

RISK OUTLOOK 2015

The Financial Market in Norway



Risk Outlook 2015: The Financial Market in Norway

Since 1994 Finanstilsynet has systematically analysed and assessed potential stability problems in the Norwegian financial market against the background of developments in the Norwegian and international economy. This is a necessary supplement to Finanstilsynet's ongoing supervision of individual institutions.

Much of the assessment of individual institutions' profitability, financial strength and risk needs to be carried out in light of the general state of the financial market. As from 2003 Finanstilsynet has given its view of the state of the financial market in a separate report. The report summarises financial institutions' results for the previous year, and assesses risks facing banks and other institutions in the Norwegian financial market and potential sources of future stability problems in the Norwegian financial system. Finanstilsynet publishes the report *Risk Outlook* in the spring and *Financial Trends* in the autumn.

RISK OUTLOOK 2015

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Cut-off date 17 April 2015.

SUMMARY

The international economic outlook remains highly uncertain. In some countries, among them the US and the UK, there are signs that activity levels have picked up. Many market participants expect a reversal of the expansionary monetary policies pursued in the US and the UK. Tightening action could cause turbulence in equity, bond and currency markets – potentially spreading to banks' funding markets. In the euro area public and private debt and unemployment remain high in many countries. Despite an expansionary monetary policy stance with a negative deposit facility rate and quantitative easing, inflation in the euro area is very low. There is a danger of deflation and of increasing real debt burdens of households, firms and governments.

For a number of European economies Russian demand accounts for a substantial portion of production. The Russian economy is in recession. The oil price fall and the region's geopolitical situation represent a major uncertainty for future economic growth in Russia. A protracted cyclical downturn will adversely affect the prospects for many EU countries.

Growth in the emerging economies slowed somewhat through 2014, but remains higher than in the industrialised countries. In China low interest rates and ready access to credit through an extensive shadow banking system have contributed to rapid credit growth and risk of overinvestment, in particular in the property market. Weaker growth is expected ahead, which will dampen overall international demand.

Although the oil price fall has so far had little impact on output and employment, a substantial, lasting fall in the oil price could have major negative effects for the Norwegian economy. Petroleum activities and suppliers to this sector are of major significance to the mainland (non-oil) economy. Buoyant profits in petroleum-related industries have led to rapid wage growth, which has fed through to other industries, contributing to a substantial cost increase specific to Norway. This has moderated somewhat in the recent past due to depreciation of the krone.

The level of debt in Norway is high relative to GDP, and has never been higher than at present. Household debt in particular has grown by a wide margin relative to incomes. Concurrently house prices have risen sharply. The build-up of debt started after the banking crisis in the early 1990s. At the same point the growth in house prices gathered momentum. Apart from in some phases, as during the international financial crisis, households' debt burden (debt relative to disposable income) and house prices have risen throughout the period. For firms too, the ratio of gross domestic debt to GDP is higher than at the start of the banking crisis.

The housing market has again hotted up after a brief cooling-off through 2013. Twelve-month growth in house prices was 7.9 per cent in March 2015. Growth in household debt remains strong, and twelve-month growth was 6.2 per cent in February. This is higher than the growth in households' disposable income.

The growth in house prices and household debt is primarily demand driven. Low interest rates, low housing taxes, low unemployment, high real income growth and migration to central areas are important explanatory factors. However, conditions on the supply side of the credit market have also contributed to the growth in debt and house prices. Competition in the mortgage market is strong, with ample access to credit. Finanstilsynet's autumn 2014 mortgage survey and other information gained from supervision suggest that the banks have eased their credit practices in the past year. Norges Bank's loan surveys suggest the same.

A weaker outlook and increased uncertainty for the Norwegian economy will in isolation contribute to dampening households' propensity to borrow. However, there is a danger that the prospect of a long period of low interest rates and ample access to credit will encourage continued strong growth in debt and house prices. This will further increase households' debt burden and maintain demand for goods and services for a period, but such a development is not sustainable. The risk of a subsequent hefty setback and financial instability will in that event increase.

Financially sound banks are crucial to the Norwegian economy's ability to tackle an economic downturn. Banks must build up capital when profits are good, as they have been in recent years. Increased capital makes banks more robust in a downturn, putting them in a position to grant new loans to creditworthy borrowers. Developments in the housing and credit markets have increased the risk of financial instability. This underscores how important it is for banks to continue to improve their financial position by retaining the bulk of their net profit.

Finanstilsynet has given advice to the Ministry of Finance on minimum capital requirements and capital buffers, and has tightened requirements on the banks' IRB models for mortgage lending. This has contributed to more robust capital requirements. In its feedback to the banks after reviewing their capital need (pillar 2), Finanstilsynet's general call was to build capital in excess of the minimum requirements of pillar 1. That laid the basis for retention of the bulk of the high profits recorded in 2014 and thereby increased banks' equity capital. The challenges facing the Norwegian economy imply that this assessment will stand firm for the current year as well. The effect on credit and house prices of increased capital requirements, whether they are requirements of a general nature or applied to specific types of loan, is probably limited, particularly in times of rapid credit growth and household optimism. Other policy instruments are better suited to dampening the growth in house prices and credit to households. In recent years instruments such as maximum loan-to-value ratios (debt relative to property value) and maximum debt-servicing capacity ratios (income relative to debt and liquidity burden), requirements on maximum loan term and requirements on annual amortisation instalments have been applied in a number of countries to limit the supply of housing credit and curb households' debt burden.

In its letter to the Ministry of Finance of 16 March 2015, Finanstilsynet proposes enshrining requirements on banks' mortgage lending practices in regulations. The norms set out in Finanstilsynet's mortgage lending guidelines are laid down as requirements in the draft regulations. This constraint on the banks' exercise of discretion is the proposal's most important contribution to tighter lending practices.

Some tightening of reference values is also proposed. The interest rate increase to be employed when stress testing borrowers' debt-servicing capacity is raised by 1 percentage point to 6 percentage points, and a special prudential assessment will no longer justify departure from the rule requiring a borrower to pass the stress test. Finanstilsynet also proposes retaining a maximum loan-to-value ratio of 85 per cent of property value. Only additional collateral in the form of security in another property will suffice to justify a higher loan-to-value ratio. A special prudential assessment will not do so. A maximum loan-to-value ratio of 65 per cent is proposed for home equity credit lines compared with 70 per cent in the current guidelines. Finanstilsynet also proposes requiring an annual instalment payment of at least 2.5 per cent from the first year in the case of all loans with a loan-to-value ratio above 65 per cent.

Norwegian banks obtain a substantial share of their funding in the market. Much of it is short term and is raised outside Norway. This funding involves higher liquidity risk than bank deposits. Although Norwegian banks' liquid reserves are larger and their funding is more long term than previously, turbulence in money and capital markets will rapidly make it costlier and more difficult for them to raise new loans. The high proportion of covered bond funding has helped to reduce the liquidity risk, but may also have rendered banks more vulnerable in the event of a housing market setback. Banks' asset encumbrance must therefore be kept to an appropriate level. Improved capital positions make banks more robust to economic setbacks and increased losses, and therefore also contribute to dampening liquidity risk. The risk of turbulence in financial markets makes it necessary for banks to continue to expand their liquid reserves and to ensure long-term funding of long-term assets.

Life insurance companies and pension funds alike face major challenges in the coming years. Low interest rates are making it difficult to ensure sufficient return on pension assets. Although the share of defined contribution pension schemes is rising, about 80 per cent of life insurers' insurance liabilities still comprise contracts with an annual guaranteed return. Further, pension institutions are having to make extra provision for future liabilities as a result of rising longevity. New mortality tariffs became effective on 1 January 2014. Surplus return and surplus on the risk result can be used for the purpose of increased provisioning over a period of up to 7 years as from 1 January 2014, but a minimum of 20 per cent of the need for increased provisioning must be met out of equity. Given the current low interest rate level and prospects of little return beyond the guaranteed rate, the contribution from equity may prove to be higher.

The new prudential framework, Solvency II, is to be introduced across the EU on 1 January 2016. Solvency II reflects insurers' real risk to a greater degree than does the current solvency regime. Among other things, insurance liabilities are to be measured at market value which, given the current low interest rate level, entails a substantial increase in the value of the liabilities compared with present rules. The new framework brings substantially higher capital requirements, in particular for life insurers offering guaranteed return. The transition to the new framework is eased somewhat by a proposed transitional arrangement allowing the increase in the value of insurance liabilities to be phased in gradually over a period 16 years. Even so, a number of insurers will need to reduce risk or increase their capital in order to satisfy the new requirements.

CHAPTER 1 ECONOMIC TRENDS AND MARKETS

The international economy remains weak. Growth is slowing in a number of emerging economies. A slight rise in growth is expected in the industrialised countries as a whole, but there are wide differences between countries. For the Norwegian economy, forecasts indicate weaker growth in 2015. Reduced investments in the oil and gas sector and the plunge in the oil price since summer 2014 put the forecasts in an uncertain light and heighten the risk of a setback in the Norwegian economy. Prospects for firms have deteriorated. Concurrently household debt and house prices continue to grow.

INTERNATIONAL ECONOMY

While growth quickened slightly in the industrialised countries and slowed in the emerging economies in 2014, growth remained substantially higher in the latter economies than in the industrialised countries (chart 1.1). The IMF lowered its growth forecasts for the international economy for 2015 and 2016 by 0.3 percentage points from October 2014 to January this year, prompted by weaker expected growth in China, Russia, Brazil, the euro area and Japan. The IMF also expected lower growth in several major oil-exporting countries. The forecast for the US was concurrently revised up substantially. The IMF's growth estimate for the industrialised countries and the emerging economies alike is unchanged from January to April 2015. However, within these groups of countries changes are made since prospects for the US are revised down whereas higher growth is expected in the euro area. Expected growth in Brazil and Russia is further reduced. The oil price fall will probably fuel the recovery in the international economy since the price fall is largely due to an increased supply of oil. However, there are also negative developments that dampen the prospects.

After a temporary weather-related setback at the start of 2014 growth picked up in the US over the year. Growth was driven both by corporate and residential investments, but also the most important growth driver, household consumption, rose substantially in 2014. This should be seen in light of some improvement in the labour market. Unemployment fell by 1.1 percentage point from the start of 2014 to 5.5 per cent in March 2015 (chart 1.2). However the employment rate is at its lowest level since the end of the 1970s. Wage growth is for the time being relatively modest, but the fall in the oil price and the recovery in equity markets is contributing to an increase in purchasing power of US households. Forecasts point to a continued recovery in the US economy (table 1.1).

1.1 GDP growth* for industrialised countries and emerging economies, and forecasts given at various times



Source: IMF World Economic Outlook, April 2015

1.2 Unemployment in selected countries



Source: Thomson Reuters Datastrea

In Japan growth in the first half of 2014 was hard hit by an increase in value added tax in April. However, after subsiding in both the second and third quarters, GDP growth picked up somewhat towards year-end – mainly on the back of an increase in private consumption and in net exports. A key aim of the recent realignment of fiscal and monetary policy was to bring inflation up to around 2 per cent. Achieving this aim appears difficult.

GDP growth in the euro area as a whole picked up through 2014, but the growth conceals considerable differences between countries. After rising slightly during spring and summer, production in Germany quickened markedly in the fourth quarter. In the same period growth in France and Italy was virtually zero. Of the previously crisis-stricken countries in the euro area, Spain and Portugal showed substantially faster growth in the fourth quarter.

	USA		Euro area			China		
2014	2015	2016	2014	2015	2016	2014	2015	2016
2.4	3.1	3.1	0.9	1.5	1.6	7.4	6.8	6.3
1.6	0.1	1.5	0.4	0.1	1.0	2.0	1.2	1.5
6.2	5.5	5.1	11.6	11.1	10.6	4.1	4.1	4.1
	2014 2.4 1.6 6.2	2014 2015 2.4 3.1 1.6 0.1 6.2 5.5	2014 2015 2016 2.4 3.1 3.1 1.6 0.1 1.5 6.2 5.5 5.1	2014 2015 2016 2014 2.4 3.1 3.1 0.9 1.6 0.1 1.5 0.4 6.2 5.5 5.1 11.6	2014 2015 2016 2014 2015 2.4 3.1 3.1 0.9 1.5 1.6 0.1 1.5 0.4 0.1 6.2 5.5 5.1 11.6 11.1	2014 2015 2016 2014 2015 2016 2.4 3.1 3.1 0.9 1.5 1.6 1.6 0.1 1.5 0.4 0.1 1.0 6.2 5.5 5.1 11.6 11.1 10.6	2014 2015 2016 2014 2015 2016 2014 2.4 3.1 3.1 0.9 1.5 1.6 7.4 1.6 0.1 1.5 0.4 0.1 1.0 2.0 6.2 5.5 5.1 11.6 11.1 10.6 4.1	2014 2015 2016 2014 2015 2016 2014 2015 2016 2014 2015 2.4 3.1 3.1 0.9 1.5 1.6 7.4 6.8 1.6 0.1 1.5 0.4 0.1 1.0 2.0 1.2 6.2 5.5 5.1 11.6 11.1 10.6 4.1 4.1

Table 1.1 Key macroeconomic variables. Forecasts for 2015 and 2016

Source: IMF, World Economic Outlook, April 2015

The downturn in Greece continued, and the Greek government is still negotiating the terms of its loan agreement with the EU, ECB and IMF. Weak growth is reflected in unemployment which for the euro area as a whole was 11.3 per cent in February 2015 (chart 1.2). However, there are wide variations between the member countries. Combined with falling energy prices, the weak wage trend due to high unemployment is holding down consumer price growth in the euro area. In March 2015 consumer prices fell by 0.1 per cent on a 12-month basis. Deflation could burden already heavily indebted households, firms and central governments, and weaken the basis for economic growth. The IMF expects GDP growth to pick up somewhat towards 2016, but to remain weak none the less (table 1.1).

In the EU countries outside the euro area the UK economy in particular has developed favourably, and GDP has risen since the start of 2013. In Sweden the first half of 2014 was weak, but growth picked up substantially towards year-end. In Denmark too, growth increased in last year's final quarter. Higher production is expected in these two Scandinavian countries in the next couple of years or so. The Finnish economy is in a weak period, and GDP contracted in the fourth quarter. Positive, but weak, growth is expected in 2015.

Despite the slowdown, the emerging economies continue to grow more strongly than the industrialised countries. In China, growth subsided through 2014. The government has reversed some of the measures deployed to cool down the housing market, and both fiscal and monetary policy have been eased. Forecasts indicate continued high, but receding, growth ahead (table 1.1). The Russian economy is undergoing an arduous period. Sanctions and the oil price fall are hitting hard, and the value of the national currency, the rouble, has fallen more than 50 per cent against the dollar since July 2014. This is fuelling a rapid rise in inflation and fall in purchasing power and demand. The bulk of the oil revenues are spent as they are earned, giving little scope for fiscal policy action. Growth prospects are weak, and the IMF estimated in April that GDP will fall by 3.8 per cent in 2015 and by a further 1.1 per cent in 2016. In India, GDP has grown by about 7 per cent in recent years, and growth looks set to pick up further. In Brazil the IMF expects GDP to contract by 1 per cent in 2015.

