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Summary of the report Financial Trends 2014

Introduction and assessments

The outlook for the international economy remains highly uncertain. In parts of Europe unemployment is high, and both public and private indebtedness are very substantial. Moreover, uncertainty has in the past half year been compounded by the conflict in Ukraine and the wars in the Middle East. The euro area has seen a weaker development than previously expected. Despite expansionary monetary policies, inflation in the euro area is very low, and the risk looms of deflation and an increase in the real debt burden of households, firms and states. In the US there are indications that the economy is picking up, but the labour market remains weak. Uncertainty regarding the Federal Reserve's future tightening of monetary policy could lead to disquiet in equity, bond and currency markets. Growth in several emerging economies has slowed in the past three years. Particular uncertainty focuses on the Chinese economy, which has seen rapid credit growth and overinvestment.

The Norwegian economy has enjoyed a marked improvement in its terms of trade since the beginning of the 2000s. The rise in the price of oil has been a major contributor, and the high oil price has brought excellent profits for petroleum-related activity. The petroleum sector has a major bearing on the Norwegian economy. A high and rising cost level has spilled over to other industries, making for increased vulnerability in the event of an economic downturn.

The oil price has fallen appreciably since the summer. A steep, lasting fall in the price of oil could have major negative effects on the Norwegian economy. Production and earnings in oil-related activity will be hit. Investment activity in the petroleum sector has declined since the third quarter of 2013, and a further decline is expected next year. A further fall in the oil price will intensify the decline in oil investment. Other business and industry and households could be strongly affected by reduced activity in the oil sector.

Norwegian firms' debt servicing capacity is now at the lowest level measured since 1999.
Interest-bearing debt has continued to grow steadily after a short-lived decline in 2009, and the smaller interest burden is due mainly to low interest rates. Many Norwegian limited companies are well capitalised and can therefore withstand a hefty impairment of debt servicing capacity for a limited period. However, a large proportion of companies are in a low or negative equity position. Although many companies will probably manage to cope with negative results by depleting equity capital for a period, reduced earnings and poorer debt servicing capacity will reduce corporate demand. The upshot will be higher unemployment and heavier bank losses.

Low unemployment, high wage growth and low interest rates have spurred substantial growth in household debt and incomes in recent years. However, household debt has risen more quickly than incomes, and the ratio of debt to incomes is unprecedentedly high. Hence a relatively moderate interest rate hike or income lapse will bring a substantial increase in the interest and instalment burden. The high level of household debt renders the Norwegian economy vulnerable to negative shocks.

Household debt and house prices are closely linked. Higher house prices mean better collaterals for banks and increased credit growth, which could in turn lead to a further rise in house prices and credit in a self-augmenting spiral. House prices are now at a historically high level, having risen steeply in the year's first three quarters. The strong rise in house prices has increased households' wealth and provided a basis for consumption growth. A turnaround in the housing market will have the opposite effect.

Developments ahead are uncertain. Several types of shock could hit the Norwegian economy and Norwegian financial institutions, and the consequences of shocks have proven to be significantly larger in situations of high household indebtedness and housing market imbalances. Since most mortgages in Norway carry floating interest, an interest rate hike rapidly reduces households' disposable income. For many households, debt significantly exceeds twice their income, and their financial buffers are limited. Moreover, many mortgages have interest-only periods, which limit households' build-up of equity. Finanstilsynet's survey of residential lending shows an increase in the past year in the proportion of mortgages with a high loan-to-value ratio, possibly indicating that lending practices have been relaxed at a number of banks. This increases banks' and households' vulnerability.

Banks enjoy good earnings, and capital adequacy has improved in the years since the international financial crisis. Minimum common equity tier 1 requirements, including buffer requirements, increased to 10 per cent as from 1 July 2014, and all Norwegian banks met the requirements at the end of the first half year. However, Norwegian banks' total assets have grown significantly faster than risk weighted assets, which have changed little in the period from 2007 to the present. The leverage ratio (measured as core tier 1 capital over total assets) is about 6.3 per cent, which is higher than in 2007, but still no larger than it was in the mid-1990s. The difference between the capital adequacy ratio and the leverage ratio has accordingly widened considerably in the past years.

Considerable uncertainty attends banks' risk models, which are used to estimate risk weighted assets and capital charges. There is a danger that systemic risk that may accumulate in cyclical upturns will be inadequately reflected in the banks' models. The Ministry of Finance and Finanstilsynet have taken steps to rectify some of the models' weaknesses, while the Basel floor rule and anticipated requirements on the leverage ratio limit the danger of the risk models diluting capital requirements to an excessive degree.

New requirements for capital buffers are to be introduced in Norway somewhat ahead of the CRD IV deadline. The Ministry of Finance has asked Finanstilsynet to consider how leverage ratio requirements and new liquidity requirements should be introduced in Norway. The assessments are to be available by June 2015.

Solid, profitable banks are highly important. Norwegian buffer requirements are being gradually stepped up in the period to 1 July 2016, and banks need to adapt to minimum requirements and buffer requirements by a good margin. With continued good earnings and prudent dividend payouts, banks will be in a position to meet the requirements through profit retention. Should the imbalances in the non-financial private sector's indebtedness and in the housing market continue to accumulate, the banks must be prepared to meet further buffer requirements, and they should exploit the good times in the industry to build up equity capital by retaining the bulk of their net profit.

A considerable share of Norwegian banks' funding is obtained in the market. A significant portion of this funding has a maturity below three months and much of it is raised in foreign currency. Greater liquidity risk is posed by market funding than by bank deposits. Although banks have larger liquid reserves and a larger share of long-term funding than previously, the financial crisis underscored the fact that turbulence in international money and capital markets immediately makes it difficult for Norwegian banks to refinance their operations. The high proportion of covered bond funding has reduced liquidity risk but may also have rendered the banks more vulnerable to a setback in the housing market. That is why it is important for banks' asset encumbrance to be kept to a prudent level. Improved financial positions render banks more robust to economic setbacks and increased losses, and the reduced loss risk for banks' funding sources will also contribute to reducing liquidity risk.

Rising stock prices and capital gains on bonds have brought good results for pension institutions (life insurers and pension funds) so far this year. However, the institutions face major challenges in the years immediately ahead. Low interest rates are making it difficult for them to secure a return above the guaranteed minimum rate. Although the volume of defined contribution pensions is rapidly growing, the bulk of life insurers' liabilities still consist of contracts providing a guaranteed annual return.

The new solvency framework, Solvency II, is scheduled for introduction in the EU on 1 January 2016. Solvency II reflects risk in insurers better than the existing solvency framework, and will bring substantially higher capital charges for a number of life insurers. The latter must either reduce risk or increase their capital to meet the new requirements. Insurance liabilities are recognised at market value, and the interest rate in effect at any time affects the value of the liabilities. In recognition of the challenges facing many European life insurers, the Directive amending Solvency II, Omnibus II, permitted some relaxation, or a more gradual introduction, of the requirements. Finanstilsynet has recommended that some of these relaxations should be applied to Norwegian life insurers to give them more time to adapt to the new capital requirements.

Rising longevity in the population entails a need for pension institutions to increase their provisioning for future pension obligations. As from 1 January 2014 a new mortality tariff was introduced that takes account of rising longevity. This tariff entails higher premiums for policyholders and a need to considerably strengthen pension institutions' technical provisions. Much of this need was met in the period 2011-2013, but a significant increase in provisioning will be required in the years ahead.

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