KREDITTILSYNET
The Financial Supervisory Authority of Norway

The Financial Market in Norway 2007

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 2007: Risk Outloook

Introduction

Unless otherwise stated, Kredittilsynet is the source of charts and tables. Cut-off date 25 February 2008.
This report is the full version of the Norwegian report *Tilstanden i finansmarkedet 2007*, published 28 February 2008.

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 the system is to function satisfactorily. Through its supervision of firms and markets, Kredittilsynet shall contribute to financial stability and well functioning markets. Sound financial institutions with good internal control and risk management are particularly important to ensuring financial stability.

In recent decades many countries, including most Nordic countries, have seen serious problems in their financial sectors, with substantial costs for society. In many cases stability problems arise as a result of macroeconomic shocks that bring vulnerabilities in the financial system to the surface. In other cases stability problems have their roots in the financial system itself. The Nordic banking crises in the 1990s, among others, showed that vigorous and persistent credit growth combined with sharply rising prices in real estate and other asset markets makes the financial system more vulnerable to macroeconomic shocks and other unforeseen events. Financial institutions, consumers and investors are particularly likely to underestimate risk in financial markets during protracted cyclical upturns with strong growth in credit and asset prices. The international financial turbulence in 2007 arose after several years of strong growth in credit and house prices in many countries, high returns on financial instruments and very low risk premiums in international financial markets. The queue of depositors outside the premises of Northern Rock showed that distrust and instability can also arise in parts of the financial system today.

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 part of prudential supervision. 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. This assessment of the state of the financial market has been published since 2003, and forms part of a tripartite collaboration between the Ministry of Finance, Norges Bank and Kredittilsynet designed to ensure financial stability.

Highlights

Based on results reported by financial institutions and investment firms and assessments of economic prospects, the main features for the Norwegian financial sector can be summarised as follows:

- The international financial turbulence that started in summer 2007, triggered by problems in the US subprime housing market, will continue to affect international financial markets in

2008. The situation is characterised by increased risk aversion, higher risk premiums along with a costlier and less ample supply of liquidity than before the second half of 2007. Substantial losses on subprime loans and structured products have left many international banks in need of increased own funds, and there are clear signs of reduced willingness to lend both in the US and Europe. There is now a danger of significantly reduced growth in the international economy, despite government measures to prevent a serious real economic downturn. Stock market falls at the start of 2008 reflect the prospects for weaker economic growth and reduced corporate earnings. The impact of the financial turbulence on Norwegian financial institutions has so far been limited. Continued turbulence may create problems for individual institutions. A serious setback in the international economy will lead to poorer prospects for the financial industry in general.

- Norwegian banks' results remained good in 2007, and return on equity was high. No overall losses were recorded, and costs rose less than total assets. Results were somewhat weaker than in 2006 due to higher capital losses on securities, no further write-back of loan losses and lower net interest revenue in relation to total assets. Norwegian banks have not been exposed to subprime mortgages or structured credit products, and in 2007 recorded only moderate impairments in foreign bond holdings as a result of higher credit risk premiums. Less willingness and ability to lend at a number of large European banks may enable Norwegian banks to strengthen their competitive power in some lending segments.

- The banks face some challenges ahead. Credit risk and liquidity risk have both increased since summer 2007. Interest margins and net interest revenues remain under pressure. The steep growth in lending to firms and households imposes high demands on banks' risk management, particularly in light of more uncertain economic prospects. The household debt burden continues to rise from an already high level. Kredittilsynet's autumn 2007 home loan survey shows that a substantial share of mortgages granted still exceed property valuation, despite a sharp slowdown in house price growth and falling house prices in the second half of 2007. Little fixed-interest borrowing and lower loan repayments increase households' vulnerability. A fall in house prices could bring problems for households borrowing 100 per cent of property value. Should interest rates need to be raised as a result of higher inflation, or a global cyclical downturn sets in, bank profits will weaken, primarily through higher losses and reduced growth. Changed expectations in regard to income growth and house prices could augment this effect. Prospects for financial stability in Norway in 2008 remain satisfactory. Thanks to high profitability and good financial positions, the banking sector is in a position to withstand moderate setbacks in the economy and markets.

- The volume of equity release loans is growing strongly. Equity release loans afford borrowers greater flexibility, but also make greater demands of borrowers and banks. Kredittilsynet will raise with the Financial Services Association and the Savings Banks Association the question of instituting industry standards to ensure prudent credit practice in this area, for example by requiring banks to assess borrowers' creditworthiness on a regular basis.

- While Norwegian banks’ liquidity situation is satisfactory, the requirements on banks’ control of liquidity risk have increased since the financial market turbulence surfaced in summer 2007. International developments in 2007 showed that neither banks nor governments had made full allowance for some of the mechanisms that created liquidity problems in international markets. Kredittilsynet will continue to give a heavy emphasis to banks' management and measurement of liquidity risk. Basel II requires banks to assess liquidity risk in their capital assessment processes and to ensure that their financial strength is sufficient to assure access to money and capital markets in difficult market conditions.

- Life insurance companies’ book results rose somewhat in 2007, while value-adjusted results, which also take into account unrealised value changes in the companies’ assets, fell. Life insurers were not significantly exposed to US mortgage loans or to securities secured on such loans, although they incurred capital losses on corporate bonds as a result of higher credit risk premiums and higher interest rates. Although share markets fell sharply in summer 2007, an advance was noted for the year as a whole with prices on Oslo Børs rising about 11 per cent. Profits grew through large property revaluations. Concurrently insurers made substantial provision in 2007 to meet higher future obligations resulting from increased life expectancy. Life insurers’ equity holdings and buffer capital were reduced in 2007, and were further reduced as a result of the share market fall early in 2008. Much uncertainty attends share market developments ahead, and an international economic setback could trigger a longer-lasting fall. Life insurers’ market risk has grown, imposing demands on sound risk management and satisfactory buffer capital.

- The new capital adequacy framework (Basel II) applies to all banks from 2008 onwards. In the case of large banks, using internal models (IRB), transitional rules in effect in 2008 and 2009 limit a possible drop in capital prompted by lower regulatory capital requirements. The increased uncertainty in the economy and housing markets indicates that banks’ capital planning needs to make sufficient allowance for economic downturns and difficult funding conditions. The lending regulations and new accounting rules have brought a lower level of loss write-downs which in isolation has slightly increased the requirements on own funds to meet unexpected losses. Moreover, it is possible that new international rules on own funds will impair the quality of tier 1 capital. Banks, in particular those using internal models, need to make allowance for uncertainties related to calibration and other features of these models.

- Confidence in the financial system is key to financial stability and well functioning markets. The losses incurred by Société Générale clearly demonstrate the significance of operational risk and of good risk management systems and internal controls. Major losses were incurred by Norwegian municipalities on investments brokered by Terra Securities. Many customers have incurred losses on debt-financed investments in structured products in recent years. This underlines the importance of good business practices when marketing securities and structured products, and shows that deficient or incomplete information on risk and return can impair confidence in financial market actors and the financial system in general. New rules will diminish such problems in future. Confidence in the financial system may also be impaired as a result of flaws in the payment and settlement systems.

Summary

The global economy continued to expand in 2007, albeit at a somewhat slower pace than in 2006. The strongest growth is among countries outside the OECD, and for the first time China made the largest contribution to overall global production growth. GDP growth is also high in India and Russia. The US is marked by the problems in the housing market and the ensuing turbulence in the financial markets. The cyclical peak in Europe is probably behind us. Problems in the credit market and plunging share markets have prompted downward adjustment of growth forecasts for most industrialised countries for 2008, especially the US. Downward adjustments for developing countries are small, however, and growth prospects for the world economy as a whole are relatively good. Steeply rising oil and food prices have quickened inflation rates in several countries. Turbulence in financial markets and the US real economy adds to the uncertainty of developments ahead.

Securities markets were highly volatile at times in 2007. The turbulence was triggered by the crisis in the US subprime mortgage market. Large portions of these home loans are securitised, and uncertainty about the size and spread of losses led to higher risk premiums on other securities. This triggered a crisis of confidence among market actors and substantial liquidity problems for banks in many countries. Interbank rates rose sharply. Several central banks injected liquidity, and the Federal Reserve lowered its key rate by 1 percentage point from September to December 2007, to 4.25 per cent. Some decline in money market rates was seen towards year-end. At the start of 2008 problems resurfaced in financial markets, prompting the Federal Reserve to lower its key rate by 1.25 per cent in the space of just over a week, bringing a further fall in money market rates. Lower growth expectations pushed down the interest rate on US 10-year government bonds by 0.6 percentage points to 4.1 per cent in 2007, while favourable economic conditions brought a slight increase in corresponding rates in the euro area. In Norway too bond rates rose, reaching 4.7 per cent by the end of 2007. Since then long interest rates have fallen in Norway as elsewhere. Share markets were affected by investor uncertainty. Volatile credit markets led to plunging share markets in summer 2007, with Oslo Børs tumbling 16 per cent in one month. Good corporate profit performances, a high oil price and a positive growth outlook for the Norwegian economy contributed to a renewed upturn as from mid-August. Developments were uneven in the autumn, however. For the full year 2007 Oslo Børs and Morgan Stanley (MS) World Index rose by 11.5 and 2.8 per cent, respectively. Thus far in 2008 share prices on Oslo Børs have fallen more than 13 per cent.

The expansion of the Norwegian economy strengthened further in 2007, driven by a strong upturn both in domestic demand for consumption and investment purposes and in exports. Adjusted for energy and indirect taxes, consumer price inflation increased through the year. However, activity in the housing market shows clear signs of abating. Monthly house price growth has been negative in each of the past seven months, and 12-month growth fell from a peak of more than 19 per cent in January 2007 to 0.3 per cent in January 2008. The market for commercial property has been marked by rising prices and a falling hurdle rate, and so far there are few signs of a weakening. Prices of downtown properties in the larger towns are particularly high, and rental prices for upmarket premises are continuing to rise concurrently with declining vacancies. Vulnerability to higher interest rates or weaker growth in the economy has increased. The labour market is very tight, with registered unemployed persons making up 1.8 per cent of the labour force in January. At the same time wage pressures are increasing. The boom conditions in the economy are reflected in credit growth, which remains high both among

households and firms. Towards year-end credit growth to firms from domestic sources rose, while credit growth from foreign sources edged down slightly.

Growth in credit to households has far outstripped their income growth for several years, bringing a steep increase in this sector's debt burden. While low in recent years, the interest burden is rising due to higher interest rates combined with still rising indebtedness. Households' financial saving has declined appreciably since 2006, and their saving rate was negative in 2007. The household sector's wealth situation is significantly better than in the 1980s, primarily thanks to the increased value of housing. Households' net liquid financial wealth, in which insurance claims are excluded, is however negative. Households show wide variation in terms of debt burden and financial wealth, the lowest age groups being particularly exposed. The period of economic expansion has increased corporate profits and equity ratios, thereby improving debt-servicing ability in most industries despite the strong increase in indebtedness. Kredittilsynet's survey of banks' exposure to selected industries shows a decline in high-risk commitments in most sectors.

The Norwegian financial market features high market shares held by large financial groups, especially in the banking, securities funds and life insurance segments. In recent years foreign actors have gained increasing influence in the Norwegian market 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 2007 were also good and return on equity was high. Profits were somewhat weaker than the previous year, primarily due to capital losses on securities and no further write-back of loan losses. Norwegian banks are not directly exposed to subprime mortgages or securities backed by such mortgages. Banks' chief source of revenue, net interest revenues, has declined markedly in relation to total assets in recent years. For 2007 as a whole this trend continued, although net interest revenues picked up in the second half-year. Bank lending growth has been very high in the past couple of years, especially to corporates. Despite the high lending growth, banks' tier 1 capital adequacy has been relatively stable. The introduction of a new capital adequacy framework (Basel II) in 2007 substantially reduces the minimum capital requirements, although transitional rules in the period 2007-2009 for banks using internal models to calculate capital requirements limit their opportunity to reduce the level of own funds.

Rapid lending growth combined with increasing competition for depositors' funds has brought a gradual decline in banks' deposit-to-loan ratios. In 2007, however, deposit-to-loan ratios picked up somewhat. A high share of long-term funding reduces banks' liquidity risk, although the share of funding with maturity in excess of one year fell in 2007 for the banks as a whole. Banks' liquidity management has become more demanding since summer 2007. While Kredittilsynet's examination of banks' funding situation in connection with the turbulence witnessed in the autumn revealed no serious funding problems, the banks did face a challenge in terms of abiding by their long-term funding limits. Although the issuance of preferential bonds has played an important role in curbing liquidity risk, this risk is heightened by pressures on long-term funding.

Life insurance companies' value-adjusted results were weaker in 2007 than the previous year, whereas book profits rose somewhat. The market turbulence in the second half-year led to capital losses on life insurers' bond portfolios. Insurers' properties were written up substantially. However, sizeable provisions were concurrently made to meet the companies' future obligations resulting from increased life expectancy. The companies realised part of their shareholdings in 2007, reducing their equity component by 4 percentage points to 23 per cent of total assets by year-end. Their holdings of money market instruments were increased in 2007. Buffer capital fell 1.5 percentage points in the course of the year, and constituted 6.7 per cent of total assets at the end of 2007.

Pension funds' return on capital was substantially lower in 2007 than the previous year. The decline was larger in private than in municipal pension funds due to the former's higher exposure to equity markets. Even so, given private pension funds' larger equity component, especially Norwegian shares, their return levels were higher than among municipal pension funds.

Non-life insurance companies' result of ordinary operations was somewhat weaker in 2007 due to lower financial revenues. Growth in premium revenues was weak, while claims payments grew by a substantially larger margin in 2007. The weak trend in premium revenues indicates that such revenues fell in real terms in relation to the value of insured objects such as cars and houses, and may therefore indicate effective competition in the non-life insurance market.

Finance companies' results were somewhat weaker in 2007 than in the previous year. Losses were roughly on a par with 2006. However, a substantial increase in defaults suggests that losses will increase ahead. Mortgage companies recorded clearly weaker results than in 2006, mainly due to capital losses on financial instruments in Eksportfinans ASA.

New securities trading legislation requires a licence to provide investment advice. The number of investment firms therefore increased steeply in 2007. Higher revenues from provision of investment services in connection with issues and mergers, contributed to higher overall operating profit for investment firms. Companies managing securities funds also posted higher revenues in 2007, but unchanged operating profits. Assets under management in Norwegian securities funds rose in 2007.

Uncertainty attending economic developments ahead has risen substantially since summer 2007. The problems in the US housing market and turbulence in international credit and money markets continued into 2008. There are increasing signs that the turbulence is having real economic consequences in the US. Other countries will in due course be negatively affected by a sharp slowdown in US growth, or directly by heavier bank losses and poorer access to funding for firms and financial institutions alike. Slower growth increases the risk of further stock market falls. Higher price pressures are making it difficult for central banks to stimulate the economy by lowering interest rates. Significantly slower growth in the international economy will in time lead to poorer prospects for Norwegian financial institutions.

Norwegian life insurance companies have virtually no direct exposure to subprime mortgages through structured credit products or hedge funds. They are however affected by general developments in Norwegian and international securities markets. Uncertainty in these markets has risen. Life insurers are vulnerable to major market setbacks, and high-quality risk management and sound risk-bearing capacity are important. With greater ability to meet increased obligations resulting from increased life expectancy, insurers have greater leeway to dispose over coming years' profits and better opportunities to withstand possible continued turbulence in financial markets.

After several years of excellent results, Norwegian banks face the prospect of weaker earnings ahead. Revenues from market-related activities could fall as a result of continued international turbulence. Banks' earnings may also be impaired by higher costs of market funding. Banks’ good profitability in recent years largely derives from strong lending growth and an absence of losses. Reduced lending growth as a result of higher interest rates, falling house prices and lower activity levels in Norway will weaken banks’ profits in the short term. Banks need in the first instance to continue to streamline operations and reduce costs if profitability is to be maintained. The competitive situation limits their opportunity to significantly increase interest margins. Increased risk may however cause margins to rise somewhat. In a situation of impaired profits banks can seek growth in new areas or increase their earnings by greater risk taking in other ways. With continued strong growth and a tight labour market in Norway, there is unlikely to be a significant increase in bank losses on either corporate customers or retail customers in the short term. Banks may nonetheless see losses rise as borrowers’ interest rate burden increases. Banks’ reputation is at risk where poor borrowing advice is given to vulnerable groups, and where losses are incurred on home loans to such groups.

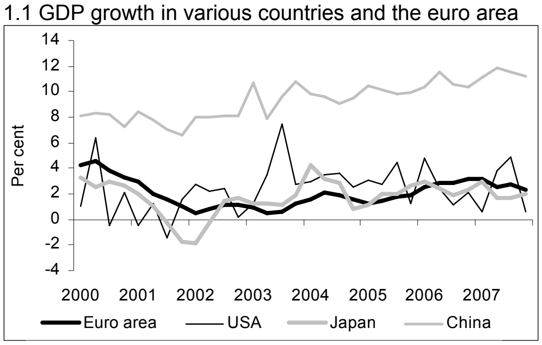
Financial vulnerability in parts of the household sector is rising as a result of rapid credit growth, a very low share of fixed-interest borrowing, longer repayment periods for instalment loans, a steep increase in equity release loans with no principal repayments required and high loan-to-value ratios. Kredittilsynet’s home loan survey for 2007 showed that while the share of new loans for house purchase with a loan-to-value ratio in excess of property valuation fell from 37 to 28 per cent for younger borrowers, the volume of fully financed house purchases remained high. Falling house prices could create problems for households borrowing 100 per cent of property value. How far a significantly weaker international trend might affect debt accumulation by Norwegian households and the trend in housing markets is uncertain. Continuing international turbulence with ensuing interest rate reductions may curb the rise in Norwegian interest rates at the same time as pressures in the Norwegian economy persist. This could lead to continued debt accumulation by households. On the other hand, slower international growth and falling house prices in many countries may change households’ expectations in regard to incomes and house prices and help to dampen debt growth.

It could take time for the ultimate effects of the US subprime crisis on the international financial markets to become clear. A significant deterioration in markets and real economy due to increased losses at international financial institutions, solvency problems, higher risk aversion and tighter credit supply will have negative consequences for the Norwegian economy. Competitively exposed industries will be hit by lower demand from abroad. At the same time firms face rising costs ahead because the stage is set for an expansionary wage round in spring 2008 and because interest rates may rise, contributing to a stronger Norwegian currency. Higher interest rates may also curb household consumption, with negative effects for consumption-related industries and commercial real estate. How serious a problem such a scenario would create for financial institutions is uncertain. It could take some time even for a serious international setback to translate into lower production, rising joblessness and reduced income growth in Norway. The corporate sector has seen a rapid quickening of debt growth in the last couple of years. Some projects now being financed could give rise to excessive capacity in parts of business and industry, particularly in the event of slower growth in the international and Norwegian economy.

1. Markets and economic trends

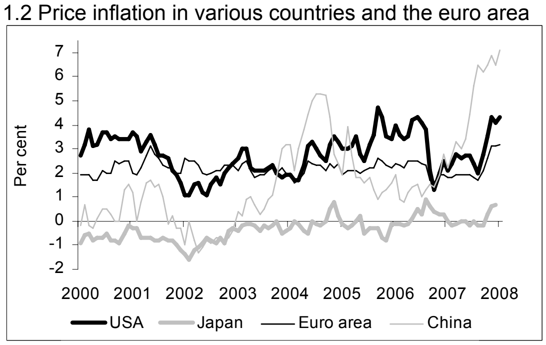
The world economy continued to expand rapidly in 2007, despite volatile international financial markets. Strongest growth was shown by countries outside the OECD area. In the US, which has long been the growth locomotive in the international economy, developments towards year-end were strongly marked by problems in the housing market and the ensuing financial market turbulence. The turmoil in financial markets and the risk premium mark-up which followed brought substantial downward adjustments in forecasts for world economic growth for 2008. This is particularly true of the US which throughout 2007 saw its growth estimate for 2008 cut by 1.3 percentage points by the IMF. The international financial turbulence continued into 2008 and the US is now probably in recession. For a long period a steep rise in the prices of oil and food had only a moderate effect on inflation, but price pressures in the international arena have intensified of late. For the world economy as a whole the IMF expects production growth of 4.1 per cent in 2008, down from 4.9 per cent in 2007.

1.1 GDP growth in various countries and the euro area



Source: Reuters EcoWin

1.2 Price inflation in various countries and the euro area



Source: Reuters EcoWin

After weaker growth in the US at the start of 2007, activity picked up through the spring and summer. Towards year-end, however, the trend reversed. In the fourth quarter GDP growth was a mere 0.6 per cent (annualised rate), due above all to lower growth in consumption and a sharp fall in housing investment. Problems in the housing market, which first emerged in the form of increased defaults of subprime mortgages, deteriorated during autumn 2007. In November house prices measured by the S&P Case Schiller Index for the 10 largest cities was 8.4 per cent lower than in November 2006, the largest fall on an annual basis in the history of the index. New house sales fell 4.7 per cent in December, while the number of unsold houses rose to a volume corresponding to 10 months' sales. A weaker housing market and labour market explain the fall-off in consumption. Towards the end of 2007 the unemployment rate rose from 4.7 to 5.0 per cent in a single month. The dollar depreciated by 10.5 per cent against the euro in 2007, mainly as a result of the crisis in the housing and credit market. A weaker dollar could provide positive impetus to growth through external trade in the medium term.

In the euro area rising activity levels since 2005, together with a rise in energy and food prices, have brought quickening price growth through 2007, bringing the twelve-month rate of growth to 3.2 per cent in January 2008. The cyclical upturn has been driven in particular by exports and private investment. Although unemployment has fallen to its lowest level in 15 years, household consumption has made little contribution to growth. The major European banks are relatively heavily exposed to the US housing market, and the financial industry is hit by heavy losses and higher funding costs. Higher funding costs, together with a stronger euro, will contribute to weaker growth in 2008 and the economic cycle appears to have peaked in the euro area too. Recent EU entrants are showing the highest growth in the union. While exports have been an important driving force for these countries, domestic demand is also making an increasing contribution. In Latvia the economy is at risk of overheating, despite tightening action taken by the authorities.

In the Nordic region the generally high GDP growth in 2006 was followed by a somewhat weaker trend in 2007 in Denmark, Sweden and Finland. In Iceland, on the other hand, activity picked up through the year. However, Icelandic financial institutions have been hit particularly hard by the international financial turbulence.

Table 1.1 Growth forecasts

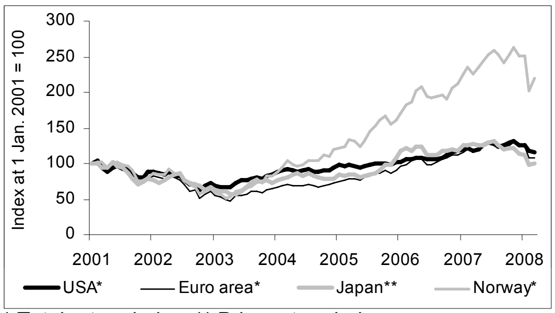
	USA		Euro area		Japan		Norway*	
	2007	2008	2007	2008	2007	2008	2007	2008
GDP	2.2	1.6	2.6	1.6	1.9	1.4	6.0	2.8
Inflation	2.9	2.9	2.1	2.5	0.0	0.5	0.8	3.5
Unemployment	4.6	5.3	7.4	7.2	3.9	3.8	2.5	2.7

Sources: Consensus Forecasts, 11 Feb 2008, and Economic Survey 1/2008, Statistics Norway *Mainland Norway

Economic expansion appears to be continuing in countries outside the OECD area, and they appear to be less affected by the financial turmoil. While growth rates are particularly buoyant in the Asian countries, higher commodity prices have also brought a substantial economic upswing to many countries in Africa and Latin America in the past year. Both Russia and India have seen high production growth in recent years. China has shown very high rates of growth since the start of the 1990s, and continued to do so in 2007, a year that brought greater balance to the Chinese expansion. Investments and exports continued to grow rapidly, and private consumption also rose substantially. Concurrently inflation rose significantly through the year, and the Chinese authorities have taken a number of steps to dampen the rate of growth. So far the action taken does not appear to have had a significant effect, and China's high growth continues to produce boom conditions in other parts of Asia. At the same time China's demand is contributing to high commodity prices. The oil price rose from just over USD 50 p/b at the end of 2006 to close to USD 100 at the end of 2007. After dipping slightly in January, the oil price rose to over USD 100 p/b in mid-February 2008.

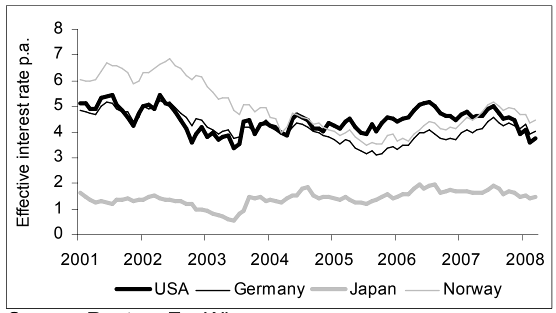
Securities markets were marked by highly volatile periods in 2007. Large sections of US subprime mortgages are securitised, and uncertainty about the size and spread of losses resulted in higher risk premiums on other securities. This led to a crisis of confidence among market actors and substantial liquidity problems in international markets. Interbank market interest rates rose sharply. Several central banks injected liquidity, and the Federal Reserve lowered its key rate by 1 percentage point from September to December 2007, to 4.25 per cent. There was some decline in money market rates towards year-end. At the start of 2008 problems resurfaced in financial markets. Risking continued rising inflation, the Federal Reserve lowered its key rate by 1.25 per cent in the space of just over a week in January, bringing a further fall in money market rates. The European Central Bank has kept its key rate unchanged at 4 per cent since June 2007. Despite the turbulence in the financial market Norges Bank has continued the process of normalising the level of interest rates in Norway. Since summer 2005 the key policy rate has been raised on a total of 14 occasions, to 5.25 per cent. Long interest rates also fluctuated widely in 2007. After rising up to the summer, bond rates fell during autumn. For the year as a whole, the rate on US 10-year government bonds fell to 4.07 per cent by the end of 2007 while corresponding rates in the euro area and Norway edged up to 4.35 and 4.69 per cent respectively. Thus far in 2008 bond rates have fallen in all areas.