NORWEGIAN ECONOMY

Although international developments have been weak, the Norwegian economy has shown good growth following the financial crisis. According to preliminary national accounts data, growth in Mainland (non-oil) Norway's GDP was 2.3 per cent in 2014, while total GDP increased by 2.2 per cent. Against the background of the substantial decline in the oil price in the second half of 2014, a pronounced fall is expected in demand from petroleum-related industries, and thus lower growth in the Norwegian economy. Between September 2014 and March 2015 Statistics Norway and Norges Bank (the central bank) both revised down their forecasts for Mainland Norway's activity level for the period 2015 to 2017. Both institutions expect a brief cyclical downturn in 2015, with estimated GDP growth in Mainland Norway of 1.1 and 11/2 per cent respectively, followed by quickening growth in the activity level from 2016 (table 1.2).

The strong growth impulses imparted to the Norwegian economy by real investment in the petroleum industry for a number of years are declining. Investments in the industry have declined gradually as from the third quarter of 2013. The halving of the oil price in the second half of 2014 contributed. However, for 2014 as a whole, petroleum investments were at the same level as in 2013. Rapid cost growth and a lower oil price - and thus lower earnings - are expected to contribute to reduced investment activity in the years ahead. Further potential fields will not be developed until development costs are reduced or earnings have risen. Extraction of oil and gas, measured in energy equivalents, was at about the same level in 2014 as in 2013. However, the fall in the oil price brings a marked fall in production value and in the central government's direct and indirect revenue from the petroleum sector. Statistics Norway expects a decline in transfers to the Government Pension Fund Global and in the current account surplus in the years ahead.

Unemployment measured by Statistics Norway's labour force survey rose through 2014 from 3.5 per cent of the labour force at the start of the year. In January 2015 the

	2014	201	2015 2016		2017		2018		
	Accounts*	Statistics Norway	Norges Bank	Statistics Norway	Norges Bank	Statistics Norway	Norges Bank	Statistics Norway	Norges Bank
Private consumption	2.1	2.1	1 3⁄4	2.2	2 1⁄2	2.4	3	2.3	2 3⁄4
Gross fixed investment, Mainland Norway	1.8	1.4	1	4.2	6 ¼	5.3	-	3.9	-
Housing investments	-1.6	-2.2	-	3.2	-	4.1	-	1.9	-
Traditional exports**	2.7	5.1	5	3.8	2 1⁄2	3.8	3 3⁄4	3.9	4 ¼
GDP Mainland Norway	2.3	1.1	1 ½	2.2	2	2.4	2 1⁄2	2.7	2 3⁄4
Unemployment rate - Labour Force Survey***	3.5	3.9	4	4.1	4	3.9	4	3.8	3 ¾
Annual pay	3.1	2.9	3	3.1	3 ¼	3.1	3 3⁄4	3.4	4
Consumer price index (CPI)	2.0	2.3	2 ¼	2.0	2 ¼	1.7	2 ¼	1.7	2
House prices	2.7	3.6	-	1.2	-	1.9	-	0.4	-
Household saving rate***	8.3	8.5	-	8.9	_	9.0	-	9.2	-

Table 1.2 Key macroeconomic variables for the Norwegian economy. Forecasts 2015-2018. Percentage change from previous year except as otherwise stated.

*Preliminary figures. **Norges Bank: exports from Mainland Norway. ***Level in per cent. Due to the main revision 2014 of the national accounts, the level of the household saving rate was revised down by approx. 1.5 pp in the period 2009-2013. Sources: Statistics Norway and Norges Bank

unemployment rate was 3.9 per cent. Both the labour force and employment continued to grow through 2014 (chart 1.3). Registered unemployment was 3.0 per cent in March 2015, a slight increase over the same month of the previous year. With a lower rate of growth in the Norwegian economy ahead, employment may weaken. Forecasts point towards higher unemployment in 2016.

Growth in household consumption was 2.1 per cent in 2014. Household consumption abroad rose by 4.4 per cent in 2014, markedly less than in the four preceding years. Statistics Norway expects a weaker economic climate and higher unemployment to contribute to a higher saving rate for households. Investments in Mainland Norway rose by 1.8 per cent in the period, substantially less than in the three preceding years. Traditional exports increased by 2.7 per cent in 2014, while traditional imports were on a par with the previous year. The Norwegian krone has depreciated by some 20 per cent since the end of 2012. This will have a favourable effect on Norwegian business and industry's competitiveness and will thus boost growth in net exports of traditional goods in the next few years.

Twelve-month growth in, respectively, the consumer price index (CPI) and consumer prices adjusted for taxes and energy (CPI-ATE) was 2.0 and 2.3 per cent in March 2015 (chart 1.4). Statistics Norway and Norges Bank expect rising inflation in 2015, followed by a decline later in the forecasting period (table 1.2).

In December 2014 Norges Bank lowered the key policy rate from 1.5 to 1.25 per cent as a result of the steep oil price fall in the second half of 2014 and impaired growth prospects

1.3 Labour force, employment and unemployment



for the Norwegian economy. At its monetary policy meeting in March 2015 Norges Bank decided to retain the key policy rate unchanged at 1.25 per cent (chart 1.4). The justification given for the decision was the relatively insignificant effects of the oil price fall on the Norwegian real economy, and the continued steep rise in house prices. In Monetary Policy Report no. 1 2015, Norges Bank expected to retain the key policy rate at its current level, or lower, up to the end of 2017. 1.4 Consumer prices (12-month growth) and key policy rate. Seasonally adjusted







Source: Thomson Reuters Datastream





Source: Thomson Reuters Datastream





Source: Thomson Reuters Datastream

SECURITIES AND FOREIGN EXCHANGE MARKETS

Developments in securities and foreign exchange markets have in recent months been marked by monetary policy realignment in several countries. A number of central banks - including West European - have put in place more expansionary monetary policy in order to counteract a weak economic situation and low - or even negative - inflation. The European Central Bank (ECB) started in March 2015 quantitative easing (purchase of public and private bonds), and decided at its monetary policy meeting in April to retain the key policy rate at 0.05 per cent. Other central banks such as the Swiss, Danish and Swedish central banks, have lowered their key rates to negative levels to counteract appreciation pressures against their countries' currencies. In recent months, increasingly expansionary monetary policy has sparked a further decline in both short-term and long-term interest rates.

Since the end of 2012 changes in US, European and Norwegian interbank rates and short-term government bond rates have generally been small and remain at a historically low level. The interest rate on three-month German government securities was -0.23 per cent in mid-April 2015 (chart 1.5). The spread between three-month interbank and government bond rates in the US, euro area and Norway alike has remained at relatively stable low levels since 2012.

Long-term government bond rates were historically low, with a few exceptions, in mid-April 2015 (chart 1.6). In some countries, and in particular for shorter maturities, rates were negative. The yield on five-year government bonds was negative in Germany, France, the Netherlands, Belgium, Denmark and Switzerland alike. With the exception of Greece, interest rates on long-term government bonds in the debt-burdened euro countries also fell markedly through 2014 and into 2015. The generally lower interest rate level and reduced uncertainty regarding the economies of these countries have been contributory factors. In the US, however, where the Federal Reserve in October 2014 ceased quantitative easing and has signalled a rise in the key policy interest rate, long-term government bond rates have not fallen by the same margin. Long-term US government bond rates rose somewhat in February 2015.

In 2014 the US dollar appreciated against most key currencies, at the same time as the euro and Norwegian krone depreciated (chart 1.7). The strengthening of the US dollar can be viewed in relation to improved growth prospects for the US economy. Since end-2014 the euro has weakened against both the US dollar and the Norwegian krone. This could be due to the announcement in January of the ECB's introduction of quantitative easing. Expectations of a long period of low inflation and low interest rates in the euro area may also have contributed. A further possible contributor to the euro depreciation is increased uncertainty about the euro union's future in the wake of the elections in Greece. However, market participants appear to be far less concerned about developments now than at the time of the Greek election in 2011. The Norwegian krone has strengthened against the euro and Swedish and Danish kroner since year-end. In terms of the trade weighted index, the krone strengthened by 1.5 per cent from end-2014 to mid-April 2015.

In Norway as elsewhere equity markets have risen markedly since the end of 2012. Increased search-for-yield activity among investors resulting from the interest rate fall in the period probably explains part of the rise in share values. In addition, stronger growth prospects for the US economy spurred an upturn in the US equities market, in particular through 2014. The fall in the oil price and increased expectations of lower growth in the Norwegian economy are likely contributors to the substantial decline on Oslo Børs in the second half of 2014 (chart 1.8). The strong upturn in share values in the euro area since yearend is probably related to the ECB's more expansionary monetary policy, improvement in European indicators and reduced uncertainty among investors. Some increase in the oil price since mid-January may have contributed to the relatively strong upturn on Oslo Børs in recent weeks.

In mid-April 2015 uncertainty regarding the trend in equity markets, as reflected in implicit volatility, was moderate (chart 1.9). Prices of CDS contracts on five-year bonds issued by banks in the euro area have declined since mid-October 2014, but in mid-April 2015 were still substantially higher than the level prior to the strong price increase in September and October 2014 (chart 1.10). Based on the pricing of CDS contracts, market participants appear to

1.8 Return on shares, MSCI indices



Source: Thomson Reuters Datastream

1.9 Implicit volatility, selected equities markets



Source: Thomson Reuters Datastream

consider European senior bank bonds to be about as risky as bonds issued by European non-financial firms with high creditworthiness.

DEVELOPMENTS IN SELECTED MARKETS CREDIT MARKET

Overall growth in credit to Mainland Norway slowed somewhat in 2013 and 2014, but remains higher than nominal GDP growth (chart 1.11). Domestic credit growth (C2) was 5.4 per cent in February. For non-financial firms growth in domestic credit has fallen substantially since 2012. Twelve-month growth was 3.2 per cent in February (chart 1.12). Local authorities' debt growth has been high for a long time and in February twelve-month growth was 8.6 per cent. Growth in household debt fell through 2014, but rose to 6.2 per cent in January and February. This compares with growth of about 5 per cent in households' disposable income in the fourth quarter of 2014. 1.10 CDS prices, European 5-year bonds, selected issuer sectors



Source: Thomson Reuters Datastream





Source: Statistics Norway

1.12 Growth in domestic credit to households, non-financial firms and local authorities



Source: Statistics Norway

1.13 Prices of existing homes



Sources: Eiendom Norge, Finn.no and Eiendomsverdi

House prices and household debt are closely related. Should the high growth in house prices persist, it will feed continued strong growth in household debt. Mortgage interest rates fell in 2014. Persistently low rates will stimulate house prices and credit growth ahead.

Twelve-month growth in overall credit (C3) decreased to 5.1 per cent in December 2014, which was lower than the previous month. The main contributory factor was overall credit from foreign sources. The growth in credit from foreign sources decreased in particular to the oil sector and foreign shipping.

High activity was noted in the Norwegian market for corporate bonds in 2014, with the high yield segment accounting for the bulk of issues. The fall in the oil price brought a substantial increase in credit spreads towards year-end, and a marked reduction in issues, particularly in the case of oil service companies.

HOUSING MARKET

Since the end of 2013 house prices have risen substantially (chart 1.13). According to Eiendomsverdi, the growth in house prices was 8.1 per cent in the period December 2013 to December 2014. However, due to the price fall in 2013, average prices for 2014 were only 2.1 per cent higher than in 2013.

Price statistics for OBOS¹ dwellings in the Oslo area also showed strong growth in 2014, with a rise of 14.5 per cent in the price per square metre between the start and end of the year. The annual growth from 2013 to 2014 was 2.9 per cent.

The growth in prices of existing dwellings continued into 2015. According to Eiendomsverdi, prices have risen by 5.7

¹ A cooperative building association.

per cent in the year's first three months. At the end of March, twelve-month growth was 7.9 per cent. However, the past year has seen substantial regional differences in price movements (chart 1.14). Twelve-month growth was positive in all major towns in March 2015. The lowest twelve-month growth was 1.5 per cent in Stavanger, compared with 15 per cent in Tromsø. Twelve-month growth was also substantial in Oslo and in Bergen, at 11.1 and 10.1 per cent respectively. Prices of OBOS dwellings in Oslo continued to rise in 2015. In March prices were 2.7 per cent higher than in February and 18.5 per cent higher than in March 2014.

The turnover rate of existing dwellings was high in 2014 compared with previous years (chart 1.15). This trend continued into 2015. After a somewhat longer selling period in 2014 than in the previous year, the selling period has edged down thus far in 2015. There are large regional differences.

The supply of existing dwellings at the end of 2014 was substantially lower than in the same period of 2013. At the end of the first quarter of 2015 supplied dwellings was still lower than in previous years, particularly in the large towns. A high turnover combined with relatively few dwellings on the market and a moderate marketing and selling period are indicative of high pressures in the market. Competition for the most attractive dwellings is intense. Downmarket houses and flats remain unsold somewhat longer. Keen competition for good dwellings and rising prices frequently lead market participants to buy before they sell. This may impact negatively on the supply side, entailing further price pressures.

Developments in the market for new dwellings suggest that demand may be on the way up in this segment too. According to the Norwegian Home Builders' Association, 1 per cent fewer new dwellings were sold in 2014 than in the previous year, after sales picked up markedly in the fourth quarter. In the first quarter of 2015 sales of new dwellings were 31 per cent higher than in the same period of the previous year. New housing starts are closely related to selling activity and the price level in the market for existing dwellings, but are also liable to react, with a lag, to the trend in prices. Construction activity picked up substantially towards the end of 2014. According to Statistics Norway the number of housing starts for 2014 as a whole was about 11 per cent lower than in 2013. The number of completed dwellings in 2014 was about 2 per cent lower than in 2013 (chart 1.16). In the course of the first two months of 2015 the number of housing starts and completions has risen substantially compared with the same period of 2014.

