KREDITTILSYNET
The Financial Supervisory Authority of Norway

The Financial Market in Norway 2008

Risk outlook

The report gives an account of the situation in financial institutions in light of economic and market developments, and assesses trends that may give rise to stability problems in the Norwegian financial system.

The Financial market in Norway 2008: Risk Outlook

Unless otherwise stated, Kredittilsynet is the source of charts and tables.
This report is the full version of the Norwegian report *Tilstanden i finansmarkedet 2008.*

Foreword

The international financial crisis initially affected Norwegian banks by restricting their access to, and increasing the price of, liquidity. After the collapse of the US investment bank Lehman Brothers the problems increased significantly, and a comprehensive response was required from the Norwegian government and central bank. The introduction of a ”swap scheme” along with a more flexible liquidity supply to Norwegian banks gradually brought a significant improvement in the functioning of the short-term money market and money market interest rates have fallen. Extending the duration of “swap loans” from three to five years is important in providing security for the future and for assuring a gentle wind-down of the scheme. Kredittilsynet has played its part by rapidly and smoothly processing eight applications to set up residential mortgage companies.

At the start of 2009 the focus shifted from liquidity to financial soundness in Norway as elsewhere. Equity capital plays a key role both for banks' ability to lend and for their ability to secure funding in wholesale markets by issuing bonds and money market instruments. Kredittilsynet therefore supported proposals for, and participated actively in the design of, the Government Finance Fund and the Government Bond Fund.

Kredittilsynet is encouraging the banks to make use of the instruments offered by the Government Finance Fund to assure sound capital adequacy and a robust basis on which to meet households' and firms' credit needs. It is important to avoid a tightening of the credit supply that could intensify the downturn in the Norwegian economy and expose banks themselves to heavier losses. At the same time the banks need to properly assess borrowers’ creditworthiness.

Although it is as yet unclear to which extent the banks will make use of the Government Finance Fund, the Fund clearly plays an important role in reducing the uncertainty surrounding banks’ access to capital. For many banks the very existence of the Fund could ease access to capital from the private market too. A number of banks will find that active interaction with the Government Bond Fund will facilitate credit supply to larger firms, thereby relieving some of the burden on the banks themselves.

Kredittilsynet, 23 February 2009

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 contributes to financial stability and well functioning markets. Solid financial institutions with good risk management and internal control are particularly important to ensuring financial stability.

The ongoing international financial crisis has shown the significance of financial stability in assuring a sound, stable development of the real economy. In many cases stability problems arise as a result of macroeconomic shocks that trigger vulnerabilities in the financial system. The Nordic bank crises in the 1990s were pertinent examples. The present international crisis has its origin to a greater degree in weaknesses in the financial system itself and the regulatory framework. Common to the Nordic bank crises and the ongoing crisis, however, is the fact that both came about after a period of vigorous and persistent credit growth combined with sharply rising prices in real estate and securities markets.

Since 1994, Kredittilsynet has analysed and assessed potential stability problems in the Norwegian financial industry, in light of developments in the Norwegian and international economy. This is a necessary supplement to the ongoing supervision of individual institutions. Significant parts 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

- The international financial crisis is the most serious since the 1930s. The ensuing international setback has brought the world economy into recession. The crisis is rooted in the interplay of weaknesses in financial markets and macroeconomic imbalances in the international economy. Many international banks have needed financial support to survive or to maintain normal lending activity. Many countries, including Norway, have initiated wide-ranging measures to meet the crisis, and the effect of the authorities' measures will have a large bearing on when a new cyclical upturn sets in. A turnaround in US housing markets will probably be needed to achieve a normalisation of international money and credit markets and a renewed cyclical upturn. Challenges to the Norwegian financial institutions depend on the strength and duration of the cyclically setback in the Norwegian and international economy.

- The international financial crisis has impacted heavily on Norwegian financial markets, with high risk premiums in the bond and money markets. Although government measures to improve banks' financing have improved the situation, banks still find it difficult to obtain long-term market finance, and the liquidity situation remains challenging. It will be important for the banks to lengthen funding maturities and improve systems for measuring and controlling liquidity risk.
- Norwegian banks recorded appreciably weaker results in 2008 than in the previous four years, mainly due to higher loan losses and losses on securities. Banks' underlying earnings are under pressure. If the banks are to maintain satisfactory earnings and financial positions ahead, their lending rates must reflect the risk inherent in their lending. Banks also need to continue to streamline operations. The possibility that some banks will encounter problems in 2009 or 2010 cannot be ruled out, and in some cases structural measures (mergers/acquisitions) may need to be considered.
- Banks' credit risk rose appreciably at the start of the downturn after several years of very strong growth in lending to households and firms alike. Rising house prices and credit expansion have for some time fuelled a vicious spiral bringing house prices and the debt burden to excessive levels. In 2008 house prices fell, and further falls in 2009 cannot be ruled out. Substantial interest rate reductions on the part of Norges Bank are helping to reduce household sector debt problems and to dampen the fall in house prices. Rising unemployment will pull in the opposite direction.
- Profitability among non-financial firms has been sound in recent years. The sharp slowdown in the Norwegian and international economy will weaken firms' financial position in 2009, and bankruptcies can be expected to increase in number. The economic setback is affecting export industries and sheltered industries alike. Higher household saving will exacerbate the decline for service industries. Both banks and insurance companies are heavily exposed to commercial property. Commercial property values fell in 2008, and a sharp downturn in the Norwegian economy may bring further falls.
- Norwegian insurers and pension funds were affected by the financial crisis in 2008 through the strong turbulence in stock and fixed income markets. Life insurers' performed poorly in 2008, and entered 2009 with diminished buffer capital. However they have reduced asset risk by substantial divestment and by hedging their share portfolios. At the start of 2009 insurers' risk is largely confined to developments in real estate and fixed income markets.
- Banks' capital over and above international minimum requirements will cushion higher losses resulting from the cyclical setback. Loss write-downs can only be forward looking up to a point. In 2007 and 2008 Kredittilsynet drew many banks' attention to the need to raise capital targets, and in a number of cases also actual capital levels, in order to meet a weaker economic climate and market conditions. The international financial crisis and government support measures have led markets to demand tier 1 capital levels that in many cases go further than the official requirements. Norwegian banks will also face such requirements, especially those borrowing in foreign markets. Banks will therefore have to choose either to strengthen capital or reduce lending growth if they are to meet higher market requirements.
- Although Norwegian banks in general should be in a position to maintain normal lending, meeting new needs brought to light by the financial crisis will pose challenges. Demand for loans among larger firms seems to be rising due to a more restrictive stance on lending among

foreign banks, for example through participation in bank syndicates, at the same time as it is difficult to obtain loans in securities markets. Higher market demands on the level and quality of banks' capital combined with uncertainty about the depth of the economic downturn and uncertain prospects for the normalisation of banks' funding threaten, in Norway as elsewhere, a shortage of equity capital which may gradually constrain lending to the point where it reinforces the economic downturn.

- The Norwegian economy is sound and there’s ample room for manoeuvre in the fiscal policy. The substantial measures taken by the Norwegian government are important in tackling the impact of the international downturn. Kredittilsynet considers that the government's measures to supply equity capital to the banks are well designed. Even so the ability and willingness of the banks to follow a lending policy that can curb the downturn in economy is uncertain.
- In the long term, awareness is needed of the likely consequences when the enormous measures taken in many countries are to be phased out. Low interest rates and massive supply of liquidity and capital could again build imbalances in financial and property markets. Expansionary fiscal policy will in many countries ultimately have to be met with higher taxes. There may also be a risk of behaviour in the financial sector based on expectations of further government measures. Hence it is important for banks to maintain sound risk management and to employ sound principles for assessment of borrowers' creditworthiness and normal profitability criteria.
- A radical revision of the international regulatory framework for financial markets will be needed in the aftermath of the financial crisis. It will be important to ensure that all countries have capital requirements and supervision covering all segments of the financial market and that sound systems are in place for overall oversight of the markets. Minimum capital requirements should be raised to ensure a larger cushion against setbacks and to reduce procyclical mechanisms in the financial system. Requirements imposed on information and transparency on financial products must be more stringent, and consideration of formal approval schemes may be necessary.

Summary

Economy, markets and institutions

The world economy is entering a severe cyclical downturn. Many years of low interest rates and strong credit growth created bubbles in housing, commercial property and securities markets, and readjusting the credit volume to real economic conditions involves a heavy withdrawal of liquidity. The real economic consequences of the financial crisis have brought the US, Japan and the Euro area into recession and a marked slowdown in the emerging economies. Unemployment is now rising steeply in all countries while price inflation is subsiding. Central banks have responded to the crisis by substantially cutting interest rates and supplying the markets with large volumes of liquidity. It remains to be seen whether the measures taken will be sufficient. Substantial fiscal action has also been taken in a number of countries. Even so, forecasts for activity growth in 2009 are steadily revised down, and global growth looks set to come to a complete halt. A large fall is expected in industrialised countries’ production in 2009, but there is unusually large uncertainty about developments further ahead. The greatest threat to the world economy is a downward spiral where the problems in the financial system cause companies to fail, joblessness to rise, household consumption and housing investment to slide – bringing further decline for business and industry along with increased losses on loans and financial investments at financial institutions. This could lead to a deep, lasting recession.

Money and capital markets were affected by highly turbulent periods in 2008. The turbulence increased sharply when major financial institutions announced losses, but subsided when governments took action. When the US's fourth largest investment bank, Lehman Brothers, was allowed to collapse in mid-September, risk premiums in the money and bond markets increased dramatically, declining slightly in October. As signs of recession became steadily clearer, risk premiums again reached new heights. Norway, with its dollar-based money market, was also heavily affected. At the start of October Norwegian three-month interbank rates were close to 8 per cent, but declined to less than 4 per cent by year-end. In other countries too money market rates fell after extensive infusions of liquidity and hefty interest rate cuts by most central banks during autumn 2008. The US Federal Reserve substantially lowered its key rate over the year, to an interval of 0-0.25 per cent in December. Since October the European Central Bank has lowered its key rate to 2 per cent, while the Bank of England has lowered its rate to 1 per cent, the lowest level in the bank's 315-year history. Sveriges Riksbank (Sweden's central bank) lowered its key rate to 1 per cent in February. Norges Bank has followed up with substantial rate cuts, to 2.5 per cent in February 2009. At the start of 2009 the money market shows signs of stabilising.

The severe turbulence also affected long government bond rates which fell steeply in 2008, particularly towards year-end. Equity markets oscillated through the first half of 2008, but have plummeted since the end of May. Recession in the industrialised world is significantly weakening prospects for companies in all sectors. In 2008 total market capitalisation on Oslo Børs fell by 54 per cent, while the MS World Index dropped 40 per cent in the same period.

After a period of strong expansion starting in 2003, the Norwegian economy has passed its cyclical peak. The international setback has had substantial ripple effects, and towards the end of 2008 household consumption, gross investment and in particular traditional exports fell. The deterioration in financial markets from mid-September caused a sharp slowdown in the housing market with a significant increase in the number of unsold dwellings and longer sale periods. House prices fell in the second half of 2008, and the 12-month rate of growth has been negative since March 2008. In January 2009 prices were almost 7 per cent lower than in the same month of the previous year, although there was a small upturn from December to January. The market for commercial property, which in recent years has seen rising prices and a falling hurdle rate, has turned round. Office rental prices fell 15-25 per cent in 2008. Turnover was very low, making valuation difficult. The market for commercial property is vulnerable to an economic setback. The labour market turned decisively downwards in the last quarter of 2008. Registered unemployment measured 2.6 per cent of the labour force in January, an increase of just over 1 percentage point since the summer. The economic downturn is now also reflected in credit growth, which is slowing substantially for households and firms alike.

Growth in credit to households has 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 rose significantly in 2008 due to higher interest rates combined with still rising indebtedness. Interest rate reductions have reversed this trend, however. Households' financial saving has declined appreciably in the past three years, and their net liquid financial wealth, from which insurance claims are excluded, is negative. At the same time, falling house prices are reducing household wealth. Households show wide variation in terms of debt burden and financial wealth, the lowest age groups and newly established households being particularly exposed.

After the substantial increase seen in corporate profits and equity ratios through the period of economic expansion, developments in 2008 significantly worsened the outlook for this segment. Lower demand combined with falling prices of oil and other commodities as well as falling freight rates pushed down earnings at large Norwegian stock exchange locomotives. At the same time declining equity markets and a sharp increase in risk premiums in bond markets made it far more difficult to raise necessary capital. Tighter credit practice on the part of international banks is exacerbating the situation since it is uncertain how far Norwegian banks have the capacity to take over as lenders. Firms in the sheltered sector are also toiling due to lower demand. The number of corporate bankruptcies rose appreciably in 2008.

After excellent profit performances among the banks in recent years, results in 2008 were clearly lower, and return on equity fell substantially. Results were affected by losses on securities due to the turbulence in financial markets and higher loan losses resulting from the weak economic climate. Banks' main revenue source, net interest revenues, crept up, mainly as a result of higher lending volumes, whereas interest margins remained at a low level. A substantial rise in loan losses was seen, particularly in the fourth quarter. In terms of outstanding loans, however, loss levels remain low. The volume of non-performing loans rose appreciably in the period, although here too levels are still low. Growth in bank lending has been very high for several years, particularly to the corporate sector. Despite the high growth in lending, banks’ tier 1 capital adequacy has been relatively stable in recent years. In 2008 the seven banks that use internal models to calculate minimum requirements under Basel II were required to hold own funds equivalent to at least 90 per cent of the minimum requirement under Basel 1. This floor will be 80 per cent in 2009. Tier 1 capital adequacy at the other banks was also stable throughout 2008.

Rapid lending growth combined with lower growth in deposits has brought a gradual decline in banks' deposit-to-loan ratios. All in all, however, Norwegian banks have a relatively high deposit-to-loan ratio and a high share of long-term funding, which reduces their liquidity risk. Kredittilsynet has closely monitored banks’ liquidity situation from the second half of 2007. The international financial crisis has sharply reduced banks’ access to capital through the securities markets, at the same time as risk premiums have increased markedly. Banks’ liquidity situation remains demanding. The problems in money and capital markets are creating difficulties for both corporate and bank funding. While the government's measures are expected to bring a gradual improvement in the markets, risk premiums on banks' funding cannot be expected to fall to their pre-crisis levels in the next few years.

A new act came into force for life insurance companies on 1 January 2008 with a large impact on the content and presentation of accounts. Life insurers' results in 2008 were negative as a result of falling values and losses realised on shareholdings, although recourse to supplementary provisions curbed the decline in performance. Value-adjusted return on capital on collective portfolios was negative. The proportion of shares carrying market risk for the companies (apart from unit-linked portfolios) was greatly reduced through 2008, mainly due to active divestment, to 10 per cent at year-end. Taking derivative positions into account, equity exposures were even lower. Companies' portions of fixed-income securities and property rose through the year. Buffer capital was substantially reduced in the course of 2008, measuring 3.8 per cent of total assets at year-end. Buffer capital levels were lowest at the largest companies. All life insurers met the minimum capital adequacy and solvency margin requirements at year-end. Some companies received capital infusions in the fourth quarter. Pension funds' return on capital was negative in 2008 as a result of a sharp decline in financial revenues. Higher exposures to equity markets and a larger proportion of Norwegian shares in their portfolios brought value-adjusted return among private pension funds even lower than return among municipal pension funds. Several pension funds failed to meet minimum regulatory requirements in the second half of 2008, necessitating capital injections. At the end of 2008 pension funds still had a relatively high equity component of 27 per cent.

Non-life insurance companies' result of ordinary operations was also appreciably weaker in 2008 than in the previous year due to lower financial revenues. An improvement was seen in the technical business, however, bolstering the overall result.

Declining revenues from provision of investment services in connection with issues and mergers etc. brought lower overall operating profit for investment firms in 2008. Companies managing securities funds saw their revenues almost halved compared with the previous year, and assets under management in Norwegian securities funds fell sharply in 2008. Net new subscription in all types of mutual funds was negative in 2008, although net new subscription in equity funds by private individuals was positive in the fourth quarter.

Outlook

Uncertainty about the further development of the Norwegian and international economy is unusually large. The largest industrialised countries are in recession, and it is uncertain how deep and protracted the downturn will be. Emerging markets are also heavily affected by the financial crisis, and these countries are hardly likely to be in a position to take over as the driving force in the world economy. Moreover, capital markets are still functioning poorly. It is thus far difficult to assess whether implemented measures are sufficient to stabilise the markets and restore confidence in and stability to the financial system.

The market trend left life insurance companies with no asset revaluation reserves and with very low supplementary provisions at the start of 2009. However, life insurers have reduced asset risk in tandem with the reduction in buffer capital, and risk present in the companies now relates mainly to possible falls in property values and possible sustained low interest rates. A small equity component reduces the companies' vulnerability to further equity markets falls, but simultaneously curbs the opportunity to build new reserves when markets recover. Developments in 2008 actualised the need to consider rule changes to better enable life insurers to honour their long-term commitments. Pension funds are vulnerable to further falls in stock markets and, for investment firms too, a continued weak trend in securities markets could compromise earnings and financial soundness.

The challenges facing Norwegian banks depend on the strength and duration of the cyclical downturn. Norwegian business and industry are hit both by the recession among their main trading partners and the sharp slowdown in domestic demand. An increasing number of bankruptcies must be expected ahead, resulting in higher unemployment. In recent years household sector finances have been marked by growing indebtedness, little repayment of debt and high loan-to-value ratios on home mortgage loans. These factors have heightened vulnerability in the event of an economic setback, as warned against by Kredittilsynet in recent years. The substantial interest rate cuts by Norges Bank will however help to reduce households' debt problems, curb the decline in house prices and dampen vulnerability in the short term. Rising unemployment will pull in the opposite direction.

Banks' capital over and above international minimum requirements constitutes a cushion against the higher losses that will result from the cyclical downturn. Loss write-downs can only to a certain extent be forward-looking. After reviewing the capital situation and risk factors in 2008, Kredittilsynet asked several banks to revise upwards both their capital target and actual capital levels. This was done to ensure that the banks have sufficient financial strength to withstand a cyclical downturn bringing increased losses and reduced earnings, and possibly also difficult access to equity capital markets and market funding. As a result of the problems experienced by many major international banks, governments in several countries have stepped in to supply banks with capital. This has been viewed as necessary and has helped to substantially raise capital levels in these banks. Market actors and rating agencies are starting to demand better capital quality and higher levels of tier 1 capital adequacy of international banks, and governments' requirements on capital may come across as moderate compared with those set by the market. If Norwegian banks' access to funding in international markets is to be assured, their tier 1 capital adequacy will also need to be strengthened. Banks must therefore as far as possible endeavour to assure sufficient equity capital through continued profitability. Banks could see earnings decline ahead as a result of continued high funding costs, increasing losses, lower contributions in mixed groups from insurance and securities business as well as reduced volume growth. If banks are to maintain sufficient profitability, their interest margins on lending need to reflect the increase in risk, cost efficiency drive must continue and dividends to stockholders must be curbed.

Adequate profitability and financial strength are necessary to maintain normal growth in credit to households and to enable banks to finance presumptively profitable projects. Weakly capitalised banks cannot promote credit growth in turbulent times. In autumn 2008 it was access to funding that constrained some banks' lending activity. Normalisation of money and capital markets and declining interest rates charged to borrowers in Norway as elsewhere will remain an important contributor to maintaining activity levels in the economy and lending by banks. However, to meet a serious economic downturn and comply with increased market requirements on the composition and level of tier 1 capital, Norwegian banks' financial position will also need to be strengthened, inter alia through recourse to the Government Finance Fund. Although Norwegian banks should largely be in a position to maintain normal lending, meeting new needs uncovered as a result of the financial crisis will pose a challenge. Demand for loans from larger firms seems to be increasing as a result a more restrictive lending practice on the part of foreign banks, engendered in part by participation in bank syndicates, at the same time as it is difficult to obtain loans in securities markets. The Government Bond Fund may relieve some of the burden on the banks.

The substantial stimuli supplied to the Norwegian economy by the government in autumn 2008 and winter 2009 in the form of interest rate cuts, improved market liquidity and opportunities to recapitalise financial institutions are in the current situation both important and necessary measures against the background of the substantial turbulence in financial markets and negative prospects for global growth. Kredittilsynet is of the view that the government's proposal to supply banks with equity capital through the Finance Fund is well conceived. Even so it will be uncertain how far banks are able and willing to maintain a lending practice that can curb the economic downturn. A strong downturn in the economy will also hit the banks in the shape of increased losses.

In the long term, awareness is needed of the consequences that will ensue when the enormous measures initiated in many countries are to be phased out. Low interest rates and a massive supply of liquidity and capital could again build price bubbles in financial and real estate markets. Credit risk may materialise when interest rates are gradually brought back to normal levels. Hence it is important for banks to maintain good risk management and to apply sound principles for assessing creditworthiness and normal profitability criteria. When the arrangement for “swapping” home mortgage loan bonds for government paper is brought to an end, and financial institutions rebalance their portfolios, wide price movements can be expected in these market segments. There may be a risk of behaviour in the financial sector based on expectations of further government measures, and the authorities must take this risk into account.

The financial crisis has uncovered a need to review and strengthen international regulation of and framework conditions for financial activities. In many countries rules and supervision have failed to prevent financial crisis and economic setback. A number of international organisations are in the process of identifying weaknesses and working out improvements. Norway's regulatory regime, essentially based on international standards and rules, also contains some deviations. Where Norwegian regulation diverges, it has consistently proved to be more robust than the regime applying in the major financial markets. In addition, Norway benefits from many years of integrated financial supervision and legislation covering the entire financial market. Regulation and supervision alike are based on a consolidated approach. However, Norwegian rules and supervisory practice should be evaluated in light of the problems that the crisis has uncovered and in light of international measures.

In market-based economic systems, fluctuations in the economy and markets are often unforeseen and far stronger than expected. It is particularly difficult to foresee turning points in the economic cycle. Especially at the end of a long period of expansion, financial institutions, investors and consumers alike are very likely to underestimate risk, with the corrections and setbacks that follow. A key aspect of financial market regulation is capital requirements that put financial institutions in a position to meet difficult periods of heavy losses and impaired profitability and enable them to continue to perform their important economic functions in society. Particular attention focuses on procyclical effects of solvency regulation and accounting standards in the financial system.

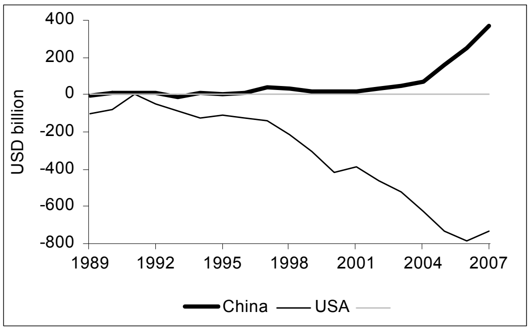
1. The financial crisis

The world economy is now in the midst of a severe economic downturn caused by the most serious shock to affect the industrialised counties' financial markets since the 1930s. While the crisis was partially created by and in the financial markets, it is also rooted in structural changes in international trade and in economic policy.

International crisis build-up

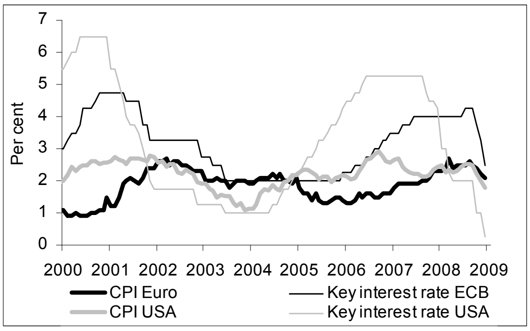
Many observers have pointed out that the substantial imbalances in international goods and capital flows that built up in the past decade posed a major threat to the stability of the international economy. In the wake of the crisis that hit several Asian countries in 1997-1998, saving in these countries rose sharply. Concurrently export-led growth gathered momentum, driving their trade balances into surplus. This was particularly true of China which, after its entry into the WTO in December 2001, became a major exporter of a wide range of goods. A strong upturn in industrial production in China and other emerging countries was followed by a hefty increase in commodity prices, especially of oil and metals, but also in time of foodstuffs. The rise in prices brought huge surpluses in the external economy of most commodity-producing countries, such as Norway and the OPEC countries, but also of manufacturers of cheap industrial goods led by China. The surpluses were invested in countries with a trade deficit, of which the US has been in a class of its own in recent years. The resultant increased liquidity pushed down long rates on private and government bonds alike. The change in the trading pattern whereby Asian countries, and China in particular, steadily increased their exports of a broad and growing range of cheap consumer goods, led to low inflation in most industrialised countries. Central banks switched to an inflation-targeting monetary policy in this period. Low price inflation prompted very low key policy rates in all industrialised countries, which also brought down short interest rates.

1.1 Current account – USA and China



Source: Reuters EcoWin

1.2 Key policy rates and inflation



Source: Reuters EcoWin

Low interest rates and ample access to liquidity led investors to enter ever new markets in a quest for higher return. This brought record-low risk premiums. The difference in return on government bonds and corporate bonds in all risk classes narrowed substantially. Concurrently a rapid development of and growth in various complex products and techniques for transfer of credit risk, often with an unknown address, was noted. Many “new” actors turned up and acquired a steadily larger role. This was true inter alia of hedge funds, private equity companies and various investment companies set up by banks. The large volume of liquidity that was supplied to the financial system in the US and Europe helped to blow up the price of assets such as securities, dwellings and commercial property. The low interest rates combined with higher asset prices made borrowing attractive. This in turn contributed to higher asset prices, especially house prices, which incentivised remortgaging and ever increasing borrowing. Much of the freed up capital went to consumption, which was an important driver of the boom in the world economy.

The banks played a very important role in the period of economic expansion, and their significance is probably even greater than previously assumed. When saving began to decline in the industrialised world, banks’ ability to finance lending through customer deposits declined. Very ample access to liquidity in domestic and international markets nonetheless enabled banks to continue their vigorous lending expansion. This led to a substantial rise in indebtedness among banks, and in consequence to greater dependence on market funding. Non-deposit taking investment banks also enjoyed favourable growth conditions thanks to ample access to funding in the markets. The financial industry expanded vigorously from the turn of the millennium onwards, and figures for 15 largest international financial conglomerates showed that total assets almost tripled between 2001 and 2007. There is much to indicate that the incentive structure in financial institutions in this period was an important factor in explaining the build-up of vulnerability in the financial system. This incentive structure, in which bonus schemes are linked to an institution's share price and growth, increased risk so as to maximise short-term return in order to satisfy market requirements. This type of incentive structure contains no mechanism to correct for detrimental long-term build up of risk.

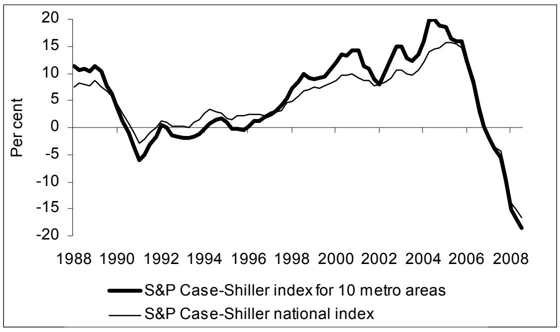
The vigorous growth in financial institutions’ lending took place in a market where regulation and supervision were fragmentary and inadequate. Only half of the US credit market was subject to capital requirements and banking supervision. Moreover, subsidiaries of banks in many countries and special investment vehicles (SIVs) were not included in banks’ accounts and capital requirements. This also contributed to an unclear situation which enabled financial institutions to blow up balance sheets so massively. Banks’ conduct was a contributor to bubble formations which laid the basis for a severe economic downturn.

The crisis unleashed

The downturn in the US, which was to pull with it the world economy into a financial crisis, was triggered by a sharp increase in defaults on subprime home mortgage loans starting in summer 2007. More than half of these loans carried fixed low interest in the initial years until rates were changed to floating. The Federal Reserve had since summer 2004 raised the base rate by 4.25 percentage points. This, together with the rising cost of servicing previously contracted loans, made it less attractive to raise new loans. The housing market turned downwards as early as 2006, price inflation subsided and in the course of 2007 house prices started to fall. The collapse of the US subprime market revealed imbalances about which many observers had had misgivings. But the spread of the financial crisis to the global markets, the scale of the crisis and the speed with which it spread, were little understood. The path taken by the crisis is largely related to the development of securitisation which was assumed would provide better risk diversification.

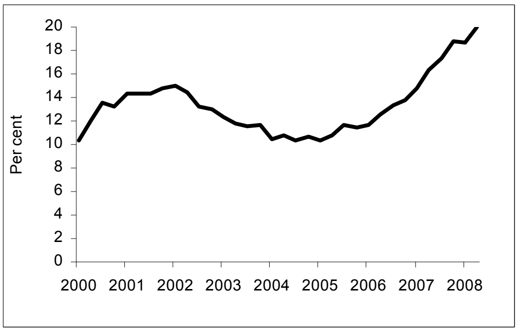
Of aggregate American home mortgage loans totalling more than USD 10,000 billion in 2007, close to 60 per cent were securitised. Securitisation entails packaging home loans in portfolios which provide backing for the issuance of various types of securities. Various groups or tranches of securities were issued with varying priority to cash flow and security and were assigned differing ratings by the credit rating agencies. These groups of securities were the 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).

