KREDITTILSYNET
The Financial Supervisory Authority of Norway

The Financial Market in Norway 2006

Risk Outlook

The report gives an account of the situation in financial institutions in light of economic and market trends, and assesses possible sources of future stability problems in the Norwegian financial system.

The Financial Market in Norway 2006: Risk Outlook

Unless otherwise stated, Kredittilsynet is the source of charts and tables. Cut-off date 20 February 2007.
This report is the full version of the Norwegian report *Tilstanden i finansmarkedet 2006*, published 28 February 2007.

Introduction

The financial system redistributes capital and risk and attends to payment and settlement functions. Financial stability, well functioning markets and confidence in the financial system are needed if these functions are to be discharged in a satisfactory manner. Through its supervision of firms and markets, Kredittilsynet contributes to financial stability and well functioning markets.

In recent decades many countries, including most Nordic countries, have seen serious problems in their financial sectors, with substantial costs for society. The experiences of a number of countries show that vigorous and persistent credit growth combined with sharply rising prices in real estate and asset markets makes the financial system more vulnerable to macroeconomic shocks and other unforeseen events. Imbalances, which are just as likely to accumulate in periods of low and stable inflation as otherwise, may be difficult to identify – all the more so if accompanied by structural changes. During protracted cyclical upturns financial institutions, consumers and investors are likely to underestimate risk. The presence of sound financial institutions with good internal control and risk management is key to ensuring financial stability.

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 backdrop of the general state of the financial system.

Highlights

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

- Norwegian banks posted very good results for 2006. No overall losses were recorded and, as in 2005, the cost trend was favourable. The sector's financial position remains satisfactory and, particularly at larger banks, much attention is given to further developing risk management. Banks are in a very favourable situation, and prospects for 2007 are good. However, they face some challenges in the longer term. Intense competition and falling interest margins continue to put net interest revenues under downward pressure and may at some point pose a challenge to earnings. The strong growth in lending imposes high demands on banks' risk management. The steep rise in indebtedness and house prices heightens banks'

credit risk and the likelihood of losses when economic conditions turn less favourable. The household debt burden is very high and is rising. Kredittilsynet's autumn 2006 home loan survey shows that two-thirds of mortgages for house purchases exceeded 80 per cent of property valuation. Concurrently mortgage repayment periods lengthened, more borrowers asked for interest-only payments and the proportion of fixed-interest borrowing decreased. A more sober lending regime would be an advantage for banks and the housing market alike in the longer term. The steep increase in lending to firms calls for thorough credit assessment in the corporate area.

- Life insurance companies' results rose in 2006, driven particularly by the share market upturn, and buffer capital strengthened. At year-end equity holdings made up 26 per cent of life insurers' balance sheet assets, the highest level since 2000. Rising equity holdings and buffer capital laid a basis for improved long-term return on assets under management, and a slight rise in long interest rates in 2006 improved the outlook for life insurers. While the largest non-life insurance companies posted good results in 2006, weak growth in premium earnings and weaker technical results reflect keen competition in the non-life market. Requirements on insurers' capital are set to rise with the advent of a new solvency framework (Solvency II, to be introduced in 2010 at the earliest) and new accounting rules giving greater emphasis to fair value (IFRS).

- A new capital adequacy framework (Basel II) can promote financial stability by encouraging better risk management and a distribution of capital among institutions that does more to reflect differences in risk. Transitional rules will prevent banks' capital from falling by an unwarranted margin in the next few years as a result of lower minimum requirements. In assessing their overall capital needs banks must be prepared to handle cyclically sensitive capital requirements, and make sufficient allowance for an economic downturn and possibly more difficult access to capital. The new accounting rules entail lower write-downs compared with earlier loss provisioning, which in isolation increases the requirements on own funds. There is a risk that in the medium term banks will reduce their capital to the point where their buffer against unforeseen events falls below the desired level.

- Growth in the Norwegian credit market has been substantially stronger than growth in the wider economy, especially in recent years. The increased debt exposure is partly a result of the upturn in the Norwegian and international economy, but also reflects a structural adjustment in the wake of the banking crisis to liberal, open markets featuring greater competition and financial innovation. The economic climate and structural change may also have laid the basis for excessive debt, however. Both long and short real interest rates have been very low for several years, and there is little experience in dealing with the effects of a persistent low interest rate level in a liberalised market. In several countries low inflation, low interest rates and rapid credit growth have been accompanied by strong growth in house prices, driven partly by expectations of continued low interest rates and steadily rising house prices. How far recent years' credit expansion reflects long-term structural changes is highly uncertain. There is a danger that rising indebtedness and house prices are not just a natural

structural adjustment, but that imbalances have been created along with a risk of corrections and potential financial stability problems.

Summary

World economic growth remains high, and overall the upturn was stronger in 2006 than in the previous year. With rising activity levels in the Euro area, this development is more evenly distributed than previously. The upturn is continuing in most emerging markets and developing countries, led by China, India and Russia. Growth rates in the Nordic countries exceed those elsewhere in western Europe. The price of oil and several other commodities remains high. Even so, inflationary pressures in the OECD area are low, mainly thanks to globalisation and monetary policy emphasis on inflation management. The major forecasting institutes expect a slight dampening of growth in the world economy in 2007 due to lower activity levels in the OECD area. The US housing market, global imbalances in goods and capital flows and a persistent high oil price make for uncertainty about developments ahead.

Money market rates are affected by the continuing rise in the key lending rates of most central banks. Between July 2004 and July 2006 the US key rate was raised by 4.25 percentage points to 5.25 per cent. Long US rates appear to be little influenced by the key rates, and the US interest rate curve is downward sloping. US bond rates rose marginally in 2006 to 4.7 per cent at year-end. The European Central Bank raised its key rate in December 2005 for the first time in five years, and a favourable trend in the Euro area has since then prompted five rate increases, bringing the key rate to 3.5 per cent. Since July 2005 Norges Bank (the Central Bank of Norway) has raised its key rate by 2 percentage points to 3.75 per cent, and further increases are expected. Norwegian long rates have largely shadowed their counterparts, but at slightly lower levels. At the end of 2006 the rate on Norwegian 10-year government bonds was 4.4 per cent, and a slight increase has been in evidence up to mid-February 2007. International equity markets dipped sharply in May, but picked up again on the back of strong corporate results and good growth prospects, especially in Europe. The US market climbed 13.5 per cent in 2006, compared with a rise of 19.7 per cent in the Euro area. Oslo Børs also tumbled in May, although all in all the year proved a good one for Norwegian share prices with a 32.4 per cent rise in the Oslo Børs Benchmark Index. Equity markets continued their upturn into 2007.

The boom in the Norwegian economy strengthened further in 2006, fuelled by strong growth in oil investment, and gradually also by mainland (non-oil) investment and a sustained expansionary monetary and fiscal policy stance. Revised national accounts figures show that growth since 2004 has been stronger than previously assumed. Adjusted for indirect taxes and energy, consumer price inflation remains extremely low, indeed far below Norges Bank's target. Low interest rates combined with a favourable labour market trend have stimulated activity in the housing market, causing house prices to accelerate in 2006: in January 2007 the 12-month growth in house prices topped 19 per cent. Employment rose sharply and joblessness decreased through 2006 to 2.1 per cent in December. The jobless rate fall and increased wage pressures reflect a high activity in the economy. The boom is also reflected in credit growth. In 2006 households' credit growth maintained a stable high level, while the

corporate sector substantially stepped up its rate of borrowing. The vigorous growth in domestic credit to firms is strengthened by borrowing abroad. The market for commercial property also picked up in 2006, with a marked increase in sales prices. Office vacancies decreased and rental prices rose, especially in the case of upmarket premises.

Growth in credit to households has far exceeded their income growth for several years, steeply increasing the debt burden. Recent years' low interest burden is also set to rise due to the ongoing normalisation of interest rates combined with continued rising indebtedness. Households' wealth has risen substantially in recent years, due above all to the steep rise in house prices. However, the saving rate declined appreciably in 2006, and financial saving turned negative. Households show wide variation both in terms of debt burden and financial wealth, the lowest age groups being particularly exposed. According to Kredittilsynet's home loan survey, as regards loans for home purchases, as much as 77 per cent of Norwegian households under the age of 35 borrowed more than 80 per cent of the dwelling's value, and 37 per cent borrowed in excess of property valuation. While corporate profits have risen substantially throughout the period of economic expansion, diminishing the debt burden, substantially higher borrowing will probably gradually reverse this effect. Kredittilsynet's survey of banks' exposure to selected industries shows a decline in high-risk commitments in most sectors. Firms' interest burden fell substantially with falling interest rates, but this will also reverse in the years immediately ahead with rising interest rates and increased indebtedness.

Large financial groupings hold high market shares in the Norwegian financial industry, especially in banking, securities funds and life insurance. The largest Norwegian financial conglomerate, DnB NOR, is smaller than its largest Nordic counterparts. Foreign actors have gained increasing influence in the Norwegian market in recent years as a result of acquisitions and appreciably higher lending growth than their Norwegian competitors.

Banks can point to very good results in recent years. Results in 2006 were also excellent. While continued write-backs of losses and a favourable cost trend contributed to improved results in 2006, lower interest margins reduced the ratio of net interest earnings to totals assets. The spread in results between individual banks has narrowed, and at the end of 2006 only one newly established bank showed an accounting loss. Bank lending growth has quickened markedly in the last couple of years, and growth was particularly high in 2006, reaching about 19 per cent by year-end after adjustment for portfolio transfers. Above all foreign-owned branches sharply increased their lending in the Norwegian market. Whereas retail customers previously accounted for the strongest growth, lending to corporate customers was far higher in 2006. Despite high lending growth, banks' tier 1 capital adequacy has been relatively stable in recent years, but was reduced in 2006 owing to the strong growth in corporate sector loans with a high risk weighting. Calculations show that the introduction of the new capital adequacy framework (Basel II) as from 2007 will substantially reduce the minimum capital requirements. Transitional rules for the largest banks that have applied to use advanced methods for calculating capital charges will prevent a large fall in 2007-2009. In assessing their overall capital needs, banks will have to allow for all risk attending their activities, and ensure that sufficient allowance is made for an economic downturn. Several years of high lending growth combined with increasing competition for depositors' funds has brought a gradual decline in banks' deposit-to-loan ratios. Banks' long-term funding has nevertheless remained relatively stable in recent years.

Life insurance companies' value-adjusted results rose from 2005 to 2006, thanks in particular to the strong upturn on equity markets in the second half year. Buffer capital declined markedly in the second quarter, but picked up again in the second half year. At end-2006 buffer capital measured 8.2 per cent of total assets compared with 7.5 per cent one year previously, an increase due both to higher fluctuation reserves and higher supplementary provisioning. Impaired risk-bearing capacity prompted life insurers to reduce their share exposures in 2000 to 2002 while expanding their holdings of bonds classified for accounting purposes as held to maturity. In the ensuing four years life insurers once again increased their equity component, to 26 per cent at the end of 2006, of which 59 per cent was invested in foreign shares. Bonds held to maturity accounted for 27 per cent of the portfolio at the end of 2006, with an interest rate averaging 5 per cent. About three-quarters of this portfolio, with an interest rate averaging 4.7 per cent, falls due after 2009. Just over half of the bonds held to maturity are foreign.

Pension funds' return on capital was somewhat lower in 2006 than the previous year, but nonetheless far higher than that recorded by life insurance companies. This was particularly true of private pension funds whose exposure to equity markets is significantly higher than that of life insurers and municipal pension funds.

The largest non-life insurance companies' result of ordinary operations was somewhat weaker in 2006, despite higher financial revenues. Growth in premium revenues was reduced, and the ratio of claims expenses to premium revenues (claims ratio) rose in 2006. A weaker trend in technical results reflects keen competition in non-life insurance markets.

Finance companies achieved about the same result in 2006 as in the previous year. Lower loan losses and a rise in net interest revenues were negated by higher costs. Finance companies' result trend has been relatively stable over the past seven years. Mortgage companies recorded a virtually unchanged result in relation to total assets.

A sharp increase in share prices and high activity on Oslo Børs brought a significant revenue increase for investment firms in 2006. A particularly strong increase was seen in issuance and advisory business and revenues from broking of equity and debt instruments. Companies managing securities funds recorded a 28 per cent increase in operating revenues in 2006.

Prospects for financial institutions in 2007 are good. A positive trend in securities markets has left life insurers in a better situation now than four to five years ago. However, life insurers still face challenges posed by relatively low long interest rates. Low buffer capital leaves their risk-bearing capacity at levels insufficient to warrant a further increase in the equity component. Despite diminishing average interest rates on bonds held to maturity, life insurers have secured satisfactory current return ahead by investing almost a third of their portfolio in this type of instrument.

The banks are currently in a favourable situation. Profits are excellent, and a very low and falling level of non-performing loans points to continued low losses ahead. However, mounting risk in some areas could increase losses and impair profits in the somewhat longer term. Absence of losses in an economic upturn may impair vigilance, and the steep growth in lending places heavy demands on risk management. Households' credit growth has been very high for seven years while income growth has been comparatively moderate. The debt burden has passed the end-1980s level and in 2007 debt will

already be well over twice the level of aggregate income. In the past year growth in lending to the business sector has also risen sharply to levels last seen in the eighties.

Several years of low interest rates, together with rising employment and incomes, have fuelled vigorous house price increase followed by rapid growth in household indebtedness. In 2006 growth in house prices was unusually strong and higher than suggested by real economic factors. Hence the trend is probably heavily influenced by expectations of a continued rise in prices. This perception is supported by Kredittilsynet's home loan survey in autumn 2006 which shows that a third of loans for house purchase exceeded property valuation. Household indebtedness and house prices have now reached a level at which even minor, negative shocks could trigger a setback. An increased supply of new housing could contribute to levelling off house prices, and should sentiment change, this could trigger a price fall. Households' financial vulnerability will grow the longer house prices and debt continue to rise. Their vulnerability is compounded by a very low share of fixed-interest borrowing and growing demand for interest-only mortgages. Calculations show that even if credit growth declines slightly from its current level, a mortgage interest rate of 7 per cent at the end of 2008 would compel more than 500,000 households (one in four) to spend more than one-fifth of their income on interest payments. Repayment of principal is not included in the calculations. There is a large spread between households, with above all younger and low-income groups carrying a heavy debt burden. Norwegian banks and the Norwegian economy are significantly better positioned than in the 1980s, and the risk of a banking crisis is small. However, should more of the latest entrants to the housing market encounter problems in servicing their mortgages, bank losses could increase. The spill-over effects to business and industry caused by households being compelled to reduce their consumption in order to service debt could inflict heavier losses on banks than those directly related to home loans.

The rapid acceleration of growth in lending to the corporate sector in 2006 reflects the boom in the economy. Hence a number of projects now being financed could lead to overcapacity in parts of the business sector in a couple of years' time. It is vital for banks to undertake thorough credit assessment in the corporate area. A more restrictive policy on lending for housing purposes is clearly desirable. Deferring tightening action until after house prices have peaked could intensify the downturn. Banks need to ensure good information to their customers, and households must think through the consequences that negative changes in the economy could have for their personal finances. A clear path has been marked out for a gradual normalisation of the interest rate over the next couple of years. A somewhat quicker rise in interest rates than that signalled will reduce the risk of house prices and indebtedness growing to a level at which a marked correction cannot be avoided. Consideration for the financial system and for the wider economy calls for continued measures to achieve a non-discriminatory taxation of various types of financial wealth and property. A high oil price and sharply rising employment are also spurring high growth in public revenues. It is important to stick to adopted central and local government spending limits and not to devote increased revenues to heavier spending that will further stimulate the economy in a period of labour shortages. In an economic boom in which capacity limits are being reached in area after area, expansionary economic policy is likely both to build up vulnerability in the financial system and to set the stage for an economic setback which could bring this vulnerability to the surface.

1. Markets and economic trends

The world economy continued to expand rapidly in 2006, as previously, and global GDP in the three years 2004-2006 grew by 16 per cent. Underlying growth rates appear particularly buoyant in Asia. Rising activity levels in Europe have now brought a more balanced look to the growth picture among industrialised countries. The IMF puts global growth at 5.1 per cent in 2006 and 4.9 per cent in 2007. In the same period the OECD expects GDP growth in the OECD area of 3.2 and 2.5 per cent respectively. Most forecasting institutes expect a slowdown ahead, albeit moderate. If the structure of the global growth pattern is maintained, the existing imbalances in goods and capital flows will continue. The global imbalances, the US housing market and persistent high prices of oil and other commodities, make for considerable uncertainty about the further development of the world economy.

Table 1.1 Growth forecast

	USA		Euro area		Japan		Norway	
	2006	2007	2006	2007	2006	2007	2006	2007
GDP	3.3	2.4	2.7	2.0	2.2	1.8	4.2*	2.4*
Inflation	3.2	1.8	2.2	2.1	0.2	0.3	2.3	0.8
Unemployment	4.7	4.8	7.8	7.5	4.1	3.9	3.5	3.0

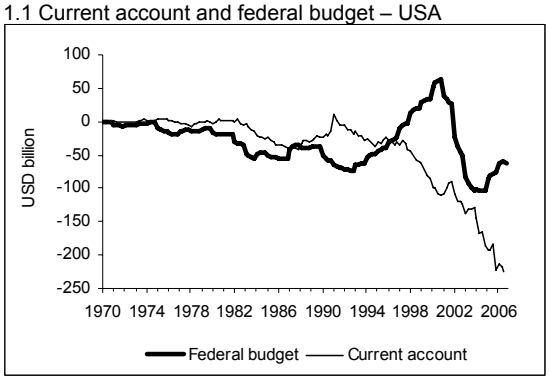
*GDP for mainland (non-oil) sector.
Sources: Consensus Forecasts, January 8, 2007 and Economic Survey 4/2006, Statistics Norway.

After high GDP growth in the US since the start of 2002, autumn 2006 brought signs of a weaker trend, particularly in the housing market. Housing starts and sales fell, while price inflation levelled off. Preliminary national accounts figures show GDP growth of 3.4 per cent in 2006. Growth in private consumption, which has been an important driver for several years, remains high. The labour market improved substantially in 2006. The economic boom has been accompanied by low wage growth and excellent earnings in American business and industry, which has stimulated corporate investment. Somewhat higher price inflation in 2006 was due above all to electricity prices, and with a target interest rate of 5.25 per cent, the Federal Reserve Bank is thought to have reached the peak of the interest rate curve in the present economic upturn. Rising consumption also stimulated imports last year, and the trade deficit continued to deepen, and at end-2006 the current account deficit was put at 6.5 per cent of GDP. China accounts for 25 per cent of the deficit, Japan and the EU for about 12.5 per cent each. The risk attending the US external balance caused the dollar to depreciate by 11 per cent against the Euro in the course of 2006. Forward exchange rates indicate a continued weakening of the dollar in the course of 2007 and 2008.

China continued to fund the US trade deficit in 2006, and has accumulated a currency reserve of USD 1,000 billion, most of it placed in the same currency. GDP growth in 2006 was all of 10.7 per cent, the fourth straight year of double-digit growth. China's GDP now accounts for more than 15 per cent of global GDP, adjusted for price differences. The Chinese authorities have initiated tightening measures

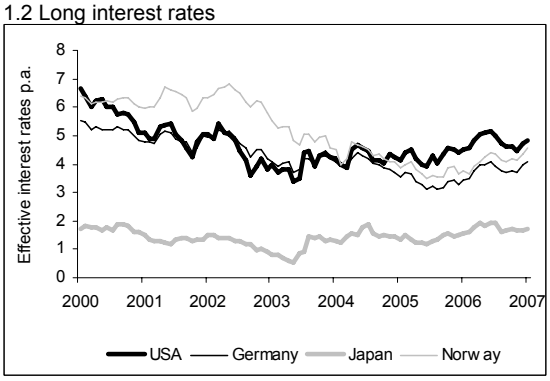
to counter overheating. China's growth has powerful spillover effects to its neighbours, and both the Chinese and the Asian domestic market expanded strongly in 2006. Even so, China's export growth is still exceptionally high: in 2006 its trade surplus increased by 27 per cent to USD 177 billion, or just over 5 per cent of GDP. A strong external economy continues to exert upward pressure on the Chinese currency and this, together with the real estate market, appears to represent the largest risk factor in the Chinese economy.

1.1 Current account and federal budget – USA



Source: Reuters EcoWin

1.2 Long interest rates



Source: Reuters EcoWin

Preliminary national accounts figures show 2.3 per cent GDP growth in Japan in 2006. There appears to be a continued sound basis for growth, with the jobless rate down towards 4 per cent, the lowest level for seven years, continued high investment growth and corporate earnings approaching the record level seen at the end of the 1980s. In summer 2006 the Bank of Japan raised its key rate to 0.25 per cent, ending five years of zero interest-rate policy. While the yen remained stable against the dollar in 2006, it weakened against the Euro.

Sentiment in Europe now appears buoyant in firms and households alike, despite some structural problems. The cyclical upturn is driven by growth in exports and investment. Preliminary figures show GDP growth of 2.8 per cent in the Euro area in 2006, and unemployment fell to 7.5 per cent in December. Above all Germany shows a good trend, with GDP growth of 2.9 per cent in 2006. Although core inflation remains low, rapid money supply growth prompted the European Central Bank to raise its key rate to 3.5 per cent, strengthening the Euro against both the dollar and the yen.

Table 1.2 Growth forecast

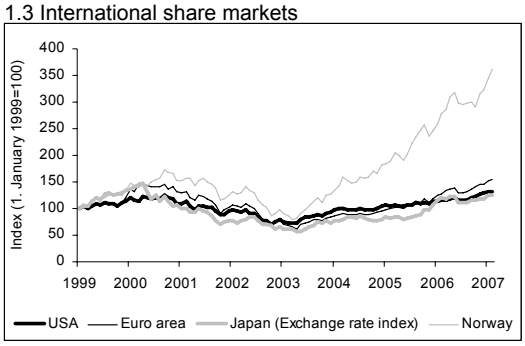
	Sweden		Denmark		Finland		Iceland	
	2006	2007	2006	2007	2006	2007	2006	2007
GDP	4.4	3.3	3.3	2.6	4.8	2.9	3.6	1.0
Inflation	1.4	2.0	1.9	2.0	1.5	1.8	6.8	3.7

Sources: Consensus Forecasts, January 8, 2007 and OECD Economic Outlook No. 80, Nov. 2006.

Economic prospects for the Nordic region remain broadly favourable. In both Sweden and Finland growth in 2006 was very good, but with prospects for a somewhat weaker trend in 2007. In Denmark too the economy is faring well, with low unemployment and moderate inflation. House price growth in Denmark has been high for some time, but is now showing signs of abating. In Iceland the key rate has been raised to 14.25 per cent to prevent economic overheating, and the OECD has pointed out that the country may be facing a recession.

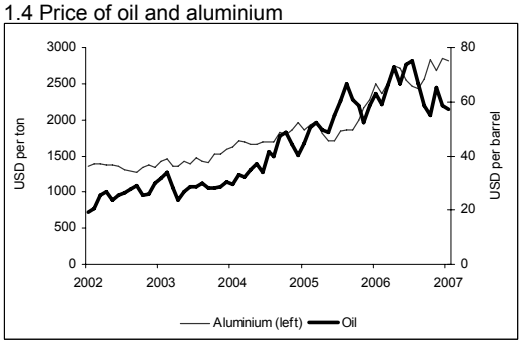
Long interest rates have been on a falling trend for several years. However, in 2006 long rates edged up internationally, despite dipping from June to December. The rise in European rates was especially large, with 10-year government bonds climbing 66 base points. The rates on their US and Japanese counterparts rose by about 30 and 21 points respectively in 2006. At the end of 2006 the rate on 10-year government bonds was 4.7 per cent in the US, 1.7 per cent in Japan and 4.0 per cent in the Euro area. In Norway the corresponding rate was 4.4 per cent at end-2006, compared with 3.6 per cent one year previously. Interest rates on long government bonds are still low, and at the end of 2006 interest rate curves were inverted in both the USA and the UK. This is due for one thing to a substantial reduction in risk premium in the past couple of years, combined with structural factors related to rule changes for pension funds, global imbalances in capital flows and greater confidence in the efficacy of monetary policy. Higher key rates in 2006, and rising money market rates, have also contributed to flatter interest rate curves. Moreover financial markets show a narrower spread in return on various fixed income securities and declining volatility. Low default probabilities and high optimism have reduced the differential between rates on corporate and government bonds, and between bonds issued in the US and in emerging markets. At the end of 2006 credit mark-ups on the latter types of bonds were down to 1.67 percentage points, which is an all-time low. The possibility that risk is underpriced in international fixed income markets cannot be ruled out.

1.3 International share markets



Source: Reuters EcoWin

1.4 Price of oil and aluminium



Source: Reuters EcoWin

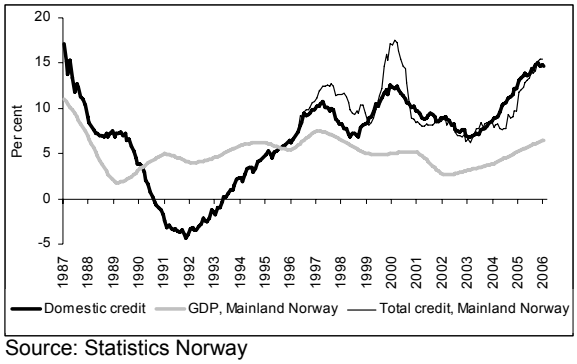
International equity markets showed a positive trend in 2006. Continued high commodity prices and increased inflationary fears brought a substantial decline in May, but good growth prospects and continued strong corporate profit performances led to a renewed rise during the autumn. Hence for 2006 as a whole S&P 500 rose by 13.5 per cent, EuroZone STOXX TMI by 19.7 per cent, Nikkei 225 by 6 .9 per cent and MS World Index by 13.6 per cent. The Norwegian equity market also plunged in May, and only in December was it back to the level prior to the correction. Oslo Børs's Benchmark Index rose by 32.4 per cent in 2006, supported by good corporate results and high prices on goods and services important for companies listed on Oslo Børs. Among others, freight rates for dry cargo increased by more than 80 per cent and the price on paper pulp by 10 per cent. Leasing prices of oil rigs reached record levels towards year-end. The very high oil price has been an important driver for the Norwegian equity market as well as the economy as a whole. OPEC has signalled its desire for an oil price of about USD 60 per barrel of Brent crude. At year-end the oil price fell to a level approaching USD 50 per barrel, but in mid-February 2007 was just over USD 55 per barrel. Stock issues at Oslo Børs rose steeply in 2006 reaching a volume of NOK 56.9 billion, compared with NOK 28.4 billion in 2005. Companies within the offshore sector accounted for a large portion of the issues in 2006. The

Norwegian economy is in the midst of a boom, and GDP growth looks set to exceed 4 per cent in 2006 for the third straight year. The growth is broad-based. Strong growth in employment in 2006 brought register-red unemployment down to 2.1 per cent in December, and several sectors are experiencing capacity problems. According to revised national accounts figures for 2004 and 2005, growth in these years was higher than previously estimated.