Measured by annual data, house prices in 2014 were about 37 per cent higher than the average for 2008 (chart 1.17). When adjusted for changes in consumer prices, growth was

1.14 Regional house prices



Sources: Eiendom Norge, Finn.no and Eiendomsverdi



2009 2010

Semi-detached

2011 2012

Apartments

2013

1.15 Number of homes sold

Sources: Eiendomsverdi, Eiendom Norge and Finn.no

2008

1.16 House completions

2006 2007

Detached

0



Source: Statistics Norway



1.17 Trend in house prices, various deflators

Sources: Eiendom Norge, Finn.no, Eiendomsverdi, Statistisk sentralbyrå and Finanstilsynet

1.18 Real office rental prices in the six largest towns in Norway



Sources: OPAK, Statistisk sentralbyrå and Finanstilsynet



1.19 Real price of commercial property

Sources: OPAK, Statistisk sentralbyrå and Finanstilsynet

23 per cent and when adjusted for growth in disposable income, growth was 3 per cent. However, the number of households has increased during the period. The growth in disposable income per household has therefore been somewhat lower than the growth in disposable income. House prices adjusted for the increase in disposable income per household have grown by about 8 per cent since 2008. On only two occasions in the past 30 years have house prices relative to disposable income been so far in excess of the historical average as present. The first occasion was just before the banking crisis at the end of the 1980s, the second in the period prior to the international financial crisis in 2008. Continued strong growth in house prices will contribute to further accumulation of financial imbalances and increase the height of fall.

COMMERCIAL PROPERTY

The turnover of commercial property was at a high level in 2014. Prices rose somewhat, and direct return (expected rental revenue relative to purchase price) declined. Rental prices of office premises in the largest towns were stable throughout 2014.

Office premise rentals are property companies' main revenue source. According to OPAK, rentals for office premises of a good standard and prime location rose somewhat in Trondheim, but were otherwise unchanged in the largest towns in the second half of 2014. With the exception of Stavanger, real rental prices in December 2014 were still lower than in 1988 (chart 1.18). OPAK expects a flat trend or a slight decline in rental prices in the largest towns in the first half of 2015.

The office vacancy rate² in Oslo, Asker and Bærum rose from 8 per cent in the third quarter of 2013 to 8.9 per cent at the end of 2014, due to a large number of completions in 2012 and 2013. According to DNB Næringsmegling (a commercial property broker), the vacancy rate is the highest since the first half of 2010. DNB still expects some increase in vacancy in the years ahead since completions will increase in 2016 and 2017, and the prospects for the Norwegian economy have weakened somewhat. This will contribute to some decline in rental prices. Rentals for premises of a high standard in prime locations are expected to remain strong.

The real price of commercial property in Oslo in prime locations and of high standard³ rose markedly in the second half of 2014 (chart 1.19). Keen competition for the best objects in this segment has brought a stronger price trend than for objects of normal standard and location.

² Premises currently vacant or to be completed within 12 months, and without a tenant.
³ Nominal price deflated by GDP deflator.

1.20 Direct return on commercial property



1.21 Property transactions above NOK 50 million



Source: DNB Næringsmegling

The price increase is also reflected in the fact that direct return on upmarket properties in the Oslo area has dropped below 5 per cent. Direct return has also fallen for commercial property of normal standard and location, but from a higher level (chart 1.20). Direct return on commercial property is none the less significantly higher than return in the market for government bonds.

Activity in the market for purchases and sales of commercial properties climbed markedly through 2014. The value of property transactions in excess of NOK 50 million rose from about NOK 42 billion in 2013 to NOK 75 billion in 2014 (chart 1.21). Demand was strongest in the office building and retail store segment. Several forces were behind the high transaction volume. Transactions connected to central government's disinvestment from Entra Eiendom amounted to about NOK 13 billion. In addition, lower borrowing rates have made it more attractive to invest in low risk commercial property.

COMMODITY MARKETS

Between 2011 and June 2014 the oil price was largely in the range USD 100 to 120 per barrel. From June to end-2014 the price of crude oil plunged 52 per cent to USD 55 per barrel. According to the IMF, the oil price fall is related primarily to supply side factors such as increased production of US shale oil and OPEC's decision in November 2014 to uphold production quotas. Reduced demand for oil due to weaker growth in Europe and China also contributed to the price decline. Thus far in 2015 the oil price has risen weakly (chart 1.22). According to the IMF the oil price, based on an average of forward prices for various oil qualities, will be USD 58 per barrel in 2015, rising to USD 66 per barrel in 2016.

Viewed as a whole, aluminium prices rose by 0.2 per cent in 2014 (chart 1.22). According to the World Bank, the price growth from year-end to September 2014 is largely

explained by reduced production of aluminium in the world market, while the price fall from September to end-2014 is related to reduced Chinese demand. China's share of world consumption of metals has over the past two decades risen from about 5 to 47 per cent and therefore has a large bearing on the price level. Between year-end and mid-April 2015 the price of aluminium fell by 0.7 per cent.

The price of farmed salmon fell by 17.1 per cent in 2014. Between the start of the year and mid-April the price fell by 4.4 per cent to about NOK 42 per kilo (chart 1.23). Russia's ban on food imports from Western countries in 2014 probably contributed to the fall in the price of farmed salmon.

SHIPPING AND OFFSHORE MARKETS

Traditional shipping has for several years been marked by low capacity utilisation, low freight rates and low profits.

The industry is likely to be marked by overcapacity for many years ahead. The IMF and WTO have revised down their estimates for growth in international trade. Reduced growth in world trade will impair profitability in shipping segments such as dry bulk, tank and container.

The situation in the dry bulk segment has deteriorated in the past year. Spot market freight rates have fallen to their lowest level since the 1980s (chart 1.24), and fail to cover the companies' ship operating costs. Failing higher rates, further ships will have to be laid up. Weak international demand combined with a quantity of new ships will impair profitability prospects ahead.

The oil price fall and the prospect of lower investment activity among oil companies have brought seriously weakened market conditions in the rig and offshore vessel segment. The rates for deepwater rigs have more than halved since last summer. Newly built rigs will further



1.22 Price of crude oil and aluminium

Source: Thomson Reuters Datastream





Source: Thomson Reuters Datastream



1.24 Baltic Dry Index - dry bulk rates in shipping





* Debt burden is domestic credit to households in per cent of households' disposable income. **Interest burden is households' interest expenses in per cent of households' disposable income plus interest expenses. Sources: Statistics Norway and Finanstilsynet

expand rig market capacity ahead. Reduced profitability in the sector has brought a marked fall in the value of the companies since summer 2014. The oil service index on Oslo Børs has fallen more than 40 per cent in this period.

HOUSEHOLDS' SITUATION

Household debt has risen more than this sector's incomes for a long time, and at the end of 2014 debt measured 212 per cent of aggregate disposable income. After a brief period around the financial crisis in 2008, in which debt and income rose in tandem, the debt burden (debt relative to income) continued to rise for households as a whole (chart 1.25). There is a close connection between trend in house prices and household debt.

In the years up to the international financial crisis, rising interest rates and growing debt led to an increased interest burden, contributing to a deterioration of households' financial position. The substantial increase in the interest burden dampened households' credit growth, which in turn affected demand for housing. However, a marked reduction in the central bank's key policy rate shortly after the financial crisis in autumn 2008 brought a pronounced decline in mortgage rates. Persistent low interest rates, low unemployment, high income growth, favourable housing taxation and ready access to credit caused housing demand and growth in house prices to pick up again rapidly. In the past year the interest burden has fallen further due to lower interest rates. The high and rising level of debt renders households increasingly vulnerable to an interest rate hike and reduced income.

However, there are wide differences between households, and some groups are considerably more vulnerable in the event of an economic setback than other groups. The larger the size of the vulnerable groups and the greater the share of overall debt possessed by them, the stronger the negative secondary effects of reduced incomes, high interest rates and weaker growth will be. Household data show large differences in average debt, interest expenses, income and wealth between different age and income groups. It is above all the younger age groups that have a high debt burden. These groups also have the lowest financial buffers in the form of bank deposits, which make up the bulk of households' liquid assets (chart 1.26).

FIRMS SITUATION

In several industries the perception is that the market situation has changed significantly over the course of the past year. Firms in petroleum-intensive manufacturing, which up to summer 2014 took a highly positive view of the market trend, considered in the first quarter of 2015 the situation to be demanding. Many export-intensive firms, construction firms and various service firms described the market situation as good (chart 1.27). Where future prospects are concerned, most manufacturing firms' view of prospects for 2015 is more negative than in previous quarters, according to the Confederation of Norwegian Enterprise (NHO). This is particularly true of petroleumoriented firms, and is related to the trend in petroleum investment.

Statistics Norway's investment surveys confirm the impression that investments in the petroleum sector will fall in 2015. The estimate given in the first quarter of 2015 for the year as a whole is 15.5 per cent lower than the corresponding estimate for 2014. As regards manufacturing industry in general, the investment surveys show higher investment in 2014 than the previous year, and the estimate for 2015 points to a further increase. Statistics Norway's economic barometer for manufacturing and mining in the first quarter of 2015 shows reduced optimism.

Norges Bank's regional network also confirms the impression of weaker prospects for Norwegian business and industry. In March the estimate of expected production was at its lowest level since April 2009. The oil supplier industry was the main contributor, although expected production is also falling in exporting industry and construction. According to the regional network, the operating margin for firms participating in the survey has remained stable in the past half-year after declining from August to October 2014 (chart 1.28). There are wide differences between industries. The export industry reported moderate margin growth while construction saw a slight improvement in margins. Other industries reported slightly weaker margins.

The challenges in Norwegian business and industry began to be reflected in firms' accounts in the second half of 2014, particularly in the fourth quarter. After rising in 2013, the

1.26 Bank deposits by age and interest burden in 2013*



*Interest burden over/under 20 per cent is defined as high/low. Source: Statistics Norway





^{*}Difference between proportion of firms that are positive and negative **Firms with at least 25 per cent of turnover in, respectively, petroleum industry or exports. Source: NHO economic barometer, March 2015.

annual total capital return of listed group companies fell in 2014 (chart 1.29). Historically there has been a close connection between listed and unlisted group companies' results at the aggregated level. Hence it is reasonable to assume that unlisted group companies have also seen a reduction in total capital return in 2014. The same is probably true of parents' and subsidiaries' total capital return, although historical data indicate a somewhat weaker connection between trends in these companies. Parent companies' total capital return would in such case be at about the same level as in the weakest year of the financial crisis.

Assuming a continued low oil price, reduced oil investments and a weak trend among many of Norway's trading partners, there is reason to expect Norwegian firms' total 1.28 Change in firms' operating margin in last three months compared with same period of previous year



The index runs from -5 to +5, where -5 indicates a large fall while +5 indicates strong growth. Sources: Norges Bank's regional network, March 2015

1.29 Return on total capital* at Norwegian non-financial firms



The lines for "All groups" and "All parent entities" are projected with the same change as for "Listed groups". *Profit (loss) before taxes in per cent of total assets. **The years 1981-1987 include only listed companies and companies with dealings with the former Regional Development Fund / Government Industrial and Regional Development Fund. Sources: Statistics Norway and Finanstilsynet

capital return and debt-servicing capacity to weaken further in the current year and possibly also subsequent years. Credit risk posed by Norwegian non-financial firms is discussed in theme II.

RISK FACTORS

The reverberations of the financial crisis and the ensuing financial problems for the central governments of many countries continue to affect the international economy. A lasting expansionary monetary policy stance in the industrialised countries is helping to maintain economic growth. Several of the risk factors that were pointed to in Financial Trends 2014 continue to have a bearing on growth prospects in the international economy, although the risk picture has changed somewhat in the last half-year due to a further fall in the oil price.

The oil price fall affects the outlook for the international economy in varying ways depending on the cause of the downturn. The overall effect is negative if the price fall is due to lack of demand. New analyses from the IMF suggest that whereas lower demand dominated developments in the period July to October 2014, the supply side has been predominant in the following months. A low oil price could stimulate global growth through increased demand among oil-importing countries, but entail lower activity levels in large oil-producing countries. On an overall view, a low oil price is expected to bring increased global growth.

In some countries, including the US and the UK, there are signs that activity levels in the economy have picked up. A reversal of the expansionary monetary policy may be imminent. In the euro area many countries are still struggling with the reverberations of the financial crisis, with extremely high public and private debt and high unemployment. Despite expansionary monetary policies, featuring a recently introduced monthly quantitative easing programme and a negative deposit rate at the ECB, inflation in the euro area is very low. Stagnation and deflation among Norway's main trading partners cannot be ruled out in the short and medium term. Uncertainty is compounded by a Russian economy in recession. Russian demand accounts for a substantial portion of production for several European economies. The oil price fall and the geopolitical situation in the region and appurtenant sanctions put future economic growth in Russia in a highly uncertain light. A lasting cyclical downturn will adversely affect prospects for many European countries.

Emerging economies have largely been the drivers of the international economy in the wake of the financial crisis. Growth in the emerging economies subsided somewhat through 2014, but remains higher than in the industrialised countries. Particular uncertainty attends the Chinese economy, whose authorities recently revised down their growth target for the coming years. Low interest rates and easy access to credit through an extensive shadow banking system have contributed to high credit growth and overinvestment, in particular in the property market. Economic growth came to a halt in 2014, and the authorities have reversed some of the tightening measures that were initiated in 2010 to prevent overheating. Weaker growth is expected ahead. This will also affect other countries in the region through lower Chinese demand.

Low interest rates in the large industrialised countries following the financial crisis contributed to capital flows to emerging economies. There is a risk that normalisation of monetary policy in the US and the prospect of higher interest rates will lead to capital outflow from emerging economies, with ensuing currency depreciation, increased inflation and lower growth prospects. In emerging oilexporting economies a persistent low oil price will pull in the same direction, with a further adverse effect on the capital inflow.

The oil price fall has increased uncertainty about the likely path of the Norwegian economy. The petroleum industry has acquired steadily increasing importance for the mainland economy. High profitability in the industry has brought high wage growth. This has fed through to other sectors, contributing to a considerable increase in costs. A marked, lasting oil price fall will have major, negative effects for the Norwegian economy, even though a substantial krone depreciation is dampening the impact somewhat. Investment activity in the petroleum sector has fallen since the third quarter of 2013, and Statistics Norway's investment survey shows that the decline is continuing into 2015. A stronger than expected reduction in the oil price will further intensify the fall in oil investments and weaken profitability in oil-related manufacturing. Households will also be heavily affected by reduced activity levels in the oil sector since unemployment will increase and income growth subside. Reduced demand from households could adversely affect wider Norwegian business and industry.

Several indicators confirm the impression of a weakened Norwegian business sector. Pessimism is particularly marked in the oil supplier industry, but also parts of the export industry and construction are noting harder times. Most industrial firms also perceive prospects for 2015 to be more negative than previously. Commercial property and shipping are industries to which Norwegian banks have considerable exposure. The market for purchases and sales of commercial property has shown a particularly favourable development over the past year. Upmarket property is seen by investors as an attractive investment object. This could contribute to prices rising more than justified by fundamentals, thereby increasing the risk of a price fall. Rental earnings on commercial property are on a downward trend in several segments. Weaker prospects for the Norwegian economy also indicate lower rental earnings ahead. At the same time prospects for shipping are substantially poorer. The oil price fall in particular has made a negative contribution to offshore-related shipping, while lower growth in international trade and strong growth in tonnage have resulted in poorer prospects for shipping in general. A weakened Norwegian business sector will bring lower income growth among households and increase the danger of higher unemployment.