1.3 Housing prices in the USA



Source: Reuters Ecowin

1.4 Non-performing subprime mortgages in the USA



Source: Bloomberg

Securitisation led to an opaque market in which valuing securities, identifying responsibilities and ascertaining size of losses was extremely difficult. Losses consequently spread across the global financial markets on an unexpectedly large scale. The mutually reinforcing mechanisms whereby rising asset prices led to credit expansion and renewed asst price growth, rapidly reversed. Uncertainty as to valuation of structured credit products rose sharply. Market actors did not know who owned problem securities. A marked lack of confidence meant that banks would not lend to each other, and interbank markets dried out. Banks that previously had easy access to funding were now unable to renew their loans, and several encountered liquidity problems. Central banks stepped in, lowered key rates and injected liquidity, leading to a brighter outlook at the start of 2008. Over the year it became increasingly clear, however, that deep-rooted structural problems had developed in financial institutions and markets during the period of economic expansion. A number of financial institutions encountered major problems.

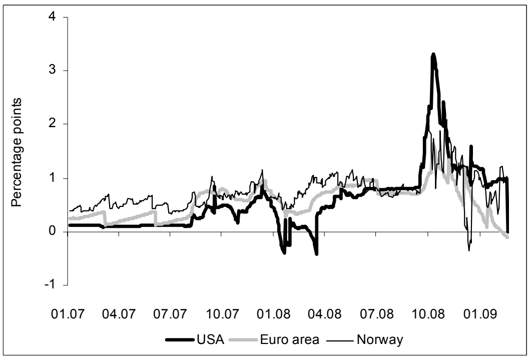
Development of the crisis through 2008

The UK bank Northern Rock was the first large international bank to encounter problems, and was temporarily taken over by the government in February 2008. The bank's risk profile and weak funding structure meant it was unable to meet its refinancing needs in the difficult money and capital market. The UK's then deposit insurance scheme under which many customers lacked cover even for moderate deposits, significantly increased the bank's problems when it was subjected to a classical run on the bank in autumn 2007.

In the US the investment bank Bear Stearns encountered such serious problems that it had to be rescued by the government in March 2008. The bailout helped to dampen market fears. Later in spring 2008, the financial turbulence looked to be subsiding, suggesting just a mild downturn in the world economy. However, in the course of summer the two largest home mortgage banks in the US, Fannie Mae and Freddie Mac, were at risk of bankruptcy after enormous losses. The two banks are lenders or guarantors for almost half of US home loans and a collapse of the two institutions would have had very serious consequences for the already hard hit US housing market. US authorities therefore intervened to offer emergency loans and the opportunity to bolster equity capital if that proved necessary. The persistent problems in many of the largest global financial institutions led to growing fear of a setback in the real economy, which was heavily reflected in securities markets. As from May 2008, equity markets slumped and risk premiums in fixed income markets were at a high level.

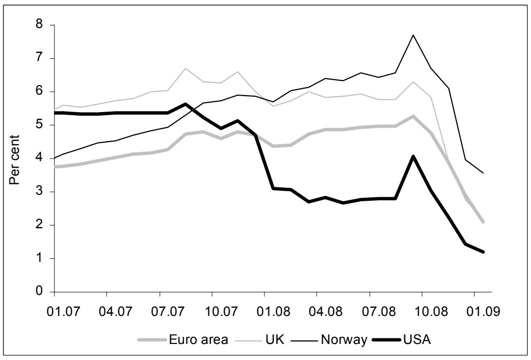
In Europe too many banks ran into difficulties. Many banks had funded substantial growth in the markets, and incurred heavy losses after investing in structured credit products tied to US home mortgage loans. In the Nordic countries it was primarily Icelandic banks that had operated with high risk. However, the first Nordic bank that had to be taken over by the authorities as early as August was the Danish Roskilde Bank. Further large banks in the United Kingdom, Ireland, Germany, France, Belgium and the Netherlands also had to be either bought out by other banks or taken over or received sizeable capital injections from the government. This was true of the UK banks Royal Bank of Scotland and Lloyds, the German Dresdner Bank and Commerzbank and the French-Belgian Dexia and Fortis.

1.5 Differential 3-month money market rate and key rate



Source: Reuters Ecowin

1.6 3-month interbank rates



Source: Reuters Ecowin

The financial turbulence developed into a global financial crisis after the US government refrained from intervening to rescue Lehman Brothers, the fourth largest investment bank, when it ran into difficulties. The bank declared itself bankrupt on 15 September. Panic spread among market participants and the money markets collapsed, despite the government bailout of the major US insurer AIG. With the benefit of hindsight it would probably have been cheaper to save Lehman than to clear up the economic crisis that followed. However, at the time it seemed very difficult politically to step in to rescue yet another badly run bank whose management earned high incomes and had a high profile. It was thought necessary to issue a signal that taking high rewards for assuming major risks in good times, and letting others carry the costs when problems surface, is unacceptable business management. Moral hazard problems were to be combated. Ensuing market reactions were unexpectedly strong and had a substantially larger negative impact than presumed when the decision to allow Lehman to go bankrupt was taken. However, bailing out Lehman Brothers could have meant pushing a number of problems ahead in time.

Interbank interest rates rose to record levels, stock markets plunged and the banks incurred acute funding problems at the same time as losses mounted. When the large US bank Washington Mutual was put into administration ten days after the Lehman bankruptcy, activity in the bond markets also came to a halt. In an attempt to shore up their balance sheets, banks sharply tightened lending, causing funding to be denied to many companies. Combined with a substantial fall in household consumption and housing investment after borrowing facilities dwindled, the financial crisis swept into the real economy as high liquidity risk triggered pent-up credit risk. During autumn 2008 it became clear that the US, Japan and the EU were in recession. Many trusted that growth in the emerging countries could take over as the driver of the world economy. However, thus far in 2009 there are clear signs of a sharp slowdown in these areas too. Forecasts suggest that growth in the world economy will be close to zero in 2009.

The crisis has turned global, but some countries have been hit far harder than others, as reflected in increased interest rate differentials on private and government bonds alike. In our region it is primarily Iceland that has come off badly. However, developments in the Baltic region, especially Latvia, have been very negative. Nordic banks are exposed to developments in these areas.

Crisis build-up in Iceland

The international financial crisis has hit the Icelandic economy hard. The country was particularly vulnerable after several years of high economic growth and large debt-financed investments by firms and households alike. This was made possible by a recently privatised domestic financial sector with ample access to foreign capital. After the process of liberalising the financial sector was brought to completion in 2003, the Icelandic banks expanded vigorously. The three largest banks' (Glitnir, Kaupthing and Landsbanki) aggregate assets were equivalent to about 100 per cent of Iceland's GDP in 2004, compared with more than 900 per cent at the end of 2007. The growth in the banking sector laid the basis for substantial macroeconomic imbalances. At the end of 2007 household debt measured close to 220 per cent of disposable income, of which 80 per cent was indexed to domestic price levels, while around 10 per cent was denominated in foreign currency. Household borrowing was mainly channelled into the housing market and to consumption, contributing to a very overheated housing market and high inflation. The corporate sector also showed a substantial debt build-up in the period. Non-financial firms' debt measured over 300 per cent of GDP in 2007. Icelandic banks accounted for about two-thirds of these loans, which were mainly denominated in foreign currency.

The turbulence in international financial markets from summer 2007 onwards had substantial impacts on Icelandic banks, both through higher funding costs and through increased risk premiums on loans. With the drying up of capital markets, domestic inflation quickened and the Icelandic krona came under heavy downward pressure, compelling the central bank to raise its key rate sharply. In October

2008 the three largest Icelandic banks filed for bankruptcy. The Icelandic state lacked the financial muscle to honour the banks' commitments, resulting in a loss of confidence in the country's financial system. In a bid to defend the Icelandic krona the key rate was raised to 18 per cent in October. The move was however futile, and in November Iceland signed loan agreements with the IMF and sought help to stabilise the economy. The main focus in the period ahead will be on stabilising the currency and inflation through tight monetary policy and restructuring of the banking sector. However, there is reason to believe that Iceland will have to endure a deep recession. In 2008 growth in GDP was close to zero. Even if the currency stabilises, the IMF does not rule out a 10 per cent drop in GDP in 2009 and unemployment approaching 10 per cent.

Crisis build-up in the Baltics

The Baltic countries recorded very high rates of growth in the period 2000-2007. A steadily tighter labour market supported high real wage growth. This, together with vigorous credit expansion, low interest rates and overblown house prices, fuelled steep growth in domestic demand. Private consumption rose by an annual average of 10 per cent in the period 2000-2007, investments by 13-15 per cent. Ample access to cheap credit from abroad, where borrowing has largely been euro-denominated, made housing markets in the Baltic countries the most overheated in the world.

The Baltic growth spree ended last year. The situation is worst for Latvia and Estonia with GDP contractions in 2008 of 4.6 and 3.6 per cent respectively. Lithuania experienced a sharp slowdown in growth in 2008 but for the full year saw GDP increase by 3.2 per cent. Lithuania too, however, will also enter a deep recession in 2009. GDP in the Baltic countries is expected to fall by about 10 per cent in 2009, although the risk of an even larger setback is substantial.

Substantial trade deficits were accumulated in the Baltic countries in the period of economic expansion. In Latvia the deficit came to as much as 24 per cent of GDP in 2007, in Estonia 18 per cent and in Lithuania 14 per cent. This has led to a steep increase in foreign debt which in 2007 measured 134 per cent of GDP in Latvia, 112 per cent in Estonia and 114 per cent in Lithuania. Higher risk aversion in financial markets in autumn 2008 left market actors uncertain whether the countries could handle such large deficits with currencies pegged to the euro. At the same time private sector access to credit was substantially tightened. Tighter borrowing terms gave particularly negative impulses to housing markets and private consumption, and investments in business and industry were also hit hard. Weaker demand stimuli have brought falling GDP and dramatic weakening of economic prospects in a short space of time. Devaluation fears loomed especially large in Latvia. The loss of confidence prompted the Latvian authorities in autumn 2008 to part-nationalise the second-largest bank, Parex Bank, to prevent a massive flight of depositors from the banking system. In the course of a single month in autumn 2008 the Latvian central bank spent a quarter of its currency reserves on keeping the exchange rate within the fluctuation band of ± 1 per cent defined through the Exchange Rate Mechanism (ERM II). In November, however, Latvia also had to seek IMF and EU assistance in dealing with the crisis. The country received a rescue package worth EUR 7.5 billion. During the winter it has become clear that the Baltic countries are in the throes of a serious recession. In February 2009 Latvia's government stepped down as a result of the country's economic situation. GDP growth forecasts for 2009 and 2010 are very weak, and their adoption of the euro appears to be a long way off for all three countries.

Impact of the crisis on the Norwegian economy

Being a small, open economy with free movement of capital, Norway has been impacted by the international financial crisis through various channels. The negative effects were very rapidly reflected in the dollar-based Norwegian interbank market. When the dollar market completely dried up in the wake of the Lehman Brothers' failure, it became difficult for Norwegian banks to obtain funding.

The Norwegian stock market is heavily affected by international events and developments. Oslo Børs is dominated by large commodity-based firms and is probably also used by investors wishing to protect themselves against high oil prices. Weaker international growth prospects have led to sharp falls in commodity prices since summer 2008, pushing down the value of many companies listed on Oslo Børs. Low international demand has contributed to weaken prospects for the export sector and shipping and has pushed the value of shares further down. Oslo Børs dropped as much as 54 per cent in 2008.

In the bond market the value of government bonds has been pushed up and interest rates down as more and more investors seek less risky alternatives. The opposite trend has been seen in the market for corporate bonds where risk premiums have risen substantially.

The outlook for Norway's real economy was gradually revised down across 2008. This was largely due to international developments, although domestic factors also played a part. The Norwegian economy has undergone the most vigorous period of economic expansion in 20 years. Private consumption and housing investment were important drivers in that period, much of it debt financed. Monetary policy was gradually tightened from mid-2005 onwards, and higher interest rates had by September 2008 already brought low growth in consumption and declining house prices. Whereas previously the stage was set for a gradual slowdown, the financial crisis has led to a severe setback in the Norwegian economy. The downturn materialised above all in the fourth quarter of 2008 and into 2009. The negative trend in the real economy will impact heavily on securities markets, financial institutions and insurance companies.

Norwegian financial institutions, insurance companies and pension funds had negligible direct exposure to subprime home mortgage loans or structured credit products and initially were not directly affected by the financial turbulence. Banks' results in 2008 were however hit by securities losses resulting from the financial market turbulence. The negative trend in the real economy has brought a substantial rise in loan losses, albeit from a very low level. The international financial crisis has substantially curbed banks' supply of capital through the securities markets. At the same time, credit risk premiums the banks need to pay on their borrowing have risen markedly. The problems in money and capital markets are creating major difficulties for both firms' and banks' funding.

Banks' lending growth was very high throughout the period of economic expansion. Growth edged down in 2008 due to falling demand but also to some tightening of credit practice on the part of Norwegian banks. Internationally, authorities in a number of countries have chosen to supply fresh tier 1 capital to their banks, raising capital levels at these banks. At the same time market actors and rating agencies alike are expecting tier 1 capital levels to be higher than previously in the banking sector. Hence in order to secure access to funding in international markets, capital adequacy needs to be raised in Norwegian banks too. Adequate financial strength is needed in order to maintain normal lending to households and in order for banks to be in a position to fund presumptively profitable projects during a downturn as at other times. However, raising capital levels while on the way into an economic downturn faces banks with a difficult balancing act. On one hand, improved solvency will assure market financing and afford a larger cushion against rising losses. But if banks strengthen their financial positions by trimming their balance sheets, they may aggravate the downturn in the real economy, bringing higher bank losses.

Life insurance companies were heavily affected in 2008 by the financial crisis through their large exposures to securities markets. Capital losses and asset write-downs contributed to poor results. Buffer capital shrank considerably over the year, and the companies reduced their risk exposures by substantial share divestment. Pension funds were also heavily affected by the financial crisis. In the course of autumn 2008 about a quarter of pension funds found themselves either short of the minimum capital adequacy requirement or were deemed to be at substantial risk of failing to meet solvency requirements in the near future. Many pension funds received capital infusions enabling them to meet the capital adequacy requirement. (See Chapter three for a further discussion of financial institutions' results in 2008.)

Handling of individual institutions

Thus far Norwegian financial institutions have had appreciably smaller problems in the wake of the financial crisis that has been the case in other countries. However, some institutions encountered acute difficulties, necessitating government assistance.

Icelandic banks in Norway

The Icelandic banks Glitnir Bank hf, Kaupthing Banki hf and Landsbanki hf operated in Norway, the first-mentioned through a subsidiary, Glitnir Bank ASA, the two others through branches. On 7 October 2008 Glitnir Banki hf was placed under the control of the Icelandic supervisory authority to ensure continued banking operation in Iceland. The Norwegian subsidiary consequently no longer had access to liquidity from its parent. The Norwegian banks' Guarantee Fund furnished a liquidity guarantee for a brief period on condition that the bank was sold. On 19 October an offer made by the Sparebank 1 consortium was broadly accepted and the consortium formally took over the bank in December.

The Icelandic supervisory authority took control of Kaupthing Banki hf on 9 October 2008 and the bank’s Norwegian branch was concurrently closed for in- and outpayments due to lack of liquidity. Upon Kredittilsynet's advice, the Ministry of Finance guaranteed the share of deposits at the branch to be covered by the Icelandic guarantee scheme, and on the same day the Norwegian Banks' Guarantee Fund decided to disburse the guaranteed deposits. The branch was put into public administration three days later. In the course of a few weeks all deposits below NOK 2 million had been transferred to other banks or disbursed. An agreement entered into between the Norwegian board of administration and the Icelandic liquidation board ensures that the administration board has access to sufficient funds to ensure an orderly wind-up of the Norwegian branch. All priority claims are expected to be satisfied in full. Also depositors with amounts above NOK 2 million, who so far have just received the guarantee amount of NOK 2 million, will now be eligible for full coverage. The Icelandic supervisory authority took control of Landsbanki hf on 7 October 2008 and the branch ceased operations in Norway and started to wind up. On 21 October the supply of liquidity from the parent bank in Iceland was temporarily halted as a result of the seizure of the bank's assets in Norway. The parent bank subsequently made sufficient liquidity available to wind up the branch.

Securities activity of the Icelandic-owned firms

Seven Icelandic or Icelandic-owned actors in the Norwegian securities market were affected when the three largest banks in Iceland encountered acute problems. The Norwegian Glitnir firms and the Swedish Glitnir AB were able to continue their activity with stock exchange membership and direct or indirect participation in the central securities settlement. The securities activities of Glitnir Bank hf and Landsbanki hf in Iceland, and of the Norwegian branches of, respectively, Kaupthing Bank hf and Landsbanki hf had to be wound up. This took place in an orderly manner without kindling problems in the securities market. The central securities settlement proceeded as normal. Kredittilsynet was in close touch with the VPS (central securities depository) and monitored developments on a continuous basis.

Counterparty risk - Lehman Brothers

Lehman Brothers International (Europe) Ltd was a remote member of Oslo Børs. It had one of the largest market shares on Oslo Børs and was an indirect participant in the central securities settlement with DnB NOR ASA as settlement agent. At the time of its bankruptcy Lehman Brothers had about 20,000 trades outstanding. The settlement agent settled all Lehman Brothers' matched purchase transactions, i.e. the bank paid for securities delivered for securities settlement. Sales transactions involving securities not in Lehman Brothers' possession, and trades executed outside the stock exchange, were not settled. Kredittilsynet was in close touch with the VPS and monitored the securities settlement process. The event did not lead to problems for the other aspects of the securities settlement, but it did reveal ambiguities in the securities settlement rules in regard to how settlement agents' obligations towards remote members of the exchange are to be understood. Kredittilsynet has asked the VPS to consider steps to remove these ambiguities.

Stimulus packages

International measures against the financial crisis

Far-reaching measures against the financial crisis have also been instituted by a number of governments, including coordinated measures across several countries. In the hardest hit countries (Iceland, Latvia, Hungary and Ukraine) the IMF has stepped in with multinational packages. In addition to sizeable cuts in key rates and substantial fiscal policy stimuli, national measures have broadly focused on improving banks' funding and financial strength. In order to improve funding access, central banks have accepted new types of collateral, provided guarantees for bank deposits and guaranteed new bank debt as well as sharply increased the supply of liquidity. Endeavours have been made to improve market liquidity by means of central bank loans and direct purchase of securities or financing of such purchases. Banks' financial strength has been addressed by bailouts of individual institutions, general recapitalisation or by relaxing the existing rules, for example by granting exemption from the requirement to book trading portfolios at fair value.

The initial fiscal policy measures taken in the US were moderate due to institutional factors. In October Congress passed tax relief for firms and private individuals equivalent to 0.1 per cent of GDP. Early in December 2008 President-elect Barack Obama introduced a fiscal policy package of measures worth USD 825 billion distributed across 2009 and 2010. After several rounds in Congress, stimulatory measures of USD 787 billion were passed in February 2009. The package includes tax cuts, higher spending on transport, aid to the poor and unemployed and investments in alternative energy. During autumn 2008 the Federal Reserve cut its key rate to an interval of 0 - 0.25 per cent. The financial sector was supplied with substantial liquidity through various programmes. US authorities have also infused capital and issued guarantees to several institutions. A rescue package, the Emergency Economic Stabilisation Act, worth USD 700 billion for the purpose of recapitalising the banks was passed on 3 October. Under the terms of the rescue package the government will buy up problem assets from financial institutions, including toxic home mortgage loans. The way was also opened for purchases of preference shares in US banks, capped at USD 250 billion.

As the crisis spread, the Federal Reserve followed up with the further measures capped at USD 800 billion. The Federal Reserve announced its intention to purchase home-loan-related debt worth up to USD 600 billion, of which USD 100 billion was to be devoted to purchasing direct commitments in government-supported mortgage loan institutions such as Fanny Mae and Freddie Mac, while USD 500 billion was to go to purchasing securitised home loans issued by the same two institutions.

A meeting of the G7 Group on 10 October 2008 concluded that the situation required rapid and extraordinary measures and that all available instruments would be applied. On 12 October the euro zone countries and the United Kingdom reached agreement on common relief measures to restore confidence in the financial system and to ensure that it functioned satisfactorily. The other EU countries acceded to the agreement on 15 October. The EU presented a fiscal policy stimulus package worth EUR 200 billion on 26 November, of which EUR 170 billion is to be provided by member countries and EUR 30 billion funded by the EU. The plan corresponds to 1.5 per cent of EU GDP. The measures are to be coordinated across national borders, but need not be identical from one country to the next. In October 7 central banks agreed a coordinated interest rate cut of 0.5 percentage points to counteract the turbulence in financial markets.

The stimulus package for the UK economy that was presented on 8 October was intended to secure for the banks access to capital and liquidity in the short and medium-term. As that part of the package, the UK government and the eight largest banks agreed to raise the banks' capital adequacy. The banks were free to raise necessary capital privately, or to accept capital from the government. A total of GBP 50 billion was made available by the government. Other banks could also apply for inclusion in the scheme. In addition, the government provided GBP 200 billion to the banks in the form of short-term credit through the Special Liquidity Scheme. The government also provided a guarantee of up to GBP 250 billion for use when refinancing longer-term debt. On 24 November the UK government presented a fiscal policy stimulus package equivalent to 1 per cent of GDP. The package includes both higher public investment and a reduction in VAT. Inasmuch as prospects for the UK economy deteriorated, the government announced on 19 January 2009 new, comprehensive measures to secure financial stability, specifically geared to ensuring banks' capacity to extend new loans. These included establishing a fund for the purchase of sound, but illiquid assets from the banks under Bank of England auspices. The government also announced the Government Asset Protection Scheme whereby, subject to a fee, the government undertakes to ensure the banks against portfolio losses. The scheme is also designed to strengthen lending capacity by reducing uncertainty as to the value of banks’ assets and improving their ability to withstand losses.

In Denmark the government adopted an Act relating to Financial Stability on 10 October 2008. The government and the banking sector established a guarantee scheme for all deposits in Danish banks not covered by other means. On 18 January 2009 the government entered an agreement with the other political parties on a Bank Package II whose intention was to ensure normal lending activity by banks. The package contains several instruments, a key one being the offer of government infusions of hybrid capital totalling DKK 100 billion to Danish banks and mortgage banks. The liquidity measures will be strengthened by prolonging the government guarantee scheme on deposits to 2013. Bank package II also strengthens regulation and supervision. Finanstilsynet (the Danish FSA) will at least yearly review institutions' solvency needs and will, in addition to seeing its resources strengthened, have more and stronger instruments made available to it. This will include the ability to make banks' solvency needs and risks public.

A Swedish stabilisation plan was adopted on 29 October 2008. The plan covers banks and building societies, and includes a guarantee programme of up to SEK 1,500 billion to support banks' and building societies' medium-term financing. A stability fund of SEK 15 billion was set up to help in the event of future solvency problems at Swedish financial institutions. The plan provides for collection of a stability levy from all credit institutions and Sweden. Banks participating in the guarantee scheme are subject to curbs on executive pay, bonus and termination compensation payments for management in the period of the guarantee agreement. Further, the Swedish government presented on 5 December a fiscal policy package worth SEK 8.3 billion, providing an overall fiscal stimulus equivalent to 1.3 per cent of GDP. A rescue package for the car industry worth SEK 28 billion was presented by the Swedish government on 11 December. At the start of 2009 a package was offered for the recapitalisation of Swedish banks. Like Det Private Beredskab in Denmark (a guarantee fund set up by the private sector), Riksgälden (the Swedish National Debt Office) has provided a guarantee in respect of bank debt.

In Germany and France too, rescue packages include liquidity support, support for recapitalisation and funding access for banks. In Germany the government set up a stabilisation fund of up to EUR 80 billion which can be supplied to financial institutions, including in the form of non-voting preference shares and hybrid capital. Conditions are attached, for example as regards business strategies, executive pay and dividends. The stabilisation fund also provides loan guarantees of up to EUR 400 billion up to the end of 2009 to ensure refinancing of German financial institutions. On 14 January the German government adopted a new, larger package of fiscal policy measures equivalent to 1 per cent of GDP, focusing on infrastructure and tax relief for the low-paid. In autumn 2008 the French government made up to EUR 320 billion available to the financial sector in the form of guarantees and liquidity support for new interbank loans. Up to EUR 40 billion has been set aside for recapitalisation purposes. In France too, institutions in receipt of government support are subject to certain restrictions. For example, requirements can be set as regards loan volume and ethical guidelines that will serve the communal interest. The first package was announced on 13 October, and as early as 20 October it was announced that the French government would inject EUR 10.5 billion into the country's six largest banks. The French government has also contributed to measures in respect of Dexia together with Belgium and Luxembourg.

Short positions and the financial turbulence in autumn 2008

In autumn 2008 regulatory authorities in a number of countries intervened against covered as well as uncovered short selling in various financial instruments, after determining that short selling intensified price falls and market fluctuations, thereby aggravating financial instability.

On 18 September 2008 the US, the UK and Ireland introduce a temporary ban on short selling of financial shares, the first countries to do so. The next day Germany and France followed suit. Subsequently Australia, Italy, the Netherlands and Denmark also imposed such bans. In the US, however, the temporary ban was lifted on 8 October in light of the Congress's approval on 3 October of the financial rescue package. In the US uncovered short selling is in principle permitted, but in partial continuation of the temporary overall ban, the Securities and Exchange Commission (SEC) has introduced a ban on uncovered short selling up to 31 July 2009.

On 16 January 2009 the UK and Ireland also lifted the temporary ban, albeit with reservations. Up to 30 June 2009 all actors holding a net short position of at least 0.25 per cent of outstanding shares in UK financial institutions, are required to notify this to the authorities. The same applies where a reportable position is increased or reduced by 0.1 percentage point or more.

In the days up to 8 October 2008 the question was raised of whether short selling also occurred at Norwegian listed financial institutions, and whether international actors pursuing short selling strategies would enter the Norwegian market as and when other markets were closed to such trading. Kredittilsynet's inquiries were unable to rule out the possibility that short selling in some Norwegian financial shares took place at Oslo Børs. In a move to stabilise financial markets, Kredittilsynet introduced restrictions on short selling. Inquiries by Kredittilsynet in the period 9-27 October gave no clear indications of short selling in Norwegian financial shares in the period.

Norwegian actions against the financial crisis

On 12 October 2008 the government presented a package of measures to give banks better access to liquidity and financing and to contribute to calm and confidence in the financial market. New government paper with a limit of NOK 350 billion will give banks access to collateral that can facilitate new long-term borrowing. One of the above measures entitles banks to exchange preferential bonds for government securities. Preferential bonds are standardised bearer bonds issued by a mortgage company and conferring a preferential claim over the mortgage company’s cover pool. Preferential bonds can only be issued by mortgage companies whose mission is to grant or acquire residential mortgages, commercial mortgages, loans secured on other registered assets or public sector loans and that finance their lending business primarily by issuing preferential bonds.

In principle only bonds conferring a preferential claim over Norwegian loans secured on dwellings (residential mortgages) were covered by the swap scheme. The scheme was later extended to enable some other types of bonds to be exchanged for government securities where a plan was in train to achieve a good credit rating. This applies to bonds conferring a preferential claim over other real property in Norway (Norwegian commercial mortgages) and bonds conferring a preferential claim over Norwegian loans granted to, or guaranteed by, the State or a municipality. Corresponding bonds (covered bonds) issued under other EEA states’ rules and secured on Norwegian residential mortgages and Norwegian commercial mortgages are also acceptable under the swap scheme. It is proposed to extend the scheme’s maturity from three to a maximum of five years.

2008 saw the establishment of seven mortgage companies authorised to issue preferential bonds, and a further company was established in February 2009.

In addition to the swap arrangements, Norges Bank has issued fixed rate loans (F-loans) with maturities of two and three years geared to smaller banks. Concurrently the requirements as to collateral for loans from Norges Bank are eased by removing the requirement of a minimum outstanding volume of NOK 300 million for securities issued in Norwegian kroner.

The government has also granted loans to, or increased equity capital at, some institutions under part-public ownership to ensure continued lending activity. In November the government agreed a loan to Eksportfinans, and the financing requirement is expected to be about NOK 50 billion over the next two years. The government loans are to be used for new export credits, i.e. loans granted to Norwegian companies that build ships and rigs and to other export-oriented industry. The Norwegian Guarantee Institute for Export Credits (GIEK) was authorised to issue new loan commitments up to a limit of NOK 80 billion for the “general guarantee arrangement” and NOK 6.5 billion for the “construction loan arrangement” for ships. The government has also proposed increasing the capital of Kommunalbanken, the local-government funding agency, by NOK 300 million. This will enable Kommunalbanken to grant local authorities new loans of NOK 15-20 billion in the period ahead.

