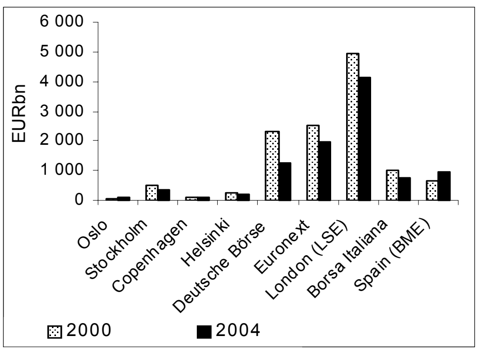
Bringing in capital by way of securities markets is an alternative to borrowing from credit institutions, either by issuing shares or fixed income securities (bonds and short-term money market instruments). Smoothly functioning secondary markets for securities are important if issuance of shares and fixed income securities is to be a competitive financing option. Recent years have seen increased

Chart 2.5 Market value of domestic listed companies




Sources: FESE and EcoWin

Chart 2.6 Volume of listed shares traded



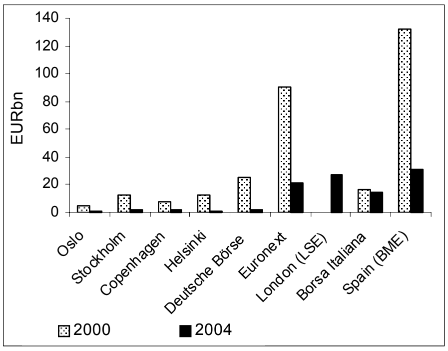

Source: FESE

cooperation between stock exchanges – including the establishment of the NOREX system by the Nordic and Baltic bourses – as well as consolidation on the owner front.

The size of security markets varies considerably between countries both in absolute terms and in relation to the home country's economic activity. The market capitalisation of Norwegian companies listed on Oslo Børs came to about one-third of Norway's GDP at the end of 2002. The same was true of the German share market, whereas in the United Kingdom and Finland the market capitalisation of domestic listed companies equalled the value of GDP.

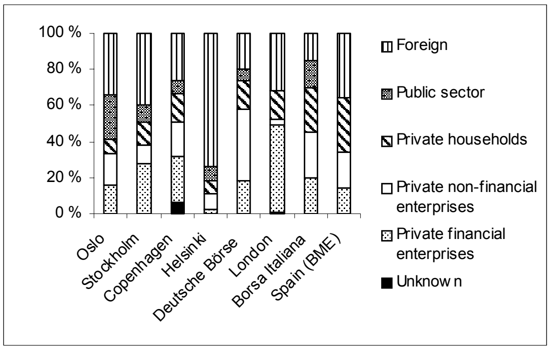
With a few exceptions, among them Norway and Spain, share markets have yet to return to the level prior to the start of the slump in the first half of 2000. The share market downturn is also reflected in issue volumes, which plunged after 2000. Risk capital was in far greater supply in 2000 than in 2004. Chart 2.7 includes new issues by listed companies as well as new stock exchange admissions.

Chart 2.7 Stock exchanges share issues




LSE figures for 2000 n.a. Source: FESE

Chart 2.8 Share ownership




Source: FESE

According to surveys by the Federation of European Securities Exchanges (FESE), the proportion of listed company shares in foreign ownership rose in the period 1994 to 2000. A large foreign ownership share is not particular to Oslo Børs. On the other hand, a large government ownership interest is more prominent in the case of Norway than other countries. Government increased its ownership from 23 to 37 per cent from 2000 to 2004, essentially due to the the admission of Statoil and Telenor to stock exchange listing.

## Banks

Once the Norwegian economy bottomed out in the summer of 2003, a brighter cyclical situation brought an improvement in banks' results. Results in 2003 were far better than the previous year's, and the positive trend continued in 2004. Overall, banks achieved a result of about NOK 20 billion in 2004, NOK 8 billion more than in 2003. At 1.21 per cent of average total assets, this was the best result since 2000. Banks' return on equity (after tax) increased from just over 9 per cent in 2003 to 13 per cent in 2004. The main contributor to the improved banking results was low loan losses, below 0.1 per cent of outstanding loans. The pre-loss result was roughly on a par with 2003. Low interest rates brought the bank's interest margins under further pressure, and net interest revenues continue to fall as a ratio of total assets. Only three small banks ended the year in a deficit position compared with nine in 2003. The spread in results shows a clear improvement for all banks, with most banks posting results between 1.0 and 1.5 per cent of total assets in 2004.

Chart 2.9 Loan losses and results before tax

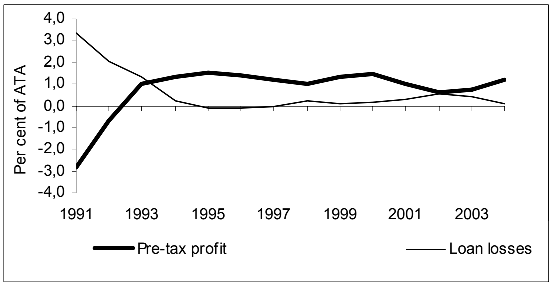
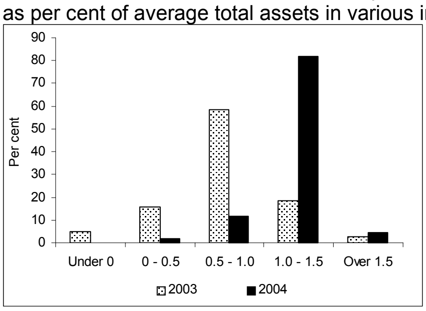



Chart 2.10 Share of banks' total assets, pre-tax result as per cent of average total assets in various intervals




Results for DnB NOR (incl. Nordlandsbanken), other banks with total assets above NOK 10 billion (39 per cent of aggregate total assets) and banks with total assets below NOK 10 billion (13 per cent of aggregate total assets) are illustrated in Chart 2.11. Lower loan losses in 2004 than in the two preceding years led to improved results for all these groups of banks. The volume of defaults was also substantially reduced in 2004. DnB NOR incurred restructuring costs in 2004 as a result of the merger process, but lower loan losses and the sale of Elcon Finans to the Spanish Santander Group made for a good result for the year.

Chart 2.11 Result before tax

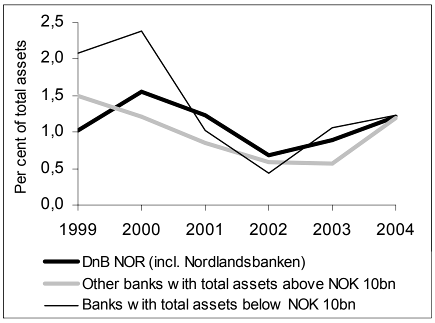
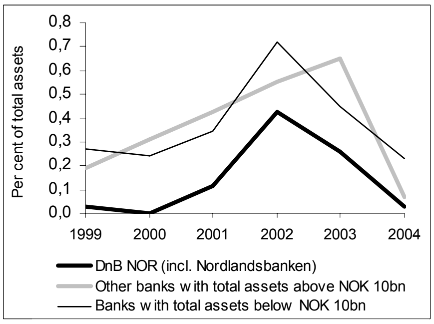



Chart 2.12 Loan losses




Net interest revenues as a ratio of average total assets fell in all bank categories in 2004. Low interest rates and continued intense competition have cut banks' interest margins. Net interest revenues are the bank's main revenue source. Over time, reduced net interest revenues have put banks' underlying earnings under pressure. Some increase in other revenues (including net commission revenues and revenues from insurance and unit linked products) have, together with some reduction in costs, offset some of the reduction in net interest revenues and helped to stabilise results before losses and securities gains. Gains on securities have varied somewhat in line with developments in the securities markets, but have none the less made a relatively stable contribution to banks' results. Loan losses have been of greatest significance for changes in banks' profit performance.

At close to 10 per cent, growth in bank lending was higher in 2004 than the previous year. Growth in lending to wage earners was particularly strong at 14.3 per cent, while growth in lending to business and industry was more moderate at close to 2 per cent. Eight foreign banks had branches in Norway in 2004, most of them Nordic. Lending by foreign branches accounted for 6 per cent of total lending to customers and 10 per cent of aggregate total assets in the banking market at the end of 2004. Several branches recorded substantial lending growth in 2004, mainly to the retail market. Overall lending by branches rose by 22 per cent in 2004.

Chart 2.13 Net interest revenues

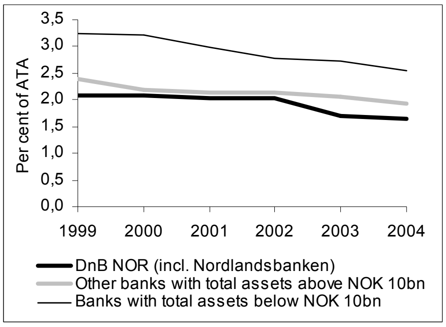
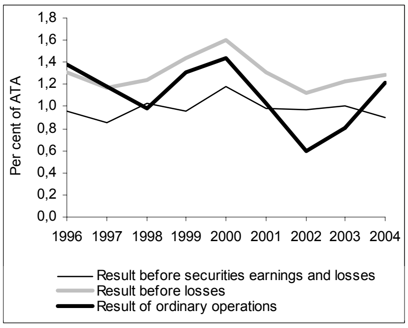



Chart 2.14 Trend in results, all banks




The trend in banks' tier 1 capital adequacy depends inter alia on their growth in lending. Even with vigorous lending growth, banks' tier 1 capital adequacy has been relatively stable in recent years thanks to fresh capital brought in both in the form of equity and hybrid capital. Several banks have seen a reduction in their risk-weighted assets in the period since lending for housing purposes (risk-weighted at 50 per cent) has expanded by a wide margin, while growth in business loans (weighted at 100 per cent) has been low. Banks' overall tier 1 capital adequacy ratio was 9.7 per cent at the end of 2004, approximately the same as 12 months previously. Growth in traditional bank deposits, which has been low in recent years, quickened in 2004 and at year-end was about 9 per cent higher than one year previously.

Chart 2.15 12-mth growth in lending to customers

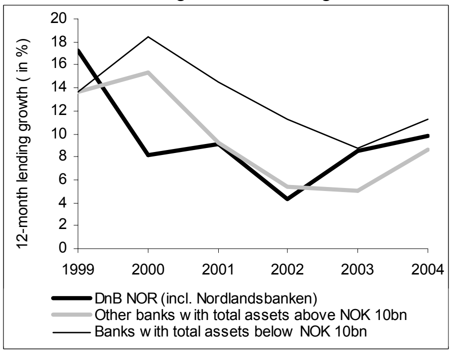
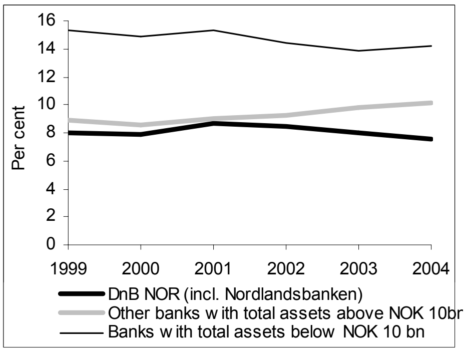



Chart 2.16 Tier 1 capital adequacy




## More about hybrid capital instruments

Several banks raised capital in 2004 by issuing hybrid capital instruments. Hybrid capital instruments share clear similarities with both debt and equity capital instruments. They enjoy better priority than share capital but poorer priority than subordinated loan capital. There is no repayment obligation with hybrid capital instruments. Holders of such instruments have no organisational rights within the company. Hybrid capital instruments yield interest at a predetermined rate, but no interest is paid in years of no dividend payments. For tax purposes they are regarded as debt instruments and payments are classified as interest. Hybrid capital instruments can constitute up to 15 per cent of the tier 1 capital of a financial institution. The first time a Norwegian bank employed hybrid capital instruments as tier 1 capital was in 2001. The number of banks with hybrid capital instruments rose from five in 2003 to twenty-nine in 2004.

Table 2.2 Hybrid capital instruments – banking sector (NOKm and per cent)

| | 4th qtr 2003 | 4th qtr 2004 |
|---|---|---|
| No. of banks with hybrid capital instruments | 5 | 29 |
| Hybrid capital instruments in tier 1 | 5 988 | 8 540 |
| Hybrid capital instruments in tier 2 (beyond 15% in tier 1) | 611 | 280 |
| Total hybrid capital instruments | 6 599 | 8 820 |
| Hybrid capital instruments in tier 1 as per cent of total tier 1 capital | 5.9 | 7.8 |
| Hybrid capital instruments in tier 1 as per cent of risk-weighted assets | 0.6 | 0.8 |

## Finance companies and mortgage companies

Finance companies' business area is special-purpose financing of business and retail customers, with the emphasis on leasing, factoring, car financing and consumer financing. Finance companies' overall result in 2004 was an improvement on 2003, mainly thanks to lower losses on lending. Whereas net interest revenues as a ratio of total assets fell in the case of companies mainly engaged in car financing, they rose in the case of companies engaged in consumer financing. Branches of foreign finance companies are highly active in the Norwegian market for loans, accounting for 30 per cent of total lending by finance companies. Their net interest revenues are higher than those of Norwegian companies, mainly because several of them are highly active in consumer financing (see Ch. 3 for further details).

Chart 2.17 Results before tax

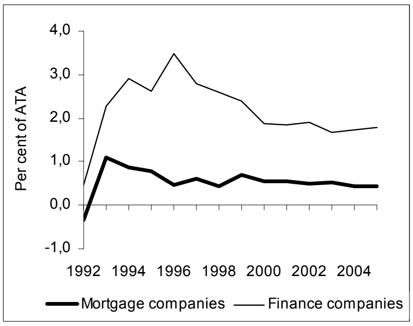
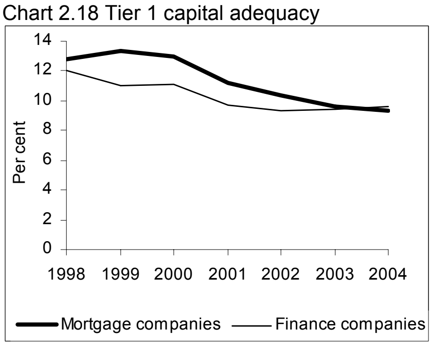



Chart 2.18 Tier 1 capital adequacy




Mortgage companies mostly provide first priority mortgages to finance commercial business and house purchases. Mortgage companies' overall results have been stable in the past 10-12 years, but showed a slight decline in 2004 due to falling net interest revenues. The results are marked by low loan losses and lower net interest revenues, mainly due to a high level of security in their loan portfolios. Lending by mortgage companies and finance companies alike has for some time been growing far more quickly than lending in general. Norwegian finance companies have expanded their lending by 17 per cent in recent years. Branches of foreign finance companies report lending growth as high as that of Norwegian companies in 2004. Mortgage companies' lending growth in 2004 came to 14 per cent. The relatively strong lending growth has reduced the tier 1 capital adequacy of mortgage companies and finance companies alike. At end-2004 tier 1 capital adequacy for finance companies was 9.6 per cent, for mortgage companies 9.3 per cent.

## Life insurance companies

Developments in securities markets have a close bearing on life insurance companies' results. After several years of weak results, life insurers recorded a substantially improved performance in 2003, mainly on the back of the share market recovery. Their 2004 results were also good, albeit somewhat weaker than in 2003. Life insurers reduced their equity exposures in 2001 and 2002 in line with their reduced risk-bearing capacity. As a result they entered 2003 with a lower share component in their balance sheets and the share market upturn accordingly had less impact on their results. At the end of 2004 their equity exposure was still relatively low, despite having increased over the year. Since almost 70 per cent of their share investments were in foreign equity markets, the vigorous upturn on Oslo Børs had a limited impact on their performance in 2004. Moreover, low interest rates brought relatively low returns on their fixed income securities.

The adjusted result for 2004 fell short of that for 2003. Low net financial revenues resulted in an average adjusted return on capital of 6.9 per cent in 2004 compared with 8.9 per cent in 2003. Average book return on capital came to 6.3 per cent in 2004 compared with 7.7 per cent the previous year. Total premium revenues were 25 per cent higher than one year previously. While part of the increase in premium revenues was due to a reduction from 4 to 3 per cent in the guaranteed minimum interest rate on existing insurance contracts in the occupational pensions field, the bulk of the increase was due to increased sales of endowment insurance.

Chart 2.19 Life insurance companies' average return on capital

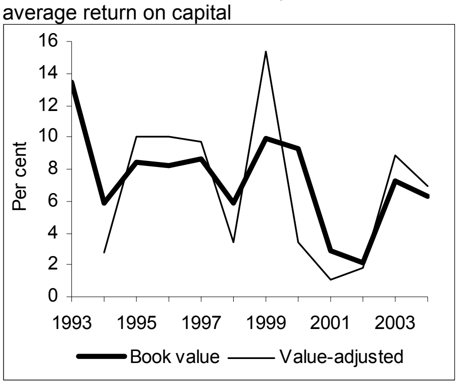
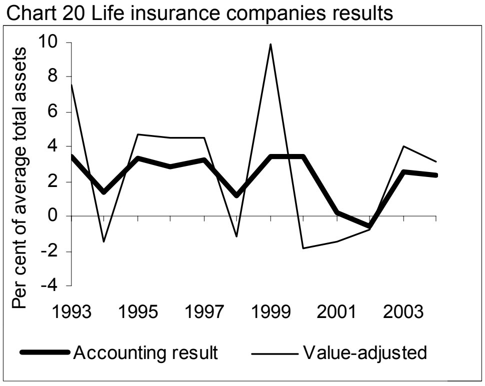



Chart 20 Life insurance companies results




Life insurance companies' capital buffers cushion their market risk and reflect their risk-bearing capacity. Buffers were strengthened slightly in 2004 but are still regarded as low. At the end of 2004 life insurers' capital buffers measured 6.4 per cent of their total assets, compared with 5.5 per cent at the end of 2003. All life insurers met the capital requirement of 8 per cent. See Chapter 4 "Pension saving in life insurance companies" for further details

## Pension funds

The largest private and municipal pension funds, accounting for 75 per cent of pension funds' agg-regate total assets, performed slightly less well in 2004 than in 2003 but better than in 2002. Seve-ral major pension funds with a high proportion of shares in their balance sheets raised this pro- portion further in 2004. As in the case of the life insurance companies, much of their assets are in foreign shares which prevented them from gaining full benefit from the vigorous upturn on Oslo Børs in 2004.