Price growth in the Norwegian housing market has been high for a long time, and significantly higher than in other countries. Several factors could influence house prices ahead. A persistent low interest rate, ready access to credit, a strong labour market and the relatively weak trend in housing starts in the larger towns could contribute to further growth in house prices. On the other hand, greater uncertainty with regard to the path of the Norwegian economy and the prospect of increased unemployment may dampen price growth.

Developments in the housing market have for a long time caused household debt to increase more than household incomes. This has heightened the danger of a build-up of financial imbalances. Norwegian households' debt burden is at a historically high level, and households are vulnerable to interest rate hikes and income reductions. Increased interest expenses or reduced incomes will add to households' debt and interest burden, thereby reducing demand, impairing profitability in business and industry and increasing banks' loan losses. A simultaneous change in sentiment could cause house prices to fall by a significantly larger margin than justified by fundamentals.

Norwegian financial institutions are exposed to developments in securities markets in Norway and internationally. A substantial portion of banks' funding is in the form of bonds and short-term paper. At the same time, insurance companies have invested large portions of their managed assets in equities and bonds. The ongoing realignment of monetary policy in several countries could influence the risk posed by exposures to the securities market.

More expansionary monetary policies on the part of European countries are contributing to low interest rates. A consequence is an increase in net capital flow from European fixed income securities to other investment alternatives (search for yield), including other types of European asset objects such as equities and real property. A lasting expansionary monetary policy could contribute to the pricing of asset objects being freed from economic fundamentals, thereby contributing to the build-up of financial imbalances.

In the US the Federal Reserve has pursued an expansionary monetary policy following the financial crisis with both a historically low key policy rate and quantitative easing. This policy has contributed to increased activity levels in the US economy and rising asset prices. Quantitative easing was ended in October 2014. Market participants expect the first interest rate increase in the second or third quarter of 2015, and in due course a normalisation of the interest rate level. There is considerable apprehension among market participants with regard to the return to a normalised US monetary policy. Analysts fear that interest rates could be raised too rapidly, resulting in a setback in the economy with substantial asset price corrections.

CHAPTER 2 BANKS

Several years of good results have enabled Norwegian banks to build up equity capital through profit retention. A favourable domestic economy has contributed to high earnings, while loan losses have been very low. Despite increased equity capital, banks have achieved high return on capital, not least relative to the risk-free interest rate. Banks have enjoyed good access to funding in recent years. The falling price of market funding is an important explanation for the positive profit trend.

Market funding, accounting for about half of the total funding, may make banks vulnerable to international market turbulence. There is still a need to increase the proportion of long-term funding and to build liquidity buffers. Capital adequacy has been on a satisfactory trend for the banks overall, and all banks fulfil the current minimum requirements. Banks will have ample opportunity to increase their capital adequacy ahead, provided economic development is not significantly impaired. Growth in lending to retail customers continues to outstrip the latter's income growth, underscoring the need for prudent lending practices.

PROFITABILITY

Norwegian banks have recorded sound profits in the years since the international financial crisis. In 2014 falling funding costs were the main contributor to profit growth, in addition to gains made at many banks on the disposal of Nets Holding. Low loan losses also contributed to good results in 2014. Pre-tax profit for the banks overall amounted to NOK 53 billion, which was 17 per cent higher than the previous year. In terms of average total assets (ATA), profit increased from 1.1 to 1.2 per cent (chart 2.1). The vigorous profit growth enabled banks' return on equity to rise to 12.7 per cent, despite substantially higher equity capital than one year previously (chart 2.2).

Net interest income is Norwegian banks' most important income source, accounting for about three quarters of total operating income (chart 2.3). This reflects the banks' balance sheet structure which is dominated by traditional lending and deposit activity. When income related to loans transferred to group-owned covered bond issuing entities is included (which are recognised as commission income in the banks' accounts), net interest income has risen as a share of total operating income in recent years. Net interest income fell considerably relative to ATA up to 2006, but has stabilised in recent years. The interest margin, i.e. the difference between average lending rates and deposit rates, also fell considerably right up to 2012 (chart 2.4).

2.1 Loan losses and pre-tax profit/loss



Source: Finanstilsynet

2.2 Return on equity



Sources: Finanstilsynet and Norges Bank

2.3 Net interest income's share of operating revenue*



*Exc. capital gains. Source: Finanstilsynet

An important explanation for the improvement in net interest income in recent years, and thus for the sound profits, is falling funding costs. In particular the cost of funding through securities markets has made a positive contribution to net interest income, with considerable decreases noted in both the reference interest rate and risk premium mark-ups in recent years (chart 2.21). Bond issues now reaching maturity are being refinanced at lower markups. This will enable a favourable trend in the average cost of funding in the immediate future provided there are no new periods of turbulence in securities markets.

After a tentative increase in mortgage rates in the first half of 2013, a declining tendency has been seen in the past year and a half (chart 2.5). Interest rate reductions already announced by a number of banks will further lower the average mortgage rate in the coming period.

Loans secured on residential property account for about 55 per cent of Norwegian banks' loan portfolio. Changes in mortgage rates accordingly have a substantial effect on banks' profits. Deposit rates have also fallen somewhat recently, although the average deposit rate remains significantly higher than the three-month money market rate (chart 2.6). Keen competition for depositors has led to a negative deposit margin at banks since 2012.

Like net interest income, other income were on a falling tendency relative to banks' total assets. This was especially evident in the case of net commission income, which have however levelled out in recent years (chart 2.7) (the chart also shows net commission income when account is taken of income from loans transferred to group-owned covered bond issuing entities; see also the account of net interest income). Norwegian banks have only moderate direct exposure to equity markets. However, the possibility of substantial market fluctuations, both in equities and in other financial instruments, means that capital gains are a volatile income source. In chart 2.7 it will for example be seen that banks in 2008 incurred net capital losses on financial instruments. Net capital losses both on equities and interest bearing securities were the reason for the weak development. A key factor behind banks' sound profits in 2014 was considerable gains on the disposal of Nets Holding. A large number of banks held owner interests in Nets, and the disposal brought an overall gain of about NOK 2.5 billion for Norwegian banks in 2014.

Banks' cost level has been on a falling tendency for many years (chart 2.8). The ratio of operating expenses to operating income (exc. capital gains on financial instruments) fell further in the past year, to 47 per cent. In 2014 wage costs in particular showed a positive development, while administrative costs were relatively stable. There is considerable difference in cost level between large

2.4 Net interest income and interest margin









Source: Finanstilsynet

2.6 Deposit interest rate



Sources: Finanstilsynet andOslo Børs

2.7 Other revenues



Source: Finanstilsynet



Source: Finanstilsynet





Source: Finanstilsynet

2.10 Loan losses for groups of banks



and small banks, with small banks facing a substantially higher cost level than their larger counterparts. Further, small banks showed only a marginal reduction in cost level in the past year, while their larger counterparts reported a considerably stronger reduction.

Low loan losses have made an important contribution to Norwegian banks' sound profits. The low loss level continued in 2014 with loan losses equivalent to 0.2 per cent of overall loan volume (chart 2.9). Banks' sound profits in recent years may diminish considerably should the economic trend weaken, leading to problems in the corporate sector; see the discussion in chapter 1. An increase of a mere 10 basis points in loan losses would in 2014, all else equal, have reduced the banks' return on equity by about 70 basis points.

Loan losses in 2014 were in the main low for large and small banks alike. The group of mid-sized banks stood out both in terms of highest loss level and increase in loss level from the previous year (chart 2.10), mainly because this group includes some banks with a large degree of consumer finance on their balance sheets, where the loss level is substantially higher than for other types of lending. See also the description of consumer loans later in this chapter.

CREDIT RISK

Norwegian banks' balance sheets are dominated by loans to customers, and credit risk is thus the largest risk they face. The development in household and corporate finances is crucial both to the banks' business and to the level of risk faced. (See the discussion on special risk factors in chapter 1.) Gross loans to customers accounted for about 72 per cent of banks' total assets at the end of 2014. Growth in lending was 7.1 per cent, taking into account loans held by the group-owned covered bond issuing entities. The rate of

2.11 Growth in lending to domestic firms



Source: Finanstilsynet

growth rose considerably towards the end of last year, although this was largely a consequence of the krone depreciation. Loans in foreign currency are converted to Norwegian kroner in the balance sheet, and the krone depreciation thus leads, all else equal, to a higher loan volume measured in kroner. Since the largest banks are generally those with a sizeable volume of foreign currency loans, it was in this group of banks that the growth rate rose markedly towards the end of 2014.

In the case of domestic corporates, growth in lending has been low for several years (chart 2.11). This is partly because firms have to a greater degree than previously found it attractive to obtain some of their funding in the bond market. Foreign banks' branches in Norway have shown somewhat higher growth than Norwegian banks in the last two years, with a marked increase in the growth rate towards the end of 2014. Chart 2.12 shows the regions in which growth to corporate borrowers has been strongest in recent years. It will be seen that growth over the 15-year period has been strongest in western Norway, although growth here has slowed considerably over the past four years. Lowest credit growth for the period as a whole is noted in the three northernmost counties, but this region has seen considerably higher credit growth than the national average since 2009.

Lending to retail borrowers consist mainly of loans secured on residential property. Hence the housing market has a major bearing on lending to this group of customers. Growth in lending to retail borrowers has been high for a long period, in part far higher than these borrowers' income growth. In the last two quarters of 2014, growth quickened somewhat to 6.4 per cent for Norwegian banks at year-end (chart 2.13).

2.12 Growth in lending to firms by region



Source: Finanstilsynet

2.13 Growth in lending to retail customers



2.14 Non-performing loans*



*The definition of non-performance was changed as from 31.12.2009 to include exposures more than 30 days past due date/overdraft date. The previous limit was 90 days. The figures are for banks in Norway. Source: Finanstilsynet

	2008	2009	2010	2011	2012	2013	2014
Consumer loans (NOKm)	43 352	43 936	48 913	58 118	62 693	68 828	75 302
Annual growth %	17.4	1.4	3.0	5.1	7.8	9.8	9.4
Losses in % of consumer loans	2.2	3.1	2.7	1.5	1.3	1.3	1.3
Net interest income in % of ATA	8.8	11.8	12.0	11.3	11.6	11.6	11.4
Result of ord. operations in % of ATA	3.3	5.4	5.7	6.5	6.9	7.0	7.0
Gross non-performance, 90 days, in % of consumer loans	6.5	6.1	5.9	5.0	4.5	4.4	4.1
Gross non-performance, 30 days, in % of consumer loans			10.0	8.4	7.6	7.4	7.2

Table 2.1 Consumer loans at a number of companies*

*The sample was enlarged in 2012. Annual growth is calculated on the basis of a comparable sample. Source Finanstilsynet



2.15 Write-downs on problem loans

Source: Finanstilsynet

The favourable domestic economic trend has contributed to a stable low level of non-performing loans for a long period (chart 2.14). At the end of 2014 a mere 1.1 per cent of banks' loans were non-performing. The level of nonperformance among retail borrowers in particular was low, corresponding to 0.8 per cent of outstanding loans. The nonperforming volume in the case of corporates is somewhat more volatile, but was also at a moderate level. At the end of 2014, 1.6 per cent of loans to corporates were nonperforming, the lowest level since 2009.

Loans that were not non-performing, but where the banks based on other indications of impairment have made individually assessed write-downs, made up 0.3 per cent of outstanding loans. Hence problem exposures accounted for 1.4 per cent of outstanding loans at the end of 2014. Chart 2.15 shows the development in banks' write-downs on problem exposures. It shows that banks made individually assessed write-downs corresponding to 22 per cent of nonperforming exposures. In the case of exposures that were not non-performing, write-downs corresponded to 45 per cent of the exposure amount. The size of write-downs made on non-performing and other potential problem loans will be affected inter alia by what collateral the borrower has made available for the problem loans concerned.

CONSUMER LOANS AND DEBT COLLECTION

Norwegian households' borrowings are largely related to house purchases where the lender has security in residential property, while some are secured on recreational property and vehicles etc., along with study loans. The volume of uncollateralised consumer borrowing is relatively small, at about 3 per cent of households' overall borrowings at the end of 2014. Consumer loans are offered in the form of various products including both card-based loans and other uncollateralised consumer loans. The effective interest rate varies widely depending on the amount involved and the repayment period, but is consistently high. The credit assessments applied to consumer loans are stringent, and a large proportion of applications are turned down.

Finanstilsynet regularly maps the business of a selection of entities engaged in consumer finance. At the end of 2014 the selection comprised 23 entities (13 banks and 10 finance companies), and included both Norwegian companies and foreign branches.

Sound profits over a long period have made consumer lending attractive to new providers. This is reflected in the substantially higher growth in consumer lending than in lending in general to retail borrowers. Consumer lending showed a strong increase in the years up to the financial crisis in 2008. Growth was clearly lower following the crisis, but has risen anew in recent years. In 2014 consumer lending increased by 9.4 per cent, somewhat less than in the previous year (table 2.1). Part of the growth is explained by increased expansion outside Norway in the case of some companies.



2.16 Consumer loans by age group





2.18 Debt collection, consumer loans by age group



Source: Finanstilsynet

2.19 Debt collections in process for more than 18 months as of 31.12.2014, by claim type



Source: Finanstilsynet

Net interest income on consumer loans has since 2009 been stable at a level above 11 per cent of average total assets (ATA), showing that these companies price in the high risk posed by consumer loans. Profit in 2014 was on a par with the previous year measured in relation to ATA.

Losses have been on a stable level in recent years, and are clearly lower than prior to the financial crisis. Nonperforming loans in per cent of overall consumer loans is somewhat lower than one year ago, but the level of losses and non-performance is generally higher than in the case of other business lines at banks and finance companies.

Finanstilsynet has obtained additional information on borrower age from the 14 largest companies in the selection, which together account for upwards of 90 per cent of consumer lending in the selection of 23 companies. The data show that little consumer lending goes to the under-30s. The share of consumer loans to this group was just under 8 per cent, and has been relatively stable in recent years (chart 2.16). Borrowers in the age group 40-49 accounted for the largest share of consumer loans at 30 per cent. Altogether 55 per cent of the loans have gone to borrowers between the age of 40 and 60.

Measured in relation to aggregate consumer loans in each age group, non-performing loans were highest among the under-30s. The non-performance rate declines with increasing age. There are relatively small changes within the various groups compared with previous years (chart 2.17).

Finanstilsynet conducted in January 2015 a survey of 13 of the largest debt collection agencies to obtain a better overview of debt recovery cases broken down by type of claim and age group. The firms participating in the survey held an aggregate market share of just over 80 per cent.