1.3 International share markets



* Total return index. ** Price return index
Source: Reuters EcoWin

1.4 Interest rate on 10-year government bonds



Source: Reuters EcoWin

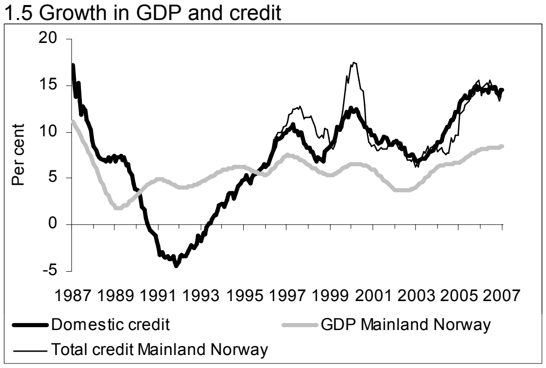
Investor uncertainty also left its mark on equity markets in 2007. At the start of the year stock values rose on the back of strong corporate profit performances, bright growth prospects and ample market liquidity. After a substantial correction in February the upturn continued. Turbulence in financial markets in late July/early August 2007 led to a sharp fall in equity markets. During the autumn equity markets were again marked by optimism until share prices fell back in late October/early November as a result of steadily increasing problems in credit markets and downward adjustment of growth prospects in the US, the euro area and Japan alike. In 2007 the MS World Index and S&P 500 rose 2.8 and 3.8 per cent respectively. Oslo Børs performed somewhat more vigorously, with the Benchmark Index rising 11.5 per cent over the year. Equity markets plunged after year-end, mainly due to fears of weaker international economic growth. In the US equity markets were affected by heavy losses sustained by financial institutions, substantial uncertainty about future losses along with growing fears of recession. Between end-2007 and 22 February 2008, S&P 500 fell 7.8 per cent, while the MS World Index fell 9.5 per cent. In the same period the Benchmark Index at Oslo Børs dropped 13.4 per cent. In January 2008 non-residents' equity interests in companies listed on Oslo Børs fell from 40.8 to 40.5 per cent. In the same period private enterprises' equity interest in companies listed on Oslo Børs fell from 18.3 to 17.4 per cent.

Strong economic expansion in Norway continued in 2007 for the fourth year running. Growth in the mainland (non-oil) economy was as high as 6.0 per cent, about twice the level indicated by forecasts at the start of the year and the highest rate of growth in the Norwegian economy for more than 20 years. The economy is marked by higher employment, record-low joblessness and capacity constraints in a growing number of industries. A good trend in the terms of trade and high corporate profitability has coincided with a marked increase in households' real wage growth. Private consumption, investment and exports are all making a substantial contribution to GDP growth. Although Norges Bank has raised its key policy rate by 3.25 percentage points in the past couple of years, credit growth remains high and the economy shows signs of overheating. Even so, most forecasts suggest that the economic expansion will be followed by a soft landing in the medium term.

The high growth in the economy, together with very low interest rates, has stimulated household consumption. In 2007 consumption rose by 6.4 per cent, the largest increase since 1985. Rapid wage growth and rising house prices, combined with falling and in due course very low joblessness, have contributed. Growth in consumption caused the household saving rate to fall to a negative 1.2 per cent in 2007, despite substantial growth in real disposable incomes. Optimism is also reflected in a high rate of corporate investment. Between 2003 and 2006 investment in mainland (non-oil) industries climbed 40 per cent, prompting Statistics Norway to make substantial upward adjustments during 2007 in its full-year investment estimates. Corporate borrowing from domestic sources in 2007 was very high, although this is partly ascribable to substitution of foreign by domestic credit sources as a result of the turbulence in international financial markets.

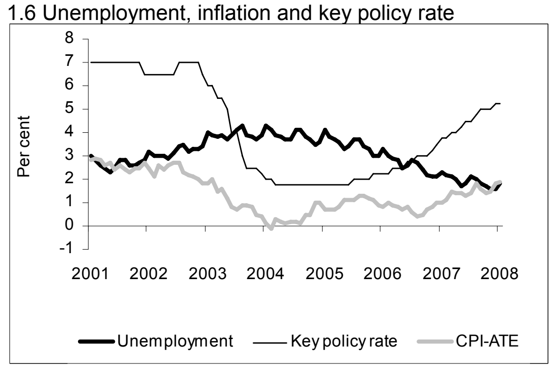
The Norwegian labour market is very tight, and the period since the second quarter of 2005 has seen a sharp increase in employment and a drop in joblessness. In terms of Statistics Norway's labour market survey, unemployment was 2.5 per cent during 2007. In contrast to previous periods of strong economic expansion, when joblessness bottomed out for only a short period, the low unemployment rate in the present upturn has persisted. Concurrently the labour force has grown by as much as 130,000 persons since November 2005. Labour immigration, particularly from Poland and the Baltic states, is probably an important contributor to the growth seen in the labour force. Registered unemployment in January 2008 was 1.8 per cent of the labour force - a historically low level.

1.5 Growth in GDP and credit



Source: Statistics Norway

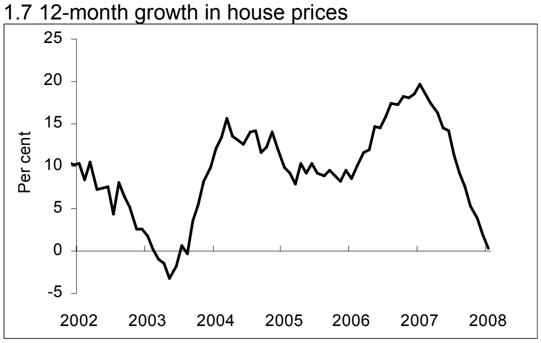
1.6 Unemployment, inflation and key policy rate



Source: Reuters EcoWin

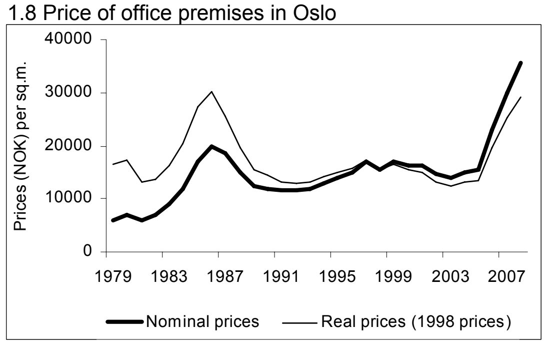
Although the Norwegian economy is growing above trend, aggregate price pressures are low. At the end of 2007, however, signs of increased price growth were in evidence. The 12-month rate of growth in consumer prices was 3.7 per cent in January 2008, while the corresponding growth in consumer prices adjusted for indirect taxes and energy (CPI-ATE) was 1.9 per cent. The rate of price increase is affected by the fact that imported inflation and prices of Norwegian-produced goods and services pull in opposite directions. Imported price inflation has for some time been very low or falling, while domestic price inflation, particularly on goods where labour is the dominant factor input, has risen. The Norwegian housing market reached a turning point in 2007. House prices fell over the autumn and were 3 per cent lower in January 2008 than in June 2007. After several years of strong growth, prices in January 2008 were nonetheless as much as 328 per cent higher than in 1992, the last trough year in the Norwegian house price cycle. Prices of apartments, semi-detached dwellings and detached dwellings were on a weak trend in the second half of 2007, and in January 2008 the 12-month rate of price increase on apartments was negative. The price of OBOS (a cooperative building association) apartments fell 2.6 per cent in the same period.

1.7 12-month growth in house prices



Sources: NEF, EFF, FINN.no and Econ Pöyry

1.8 Price of office premises in Oslo



Sources: OPAK and Kredittilsynet

Both rising interest rates and high house prices have contributed to a weak trend on the housing market. A highly expansionary supply side pulls in the same direction. At the start of 2008, 14,225 dwellings had been placed on the market at Finn.no (the main Norwegian marketplace for purchase and sale over the Internet). The supply side has long featured a high rate of house building, but a fall in housing starts in December 2007 compared with December 2006 contributed to an overall 1.1 per cent fall in housing starts in the 12-month period.

Concurrently the sale time of dwellings placed on the market rose by 18 days between January 2007 and January 2008. The number of dwellings sold is also receding. According to Statistics Norway 20,700 dwellings were sold on the open market in the third quarter of 2007, a decline of 6.7 per cent on the same quarter of the previous year. However the value of sold dwellings rose by almost 9 per cent in the period. In the third quarter of 2007, 2,800 recreational properties were sold, a rise of just over 3 per cent compared with the third quarter of 2006, while the average purchase price for cabins and recreational properties rose by as much as 23 per cent. Recent months show signs of a slowdown in the market for recreational properties.

The market for commercial property in Norway has been marked by great optimism in recent years, combined with an unusual situation in which strong economic expansion has been followed by very low interest rates. Low return on fixed income securities has prompted private investors to turn to other investment objects, and this has pushed down the hurdle rate on commercial property to a level approaching 4.25 per cent. A lower hurdle rate has resulted in substantially higher prices on office property. OPAK's rental price indicator shows steep growth in the past two years with upmarket premises showing the strongest trend. Office rentals have risen in all major towns. Aberdeen Property puts overall return on office premises in the Norwegian market at 13.2 per cent in 2007, down from 18.2 per cent in 2006. Even so, overall return in Norway is still significantly higher than elsewhere in Europe.

2. Financial institutions

Financial institutions' 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 2007 by 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.

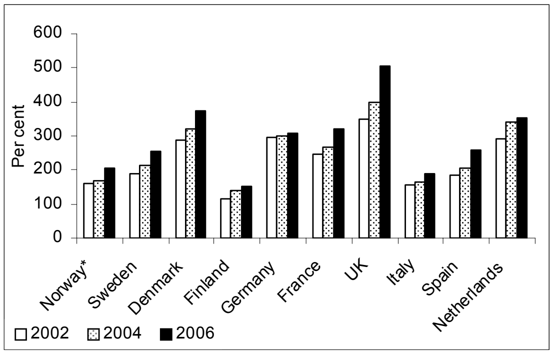
Financial market structure

The financial markets have seen major regulatory changes in recent years (see chapter 4). The changes are taking place within the framework of harmonised European legislation, and have a bearing on market structure and competition. Another driver of changes in financial markets is new technology. Norway is at the forefront in applying new technology, particularly in the fields of payment transmission and information dissemination. Technology and internationalisation are probably the most important factors in the evolution of the financial sector in Europe ahead. While only a small increase was seen between 2001 and 2005 in the number of banking groups in the EU with substantial cross-border activities, their share of the EU banking sector's total assets rose substantially from 54 to 68 per cent in the same period.

Substantial consolidation has taken place over time leaving fewer, larger entities in the European financial market. Whereas domestic mergers and acquisitions have diminished somewhat in recent times, cross-border consolidation has continued. Various factors are behind this development, including limited possibilities of expansion in the domestic market and a desire to achieve economies of scale. In 2004 Banco Santander (Spain) acquired Abbey National (UK), and in 2005 Unicredit (Italy) acquired HypoVereinsbank (Germany) with subsidiaries in Austria and Poland. In the same year the Dutch ABN Amro acquired the Italian bank Antonveneta. In 2006 French BNP Paribas took over Italian BNL. Royal Bank of Scotland Group, Banco Santander and Fortis were authorised by the Dutch authorities, subject to certain conditions, to acquire ABN Amro in September 2007.

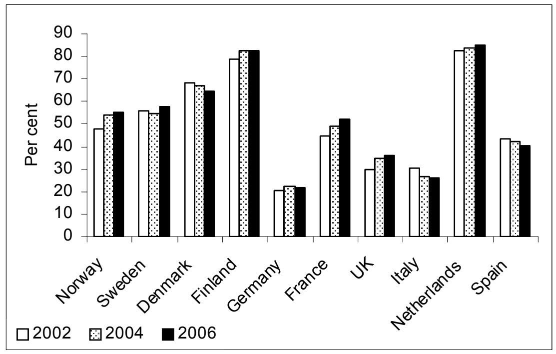
Credit institutions' total assets have risen at a faster rate than the wider economy in most European countries. Credit institutions' share of GDP is not particularly high in Norway, possibly because Norwegian credit institutions lend relatively less to foreign entities and to the public sector than do their counterparts in other countries. Credit market concentration, measured by the five largest institutions' share of the overall 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 53 per cent of the Norwegian credit market at the end of 2007. Three of the five largest institutions are foreign-owned.

2.1 Credit institutions' total assets to GDP



Sources: ECB and Kredittilsynet. *GDP Mainland Norway

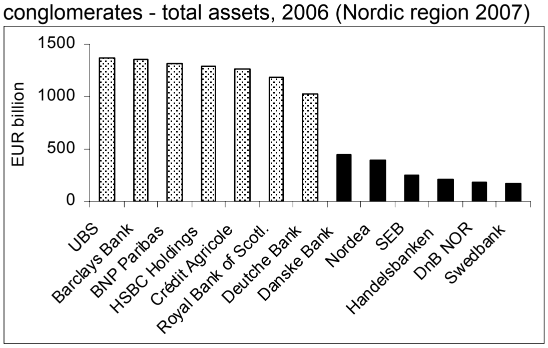
2.2 Five largest credit institutions' share of total assets in the credit market



Sources: ECB and Kredittilsynet

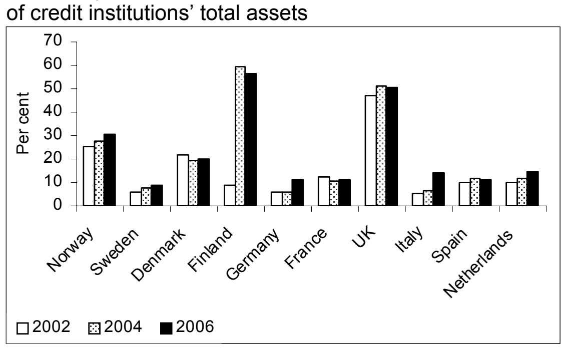
Like the European market, the Nordic market has seen establishments, mergers and acquisitions across national borders. And like their Nordic counterparts, Norwegian financial institutions have been active in acquiring Nordic financial institutions. In November the Storebrand Group was authorised to acquire SPP Gruppen from Svenska Handelsbanken, and DnB NOR was authorised to acquire the Swedish SalusAnsvar and Skandiabanken's car finance business in both Sweden and Norway. The largest Nordic financial conglomerates have established operations not only in their neighbouring countries, but also in Asia, the Baltic states, Russia and elsewhere in Eastern Europe. Nordic financial conglomerates have in particular expanded into the Baltic countries, where the major Swedish operators hold large market shares. DnB NOR is also represented in the Baltic region through its subsidiary DNB NORD. Loans to the Baltic region accounted for about 3 per cent of the DnB NOR Group's total lending in 2007. Despite acquisitions and expansion, the large Nordic financial conglomerates remain small by European standards.

2.3 Largest European and Nordic financial conglomerates - total assets, 2006 (Nordic region 2007)



Sources: The Banker and quarterly reports

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



Sources: The Banker and Nordic supervisory authorities

After the reorganisation of Nordea, of which Nordea Bank Finland became a foreign-owned subsidiary, foreign-owned financial institutions' market share in Finland rose from around 7 per cent to close to 60 per cent. Norway has also seen an increase in the foreign market share in recent years. All the largest Nordic financial conglomerates have established operations in Norway, in addition to the largest Icelandic banks - Glitnir Bank, Landsbanki and Kaupthing. In the wake of the financial turbulence in the second half of 2007, the situation of Icelandic banks has been a matter of uncertainty in the financial market. Altogether the Icelandic banks make up only a small portion of the Norwegian banking market, 1.5 per cent.

Several structural changes were seen in Norwegian financial markets in 2007 in the banking area, among finance companies and mortgage companies, and in insurance. In connection with new securities trading legislation, Kredittilsynet awarded licences to 59 new investment firms. Four large banks were authorised to establish a joint non-life insurance company and a joint life insurance company. Kredittilsynet recommended that DnB NOR be authorised to establish a non-life insurance company. Two large Norwegian financial institutions were converted from subsidiary to branch status in 2007. Fokus Bank was converted to a branch of Den Danske Bank and Vesta Skadeforsikring was converted to a branch of the Tryg Vesta Group. These are respectively the third largest bank and the third largest non-life insurance company in the Norwegian market.

There are five major financial groupings in the Norwegian financial market, of which DnB NOR is by far the largest. Other sizeable groupings are Sparebank 1 Group with 22 banks and Terra Group with 78 banks. Concentration is higher in the insurance market than in the credit market. Of ten life insurance companies engaged in traditional life insurance in Norway, the three largest (Vital, KLP and Storebrand) have a market share of 84 per cent. In the non-life insurance market the four largest companies (Gjensidige Forsikringsgruppen, If, Tryg Vesta and Sparebank 1 Skadeforsikring) hold a market share of 65 per cent in terms of total assets and 70 per cent in terms of gross premium earnings.

Table 2.1 Structure of the Norwegian financial market at end-2007

Per cent of total assets	Banks	Finance	Mortgage	Life insurance	Non-life insurance
DnB NOR (incl. Nordlandsbanken)	37	25	15	31	0
Nordea Bank Norway	14	8	4	6	0
Sparebank1 Group*	12	6	3	3	6
Storebrand	1	0	0	26	1
Terra-Group*	5	1	2	0	1
Total financial groups	69	40	23	66	8
Other companies	**31	60	77	34	92
Total	100	100	100	100	100
- of which foreign branches in Norway	17	20	1	1	31
- of which foreign subsidiaries	17	46	8	6	2

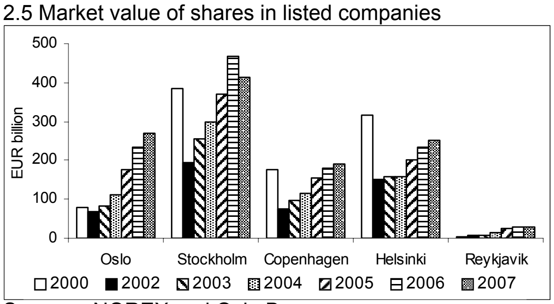
*For Sparebank1 Group and Terra-Group, market shares include the owner banks. **Savings banks accounted for 10 per cent, and commercial banks (incl. branches of foreign banks) for 21 per cent, of other banks.

Securities markets

Securities markets play an important role 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 essential if issuance of shares and fixed income securities is to be a competitive alternative to borrowing from credit institutions. The significance of securities markets varies across the Nordic region. At the end of 2006 the market value of listed companies measured about 149 per cent of GDP in Sweden and 140 per cent in Finland compared with, respectively, 74 and 71 per cent in Norway and Denmark. 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 Helsinki, Copenhagen and Reykjavik stock exchanges.

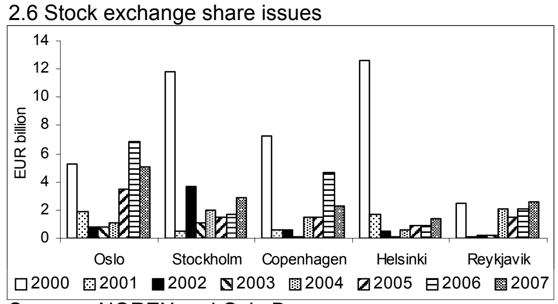
Companies listed on the Nordic stock exchanges have increased in value, and the market value of quoted shares passed the 2000 level at the end of 2006, except in the case of the Finnish stock market. Market value rose further into 2007, but subsided in the second half-year in the wake of the general turbulence in international financial markets. Issue volumes shadow to some extent the trend in the secondary markets. The equity market slump from 2000 to 2002 was reflected in issue volumes, which dropped sharply after 2000. Issue volumes have picked up in recent years, however. In 2007 shares worth about NOK 40 billion were issued on Oslo Børs, slightly less than the 2006 figure. In recent years Oslo Børs has recorded a larger issue volume than other Nordic bourses.

2.5 Market value of shares in listed companies



Sources: NOREX and Oslo Børs

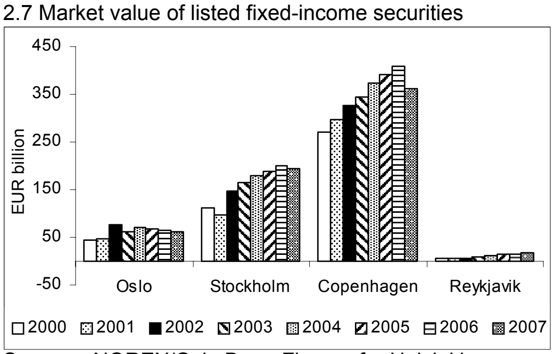
2.6 Stock exchange share issues



Sources: NOREX and Oslo Børs

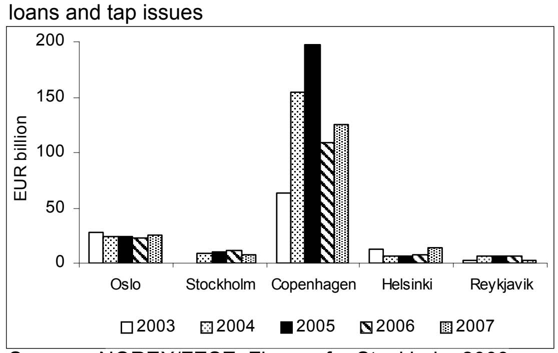
After rising appreciably from 2000 to 2006, the market value of fixed income securities quoted on Nordic stock exchanges fell somewhat in 2007. The Danish fixed income market looms particularly large in the Nordic region owing to the structure of Danish housing finance.

2.7 Market value of listed fixed-income securities



Sources: NOREX/Oslo Børs. Figures for Helsinki not available

2.8 Issuance of listed fixed-income securities, new loans and tap issues



Sources: NOREX/FESE. Figures for Stockholm 2003 not available

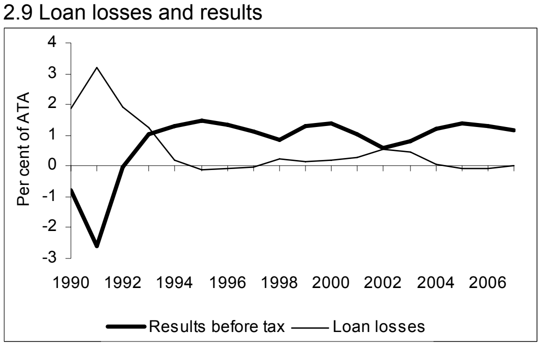
Since an unregulated market for securities exists alongside the stock markets, figures published for stock exchange trading fail to capture overall developments in the securities markets. Figures for market value and issuance of fixed income securities for Oslo Børs do not include the alternative bond market (ABM), which Oslo Børs established in June 2005. In 2007 the ABM market saw new loans and tap issues worth NOK 68 billion while the market value of fixed income securities came to NOK 129 billion at year-end. Oslo Axess started business as a regulated market place for shares in 2007, and shares listed on Oslo Axess have a market value of NOK 23 billion.

In Norway there are four regulated markets authorised for trade in commodity derivatives, with power derivatives accounting for the highest market value. Trade in commodity derivatives on a modern platform is broadly increasing, and was brought under regulation throughout the EU/EEA area with the implementation of the Markets in Financial Instruments Directive (MiFID). Commodity derivatives are largely traded together with the underlying commodity, although the presence of financial actors in this market is growing.

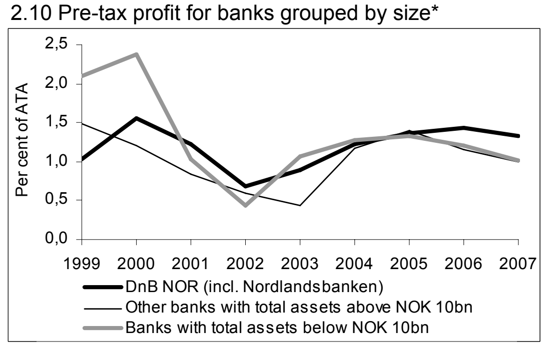
Banks

Banks have recorded good results in recent years. Norwegian banks recorded a pre-tax profit of NOK 28 billion in 2007, an increase of NOK 1.2 billion over 2006. Return on equity fell from 17 per cent to 16 per cent. In terms of average total assets the result was 0.14 percentage points down at 1.15 per cent. A continued reduction in costs in relation to total assets and very low loan losses marked the results. Pressure on interest margins brought a further decline in net interest revenues in relation to average total assets. The financial market turbulence has had negligible impact on the results of Norwegian banks which are little exposed to US subprime mortgages. Altogether banks recorded a net capital losses of NOK 0.8 billion on fixed income securities in 2007, related mainly to the general increase in credit risk mark-ups on corporate bonds. The largest banks presented their accounts under IFRS in 2007.

2.9 Loan losses and results



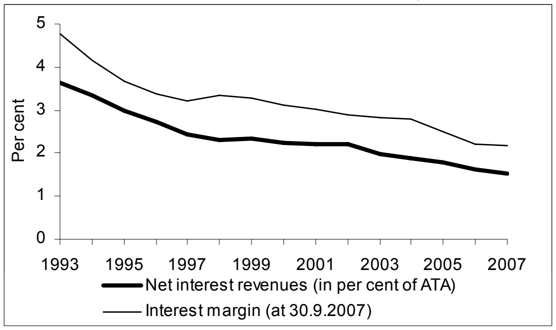
2.10 Pre-tax profit for banks grouped by size*



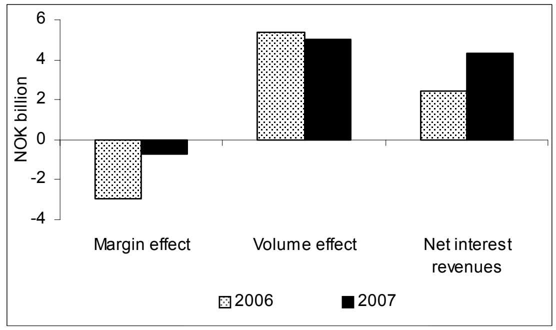
*Other banks with total assets above NOK 10bn (22 banks) and banks with total assets below 10bn (116 banks) accounted for 37% and 9% respectively of total assets in the banking market (incl. foreign branches).

Strong lending growth increased banks' net interest revenues by 13 per cent in 2007. In terms of average total assets, net interest revenues fell from 1.59 per cent to 1.53 per cent. The interest margin, i.e. the difference between lending rates and deposit rates, levelled off somewhat in 2007, and net interest revenues in relation to total assets rose in the last two quarters. Calculations show that the strong growth in lending contributed to an increase of NOK of 5.0 billion in net interest revenues, while falling interest margins pushed down net interest revenues by NOK 0.7 billion. In 2006 the effects of reduced interest margins were stronger, lowering net interest revenues by NOK 3.0 billion.