Fiscal policy measures

The changes made by the government in the fiscal budget for 2009 to counter the negative effects of the financial crisis entailed a fiscal policy stimulus of NOK 20 billion, breaking down to NOK 3.25 billion in tax relief and NOK 16.75 billion in increased public spending, distributed across local and central government authorities. The stimulus package entails an overall budget impulse of 2.3 per cent of mainland (non-oil) GDP. The government gave special priority to local authorities and transport projects, with NOK 6.4 million going to local authorities and investment in transport rising by NOK 3.8 billion. In a move to counteract liquidity problems in the corporate sector, firms will be temporarily entitled to offset deficits incurred in 2008 and 2009 against profits taxed in the two preceding years. While the changes to the tax policy programme are industry-neutral, they will mainly benefit the most cyclically vulnerable firms. At the same time the tax modifications will not impede necessary adjustments. After a review by the Storting’s Standing Committee on Finance and Economic Affairs, some changes were proposed to the government’s stimulus package, including higher depreciation allowances for investments in machinery and longer lay-off periods.

Financial package

The government’s financial package was presented on 8 February 2009. This package is intended to assure credit supply to households and firms and to stabilise the financial market. The government proposed the establishment of two new funds with a total capital of NOK 100 billion. The Government Finance Fund will supply up to NOK 50 billion of capital to banks. The object is to contribute tier 1 capital on a temporary basis to enable banks to maintain normal lending in a period when financial markets are very difficult and higher capital levels are required by international markets. The Government Bond Fund (GBF), managed by the National Insurance Scheme Fund, is a temporary fund capped at NOK 50 billion that will invest in Norwegian bonds. Together with other investors, the GBF will purchase ordinary bonds issued by Norwegian firms in both the primary and secondary markets. By this means the GBF will increase liquidity, and access to capital, in the bond market.

Deposit guarantee scheme

The Norwegian deposit guarantee scheme singles itself out in both the European and global context by offering a high guarantee limit of NOK 2 million. In view of the turbulence seen in financial markets this autumn and winter, a large number of European countries have raised their deposit guarantee limit substantially; some have even introduced unlimited guarantees in respect of banks' borrowings.

Until recently the minimum deposit guarantee required in the EU was EUR 20,000, or just under NOK 200,000. The EU has decided to raise the minimum requirement in two stages. As from 1 July 2009 the minimum coverage in the EU will be EUR 50,000; as from 1 January 2011 it will be EUR 100,000. Full harmonisation across the EU might be introduced on the same date, such that EUR 100,000 will at the same time constitute the maximum of what member countries can offer. Directive amendments are relevant to Norway by virtue of the EEA Agreement. According to the amended directive, Norway would be required to reduce its deposit guarantee to EUR 100,000 by the end of 2010. The Minister of Finance has taken initiatives vis-à-vis the EU to retain the Norwegian scheme.

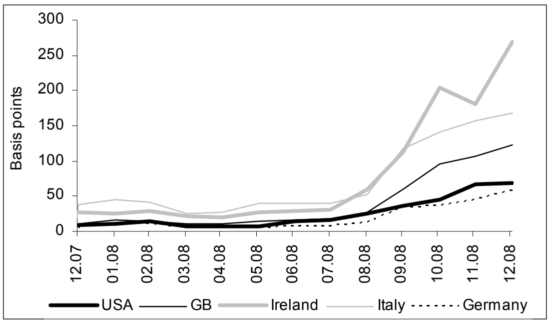
Challenges

The authorities face a very difficult situation in the aftermath of the financial crisis. All possible means of stabilising financial markets and the economy have been applied. Central banks have lowered key rates to record-low levels and supplied much liquidity to the markets. Concurrently fiscal policy instruments of unprecedented size have been used to dampen the forthcoming setback in the real economy. It remains to be seen whether the measures taken are sufficient. Risk that is building up must be identified.

Intervention by the authorities at short notice in so many areas of the economy is not unproblematic. Supplying substantial volumes of liquidity could lay the basis for higher inflation in the longer term. Government takeover of banks may also have an unintended effect on competitive conditions in a country’s banking sector. Government ownership may also be long-lasting if the crisis persists and banks’ earnings are impaired to the point where it is difficult for private capital to replace public capital. In addition, measures taken may give rise to undesirable conduct on the part of financial market actors. Nor are large fiscal policy support measures without problems. In the first place, finding a sufficient number of economically profitable projects at short notice poses a challenge. Moreover, the design of such measures must not hamper necessary structural change (e.g. mergers) or support unprofitable enterprises.

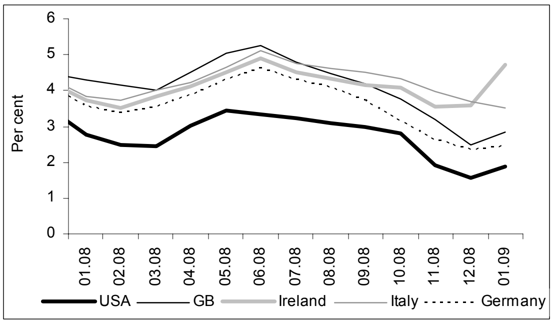
The way fiscal policy measures are funded is also highly significant for developments ahead. Many of the hardest hit countries were in a weak financial position at the outset with government indebtedness and public budget deficits. The deficits are substantially increased by the measures taken. This is particularly true for the US, although government indebtedness is now rising quickly in countries such as the UK and Ireland too. Debt financing of interventions on the scale in question will affect domestic financial and currency markets. Capital supply to the private sector may be impeded. In recent months CDS spreads on government debt has risen substantially for some countries, especially Ireland. Government bond rates have also risen as a result of investors’ scepticism to further heavy government borrowing. Norway is in this sense in a unique situation with large surpluses both on public budgets and the balance of payments.

1.7 CDS spreads on government debt



Source: Bloomberg

1.8 5-year government bonds



Source: Reuters Ecowin

For the authorities in many countries, dampening the setback while ensuring that the imbalances accumulated during the period of economic expansion up to 2008 are not taken forward, will be a difficult balancing act. The financial crisis is rooted in debt-financed consumption and housing bubbles in many industrialised countries which over time must be corrected to ensure more sustainable long-term growth.

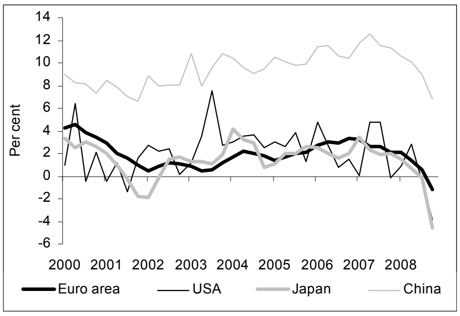
The substantial imbalances in the external economy must also be corrected in due course. This must be done gradually to prevent unnecessarily large exchange rate fluctuations. At the same time several of the proposed support measures contained clauses confining use of the funds to national enterprises. Experience shows that crises can lead to increased protectionism, which dampens global growth. The fact that the G7 countries have discussed this problem and agreed to combat protectionist elements in their stimulus packages is encouraging.

In addition to addressing the short-term challenges posed by the international financial crisis, it is also important right now to start planning how to reverse the measures taken once economic growth starts to pick up again. The consequences ensuing when the enormous measures taken in most countries are phased out, must be identified. Low interest rates and massive infusions of liquidity and capital may again build up price bubbles in financial and real estate markets where credit risk may materialise when interest rates are gradually brought back to normal levels. That is why it is important for banks to maintain sound risk management and apply sound principles for assessing borrowers' creditworthiness and normal profitability criteria. When the various schemes to support bank funding are phased out, and banks rebalance their portfolios, substantial price fluctuations can be expected in the bond markets. There is a risk that the stimulus packages may contribute to the build-up of price bubbles in the government bond market. Moral-hazard problems will be important ahead, and authorities need to allow for behaviour based on the expectation of further rescue packages. In the wake of the financial crisis the conduct of both monetary and fiscal policy will have to take account of new risk structures and the increased potential for undesirable behaviour to which the stimulus packages may at worst contribute, if financial stability ahead is to be assured.

2. Markets and economic trends

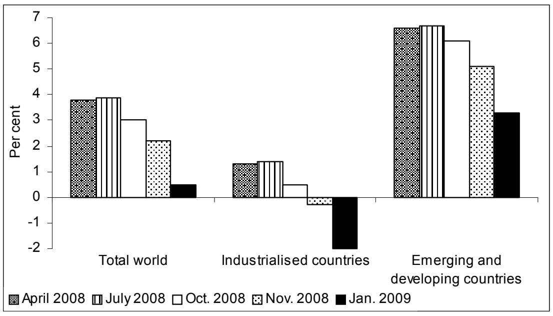
The world economy is in a severe cyclical downturn. The United States, Japan, United Kingdom and the euro area are already in recession, while growth has slowed substantially in the emerging economies. The international financial crisis has thus hit the global economy hard across a broad front. Production is falling in the Nordic countries. In Iceland the crisis has resulted in demonstrations and the government's downfall. Despite wide-ranging support measures on the part of national governments, financial markets had yet to normalise in February 2009. A sharp slowdown in economic growth and very sluggish real estate markets in many countries pose major challenges for financial institutions. Slower growth and greater uncertainty in the economy have led to declining demand for credit among firms and households alike, while still unstable money and capital markets and prospects of rising losses constrain banks' ability and willingness to lend. The liquidity risk triggered by the bankruptcy of Lehman Brothers has in the course of autumn and winter gradually translated into increased credit risk. For 2009 the IMF envisages global growth of a mere 0.5 per cent compared with 3.4 per cent in 2008 and as much as 5.2 per cent in 2007. Even so, the risk appears to be on the downside. Growth forecasts for the world economy in 2009 have been substantially revised down in the past year.

2.1 GDP growth in various countries



Source: Reuters Ecowin

2.2 Growth estimates for 2009 given at various points



Source: IMF

International real economy

The US National Bureau of Economic Research recently ruled that the US is in a recession that started as early as December 2007. The recession is likely to be long-lasting. The IMF puts GDP growth in 2009 at a negative 1.6 per cent. Private consumption in particular has fallen sharply. Developments in the housing market and labour market alike have contributed. House prices in the largest cities have fallen by almost 20 per cent. Concurrently investment has declined in the past three years, in 2008 by more than 20 per cent. The number of unsold dwellings is record-high and suggests a further decline in the housing market. Banks' credit practice in the home loan area has also tightened substantially after the subprime crisis. An increase of three million in the number of unemployed in 2008 was followed by the addition of a further 600,000 unemployed in January, and by the end of January 2009 the jobless rate was 7.6 per cent. Weaker income growth resulting from higher unemployment impairs both the housing market and consumption, as do the negative asset effects of the slump in equity markets through 2008. Substantial falls in the volume of new orders towards the end of 2008 suggest a weak trend in investment ahead. In response, US economic policy has been realigned in a very expansionary direction, and the Federal Reserve has in effect introduced a zero interest rate policy. Congress approved a stimulus package of about 5.5 per cent of GDP which was signed by the president on 17 February 2009.

In Japan GDP fell at an annual rate of 12.7 per cent in the fourth quarter of 2008, the main contributor being the negative development in corporate investment and exports. The central bank lowered its key rate to 0.3 per cent. Once again there is a fear of deflation in Japan. The financial crisis has also had consequences elsewhere in Asia. Towards the end of 2008 growth in exports from the region came to a complete halt. In China the authorities, fearing a hard landing, have introduced a series of expansionary measures in the shape of interest rate cuts and fiscal easing designed to check the fall in exports. The IMF expects a growth rate of 6.7 per cent in 2009 compared with 9 per cent in 2008 and as much as 13 per cent in 2007.

Table 2.1 Forecasts of GDP growth, consumer price growth and unemployment

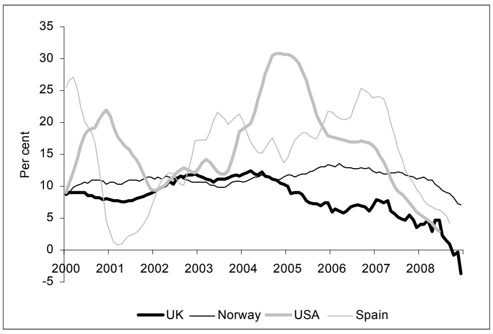
	USA			Japan			Euro area		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
GDP*	1,1	-1,6	1,6	-0,3	-2,6	0,6	1,0	-2,0	0,2
GDP	1,3	-2,1	2,0	-0,4	-3,8	0,8	0,8	-2,0	0,7
Inflation	3,8	-0,9	1,7	1,4	-0,8	-0,2	3,3	0,8	1,6
Unemployment	5,8	8,4	9,0	4,0	4,8	5,1	7,5	8,8	9,5

Sources: Consensus Forecasts, 9 Feb 2009. * IMF. World Economic Outlook Update, 28 January, 2009.

A very sluggish trend is evident in the euro area, with activity levels declining sharply particularly in Italy and Germany during 2008. For 2009 a substantial decline in GDP is expected in Italy, France, Germany and Spain alike. The European Central Bank lowered its key rate from 4.25 per cent in October 2008 to 2 per cent in January 2009. The UK is in deep recession, hit hard by the housing market bubble and problems in the financial sector. The Bank of England has lowered its key rate to 1 per cent, the lowest level since the bank's founding in 1694. Pound sterling has depreciated by more than 30 per cent since summer 2007, and house prices fell 20 per cent in the past year. Investments have fallen by 10 per cent and growth in private consumption has come to a halt. The IMF expects GDP to contract by 2.8 per cent in 2009. Growth forecasts for East European countries have been revised down sharply of late. Given the economic imbalances in Eastern European markets, the stage is set for a downturn both deeper and longer lasting than previously envisaged. This could result in heavy losses among Western European banks accounting for the bulk of lending in these countries. Russia too is hit by the financial crisis. Falling commodity prices and tighter access to credit fed through to Russian markets in 2008, and in November the stock exchange stayed closed for several days due to plummeting stock values. Forecasts point to a contraction of GDP in Russia in 2009.

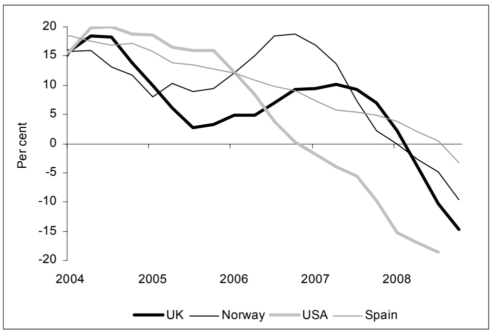
A weak trend is expected throughout the Nordic region. In Denmark house prices are falling steeply, pushing down debt-financed consumption growth. In Sweden manufacturing industry has been hit hard by the international downturn, and the central bank has lowered its key rate to 1 per cent. In Iceland the economy has collapsed. A long period of unbalanced growth culminated in 2008 in the failure of the country's three largest banks and subsequent re-indexing of Iceland's stock exchange. During the autumn the Icelandic krona depreciated by 50 per cent, inflation rose to almost 20 per cent, and unemployment to 10 per cent.

2.3 Growth in credit to households



Source: Reuters Ecowin

2.4 12-month growth in house prices

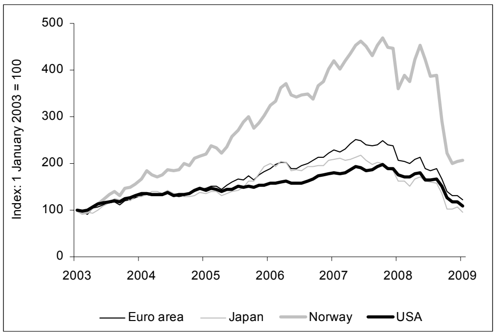


Source: Reuters Ecowin

Money and capital markets

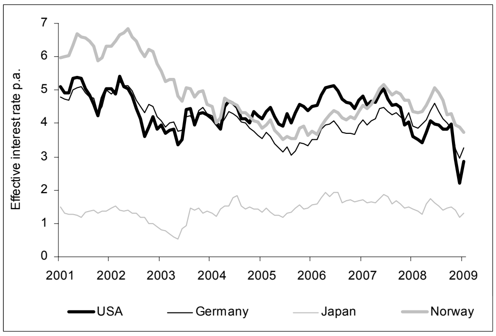
The turbulence which affected securities markets in 2007 increased further in 2008. The problems triggered by the crisis in the US market for subprime home mortgage loans escalated with the bankruptcy of Lehman Brothers on 15 September 2008. The ensuing crisis of confidence caused money markets to stop functioning (see Chapter 1 for a discussion of the financial crisis). Interest rates in the money market rose particularly sharply in the US and liquidity dried up. The Norwegian money market is dollar-based, and Norwegian interbank rates also rose substantially in autumn 2008. However, rates have fallen markedly since December.

2.5 Stock markets



Source: Reuters Ecowin

2.6 Interest rate on 10-year government bonds



Source: Reuters Ecowin

Stock markets, in Norway as elsewhere, have also been heavily affected by financial turbulence. Poor economic prospects have brought substantial downward adjustment of earnings estimates, hence also falling share prices. In 2008 the MS World Index and S&P 500 fell respectively by 40.1 and 38.5 per cent. Oslo Børs fared even worse, with the Benchmark Index tumbling 54.1 per cent. Of the sub-indices, energy and financials fell furthest. Stock markets failed to stabilise in the New Year. Between year-end and 20 February S&P 500 and the MS World Index fell 14.7 and 13.6 per cent respectively, while the Benchmark Index at Oslo Børs declined by 6.3 per cent. Along with falling commodity prices, non-resident divestment was an important contributor to developments on Oslo Børs in 2008. Non-resident investors' flight from various types of krone placements brought a 17.2 per cent weakening of the trade-weighted krone, and a weakening of 27.8 per cent and 22.6 per cent against the dollar and the euro. Long interest rates changed considerably towards the end of 2008 both in Norway and elsewhere, mainly as a result of government stimulus packages. For 2008 as a whole, the rate on US 10-year government bonds fell to 2.2 per cent by year-end while corresponding rates in the euro area and Norway declined to 2.9 and 3.9 per cent respectively. January saw rising government bond rates, particularly in the US, possibly because investors are expecting an increased offering of government bonds when the fiscal policy measures are to be financed. However, rates have fallen back somewhat in February.

Norway's real economy

The Norwegian economy passed its cyclical peak as early as end-2007, and growth slipped throughout 2008. The financial crisis and the negative trend in the international economy as from September intensified the downturn. Sharp increases in money market rates in autumn 2008 led to pessimism among firms and households, and during autumn a clear deterioration was seen in expectations indexes for firms and households alike. The housing market was hit first, but investment growth in mainland (non-oil) firms also came to a halt. Unemployment rose as from July 2008, and private consumption declined as from the second quarter, while registered unemployment rose from 1.5 per cent in summer 2008 to 2.6 per cent in January 2009. The national accounts showed that GDP for Mainland Norway declined in the fourth quarter of 2008. After the sharp slowdown towards the end of 2008, 2009 looks set to be the first year since the mid-1980s in which Mainland GDP will fall compared with the previous year. Monetary policy is Norway's first line of defence against the effects of the financial crisis, and in autumn 2008 Norges Bank lowered its key rate by a total of 2.75 percentage points to 3 per cent. By the start of 2009 the key rate had been further lowered, to 2.5 per cent. The government has concurrently presented an expansionary fiscal stimulus package along with a credit package worth NOK 100 billion to counteract the effects of the financial crisis. Even so the forecasts must be said to be uncertain, with risk on the downside.

Table 2.2 Forecasts for the Norwegian economy

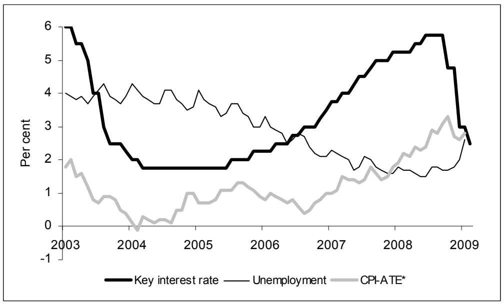
	Accounts	2009			2010	
	2008	Statistics Norway	Ministry of Finance	Norges Bank	Statistics Norway	Norges Bank
GDP	2,0	-1,7	-0,5	1,0	0,5	2,25
GDP mainland sector	2,4	-1,7	0,0	0,25	0,9	2,5
Inflation	3,8	1,4	2,0	3,0	1,0	2,75
Unemployment	2,6	3,7	3,5	3,75	4,7	4

Sources: Statistics Norway: Economic Survey 1/2009. Norges Bank: Monetary Policy Report 3/08 and Ministry of Finance; Proposition to the Storting No. 37 (2008-2009)

National accounts figures show that private consumption, investment and exports all contributed to the turnaround in GDP in 2008. The slowdown in private consumption was particularly marked, and consumption growth declined to 1.5 per cent in 2008 compared with 6.0 per cent in 2007. Sales of larger consumer goods such as cars and furniture were particularly affected, contributors being a normalised savings rate and higher interest expenditure. Falling house prices and rising unemployment will continue to have a negative impact on private consumption in 2009. During autumn 2008 notice was given of lay-offs and recruitment freezes in several sectors, including in major Norwegian industrial companies. In the building and construction trade unemployment has already risen considerably, while employees in retail trade, parts of the manufacturing industry and business services have hard times ahead in 2009. Between December 2008 and January 2009 unemployment rose by 0.5 percentage points to 2.6 per cent. This is still a low level, but the number of job vacancies has fallen considerably in most sectors and forecasts suggest a marked increase in unemployment in the period to 2010.

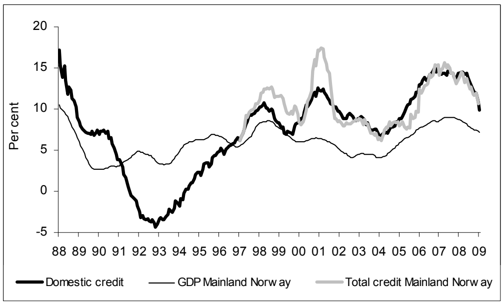
Several years of high investment growth were replaced by a downward trend in 2008. Investment activity was particularly weak in service industries. In manufacturing the trend was also negative, but showed somewhat larger fluctuations. During the autumn it became both costlier and more difficult to finance new projects, and a greater tendency was seen to attempt to shift loan refinancing from the bond market to the banks. Investment in mainland firms fell through 2008, particularly in the second half year. The combination of a deteriorating economic environment and tighter and costlier access to financing will bring a substantial fall in investment in 2009. Industries where leverage volumes are highest and investments generally largest, such as commercial real estate, appear vulnerable. The export industry is also heavily affected by the international economic turnaround, and exports of traditional goods fell sharply in the fourth quarter.

2.7 Unemployment, key interest rate and inflation



Source: Reuters Ecowin * Consumer price index adjusted for taxes and excluding energy

2.8 Growth in GDP and credit



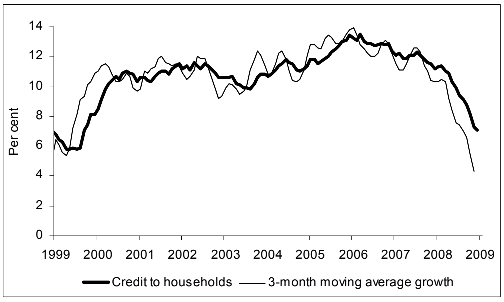
Source: Statistics Norway

Norwegian credit and real estate markets

A favourable economic climate, low interest rates and a positive trend in household and corporate finances have fuelled substantial demand for credit in Norway in recent years. Credit growth has far exceeded growth in nominal GDP, particularly in the period 2005-2007. Debt growth has been high among firms and households alike, and rising property prices and credit growth have been mutually reinforcing in the period. However, in the second half of 2008 lending growth subsided. Growth in credit to the non-financial private sector to the non-financial private sector from domestic sources (C2) receded through 2008 from an annual rate of 14.3 per cent at end-2007 to 9.9 per cent at end-2008. The decline became marked particularly towards the end of the year. Total annual growth in credit (C3) declined in 2008 to 11.3 per cent at end-November. The fall in credit growth is due to weaker demand for credit and some tightening on the part of the banks.

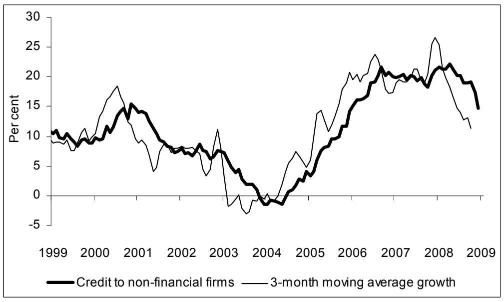
Households' overall credit growth fell during 2008, driven by higher borrowing rates and a steadily weaker housing market. By end-2008, the 12-month rate of growth was 7.1 per cent, the lowest since September 1999. Firms' overall credit growth remained on a generally very high level in 2008 but fell sharply towards year-end. At end-2008 the 12-month rate of corporate debt growth was 14.8 per cent. Lower debt growth is both a cause and consequence of developments in the real estate markets. The self-reinforcing processes that have stimulated house price and credit growth in the period of economic expansion can work in the same way in a downturn.

2.9 Growth in credit to households



Source: Statistics Norway

2.10 Growth in credit to firms

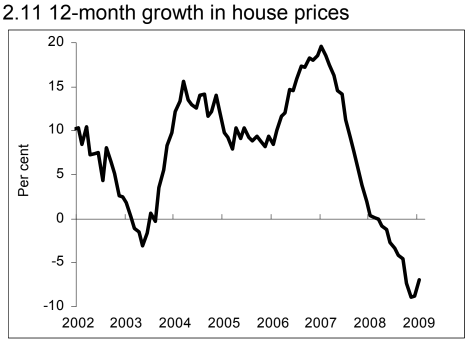


Source: Statistics Norway

The Norwegian housing market reached a turning point in 2007. Falling prices, lower turnover and an increasing supply of dwellings, combined with some tightening in banks' credit practice towards house-buyers, characterise the Norwegian housing market at the start of 2009. After a weak rise from December 2008 to January 2009, house prices in Norway were 6.9 per cent lower than in January 2008 and 10 per cent lower than in the peak month August 2007. On an annual basis, prices of detached dwellings fell by 4.2 per cent, prices of semi-detached dwellings by 8.6 per cent and prices of apartments by 7.4 per cent in January. Compared with the last trough year in the Norwegian house price cycle (1992), house prices are nonetheless 295 per cent higher. The real rise in prices in the period is 182 per cent. The decline in house prices shows that the Norwegian housing market is on the same trend as international housing markets. Statistics Norway expects house prices to fall by 12.1 per cent in 2009.

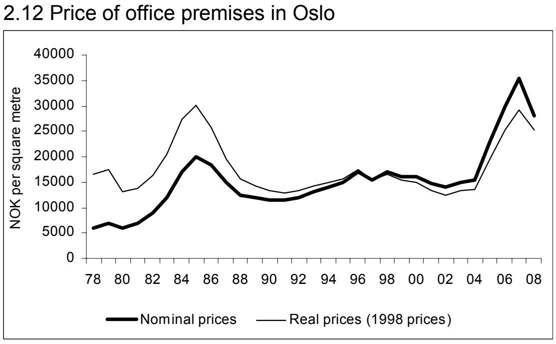
Concurrently the sale time of dwellings placed on the market rose substantially, to 62 days in January 2009, but there are large regional differences. In January 2009, 17,062 dwellings were registered for sale on the internet portal Finn.no, almost three times as many as in January 2006. From 2007 to 2008 housing investments fell by 9 per cent, and sales of new dwellings seem to have come to a complete halt in autumn 2008. Sales of existing dwellings have also fallen. According to Statistics Norway, 20 per cent fewer dwellings were sold on the open market in the fourth quarter of 2008 than in the same period of 2007. For recreational properties the fall was 22 per cent. The low sales volume renders house price statistics uncertain.

2.11 12-month growth in house prices



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

2.12 Price of office premises in Oslo



Source: OPAK

Increased risk aversion among investors and creditors also brought a change of sentiment in the market for commercial property in 2008. OPAK estimates the value of office premises in Oslo to have fallen by 20 per cent between January 2008 and January 2009, while the hurdle rate rose by 1.5 percentage points in the same period. Rental prices of office premises are also falling. The high turnover of commercial property in 2006 and 2007 came to a complete halt in 2008, when turnover almost halved compared with 2007. Low turnover volumes render estimates of the trend in real values very uncertain. Given rising unemployment and declining consumption, the stage is set for further falls in both rental prices and values of commercial property in 2009.

At the start of 2009 interest rates in the money market are down compared with the high levels seen in October and November 2008. However, financial markets are still marked by uncertainty, and both banks and non-financial firms are finding it difficult to obtain long term financing. Prospects for the international economy are gloomy, and the recession may be both deep and long-lasting. A large public sector puts the Norwegian economy in a better position to withstand the recession than most countries. Public finances provide policy space, and high activity levels in the petroleum sector provide stimuli to other areas of industry. However, parts of the manufacturing sector and export-oriented business will be hard hit. This suggests a two-track economy of significance for banks' credit risk.

3. Financial institutions

Financial institutions' position needs to be assessed in light of the trend in economic conditions and markets, discussed in Chapter 2. The present chapter starts by briefly describing the structure of the financial market, including the European and Nordic financial market. It then summarises results reported in 2008 by financial institutions: banks, finance companies and mortgage companies, life insurance companies, pension funds and non-life insurance companies. The results of investment firms and companies managing securities funds are also covered.