Chart 2.21 Private pension funds' return on capital

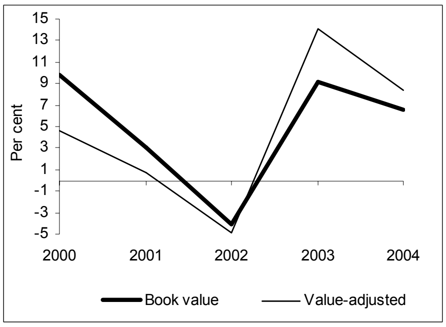
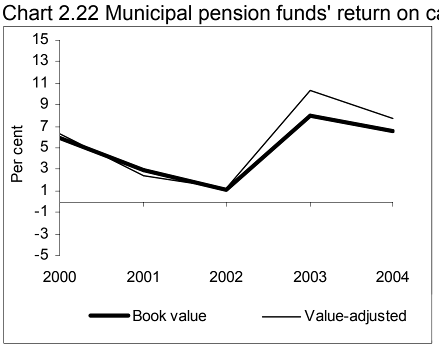



Chart 2.22 Municipal pension funds' return on capital




Pension funds' overall book return on capital came to 6.6 per cent compared with 8.6 per cent in 2003. Adjusted return on capital was 8.2 per cent compared with 12.1 per cent the previous year, while life insurers posted an adjusted return of 6.9 per cent. Private pension funds reported an adjusted return of 8.4 per cent in 2004, while their municipal counterparts recorded a return of 7.7 per cent. Private pension funds had higher exposure to shares than did municipal pension funds at the end of 2004. Pension funds' buffer position was stronger than at the end of 2003, at 18.5 per cent of total assets.

## Non-life insurance companies

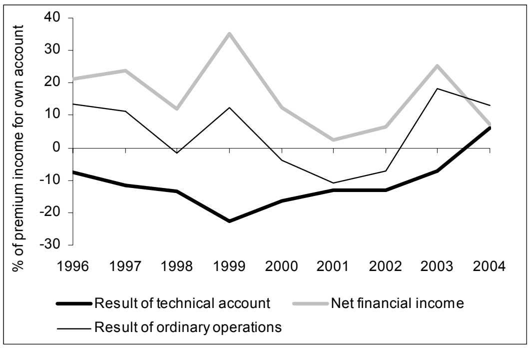
In this survey, the non-life insurance companies are represented by the three largest non-life insurance groups (Gjensidige NOR Forsikringsgruppen, Vesta Forsikring Konsern and SpareBank 1 Skadeforsikring). These companies account for about two thirds of the non-life insurance market, excluding branches of foreign companies.

The three largest groups have seen a substantial improvement in profit performance in their insurance-related business in recent years. Steep premium growth, together with declining claims and stable costs have improved their technical account. The result of the technical account measured 6.0 per cent of premium revenues for own account in 2004 compared with a negative 7.1 per cent in 2003 (excluding allocated investment return). The companies substantially reduced their exposure to equity markets in

2002. A continued low share component in 2004 rendered results less sensitive than previously to equity market developments. Net financial revenues accounted for just 7.2 per cent of premium revenues in 2004, compared with 25.3 per cent in 2003. The three non-life groups' combined result of ordinary operations came to NOK 2.8 billion in 2004, NOK 0.6 billion down on the 2003 figure. Branches of foreign companies account for a substantial share of the Norwegian non-life insurance market. While their claims ratio has been considerably lower than that of the Norwegian companies for some time, improved claims ratios of Norwegian companies in recent years have narrowed the gap. The low level of claims and expense ratios indicates little need for general premium increases in the period ahead. The good results can be expected to lead to intensified competition and, in due course, to some reduction in the level of premiums on a number of non-life insurance products.

Non-life insurers' capital base has expanded in recent years on the back of the good results. All non-life insurers met the capital adequacy requirement at the end of 2004. All companies also complied with the solvency margin requirements.

Chart 2.23 Results of the three largest non-life insurance groups




The result of the technical account is exclusive of allocated investment return.

## Investment firms

It is useful to distinguish between investment firms that are banks offering investment services in connection with ordinary banking operations, and non-bank institutions. At the end of 2004 78 investment firms were licensed to offer investment services. Fifteen of these were banks.

Banks' revenues from investment services largely derive from trading in foreign-exchange and interest-rate instruments. Investment firms that are banks recorded operating revenues totalling NOK 3.1 billion in 2004, as in 2003. Half of the investment firms that are banks saw a decline in investment service revenues from 2003 to 2004. Non-bank investment firms reported aggregate operating revenues of NOK 1.7 billion in 2004, an increase of NOK 714 million (74 per cent) from 2003. The principal revenue components for non-bank investment firms are broking of equity capital and debt instruments, stock issuance and counselling activity, and active management of portfolios on behalf of insurance companies, pension funds and private firms. Non-bank investment firms recorded operating revenues of NOK 4.8 billion in 2004, an increase of NOK 922 million (24 per cent) over the 2003 figure. Assets under active management declined from NOK 630 to NOK 261 billion in 2004 as a result of transfers of business from investment firms licensed to carry on active asset management to management companies for securities funds licensed to carry on the same business. About one-fifth of non-bank investment firms saw their operating revenues decline from 2003 to 2004.

Chart 2.24 Operating revenues of investment firms which are banks (NOK million)

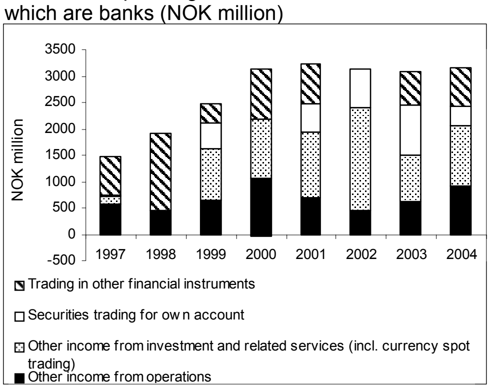
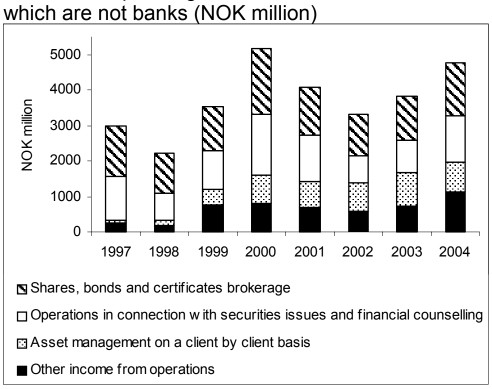



Chart 2.25 Operating revenues of investment firms which are not banks (NOK million)




## Management companies for securities funds

At the end of 2004 21 companies held a licence from Kredittilsynet to manage securities funds. Securities funds are independent legal entities. Capital invested in securities funds will not be affected should the management company in question be wound up. Management companies' revenues largely comprise remuneration from management of securities funds. Management companies also earn commission revenues on subscription and redemption of mutual fund units. As from August 2003 management companies could apply for a licence under the Securities Trading Act to engage in active management of investor portfolios. At end-2004 seven management companies were licensed to provide active management services.

Chart 2.26 Management companies' operating revenues

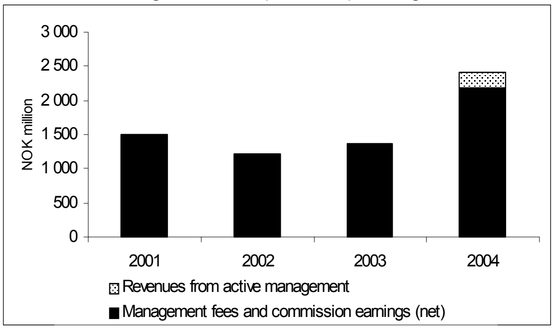
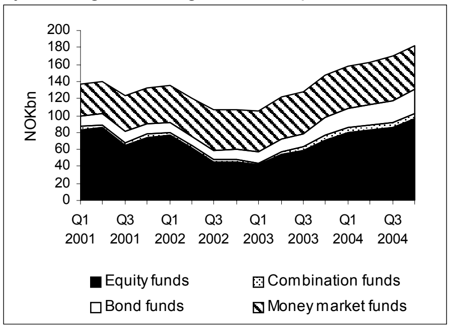



Chart 2.27 Assets in the securities funds managed by Norwegian management companies

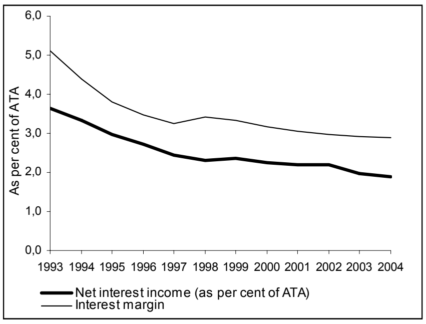



Management companies' overall operating profit came to NOK 666 million in 2004, an increase of NOK 364 million (121 per cent) over 2003. Aggregate operating revenues rose from NOK 1 360 million in 2003 to NOK 2 410 million in 2004. Active management revenues accounted for NOK 231 million of management companies' operating revenues in 2004. At the end of 2004 capital under active management totalled NOK 379 billion.

## Nordic banks' interest margins

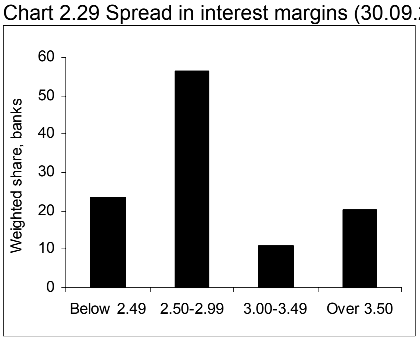
The (net) interest margin shows the difference between the interest rates on lending (including commissions) and interest rates on deposits. Norwegian banks' interest margins declined in the 1990s, bringing a decline in banks' net interest revenues as a ratio of total assets since 1993. As from 1998 interest margins have fallen by a somewhat smaller margin than in the preceding period. Declining interest margins over time may indicate strong competition in the Norwegian banking market, and that structural and technological changes have benefited the customer. At the end of the third quarter of 2004, the bulk of Norwegian banks, almost 60 per cent, reported interest margins in the range 2.5 per cent to 2.99 per cent. This narrow range could indicate continued strong competition and limited opportunities of achieving wider margins than competitors. Interest margins are also affected by the general interest rate trend. Norges Bank has lowered its key rate on several occasions in the period since December 2002, and short rates were at historically low levels in 2004. Large interest rate reductions over a relatively short period may by itself contribute to increasing interest margins since interest rate changes are rapidly reflected in parts of the banks' funding.

Chart 2.28 Interest margins and net interest revenues




As of 30.09.04 Sources: Kredittilsynet and Norges bank

Chart 2.29 Spread in interest margins (30.09.2004)

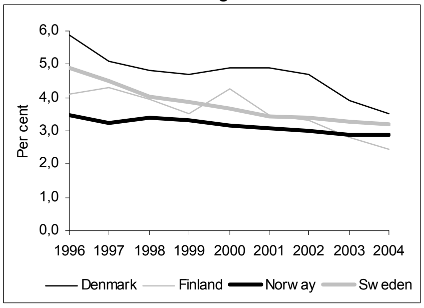



Source: Norges bank

Banks' interest margins have narrowed in most countries, including the Nordic countries. In the Nordic region, Norway and Finland had the lowest net margin level in 2004. Differing lending market structures make it difficult to compare interest margin levels. Whereas floating-rate home loans make up well over half of banks' overall lending in Norway and Finland, the proportion is far lower among Danish and Swedish banks where home loans largely carry fixed interest and are provided by mortgage companies. Home loans are as a rule mortgage loans carrying lower interest margins than other lending. While interest margins on home loans have a heavy bearing on the level of banks' overall interest margin in Norway and Finland, interest margins on commercial lending have the greatest bearing on banks' interest margin in Sweden and Denmark. Whereas banks account for between 80 and 90 per cent of total loans in Norway and Finland, the figures for Sweden and Denmark are far lower.

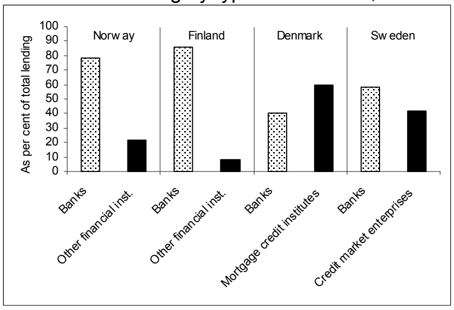
A number of factors in the period ahead suggest continued pressure on banks' interest margins. A new capital adequacy framework (Basel II) may mean that the best business loans will offer lower margins because banks will to a greater degree base their loan pricing on their own risk models. Lower minimum capital requirements on home loans under Basel II are likely to be reflected in loan pricing. New rules on the use of mortgage bonds may open the way for banks to assign home loans to separate vehicles that will fund their operations via the bond market. Now that many actors are intensifying their focus on the home loan segment, there will be keener competition for home loan customers and increased pressure on the banks' interest margins. Further pressure on banks' net interest revenues as a result of lower margins will pose a greater challenge for banks in terms of improved cost-efficiency and increased revenues from other sources if satisfactory results are to be achieved ahead.

Chart 2.30 Interest margins in the Nordic area




Sources: Nordic supervisors / Central banks

Chart 2.31 Lending by type of institution, 2003

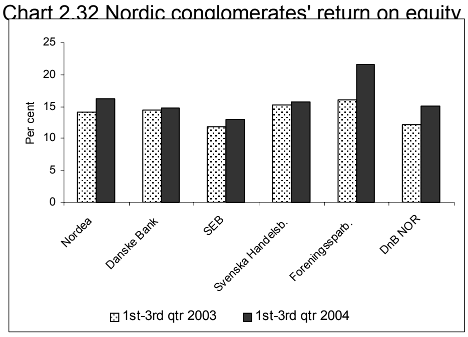



Sources: Nordic supervisors / Central banks

## Profitability and financial strength of Nordic financial conglomerates

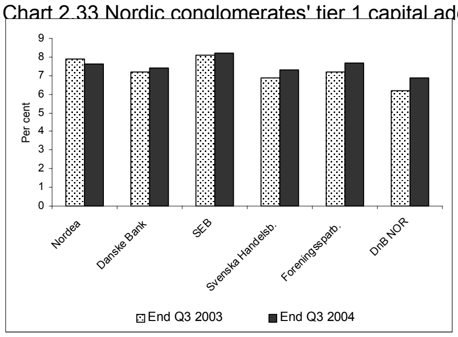
An improved economic climate in all the Nordic countries has contributed to good results for Nordic financial conglomerates. Return on equity has risen at all the major conglomerates compared with the same period last year, apart from in the case of Danske Bank. SEB reported the highest tier 1 capital ratio at the end of the third quarter of 2004, DnB NOR the lowest. Compared with the third quarter of 2003, tier 1 capital adequacy increased at all the largest Nordic conglomerates, with the exception of Nordea.

Chart 2.32 Nordic conglomerates' return on equity




Source: Quarterly reports

Chart 2.33 Nordic conglomerates' tier 1 capital adequacy




Source: Quarterly reports

The improved profits of Nordic conglomerates are mainly attributable to very low losses on loans. Loan losses in the first three quarters of 2004 were at a lower level than in the same period of 2003, and, in the case of DnB NOR, far lower.

# 3 Risk areas

Against the background of the macroeconomic developments outlined in Chapter 1, Chapter 2 described the trend in financial institutions' profitability and financial strength in 2004. The present chapter takes a closer look at the various types of risks facing financial institutions, with the emphasis on developments ahead. For banks and other credit institutions credit risk is of greatest significance, although liquidity risk and operational risk are also important. Operational risk is important for investment firms. While Norwegian banks are little exposed to market risk, this type of risk in combination with insurance risk is of great significance for insurance companies. The chapter concludes with a brief account of important ongoing changes in the body of rules governing financial institutions. Chapter 4 gives a close assessment of life insurance companies with particular focus on pension savings.

## Credit risk

Credit risk denotes the risk that banks or other credit institutions will not receive payment as agreed, and that they will incur loss as a result. Hence credit risk includes both the likelihood of a counterparty being unable to honour its obligations and the loss the credit institution incurs in that event, account being taken of the value of any security held by the bank.

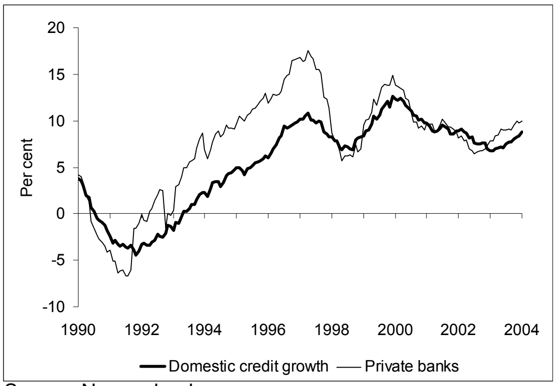
Changes in the financial position of households and business customers are likely to influence their vulnerability to changes in the economy and markets. Where lending to households is concerned, home mortgage loans and other loans, including consumer loans, are assessed, and calculations of household finances' interest rate sensitivity are illustrated. The quality of banks' credit practice, their internal management and control systems and their exposures are decisive for the extent of credit risk. Results from surveys of banks' practice as regards home mortgage loans, loans backed by securities, assessments of risk vis-à-vis particular industries and experience gained from supervisory activity on the credit risk side, are given in this chapter.

### Credit growth

Having fallen in 2003, growth in credit to the non-financial private sector (households and enterprises, but also including municipal administrations) from domestic sources (C2) picked up in 2004 to reach a year-on-year rate of 8.8 per cent in December 2004. Growth in credit from foreign sources was negative and growth in total credit to the non-financial private sector was 6.9 per cent in November, disregarding oil and shipping. Total credit growth remains higher than the economy's nominal growth rate, leading to increased gearing in the economy.

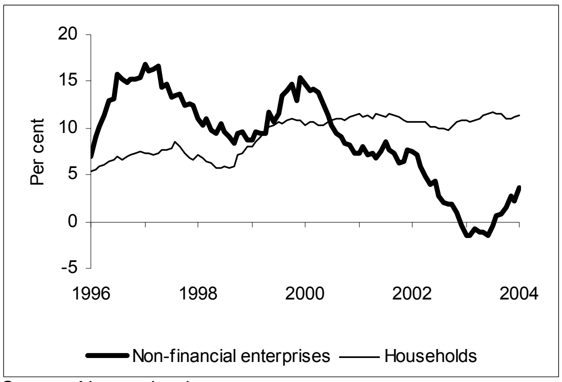
Recent years' growth in credit to households and enterprises reflects the macroeconomic developments described in Chapter 1. Surging house prices caused household demand for loans to remain at a high level in 2004. In December the year-on-year rate of growth was 11.4 per cent. A slower rate of investment caused growth in credit to enterprises to slow down as from end-2000 and to turn negative in 2003. In 2004 growth in credit to enterprises quickened, reaching a year-on-year rate of 3.7 per cent in December 2004.