2.11 Net interest revenues and interest margins



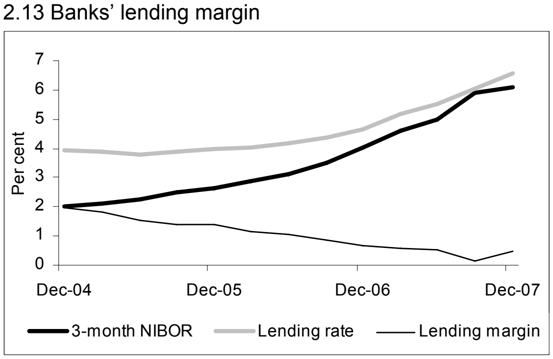
2.12 Banks' net interest revenues, decomposed



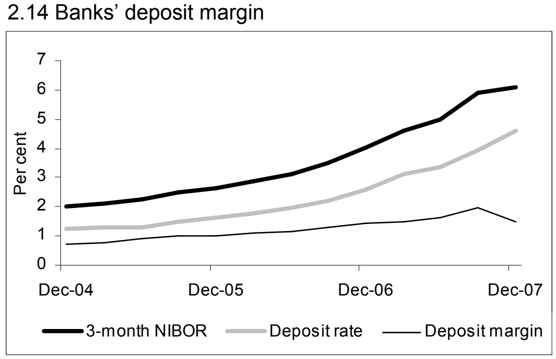
Net interest revenues are the most important source of revenue for Norwegian banks, accounting for 70 per cent of total revenues in 2007. Bank profits are therefore sensitive to changes in interest margins on loans and deposits. In the period after Norges Bank increased the pace of its interest rate increases, banks' marginal funding rate, three-month NIBOR, has risen more than their average lending rate. Inasmuch as the required notice of a lending rate increase is six weeks, Norges Bank's rate increases in the autumn were not fully reflected in bank lending rates in 2007. The general competition in the banking market also reduced banks' lending margin (the lending rate less three-month NIBOR). Banks raised their deposit rates in the same period. Since customer deposits only comprise about two thirds of loans, the overall interest margin nonetheless fell. Over time foreign banks have had lower interest margins than their Norwegian counterparts.

In February 2008 Finansportalen.no showed that the lowest interest rate offerings on home loans stood just above the three-month NIBOR, and below the best offerings on deposit rates. The latter reflects somewhat higher prices in the interbank market. Given a funding rate of 5.9 per cent, the lending rate should stand at least at about 6.5 per cent when administrative costs and required return on equity are taken into account. The competition for market share appears to be an important driver of bank behaviour, possibly posing a significant risk in the longer term.

2.13 Banks' lending margin



2.14 Banks' deposit margin

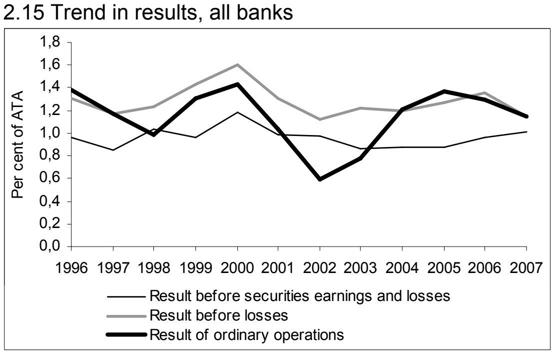


Finansportalen.no, which opened in January 2008, has improved borrowers' ability to obtain information and compare prices of products and services. On 1 January 2006 the registration fee payable when refinancing a loan within the same borrowing limit was lowered from NOK 1,900 to NOK 215. This has made it easier to switch banks, especially for retail customers. Kredittilsynet's survey of information to borrowers (see chapter 3) shows that customers are nonetheless very loyal to their bank. Only 17 per cent of the respondents checked offers from more than one bank before taking out a loan. Existing customer relationships were the most important factor when choosing a bank for 50 per cent of respondents. Only 16 per cent reported that prices, i.e. interest rates and charges, were the decisive factor. Where borrowing from a new bank was concerned, the survey showed that customers did not necessarily terminate their entire relationship to their existing bank, but rather purchased single products from a variety of banks based on an assessment of price and quality. The establishment of niche banks has also increased mobility in the banking market.

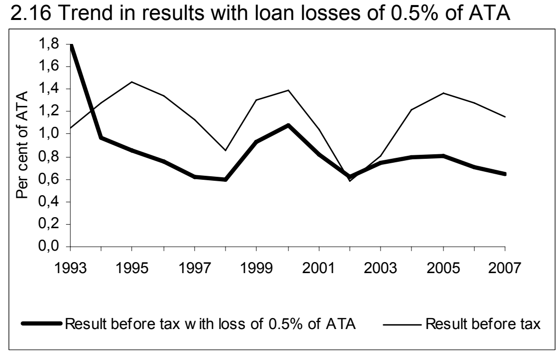
Continued low loan losses characterise bank results. After a long period of net recovery of previous loan losses, losses in 2007 amounted to a mere NOK 33 million for the banks as a whole. Some banks were still recording net recovery of loan losses in 2007. Non-performing bank loans have been on a falling trend since 2002, and were at a very low level at the end of 2007, particularly at the largest banks. Gross non-performing exposures fell by 8 per cent in 2007 for the banks as a whole, and measured 0.5 per cent of their outstanding loan volume.

Recent years' good results and high return on equity are largely ascribable to banks' low loan losses. Although non-performing commitments are at a lower level and growth projections for the Norwegian economy in 2008 are good, bank losses can be expected to increase from today's level. Chart 2.16 shows the trend in profit had losses measured 0.5 per cent of average total assets throughout the period. At the top of the banking crisis (1990-1993) loan losses averaged 2.1 per cent of average total assets. By way of comparison, average losses for the period from 1994 onwards were a mere 0.13 per cent. No allowance is made here for changes in other profit items under such circumstances.

2.15 Trend in results, all banks



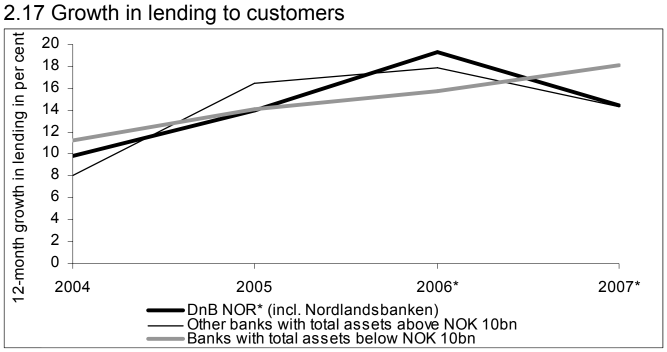
2.16 Trend in results with loan losses of 0.5% of ATA



At 10 per cent, the growth in lending by Norwegian banks was high in 2007, as in 2006. Transfers of home mortgage loans from banks to residential mortgage companies have a bearing on the growth in bank lending to retail customers. Bank lending to retail customers grew 5 per cent, while growth in the case of banks and mortgage companies combined was 12 per cent. While the lending growth slowed at the largest banks, it quickened at smaller banks. Strong growth in lending to corporates continued in 2007, by as much as 20 per cent to domestic corporate customers and 40 per cent to foreign corporate customers. Lending to foreign corporates accounted for about 20 per cent of overall lending to corporates. Strong deposit growth of 15 per cent nonetheless increased banks' deposit-to-loan ratios. Corporate deposits grew far quicker than retail deposits, 20 per cent as against 10 per cent. Although the Norwegian banks are now paying higher funding costs in the money market, high deposit-to-loan ratios have reduced some of the effect of this in banks' results.

A new capital adequacy framework (Basel II) became effective on 1 January 2007. Six banks used the IRB approach to calculate capital charges in 2007. In the years 2007-2009 own funds at IRB banks must be at least 95, 90 and 80 per cent, respectively, of the minimum capital charge under Basel I. Compared with figures calculated under Basel I at the end-2006, tier 1 adequacy increased at one of the banks, and decreased at the other five. In the case of banks which measured capital under the Basel I rules in 2007, the strong growth in lending to corporates led to a steep increase in risk weighted assets, pushing down those banks' tier 1 capital adequacy. Even with their strong lending growth, banks' tier 1 capital adequacy has been relatively stable in recent years. Good results have increased banks' equity capital and this, combined with new capital brought in, has partially offset the decline in tier 1 capital adequacy resulting from the strong growth in lending.

2.17 Growth in lending to customers

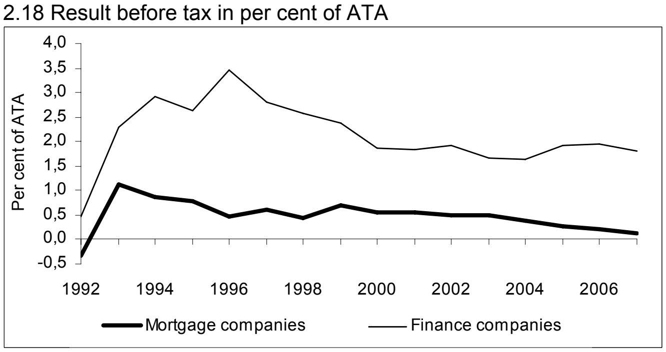


*Growth for 2006 and 2007 includes residential mortgage companies

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.

2.18 Result before tax in per cent of ATA

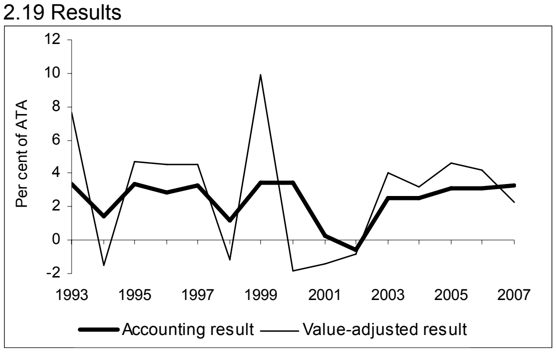


Norwegian finance companies recorded good results in 2007, albeit somewhat weaker than in 2006 in terms of average total assets. Return on equity came to 16 per cent in 2007. A sizeable number of branches of foreign finance companies operate in the Norwegian market. Several of them offer consumer finance (see Chapter 3 for details). Both Norwegian finance companies and foreign branches show rapid credit growth, respectively 20 and 15 per cent in the past year. Mortgage companies' aggregate profit was reduced in 2007 compared with 2006, mainly on account of net losses on financial instruments in Eksportfinans ASA. Return on equity was a mere 4 per cent. Mortgage companies as a whole recorded lending growth of 50 per cent. This was due to portfolio transfers from banks to mortgage companies in the period. When residential mortgage companies are excluded, growth in lending came to 17 per cent.

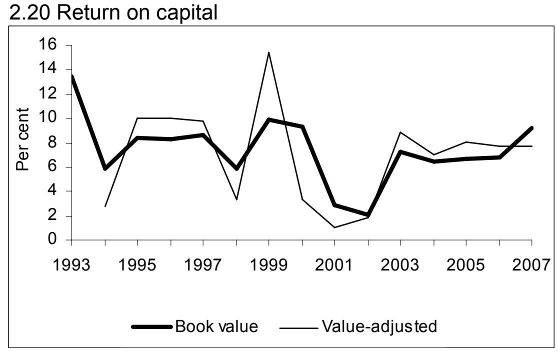
Life insurance companies

The turbulence in financial markets in autumn 2007 brought a reduction in the companies' financial revenues and declining fluctuation reserves. Book profit was NOK 23 billion in 2007, up NOK 3.5 billion compared with 2006. Life insurers saw a substantial appreciation of property values in 2007. Partly as a result of pressure from Kredittilsynet to raise safety margins in their mortality base, the largest life insurers made provisions at the end of 2007 to meet obligations related to increased life expectancy. Like Norwegian banks, insurers have little direct exposure to the US subprime mortgage market. Higher credit risk mark-ups on corporate bonds in general brought some net capital losses on bond portfolios. Fluctuation reserves were reduced, in particular in the second half-year, and the value-adjusted result was down almost NOK 11 billion compared with 2006 at NOK 16 billion. Value-adjusted return on capital, i.e. return on financial assets alone, was 7.7 per cent, more or less unchanged from 2006.

2.19 Results



2.20 Return on capital



Pension funds

The largest private and municipal pension funds, accounting for 80 per cent of pension funds' total assets, have seen a decline in adjusted return on capital in the last two years. Value-adjusted return on capital was 5.8 per cent in 2007 compared with 10.8 per cent the previous year. This compares with a figure of 7.7 per cent for life insurers. Since pension funds have a higher equity component in their balance sheet than life insurers, the weaker share market trend in 2007 and in 2006 resulted in a larger fall in their value-adjusted return on capital. Private pension funds had a higher return on capital than municipal pension funds, 6.2 compared with 4.8 per cent. Overall book return on capital for pension funds was 8.1 per cent in 2007 compared with 8.4 per cent in 2006.

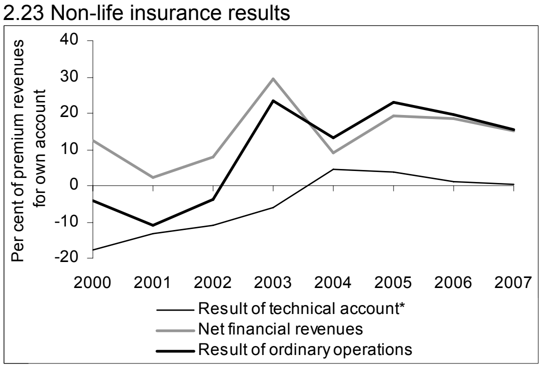
2.21 Private pension funds' return on capital

2.22 Municipal pension funds' return on capital

Non-life insurance companies

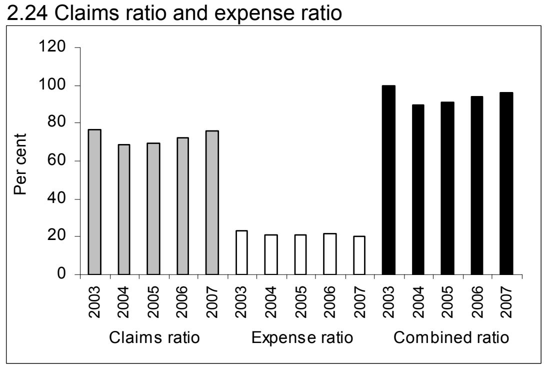
Norwegian non-life insurers recorded a profit of NOK 3.2 billion on ordinary operations in 2007, compared with NOK 3.9 billion in 2006. The decline is mainly attributable to reduced financial revenues. Premium revenues rose by a mere 3 per cent compared with 2007 while claims payments rose by 8 per cent. Quicker growth in claims payments than in premium revenues caused the combined ratio (the ratio of claims and operating expenses as a percentage of premiums) to rise from 94 per cent in 2006 to 96 per cent in 2007. The weak growth in premium revenues indicates that these revenues declined in real terms in relation to the value of the insured objects, such as cars and houses, and may therefore be a function of effective competition in the non-life insurance market. Captive companies are not included due to wide variations in their results from year to year.

2.23 Non-life insurance results



*Allocated return on investment deducted

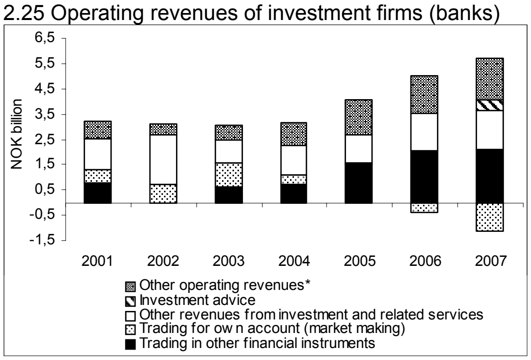
2.24 Claims ratio and expense ratio



Investment firms

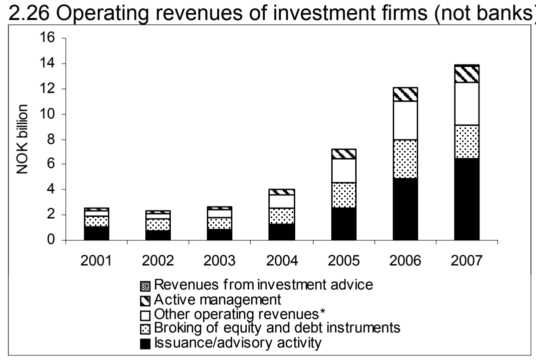
The number of licensed investment firms increased from 85 to 132 in 2007, of which 25 were banks. This increase should be seen in relation to the coming into force of new securities trading legislation requiring a licence in order to provide investment advice. It is useful to distinguish between investment firms that are banks offering investment services in connection with ordinary banking operations, and investment firms that are not banks. Banks' revenues from investment services largely derive from trading in foreign-exchange and fixed-income instruments. Revenues of investment firms that are banks totalled NOK 4.6 billion in 2007, slightly down on the 2006 figure. Operating revenues of other investment firms were NOK 14.4 billion in 2007. The principal revenue components for non-bank investment firms are stock issuance and counselling activity along with broking of equity and debt instruments, in addition to active management of portfolios on behalf of insurance companies, pension funds and private firms. The overall operating profit of these entities was NOK 6.3 billion in 2007, an increase of 5 per cent over 2006.

2.25 Operating revenues of investment firms (banks)



*Including revenues from equity and debt instruments, issuance and advisory activity, and active management.

2.26 Operating revenues of investment firms (not banks)

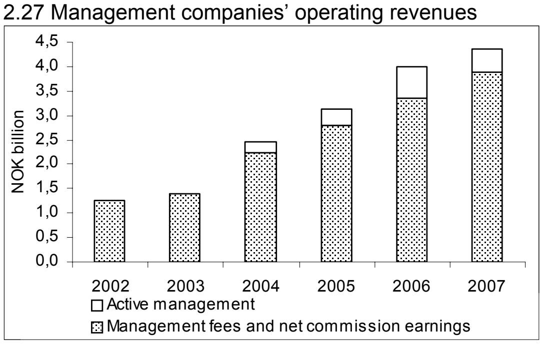


*Including revenues from trading in other financial instruments and result of trading for own account.

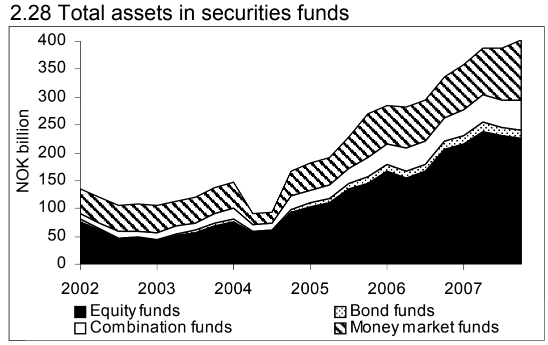
Management companies for securities funds

At the end of 2007 23 companies were licensed to manage securities funds, 11 of which were also licensed to provide active management services. 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. Management companies' aggregate operating profit was NOK 1.5 billion in 2007, about the same as in 2006. At the end of 2007, capital under active management totalled NOK 487 billion, an increase of NOK 34 billion over the previous year. Assets under management in Norwegian securities funds rose by NOK 65 billion to reach NOK 403 billion at the end of 2007.

2.27 Management companies' operating revenues



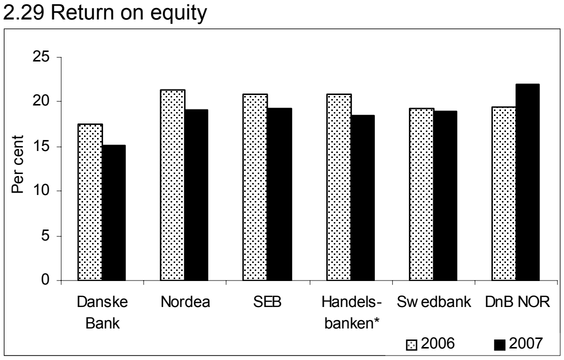
2.28 Total assets in securities funds



Nordic financial conglomerates: profits and financial strength

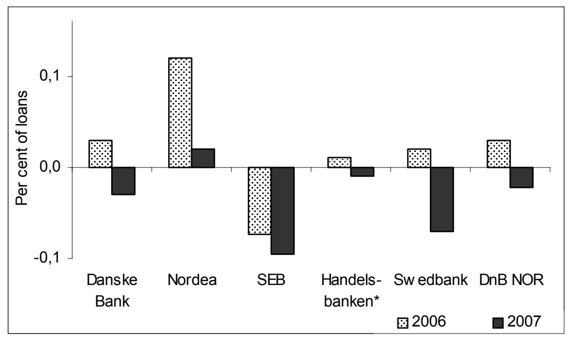
Both in Norway and elsewhere in the Nordic region, financial institutions' results have been good, reflecting a stable cost trend and low loan losses. Strong growth in lending, both for housing purposes and to corporates, has boosted revenues. Return on equity fell in 2007 at the largest financial conglomerates with the exception of DnB NOR. For Danske Bank's part, the reduction in return on equity is related to the acquisition of Sampo Bank in 2007. Loan losses continued at a very low level in 2007. The largest, albeit small, loan losses were recorded by SEB, and were mainly due to increased loan impairments related to Baltic customers. The largest Nordic financial conglomerates incurred some losses on financial instruments as a result of turbulent financial markets in the second half of 2007.

2.29 Return on equity



Sources: Quarterly reports *Figures for Q1 to Q3 2007

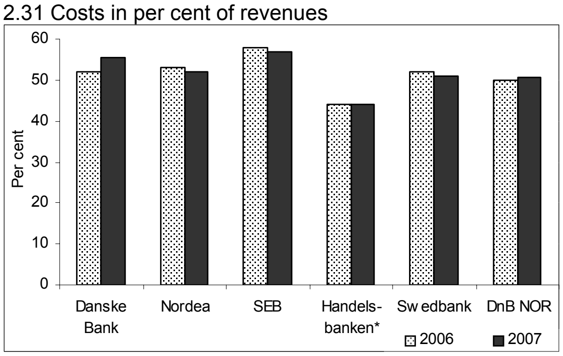
2.30 Loan losses



Sources: Quarterly reports *Figures for Q1 to Q3 2007

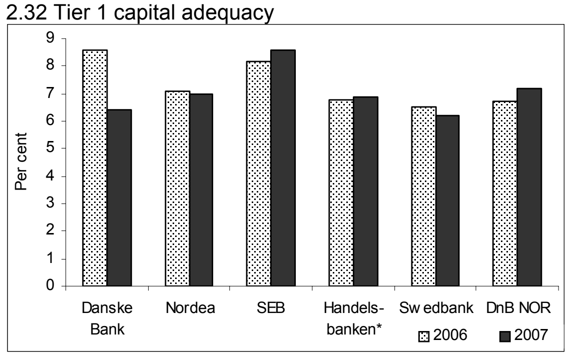
For most of the largest financial conglomerates the cost ratio was unchanged or lower in 2007 compared with 2006. In the case of Danske Bank and DnB NOR, however, an increase was recorded. Volatile credit and liquidity markets in the second half-year brought tougher terms for issuers of short-term and, in particular, long-term debt. Even so, the liquidity situation of Nordic financial conglomerates was relatively satisfactory in the period. Five of the six major Nordic financial conglomerates used the IRB approach under Basel II in 2007. Compared with the end of 2006 (Basel I), three of six financial conglomerates saw an increase in tier 1 capital adequacy.

2.31 Costs in per cent of revenues



Sources: Quarterly reports *Figures for Q1 to Q3 2007

2.32 Tier 1 capital adequacy



Sources: Quarterly reports *Figures for Q1 to Q3 2007

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, liquidity risk and operational risk are of greatest significance. 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.

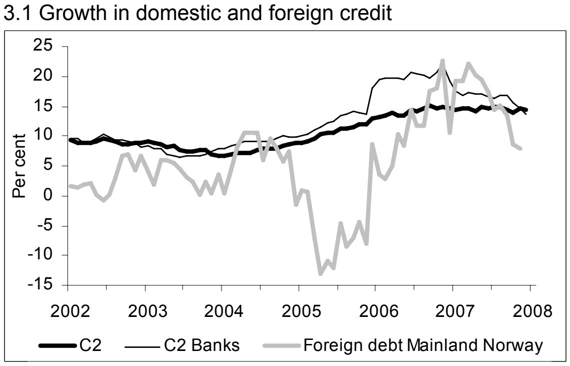
Credit risk

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

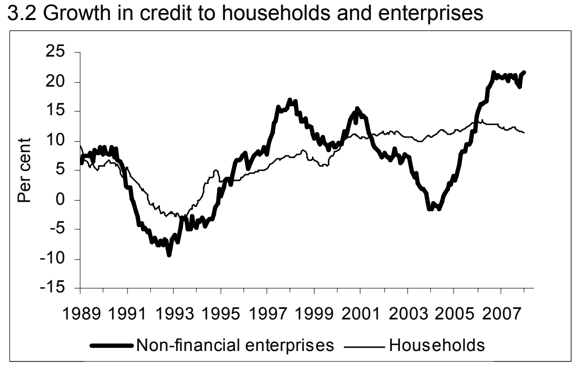
Growth in credit to the non-financial private sector (households and firms, but also including municipal administrations) from domestic sources (C2) has increased since early 2003. 12-month growth exceeded 14 per cent throughout 2007 and was 14.5 per cent at year-end. Total annual growth in credit to the non-financial private sector (C3) was 13.8 per cent at end-November, disregarding oil and shipping. After rising steeply in the first half of 2007, annual growth in credit from foreign sources to Mainland Norway (the non-oil sector) declined towards year-end, probably as a result of turbulence in international financial markets.

3.1 Growth in domestic and foreign credit



Source: Statistics Norway

3.2 Growth in credit to households and enterprises

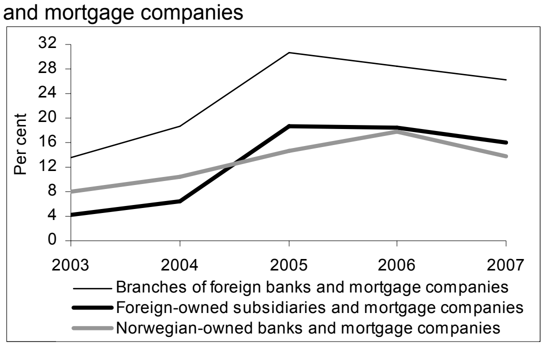


Source: Statistics Norway

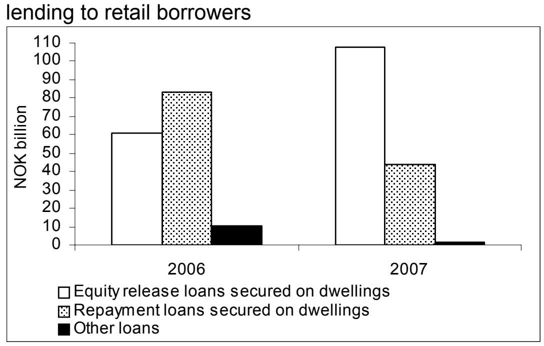
The rapid growth in credit to households from domestic sources over the past seven years is closely related to the strong upturn in the housing market. Higher interest rates and falling house prices as from summer 2007 have so far done little to dampen household borrowing which rose by 11.3 per cent from December 2006 to December 2007. Corporate investment remained at a high level throughout the period of strong economic expansion, and growth in credit to non-financial enterprises accelerated substantially from the 2005 level. At end-2007 growth was 21.6 per cent, the second highest growth rate recorded.

Overall growth in lending by Norwegian banks was 10 per cent in 2007. Growth in lending by Norwegian banks and mortgage companies combined was 14 per cent. At 27 per cent, growth in lending by foreign banks' branches exceeded the growth in lending by Norwegian banks. Overall growth in lending by banks and mortgage companies was 16 per cent.