Financial market structure

The international financial crisis greatly affected financial market structure in 2008, as evidenced by increased consolidation and (part-) nationalisation in the banking sector. Structural changes in 2008 were particularly marked in the US. In March the investment bank Bear Stearns encountered difficulties and, with government help, was taken over by JP Morgan Chase. In September the mortgage banks Fanny Mae and Freddie Mac were taken over by the government, Lehman Brothers filed for bankruptcy, and Merrill Lynch was bought out by the Bank of America. The two remaining American investment banks, Morgan Stanley and Goldman Sachs, were converted to ordinary banks. Washington Mutual went to the wall and the bank's deposits, loans and branch network were taken over by JP Morgan Chase. In addition, the American insurer AIG was compelled to accept government help in the shape of guarantees and capital, Wells Fargo signed an agreement to take over Wachovia in October and Citigroup accepted government capital and guarantees in November. A number of smaller banks were also closed down by the authorities in 2008.

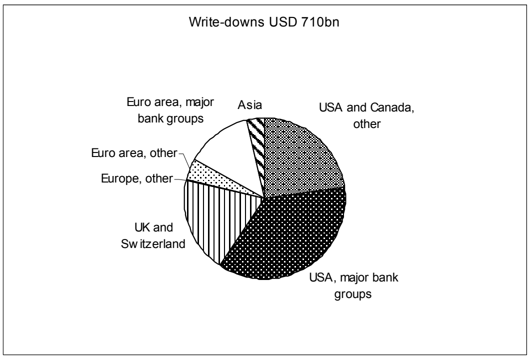
Fortis and the Royal Bank of Scotland are two of a number of major European financial institutions that were hit by the financial crisis in 2008. The previous year these two banks and Banco Santander acquired the Dutch ABN Amro, splitting the business between them. In October 2008 the Dutch portion of Fortis (and ABN Amro) were taken over by Dutch authorities. The Belgian state took over the remaining shares in Fortis, and then signed an agreement with BNP Paribas to purchase 75 per cent of Fortis' banking business in Luxembourg and Belgium, and Fortis' entire insurance business in Belgium. However, the general meeting of Fortis voted against the agreement, although there is still a possibility that it will go ahead.

The Royal Bank of Scotland was one of several major UK banks to receive government capital in 2008. By year-end the government's stake was 58 per cent, rising in January 2009 to 70 per cent. Northern Rock was taken over by the government in February 2008, and Bradford & Bingley was taken over in September. Banco Santander took over Bradford & Bingley's deposits and branch network. Earlier in 2008 Banco Santander had purchased Alliance & Leicester. Another major UK bank, HBOS, was taken over by the UK Lloyds TSB in September. In October the merged bank was supplied with government capital, and at year-end 43 per cent of the bank was in government hands.

In the Nordic countries most structural changes in the wake of the financial crisis have taken place in Denmark where 12 banks were taken over by other financial institutions or put into administration by the government. In Sweden, Carnegie Investment Bank was taken over by the government in November 2008. Financial sector structure in Finland and Norway was little affected by the financial crisis in 2008. The collapse the Icelandic banking segment is discussed in Chapter 1.

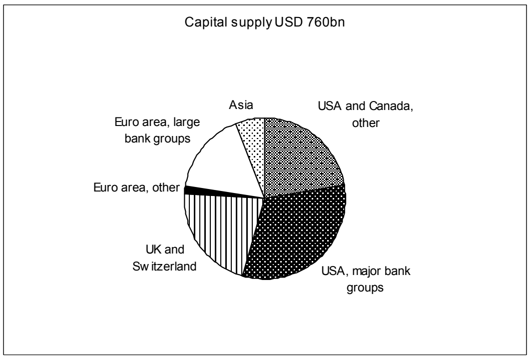
An important cause of structural change is large write-downs of financial assets at US and European banks, leading to poor results and a need for government capital or merger partners. The supply of private and government capital has more or less matched the write-downs made in the period from the second quarter of 2007 to November 2008.

3.1 Banks' write-downs by region



Source: ECB, Financial Stability Review, December 2008

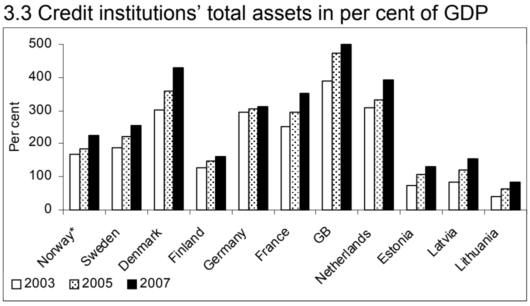
3.2 Capital supply to banks by region



Based on Bloomberg's and ECB's own estimates.

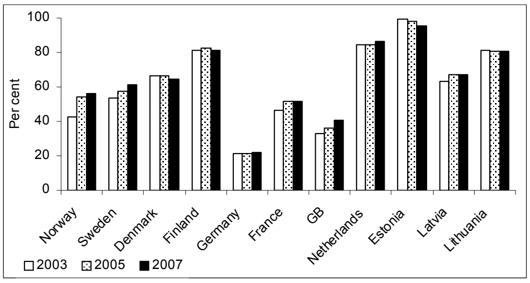
Over time credit institutions' total assets have risen at a faster rate than the wider economy in most European countries. Credit institutions' share of GDP is not particularly high in Norway, despite very strong credit expansion in recent years. This may be because Norwegian credit institutions lend relatively less to foreign entities and to the public sector than do their counterparts in other countries.

3.3 Credit institutions' total assets in per cent of GDP



Sources: ECB and Kredittilsynet *GDP Mainland Norway

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

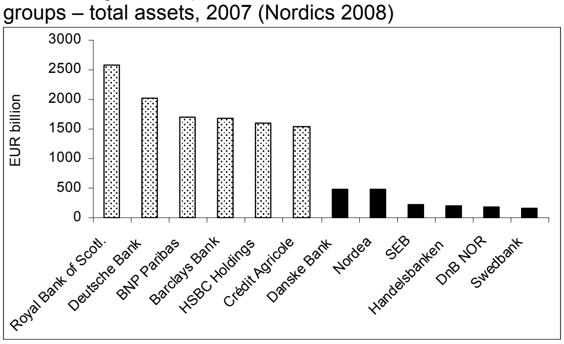


Sources: ECB and Kredittilsynet

Credit market concentration, measured by the five largest institutions' total assets in per cent of aggregate total assets, is highest in Estonia, the Netherlands and Finland and lowest in Germany. Structural changes in the wake of the financial crisis could alter this picture. The five largest credit institutions in Norway – DnB NOR Bank, Nordea Bank Norway, Fokus Bank, Handelsbanken and Sparebank 1 SR Bank – had a combined share of 59 per cent of the Norwegian credit market at the end of 2008. Three of the five largest institutions in Norway are foreign-owned.

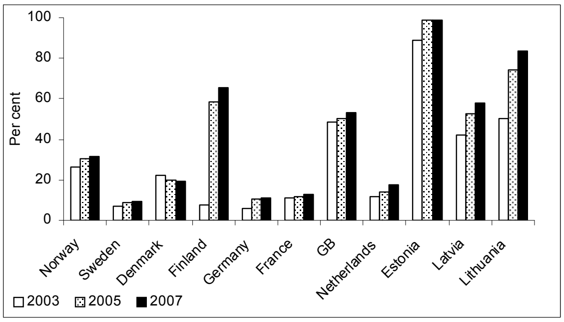
Like the European market, the Nordic market has seen establishments, mergers and acquisitions across national borders in recent years. In the Nordic region, both Nordea and Danske Bank have expanded primarily by acquiring banks in the domestic market. Despite acquisitions and expansion, the large Nordic financial conglomerates remain small by European standards. Foreign-owned financial institutions' market share in the Nordic countries is largest in Finland. This share grew substantially after the reorganisation of Nordea, and after Danske Bank's acquisition of Sampo Bank. Norway has also seen an increase in the foreign market share in recent years, and all the largest Nordic financial conglomerates have established operations in Norway. Up to October 2008 the largest Icelandic banks were also established in Norway. As of the third quarter 2008 the Icelandic banks Glitnir Bank and Kaupthing had a market share of 1 per cent. In December a consortium of 20 Sparebank 1 banks were authorised to acquire Glitnir Bank ASA, which has changed its name back to BNbank.

3.5 The largest European and Nordic financial groups – total assets, 2007 (Nordics 2008)



Sources: The Banker, 2008 and quart. reps (Nordic groups)

3.6 Foreign branches and subsidiaries in per cent of credit institutions' total assets



Sources: ECB and Kredittilsynet

The largest Nordic financial conglomerates have also established operations in Asia, the Baltics, Russia and elsewhere in Eastern Europe. Their expansion in the Baltic countries, where Swedbank and SEB in particular hold large market shares, has been substantial. Swedbank has acquired several banks in the region: Hansabank in 2005 and the Ukrainian OJSC Swedbank in 2007. DnB NOR is represented in the Baltic region through DnB NORD in which DnB NOR has a 51 per cent stake. At the start of 2008 DnB NORD was the third largest bank in Latvia. Danske Bank is established in the Baltic region through Sampo Bank. Danske Bank is also represented in Ireland through National Irish Bank and Northern Bank which were acquired in 2005. Loans to the Republic of Ireland and Northern Ireland accounted for about 7 per cent of the bank's total lending in 2008.

Table 3.1 Largest Nordic financial conglomerates' lending to customers in the Baltics as of end-2008

	Swed-bank	SEB	Nordea	Handels-banken	DnB NOR	Danske Bank
Lending to the Baltics	SEK 218bn	SEK 194bn	NOK 75bn	SEK 2bn	NOK 64bn	DKK 30bn
% of the bank's total lending to customers	16,9 %	15,0 %	2,9 %	0,1 %	3,5 %	1,7 %

Sources: Quarterly reports

Several structural changes were seen in the Norwegian financial market in 2008 in the banking area, among finance companies and mortgage companies, and in insurance. In the savings bank segment

Sparebanken Telemark merged with Sparebanken Grenland, while SpareBank 1 Buskerud-Vestfold was established through the merger of Sparebanken Vestfold and Sandsvær Sparebank. In January 2009 the Bank Law Commission presented NOU 2009:2 on capital and organisation in the savings bank segment, in which it recommends rules which, if adopted, will provide increased opportunities for structural change in the savings bank sector in the period ahead.

2008 saw the establishment of a number of mortgage companies licensed to issue preferential bonds: Sparebanken Vest Boligkreditt AS, Møre Boligkreditt AS, Sør Boligkreditt AS, SSB Boligkreditt AS, SSF Bustadkreditt AS and Pluss Boligkreditt AS. The Nordea-owned Norgeskreditt AS was also authorised to issue preferential bonds, at which point the company changed name to Nordea Eiendomskreditt AS. Øst Boligkreditt was established in February 2009. Terra Boligkreditt has signed a distribution agreement with OBOS (a cooperative building association) under the terms of which OBOS is to join the Terra Group as an owner. This gives OBOS access to the arrangement whereby preferential bonds can be “swapped” for government securities.

The newly started holding company Frende Holding AS established Frende Livsforsikring AS and Frende Skadeforsikring AS in 2008. Frende Holding AS is owned by 15 independent savings banks. DnB NOR established DnB NOR Skadeforsikring. In October Gjensidige Forsikring was authorised to increase its stake in Storebrand to 24.99 per cent upon Kaupthing’s divestment from Storebrand. As of 16 February Gjensidige’s stake in Storebrand was 24.33 per cent. The new Securities Trading Act came into force on 1 November 2007, and in 2008 38 entities were granted licences to operate as investment firms. Sixteen licences were revoked, in four cases due to structural changes. Three of the firms appealed against the revocation decision. Two of these appeals were turned down.

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 11 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 terms total assets. In the non-life insurance market the four largest companies (Gjensidige Forsikringsgruppen, If, Tryg Vesta and Sparebank 1 Skadeforsikring) hold a market share of 67 per cent in terms of total assets and 66 per cent in terms of gross premium revenues.

Table 3.2 Structure of the Norwegian financial market at end-2008. Per cent of total assets

	Banks	Finance	Mortgage	Life insurance	Non-life insurance
DnB NOR (incl. Nordlandsbanken)	39	31	20	30	0
Nordea Bank Norway	14	8	2	6	0
Sparebank 1 Group*	12	7	8	3	6
Storebrand	1	0	1	27	1
Terra-Group*	5	1	2	0	1
Total financial groups	70	47	36	66	9
Other companies**	30	53	64	34	91
Total	100	100	100	100	100
- of which foreign branches in Norway	19	19	5	1	34
- of which foreign subsidiaries	15	41	2	6	2

* Market shares include the owner banks. ** Other savings banks accounted for 9 per cent, and commercial banks (incl. branches of foreign banks) for 20 per cent, of other banks. Sources: Quarterly reports and Kredittilsynet

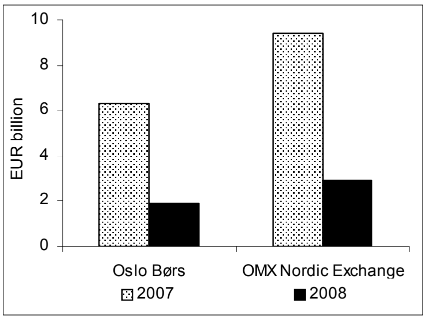
Securities market structure

Securities markets play an important role for financing and saving. The organised securities markets vary in size across the Nordic region. At the end of 2008 the market value of listed companies measured about 127 per cent of GDP in Sweden and 152 per cent in Finland compared with, respectively, just 94 and 90 per cent in Norway and Denmark. Since both regulated and unregulated markets for securities exist alongside the stock markets, figures published for stock exchange trading fail to capture overall developments in the securities markets

Recent years have seen increased cooperation between stock exchanges and a trend towards ownership consolidation. The NOREX alliance between the Nordic stock exchanges was established in 1998, and all stock exchanges in the Nordic and Baltic regions have joined the alliance. OMX, which owns the stock exchanges in Stockholm, Helsinki, Copenhagen, Reykjavik and the Baltic countries, was bought up by NASDAQ in February 2008. After rising for several years on the Nordic bourses, the market value of shares fell in 2008 as a result of the turbulence in financial markets.

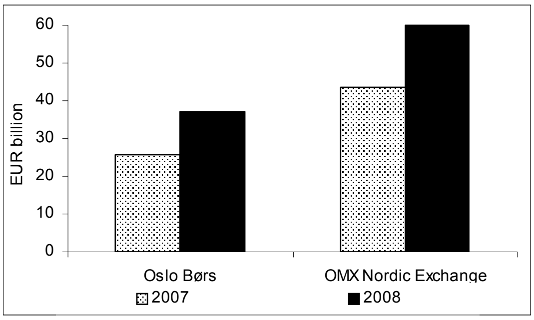
After some years of substantial issue activity, not least on Oslo Børs, 2008 proved a very weak year. Issues of fixed income securities rose, however, both on Oslo Børs and other Nordic bourses.

3.7 Shares issued on securities exchanges



Source: FESE

3.8 Issuance of listed fixed-income securities



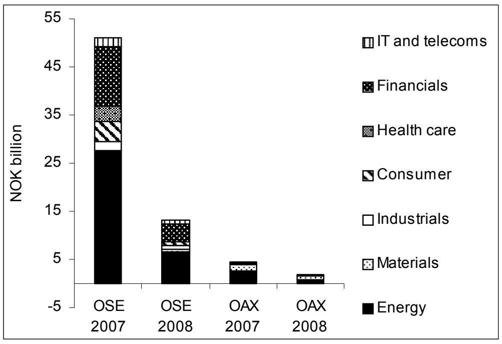
Source: FESE

Capital brought in by companies listed on Oslo Børs fell from NOK 51 billion in 2007 to NOK 13 billion in 2008, with the energy and financial sectors accounting for the steepest fall. Oslo Børs established the regulated marketplace Oslo Axess in May 2007 on which shares worth NOK 1.8 billion were issued in 2008 compared with NOK 4.4 billion in 2007. The market value of shares traded on Oslo Børs was halved in 2008 to NOK 997 billion, while the value of shares traded on Oslo Axess was reduced to NOK 7 billion.

The public sector owns a substantial portion of shares quoted on Oslo Børs, rising from 30 to 40 per cent in 2008. Non-residents' own 33 per cent, down 8 percentage points compare with 2007. Private investor ownership on Oslo Børs is small by Nordic standards.

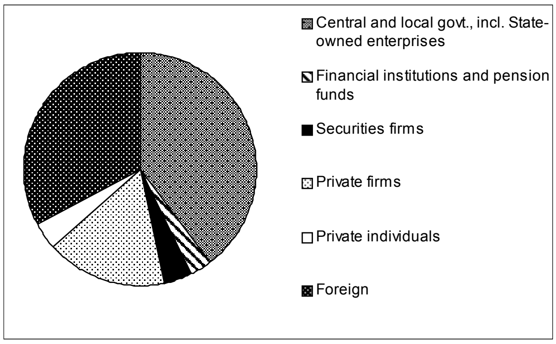
Compared with 2007 there was an increase in the issuance both of bonds and money market instruments quoted on Oslo Børs and Oslo Alternative Bond Market (ABM) in 2008. The increase on Oslo Børs relates to issuance of treasury bills and preferential bonds. Industrial firms brought in considerably less capital via the bond market in 2008, whereas financial institutions' bond issuance rose. Preferential bonds totalled NOK 24 billion on Oslo Børs, compared with NOK 7 billion on Oslo ABM at end-2008.

3.9 Share issues on Oslo Børs and Oslo Axess



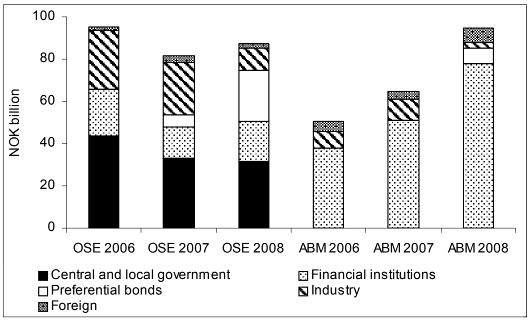
Source: Oslo Børs. Oslo Axess was establ. in May 2007

3.10 Share ownership, shares, Oslo Børs in 2008



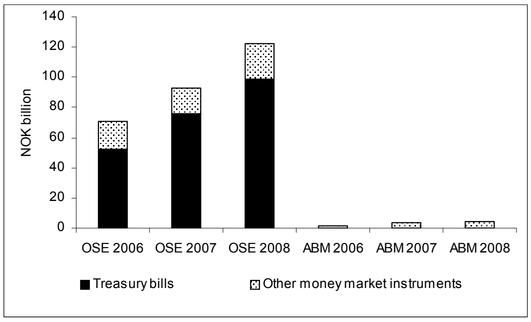
Sources: Oslo Børs and VPS

3.11 Bond issues



Source: Oslo Børs

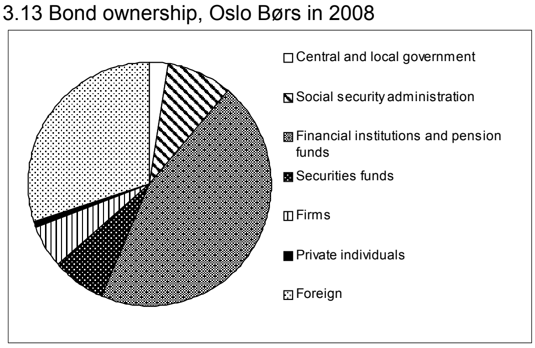
3.12 Issuance of money market instruments



Source: Oslo Børs

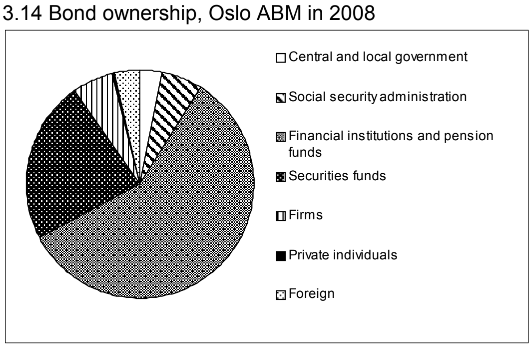
Financial institutions and non-resident investors owned the bulk of bonds quoted on Oslo Børs at the end of 2008. On Oslo ABM, financial institutions predominate, although securities funds have a substantial presence.

3.13 Bond ownership, Oslo Børs in 2008



Sources: Oslo Børs and VPS

3.14 Bond ownership, Oslo ABM in 2008



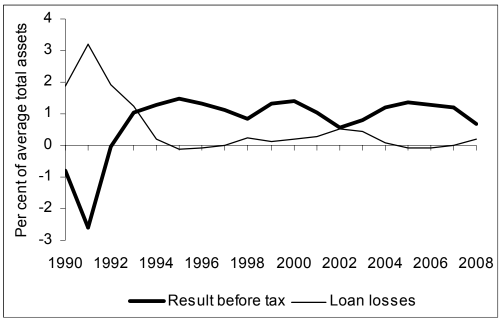
Sources: Oslo Børs and VPS

Financial institutions' results

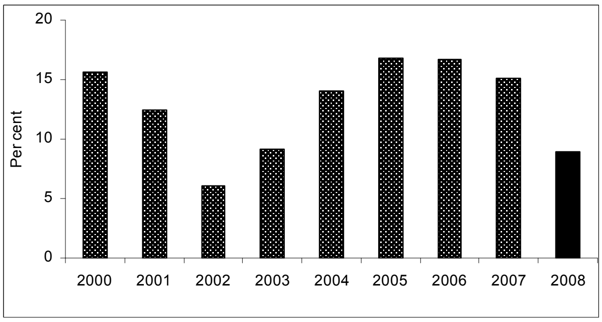
Banks

Banks recorded an overall pre-tax profit of NOK 19.8 billion in 2008, about NOK 8.8 billion less than in 2007. In terms of average total assets the result was 0.5 percentage points down at 0.7 per cent. Return on equity fell from 15 per cent to 9 per cent in the same period. A substantial increase in loan losses towards year-end was the main contributor to the poor results. At the same time the turbulence in financial markets brought capital losses on securities. Twenty banks ended the year with operating deficits, including three with total assets in excess of NOK 10 billion. Twenty-five of the 30 largest banks posted a net profit in 2008.

3.15 Loan losses and result of ordinary operations

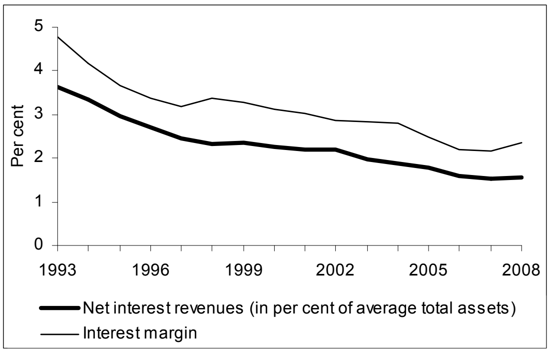


3.16 Return on equity after tax

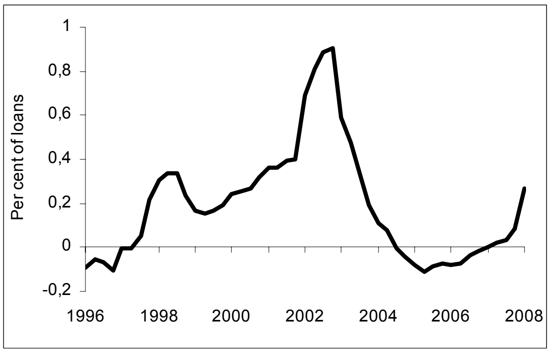


Net interest revenues are the most important revenue component for Norwegian banks, accounting for 80 per cent of total operating revenues in 2008. Net interest revenues showed an increase on 2007 both as a result of increased loan and deposit volumes and a slight improvement in interest margins. In terms of total assets there was an increase of just 0.04 percentage points to 1.57 per cent.

3.17 Net interest revenues and interest margin



3.18 Loan losses in per cent of gross loans



Banks' interest margins were at a historically low level despite rising slightly in 2008. Although financial market volatility in 2008 raised the price of banks' external funding, the effect on banks' net interest revenues was limited since only small portions of banks' borrowing were re-priced in the period. Norwegian banks are largely financed by customer deposits, which has been a particularly reasonable funding source after the large increase in risk premiums on banks' market funding. Given the intense competition for customer deposits and the high cost of refinancing bank and securities debt, funding costs are expected to rise ahead. In many banks, charge-free use of electronic services for loyalty programme customers has reduced other revenues. Norwegian banks' costs have been under pressure for some time on account of a tight labour market, good wage settlements and geographical expansion. Even so, costs in per cent of average total assets have edged down over time.

A steep generalised increase in risk premiums on bonds caused banks as a whole to make substantial write-downs on fixed income securities despite the fact that exposures to market risk are lower at Norwegian banks than at banks in many other countries. Some banks also recognise debt at fair value, producing capital gain when credit spreads increase. In October 2008 the Ministry of Finance issued regulations to implement changes in international accounting standards IAS 39 and IFRS 7. The regulations were prompted by changes made by the International Accounting Standards Board (IASB) in the rules governing accounting for financial instruments. The changes allow financial instruments in the trading portfolio to be reclassified to an amortised cost category (loans and receivables or held to maturity). The ability to reclassify does not apply to financial instruments recognised at fair value (fair value option). Institutions were able, but not required, to apply the new rules as from 1 July 2008. The ability to reclassify curbed price losses by about NOK 2.9 billion. Despite the low share component in Norwegian banks' balance sheets, the capital loss on shares came to about NOK 2 billion. Revenues from derivative and currency trading totalling NOK 7.6 billion pulled in the opposite direction.

Many years of low loan losses have brought good results for banks in recent years. In 2008, however, loan losses increased markedly, particularly towards year-end. Book losses for the full year were NOK 5.7 billion compared with virtually zero in 2007. In terms of gross lending, losses measured 0.3 per cent. A large part of the increase was due to write-downs on individual exposures. Losses were especially high in the fourth quarter, 0.7 per cent of gross loans, the highest level in a single quarter since the fourth quarter of 2002. Many banks also recorded substantial write-downs on groups of loans in the same quarter. In December 2008 Kredittilsynet issued a circular to all banks reminding them to thoroughly assess the need for write-downs in light of the economic climate.

The volume of non-performing loans rose by all of 70 per cent compared with the end of 2007. Non-performing loans in per cent of gross loans were still low at 0.8 per cent. At 1.2 per cent, the ratio of non-performing loans to gross loans was highest at the smallest banks, which saw a marked increase in non-performing business loans in the past year.

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. Norwegian finance companies overall reported a pre-tax profit of NOK 1.7 billion in 2008, a decline of NOK 0.1 billion on 2007. Return on equity was 13 per cent in 2008 compared with 16 per cent the previous year. Non-performing loans increased by 53 per cent and measured 3.1 per cent of gross loans at end-2008.

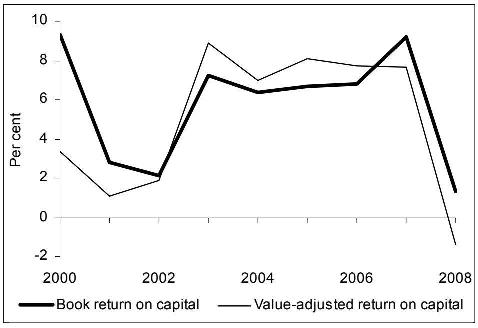
Mortgage companies mainly offer mortgage loans to finance commercial business and house purchases. Mortgage companies' pre-tax profit, excluding Eksportfinans, was NOK 2.5 billion in 2008, NOK 1.5 billion higher than in 2007. In terms of average total assets, the result showed an improvement of 0.2 percentage points. The positive result was largely a result of volume growth at residential mortgage companies due to loan portfolio transfers from banks.

Life insurance companies

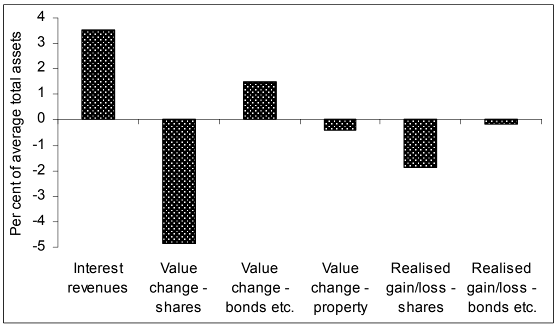
Business rules and accounting rules for insurance companies and pension funds were amended as from 1 January 2008, bringing major changes in the content and presentation of accounts. Since the new business rules complicate the work of restating previous years' accounts, insurers may not be required to prepare comparatives for 2007.

The equity market slump in 2008 contributed to life insurers' poor results. Both unrealised value falls and realised losses on shareholdings played a part. Whereas negative changes in the value of bonds were seen in the first three quarters, the interest rate fall in the fourth quarter brought an increase in bond values for the full year 2008. Higher interest revenues made a positive contribution. Overall, life insurers recorded a negative change of NOK 2.2 billion in real estate portfolios. Companies spent NOK 11 billions' worth of supplementary provisions on meeting the interest guarantee to customers, thereby ensuring that pre-tax profit fell no lower than NOK -2.7 billion. The value-adjusted result, which includes a NOK 17 billion reduction in fluctuation reserves, was NOK -20 billion. Apart from one small company, all life insurers reported a negative value-adjusted result for 2008. Value-adjusted return on capital on the collective portfolio, which shows return on financial assets, was a negative 1.4 per cent in 2008. Book return on capital was 1.3 per cent in the same period.