2.20 Key policy rate, Nibor and covered bond mark-up

Sources: Oslo Børs, DNB Markets and Norges Bank

2.21 DNB Markets' indicative mark-ups for senior bonds and covered bonds against three-month NIBOR, 5-year. Weekly observations



At the end of 2014 11.1 per cent of debt collection cases in process related to consumer loans compared with 12.5 per cent at the end of the previous year. Mortgage debt recovery accounted for a mere 1.5 per cent. As in previous years, the bulk of debt collection business in process comprised minor claims related to postal order sales and parking fines et al. The age distribution of consumer debt recovery cases showed a reduction in the proportion of cases related to debtors in the age groups 18-29 and 40-49, whereas an increase was seen for the other groups compared with the previous year (chart 2.18).

Full recovery of mortgage debt/unpaid rent and consumer loans, and thus closure of such claims, may appear more difficult to achieve than in the case of other debt. Chart 2.19 shows that just over 70 per cent of claims have been in process for more than 18 months for both these categories. There has in general been a strong increase in the number of debt collection cases in recent years, among other reasons because firms are sending unpaid claims for recovery at an earlier stage. Moreover, firms are outsourcing the recovery effort to a larger degree than previously to debt collection agencies that report to Finanstilsynet. Hence the increase in the number of debt recovery cases and the size of defaulted obligations does not necessarily reflect a genuine increase in the default volume.

Although debt collection agencies are receiving more claims for recovery, the reports to Finanstilsynet also show a strong increase in the number of completed cases. Almost 34 per cent of cases completed in 2014 were closed before dispatch of a demand for payment. The fact that payment is remitted after dispatch of a reminder/debt collection notice indicates that in many cases the borrower does not have a serious payment problem.

LIQUIDITY RISK

Liquidity risk is the risk that a bank will be unable to honour its obligations when they fall due. Since banks' lending normally has far longer maturity than their funding, ongoing refinancing is important. Funding markets work well in normal periods, but may lapse entirely in periods of failing confidence. In such situations it is difficult to meet current funding needs by way of the market, even at an interest rate level involving a considerable liquidity or credit risk premium. Long-term funding and a high proportion of liquid assets make banks more robust to market turbulence.

SITUATION IN THE MONEY AND CAPITAL MARKETS

Conditions in the money and capital markets were generally good in 2014. Risk premiums fell during the year, in particular for covered bonds. This is ascribable inter alia to the covered bond purchase programme in the euro area, which was one of a number of measures put in place by the European Central Bank (ECB) in 2014 to stimulate the European economy. The favourable trend in money and capital markets continued into 2015. Prospects for the European economy are more positive than expected, and in January the ECB announced a widening of the purchase programme to include government bonds.

Norwegian banks had ample access to both long-term and short-term funding throughout 2014, and mark-ups on Norwegian senior bonds and covered bonds fell. At year-end the risk mark-up on Norwegian five-year covered bonds was 21 basis points, a decline of more than 20 basis points since end-2013. The risk mark-up on Norwegian five-year senior bonds fell almost 25 basis points during 2014, and was 66 basis points at end-2014 (chart 2.21). A low oil price and weaker growth prospects for the Norwegian economy

2.22 Norwegian banks' and mortgage companies' bond issues









Source: Finanstilsynet

contributed to somewhat higher mark-ups towards the end of 2014 and into 2015, but mark-ups remain low, and market funding is still in good supply for Norwegian banks.

Norwegian banks and mortgage companies issued bonds worth about NOK 360 billion in 2014. Covered bonds were issued in a far larger volume than senior bonds. Despite a decline in covered bonds issued abroad, the bulk of covered bond issues still take place in the international capital market (chart 2.22). Covered bonds issued in in Norway have increased compared with 2013, while senior bonds issued in Norway and abroad alike have fallen.

At the end of 2014 bond issued by Norwegian banks and mortgage companies came to more than NOK 1,400 billion. Almost 70 per cent of this was covered bonds. Just over NOK 40 billion of the covered bond debt falls due in 2015, while just under NOK 40 billion of the senior bond debt falls due

2.24 Norwegian banks' deposit-to-loan ratio



Source: Finanstilsynet





Source: Finanstilsynet

in the same period. The bulk of outstanding senior bonds and covered bonds mature between 2016 and 2021 (chart 2.23).

FUNDING OF BANKS' OPERATIONS

Banks' funding consists mainly of customer deposits and borrowings in money and securities markets.

Customer deposits have proven to be a stable funding source for the banks, also in periods of market turbulence. Customer deposits rose by more than 8 per cent in 2014. Medium-sized banks reported particularly high deposit growth, at close to 13 per cent.

The deposit to loan ratio at parent banks has risen markedly in recent years as a result of transfers of loans from the banks to residential mortgage companies, and stood at almost 94 per cent at the end of 2014. When loans placed



2.26 Market funding, banks and covered-bond-issuing entities at 31.12.2014

Source: Finanstilsynet









with covered bond issuing entities are taken into account, including the co-owned entities, the deposit to loan ratio was 58 per cent (chart 2.24).

Customer deposits accounted for 43 per cent of overall funding (parent banks) at the end of 2014, showing no change from the end of the third quarter of 2014, but a slight decline compared with the end of 2013 (chart 2.25).

Banks' market funding rose markedly as from 2007 when banks were permitted to issue covered bonds through mortgage companies. In recent years market funding relative to total funding has been stable at just under 50 per cent. At the end of 2014 the figure was 48 per cent, as at the end of 2013.

A substantial share of Norwegian banks' market funding consists of borrowings from abroad. It is mainly the largest banks that utilise this option since size and credit rating are important for access to funding from foreign sources. Foreign sources accounted for more than 60 per cent of total market funding (incl. all interbank debt) at the end of 2014 (chart 2.26). A substantial portion of this is short-term funding (below three months) in the money markets. This share was 21 per cent at the end of 2014. A high proportion of short-term market funding renders banks more vulnerable in the event of a deteriorating market situation.

Financing with a maturity above 1 year was reduced somewhat compared with one year previously, but still accounted for 63 per cent of market funding (chart 2.27). A reason for some reduction in long-term funding in the past year is the increase in covered bonds with residual maturity between three months and one year.

STABLE FUNDING

Liquidity indicator 1 is used to monitor banks' liquidity risk and shows banks' funding with a maturity above 1 year as a share of liquid assets. Funding includes customer deposits, bond issues, debt to credit institutions, subordinated loan capital and equity capital. Illiquid assets consist mainly of loans to customers and credit institutions, and mortgaged securities. Finanstilsynet considers that institutions should have a liquidity indicator value equal to or exceeding 105 per cent. For the large banks the proportion of long-term funding was 108 per cent at end-2014, an increase of about 4 percentage points compared with the end of 2013. For medium-sized and smaller banks the proportion was, respectively, 104 and 110 per cent. This entails an increase of about 4 percentage points for the medium-sized banks and an increase of 2 percentage points for small banks compared with 2013. The indicator has gradually risen for all groups in recent years (chart 2.28).



2.29 Total NSFR and NOK, weighted average at 31.12.2014

Source: Finanstilsynet

NET STABLE FUNDING RATIO (NSFR)

The Net Stable Funding Ratio (NSFR) is part of CRD IV / CRR and measures banks' available stable funding relative to necessary stable funding over a period of one year. The NSFR has yet to be finally configured, but the EU Commission is expected to produce a closer definition of NSFR by the end of 2016. A possible minimum requirement is expected to be made effective as from 2018 at the earliest. It will however be possible for national authorities to introduce the requirement at an earlier stage. The Ministry of Finance has asked Finanstilsynet to consider how liquidity requirements should be introduced in Norway pending incorporation of CRD IV / CRR in the EEA Agreement. Consideration of the NSFR will be part of this assignment.

Up to and including the second quarter of 2014 the 16 largest Norwegian banks reported the NSFR in accordance with the Basel Committee's recommendations from 2010. After the introduction of CRD IV Finanstilsynet receives NSFR reports for all Norwegian banks, the first one for the end of the third quarter of 2014. Reporting from and including the third quarter of 2014 was based on the Basel Committee's recommendations for the final design of the NSFR. Changes in the Basel Committee's recommendations from 2010 to 2014 largely involve easings in the design of the indicator. Among other things, operational deposits, secured funding and deposits provided by households and SMEs are now to a greater degree recognised as stable funding on the liability side of the balance sheet. On the asset side, unencumbered loans to households and SMEs and certain other assets subject to a 35 per cent or higher risk weighting, require less stable funding. At the same time certain non-renewable loans, encumbered liquid assets, derivatives and interbank loans, require more stable funding.



2.30 Total LCR, weighted average

For the banks as a whole the NSFR increased by about 3 percentage points between the end of the third guarter of 2014 and the end of the fourth quarter of 2014. This is mainly due to a 4 percentage point increase in the large banks' NSFR to 105 per cent, where the increase in available stable funding was larger than the increase in required stable funding. For medium-sized banks the indicator was reduced by 1 percentage point to 114 per cent while for small banks it increased by 2 percentage points to 133 per cent. The large banks generally have a lower NSFR than medium-sized and small banks. This is partly because the largest banks have a larger proportion of market funding than the medium-sized and small banks. At the end of the fourth quarter of 2014 the NSFR in Norwegian kroner was 80 per cent for the large banks, 118 per cent for the medium-sized banks and 133 per cent for the small banks. The large banks are, more so than other banks, dependent on funding in foreign currency. Hence the NSFR for Norwegian kroner in isolation will be somewhat lower for the large banks compared with the others, since their loans in Norwegian kroner are to a lesser degree funded by borrowings in Norwegian kroner (chart 2.29).

At the end of the fourth quarter of 2014 a total of 10 banks had an overall NSFR below 100 per cent for all currencies. This was unchanged compared with the end of the third quarter. For the NSFR in Norwegian kroner a total of 12 banks had an indicator value below 100 per cent compared with 17 banks at the end of the third quarter of 2014.

LIQUIDITY BUFFER

It is important for banks to have sufficient liquidity buffers to withstand a period of limited access to liquid funds. The new liquidity buffer requirement in CRD IV, the Liquidity Coverage Ratio (LCR), measures the size of a financial institution's liquid assets as a ratio of net liquidity outflow 30 days ahead in time, given a stressed situation.

Source: Finanstilsynet



2.31 Distribution of liquid assets in LCR at 31.12.2014

Source: Finanstilsynet

2.32 Total LCR and LCR in NOK, weighted average



Source: Finanstilsynet



2.33 LCR in significant currencies other than NOK

Source: Finanstilsvnet

Norwegian credit institutions have since July 2014 reported the LCR as specified in CRR/CRD IV. As a result of the Commission Regulation containing the final definition of the LCR, the calculation of the LCR will change. New report forms from the EU, adapted to the final LCR definition, will be available from October 2015 at the earliest. Finanstilsynet has therefore as far as possible made provisional adjustments to the existing report forms. The changes were effective from and including December 2014, and the results at end-2014 therefore largely reflect the final definition of the LCR.

The LCR for banks (banking groups) overall was 115 per cent at the end of 2014. The large banks had an LCR of 117 per cent, while the medium-sized and small banks had an LCR of, respectively, 92 and 116 per cent. All banking groups increased their LCR compared with the third quarter of 2014. With the exception of the large banks, the bulk of the increase came in the period from November to December (chart 2.30). The increase is mainly due to changes in the definition of liquid assets in the LCR which became effective from and including December 2014. Under the earlier definition several banks were unable to recognise their actual holding of covered bonds since level 2 assets can at maximum constitute 40 per cent of total liquid assets. Under the new definition more than half of the banks' LCRapproved covered bonds are recognised as level 1 assets. Hence markedly fewer banks are affected by this constraint. At the end of the third quarter of 2014 94 banks were affected by the constraint, compared with 23 at end-2014. In addition, the haircut in respect of these covered bonds is reduced from 15 to 7 per cent in the final definition of the LCR, which, all else equal, raises the LCR ratio.

The minimum LCR requirement will according to the Regulation be introduced gradually from 60 per cent on 1 October 2015 to 100 per cent as from 1 January 2018. At the end of 2014 nine banks had a total LCR below 60 per cent, while a total of 43 banks were below 100 per cent. In comparison, the numbers at the end of November 2014 were 28 and 82 respectively.

80 per cent of Norwegian banks' liquidity buffer consists of level 1 assets. 20 per cent of this comprises covered bonds, while the remaining 60 per cent consist mainly of deposits in central banks and government securities. The remainder of Norwegian banks' liquidity buffer consists of level 2A assets, mainly covered bonds, but also securities with a risk weight of 20 per cent, such as bonds issued by Norwegian local authorities. Norwegian banks have little in the way of level 2B assets such as shares, residential mortgage backed securities (RMBS) or asset backed securities (ABS).

The medium-sized and small banks have a particularly large proportion of covered bonds in their liquidity buffer. Respectively 53 and 45 per cent of their buffer consists of level 1 covered bonds and level 2A assets (mainly covered bonds), compared with 36 per cent of the buffer of the large banks (chart 2.31). This explains why the effect of the changes in the LCR definition, where certain covered bonds are recognised as level 1 assets as opposed to level 2A assets previously, is greatest for medium-sized and small banks.

In addition to total LCR (total liquid assets over total net cash outflows), the LCR is also calculated in Norwegian kroner (liquid assets in Norwegian kroner over net cash outflows in Norwegian kroner), and in other significant currencies where liabilities in a currency other than Norwegian kroner constitute more than 5 per cent of the institution's total liabilities.

The LCR in Norwegian kroner was 40 per cent for the banks overall at the end of 2014, i.e. markedly below the total LCR. The large banks are the main reason for this. These banks' LCR in other significant currencies is high and pushes up the total LCR. For the medium-sized banks the LCR in Norwegian kroner was higher than the total LCR. The reason for this is that some banks had low LCR values in significant currencies other than Norwegian kroner. The small banks do not have significant currencies beyond Norwegian kroner. Their total LCR is therefore virtually identical to their LCR in Norwegian kroner (chart 2.32).

Norwegian banks overall have the euro, US dollar and Swedish krona as significant currencies alongside the Norwegian krone. It is mainly the large banks that have significant currencies other than the Norwegian krone (chart 2.33).