3.3 Growth in lending by banks and mortgage companies



3.4 Growth in banks' and mortgage companies' lending to retail borrowers



At the end of 2007 the growth in Norwegian banks' lending to retail customers was 12 per cent adjusted for portfolio transfers to residential mortgage companies. Growth in lending to retail customers from branches of foreign banks was 15 per cent, bringing total growth from banks to retail customers to 13 per cent. With almost 90 per cent of lending to retail customers secured on dwellings, banks are closely linked to housing market developments. Equity release loans secured on dwellings are growing strongly. Banks' and mortgage companies' volume of this type of loan product rose by more than 100 per cent from end-2006 to end-2007 to about NOK 200 billion or 17 per cent of total loans secured on dwellings. Norwegian banks' growth in lending to domestic corporates was as high as 20 per cent in 2007. Foreign branches also showed strong growth in lending to this sector, 40 per cent in 2007, bringing overall growth in bank lending to 23 per cent.

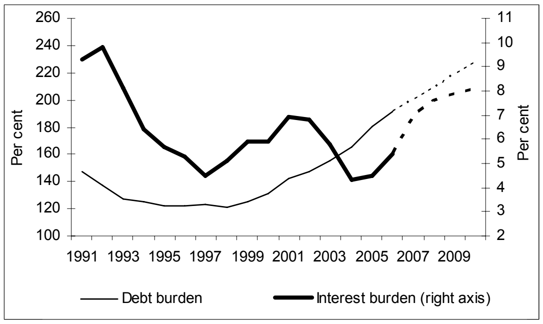
Households

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 % of disposable income. Norges Bank has also projected the trend in the debt burden. The projections are based on the assumptions underlying the central bank's Monetary Policy Report 3/2007 which envisages a sight deposit rate of just over 5 per cent at the end of 2010. The calculations show a steep increase in the debt burden in the same period. On the assumptions outlined, debt will approach an average of 230 % of disposable income towards the end of 2010.

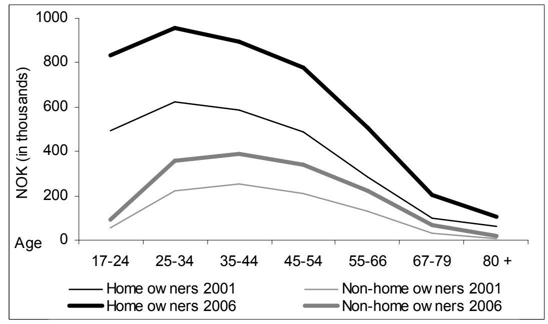
There are wide variations between different groups of households. Both indebtedness and interest expenses are highest among the youngest households entering the housing market. According to figures from Statistics Norway, homeowners in the age range 25-34 carried debt averaging close to NOK 1 million in 2006.

3.5 Households' debt and interest burden



Debt in per cent of disposable income less return on insurance claims (liquid disposable income). Interest expenditure after tax in per cent of liquid disposable income + interest expenditure.
Sources: Statistics Norway and Norges Bank

3.6 Average debt by age

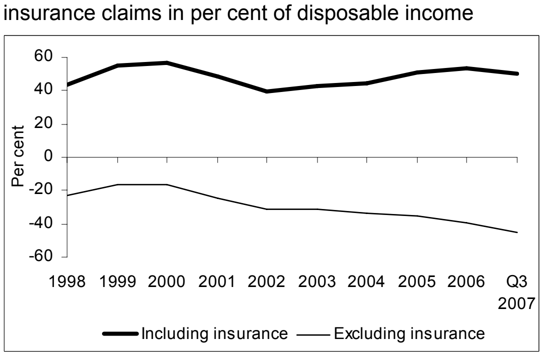


Source: Statistics Norway

Households' financial wealth and financial saving

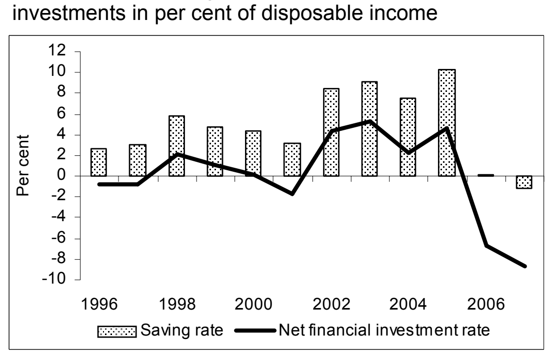
Liquid financial wealth could play an important role as a buffer to withstand an economic downturn and unforeseen expenditure increases, for instance caused by interest rate hikes. At the end of the third quarter 2007 households' net assets made up about 50 per cent of their disposable income (net asset ratio). A large part of households' financial wealth is tied up in illiquid insurance technical reserves which are not available until retirement age. If these investments are excluded, the household net asset ratio is negative. Moreover, this wealth is unevenly distributed: while younger age groups carry the highest debt, the oldest own the highest wealth.

3.7 Households' net financial assets, with and without insurance claims in per cent of disposable income



Source: Statistics Norway

3.8 Household saving rate and net financial investments in per cent of disposable income



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

Households' assets by sector have shown little change over the past 10 years. The bank deposit component has fallen from 36 to 31 per cent, at the same time as share and securities components have increased somewhat. Households' saving in the share market is nonetheless low, making up 12 per cent of households' wealth in the third quarter of 2007. Moreover, wealth invested in shares is unevenly distributed so that the recent stock exchange fall does not affect households' overall consumption to a significant degree. Greater share market uncertainty could increase the portion of household wealth placed in bank deposits ahead.

Having stood at a high level since 2002, the household saving rate fell from 10.3 per cent in 2005 to 0.1 per cent in 2006, in the last two quarters of which it was negative. The decline in share dividends received explains most of the fall in the saving rate. Households' saving rate fell further in 2007 to a negative 1.2 per cent.

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 2007 provides projections to the end of 2009. The interest rate increase in the stress test is incorporated at the turn of the year 2009/2010.

The model starts out from volume figures for 2005 taken from the tax assessment statistics. The assumptions underlying the projections are based on historical data as of the third quarter 2007, where available, while the forecasts for wage growth and bank lending rates are taken from Economic Survey (Statistics Norway, September 2007). The tax programme in the model comprises current 2008 rules, which as a purely technical assumption are continued for 2009 such that the thresholds in 2008 are wage-adjusted for 2009. Credit growth is expected to edge down from the current level to 10 per cent in 2008, and further to 8 per cent in 2009. Whereas households are in a relatively favourable financial position overall, some groups are significantly more vulnerable to interest rate changes than others. For this reason households are classified in three main groups on the basis of interest burden (defined as interest rate expenses divided by disposable income after tax). Based on the distribution of debt, income and wealth in 2005, the model projects the number of households falling within each of the three groups in 2009, as well as each group’s share of the total debt.

The steep interest rate fall as from 2002 meant that only 90,000 households had an interest burden above 20 per cent in 2005. The interest rate increase starting in summer 2005, combined with rapid credit growth, caused this figure to rise sharply in 2007. The assumption of a continuing rise in interest rates ahead makes for a further rise in the number of households with a high interest burden in 2009, even with declining credit growth and high income growth. The group with the highest interest burden will account for a quarter of overall debt.

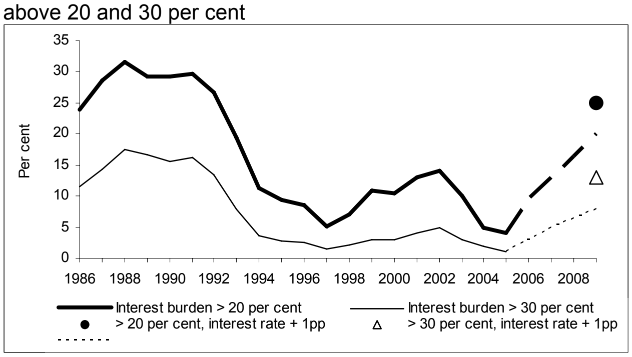
Table 3.1 Number of households and share of total debt by interest burden

	2007, 5.5 per cent interest		2009, 6.5 per cent interest		2009, interest rate up 1 percentage point		2009, interest rate up 2 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%	1 428	63	1 303	49	1 179	39	1 093	33
20 – 30%	184	20	252	24	286	24	295	23
Over 30%	101	15	188	25	279	34	355	41

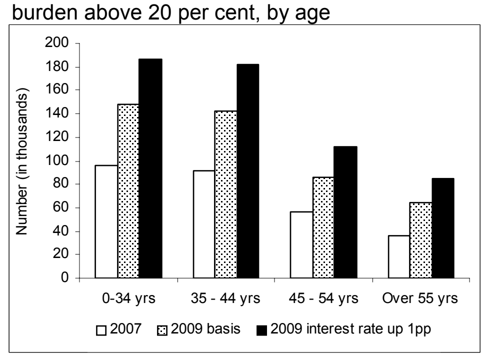
Sources: Statistics Norway and Kredittilsynet

Should, on the other hand, interest rates climb further than expected, the most exposed groups will be heavily affected. Two stress tests are carried out in which interest rates rise 1 and 2 percentage points respectively by the start of 2010. Both increases are within Norges Bank's uncertainty fan as presented in Monetary Policy Report 3/2007. In the case where interest rates rise by 1 percentage point the calculations show that well over half a million households acquire an interest burden in excess of 20 per cent, and half of these a burden of more than 30 per cent. About 58 per cent of the overall debt will reside with these groups. If interest rates rise by 2 percentage points, the number of households with an interest burden in excess of 20 per cent rises substantially to comprise about 30 per cent of households. These households hold almost two-thirds of aggregate debt. The projection also shows that the proportion of households with a high interest burden in 2009 approaches the levels seen at the end of the 1980s. Households with a buffer in the form of liquid assets will be better placed to tackle the debt and interest burden. As shown by the projection, however, groups with the highest debt burden have the smallest buffer in the form of financial wealth.

3.9 Share of households with an interest burden above 20 and 30 per cent



3.10 Number of households with an interest burden above 20 per cent, by age



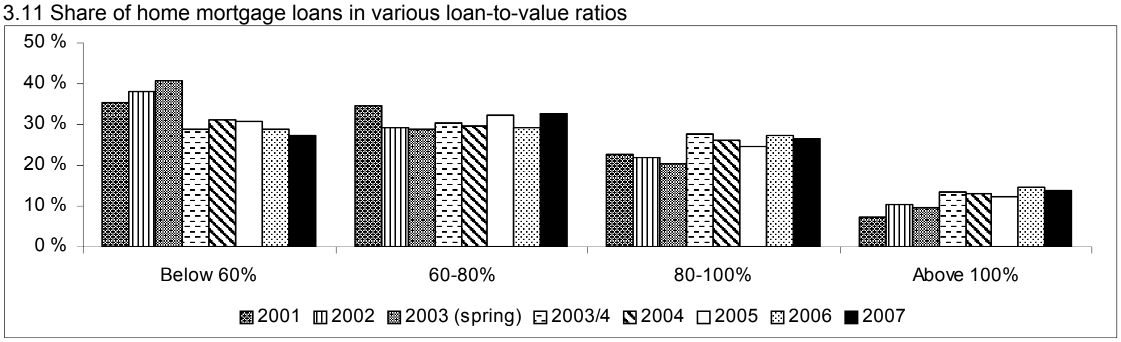
Sources: Statistics Norway and Kredittilsynet

Where the situation in various age groups is concerned, the 2007 figures show that two-thirds of households with an interest burden in excess of 20 per cent are below age 45. The reason is that these age groups are entering the housing market. The age-group distribution remains constant in the projection to 2009 and in the stress tests.

Loans secured on dwellings

Since 1994 Kredittilsynet has conducted an annual survey of banks' practice in regard to instalment loans secured on dwellings. This is a sample survey, and the respondent banks account for almost 90 per cent of all bank lending secured on dwellings in Norway.

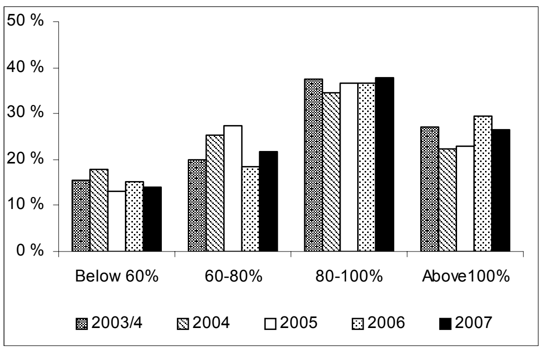
3.11 Share of home mortgage loans in various loan-to-value ratios



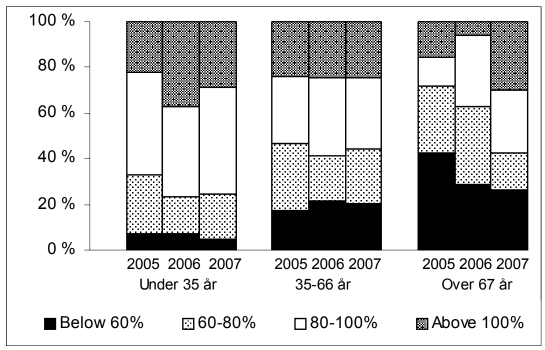
In the autumn 2007 survey 40 per cent of the reported portfolio entailed a loan-to-value ratio higher than 80 per cent of prudent valuation compared with 42 per cent one year previously. The proportion of loans in excess of prudent valuation fell slightly to 14 per cent.

Of loans intended for house purchase, 64 per cent had a loan-to-value ratio in excess of 80 per cent, 2 percentage points down on the previous year. For loans in excess of 100 per cent of property value, there was a decline of 3 percentage points to 27 per cent. About 45 per cent of loans in excess of prudent property value lacked (sufficient) additional collateral to bring overall security into line with or above the loan amount, a somewhat higher figure than the previous year.

3.12 Loan-to-value ratio – house purchase/housebuilding

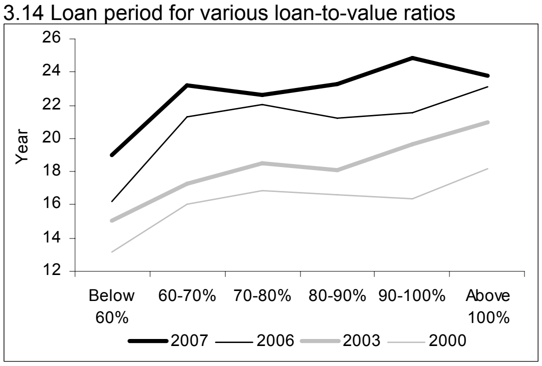


3.13 Loan-to-value ratio by age of borrowers – house purchase/housebuilding

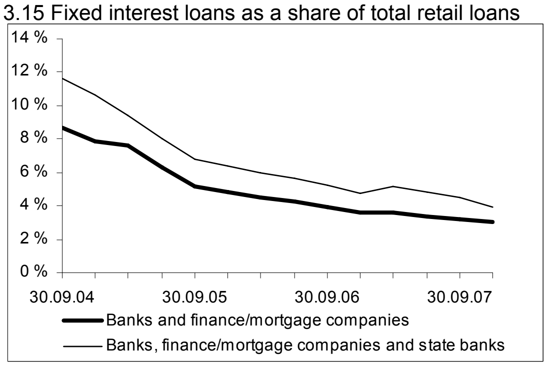


Younger borrowers in particular have a high proportion of loans with a loan-to-value ratio in excess of 80 per cent. In 2007 55 per cent of loans to under-35s had a loan-to-value ratio in excess of 80 per cent, a decline of 7 percentage points compared with the previous year's survey. In comparison, 33 per cent of loans to customers in the age range 35 to 66 had a loan-to-value ratio in excess of 80 per cent, on a par with the previous year. In the case of loans to younger borrowers for the purpose of house purchase there was only a marginal decline in loans in excess of 80 per cent of property value to 76 per cent of the portfolio. As regards loans in excess of property valuation, there was a marked decline, from 37 per cent in 2006 to 28 per cent in the 2007 survey. This can be seen as a signal that a somewhat less risky lending practice is in process.

3.14 Loan period for various loan-to-value ratios



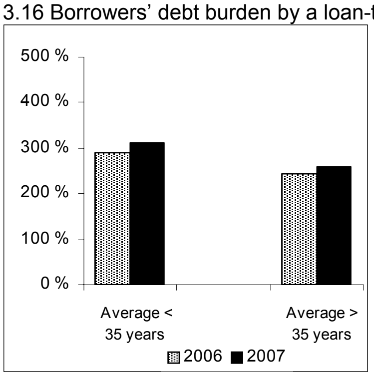
3.15 Fixed interest loans as a share of total retail loans

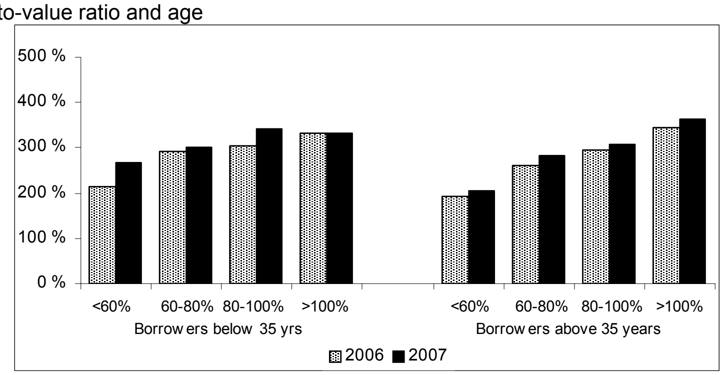


The average duration of home mortgage loans has lengthened considerably in recent years. Longer durations entail lower instalment payments and enable more borrowers to take out larger loans than would otherwise have been the case. Opting for long loan duration reduces flexibility should the borrower's private finances become tighter. The advent of more liberal bank practice is illustrated by the increase in loans that are interest-only for a shorter or longer period. A total of one in five loans in the survey was interest-only compared with one in six the previous year. The average interest-only period was virtually unchanged at just over four years. Interest-only loans and long interest-only periods are particularly prevalent among older borrowers. More than one in three loans to borrowers over age 67 was interest-only, and the average interest-free period was eight years. The increase in interest-free lending is also related to the strong growth in equity-release loans secured on dwellings.

Norwegian borrowers appear to demand fixed-interest loans only in periods where banks' fixed-interest offerings are below the floating interest rate. In the 2007 survey only 1.3 per cent of new loans carried fixed interest. Of aggregate loans granted by all banks, finance companies, mortgage companies and state lending institutions to retail customers, the proportion carrying fixed interest at end-2007 was 5.9 per cent. Of these, 4.0 per cent had a lock-in period above one year. The low proportion of fixed-interest loans means that's Norwegian borrowers' private finances are rapidly affected by changes in the market interest rate.

3.16 Borrowers' debt burden by a loan-to-value ratio and age





Banks also report borrowers' debt burden (defined as total debt divided by gross annual income). The average debt burden of customers included in the survey was higher than one year earlier. The under-35s had an average debt burden of 313 per cent, 24 percentage points higher than in the 2006 survey. The over-35s' average debt burden was 15 percentage points higher at 259 per cent. The overall debt burden is higher in the case of borrowers with a high loan-to-value ratio on loans taken out in 2007.

Customers who borrowed to purchase a dwelling had a substantially higher debt burden than those who borrowed for refinancing or other purposes. The average debt burden of young borrowers was 350 per cent, up 15 percentage points over the past year. Older borrowers intending to purchase a dwelling had a debt burden on a par with that of their younger counterparts. The increase from 2006 was 15 percentage points.

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). Their guidelines also require loan officers to assess the impact of higher interest rates on borrowers' finances. Most banks add a mark-up of 3-4 percentage points to the current lending rate. In the past year many banks have revised this margin down as a result of the increase in the general interest rate level.

Home loan survey of small banks

In autumn 2007 the first-ever home loan survey was carried out among medium-sized and small banks not included in the ordinary survey. The overall reported portfolio included about 8,000 loans.

The volume of loans with a high loan-to-value ratio was somewhat higher in the case of small banks in aggregate than in the case of banks in the ordinary survey. In all, 44 per cent of the portfolio comprised loans with a loan-to-value ratio in excess of 80 per cent, of which 14 per cent exceeded property value. A sizeable proportion of the small banks define property value below the purchase price, estimated market value or the like. In the case of loans for house purchase the volume with a high loan-to-value ratio was roughly on a par with the larger banks. The small banks had a somewhat higher proportion of loans in excess of property value in cases where they did not have (sufficient) additional collateral to bring overall security into line with or above the loan amount. The volume of fixed-interest loans at the small banks was even lower than at the large banks.

Home loan survey of equity release loans secured on dwellings

In the past couple of years banks have increasingly promoted equity release loans secured on a dwelling as an alternative to ordinary repayment loans. Borrowers are able to draw on the facility without having to apply each time ready funds are needed, and pay interest only on the amount drawn at any time. In light of the strong growth in equity release facilities Kredittilsynet conducted in autumn 2007 a separate survey of banks' practice in regard to this product. The 15 most active banks reported qualitative and quantitative details of a selection of concrete equity release loans.

Just over 46 per cent of loans (ceiling granted) were within a 60 per cent loan-to-value ratio, while 42 per cent were between a 60 and 80 per cent loan-to-value ratio. Almost all banks in the survey reported applying stricter loan-to-value criteria to equity release loans than to ordinary repayment loans. A majority allowed a loan-to-value ratio approaching 75-80 per cent of property value. Internal guidelines for equity release facilities were reported to be the same as for ordinary repayment loans at a great majority of banks. A majority of banks reported that specific requirements were not imposed on a customer's expected income situation upon expiry of the facility, although some banks carefully assessed customers' future transition from employment income to retirement pension. Nine of the 15 banks allowed accrued interest to be added to the loan instead of being paid on a continual basis. However this applied only so long as the sum of the amount drawn and accrued interest was within the ceiling granted.

On-site inspections of banks' home mortgage loan practice

In 2007 Kredittilsynet conducted on-site inspections of home finance at eight banks of various sizes. The main purpose was to illuminate banks' lending practice in regard to repayment loans and equity release facilities secured on dwellings. The inspections showed that a majority of the banks had liberalised their internal guidelines on home mortgage loans over the past three years. This was particularly true of maximum loan-to-value ratios and debt burden, as well as interest-free lending. Three banks granted home mortgage loans with no requirement as to repayment during the life of the loan. The inspections also revealed that customers' liquidity position, and hence their debt-servicing ability, was overestimated at five of the banks. It turned out that a relatively large volume of loans departed from internal guidelines and that banks lacked a systematic overview of such departures.

Banks' extra requirements on equity release loans compared to repayment loans were limited to higher collateral cover at the time the loan was set up and shorter durations. None of the banks assessed customers’ expected debt repayment ability upon expiry of the loan facility.

Granting interest-only loans or departing from the most important lending criteria in order to offer larger loans to borrowers with weak debt-servicing ability increases banks’ credit risk. Banks with a large proportion of departures from the lending criteria should consider tightening their lending practice. Kredittilsynet will raise with the Financial Services Association and the Savings Banks Association the question of instituting industry standards to ensure proper credit practice as regards equity release loans, for example by requiring banks to assess borrowers’ creditworthiness on a regular basis.

Low-deposit housing

Housing requiring a low initial deposit has long been a feature of the Norwegian housing market, based partly on housing policy motives. However, recent years have seen the emergence of low-deposit housing that does not involve State Housing Bank funding. Low initial deposits and high joint mortgages no longer appear to be purely a housing policy instrument, but an instrument to facilitate housing unit sales by making it easier for vulnerable households to set up a home. Although low deposit dwellings do not appear to be appreciably smaller than other housing cooperative flats, a preponderant number of them appear to target the youngest homebuyers. These are often individuals who lack equity but have high expectations of future income. High house prices make ordinary purchase difficult for this group in cases where debt finance is needed. Low deposit dwellings where the down payment is reduced and the joint mortgage correspondingly increased, may make such housing seem cheaper than it really is. If the joint mortgage is not taken into account in a bank’s credit assessments, low deposits may be a means to obtain a loan where an overall credit assessment would have resulted in the loan application being turned down.

The scale of such housing projects appears to be limited, but for those who have invested in a dwelling of this type the situation may prove difficult. Such projects are often marketed energetically, offering both a low mortgage interest rate and interest-only payments in the initial phase. In 2006 and 2007 the period of interest-only payments and fixed interest was seen to expire concurrently with the advent of higher interest rates, resulting in payment problems for a number of those who had invested in such dwellings.

Banks’ information to borrowers

Kredittilsynet has since 2004 commissioned TNS Gallup to conduct a survey among banks’ home-loan borrowers. The respondents are the same as those included in the home loan survey. The intention is to gain an impression of the extent to which borrowers receive information considered important when taking out a loan, and how borrowers view the information given by their bank in the process leading to the granting of the loan. In the wake of the first survey from 2004 Kredittilsynet dialogued with the trade associations on ways to enhance the information flow between bank and customer. In a joint circular the banks’ 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 risk for and the consequences of future interest rate increases. New standardised texts were also prepared for inclusion in loan documents.

In 2007 54 per cent of borrowers reported having been informed of consequences that interest rate increases could have for their personal finances. This was the same as in 2006, whereas the proportion of borrowers who were informed that the interest rate could rise from the current level was higher than in the previous year. An improvement was also seen in the proportion of borrowers who said they were informed of the effective interest rate on a loan and of the consequences of defaulting on a loan. 65 per cent of the respondents report that they were informed of various alternatives to the loan they took out. Altogether 77 per cent replied that they were satisfied with the information they received from their bank, while 73 per cent were satisfied with the clarity of the information given. This was a slight improvement on 2006. Although the trend is positive, there is still room for improvement in the flow of information between bank and customer.

Unsecured consumer loans

A substantial share of loans for consumption is granted in the form of loans secured on dwellings. Both banks and finance companies also offer pure consumer loans which are generally unsecured and entail high credit risk. Surveys conducted in 2007 by NOVA indicate that whereas the size of home mortgage loans largely follows income level, the proportion in receipt of consumer loans and the size of consumer debt is independent of household income and appears evenly distributed across age groups.

As in previous years, a survey was conducted of a sample of companies offering consumer loans, including credit card loans and other consumer loans without collateral. The companies in the sample offer a variety of products, for example credit cards providing credit up to NOK 100,000 and unsecured loans ranging from NOK 10,000 to NOK 350,000, although larger loan amounts do occur. The effective interest rate on these loans varies from 8 to over 30 per cent, depending on the loan's size and repayment period.