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 non-financial enterprises




Source: Norges bank

Banks account for about two-thirds of total domestic credit growth. Growth in bank lending to households quickened over the year to reach a year-on-year rate of 10 per cent at end-2004. Growth in credit from finance companies rose markedly over the year.

Chart 3.3 Share of lending by banks' lending growth

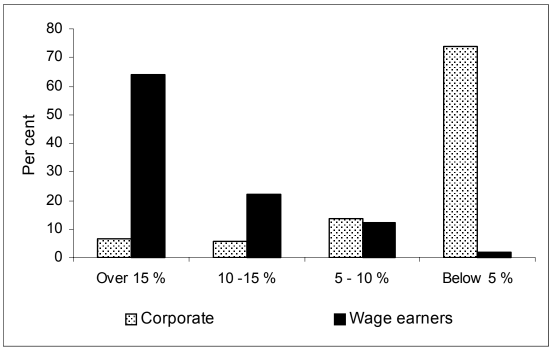
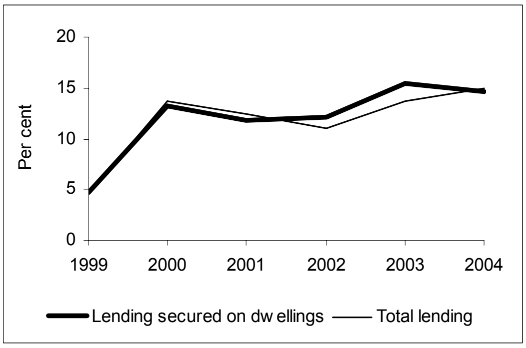



Chart 3.4 Growth in bank lending to wage earners




Loans secured on dwellings (home mortgages) account for 77 per cent of total lending to households from credit institutions (banks, mortgage companies and finance companies). Alongside wage earners, the household sector includes pensioners, students, the self-employed, etc. Lending to wage earners accounts for about 90 per cent of loans to the household sector. Banks have substantially increased their lending to this category in recent years. This is particularly true of the major banks. By the end of 2004 banks whose year-on-year growth in lending to wage earners was in excess of 15 per cent accounted for 64 per cent of total lending (chart 3.3). While growth in lending to enterprises quickened in 2004, it was still sluggish at year-end. It is above all small banks that are expanding their lending to enterprises.

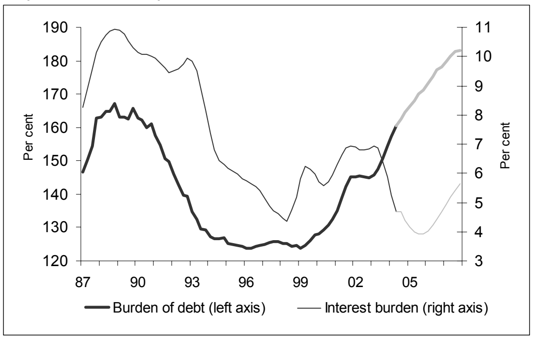
Growth in wage earners' home mortgages was just under 15 per cent at the end of 2004, compared with 14 per cent 12 months previously. Mortgage companies and state lending institutions, which accounted for 12 per cent of total home mortgages at the end of 2004, showed far lower growth. Bank lending to wage earners for non-housing purposes accounts for about 10 per cent of total lending to this group. Such lending rose by 18 per cent in 2004. The strong lending growth imposes increased requirements both in terms of banks' profitability with a view to maintaining financial positions and in terms of their risk management and control systems.

# Households

## Household indebtedness

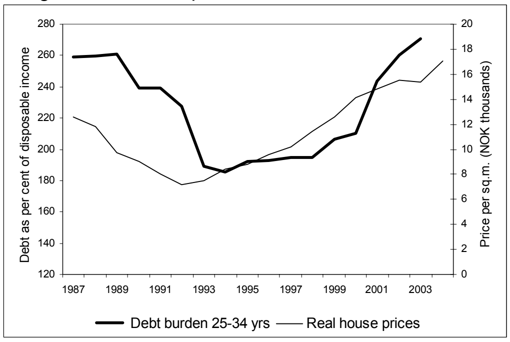
The rapid growth in lending to households, which is far higher than the growth in this sector's incomes, is explained by surging house prices, a favourable economic climate, low interest rates and some improvement in the labour market. Norges Bank puts households' gross indebtedness at the end of the third quarter at just over 160 per cent of their disposable income. Norges Bank has also constructed projections of households' debt and interest burden. The projections are based on the assumptions underlying the reference path in the central bank's Inflation Report 3/2004 which envisages interest rates rising from 1.7 per cent at end-2004 to 4.0 per cent at end-2007. Given these assumptions, household debt will rise faster than disposable income throughout the projection period. The projections show rapid growth in households' debt burden: it will reach the end-1980s level as early as in 2005, and will far exceed this level in 2007.

Chart 3.5 Household debt and interest burden as per cent of disposable income




Loan debt as % of disposable income less return on insurance claims (liquid disposable income). After-tax interest expenditure as % of liquid disposable income plus interest expenditure. Sources: Statistics Norway and Norges Bank

Chart 3.6 Debt burden for younger households and growth in house prices




Sources: Ass. of Real Estate Agents/Ass. of Real Estate Undertakings, Finn.no, Statistics Norway and Norges Bank

The sharp fall in interest rates since December 2002 has brought down interest expenses despite the strong debt growth. According to Norges bank's projections, the interest burden will still be moderate in 2007.

Debt is highest among younger households buying their first home. Since the mid-1990s higher house prices have coincided with an increase in this group's debt burden, just as falling house prices in the wake of the banking crisis coincided with this group's consolidation of their personal finances. The close correlation between growth in house prices and younger households' debt burden is probably attributable to supply and demand factors in both the housing market and its financing structure.

## Home mortgage loans

Bank lending secured on dwellings rose at a very high rate throughout 2004 to reach 14.5 per cent at year-end. This was far higher than the growth in house prices. Since 1994 Kredittilsynet has conducted surveys of banks' lending practice as regards home mortgage loans. In the survey carried out in autumn 2004 29 banks were asked to report data on the first 100 loans disbursed after 1 September. The banks in question accounted for about 85 per cent of all bank loans secured on dwellings in Norway.

Of the loans reported to the 2004 survey, the share going to house purchase was markedly higher than in the previous year, while the share going to refinancing or other purposes was correspondingly reduced. All else equal, such a shift would have led to an increase in the share of loans with a high loan-to-value ratio. Instead the share of loans with a loan-to-value ratio in excess of 80 per cent of property valuation showed a slight decline on the previous year, but remained high. In the case of 39 per cent of the reported portfolio, loans exceeded 80 per cent of property valuation, whereas 13 per cent were in excess of 100 per cent. In the case of loans for house purchase or housebuilding, 57 per cent had a loan-to-value in excess of 80 per cent compared with 65 per cent in the previous year's survey. In the portfolio as a whole, only a small number of loans were backed by additional collateral. In the case of loans in excess of property valuation, only half were backed by (sufficient) additional collateral to contain the loan to the value of the overall security furnished.

Chart 3.7 Share of home mortgage loans in various loan-to-value categories

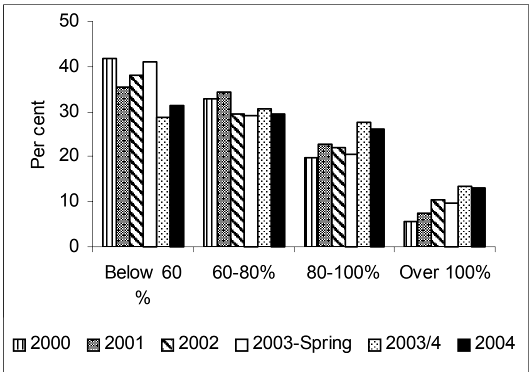
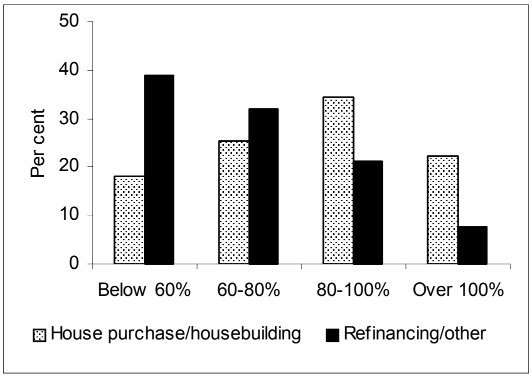



Chart 3.8 Share of loans for house purchase/house-building and home refinancing




Floating home mortgage rates have been at a very low level for some time, keeping the share of fixed interest loans well down. Of the loans forming the basis for the home loan survey in the autumn of 2004, just under 1 per cent carried fixed interest. Of the banks' total loans to households, only 9.6 per cent carry fixed interest, the majority with a lock-in period of one to five years.

Table 3.1 Fixed and floating interest loans to households as per cent of total lending as at 30.09 2004

| | State lending institutions | Mortgage companies | Banks | Total |
|---|---|---|---|---|
| Loans to household sector (NOKbn) | 158 | 59 | 905 | 1 123 |
| Fixed interest loans as per cent of total lending | 47.4 | 37.4 | 9.6 | 16.4 |
| - of which below 1 year | 5.4 | 11.2 | 1.4 | 2.5 |
| - of which 1 year – 5 years | 42.1 | 19.1 | 7.7 | 13.1 |
| - of which over 5 years | 0.0 | 7.1 | 0.4 | 0.7 |

Source: Norges Bank

### *Home mortgage loans: Observations from inspections*

Over the past half-year Kredittilsynet has conducted six inspections at large and mid-size banks, giving special attention to the banks' exposure to the retail market. The inspections showed that several of the banks, including the largest, are aiming to increase their market share.

The banks perform routine calculations to ensure that borrowers' incomes are sufficient to meet expected loan costs. As a rule such calculations take account of loan applicants' fixed expenses, while standard rates are employed for current household expenditure. While all the inspected banks take possible interest rate increases into account, the interest rate mark-up varies from 2 to 5.5 per cent. Practice differs as regards whether the banks take account of tax reliefs and staggered instalment payments (in the case of self-amortising loans) when computing the liquidity effect of an interest rate increase. Some banks' guidelines require the calculations to show a defined liquidity surplus that is in proportion to income or anticipated expenses. In their credit assessment of home mortgage loans, the banks also attach importance to the relationship between the mortgage loan and the value of security furnished, as well as to the relationship between overall debt and household income.

The largest banks employ IT-based scoring models which recommend that loan applications be granted, refused or subjected to special consideration based on recorded customer data and the bank's credit granting criteria. As a step in the inspections, a look was taken at the extent to which applications that failed to meet the model criteria were nevertheless granted. Such instances were few in number. Moreover, at each of the inspected banks, ten selected loans with a high loan-to-value ratio were scrutinised. Departures were noted, albeit few in number, from the banks' internal guidelines requiring the inclusion of possible interest rate increases as well as departures from an established maximum loan-to-value ratio.

## Consumer loans

A substantial share of loans for consumption purposes are probably secured on dwellings, although both banks and finance companies also offer pure consumer loans. These loans are usually unsecured and entail high credit risk. As in 2003, a survey was conducted in 2004 of companies whose main business is consumer finance. In this context consumer loans include both card-based loans and other unsecured consumer loans.

The sample comprised ten companies, including one bank, Bankia Bank, which was included since it primarily offers consumer loans. Cresco and DnB Kort, also included in the sample, are part of DnB NOR Bank. Several of the companies in the sample show relatively high lending growth in recent years. At the end of 2004 the companies had a combined annual lending growth of 9.6 per cent, compared with 7.4 per cent in 2003. The growth in these companies' lending was, however, appreciably lower at the end of 2004 than growth for all finance companies combined.

Table 3.2 Trend in consumer loans in a selection of companies*

| | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| Consumer loans (NOKm) | 16 755 | 19 381 | 20 816 | 22 823 |
| Growth % (12-month) | 27.3 | 15.7 | 7.4 | 9.6 |
| Book losses (NOKm) | 277 | 511 | 574 | 398 |
| Losses as % of consumer loans | 1.7 | 2.6 | 2.8 | 1.7 |
| Net interest as % of ATA | 8.2 | 8.4 | 10.1 | 12.0 |
| Ordinary operating profit as % of ATA | 4.2 | 4.0 | 4.9 | 7.7 |
| Loan defaults, net (NOKm) | 1 013 | 1 338 | 1 473 | 1 500 |
| Defaults as % of consumer loans | 6.0 | 6.9 | 7.1 | 6.6 |

*GE Money Bank, Enter Card, Finaref, Ikano Finans, Citifinancial Europe, Europay Norway, Diners Club Norge, Bankia Bank, DnB Kort and Cresco.

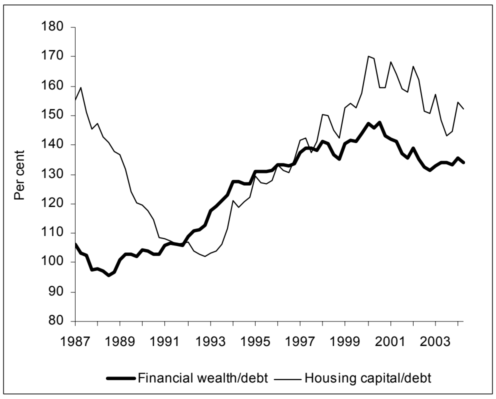
Book losses and defaults in the sample are higher than for finance companies in general. Net defaults measured 6.6 per cent of consumer loans at year-end. However, there was a reduction in both losses and defaults as a ratio of consumer loans compared with 2003. There are relatively wide variations between the companies in the sample. As a group, they report high net interest revenues compared with other companies (12.0 per cent of average total assets, ATA), showing that loan pricing reflects higher credit risk. At 7.7 per cent of ATA at end-2004, these companies' profit on ordinary trading is also higher than that of other companies. This is a clear improvement on the previous year.

## Households' financial wealth and financial saving

The growth in household indebtedness has been accompanied by an increase in this sector's gross financial wealth. Financial wealth as a ratio of debt rose continuously from the end of the 1980s to the second half of 2000. Although it subsequently declined, financial wealth for the sector as a whole remains larger than indebtedness. Financial wealth can serve as a buffer to cushion unforeseen events, and its high level offsets some of the risk inherent in households' sizeable debt accumulation. However, as much as one-third of the sector's gross financial wealth is tied up in illiquid insurance claims and cannot therefore serve as a buffer.

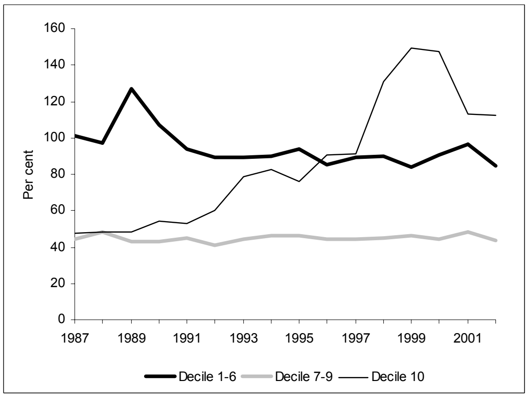
Financial wealth and debt are unevenly distributed between household groups. When gross financial capital is distributed by income category, substantial differences are seen in terms of both level and trend. The bulk of the sector's financial wealth is concentrated in households with the highest income (decile 10), which substantially increased their financial capital through the latter half of the 1990s. Financial capital as a ratio of debt concurrently fell among the lowest income groups (decile 1-6). The trend in financial capital in the case of high-income households closely shadows the share market, and the slump in share values as from 2000 substantially reduced this group's financial position. In the case of the lowest income group, on the other hand, the development can reasonably be ascribed to the increase in house prices and these households' entry to the housing market in the period. In the case of wage earners, who in numerical terms constitute about 60 per cent of households, financial wealth is far lower than for households as a whole. This is especially true of wage earners on low and medium incomes. Higher house prices have increased debt and wealth concentration for first-home buyers in the housing market. In the lowest income groups, financial buffers are now significantly lower than they were at the end of the 1980s.

Chart 3.9 Households' financial wealth and housing capital in per cent of indebtedness




Source: Norges bank

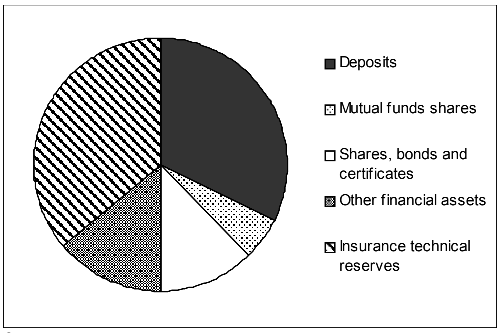
Chart 3.10 Gross financial capital (excl. insurance claims) as % of household debt by income deciles




Source: Norges bank

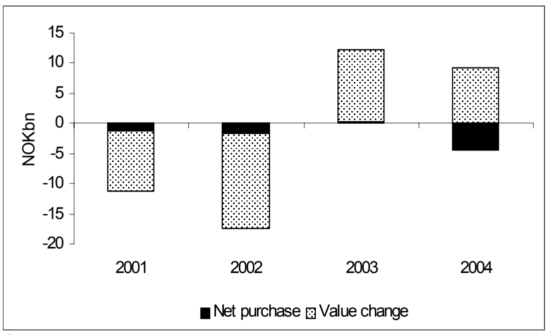
Bank deposits have traditionally accounted for the bulk of Norwegian households' financial investments. Investments in securities – including shares, bonds and mutual fund units – are modest compared with households in other countries. Whereas Swedish households have invested 36 per cent of their financial wealth in securities, the figure for Norwegian households is 18 per cent. The share of financial assets held as bank deposits has fallen substantially in recent years, at the same time as the share held as securities has risen considerably. This trend was partially reversed between the autumn of 2000 and the start of 2003 due to the weak equity market trend combined with relatively high deposit rates. Equity markets have shown a positive trend since the first half of 2003, however, while deposit rates have fallen. As a result, a trend towards an increase in the share held as securities and a decline in the share held as bank deposits has reappeared.

Chart 3.11 Composition of household financial assets at end of third quarter 2004




Source: Norges bank

Chart 3.12 Net purchase and value change of equity funds held by households




Source: Norwegian Mutual Fund Ass., Kredittilsynet (2004)

At the end of the third quarter of 2004 5.6 per cent of Norwegian households' financial assets was invested in mutual funds, while 10.4 per cent was invested in shares and primary capital certificates. In 2004 households purchased equity fund units worth NOK 8.9 billion and redeemed units worth NOK

13.4 billion, resulting in a net purchase of minus NOK 4.5 billion. The same period saw a value increase of NOK 9.2 billion bringing the change in the sector's holding of Norwegian-registered equity funds to NOK 4.7 billion.