3.19 Return on capital



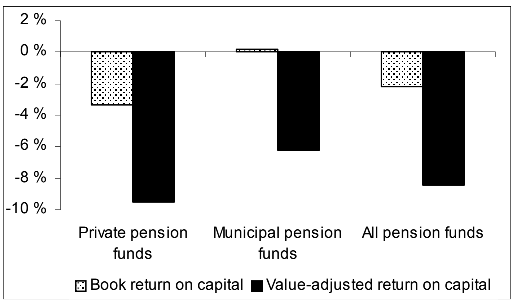
3.20 Net revenues on investments in the collective portfolio



Pension funds

Like life insurers, pension funds posted poor results in 2008 as a result of the equity market slump. A still relatively high equity component in their balance sheets meant that the value-adjusted return on capital was very weak in 2008. The largest private and municipal pension funds, which accounted for about 80 per cent of aggregate total assets, showed a negative value-adjusted return on capital of -8.5 per cent in 2008.

3.21 Return on capital at a selection of pension funds

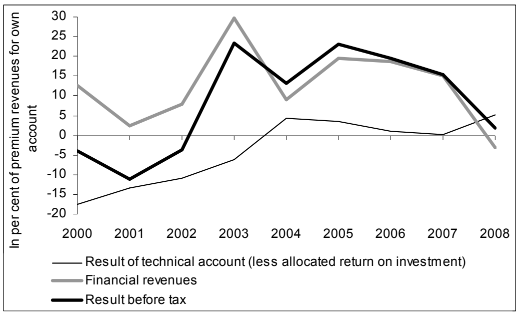


Although pension funds also have a minimum required annual rate of return, many of them have not divested equity holdings to the same extent as life insurers. Their equity component remained high throughout 2008, especially in the case of private pension funds. Hence value-adjusted return on capital was weaker at private pension funds than at their municipal counterparts, -9.6 per cent compared with -6.2 per cent. Book return on capital was -2.3 per cent for all pension funds combined in 2008.

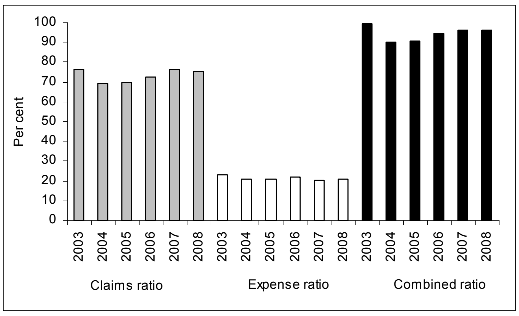
Non-life insurance companies

The market for non-life insurance is a composite market featuring a range of providers. The four largest non-life insurers (Norwegian and foreign) predominate with a market share of 66 per cent measured by gross premiums due.

3.22 Results in non-life insurance



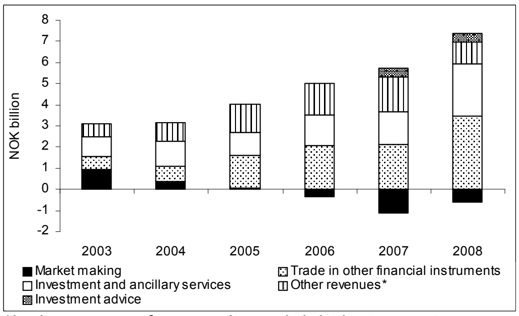
3.23 Claims ratio and expense ratio (combined ratio)



Non-life insurers recorded a profit of NOK 418 million on ordinary operations in 2008, compared with NOK 4.2 billion in 2007 (excluding captive companies). The decline is attributable to reduced net financial revenues. Greater recourse to contingency provisions bolstered technical results. The combined ratio (the ratio of claims and operating expenses as a percentage of premiums) was unchanged from 2007 at 96 per cent. Premium revenues rose by a mere 4 per cent compared with 2007 and a slight increase was also noted in claims payments and operating expenses compared with 2007. Eighteen of 40 non-life insurers reported a negative pre-tax profit in 2008.

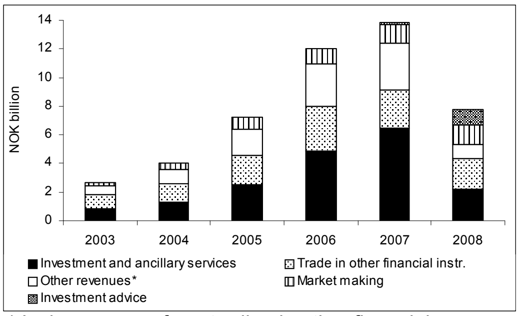
Investment firms

3.24 Operating revenues of investment firms (banks)



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

3.25 Operating revenues of investment firms (not banks)



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

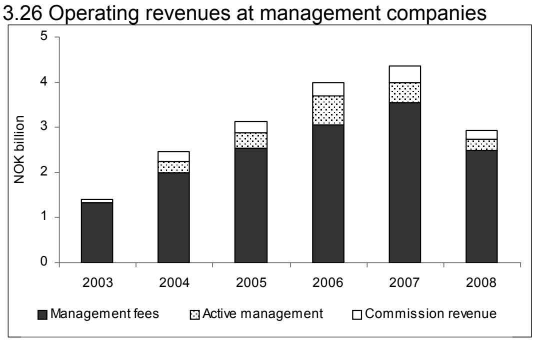
The number of licensed investment firms increased from 132 to 154 in 2008, of which 31 were banks. A distinction is drawn between investment firms that are banks offering investment services in connection with ordinary banking operations, and investment firms that are not banks. Banks' revenues from investment services largely derive from trading in debt and foreign-exchange instruments (both underlying and derivatives). Compared with 2007, revenues were up NOK 2 billion to NOK 7 billion, mainly as a result of changes to the accounting rules governing the right to reclassify financial instruments. Although not all banks availed themselves of this right, the rule change nonetheless impacted heavily on revenues from own-account trading performed as part of investment services activity / market-making.

Revenues of non-bank investment firms were reduced by NOK 6 billion to NOK 8 billion in the same period. Their principal revenue components are related to stock issuance and advisory 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 reduced by 79 per cent to NOK 1.3 billion compared with 2007. A weak trend in securities markets ahead will pose a challenge to the firms' earnings and financial position.

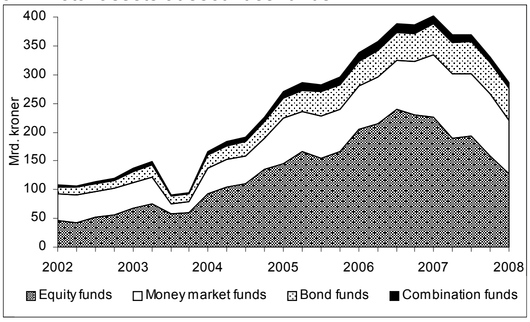
Management companies for securities funds

At the end of 2008 22 companies were licensed to manage securities funds, 11 of which were also licensed to provide active management services. Securities funds are collective investment schemes 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. The turbulence in financial markets brought poor results for management companies in 2008. At a mere NOK 0.7 billion, aggregate operating profit was less than half the figure for 2007. Capital under management in Norwegian-registered securities funds was reduced by NOK 115 billion to NOK 288 billion, with NOK 92 billion of the reduction attributable to depreciation of invested funds, while negative net subscription of mutual fund units (including reinvested dividends) came to NOK 23 billion. Capital under active management was almost halved to NOK 267 billion by the end of 2008. The substantial reduction was largely due to the transfer by a management company of its active management business to an investment firm within the same group.

3.26 Operating revenues at management companies



3.27 Total assets at securities funds

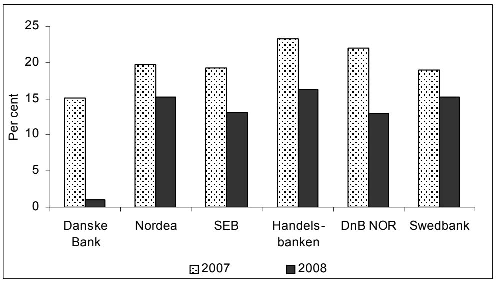


Profits and financial strength in the Nordic financial market

The results of the largest Nordic financial conglomerates were affected by the international financial crisis and the international economic slowdown in 2008. Loan losses increased, as did goodwill write-downs. Most of the conglomerates saw a substantial reduction in profits and thus also in return on capital. The largest Nordic banking conglomerates availed themselves of the opportunity to reclassify financial instruments in 2008, which in isolation curbed capital losses on securities.

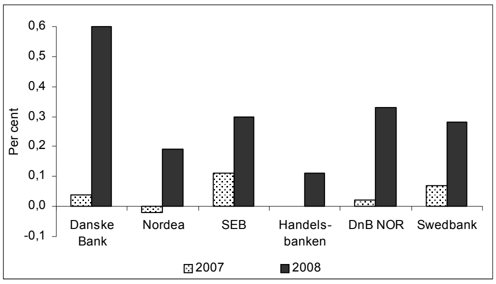
Danske Bank saw the largest profit reduction in 2008, for the most part attributable to a heavy increase in loan losses and write-down of goodwill for the Irish operation. Loan losses were heaviest in Ireland and Denmark, relating in particular to business loans and financial counterparties. Expenses on participation in the Danish government guarantee scheme for deposits and certain types of debt in Danish banks that was introduced in October 2008 also contributed to the profit decline.

3.28 Return on equity



Sources: Quarterly reports

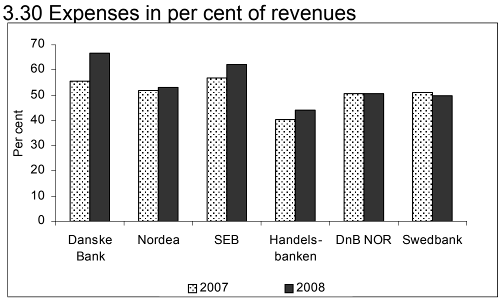
3.29 Loan losses



Sources: Quarterly reports

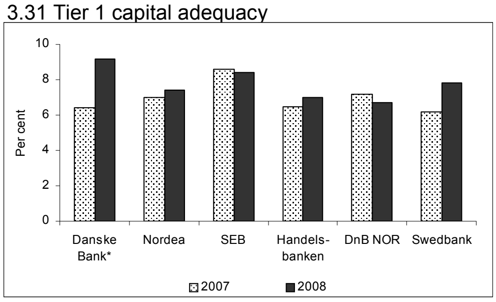
For Swedbank, loan losses in the Baltics accounted for more than half of the Group's total loan losses, in the first instance related to retail customers and property companies in Latvia and Estonia. Goodwill write-downs on the Ukraine operation also impaired profit. In November Swedbank and Swedbank Hypotek joined the Swedish guarantee programme. In the fourth quarter of 2008 Swedbank launched an issue, brought to completion in January 2009, which was designed to raise its tier 1 capital adequacy ratio. Substantial write-downs on loans to the Baltics and increased loan losses on other activities contributed to SEB's decline in profit. The group decided not to pay dividends for 2008, and plans a stock issue in 2009.

3.30 Expenses in per cent of revenues



Sources: Quarterly reports

3.31 Tier 1 capital adequacy



Sources: Quarterly reports
*Tier 1 capital adequacy 2007 – Basel I

Results in the DnB NOR Group were also lower than in 2007. Loan losses increased, with write-downs on DnB NORD's property portfolios in Denmark, Latvia and Lithuania being major contributors. The group's tier 1 capital adequacy weakened due to increased write-downs, volatility in financial markets and depreciation of the Norwegian currency. Nordea and Handelsbanken incurred lower loan losses than other Nordic conglomerates in 2008. A large portion of Nordea's loan losses were related to exposures in the Danish market. Nordea plans a stock issue in 2009 that will improve tier 1 capital adequacy. All the six largest Nordic financial conglomerates used internal models (IRB) to compute capital charges in 2008.

European banks' profits in general were impaired in 2008. Write-downs on financial assets and reductions in other revenues brought weaker results, although changes in accounting rules to permit reclassification of financial instruments curbed capital losses to some extent. Tier 1 capital adequacy is expected to increase in the second half of 2008 as a result of stock issues and infusions of government capital. Phasing out the floors under Basel II and trimming of balance sheets will also contribute. Reduced earnings and increased risk will bring the European banking sector's solidity under pressure in 2009.

4. Risk areas

The financial crisis and its consequences for the economic situation and markets and for financial institutions' profits in 2008 were discussed in Chapters 1, 2 and 3. The present chapter takes a closer look at various types of risk facing institutions. For banks, finance companies and mortgage companies, credit risk, liquidity risk and operational risk are of greatest significance. While Norwegian banks are little exposed to market risk, this type of risk is of greatest significance to insurance companies. Operational risk is an important concern for investment firms, although they too are exposed to credit risk.

Liquidity risk

The risk that an institution will be unable to honour its commitments as they fall due without incurring substantial additional costs relates to differences in the maturity structure of its assets and liabilities. Where banks' fund their lending activity and other illiquid assets largely by short-term borrowings, they need to refinance on a regular basis. Banks' access to funding in the market, and the price of such funding, depend in the first instance on their earnings and financial strength. Alongside customer deposits, important funding sources for banks are the money and securities markets.

Banks have had limited access to funding via the securities markets in the period of financial turbulence, and risk premiums paid by the banks have risen substantially. Even so, new loans were raised, but at high costs. International money and capital markets deteriorated after the collapse of the investment bank Lehman Brothers in mid-September 2008. The collapse of the international money market hit institutions in Norway as elsewhere. Stimulus packages were launched to normalise market conditions, and central banks increased the liquidity available to banks and eased borrowing terms. Several central banks cut their key rates to stimulate lower interest rates in the interbank markets. The spread between money market rates and the key policy rate has narrowed as a result of the government action, but remains far in excess of levels prior to the financial turbulence.

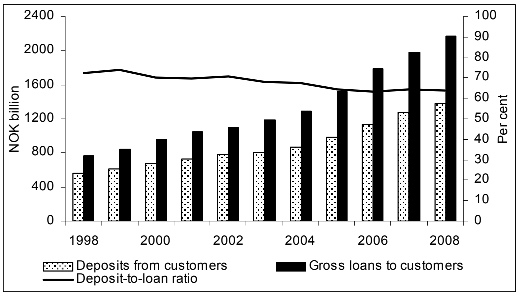
The Norwegian measures, launched in October 2008, improved Norwegian banks' access to long-term financing by enabling them to exchange preferential bonds for treasury bills. Banks have set up residential mortgage companies and transferred a large proportion of loans to them in order to avail themselves of the scheme. For many banks the task of qualifying loan portfolios for sale to their residential mortgage companies has posed a challenge. The government securities obtained by banks under the "swap scheme" have been in demand in the market.

Norges Bank issued long F-loans (fixed-rate loans) with maturities of two and three years geared to small and medium-size banks and banks that were not in a position to issue preferential bonds through a residential mortgage company. Concurrently the requirements on collateral for loans from Norges Bank were eased by removing the requirement of a minimum outstanding volume of NOK 300 million for securities issued in NOK. Norges Bank also supplied Norwegian banks with liquidity in the form of US dollars. The supply of dollars improved krone liquidity in the market through currency swaps.

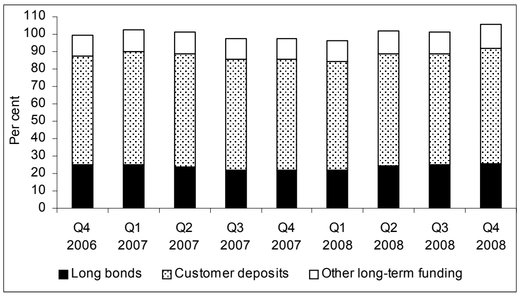
Norwegian banks' access to funding gradually improved in late 2008 and early 2009. However, new events are rapidly affecting the market situation. A profit warning from the Royal Bank of Scotland in January 2009 led once again to difficult markets and reduced maturities on offered funding. Markets remain nervous and uncertain.

Deposits from customers are an important source of finance for Norwegian banks. Growth in overall customer deposits was 10 per cent in 2008. Deposits from households rose by 10 per cent over the year. Foreign firms increased their deposits by 30 per cent, while domestic firms increased their deposits by a mere 3 per cent. The strong growth in foreign firms' deposits is partly related to the depreciation of the Norwegian currency in the second half year. The banking sector's overall deposit-to-loan ratio was 64 per cent at the end of 2008, a slight decline in the course of the year.

4.1 Deposits in per cent of gross loans to customers



4.2 Long term funding in per cent of illiquid assets

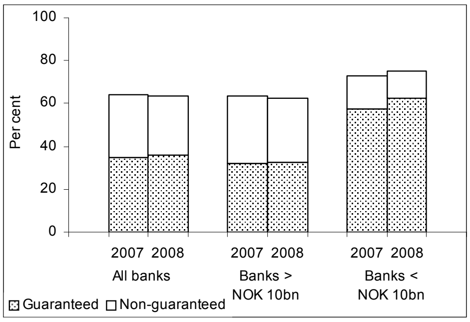


Banks' long-term funding (customer deposits, bonds with a maturity above one year, subordinated debt and equity capital) measured 97 per cent of their illiquid assets at end-2008. In the second half-year the proportion of long-term funding rose among large and small Norwegian-owned banks alike. Long-term funding is substantially lower at foreign banks' subsidiaries than at Norwegian-owned banks since the former receive substantial short-term funding through their respective groups.

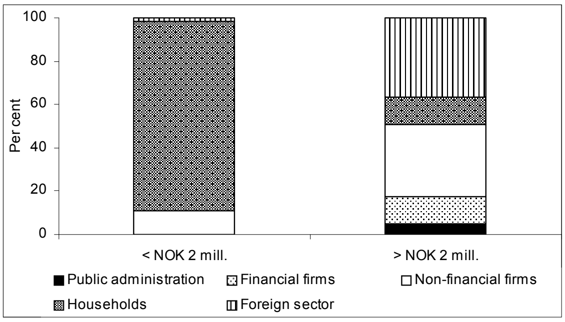
Although the bulk of customer deposits do not carry a lock-in period, they are nonetheless regarded as a stable source of finance, albeit less stable in the case of deposits not covered by the deposit guarantee scheme. The Norwegian deposit-guarantee scheme covers up to NOK 2 million per depositor, although not deposits from, among others, financial institutions. Small and medium-size banks have a substantially higher ratio of guaranteed deposits than large banks. At several small banks, deposits from the public administration account for a large proportion of the largest deposits. For banks as a whole, guaranteed deposits measured 56 per cent of aggregate deposits at the end of 2008. Of branches of foreign banks, Nordnet Bank, Fokus Bank, Swedbank and Skandiabanken are members of the Norwegian Banks' Guarantee Fund.

Deposits from households and firms made up the bulk of customer deposits at end-2008, at 50 and 40 per cent respectively. Households account for the bulk of deposits at the smallest banks. Of deposits below NOK 2 million, households accounted for 87 per cent, while deposits above NOK 2 million are mainly from firms. The proportion of deposits above NOK 20 million is highest at larger banks.

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

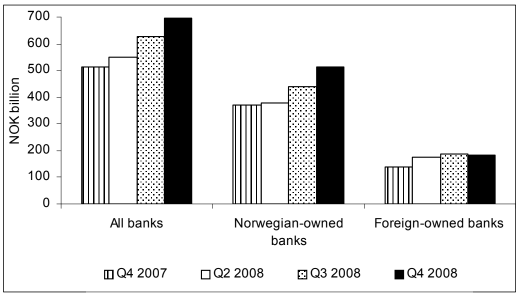


4.4 Deposits above/below NOK 2 million at all banks by sector, 31.12.2008

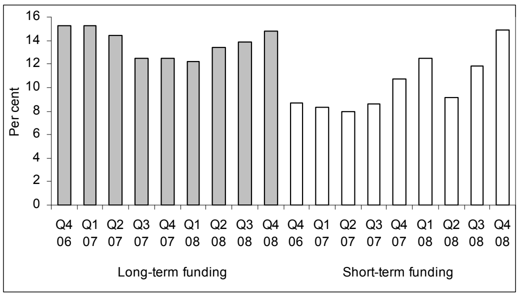


At the end of 2008 banks' net foreign debt totalled close to NOK 700 billion, an increase of about NOK 190 billion over the year. It is mainly the largest banks that have foreign debt. Earnings and financial position, along with rating and size, are crucial to both access to and the price of foreign funding. DnB NOR is an important source of credit for other Norwegian banks, and the bank's foreign funding is an indirect source of finance for them.

4.5 Foreign funding in NOK billion



4.6 Foreign funding as a share of illiquid assets at Norwegian banks



Kredittilsynet's follow-up of Norwegian banks' liquidity situation

Norwegian banks' liquidity situation posed challenges in 2008 as a result of growing uncertainty and reticence among both investors and the banks themselves. Kredittilsynet utilises liquidity indicators to assess banks' actual risk exposures. Despite sizeable market fluctuations, the liquidity indicators have shown that banks managed to exploit the opportunities available to obtain longer-term financing when replacing maturities. The banks were in some measure compelled to accept a higher price on new funding in order to limit liquidity risk. According to liquidity indicators for the 14 largest Norwegian-owned banks, the average level of long-term financing showed some decline in the third quarter, but rose again towards the end of 2008.

Norway's deposit guarantee scheme has made deposits a stable source of funding for the country's banks. Even so depositors redistributed deposits to secure protection from the scheme. Market turbulence and measures planned by government authorities in other countries, including as regards cover of deposits, sparked concern in Norwegian banks about competitive distortions and deposit flight. In order to monitor the trend in customer deposits, Kredittilsynet required 25 banks to report changes in deposits on a weekly basis starting in October 2008. The reporting showed customer deposits to have been relatively stable throughout the period.

Kredittilsynet conducted surveys of Norwegian banks' liquidity situation on several occasions in 2008. The banks reported their liquidity position and major liabilities maturing ahead. A survey conducted at the start of January 2009 showed that the liquidity situation was still regarded as challenging by most banks, although the government's stimulus packages had helped to reduce liquidity risk. The banks pointed out that the short-term market for liquidity showed some improvement towards end-2008, whereas long-term funding was still viewed as challenging and costly. Banks had deposited surplus liquidity in the central bank to a greater degree than previously. Many banks regarded their liquidity buffers as sufficient to meet, if necessary, payments due on loan capital maturing in a period ahead.

Residential mortgage companies

Banks have transferred home mortgage loans to residential mortgage companies in order to increase their long term funding and thereby reduce liquidity risk. By end-2008, residential mortgage companies had issued preferential bonds worth about NOK 210 billion, NOK 50 billion more than one year previously. Banks that pass loans to mortgage companies are still exposed to credit, pricing and liquidity risk. Only the parent-banks, and not the mortgage companies, can lend to customers. Loans are transferred to a residential mortgage company by agreement between the bank and the mortgage company. When contracting loans, a bank has no knowing what terms the mortgage company will obtain upon issuing bonds or whether the mortgage company will succeed in bringing in funds in the market as planned. Hence the bank carries risk related both to whether the loans can be transferred as planned and to what price the mortgage company achieves in the market. In other words, a bank could risk finding itself in an adverse liquidity situation. The mortgage company's ability to obtain new, sufficient loans when the bonds mature is also a liquidity risk. Moreover, moving large volumes of loans with a relatively low loan-to-value ratio out of a bank may affect its rating and funding terms. All in all, however, the issuance of preferential bonds has helped to curb banks' liquidity risk.

Money market funds

Money market funds are an important option for firms and private individuals investing in the short term, and many firms use money market funds as an alternative to bank deposits. Up to autumn 2008, moving large amounts of money in and out of these funds was a simple matter, and they were regarded as secure, irrespective of investment profile. Money market funds are an important source of finance for many small banks, and a substantial part of their investments are in bonds and money market instruments issued by small banks. A little over half of the funds offered are money market funds that have invested in highly secure paper with a risk weighting of 20 % or lower. These funds have short paper in their portfolio and are the most liquid. Money market funds in which securities with a 100 % risk weighting, such as industrial bonds and subordinated debt, figure prominently are significantly more exposed to liquidity shortages and the problem of correct pricing in the present market climate.

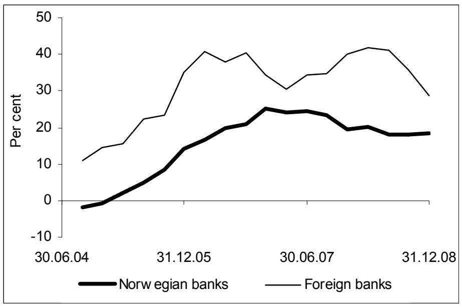
The worsening of the financial crisis in the autumn led to thinner liquidity in the bond and money market. Both at Kredittilsynet and in the trade itself, concern mounted that substantial redemptions in money market funds, and hence sales of large securities holdings, would become difficult. There was also a risk that upon redemption funds would sell their most liquid holdings and be left with the least transferable. The importance of fair and equal treatment of unit holders and lack of market making in securities in the market could compel suspension of redemption rights in some funds. In October 2008 Kredittilsynet conducted a survey of portfolio composition and unit holder structure in selected money market funds. Although the survey showed that the proportion of the least transferable securities had risen slightly in some funds, fund managers' handling of the situation and valuation of the funds were considered satisfactory. The Norwegian Mutual Fund Association has subsequently assisted managers in obtaining prices from the market and facilitated correct pricing of funds. The market for money market funds improved somewhat after Norges Bank in November 2008 allowed banks to use money market fund units as collateral for loans from the central bank.

Credit risk

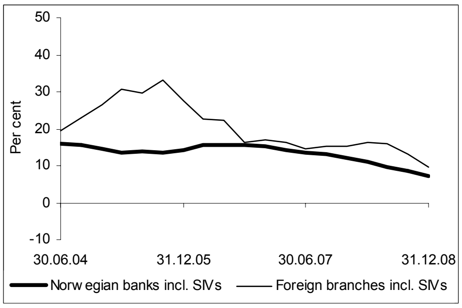
Credit risk includes both the likelihood of a counterparty being unable to honour its obligations and the loss the credit institution incurs in that event, account being taken of the value of any collateral held by the institution. Banks and mortgage companies account for the bulk of credit to the non-financial private sector (households and firms, but also including municipal administrations) from domestic sources in Norway. Lending by Norwegian banks has grown rapidly in recent years. The rate of growth slowed slightly in the second half of 2008, but was still 18 per cent (including loans transferred to residential mortgage companies) at the end of 2008. In 2007 bank lending to customers grew by 15 per cent. Some of the high growth in 2008 is attributable to the krone depreciation in the second half year whereby foreign currency loans rose upon conversion to Norwegian kroner. When Norwegian banks' loans to foreign firms are excluded, growth in lending came to 14 per cent in 2008.

Bank lending to domestic firms grew far more quickly than lending to retail customers, by 18 per cent compared with 7 per cent (incl. residential mortgage companies). Foreign branches have been very active in the Norwegian loan market in recent years, although growth in their lending also slowed somewhat in 2008. Branches increased their lending to retail customers by almost 10 per cent last year, while lending to firms grew as much as 29 per cent.

4.7 Growth in lending to firms



4.8 Growth in lending to retail customers



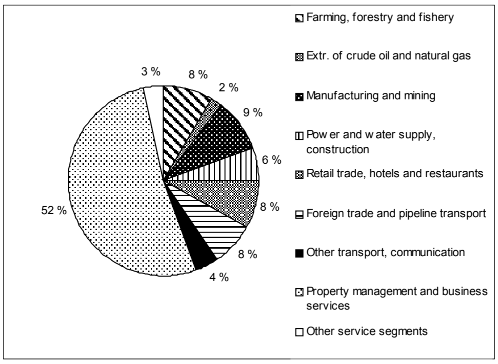
The banks are budgeting for lower lending growth in 2009, and the largest banks envisage growth of 4-7 per cent. The reduced growth in the second half of 2008 was due partly to demand, but also to reduced loan offerings as a result of higher risk and somewhat tighter lending practice. By far most of the 30 banks from which Kredittilsynet solicited information at the start of January 2009 would be in a position to continue normal lending activity based on their current solvency and liquidity situation. However, they had little capacity to grant credit to new large customers.

Corporate sector

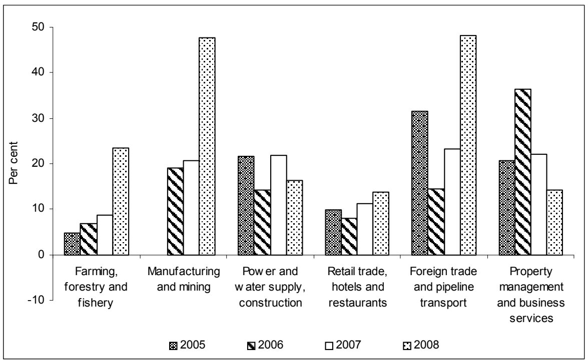
The corporate sector comprises large firms and small and medium size firms. Whereas large Norwegian firms also utilise international banks and to some extent securities markets, their small and medium size counterparts are dependent on credit from local and regional banks. Loans to corporates made up 39 per cent of Norwegian banks' total loan portfolio at the end of 2008. The share of loans to corporates is higher at larger banks than at smaller banks. Property management accounts for about 42 per cent of total lending to corporates by Norwegian banks, and the share has increased by almost 4 percentage points since the end of 2005. Loans to shipping make up a small share of the aggregate loan portfolio, but are concentrated on a few large banks.