Table 3.2 Trend in consumer loans in selected companies

	2002	2003	2004	2005	2006	2007
Consumer loans (NOKm)	19 381	20 816	22 823	26 276	31 057	36 890
Growth (%, 12-month)*	15.7	7.4	9.6	15.1	18.2	18.8
Book losses (NOKm)	511	574	398	382	253	341
Losses (% of consumer loans)	2.6	2.8	1.7	1.5	0.8	0.9
Net interest (% of ATA)	8.4	10.1	12.0	11.6	11.2	10.0
Ordinary operating profit (% of ATA)	4.0	4.9	7.7	7.6	7.6	5.7
Non-performing loans (NOKm)	1 540	1 758	1 552	1 471	1 532	1 791
Non-performing loans (% of consumer loans)	7.9	8.4	6.8	5.5	4.9	4.9

*The growth rate in 2003 and 2004 was affected by one company's lending reduction in this period. Percentage growth in 2006 was adjusted for new companies in the selection.

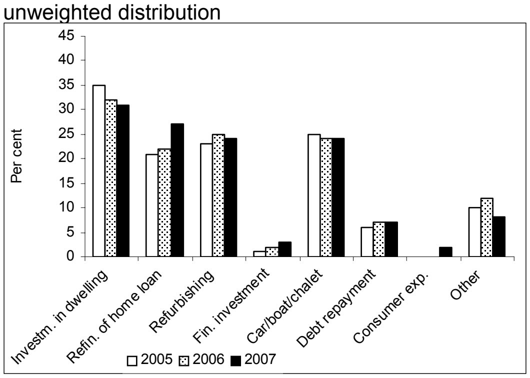
The sample comprises six finance companies and eight banks that offer consumer loans as part of their business. In 2007 the companies reported overall growth of 18.8 per cent, somewhat lower than overall lending growth for finance companies. There are wide variations in growth between the various companies.

Book losses and loan defaults in per cent of outstanding loans are higher than for other companies, but have gradually edged down. Losses and defaults stabilised at a relatively low level in 2007. In result terms there are relatively wide variations between the companies. As a group, their net interest revenues are higher than those of banks and finance companies in general, and their profits are appreciably higher.

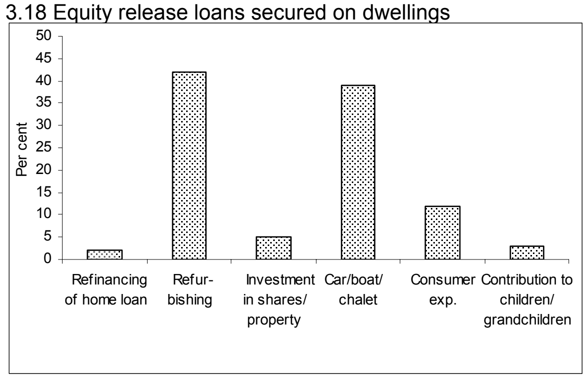
Loan purposes

As a part of Kredittilsynet's survey of banks' information to borrowers (see above), respondents are questioned on the purpose of their home mortgage borrowing. Customers who had taken out equity release loans secured on a dwelling were not covered. Respondents were free to report a number of purposes for each loan. In the 2007 survey close to 30 per cent reported that the purpose of the loan was to invest in a dwelling, including purchase and/or construction of one's own house. This was on a par with the previous survey. Refinancing a home mortgage loan was the next most reported loan purpose, rising from 22 per cent in 2006 to reach 27 per cent in 2007. This was followed by purchase of a car, boat or recreational property, and home refurbishment.

3.17 Repayment loans secured on dwellings, unweighted distribution



3.18 Equity release loans secured on dwellings



Source: Savings Banks Association

In 2007 the Norwegian Savings Banks Association conducted a survey of the use to which equity release loans were put, showing that home mortgage loans went largely to home refurbishment and purchase of a car, boat or recreational property. The results of the surveys by Kredittilsynet and the Savings Banks Association indicate that equity release loans are used more often for consumption than are repayment loans secured on dwellings.

Loans backed by securities

Since 1997 Kredittilsynet has conducted annual surveys of the volume, and banks' treatment, of loans backed by financial instruments. In 2007 21 banks participated in the survey which draws a distinction between commercial credits, with a term of up to one year, and other loans with a term above one year. Loans secured on structured products, including index-linked deposits and equity and index bonds come under the category of terms above one year.

The volume of loans backed by financial instruments, traditionally low in Norway, has risen somewhat in recent years. Although overall exposure is limited, some banks are heavily exposed to such types of commitments. Moreover, there was a strong increase in short-term commercial credits in autumn 2007

Table 3.3 Credits backed by financial instruments, 3rd qtr 2007

	Commercial credits backed by financial instruments				Other loans backed by financial instruments				Total loans backed by financial instruments			
	NOKbn		In % of gross loans		NOKbn		In % of gross loans		NOKbn		In % of gross loans	
	Q3 06	Q3 07	Q3 06	Q3 07	Q3 06	Q3 07	Q3 06	Q3 07	Q3 06	Q3 07	Q3 06	Q3 07
5 most exp. banks	3.0	8.9	1.8%	4.6%	17.9	17.7	11.1%	9.1%	20.9	26.6	13.0%	13.6%
Total, all banks	9.5	22.3	0.6%	1.2%	47.5	41.2	3.0%	2.3%	57.0	63.5	3.6%	3.5%

compared with the previous survey. About one half of loans backed by securities are connected with structured products. The large volume of loans to this type of savings product is accounted for by a small number of banks.

Table 3.4 Credits backed by financial instruments - structured products, 3rd qtr 2007

	Structured products					
	NOKbn		In % of loans backed by financial instruments		In % of gross loans	
	Q3 06	Q3 07	Q3 06	Q3 07	Q3 06	Q3 07
5 most exposed banks	14.9	17.0	71.5%	63.6%	9.3%	8.7%
Total (21 banks)	34.6	33.1	60.7%	52.1%	2.2%	1.8%

Banks' reporting period was to a greater degree than in previous years marked by fluctuating securities values. Even so only five cases of forced selling were reported. There is reason to believe that the volume of sales resulting from loans in excess of collateral value is larger than this since investors often sell on their own initiative, or on a creditor's recommendation if additional collateral is unobtainable. In light of the market turbulence at the start of 2008, Kredittilsynet conducted a follow-up survey among the two largest and the five most exposed banks to ascertain the scale of forced sale of collateral. Fluctuating securities prices have resulted in several clients of the selected banks having to make good the lost value of collateral, either by obtaining additional security, selling collateral items or transferring cash.

Survey of structured products

Customer placements in structured products in Norwegian banks declined from NOK 48 billion at the start of 2007 to NOK 39 billion at year-end. In the same period banks' loans for investment in structured products fell from NOK 34 billion to 30 billion.

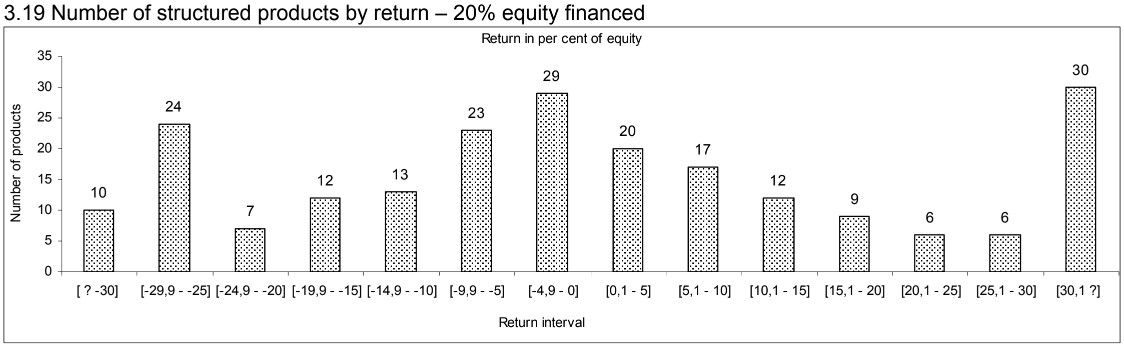
In autumn 2007 Kredittilsynet conducted a survey of structured products among 15 banks. The survey covered return, sales and marketing of structured products, in-house training of advisers/sales personnel, institutions' revenues from the products, and advisers'/sales personnel's compensation related to sales of structured products.

Calculations based on return reported by the banks showed that the majority of products held to maturity as of the third quarter 2007 did not produce return in excess of a risk-free investment. This is true both of equity-financed and debt-financed investments covered by the survey. The products have varying maturity, with subscription from 1997 onwards. For most products the maturity is 2 - 5 years.

218 of 350 equity-financed products yielded an average annual return of 5 per cent or less, before subscription costs. About 40 per cent of the products yielded zero return or less. In these cases losses to the investor were limited to subscription costs and lost return on alternative investments. A volume-weighted average of return on the 350 products indicated an annual average return of about 4 per cent.

Of 218 reported return figures for structured products with 80 per cent debt finance, about 55 per cent of the products produced zero return or less. The volume-weighted annual return on debt-financed products was calculated at about 2 per cent.

3.19 Number of structured products by return – 20% equity financed



Earnings before tax, depreciation, and amortisation in per cent of interest-bearing debt. Only firms with interest-bearing debt are included. Source: Norges Bank

Product subscription costs reduce the return both on equity-financed and debt-financed investments. Assuming 4 per cent subscription costs and a duration of four years, average return on contributed equity is reduced to about 3 per cent in the case of full equity finance and to -3 per cent in the case of 80 per cent debt finance. In comparison, the average annual interest rate on a 5-year government bond, which can be regarded as return on a risk-free investment, in the period 1997 to the third quarter 2007, was almost 5 per cent. Structured products maturing in the three first quarters of 2007 have, however, generated high positive return. Rising interest rates between 2005 and 2007 are only likely to materialise on debt-financed products maturing after this period.

The survey reinforced the impression that the distinction between advice and sales does not emerge with due clarity in banks' practice. The banks’ reports give the impression that they do not offer their sales personnel/advisers financial incentives to promote structured products rather than other savings products. Banks' revenues on such products proved very difficult to identify. The survey also suggested that sales and debt-finance of structured products is declining. It emerged that the banks' management boards have been little involved in launching structured products, despite the reputational risk inherent in selling such products.

In 2007 Kredittilsynet worked on extending the rules now governing the provision of advice under new legislation on the securities market to banks' activity in this area (see regulations and circular of 12 February 2008).

Corporate sector

Corporate profitability

The good economic climate for Norwegian business and industry is reflected in company profits. Financial statements show that 2006 was an excellent year for Norwegian businesses. Return on equity increased, particularly for enterprises in the fields of power and water supply, construction and shipping. Return declined in the oil and gas, although this industry still has the highest return on equity.

Table 3.5 Return on equity and equity ratio. Per cent.

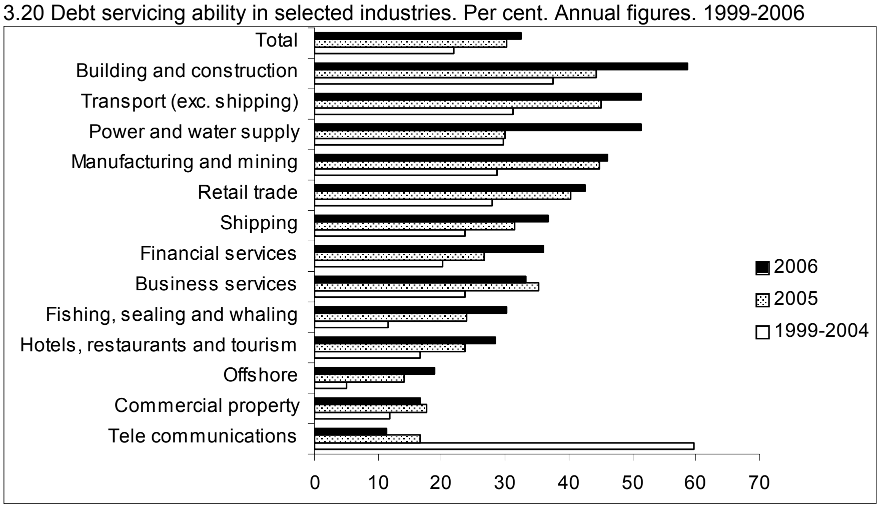
Industry	Return on equity 2005	Return on equity 2006	Equity ratio 2005	Equity ratio 2006	Share of firms with negative equity 2005	Share of firms with negative equity 2006
Farming, forestry and fisheries	21	22	33	43	20	19
Extraction of oil and gas, incl. offshore	38	31	35	37	12	9
Manufacturing and mining	15	16	43	42	13	14
Power and water supply, construction	11	20	44	41	11	11
Retail trade, hotels and restaurants	22	23	33	33	17	18
Shipping and pipeline transport	15	20	48	49	13	12
Other transport, communication	12	14	37	37	15	15
Property management and business services	20	22	38	40	11	12
Other service segments	23	22	46	46	15	15
Unspecified	15	20	52	52	13	13
Total	**20**	**22**	**39**	**40**	**14**	**14**

Sources: Sebra and D&B

Norwegian enterprises' financial strength has risen by 1 percentage point. Equity ratios stood at 40 per cent in 2006. Apart from the primary industries, which had markedly improved their financial position, there were small changes compared with 2005. There was also little change in the proportion of enterprises in a negative equity position.

Debt-servicing ability in the corporate sector

3.20 Debt servicing ability in selected industries. Per cent. Annual figures. 1999-2006



Earnings before tax, depreciation, and amortisation in per cent of interest-bearing debt.
Only firms with interest-bearing debt are included. Source: Norges Bank

Corporate debt-servicing ability continued to improve in 2006. Debt-servicing ability was weakest in the telecommunications, commercial property and offshore industries. Companies in these industries generally have long loan repayment periods, enabling them to get by on lower profits in relation to debt. Continued strong growth in indebtedness and higher funding costs may have impaired debt-servicing ability in the course of 2007.

The number of bankruptcies has fallen over the past four years; from 2006 to 2007 the decline was just under 6 per cent. In terms of turnover the segments most vulnerable to bankruptcy are property management and business services, and 2007 figures show an increase in bankruptcy proceedings instituted in these sectors.

Exposure to selected industries

Each year since 1998 Kredittilsynet has investigated banks' exposure to selected industries. The 2007 survey covered shipping, the shipbuilding industry, offshore industry, fishing and whaling, fish farming, property management and construction. The 10 largest banks in Norway are surveyed, and the analysis is based on the banks' own risk assessments and classifications. The banks' total commitments to the seven selected industries rose by 31 per cent from the third quarter 2006 to the same quarter 2007. The volume drawn rose in the same period by 25 per cent, suggesting lower draw-downs on credit facilities than in the autumn 2006 survey.

The third quarter 2007 survey showed that, apart from the offshore industry and fishing and whaling, all industries have reduced the high-risk portion of their lending compared with the third quarter 2006. The largest reduction was in shipbuilding and fish farming. Property management is the industry where most banks have their largest exposures, and bank lending to this industry grew substantially in 2007. This development reflects high activity and record-high rental prices for office premises. However, vulnerability in this industry to higher interest rates or weaker growth in the economy has increased. Shipbuilding benefited from the strong economic expansion in the same period, with prosperous times seen by the industry's customer segments.

Table 3.6 Banks' exposure to selected industries as of the third quarter of 2007

Industry	Loan commitments		Amount drawn		High risk in % of amount drawn		Exposure in % of capital base
	NOKbn	Growth Q3 06 – Q3 07	NOKbn	Growth Q3 06 – Q3 07	Q3 2006	Q3 2007	
Shipping	250	21%	213	11%	2%	1%	178%
Shipbuilding	25	86%	15	55%	16%	8%	18%
Offshore	26	34%	19	60%	0%	10%	18%
Fishing, sealing and whaling	22	21%	18	17%	4%	5%	16%
Fish farming	15	-13%	11	-1%	10%	5%	10%
Property Management	306	45%	253	40%	4%	3%	201%
Building and construction	40	12%	25	12%	5%	5%	28%
Total	**684**	**31%**	**554**	**25%**			

The largest banks' exposures to credit risk

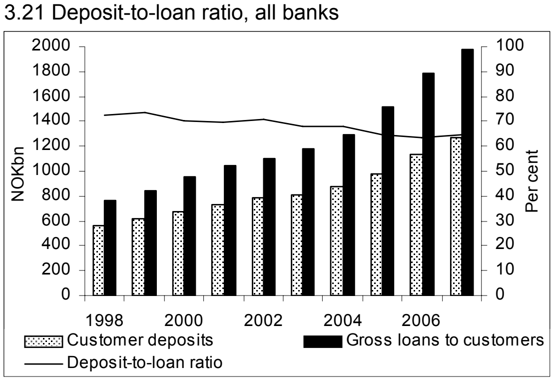
In autumn 2007 Kredittilsynet carried out an overall risk assessment of 17 large banks. The banks' corporate market portfolios were analysed using Norges Bank's bankruptcy prediction model which takes in all limited liability companies. The model predicts the likelihood of a company going bankrupt one year ahead based on the last published annual accounts. On average just over half of the banks' corporate market portfolio was analysed using the above model. The calculations do not take into account collateral held by the banks. Gross expected loss on banks' exposure to all Norwegian limited companies that have filed annual financial statements in 2006, calculated with a basis in bankruptcy likelihoods, was 0.72 per cent in 2006. In the case of the banks included in the survey a basis was taken in loans granted, and gross expected loan losses (unweighted) rose from 0.83 to 0.85 per cent between end-2006 and the end of the third quarter 2007. In 2005 expected losses came to 0.93 per cent (13 banks). Banks' expected losses at the end of the third quarter 2007 varied between 0.5 and 1.1 per cent. Ten of the banks showed an increase in credit risk in the course of 2007. The analysis also showed that gross expected loss for the banks' new customers (customers not included in the analysis base at the previous survey) was in general higher than for the banks' total portfolio. In 2007 new customers' expected loss averaged 0.92 per cent, down from 1.09 per cent in 2006.

Banks' expected losses are also assessed in relation to expected losses for all firms in the region relevant to the particular bank, as are individual banks' losses on corporates in individual industries. Expected losses were highest for retail trade, business services and construction.

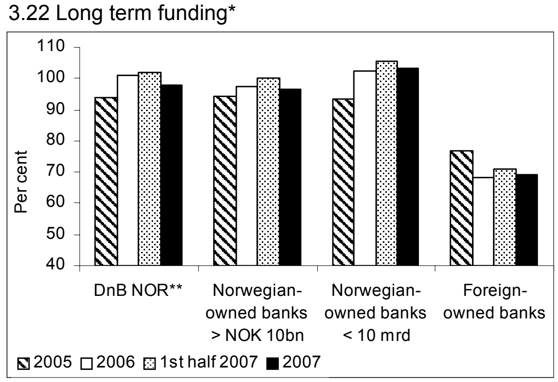
Liquidity risk

Liquidity risk is the risk that an institution will be unable to honour its commitments as they fall due without incurring substantial additional costs. An institution's liquidity risk is related to differing maturities on its 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 in the first instance 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.

3.21 Deposit-to-loan ratio, all banks



3.22 Long term funding*



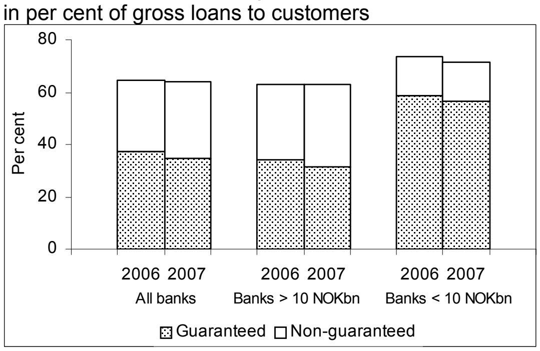
*Funding with a maturity above one year as a share of illiquid assets. **Incl. Nordlandsbanken

Growth in customer deposits was 15 per cent in 2007, somewhat higher than the growth in gross outstanding loans. The banking sector's overall deposit-to-loan ratio was 64 per cent at the end of 2007, a slight increase in the course of the year. Banks' long-term funding (customer deposits, bonds with a maturity of more than one year and equity capital) rose in the first half of 2007. In the second half-year large and small banks alike saw a decline in long-term funding, due mainly to the market turbulence. For Norwegian-owned banks long-term funding measured 98 per cent of their illiquid assets at year-end. Long-term funding is substantially lower at foreign-owned banks, which receive substantial short-term funding through their respective groups.

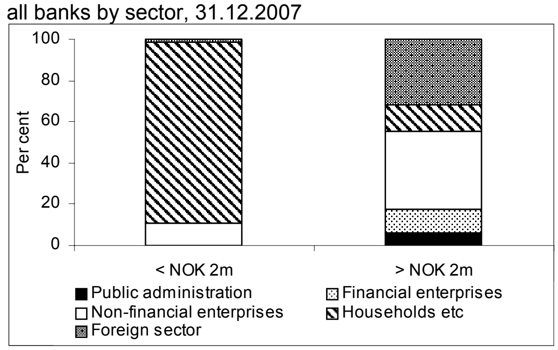
Although the bulk of customer deposits do not carry a lock-in period, they can nonetheless be regarded as a stable source of finance, albeit less stable in the case of deposits not covered by the deposit-guarantee arrangement. The Norwegian deposit-guarantee arrangement broadly covers up to NOK 2 million per depositor, although not deposits by, among others, financial institutions. The smallest banks have a substantially higher ratio of guaranteed deposits to loans than the large banks, although several small banks also have a high proportion of large deposits, inter alia from the public administration. For banks as a whole, guaranteed deposits measured 54 per cent of aggregate deposits at the end of 2007, while guaranteed deposits as a ratio of gross loans to customers was 35 per cent. Three new banks were accepted as branch members of the Norwegian Banks' Guarantee Fund. The agreement covers information exchange and assistance from Kredittilsynet designed to protect depositors' interests at branches facing liquidation.

Deposits from households and non-financial enterprises make up the bulk of aggregate deposits, and accounted for 41 and 28 per cent respectively of overall deposits at end-2007. Households account for the bulk of deposits below NOK 2 million while non-financial enterprises and foreign sources account for the bulk of deposits above NOK 2 million. The smallest Norwegian-owned banks have a substantially higher share of deposits from households than do the largest banks. At the end of 2007 household deposits with the smallest banks accounted for as much as 73 per cent of aggregate deposits. Foreign-owned banks have the largest share of deposits from abroad, significantly affecting the figures for the banks as a whole. Banks with a high share of large deposits, in excess of NOK 20 million, from non-financial enterprises, may be more vulnerable to market fluctuations than banks with a lower share. The largest banks have a substantially higher share of such deposits than the smaller banks.

3.23 Guaranteed and non-guaranteed deposits in per cent of gross loans to customers



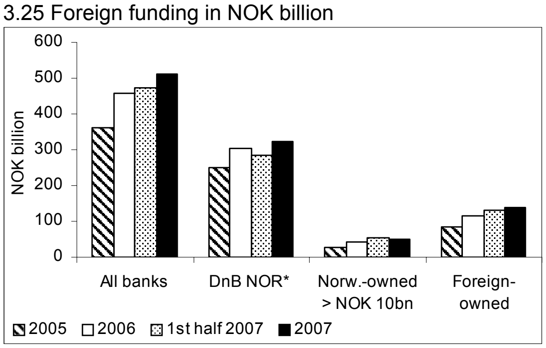
3.24 Deposits above/below NOK 2 million at all banks by sector, 31.12.2007



At the end of 2007 overall funding from foreign sources totalled about NOK 512 billion, with DnB NOR and Nordea Bank Norway accounting for 90 per cent of this figure. DnB NOR's foreign debt mainly comprises securities, while in Nordea's case the foreign debt chiefly comprises debt to the wider group. The smallest Norwegian banks have little foreign funding. 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.

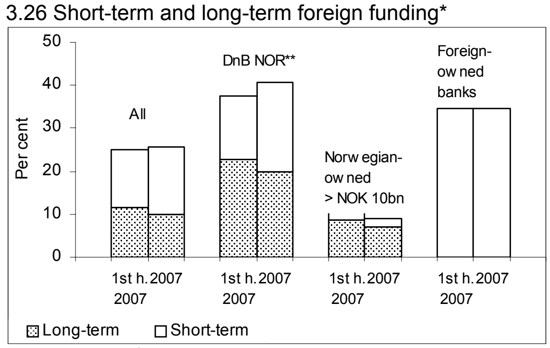
On the other hand, funding from a variety of sources can make for better diversification of liquidity risk. Banks' earnings and financial strength, along with rating and size, are crucial for access to funding from abroad and for its price. DnB NOR is an important channel for other Norwegian banks' foreign funding and can therefore act as an indirect funding source for them. For the banking sector as a whole there was little change in funding from foreign sources in the first half of 2007. In the second half-year, long-term foreign funding fell concurrently with an increase in short-term funding from foreign sources.

3.25 Foreign funding in NOK billion



*Incl. Nordlandsbanken

3.26 Short-term and long-term foreign funding*



*As a share of illiquid assets ** Incl. Nordlandsbanken

Banks' liquidity situation during international financial turbulence

Kredittilsynet's surveys in the second half of 2007 showed that Norwegian banks' liquidity situation was relatively satisfactory. Market turbulence in the international arena had a smaller impact on Norwegian financial institutions. However, contagion effects in international markets translated into far higher funding costs which then spread to the Norwegian market. Whereas it was at times difficult to bring in other than very short-term funding in foreign markets, the situation in the Norwegian market was more favourable and gave access to somewhat longer-term funding.

Many banks with a good funding situation before the crisis have opted to refinance a number of maturities somewhat shorter than originally planned in order to reduce long-term funding costs. However, the picture is complex. There are also cases where banks carrying somewhat higher liquidity risk of late have considered setting tighter overall limits to ensure adequate liquidity. Although none of these banks has incurred significant refinancing problems, there is a continuous weighing up between risk levels and funding costs.

Some of the largest Norwegian banks have substantial foreign funding, and face a challenging situation at times in international markets, in particular for the US dollar. Dependence on refunding in foreign currency varies from one institution to the next. Although sizeable fluctuations were seen in the funding situation in autumn 2007, the impression is that many of the major Nordic banks were regarded as relatively secure institutions by international market actors.

Many banks transferred home loans to mortgage companies entitled to issue preferential bonds as an important means of reducing their liquidity risk. In the current situation these companies' funding costs are fairly favourable. In 2007 Norwegian banks issued preferential bonds worth about NOK 50 billion through residential mortgage companies.

Although Norwegian banks' situation is relatively satisfactory, the market turbulence has spurred a gradual move towards somewhat shorter-term funding and pressure on institutions' long-term funding limits. Since year-end access to liquidity on international markets has been ample, enabling banks to bring in a substantial funding in US dollars with maturities from three to six months. Moreover, longer-term funding was obtained up to the loss announcement by Credit Suisse. This specific event has however in its turn affected the price of longer-term funding, and clearly illustrates that the market situation is still pervaded by nervousness and uncertainty.

Since year-end residential mortgage companies entitled to issue preferential bonds have continued to bring in substantial longer-term funding on international markets. For banks whose funding is primarily in Norwegian currency the situation has been satisfactory.