Household demand remained buoyant, supported by high real wage growth and rising employment. Residential investment was high, and consumption is expected to have grown by about 4 per cent in 2006. Fiscal policy also made an expansionary contribution. The international economic boom has provided strong demand impetus to the economy, and despite record high imports the trade surplus for 2006 was as high as NOK 367.9 billion, the largest ever recorded. High oil prices also lifted oil investments, and estimates for 2006 suggest growth close to 7 per cent, from an already very high level. Mainland (non-oil) investments also appear to have risen sharply in 2006. Capacity utilisation in manufacturing industry was at its highest level since 1987, contributing to the trend in investments. Growth in corporate borrowing from domestic sources quickened rapidly in 2006 and growth in household borrowing remained strong.

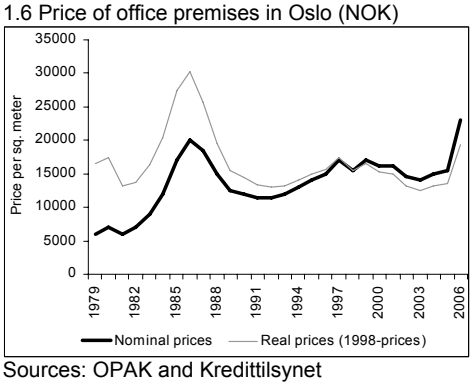
Consumer prices rose by 2.3 per cent from 2005 to 2006, compared with 1.6 per cent the previous year. Price inflation was dominated by particularly high growth in energy prices in 2006. While prices of services pushed up price inflation, lower prices on clothing and audiovisual equipment had the opposite effect. Adjusted for indirect taxes and excluding energy goods, inflation was 0.8 per cent in 2006, far below the monetary policy target. The negative contribution of import prices to inflation was accompanied by slow price growth on Norwegian-produced goods. In January, consumer prices rose by as little as 1.2 per cent and, when adjusted for indirect taxes and energy, by 1.0 per cent. Thus far, in contrast to previously, higher pressures in the economy have not translated into higher inflation.

1.5 Growth in GDP and credit



Source: Statistics Norway

1.6 Price of office premises in Oslo (NOK)



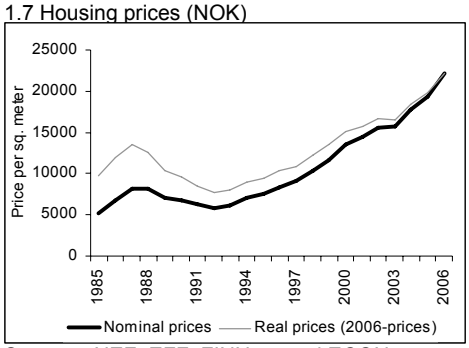
Sources: OPAK and Kredittilsynet

Low price inflation augmented the expansionary nature of monetary policy in 2006, as previously. In January 2007 Norges Bank raised its key rate to 3.75 per cent, the third straight interest rate meeting to bring an interest rate increase. Although monetary policy has fuelled investment and activity growth in the economy for several years, it was only in 2006 that the growth was also reflected in the labour market. A combination of buoyant economic growth and a moderate trend in both unemployment and wages have made this economic boom different. Preliminary figures for the fourth quarter of 2006

indicate that pressures in the economy have now started to translate into quicker wage growth. This appears however to be dominated by non-contractual components.

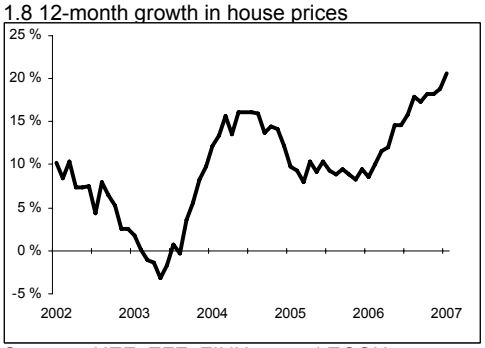
The economic upturn is fuelling house prices, and the quickening house price growth seen in 2006 continued into 2007: in January 2007 the 12-month rate of growth was 19.4 per cent. Adjusted for inflation, prices in January were 81 per cent higher than in the previous peak year in the housing market, 1987. The average sales period for houses advertised for sale on Finn.no has declined since 2003, and in January was 27 days, six days fewer than one year previously.

1.7 Housing prices (NOK)



Sources: NEF, EFF, FINN.no and ECON

1.8 12-month growth in house prices



Sources: NEF, EFF, FINN.no and ECON

Housing starts in 2006 totalled 32,762, the highest figure since 1982. Even so the rise in housing investment slowed in 2006. 2,700 sales of built-on recreational properties were registered on the open market in the 4th quarter of 2006, marginally fewer than in the 4th quarter of 2005. Based on average prices, the same period saw a value increase of 29 per cent. At the end of 2006, 682 firms were licensed real estate agencies, and Kredittilsynet issued 97 new licences compared with 106 in 2005.

The market for commercial property was marked by a substantial increase in both sales and rental prices in 2006. Despite rising interest rates the hurdle rate is very low, 5.25 per cent according to OPAK. The average sale price in the Norwegian office premises market is put at NOK 23,000 per square metre, compared with NOK 15,000 per square metre one year previously. For upmarket premises the average sale price is put at NOK 50,000 per square metre, a two-fold increase since 2004, while rental prices rose by 17 per cent in the second half of 2006, the highest ever registered increase according to OPAK. At the end of 2006 rental prices for the most attractive premises were estimated to be 8 per cent above the 1988 level. Office premise vacancies in the Oslo area at the start of 2007 are at 6 per cent according to Eiendomsspar.

Low interest rates stimulated property sales in 2006, and both property funds and syndication companies turned to real estate as an investment. While the volume of commercial property sold rose both in the hotel and the retail sector in 2006, the largest rise was seen in office property. In the first half of 2006 commercial property worth NOK 27 billion was sold, compared with NOK 18 billion in the same period of 2005 (transactions in excess of NOK 50 million). Property companies seem to have been particularly active on both the buyer and seller side in the past two years, whereas life insurance companies have been active buyers. According to Statistics Norway's preliminary building area statistics, the supply side of the market for commercial property also shows high activity levels, with building starts equivalent to 3.5 million square metres in 2006, 8.3 per cent more than in 2005.

2. Financial institutions

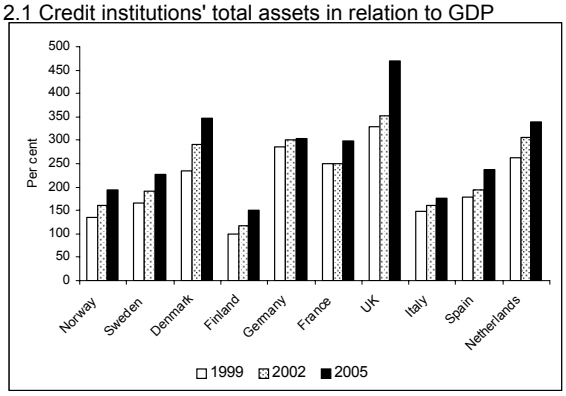
Financial institutions' financial position needs to be assessed in light of the trend in economic conditions and markets, discussed in Chapter 1. The present chapter starts by briefly describing the structure of Norway's financial market. It then summarises results reported in 2006 by financial institutions: banks, finance companies and mortgage companies, life insurance companies, pension funds and non-life insurance companies, as well as investment firms and companies managing securities funds.

Financial market structure

Developments in technology along with demographic and regulatory changes are important drivers of structural change. Changing patterns of saving and financing are particularly important for institutional adjustments and market structure. Securities markets are likely to become the vehicle for an increasing share of corporate financing and household saving, increasing these markets' significance for the financial system.

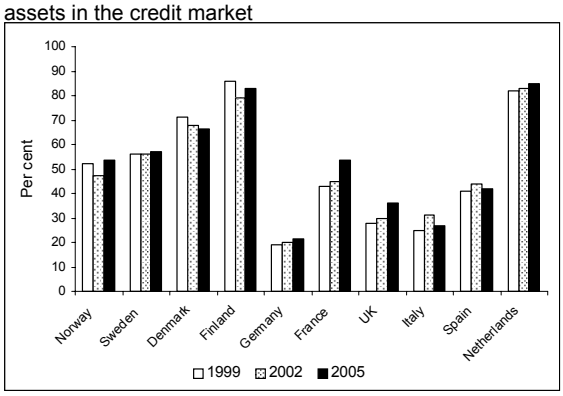
European financial markets are affected by consolidation and internationalisation. The number of institutions operating in credit markets has been reduced, at the same time as these institutions' total assets have grown at a faster rate than the wider economy. Although credit institutions account for a dominant portion of lending to domestic households and firms in Norway, their total assets as a ratio of GDP is not particularly high. An explanation may be that Norwegian credit institutions lend relatively less to foreign entities and to the public sector than is the case in other countries.

2.1 Credit institutions' total assets in relation to GDP



Sources: ECB and Kredittilsynet (Norway: mainland GDP employed.)

2.2 Five largest credit institutions' share of total assets in the credit market

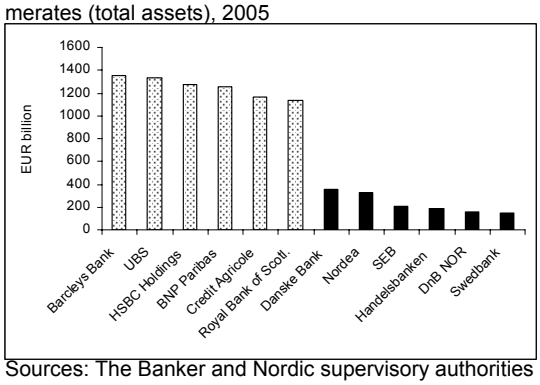


Sources: ECB and Kredittilsynet

Concentration in the credit market, measured by the five largest institutions' share of the total credit market, is highest in Finland and the Netherlands and lowest in Germany. The five largest credit institutions in Norway – DnB NOR Bank, Nordea Bank Norway, Fokus Bank, Handelsbanken and Sparebanken Rogaland – had a combined share of 54 per cent of the Norwegian credit market at the end of 2006.

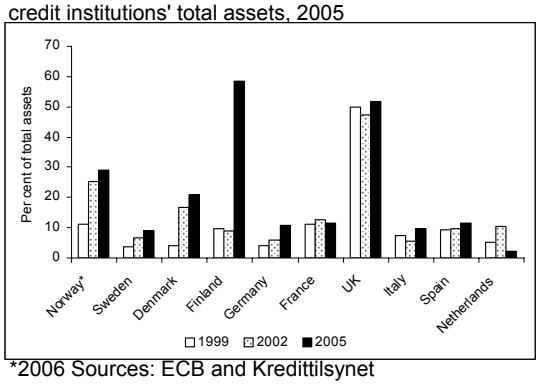
The largest Nordic banks have established operations in their neighbouring countries and regard the Nordic region as their domestic market. They have also established operations in Asia, the Baltic, Russia and elsewhere in Eastern Europe, the main purpose being to play their part in the vigorous growth and structural changes taking place in these markets. The largest Norwegian financial conglomerate, DnB NOR, is part of this development through its acquisitions in Poland and Russia and other countries and its branch establishment in China. Even after their further expansion via new establishments and acquisitions, the largest Nordic conglomerates are still small by European standards. Finland is the Nordic country in which foreign financial institutions have their largest market share. This is due to the reorganisation of Nordea (as a result of which Nordea Bank of Finland became a foreign-owned subsidiary) and to Danske Bank's acquisition of Sampo Bank Group.

2.3 Largest European and Nordic financial conglomerates (total assets), 2005



Sources: The Banker and Nordic supervisory authorities

2.4 Foreign branches and subsidiaries as a share of credit institutions' total assets, 2005



*2006 Sources: ECB and Kredittilsynet

There are five major financial groups in the Norwegian financial market, of which DnB NOR is by far the largest. Other sizeable groups are SpareBank 1 Group with 23 banks and Terra Group with 79 savings banks. Four new savings banks joined the SpareBank 1 Group in 2006. Sparebanken Hedmark, which acquired Swedbank's stake, is the largest of these. Concentration is higher in the insurance market than in the credit market. Of the seven life insurance companies engaged in traditional life insurance in Norway, the three largest (Vital, KLP and Storebrand) have a market share of 87 per cent. In the non-life insurance market the four largest companies (Gjensidige Forsikringsgruppen, If, Vesta Skadekonsern and SpareBank 1 Skadeforsikring) have a market share of 75 per cent in terms of gross premium earnings.

Vesta Forsikring is to be converted to a branch within the Nordic Tryg Group after the Ministry of Finance gave its approval in December 2006. This will increase foreign branches' position in the non-life insurance market, raising their market share from 28 to about 40 per cent of gross premium earnings. In the remaining markets the foreign-owner share is especially large among finance companies, where branches and subsidiaries had a market share of 63 per cent of total assets. In the

banking market too the market share of foreign financial institutions is on the increase. At the end of 2006 there were six foreign-owned subsidiaries in the Norwegian banking market, the largest of which are Nordea Bank Norway and Fokus Bank. Fokus Bank is to be converted to a branch of Danske Bank after the Ministry of Finance gave its approval in December 2006. After conversion, the market share of foreign branches will increase from about 11 to 15 per cent in terms of total assets.

Table 2.1 Structure of the Norwegian financial market at end-2006

Per cent of total assets	Banks	Finance	Mortgage	Life insurance	Non-life insurance*
DnB NOR (incl. Nordlandsbanken)	40.0	20.8	6.1	32.3	0.0
Nordea Bank Norge	13.2	6.7	4.1	6.2	0.0
SpareBank 1 Group**	12.4	5.7	0.2	3.3	7.5
Storebrand	1.3	0.0	0.0	25.5	0.4
Terra Group **	5.2	0.7	1.3	0.0	2.3
Total financial groups	72.2	33.9	11.7	67.4	10.2
Other companies	27.8	66.1	88.3	32.6	89.8
Total	100.0	100.0	100.0	100.0	100.0
- of which foreign branches in Norway	11.1	28.9	1.9	1.0	27.9
- of which foreign subsidiaries	20.4	37.4	9.8	6.7	14.7

*As % of gross premium income **For SpareBank 1 Group and Terra Group, market shares include the owner banks

Structural changes in the savings banks sector

While independent commercial banks have mainly been taken over by other banks in recent years, the reduction in the number of savings banks is largely the result of mergers designed to create larger, more effective entities. Since the end of the 1950s the number of savings banks has been substantially reduced from more than 600 to 124 at the end of 2006. Foreign banks' strong growth is the biggest challenge to the savings banks. Competition could be further intensified by banks opening branches outside their local area.

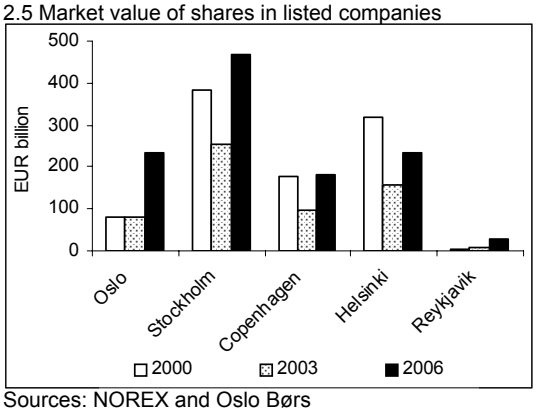
Five out of six independent commercial banks were taken over between autumn 2004 and autumn 2005. After this wave of commercial bank takeovers, interest in acquiring savings banks increased significantly. Savings banks currently have three options for changing status: winding up, merging with other savings banks or converting to limited liability savings banks. The main aim of enabling conversion to limited liability status was to improve savings banks' access to equity capital. To date only Gjensidige NOR Sparebank has availed itself of this right.

A number of alternative models for restructuring the savings bank sector have been advanced of late, and Kredittilsynet has received several approaches regarding acquisition or takeover of savings banks. They involve both commercial banks' acquisition of savings banks, and savings banks' acquisition of savings banks. Permission for acquisition of savings banks could lead to major structural changes. Law interpretations or law amendments allowing Sparebanken Møre and Gjensidige to acquire, respectively, Tingvoll Sparebank and Sparebanken Sogn og Fjordane may result in other Norwegian and foreign financial institutions having to be granted the same right. If a savings bank is authorised to take over another savings bank's basic capital and convert it to primary capital certificates, it will not be easy to prevent commercial banks from following suit against settlement in shares. In countries where acquisition of savings banks is permitted, the number of savings banks has over time been substantially reduced. Key issues of principle are involved in takeovers of savings banks, and a precept for Norwegian authorities has been to retain Norwegian ownership of Norwegian financial institutions and to preserve savings banks with a local identity.

Securities markets

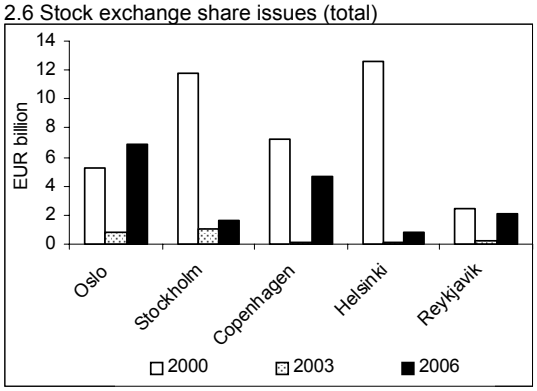
Securities markets have an important role to play both as a source of capital to finance private and public sector activity and for saving and consumption. Well functioning secondary markets for securities are important if issuance of shares and fixed income securities is to be a competitive alternative to borrowing from credit institutions.

2.5 Market value of shares in listed companies



Sources: NOREX and Oslo Børs

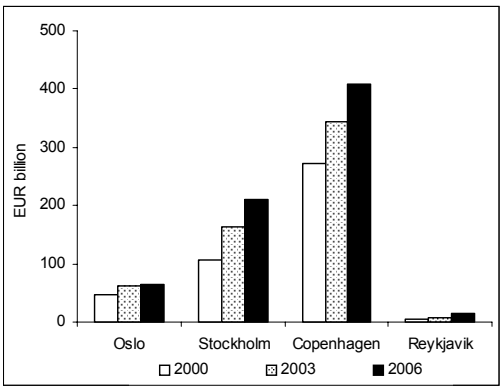
2.6 Stock exchange share issues (total)



Sources: NOREX and Oslo Børs

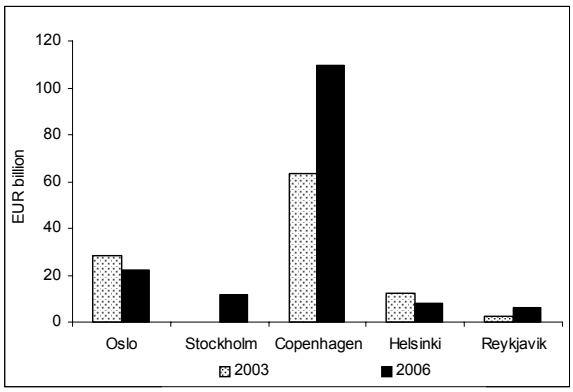
Recent years have seen increased cooperation between stock exchanges and ownership consolidation. The NOREX alliance between the Nordic stock exchanges has been established step-by-step since 1998. Subsequently the owner of the Stockholm Stock Exchange, OMX, has acquired the stock exchanges in Helsinki, Copenhagen and Reykjavik. The significance of organised securities markets varies across the Nordic region. At the end of 2005 the market value of listed companies measured about 130 and 122 per cent of GDP in Sweden and Finland, compared with, respectively, 74 and 71 per cent in Norway and Denmark.

2.7 Market value of listed fixed-income securities



Sources: NOREX/FESE. Figures for Helsinki not avail.

2.8 Issuance of listed fixed-income securities (total)



Sources: NOREX/FESE. Figures for Stockh. 2003 not avail.

Nordic equity markets have shown a positive trend in recent years. The market value of quoted shares passed the 2000 level at the end of 2006, except in the case of the Finnish stock market. The equity market slump from 2000 to 2002 was reflected in issue volumes, which dropped sharply after 2000. Although they have picked up in recent years, issue volumes are still lower than in 2000, with the exception of Oslo Børs which recorded a larger issue volume than other Nordic bourses. The market

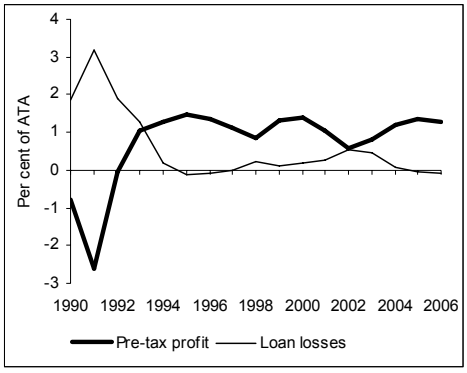
value of fixed income securities quoted on Nordic stock exchanges rose appreciably from 2000 to 2006. The Danish fixed income market looms particularly large in the Nordic region owing to the structure of Danish housing finance.

Since an unregulated market for securities exists alongside the stock markets, figures published for stock exchange trading do not capture overall developments in the securities markets. Figures for market value and issuance of fixed income securities for Oslo Børs do not include the Alternative Bond Market (ABM), which Oslo Børs established in June 2005. In 2006 this market saw new loans and tap issues worth NOK 52.4 billion (about EUR 6 billion), and the market value of fixed income securities in this market was NOK 61.3 billion (about EUR 7 billion) at year-end.

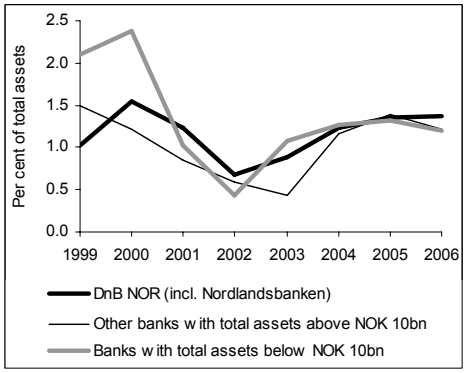
Banks

Banks have recorded very good results in recent years. Aggregate profit in 2006 came to NOK 28.1 billion, an increase of NOK 2.5 billion over 2005. Return on equity (after tax) was 17 per cent, approximately unchanged from the previous year. In terms of average total assets, however, the result was 0.09 percentage points down to 1.28 per cent. Despite a favourable trend in costs, net loss recovery by the largest banks and low losses among the smaller banks, the decline in net interest revenues lead to a reduction in profits in terms of average total assets.

2.9 Loan losses and results before tax



2.10 Pre-tax profit for banks grouped by size*

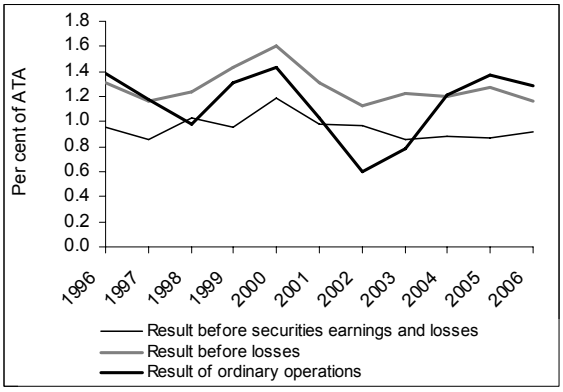


*Other banks with total assets above NOK 10bn (20 banks) and banks with total assets below NOK 10bn (117 banks) accounted for, respectively, 40% and 10% of total assets in the banking market.

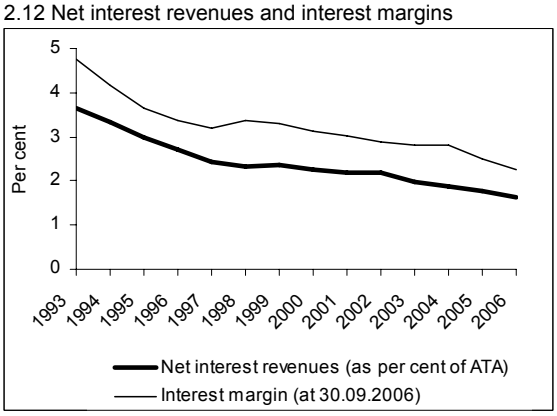
The banks have recovered earlier loan losses in each quarter of the past two years. Overall they recognised loan losses of NOK 1.5 billion as revenue in 2006. This is partly a result of write-backs of previous loan impairments, with collective and specific impairments being reduced by NOK 3.9 billion and NOK 1.4 billion respectively in 2006. Changes in loan impairments as a result of the switch to new accounting rules are now to be directly reflected in equity (see Chapter 4 on IFRS). Changes in loan losses have had greatest bearing on changes in the banks' results over time. Non-performing loans have been falling since 2002, and were at a very low level at the end of 2006, especially at the largest banks. Aggregate non-performing loans accounted for 0.6 per cent of outstanding loans, down 0.8 per cent from one year previously. Non-performing loans to corporate customers measured 0.8 per cent of

loans to such customers while non-performing loans to retail customers measured 0.5 per cent of loans to that customer group.

2.11 Trends in results, all banks

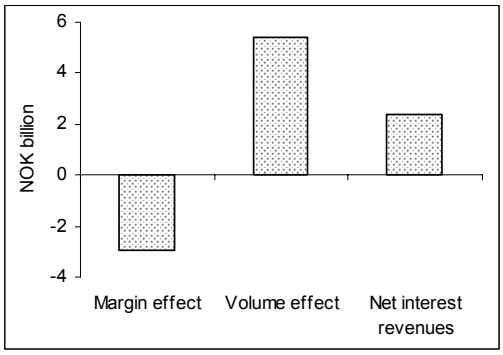


2.12 Net interest revenues and interest margins

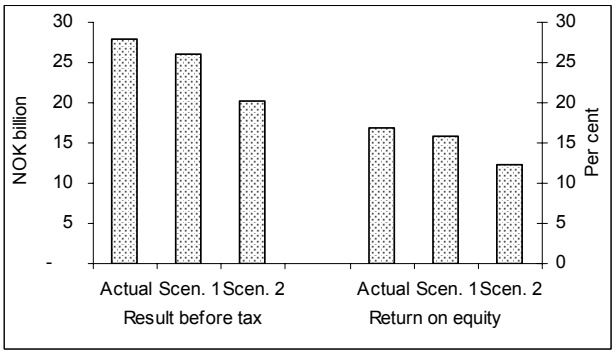


Strong volume growth increased net interest revenues by 7 per cent. In terms of average total assets, net interest revenues fell from 1.77 per cent to 1.62 per cent. The interest margin – the difference between interest rates on lending (including commissions) and deposits – was 2.2 per cent at the end of the third quarter of 2006. The interest margin has narrowed by more than half over the past 10 years, and is at its lowest level since measurements started in December 1987. According to rough calculations, the strong growth in lending raised net interest revenues by NOK 5.4 billion, while the reduction in interest margins lowered net interest revenues by NOK 3.0 billion.