## Households' sensitivity to interest rate increases

In response to a request from Kredittilsynet, Statistics Norway has made model-based projections of households' debt and interest burden up to the end of 2005. The model also analysed households' interest burden in the event of a substantial interest rate increase at end-2005/start-2006. Kredittilsynet commissioned a similar study in 2004 with projections to the end of 2006. The interest rate increase in the stress test is incorporated at end-2006/start-2007.

The model starts out from volume figures for 2002 taken from tax returns. The assumptions underlying the projections are based on historical data up to and including 2003 while the forecasts for wage growth and bank lending rates are taken from Economic Survey (September 2004). Households' debt growth is put at 11 per cent, i.e. somewhat lower than the current level, in both 2005 and 2006. The tax programme in the model comprises current 2005 rules, which, as a purely technical assumption, are continued for 2006, such that the thresholds in 2005 are wage-adjusted for 2006.

Under the assumptions outlined, the calculations show that households' total debt burden, which in 2002 measured about 143 per cent of total after-tax incomes, rises to 178 per cent by the end of 2006. Total debt is estimated at NOK 1 454 billion. The figures diverge somewhat from Norges Bank's projections since the model is based on a sample of households and employs a different definition of income.

Households are in a relatively favourable financial position overall. However, some groups are substantially more vulnerable to interest-rate changes than others. As in the previous study, households are therefore classified in three main groups on the basis of interest-rate burden (defined as interest rate expenses divided by after-tax income): up to 20 per cent, from 20 to 30 per cent and over 30 per cent. Based on the distribution of debt and wealth in 2002, a projection is made of the number of households falling within each of the three groups in 2006, as well as each group's share of total debt, given the assumptions outlined.

Table 3.3 Number of households and share of total debt by interest burden

| | 2002 | | 2006 | | 2006, interest rate at 2001 level (+4.4 pp) | | 2006, interest rate up 3 percentage points | |
|---|---|---|---|---|---|---|---|---|
| Interest burden | Number (thousands) | % of total debt | Number (thousands) | % of total debt | Number (thousands) | % of total debt | Number (thousands) | % of total debt |
| 0.1 – 19.9 % | 1 315 | 58 | 1 574 | 87 | 1 176 | 42 | 1 307 | 55 |
| 20 – 30 % | 195 | 23 | 37 | 7 | 260 | 26 | 212 | 24 |
| Over 30 % | 97 | 17 | 19 | 4 | 195 | 30 | 111 | 19 |

Source: Statistics Norway

A substantial number of households had a high interest burden in 2002. As a result of the interest rate fall in 2003 and into 2004, and the assumption of persistent low interest rates (calculated at 3.1 per cent in both 2005 and 2006), the projections show this number to be significantly reduced in 2006. The share of total debt held by the group with the highest interest burden is also sharply reduced. Should, on the other hand, interest rates rapidly climb, the most vulnerable groups will be substantially affected. Two stress tests are carried out, one in which interest rates return to the 2001 level of 7.5 per cent, corresponding to the calculations done in 2003, and one in which rates rise by 3 percentage points. In the first case the calculations show that 455 000 households acquire an interest burden in excess of 20 per cent, and close to 200 000 a burden in excess of 30 per cent. More than half of the overall debt will reside with these two groups.

In the stress test where the interest rate is assumed to climb 3 percentage points, the number of households with an interest burden in excess of 20 per cent will rise to 323 000, while 43 per cent of total indebtedness will be held by this group. Households' financial interest rate sensitivity is also illustrated in the two scenarios by the fact that a 1.4 percentage point difference in the interest rate increase produces 84 000 more households with an interest burden in excess of 30 per cent.

Table 3.4 Household financial wealth and financial wealth as a share of debt by interest burden

| | 2002 | | 2006 | | 2006, interest rate at 2001 level (+4.4 pp) | | 2006, interest rate up 3 percentage points | |
|---|---|---|---|---|---|---|---|---|
| Interest burden | Wealth in NOKbn | Wealth as per cent of debt | Wealth in NOKbn | Wealth as per cent of debt | Wealth in NOKbn | Wealth as per cent of debt | Wealth in NOKbn | Wealth as per cent of debt |
| 0.1 – 19.9 % | 392 | 68 | 494 | 39 | 425 | 69 | 448 | 56 |
| 20 – 30 % | 33 | 14 | 12 | 12 | 42 | 11 | 37 | 10 |
| Over 30 % | 20 | 12 | 5 | 8 | 44 | 10 | 27 | 10 |

Source: Statistics Norway

A buffer in the form of liquid assets puts households in a far better position to tackle the debt and interest burden. In 2002 the group with the lowest interest burden held 58 per cent of the total debt, while financial assets (defined as bank deposits, cash, equity and bond funds along with securities in and outside the Central Securities Depository) made up 68 per cent of this group's debt. In 2001 the group with an interest burden in excess of 30 per cent had relatively sizeable assets in relation to their debt, mainly in the form of shares. As a result of the steep fall in share markets in 2002 this pattern altered such that both groups with the highest interest burden are left with relatively little financial wealth in relation to debt. In our projections financial wealth as a share of debt is reduced in the case of all groups. Should interest rates return to the 2001 level of 7.5 per cent, this wealth pattern will be further reinforced. In this case, the 455 000 households with an interest burden in excess of 20 per cent will have financial assets of about 10.5 per cent of total indebtedness.

The sensitivity calculation shows that in the event of a sudden interest-rate hike, households' vulnerability will rise substantially from today's low level. While a sudden return of interest rates to the 2001 level is not the most likely scenario, a gradual return to this level cannot be ruled out. If interest rates remain low for a long period and households' rapid credit growth persists or accelerates, the stage may be set for a substantial increase in households' credit risk in the medium term. Figures from Statistics Norway's incomes and wealth survey show that recent years' debt growth has been highest in the lowest-income groups. These groups can be assumed to have few assets, and in a number of cases an uncertain labour market status. The last banking crisis showed that banks' losses on retail customers accounted for about 20 per cent of their total losses. Banks' exposure to the household sector is now significantly higher.

## Banks' information to borrowers

In its follow-up of the home loan survey, Kredittilsynet organised in the autumn of 2004 a survey of home-loan borrowers' perceptions of what information they had received from banks. The survey, carried out by TNS Gallup, addressed the same customers that had formed the basis for the home loan survey. The survey results showed that borrowers were highly satisfied both with the amount of information received and the clarity of its presentation. The replies nevertheless showed that by and large borrowers did not recall being given several important pieces of information during the application process. As much as 44 per cent reported not having been made aware of the consequence of defaulting on a loan, while 11 per cent did not believe they had been informed of the effective mortgage rate. Banks are required to inform borrowers of both these items before a loan is arranged. The survey also showed that 18 per cent of borrowers had not been informed that the mortgage rate might well increase, and that 55 per cent had not been informed of personal financial consequences in the event of an interest rate increase. Banks are not required to provide information on the latter points. Kredittilsynet has no reason to believe that banks are in breach of the information requirement set out in laws and regulations. Borrowers have a substantial personal responsibility for apprising themselves of potential consequences when taking out a home mortgage loan. This includes familiarising themselves with the information they actually receive from their bank. The respondents' replies nevertheless suggest that there may be flaws in the way that information is passed to the customer and in the accessibility of this information. It is important for both borrower and lender to ensure that information of significance for personal finances is received and understood.

In the wake of the survey a meeting was held between Kredittilsynet, the Savings Banks Association and the Financial Services Association to discuss the survey findings and to look into ways of enhancing the information given to borrowers. The two associations thereafter urged their members to supplement statutory, written information with other information designed to ensure that customers are in fact informed of important aspects of taking out a loan. The associations also asked their joint document committee to draw up documents incorporating information on the risk of interest rate increases and on the consequences such increases will have for the borrower's finances.

A less comprehensive survey targeted customers whose loan applications had been refused or who had been granted a smaller loan than initially requested. The survey addressed TNS Gallup's own respondent panel. Of respondents who had applied for a loan during the past 24 months, 8 per cent had been refused, and a further 5 per cent had been granted a smaller loan than initially requested.

### *Banks' information to borrowers: Observations from inspections*

None of the banks inspected in the past half-year presented documentation showing that borrowers and, where applicable, guarantors had been informed of how a future interest rate increase would affect their financial situation. However, the banks state that information on the consequences of an interest rate increase does form part of the counselling provided when a customer visits a bank to apply for a loan.

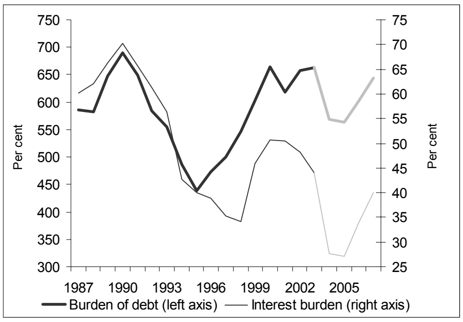
With one exception, the obligation to advise borrowers and their guarantors against taking out a loan is set out in the inspected banks' guidelines. One of the other banks refers in its guidelines to the provisions of the Financial Contracts Act without specifying criteria for when a borrower should be dissuaded from taking out a loan. However, half of the inspected banks employ a rule to the effect that a loan applicant shall be dissuaded in cases where the bank's standard requirement as to debt-servicing ability is not met. The guidelines of one of the major banks in the sample do not indicate that account should be taken of future interest rate increases when considering whether to advise the customer against taking out a loan. In the ten loan applications that were reviewed at each bank, the internal guidelines for dissuading were, with few exceptions, complied with.

## Corporate sector

Following relatively sluggish growth among mainland (non-oil sector) enterprises in the past couple of years, current statistics show that activity levels picked up in 2004, and gross investment in mainland enterprises rose over the year. Weak credit growth and improved earnings resulted in declining debt burdens in 2004, while lower interest rates have substantially reduced enterprises' interest burden. Given high activity levels in the Norwegian economy, low interest rates, improved earnings in many sectors and generally greater business optimism, enterprises' credit demand is probably set to resume an upward path. Norges Bank expects both debt and interest burdens to grow in 2006 and 2007.

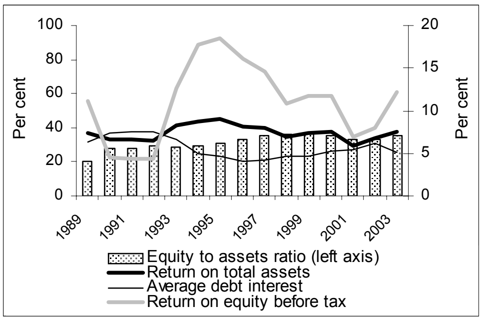
Preliminary figures from limited liability companies' annual accounts for 2003 show improved profitability and financial strength compared with the 2002 accounts. While most industries showed improved operating margins, fish-farming profit performances deteriorated. Equity-to-assets ratios, which subsided in the period 1999-2002, rose appreciably in 2003.

Chart 3.13 Mainland enterprises' debt and interest burden




Except enterprises in oil and gas industry and foreign trade. Debt as per cent of cash surplus. Interest expenditure as per cent of cash surplus plus interest expenditure. Estimate for 2004-2007. Sources: Statistics Norway and Norges Bank

Chart 3.14 Key figures for the enterprise sector



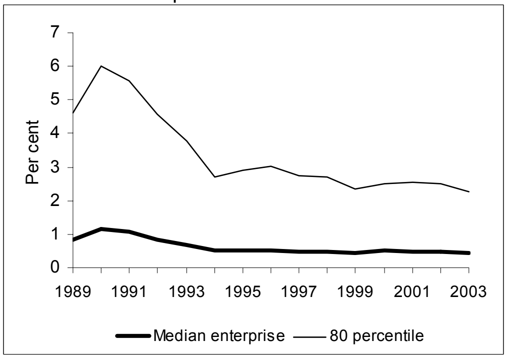

Limited companies except in the oil and gas industry, financial industry and public sector. Debt interest is computed as the ratio of interest expenses to total debt. Source: Norges Bank

The number of bankruptcy proceedings remained more or less stable in the period 1995 to 2001. A marked increase from 2002 to 2003 was however followed by a turnaround in keeping with the cyclical recovery. From 2003 to 2004 the number of bankruptcies fell by 18 per cent to a level close to that witnessed in 2002. The cyclical upturn combined with continued low interest rates is brightening the outlook for Norwegian enterprises. Projections using KMV's credit risk model and Norges Bank's bankruptcy prediction model also point in the direction of a more favourable trend in the enterprise sector.

Chart 3.15 Likelihood of default, Norwegian enterprises


Sources: Moodys/KMV

Chart 3.16 Predicted bankruptcy probabilities for non-financial enterprises




Source: Norges bank

KMV's Private Firm Model calculates the likelihood of default for the 4 000-5 000 largest Norwegian companies, which in aggregate account for the bulk of the enterprise sector's debt. The KMV model utilises market information, and can therefore be said to be more forward-looking than models based on historical accounting data. Norwegian enterprises' likelihood of default has been calculated on the basis of data up to December 2004. The likelihood of default fell appreciably in 2003 and continued to do so on an overall basis in 2004, and is now back at the level in effect prior to the steep increase from the autumn of 2001.

Norges Bank's bankruptcy prediction model (SEBRA) estimates the likelihood of bankruptcy among non-financial enterprises over the three ensuing accounting years. The figures predicted after the accounting year 2003 are slightly lower than one year previously. The decline is somewhat larger for the most exposed enterprises than for median enterprises. In terms of industries the improvement is strongest in business services and property management, both of which are segments carrying a large volume of bank loans.

In 2004 Kredittilsynet, as part of its supervisory effort, also carried out analyses of large and midsized banks' corporate portfolios. The analyses are based on Norges Bank's bankruptcy prediction model which indicates enterprises' bankruptcy probability based on age, size, industry characteristics, as well as accounting variables that shed light on the individual enterprise's revenues, liquidity and financial strength.

The analyses, employing accounting data submitted by the enterprises to the Brønnøysund Register Centre up to and including 2003, show that most banks were heading in the direction of lower credit risk in 2004. This is related to a reduction in underlying risk among enterprises, and to the moderate risk profile on loans and credits granted in 2004. However, some banks stand out because recently granted loans carry relatively higher risk than other commitments and because corporate portfolio risk has either increased or remains unchanged. The analyses also show that the largest banks carry a lower risk profile than other banks. A further tendency is that banks are starting to differentiate their risk pricing of clients, which may reflect differences in risk between enterprises.

## Exposure to selected industries

Each year since 1998 Kredittilsynet has investigated banks' exposure to selected industries. The 2004 survey covered shipping, the engineering industry, offshore industry, extraction of oil and gas, fish farming, property management and construction. The last-mentioned industry features in the survey for the first time. The 11 largest banks are included, and the analysis is based on the banks' own risk assessments and classifications.

The banks' highest, and increasing, exposure is to property management and shipping, while exposure to other sectors is declining. The decline vis-à-vis the fish farming industry has to do with the fact that DnB NOR and Nordea have become shareholders in several companies. The 2004 survey shows that all industries have a lower share of high risk in relation to drawn commitments than in the previous year, with the exception of the offshore industry where the level is more or less unchanged. However, the high-risk share remains high in the fish farming and hatchery industry. It is unclear how the EU's recently introduced protection measures will affect Norwegian salmon producers, although the consequences could be large. Other industries are benefiting from the cyclical recovery in Norway and abroad, and the engineering industry in particular recorded sharp growth in orders in 2004 after several poor years.

Table 3.5 Banks' exposure to selected industries as of the third quarter of 2004

| Industry | Loan commitments | | Amount drawn | High risk as % of amount drawn | | Exposure as % of capital base |
|---|---|---|---|---|---|---|
| | NOK billion | Annual growth % | NOK billion | 30.09.2003 | 30.09.2004 | Per cent |
| Shipping | 120.3 | 4 | 114.3 | 8.7 | 2.8 | 116 |
| Shipbuilding | 6.2 | -9 | 4.3 | 13.4 | 4.9 | 4 |
| Offshore | 16.3 | -1 | 6.2 | 4.9 | 5.0 | 6 |
| Oil/gas extraction | 30.5 | 21 | 7.0 | 4.3 | 0.5 | 7 |
| Fish farming and hatcheries | 13.7 | -22 | 11.9 | 44.4 | 41.8 | 12 |
| Property management | 148.2 | 9 | 125.0 | 7.6 | 6.8 | 127 |
| Building and construction | 30.0 | | 20.3 | | 5.4 | 21 |

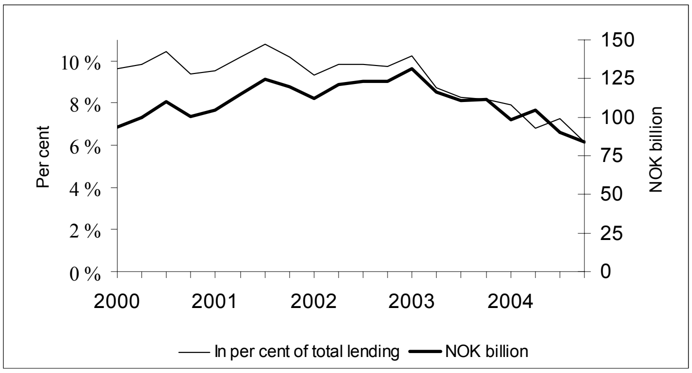
Looking at the selected banks' drawn commitments to the various industries in relation to banks' aggregate capital base, it is clear that a pronounced economic setback for the property management and shipping industries, triggering bank losses, could have a major effect on banks' financial position. In order for losses in other industries to have equally serious consequences, a substantially higher likelihood of default and higher losses in the event of default would be required.

## Large commitments in financial institutions

All Norwegian banks submit quarterly reports on large commitments. A large commitment is defined as a commitment which prior to weighting represents more than 10 per cent of a bank's net capital base. Institutions are not permitted to carry commitments measuring more than 800 per cent of their overall capital or any single commitment measuring more than 25 per cent.

From 1998 up to and including the first quarter of 2003, banks' total volume of large commitments (after weighting) came to about 10 per cent of their total lending. This volume has since been reduced to close to 7 per cent of total lending. As from 2003 consolidation has been more evident among banks than among their corporate clients.

Chart 3.17 Trend in large exposures




Twenty banks carry large commitments which after weighting are in aggregate higher than the respective bank's net capital base, although no bank is anywhere near the maximum limit of 800 per cent of its net capital base. Generally speaking, the ten largest banks in Norway carry a smaller volume of large commitments than other banks.

In addition to banks, mortgage companies and finance companies also report large commitments. Mortgage companies' share of large commitments is clearly higher than that of banks. Of 11 mortgage companies, nine carry large commitments which after weighting constitute more than their net capital base. Large commitments among finance companies are on a smaller scale although, here too, there are wide variations between the companies. At inspections, importance is attached to correct consolidation of large commitments.