Kredittilsynet's liquidity monitoring

Further development of a framework for measuring liquidity risk and assessing risk management systems started at the end of the 1990s as part of the development of risk-based supervision. This work was based on international experience and Kredittilsynet's own experience gained from the supervisory process. Basel II imposes requirements on supervisory authorities in regard to risk-based supervision. Through its ongoing supervision of institutions, Kredittilsynet oversees exposure to and management of liquidity risk. A key aspect of Kredittilsynet's liquidity supervision is of a preventive nature, and has helped to improve banks' liquidity management. In situations where a crisis in the market or at an individual institution nonetheless occurs, Kredittilsynet's liquidity monitoring will be realigned and emphasis on coordination with other government bodies will increase.

Kredittilsynet has developed a liquidity risk module showing what factors are given emphasis in the supervisory regime. Where risk exposure is concerned, liquidity indicators of long-term and short-term funding are employed that show the degree to which the particular bank's illiquid assets are funded on a long-term basis. Other factors are also assessed: deposit-to-loan ratios, stability of customer deposits, degree of diversification of funding, committed drawing rights, liquidity of securities portfolios etc. Where management and control are concerned, strategies, liquidity risk limits, organisation and responsibility structures, measuring methods, monitoring and reporting, independent control, role of the management board etc., are assessed.

Liquidity risk is supervised and monitored by several means - general assessments of the situation in financial markets, off-site follow up of individual institutions based on their reporting, an early warning system for banks and on-site inspections. In addition to general inspections, Kredittilsynet conducts on-site thematic inspections of liquidity at major banks focusing on risk exposure and the quality of risk-management systems. Thematic inspections were carried out at 11 banks in 2002 and 14 banks in 2005, and further inspections are planned in 2008. At on-site inspections of banks with high risk and/or weak management systems, discussion on strategies, risk exposure, management and control are held with the bank's senior management and with leaders of the control committee. The bank's management board is required to respond to Kredittilsynet's report and to give an account of measures they are planning to take.

In the event of particular market turbulence, as seen in 2002 and 2007, follow-up of the liquidity situation is intensified through special reporting, telephone surveys and through meetings with individual institutions. Emphasis is given to ascertaining major due dates, plans to obtain funding, any major loss events as well as the institution's general assessment of the situation. Special reporting was instituted for 19 banks in December 2002 and for all banks, mortgage companies and finance companies in September 2007. There has been ongoing contact with the major banks since August 2007. As mentioned above, the liquidity situation of Norwegian banks was relatively satisfactory during the turbulence seen in the second half of 2007.

The new capital adequacy regime (Basel II) requires banks to assess liquidity risk in their Internal Capital Adequacy Assessment Processes (ICAAP). The linkage between liquidity risk and required own funds has been subject to thorough international debate, so far without producing any final or generally accepted method. In its ICAAP responses to the largest banks, Kredittilsynet has recommended management boards to decide what capital adequacy they see as necessary to ensure access to money markets and capital markets, also under difficult market conditions.

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, commodities or property, 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 little exposed to market risk. Shares account for a very small proportion of banks’ total assets, 0.4 per cent at the end of 2007. Bonds accounted for 6 per cent of the banking sector’s total assets, mainly corporate bonds, while money market instruments made at less than 1 per cent of the sector’s total assets. The largest banks had a larger portion of their assets invested in bonds, mainly in foreign corporate bonds. As a result of the turbulence on international financial markets, banks have incurred a net capital loss on their bond portfolios. Downward adjustments of bond portfolios' market values shall be reflected in profit/loss in the quarters in which they arise.

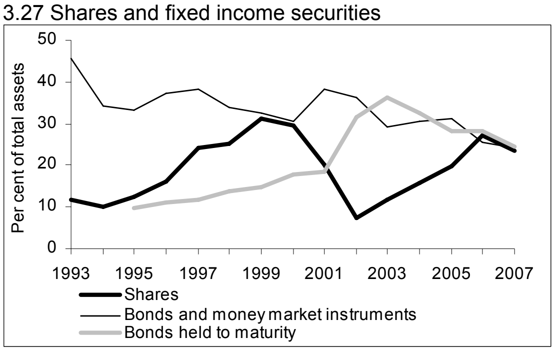
Banks are required to calculate capital charges for market risk. In 2007 the trading portfolio’s measurement base constituted 4.5 per cent of the overall measurement base for capital adequacy, somewhat higher in the larger banks than in medium-sized and small banks. This reflects the fact that credit 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

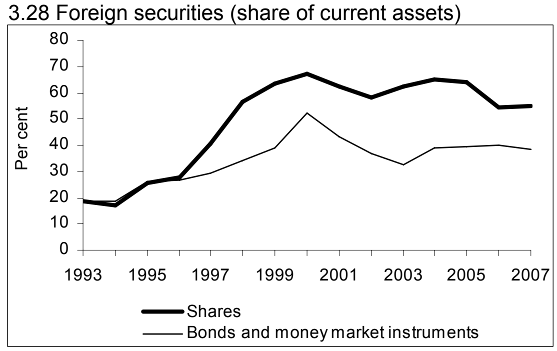
Life insurance companies are exposed to market risk through their holdings of securities and through property investments.

Shareholdings as a proportion of life insurance companies' total assets rose in the period from the trough in 2002 up to the end of the second quarter 2007. As a result of turbulent equity markets in autumn 2007, life insurers again reduced their equity component, to 23 per cent at the end of 2007. At year-and, shareholdings were still higher than prior to their substantial reduction in 2001. Equity markets continued to fall into 2008, and life insurers have further reduced their equity component. Money market instruments and bonds held as current assets have been reduced since 2005, and made up 25 per cent of total assets at the end of 2007. There was however an increase in the holding of such securities in the second half of 2007, in particular of money market instruments. Bonds held to maturity have fallen as a share of total assets since the peak reached at end-2004. At the end of 2007 these bonds accounted for 25 per cent of total assets.

3.27 Shares and fixed income securities

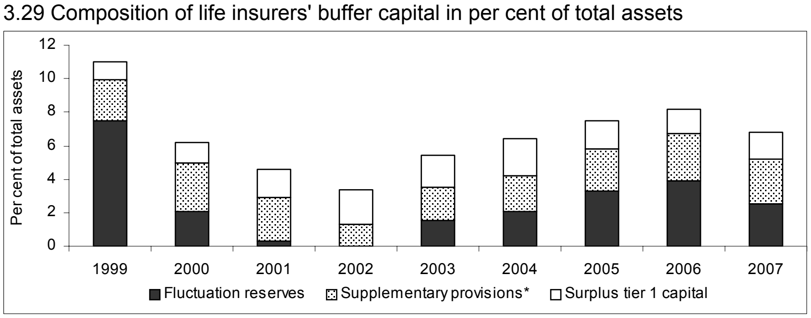


3.28 Foreign securities (share of current assets)



After falling by almost 10 percentage points from 2005 to 2006, the foreign share component remained stable in 2007 at 55 per cent. The proportion of current bonds and money market instruments held as foreign paper was close to 40 per cent at the end of 2007, showing more or less no change the last four years.

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



*Includes supplementary provisions limited to the year's interest guarantee.

Life insurers' buffer capital is designed to cushion their market risk and other risk. Buffer capital comprises 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. Life insurers' aggregate buffer capital came to NOK 49.6 billion at end-2007, a reduction of NOK 3.8

billion over the end of 2006. Fluctuation reserves were reduced by NOK 7 billion, while supplementary provisions included in buffer capital ended the year NOK 1 billion higher than in 2006. Buffer capital measured 6.7 per cent of total assets at end-2007, 1.5 percentage points lower than one year previously. Buffer capital fell in each quarter of 2007. Developments in share and fixed income markets thus far in 2008 have brought a further reduction in life insurers' buffer capital. The further development of share markets, both in Norway and internationally, is highly uncertain. Life insurers' market risk has increased, imposing substantial requirements on insurers as regards sound risk management and satisfactory buffer capital alike.

Stress tests

In the wake of the steep fall in share prices in the early weeks of 2008 and the increased uncertainty in the markets, Kredittilsynet asked life insurance companies and a selection of pension funds to conduct stress tests as of 23 January 2008 based on the following scenarios:

- a 20 per cent fall in the Oslo Børs Benchmark index
- a 15 per cent fall in equivalent indices in international equity markets

The companies were also asked to give their own assessment of the market situation and if adjustments had been, or would be, made in their balance sheet mix. On 23 January stock values at Oslo Børs were at their lowest thus far in 2008, 22 per cent below the level at year-end and 11.5 per cent lower than on 22 February.

Table 3.7 Result of stress testing at life insurers and pension funds based on buffer capital as of 23.1.2008

NOKm	Buffer capital 23.01.2008	Stress test	Buffer capital after stress test	Buffer capital after stress test in % of total assets
Life insurers	35 027	-16 590	18 438	2.5%
Pension funds*	11 772	-4 818	6 973	8.1%

*12 pension funds were selected based on criteria including size and share exposure

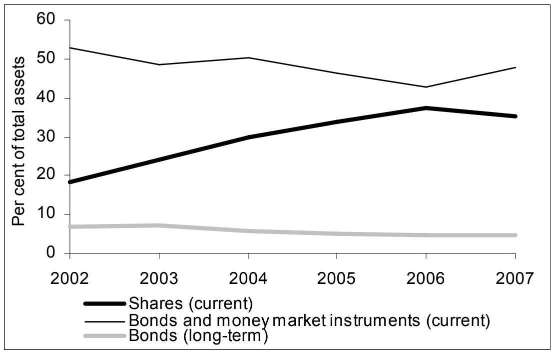
All life insurance companies and pension funds in the survey had positive buffer capital after the stress test. There were sizeable differences between the companies, however. Buffer capital is likely to be somewhat higher than shown, since year-end adjustments, including supplementary provisions, for some companies are not included. Several life insurers state that they have reduced their equity exposure since year-end, while the pension funds in the survey have not made specific adjustments.

Pension funds

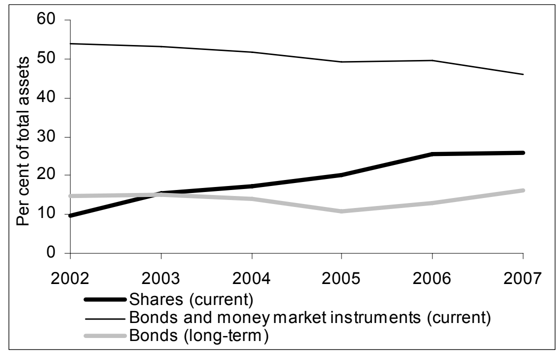
Private pension funds reduced their equity component by 2 percentage points in 2007 compared with end-2006. The level was nonetheless higher than in 2005. Municipal pension funds’ equity component remained virtually unchanged compared with 2006. Shareholdings’ foreign equity component fell substantially in private pension funds, from 54 per cent to 39 per cent, but remained virtually unchanged in municipal pension funds. Private pension funds’ foreign component was at approximately the same level as in life insurance companies.

As in the case of life insurers, share market developments have brought a decline in pension funds' 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 13 per cent of total

3.30 Shares and fixed income securities in private pension funds

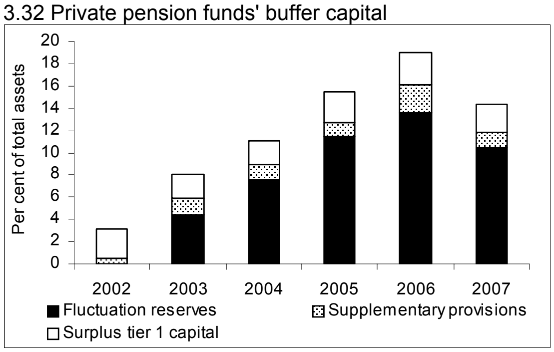


3.31 Shares and fixed income securities in municipal pension funds

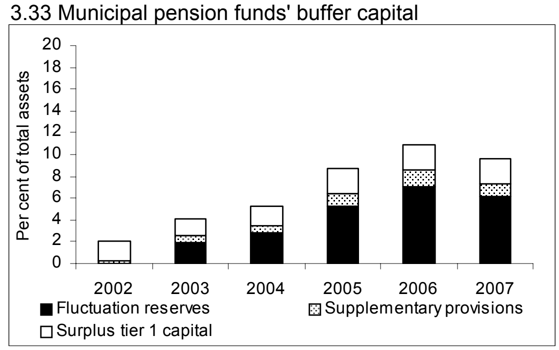


assets at end-2007, a decline of 4 percentage points compared with end-2006. There is a wide difference in buffer capital levels between private and municipal pension funds, 14 per cent and 10 per cent respectively, mainly related to differing size of fluctuation reserves. Premium funds made up 9 per cent of total assets of private pension funds and 4 per cent in the case of municipal pension funds.

3.32 Private pension funds' buffer capital



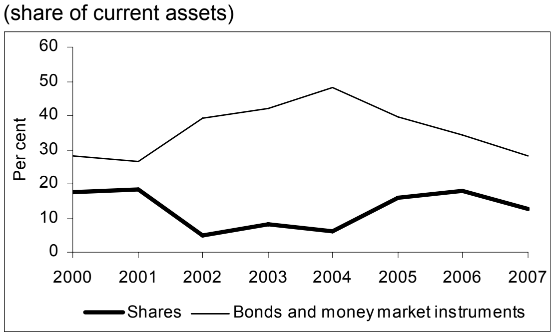
3.33 Municipal pension funds' buffer capital



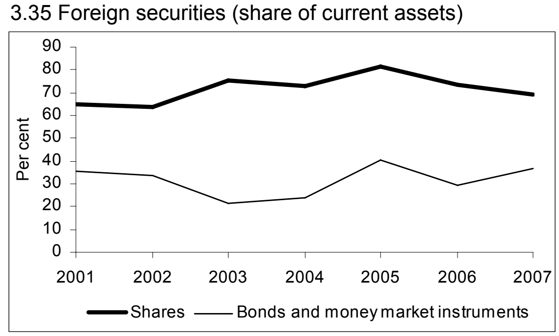
Non-life insurance companies

For the non-life insurers, aggregate holdings of money market instruments and bonds classified as current assets made up 28 per cent of total assets at the end of 2007, down 4 percentage points over the year. Aggregate shareholdings fell 5 percentage points over the same period, to 13 per cent. At end-2002 the equity component was 5 per cent. Bonds held to maturity make up a smaller share of total

3.34 Shares and fixed income securities (share of current assets)



3.35 Foreign securities (share of current assets)



assets than in the case of life insurers. The foreign component of aggregate shareholdings was high at end-2007, at 69 per cent. This is significantly higher than for life insurers and pension funds. The foreign component of fixed income securities was 37 per cent.

All non-life insurers met the capital adequacy requirement and minimum requirement on technical provisions at the end of 2007. The cover ratio (actual provisions in per cent of the minimum requirement) rose over the year. 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 solvency problems in this segment.

Insurance risk

Insurance risk denotes the risk that current premiums and provisions are insufficient to meet future claims. 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 where the uncertainty lies in the mortality trend over time. In view of increased life expectancy in the population, life insurers and Kredittilsynet alike see a growing need to strengthen the mortality base used when calculating future obligations. For this reason new 'long life' tariffs were introduced as from 1 January 2008, concurrently with the commencement of new insurance legislation.

Kredittilsynet maintained a close dialogue with insurers in 2007 on their plans to increase technical provisions to meet the provisioning requirement under the new tariffs. Kredittilsynet conducted a broad assessment based on the trend in life expectancy both in Norway, as determined by Statistics Norway, and in other countries. The statistics show a strong increase in life expectancy, especially over the past decade. Against this background Kredittilsynet concluded that the proposed tariffs would not contain sufficient prudence margins in relation to the life expectancy trend that is considered most likely. In the fourth quarter 2007 Kredittilsynet accordingly requested all insurers to apply a minimum prudence margin to their mortality assumptions. All companies complied with Kredittilsynet's request.

Kredittilsynet originally signalled the possibility of a stepping-up period of three years to increase technical provisions in line with the adjusted requirements. It became clear that the largest companies were prepared to make the necessary provisions in their 2007 accounts. Good results, partly a result of property revaluations, led to most companies taking this action in 2007. In aggregate, technical provisions at the five largest life insurance companies were increased by NOK 12 billion in 2007. This is a substantial strengthening of technical provisions and gives the companies greater leeway to dispose over coming years' profits and a better chance to cope with continued turbulence in financial markets.

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 insurance-related operating expenses in per cent of premium revenues (the expense ratio) has shown a more stable trend. Growth in claims expenses was particularly high in 1999 to 2001, but then slowed sharply. Premium growth edged down as from 2001, but remained above the growth in claims up to 2005. A period of higher claims ratios was thus replaced by a period of lower claims ratios. Since 2005 the claims ratio has again risen as claims have increased more quickly than premium revenues. The ratio of claims and operating expenses as a percentage of premiums is known as the combined ratio. As from the third quarter 2004 the combined ratio has each quarter been higher than in the same quarter of the previous year. In 2006 the combined ratio averaged 91.5 per cent. This compares with a combined ratio of 95.3 per cent for the EU/EEA countries in the same period. Results in recent years reflect cyclical variations in the claims ratio, whereby changes in the premium level lag changes in the claims level. This is because decisions to change premium rates are delayed by uncertainty as to whether the changes in claims are permanent or temporary, random effects. Moreover, it takes time for adopted premium increases to be fully reflected in the accounts.

Wide variations in the claims ratio over time are also seen in the various branches. The ratio is clearly highest in workers' compensation insurance and lowest in fire insurance and combined insurance.

Operational risk

Operational risk means the risk of loss resulting from inadequate or failed internal processes or systems, human error or external events. Losses resulting from operational risk may arise from internal or external events. Historically and internationally the heaviest losses have been related to failed internal management and control systems. A pertinent example is the French bank Société Générale where a broker reportedly managed to circumvent the bank's control systems and allegedly inflicted on the bank a loss in the region of NOK 40 billion by means of unauthorised securities trading. Reputational risk is a risk category in its own right, although closely linked to operational risk. A pertinent example is the Terra affair in which a negative event in a group company evidently affected the reputation of the other companies in the group, although the ultimate consequences are not clear.

As from 1 January 2008 banks and investment firms are required to calculate a minimum capital charge in respect of operational risk. They can choose between the basic, standardised and advanced measurement approach (AMA). Most institutions have opted for the basic approach, which is the simplest one, while nine banks have opted for the standardised approach. The largest banks which aspire to use the internal ratings-based (IRB) approach to compute the capital charge, are participating in an R&D project together with the University of Stavanger the aim of which is to develop a framework and models that meet the requirements on advanced measurement methods. It is safe to assume that some years will pass before Norwegian banks put AMA to use. Similar capital requirement rules are scheduled to be introduced for insurance companies in 2012 (Solvency II). Kredittilsynet considers it important that companies intending to use internal models (AMA) in the longer term to compute capital charges should start right now to build up a loss and event database which will be a requirement when using advanced methods.

Over the year Kredittilsynet observed a substantial effort by banks to further develop and adjust frameworks to meet the requirements on risk management under the new capital requirements rules. The new rules spurred the development of risk management at banks, which indeed was one of the aims of the rules. Kredittilsynet did not register significant losses related to operational risk in the banking and insurance sector in 2007. Compared to other risk categories, data on the scope of operational losses are deficient. One significant flaw in the data basis is that such losses are not as a rule separated from credit losses and registered as operational losses. Based on international experience, it is safe to assume that a significant portion of credit losses in Norwegian banks are related to operational shortcomings.

In 2007 Kredittilsynet dealt with several cases concerning investment firms' handling of operational risk, including two cases ending in licence withdrawal. In one case Kredittilsynet's preliminary assessment concluded that Terra Securities AS had committed serious and systematic violations of conduct-of-business rules when selling investment services to local authorities. The company declared itself bankrupt on 28 November 2007 and its licence was revoked on the same day (see Chapter 5 for further details). In the other case an on-site inspection at Handelspartner Securities ASA revealed that the company management lacked knowledge of the securities trading rules and uncovered wide-ranging breaches of the Securities Trading Act. Kredittilsynet revoked the company's authorisation to provide investment services, and the business ceased with effect from 5 December 2007.

Financial institutions' use of information and communication technology (ICT) is an important area under operational risk. Institutions’ responsibility for management and control of operational risk requires a focus on ICT operations both at the individual institution and at companies that deliver ICT infrastructure. A lack of insight into and information about deliveries from sub-suppliers may entail an operational risk for institutions. Thorough risk analyses are important in identifying vulnerabilities and defining measures. Growing use of a steadily growing range of financial services on the internet is independent of time and place. This increases operational risk, and requirements on continuity and catastrophe solutions and testing of such solutions are crucial.

Financial services are linked together with related services. Greater integration of services makes for greater vulnerability and a need for safeguards at all levels. This dependence on joint infrastructure became clear in connection with the fire in the cable network at Oslo Central Station on 28 November 2007. The event hit many institutions in the financial sector, including a number of brokerage houses whose trading systems went offline. Supposedly redundant solutions (a minimum of two independent hook-ups) proved not to be redundant since the cables were physically located in the same conduit.

Shutdowns and offline internet banks are a constant problem. Inadequate change-control routines are one reason for recurring problems in this area. Services delivered through open networks, such as the internet, are vulnerable to new types of malicious attack. Criminal circles are being put on a professsional footing, and well organised markets now appear to exist for software and information which can be used with fraudulent intent. Identity theft where the victim's digital identity characteristics go astray and are misused is a serious threat. In 2007 Norway also experienced a serious attempt to overload a service in order to put it out of commission. This attack confirmed how difficult it is to separate ordinary traffic from malicious traffic and to protect a service. Such attacks are regarded as a very serious threat, especially when it comes to socially critical services using open networks.

Risk factors and events are otherwise thoroughly dealt with in Kredittilsynet's risk and vulnerability analysis of financial institutions’ use of information and communications technology, which is published annually.

4. Regulatory developments

The rules governing financial markets are changing in key aspects within the framework of harmonised European legislation. This chapter gives an overview of the current position of the capital adequacy framework (Basel II), ongoing changes in the rules governing own funds, changes in the accounting rules (IFRS), new insurance legislation and the development of solvency rules for insurance (Solvency II). A further brief account is given of changes in infrastructure rules. Requirements on institutions and supervision under Basel II, the quality of own funds, greater use of fair value in financial statements, and the shaping of Solvency II are of great significance both for the soundness of individual institutions and for the stability of the financial system. The rules are complex and wide-ranging and present significant challenges for institutions and authorities alike. A weaker economic picture in some countries and increased market volatility will provide input on important aspects of the new rules, in the first instance Basel II and IFRS. The rules were calibrated and tested in a period of strong market and economic expansion.

Capital adequacy framework – Basel II

The new capital adequacy rules went into force on 1 January 2007. Institutions were entitled to defer transfer to the new regime to 2008. A large number of small and medium-sized institutions have chosen this option.

The new rules enable credit institutions to apply to Kredittilsynet to use internal models (the IRB approach) to compute capital charges for credit risk. In February 2007 Kredittilsynet authorised DnB NOR Bank ASA, Sparebanken Nord-Norge, Sparebanken 1 SR-Bank, Sparebanken Midt-Norge and Sparebanken Vest to apply the foundation IRB approach. These five Norwegian banks were the first in the Nordic region and among the first in Europe to receive formal IRB authorisation. Later in 2007 Nordea Bank Norway and DnB NOR Boligkreditt were also authorised to use the IRB approach.

Minimum capital requirements for credit risks are expected to be lower for banks using IRB models than for banks using the standardised approach. Transitional rules until 2010 limit the possible reduction in capital. In addition to computing the minimum requirement under pillar 1, pillar 2 requires institutions to conduct an internal capital adequacy assessment process (ICAAP) to determine their actual capital needs. Actual capital needs will also take into account risks not covered under pillar 1.

An important element of Kredittilsynet's assessment of IRB institutions' ICAAP is the margin by which the own funds exceed the minimum requirement. Since IRB institutions' capital charges are expected to vary over the business cycle, assessments of the models' sensitivity to cyclical movements will be key to determining buffer size. Buffers are also intended to cover risk posed by the uncertainty of methods and data underlying the quantification of risk and capital needs. Overall, the level of own funds must be sufficient to live through an economic downturn with negative results and when fresh capital may be difficult to obtain.

The subprime loan crisis in the USA has led to reduced willingness to lend and higher losses at many large European and American banks. For European banks, which operate under Basel II, capital charges will increase as a result of higher risk in banks' portfolios and concurrent pressures on profitability and earnings. This may further reduce banks' willingness to lend. Procyclical effects of Basel II resulting from capital charges that are more risk-sensitive than under Basel I have been brought into play by the likelihood of a weaker cyclical trend.

The new capital adequacy rules set requirements on disclosure of financial information (pillar 3) as a means of strengthening market discipline. The market turbulence has shown the importance of this aspect of the new capital adequacy regime. Basel II also contains stricter requirements on information and capital in regard to off-balance sheet items compared with Basel I. See Chapter 5 for further details.

Rules on own funds

Work is in progress on revising the rules governing own funds under the auspices of the European Commission and the Basel Committee. An area where a wide difference between countries has been demonstrated is hybrid capital and the extent to which such instruments qualify for inclusion in tier 1 capital and the quality requirements that are applied. Based on reports prepared, the European Commission has asked the Committee of European Banking Supervisors (CEBS) to prepare an advice on the criteria for approval of hybrid instruments and the limits for inclusion of hybrid instruments in tier 1 capital.

A proposed EU-wide definition of hybrid instruments in tier 1 capital was circulated for comment in December 2007 with a deadline for responses set at 22 February 2008. Where interpretation of the various quality requirements on hybrid instruments established by the Basel Committee is concerned, CEBS' member countries have agreed on a proposal as to how the requirements should be understood. However, the proposal also contains recommended limits for inclusion of hybrid instruments in tier 1 capital that are not supported by supervisory authorities in some countries, including Norway.

The recommended limits for inclusion of hybrid capital in tier 1 capital could open the way for a reduction in the quality of own funds in Norwegian institutions, since such limits are likely to result in a trend whereby a smaller portion of the capital charge than at present would be covered by sound tier 1 capital. CEBS has however decided that during the consultative process an impact analysis should be conducted designed to ensure that the ultimate proposal for an EU-wide definition and limits is such that own funds within the EU retain suitable quality. Hence there is still a slight possibility that the proposed limits for inclusion of hybrid instruments in tier 1 capital will be amended.

As regards the proposal for an EU-wide definition of hybrid instruments that qualify for inclusion in tier 1 capital, an especially challenging issue for the various countries' supervisory authorities has been to agree on an interpretation of the criterion concerning the ability to cover losses in going concern. Most countries have not previously faced a requirement to the effect that hybrid capital must be capable of being written down or converted to ordinary shares in the course of ordinary operations in order to cover losses. Together with the supervisory authorities of some countries, Kredittilsynet has argued for a tighter interpretation of the criterion concerning the ability to cover losses.