2.13 Banks' net interest revenues, decomposed



2.14 Banks' result in 2006, actual and normalised



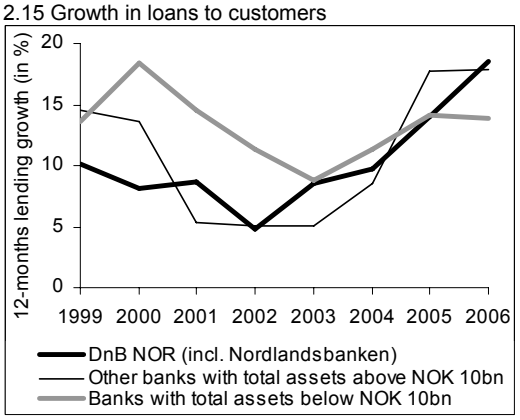
The banks' favourable loss situation is unlikely to last. Moreover, competition in the lending market could make it difficult for banks to increase their interest margins. Figure 2.14 illustrates changes estimated in the results for 2006 in the event of a "normalisation" of lending growth and loan losses. Scenario 1 posits lending growth in step with growth in nominal GDP, while scenario 2 assumes in addition loan losses corresponding to average losses over the past 14 years. If other result items are kept unchanged, banks' return on equity would have been about 5 percentage points lower than the actual return on equity in 2006.

Growth in Norwegian banks' lending to customers was again very high in 2006 at close to 18 per cent. Branches of foreign banks also reported strong lending growth in 2006 (see Chapter 3). While growth

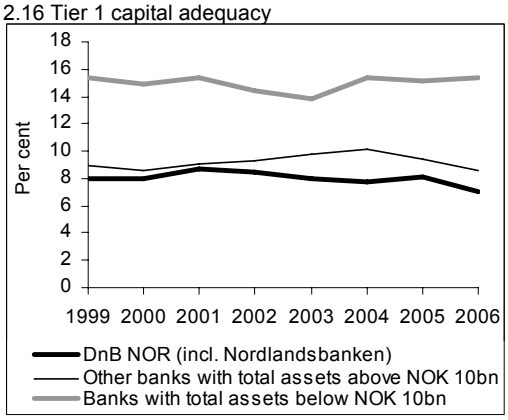
in lending to businesses quickened substantially in 2006, growth in lending to wage earners has already been high for several years. Despite strong growth in customer deposits, 16 per cent, the strong increase in lending brought a fall in the ratio of deposits to loans.

Fresh capital, including hybrid capital instruments which accounted for 7 per cent of tier 1 capital at the end of 2006, along with good results has served to stabilise tier 1 capital adequacy in recent years. Most banks have a solid capital base which has enabled strong credit growth to take place without significantly impairing their financial strength. However rapid lending growth puts an onus on earnings to maintain financial strength through operations. The steep growth in lending to businesses pushed down tier 1 capital adequacy in 2006.

2.15 Growth in loans to customers



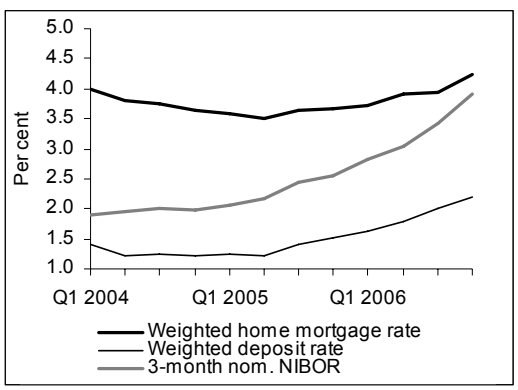
2.16 Tier 1 capital adequacy



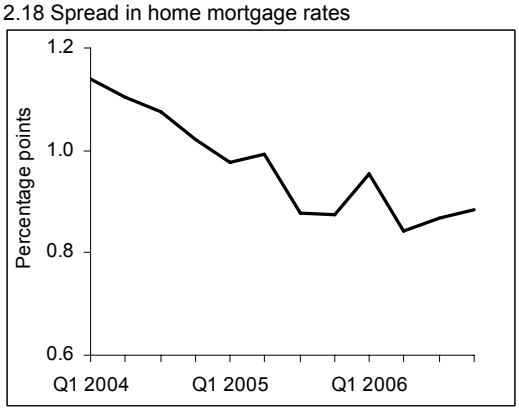
Home mortgage loans and the interest margin

Norges Bank raised its key rates from 1.75 per cent in July 2005 to 3.50 per cent at the end of 2006. In the same period the banks' marginal funding rate, three-month NIBOR, rose by 1.73 percentage points to 3.91 per cent. The increase in key rates and short market rates was only limitedly reflected in higher mortgage rates, and interest margins on home mortgages fell. Since home mortgage loans make up 51 per cent of all loans to customers, this put banks' net interest revenues under pressure. Norges Bank's last interest rate increase in 2006 came on 14 December, and most banks gave their customers notice of higher mortgage interest rates at that point. Since banks are obliged to give existing customers at least six weeks' notice of interest rate increases, the last increase was not reflected in mortgage interest rates at the end of 2006.

2.17 Bank interest rates and NIBOR



2.18 Spread in home mortgage rates



Average mortgage interest rates were at their lowest level at the end of the second quarter of 2005, 1.33 percentage points higher than NIBOR. By the end of 2006 the margin to NIBOR had fallen to a mere 0.33 percentage points. Although customer deposits have lost some significance in recent years, they still accounted for almost one half of banks' retail home loans at the end of 2006. In the interest rate trough at the end of the second quarter 2005 the mortgage interest rate was 2.29 percentage points higher than the average deposit rate. This differential was narrowed by 0.25 percentage points in the period to end-2006. In isolation deposit margins improved in the same period. Chart 2.17 shows the quarterly trend in average home mortgage and deposit rates for retail customers of all banks in Norway (including foreign banks' branches in Norway).

A small spread in mortgage rates between banks may be an indication of intense competition in the lending market, and this spread has clearly narrowed since the start of the first quarter of 2004. The spread is defined as the interest rate differential between the 10 per cent of banks with the highest interest rate and the 10 per cent of banks with the lowest interest rate at the point in time concerned. The largest fall is seen in the differential between banks with the highest interest rate and the average interest rate for all banks, which strengthens the impression of strong competition in the market for mortgage loans. It seems that banks consider it difficult to attract customers unless their loan terms, including price, are viewed as competitive. The media have contributed greatly to the focus on mortgage rates as a competitive parameter.

There are indications that bank customers are switching banks more often than previously. In Kredittilsynet's survey of information disclosed to borrowers (see Chapter 3), existing customer relationships stood out as the most important factor in the choice of bank, whereas prices, i.e. interest rate and charges, were the next most important factor. Compared with 2004 and 2005, the autumn of 2006 showed a marked increase in the proportion of customers borrowing from a bank that was not previously their main bank. In 2006 20 per cent reported taking out a home mortgage loan in a bank of which they were not already a customer, compared with 12 per cent in 2005. Kredittilsynet's home loan survey (see Chapter 3) also showed a substantial rise in recent years in the proportion of bank customers having switched banks. One in six mortgages involved a switch of bank to refinance a mortgage loan, whereas only one in 11 mortgages involved a switch of bank in the survey conducted two years earlier. The reduction in the registration fee charged for refinancing as from 2006 may explain this increase, alongside the intense competition between banks.

It is reasonable to ask whether banks are pricing residential loans high enough, and if their pricing is based on a desire to expand market shares or is possibly an early adjustment to Basel II. Basel II entails lower minimum capital requirements which reduce the hurdle rate on mortgage lending. Since most banks are deferring Basel II to 2008, and IRB banks are constrained by transitional floors (95 per cent of the Basel requirements in 2007), few banks will in fact achieve a lower risk weighting on mortgage loans in 2007. (See Chapter 4 for a further account of Basel II.) The interest on mortgage loans covers in principle funding costs, return on own funds, administrative expenses and losses on such loans.

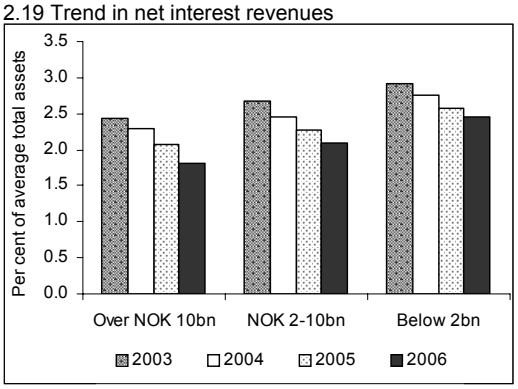
The costs of own funds depend on the composition of such funds, the required rate of return on equity and interest charges on other capital. If NIBOR is 4.15 per cent (as at the start of February 2007), the

required rate of return on equity is 10 per cent after tax, the capital adequacy requirement is 2.8 per cent (met by equity alone), and 0.30 per cent of the loan balance is required to cover administration costs and losses, then the lending rate needed will be about 4.7 per cent. Offerings from individual banks with an effective interest rate in the range 0.1 to 0.2 percentage points over NIBOR must be anchored in growth strategies and/or a belief that higher margins can be taken out over the life of the loan. Such practice involves a clear risk for the banks.

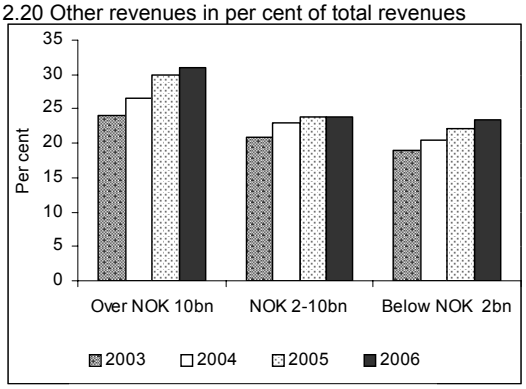
Profitability at medium-sized and small savings banks

Savings banks' interest margins and net interest revenues are also under pressure. The largest savings banks earn the lowest net interest revenues, and the fall in net interest revenues has also been largest in their case. Revenues over and above net interest revenues constitute a relatively larger share of total revenues for the largest savings banks where sales of insurance and mutual fund products are a substantial source of revenue. The smaller the bank, the more dependent it is on net interest revenues to assure earnings. The largest banks appear to be the most cost-effective, and earn the highest return on equity. Low return on equity at smaller banks is due to a combination of higher costs and a high level of equity capital.

2.19 Trend in net interest revenues

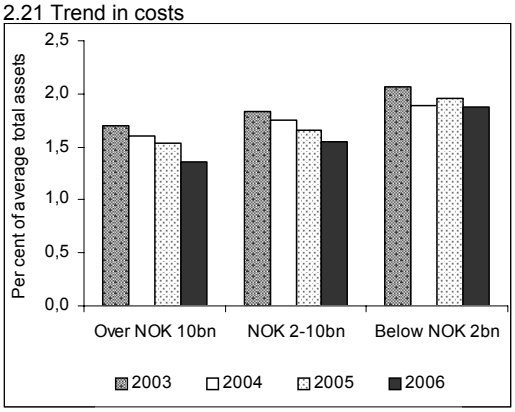


2.20 Other revenues in per cent of total revenues

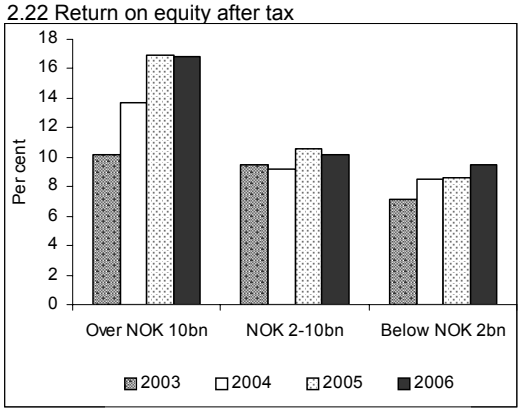


12 banks with more than NOK 10bn in total assets, 44 banks with total assets between NOK 2bn and 10bn and 27 banks with total assets below NOK 2bn accounted for, respectively, 64, 25 and 11 per cent of the savings bank market (exc. DnB NOR) at end-2006.

2.21 Trend in costs



2.22 Return on equity after tax



While branch and staff numbers both declined in the years 1993 to 2004, the number of branches has risen anew since 2005. Continued good economic prospects and savings banks' desire to participate in

the economic expansion may be contributory reasons. According to figures obtained by the Savings Banks Association from member banks, branch numbers increased from 2005 and 2006, with further branch openings planned in 2007, while the number of sales and advisory offices rose by 19 from 2005 to 2006. An increase in the number of establishments beyond the parent bank's traditional local area could increase costs and further intensify competition.

Table 2.3 Trend in branch offices in the savings bank sector (excl. DnB NOR)

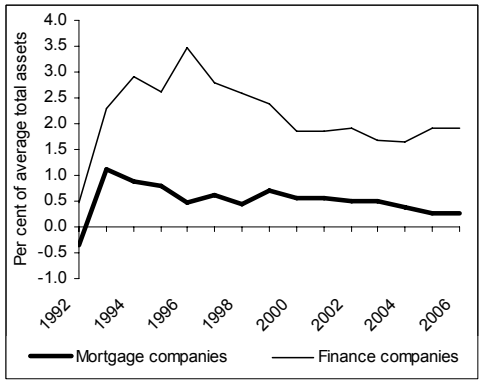
	1993	1997	2001	2004	2005	2006	Planned 2007
No. of traditional branches (incl. head office)	979	942	845	666	721	725	25
No. of sales and advisory offices					43	62	26
No. of employees	8,571	7,920	8,284	8,028	8,391	8,488	

Pre-2005 figures for branch offices, and employee numbers, are taken from Finansdatabasen.
Sources: Norwegian Savings Banks Association and Kredittilsynet

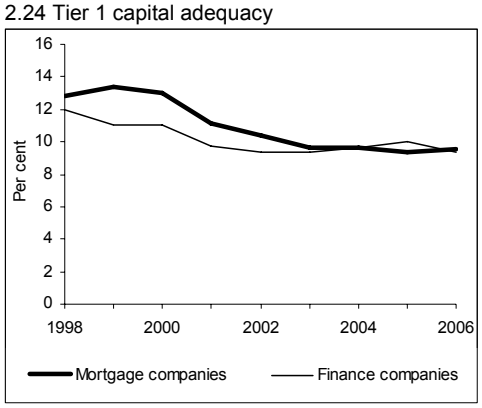
Finance companies and mortgage companies

Finance companies offer various forms of special purpose financing to corporate and retail customers, with the emphasis on leasing, factoring, car financing and consumer financing while mortgage companies offer mortgage loans to finance commercial business and house purchases. Finance companies' results have been stable for some time. A sizeable number of branches of foreign finance companies operate in the Norwegian market. Several of them offer consumer financing (see Chapter 3 for details). Both Norwegian finance companies and foreign branches show rapid credit growth, respectively 23 and 17 per cent in the past year. Mortgage companies report an overall lending growth of 17 per cent, in part related to portfolio transfers from banks to mortgage companies in the period. In spite of strong growth in lending, core capital adequacy has been relatively stable.

2.23 Profit before tax



2.24 Tier 1 capital adequacy

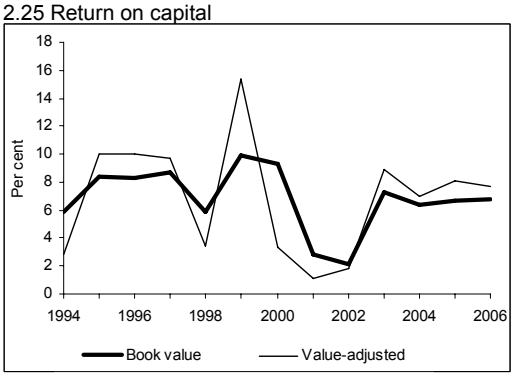


Life insurance companies

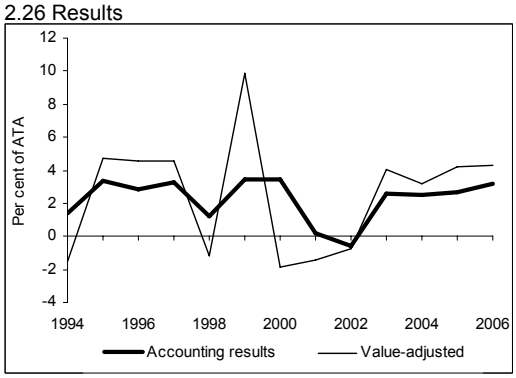
An improvement in equity markets in the second half of 2006, following a sharp correction in May, caused life insurers' results to pick up towards year-end. Premium revenues rose by 4 per cent compared with 2005. The equity market upturn boosted financial revenues in particular. Claims increased both as a result of increased disbursements to insureds and increased transfers of reserves to other insurance companies. Fluctuation reserves were reduced somewhat compared with 2005, partly

because companies realised gains on securities portfolios in 2006 to a greater degree than in the previous year. The value-adjusted result was NOK 26.7 billion compared with NOK 22.9 billion in 2005. Whereas companies made new supplementary provisions worth NOK 2.5 billion in 2005, such provisions rose by NOK 5.3 billion in 2006. Value-adjusted return on equity, i.e. return on financial assets alone, was 7.7 per cent compared with 8.1 per cent in 2005.

2.25 Return on capital



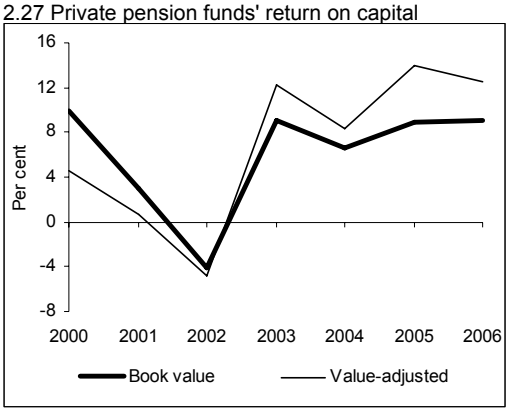
2.26 Results



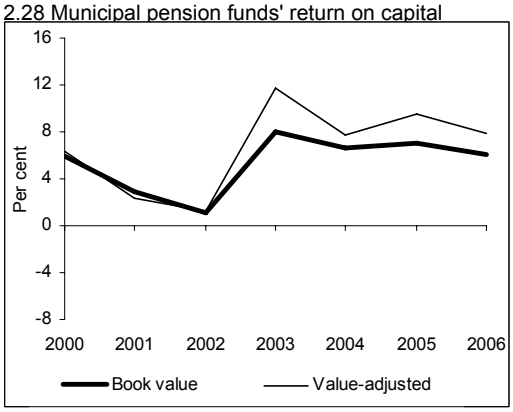
Pension funds

The largest private and municipal pension funds, accounting for 80 per cent of pension funds' total assets, posted slightly less return on capital in 2006 than in 2005. Several major pension funds have a high equity component in their balance sheets, higher than in the case of life insurers. Overall book return on capital was 8.3 per cent in 2006, unchanged compared with 2005. Pension funds' value-adjusted return on capital was 11.2 per cent compared with 12.7 per cent the previous year, while life insurers posted a value-adjusted return on capital of 7.7 per cent. Private pension funds had higher exposure to shares than municipal pension funds and accordingly achieved a higher return on capital, 12.5 per cent compared with 7.9 per cent.

2.27 Private pension funds' return on capital



2.28 Municipal pension funds' return on capital

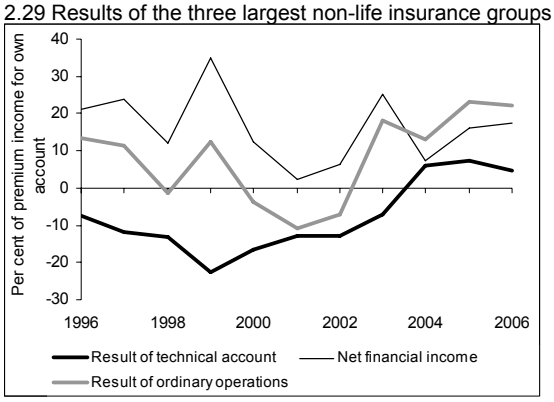


Non-life insurance companies

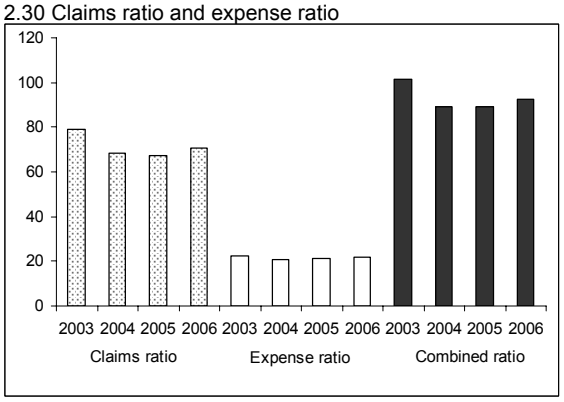
The three largest non-life insurance groups – Gjensidige Forsikring, Vesta Forsikring and SpareBank 1 Skadeforsikring – make up about half of the non-life insurance market in terms of gross premium revenues. These groups have shown improving profit positions in insurance-related business for several years, but in 2006 the technical result was somewhat lower than in 2005. Claims expenses

increased somewhat more than operating expenses and premium revenues compared with 2005. The combined ratio (the ratio of claims and operating expenses as a percentage of premiums) was 92 compared with 89 in 2005. The result of ordinary operations was NOK 5.1 billion in 2006, NOK 200 million lower than in 2005.

2.29 Results of the three largest non-life insurance groups

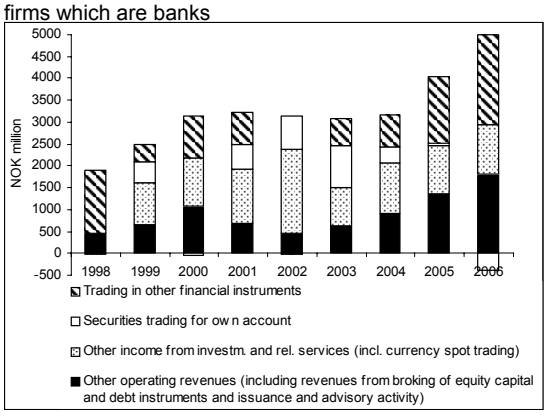


2.30 Claims ratio and expense ratio

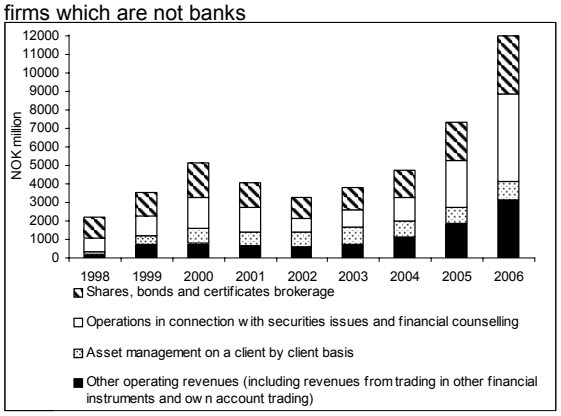


Investment firms

2.31 Operating revenues of investment firms which are banks



2.32 Operating revenues of investment firms which are not banks

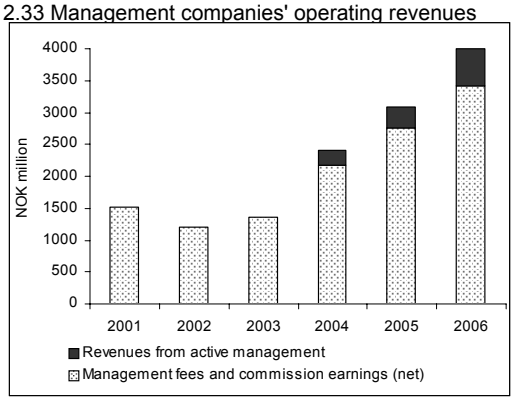


It is useful to distinguish between investment firms that are banks offering investment services in connection with ordinary banking operations, and investment firms that are not banks. Licensed investment firms increased from 75 in 2005 to 85 in 2006, of which 17 were banks. Both types posted substantially higher operating revenues in 2006 than in 2005. Banks offering investment services increased their revenues by NOK 0.6 billion to NOK 4.7 billion, while operating revenues of other investment firms rose by NOK 4.7 billion to NOK 12.0 billion. Banks' revenues from investment services largely derive from trading in foreign-exchange and fixed-income instruments; their income from issuance and counselling activity rose as a share of operating revenues. 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.

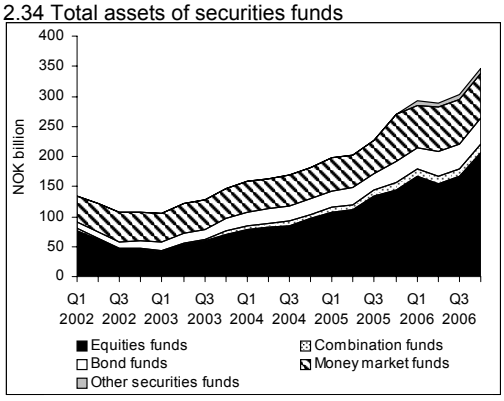
Management companies for securities funds

At the end of 2006 23 companies were licensed to manage securities funds. Securities funds are collective investment scheme and are independent legal entities. Capital invested in securities funds is not affected in the event of the management company's failure. Management companies' revenues largely consist of fees for managing securities funds along with commission revenues from subscription and redemption of fund units. In August 2003 management companies became eligible, subject to authorisation, to engage in active management of investor portfolios. At the end of 2006 ten companies were licensed to provide active management services. Management companies' aggregate operating profit was somewhat higher in 2006 than in 2005. Operating revenues rose in all business areas to reach a total of NOK 4.0 billion in 2006. At the end of 2006, capital under active management totalled NOK 453.4 billion, an increase of NOK 14.9 billion over the previous year. Securities funds worth NOK 338.2 billion were managed by Norwegian management companies at the end of 2006.

2.33 Management companies' operating revenues



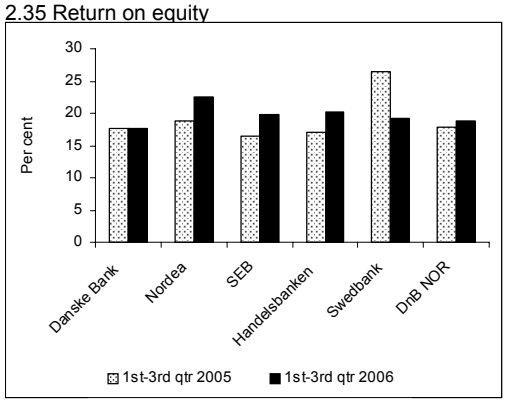
2.34 Total assets of securities funds



Nordic financial conglomerates: profits and financial strength

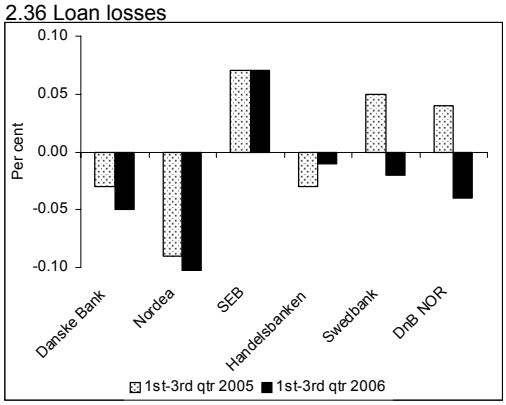
High economic growth in the Nordic countries is reflected in the major Nordic financial conglomerates' good results and high return on equity in 2006. A favourable economic trend, low inflation and rising house prices have fuelled rapid growth in lending in the Nordic financial markets. The economic boom is also reflected in conglomerates' loan losses: previous loan impairments have largely been written back and new impairments in 2006 were at a very low level.