## Counterparty risk

Kredittilsynet obtains overviews of banks' largest counterparty exposures in order to gauge the risk of loss due to payment problems incurred by such a counterparty. The risk of contagion increases where a counterparty who experiences payment problems is a counterparty to several banks simultaneously. A financial institution could be such a counterparty. There is a relatively large spread across the banks' largest counterparties. Total exposure has diminished since the Norwegian currency was incorporated in the European foreign exchange settlement system, CLS, in autumn 2003. Charts 3.18 and 3.19 show the average of the seven largest banks' 15 largest counterparties as a ratio of tier 1 capital.

Chart 3.18 Banks' 15 largest counterparties as a ratio of tier 1 capital. Weighted average, 31.03.03

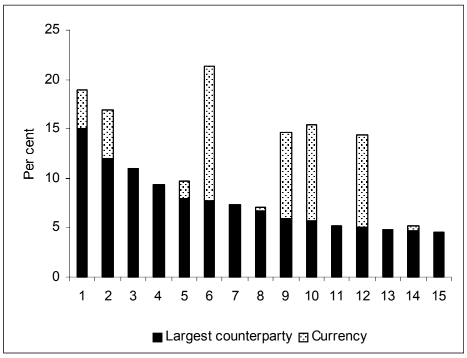
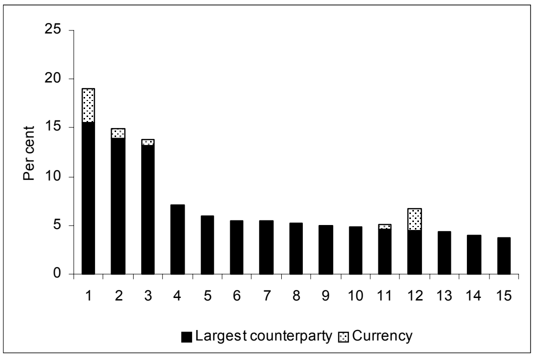



Chart 3.19 Banks' 15 largest counterparties as a ratio of tier 1 capital. Weighted average, 31.03.2004




## Loans backed by securities

Banks offer loans to households and businesses to finance the purchase of securities where the securities themselves constitute the collateral. An additional risk associated with such loans is that the value of the underlying securities will be exposed to market fluctuations. In light of the growth in such loans in other countries, Kredittilsynet has since 1997 conducted annual surveys of loans backed by securities and banks' treatment of such loans. Twenty-three banks and investment firms participated in the 2004 survey. Securities purchases can also be secured by other means, or not secured at all – which is not captured by this survey.

The level of loans backed by securities is relatively low in Norway. It rose at the end of the 1990s but subsided from 2001 to 2003, in parallel with the share market slump. 2004 saw an increase in this type of loan on the back of rising share market values. Such loans' share of overall lending stood at 2.5 per cent in both 2002 and 2003, rising to 2.7 per cent in 2004. The banks in the sample have also shown a clear shift over the past couple of years from commercial credits to other loans, thereby increasing the maturity of their exposures of this type. Changes in households' savings pattern and in banks' willingness to finance short-term business of this type may be a contributory factor. In 2004 the share of other loans associated with the financing of long-term savings products edged down, probably as a result of takeovers and ownership changes in Norwegian industry, which has increased enterprises' demand for credits of this type.

Table 3.6 Credits granted, mainly secured on financial instruments, as of 30.09.2003 and 30.09.2004

| | Commercial credits* | | | Other loans secured on fin.instr. | | | Total loans secured on fin. instr. | | |
|---|---|---|---|---|---|---|---|---|---|
| | NOKbn | As % of loans | | NOKbn | As % of loans | | NOKbn | As % of loans | |
| | 30.09.04 | 30.09.03 | 30.09.04 | 30.09.04 | 30.09.03 | 30.09.04 | 30.09.04 | 30.09.03 | 30.09.04 |
| 5 most exposed banks | 0.2 | 0.9 | 0.3 | 6.5 | 7.4 | 9.1 | 6.7 | 8.3 | 9.5 |
| Total | 3.5 | 0.4 | 0.3 | 27.5 | 2.1 | 2.4 | 31.3 | 2.5 | 2.7 |

* Commercial credits are defined as loans of up to 1 years' maturity

Although aggregate exposure is limited, some banks in the sample are substantially exposed to this type of commitment. Such exposure requires sound control and monitoring routines. 2002 saw an increase in the scale of payments problems and losses compared with previous year. Since 2003 the volume of commitments posing payments problems and losses has subsided in keeping with the share market recovery.

# Defaults and bank losses

The volume of non-performing loans recorded by Norwegian bank fell from 2003 to 2004 and was at a very low level at year-end. The concurrent strong increase in lending volume meant that defaults as a ratio of total lending fell from 1.7 to 1.1 per cent, an unprecedented low level.

Chart 3.20 Defaults as % of loans to customers

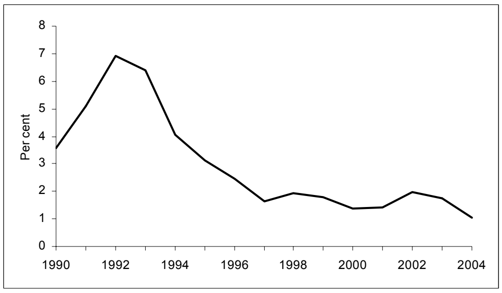
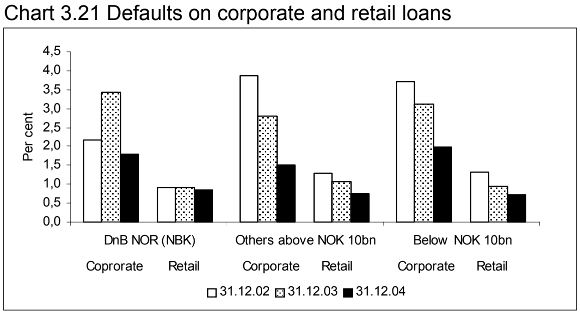



Chart 3.21 Defaults on corporate and retail loans




In the case of loans to retail customers, non-performaning loans have been at a very low level for a long time, and below 1 per cent of total lending in the past year. Loans to retail customers rose by just over 14 per cent in 2004, whereas the volume of defaults on loans to this group fell by 7 per cent. In the corporate market, default volumes have been substantially higher, but were almost halved last year. At the end of 2004 1.7 per cent of corporate loans were in default, compared with only 0.8 per cent of retail loans.

## Trend in losses

Norwegian banks' good results in 2004 are largely ascribable to very low loan losses. The level was particularly low compared with 2002 and 2003, which were affected by heavy losses on loans to the Finance Credit system and difficulties in the fish farming industry. Banks may recover some of their losses to Finance Credit in legal settlements. At 0.1 per cent of lending, losses in 2004 were at their lowest since 1997.

Chart 3.22 Loan losses, Norwegian banks
(as per cent of loans to customers)

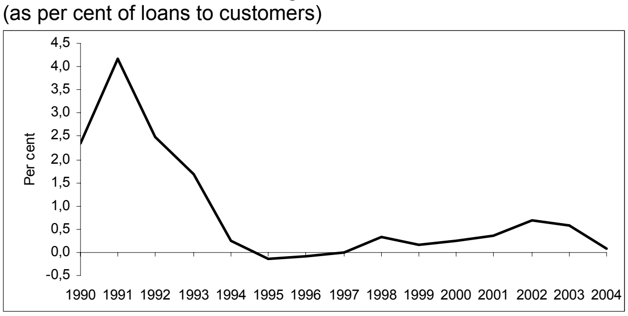
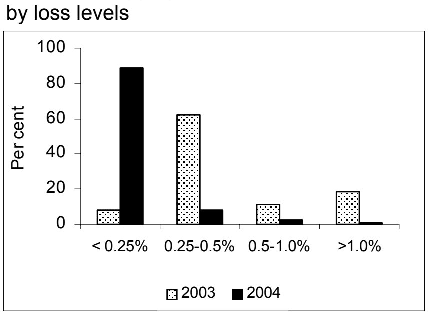



Chart 3.23 Aggregate total assets distributed
by loss levels



There was a substantial decline in the number of banks with losses in excess of 0.25 per cent of lending in 2004. The substantial change in the share of aggregate total assets distributed by banks' loan loss levels from 2003 to 2004 is largely due to the very low losses recorded by large banks in the latter year.

## Market risk

Market risk, i.e. the risk of loss of revenue or capital as a result of changes in the market prices of shares, fixed income instruments, currencies and commodities, depends on both the volatility of market prices and the size of positions taken.

## Banks

Banks' exposure to market risk is negligible since a relatively low share of their total assets is invested in securities affected by market volatility. Their holding of fixed-income securities (held as current assets) is relatively small. The share component of banks' total assets is minimal: in the case of DnB NOR Bank, 0.5 per cent of its total assets was held in shares (held as current assets) while the equivalent figure for other banks with total assets in excess of NOK 10 billion was 0.3 per cent, and for the smallest banks 1.8 per cent. Banks report market risk in their trading portfolios in accordance with special provisions contained in the capital adequacy regulations. Norwegian credit institutions carry significantly lower market risk in trading portfolios than credit institutions in other Nordic countries.

Chart 3.24 Money market instruments and bonds (held as current assets)

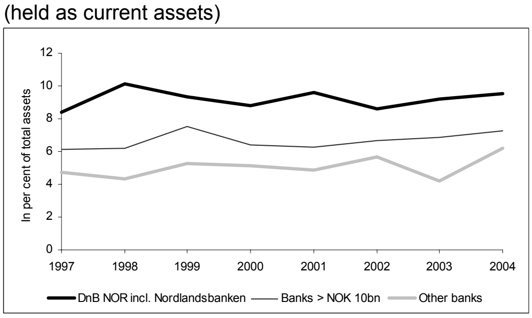
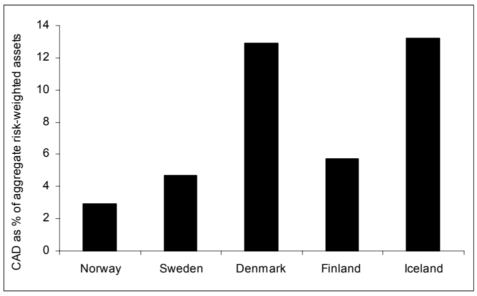



Chart 3.25 Market risk in trading portfolios, Nordic countries, 2003




## Life insurance companies

Of Norwegian financial institutions, life insurance companies are those with highest exposure to market risk. Compared with the end-1990s, life insurers have reduced their shareholdings and increased their holding of bonds "held to maturity". In 2004 life insurers' share component rose by almost 4 percentage points to 16 per cent of total assets. The volume of bonds "held to maturity" declined in 2004, and at year-end accounted for 32 per cent of the companies' total assets. This was a decrease of 4 percentage points from the end of 2003. Money market instruments and bonds held as current assets accounted for 31 per cent of total assets at end-2004 compared with 29 per cent one year earlier.

Life insurers expanded their foreign securities holdings substantially from the mid-1990s onwards, with the strongest increase recorded in shares. Since the peak in 2000 investments in foreign securities have fallen, however. Where 2001 and 2002 are concerned this is probably due to the highly uncertain outlook for the world economy and the high level of Norwegian interest rates. In the past two years investments in foreign shares increased anew to reach 68 per cent of total shares held at end-2004. The portion of foreign bonds and money market instruments also rose in 2004 to reach 39 per cent at year-end. See Chapter 4 for a closer discussion of the life insurers' situation.

Chart 3.26 Life insurance companies' holdings of equities and fixed income securities

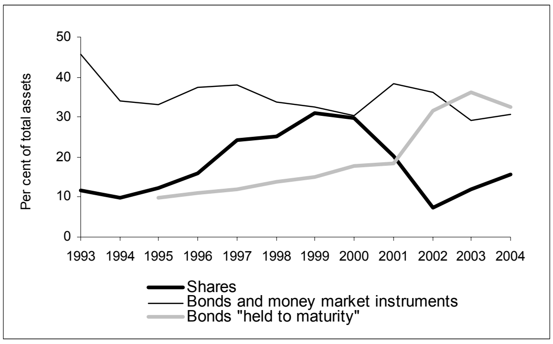
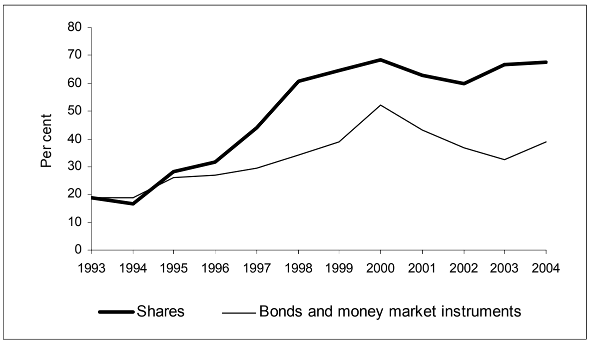



Chart 3.27 Life insurance companies' foreign securities (share of current assets)




# Pension funds

The largest private and municipal pension funds (representing about 75 per cent of pension funds' aggregate total assets) raised their share component and reduced their fixed interest component in 2004. Private pension funds held a larger share component in their balance sheets than municipal pension funds, 32 per cent compared with 19 per cent. Private pension funds increased their shareholdings by 8 percentage points over the year, municipal pension funds by 4 percentage points.

Chart 3.28 Equities and fixed income securities in private pension funds, 2002-2004

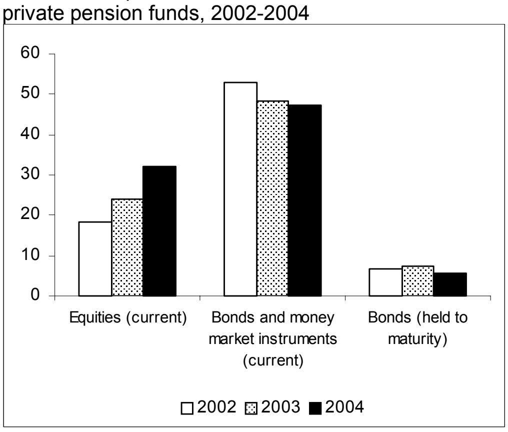
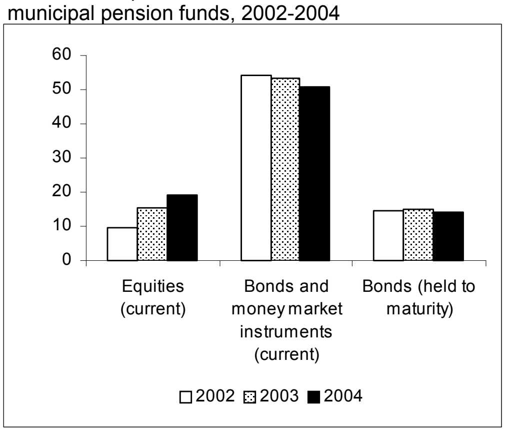



Chart 3.29 Equities and fixed income securities in municipal pension funds, 2002-2004



Foreign shares make up a relatively large component of pension funds' overall shareholding, although significantly lower than in the case of life insurance companies. Whereas foreign shares accounted for 46 per cent private pension funds' total shareholding, the corresponding figure for municipal pension funds at end-2004 was 49 per cent.

The securities market trend in 2004 strengthened pension funds' aggregate buffer capital. At year-end, capital buffers (when defined as premium funds, surplus tier 1 capital, supplementary provisions with an upward limit of one year's interest guarantee and fluctuation reserves) totalled NOK 15.8 billion. This was 18.5 per cent of total assets, 4.3 percentage points more than one year previously. Buffer capital is higher in private pension funds than in municipal pension funds. Buffers constituted 22.3 per cent of total assets in private pension funds and 9.2 per cent in municipal pension funds at the end of 2004.

Under current rules, the premium fund can only be used to make good a deficit in a situation where supplementary provisions, tier 1 capital and other key capital elements have been exhausted. In defined contribution schemes with a unit-linked element (which can be arranged with a pension fund or insurer), however, the premium fund can be used to make good a shortfall in return, thereby functioning as a buffer once new legislation comes into force. Report no. 12 from the Bank Law Commission discusses the possibility of converting municipal pension funds' premium fund to buffer capital. Further guidelines are recommended for inclusion in transitional rules to new legislation for pension funds. When premium funds are excluded, pension funds' aggregate buffer capital made up 9.6 per cent of total assets at the end of 2004. Buffer capital excluding premium funds comprised 11.2 per cent of private pension funds' total assets and 5.8 per cent of their municipal counterparts' assets. In comparison, life insurers' buffer capital measured 6.4 per cent of their total assets.

Chart 3.30 Private pension funds' buffer capital

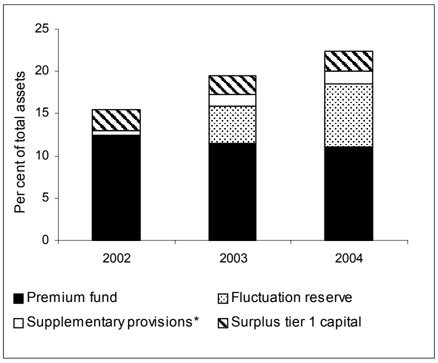
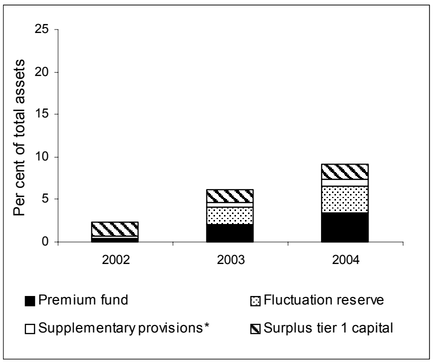



Chart 3.31 Municipal pension funds' buffer capital




## Non-life insurance companies

Non-life insurers are substantially exposed to market risk, mainly due to a high fixed income balance sheet component. In the case of the three largest non-life insurance groups, 56.3 per cent of their aggregate total assets was invested in bonds and money market instruments (current assets) at the end of 2004, while bonds held to maturity accounted for 8.6 per cent of their total assets at the same point. This compares with end-2003 figures of 49.1 per cent for bonds and money market instruments (current assets) and 4.5 per cent for bonds held to maturity. Shares classified as current assets accounted for 4.7 per cent of total assets at the end of 2004 compared with 15-20 per cent in the period to 2002. This portion fell by 1.7 percentage points in 2004, after a substantial reduction in the holding of foreign shares.

Non-life insurers are in a stronger financial position after the good results achieved in 2003 and 2004. Generally speaking these companies' exposure to market risk is moderate seen in light of their buffer capital (capital over and above the statutory minimum). Hence sizeable falls in securities markets will in most cases not result in serious solvency problems for non-life insurers.