FINANCIAL SOUNDNESS

The overarching capital and buffer requirements in the EU's capital adequacy framework (CRR/CRD IV) were incorporated in Norwegian law in June 2013. Detailed provisions in the new framework were introduced in Norway through amendments to, inter alia, the Capital Requirements Regulations and the Regulations on the Measurement of Own Funds of Financial Institutions, Clearing Houses and Investment Firms adopted on 22 August 2014. The amendments entered into force on 30 September 2014. The amendments impose on Norwegian institutions generally more stringent requirements on overall capital, and the requirements on common equity tier 1 capital in particular are raised. Financial institutions are required by law to hold common equity tier 1 (CET1) capital, tier 1 capital and own funds of 4.5, 6 and 8 per cent of risk weighted assets respectively. Buffers consisting of CET1 capital are also required: a capital conservation buffer of 2.5 per cent and a systemic risk buffer of 3 per cent of risk weighted assets. In addition the Ministry of Finance has introduced a countercyclical buffer requirement of 1 per

Table 2.2 Minimum	requirements	on CET1	capital	adequacy.
Per cent				

	From 30	From 30	From 30
	June	June	June
	2014	2015*	2016*
Systemically important institutions	10	12	13
Other institutions	10	11	11

* From 1 July for systemically important institutions. Source: Finanstilsynet

2.34 CET1 capital adequacy and leverage ratio



Source: Finanstilsynet

2.35 CET1 capital adequacy, all banks, 31.12.2014



Source: Finanstilsynet

cent, and identified DNB, Nordea and Kommunalbanken as systemically important. Systemically important institutions are subject to a separate buffer requirement of 1 per cent as from 1 July 2015 and 2 per cent as from 1 July 2016.

The minimum CET1 requirement, including buffers, for Norwegian financial institutions is 10 per cent of risk weighted assets. This requirement will gradually increase as a result of the introduction of a countercyclical buffer for systemically important institutions (table 2.2 below). From



2.36 CET1 capital adequacy at Norwegian banks / banking

Source: Finanstilsynet

2.37 Changes in CET1 capital adequacy at all banks / banking groups (decomposed)



Source: Finanstilsynet







100 %





Source: Finanstilsynet

1 July 2016 onwards the CET1 requirement will be 13 per cent for systemically important institutions and from 30 June 2016 11 per cent for other institutions, assuming no change in the countercyclical buffer in the period. The minimum tier 1 capital adequacy requirement and the total capital adequacy requirements are 1.5 and 3.5 percentage points respectively above the CET1 requirement.

Banks' CET1 ratio increased from 12.2 per cent in 2013 to 12.9 per cent at the end of 2014, and all Norwegian banks satisfied the applicable minimum CET1 requirements (charts 2.34 and 2.35). The CET1 ratio for the large banks combined was 12.4 per cent at the end of 2014, while for the small and medium-sized banks the figure was 17.3 per cent and 13.4 per cent respectively (chart 2.36). CET1 capital relative to total assets also rose for all banks combined, to 6.6 per cent at end-2014. All in all, banks strengthened their financial position by retaining a considerable share of their sound profits for 2014. The average dividend rate for the largest banks was about 17 per cent. Overall risk weighted assets for all banks increased by 6 per cent in 2014, and all large banks contributed to the growth. Chart 2.37 shows the development in CET1 capital adequacy with effects from CET1 capital and risk weighted assets overall for all Norwegian banks.

Risk weighted assets increased considerably in 2014, in part due to the amendments to regulations that became effective on 1 January 2014. Banks using internal models to compute capital charges (IRB banks) were required to increase the model parameter 'loss given default' (LGD) for home mortgage loans from 10 to 20 per cent. This was designed to strengthen the above internal models. The CRD IV framework also introduced an additional requirement in risk weighted assets to address impaired creditworthiness of counterparties in derivatives contracts (CVA risk), which in isolation contributes to an increase in risk weighted assets.

	Estimated capital need					
	0% annual growth in risk weighted assets	2.5% annual growth in risk weighted assets	5% annual growth in risk weighted assets			
Total, Norwegian banks	21	31	41			
CET1 capital	6	14	22			
Hybrid (or higher quality) capital	12	13	14			
Supplementary (or higher quality) capital	3	4	5			

Table 2.3 Estimated capital need for Norwegian banks/banking groups as from 30 June 2016 (NOKbn)

Source: Finanstilsynet

The gap between risk weighted assets and total assets has widened considerably since 2008, when internal models and lower risk weights for the standardised approach were introduced through Basel II (chart 2.38). Even with relatively strong growth in risk weighted assets in 2014, growth was still considerably lower than the growth in total assets, and the gap between the two widened further. At the end of 2014 risk weighted assets, with account taken of the Basel I floor, measured 51 per cent of total assets. The floor requirement was introduced in Norway and elsewhere in Europe in the transition to Basel II to counter a reduction and low level of risk weighted assets. This floor requirement entails that risk weighted assets under the Basel II rules cannot be lower than 80 per cent of risk weighted assets under Basel I. The floor requirement is retained in the new capital adequacy framework, CRD IV. Of total capital requirements at the IRB banks, the Basel I floor amounted to 13 per cent at the end of 2014, compared with 14 per cent the previous year.

IRB MODELS

The average risk weights for mortgages among Norwegian IRB banks was 16 per cent at the end of 2014 (chart 2.39). Finanstilsynet's further tightening of the requirements on IRB mortgage models ensuing from circular 8/2014 have yet to be taken into account. The circular applies as from the first quarter of 2015, and contains assumptions designed to contribute to prudent PD and LGD estimates in the models. For banks applying the standardised approach, the risk weight for well-secured mortgages is 35 per cent. Chart 2.40 shows that mortgages and exposures to corporates account for approximately equal portions of total credit exposures for Norwegian IRB portfolios, but that exposures to corporates represent the clearly largest portion of the capital requirement.

BANKS' CAPITAL NEED

Norwegian banks still need to build up capital in the period to 30 June 2016 in order to meet buffer requirements on systemically important institutions and the countercyclical buffer requirement. Table 2.3 shows estimates for the banks' total capital need given an annual growth in risk weighted assets of 0, 2.5 and 5 per cent respectively. Banks' 2.40 Credit exposure (inner circle) and capital requirements (outer circle) for IRB portfolios in Norway



Source: Finanstilsynet

overall CET1 capital amounted to NOK 306 billion at the end of 2014.

With no change in the level of risk weighted assets, CET1 capital will need to be increased by about NOK 6 billion in order to meet the capital requirements effective as from 30 June 2016, and there will be a total capital need of NOK 21 billion. The calculations were done with a basis in an unchanged CET1 requirement and retention of a 1 per cent countercyclical buffer up to 30 June 2016. Should risk weighted assets grow by 5 per cent, in line with the average growth for the last two years, the total capital need will be about NOK 41 billion, of which at least NOK 22 billion must be CET1 capital.

The minimum requirements on tier 1 capital and total capital of 1.5 and 3.5 percentage points respectively above the minimum CET1 capital requirement mean that some banks may need to raise hybrid capital and/or issue own funds. The CRD IV framework imposes stringent requirements on own funds, and transitional provisions have been introduced for instruments that do not meet the requirements, with a gradual phase-out in the period to 2021. The need for own funds may thus be higher for some banks than estimated. Finanstilsynet expects banks to meet



2.41 CET1 capital adequacy and leverage ratio at Norwegian banks. 31.12.2014

Source: Finanstilsynet

the minimum requirements by a reasonable margin, entailing that the actual capital need may prove higher than shown in table 2.3.

LEVERAGE RATIO

Reporting of leverage ratios was introduced in Norway in keeping with CRD IV from and including the third quarter of 2014. The leverage ratio is intended to function as a backstop against too low a level of risk weighted assets in capital adequacy calculations. Another key purpose of the leverage ratio is to introduce a less advanced prudential measure which allows comparison, also across national borders. The indicator comprises tier 1 capital (numerator) and the exposure measure (denominator). The exposure measure consists in the main of asset items corresponding to those in capital adequacy, but without the use of risk weights. Since off-balance sheet items are included in the numerator, the exposure measure will normally be higher than the bank's total assets. In the EU the intention is to introduce a minimum leverage ratio requirement as from 1 January 2018. The Ministry of Finance has asked Finanstilsynet to consider by the end of June when and how a leverage ratio requirement with associated definitions should be implemented in Norway

The EU Commission adopted a Commission Regulation on 10 October 2014 which brought the definition of leverage ratio more into line with that given by the Basel Committee in January 2014. The changes are small, and mainly related to various conversion factors for off-balance sheet items, recognition of collateral in derivatives contracts, differing treatment of repurchase agreements and treatment of exposures to clearing houses. The EU considers that the changes render conversion factors for off-balance sheet items less stringent compared with the original definition in the CRR. The Basel definition is used in the calculations of leverage ratio in the paragraph below. Norwegian banks' overall leverage ratio was 6.4 per cent at the end of the fourth quarter of 2014 (chart 2.41). The median was 9.1 per cent, which reflects the fact that the large institutions in general have a lower leverage ratio than their smaller counterparts. At the end of the fourth quarter the exposure in terms of leverage ratio measured 110 per cent of Norwegian banks' total assets.

CHAPTER 3 INSURANCE AND PENSIONS

Life insurers and pension funds (together termed pension providers) face major challenges in the coming years. Low interest rates are making it difficult to ensure sufficient return on pension assets. Although the share of defined contribution pension schemes is rising, it is still the case that about 80 per cent of life insurers' insurance liabilities are contracts with an annual guaranteed return. Further, pension institutions have to make extra provision for future liabilities as a result of rising longevity. New mortality tables became effective on 1 January 2014. Surplus return and surplus on the risk result can be used for the purpose of increased provisioning over a period of up to seven years as from 1 January 2014, but a minimum of 20 per cent of the need for increased provisioning must be met out of equity. Given the current low interest rate level and prospects of little return beyond the guaranteed rate, the contribution from equity may prove to be higher.

The new prudential framework, Solvency II, is to be introduced across the EU on 1 January 2016. Solvency II reflects insurers' real risk to a greater degree than does the current solvency regime. Among other things, insurance liabilities are to be measured at market value which, given the current low interest rate level, entails a substantial increase in the value of the liabilities compared with present regime. The new framework brings substantially higher capital requirements, in particular for life insurers offering guaranteed return. The transition to the new framework is eased somewhat by a proposed transitional arrangement allowing the increase in the value of insurance liabilities to be phased in gradually over a period of 16 years. Even so, a number of insurers will need to increase their capital in order to satisfy the new requirements.

PENSION PROVIDERS' FINANCIAL RESULTS

Life insurers reported a pre-tax profit of NOK 21.6 billion before provisioning for increasing longevity and other allocations to policyholders in 2014 (chart 3.1). This is somewhat weaker than the previous year. Policyholder surplus amounted to NOK 9 billion, while increased provisioning for rising longevity came to NOK 6.5 billion. After the provisioning undertaken in 2014, life insurers' residual need for technical provisions is just under NOK 14 billion, compared with the initial figure of NOK 42 billion. Public pension schemes have now in all essentials completed the process of increasing their technical provisions, while paid-up policies have the largest residual need – close to NOK 10 billion.

3.1 Life insurers' profits before allocation of surplus and provisioning for longevity



■ Pre-tax profit (to owners) ■ Profit to policyholders ■ Provisioning for longevity Source: Finanstilsvnet





Pre-tax profit (to owners) Profit to policyholders Provisioning for longevity Source: Finanstilsynet

Before increased provisioning, allocations to policyholders and tax, pension funds posted a profit of NOK 7.9 billion in 2014, the same level as in 2013. As a share of average total assets this was somewhat weaker than in 2013 (chart 3.2). Pension funds' increased provisioning for longevity totalled NOK 2 billion in 2014. As of end-2014 pension funds had set aside NOK 10.5 billion of a total extra provisioning need of NOK 11.5 billion. Municipal pension funds have now essentially completed their extra provisioning process, as have most private pension funds.

Life insurers have substantial investments in equities, fixed income securities and property. As shown in the chart 3.3, fixed income revenues account for a significant portion of overall financial revenues. Fixed income revenues have been a relatively stable revenue source, but have fallen somewhat in the last two years or so due to declining interest rates. Stock market fluctuations impact heavily on revenues. In 2014 the value increase on the equity portfolio was some-

3.3 Financial revenues - life insurers



Source: Finanstilsynet

3.4 Financial revenue - pension funds



Source: Finanstilsynet



3.5 Adjusted return on capital, life insurers and pension funds

Source: Finanstilsynet

what lower than in 2013, when the stock market upturn was significantly higher. However, several insurers recorded larger realised equity gains in 2014. The interest rate fall in the second half of 2014 contributed to the increase in bond portfolio value, an increase that was significantly higher than in the previous five years. Pension funds also noted considerably lower unrealised gains on their equity portfolio in 2014 than in 2013 (chart 3.4). However, pension funds realised equity gains to a larger degree than in 2013.

More than 80 per cent of life insurers' insurance liabilities carry a guaranteed annual minimum rate of return, which averaged just under 3.2 per cent at the end of 2014. This applies mainly to private and public defined benefit pensions and paid-up policies deriving from private collective pension schemes. A considerable portion of the contracts were entered into in a period of higher interest rates than at present, and, given a low interest rate level, pension providers face a challenge in securing sufficient annual return on their investments ahead. In the short term, however, the interest rate fall contributed to sound return due to the increased value of the bond portfolio. The stock market upturn, in particular in the US, also made a made a positive contribution to return, although the overall upturn was lower in 2014 than in 2013. For life insurers, the adjusted return was 6.4 per cent. an increase of 0.5 percentage points compared with 2013 (chart 3.5).

For pension funds, the adjusted return was 7.4 per cent, a substantial reduction from the previous year. Pension funds' adjusted return has in periods been significantly higher than at life insurers due to their higher equity component. At the same time this has contributed to a larger fall in return in the event of a stock market downturn. Booked return, which does not take account of unrealised gains on securities, and which is intended to cover the annual guaranteed commitments, was unchanged from 2013 at 4.8 per cent at life insurers. Pension funds booked a return of 5.9 per cent, an increase of 0.9 percentage points.

PENSION PROVIDERS' INVESTMENTS

Since pension providers' liabilities carry an annual guaranteed rate of return, pension providers have to ensure sufficient return for their policyholders. The low interest rate level will in due course lead to lower return on fixed income securities, and alternative investments may gain relevance. However, investments with higher expected return involve higher risk and greater potential for loss. Under Solvency II capital charges will also increase with greater presumed risk.


3.6 Investments in the collective portfolio, life insurers





At the end of 2014, shares accounted for 15 per cent of investments in life insurers' collective portfolio (3.6). The increase is due both to increased equity investments and some rise in value. Actual equity exposure may diverge somewhat, since a number of companies make use of derivatives in risk management. Their equity holding consists mainly of Norwegian and foreign quoted shares. The proportion of unquoted shares, including private equity and hedge funds, made up 36 per cent of the equity portfolio. This proportion has been falling over the past four years. Pension funds have an equity component of 35 per cent (chart 3.7).

In total, fixed income securities account for almost 70 per cent of life insurers' collective portfolio investments. The proportion of bonds measured at fair value has been stable in recent years at about 30 per cent, while bonds measured at amortised cost, including bonds held to maturity, accounted for a total close to 40 per cent. Hold-to-maturity bonds provide a stable, predictable return over the instrument's lifetime since their accounting value does not fluctuate with interest rate changes. Life insurers hold little in the way of direct investments in high yield bonds. At pension funds, bonds measured at fair value made up almost 50 per cent of investments in the collective portfolio. The proportion of high yield bonds was somewhat higher than at life insurers.