2.35 Return on equity



Sources: Quarterly reports

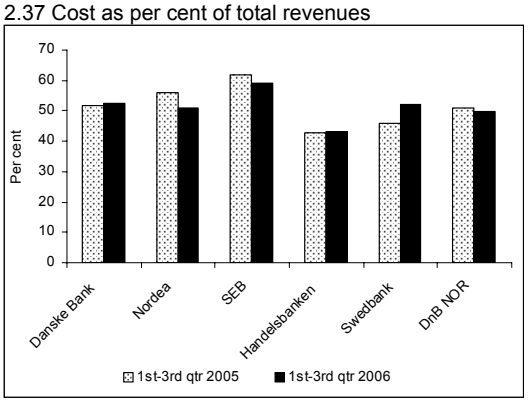
2.36 Loan losses



Sources: Quarterly reports

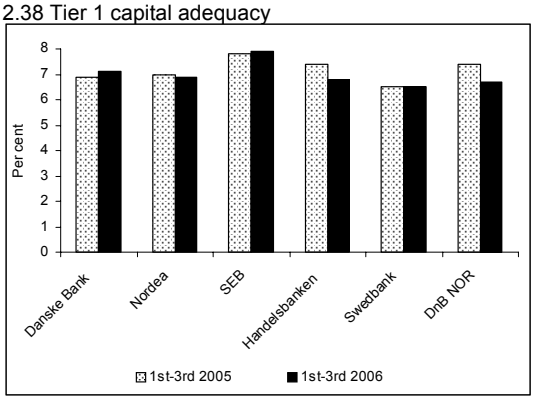
Increased cost effectiveness is a feature of the largest Nordic financial conglomerates, whose cost share of revenues has fallen despite higher costs associated with acquisitions and establishments abroad. Tier 1 capital adequacy was stable from the end of the third quarter 2005 to the same point in 2006, despite high activity levels and strong lending growth. In chart 2.38 the result of the period is not included in the figures for Handelsbanken and DnB NOR, so comparing levels between these two banks and the other banks might be misleading.

2.37 Cost as per cent of total revenues



Sources: Quarterly reports

2.38 Tier 1 capital adequacy



Sources: Quarterly reports

3. Risk areas

Macroeconomic developments and financial institutions' profitability and financial strength were described in Chapter 1 and 2. The present chapter takes a closer look at various types of risk facing financial institutions. For banks and other credit institutions credit risk is crucial, although liquidity risk and operational risk are also significant. Operational risk is an important concern for investment firms. While Norwegian banks are little exposed to market risk, this type of risk together with insurance risk is of greatest significance to insurance companies.

Credit risk

Credit risk is the risk that banks or other credit institutions will not receive payment as agreed, thereby incurring loss. 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 collateral held by the institution.

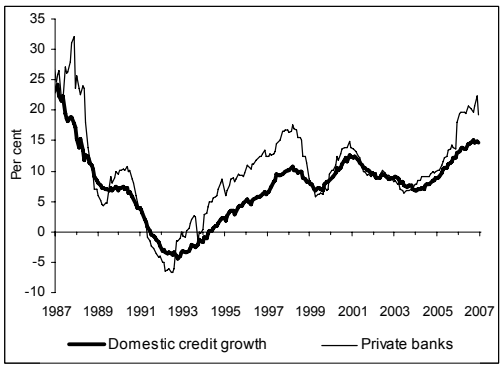
Credit growth

Growth in credit to the non-financial private sector (households and firms, but also including municipal administrations) from domestic sources has quickened substantially over the past three years, from 6.8 per cent at the end of 2003 to 14.6 per cent at the end of 2006. After falling for much of 2005, growth in foreign debt picked up sharply last year, especially to Mainland Norway (the non-oil sector). Total annual growth in credit to the non-financial private sector was 15.5 per cent at end-November 2006, disregarding oil and shipping. This is far higher than the nominal rate of growth in the economy.

The upturn in the housing market has contributed to a very high level of growth in credit to households in the past seven years. Although growth edged back in 2006, households nevertheless increased their incurrence of debt by 12.5 per cent in December on an annual basis. The economic slowdown as from 2000 meant that non-financial firms raised few new loans up to the spring of 2004. As from the summer of 2004, however, profitability and investments picked up and credit growth quickened. Growth was particularly strong in 2006, and by the end of December firms' borrowing from domestic sources was increasing at an annual rate as high as 20.6 per cent.

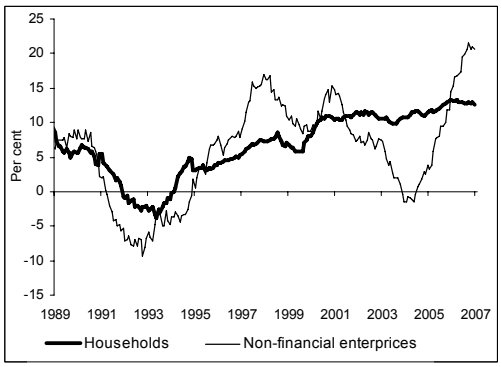
Banks account for just over two-thirds of total domestic credit. Overall growth in lending from banks and foreign banks' branches in Norway rose sharply in 2006, reaching 19 per cent on a 12-month basis by year-end. Lending by foreign branches grew by almost 37 per cent in 2006.

3.1 Growth in domestic credit and in credit from banks



Source: Statistics Norway

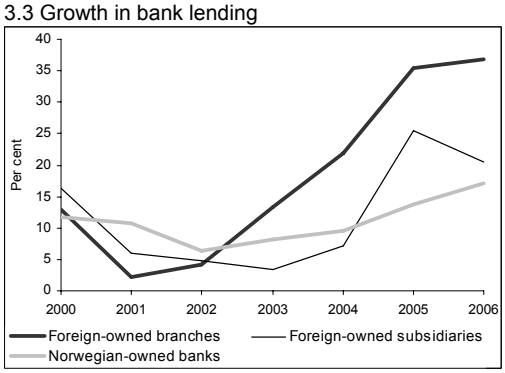
3.2 Growth in credit to households and non-financial enterprises



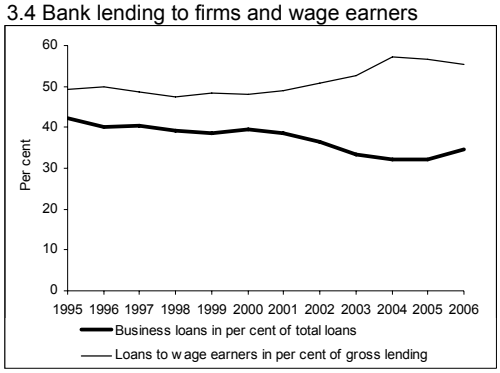
Source: Statistics Norway

Growth in bank lending to wage earners, accounting for about 90 per cent of households, has been particularly high in recent years. By the end of 2006 growth was 15 per cent, about the same as in 2005. With almost 90 per cent of lending to wage earners secured on dwellings, banks are closely linked to the trend in the housing market. Given the prolonged high growth in credit to wage earners, this sector's share of overall borrowing increased up to the end of 2004. Rapid growth in lending to firms has reversed this trend, and at the end of 2006 bank lending to corporate customers was rising at an annual rate of about 22 per cent (adjusted for portfolio transfers). Banks' loan portfolios broken down by sector reflect the fact that the economy is in the midst of a boom with steep growth in lending to most sectors, with property management and foreign shipping figuring among the sectors to which lending growth has been highest in the past twelve months. At almost 43 per cent, foreign branches' growth in lending to the corporate sector was particularly strong in 2006.

3.3 Growth in bank lending



3.4 Bank lending to firms and wage earners



Households

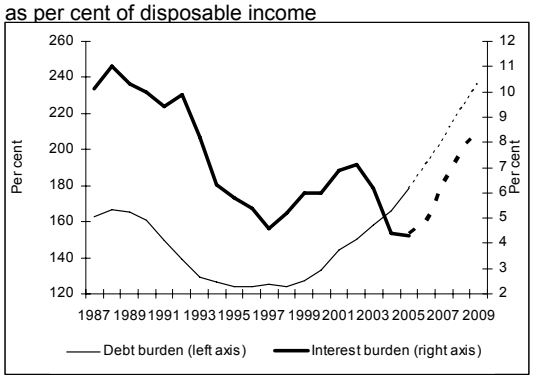
Household indebtedness

Gross household indebtedness has risen sharply in the past seven years, driven by strong growth in house prices, a favourable economic climate and low interest rates. Debt has risen at a far higher rate than incomes, spurring a sharp increase in the debt burden. Norges Bank puts household debt at the end of 2006 at just over 190 per cent of disposable income. Projections by Norges Bank show that by the end of 2009 debt will exceed 230 per cent of disposable income. The projections are based on the

assumptions underlying the central bank's Inflation Report which envisages a gradual rise in the sight deposit rate from 3.25 per cent to almost 5.25 per cent by the start of 2009. The marked fall in interest rates from autumn 2002 to spring 2005 brought a substantial decline in households' interest burden up to the end of 2005, despite strong debt accumulation in the period. High debt growth and increased interest rates indicate a renewed increase in the interest burden, and the projections show that the interest burden will rise above its 2002 level in the period to 2009.

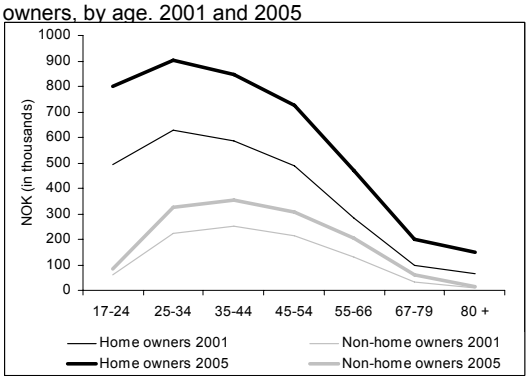
There are wide variations between different groups of households. Both indebtedness and interest expenses are highest among the youngest households entering the housing market. According to figures from Statistics Norway, homeowners in the age range 25-34 carried debt averaging just over NOK 900,000 in 2005. There has been a substantial increase in recent years and, given the very high growth in house prices in 2006, homeowners' indebtedness is likely to be far higher at the start of 2007.

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



Sources: Statistics Norway and Norges Bank

3.6 Average debt of home owners and non-home owners, by age. 2001 and 2005



Source: Statistics Norway

Households' wealth and saving

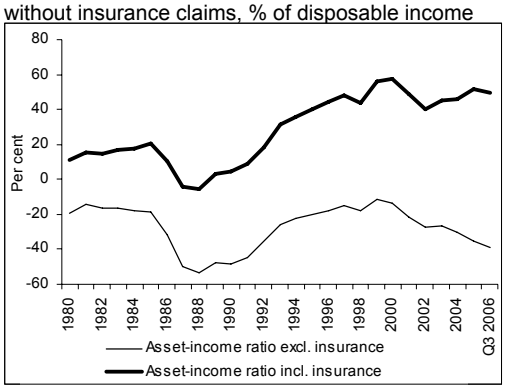
Households' gross wealth is distributed between housing, other real capital and financial assets. Calculations by Norges Bank for the second quarter of 2006 put housing wealth at about NOK 3,600 billion, equivalent to about 63 per cent of this sector's wealth.

Like indebtedness, financial wealth is very unevenly distributed. According to the income tax return statistics for 2005, the over-54s had the highest gross wealth, and it was this group that saw the largest growth in wealth compared with the previous year. Liquid financial wealth could play an important role as a buffer to withstand an economic downturn and unforeseen expenditure increases, for instance caused by interest rate hikes. At the end of the third quarter 2006 households' net assets made up about 50 per cent of their disposable income (net asset ratio). About a third of households' gross financial wealth is tied up in illiquid insurance technical reserves which cannot be utilised at short notice. If these placings are excluded, the household net asset ratio is negative.

Households’ net financial investments reflect the change in households' financial saving. Several methods are used to measure this variable, in recent years producing differing results. Revisions of national accounts figures for 2004 and 2005 have reduced the discrepancies somewhat, however. In the first three quarters of 2006 households' net financial investments fell, turning the net financial

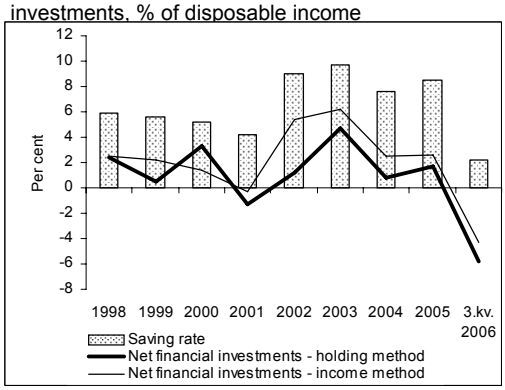
investment ratio negative. Despite positive contributions from net revaluations, net financial wealth was smaller at the end of the third quarter 2006 than at the end of 2005.

3.7 Households' net financial assets, with and without insurance claims, % of disposable income



Source: Statistics Norway

3.8 Household saving rate and net financial investments, % of disposable income



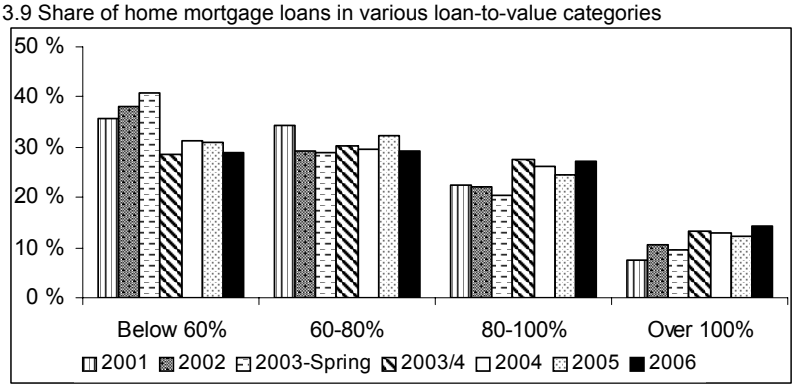
Revision of 2004 figures creates a break in the series.
Source: Statistics Norway

Revised national accounts figures show that households' saving in 2005 measured 8.5 per cent of disposable income. In recent years, however, the saving rate has been strongly affected by extraordinary, tax-motivated stock dividends taken out before the reintroduction of dividend tax as from 2006. When adjusted for these dividends, the saving rate for 2002-2005 is considerably lower. Recently household saving appears to have fallen markedly, and the saving rate for the first three quarters 2006 was 2.2 per cent. Statistics Norway's estimate for 2006 is 0.9 per cent of disposable income.

Loans secured on dwellings

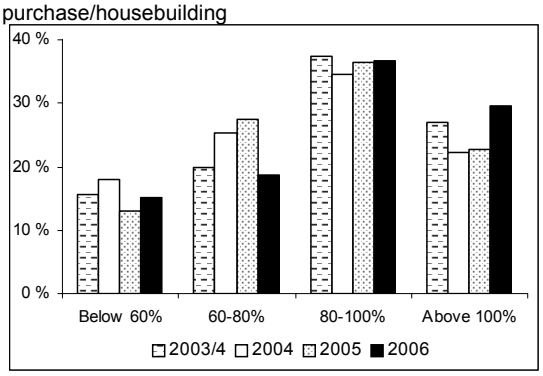
House prices rose by an unusually large margin in 2006, and the rate of increase quickened over the year and into 2007. The high activity in the housing market is contributing to the rapid accumulation of household debt. Bank lending secured on dwellings rose strongly in 2006, as previously. Since 1994 Kredittilsynet has conducted surveys of banks' practice as regards home mortgage loans. In 2006 29 banks, with a market share of about 85 per cent, reviewed almost 3000 loans secured on dwellings, and responded to a number of qualitative and quantitative questions. Equity release agreements were not included in the ordinary home loan survey.

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

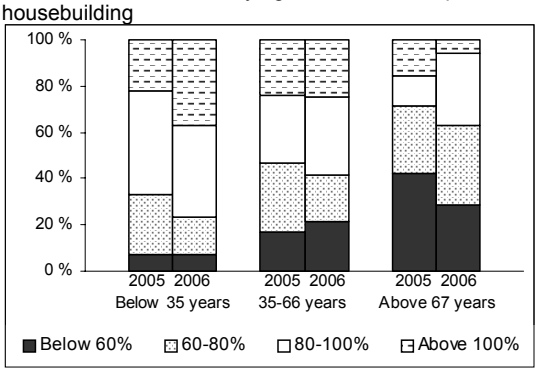


In the 2006 survey, refinancing loans made up just over half of the portfolio, whereas just over one in four loans were for house purchase. After edging down in the two preceding surveys, the proportion of loans with a loan-to-value ratio above 80 per cent increased substantially in 2006 from 37 to 42 per cent, the highest figure recorded in these surveys. Loans in excess of fair valuation increased from 12 to 14 per cent. More than four out of 10 loans with a loan-to-value ratio in excess of property valuation lacked (sufficient) additional collateral to bring overall security into line with the loan amount. Almost 30 per cent of loans for house purchase had a loan-to-value ratio in excess of 100 per cent, an increase of 7 percentage points over the previous year. When all loans in excess of 80 per cent of valuation are included there was an increase from 59 to 66 per cent.

3.10 Loan-to-value ratio, loans for house purchase/housebuilding



3.11 Loan-to-value ratio by age of borrowers – purchase/ housebuilding



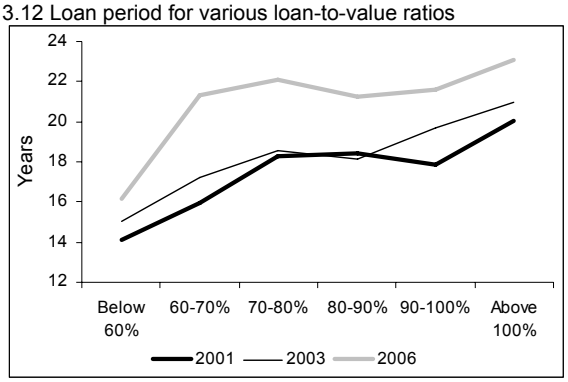
Younger borrowers have less equity available than their older counterparts, entailing a larger borrowing requirement for house purchase. Loan-to-value ratios showed a particular increase for this age group in 2006. As much as 77 per cent of loans for house purchase in the youngest age group had a loan-to-value ratio in excess of 80 per cent. There was also a marked increase in loans in excess of property valuation, from 22 to 37 per cent of the portfolio. For borrowers in the age range 35 to 66 there were only minor changes from 2005, and almost 60 per cent of loans for house purchase had a loan-to-value ratio in excess of 80 per cent.

Borrower with a high debt burden need some flexibility to face situations where their ability to pay is under pressure, for example as a result of interest rate hikes, lapse of income or other reasons. Cash-flow problems can be remedied by prolonging the repayment period or by agreeing an interest-only period. If borrowers already resort to such buffers when taking out a loan, this could be a danger signal. According to the autumn 2006 survey, the average life of home mortgage loans has risen markedly in recent years, as has the volume of interest-only loans. Roughly one in six loans granted is interest-only, compared with one in eight loans in the autumn 2005 survey. It is primarily the oldest and youngest borrowers who seek interest-only loans; for the under-35s almost one in five loans was interest-only in 2006.

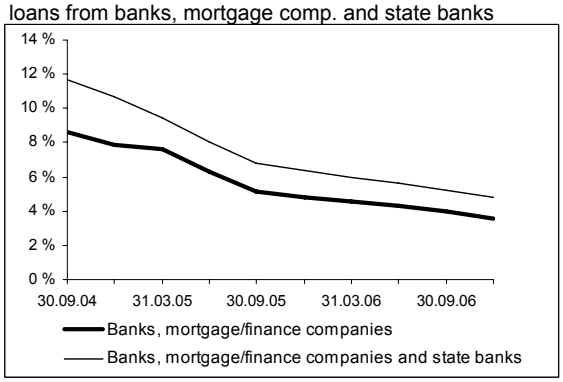
Insurance against high interest rates rarely appears to be a motive for Norwegian customers seeking a fixed-interest loan. Demand for such loans has been very low, except in periods where the fixed rate option has been lower than the floating rate. Because of the low level of floating rates in the survey period, the volume of fixed-interest agreements in the reported portfolio was below 1 per cent, despite clear signals of a substantial interest rate increase in the years immediately ahead. At end-2006 only

4.8 per cent of retail loans from Norwegian banks and mortgage companies (including the State Housing Bank and the State Educational Loan Fund) had a lock-in period above one year. The low proportion of fixed-interest loans in Norway increases borrowers' vulnerability to interest rate increases.

3.12 Loan period for various loan-to-value ratios



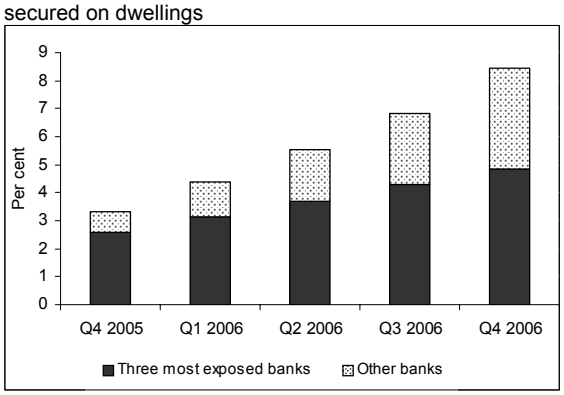
3.13 Fixed interest loans as a share of total retail loans from banks, mortgage comp. and state banks



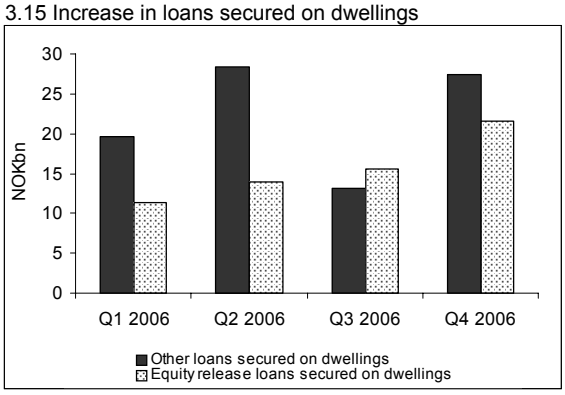
When processing loan applications, banks generally regard collateralisation as a second line of defence, their main focus being on the borrower's debt-servicing ability (and willingness). Most banks use models, largely based on the National Institute for Consumer Research, to compute borrowers' cash position after payment of fixed expenses. Their guidelines also require loan officers to assess the impact of higher interest rates on borrowers' finances. Most banks add a mark-up of 4-5 percentage points to the current lending rate.

More and more banks are offering retail customers a loan product in the form of a credit facility secured on the borrower's dwelling, enabling the customer to draw on the facility without having to apply each time ready funds are needed (equity release loans). At the end of 2006 such loans totalled some NOK 95 billion, or about 8 per cent of banks' total retail home mortgages, compared with 3.5 per cent the previous year. Three banks are especially active in this market, and were joined in 2006 by others offering the same product. Nearly half the growth in total home mortgage loans in 2006 was accounted for by equity release loans.

3.14 Equity release loans as a share of total loans secured on dwellings



3.15 Increase in loans secured on dwellings



(Note: Corrected 26.04.2007.)

Equity release loans make debt-financed consumption possible on favourable borrowing terms and afford borrowers greater financial flexibility. The growing significance of this type of loan product, where the customer himself decides the size of repayments, along with an increased volume of interest-only schemes and longer repayment periods for traditional home mortgages, means that households' loans are repaid at a significantly slower rate than previously. Hence, deferring principal payments is less able than previously to function as a buffer in periods of impaired ability to pay.

Some banks also offer home-equity pension products providing credit in the form of a lump sum payment and/or fixed monthly payments for a limited number of years against a house or recreational property. These products link banks' credit risk even more closely to the housing market. The risk is nonetheless acceptable provided banks' guidelines as regards loan-to-value-ratios and debt-servicing capacity are practised in a prudent and consistent manner.

Banks' information to borrowers

In the past three years Kredittilsynet has conducted surveys targeting banks' home-loan borrowers. The intention is to gain an impression of the extent to which borrowers receive, or believe they have received, information considered important when taking out a loan. The respondents are the same as those included in the home loan survey. In the wake of the first survey from 2004 Kredittilsynet dialogued with the banks' trade associations on ways to enhance the information flow between bank and customer. In a joint circular the trade associations asked the banks to supplement their mandatory information with information designed to ensure that customers are informed of important aspects of taking out a loan, such as the risks involved and the consequences of future interest rate increases. New standardised texts were also prepared for inclusion in loan documents.

In the 2006 survey a significantly higher proportion of customers reported having been informed of consequences that interest rate increases could have for their personal finances than was the case in the preceding surveys (54 per cent compared with 41 per cent in 2005). Despite some improvement on the preceding years, the autumn 2006 survey nevertheless shows a need for better communication between bank and customer. There is still a large proportion of customers who did not recall receiving information on the effective interest rate, or on the consequences of defaulting on a loan.

Unsecured consumer loans

A substantial share of loans for consumption purposes is secured on dwellings. In addition, both banks and finance companies offer unsecured consumer loans, which entail higher credit risk than loans secured on dwellings. As in 2005, a survey was conducted of a sample of companies which offer unsecured consumer loans, including credit card loans and other consumer loans without collateral. The companies in the sample offer various products, for example credit cards providing credit up to NOK 75,000 and unsecured loans ranging from NOK 10,000 to NOK 200,000, although larger loan amounts do occur. The effective interest rate on these loans varies from 7 to over 30 per cent, depending on the loan's size and repayment period.

Alongside eight finance companies the sample includes banks offering consumer loans as part of their business. The finance companies in the sample account for about 40 per cent of aggregate lending by

finance companies to wage earners. Growth in lending was 15.9 per cent in 2006 (adjusted for the effect of new companies in the sample). There are wide variations in growth between the companies.

Table 3.1 Trend in consumer loans in selected companies

	2002	2003	2004	2005	2006
Consumer loans (NOKm)	19,381	20,816	22,823	26,276	31,073
Growth % (12-month)*	15.7	7.4	9.6	15.1	15.9
Book losses (NOKm)	511	574	398	382	255
Losses as % of consumer loans	2.6	2.8	1.7	1.5	0.8
Net interests as % of ATA	8.4	10.1	12.0	11.6	11.3
Ordinary operating profits as % of ATA	4.0	4.9	7.7	7.6	7.7
Loan defaults, net (NOKm)	961	1,116	893	848	911
Defaults as % of consumer loans	5.0	5.4	3.9	3.2	2.9

*Percentage growth in 2006 is adjusted for new companies in the selection.