Chart 3.32 Non-life insurance companies' holding of equities and fixed-income securities

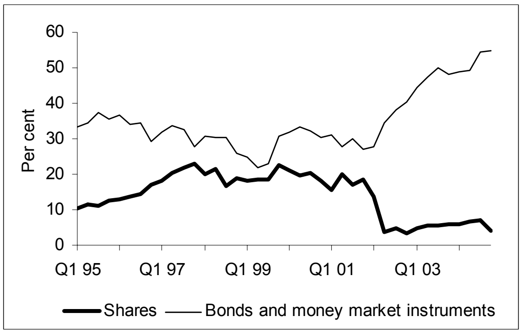
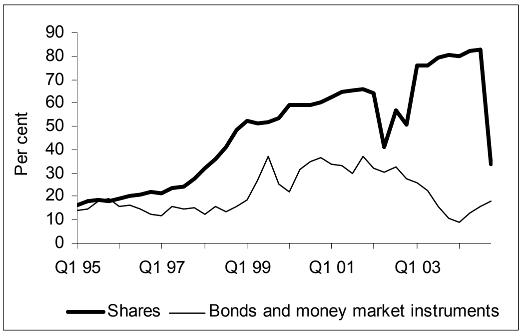



Chart 3.33 Non-life insurance companies' foreign securities (share of current assets)




## Insurance risk

Insurance risk is rooted in the balance between claims expenses and other insurance-related expenses on the one hand and premium income on the other – a balance which varies unpredictably over time. The main cause of insurance risk is that claims expenses turn out to diverge from the level anticipated when the premium levels were set.

Insurance risk usually affects non-life insurers' results more than it does life insurers' results, since claims expenses are more variable in the non-life sector. While the trend in mortality is relatively stable in life insurance, life insurers are exposed to insurance risk through variations in the trend in disability. Even so, the dominant risk for life insurers in the short term is market risk.

The non-life insurance sector has seen wide fluctuations in recent years in the relationship between claims expenses and premium income (the claims ratio). As a result of a strong increase in claims expenses from 1998 onwards, the claims ratio rose considerably, contributing to very weak results for non-life insurers. Sizeable premium increases from 2000 onwards have brought a gradual decline in the claims ratio. The claims ratio trend is shown in Chart 3.34 along with the trend in the expense ratio (insurance-related operating expenses as a per cent of premium income). The expense ratio has shown a more stable trend, but tending to fall over time.

Chart 3.34 Claims ratio and expense ratio for non-life insurance companies

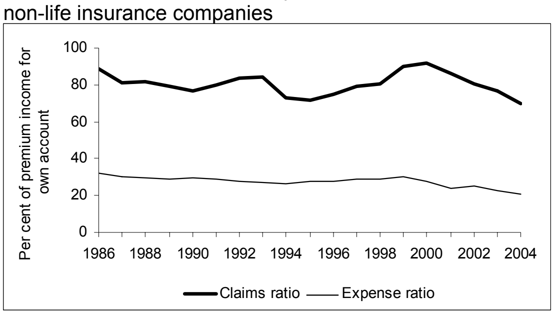
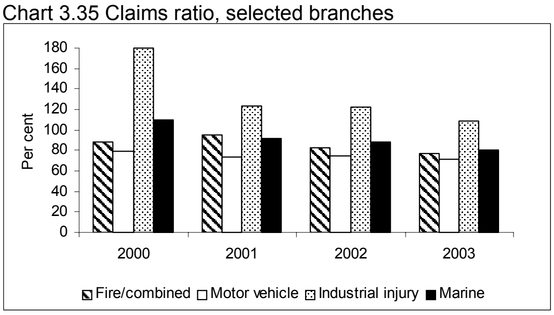



Chart 3.35 Claims ratio, selected branches




The very high claims ratio in the years on either side of the millennium is attributable to a generalised imbalance between premium income and claims expenses, although certain branches showed a particularly weak trend. A pertinent example is occupational injury insurance where the claims ratio was very high partly because earlier claims projections proved too low. Recent years' premium increases have led to a broad improvement in results (see Chapter 2) and to more uniform results across the various branches. Chart 3.35 shows the trend in the claims ratio in recent years for the most important branches of non-life insurance.

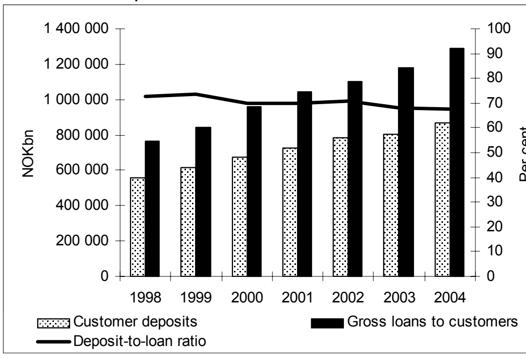
Norwegian insurers offer very little in the way of reinsurance. As purchasers of reinsurance, non-life insurers are however affected by developments in major international reinsurers. Prices in the reinsurance market have tended to rise in recent years, thereby weakening Norwegian non-life insurers' profits. This effect has however been curbed by companies' reduced recourse to reinsurance.

## Liquidity risk

Liquidity risk, i.e. the risk that an institution will be unable to honour its commitments as they fall due without incurring substantial additional costs, is rooted in differing maturities on banks' assets and liabilities. A high level of short-term funding of lending activity and other illiquid assets entails high refinancing requirements. Banks' access to funding in the market, and the price of such funding, depends to a large extent on their earnings and financial strength. Small banks generally have poorer access than large banks to funding in money and securities markets, especially in periods of tight market liquidity, and are therefore more dependent on customer deposits as a source of funding.

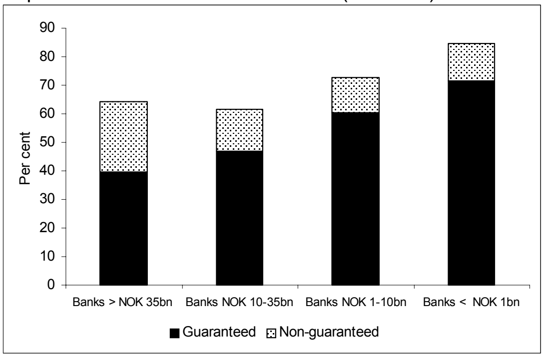
The deposit-to-loan ratio for Norwegian banks as a whole was somewhat lower at the end of 2004 than one year previously. Despite low deposit rates, bank deposits grew fairly strongly in 2004. The high, and quickening, rate of lending growth nevertheless brought a slight fall in the deposit-to-loan ratio. The ratio reported by the smallest banks (i.e. banks with total assets below NOK 10 billion) remains at a higher level than among the larger banks.

Chart 3.36 Deposit-to-loan ratio*, all banks, 1996-2004




*Deposits from customers as % of loans to customers

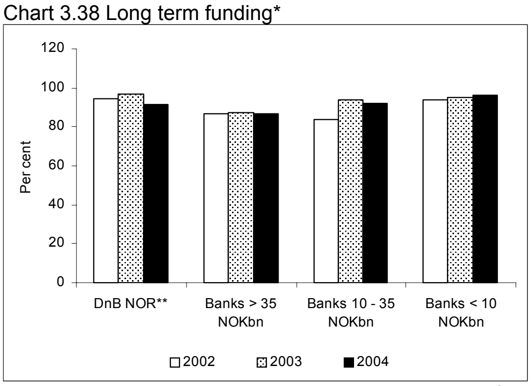
Chart 3.37 Share of guaranteed and non-guaranteed deposits as % of loans to customers (30.09.04)




Source: The Banks' Guarantee Fund

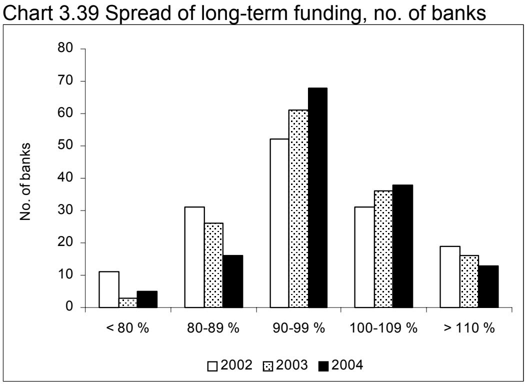
Although customer deposits can be withdrawn at short notice they are regarded as a stable, long-term source of funding. Banks' mandatory membership of the guarantee fund means that deposits up to the maximum covered by the guarantee scheme are viewed as a "risk-free" investment option for customers. Under the Guarantee Schemes Act the fund is required to cover deposits of up to NOK 2 million per depositor. Deposits by financial institutions, among others, are not covered by this requirement. Deposits not included in the Guarantee Schemes Act's definition of guaranteed deposits are likely to be less stable than other bank deposits. Customer deposits measured 67 per cent of loans at the end of 2004, while guaranteed deposits accounted for 44 per cent. In other words, two-thirds of deposits are covered by the guarantee scheme. The smallest banks have the highest ratio of guaranteed deposits to loans.

Chart 3.38 Long term funding*




*Funding with a maturity above one year as a share of illiquid assets. ** Incl. Nordlandsbanken

Chart 3.39 Spread of long-term funding, no. of banks




The largest banks reduced their long-term funding (including customer deposits, bonds with a maturity of more than one year and equity capital) in 2004. Most banks, however, increased their long-term funding, mainly through increased bond issuance, particularly by the large savings banks (apart from DnB NOR). Far fewer banks had long-term funding below 90 per cent of illiquid assets (mainly loans) compared with 2002. The number of banks with long-term funding below 80 per cent has fallen from eleven to five in the past two years. Since the autumn of 2002, when several banks experienced liquidity problems, there has been a greater focus on banks' liquidity. Banks in general appear to have sharpened their awareness of liquidity risk and liquidity management.

In addition to funding in domestic interbank and securities markets, larger banks avail themselves of foreign money and capital markets. Greater risk is liable to attend funding from foreign than domestic sources, in part because foreign actors are more likely to respond collectively to negative information about the Norwegian economy or Norwegian financial markets in general. On the other hand, funding from a variety of sources can contribute to improved diversification of risk associated with funding. While funding in foreign currencies renders banks somewhat more vulnerable to swap market liquidity, the Norwegian currency market is viewed as relatively liquid, particularly in the shortest maturity bands.

The largest banks have best access to, and make most use of, funding from foreign sources, and banks' rating is crucial both to the supply and pricing of such funding. Foreign funding for the banking sector as a whole has accounted for about 20 per cent of total lending in recent years, and about 70 per cent of

Chart 3.40 Debt to foreign credit institutions and Securities debt in foreign currency

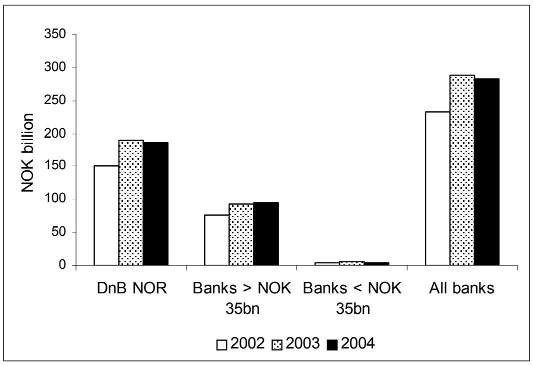
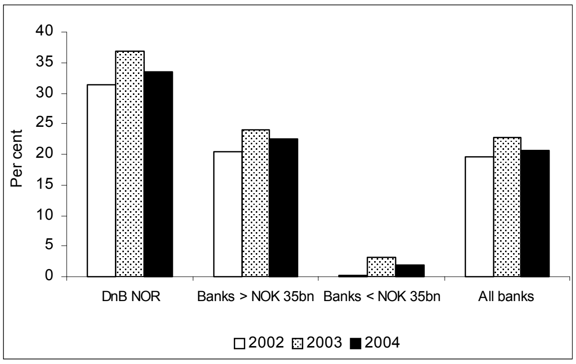



Chart 3.41 Debt to foreign credit institutions and securities debt in foreign currency, share of lending




this has been short term. DnB NOR and Nordea Bank Norway are the main users of foreign funding sources. In the case of Nordea Bank Norway, loans from companies within the Nordea group account for much of the foreign funding. For its part, DnB NOR is an important funding source for small Norwegian banks, and the contagion effects of any reduction in DnB NOR's access to foreign funding could be substantial. Small banks have little or no foreign funding.

## Monitoring banks' liquidity situation

In 2004 Kredittilsynet conducted 11 inspections at midsized and small banks with a special focus on liquidity. The banks were selected partly on the basis of indicators showing relatively high liquidity risk. Where management and control of liquidity risk is concerned, the supervisory effort highlighted the need for management boards to clarify what level of liquidity risk is acceptable, and on this basis to establish clear-cut, binding limits. Importance was also attached to the need to establish systematic reporting of liquidity risk to the board of directors and senior management, and to the need to establish contingency plans to handle problematic liquidity situations.

Experience gained from inspections in the liquidity field in 2004 provides a relatively unequivocal picture of the liquidity situation. The main conclusion is that banks are not experiencing problems in funding their operations. There is an ample supply of funding in various markets and prices are viewed as favourable. Smaller banks in particular report that they are once again able to obtain longer-term funding, and that the higher prices they were compelled to pay for a time have now been substantially reduced. Large banks that obtain much of their funding abroad also report a favourable funding situation in foreign markets.

## Operational risk

Operational risk is defined as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events" (Basel Committee on Banking Supervision). It is difficult to estimate what share of total losses incurred by the Norwegian financial industry is due to operational deficiencies and failures as it has not been customary to categorise such losses in a systematic manner. There is however reason to believe that losses in this category are substantial. In recent years larger banks in particular have started to compile loss events databases which will in due course provide a better picture of the volume of losses incurred. Such bases will help to improve enterprises' management and control of operational risk.

Financial institutions' operational risk is influenced both by the external environment and by their own ability to identify, manage and control such risk. A key aspect is the growth in financial crime, which is now more international in character. Financial crime includes money laundering, corruption, computer crime, fraud and manipulation of accounts. A number of events witnessed in the past year confirm this development. Another category of operational risk relates to mergers, acquisitions and other structural changes in financial markets which often entail restructuring, staff reductions and replacement of IT systems and service providers.

Operational risk is the most significant risk faced by investment firms and management companies. The most serious breaches of public and internal rules brought to light in enterprises in recent years have all been made possible by poor compliance with rules and by deficient or inadequate processes and systems. They involve customer discrimination, unauthorised own-account trading and trading with client assets, along with breaches of internal own-account trading limits and mandate agreements. Such breaches can have serious consequences in the form of direct loss and liability for damages or impaired reputation and resultant loss of income. Investment firms will be subject to capital requirements for operational risk once the new capital adequacy framework becomes effective and, like banks and other institutions, will have to meet minimum standards of management and control of operational risk.

A significant aspect of operational risk refers to enterprises' use of information and communication technology (ICT). Structural changes in the IT field are under way in the financial industry. Banks relocated much of their IT operations abroad in 2004. In the Nordic region, IBM is gaining a powerful position as a provider of IT services to institutions in banking and finance, and has signed several strategic agreements in the infrastructure and IT field. Cross-border outsourcing is on the increase. A prominent example here is Nordea Bank Norway ASA which in 2004 relocated much of its IT operations to Sweden in a joint venture with Nordea and IBM. Another example is the Terra Group which opted to collaborate with SDC in Denmark on future IT solutions and operations, with the result that small Norwegian savings banks' computer systems will now be run from Denmark.

Risk is likely to increase where different change processes take place simultaneously. Kredittilsynet is monitoring several such processes. They involve a trend of increasing concentration among IT providers, project management (major change projects), organised crime (use of the internet as an open infrastructure), changing modes of collaboration between banks or bank groupings, cross-border outsourcing and long-term impairment of Norwegian IT competence in banking and finance. Areas in focus in 2003 – above all catastrophe preparedness, change management and organisation of protective (anti-virus) measures – will continue to receive high priority.

The new capital adequacy framework, due to become effective at the start of 2007, defines operational risk as a distinct risk category on a par with credit and market risk, and imposes operational risk-related capital charges. The Basel Committee on Banking Supervision has published minimum standards: "Sound Practices for Management and Supervision of Operational Risk", which will be an integral aspect of the capital adequacy framework. Several banks have already implemented the minimum standards in their risk management regimes, and Kredittilsynet includes the standards in the basis for its supervisory effort.

## Regulatory changes

### Financial Services Action Plan and European financial markets

In 1999 the European Commission presented its Financial Services Action Plan (FSAP) to promote a competitive and efficient single market for financial services in Europe. The plan gave particular importance to removing impediments to cross-border investment and financial services, creating transparent and confidence-inspiring markets for investors and consumers, and ensuring high-quality and effective regulation and supervision.

Legislative drafting in Norway largely involves implementing the EU Financial Services Action Plan. The EEA agreement requires Norway to transpose the relevant EU directives into national legislation. Increasingly extensive and detailed regulation and harmonisation affect the authorities' scope for introducing divergent national regulation. The Action Plan covers inter alia regulation of the securities markets, international accounting standards, supervision of financial conglomerates, occupational pension funds, a new solvency regime for insurance, and new capital adequacy rules for credit institutions and investment firms.

Both the EU Commission and independent expert groups have considered the impact of the Action Plan, and what remains to be done to achieve a smoothly functioning single market for financial services. A general conclusion is that in important areas financial markets remain essentially "national" despite the positive trend seen since 1999. From the consumers' vantage point the supply of products and services has increased somewhat, although further price reductions will require an even higher degree of integration and further harmonisation measures. While a number of framework conditions are now in place, it is still uncertain how long it will take to reach the goal of a single market for financial services in Europe. The issue of regulating clearing and settlement activity in securities markets, for example, is still being considered.

Increased integration of national financial markets via cross-border establishments and operations will have repercussions for financial stability. The presence of fewer but larger actors operating across several countries, such as Nordea, confronts the authorities with new challenges. Increasing cross-sectoral and cross-border financial activity promotes efficient distribution of capital and risk, but may also increase the risk of contagion, as problems arising in institutions and markets are likely to spread more rapidly across sectors and national borders.

## Basel II

New capital adequacy rules for banks were finally adopted by the Basel Committee on Banking Supervision in June 2004 (Basel II). In the EU/EEA context it has been decided to implement the new framework on the basis of a Directive which is expected to be formally adopted in the autumn of 2005. This framework is expected to be given effect for credit institutions and investment firms as from 1 January 2007. Parts of the framework will apply as from 1 January 2008. On 17 January 2005 Kredittilsynet arranged, in conjunction with trade organisations, a meeting with banks and credit institutions to inform them of the content, possible consequences and implementation of Basel II. The presentations given at the meeting are published on Kredittilsynet's website.