Preferential bonds

Amendments to the Financial Institutions Act dealing with preferential bonds went into force on 1 June 2007. Five mortgage companies have been licensed to issue preferential bonds. The rules governing preferential bonds enable mortgage companies to fund their operations by issuing bonds secured on home loan portfolios. This gives mortgage companies an opportunity to bring in capital on terms more favourable than would have been available to them elsewhere, and by the same token to offer borrowers lower interest rates while achieving increased interest margins. Preferential bonds are likely to promote competition which in turn may lead to further pressure on interest margins. Under Basel II preferential bonds receive a weighting of 10 per cent instead of 20 per cent.

The legislation specifies that this type of mortgage company should mainly finance its operations by issuing preferential bonds. The assets of these mortgage companies should be secured on mortgage loans and liquid assets with a satisfactory rating. Bondholders and derivatives counterparties have a preferential claim over the cover pool in the event of liquidation and rank equally between themselves in this respect. The cover pool may comprise loans secured on dwellings to within 75 per cent of market value, loans secured on commercial property to within 60 per cent, loans secured on other registered assets, loans guaranteed by a public authority, assets in the form of derivative contracts and other liquid assets (substitute assets). The cover pool market value shall at all times exceed the value of the bonds, and must at all times enable the company to honour its payment obligations towards bondholders and derivative counterparties.

Residential mortgage companies issued preferential bonds for a total of about NOK 50 billion in 2007. DnB NOR Boligkreditt accounted for about 60 per cent of this volume, and Sparebank 1 Boligkreditt and Terra Boligkreditt for the remainder. BN Boligkreditt and Storebrand Kredittforetak issued no bonds in 2007. Such bonds were also issued early in 2008.

Banks' chief motive for establishing a residential mortgage company is to achieve lower overall funding costs. Issuing mortgage bonds assures easier access to, and cheaper, funding than using the bond market, even though market turbulence has led to higher risk mark-ups on preferential bonds as on other funding instruments.

Banks still carry some credit risk on the loans transferred to mortgage companies. The risk is negligible, however. The quality of a bank's residential loan portfolio falls when the best secured loans are transferred. Whether this leads to lower ratings for rated banks and higher funding costs for banks is uncertain. A poorer rating or higher funding costs may make it difficult to find funding solutions in a crisis situation.

International financial reporting standards (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 company accounts under IFRS. As of 31 March 2007 banks, finance companies and mortgage companies were also entitled to prepare company accounts under IFRS. Whereas banks, finance companies and mortgage companies that form part of listed groups were required to apply IFRS or its simplified version, other banks, finance companies and mortgage companies were allowed to choose between IFRS, simplified IFRS and the ordinary rules of the Accounting Act. The Annual Accounts Regulations for insurance companies were amended as from the same date, enabling non-life insurers to recognise investment properties at fair value and to account for reinsurance in conformity with IFRS. In November 2007 the Ministry of Finance circulated a discussion document proposing full adjustment of the Annual Accounts Regulations to IFRS for insurance companies. A further recommendation is that pension funds, as a provisional solution, should apply the Annual Accounts Regulations for insurance companies insofar as appropriate. The consultation period expired on 4 January 2008.

IFRS is designed to increase transparency and comparability of European financial institutions, and by that means promote more effective market discipline. This could enhance the stability of the financial system. The new accounting rules mean that financial institutions' results will to a greater degree fluctuate with economic conditions, and economic conditions will have a greater impact on institutions' accounts.

IFRS entails a greater right/obligation to employ fair value, inter alia in regard to loans. The rules also entail stricter rules on write-down of loans. IFRS does not permit write-down for probable losses, only write-down in cases where there is objective evidence of value impairment (loss). Hence future events cannot be taken into account, and write-downs will therefore fluctuate more in step with economic conditions. Accounting treatment of loans was brought into line with IFRS via the “lending regulations” which went into effect on 1 January 2005. Kredittilsynet conducted a thematic inspection of the compliance with these regulations at ten large banks in 2006 which showed that the switch to the lending regulations led to a 27 per cent reduction in impairment loss.

The accounting rules governing insurance contracts are also of significance for insurance companies. Where such contracts are concerned, the development of international accounting standards is a multi-staged process, and only the first part of the standard on accounting for insurance contracts has been introduced.

MiFID

Directive 2004/39 on markets in financial instruments (MiFID) regulates intermediary services in the securities market at the European level. This is a framework directive with implementing regulations on level 2 set out in Commission Directive 2006/73 and Commission Regulation 1287/2006. MiFID was transposed into Norwegian law by virtue of Act of 29 June 2007 No. 75 on Securities Trading (Securities Trading Act) and Act of 29 June 2007 No. 74 relating to Stock Exchange Activities (Stock Exchange Act). Supplementary regulations to each of the above Acts have been laid down. The Act and regulations went into force on 1 November 2007.

The new Securities Trading Act expands the field of business subject to authorisation. Investment advice and operation of multilateral trading facilities are now licensable investment services. Order-transmission to investment firms is no longer exempt from the licensing obligation, nor is commodity derivatives trading. These changes mean that services connected with investment advice and selling of financial instruments, which could previously be provided by companies without a licence, can now only be provided by companies duly authorised under the Securities Trading Act. This also applies to services which did not previously require authorisation.

The Securities Trading Act builds further on the general principles underlying earlier legislation. However, the Securities Trading Act and the Securities Trading Regulations entail far more detailed regulation than the earlier legislation. According to the requirements on business conduct in the new Securities Trading Act, investment firms must classify their clients as non-professional, professional or qualified counterparties respectively. The strongest investor protection is provided to non-professional clients.

Where banks' advice on and sales of structured products is concerned, regulations have been issued bringing this activity under investment protection provisions in the Securities Trading Act. This has been done to achieve identical rules for sales of index-linked deposits and sales of equity bonds, and thereby ensure better protection of bank customers.

Insurance Act

A new Insurance Act came into force in July 2006, although the business rules applying to life insurance only became effective on 1 January 2008. Life insurance companies (and pension funds) are subject to a new price and earnings structure, a requirement as to division of assets between owners and customers (i.e. division into a group portfolio, investment portfolio and company portfolio), and new rules on profit distribution. The new rules are designed to promote effective operation with good profitability and a clearer distribution of risk and return between customers and owners.

The price tariffs must state the overall compensation charged by the company to insure the various types of risk that are associated with, and to provide the various types of services that are included in, the various products and product combinations. Prices must be fixed and premiums paid beforehand.

In the collective portfolio, surplus on the return over and above the return required by the interest guarantee, and allocation to supplementary provisions, will accrue to the customer. Any deficit (up to the interest guarantee) will be covered by the company, possibly by recourse to supplementary provisions. In the company portfolio all return accrues to the company. Profit on the risk result is transferred to the customer, although one-half can be set aside to the risk equalisation fund. Any deficit is met by the company, in the event from the risk equalisation fund. Profit on the administration result accrues to the company, which must also meet any deficit. The company can retain up to 20 per cent of the profit on paid-up policies and pension rights certificates etc (modified profit-sharing model).

The new rules bring a number of significant changes that may reduce companies' risk. Changes may now be made in the premium (price tariff) on premium-paying insurances for future accumulation to a greater degree than under previous legislation, giving companies an opportunity to reduce loss potentials by permanently revising the mortality assumptions in respect of death and disability in the basis of calculation. The rules governing supplementary provisions are amended and broadened, from 8 per cent at company level to 12 per cent at contract level. A risk equalisation fund has also been introduced to which the company can allocate up to one half of the profit on the risk result. The resources in this fund can be applied to strengthen the premium reserves in respect of personal risk. The intention is to enable the risk equalisation fund (to a greater degree than the previous contingency fund) to be utilised by companies to even out personal risk insured by the company. The right to transfer fluctuation reserves (i.e. unrealised gains on financial current assets in the collective portfolio) is reduced in regard to collective pension insurances in the collective portfolio.

The new legislation also contains factors that may increase companies' risk. A deficit on the risk result or administration result can no longer be set off against profit on return. Nor, as a general rule, are companies any longer able to assign part of their profit to insurance risk. The companies' earnings on premium-paying insurances will from now on mainly comprise the earnings elements that are incorporated in the price tariffs, and return on the company portfolio. Moreover a requirement as to consent from Kredittilsynet is also introduced to enable return profit and risk profit to be applied to increase the technical provisions on the company's existing insurance obligations. In this connection consideration will need to be given to imposing conditions for approval of the contribution to be made by the company's profit, equity capital etc., to increasing the technical provisions. One insurance company has already received approval on certain conditions in connection with the change to be made in 2008 to insurers' mortality assumptions in the basis of calculation. Supplementary provisions may only be used to cover deficient return on the contract to which they relate. In other words the provisions are no longer a solidary buffer.

Solvency II

In July 2007 the European Commission presented a proposal for a new framework directive for insurance companies. The proposal entails that all central directives covering the areas of life insurance, non-life insurance and reinsurance along with insurance groups will be codified into a single directive. The key changes in the unified body of rules for insurers are related to the new solvency regime (Solvency II). According to the proposed directive, the new solvency framework will build on a three-pillar structure corresponding to the Basel II rules in banking. In the Solvency II directive, pillar 1 comprises all quantitative rules for calculating capital charges, pillar 2 comprises qualitative rules for institutions' risk management and internal control along with supervisory oversight and control of insurers, while pillar 3 contains rules governing companies' disclosure obligation towards the public and the authorities. According to the plan, the proposed directive will be the subject of discussions between the Commission, the Parliament and the Council for the remainder of 2008 with a view to adoption in 2009. The rules are accordingly expected to come into force in national legislations in 2012.

There remain a number of technical and practical issues related to methods of calculating technical provisions and capital requirements to be utilised under Solvency II. As part of the effort to resolve these issues, several new rounds of quantitative impact studies (QIS) will be undertaken. The second and third quarter of 2007 saw the third round of impact studies of the proposed new solvency framework (QIS 3) under the auspices of CEIOPS. This round focused on calibrating methods for calculating solvency capital requirements and minimum capital requirements (MCR), further developing methods to compute best estimates and risk margins in respect of technical provisions, as well as defining and calculating capital elements eligible for inclusion for the purpose of meeting the capital requirements. In addition, preparations were made to test the calculation methods on insurance groups.

Just over 1,000 EEA-based insurance companies participated in QIS 3, of which 16 were Norwegian non-life insurers and three were Norwegian life insurers. In the case of the non-life insurers, the results of QIS 3 show that the estimated solvency capital requirement (SCR) is significantly higher than the current solvency margin requirement. (SCR is about four times higher than the current requirement in the case of all the Norwegian companies participating in QIS 3.) Concurrently, available capital in the non-life companies increases, partly as a result of the reclassification of parts of the technical provisions. The percentage increase in capital is lower than the increase in SCR compared with the current solvency margin requirement.

For life insurance the conclusion is less clear, partly due to unresolved issues related to calculation of the risk margin for technical provisions and the handling of risk-mitigating effects of undistributed bonus. Since life insurance companies' own funds are relatively small in relation to their overall insurance obligations, the calculation of available capital under Solvency II is substantially affected by the size of the estimated risk margin.

It should be emphasised that QIS 3 also brought to light substantial differences in company-specific calculations of technical provisions, capital requirements and available capital - both within a particular country and between countries.

The fourth round of impact studies (QIS 4) which is headed up by the European Commission will be conducted in the second quarter of 2008. QIS 4 is viewed as particularly important both in connection with the (closing) discussions on the Solvency II Directive and as a part of the basis for the work on implementing measures that will be initiated to the full in the course of 2008.
In January 2007 Kredittilsynet published a programme of risk-based stress tests for insurance companies, which is largely based on the calculation methods so far suggested under Solvency II. The

stress tests do not represent a formalised capital requirement but are nonetheless expected to constitute an important aspect of insurance companies' preparations for Solvency II. The design of the stress tests will consequently be updated in step with the development of the Solvency II framework. The aim is to initiate regular reporting of stress test results as from the first quarter of 2008.

Infrastructure

The European banking industry, under the auspices of the European Payments Council (EPC) is engaged in establishing a common European infrastructure for euro payment services. The services will constitute the start of the Single Euro Payments Area (SEPA), whose regulatory framework will be common to the entire internal market. The internal market in this context is defined as the entire EEA plus Switzerland. 1 January 2008 saw the launch of the SEPA Credit Transfer Service. The service is expected to become available to bank customers in Norway. SEPA Direct Debit will be launched in 2009. This service will also be available to bank customers in Norway.

On 13 November 2007 the EU adopted Directive 2007/64/EC on payment services in the internal market. The Payment Services Directive regulates the market access and business rules for payment intermediaries which are not credit institutions, stipulates conditions and rules for payment services and information requirements on service providers, and rights and obligations for users and providers of payment services. The Directive regulates both the public-law and the private-law aspect of payment services and will require changes to Norwegian rules, including the Payment System Act, the Financial Institutions Act and the Financial Contracts Act. The Ministry of Finance has appointed a committee drawing representatives from the authorities and the banking industry that is mandated to draw up amendments to the Norwegian rules.

5. What happened in financial markets in 2007?

This chapter summarises the assessments of the outlook for financial institutions, markets and economy in the corresponding report on 2006. Developments in 2007 were strongly marked by turbulence in international financial market triggered by the crisis in the US mortgage loan market. A summary is given of the financial turbulence, its impact on Norwegian financial institutions in 2007 and a brief description of the Terra Securities affair. The chapter concludes with a description of general trends in financial markets in recent years, and a brief overview of assessments of the need for changes in international regulation and supervision.

Assessments of financial stability in 2007

At the start of 2007 the major forecasting institutes expected the relatively strong growth in the international economy to continue, driven above all by countries outside the OECD area. A slowdown was envisaged after 2007, albeit moderate. Global imbalances, the US housing market and persistent high prices of oil and commodities were highlighted as risk factors for developments ahead. Forecasts for the Norwegian economy suggested that the economic boom would continue, but with significantly slower growth in GDP in 2007.

The situation in the banking sector was viewed as favourable at the start of 2007, with high profits and an absence of losses. Kredittilsynet's work on financial stability in 2007 focused especially developments in housing markets and household debt, especially the debt situation of vulnerable households. It was pointed out that debt and house prices were at a level where even minor, negative shocks could trigger a setback, that an increased supply of newly built housing could cause house prices to level off, and that a change of sentiment could lead to falling prices. High loan-to-value ratios on new home loans, a low volume of fixed interest borrowing and other factors liable to increase the vulnerability of households at risk, were singled out. The need for thorough credit assessment in the corporate market and prudent credit practices in the mortgage loan market were highlighted. For life insurance companies it was pointed out that a higher level of buffer capital and shareholdings could lay the basis for better long-term return on managed assets.

Emphasis was given to the impact of the new capital adequacy framework (Basel II) and the risk that banks would reduce their capital by such a margin in the medium term that their buffer against unforeseen events would fall below the desired level. Attention was also drawn to the unclear causes of the escalation of debt and house prices in many countries, and to inadequate knowledge of the effects of persistent low interest rates in a liberalised market. The risk that the upturn in debt and house prices is not merely a natural structural adjustment, but that imbalances have been created along with a risk of corrections and possible financial stability problems, was also pointed out.

Developments in 2007 were marked by the international financial turbulence starting in summer 2007, which led to downward adjustment of growth estimates for 2008. Preliminary figures for 2007 show that global economic growth turned out roughly as expected at the start of the year, also in the case of the US. Inflation in 2007 in the US and the euro area was higher than expected by the forecasting institutes, mainly as a result of higher energy and food prices. Central banks' key rates and interest rates in interbank markets were heavily affected by the financial turbulence in the second half year. Long interest rates were also affected, with very disparate trends noted for government bonds as opposed to bonds issued by private entities.

Growth in the Norwegian economy in 2007 proved far stronger than expected, due mainly to higher growth in consumption. Forecasts for consumption growth were around 3,5 per cent whereas preliminary national accounts figures show 6.4 per cent. Investments were also higher than expected. Even with stronger growth, core inflation in 2007 was as envisaged at the start of the year, but still appreciably lower than the monetary policy target. In the course of 2007 Norges Bank raised the interest rate on seven occasions by a total of 1.75 percentage points. As a result of the international financial turbulence, Norges Bank announced in October that interest rates would continue to rise, albeit somewhat less than previously indicated. The rate of house price growth fell sharply through 2007, from an annual rate of 19.4 per cent in January to 1.9 per cent in December. Despite this, growth in credit to households fell by a mere 0.8 percentage points, from an annual rate of 12.1 per cent in January to 11.3 per cent in December. Corporate debt growth rose by 1 percentage point to 21.6 per cent in the same period.

The household saving rate continued to fall in 2007, and the household debt burden continued to rise. The term of repayment loans increased and sharp growth was noted in equity release loans not requiring repayment. Although there was still a large volume of home mortgage loans with a high loan-to-value ratio, there were signs that the volume of 100 per cent mortgages to young borrowers edged down in 2007. The very strong growth in the economy and still manageable interest rates resulted in few defaults and low losses, and banks posted good results in 2007, as in 2006, despite the international financial turbulence. Life insurance companies' results were marked by contagion effects from the international financial turbulence in the second half-year.

American home loan crisis and financial turbulence

Developments in the international economy have for several years been marked by low inflation, low interest rates and strong growth in money supply, credit and prices in securities and property markets. New actors, new financial products and techniques, especially for risk transfer, have also marked developments. Risk premiums in securities markets have been record-low, and return on financial instruments and residential property over the past 25 years has far exceeded historical average values.

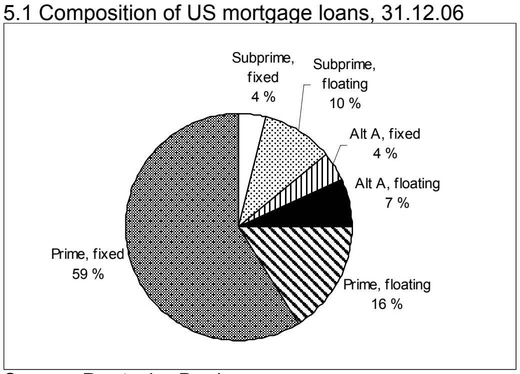
In several countries potential problems associated with the strong growth in household debt and house prices have stood at centre stage. This risk materialised in the US in 2007.

Crisis in US housing markets and international contagion effects

American subprime mortgage loans are characterised by borrowers with a poor debt-servicing history, a low credit score and a very high interest burden, often in excess of 50 per cent. Such loans have grown strongly in recent years. Mortgage brokers have been at centre stage in selling subprime mortgage loans, accounting for almost two thirds of such loans in 2006. The loans are largely provided by companies specialising in home mortgage loans. Neither these mortgage brokers nor lenders have been subject to federal supervision in the US. Among the one-fifth of the lowest income households in the US, twice as many took out home mortgages in 2004 as in 1989. In addition to subprime mortgages there is a large volume of Alternative-A loans made to borrowers whose qualifying mortgage characteristics prevent them from prime credit.

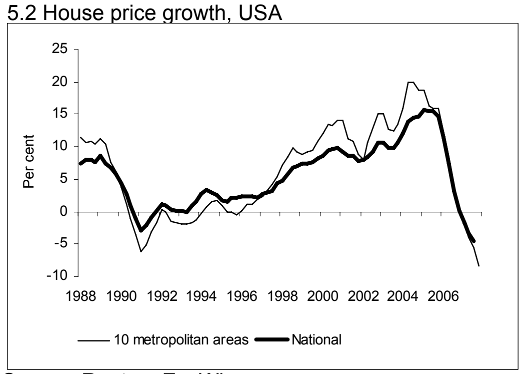
The fall in house prices in the US at the end of 2006 and through 2007 made refinancing and higher loan-to-value ratios more difficult. Refinancing was an important driver of demand growth in the US economy for several years. Higher interest rates, falling house prices and a weaker economic climate in some parts of the US brought accelerating defaults on subprime mortgage loans - close to 15 per cent. More than half of these loans carry fixed, low interest in the initial years after which the rates float and are substantially raised. Defaults on Alternative-A loans have also risen. As regards prime mortgage loans, defaults are still low but rising, particularly on loans carrying floating interest. The increase is largest in the case of the most recent loans. There have also been signs of increasing default rates on credit card loans. In some states borrowers can move out of their homes and escape liability for their mortgage loan. This is likely to happen where the property value falls below the mortgage loan, and has probably increased defaults and lenders' losses.

5.1 Composition of US mortgage loans, 31.12.06



Source: Deutsche Bank

5.2 House price growth, USA



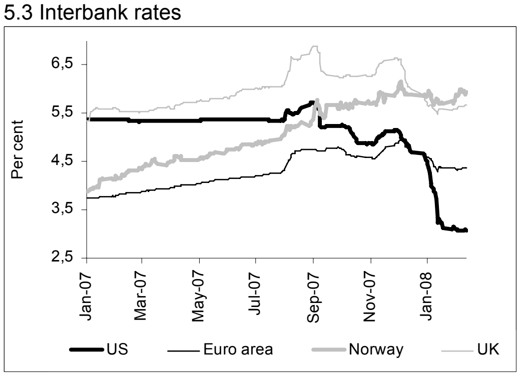
Source: Reuters EcoWin

Of aggregate American home mortgage loans totalling more than USD 10,000 billion, close to 60 per cent are securitised. Securitisation entails packaging home loans in portfolios which provide backing for the issuance of various types of securities. Various groups or tranches of securities are issued with varying priority in regard to cash flow and security, and are assigned differing ratings by the credit rating agencies. These groups of securities can in turn be packaged, tranched and assigned differing ratings. By means of securitisation a variety of securities backed by US home mortgage loans have been sold to investors, and in large measure also outside the US. It is estimated that about USD 850 billion of securitised home loans are subprime (corresponding to more than twice Norway's GDP).

Securitisation of large volumes of home loans in the form of complex, structured products has given rise to a very high degree of uncertainty as to the distribution and size of losses related to subprime exposures. These effects of securitisation and derivatives were largely unforeseen. Attention had focused on the advantages of structured products, primarily the opportunity for risk diversification. Through the autumn and winter major problems have encumbered valuation of the most complex securities, causing substantial uncertainty about the assumptions on which the rating agencies based their ratings. Provisional losses on subprime exposures at the 20 largest international banks in 2007 are put at more than USD 100 billion. The figures are uncertain, and further losses of USD 30-40 billion in the fourth quarter are expected to come to light in accounts in 2008.

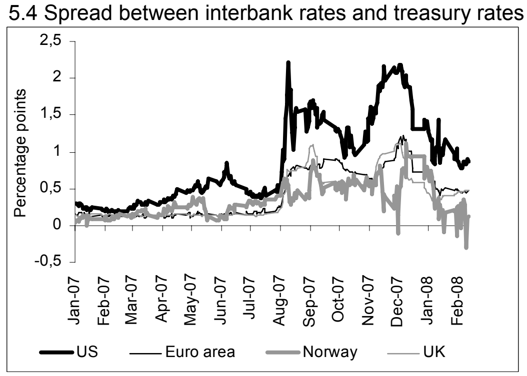
Uncertainty as to the distribution and size of losses on subprime exposures and increased risk aversion among investors have led to strong contagion effects to other parts of the financial system, causing investors to demand higher risk premiums on other types of securities. Required risk premiums rose in share markets, and the markets fell in periods in 2007. However, share markets were sustained through the autumn by a belief that growth in the international economy would not weaken significantly as a result of the subprime factor. At the start of 2008 share markets plunged, primarily due to the danger of a substantial cyclical weakening in the US and Europe and weaker corporate earnings as the extent of subprime losses and risk mark-ups in the bond market became clearer. Poor access to risk capital for non-financial enterprises may also reduce real investments and impair growth prospects. Share market fall in emerging economies suggests greater risk of contagion effects to these countries. Capital flight to secure investments has kept down government bond rates, and rates fell at the start of 2008.

5.3 Interbank rates



Source: Reuters EcoWin

5.4 Spread between interbank rates and treasury rates



Source: Reuters EcoWin

However, the main contagion effect has been through interbank markets. Uncertainty about the size of individual actors' exposures to subprime mortgages has made banks unwilling to lend to one another. Much of the uncertainty derives from not knowing how much of the banks' exposures are outside their balance sheets. Many international banks have credit and liquidity lines to various investment companies (conduits, SIVs etc) which have been used by banks to move holdings of structured and other products out of their balance sheets, in many cases in order to exploit regulatory shortcomings. The investment companies have generally been funded in the short-term market. When their asset values have fallen, the companies have been unable to refinance. The banks have had to choose between further value falls through forced sale of the companies' assets, refinancing the companies or incorporating the companies' assets into their own balance sheets. Refinancing depleted banks' liquidity in the autumn and winter of 2007. For long periods it was very difficult for banks to obtain long-term funding on the market, and at times also short-term funding. There have also been signs of clusters of banks forming to support short-term funding opportunities. Risk mark-ups in the interbank market have been substantial. Central banks have supplied liquidity and eased borrowing terms. In the course of just over a week in January the US Federal Reserve lowered its key rates by as much as 1.25 percentage points.

At the start of 2008 considerable uncertainty persists in international credit and money markets. A continued fall in US housing markets could push consumption and growth in the US economy further down. Further house price falls in the US will bring increased defaults on home loans, especially on large volumes of subprime mortgages where a higher, floating interest rate will kick in during the course of 2008. This could also lead to higher losses on securities backed by these loans. It is estimated that subprime mortgages worth close to USD 900 billion will come up for interest rate adjustment in 2008. The same applies to a corresponding volume of prime mortgage loans. There is also a risk of increased defaults on the latter, higher quality, loans in 2008 and of increased defaults on credit card debt and other consumer debt.

Weaker growth in the US may also result in higher bank lending losses on loans to corporates. Bankruptcy rates in both the US and in Europe have been low in recent years, thanks partly to ample supplies of liquidity and credit. There are already signs that debt-financed acquisitions have come to a halt, and that banks h to retain such loans in their balance sheets. Insurance companies appear to a significantly smaller extent than banks to have been directly exposed to securities backed by subprime mortgages, but are affected by contagion effects to other areas of bond markets and share markets. Lower ratings or solvency problems among major international credit insurance companies (monolines) will lead to higher losses on structured products at banks.

Differing, uncertain estimates have been given of the size of overall losses on subprime mortgages. The OECD recently put overall losses on subprime and Alt-A mortgages at some USD 200-300 billion. Other estimates have suggested USD 300-400 billion. Only a relatively small portion of such losses have thus far been charged to banks' profits. Various measures have been taken to reduce losses. A proposal put forward by four major banks to establish a 'superfund' to purchase structured products of highest quality from investment companies to ease funding of the superfund did not win through. These assets from investment companies have instead been incorporated in banks' balance sheets. A voluntary arrangement has also been proposed involving freezing the interest rate on subprime mortgages. A sizeable tax package to improve households' finances was approved by the US Congress in February. However, low interest rates and high growth in consumption are among the main causes of the home loan problems, and the effects of these measures could therefore be of a short-term nature.