Book losses and loan defaults are higher than for finance companies and banks in general. However, there has been a marked reduction in the level of losses and defaults in recent years, possibly reflecting improved borrower finances and more careful credit assessments on the part of the companies. In result terms there are relatively wide variations between the companies. As a group, their net interest revenues were higher than for companies whose main business is not consumer financing, and their profits are clearly on a higher level.

Households' sensitivity to interest rate increases

Since autumn 2003, on commission from Kredittilsynet, Statistics Norway has provided model projections of households' debt and interest burden. The model also analyses households' interest burden in the event of a substantial interest rate increase at the end of the projection period. The study conducted in autumn 2006 provides projections to the end of 2008. The interest rate increase in the stress test is incorporated at the turn of the year 2008/2009.

The model starts out from volume figures for 2004 taken from the tax assessment statistics. The assumptions underlying the projections are based on historical data as of the third quarter 2006, where available, while the forecasts for wage growth and bank lending rates are taken from Economic Survey (September 2006). The tax programme in the model comprises current 2007 rules, which as a purely technical assumption are continued for 2008 such that the thresholds in 2007 are wage-adjusted for 2008. Credit growth is assumed to edge down from the current level to 12 per cent in 2007 and 2008. Under the assumptions outlined, the calculations show that households' total debt burden, which in 2004 measured about 160 per cent of total incomes, rises to 200 per cent by the end of 2008. Whereas households are in a relatively favourable financial position overall, some groups are significantly more vulnerable to interest rate changes than others. Households are classified in three main groups on the basis of interest burden (defined as interest rate expenses divided by disposable income). Based on the distribution of debt, income and wealth in 2004, the model projects the number of households falling within each of the three groups in 2008, as well as each group’s share of the total debt.

After a high interest burden in 2002, the steep interest rate fall in 2003 and into 2004 meant that relatively few households had an interest burden above 20 per cent towards the end of 2004. The

interest rate increase starting in summer 2005, the assumption of a continuing rise in interest rates ahead and 12 per cent credit growth in the next two years entail a significantly higher number in 2008. In the basis scenario for 2008 the number of households with an interest burden above 20 per cent is back to about the same level as in 2002. The interest rate is however assumed to be 5 per cent, significantly lower than in 2002, i.e. the rise must be ascribed to the period's growth in credit. The proportion of total debt among households with a high interest burden is doubled.

Table 3.2 Number of households and share of total debt by interest burden

	2004		2008, interest rate of 5 per cent		2008, interest rate up 2 percentage points		2008, 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 %	1,563	81	1,453	63	1,223	43	1,134	36
20 – 30 %	75	11	180	20	259	23	273	23
Over 30 %	37	7	105	16	257	33	331	40

Sources: Statistics Norway and Kredittilsynet

Should, on the other hand, interest rates rapidly climb, the most vulnerable groups will be heavily affected. Two stress tests are carried out in which interest rates rise 2 and 3 percentage points respectively by the start of 2009. Both increases are within Norges Bank's uncertainty fan as presented in Inflation Report 3/2006. In the case where interest rates rise by 2 percentage points the calculations show that just over half a million households acquire an interest burden in excess of 20 per cent, and half of these a burden in excess of 30 per cent. About 56 per cent of the overall debt will reside with these groups. If interest rates rise by 3 percentage points, the number of households with an interest burden in excess of 20 per cent rises to just over 600,000, i.e. more than a quarter of households. These households hold almost two-thirds of aggregate debt. Households with a buffer in the form of liquid assets will be better placed to tackle the debt and interest burden. The calculations show that the groups with the highest debt burden have the smallest buffer in the form of financial wealth.

Loans backed by securities

Since 1997 Kredittilsynet has conducted annual surveys of the volume, and banks' treatment, of loans secured by financial instruments. Twenty-one banks participated in the 2006 survey. The survey draws a distinction between commercial credits, with a term of up to one year, and other loans with a term above one year. In order to identify the extent of debt-financed savings products secured by financial instruments, the 2006 survey was extended to include structured products such as index-linked deposits and equity and index bonds. These products come under the category of other loans with terms above one year.

Table 3.3 Credits backed by financial instruments, 3rd qtr 2006

	Commercial credits backed by financial instruments				Other loans backed by financial instruments				Total loans backed by financial instruments			
	NOKbn		As per cent of gross loans		NOKbn		As per cent of gross loans		NOKbn		As per cent of gross loans	
	Q3 05	Q3 06	Q3 05	Q3 06	Q3 05	Q3 06	Q3 05	Q3 06	Q3 05	Q3 06	Q3 05	Q3 06
5 most exposed banks	0.6	1.8	0.7	1.8	12.0	0.2	13.9	16.5	12.7	18.7	14.7	18.3
Total (21 banks)	6.4	9.5	0.5	0.6	40.4	47.5	3.0	3.0	46.8	57.0	3.5	3.6

The volume of loans backed by financial instruments, traditionally low in Norway, has risen somewhat in recent years. Overall, the loan volume has increased from NOK 46.8 billion as of the third quarter 2005 to NOK 57 billion as of the third quarter 2006. This is equivalent to 3.6 per cent of banks' total gross lending. Although overall exposure is limited, some banks are heavily exposed to such types of commitments. The bulk of the volume growth relates to structured products posing low risk for the banks, and is accounted for by a small number of banks that are putting substantial resources into this market. However, figures from a follow-up survey carried out by Kredittilsynet in the first quarter of 2006 among the five banks with the highest exposure in debt-financed structured products suggest that the popularity of these products is waning. Whereas the five banks' total loan volume for purchase of this type of financial instrument rose from NOK 9.1 at the end of the third quarter 2005 to NOK 14.5 billion in the first quarter 2006, it had risen to a mere NOK 15.2 billion by the end of the third quarter 2006.

Table 3.4 Credits backed by financial instruments – structured products, 3rd qtr 2006

	Structured products					
	NOKbn		As % of loans backed by financial instruments		As % of gross loans	
	Q3 2005	Q3 2006	Q3 2005	Q3 2006	Q3 2005	Q3 2006
5 most exposed banks	9.1	15.2	71.6	81.4	10.5	14.9
Total (21 banks)	23.3	34.6	49.8	60.7	1.7	2.2

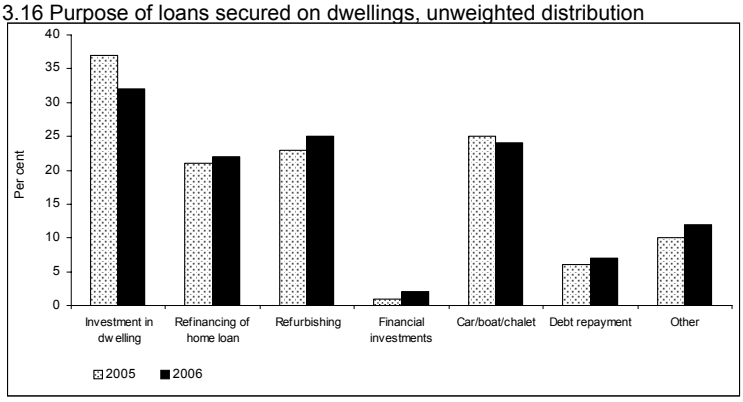
About NOK 48 billion was invested in structured products in Norwegian banks and foreign branches in Norway as of the third quarter 2006, an increase of NOK 2 billion over the third quarter 2005, but somewhat lower than the second quarter 2006. The 21 banks in the survey reported a total investment of NOK 34.6 billion in debt-financed equity bonds, index bonds and index-linked deposits as of the third quarter 2006. Hence it is safe to assume that large portions of the investments in these products are debt financed. Other surveys conducted by Kredittilsynet have brought to light incentives for advisers to offer structured products rather than other products, as well as instances where subscription material has contained deficient and misleading information on costs and real return on the products concerned. In 2006 Kredittilsynet elaborated and established new rules and guidelines for institutions that offer such products.

Loan purposes

In conjunction with Kredittilsynet's surveys of banks' information to borrowers (see above), respondents were questioned on the purpose of their home mortgage borrowing. They were free to report a number of purposes for each loan. Customers who had taken out equity release loans were not covered. The survey indicated that the most common loan purpose was to invest in a dwelling, including purchase or construction of one's own house. More than 30 per cent of respondents reported this as the purpose of the loan, somewhat fewer than in the previous survey. Home refurbishment, purchase of a car, boat or recreational property, along with refinancing were the next most reported loan purposes. The volume of financial investments in structured products, shares, bonds and equity funds was limited, and only 2 per cent reported using the loan for these purposes. The number reporting repayment of other debt as one of the purposes of the loan was also small.

In January 2007 Fokus Bank conducted a survey of the use to which equity release loans were put, which shows largely the same picture as Kredittilsynet's survey. However, based on the results of the surveys, equity release loans appear to be used more often for consumption purposes than is the case with traditional loans secured on dwellings. Moreover, a somewhat higher share reported securities purchase as the purpose of the loan.

3.16 Purpose of loans secured on dwellings, unweighted distribution

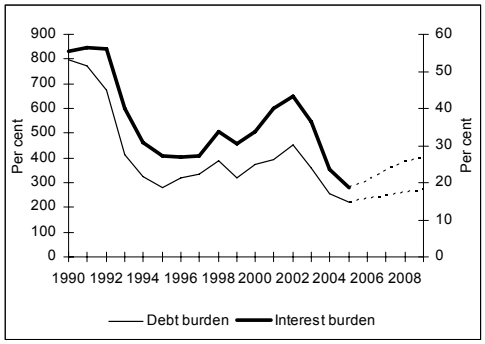


Corporate sector

Since the cyclical turnaround in mid-2003 production has picked up among mainland (non-oil sector) enterprises. The upturn has fuelled strong growth in investment. Return on equity has risen sharply in recent years, reaching 20 per cent in 2005. Corporate equity ratios have concurrently increased to levels significantly higher than at the start of the 1990s. Corporate profit performances improved substantially in 2005, and according to their annual accounts Norwegian limited companies' profits rose by a good 50 per cent from 2004 to 2005. Preliminary figures for 2006 indicate that the positive trend has continued. While improvements are noted in most industries, the upswing has been most marked in relative terms in the primary industries and manufacturing.

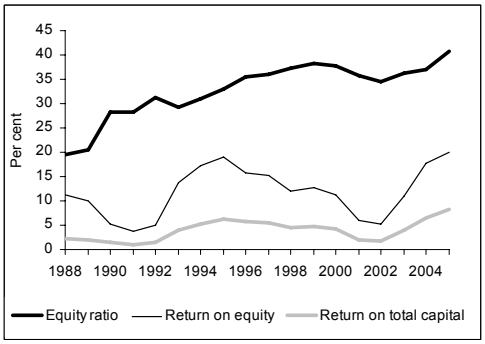
Corporate indebtedness has fallen sharply in recent years on the back of high profits and low debt growth, while low interest rates have reduced the interest burden. The rapid growth in corporate debt in 2006 is probably adding to the debt burden despite the high profits. Projections by Norges Bank show that the debt and interest burden in the corporate sector is likely to rise ahead if profitability is impaired and debt growth remains high.

3.17 Enterprises' debt and interest burden



Source: Norges Bank

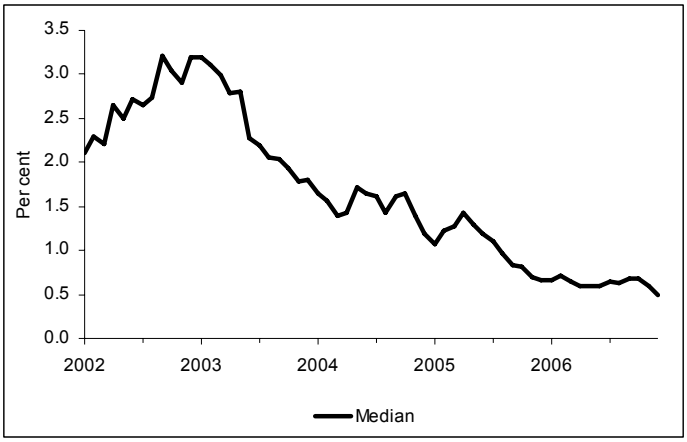
3.18 Return on capital and equity ratio



Source: Norges Bank

The number of bankruptcies has fallen steadily in the past three years, and 2006 brought 14 per cent fewer bankruptcies than the previous year. In the fourth quarter 2006, however, more bankruptcies were recorded than in the same period the previous year. Calculations using Moody's KMV credit risk model show a favourable trend for the full year 2006. This model calculates the likelihood of default for the 4,000 or so largest Norwegian companies, which in aggregate account for the bulk of the corporate sector's debt. The model utilises market information in addition to accounting data. Norwegian firms' likelihood of default has been calculated on the basis of accounting data for 2005 and market information up to and including 2006. The likelihood of default has fallen appreciably since autumn 2002, and was at a very low level at the end of 2006.

3.19 Likelihood of default, Norwegian enterprises



Source: Moody's KMV

Exposure to selected industries

Each year since 1998 Kredittilsynet has investigated banks' exposure to selected industries. The 2006 survey covered shipping, the shipbuilding industry, offshore industry, extraction of oil and gas, fishing and whaling, fish farming, property management and construction. The 11 largest banks are covered, and the analysis is based on the banks' own risk assessments and classifications. The banks' total commitments to the eight selected industries rose by 24 per cent from the third quarter 2005 to the same quarter 2006. The volume drawn rose in the same period by 28 per cent, suggesting that borrowers are drawing down credit facilities to greater degree than previously. The growth in lending to the various industries largely shadows cyclical trends.

The third quarter 2006 survey showed that, apart from the engineering industry and construction, all industries have reduced the high-risk portion of their lending. The largest reduction was in fish farming. Property management is the industry where most banks have their largest exposures, and bank lending to this industry totalled NOK 216 billion at the end of the third quarter 2006, an increase of 25 per cent over the previous year. Interest in commercial property is intense. In addition to capital-rich professional investors, smaller private investors have also contributed to pushing up commercial property prices via new forms of investment. The price growth puts pressure on return from investment projects, rendering investors more vulnerable to market fluctuations.

Table 3.5 Banks exposure to selected industries as of the third quarter of 2006

Industry	Loan commitments		Amount drawn		High risk as % of amount drawn		Exposure as % of capital base
	NOK billion	Growth Q3 05 – Q3 06 as per cent	NOK billion	Growth Q3 05 – Q3 06 as per cent	Q3 2005	Q3 2006	
Shipping	208	30	192	26	1.8	1.6	153
Shipbuilding	14	80	10	176	16.1	16.3	10
Offshore	20	69	12	159	0.8	0.0	14
Oil/gas extraction	26	-30	13	50	1.3	0.5	19
Fishing, sealing and whaling	18	23	15	11	9.2	4.4	13
Fish farming	17	28	11	8	17.8	9.8	13
Property management	216	25	185	21	3.6	3.5	158
Building and construction	36	25	23	24	4.6	4.6	26
Total	554	24	462	27			

The largest banks' exposures to credit risk

In autumn 2006 Kredittilsynet carried out an overall risk assessment of eight large banks. The banks' corporate market portfolios were analysed using Norges Bank's bankruptcy prediction model which takes in all limited liability companies. The model predicts the likelihood of a company going bankrupt one year ahead based on the last published annual accounts. The calculations do not take into account collateral held by the banks.

Gross expected loss on banks' exposure to all firms, calculated with a basis in bankruptcy likelihoods, fell from 0.53 per cent in 2005 to 0.45 per cent in 2006. In the case of the banks that were analysed in connection with the overall risk assessment, gross expected loan losses (unweighted) fell from 0.63 to 0.59 per cent, i.e. a somewhat higher level than for all firms as a whole. About 60 per cent of the banks' corporate market portfolio was analysed using the bankruptcy prediction model. The banks' expected loan losses in 2006 varied between 0.3 and 0.8 per cent. Three of the banks showed an increase in credit risk in the period. The analysis also showed that gross expected loss for the banks' new customers was in general higher than for the banks' total portfolio. In 2006 new customers' expected loss averaged 0.92 per cent.

Bank losses are also assessed in relation to expected losses for all firms in the region of relevance to the particular bank, as are individual banks' losses on corporates in individual industries. Expected losses were highest for retail trade, construction and fishing and whaling. For all industries, expected losses were unchanged or falling from 2005 to 2006. In several industries variation among banks was higher in 2006 than the previous year.

Market risk

Market risk is the risk of loss of revenue or capital as a result of changes in the market prices of shares, fixed income instruments, currencies or commodities, and depends on both the volatility of market prices and the size of positions taken. Insurance companies and pension funds are most exposed to market risk.

Banks

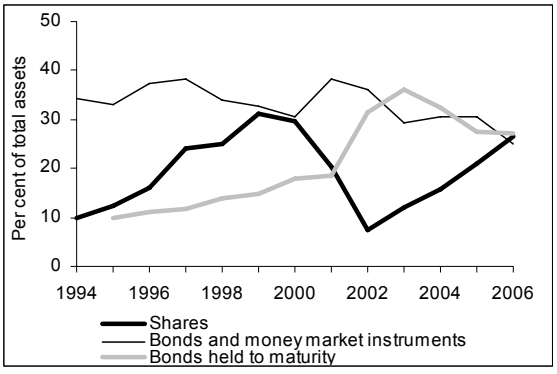
Banks are less exposed to market risk than insurance companies. In 2006 Kredittilsynet employed stress tests to assess eight of the largest banks' exposure to market risk. The stress tests incorporate a 30 per cent fall in share prices, a 2 percentage point parallel shift in the interest rate curve and a 10 per cent change in the exchange rate. Derivative positions are taken into account. It is assumed that the banks exposure limits are fully utilised; diversification effects across asset classes are not taken into account. In addition to stress tests on exposure limits, qualitatively based additions are made in respect of risk diversification within asset classes as well as market liquidity. The average for the eight banks showed a loss potential on shares, fixed income securities and foreign currency representing 63 per cent of the average pre-tax profit for the last three years, equivalent in isolation to a reduction of 0.8 percentage points in tier 1 capital adequacy.

Banks are required to calculate capital charges for market risk. In 2006 the measurement base for the trading portfolio measured between 4 and 5 per cent of the overall measurement base for capital adequacy, somewhat higher in the larger banks than in medium-sized and small banks. This reflects the fact that credit risk is of far greater significance than market risk for Norwegian banks. Position risk for debt instruments makes up by far the largest part of the measurement base for the trading portfolio, followed by counterparty risk and other risk.

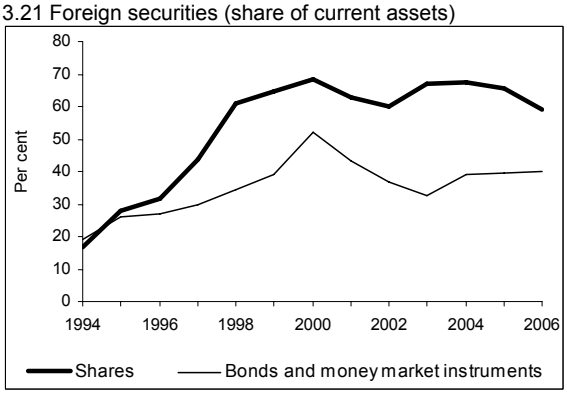
Life insurance companies

Falling share markets in the period 2000 to 2002 led to a substantial reduction in shareholdings as a proportion of life insurance companies' total assets. Since 2003 the equity component has increased anew, mainly as a result of a positive share market trend, and accounted for 26 per cent of life insurers' total assets at the end of 2006, somewhat higher than the level in effect before shareholdings were reduced in 2001. Since the end of 2005 the equity component has increased by about 5 percentage points, of which about 1 percentage point is due to mergers of unit linked companies with traditional life insurers. Money market instruments and bonds held as current assets have been stable as a proportion of total assets for a long period, but were reduced by almost 5 per cent in 2006 to 25 per cent at year-end. The volume of bonds held to maturity is lower than in the peak year 2003, accounting for 27 per cent of the balance sheet at end-2006. The interest rate on this part of the portfolio averaged 5.0 per cent. Almost three-quarters of the portfolio matures after 2009, with an average interest rate of 4.7 per cent.

3.20 Shares and fixed income securities



3.21 Foreign securities (share of current assets)

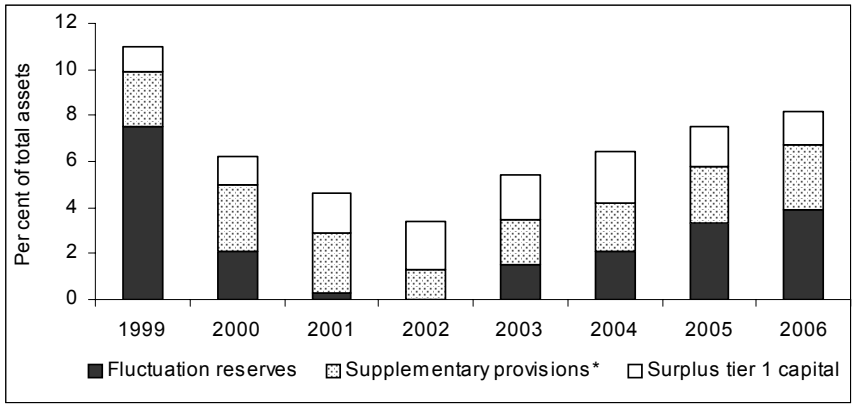


Life insurers expanded their foreign securities component substantially from the mid-1990s onwards, with the strongest increase recorded in shares. After remaining relatively stable from 1998 onwards, the foreign share component fell from 65 per cent to 59 per cent of total assets in 2006, partly due to the relatively stronger increase in Norwegian share values. The proportion of current bonds and money market instruments held as foreign paper was close to 40 per cent at the end of 2006, showing more or less no change compared with the last three years.

Life insurers' buffer capital is designed to cushion their market risk and other risk. Buffer capital is defined as surplus tier 1 capital, supplementary provisions with an upward limit of one year's interest guarantee (less supplementary provisions used to compute regulatory capital) and fluctuation reserves. Supplementary provisions are entirely customer assets, whereas fluctuation reserves mainly comprise customer assets and tier 1 capital comprises the company's assets.

Life insurers' aggregate buffer capital came to NOK 53.4 billion at the end-2006, an increase of NOK 10.3 billion over the end of 2005. According to preliminary figures, increased fluctuation reserves contributed NOK 6.6 billion, while supplementary provisions included in buffer capital ended the year NOK 3.9 billion higher than in 2005. Buffer capital measured 8.2 per cent of total assets at end-2006, the highest level since the end of 1999. Buffer capital fluctuated somewhat through the year, measuring 6.3 per cent at the end of the second quarter after the share market fall in May.

3.22 Composition of life insurers' buffer capital in per cent of total assets



*Includes supplementary provisions with an upward limit of the year's interest guarantee.

Profitability in the European insurance market has improved in recent years after the weak years following 2000. While results vary across countries, some general trends appear to be in evidence. The positive trend in international equity markets has improved the results of life insurers and pension funds. Low interest rates have boosted demand for unit linked products, which account for some 28 per cent of aggregate premium revenues in life insurance in Europe, and for over half of the growth in premium revenues.

Stress tests

Both Kredittilsynet and life insurers employ stress testing when assessing insurers' ability to withstand unexpected, unfavourable market movements. The outcome of three different stress tests, with a basis in companies' buffer capital at the end of 2006, is illustrated below. They contain no information on the likelihood of the scenarios actually materialising.

Scenario 1 assumes a 30 per cent fall in the Oslo Børs all-share index, and a 20 per cent fall in equivalent indices in international equity markets.
Scenario 2 assumes a 10 per cent fall in the real estate market.
Scenario 3 assumes a 1.0 percentage point interest rate rise in Norwegian and international fixed income markets.

Table 3.6 Stress tests as at 31.12.2006

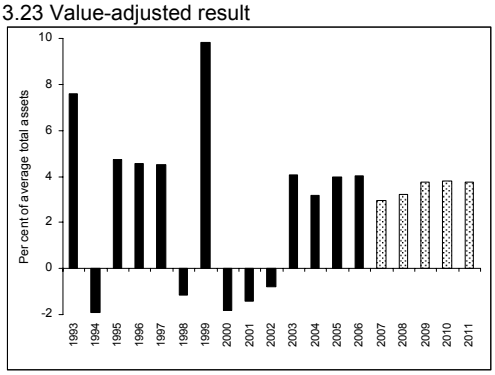
	Buffer capital before stress test		Value fall in stress scenario						Buffer capital after stress test	
			Equities		Real estate	Bonds		Total		
	NOKm	% of TA	Norwegian	Foreign		Norwegian	Foreign		NOKm	% of TA
Scenario 1	53,367	8.2	-19,491	-17,501	0	0	0	-36,992	16,375	2.5
Scenario 2	53,367	8.2	0	0	-6,873	0	0	-6,873	46,494	7.1
Scenario 3	53,367	8.2	0	0		-1,721	-2,604	-4,325	49,042	7.5
1, 2 and 3	53,367	8.2	-19,491	-17,501	-6,873	-1,721	-2,604	-48,190	5,176	0.8

Six of the nine companies have the buffer capital needed to withstand a combination of all three scenarios. This type of stress test focuses on the short-term effects of higher interest rates through capital losses on holdings. In the longer term higher long rates will in isolation impact favourably on insurers' return on their assets. Although the companies' buffer capital is higher at end-2006 than at end-2005, the risk faced is also higher. A comparison with the stress test carried out at the same point in 2005 (see *The Financial Market in Norway 2005: Risk Outlook*) shows that although buffer capital is significantly higher in 2006, it falls to about the same level should the three scenarios materialise simultaneously. This is due to the companies' increasing exposure to shares in 2006.

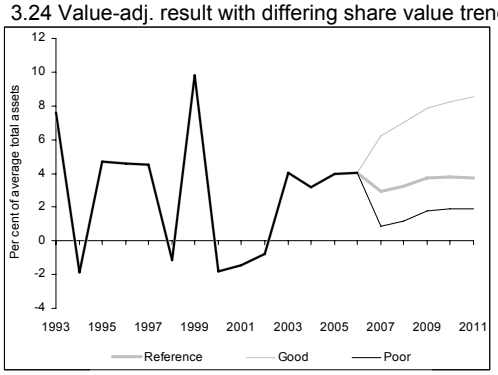
Long-term projections

Projections of life insurers' results have been made for the period 2007 to 2011, based on actual results for 2006. Assumptions include a slow rise in long interest rates ahead, to 4.9 per cent in Norway and 4.8 per cent in the US in 2011, based on an average of forecasts by international forecasting institutes (Consensus Forecasts). An annual rise of 8 per cent is incorporated for shares in a reference path. In a "good" and a "poor" scenario, share prices are assumed to rise by 20 per cent and 0 per cent respectively. Furthermore, insurers' asset mix is assumed to change only as a result of value changes and not as a result of active reallocation between asset classes. On these assumptions the projections show that value-adjusted results in the reference path will continue on the same level as in recent

3.23 Value-adjusted result



3.24 Value-adj. result with differing share value trends

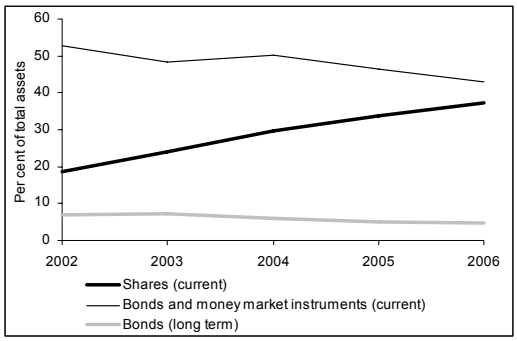


years. The decline in 2007 is due to the fact that in the projections equity markets are assumed to rise substantially less than was the case in 2006. Later in the period the rise in long rates has a positive effect on results. Since the results are sensitive to alternative assumptions for the share market trend, the projections merely illustrate possible scenarios. No account is taken of regulatory changes affecting life insurers.