Bank lending to corporates has risen substantially in recent years but slowed somewhat in autumn 2008. There was a particularly marked increase in lending to property management, shipping and manufacturing and mining due to several years of high capacity utilisation and investment activity. Loans to property management, including business services (of which 77 per cent are related to property management), rose by an annual average of 26 per cent in the period 2005-2007. Loans to shipping rose by an annual average of 23 per cent in the same period. In 2008 growth in lending to property management including business services fell to 14 per cent, while loans to shipping activity increased by as much as 48 per cent. The strong growth in lending to shipping activity is largely due to currency effects since most shipping loans are in US dollars.

4.9 Loans to firms by sector

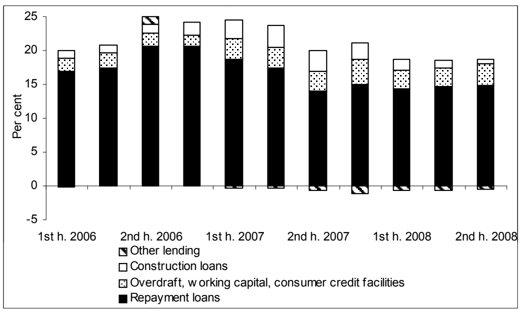


4.10 12-month growth in bank lending to various industries

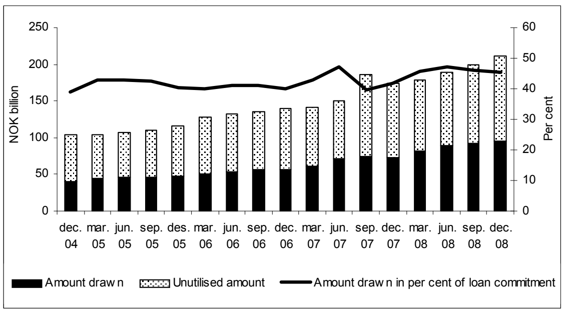


Repayment loans constitute the bulk of bank lending to corporates and were the biggest contributor to the persistent high growth in lending to corporates in 2008. Overdraft, working capital and consumer credit facilities together with building loans make up 17 per cent of banks' total lending to corporates. Both credit commitments and volume drawn rose in 2008, and utilisation of overdraft, working capital and consumer credit facilities was relatively stable.

4.11 Contr. to 12-month growth in bank lending to firms



4.12 Overdraft, working capital and consumer credit facilities



Substantial growth has been seen in Norwegian banks' lending to corporates abroad in recent years. Loans to foreign corporates accounted for 11 per cent of banks' total loans to corporates at end-2008, compared with 8 per cent at end-December 2007. The loans increased by an annual average of 30 per cent in the period 2006-2008. Loans to foreign corporates are provided primarily through Norwegian banks' branches abroad, and go mainly to corporates in the UK, Denmark, Germany and the US. Loans are provided not only via branches, but also through foreign subsidiaries. Of Norwegian banks, only DnB NOR has subsidiaries abroad, of which DnB NORD is the largest. Lending by DnB NORD accounted for about 3 per cent of the DnB NOR Group's total loans at end-2008, the largest portion of the bank's exposures being in Denmark and the Baltics.

Loans backed by securities

Since 1997 Kredittilsynet has conducted annual surveys of loans backed by financial instruments that are granted by banks with the greatest volume of such loans. In 2008 21 banks participated in the survey which distinguishes 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.

Table 4.1 Credits backed by financial instruments, 3rd qtr 2008

Actors	Commercial credits backed by financial instruments				Other loans backed by financial instruments				Total loans backed by financial instruments			
	NOKbn		In per cent of gross loans		NOKbn		In per cent of gross loans		NOKbn		In per cent of gross loans	
	Q3 07	Q3 08	Q3 07	Q3 08	Q3 07	Q3 08	Q3 07	Q3 08	Q3 07	Q3 08	Q3 07	Q3 08
3 most exposed banks	5.8	8.5	3.2%	5.4%	14.8	16.5	9.4%	9.2%	23.3	22.3	14.8%	12.4%
Total	21.9	26.5	1.2%	1.3%	38.3	35.2	2.1%	1.8%	60.2	61.7	3.4%	3.1%

The volume of loans backed by financial instruments, traditionally low in Norway, has risen somewhat in recent years despite a decline in loans to structured products and falling stock markets. There was little volume increase in 2008, and securities-backed loans have decreased as a share of total bank lending. Concurrently there have been clear signs of a shift from long maturities to maturities below one year. This trend is probably related to a general increase in demand for credit from the corporate market, which in the main seeks shorter-term securities loans, combined with a strong decrease in loans to structured products which come into the category "other loans".

Bank lending for investment in structured products fell from NOK 30 to 20 billion in 2008, and most of the surveyed banks no longer offer such loans.

Table 4.2 Credits backed by financial instruments – structured products, 3rd qtr 2008

Actors	Structured products					
	NOKbn		In per cent of loans backed by financial instruments		In per cent of gross loans	
	Q3 07	Q3 08	Q3 07	Q3 08	Q3 07	Q3 08
3 most exposed banks	14.6	11.1	62.6%	49.6%	9.3%	6.2%
Total	30.7	20.2	51.3%	32.8%	1.7%	1.0%

Banks' reporting period was to a greater degree than in previous years marked by fluctuating securities values. A substantial increase was reported in the number of cases of forced sale of collateral, 105 compared with five the previous year. There is reason to believe that the volume of sales resulting from loans in excess of collateral value is larger than the reported figure since investors often sell on their own initiative, or on a creditor's recommendation if additional collateral is unobtainable.

Survey of exposures to selected industries

Each year since 1998 Kredittilsynet has investigated banks' exposure to selected industries. The selected industries are in the main cyclically sensitive. The 2008 survey covered lending to shipping, the shipbuilding industry, offshore industry, fishing and whaling, fish farming, property management and construction. The nine largest banks in Norway were surveyed, and the analysis is based on the banks' own risk assessments and classifications. Classification is based partly on accounting data and is thus largely retrospective.

Table 4.3 Banks exposure to selected industries as of the 3rd quarter of 2008. Volume in billions of NOK

Industry	Loan commitments		Amount drawn		High risk in % of amount drawn		Exposure in per cent of own funds
	Volume Q3 08	Growth Q3 07-Q3.08	Volume Q3 08	Growth Q3 07-Q3 08	Q3 07	Q3 08	
Shipping	300	25%	292	33 %	1%	1%	192%
Shipbuilding	22	-9%	14	-3 %	7%	7%	14%
Offshore	34	42%	24	38 %	11%	7%	22%
Fishing, sealing, whaling	20	-9%	18	4 %	5%	3%	13%
Fish farming	17	18%	12	16 %	5%	3%	11%
Property management	306	10%	264	16 %	3%	4%	196%
- of which building loans	44		38			7%	28%
Building and construction	36	-6%	24	1 %	5%	7%	23%
Total	734	15%	649	22 %			

The banks' total commitments to the seven selected industries rose by 15 per cent compared with the same quarter of 2007. The volume drawn rose in the same period by 22 per cent, suggesting that corporate customers may have drawn on already existing credit lines to a greater degree than previously. In the case of most banks the largest industry in the portfolio was property management both in volume terms and as a share of own funds. Only the largest banks had exposures to shipping. The survey showed that, apart from construction and property management, all industries reduced the high-risk portion of their lending compared with 2007, and write-downs were small. Since the time of the survey, economic prospects in Norway as elsewhere have deteriorated markedly. The substantial challenges facing industries ahead will push up the high-risk portion of banks' lending and increase their impairment write-downs.

Thematic inspection of commercial property

In 2008 Kredittilsynet carried out a thematic inspection of financing of commercial properties at 11 commercial banks which accounted for about 66 per cent of loans by Norwegian banks to commercial property. The inspection programme was designed to ascertain the banks' exposure to various commercial property segments, as well as to throw light on their strategies and guidelines for financing commercial properties. Particular emphasis was given to changes made in strategies and lending practice in the past three years. In conjunction with the inspection programme, sensitivity analyses were made of the banks' property portfolios using Norges Bank's bankruptcy prediction model (Sebra).

This model estimates default probabilities based on macro scenarios giving changes in GDP, employment income, trend in the Norwegian krone exchange rate, borrowing rates and house prices. The share of high-risk loans varied between banks, but overall portfolio quality at the time of inspection was regarded as good. Hence strong growth in lending to commercial property does not appear to have affected portfolio quality to any appreciable extent. Projections made by Kredittilsynet with a basis in the Sebra model showed that the average default probability for loans to commercial properties in a likely future scenario would increase from 1.1 per cent in 2007 to 2.4 per cent in 2011. If a stress-test scenario for the macro economy up to 2011 is employed, average default probability would have increased to 3.8 per cent.

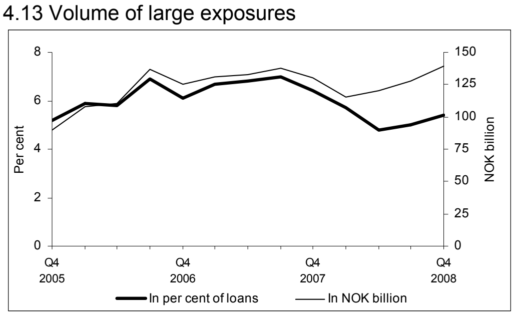
Most of the inspected banks had established strategies and guidelines for the commercial segment as a whole. Little had been done to prepare strategies and guidelines for the respective sub-segments. Several of the banks have drawn up such sub-strategies in the wake of the thematic inspection programme. A majority had to some extent liberalised their guidelines for financing commercial properties in the past three years. This was reflected in increased exposure limits, expansion of geographical market area, reduced requirements on equity ratios and adjustment of parameters to increase the valuations underlying loan disbursements. A review of individual exposures indicated frequent departure from strategies and guidelines. Departures included failure to comply with equity capital requirements, with cash flow requirements in relation to interest-bearing debt and with requirements regarding use of models to estimate property values. Only a minority of the banks had stress-tested their property portfolio.

Contact with the banks after completion of the inspection programme indicates that the banks have tightened their guidelines as a result of the financial crisis. They also appear to have tightened credit practice in such a way that departures from strategies and guidelines are less likely to be accepted.

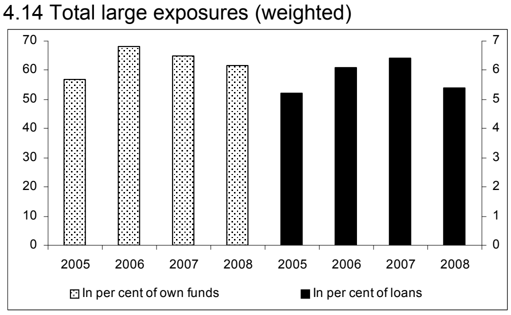
Large exposures

The rules governing large exposures are designed to reduce concentration risk in terms of single exposures. All Norwegian banks report large exposures to Kredittilsynet on a quarterly basis. A large exposure to a counter party is defined as an exposure having a value of 10 per cent or more of own funds prior to risk weighting. An institution may not have large exposures constituting more than 800 per cent of own funds or a single exposure constituting more than 25 per cent. At the end of 2008, 13 banks had large exposures which after weighting constituted more than 100 per cent of the bank's own funds. No banks were close to the maximum limit of 800 per cent of own funds.

4.13 Volume of large exposures



4.14 Total large exposures (weighted)

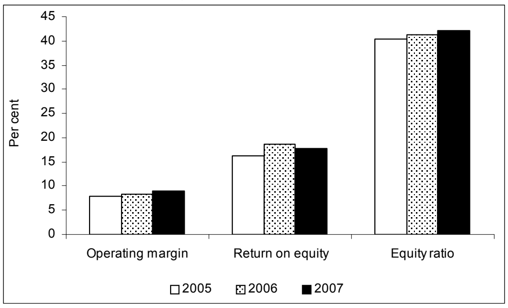


Mortgage companies and finance companies also report large exposures. Mortgage companies generally have an appreciably higher share of large exposures than banks, and at end-2008 seven mortgage companies had large exposures which after weighting totalled more than net own funds. Finance companies have less large exposures.

Financial vulnerability in the corporate sector

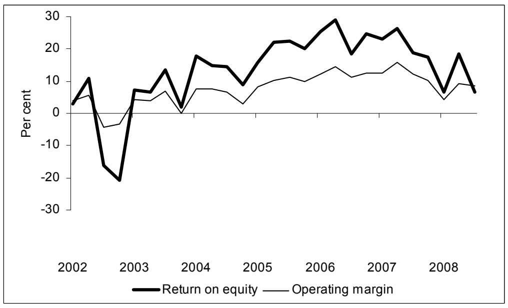
Norwegian business and industry have shown good results for several years, and financial statements showed that return on equity and operating margins were still high in 2007. The equity ratio was about 40 per cent and stable in 2007, despite high debt growth. A large element of retained earnings and high issue activity served to maintain a sound capital structure in 2007. The cyclical turnaround, together with rapid cost growth, brought weaker profits in 2008. Operating margins and return on equity at listed non-financial mainland firms was weaker overall in the first three quarters of 2008 than in the same period of 2007.

4.15 Operating margin, return on equity and equity ratio



Sources: Norges Bank and D&B

4.16 Key ratios for non-financial listed firms



Source: Statistics Norway

Corporate debt-servicing ability in most industries declined somewhat in 2007 as a result of quicker debt growth, higher funding costs and low growth in net sales earnings. Higher debt growth and weaker profits probably weakened debt-servicing ability in 2008.

In 2008 the number of bankruptcies rose for the first time since 2003. A total of 2,315 bankruptcies were registered excluding sole proprietorships and Norwegian-registered foreign firms, 42 per cent more than in 2007. The number of bankruptcies rose in all industries. The increase was greatest in construction and manufacturing. The number of bankruptcies rose in all counties apart from two.

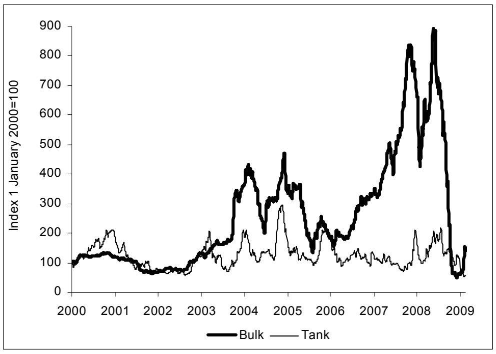
Prospects for the international economy are gloomy, and the recession may prove both deep and long-lasting. The Norwegian economy is better equipped than others to withstand a downturn by virtue of its large public sector and substantial government financial surpluses. Parts of manufacturing and export-oriented businesses will however be hard hit, and the trend seen in 2008 significantly worsened corporate prospects. The fall in oil and other commodity prices along with freight rates pushed down the earnings of the largest Norwegian companies. Concurrently falling equity markets and a sharp increase in risk premiums in the bond market made it far more difficult for large Norwegian firms to raise necessary capital. The situation is further exacerbated by tighter credit practice by international banks, and it is uncertain that Norwegian banks have sufficient capacity to take over as lenders. Moreover, many firms in the sheltered sector have found life harder due to falling domestic demand.

Overall risk in the corporate sector has risen. There are however differences between sectors, and construction and export-oriented business in particular should expect a weak trend ahead. Higher household saving and reduced consumption will dampen earnings for trade and commerce, and this may gradually feed through to commercial property. Despite a sharp slowdown, the stage remains set for growth in petroleum investments. So long as the oil price holds up, the situation therefore appears more favourable for the petroleum sector and firms that deliver to this sector.

Shipping and commercial property

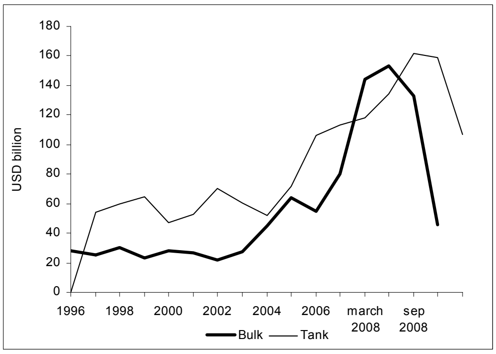
The two largest banks in Norway have large outstanding loans to shipping. 2008 was a turning point for the shipping industry after a five-year upturn. Strong growth in the global economy, including Asia, fuelled demand for tonnage, and capacity constraints at shipyards led to record-high freight rates and prices of new and second-hand ships. The rapid reversal in the international economy in autumn 2008 coincided with a strong increase in total tonnage in the market, contributing to lower freight rates and ship prices. The turning point was most pronounced in the dry bulk market, where freight rates both peaked and bottomed in the course of the year. However, the average for 2008 was a decline of 10-15 per cent compared with 2007. Future contracts for the first half of 2009 suggest higher freight rates in the period ahead. This may be short lived however since the forecasts point to a fall in international trade in 2009. Despite weak figures in the fourth quarter of 2008, tank market earnings were very good, mainly on the back of high activity for much of the year. Indeed the fall in tank rates was less marked than in the case of the bulk market. Lower oil prices at the start of 2009 will dampen earnings ahead in Norway, as elsewhere.

4.17 Freight rates for the tank and bulk segment



Source: Reuters EcoWin

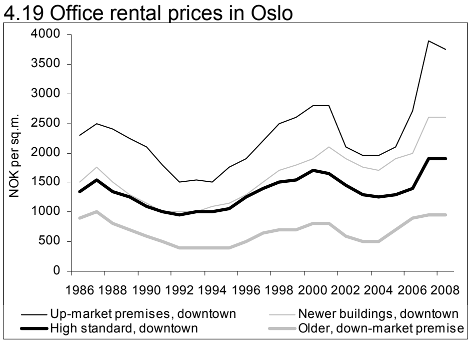
4.18 Value of tank and bulk ships in the second-hand market



Source: RS Platou

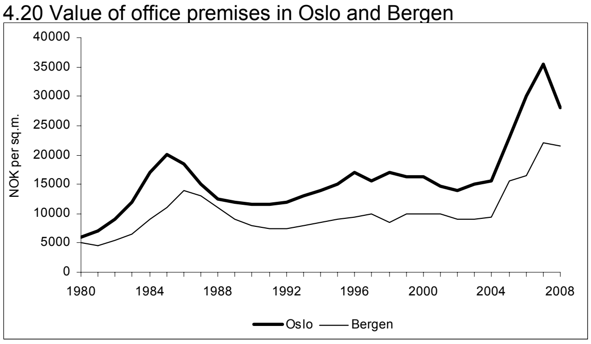
Commercial property accounts for the bulk of Norwegian banks' lending to corporates. Experience from previous bank crises, including in the Nordic countries at the start of the 1990s, has shown over-expansion and slump in the commercial property market to be a central element in the crisis build-up. After a long period of expansion and positive outlook, sentiment in the market for commercial property turned downwards in 2008. The negative economic climate brought uncertainty to the industry and lower rental prices and office values in the large towns. According to OPAK the market hurdle rate rose through 2008 to reach 6.75 per cent in November. Turnover in the market for office premises was very low, particularly in the second half of 2008. This may in part be due to more stringent loan terms, but also to high leverage on the part of many actors. Activity in the sublet market rose in 2008, possibly because a number of tenants have been compelled to reduce their business after the cyclical turnaround and are left with larger floorage than they need. It has previously been noted that increased activity in the sublet market brings falling rental prices and a negative trend in commercial property values. As a result of the low turnover, greater uncertainty attends commercial property values in 2008 although OPAK envisages a fall of 15-25 per cent depending on geographical location and standard. A further fall cannot be ruled out.

4.19 Office rental prices in Oslo



Sources: OPAK, Dagens Næringsliv

4.20 Value of office premises in Oslo and Bergen

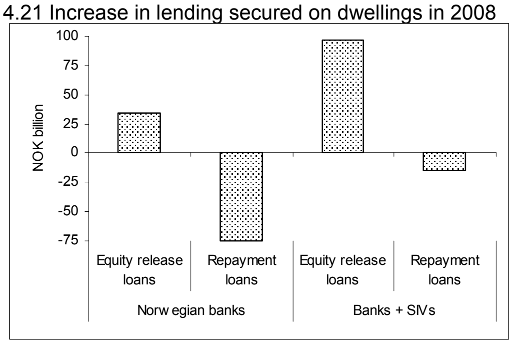


Source: OPAK

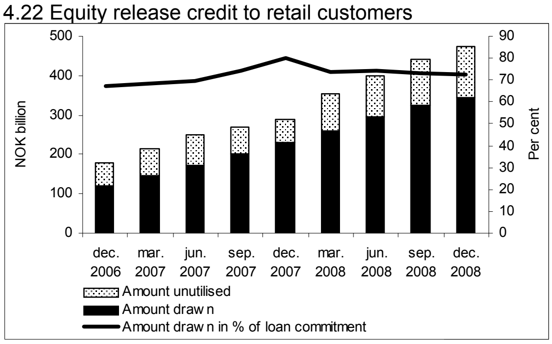
Household sector

Almost 95 per cent of banks' (including residential mortgage companies) loans to retail customers are secured on dwellings. Banks are increasingly offering loan products in the form of equity release loans secured on the borrower’s dwelling. Such loans have increased substantially in the past two years, and accounted for about 24 per cent of home mortgage loans at end-2008. While ordinary repayment loans were NOK 15 billion lower than at the end of 2007, equity release loans rose by NOK 97 billion. Drawings on equity release facilities in relation to the ceiling granted have been stable over time at just under 70 per cent.

4.21 Increase in lending secured on dwellings in 2008



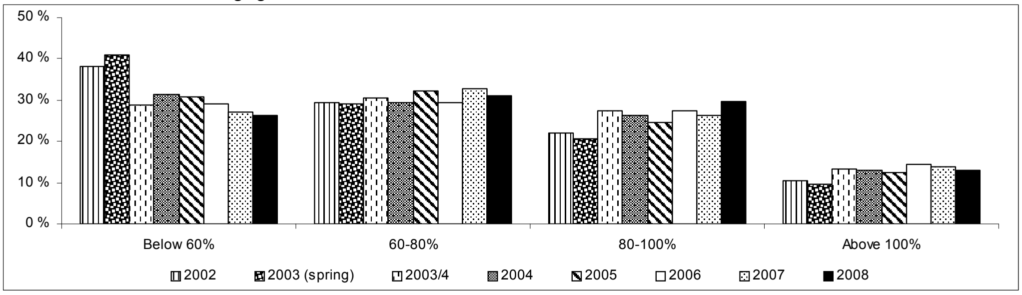
4.22 Equity release credit to retail customers



Home mortgage loans – repayment loans

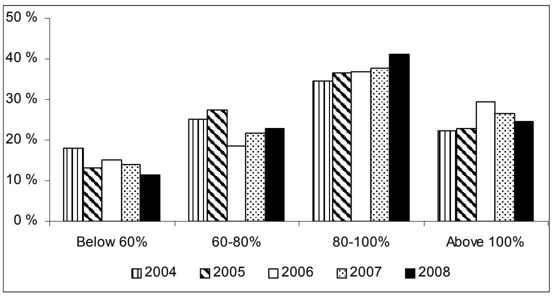
Since 1994 Kredittilsynet has examined banks’ practice in regard to loans secured on dwellings. The surveys have focused on a selection of banks covering about 85 per cent of the market for such loans. The present survey concerns a selection of new home loans granted before 15 September 2008, and any tightening of credit practice after that date will consequently not be captured. Almost 43 per cent of the loans entailed a loan-to-value ratio higher than 80 per cent of prudent valuation compared with 40 per cent in 2007. The proportion of loans in excess of prudent valuation was about the same as the previous year, at 13 per cent. More than half of the loans in excess of prudent property value lacked (sufficient) additional collateral to bring overall security into line with the loan amount. The proportion of loans in excess of overall security has risen by about 8 per cent in the space of two years.

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

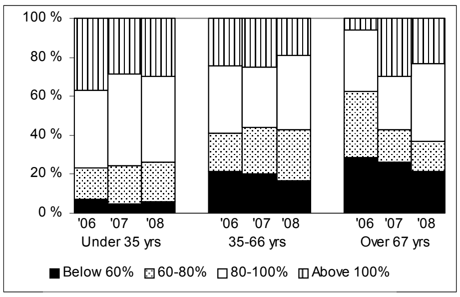


Of loans intended for purchase/building, 66 per cent had a loan-to-value ratio in excess of 80 per cent, about the same as the previous year. There was a slight reduction in loans in excess of house value, from 26 to 24 per cent. Of loans intended for house purchase, 74 per cent had a loan-to-value ratio in excess of 80 per cent among the youngest borrowers, down 2 per cent from 2007. For loans in excess of property value, there was a slight increase to 30 per cent. In the age group 35-66, the proportion of households borrowing 100 per cent (or more) of property value fell from 25 to 19 per cent.

4.24 Loan-to-value ratio – house purchase

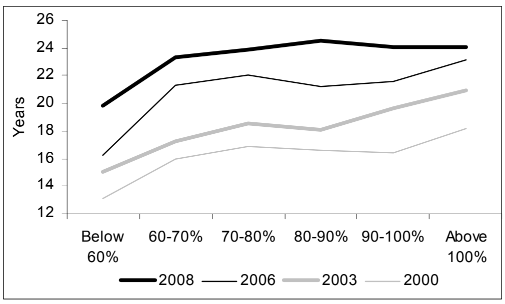


4.25 Loan-to-value ratio by age – house purchase

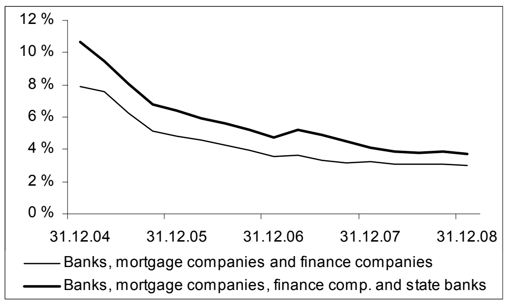


The average duration of home mortgage loans has lengthened considerably in recent years. Longer durations enable borrowers to take out larger loans. Opting for long loan duration reduces flexibility should the borrower's private finances become tighter. About one in six loans in the survey was interest-only compared with one in five the previous year. The trend should be viewed in connection with the strong growth in demand for equity release facilities. The average interest-only period was 3.9 years, somewhat lower than the previous year.

4.26 Loan period for various loan-to-value ratios



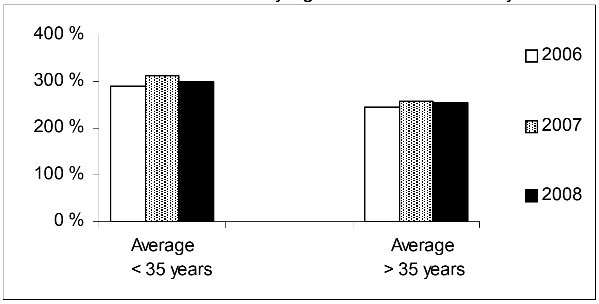
4.27 Share of loans with fixed interest above 1 year



The insurance element (against high interest rates) does not appear to motivate the demand for fixed-rate loans. Historically there has been very little demand for such loans except in periods where fixed-interest offerings have been below the floating interest rate. The survey showed that only 4.1 per cent of new loans carried fixed interest. Even so, this was the highest level of fixed-interest borrowing since in the survey in autumn 2003. Of aggregate loans granted by all banks, finance companies, mortgage companies and state lending institutions, 3.7 per cent had a lock-in period above one year. The low proportion of fixed-interest loans means that Norwegian borrowers' private finances are rapidly affected by changes in the market interest rate.

The average debt burden (total debt divided by gross annual income) was lower than one year earlier. The under-35s had an average debt burden of 301 per cent, 12 percentage points lower than in 2007. The over-35s' average debt burden was 4 percentage points lower at 255 per cent. Younger house-buyers' debt burden averaged 343 per cent.

4.28 Borrowers' debt burden by age – Home loan survey



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. Most banks use models to calculate borrowers' liquidity position after fixed expenses. Banks' 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 when assessing a borrower's debt-servicing ability.

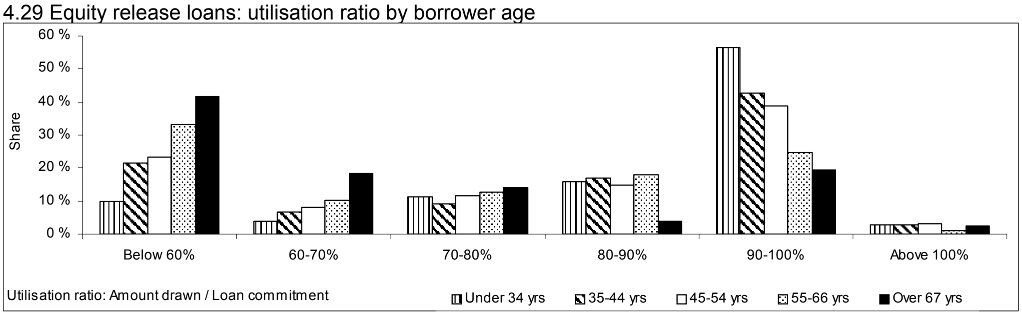
Home mortgage loans – equity release loans

In recent years banks have increasingly promoted equity release loans secured on a dwelling as an alternative to ordinary repayment loans. In light of the strong growth in equity release facilities, Kredittilsynet has in the past two years conducted separate surveys of banks' practice in regard to this product. Borrowers are able to draw on the facility as and when needed, and pay interest only on the amount drawn. One-third of repayment loans went to borrowers under 35 compared with 12 per cent of equity release loans. 82 per cent of equity release loans in the survey went to borrowers between 35 and 66 compared with 61 per cent of ordinary repayment loans.