EIOPA's survey of pension funds' investments and investment decisions

The European Insurance and Occupational Pensions Authority (EIOPA) decided in 2014 to conduct a stress test of European pension providers (Institutions for Occupational Retirement Provision, IORP) subject to the IORP Directive in the course of 2015. The stress test is to cover member countries with a substantial element of occupational pension schemes. As part of the planning and design of the stress test, EIOPA conducted at the end of 2014 and start of 2015 a survey of pension funds' investment decisions and investment strategy in the period 2004 to 2013. The survey aims to provide insight into pension funds' significance for financial stability, including how shocks are transferred between pension funds and other financial sectors. Seventeen countries took part in the survey, covering a minimum of 40 per cent of pension funds' total assets. Six of the seven largest Norwegian pension funds took part in the survey, accounting for about 49 per cent of Norwegian pension funds' total assets in 2013.

Quoted shares, government bonds and financial bonds made up a substantial portion of the six pension funds' aggregate investments in the period 2004 to 2013. Investments in equities and various types of bonds, however, have varied over time. At the end of 2013 the equity component (quoted shares) stood at 26 per cent, while financial bonds and government bonds accounted respectively for 23 per cent and 22 per cent of the largest pension funds' total assets (chart 3.8).

Pension funds' equity component was at its highest in 2006 at 30 per cent, but subsided during the international financial crisis in 2008 and 2011 when the trend in Norwegian and international stock markets alike was weak. In 2008 the equity component fell by as much as 10 percentage points to 18 per cent, at the same time as investments in government bonds and financial bonds rose by 8 percentage points and 4 percentage points respectively to 34 per cent and 20 per cent respectively. The year 2011 was also marked by government debt problems in several euro countries. Norwegian pension funds have, and have had, little exposure to government bonds of the debtburdened euro countries. 3.8 Investments in bonds and quoted equities at the largest pension funds







Source: Finanstilsynet and Thomson Reuters Datastream

In 2008 and 2009 a number of covered bond issuing entities were established in Norway. For the pension funds in the selection, investments in covered bonds increased from just under 1 per cent of total assets in 2007 to 9 per cent in 2013.

PENSION PROVIDERS: FINANCIAL SOUNDNESS AND STRESS TESTING

Pension providers' loss-bearing capacity, i.e. the size and quality of their buffer capital, has a large bearing on their freedom in terms of asset management. High buffer capital improves the capacity to withstand losses, and provides the opportunity to invest in assets presenting somewhat higher risk and potentially higher return. Buffer capital in the present context includes tier 1 capital above the minimum requirement, supplementary provisions capped at the

3.10 Life insurers' buffer capital





3.11 Pension funds' buffer capital



Source: Finanstilsynet

amount covering the year's guaranteed interest, fluctuation reserves, risk equalisation fund, unrealised gains reserve in the company portfolio, and premium funds for unit linked defined benefit company pensions. This is buffer capital over and above the minimum requirement of the current solvency framework.

Life insurers' buffer capital was strengthened by NOK 20 billion during 2014, and stood at NOK 87 billion at year-end. This is due largely to a substantial increase in fluctuation reserves. Buffer capital measured 10.2 per cent of insurance liabilities (chart 3.10). Pension funds have higher buffer capital relative to insurance liabilities than life insurers. Buffer capital amounted to NOK 49 billion, corresponding to 23.3 per cent of insurance liabilities at end-2014 (chart 3.11). At pension funds too, increased fluctuation reserves in particular boosted buffer capital. Higher buffer capital at pension funds enables them to take higher risk in their investments, and thus to hold a higher equity component

than life insurers, as stated above.

Life insurers and pension funds both report two stress tests on a quarterly basis to Finanstilsynet (smaller pension funds, i.e. the majority, report on a half-yearly basis). The main stress test, stress test I, is based on fair value of assets and liabilities, and a definition of buffer capital on the assumption that the entity will be wound up. Finanstilsynet's methodology and assumptions are adapted to Solvency II. Stress test I is based on book values and buffer capital over and above applicable solvency requirements, and illuminates the entity's ability to meet the solvency requirements.

Both stress tests measure the loss potential for all relevant risks such as market risk, insurance risk and counterparty risk, relative to buffer capital, and show overall buffer capital utilisation. Buffer capital utilisation above 100 per cent indicates that the entity's overall loss potential exceeds its buffer capital. Life insurers had a buffer capital utilisation in stress test II of 64 per cent, indicating that they in general maintain a sound margin to the solvency requirements under current rules. For pension funds, buffer capital utilisation was 53 per cent. For life insurers and pension funds alike this was somewhat better than at the end of 2013, primarily due to the increase in buffer capital, in particular the increase in fluctuation reserves, in the period. Under Solvency II, liabilities are recognised at fair value. This means that the interest rate level in effect at any time influences the estimated value of future liabilities. Given today's low interest rates, meeting the Solvency II capital requirements poses a challenge to insurers. This is reflected in buffer capital utilisation in stress test I, which is significantly higher than in stress test II, with an average utilisation of 147 per cent for life insurers overall at the end of 2014. Insurers with a large proportion of private defined benefit pension plans with a guaranteed return, along with paid-up policies, will face the largest challenges in meeting the coming capital requirements. See also the account below.

The capital requirements under Solvency II will not apply to pension funds, but the latter report stress test 1 on a par with life insurers. This reporting will continue when Solvency II is introduced for life insurers, and pension funds will be closely monitored based inter alia on the stress test results. For pension funds, buffer capital utilisation averaged 125 per cent in stress test I, and several funds reported considerably higher utilisation. As in the case of life insurers, the interest rate fall has contributed to higher buffer capital utilisation among pension funds.

INTEREST RATE FALL – CHALLENGES FACING PENSION PROVIDERS

The low level of interest rates poses a challenge to pension providers. Low interest rates make it difficult to achieve a return above the guaranteed rate. The bulk of life insurers' liabilities consist of contracts carrying a guaranteed annual rate of return. In the past year the interest rate level fell substantially, further intensifying these challenges. In summer 2014 the maximum interest rate available to life insurers for new life insurance contracts and new pension accumulation was reduced from 2.5 to 2.0 per cent with effect from 1 January 2015. Since this decision was taken, interest rates have fallen further. When the maximum rate available to insurers was reduced, the 10-year government bond rate stood at 2.5 per cent. By end-2014 this rate had fallen to 1.6 per cent (chart 3.12).

Elsewhere in Europe too, much attention is focused on the low level of interest rates and the challenges this creates for life insurers. EIOPA's Financial Stability Report highlights low interest rates as one of the key challenges to life insurers in European countries featuring a large proportion of guaranteed benefits, and there is a clear tendency for insurers to increasingly offer less interest-rate-sensitive pension products, such as unit linked products with no interest guarantee, at the expense of traditional life insurance products.

As will be clear from the description of financial results above, life insurers' return is still higher than their average interest rate guarantee. This is due in part to a favourable trend in stock markets and in part to the fact that the interest rate fall provides a positive short-term gain in the form of increased value on that part of the bond portfolio that is measured at fair value. In addition, insurers' bond portfolios continue to comprise bonds maturing some time from now and carrying an interest rate substantially higher than that in effect at present. Slightly more than half of the bonds measured at amortised cost have a maturity of four years or more (chart 3.13), and the interest rate on these securities is largely between 4 and 5 per cent. However this proportion was significantly reduced from 2013 to 2014. The average return on the bond portfolio is expected to gradually decline as the bonds mature and have to be reinvested at a substantially lower interest rate.

The effect of the interest rate fall is unevenly distributed on pension providers depending on the composition of insurance liabilities. In public service pensions the interest rate fall can be fully compensated for by increasing the interest guarantee premium, since it is not possible to close the schemes. This means that the increased costs arising from the interest rate fall can be passed on to the local authorities. In private occupational pensions it is also possible to increase the interest guarantee premium, but

3.12 10-year government bond yield and guaranteed return at life insurers



Sources: Thomson Reuters Datastream, Norges Bank and Finanstilsynet



Source: Finanstilsynet





here entities can opt to close the schemes if costs become excessive, and paid-up policies are issued. For pension providers, paid-up policies are clearly the most capitalintensive product in today's low interest rate regime. For paid-up policies no premium is payable in future, and pension providers must have sufficient provisions and capital to secure future pension disbursements. Given the current interest rate level, securing sufficient annual return on pension assets poses a challenge. The average interest rate guarantee is somewhat higher in the paid-up policy portfolio than the average for overall insurance liabilities. The number of paid-up policies at pension providers is clearly growing, which further increases the challenges faced by pension providers ahead.

Solvency II is scheduled for introduction in the EU on 1 January 2016. Given the current interest rate level, life insurers face a challenge in meeting the capital requirements under Solvency II. This is reflected in stress test I, as described above. The stress test employs, however, a simplified version of the full Solvency II calculation, and this has a bearing on the financial results of a number of insurers. Several insurers point out that important elements of full Solvency II calculation will have a positive effect on capital measurement compared with the simplified version employed in the stress test. However, this does not change the fundamental challenges insurers face with the introduction of a substantially more stringent solvency framework in a period of historically low interest rates and increased provisioning requirements resulting from rising life expectancy.

The Omnibus II Directive provided for a number of permanent and transitional measures particularly addressing life insurers offering long-term guarantees. Finanstilsynet has forwarded to the Ministry of Finance a proposal for permanent and transitional measures considered relevant to Norwegian insurers (see further details in chapter 4 Regulation). Of greatest significance for Norwegian life insurers is the proposal allowing insurers to apply the general transitional measure to technical provisions. This rule entails that any increase in the value of insurance liabilities upon the transition to Solvency II will be gradually phased in over a period of 16 years. The transitional measure on technical provisions could be of major significance for companies whose insurance liabilities will acquire significantly higher value under Solvency II than under the existing rules, such as insurers with a high proportion of paid-up policies. This divergence will increase with falling interest rates.

CLOSURE OF SCHEMES, INCREASE IN (UNIT LINKED) DEFINED CONTRIBUTION PENSIONS AND PAID-UP POLICIES

The interest rate fall in recent years has further strengthened the clear trend towards unit linked defined contribution pensions. These are products where the risk rests mainly with the customer rather than the insurer. This is also a clear trend in many European countries.

As from 1 September 2014 pension providers were able to offer paid-up policyholders the option of converting to a new product, unit linked paid-up policies, which in the long term may dampen the increase in pension providers' paidup policy portfolios. The Ministry of Finance has resolved that paid-up policies must be fully provisioned for longer life expectancy before conversion can take place. At the end of the first quarter of 2015, two life insurers are offering this product, and more than NOK 2 billions' worth of the insurers' liabilities under paid-up policy contracts are now managed on a unit-linked basis. This means that all return accrues to the paid-up policy account, and the policyholder has full control over how his/her pension assets are invested. At the same time the interest rate guarantee borne by life insurers lapses, and the paid-up policyholder him/herself bears the costs of administration and management of the assets concerned, and also the risk of reduction in the value of the accumulated pension capital. Longevity risk is to some extent transferred from the pension provider to the paid-up policyholder. See a further description of unit-linked products in Theme III: Pension saving - unit-linked pension products.

Statoil Pensjon, which is the clearly largest pension fund in Norway, closed its defined benefit scheme as from 1 January 2015. From then on, all new employees are enrolled in a defined contribution scheme. A substantial portion of existing employees were transferred to the defined contribution scheme on 1 April 2015. In addition, a number of other large and small private pension funds have closed their doors to new members. The sponsoring entities have in many cases established a defined contribution scheme with a life insurer for new employees, in some cases also for employees below a certain age. In that connection a number of pension funds now have paid-up policies on their own balance sheet.

Paid-up policies account for a growing and in the course of time substantial portion of private pension funds' insurance liabilities. At the end of 2014, 32 of the 50 private pension funds had paid-up policies in their portfolio. The overall holding was NOK 27 billion, equal to 21 per cent of insurance liabilities. This was an increase of NOK 3 billion compared with the previous year.

3.15 Distribution of gross premium fallen due between private defined benefit pensions and defined contribution pensions



Source: FNO

PROVISIONING FOR DISABILITY BENEFITS IN COLLECTIVE PENSION INSURANCE

There are wide differences between life insurers as regards provisioning for disabled members in the private sector in the collective pension insurance field. The differences have proven to be sufficiently large to affect competition in the pensions market, in particular as regards transfer of pension schemes and conversion from defined benefit to defined contribution pensions. The size of provisions depends on several factors. The question may also be raised whether the premiums and provisions employed are in line with the insurance legislation.

Finanstilsynet is conducting a survey of provisioning for disabled members, in the first instance confined to private pension schemes (with and without pension rights accumulated under paid-up policies) and paid-up policies derived from collective pensions. The survey covers disability pension and waiver of premium payments (mandatory risk cover in defined contribution pension schemes).

With this as a basis, Finanstilsynet has asked life insurers to state what extra provision (additional reserve), beyond the provision for active members, is made for disabled members (disability benefits under disbursement). Finanstilsynet is concurrently reviewing the principles and methods applied to determine provisioning for disabled members and premiums for active members.

Finanstilsynet will review insurers' explanations, also in light of already submitted product notices, to ensure that premiums and provisioning are in line with Finanstilsynet's understanding of the insurance legislation. In the event that further investigations, and/or intervention, are called for, this will be done vis-a-vis the individual insurer.

3.16 Results of non-life insurers



3.17 Claims ratio and expense ratio (combined ratio)



burce: Finanstilsynet

Finanstilsynet is also revealing on a general basis certain pension funds' provisioning for disabled members, with the main focus on the largest pension funds.

NON-LIFE INSURANCE

Norwegian non-life insurers (without captives) recorded a pre-tax profit of NOK 10 billion in 2014, an increase of NOK 3.3 billion compared with 2013 (chart 3.16). The improvement is due mainly to sound premium growth of 11 per cent. Premium growth was higher than the growth in claim payment expenses, a tendency noted for several years. Improved financial revenues also contributed to the profit growth.

Financial revenues have been the most important driver of non-life insurers' profits for several years. However, in the last 3 to 4 years premium revenues have risen considerably, and far more than claim payment expenses, so that the underwriting result has contributed far more to the overall financial results of the non-life companies. Given the current low level of interest rates, and expectations of lower financial return ahead, efficient and profitable insurance operations will be crucial to the results of non-life insurers in the coming years.