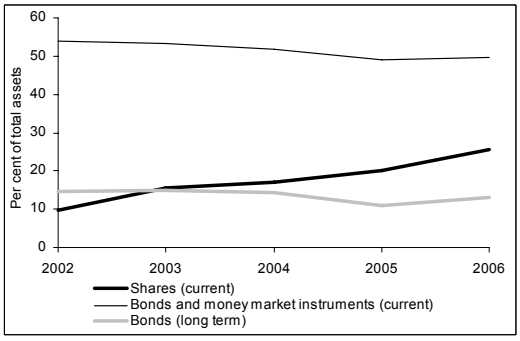
Pension funds

Private pension funds raised their equity component by 3 percentage points, bringing it to 37 per cent of total assets by end-2006. Municipal pension funds' equity component rose by almost 6 percentage points to 25 per cent. Both municipal and private pension funds had a higher foreign equity component at end-2006 than one year previously, with respectively 59 and 54 per cent of total shareholdings consisting of foreign shares. While pension funds have held a higher proportion of Norwegian shares than life insurance companies in recent years, the foreign component is now at about the same level in both types of institution.

3.25 Equities and fixed income securities in private pension funds

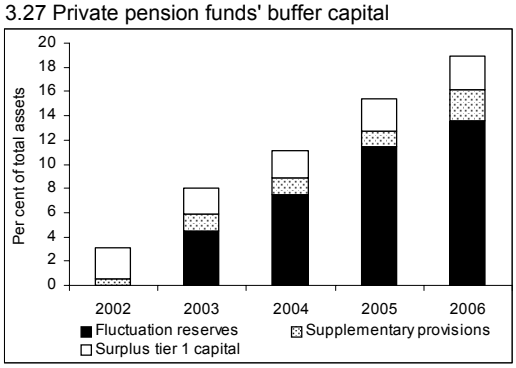


3.26 Equities and fixed income securities in municipal pension funds

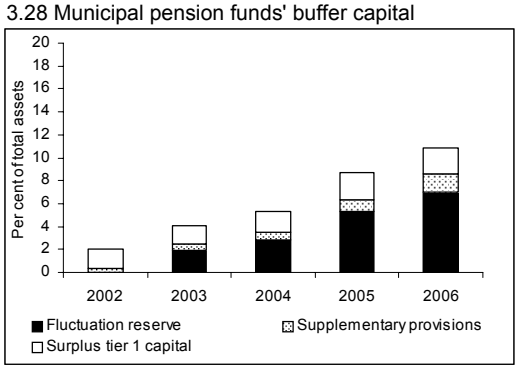


The trend in securities markets in 2006 strengthened pension funds' overall buffer capital. Buffer capital (defined as surplus tier 1 capital, supplementary provisions with an upward limit of one year's interest guarantee and fluctuation reserves) measured 17 per cent at end-2006 compared with 13 per cent one year previously. There is a wide difference in buffer capital levels between private and municipal pension funds, 19 per cent and 11 per cent respectively, mainly related to the size of fluctuation reserves. Premium funds made up 9 per cent of total assets of private pension funds and 5 per cent in the case of municipal pension funds.

3.27 Private pension funds' buffer capital



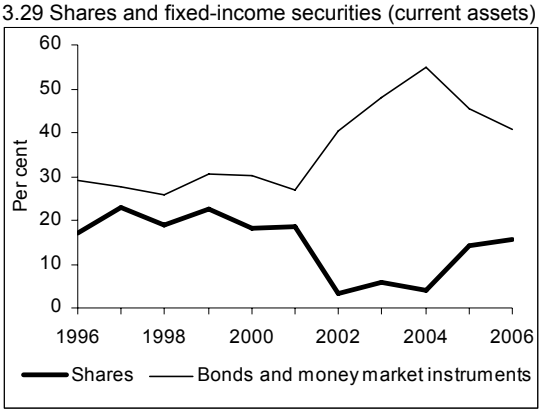
3.28 Municipal pension funds' buffer capital



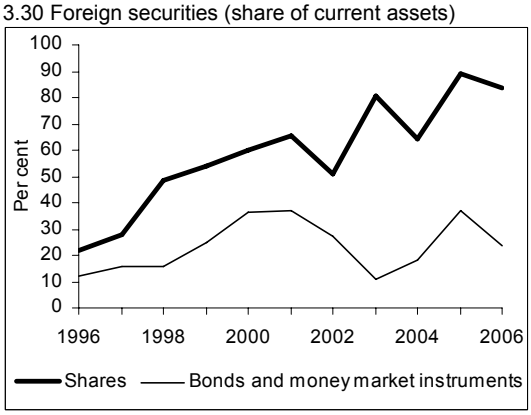
Non-life insurance companies

In the case of the three largest non-life insurance groups, aggregate holdings of money market instruments and bonds classified as current assets constituted 41 per cent of total assets at the end of 2006, down 4.5 percentage points on last year and 14 percentage points on the last two years. Aggregate shareholdings rose substantially in the same period, from 4 per cent of total assets at the end of 2004 to 16 per cent at the end of 2006. At 10 per cent, bonds held to maturity make up a smaller share of total assets than in the case of life insurance companies at the end of 2006. The foreign component of aggregate shareholdings has been rising for a long period, reaching a very high 84 per cent at end-2006. This is significantly higher than for life insurers and pension funds. The foreign component of fixed income securities fell to 24 per cent in 2006.

3.29 Shares and fixed-income securities (current assets)



3.30 Foreign securities (share of current assets)



The past three years' sound results have substantially strengthened non-life insurers' financial position. The largest non-life groups met the capital adequacy requirement and minimum requirement on technical provisions at the end of 2006. The cover ratio (actual provisions in per cent of the minimum requirement) rose from 109 per cent to 112 per cent. Non-life insurers' exposure to market risk is in general moderate, and large falls in securities markets will in most cases not lead to serious capital problems in this segment.

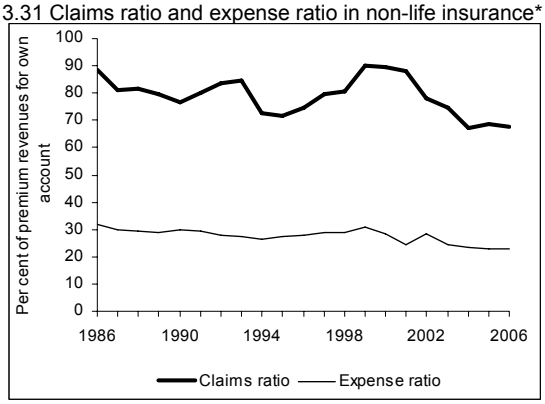
Insurance risk

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 diverge from what was anticipated when the premium levels were set. Claims expenses are usually more variable in non-life insurance than in life insurance since the mortality trend is relatively stable. In the longer term changes in life expectancy represent a substantial insurance risk. While variations in the disability trend may affect results in the short term, market risk is the dominant risk for life insurers.

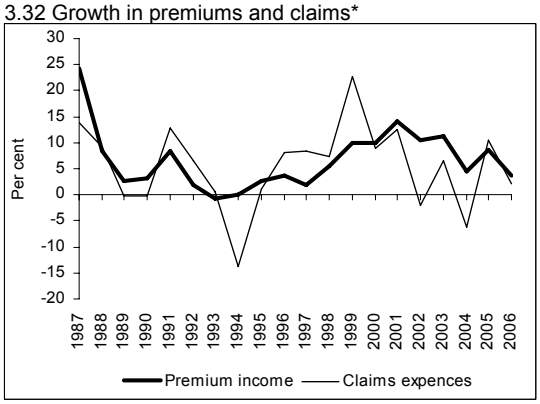
The non-life insurance sector has seen wide fluctuations in recent years in the ratio of claims expenses to premium revenues (the claims ratio), while the expense ratio (insurance-related operating expenses in per cent of premium revenues) has shown a more stable trend. Growth in claims expenses was

particularly high in 1999 to 2001, but has since slowed sharply. Premium growth edged down as from 2001, but remained above the growth in claims up to 2005.

3.31 Claims ratio and expense ratio in non-life insurance*



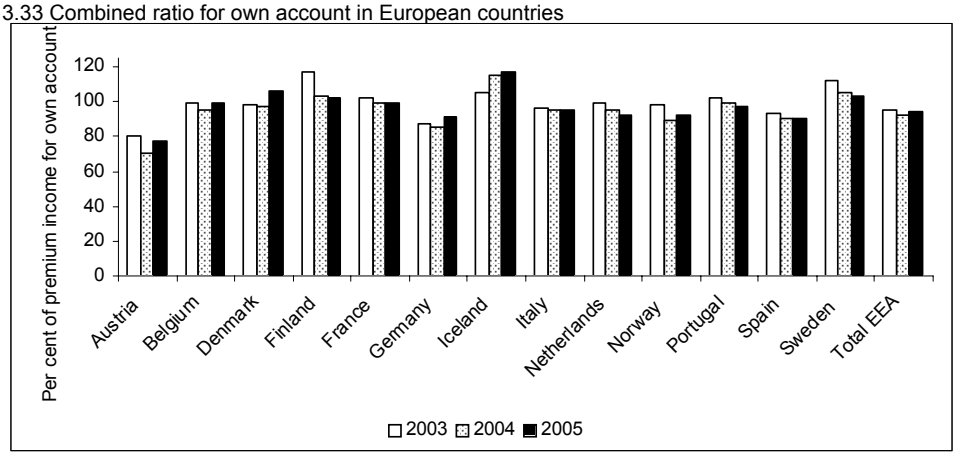
3.32 Growth in premiums and claims*



*Norwegian non-life insurers and branches of foreign non-life insurers.

The claims ratio has varied widely over time, also within branches. This ratio was very high in occupational injury insurance from 1998 to 2000, and is still appreciably higher than in other branches, reflecting lasting upward adjustments of estimates of future claims payments. In other sectors the claims ratio shows a clear falling tendency in recent years. In 2005 the claims ratio was lowest in fire insurance and combined insurance, particularly in the business market. It rose in 2005 in motor vehicle, business and marine insurance, while remaining unchanged or lower in other segments.

3.33 Combined ratio for own account in European countries



Source: Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

The low claims ratio and good results in recent years have drawn attention on the competitive situation in the non-life insurance market. Recent years' good results are related to cyclical variations in the claims ratio inasmuch as changes in the premium level lag changes in the claims level. This is partly because it takes a while for premium increases, once decided, to be fully reflected in the accounts, and partly because decisions to change premiums are delayed as a result of uncertainty about whether the changes are permanent or random effects. Results in the three years 2003-2005 must be seen in light of the very weak results in the three preceding years 2000-2002, and, viewed over time, the results so far do not suggest that competition in the non-life insurance market is on the weak side. Non-life insurers

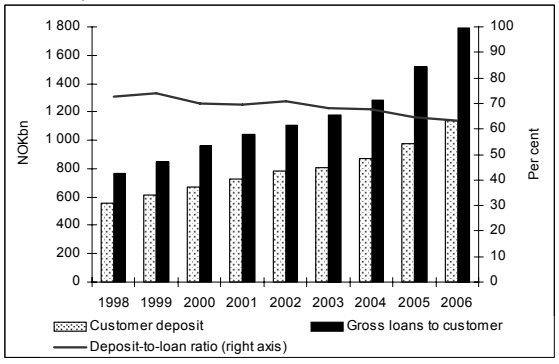
in many countries have seen substantially improved performances in recent years compared with the situation around 2000. Technical results are very good in most countries, and the combined ratio in 2005 was well below 100. For the EU/EEA countries as a whole the combined ratio in 2005 was 94, compared with 92 in Norway.

The 2006 results show that while premium growth declined for non-life insurers as a whole, growth in claims expenses has also significantly declined, producing a very low claims ratio in 2006. For the largest non-life groups premiums grew at a slower rate than claims expenses in 2006, bringing an increase in their claims ratio. The weak growth in premium revenues may indicate that premiums fell in real terms in relation to the value of insured objects, such as motor vehicles and dwellings, in other words the weak growth is a function of competition in the non-life insurance market.

Liquidity risk

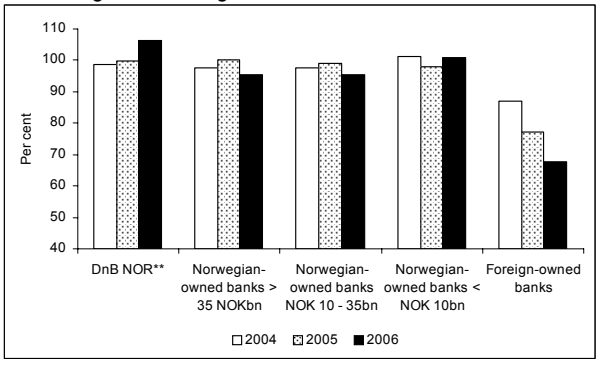
Liquidity risk, i.e. the risk that an institution will be unable to honour its commitments as they fall due without incurring substantial additional costs, is rooted in differing maturities on banks' assets and liabilities. A high level of short-term funding of lending activity and other illiquid assets 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. It is primarily the large banks that obtain funding in the money and securities markets. Smaller banks are more dependent on customer deposits as a source of funding.

3.34 Deposit-to-loan ratio*, all banks



*Deposits from customers as per cent of loans to customers

3.35 Long term funding*



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

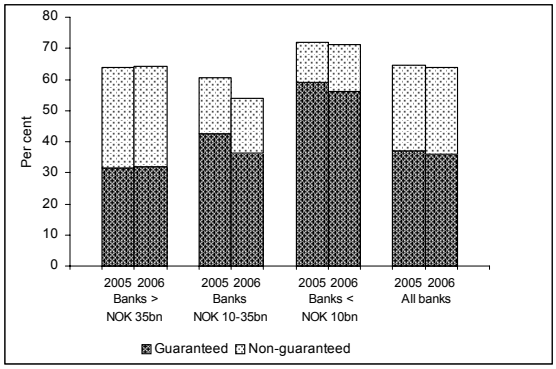
High lending growth over several years and increased competition for deposits have put pressure on banks' deposit-to-loan ratios. Bank deposits rose by all of 15 per cent in 2006, particularly deposits from corporate customers. Despite this, the deposit-to-loan ratio fell to 63 per cent for the banks as a whole by end-2006. A decline in this ratio requires banks to bring in other long-term funding if they are to maintain their overall level of such funding. Long-term funding (customer deposits, bonds with a maturity of more than one year and equity capital) has been relatively stable in recent years for the bulk of the banks. Whereas long-term funding of lending has increased at DnB NOR, particularly in

the past year, and also at the smallest banks, it has significantly declined at foreign-owned banks which receive substantial funding from the parent company.

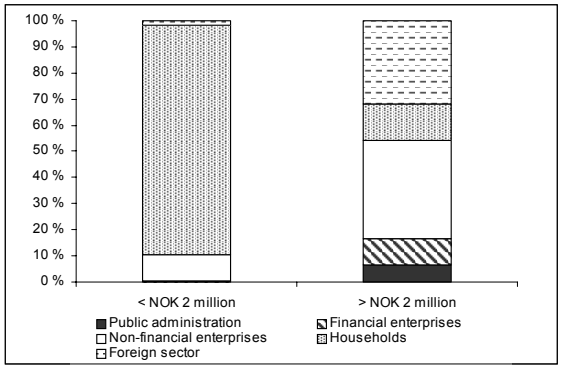
Although the bulk of customer deposits do not carry a lock-in period, they can probably be regarded as a stable source of finance, albeit less stable in the case of deposits not covered by the deposit-guarantee arrangement. Under the Guarantee Schemes Act deposits of up to NOK 2 million per depositor are covered, although not deposits by, among others, financial institutions. At the end of 2006 guaranteed deposits accounted for 36 per cent of lending, while the overall deposit-to-loan ratio was 63 per cent. The share of guaranteed deposits was somewhat lower in 2006 than in 2005. The smallest banks have the highest ratio of guaranteed deposits to loans. Households accounted for 42 per cent of bank deposits at the end of 2006, the bulk of which are below NOK 2 million. Deposits from non-financial enterprises and from abroad make up the bulk of deposits above NOK 2 million.

At the end of 2006 overall funding from foreign sources totalled almost NOK 470 billion, with the largest banks accounting for more than 80 per cent. Higher risk may attend funding from foreign sources than from domestic sources, partly because foreign actors may respond collectively to negative changes in the Norwegian economy or Norwegian financial markets. On the other hand, funding from a variety of sources can make for better diversification of funding risk. Banks' earnings and financial strength, along with rating and size, are crucial for access to funding from abroad and for its price. DnB NOR is an important credit line for small Norwegian banks, and the contagion effects of any reduction in DnB NOR's access to foreign funding could be substantial.

3.36 Guaranteed and non-guaranteed deposits, share of gross loans to customers, 31.12.2005/2006



3.37 Deposits above/below NOK 2 million at all banks by sector at 31.12.2006



Kredittilsynet investigated liquidity risk at seven large banks in 2006 in a follow up to the survey in the liquidity field carried out in 2005. Banks' long-term funding of lending operations has been stable. The impression gained from reviewing banks' management and control of liquidity risk is that they function satisfactorily. Improvements have been noted at several banks since the assessments made in 2005.

New liquidity rules for financial institutions

New liquidity rules went into force for financial institutions on 1 July 2006. The new rules, which were moved from the banking acts to the Financial Institutions Act, apply to banks, finance companies, mortgage companies, insurance companies and branches of foreign financial institutions in Norway.

Kredittilsynet forwarded draft regulations on prudent liquidity management to the Ministry of Finance in November 2006. The new liquidity rules revoke the earlier requirement that institutions' liquid funds should be equivalent to at least 6 per cent of overall liabilities. Institutions must have sufficient liquidity to meet their obligations upon maturity at all times, and management boards must establish guidelines to ensure that liquidity management is prudent.

Operational risk

Operational risk means the risk of loss resulting from inadequate or failed internal processes or systems, human error or external events. This definition covers legal risk, and is in line with the definition used in connection with the new capital adequacy framework (Basel II). Basel II requires institutions to calculate a minimum capital charge for operational risk as buffer capital to meet losses which rarely occur but have major consequences when they do. The method of calculation is differentiated based on the institution's size and complexity, and ranges from simpler methods to an advanced method whereby the institution itself calculates the capital charge using internal models requiring supervisory approval. Identifying future events and quantifying unexpected losses are a central challenge for institutions, since no historical data are available containing information on the volume of losses and "almost events" that can be related to operational risk. The new rules will promote systematic registration, and improvement, of the underlying data. The SpareBank 1 Alliance and DnB NOR have joined forces with the University of Stavanger on a project to develop an operational-risk-management tool to qualify institutions to utilise the advanced method to calculate capital charges.

Management and control are a key theme of the new rules. Based on the EU Directive, general overarching requirements on risk management, adapted to the individual institution's size and complexity, has been incorporated in the Financial Institutions Act. Kredittilsynet has clarified and specified the requirements in a guidance to institutions reflecting best practice among European countries' supervisory authorities.

Operational risk is important for securities institutions. In 2006 Kredittilsynet investigated investment firms' role in connection with short sales of shares of Opticom ASA. Six investment firms came in for varying degrees of censure for mediating uncovered short sales of shares, for deficient internal routines to verify compliance with the prohibition against mediation of such sales of financial instruments, and for deficient internal measures for checking compliance with statutory provisions in this area. In Kredittilsynet's assessment, better internal routines and more effective internal control measures at investment firms would have reduced the scope and consequences of the uncovered short sale of the Opticom share. Investment firms are encompassed by the new capital adequacy rules, and by the requirements on management and control of operational risk that are set out in that body of rules.

A significant portion of operational risk arises from financial institutions' use of information and communication technology (ICT). Each institution is itself responsible both for its management and control of operational risk and for its use of ICT. Ensuring sufficient institutional management and

control when products and services are in part distributed through bilateral collaboration, shared national schemes and much outsourcing to IT providers, presents a challenge.

Much of the responsibility is left to the customer through growing use of digital distribution channels. A substantial risk may be involved in basing the security of such channels on security devices installed in the customer's PC. In 2006 internet banking facilities were exposed to various types of attack which could well impair customers' confidence in these facilities, leading to financial loss for banks. Moreover, robust solutions are needed that can protect the customer against inadvertent mistakes at the keyboard. If new solutions are launched and put to use too early, possibly because security solutions have not been adequately verified, the risk is compounded. This could arise in the event of major ICT changes or when niche technologies are introduced as part of new products and services, for example wireless communication, mobile technology and card technology.

The financial sector appears increasingly to be the target of organised crime, in Norway as elsewhere. This changes the risk picture and necessitates identification of vulnerable areas. Developing continuity solutions and establishing a catastrophe solution is key to ensuring stability and accessibility. There are also external threats to the stability of ICT solutions, such as the possibility of power and telecommunications-supply failure. Clear-cut organisational and responsibility structures are important for ensuring adequate control of ICT usage.

4. Regulatory developments

The rules governing Norway's financial markets are changing in key respects within the wider framework of harmonised European legislation. This chapter gives an overview of changes in the capital adequacy framework for credit institutions and investment firms (Basel II), changes in the accounting rules (IFRS) and changes in the solvency rules for insurance (Solvency II). Basel II, Solvency II and IFRS are of great significance both for the soundness of individual institutions and for the stability of the financial system. The rules are complex and present far-reaching, long-term challenges for institutions and authorities alike. IFRS and Basel II are being put into effect in a period of strong market and economic expansion. The same is true of the preparations for and calibration of Solvency II.

New capital adequacy rules – Basel II

The capital adequacy rules are an integral aspect of the regulatory framework for the financial sector, and are designed to promote stability in the financial system. Revision of these rules, under the auspices of both the Basel Committee and the EU Commission, has been under way for several years. The new rules were adopted by the Basel Committee in June 2004 and in the EU in October 2005. On 14 December 2006 the Ministry of Finance adopted regulations on capital requirements for banks, investment firms etc., (capital requirements regulations), which went into force on 1 January 2007. The current capital adequacy rules for insurance companies etc., are continued, but with some adjustments in relation to the capital requirements regulations.

The new capital adequacy rules entail fundamental changes compared with Basel I. In addition to general minimum requirements on own funds (pillar 1), rules are introduced on assessment of overall capital needs and supervisory review (pillar 2) and disclosure requirements to encourage market discipline (pillar 3). Under pillar 1 banks can choose the standard approach or the internal ratings based approach (IRB) to compute minimum capital charges for credit risk. Use of the IRB approach institutions requires the supervisory authorities' approval. The rules continue the current minimum requirement of an 8 per cent capital ratio.

Both the capital requirements regulations and the capital adequacy rules applying to insurance companies etc., contain a transitional arrangement which enable institutions up to end-2007 to opt to compute capital charges under the rules that applied up to and including 2006. The condition is that this right is exercised group-wide. A survey conducted by Kredittilsynet shows that the great majority of medium-sized and small institutions wish to utilise the transitional rules and to defer Basel II until

2008. Seven large banks have applied to use the IRB approach to compute capital charges for credit risk in 2007. Five of these had received approval by 20 February 2007. Only four banks have announced their intention to adopt the standard approach as from 1 January 2007, while at most nine banks have signalled their intention to do so in the course of 2007. The remainder intend to operate under Basel II rules as from 1 January 2008.

Possible impact on minimum capital requirements

Home mortgage loans and loans to small and medium-size enterprises will attract a lower capital charge under Basel II than Basel I. Residential mortgages are of great importance to Norwegian banks and this, combined with substantial lending to small and medium-size enterprises, will entail a larger reduction in the minimum capital requirement for credit risk in Norway than is the case in many other countries. Calculations show that savings banks that use the standard approach for credit risk could achieve an average reduction in the capital requirement, including market risk and operational risk, of 10-12 per cent. For individual banks a range of 5-20 per cent is envisaged. Commercial banks, whose balance sheets include a smaller proportion of residential mortgages, will see somewhat smaller reductions.

Compared with banks utilising the standard approach, banks opting for the IRB approach will see further reductions in the minimum requirement. Based on the banks' own calculations, the overall capital requirement could be reduced by 35-45 per cent compared with the current rules. This estimate does not compute the effect on own funds. Although the capital requirement is substantially reduced, IRB banks will not be able to free this capital in the initial years. In 2007 own funds must constitute at least 95 per cent of the minimum requirement computed under early rules (Basel I). In 2008 and 2009 the figure is 90 per cent and 80 per cent, respectively. There is no equivalent transitional arrangement for banks in the standard approach. For Norwegian IRB banks the floors will probably be the actual minimum requirement in the period 2007-2009, and only in 2009 is the reduction in the minimum requirement likely to be larger for IRB banks than banks using the standard approach.

Institutions using risk management models as a basis for computing capital charges will be exposed to model risk, i.e. the risk of a model being erroneous or implemented incorrectly. The importance of managing and controlling model risk is reflected in Basel II's validation requirements. However, since validation requirements cannot eliminate all model risk it is important that institutions maintain capital buffers to cover such risk, and is imperative until they gain more experience in determining capitalisation with the aid of risk management models. If institutions increasingly build on the same methods and models, this could in certain situations lead to uniform behaviour.

Requirements on assessment of overall capital needs and supervisory review

Where banks actually pitch their capital level will also depend on their assessments of overall capital needs under pillar 2 (Internal Capital Adequacy Assessment Process – ICAAP). A bank's capitalisation will affect its access to borrowing and other funding. Some rating agencies have indicated that a bank's rating may be downgraded if it reduces its capital to a level approaching the minimum requirement. In applying pillar 2 Kredittilsynet will make an overall assessment of risk exposure, capitalisation and the quality of management and control, with particular focus on factors that render the individual bank vulnerable to the effects of a cyclical turnaround. Kredittilsynet will

consider supplementary capital charges for institutions whose ICAAP outcome is not regarded as adequate. Kredittilsynet's circular no. 21/2006 gives further guidelines for assessing risk level and calculating institutions' capital needs.