Just over 47 per cent of loans (ceiling granted) were within a 60 per cent loan-to-value ratio, while 45 per cent were between a 60 and 80 per cent loan-to-value ratio. The proportion of loans with a high loan-to-value ratio was reduced from 12 to 7 per cent compared with 2007. Almost all banks in the survey allowed a higher loan-to-value ratio for repayment loans than for equity release loans. A majority allowed a loan-to-value ratio approaching 75-80 per cent of property valuation for equity release loans. Maximum loan-to-value ratios appeared to have been reduced in relation to one year previously.

A review of loans from the autumn 2007 survey showed that the utilisation ratio (amount drawn in per cent of ceiling granted) in the case of equity release loans established in autumn 2007 varied widely depending on borrower age. Younger borrowers single themselves out in that a high proportion had drawn more than 90 per cent of the ceiling granted.

4.29 Equity release loans: utilisation ratio by borrower age



Credit practice in relation to equity release loans

Internal guidelines for equity release facilities appeared to be the same as for ordinary repayment loans at a great majority of banks, except in regard to lower maximum loan-to-value ratios. Some banks had incorporated a higher safety margin against interest rate increases. 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. A majority of the 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.

Kredittilsynet contacted the Financial Services Association and the Savings Banks Association in 2008 to assess measures to ensure proper credit practice as regards granting and monitoring equity release loans. As a result of this initiative the Financial Services Association issued a circular to its members. The circular lists factors to which member banks are recommended to give emphasis in the ongoing assessment of the creditworthiness of applicants for equity release loans, including the need to monitor borrowers’ financial position and to provide good information to borrowers. The Savings Banks Association addressed similar issues in a circular to its members, but without making explicit recommendations. This Association considers it has a firm basis for the conclusion that savings banks have a proper credit practice when it comes to equity release loans. Kredittilsynet’s supervisory effort will follow up both credit risk and liquidity risk in relation to equity release loans.

Banks’ information to borrowers

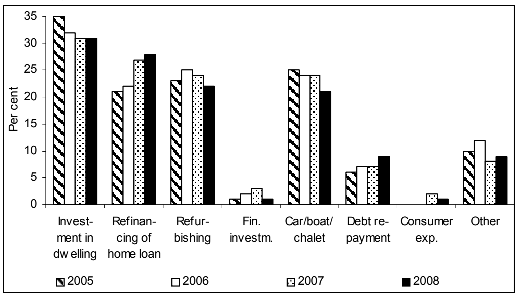
Since 2004 TNS Gallup has on behalf of Kredittilsynet conducted a survey among banks’ home-loan borrowers. In 2008 the survey addressed both recipients of equity release loans and repayment loans. The respondents are the same as those included in the home loan survey and the survey of equity release loans secured on dwellings. 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. After the first survey in 2004 Kredittilsynet dialogued with the trade associations on ways to enhance the information flow between bank and borrower. In a joint circular the banks’ trade associations asked their members to supplement their mandatory information with information designed to ensure that borrowers are informed of important aspects of taking out a loan, such as the risk of, and the consequences of, future interest rate increases. New standardised texts were also prepared for inclusion in loan documents.
In both surveys 86 per cent of borrowers reported having been informed of the effective interest rate and 54 per cent of the consequences of defaulting on a loan. 84 per cent of those who had taken out a repayment loan had been informed that the interest rate could rise from the current level, while 64 per

cent had been informed of the consequences that interest rate increases could have for their personal finances. This was a considerable improvement over 2007. In the survey of equity release loans the figures were somewhat lower. Just over 70 per cent of respondents in both surveys replied that they were satisfied with the scope and clarity of the information given by the bank. Even so, both surveys showed that there is still room for improvement in the flow of information between bank and borrower.

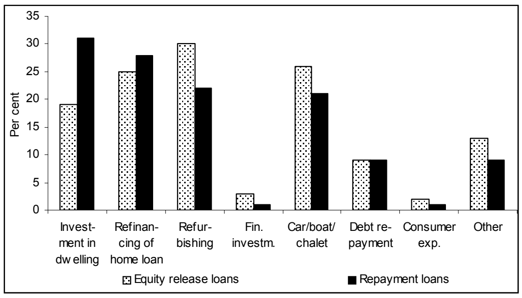
Loan purposes

As a part of Kredittilsynet's survey of banks' information to borrowers, respondents are questioned on the purpose of their borrowing. Respondents were free to report a number of purposes for each loan.

4.30 Repayment loans secured on dwellings, unweigthed distribution



4.31 Equity release and repayment loans by purpose



30 per cent of respondents in the survey of repayment loans stated that the purpose of the loan was to invest in a dwelling, including purchase and/or construction of one’s own house. Refinancing a home mortgage loan was the next most reported purpose, having risen gradually since 2005. There was a decline in the share reporting that the loan was to go to home refurbishment or purchase of a car, boat or recreational property compared with 2007. Equity release loans are used to a greater degree for home refurbishment and purchase of a car, boat or recreational property. Only a small proportion of home mortgage loans are spent on financial investments or repayments on other debt.

Consumer loans

A substantial share of loans for consumption, in particularly for purchase of consumer durables, is probably secured on dwellings. In addition, both banks and finance companies offer pure consumer loans which are generally unsecured and entail high credit risk. 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. These companies 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 depends on loan size, and repayment periods vary widely. In 2008 the sample comprised 15 companies, six of them finance companies engaged mainly in the provision of consumer loans. Lending by these companies accounted for 27 per cent of finance companies’ total loans to retail customers. The selection also includes nine banks as well as entities within banks and finance companies.

The volume of pure consumer loans in Norway is small, but increased by 17 per cent in 2008. There was a clear increase in losses and defaults, particularly in the last quarter of 2008. The level of book losses and loan defaults related to consumer loans was higher than for banks and finance companies in general. The result of ordinary operations, in per cent of average total assets, weakened somewhat in 2008, while net interest and results are still above the average for banks and finance companies.

Table 4.4 Trend in consumer loans in selected companies

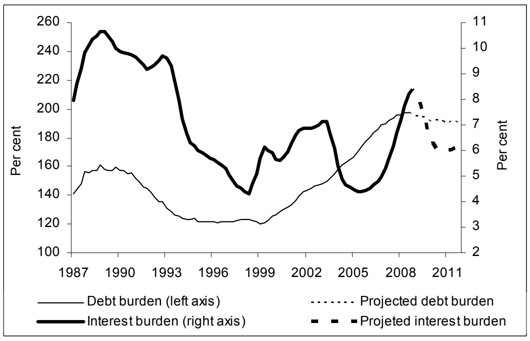
	2003	2004	2005	2006	2007	2008
Consumer loans (NOKm)	20 816	22 823	26 276	31 057	36 925	43 122
Growth in % (12-month)*	7.4	9.6	15.1	18.2	18.9	16.8
Book losses (NOKm)	574	398	382	253	339	903
Losses in % of consumers loans	2.8	1.7	1.5	0.8	0.9	2.1
Net interest in % of ATA	10.1	12.0	11.6	11.2	9.8	8.8
Ordinary oprerating profit in % of ATA	4.9	7.7	7.6	7.6	5.5	3.2
Loan defaults, gross (NOKm)	1 758	1 552	1 471	1 532	1 823	2 867
Gross defaults in % of consumer loans	8.4	6.8	5.5	4.9	5.0	6.6

*The growth rate in 2003 and 2004 was affected by one company's lending reduction in this period.

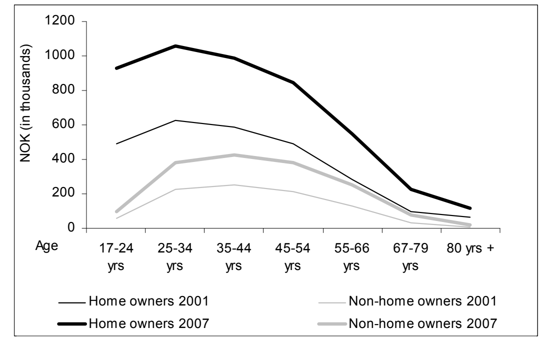
Financial vulnerability in the household sector

Gross household indebtedness has risen steeply 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 quicker rate than incomes, spurring a sharp increase in the debt burden. Growth has subsided since mid-2007, from a high level. According to figures from Norges Bank, household debt at the end of 2008 measured close to 200 per cent 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 3/2008 which envisages a key rate of just over 4 per cent at the end of 2011. According to the calculations, the debt burden is expected to edge down in the same period, ending 2011 at 190 per cent. However, the reference path for the key rate was revised down in December 2008 due to negative impulses from the international financial crisis to the Norwegian economy, and the interest burden is expected to decline more strongly than the debt burden.

4.32 Households' debt and interest burden



4.33 Average debt by age



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

Source: Statistics Norway

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 over NOK 1 million in 2007, whereas the figure for non-homeowners in the same age group was just under NOK 400,000. Debt growth in the period 2001-2007 was almost 70 per cent for both groups.

Households' interest burden

Since autumn 2003, on commission from Kredittilsynet, Statistics Norway has provided model projections of households' debt and interest burden. The model starts out from volume figures for 2006 taken from the tax assessment statistics. The assumptions underlying the projections are based on historical data as of the third quarter 2008, where available, while the forecasts for wage growth and bank lending rates are taken from Economic Survey (Statistics Norway, December 2008). The tax programme in the model comprises 2008 and 2009 rules. Credit growth is expected to decrease to 6 per cent in 2009, based on a lending rate of 5.3 per cent. 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 after-tax income). Based on the distribution of debt, income and wealth in 2006, the model projects the number of households falling within each of the three groups up to 2009, as well as each group’s share of total household debt.

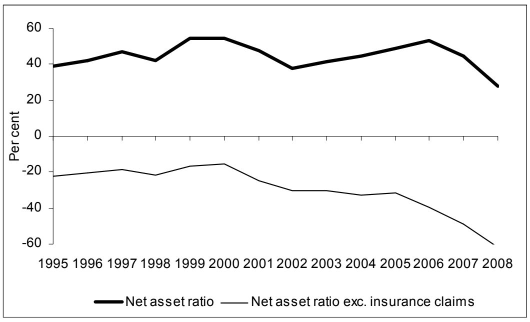
Table 4.5 Number of households and share of total debt by interest burden

	2008		2009	
Interest burden:	Number (thousands)	% of total debt	Number (thousands)	% of total debt
0.1 – 19.9 %	1 340	50	1 520	66
20 – 30 %	261	25	164	19
Over 30 %	158	23	77	13

Sources: Statistics Norway and Kredittilsynet

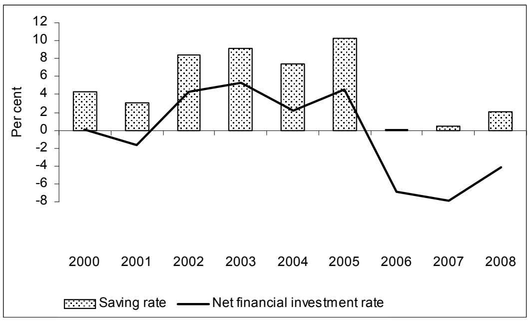
The steep interest rate fall as from 2002 led to a substantial fall in the household interest burden. The interest rate increase starting in summer 2005, combined with rapid credit growth, reversed this trend. In 2008 420,000 households have to spend more than 20 per cent of their income on interest payments. This is four and a half times as many households as in 2005. Since October 2008 Norges Bank has lowered its key rate by 2.75 percentage points, prompting a reduction in bank lending rates. Hence the interest rate posited in the estimates for 2009 may appear on the high side. The estimates none the less show that the number of households with the highest interest burden will fall sharply, as will the share of total debt of the group with the highest interest burden. The interest rate reductions have thus contributed to a significant dampening of households’ financial vulnerability in 2009.

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



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

4.35 Households saving rate and net financial investments in per cent of disposable income



Source: Statistics Norway

Households with a liquid financial buffer will be better placed to tackle any lapse of income or increase in expenditure. Households’ net assets were substantially reduced in 2008, mainly as a result of negative net financial investments and losses in securities markets. At end-2008 households' net assets made up just under 30 per cent of their disposable income (net asset ratio), down from about 50 per cent the previous year. About a third of households' financial wealth is tied up in illiquid insurance technical reserves. If these investments are excluded, the household net asset ratio is negative.

At the same point, bank saving accounted for around 30 per cent of households' assets, while household saving in the stock market was relatively low. The equity component fell from 10 to 6 per cent from 2007 to 2008, mainly due to the negative trend in securities values through 2008. Increased stock market uncertainty is likely to increase the portion of household wealth placed in bank deposits ahead.

After standing at a high level since 2002, the household saving rate fell from 10.3 per cent in 2005 to 0.4 per cent in 2007, and household consumption rose more than disposable income through 2006 and 2007. The household saving rate in 2008 was 2.1 per cent. The increase is attributable to moderate growth in consumption and higher employment income, among other factors.

In recent years the trend in the household sector has been marked by a growing debt burden, little repayment of debt and high loan-to-value ratios. These factors have increased the sector's vulnerability in the event of an economic setback. However, Norges Bank's substantial interest rate cuts will reduce households' debt problems, check the decline in house prices and dampen vulnerability in the short term. At the same time unemployment rose considerably from December 2008 to January 2009, and projections point to a further increase in the years immediately ahead. Higher unemployment means that more households could find it difficult to service their debt even if interest rates remain low.

Counterparty risk in investment firms

In addition to the credit risk facing banks, there is credit risk facing investment firms that trade on their own account or on customers' account in the financial market. Here credit risk refers to the possibility that the counterparty will be unable to honour it's commitments in the normal trade settlement process and to whether the value of collateral the counterparty has made available for settlement at a future point is adequate. Where customer account trading on credit and in derivatives not conducted through a clearing house is concerned, firms are responsible for ensuring that the counterparty at all times provides adequate collateral against unrealised losses.

Some investment firms' practice as regards securing access to adequate collateral has in some cases not been satisfactory. Decline in several markets has caused collateral in the form of securities, property or other assets to fall in value at the same time as some customers have incurred heavy losses on underlying financial positions. As a result several investment firms have incurred losses due to customers being unable to settle their accounts or because failure to provide security has led to forced sale of the customer's holding leaving the firm with an uncovered loss. Forced sales of large holdings may have exacerbated the decline in an already burdened market. Some of the market's larger actors are customers of several investment firms, making it difficult for firms to gain an overview of the actor's true assets.

In October and November 2008, Kredittilsynet examined investment firms' trading in equity derivatives, and there were reports of some heavy losses, albeit not on a scale liable to threaten the individual firm's equity capital position. Kredittilsynet will repeat this type of investigation in 2009.

Market risk

Market risk is the risk of loss as a result of changes in the 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 since loans make up the bulk of their balance sheets. About 1 per cent of the banks' aggregate total assets comprised shares, while bonds accounted for 9 per cent at end-2008. Despite low securities components, the turbulence on financial markets contributed to substantial losses on shares and interest-bearing securities in 2008. Increased credit spreads on both international and Norwegian corporate bonds brought net losses on fixed-income securities, in the main unrealised losses. The ability to reclassify financial instruments limited some of the banks' capital losses. It was mainly the largest banks that availed themselves of the opportunity to reclassify.

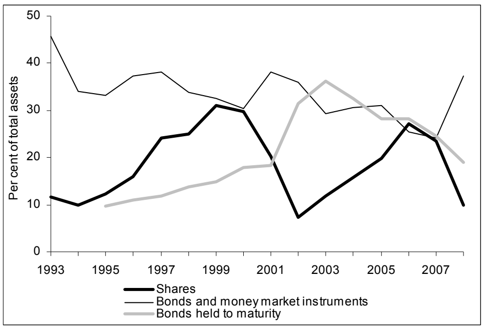
Banks calculate capital charges for market risk. The risk-weighted assets for market risk include foreign exchange risk, commodity risk and position risk for debt and equity instruments and constituted 2.4 per cent of the total risk-weighted assets at the larger banks and a mere 0.2 per cent at medium size and small banks.

Life insurance companies

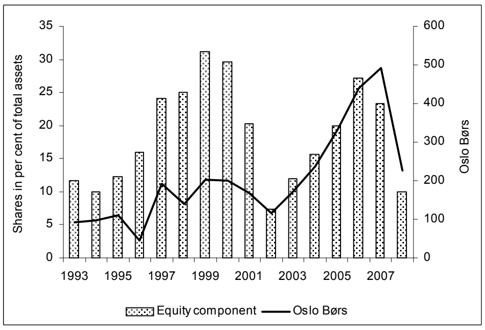
Life insurance companies are particularly exposed to market risk through large holdings of shares and fixed income securities. The extent of market risk depends on the size and composition of the securities portfolio, fluctuation in prices and market liquidity. The stock market slump in 2008 led to poor results at life insurers.

Shareholdings as a proportion of life insurance companies' total assets rose in the period from the trough in 2002 to the end of the first half of 2007. Shareholdings were again reduced in the second half of 2007, and were very low at the end of 2008. Shares made up 10 per cent of the collective portfolio at end-2008, and when life insurers' hedging instruments are taken into account, the figure was even lower. The companies adjusted their portfolio risk on a gradual basis. Equity components were reduced both as a result of divestment and value falls. Low equity components rendered the companies less vulnerable to further decline in equity markets but reduced opportunities to build up new reserves. Clear co-variation was seen between the equity component in life insurers' balance sheets and the trend in Norwegian share values, with companies divesting when markets have fallen and not buying when markets recover.

4.36 Shares and fixed income securities



4.37 Equity component and Norwegian share prices



Funds freed up as a result of divestment were largely placed in fixed income securities. Money market instruments and bonds recognised at fair value made up 37 per cent of the collective portfolio at end-2008 while bonds held to maturity made up 19 per cent. An increased share of interest-bearing securities renders the companies more vulnerable to interest rate movements. An interest rate fall increases the value of the portfolio of interest-bearing securities, in the short term compensating for lower return. Bonds held to maturity are not affected by the interest rate fall since they are recognised at cost price. Over time, redemption and reinvestment of these bonds will lead to gradually lower return at low interest rates. About 30 per cent of the held-to-maturity portfolio has a residual term below three years. Interest rates in Norway, as elsewhere, have plummeted as a result of the financial crisis, and interest rates are expected to remain low for several years ahead. Low return on fixed-income securities therefore poses a challenge in relation to the guaranteed annual return.

Buildings and real property as a share of the balance sheet have been stable for a long period but have increased somewhat in the last two years on account of written-up property values and higher investments. Property constituted 13 per cent of total assets at end-2008 compared with 10 per cent at end-2006. In a period of great uncertainty about the development of the real economy, commercial property values could come to be of major significance for life insurers' results. However, the short-term effects of a fall in property prices on results are uncertain. Kredittilsynet surveyed companies' property valuation practice in 2008, finding wide variation in the methods used to determine cash flows from one company to the next. Some reported that it was unclear how fair property values should be determined in a low turnover situation providing little basis for market prices. The regulations on insurance companies' annual accounts set substantial requirements in regard to information given in the notes on valuation of investment properties, including information both on the methods and the assumptions used to determine the fair value of investment properties. In addition to risk related to shares, property and interest rates, companies are also exposed to private equity risk as well as counterparty and spread risk.

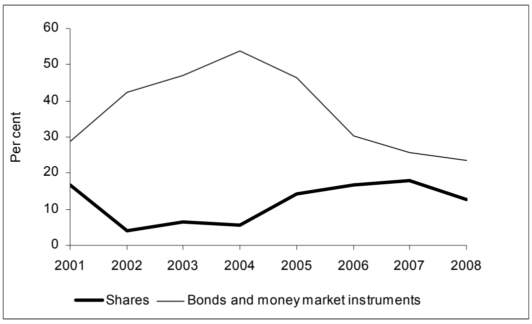
Pension funds

Pension funds reduced their equity component by a smaller margin than life insurance companies in 2008, and at year-end shares made up 30 per cent of the balance sheet of private pension funds and 21 per cent at municipal pension funds. A still high equity component meant that results were poorer at pension funds than at life insurers. The proportion of foreign-issued shares was 56 per cent at private and 31 per cent at municipal pension funds. Bonds and other securities also figured prominently in the balance sheet, 52 per cent at private pension funds and 34 per cent at municipal pension funds at end-2008. Hence the interest rate level ahead will be of major significance to pension funds' results.

Non-life insurance companies

Norwegian non-life insurers (excluding captive companies) had an equity component of 13 per cent at end-2008, down 5 percentage points compared with one year previously. Bonds and money market instruments made up 24 per cent of total assets, down 2 percentage points. Non-life insurers have invested to a larger degree in held-to-maturity bonds, which rose from 14 to 21 per cent in 2008. Although exposure to market risk is lower other than among other insurance companies, the development in securities markets nevertheless of large significance for results in 2008.

4.38 Shares and fixed income securities in per cent of total assets



Operational risk

Operational risk can be defined as the risk of loss resulting from inadequate or failed internal processes or systems, human error or external events.

Individual events occurring in 2008 as a result of operational failures inflicted losses of varying size on financial institutions. One savings bank incurred a heavy loss due to poor or non-existent control routines in the credit area as a result of which the bank required an infusion of fresh equity capital. Failures were also noted in shared infrastructure with consequences for several institutions and firms.

The external threat situation showed an increasing element of organised crime in 2008, directed towards the financial sector's open networks that are used to distribute products and services. Various forms of attack on banks' internet systems and websites are relevant examples. Another significant threat area is data and identity theft, in particular the production of bogus cards based on stolen information. Outsourcing, in particular to countries outside Norway, remains a challenge in terms of devising measures to handle such risk.

A lack of overview and control over the use of shared or own ICT infrastructure represents a growing challenge, for instance where newly introduced technology and solutions are not tested or where the firm has insufficiently detailed information to assess security. Failure to carry out testing in connection with implementation and system changes may have serious consequences. Several pertinent examples were noted in 2008, both as regards application errors and major faults due to factors related to the technical environment, server use (hardware) and operative and communication systems. Problems continue to arise when implementing new systems. This represents both a resource and a cost problem, but also an operations problem as obsolete solutions must be utilised for a longer period than intended.

Thus far, in a period of financial turbulence, securities and currency transactions and payments transmission have not been affected by significant problems. Transaction clearing and monetary settlement have shown high stability across the globe.

At the end of 2007 an event-reporting arrangement was introduced on a trial basis in the ICT area. The arrangement has provided useful information on the event situation in the financial sector and a good basis for analyses and initiation of preventative measures.

Solidity of financial institutions
Banks

The trend in banks' financial strength needs to be viewed in the context of the transition to the Basel II framework which became effective for all banks on 1 January 2008. The switch to new capital adequacy rules entails significant reductions in minimum capital requirements for credit risk. Basel II also requires capital charges for operational risk, which in isolation heightens capital requirements. The greatest change in capital requirements concerns banks that apply internal models (the IRB approach) to calculate capital. Transitional arrangements have been introduced for their benefit that set limits to possible reductions in capital adequacy. In 2009 capital cannot fall below 80 per cent of the requirement under Basel I.

The largest Norwegian banks have been authorised to use the IRB approach, viz. DnB NOR, Nordea Bank Norge, Sparebanken Vest, SpareBank 1 SMN, SpareBank 1 Nord-Norge, SpareBank 1 SR-Bank and Bank 1 Oslo. Bank 1 Oslo was authorised to do so as from 2008, the other banks in 2007.

Table 4.6 Tier 1 capital adequacy at IRB banks (group)

	DnB NOR Group	Nordea Bank Norway	SpareBank 1 SMN	SpareBank 1 Nord-Norge	SpareBank 1 SR-Bank	Sparebanken Vest	Bank 1 Oslo *
31.12.2008	6.7	6.6	8.2	9.1	6.4	8.1	8.1
31.12.2007	7.2	6.6	8.2	8.9	7.4	8.3	9.8

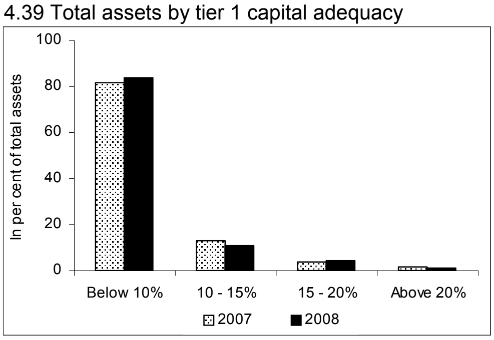
Parent bank. Source: Quarterly reports

Other institutions use the standardised approach to calculate capital. Their tier 1 capital adequacy averaged 12.2 per cent at end-2008, up 0.7 percentage points compared with 2007. Tier 1 capital adequacy has fallen at medium size banks and risen at the smallest banks.

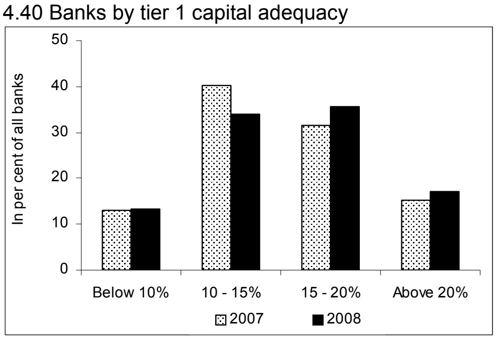
Table 4.7 Capital adequacy in per cent for banks using the standardised approach under Basel II

	Tier 1 capital adequacy		Total capital adequacy	
	31.12.2008	31.12.2007	31.12.2008	31.12.2007
Banks with total assets above NOK 10bn	10,1	10,5	11,9	12,3
Banks with total assets below NOK 10bn	16,3	15,9	17,2	16,7
All standardised-approach banks	12,2	11,5	13,7	13,1

4.39 Total assets by tier 1 capital adequacy



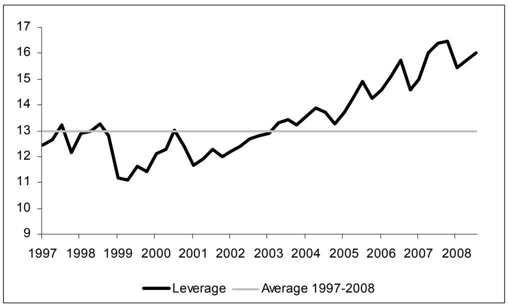
4.40 Banks by tier 1 capital adequacy



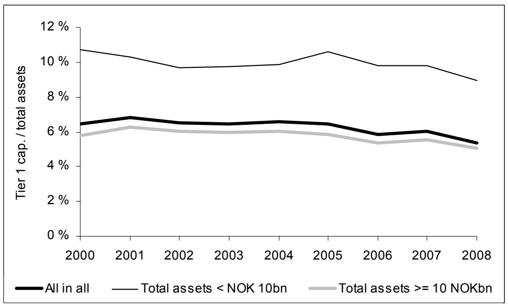
The proportion of banks whose tier 1 capital measured below 10 per cent of total assets was somewhat higher than at the end of 2007, and accounted for 84 per cent of total assets at the end of 2008. 13 per cent of all banks had tier 1 capital adequacy below 10 per cent, showing that the largest banks have the lowest tier 1 capital adequacy.

Norwegian banks lent their equity capital on average 16 times in 2008 compared with an average of 13 times for the period 1997-2008. In order to return to an average gearing of 13 times, either bank lending has to fall by 19 per cent or equity capital has to increase by 23 per cent.

4.41 Norwegian banks' leverage, 1997-2008



4.42 Tier 1 capital in per cent of total assets



After reviewing banks' internal capital adequacy assessment process (ICAAP) in 2008, Kredittilsynet asked a number of banks to adjust upwards their tier 1 capital adequacy targets and actual capital adequacy. Some weaknesses and flaws in the banks' own capital assessments were also pointed out. A counter argument was that increased requirements on financial strength could intensify the tightening of credit growth and thus negatively affect the real economy. Strengthening financial positions, for example by withholding dividends while results are still at an acceptable level, will enable banks to fund presumptively profitable projects even if results decline somewhat in coming years.

Authorities in a number of countries have opted to provide their banks with fresh tier 1 capital, at the same time as market actors and rating agencies alike appear to expect higher capital levels than previously. Banks competing abroad, or that are dependent on international capital and money market funding, will particularly need to be in a financial position that meets the requirements of investors in the market. However, what level of tier 1 capital adequacy can be considered competitive among banks in the international arena in the long term is uncertain. Governments in a number of countries have given banks capital infusions. The German Commerzbank attained a tier 1 capital adequacy of 10.9 per cent at the end of the third quarter 2008 after an infusion of government capital worth EUR 8.2 billion. The Danish government scheme of capital injections in banks and mortgage credit institutions requires all participating institutions to have a tier 1 capital ratio of at least 12 per cent after the infusion. The Bank of England's Financial Stability Report of October 2008 points to a possible need to recapitalise UK banks to the tune of GBP 50 billion, which will raise the five largest banks' tier 1 capital adequacy by about 2 percentage points to an average of 10.7 per cent.