New substantial losses and disclosure of already incurred losses may further intensify investors' and lenders' risk aversion and risk premium requirement, heighten the risk of a credit crunch and prevent normalisation of the situation in international money markets. The heavy losses suffered have compelled many banks to bring in more capital. American banks in particular have brought in far more share capital in the second half of 2007 than in the first half, including from large investment funds in the Middle East. According to some estimates, such funds have invested USD 60-80 billion in American and European banks up to February 2008. Bringing in capital may become more difficult should the situation in the economy and share markets deteriorate. Even if international banks were to have sufficient capital to absorb the losses, their lending ability will be impaired. This particularly applies when they need to incorporate investment companies' assets in their balance sheets to prevent sale and further value falls. Impairment of lending ability will be compounded if the difficult funding conditions on bond and money markets persist. In the US and Europe alike there are clear signals of tighter lending practice among banks, although this had not led to significantly slower lending growth in Europe at the start of 2008.

The most significant contagion effects to Europe from the American home loan crisis at the start of 2008 were largely confined to the financial sector - losses on securities backed by American home loans, losses on other securities as a result of higher risk mark-ups, stock market falls, along with poor access to and higher prices of funding on the bond and money market. In the US there are clear-cut real economic impacts of the home loan crisis. In Europe, substantial real economic effects could arise through a number of different channels. Further tightening of bank lending and slower growth in lending to firms and households will reduce growth in consumption and may augment signs of decline in housing markets in several countries. A serious cyclical setback in the US, mainly through lower consumption, will have substantial contagion effects through declining imports and will reduce growth in Europe and other regions. Uncertainties related to housing markets in many European countries make for substantial vulnerability to changes in household expectations of house prices and incomes. A setback in the US could bring about such changing expectations, and may also affect investment growth through impaired confidence in corporate earnings.

Northern Rock

Northern Rock is the United Kingdom's fifth largest lender to the housing market. The bank had a very high lending growth, more than 30 per cent over the year to summer 2007. The bank permitted loans up to 125 per cent of property value and up to five times borrowers' income. Northern Rock's deposit-to-loan ratio was very low, at 31 per cent, making the company highly dependent on capital market funding. A significant portion of this funding was short-term. The bank applied Basel II and had a tier 1 capital ratio of 11 per cent. However, more than 40 per cent of this was hybrid capital of various types, leaving 'pure' tier 1 capital at a much lower level, making up a mere 1.65 per cent of its balance sheet. The turbulence in international money and securities markets compelled the bank to ask the Bank of England for assistance. The UK has low deposit guarantee coverage compared with Norway. Depositors were reimbursed 100 per cent of the first £2,000, 90 per cent of the next £33,000 and nothing over £35,000. When difficulties arose, customers got nervous and a classical bank run ensued for the first time in the UK since the 1860s. The deposit guarantee scheme was revised to provide full reimbursement up to £35,000. The bank was temporarily nationalised in February 2008.

Northern Rock's risk profile and weaker funding structure meant that the bank was unable to meet its refinancing needs under very difficult conditions in capital and money markets. A deposit guarantee arrangement under which a large number of customers lacked cover even for moderate deposits significantly compounded the bank's problems.

Norwegian financial institutions and international financial turbulence

Profit performances in 2007 show that the financial turbulence had little direct impact on Norwegian banks. Norwegian banks were not directly exposed to subprime mortgages or structured credit products (such as CDOs or other products containing subprime mortgage loans). Increased funding costs only limitedly affected banks' net interest revenues, but will probably have a stronger impact in 2008 as long-term borrowings are refinanced. Banks' funding situation was relatively satisfactory in 2007, due inter alia to high deposit-to-loan ratios and other long-term funding. Banks incurred capital losses of about NOK 1.5 billion on parts of their bond holding as a result of the general increase in risk mark-ups on corporate bonds, in addition to the fact that Eksportfinans ASA recorded substantial net capital losses on financial instruments (NOK 0.7 billion). Market risk and credit risk on securities is limited due to generally low securities holdings at Norwegian banks. There were no clear signs in 2007 that the financial turbulence was translating into slower growth in lending by banks in Norway.

Insurance companies and pension funds reported no direct exposure of significance to structured products. One pension fund had invested 0.5 per cent of its portfolio in a structured product (a CDO). Life insurers' losses on bond holdings resulting from higher risk mark-ups on bonds issued by private enterprises came to about NOK 2 billion in 2007. Insurance companies and pension funds are left with a substantial burden as a result of the strong fall in share markets since year-end, although sound buffer capital prior to year-end enabled them to cope with the situation without major adverse impacts.

Norwegian securities funds are little exposed to subprime mortgage loans or securities backed by such loans. At end-2007 about 8 per cent of managed capital was invested in American companies, while only just over 1 per cent was invested in American financial institutions. Exposure was somewhat higher in August 2007. At year-end, 27 per cent of securities funds’ total assets were invested in financial institutions outside the US.

Kredittilsynet has monitored effects of the financial turbulence on Norwegian institutions and financial markets in several ways: through its oversight of individual institutions, macroeconomic surveillance and through international work. Banks and insurance companies are now required to submit extraordinary exposure reports, the liquidity situation of credit institutions (primarily major banks) has been subject to closer monitoring, and reports have been filed on stress tests conducted at insurance companies and pension funds. Impacts on the institutions have been discussed at meetings with the institutions and as part of on-site inspections. The situation has also been discussed with other public bodies, in the first instance the Ministry of Finance and Norges Bank, within the framework of the tripartite collaboration established between the three institutions.

Norwegian banks' and insurance companies' negligible exposure to very risky securities may in part be due to cautiousness. It may also be due to stricter rules applied to securitisation in Norway than in a number of other countries, and partly to an extensive and integrated supervision of the financial market in Norway, including supervision of financial groups and their subsidiaries and funds. If the financial turbulence continues in 2008, and the real economic situation in the US and Europe worsens, prospects for Norwegian financial institutions will also worsen. A serious event in the Norwegian financial market in the wake of the financial turbulence was Terra Securities' declaration of bankruptcy.

Terra Securities

At the end of October 2007 media sources revealed that four local authorities in Nordland County were exposed to the US fixed income market through products provided by Terra Securities with Citibank as facilitator. The local authorities had funded these and earlier investments largely by borrowing against future hydro-electric power revenues. In 2006 they invested in a product comprising a large number of bonds. Their overall share of this product was less than 1 per cent. Each investor in the product was however liable for a substantially larger portion of the credit risk than his percentage share of the product. Hence the value of the product dropped significantly when the market required a higher risk premium than previously due to changes in market conditions resulting from problems in the subprime market in the US.

In summer 2007 the local authorities opted, based on advice from Terra Securities, to furnish their shares of the product as security for new investments in shares of a portfolio of American municipal loans organised and funded by Citibank. In order to increase the return on the investments Citibank purchased municipal loans worth 7-8 times the amount invested. This gearing meant that the latter investments were also highly price sensitive to changes in market conditions. In the agreements signed by the local authorities with Citibank, Citibank reserved the right to terminate the contract if the market value of the overall product fell below 55 per cent of its nominal value. The local authorities could avoid such an outcome by furnishing additional collateral. A situation as mentioned arose at the end of August, and the local authorities furnished additional collateral totalling NOK 89 million. Later in the autumn the market value dropped further, and the local authorities were again asked to deposit further collateral. This margin requirement was not complied with, prompting Citibank to realise the local authorities' positions. The local authorities were repaid the remitted margin and the realised value of the original investment of NOK 451 million. The total loss came to NOK 380 million.

Kredittilsynet started investigations as soon as it learned of the matter. After gaining an insight into the product and the risk associated with the investment, Kredittilsynet considered Terra Securities' role as investment adviser. Kredittilsynet found Terra Securities' advice to be deficient, especially its failure to clearly point out the risk involved and potential demands for additional collateral. Kredittilsynet also considered the product's complexity to be such that it should not have been offered to Norwegian local authorities, which are not considered professional investors. On 27 November 2007 Kredittilsynet gave Terra Securities advance warning of withdrawal of its licences to provide investment services, giving Terra Securities' until 6 December to respond. Terra Securities opted to declare itself bankrupt on 28 November, and Kredittilsynet revoked the company's licences on the same date.

A pertinent question is whether the Terra Securities affair has had a contagion effect to customer relationships at other Terra companies and the owner banks. The Terra Group and other banks were in contact at an early stage to help maintain credit lines with banks in the Terra Group. It is still too early to attempt a quantitative analysis of key figures and market shares to illuminate this issue. Verbal contact with the Terra Group and some of the owner banks suggests, however, some customer reactions when media coverage was at its most intense, but that the situation has now returned to normal. Even banks physically located in or close to the loss-making local authorities have not registered dramatic customer reactions. None of the savings banks in the Terra Group has purchased products of the type Terra Securities sold to a number of local authorities.

Developments in financial markets and consequences for regulation and supervision

Prevention of financial stability problems through monitoring and supervision of financial institutions has become more difficult as a result of developments in financial markets. The last decade in particular has been marked by internationalisation, consolidation into larger entities, changes in technology and by financial innovations in the form of new financial products and services. The financial sector has expanded at a clearly stronger rate than the remainder of the economy.

The development of large, complex, cross-border financial conglomerates, which have gained increasingly larger significance for financial markets, means that problems arising in one conglomerate can have substantial impacts outside the conglomerate's home country. The large financial conglomerates' activity intensifies the impacts of liberalisation of capital movements and ties national financial markets closer together. Private and public institutional investors are managing more and more capital, partly as a result of rapid growth in the world economy and changes in pension systems. A desire to spread risk has spurred investment across countries, sectors and financial instruments. While this dampens risk for the individual institution, it may at the same time heighten the risk of contagion effects of shocks and disturbances occurring in the economy and markets.

Recent years have seen intensive development of new financial products, financial techniques and advanced models for measuring and managing risk. New actors, such as hedge funds and private equity companies, are also playing an ever more important role. Banks' role has changed in recent years, and the major investment banks in particular are key actors in capital markets. Financial innovation has resulted in a wider range of options for households, firms and investors when making savings and investment decisions. Financial institutions now have more opportunities to choose a different risk profile from that created through their core operations. The growth of complex products and techniques has however blurred the distribution of overall risk in the financial system and increased the risk that professional and non-professional investors alike will fail to completely understand the products they are dealing with. The international financial turbulence, which started in the summer of 2007, showed that even major investment banks lacked a complete overview and were exposed to far greater risk than they assumed.

The situation in the financial system is of ever growing significance for real economic developments. This is illustrated by the fact that trends in housing markets, credit markets and household debt are now a more important risk factor in the economic policy of many countries. Transfer mechanisms from monetary policy to the real economy are probably more complex than previously. In many countries discussions are in progress on how and to what extent the authorities should take into account developments in share, credit and property markets in the exercise of monetary policy, in addition to the inflation targets set.

The turbulence in international financial markets, which was triggered by the US mortgage loan crisis, illustrates financial markets' increased complexity and significance for the real economy. The turbulence concurrently illustrates the internationalisation of financial markets and, in particular, the significance of the major cross-border financial conglomerates. The contagion effects by way of monetary and capital markets were, both in their nature and their size, unexpected to actors and authorities, one reason being flaws in the valuation of financial instruments and inadequate information on the distribution and size of the losses involved.

The increased complexity of financial markets faces supervisors with sizeable challenges in their effort to prevent financial stability problems. This is true both in general monitoring activity and in the supervision of individual institutions. Advanced models for risk management and capital planning, complex financial products and risk-transfer techniques make it more demanding to assess the quality of institutions' internal risk management and control and whether financial strength reflects actual risk. Internationalisation and more complex transfer mechanisms between the financial sector, property markets and the real economy represent challenges in the general monitoring of financial stability.

The new capital adequacy framework, Basel II, introduced as from 2007, imposes new requirements on market actors and supervisory authorities alike. Requirements on risk management and control in the banking sector have grown, at the same time as banking supervision is increasingly risk-focused, in line with international standards. In the EEA the Committee of European Banking Supervisors (CEBS) plays a key role in the development and convergence of supervisory methodology. Kredittilsynet has received increased resources in recent years, putting it in a better position to exercise supervision under new international standards.

Closer integration between national economies and financial markets, resulting in particular from the growing importance of large, cross-border financial conglomerates and large institutional investors, creates a particular need for collaboration between the supervisory authorities of affected countries. A crisis in one of the major cross-border institutions will necessitate cooperation between supervisory authorities, central banks and finance ministries in the countries concerned, and both bilateral and multilateral MoUs have been developed.

International efforts to improve regulation and supervision

The crisis in American housing markets is rooted partly in poor credit workmanship and gaps in American legislation and supervision. The powerful contagion effects across the financial markets have however prompted an assessment of potential weaknesses in monitoring and regulations in other countries too. A series of international bodies including the Financial Stability Forum, the IMF, the Basel Committee and the European Commission are closely assessing reasons for the contagion effects and potential improvements in regulation and supervision. Changes in rules and international supervisory standards may also bring changes in supervision and regulation in Norway.

In the international arena particular attention is focused on institutions' liquidity management and authorities' monitoring of liquidity risk, following recent years' focus on credit risk in connection with the introduction of Basel II. The international effort could result in updated principles and guidelines for sound liquidity management at banks, in turn forming the basis for further development of the authorities' supervision and monitoring of liquidity risk. The current international guidelines on sound liquidity management were developed and published by the Basel Committee in 2000.

The problems in interbank markets and markets for structured products in the second half of 2007 clearly demonstrated the significance of liquidity for developments in the banking sector in particular and the financial industry in general. Some of the experience gained came as a surprise, despite the fact that liquidity problems originating in markets have also arisen previously. The events showed the significance of the link between liquidity and credit risk, and the link between problems in the markets resulting from uncertainty and failure of confidence on the one hand and funding problems at individual institutions on the other. The turbulence also showed the significance of securitisation and of commitments outside banks' balance sheets for liquidity risk.

The use of quantitative stress tests and more qualitative scenario techniques is a central aspect of banks' management of liquidity risk; here too shortcomings were identified. Stress testing of liquidity risk has been designed with institution-specific shocks in mind rather than market shocks. Moreover, it has not been usual to allow for the possibility of liquidity problems arising in several markets simultaneously. Banks' stress testing and contingency planning are currently being assessed at the international level to identify improvements that can be made in light of the experience gained from the financial turbulence. One clear lesson is that stress testing and contingency planning both need to make allowance for institution-specific liquidity problems and problems due to market factors. Since liquidity management and stress testing vary widely from one institution to the next, there may be little point in the authorities applying quantitative requirements or regulation to institutions.

In Norway institutions are required to use stress tests when analysing their liquidity situation (see Regulations of 29 June 2007 on prudent liquidity management). Stress tests need to be geared to the institution's scope, complexity and risk, and are employed when the management board assesses liquidity strategy and liquidity risk limits that have been adopted.

The financial turbulence also illustrates the fact that stress testing in more general terms is an important tool for financial institutions. Stress testing enables an assessment to be made of the impact on profits and financial strength of extreme - but not improbable - economic shocks. Basel II requires the use of stress testing and, for institutions using internal models to compute minimum capital requirements (pillar 1), this is part of the authorities' basis for approval. Stress testing has to be included in an assessment of the institution's overall capital needs (pillar 2). Credit institutions are required to assess the level of all significant risks to which they are exposed, including liquidity risk, as part of the capital assessment process. Institutions must have sufficient capital to withstand economic downturns with negative profits, and when bringing in new capital may be a problem. Institutions must also consider what level of capital is sufficient in order to bring in funding under difficult market conditions. Although higher capital levels will ease refunding, and enable a better funding mix, experience from the financial turbulence in 2007 shows that liquidity problems can also arise in well capitalised institutions. This demonstrates the importance of sound liquidity management at institutions and of the authorities' regulation and monitoring of liquidity risk.

The substantial uncertainty about values of complex products and which institutions incurred losses on such exposures has sparked a need for changes in requirements on valuation, on financial statements and on market disclosures by financial institutions. This particularly applies to structured and other complex financial products. Basel II sets requirements as to disclosure of financial information (pillar 3). New financial reporting rules (IFRS) also impose stricter requirements on information disclosure.

A circular issued by Kredittilsynet provides further guidelines on the disclosure obligation under Basel II. The requirements on disclosure of financial information are designed to give various market actors a better opportunity to judge institutions' risk level, their management and control of risk and their capitalisation. The new capital adequacy rules permit institutions to apply their own methods to compute capital charges, and publication of relevant information has become more important for this reason too. Information has to be published and updated at least yearly. Initial reporting by institutions which utilised Basel II as from 2007 is to be filed in conjunction with the presentation of annual financial statements for 2007 at the latest. Financial institutions which present their financial statements for 2007 under IFRS are required to disclose information enabling assessment of financial instruments' significance for their financial position and risk, and how this risk is managed.

The financial turbulence has demonstrated a need for improved ground rules for securitisation, and that a clean break must be enforced if banks are to escape capital requirements when securitising loan portfolios. In contrast to Basel I, Basel II contains clear requirements as to capital for all types of commitments connected with securitisation. The need for such rules has in particular been demonstrated where banks assigned commitments to entities outside the bank that were to receive special funding from the markets (SIVs and conduits), but where the banks have nonetheless incurred exposure. Under Basel II capital requirements apply to liquidity facilities set up for these entities that are inter alia dependent on the maturity of the facility. Moreover, capital charges are not confined to clear-cut contractual support in the form of liquidity or guarantees etc., in connection with securitisation. Implicit support for securitisation, i.e. the absence of a genuine transfer of risk from the bank, also has such an effect. This covers for example cases where the bank, in order to uphold its reputation, provides funding for SIVs and conduits.

In Norway securitisation is controlled both by means of a stringent body of rules on the issuer side and by the fact that most buyers are institutional investors the management of whose assets is subject to regulation and supervision. Only the safest portion of home mortgage loans (maximum loan-to-value ratio 75 per cent) can be transferred to mortgage companies entitled to issue preferential bonds.

Rating agencies play a key role in assessing structured products' risk profiles and characteristics, and risk weighting based on rating is approved under Basel II. The problems in the subprime market in the US prompted rating agencies to downgrade new structured products secured on these mortgage loans. Against this background the agencies' methodology was called into question on the grounds that ratings are less robust to short-term changes in market and liquidity conditions. One problem is that short data series do not provide sufficient basis for assessing risk attending structured products. Questions have also been raised in regard to role conflicts and rating agencies' independence of the companies that are rated. An assessment of rating agencies' role and methods is in progress in several international forums and at the US Securities and Exchange Commission.

The results of the international effort are expected to be published in the course of 2008. Norwegian laws and regulations, and an integrated supervisory regime encompassing the entire financial market and all types of loan mediation, preclude loans of the subprime type in Norway, and securitisation and onward distribution of such loans. It is important to preserve and further develop this legislation. Possible changes will nonetheless be considered in light of the results of international efforts to clarify causes of financial turbulence and contagion effects emanating from the American home loan crisis.

ANNEX

The Financial Market in Norway 2007 – Kredittilsynet

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

(Preliminary figures. Foreign branches in Norway are not included.)

Table 1: Banks: selected results and balance-sheet items

	2004		2005		2006*		2007*	
	NOKm	% of ATA	NOKm	% of ATA	NOKm	% of ATA	NOKm	% of ATA
Net interest revenues	30 818	1.87	32 990	1.77	33 678	1.59	37 977	1.53
Other revenues	15 178	0.92	17 254	0.92	18 495	0.88	17 308	0.70
Other expenses	26 265	1.60	26 535	1.42	26 365	1.25	28 476	1.15
Book losses	1 372	0.08	- 1 205	-0.06	-1 410	-0.07	33	0.00
Result of ordinary operations before tax	19 912	1.21	25 534	1.37	27 286	1.29	28 467	1.15
Result of ordinary operations after tax	14 702	0.89	18 913	1.01	20 541	0.97	21 331	0.86
	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA
Total assets	1 661 898		1 978 074		2 324 729		2 640 899	
Gross loans to customers	1 343 645	80.8	1 579 255	79.8	1 797 392	77.3	1 982 926	75.1
Deposits and debt from clients	886 719	53.4	1 002 183	50.7	1 110 423	47.8	1 272 734	48.2

ATA: Average total assets. TA: Total assets * Accounts presented under IFRS for the largest banks (90 per cent of aggregate total assets) in 2007. Figures for 2006 are restated under IFRS for the same banks.

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

	2004		2005		2006		2007	
	NOKm	% of ATA	NOKm	% of ATA	NOKm	% of ATA	NOKm	% of ATA
Premium revenues for own account	56 835	11.7	64 690	11.9	71 296	11.1	78 322	11.1
Net revenues from financial assets	32 326	6.7	42 545	7.8	47 364	7.4	51 783	7.3
Claims	31 465	6.5	32 108	5.9	46 271	7.2	68 885	9.8
Change in technical provisions	37 741	7.8	43 543	8.0	48 754	7.6	42 685	6.1
Result before new supplementary provisions, allocation to policyholders and tax	12 077	2.5	14 721	2.7	20 001	3.1	23 427	3.3
Change in fluctuation reserves	3 487	0.7	8 204	1.5	6 799	1.1	-7 201	-1.0
Value-adjusted result before new supplementary provisions, allocation to policyholders and tax	15 565	3.2	22 924	4.2	26 799	4.2	16 225	2.3
	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA
Total assets	509 461		595 904		672 934		737 849	
Bonds held to maturity	165 405	32.5	162 333	27.2	184 129	27.4	180 643	24.5
Equities and units (current assets)	79 812	15.7	126 728	21.3	183 320	27.2	172 682	23.4
Money market instruments and bonds (current assets)	155 791	30.6	181 966	30.6	171 260	25.5	187 275	25.4
Buffer capital	33 365	6.6	43 551	7.6	53 367	8.2	49 580	6.7

Table 3: Non-life insurance companies (without captives): selected results and balance-sheet items

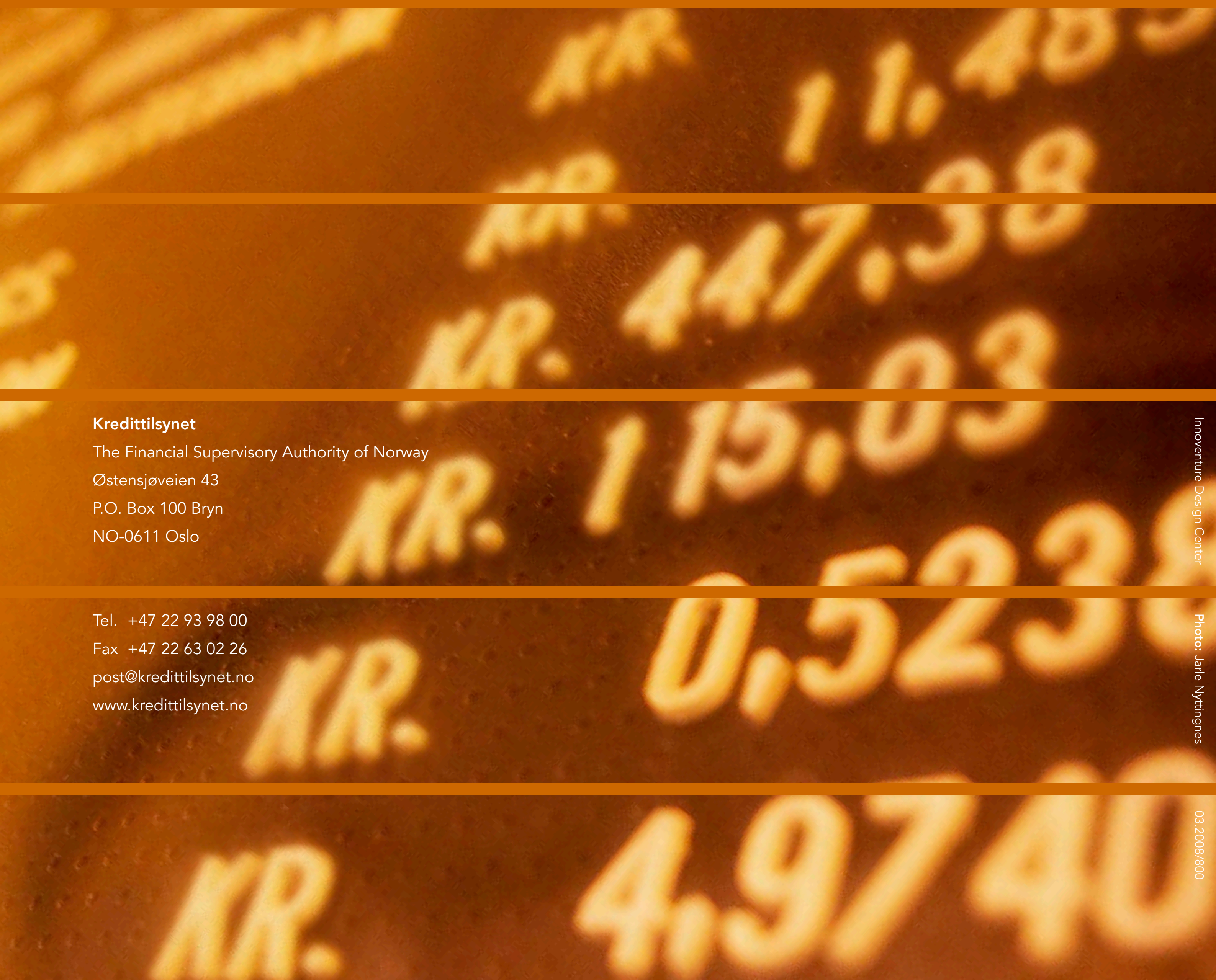
	2004		2005		2006		2007	
	NOKm	% of PFO	NOKm	% of PFO	NOKm	% of PFO	NOKm	% of PFO
Premium revenues for own account	18 137		19 540		20 300		20 853	
Claims expenses for own account	12 507	69.0	13 623	69.7	14 716	72.5	15 873	76.1
Operating expenses for own account	3 788	20.9	4 122	21.1	4 426	21.8	4 226	20.3
Result of technical account*	806	4.4	706	3.6	200	1.0	60	0.3
Net financial revenues	1 606	8.9	3 793	19.4	3 776	18.6	3 145	15.1
Result of ordinary operations	2 398	13.2	4 491	23.0	3 982	19.6	3 212	15.4
	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA	NOKm	% of TA
Total assets	50 675		59 456		70 777		78 416	
Equities and units (current assets)	2 993	5.9	9 300	15.6	11 851	16.7	10 014	12.8
Bonds and money market instruments (total)	29 838	58.9	29 965	50.4	30 945	43.7	33 457	42.7
Technical provisions	30 663	60.5	34 737	58.4	38 450	54.3	41 259	52.6

PFO: premium revenues for own account *Exc. allocated investment return.

The report entitled The Financial Market in Norway 2007: Risk Outlook is a supplement to Kredittilsynet's annual report for 2007.

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.

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



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