At the start of 2006 Kredittilsynet reviewed the progress made in preparing for and implementing a process for assessing risk profiles and overall capital needs in the largest banking conglomerates in Norway. The survey and overall risk assessment of the eight largest banking conglomerates in the third quarter 2006 shows that the institutions concerned have made good progress in their preparations for meeting the requirements of pillar 2 of the new rules. Pillar 2 will not apply in 2007 to small and medium-sized institutions that have opted to defer Basel II until 1 January 2008.

Institutions' assessment of their credit risk is important in assessing overall capital needs in Norwegian banking conglomerates. Key elements in such assessments are general portfolio quality, concentration risk related to large exposures, sector and industry, along with a forward-looking assessment of capital needs in which allowance is made for changing economic conditions and the ability to withstand several years of negative results. The quality of management and control of various risks is of key importance.

In addition to the quality and robustness of methods used to assess various types of risk and appurtenant capital needs, methods for computing overall capital needs will be given special emphasis. Assumptions in regard to diversification, general model uncertainty, models' inherent cyclical characteristics and uncertainty in the choice of parameters will be thoroughly reviewed. In cases where methods and assumptions are uncertain and poorly founded in historical data, vigilance and satisfactory capital buffers will be expected. Until more experience has been gained with the new capital adequacy rules, Kredittilsynet will be disinclined to accept reductions in capital needs based on diversification gains.

Financial stability

Basel II's overarching aim is to strengthen the stability of the financial system through requirements and incentives designed to improve risk management, and by ensuring that capital requirements more closely reflect risks faced. Levels of and variation in capital and capital requirements are all of key importance for financial stability. An important issue in this context is whether Basel II will bring increased procyclicality via the tendency of bank lending to fluctuate with and intensify the business cycle. In an upturn low losses and good profits bring higher capital, lower capital charges and higher growth in lending, while in a downturn increased losses and weaker earnings lead to lower capital, higher capital requirements and slower growth in lending. More risk-sensitive capital requirements, as embodied in Basel II, could magnify these effects.

For institutions utilising the standard approach to credit risk, capital requirements will largely resemble those under Basel I, although the possible use of external rating could lead to increased variation in the capital requirement under pillar 1. It is, however, primarily among institutions employing IRB methods that wider variation in the capital requirement can be expected. Institutions must have adequate information on how capital requirements vary as a result of changing economic conditions to enable them to take this into account in their assessments of their own capital needs under pillar 2.

Procyclical effects will be less pronounced if banks under pillar 2 maintain adequate buffers of own funds in excess of the minimum requirement under pillar 1. The presence of such buffers will contribute to ensuring that banks are sufficiently capitalised in downturns, when minimum requirements are raised, and that the minimum requirement does not constrain their lending. Long-term capital planning can supplement capital buffers in reducing procyclicality. In their capital planning institutions must ensure that they will have access to fresh capital at a sufficiently early point once economic prospects start to deteriorate.

Further work on the capital adequacy framework

The rules on own funds and large exposures were not reviewed under Basel II. In summer 2006 a report was presented showing how the directives' provisions on own funds have been implemented in EU countries and in Norway, as well as an analysis of recently developed capital instruments. The report shows wide differences between countries as regards hybrid instruments and the extent to which such instruments are eligible as tier 1 capital. Quantitative impact studies are conducted to measure the volume of hybrid instruments issued on varying terms and to map the composition of institutions' own funds in the respective countries. The rules on large exposures are also being revised. CEBS has been asked to look into concentration risk in the broad sense, an effort which could extend over two to three years. Rules for commodities firms are also in process.

New accounting rules (IFRS)

Since the accounting year 2005 all firms, including firms under supervision, have been obliged or entitled to prepare consolidated accounts under IFRS. Non-financial firms are also entitled to prepare individual accounts under IFRS. As of February 2007 no such right is available to financial institutions or investment firms, although a proposal to bring the annual accounts regulations for banks, finance companies, mortgage companies and investment firms into line with IFRS is being considered by the Ministry of Finance. This is a first step towards full adjustment to IFRS for financial institutions. In the case of non-life insurance only two minor adjustments to IFRS have thus far been proposed, while full adjustment of the annual accounts regulations to IFRS for insurance companies will be considered at a later stage.

Where banks, finance and mortgage companies are concerned, the switch to IFRS particularly affects the valuation of financial instruments, with greater allowance made for the right/obligation to employ fair value, inter alia in regard to loans. The rules on impairment write-down of loans could entail lower write-downs than under Norwegian accounting rules. Accounting treatment of loans was brought into line with IFRS via the lending regulations which went into effect on 1 January 2005. In contrast to the earlier loan loss regulations, which only dealt with valuation rules in relation to loss, the lending regulations focus on valuation of and accounting for all types of loans.

Kredittilsynet has conducted a thematic inspection of the implementation of the lending regulations at ten large banks. Upon the switch to the lending regulations the earlier overall loss provisions were reduced by NOK 3.2 billion, or 27 per cent. This was primarily because, under the lending regulations, impairment write-downs of loans can only be made provided there is objective evidence of value fall

(loss events). The requirement of actual loss event means that banks' write-downs in an economic boom will be relatively small. Expectations of future events can no longer justify write-downs. The size of the write-downs will therefore fluctuate more in step with the economic cycle, and the lending regulations could by the same token lead to greater volatility in the size of write-downs than under the earlier loan loss regulations. For insurance companies the development of international accounting standards is a multi-staged process, and so far only the first stage of a complete standard for accounting for insurance contracts has been introduced. Alongside the rules for insurance contracts, the accounting standards dealing with financial instruments and investment properties are of particular significance.

IFRS is designed to promote transparency, clarity and comparability of European financial institutions, and by that means encourage more effective market discipline. This could promote the stability of the financial system. Valuation based to a greater degree on market values results in a more correct picture of a firm's financial position at any time, and is seen as an important contribution to the development of well functioning markets. There is nevertheless some risk that widespread application of fair valuation will increase the volatility of institutional balance sheets, and that immediate recognition of unrealised value changes could produce significant effects from purely transitory events and temporary shocks with a substantial impact on the financial system. Greater recourse to fair valuation could intensify procyclicality in the financial system such that institutions are prompted by impaired finances and profitability to reduce their lending, thereby intensifying an economic downturn. In the interests of financial soundness, CEBS has introduced prudential filters in the capital adequacy framework that will reduce, and in some cases neutralise, the impact of new accounting rules on capital adequacy measurement. An important rationale for introducing prudential filters is the need to maintain the quality requirements applied to institutions' own funds in the interests of stability and loss absorption.

Solvency II

Like Basel II, the EU's new harmonised solvency framework for the insurance industry, Solvency II, will comprise three pillars. The first pillar will contain quantitative rules on technical provisions, solvency capital requirements (SCR) and minimum capital requirements (MCR), as well as requirements on investment of insurers' assets. Use of internal models will be permitted for calculating SCR. The second pillar will contain rules on supervisory oversight and monitoring that will enable capital requirements to be tailored to the risk present in a company. The third pillar will comprise market discipline rules, including reporting and disclosure obligations towards both the public and the supervisory authorities.

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has completed two rounds of impact studies of proposals for computing capital requirements and technical provisions. The first round (QIS 1) was confined to the computing of provisions based on market value or realistic value, in keeping with expected future changes in international accounting standards. The second round of impact studies (QIS 2) dealt in addition with the computing of SCR and MCR. The capital requirement is arrived at by combining computations of market risk, credit risk, insurance risk

and operational risk. The results from QIS 2 suggest that SCR will be substantially higher than the requirement under the current solvency framework. On the other hand available capital will, given current interest rates, increase since all assets and underwriting liabilities are recognised at market value or realistic value. Based on QIS 2, the majority of insurers will satisfy the new capital requirements, although some companies will have to either increase their capital or reduce their risk. Changes will however be made both in the calculation methods and in the calibration of parameters employed in QIS 2. Hence the results from QIS 2 are not necessarily representative of how the final capital requirements will affect Norwegian insurers when Solvency II is implemented. This possibly applies above all to life insurance companies where inter alia the new Insurance Act, including annual pricing of the interest guarantee, was not taken into account in the QIS 2 calculations. A new round of impact studies (QIS 3) will be initiated in April 2007. The EU Commission will finalise the directive incorporating Solvency II in summer 2007. Supplementary guidelines on calculation of SCR are expected to be available in spring 2008.

In December 2005 Kredittilsynet published a report containing preliminary proposals for provisional capital requirements for insurers pending implementation of Solvency II. In light of the report, the Ministry of Finance has asked Kredittilsynet to refine the requirements on stress tests in life- and non-life insurers, and to prepare draft regulations and a consultation document on the same. The ministry points out that the stress tests are designed to improve insurers' measurement and control of risk, and to provide experience that will be relevant when implementing Solvency II. It underlines that the idea is not to derive concrete capital adequacy or investment restrictions from the stress tests. In January 2007 Kredittilsynet published a methodology for assessing risk levels in insurance companies. While the stress-test-based methodology is largely based on the present content of Solvency II, the emphasis is on making the calculations as simple as possible. The method for evaluating risk levels will be utilised in on-site inspections and will underlie insurers' periodic reports to Kredittilsynet.

Act on mandatory occupational pensions

The Act on Mandatory Occupational Pensions went into force on 1 January 2006. The act requires all firms coming under the act to establish either a defined benefit pension scheme under the Defined Benefit Pensions Act or a defined contribution scheme under the Defined Contribution Pensions Act. Firms must have established an occupational pension scheme by the end of 2006, valid as from 1 July 2006. According to data from the Financial Services Association, 618,000 employees at 66,000 firms became members of a mandatory pension scheme in 2006. The figures show new members, not conversions from defined-benefit to defined-contribution schemes. Based on data from Fafo (the Norwegian Trade Union Centre for Social Science and Research), the Financial Services Association has estimated that about 650,000 employees were entitled to membership of a pension arrangement under the Act on Mandatory Occupational Pensions. These figures are however uncertain.

The defined benefit pension schemes now established are largely minimum arrangements involving 2 per cent contributions for salaries between 1G (1G is the threshold for accrual of social security and pension rights) and 12G and exemption from contributions in the case of disability. Very few firms have taken out additional risk cover such as a disability pension scheme. The number of banks and

management companies that are offering defined contribution schemes is smaller than expected, which may be due to differences in the regulatory framework for the latter providers compared with other providers. Kredittilsynet is empowered to require firms not possessing a pension scheme in accordance with the Act to rectify the situation within a specified period, and to impose a cumulative fine if they fail to do so. Kredittilsynet will rely largely on reports submitted by employees, auditors and tax assessment authorities. Firms legally bound to maintain accounting records must state in their annual accounts whether they are required to maintain a pension scheme and whether the scheme complies with the statutory requirements. Firms not subject to the accounting requirement must provide corresponding information in their trading statement. The first time employers will be required to state whether they have established an occupational pension scheme in compliance with the law will be in the periodic return for employer's contributions and advanced tax deductions, the deadline for which is 8 March 2007.

5. Financial stability – what happened in 2006?

Kredittilsynet's strategy for the period to 2010 describes the overarching goals of financial stability and well functioning markets, and operationalisation through intermediate goals. This chapter discusses financial stability and performance measurement in financial supervision. It then recapitulates the previous Risk Outlook's assessments of financial stability in light of actual developments in 2006 in the economy, markets and institutions. It concludes with a discussion of long-term trends of significance for assessing potential stability problems in the financial sector in the medium term.

Kredittilsynet's goal of financial stability

The financial system consists of institutions, markets and infrastructure. Financial instability may emanate from any one of these elements, often in interaction with others. In bank-dominated systems, like Norway's, the banks (inter alia through their role in payment and settlement systems) are of greatest significance for financial stability. However, supervision and regulation of insurance companies and securities markets are also important in securing stability and confidence in the financial system. There is no clear, unambiguous definition of financial stability, and quantifying systemic risk is difficult. It is however possible to point to some characteristics of institutions and markets that are crucial to financial stability. Important institutions must be stable and enjoy a high degree of public confidence in their ability to maintain their functions without interruption or external intervention. Stability also requires key markets to be stable, characterised by market participants' certainty that they can carry out transactions at prices that will not vary widely over short periods, barring changes in fundamentals. What are regarded as important institutions and markets may differ from country to country and may change over time.

Since Kredittilsynet alone is not in a position to ensure financial stability, there is no hard and fast correlation between its activities and the situation in the financial system in a given year. Financial stability depends essentially on factors and actions beyond Kredittilsynet's control – related both to the design of monetary and fiscal policy and the overarching responsibility for financial sector regulation. Important premises are set by the EEA Agreement and financial legislation framed within the EU. Moreover, the fact that much supervision is of a preventive nature involves major challenges.

Supervision of individual institutions and market players is Kredittilsynet's principal instrument for promoting financial stability. Supervision focuses on financial strength, fit and proper management,

good internal control and risk management, but also builds on the premise that responsibility for business operations rests with institutions' board and management. Hence Kredittilsynet's instruments are primarily geared to preventing problems arising at specific institutions, problems which may jeopardise confidence in the financial system through contagion effects to other institutions. Experience gained in many countries shows that stability problems can arise as a result of macroeconomic shocks which trigger imbalances that have built up in credit, housing or securities markets. Kredittilsynet has little opportunity to countervail such eventualities directly, but can through analyses and public statements influence the attitudes of other authorities, market actors and the general public. Through its advisory function, and within the framework set by EU rules, Kredittilsynet can influence the development of rules and framework for financial activities.

Although evident methodological problems attend performance measurement in the field of financial supervision, qualitative assessment of the situation in the financial market and of changes in the likelihood of systemic risk is none the less desirable. Where financial stability is concerned Norway, like many other countries, has a well-developed tradition of using indicators, supplemented with stress tests, worst-case scenarios and analyses of trends that the indicators fail to capture. Indicators often include the economic situation both at home and abroad, households' and firms' financial position, structural changes and competition in financial markets, as well as the situation in financial institutions and markets. Since 1994 Kredittilsynet has systematically assessed the situation in financial markets and interaction between the financial sector and the wider economy. This is a necessary supplement to the agency's ongoing supervision of individual institutions. There is no comparable tradition in relation to well functioning markets and Kredittilsynet plans to develop indicators in this area.

Assessments of financial stability in 2006

At the start of 2006 the major forecasting institutes expected the relatively strong growth in the international economy to continue, driven above all by countries outside the OECD area. Imbalances in the US and continued high oil prices represented downside risks of this trend. Forecasts for the Norwegian economy suggested that the economic boom would continue, albeit with some slower growth in GDP. The situation in the banking sector was viewed as favourable at the start of 2006, with an absence of losses, and high profits. Kredittilsynet's work on financial stability in 2006 focused especially on the trend in housing markets and household debt, and on the challenges that this trend posed to banks in the somewhat longer term. High loan-to-value ratios on new home mortgage loans, a low volume of fixed interest loans and other factors liable to increase the vulnerability of households at risk, mainly households in the lowest income and age groups, were singled out. It was pointed out that financial stability considerations called for a normalisation of interest rates which should not be put off for too long. The need for continued, thorough, credit assessment in the corporate market was highlighted and tighter lending practices in the retail market were regarded as clearly desirable. Attention was also drawn to challenges facing life insurers as a result of the low level of interest rates at the start of 2006. It was pointed out that life insurers' risk-bearing capacity needed to be strengthened in order to improve prospects of higher return and assure good long-term return on assets under management. Reputational risk for banks owing to deficient information accompanying sales of structured products

was mentioned. The challenges facing banks and authorities alike in assuring adequate capital levels when the new capital adequacy framework (Basel II) took effect were also pointed out.

The high rate of growth in the international economy continued as expected in 2006, at a somewhat quicker-than-forecast rate in the Euro area. Central banks in a number of countries raised their key rates, despite continued low core inflation. Long rates climbed somewhat in the course of 2006, but were still lower than expected at the start of the year in the US and Japan, and higher than expected in the Euro area due to the latter's stronger growth. Consensus Forecasts' estimates from January 2006 for 10-year bond rates one year hence were: 5.5 per cent for the US, 3.7 per cent for Germany and 4.4 per cent for Norway. At end-2006 the US 10-year bond rate was 4.7 per cent, while its German and Norwegian counterparts were, respectively, 4.0 and 4.4 per cent, i.e. far lower than the estimates one year previously for the US and higher for Germany, but correct for Norway.

Growth in the Norwegian economy was higher than expected in 2006, while revision of the national accounts figures showed that growth in 2004 and 2005 was also substantially stronger than estimated. Even with rapid growth in the economy, core inflation in 2006 remained significantly below the monetary policy target. Even so, in autumn 2006 Norges Bank announced a quicker increase in its key rates than was previously signalled. In the course of 2006, Norges Bank raised the interest rate on five occasions by a total of 1.25 percentage points. Despite higher interest rates and signals of quicker rate increases, growth in house prices accelerated in 2006. House prices rose by 15 per cent in 2006, compared with 9 per cent in 2005, and by the end of 2006 the annual rate of increase was as high as 18 per cent. This was higher than all forecasts. Commercial property prices also appear to have risen sharply in 2006.

Growth in household borrowing remained very high in 2006, the impact on credit expansion of accelerating growth in house prices in 2006 probably being subject to a time lag. Although investments rose strongly in 2006, growth in credit to firms was unexpectedly steep, reaching more than 20 per cent at year-end. Growth in sales of structured products appeared to edge down in 2006, probably due to improved information on risk and return. Several indicators pointed to growing vulnerability in parts of the household sector in 2006. Revision of the national accounts figures showed that the household saving rate was lower than assumed in 2004-2005, and dropped to a low level in 2006 – 2.2 per cent after the first three quarters. The interest burden rose, both as a result of a continuing increase in debt and of higher interest rates. Whereas loan-to-value ratios on new mortgage loans and repayment periods increased, the volume of fixed interest borrowing fell at the same time as more and more borrowers opted for equity release mortgages not requiring repayment. There were no clear indications in 2006 of any tightening of bank lending practice in regard to residential loans.

Profit performances reported by Norwegian banks in 2006 proved very good. The economic boom and interest rates that were still manageable for most households resulted in few defaults and low losses. Extremely high volume growth on the part of the banks curbed the effect of falling interest margins on net interest revenues. Rating agencies' assessments of Norwegian banks and insurance companies changed little in 2006. Moody's, Standard & Poor's and Fitch upgraded their ratings for two Norwegian banks, while one insurance company saw its rating downgraded, in 2006.

At the start of 2006 Kredittilsynet drew attention to risk attached to high growth in house prices and strong growth in household debt, and that this could pose a threat to financial stability in the longer term. Although the economic expansion continued in 2006, debt was manageable for most households, bank profits were excellent and financial positions satisfactory, developments in 2006 heightened banks' credit risk in the long term. Despite Norges Bank's interest rate increases and signals that it would step up interest rates at a quicker pace, the low level of nominal rates and real after-tax rates stimulated demand for houses and credit in 2006 as previously. The accelerating growth of house prices in 2006 probably also reflected structural changes in the shape of innovations on the credit market's supply side and changes in household adjustment in the housing market. Structural changes are of significance when assessing potential stability problems linked to the growing debt exposure in the economy in general and in the household sector in particular.

Some long-term trends

Since the 1990s the Norwegian credit market has grown more quickly than the economy as a whole. Particularly in recent years, credit growth has been significantly higher than GDP growth, contributing to increased debt exposure in the Norwegian economy. Norway's financial system is bank-dominated, and the banks are the chief source of the credit expansion. The increased debt exposure is partly a result of a long period of relatively strong growth in a Norwegian economy free of disturbances kindled by serious setbacks in the international economy. The present cyclical upturn, which started in summer 2003, followed a downturn that was weaker than seen in the 1980s and the 1990s. Household demand, an important driver of economic growth, also mitigated the downturn compared with those experienced in previous decades. Household debt growth has been at two-digit levels since 2000. The build-up of household debt has been accompanied by an upturn in housing markets which have risen by an annual average close to 10 per cent since 2000. Real house prices have more than tripled since the trough reached in 1992.

Both monetary and fiscal policy are important contributors to the ongoing upswing in the Norwegian economy. As in previous cyclical upturns, changes in money and credit markets have played an important role, such as the deregulation of credit markets in the mid-1980s and the interest rate decline in Europe in the early 1990s, which in both cases fuelled growth in consumption. Low inflation resulting from a low wage growth and very low imported inflation, partly due to increasing trade with China and other low-cost countries, have set the stage for very low interest rates. Low real after-tax interest rates and favourable taxation of property as opposed to financial saving have stimulated debt-financed consumption and house investments during the ongoing upturn.

Interest rates have fallen in many countries since the mid-1990s. A number of not mutually exclusive explanations for this fall have been put forward. While low inflation has reduced nominal interest rates, stable inflation has lowered risk premiums and real interest rates. It has also been asserted that the strong international growth in various risk transfer instruments has led to reduced risk premiums. An increase in global saving from about the mid-1990s onwards, influenced by demographic factors, is a possible explanation for lower real interest rates. Another explanation is that the decline in both real

interest rates and nominal interest rates is related to the trend in money supply and credit, which have increased in relation to GDP since the start of the 1990s. This has not translated into higher inflation, mainly thanks to low-cost countries' increasing significance in the world economy. The ample availability of liquidity, on the other hand, has pushed financial asset prices up and risk premiums and interest rates down.

International markets flush with liquidity, low interest rates and the search for yield may have contributed not only to pushing up prices of financial instruments, but also to the vigorous upturn in housing markets witnessed in a number of countries, an upturn stronger and longer lasting than previous ones. Linked to this trend is a sharp increase in household debt burdens in many countries, coincident with a manageable interest burden produced by low interest rates. Hence a number of the features which characterise the trend in Norway parallel developments in other countries. The strength of the upturn varies between countries, however.

The financial sector has expanded sharply in most countries over the past 10-15 years, and developments in this sector have acquired greater significance for the real economy that was the case 20-30 years ago. Liberalisation of national credit markets has brought real estate, securities and credit markets closer together. Technological progress, financial innovation, internationalisation and a blurring of traditional sectoral divides have increased competition in most areas of the financial markets as well as saving flows between markets and across national borders. The distribution of overall risk within the financial system has changed, at the same time as an increasing portion of the risk is borne by consumers. In liberalised markets featuring increased competition and new financial products, households and firms alike enjoy greater freedom of choice and wider opportunities in their saving, consumption and investment decisions, and this may, in combination with demographic changes, have intensified the effects of inter-generational behavioural differences. Given major shifts in the population's age distribution, differences in attitudes to risk and inheritance may lead to significant changes in patterns of saving.

International financial markets are marked by rising prices and historically high returns on a number of financial instruments, within and across geographical regions, at the same time as debt exposure and house prices are rising steeply in many countries. Historical experience shows that a strong upswing in credit, strong growth in corporate investment and a sharp rise in asset markets, including housing and commercial real estate markets, heighten the risk of financial stability problems. This experience appears to be robust, but is also based on periods of greater market regulation or of market deregulation.

It is uncertain whether lasting changes have taken place in the international economy and international financial markets, or whether inflation and interest rates may again rise significantly from today's low levels. It is also uncertain how much of the strong upswing in securities, debt and housing has its roots in liberalised markets featuring increased competition, a wider range of financial products and changed behaviour related to demographic factors. If fundamental changes in markets or the real economy have not taken place, and low interest rates and inflation are transient features of the overall picture, imbalances may have been accumulated that could give rise to significant corrections in prices and return on financial instruments and dwellings. Such corrections could be triggered by rising inflation and

higher interest rates, weaker international business conditions, macroeconomics shocks, materialisation of imbalances in the international economy, tighter access to liquidity or a combination of such factors. Since the rise in prices of financial instruments and dwellings is synchronised, any correction could take place simultaneously in several countries with mutually intensifying effects between countries.

Recent years' growth in the international economy has been good, no serious shocks have occurred and the real economy appears more stable than previously. However, international financial markets have frequently been exposed to shocks over the past 20 years. Although the frequency of such shocks has been significantly higher than in the preceding period, the impacts have been limited, and the international financial system has not been hit by serious problems. Such limited impacts may be due to several factors: that the actors have had sufficient capacity to withstand losses on the scale concerned, that the authorities have met the shocks in an effective manner, or that the overall risk is better distributed such that it is borne by actors with a greater capacity to do so. When assessing financial stability it is vital to know whether the changes in the international financial industry represent lasting structural shifts that have strengthened the financial system, or whether the financial system has yet to be tested for serious shocks.

For Norway too, it is uncertain how much of the upturn in debt and house prices reflects a structural adjustment in the wake of the banking crisis to liberal and open markets. Increased competition and strong product development contribute to an improvement of the financial system's ability to distribute capital and risk. Part of the upswing in debt and housing markets is probably due to a combination of changing saving behaviour and adjustment to changing markets. However there is also a danger that economic conditions and structural changes have set the stage for excessive house prices and debt levels. A large number of households may have based, or may be basing, their behaviour on expectations of continued low interest rates and a steadily rising house prices. Surveys show that optimism among Norwegian households is very pronounced. Both households and banks could overestimate expected future earnings and underestimate the risk of fluctuations in financial wealth and housing wealth. The increased opportunities to use home loans for consumption purposes and to defer debt repayment could intensify the risk of overexposure and corrections. Strong credit expansion and rising housing markets often intensify one another since rising house prices boost wealth, consumption and credit demand, while rising house values improve banks' collateral and willingness to lend.

Kredittilsynet's opportunities to influence the demand side of the credit market are limited. Instilling an awareness that highly favourable macroeconomic conditions entail a risk of debt and house prices rising to levels which could trigger problems for banks and households under less favourable conditions poses a major challenge. It is particularly important to ensure that banks do not reduce their capital levels as a result of Basel II to the point where they lack sufficient capital to meet a situation in which it turns out that debt and house prices have risen above their equilibrium levels. Should such corrections occur, procyclical features of the accounting and capital adequacy framework may exacerbate the situation. It will be particularly important for the supervisory authority in 2007 to help to ensure that banks prepare the ground for capital planning that takes account of increased uncertainty in the economy and financial markets.

Theme article: The need for a long-term bond market in Norway

Future demand for long bonds will depend on the new rules. The EU Commission has initiated a wide-ranging project to modernise and harmonise the present solvency rules for European insurance companies. The new body of rules (Solvency II) is expected to come into force in 2010 or 2011. Norway is obliged to implement Solvency II under the EEA agreement. The EU Regulation on the application of international accounting standards (IFRS) in the preparation of consolidated accounts requires a move towards fair valuation on both the asset and liability side of the balance sheet. A guiding principle when drafting Solvency II was to ensure compatibility with the new accounting rules, thereby entailing a move towards market-based valuation of the entire balance sheet.