In the international arena, banks that are recapitalised to levels of 10-12 per cent will be assumed to have reserves ensuring that they will not fall below the minimum capital requirements in the trough of the economic cycle. Perceptions of what constitutes a competitive level of capital adequacy may change as uncertainty concerning the duration and strength of the cyclical setback is reduced and international banks' financial situation stabilises. Even so, the uncertainty could lead to a period in which capital requirements are overplayed in relation to banks' long-term needs and debt-servicing ability. It is difficult to determine the margin by which capital adequacy needs to increase in order to ensure the necessary supply of credit.

Kredittilsynet has performed simple calculations to estimate the supply of external capital required by various increases in tier 1 capital adequacy. The results are highly uncertain, but within a reasonable range of possibilities. The level of external supply could be in the region of NOK 50 billion if allowance is made for a 3.5 percentage point increase in tier 1 capital adequacy by all banks, and for banks needing a supply of capital that takes them above a tier 1 capital adequacy of 12 per cent.

Table 4.8 Need for external capital

NOKm	Measurement base	Effect of 2.5 pp increase in Tier 1 capital adequacy *	Effect of 2.5 pp increase, with 12% cap on Tier 1 capital adequacy *	Effect of 3.5 pp increase, with 12% cap on Tier 1 capital adequacy *
8 largest banking groups**	1 786 608	31 208	31 208	48 766
Other banks	397 872	6 932	2 243	2 781
Total banks	2 184 480	38 140	33 451	51 547

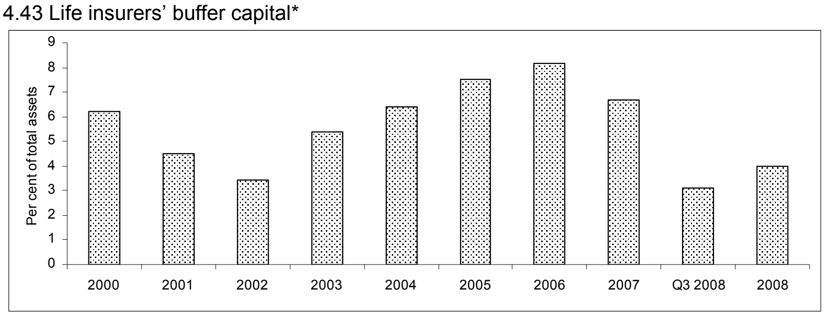
*Expected internal supply of capital (capital generated by operations with zero dividends) is taken into account.
**DnB NOR, Nordea Bank Norway, Storebrand Bank, Sparebanken Vest, Sparebank 1 SR-bank, SpareBank 1 SMN, SpareBank 1 Nord-Norge, Sparebanken Møre

Among the factors that will affect tier 1 capital adequacy ahead are the effects of migration and higher capital requirements at banks using an IRB approach. Opposite effects are the phasing out of the floors in the calculation of capital requirements and the introduction of more portfolio segments into IRB. Uncertain estimates show that these effects could offset each other in 2009 and 2010. A weaker economic climate will lead to higher loan losses at banks. A supply of capital leading to quicker lending growth will expand the risk-weighted assets and reduce tier 1 capital adequacy. If tier 1 capital adequacy were to decline by a large margin during the recession in the years immediately ahead, a low level at Norwegian banks compared with international banks could lead to poorer ratings when the cyclical trough approaches.

Life insurance companies

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. Supplementary provisions are exclusively customer assets, fluctuation reserves are mainly customer assets while tier 1 capital is the company's assets.

4.43 Life insurers' buffer capital*



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

The fall in share prices hit life insurers hard in 2008, and only one small company had fluctuation reserves left at year-end. Several companies used large portions of their supplementary provisions to meet customers' interest guarantee. Life insurers' aggregate buffer capital fell by NOK 34 billion to

NOK 27 billion at end-2008, at which point it measured 4 per cent of total assets, about 3 percentage points lower than at end-2007. Buffer capital is now at the same level as the low point in 2002.

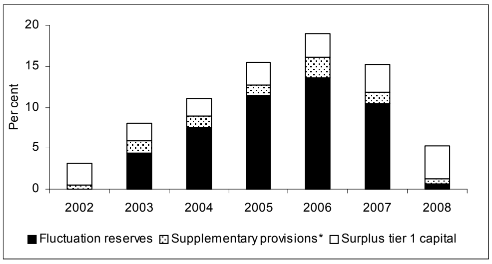
If life insurers' results remain weak, their opportunity to build up buffer capital through operations will be limited. Conflicts may arise, especially in years of low profit, between allocating to supplementary provisions and increasing buffer capital at the same time as equity has to be serviced. Recent years' experience suggests that insurers reduce investment risk when buffers are small, impairing their ability to subsequently increase buffer capital.

All life insurers met the minimum capital adequacy requirement and the solvency margin requirement at end-2008. Some companies received a capital infusion in the fourth quarter of 2008.

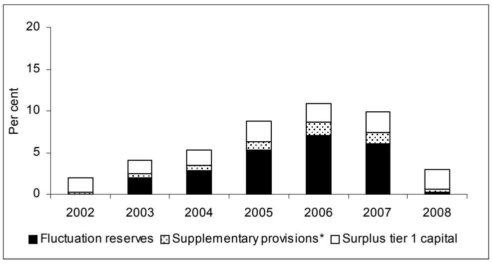
Pension funds

As in the case of life insurers, stock 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 4.5 per cent of total assets at end-2008, a decline of 9.2 percentage points compared with end-2007. In comparison, life insurers' buffer capital measured 3.8 per cent of their total assets at the same point.

4.44 Private pension funds’ buffer capital



4.45 Municipal pension funds’ buffer capital



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

Most of the challenges referred to in relation to life insurance companies also largely apply to pension funds. However, there are some differences. Life insurers opted to reduce their equity component when buffer capital diminished; the same cannot be said of pension funds. Although pension funds are also subject to a minimum required annual return, many opted not to disinvest from shares. Moreover, firms behind the pension funds have supplied the pension funds with fresh risk capital, probably considering it more profitable over time to strengthen risk-bearing capacity rather than reduce the equity component. At the end of 2008, the selection of pension funds had an average capital adequacy ratio of 15.4 per cent compared with 14.2 per cent at the end of 2007. All pension funds met the capital adequacy requirement of 8 per cent.

Non-life insurance companies

All non-life insurers bar two met the capital adequacy requirement at end-2008, while all met the minimum requirement for technical provisions. 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 compared with life insurers, and the slump in securities markets has not led to serious solvency problems for non-life insurers as a whole.

5. The financial crisis and regulation

The financial crisis has exposed a need to revise and strengthen international regulation and framework conditions for financial activities. In many countries rules and supervision have failed to prevent financial crisis and economic setbacks. International organisations responsible for framing standards and rules are currently working to identify weaknesses and make improvements. Norwegian rules, which in all essentials are based on international standards and the EEA Agreement, deviate somewhat from applicable international standards and rules. Where Norwegian regulation diverges, it has consistently proved to be more robust than the regime applying in the major financial markets. In addition, Norway benefits from many years of integrated financial supervision and legislation that covers the entire financial market. Regulation and supervision alike are based on a consolidated approach. However, in Norway as elsewhere rules and supervisory practice should be evaluated in light of the problems uncovered by the crisis and of international measures. That task will be assigned to a finance commission to be appointed by the Ministry of Finance.

Much analysis remains to be done before a complete picture of the fundamental causes of the financial crisis is in place. In addition to significant macroeconomic imbalances, major flaws have been brought to light in systems for measuring and managing risk, and financial institutions have not made sufficient allowance, either solvency wise or liquidity wise, for the risk they have assumed. Some business models have proven very vulnerable, especially ones based on extensive market financing. Loan securitisation has not distributed risk on sustainable actors in the securities markets; risk has rather been concentrated in the financial institutions. Uncertainty about the distribution of risk and doubt about individual institutions' financial strength and liquidity position have developed into a threat to the financial system. Stricter requirements on information about the characteristics of financial instruments are needed to improve transparency and market discipline.

At a global level attention is being given to the monitoring of financial stability, to improving systems for identification and assessment of risk and to how authorities should respond when risk is identified. Consideration is being given to widening the scope of regulation and to bringing larger sections of the financial market, such as non-standardised derivatives (OTC) and hedge funds, under stricter regulation. Supervisory structures for cross-border institutions are being looked into, inter alia by the de Larosière Group. The financial crisis has also shown that existing systems for crisis management and information exchange between authorities during a crisis need to be reviewed. Flaws in, and challenges to, cooperation between authorities in handling problems at cross-border institutions have been brought to light.

In market-based economic systems, fluctuations in the economy and markets are often unforeseen and more intense than expected. It is particularly difficult to predict turning points in the economy. Financial institutions, consumers and investors are particularly likely to underestimate risk in financial markets at the end of a protracted cyclical upturn, with ensuing corrections and setbacks. A key element of financial market regulation is capital requirements that put financial institutions in a position to cope with periods of higher losses on loans and financial instruments and to continue to fulfil their role in the economy and society. Particular attention is being given to the procyclical effects of solvency regulation and accounting standards in the financial system. The following is an overview of central rules with a particular bearing on the effects of the financial crisis on the Norwegian financial market.

Securitisation – lack of consolidation

The strong supply of credit in international financial markets, particularly the US, is closely tied up with loan securitisation. In this process banks moved loans out of their own balance sheets into various investment vehicles, thereby freeing up capital thanks to lower capital charges. Most major universal banks outside Asia were sponsors or guarantors of such vehicles. Doubts that arose about the quality of the underlying loans prompted a number of banks to return securitised portfolios to their own balance sheets or compelled them to finance investment vehicles that were no longer able to obtain refinancing in the market. In order to meet higher capital requirements and liquidity needs, while facing rising losses, banks had to trim their balance sheets or bring in fresh capital.

The quality of the securitised portfolios varies, and has turned out significantly weaker than expected. Rating agencies greatly underestimated the risk inherent in structured products based on US subprime mortgages. This was due both to a lack of time series long enough to estimate risk over economic cycles, and to the fact that agencies' methodology was neither robust, nor was it intended by the agencies to be robust, to changes in market and liquidity conditions. Questions were also raised about the disparate roles of rating agencies' and their independence of the firms they rated.

Falling, and ultimately very low, risk premiums in international financial markets were an important driver behind the development of increasingly complex and high-risk products. Absolute-return investors saw declining returns on their investments and sought excess return inter alia through higher-risk variants of structured products. Synthetic products were in part a response to such demand. The Terra affair in 2007 provides a good picture of the complexity of securitisation.

Banks' de facto risk as issuers proved to be considerably larger than suggested by the immediate legal risk. As sponsors of the investment vehicles, banks were compelled, in recognition of reputational risk, to support them when they ran into problems. The banks also incurred losses in their capacity as investors in the very types of products they had implemented. A number of banks, in particular investment banks, employed a business model which can be characterised as "originate and distribute". Through this model banks created credit risk and spread it elsewhere through securitisation, and their incentives to control this risk became minimal.

The financial crisis has shown that the gains achieved through risk diversification enabled by securitisation were overshadowed by highly opaque distribution of risk and higher-than-assumed concentration of risk. Securitisation and financial innovations appear to a greater degree to have led more to opaque distribution of risk than to effective spreading of risk. In the wake of the financial crisis the regulators and market actors have drawn attention to the lack of transparency in the market for securitised products in general. Securitisation will probably return, but in less complex and more transparent forms. The need for a central clearing counterparty in the credit derivatives market has also pointed out. It is recommended that rating agencies is subject to regulation and supervision.

Norwegian rules have not allowed for the type of securitisation seen in the US and some other markets. Nor were Norwegian banks sponsors for investment vehicles. Strict requirements apply to securitisation, and only the most secure loans (up to 75 per cent in the case of home mortgage loans) can be used to back preferential bonds. Even where loans are passed to separate vehicles and the bonds are sold in the market, banks monitor customers' servicing of the loans. Residential mortgage companies that are set up are subject to regulation and supervision, both at solo level and at consolidated level, and are subject to capital requirements on a par with banks. In Norway all subsidiaries are consolidated in the bank group's accounts and subject to capital requirements and supervision.

Basel II and procyclicality

The capital adequacy framework under Basel II contains minimum requirements on regulatory capital (pillar 1), rules on assessment of overall risk and capital (pillar 2) and requirements on disclosure of financial information (pillar 3). Basel II was implemented in Norway with effect from 1 January 2007, but with transitional rules and the option of reporting under Basel I in that year. Under pillar 1, banks can choose whether to use a standardised approach or their own internal models (IRB), subject to approval by the supervisory authority, when calculating minimum charges. At the end of 2008, seven institutions were authorised to use the foundation IRB approach in Norway.

Underlying the revision of the capital adequacy regime was a desire that Basel II should provide more risk-sensitive capital requirements than Basel 1. However, there was a concern that heightened risk sensitivity could be a source of procyclicality. Procyclicality refers to activities and conduct in the financial sector that could magnify fluctuations in the wider economy. If banks’ capital adequacy weakens sufficiently in a downturn due to poor results bringing low equity capital growth, at the same time as the minimum requirements increase in line with higher risk, the minimum capital requirement may become a constraint that limits banks’ lending ability in such a way as to reinforce the downturn. In an upturn with good earnings and capital accumulation the opposite effects will provide a basis for expansive lending growth. The Basel Committee incorporated under both pillar 1 and pillar 2 requirements designed to dampen procyclical effects. At centre stage were requirements as to stress testing, forward-looking capital need assessments and long time series to allow estimation of default probabilities and collateral values to enable account to be taken of variations over the economic cycle.

A number of international organisations are working to identify procyclicality and consider measures to curb such effects. Measures are being considered within the existing rules, either through changes in pillar 1 or pillar 2. Changes in pillar 2 will require further harmonisation of countries’ practices. In November 2008 the Basel Committee put forward an overall strategy to address important shortcomings in regulation, supervision and risk management in international banks that have been brought to light by the financial crisis. One building block in the strategy was to build further buffers that banks could draw on in stress periods and which could reduce procyclicality. It was announced that the Basel Committee was to present further proposals for comment early in 2009. Another proposal is to supplement existing rules with indicators that can be more directly related to the economic cycle such as lending growth (aggregate or for individual banks) and loan-to-value ratios of home mortgage loans.

In Norway procyclicality has been viewed in conjunction with both pillar 1 and pillar 2 of the Basel II framework. Kredittilsynet stresses the importance of the data underlying the models and has called for considerable prudential margins or other adjustments in the calibration of models that are based on relatively short time series with little recognition of economic downturns. Kredittilsynet has also called for the years of the Nordic banking crisis to be specifically included for calibration purposes. The latter requirement meant that all banks had to adjust upward the capital requirement somewhat compared with the level applied internally by the banks.

Kredittilsynet has instructed the banks to analyse effects of negative migration in their portfolios and to document the analyses made in connection with the annual ICAAP assessments under pillar 2. In connection with ICAAP institutions are to provide information on their methods and results of stress tests or scenario estimates. Stress tests should be conservative, and also make allowance for weaknesses in the actual stress test methodology. The effect of a serious economic setback on capital calculation should be estimated, using an extraordinary, but probable, scenario. Kredittilsynet has made it clear that institutions should look into the effect of a setback lasting at least three years. Institutions should make projections of their financial situation based on this time horizon. Stress testing at the six largest Norwegian banks show that under the given assumptions the banks can live through the downturn scenario without breaching the minimum capital requirement.

In Norway it has been made clear to the banks that they are obliged in pillar 2, to secure sufficient buffers to withstand variations in the minimum requirement. Banks' compliance with this obligation is followed up in the ICAAP review and in the ongoing supervision.

Internal capital adequacy assessment process (ICAAP)

All banks, finance companies and mortgage companies received feedback from Kredittilsynet on the ICAAP process in 2008. The six largest Norwegian banks also received ICAAP responses in 2007.

In its responses on banks' ICAAPs in the course of 2008, Kredittilsynet called on about half of the larger Norwegian banks to consider action to increase their actual capital levels. It did so in light of the following factors:

- Flaws in stress tests and estimates of the prudential buffers needed to meet the requirement that the ICAAP should be forward looking and ensure that the bank has sufficient capital to withstand a severe cyclical downturn
- Experience with the ongoing global financial crisis, where banks are in the process of increasing their tier 1 capital adequacy
- Too low assessment of concentration risks and associated capital needs
- Uncertainty related to model estimates, including gains resulting from diversification across various risk types, as well as too low confidence levels
- A need to ensure access to long-term funding under difficult market conditions

Kredittilsynet pointed out that banks should in the first instance exploit opportunities to generate as much capital as possible from operations in connection with the year-end adjustments for 2008. This would help to maintain normal growth in credit volume even if results were weakened by losses and fluctuating earnings in 2009. At the largest banking groups, equity capital generation from operations produced an increase in tier 1 capital adequacy averaging just under 1 percentage point in 2008, provided no dividend was declared.

Hybrid capital

In the interest of capital quality, Norway has been more restrictive than other countries in allowing hybrid capital to be included in tier 1 capital and own funds. Such capital may only make up 15 per cent of tier 1 capital in Norway. Stricter international rules for hybrid capital may make it acceptable to raise this limit in Norway. If adopted, the proposed rules on hybrid capital will impose quality requirements on hybrid instruments intended for inclusion in own funds as well as limits for the inclusion of hybrid capital in tier 1 capital. The proposal is largely based on a proposal of 26 March 2008 from the Committee of European Banking Supervisors (CEBS) for an EU-wide definition of hybrid instruments eligible for inclusion in tier 1 capital. CEBS will draw up further guidelines in regard to hybrid capital. The EU Capital Requirements Directive (CRD) has not previously contained provisions on hybrid capital.

According to the European Commission's proposal, hybrid instruments that are converted to ordinary shares in crisis situations may only constitute up to 50 per cent of tier 1 capital. Up to this limit, hybrid instruments with a fixed maturity or featuring terms that incentivise redemption can constitute up to 15 per cent, and other hybrid capital can constitute up to 35 per cent of tier 1 capital. Each country's supervisory authorities will, in addition to the proposed limitation, be entitled to impose demands on the level of pure tier 1 capital (tier 1 capital excluding hybrid capital) needed by an institution in order to be able to issue hybrid capital. The authorities may also depart from the above proposal within the constraints inherent in the state aid rules.

Supervision of liquidity risk

The financial crisis has prompted international organisations and numerous authorities to critically review rules and standards for supervision of liquidity risk. This process is taking place in forums including the IMF, CEBS, Financial Stability Forum, Institute of International Finance and the Basel Committee. The resulting recommendations are also incorporated in amendments proposed to the Capital Requirements Directive (CRD) which is to be implemented in national legislations by the end of October 2010.

The financial crisis has highlighted the significance of liquidity risk and prompts consideration of stricter standards for measuring and managing liquidity risk, including greater emphasis on quantitative rules. Increased emphasis is given to liquidity buffers and to identifying all liquidity risks, including risk related to securitisation. There is a greater need now to allow for the possibility of liquidity problems in the market coinciding with liquidity problems at individual institutions, of disturbances occurring in several markets simultaneously, and of close links between liquidity risk and credit risk. Further, it is considered important that incentive structures should also take sufficient account of risk in this area. Increased requirements will be made of stress testing and crisis preparedness planning, with account being taken of the duration of a crisis. There is also a focus on management of intraday liquidity risk.

In recent years Kredittilsynet has given priority to follow up of liquidity risk management at Norwegian financial institutions. A supervisory methodology has been developed within the framework of risk-based supervision with a basis in international practice and the authority’s own experience. In the aftermath of events in 2002 particular emphasis was given to contributing to improvements in banks' management of liquidity risk. Kredittilsynet's liquidity risk module includes a framework for evaluation of management and control and for evaluation of liquidity risk levels. The methodology was primarily developed as a supervisory tool, but is also published in the form of guidance documents giving institutions an insight into factors highlighted by the authorities in the supervisory context. The liquidity risk module was revised in 2008. Kredittilsynet will follow up on improvements proposed at international level, at the same time as the authority’s own methodology for supervision of liquidity risk will be evaluated on an ongoing basis.

Regulation of complex products

The period 2002 to 2007 saw a strong increase in Norwegian bank’s sales of savings products carrying market risk. The subsequent slump in market values inflicted losses on customers that were exacerbated by relatively high up-front fees payable upon contract signing, in particular where the investments were debt-financed. In a circular from early 2004 and regulatory amendments in 2007, Kredittilsynet underlined the responsibility for providing advice. As losses materialise, banks can be expected to incur further reputation risk. It would be up to the court to decide whether the banks have breached the law.

Both the results of securitisation in the international arena, i.e. complex packaged products, and other innovations in the shape of financial savings products, raise the question of whether such products should be subject to regulation and licensing. The financial crisis has evidently been intensified by a number of products whose risk has been insufficiently understood by their originators, vendors and buyers. Current financial regulation is based on the assumption that authorities should not as a rule intervene in product development and product design, but regulate the market indirectly by requiring lead managers and vendors to be fit and proper. There is a danger that direct regulation of financial products would inhibit innovation and dynamics in financial markets. However, the belief that the markets themselves would set necessary limits to the risk built into the products, and that this risk would be properly communicated, has greatly diminished.

Challenges facing life insurance companies

Developments in the life insurance segment in 2008 were marked by the international financial crisis and by a new act that came into force on 1 January 2008. The new body of rules brings a switch from one to three profit models. The profit model for all collective contracts and new individual contracts signed after 1 January 2008 does not permit profit sharing. The owners' share of the return is determined by reference to premiums paid in advance.

According to Norwegian practice, calculation of minimum requirements on technical provisions is by reference to the premium base. Hence the size of the minimum guaranteed interest rates employed is crucial to determining the level of provisions. In other words provisions are determined relatively independently of the market interest rate in effect. Life insurers are required each year to recognise value changes on invested funds and changes in technical provisions through profit.

Life insurers were compelled to sharply reduce their share exposures in 2008 as a result of the slump in share prices. Although they are less exposed to further stock market falls, their opportunities to build up new reserves are limited. The risk they now face is instead related to developments in property markets and interest rates.

The challenge of achieving sufficient annual return on financial investments is causing life insurers to consider other investment options. Kredittilsynet has received enquiries from several actors contemplating infrastructure investments, prompting the authority to initiate an assessment of the characteristics of such investments and how they relate to existing rules. The system of annual minimum guaranteed interest rates to policyholders could encourage undesired short-term adjustments in companies' asset management. Partly in response to calls from the industry, Kredittilsynet is now examining issues related to multi-year minimum guaranteed interest rates.

The new profit model for collective contracts and new individual contracts requires life insurers to absorb losses in years of weak financial results and to forego any share of excess return in years of good financial results. The model does, however, add some stability to life insurers' earnings through the pricing of the minimum guaranteed interest rate.

Insurers are subject to capital adequacy requirements under Basel I in a transition period until Solvency II comes into effect. Questions have been raised about whether these requirements influence insurers' asset management adjustments to an excessive degree.

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 relate to the new solvency regime (Solvency II). The new solvency framework will build on a three-pillar structure corresponding to the Basel II rules in banking.

The proposed directive is the subject of discussions between the Commission, the Parliament and the Council. The Council has proposed changes that are delaying the adoption process. Some of the proposals originate in issues related to the financial crisis. The Commission none the less hopes that a final directive can be adopted in April 2009. In addition, technical implementing measures are to be adopted in 2011. CEIOPS will also adopt common supplementary guidelines in a further move to promote rule harmonisation in the EEA area. The new body of rules is scheduled for transposition into national legislations towards the end of 2012.

As part of the effort to resolve a number of technical and practical issues related to methods of calculating technical provisions and capital requirements, several rounds of quantitative impact studies (QIS) have been undertaken. 2008 saw the fourth round of impact studies (QIS 4). This round focused on methods for calculating operational capital requirements and minimum capital requirements, 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, the calculation methods were tested on insurance groups. Further, information was obtained on internal models, which can be used to calculate solvency capital requirements (SCR) under the new rules.

Just over 1,400 EEA-based insurance companies participated in QIS 4, of which 16 were Norwegian non-life insurers and four were Norwegian life insurers. At the European level, the results for life insurers show that capital over and above that needed to meet the solvency capital requirement is reduced overall compared with the situation under the current solvency framework. For non-life insurers on the other hand, surplus capital shows an overall increase. However, there are wide variations both within and between countries. Also in the case of Norwegian insurers participating in QIS 4, the results show that surplus capital falls for life insurers and rises for non-life insurers.

A fifth round of quantitative impact studies (QIS 5) will be undertaken in the second quarter of 2010. QIS 5 is seen as particularly important with regard to testing the implementing measures ahead of final adoption and to testing the supplementary guidelines.

The European Commission published in autumn 2008 a consultation document on the need for new solvency rules for occupational pension funds. With a background in Solvency II the Commission addresses a number of matters, including the merits of introducing a harmonised solvency requirement for occupational pension funds. Processing of the submissions has yet to be completed. Work on new solvency rules for occupational pension funds may start in spring 2009.

International financial reporting standards (IFRS)

The central IFRS principle is that values employed in institutional accounts should be market values. The financial crisis has shown how vulnerable financial institutions are to changes in market values. With the amendment of the regulations governing insurers’ annual accounts with effect from 1 January 2008, the rules governing the accounts of banks and insurers in listed conglomerates are now largely in line with IFRS. With effect for 2008, further adjustments have been made in 2009 to bring requirements on notes to accounts into line with IFRS.

In October 2008 the International Accounting Standards Board (IASB) adopted, after pressure from the EU, changes in the accounting standards for financial instruments. The changes permit institutions to omit to make write-downs in respect of falling financial asset values under certain conditions. For Norwegian banks following IFRS the changes mean that financial instruments in the trading portfolio can be reclassified to an amortised cost category (loans and receivables or held to maturity). The ability to reclassify does not apply to financial instruments recognised at fair value. The changes should be viewed in light of the fact that US GAAP permits corresponding reclassifications and of the EU's desire to achieve a level playing field. Banks applying Norwegian accounting rules were given a corresponding right, by a regulatory amendment, to omit to make write-downs for falling asset values through the establishment of a held-to-maturity category.

The volatile market conditions have resulted in problems in valuing financial instruments. Observed prices resulting from forced transactions, and no-longer-liquid markets, are pertinent examples. This has prompted initiatives resulting in guidelines and statements on how fair value should be determined. IASB published on 31 October 2008 a guidance entitled 'Using judgement to measure the fair value of financial instruments when markets are no longer active. Further, the Committee of European Banking Supervisors (CEBS) and the Committee of European Securities Regulators (CESR) have, on commission from the Ecofin Council, prepared reports that discuss valuation of assets in periods of market turbulence and illiquid markets.

The international financial crisis has shown a need to take a closer look at the relationship between market values and financial stability. Use of market values is intended to promote effective market discipline by giving investors and other market actors as correct a view as possible of the values of an institution's financial instruments and thereby also of the institution's financial situation. However, this has led to much volatility in financial institutions' accounts, which may in turn fuel instability and increase the impact of procyclical mechanisms in the financial system. The linkage between accounting rules and principles for writing down loans is also being looked into, as exemplified by the discussion on dynamic provisioning. It is too early to conclude whether, and if so how, financial stability concerns can be better attended to within the accounting framework, without thereby reducing the quality of information about institutions' true situation. There will be a need to consider improving the information given about valuation uncertainty in relation to complex financial instruments and financial instruments traded in illiquid markets.

Short selling

Experience from the financial crisis shows that normal market mechanisms may be put out of action. During the turbulence in autumn 2008 international financial actors were seen to push down the price of shares of exposed listed financial institutions by means of extensive uncovered short selling. These institutions' access to financing was difficult, and the value fall had a self-perpetuating impact on their need for funding, the value of collateral and their access to funding. Since financial institutions are dependent on the markets for upholding confidence and assuring access to liquidity and equity capital, there was a danger that such short selling would exacerbate turbulence and heighten stability problems. Regulatory authorities in a number of countries intervened in September/October against covered as well as uncovered short selling in particular financial instruments.

Kredittilsynet considered the Securities Trading Act section 3-9 on unreasonable business methods to be a suitable legal basis on which to curb opportunities for short selling. Unusual market movements with very large price impacts, especially on certain financial shares, had been observed. In Kredittilsynet's assessment the price fluctuations were not warranted by the de facto situation of the companies concerned. Kredittilsynet therefore deemed that, in light of the prevailing market situation, short selling in the shares potentially constituted an unreasonable business method.

Kredittilsynet recommended to the Ministry of Finance (in letter of 30 January 2009) a new basis in law for temporarily banning short selling under market conditions where such selling may have effects that are liable to disrupt financial stability or market integrity.

In Kredittilsynet's view, adding a new provision to section 17-5 will provide a clear legal basis, make clear Kredittilsynet's competence and responsibility as a government agency, and simplify procedures when similar assessments are made in the future. Moreover, a temporary ban on short selling will have an immediate effect in the market, whereas the effect of purely penal provisions and sanctions is primarily preventive and is felt at a later point. The new provision will cover any entity selling in the Norwegian market. Actors who assume a financial position entailing that the underlying instrument must be delivered or furnished as collateral, may be covered by the provision. Hence the provision also covers derivatives contracts involving a short position that is liable to influence the price of the underlying.

The report entitled The Financial Market in Norway 2008: Risk Outlook is a supplement to Kredittilsynet's annual report for 2008.

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, consumer issues and Kredittilsynet's international activity.

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

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