Compared with the present credit risk and market risk regime, Basel II goes several steps further in making institutions' minimum capital requirements more sensitive to the risks faced. Basel II aims to give credit institutions and investment firms an incentive to maintain high-quality risk management, geared to the particular business and risk involved. The rules do more to formalise role distribution between institutions, public authorities and the market. Several new types of risk are to be explicitly addressed, among them operational risk, concentration risk and interest rate risk. A key aspect of Basel II is that institutions' own internal models can now, subject to the supervisory authorities' approval, be used to calculate minimum capital charges.

Under Pillar 1 of the new regime (minimum capital requirements), reduced capital charges will apply above all to loans to retail customers, including home mortgage loans, and to loans to small and medium-sized enterprises. Norwegian credit institutions are substantially exposed to these areas, and quantitative impact studies show that Norwegian banks will see substantial reductions in the minimum requirement (see The Financial Market in Norway 2003 – Risk outlook).

Under Pillar 2 of the new regime, institutions will be required to assess their total capital needs in relation to the risk faced. Risk types not assessed in Pillar 1 will be assessed and quantified in Pillar 2. Supervisory authorities will evaluate the institutions' process for assessing their total capital needs. Where action has to be taken, individualised capital requirements are one of the several instruments available. Pillar 3 (market discipline) requires the publication of information that will make it easier for the market, including analysts and investors, to assess risk levels, capitalisation and management and control. This will become even more important once institutions start using their own models to calculate capital charges.

Although the minimum capital requirements under Pillar 1 will diminish, mainly as a result of substantial holdings of home mortgage loans and loans to small and medium-sized enterprises, institutions cannot without further ado gear down the level of their own funds to the minimum requirement. The proposal requires institutions at all times to maintain own funds in excess of the minimum requirement, for one thing because the minimum requirement does not cover all risk inherent in institutions' portfolios. There is nonetheless reason to believe that banks will in time adapt to the new requirements by maintaining a somewhat lower share of own funds than they do at present. It will be important for banks to have sufficient own funds to meet unforeseen losses arising in economic downturns. Improved risk management at the individual bank will be key to identifying and monitoring the overall risk to which banks expose themselves.

## New accounting rules for financial institutions

With effect from 1 January 2005 all stock exchange listed groups, including financial institutions, are required to apply international accounting standards (IAS/IFRS) when preparing consolidated accounts. This follows from a Regulation adopted by the Council and European Parliament in July 2002 which has been implemented in Norway through amendments to the Accounting Act etc. The accounting standards have been drawn up by the International Accounting Standards Board (IASB) with a view to harmonising the financial information presented by companies in different countries. The IAS Regulation is a part of the EU's financial services action plan. Unlisted groups are permitted, but not required, to comply with the Regulation when preparing their consolidated accounts. The Accounting Act also permits company accounts to be drawn up in accordance with IFRS/IAS, although this provision has yet to become effective. Kredittilsynet has written to the Ministry of Finance to request exemption for insurance companies.

For banks, IAS 39 implies the greatest changes. It gives greater leeway to measure financial instruments at fair value. Since banks' assets largely comprise financial instruments, this could have an effect on financial institutions' results. Under Norwegian accounting legislation only securities and derivatives included in the trading portfolio can be measured at fair value. IAS 39 also opens the way for other financial instruments to be measured at fair value, including loans. In the case of financial instruments traded in a market, like most shares and bonds, measurement will be based on market prices, resulting in more correct valuation of assets. In the case of financial instruments not traded in a market, valuation is far more problematic. Increased use of fair values in accounting can be expected to increase the volatility of financial institutions' results.

Of other international accounting standards, IAS 19 on employee benefits and provisions for pension commitments will have repercussions for financial institutions. The transition to IAS 19 will entail substantial one-time effects that will impact on institutions' equity in a transitional phase. Where insurance companies are concerned, the evolution of the international accounting standards is multistaged, and the first stage of a complete standard for accounting for insurance contracts has now been introduced.

In 2004, under EU auspices, a survey was carried out of the effects of international accounting standards on financial institutions' own funds, and a recommendation for prudential filters was drawn up. An important justification for introducing potential filters is the need to maintain quality requirements imposed on institutions' own funds. Own funds must be available to absorb losses and must be of sufficient duration. Some of the recommended prudential filters will neutralise the impact of the new accounting rules when it comes to calculating regulatory capital.

## Solvency II

Solvency II is a project initiated by the EU Commission to improve and harmonise solvency rules and supervisory methods in respect of insurance companies in the European Economic Area. The new solvency margin requirements are intended to reflect, to a far larger degree than the present requirements, the various types of risk to which the individual insurance company is exposed.

The new solvency regime is expected, like the new capital adequacy regime for banks, to comprise three pillars. The first pillar will include quantitative rules in regard to technical provisions and solvency margins (solvency capital requirements) and in regard to investment of companies' assets. Large companies at any rate will be permitted to utilise internal models to compute all or parts of the capital requirement. The second pillar will comprise qualitative rules for internal control and risk management in addition to rules governing supervisory authorities' oversight and monitoring of companies. The third pillar will comprise market discipline rules, including rules on the reporting and publication of relevant accounting data as well as coordination of risk statistics.

The EU Commission aims to finalise a framework directive by the end of 2006. It is suggested that supplementary rules and guidelines could be adopted by 2008. Some changes to this timetable cannot be ruled out, however.

## IMF and assessments of the Norwegian financial sector

Norway has in 2004/2005 undergone an FSAP review (Financial Sector Assessment Program). FSAP is a joint programme under IMF and World Bank auspices, introduced in 1999, whose purpose is "to promote the soundness of financial systems in member countries". A number of countries have been FSAP-reviewed, including Iceland (2001), Finland (2001) and Sweden (2002).

The IMF has held meetings with Norwegian authorities (Ministry of Finance, Norges Bank and Kredittilsynet) and a number of financial institutions and trade associations. A key aspect of the FSAP is to assess Norway's observance of international standards and codes for banking, insurance and payment systems. The FSAP review will form the basis for the IMF's assessment of the stability of the Norwegian financial system. The assessments will be summed up in an FSSA (Financial System Stability Assessment) which may be published in the first half of 2005.

The Financial Action Task Force has, in January 2005, also completed an assessment of Norway's compliance with recommendations for combating money laundering and financing of terrorism.

# 4 Pension saving in life insurance companies

Chapter 4 of "The Financial Market in Norway 2003" focused on challenges faced by life insurance companies in their management of pension insurance assets in a low interest rate scenario. Developments in 2004 and so far in 2005 confirm that this is still a highly relevant issue.

Life insurers' mission in the area of pension insurance is to ensure that customer assets are managed in such a way that the agreed pensions can be paid when they fall due, in many cases 20-30 years ahead. Norwegian rules also require managed assets to yield an annual return at least corresponding to the annual interest guarantee agreed by the life insurance companies. Pension insurance is funded by premiums paid and by the return insurers achieve on their asset management.

This chapter gives particular attention to the challenge facing life insurers in their management of pension insurance assets. They have to reconcile two disparate requirements: that of applying a long-term management perspective and that of achieving a return each year that covers their interest rate guarantee.

## Weaker financial position for life insurance companies in 2000-2004

Interest rate and pension insurance contracts have a long duration since pension rights are accumulated at working age and are normally disbursed either annually from retirement age up to the policyholder's death or for a specified period. This category of contracts accounts for more than 90 per cent of total technical provisions. Norwegian life insurers have a fairly uniform insurance portfolio mix, and therefore approximately the same risk profile on the liability side.

Norwegian life insurers offer a range of products. Table 4.1 shows each product group's relative share of overall life insurance funds. Group life insurance is not included.

Products where the insurer offers an annual interest guarantee account for more than 95 per cent of life insurance companies' insurance funds. The interest guarantee on a contract lasting 30 years carries greater uncertainty than a contract lasting 10 years. Hence it is not only the size of the aggregate technical provisions that is of significance but also the profile of the underlying insurance contracts. Put simply, the companies' financial strength is a mirror image of their ability to handle uncertainty (risk) over time. Financial strength is affected by a company's risk-bearing capacity (buffer capital) and the nature of its technical liabilities. With equal buffer capital, a company with long-term technical liabilities has less financial strength, or risk-bearing capacity, than a company with short-term technical liabilities.

Table 4.1: Product categories in Norwegian life insurance companies. As per cent of aggregate life insurance funds as of 30.09.2004

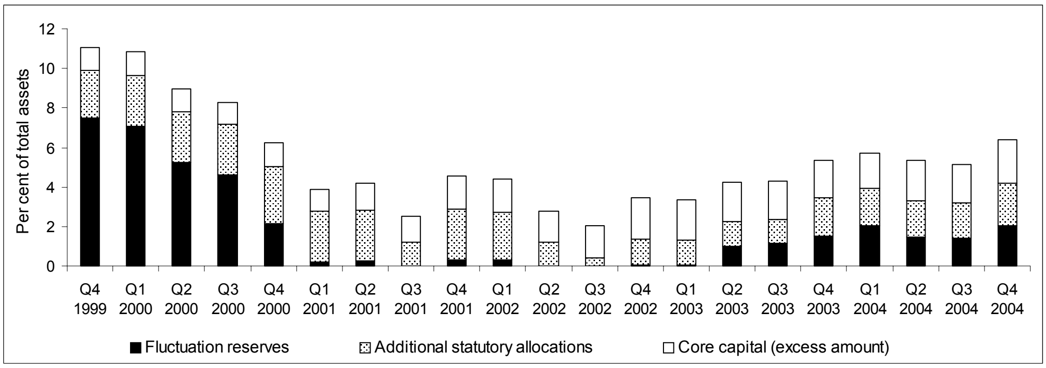
| Product category | As per cent of life insurance funds |
|---|---|
| Individual endowment insurance, guaranteed minimum annual return | 4.8 |
| Individual endowment insurance, unit linked | 0.6 |
| Individual pension insurance, guaranteed minimum annual return | 15.9 |
| Individual pension insurance, unit linked | 4.1 |
| Group pension insurance, guaranteed minimum annual return | 74.3 |
| Group pension insurance, unit linked | 0.3 |

Oslo Pensjonsforsikring AS is not included in this table.
Source: Norwegian Financial Services Association

# Life insurance companies' buffer capital

At the end of 2004 life insurers' buffer totalled NOK 32.5 billion or 6.4 per cent of their aggregate total assets. Although the share market recovery has added NOK 8 billion to their buffer capital since the end of 2003, their risk-bearing capacity as measured by the size of the buffer capital remains unsatisfactory.

Chart 4.1 Life insurance companies' buffer capital




In the period 2000-2002 life insurers' customer-generated buffer capital (fluctuation reserves and supplementary provisions) fell from close to 10 per cent of aggregate total assets to just under 2 per cent as a result of their asset management strategy and the share market slump. The downturn brought a substantial impairment of life insurers' financial position. Interest rates in Norway remained high, making interest-bearing securities a good alternative to investing in shares.

Between December 2002 and March 2004 Norges Bank cut its key rate from 7 per cent to 1.75 per cent. Life insurers guarantee that the assets backing their technical liabilities will yield 4 per cent interest each year on all premiums paid up to 1 January 2004, and 3 per cent on premiums paid after that date. The average guaranteed interest rate for the entire portfolio comes out at about 3.7 per cent.

Had life insurers at an earlier stage invested their assets in such a way that the duration of fixed income instruments mirrored their technical liabilities, the interest rate fall would have produced substantial capital gains, and any impact on their financial position would have been negligible. The duration of fixed income instruments at end-2004 was however far shorter than technical liabilities, with the result that life insurers' general financial capacity was significantly weakened in the period 2000-2004. Despite this, they could point to substantial accounting profits in 2003 and 2004, even though their de facto financial capacity to honour their contractual commitments was weakened in the period.

Kredittilsynet has in recent years called on life insurers to expand their buffer capital. Current rules – requiring an annual distribution of fair-valued profit to customers and owners, however such that parts of the profit can be recognised as supplementary provisions not distributed to customers with final effect – pose a challenge in terms of asset management and build-up of buffer capital. The concurrent obligation to pay an annual guaranteed return makes this an even larger challenge.

The current rules permit owners to take funds out of companies that have been financially weakened by falling interest rates over the past two to three years. By lowering the guaranteed minimum interest rate to 3 per cent on all premiums paid after 1 January 2004, Kredittilsynet took some account of the need to strengthen the capital base for new business. Kredittilsynet's action lowers the annual interest guarantee on pension assets allocated after 1 January 2004, concurrently with a general increase in the supply of new assets in the form of higher premiums.

Life insurers are not, on the other hand, permitted to reduce the interest rate guarantee on benefits already accumulated. This means that they have the same obligation as previously to deliver guaranteed interest on premium reserves accumulated prior to 1 January 2004, whereas their opportunities to achieve sufficient return on the invested funds have been reduced. The accounts fail to capture sufficiently mismatches between assets and liabilities in terms of debt size and duration and how debt is backed on the assets side.

Both Kredittilsynet and life insurers employ stress tests to assess insurers' ability to withstand unexpected, unfavourable market movements. Four stress tests, with a basis in the companies' capital buffer at end-2004, are illustrated below. They contain no information on the likelihood of the scenarios actually materialising.

**Scenario 1** is based on 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** is based on the following assumption: a 1.0 percentage point rise in Norwegian and international fixed income markets.
**Scenario 3** is based on the following assumption: a 2.0 percentage point rise in Norwegian and international fixed income markets.
**Scenario 4** is based on 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 1.0 percentage point rise in interest rates in Norwegian and international fixed income markets. The stress tests do not take real estate into account.

Table 4.2 Stress tests for life insurance companies as at 31.12.2004

| 31.12.2004 | Buffer capital before stress test | | Value fall in stress scenario, NOK billion | | | | Buffer capital after stress test | |
|---|---|---|---|---|---|---|---|---|
| | | | Equities | | Bonds | | | |
| | NOKbn | % of TA | Norwegian | Foreign | Norwegian | Foreign | NOKbn | % of TA |
| Scenario 1 | 32.5 | 6.4 | -5.1 | -10.7 | 0 | 0 | 16.6 | 3.3 |
| Scenario 2 | 32. 5 | 6.4 | 0 | 0 | -1.6 | -1.9 | 29.0 | 5.7 |
| Scenario 3 | 32.5 | 6.4 | 0 | 0 | -3.1 | -3.8 | 25.5 | 5.0 |
| Scenario 4 | 32.5 | 6.4 | -5.1 | -10.7 | -1.6 | -1.9 | 13.2 | 2.6 |

All life insurers have the buffer capital needed to withstand these scenarios. Stress tests of this type focus on the short-term effects of higher interest rates in the form of capital losses. In the longer term an increase in long rates will impact favourably on companies' results while persistent low rates will pose a substantial challenge to companies' ability to honour their commitments.

Table 4.3 shows life insurers' own projections of value-adjusted return and of the trend in buffer capital, based on a scenario in which both Norwegian and international interest rates remain at their low, end-2004, level up to the end of 2008. This scenario assumes no significant change in share markets in the period.

Table 4.3 Life insurance companies' expectations of return and buffer capital

| | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|
| Adjusted return | 6.9 % | 5.2 % | 5.0 % | 4.9 % |
| Buffer capital as % of total assets | 6.4 % | 5.8 % | 5.6 % | 5.4 % |

Figures for 2004 are based on preliminary figures from companies as of February 2005.

In the years immediately ahead insurers will benefit from their portfolio of bonds held to maturity, both in terms of annual return and accounting value. However, a scenario of persistent low interest rates could create substantial problems for their ability to generate sufficient return, given the insurers' own assumption for the trend in buffer capital shown in table 4.3. This constraint will apply both to investments in the share market and at the long end of the fixed income market.

Table 4.4 Holding as at 31.12.2004 of bonds classified as "held to maturity"

| | Maturing in 2005 | Maturing in 2006 | Maturing in 2007 | Maturing after 2007 | Total |
|---|---|---|---|---|---|
| Per cent of total assets | 2.6 % | 2.8 % | 3.2 % | 23.4 % | 32.0 % |
| Average interest rate | 6.7 % | 6.2 % | 5.7 % | 5.3 % | 5.6 % |

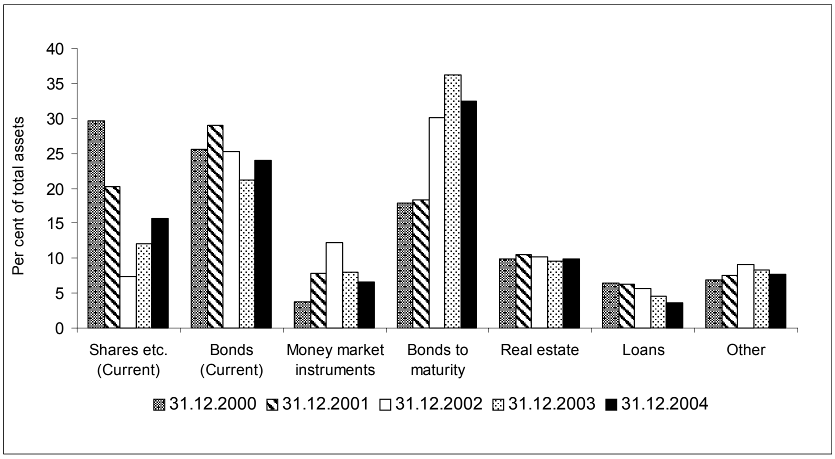
"Average interest rate" means interest taken to income as a per cent of the holding maturing in the period in question.

As part of its continual monitoring of life insurers' financial strength, Kredittilsynet has, in connection with the closing of accounts for 2004, contacted insurers about the application of their profit for the year. Kredittilsynet had considered instructing them to set aside funds for supplementary provisions, but decided not to on the basis of interviews that confirmed the insurers’ intention to largely devote profits to expanding their buffers.

## Life insurance companies' investment strategy

Norwegian rules governing the application of net profit give little opportunity to build up capital buffers rapidly. According to section 8-1 of the Insurance Activity Act, net profit must revert to the policyholders or to the beneficiaries of insurance contracts, unless otherwise provided by the insurer's articles of association. Life insurers may in addition set aside funds for supplementary provisions up to certain limits. Their buffers were far below the level desired at the end of 2004. Movements in life insurers' asset mix show how they have adjusted their investment strategy to a situation of low buffer capital, low interest rates and existing accounting rules.