The switch towards market-based valuation of insurance liabilities could lead to a sharp increase in Norwegian life insurers' demand for long bonds. Implementing Solvency II will require all risks to which a company is exposed, including interest rate risk linked to the liabilities, to be taken into account in insurers' asset management/risk management. The interest rate risk related to insurance liabilities will have a major bearing on the minimum solvency margin requirement under Solvency II. In the report entitled *Provisional capital requirements for Norwegian life insurance companies in the period 2007-2009 – Current challenges to ensuring the financial strength of insurance companies (December 2005)* calculations were presented showing that, with their current asset mix, Norwegian life insurers' solvency margin is considerably lower than that expected under Solvency II. The only way to reduce Norwegian life insurers' solvency margin is to change the asset mix such that the portfolio contains either a larger volume of bonds with a long lock-in period (long duration) or instruments with the same characteristics. However, the design of the final accounting standards, and how they will be applied to Norwegian life insurance companies, is uncertain. Phase two of IFRS 4 *Insurance Contracts* deals with valuation of insurance liabilities, and has yet to be finalised. The final standard in this area can be expected in autumn 2009 at the earliest.

Group pension insurance

Norwegian life insurers offer a variety of products. Table 1 shows each product group's share of the overall product offering. Group life insurance is not included.

Individual pension insurance carrying an annual guarantee and group pension insurance carrying an annual guarantee share approximately the same product features. In the first case it is individuals who

have arranged their own pension insurance while in the second case it is the employer who has arranged pension insurance for his employees. The two product groups combined account for about 86 per cent of Norwegian life insurers' total assets.

Table 1 Norwegian life insurers' product groups at 30.09.2006

Product group	In per cent of total insurance funds
Individual endowment insurance with annual guarantees	7.0
Individual endowment insurance, unit linked	1.3
Individual pension insurance with annual guarantee	14.5
Individual pension insurance, unit linked	4.7
Group pension insurance with annual guarantee	71.7
Group pension insurance, unit linked	0.8

Source: Norwegian Financial Services Association (Oslo Pensjonsforsikring AS is not included in the table.)

Under a guaranteed group pension insurance contract, the insurer undertakes to pay each member a pre-agreed old age pension upon reaching retirement age, for as long as the member is alive, or for a specified number of years. In addition to old-age pension, a group pension insurance contract can consist of a disability pension, spouse's pension and children's pension. The policyholder (the firm) undertakes on the other hand to pay to the life insurance company agreed annual premiums for the members for as long as they are in the policyholder's employment. Where the pension scheme has associated benefits which become payable should the member become disabled or die, the policyholder pays a risk premium on such benefits. The saving premium, i.e. the portion which does not go to risk premium and overheads, is managed by the insurer to cover future old-age pensions. The premiums for old-age pension are paid to the insurer when the employee is of working age, while the old-age pension itself is payable upon reaching retirement age. In such group schemes the insurer has undertaken to provide an annual minimal return on the savings premiums. The minimum rate of return is currently 2.75 per cent per annum for new contracts, although the guaranteed interest is 4 per cent for large portions of the accumulated savings capital.

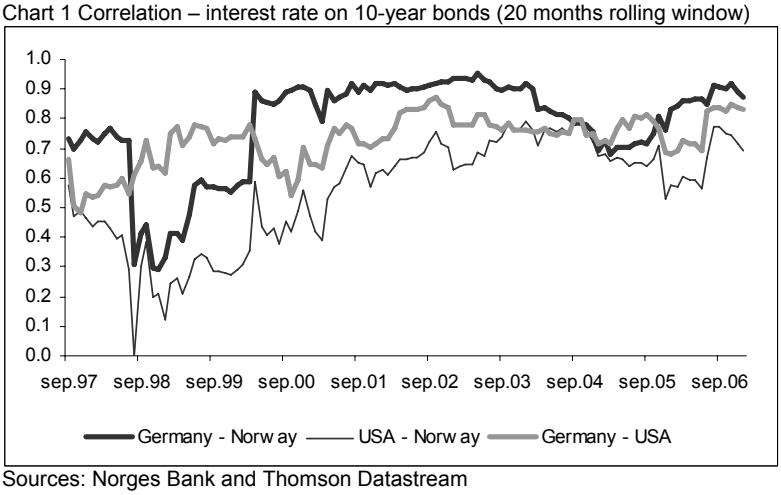
For the individual member the period from the first payment to disbursement of pension will often be more than 30 years. Moreover, the funds will, also in the disbursement period, be managed such that the return on them is at least equivalent to the guaranteed interest. Hence there is a large potential need for life insurers to invest in instruments which have cash flows coinciding with the structure of their insurance liabilities.

Life insurers' financial strength is affected by their risk-bearing capacity (buffer capital), the characteristics of their insurance commitments and of their investments. However, the current rules for measuring life insurers' financial strength primarily take account of risk related to their assets, and do not capture interest rate risk associated with their insurance commitments. Under the current accounting rules the value of liabilities is determined by discounting future disbursements at a fixed interest rate (the minimum guaranteed interest rate). The minimum guaranteed interest rate on a given contract is independent of developments in the fixed income markets, and interest rate risk related to the commitments therefore has no bearing on life insurers' buffer capital. These weaknesses of the current rules have adverse consequences for life insurers' asset management, whose main aim should be to ensure that assets are invested in such a way that the insurers will be able with a high degree of

certainty to honour their insurance commitments as they fall due. As long as the interest rate risk on commitments is not explicitly taken into account in the rules, there will not be sufficient incentive for insurers to organise their asset management in a way that supports their main objective.

Market-based valuation of insurance liabilities has already been introduced in Denmark and Sweden. However, the Danish krone's close correlation with the Euro has given Danish life insurers and pension funds an opportunity to reduce their overall interest rate risk by investing in the Euro-denominated bonds carrying little foreign exchange risk. If Norwegian insurers were to invest in foreign bonds, this would reduce the duration gap, but would also entail exchange rate risk and risk due to the fact that Norwegian interest rates can at times diverge significantly from international interest rates. Chart 1 shows the correlation between changes in 10-year Norwegian bond rates and their German and US counterparts. The buffer capital needed to countervail these two risks is likely to be too large for this option to be relevant.[1]

Chart 1 Correlation – interest rate on 10-year bonds (20 months rolling window)



Sources: Norges Bank and Thomson Datastream

[1] [Note 1: This can be illustrated with a stylised example in which it is assumed that underwriting liabilities have a modified duration of 15 years, and equity capital, which is assumed to constitute 12 per cent of total assets, is invested in short-term money market instruments. A modified duration of 15 years involves, as a surrogate for underwriting liabilities, starting out from a short position (a "debt position") in Norwegian government bonds with 30 years' maturity. Since such instruments do not exist, a 30-year Norwegian government bond is assumed to have the same yield as a 10-year Norwegian government bond. On these assumptions, the risk posed by changes in equity capital will be approximately covered by investing the insurer's funds in Norwegian government bonds with 15 years' modified duration. However, if the insurer's assets are invested in Norwegian government bonds with three years' modified duration, estimated risk is measured as the expected annualised standard deviation on return on equity, equalling 72 per cent, in other words equity capital can be expected to be reduced by more than half in one year out of four. If the insurer's assets are invested in Euro-denominated bonds with 15 years' modified duration, the estimated standard deviation rises to 79 per cent. With foreign currency hedging (rolling foreign currency hedging of the current value of the investment), the estimated standard deviation is reduced to 62 per cent. Hence this analysis, which is based on monthly figures from February 1996, appears to show that the interest rate risk associated with underwriting liabilities can to only a limited degree be hedged by investing in foreign bonds.]

In Sweden a solution has been provided by Swedish insurers' and pension funds' large, undistributed bonus funds. Buffer capital made up as much as 25 per cent of insurers' aggregate total assets by the end of 2004. Swedish insurers are therefore substantially better capitalised than their Norwegian counterparts, and can square up to the challenges associated with the duration gap with substantially stronger financial resources.

Increased demand for long bonds

Life insurers' future needs for bonds with a long interest rate lock-in period will depend on their involvement with defined-benefit schemes. At the end of 2005 premium reserves attached to defined-benefit schemes in Norwegian life insurance companies and pension funds totalled about NOK 500 billion. Over the next 10 years these reserves will grow to between NOK 700 and 1,300 billion, depending on the relative growth of defined-benefit and defined-contribution schemes.

To gain an understanding of the relative development in insurers' defined-benefit and defined-contribution schemes in the years ahead, a look has been taken at scenarios which can be said to represent opposite ends of the scale. Total assets and premium reserves have grown by an average of about 9 per cent over the past 10 years. It is presumed that average duration (period to maturity) of insurers' insurance commitments is 15 years, and that current disbursements are evenly distributed over the next 30 years. An annual guaranteed minimum return of 3.5 per cent is assumed.

If life insurers' defined-benefit schemes are maintained as at present, and the average annual growth in premium reserves over the past 10 years is taken as a basis for developments ahead, life insurers' insurance commitments will grow substantially in the 30-year period (see Chart 2). It is assumed that all pension schemes established as from 2006 following the Mandatory Occupational Pensions Act will be defined-contribution schemes. Norwegian Official Report 2005:15 (Act relating to Mandatory Occupational Pensions) examines the overall economic consequences of introducing mandatory occupational pensions. The survey starts out from the decision of the Storting (Norwegian Parliament) to require employers to pay a pension contribution of at least 2 per cent of pensionable income in excess of 1 G . According to figures from the Norwegian Financial Services Association, 618,000 employees at 66,000 firms were enrolled in mandatory occupational pension schemes in 2006 (see Chapter 4 for further details). The impact on wage costs for 2006 is put at about NOK 3.3 billion. This estimate is based on an assumption of 5 per cent annual growth in pension costs as a result of employment and wage growth. Assuming an average duration of 15 years for mandatory occupational pension insurance commitments, and that current disbursements are evenly distributed over the next 30 years, premium reserves associated with the mandatory occupational pension scheme will follow the trend shown in Chart 2. In the calculations, annual return on capital equals the minimum guaranteed return plus 1 percentage point.

The development in premium reserves related to defined-benefit schemes in Chart 2 is dramatic. However, there is much to suggest that a number of firms will switch from defined-benefit schemes to defined-contribution schemes. Chart 3 shows the trend in life insurers' premium reserves related to, respectively, defined-benefit and defined-contribution contracts in a situation where all defined-benefit

Chart 2 Continuation of present defined-benefit schemes and introduction of mandatory occupational pensions (MOP)

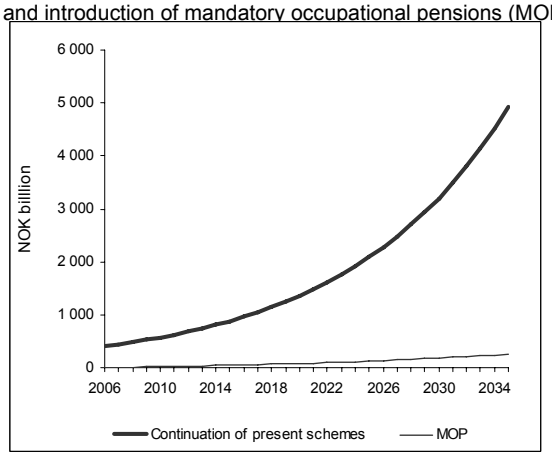
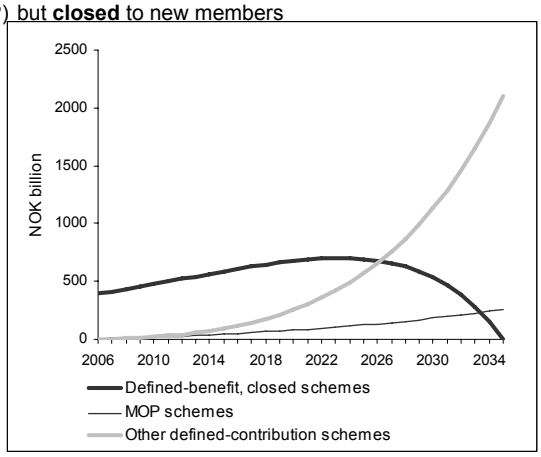


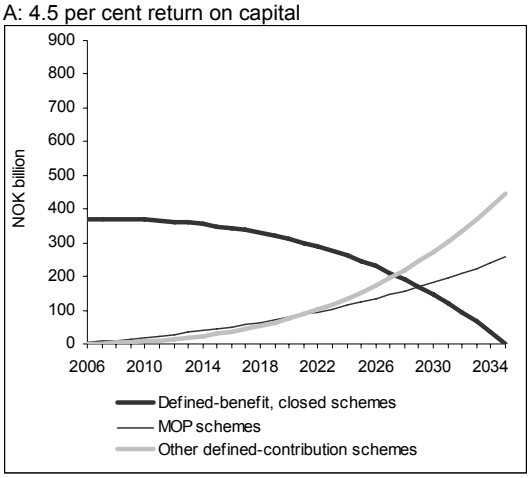
Chart 3 Present defined-benefit schemes continued, but **closed** to new members



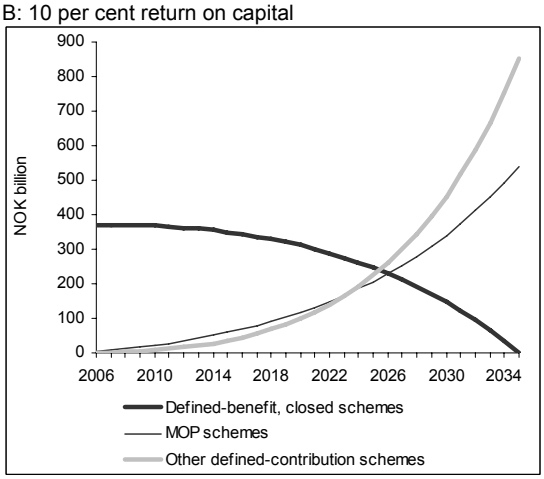
schemes are **closed** to new members, and there is a gradual transition to defined-contribution schemes. It is assumed that if the defined-benefit scheme is closed to new members and is replaced by a defined-contribution scheme for new members, the firm's premium receipts to the new scheme will be kept at the same level as in the old scheme (given that the same amount can be remitted to defined-contribution schemes). In other words the firm intends to maintain about the same pension level as under the old scheme. Hence it is assumed that the annual growth in premium reserves related to defined-contribution schemes at firms that have closed their defined-benefit schemes, equals the growth in premium reserves attached to the defined-benefit schemes. Chart 3 shows that close to 20 years will pass before the volume of defined-contribution schemes exceeds the volume of defined-benefit schemes in this scenario.

Chart 4 Defined-benefit schemes wound down, paid-up policies issued, all new accrual within defined-contribution schemes

A: 4.5 per cent return on capital



B: 10 per cent return on capital



Note the substantial reduction in the vertical-axis scale from chart 2 to charts 3 and 4

A third scenario examines a situation in which all of today's defined-benefit schemes are **wind up**. Paid-up policies are issued and all new accrual takes place within defined-contribution schemes. The paid-up policies remain under management, and achieve the minimum guaranteed return of 3.5 per

cent. A further assumption is that the annual growth in premium reserves related to defined-contribution schemes equals the growth in premium reserves for paid-up policies. Chart 4A and 4B show the development of premium reserves attached, respectively, to defined-benefit and defined-contribution schemes in such a scenario.

The trend in premium reserves attached to defined-contribution schemes will also depend on the return on capital. However, an increase in annual expected return on capital has little effect on the point where the curves for defined-benefit and defined-contribution premium reserves intersect (cf Chart 4B). Statistics provided by the Financial Services Association show that at the end of 2005 insurance provisions for municipal group pension schemes accounted for 45 per cent of life insurers' total insurance provisions related to group pension schemes. For the time being it appears reasonable to assume that these will remain defined-benefit schemes. If allowance is made for the possibility that a number of private sector schemes will also remain benefit-based, and that premiums will continue to be paid for those schemes that are closed, the possibility that 60-70 per cent of the insurers' group schemes will continue as previously over the next 10 years cannot be ruled out.

Hence there is every likelihood of a large increase in future demand for long fixed income securities to meet commitments in defined-benefit contracts. However, the implementation of new insurance legislation of 10 June 2005 under which the interest rate guarantee has to be pre-priced for one year at a time, could affect this assessment. If insurers can revise their price tariffs annually, and send the bill for the interest rate change to their customers annually, the maximum duration of life insurers' commitments can be said to be one year. The other end of the scale is where customers close their pension schemes (paid-up policies), and there is no-one to send the bill to. If pre-pricing of the interest rate guarantee results in substantial premium increases, many customers can be expected to close their pension schemes. How these issues should be handled under the rules ensuing from Solvency II and new international accounting standards is too early to tell.

The introduction of Solvency II and a switch to market-based valuation of insurance liabilities is likely to require some modification of the rules of the new Insurance Act. This applies inter alia to the rules on transfer. Under current rules the premium reserve that is to be transferred is calculated by discounting expected payments on the contract at the guaranteed interest rate. This premium reserve will, depending on market interest rates, be larger or smaller than the provision required of the company under the rules on market-based valuation of liabilities.

Pre-pricing of the interest rate guarantee and transfers are two issues where there may prove to be inconsistencies between the new Insurance Act and Solvency II when the latter is implemented. The solution arrived at could influence demand for long bonds.

Possible changes in the supply of long bonds

In the event of a large increase in future demand for long fixed income securities, a meagre supply of such securities will be a problem. Providers of long bonds will normally be the corporate sector, the household sector or the public sector.

In the **corporate sector** the financial rationality of locking in the interest rate in own funds in today's market may be questioned. Parts of the corporate sector in Norway are among the few actors willing to borrow long (five to 10 years), but their activity is thin compared to the potential increase in demand. In earlier days power companies were genuine providers of long fixed-income securities. Today few of these companies contemplate major development plans, and therefore have no significant borrowing needs. One major insurer has drawn attention to other possible investment mediums such as investment in infrastructure, for example oil pipelines, water and drainage systems, highway development and power production. Norway's present and future need for electrical power could prompt the investment of substantial funds in the development of production capacity (eg gas power stations) and power distribution grids. The current return on such projects could be designed in such a way that the cash flow assumes the character of bonds with a long duration. However, a precondition will be that the stage is set for life insurers to invest in such projects, and that an avenue for such investments is opened within the Solvency II rules.

The **household sector** could be a provider of interest rate risk through demand for home mortgage loans, which are of a long-term nature. However, there is no tradition of a fixed interest lending in Norway. More than 95 per cent of bank loans that finance private dwellings carry floating interest. Experience shows that fixed interest loans with a maturity of three to five years have been sought in periods where the short interest rate has been higher than the long interest rate. This indicates that the demand for fixed interest loans is rooted in cash-flow factors, and only to a modest degree in a wish to insure against higher interest rates. Thus a shift in demand towards fixed interest borrowing by households could take some time.

It has been suggested that if trade is permitted in covered bonds, such bonds conferring preferential rights to a cover assets pool consisting of home mortgage loans could have a significant bearing on the overall supply of bonds. In *NOU 2001: 23 Finance companies' and mortgage companies' activities*, Chapter 8, the Bank Law Commission recommended that mortgage companies should be able to issue bonds conferring a statutory preferential claim over a cover pool of loans. The legislation needed for the issuance of such bonds went into force on 1 January 2004 but, pending supplementary regulations, no company has so far issued bonds of this type. In Proposition No. 11 to the Odelsting (2006-2007) the Ministry of Finance recommends law changes entailing a move away from a mortgage law model towards a model based on a preferential claim over a cover asseets pool consisting of loans. The Lagting division of the Storting adopted in February 2007 a resolution in line with the ministry's recommendation.

It is reasonable to assume that reduced capital requirements and other factors related to covered bonds will enable banks to offer fixed interest loans at an interest rate somewhat lower than that of ordinary fixed interest loans. However, the price reduction is likely to be small, and there is therefore no reason to believe that borrowers' preferences for floating interest loans will change significantly. The positive price effects will moreover not depend on the loan's maturity, such that the price reduction in itself will not provide any financial incentive to opt for loans with a lock-in period in excess of three to five years.

The **public sector** assumes interest rate risk by issuing government bonds in the Norwegian market. The Ministry of Finance, as the government debt manager, points to three main motives for government borrowing: consideration for balance in the money market, consideration for the government's cash holding and the intrinsic value of government borrowing in providing a risk-free interest rate curve and investment medium. Long periods of budget surplus and the prospect of budget surpluses for many years ahead has turned the government into a net creditor with no substantive borrowing requirement. However, the government raises loans in the domestic market while allocating the fiscal budget surplus to the Government Pension Fund - Global. Borrowing ensures government simpler and cheaper access to capital markets, and can be looked upon as a form of insurance should a net borrowing requirement arise in the future. The aim of government debt management is to meet actual borrowing requirements at the lowest possible cost (due account being taken of risk), and to promote well functioning financial markets.

Previously the strategy on domestic bond issues has reflected a desire to deliver a correct risk-free yield curve of up to 10 years. Borrowing on the bond market has built on a pattern in which a new 11-year bond is introduced roughly every second year. The rate of issuance has essentially reflected a desire to speedily build up volume in the most recent (and longest) bond. Predictable bond issuance is of value to market actors, which is why the State does not borrow for short-term commercial gain.

As from 1 June 2005, however, the State has made active use of interest rate swaps in debt management. This is based on a balance sheet management perspective, the justification being that the borrowing strategy results in an excessively long interest rate lock-in on government debt compared with domestic interest-bearing assets. The idea is to reduce fluctuations in net interest expenditure, while also recognising historical figures' indication that a shorter interest rate lock-in results in lower borrowing costs over time. However, this activity reduces the basis for a risk-free yield curve in Norway. Pricing in financial markets is anchored in the risk-free yield curve. It is normally derived from the government securities market and contains information about the market's perception of future required real hurdle rates and inflation. The quality of information that can be derived from financial market prices depends on how well the market functions.

The supply of bonds with a long interest rate lock-in in Norway is unlikely to increase significantly in the next 10 years, unless active steps are taken to bring this about.

Summary

The EU's new solvency regime for insurance companies - Solvency II – is scheduled to be transposed into Norwegian legislation from 2010 or 2011 onwards. It has been pointed out that the sizeable element of pension insurance carrying an interest guarantee – 86 per cent of total assets – will present Norwegian life insurers with particular challenges.

Norwegian life insurers' buffer capital is relatively small compared with that of their counterparts in Denmark and Sweden. Drawing a comparison with these countries is natural since they too feature a relatively large element of pension insurance providing an interest guarantee. In Europe as a whole

such products are usually managed by pension funds, which in principle are not affected by Solvency II.

Low buffer capital suggests that Norwegian life insurers will seek a large volume of long bonds in order to reduce the discrepancy between the interest rate risk on their assets on one hand and the interest rate risk on their liabilities on the other. The demand expected for such bonds in the Norwegian market is unlikely to be met. The size of the Norwegian bond market is largely determined by the volume of government bonds which the authorities decide to issue, and the Norwegian public sector borrowing requirement is low.

The lack of a long-term bond market represents a structural problem which may render pension scheme management more costly in Norway than in comparable countries when Solvency II is introduced. In Kredittilsynet's view these issues need to be closely addressed when reviewing the rules governing accounting, solvency in insurance and the financial market in general.

ANNEX

The Financial Market in Norway 2006 – 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

	2003		2004		2005		2006	
	NOKm	% of ATA	NOKm	% of ATA	NOKm	% of ATA	NOKm	% of ATA
Net interest revenues	30 518	1,98	30 818	1,87	32 990	1,77	35 395	1,62
Other revenues	13 700	0,89	15 178	0,92	17 254	0,92	18 183	0,83
Other expenses	25 487	1,65	26 265	1,60	26 535	1,42	28 167	1,29
Book losses	6 892	0,45	1 372	0,08	- 1 205	-0,06	-1 453	-0,07
Result of ordinary operations before tax	12 023	0,78	19 912	1,21	25 534	1,37	28 075	1,28
Result of ordinary operations after tax	9 261	0,60	14 702	0,89	18 913	1,01	21 096	0,96
	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA
Total assets	1 568 960		1 661 898		1 978 074		2 399 428	
Gross loans to customers	1 197 603	76,3	1 343 645	80,8	1 579 255	79,8	1 857 468	77,4
Deposits and debt from clients	814 910	51,9	886 719	53,4	1 002 183	50,7	1 158 108	48,3
Tier 1 capital adequacy (%)	9,7		9,8		9,6		8,6	

ATA: average total assets TA: total assets

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

	2003		2004		2005		2006	
	NOKm	% of ATA	NOKm	% of ATA	NOKm	% of ATA	NOKm	% of ATA
Premium revenues for own account	44 990	10,3	56 835	11,7	64 690	11,9	71 194	11,4
Net revenues from financial assets	36 441	8,3	32 326	6,7	42 545	7,8	47 230	7,6
Claims	29 610	6,8	31 465	6,5	32 108	5,9	44 437	7,1
Change in technical provisions	29 327	6,7	37 741	7,8	43 543	8,0	37 678	6,1
Result before new supplementary provisions, allocation to policyholders and tax	11 201	2,6	12 077	2,5	14 721	2,7	20 069	3,2
Change in fluctuation reserves	6 818	1,6	3 487	0,7	8 204	1,5	6 644	1,1
Value-adjusted result before new supplementary provisions, allocation to policyholders and tax	18 019	4,1	15 565	3,2	22 924	4,2	26 712	4,3
	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA
Total assets	458 679		509 461		595 904		673 352	
Bonds held to maturity	166 229	36,2	165 405	32,5	162 333	27,2	184 129	27,3
Equities and units (current assets)	55 440	12,0	79 812	15,7	126 728	21,3	177 912	26,4
Money market instruments and bonds (current assets)	134 297	29,3	155 791	30,6	181 966	30,6	168 808	25,1
Buffer capital	25 266	5,5	32 568	6,4	43 045		53 367	

Figures for 2003 and 2004 are exclusive of unit linked companies.

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

	2003		2004		2005		2006	
	NOKm	% of PFO	NOKm	% of PFO	NOKm	% of PFO	NOKm	% of PFO
Premium revenue for own account	18 746		20 985		22 954		23 300	
Claims expenses for own account	14 807	79,0	14 368	68,5	15 478	67,4	16 459	70,6
Operating expenses for own account	4 245	22,6	4 384	20,9	4 933	21,5	5 074	21,8
Result of technical account	186	1,0	2 387	11,4	2 872	12,5	2 867	12,3
Net financial revenues	4 749	25,3	1 506	7,2	3 708	16,2	4 043	17,4
Result of ordinary operations	3 404	18,2	2 715	12,9	5 302	23,1	5 138	22,1
	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA
Total assets	48 745		55 428		64 018		71 908	
Equities and units (current assets)	3 141	6,4	2 621	4,7	9 233	14,4	11 705	16,3
Bonds and money market instruments (total)	26 148	53,6	35 876	64,7	35 831	56,0	36 971	51,4
Technical provisions	32 062	65,8	35 671	64,4	39 495	61,7	43 275	60,2

PFO: premium revenue for own account

The report entitled *The Financial Market in Norway 2006: Risk Outlook* is a supplement to Kredittilsynet's annual report for 2006.

The annual report covers Kredittilsynet's operations in the preceding year. It includes the agency's activities in the sectors under supervision, i.e. banking and finance, insurance, securities market, financial reporting supervision – listed companies, auditing, external accounting services, estate agency and debt collection. It also covers supervision of ICT systems in the financial sector and measures to combat money laundering etc.

Both publications are available in electronic form at www.kredittilsynet.no.
Printed versions can be ordered from Kredittilsynet.

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