Chart 4.2 Life insurance companies' balance sheet assets




Due to their low capital buffer position, life insurers were compelled to reduce the proportion of shares in their balance sheets in 2001 and 2002. They therefore benefited little from the vigorous share market upswing in 2003 and 2004. Investments in bonds classified as held to maturity have burgeoned. Bonds held as current assets have a duration of around four years, while for bonds classified as held to maturity the figure is about five years. This confirms that life insurers have ensured a portfolio asset mix making it highly likely that the requirement as to guaranteed return will be met in the years immediately ahead. The "held to maturity" portfolio assures a return of the order of 5.5-6.5 per cent in this period. The real estate portfolio, which accounts for about 10 per cent, has traditionally produced sound returns, and life insurers have signed long-term leasing agreements. The utilisation rate in terms of let space is also very high. Life insurers have by this means assured themselves a reliable return (far higher than the guaranteed interest rate) of close to 50 per cent of their total assets and can therefore permit the remainder of their assets to yield low or varying return. Only shares, and to some extent real estate, are by nature sufficiently long-term to match the companies' insurance liabilities. It could be argued that inadequate buffers are encouraging companies to engage in short-term asset management in order to meet their long-term pension commitments.

In 2003/2004 Kredittilsynet took the initiative to draft a programme for a new type of long-term pension insurance contract enabling quicker accumulation of buffer capital than is possible under existing rules. Larger buffers are a prerequisite for assuming larger risk in asset management. The model's principal feature is that it enables the retention of all net profit until the buffer capital reaches the desired size. The model also enables the policyholder to earmark all or parts of his/her premium fund as buffer capital in order for the buffer to reach the desired size more quickly. If necessary, additional payments to the premium fund would be permitted. However, this would require amendments to the Defined Benefit Pensions Act and possibly also to the Tax Act. When reviewing new life insurance legislation, Parliament's Standing Committee on Finance and Economic Affairs was favourably disposed to Kredittilsynet's model and asked the Ministry of Finance to come back to Parliament with any amendments that might be needed to achieve a smoothly functioning regime.

## Further details of long-term pension asset management

### Basic principles

Life insurers' financial strength is assessed on the basis of their ability to honour their insurance commitments as and when they fall due. Norwegian rules additionally require assets corresponding to the premium reserve to generate an annual return at least equal to the guaranteed interest.

The Insurance Activity Act section 7-4 first paragraph reads:

> *An insurance company shall provide for proper asset management. In order to fulfil its insurance obligations, an insurance company shall ensure that assets covering its technical provisions are at all times appropriately and satisfactorily invested with reference to the nature of the company's insurance obligations and in the interest of safety, risk diversification, liquidity and yield.*

The provisions of the Insurance Activity Act on asset management complement the basic rules for assuring financial strength. The intention is to ensure that a company can honour its insurance commitments regardless of market trends. Asset management must be conducted in such a way as to ensure that assets yield the required annual minimum rate of return and that sufficient funds are released when insured sums and pensions are to be disbursed. If asset management fails to do this, the company needs to ensure that it has sufficient free funds available (buffer capital) to eliminate any uncertainty. Risks that need to be offset by means of a buffer capital include market risk, credit risk, liquidity risk, currency risk, and reinvestment risk (which arises if funds are freed before ensured sums/pensions are disbursed and have to be invested anew).

### Asset characteristics

The matrix below shows important features of the most commonly used investment instruments. It shows whether assets invested in the various instruments will meet the required rate of return which the company has agreed with its policyholders and whether the value of the respective instruments at the maturity date matches the amount to be disbursed. For simplicity's sake it is assumed that the insured sum/pension is to be disbursed in its entirety in ten years' time.

A bond with a duration of ten years exactly mirrors the insurance contract when disbursement takes place in ten years' time. If the bond has a coupon rate higher or equal to the annual guaranteed rate, the coupon interest together with the bond's nominal value will be sufficient to meet the agreed insured sum/pension. (An assumption is that coupon interest can also be invested at a rate of return higher than or equal to the guaranteed rate in order for the overall amount to be sufficient to cover the agreed insured sum/pension.) A bond held to maturity ensures that the annual return it generates each year is sufficient to meet the interest guarantee commitment, as well as ensuring that the insured sum/pension can be disbursed at maturity. The drawback of this type of investment is the absence of any possibility of excess return. A bond held as a current asset with a duration of ten years will also ensure disbursement of the insured sum since the overall return generated in the period will be sufficient.

Table 4.5: Risk matrix

| Asset | Assurance that agreed sum will be paid upon maturity (=10 yrs) | Assurance that annual return will be higher than interest guarantee | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 1 yr | 2 yr | 3 yr | 4 yr | 5 yr | 6 yr | 7 yr | 8 yr | 9 yr | 10 yr |
| "Held to maturity", 10 yr | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Bond (current asset), 10 yr | Yes | No | No | No | No | No | No | No | No | No | No |
| Real estate with lease agreement, 10 yr | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| "Held to maturity", 5 yr | No | Yes | Yes | Yes | Yes | Yes | No | No | No | No | No |
| Real estate with lease agreement, 5 yr | No | Yes | Yes | Yes | Yes | Yes | No | No | No | No | No |
| Bond (current asset), 5 yr | No | No | No | No | No | No | No | No | No | No | No |
| Listed shares | No | No | No | No | No | No | No | No | No | No | No |

Investing in a long-duration bond held as the current asset is risky if interest rates in general are low at the time of investment. By experience, a well diversified share portfolio yields a sound return over time, even allowing for wide fluctuations in some years.

Since a bond held as a current asset will be valued each year, it will provide no guarantee of return sufficient to meet the annual interest guarantee. A current-asset bond will invariably offer possibilities of excess return in the form of capital gains, but will also be exposed to the risk of value falls should interest rates rise. A bond held as a current asset with a duration of three years will neither ensure that the insured sum can be disbursed nor that the required minimum guaranteed return can be honoured. Possibilities for excess return in the form of capital gains will, on the other hand, be present.

## Asset portfolio risk

There are various reasons why life insurance companies opt to invest in bonds with a short duration. One reason may be the expectation of higher interest rates. Bonds are valued each year, and the annual accounting return will comprise the coupon interest plus any change in market value. As will be seen from the risk matrix in table 4.5, such an investment only indicates possible overall return on the bond, not whether each year's return will suffice to meet the minimum interest guarantee. Moreover, the funds need to be reinvested for the remainder of the insured period, and there is no saying what the situation will be when the bond matures. Hence it is uncertain whether the return achieved will be sufficient both to meet the future interest guarantee and honour the insurance obligation.

Although the pension agreements established by the companies suggest that managed assets should be invested in instruments reflecting the duration of the commitments entered into, neither the insurance contracts as such nor Section 7-4 first paragraph of the Insurance Activity Act is necessarily any obstacle to the investment behaviour now practised by life insurers. The requirement that they maintain an investment strategy ensuring their ability to meet their insurance commitments stands firm, however. Insurers must, in principle, have a buffer capital sufficient to withstand changes that may arise in the securities market throughout the insured period, unless this has already been taken into account in the choice of assets.

The following situations may arise if parts of assets under management are invested in fixed income instruments with a short duration:

a) *Rising interest rates*. In this situation it is an advantage to have invested in fixed income instruments with a short duration. Short duration means a smaller capital loss if interest rates rise, and funds can be reinvested at a higher rate of interest.
b) *Unchanged interest rates*. In this situation the company must have considered in advance whether to invest funds on a permanent basis or opt for a new short-term period to see if interest rates go up.
c) *Falling interest rates*. In this situation the company must have considered in advance how to ensure that it has funds available to meet its technical liabilities.

Interest rates in Norway, as in most countries, are currently low. Norwegian 10-year government bonds generate an annual return of just under 4 per cent. Norwegian government bonds with a longer duration do not exist. Given their current low level, any change in interest rates is likely to be upwards. The possibility that interest rates will remain at a very low level cannot be ruled out, however.

There is not necessarily any advantage attached to investing in a fixed income instrument with shorter duration compared with investing in the same instrument but with a duration which precisely matches the insurance commitment. Choosing a shorter duration pushes risk further ahead, and total risk is probably likely to increase. The advantage of the latter choice, however, is that it increases the likelihood of excess return and reduces uncertainty associated with fluctuations in the fixed income market further into the future. Where pension insurance is concerned, bonds with a duration longer than ten years will often be needed. The implication here is that funds managed by Norwegian life insurers may have to be reinvested several times before the pensions are disbursed. This makes for additional uncertainty which companies have to take into account when considering their need for buffer capital.

Shares differ from bonds in that their duration is virtually unlimited. Moreover, their annual return depends on their market value over the year. Provided they are liquid, shares can be said to precisely reflect the duration of the insurance contract, although they do not meet the requirement of a return that is at least equivalent to the annual guarantee or the requirement that the value of the funds upon expiry of the insured period matches a particular insured sum/pension. In many other countries a large, differentiated share portfolio is the main instrument employed to fulfil long-term pension commitments and at the same time generate excess return over time, thereby keeping down pension costs.

Real estate possesses characteristics of both bonds and shares. As in the case of bonds, the investor is assured an annual rate of return so long as he/she has an agreed rental contract. Once the rental contract expires, return is dependent on the signing of a new or extended rental contract and on the market value of the property itself.

## Challenges ahead

In recent years life insurers in Norway and elsewhere have faced major challenges as a result of sharp fluctuations in share markets combined with unprecedented low interest rates. Buffer capital were accordingly pushed down towards the statutory minimum in the period 2000-2002, and some international companies, including in the United Kingdom and Germany, were particularly hard hit.

In the wake of these unforeseen events, some foreign supervisory authorities have introduced new, more sophisticated rules and methods to monitor life insurers' financial position. The Netherlands, the United Kingdom and Switzerland have opted not to await completion of the EU regime of solvency measurement and supervisory methodology, Solvency II, and are implementing their own models whose characteristics are assumed to be fundamental to Solvency II as well. Key to these new models is the fact that they fix market values for liabilities and assets alike, substantially extend the scope of current stress tests and project profit and balance sheet figures. The models devote particular attention to long-term liabilities associated with pension saving, but also cover other life insurance products.

The work on Solvency II and international financial reporting standards (IFRS) is likely to lead to agreed standards for determining market values of both assets and liabilities. EU rules on cross-border activity also imply a move in the direction of a wider generalised harmonisation of rules and of aspects of product design. It is difficult to conceive that Norwegian rules governing premium calculation and reservation based inter alia on a fixed discount rate (guaranteed minimum rate of interest), a one-year interest guarantee and full unit-linked cover at all times, can be taken forward in the longer term without substantial changes or additions to meet forthcoming international requirements in respect of provisions and capital buffers in the field of pension insurance.

Kredittilsynet participates in a number of EU expert groups engaged in drawing up new rules for insurance within the EU, and will continue to consider how ongoing processes, for example in the Netherlands, can be turned to account in measuring the solvency of Norwegian life insurers within the framework of current rules. The result of the new requirements in respect of insurance business, introduced by Solvency II, may be that companies, to an even greater extent than at present, switch their offerings to products with reduced guarantees, lower requirements as to owner-exposed capital buffers and less risk in general. Use of hedging instruments to reduce investment risk in fixed income and equity markets could gain even greater currency than at present.

Norwegian rules have gradually moved in the direction of market valuation of assets. The Bank Law Commission and other bodies engaged in revising the legislation have so far not considered market value adjustment of liabilities beyond the opportunity presently available to adjust the technical guaranteed interest rate.

Whereas Norwegian life insurers can to an extent await the result of initiatives taken by the EU Commission through Solvency II, they will over the next two or three years need to adjust to requirements and opportunities embodied in an amended insurance activity act. Parts of the new act affect the distribution of risk between the insurer and the insured, and thereby in principle also the financial strength of the insurer. The new legislation will also require life insurers to comply with the requirement of an annual return that meets the interest guarantee commitment, and at the same time ensures that they can meet their insurance obligations as and when they fall due.

Under the new rules, policyholders will pay in advance a separate premium in respect of the interest guarantee. For their part, insurers will be required to fulfil the interest guarantee, although policyholders' supplementary provisions will be available for this purpose before insurers have to deplete their equity capital. Supplementary provisions will not constitute a solidary capital buffer under the new rules since supplementary provisions associated with a contract will no longer be available to make good a shortfall in return on another contract.

How far insurers will avail themselves of the opportunity provided by the new rules to allocate pension assets to a range of portfolios with differing investment strategies is uncertain. It is conceivable that clients with a substantial buffer in the form of supplementary provisions that have already been registered to account will be in a position to negotiate a lower premium for the interest guarantee than clients who are unable to furnish their own risk capital, given an identical asset mix. It is also conceivable that policyholders will oppose the build-up of excessively large supplementary provisions, knowing that these provisions can wholly or in part be used to cover insurers' interest guarantee and that the guarantee has already been paid for.

## ANNEX

### *The Financial Market in Norway in 2004: Risk Outlook* – Kredittilsynet

# Selected result items and balance-sheet items for Norwegian financial institutions

(Foreign branches in Norway are not included)

Table 1 Banks: selected result and balance-sheet items

| | 2001 | | 2002 | | 2003 | | 2004 | |
|---|---|---|---|---|---|---|---|---|
| | NOKm | % of ATA | NOKm | % of ATA | NOKm | % of ATA | NOKm | % of ATA |
| Net interest revenues | 29 578 | 2.20 | 31 101 | 2.19 | 30 518 | 1.98 | 31 052 | 1.89 |
| Other revenues | 13 010 | 0.97 | 9 698 | 0.68 | 13 700 | 0.89 | 14 799 | 0.90 |
| Other expenses | 24 790 | 1.85 | 25 055 | 1.76 | 25 487 | 1.65 | 26 272 | 1.60 |
| Book losses | 3 721 | 0.28 | 7 560 | 0.53 | 6 892 | 0.45 | 1 232 | 0.07 |
| Result of ordinary operations before tax | 13 941 | 1.04 | 8 267 | 0.58 | 12 023 | 0.78 | 19 889 | 1.21 |
| Result of ordinary operations after tax | 11 727 | 0.87 | 5 859 | 0.41 | 9 261 | 0.60 | 14 925 | 0.91 |
| | NOKm | % of TA | NOKm | % of TA | NOKm | % of TA | NOKm | % of TA |
| Total assets | 1 356 512 | | 1 461 528 | | 1 568 960 | | 1 661 429 | |
| Gross loans to customers | 1 057 352 | 77.9 | 1 119 898 | 76.6 | 1 197 603 | 76.3 | 1 311 278 | 78.9 |
| Deposits and debt from clients | 732 900 | 54.0 | 792 844 | 54.2 | 814 910 | 51.9 | 886 904 | 53.4 |
| Tier 1 capital adequacy | 9.7 | | 9.6 | | 9.7 | | 9.7 | |

ATA: average total assets TA: total assets

Table 2: Life insurance companies: selected results and balance-sheet items

| | 2001 | | 2002 | | 2003 | | 2004 | |
|---|---|---|---|---|---|---|---|---|
| | NOKm | % of ATA | NOKm | % of ATA | NOKm | % of ATA | NOKm | % of ATA |
| Premium revenues for own account | 38 305 | 9.6 | 42 780 | 10.5 | 44 990 | 10.3 | 56 998 | 11.8 |
| Net revenues from financial assets | 3 890 | 1.0 | 7 275 | 1.8 | 36 441 | 8.3 | 31 812 | 6.6 |
| Claims | 27 737 | 7.0 | 27 882 | 6.8 | 29 610 | 6.8 | 31 639 | 6.5 |
| Change in technical provisions | 20 314 | 5.1 | 23 946 | 5.8 | 29 327 | 6.7 | 37 655 | 7.8 |
| Result before new supplementary provisions, allocation to policyholders and tax | 936 | 0.2 | -2 434 | -0.6 | 11 201 | 2.6 | 11 689 | 2.4 |
| Change in fluctuation reserves | -6 630 | -1.7 | -1 025 | -0.3 | 6 818 | 1.6 | 3 488 | 0.7 |
| Value-adjusted result before new supplementary provisions, allocation to policyholders and tax | -5 694 | -1.4 | -3 459 | -0.8 | 18 019 | 4.1 | 15 177 | 3.1 |
| | NOKm | % of TA | NOKm | % of TA | NOKm | % of TA | NOKm | % of TA |
| Total assets | 394 656 | | 414 154 | | 459 188 | | 508 991 | |
| Bonds held to maturity | 72 548 | 18.4 | 124 673 | 30.1 | 166 206 | 36.2 | 165 405 | 32.5 |
| Equities and units (current assets) | 80 127 | 20.3 | 30 497 | 7.4 | 55 440 | 12.0 | 79 812 | 15.7 |
| Money market instruments and bonds (current assets) | 145 945 | 37.0 | 155 530 | 37.6 | 134 297 | 29.3 | 155 791 | 30.6 |
| Buffer capital | 17 973 | 4.5 | 14 274 | 3.4 | 25 266 | 5.5 | 32 477 | 6.4 |

Table 3: Non-life insurance companies (three largest non-life groups): selected result and balance-sheet items

| | 2001 | | 2002 | | 2003 | | 2004 | |
|---|---|---|---|---|---|---|---|---|
| | NOKm | % PFO | NOKm | % PFO | NOKm | % PFO | NOKm | % PFO |
| Premium revenue for own account | 14 424 | | 16 326 | | 18 746 | | 20 985 | |
| Allocated investment return | 1 789 | 12.4 | 1 846 | 11.3 | 1 526 | 8.1 | 1 029 | 4.9 |
| Claims expenses for own account | 12 033 | 83.4 | 13 286 | 81.4 | 14 807 | 79.0 | 14 368 | 68.5 |
| Operating expenses for own account | 3 501 | 24.3 | 3 963 | 24.3 | 4 245 | 22.6 | 4 316 | 20.6 |
| Change in contingency provisions etc | 766 | 5.3 | 1 224 | 7.5 | 1 061 | 5.7 | 1 064 | 5.1 |
| Result of technical account | -61 | -0.4 | -276 | -1.7 | 186 | 1.0 | 2 289 | 10.9 |
| Net financial revenues | 320 | 2.2 | 1 048 | 6.4 | 4 749 | 25.3 | 1 508 | 7.2 |
| Allocated investment return (transferred to technical account) | 1 789 | 12.4 | 1 846 | 11.3 | 1 526 | 8.1 | 1 029 | 4.9 |
| Result of ordinary operations | -1 553 | -10.8 | -1 175 | -7.2 | 3 404 | 18.2 | 2 764 | 13.2 |
| | NOKm | % of TA | NOKm | % of TA | NOKm | % of TA | NOKm | % of TA |
| Total assets | 39 184 | | 40 674 | | 48 745 | | 55 278 | |
| Equities and units (current assets) | 7 265 | 18.5 | 1 544 | 3.8 | 3 141 | 6.4 | 2 619 | 4.7 |
| Bonds and money market instr. (total) | 12 718 | 32.5 | 22 487 | 55.3 | 26 148 | 53.6 | 35 876 | 64.9 |
| Technical provisions | 25 166 | 64.2 | 28 157 | 69.2 | 32 062 | 65.8 | 35 676 | 64.5 |

PFO: premium revenue for own account