The combined ratio, which shows the sum of claim payments and operating expenses relative to premium revenues, is an indicator expressing the profitability of insurance business. With a combined ratio above 100 per cent, overall claim payments and expenses exceed premium revenues, indicating that insurance operations are not profitable. In 2014 the combined ratio was 85 per cent, an improvement of 4 percentage points compared with previous year (chart 3.17). Both the claims ratio and the cost ratio have shown improvement in recent years. Norwegian non-life insurers are generally financially sound, and there is little to suggest that Solvency II will present them with major capital adequacy challenges. However, this does not preclude the possibility that some companies may experience such challenges for one reason or another.

CHAPTER 4 REGULATION

A new Financial Institutions Act, sanctioned on 10 April 2015 and tailored to new EU rules - the insurance area included (Solvency II) - brings all financial institutions under the same statute. The Ministry of Finance circulated Finanstilsynet's proposal for regulations implementing Solvency II in Norwegian law for comment, setting 20 March 2015 as the deadline for response. In March Finanstilsynet communicated its advice to the Ministry of Finance on what institutions should be deemed systemically important in Norway. Internationally the Basel Committee, among others, has proposed changes to the capital adequacy framework for credit institutions. In the EU, changes to the rules governing the securities market area are in process. In addition the EU Commission published in February 2015 a submission ('Green Book') preparing the way for a capital market union in the EU.

NEW FINANCIAL INSTITUTIONS ACT

The new Financial Institutions Act is a portmanteau statute covering all financial institutions. It broadly continues current rules, but takes account of new European legislation such as the Solvency II Directive for the insurance industry. Entering into force on 1 January 2016, the new act contains 270 enabling provisions for new regulations, although many existing regulations can be retained.

SOLVENCY II – THE NEW EUROPEAN LEGISLATION FOR INSURANCE COMPANIES

The Solvency II Directive was adopted in 2009. In April 2014, after protracted negotiations, amendments were adopted to the Solvency II Directive through the Omnibus II Directive. The Solvency II legislation enters into force across the EU on 1 January 2016.

The Solvency II Directive is supplemented by implementing provisions and technical standards and recommendations. The EU Commission adopted the Regulation with implementing provisions in October 2014. The European Insurance and Occupational Pensions Authority (EIOPA) has circulated draft standards and recommendations for comment. These are expected to be ratified in 2015.

On 11 December 2014 Finanstilsynet forwarded to the Ministry of Finance draft regulations for implementation of Solvency II in Norwegian law. The proposal was circulated for comment with 20 March 2015 as the deadline. The proposal covers provisions in the Directive not taken into account in the new Financial Institutions Act, and a reference to the Commission Regulation with implementing provisions. The technical standards will also be implemented in Norwegian law by means of a reference included in regulations. Hence the proposed regulations are essentially a technical implementation of the legislation. In areas where national discretion is available, the draft is based on Finanstilsynet's previous assessments.

Implementing Solvency II requires a number of regulations governing insurers to be revoked or amended. A proposal for amending regulations will be coordinated with changes necessary in regulations to the new Financial Institutions Act. It is proposed that regulations currently applying to credit institutions, investment firms and insurance companies should be revoked for insurance companies. They include regulations on consolidation, risk management and internal control, liquidity and remuneration. Complete or partial revocation for insurers is proposed in the case of regulations that are common to pension providers and insurers, including the asset management regulations and regulations on actuaries.

Impact studies have shown that many life insurers in the EEA area will not meet the Solvency II-requirements. In view of this, the Omnibus II Directive institutes a number of measures and transitional arrangements primarily addressing insurers that offer long-term guarantees. In a letter to the Ministry of Finance of 8 September 2014, Finanstilsynet considers what measures and transitional arrangements should apply to Norwegian companies. Its assessments are reflected, and clarified, in the proposed regulations, and concern the following measures:

- Norwegian companies should be given the opportunity to apply the volatility adjustment. This involves adjustment of the risk-free market interest rates used to discount insurance liabilities. In February 2015 EIOPA published details of the methods used to determine the interest rate curve, and estimated interest rate curves on 31.12.2014. The volatility adjustment at end-2014 was calculated to be an add-on of 11 basis points to the risk-free interest rate curve for Norway.
- The general transition rule for technical provisions should be available to Norwegian life insurers. The rule states that any increase in the value of insurance liabilities upon the transition to Solvency II is to be phased in gradually over a period of 16 years. Finanstilsynet will follow up on the companies with a view to putting in place measures to ensure that the solvency capital requirement can be met as soon as possible without use of the transitional rule.
- Assessments concerning specifically national matters were presented in a letter of 19 June 2014 to the Ministry of Finance. They include capital requirements for credit exposure to local and county authorities, possible tax-related consequences of Solvency II,

treatment of life insurance products at non-life insurers and treatment of the Norwegian Natural Perils Pool in the solvency calculations.

The adjustments following Solvency II and CRD IV require a closer assessment of what rules are to apply to groupings that include both banking and insurance. A holding company owning both a bank and an insurance company may in principle come under Solvency II, CRD IV and the Financial Conglomerates Directive. Supervisory authorities can however derogate from Directives where a group is subject to similar rules in different Directives. Finanstilsynet will in the course of April 2015 propose rules for cross-sectoral groups. Finanstilsynet will also consider what rules should apply at company level (solo level) to holding companies that mainlyown insurance companies.

Finanstilsynet is following EIOPA's recommendations regarding preparations for Solvency II. The recommendations cover requirements on insurers' risk management and internal control, including self-assessment of risk and solvency (ORSA), the requirement for a pre-application dialogue for internal models used to calculate capital charges and requirements on reporting.

The Solvency II Directive does not cover pension funds. Work is under way at EU level with a view to establishing harmonised solvency rules for pension funds. The Commission presented a draft Directive in March 2014 covering requirements on pension funds' management and control (Pillar 2) and information disclosure (Pillar 3).

The introduction of the Solvency II framework necessitates amendment of the accounting rules for insurers. Finanstilsynet recently forwarded a consultation document to the Ministry of Finance recommending amendments. Under current rules insurers must present company accounts in accordance with international accounting standards (IFRS), taking account of the limitations and additions ensuing from the annual accounts regulations. Since IFRS do not contain provisions specifically concerning the valuation of insurance liabilities, the Norwegian annual accounts regulations require insurance liabilities to be valued in accordance with the rules of the insurance legislation. The question for non-life and life insurers alike is whether valuation for solvency purposes should also be applied when Solvency II enters into force.

SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

An institution is systemically important if problems affecting it may have considerable adverse consequences for the financial system and the real economy. The Basel Committee has published frameworks for the regulation of, respectively, systemically important banks and domestic systemically important banks. The frameworks are implemented in the EU through CRD IV. Provisions on national systemically important financial institutions are included in Norwegian legislation.

CRD IV requires systemically important institutions to be identified by one of the following criteria: size of total assets, economic significance in the EU or the member country, interconnectedness with other financial institutions or significance for cross-border activities. The EBA has published recommendations for the identification of systemically important institutions. The recommendation plans for systemically important institutions to be identified using the objective criteria. National authorities can in addition conduct their own assessments, both based on the objective criteria in the recommendations but also using other indicators listed. Finanstilsynet has had an eye to the EBA recommendations in its assessment.

According to the Act on Financing Activity, a systemically important financial institution shall have a buffer consisting of common equity tier 1 capital accounting for 2 per cent of total risk weighted assets. A transitional rule sets the buffer requirement at 1 per cent as from 1 July 2015 and 2 per cent as from 1 July 2016. The purpose of the extra buffer requirement is to reduce the likelihood of problems arising in systemically important institutions, and to reduce secondary effects of any such problems.

Regulations on the identification of systemically important financial institutions were adopted on 12 May 2014. Finanstilsynet is required by the end of the first quarter of each year to provide reasoned advice to the Ministry of Finance on which financial institutions should be regarded as systemically important in Norway. According to the regulations, institutions that meet at least one of the following criteria are systemically important:

- total assets in excess of 10 per cent of Mainland Norway's GDP
- a volume of lending to the non-financial private sector in Norway that exceeds 5 per cent of aggregate loans to this sector in Norway

Finanstilsynet is also required to base its advice on an assessment of inter alia the institution's size, the scale of its business in Norway and elsewhere, its complexity, role in the financial infrastructure and its interconnectedness with the rest of the financial system.

DNB Bank ASA, Nordea Bank Norge ASA and Kommunalbanken AS were designated as systemically important institutions in Norway in the advice given by Finanstilsynet to the Ministry of Finance in March 2015. The same institutions were considered systemically important by the Ministry of Finance in May 2014. Where DNB is concerned it is pointed out that although the assessment of systemic importance is confined to DNB Bank ASA, the buffer requirement must also be met at group level, i.e. by DNB ASA.

BANKING RECOVERY AND RESOLUTION DIRECTIVE

The European Directive establishing a framework for the recovery and resolution of banks and large investment firms was adopted on 15 May 2014. The Bank Law Commission has been mandated to propose rule changes transposing the Directive into Norwegian law. By ensuring that a bank's critical functions can be maintained in crises and that losses are borne by owners and creditors even though a bank is in operation, the Directive sets the stage for banks to be able to fail without thereby threatening financial stability. The Directive consists of three parts: preparation and prevention, early intervention and crisis resolution.

A key element of the Directive's rules on preparation and prevention is the requirement for institution-specific recovery plans. These plans are drawn up by the institutions and contain concrete measures designed to assist the institution in recovering after a material deterioration of its financial position. The plans must be reviewed by the supervisory authority. The considerations justifying the Directive's requirement for recovery plans are also relevant to Norwegian banks, irrespective of the timing of implementation of the Directive in Norwegian law.

DNB has already drawn up a group recovery plan, and Nordea Bank Norway is covered by the Nordea Group's group recovery plan. Kommunalbanken, Sparebank 1 Nord Norge, Sparebank 1 SMN, Sparebank 1 SR-bank, Sparebanken Vest and Sparebanken Sør are expected to forward their recovery plans to Finanstilsynet by the end of 2015. In the case of the medium-sized and small banks, Finanstilsynet will, in light of the Directive's proportionality principle, consider more closely what requirements on recovery plans should apply when the Banking Law Commission's proposal for implementation of the Directive becomes available. According to the current working plan, the Banking Law Commission's proposal will be presented by the end of 2015.

The EU Commission is also expected to present draft rules for crisis management at institutions other than banks. The draft will probably build on a consultation document circulated by the EU Commission in October 2012 which covered crisis management at central counterparties, securities registers and systemically important insurance companies.

BASEL COMMITTEE PROPOSAL ON CHANGES TO THE CAPITAL ADEQUACY FRAMWORK

The Basel Committee prepares standards underlying the regulation of banks and other credit institutions. In the past year the Committee has prepared several consultation papers on changes to the capital adequacy framework.

CHANGES IN THE STANDARDISED APPROACH FOR CREDIT RISK AND FLOOR BASED ON THE REVISED STANDARDISED APPROACH

In December 2014 the Basel Committee circulated for comment a proposal for comprehensive changes to the standardised approach for credit risk. The proposal is part of a broader effort to reduce observed variations in banks' risk weighted assets that are due to factors other than differences in risk. The changes to the standardised approach aim to ensure that the approach captures to a reasonable extent the risk present in exposures and that it provides a good alternative to internal models.

The revision of the standardised approach is based inter alia on a desire to reduce the use of ratings in the capital adequacy framework, as is also pointed out by the Financial Stability Board (FSB). Banks' use of rating tends to become mechanical, and to lead to poorer independent risk assessment of exposures. Far from all exposures are rated, which entails the need for alternative risk differentiation without the use of rating.

The Basel Committee wishes to make the standardised approach for risk sensitive by updating the calibration of some of the risk weights and the volatility adjustments by taking into account the scale of losses during the financial crisis. The proposed risk weights are merely provisional. A quantitative impact study is to be conducted to estimate the effects of the changes. The ensuing calibration will determine the risk weights. The Basel Committee will consider risk weighting of central governments, central banks and public enterprises as part of a more overall, broader review of government-related risk.

Key aspects of the proposals are:

- For mortgages secured on residential property the risk weight would be determined based on the loan to value ratio and the debt servicing capacity.
- For mortgages secured on commercial property two alternative methods are proposed: either as a main rule not to take collateral in commercial property into account when determining risk weights, or to conduct a risk classification based on loan to value ratio.
- For corporate exposures, risk weights based on external credit rating would be replaced by risk weights determined based on enterprises' incomes and

leverage.

- For the retail portfolio, stricter conditions are proposed for what is included.
- For exposures to banks, it is proposed that risk weights be determined based on common tier 1 capital adequacy and the proportion of non-performing exposures after provisions, instead of on the basis of rating or risk weighting for the central government.
- As regards credit risk mitigation, it is proposed that the legislation be simplified for standardised approach banks, with fewer choices and without the opportunity to utilise internal models.

The Basel Committee proposes that the transitional floor arrangement based on Basel I risk weights be replaced by a floor based on the revised standardised approach. The floor will help to prevent excessive reduction of capital requirements in the use of internal models. Use of a floor could reduce some of the risk inherent in the models and banks' incentives to underestimate risk. Use of a floor also increases transparency, by simplifying comparison of capital adequacy figures across institutions. The floor requirement supplements the leverage ratio requirement.

Finanstilsynet has submitted consultative statements in conjunction with Norges Bank, supporting both the proposal for a more risk sensitive standardised approach able to give banks more correct incentives in their lending, and the proposal for a new capital requirements floor based on a revised standardised approach.

REVIEW OF THE MARKET RISK FRAMEWORK

The financial crisis revealed shortcomings in the rules governing the calculation of capital charges against market risk – a large portion of banks' losses could be traced to activities covered by this body of rules. The rules regulating market risk were last amended by the Basel Committee in their "Revisions to the Basel II market risk framework"⁴ published in 2009, also referred to as Basel 2.5. This framework is implemented in Norway through the CRD III Directive. The amendments entered into force in 2011. The Basel Committee considers that weaknesses remain in the framework, and has now conducted a more extensive review.

Against the background of the Basel Committee's consultations on the extensive changes to the market risk framework that were carried out in 2012 and 2013⁵, and based on completed quantitative impact studies, the Committee conducted a new consultation with the deadline

⁵ http://www.bis.org/publ/bcbs265.htm

set at 20 February 20156.

The following changes are proposed:

- New treatment of internal risk transfers of equity capital and interest rate risk between the banking and the trading book.
- A revised standardised approach that is more risk sensitive, where changes in the value of an instrument are calculated against the background of the instruments' sensitivity to underlying risk factors.
- Institutions utilising internal models for market risk should take account of illiquidity through so-called liquidity horizons, i.e. how long a period it would take to sell or secure a position in a stressed market without producing major price effects. The method for taking this into account has been simplified.

The Basel Committee has in parallel with the consultation process conducted a quantitative impact study. It is not clear when a final proposal for new rules will become available.

NEW LOSS RULES

In the accounting area it is above all the development of new loss rules that is likely to be of major significance for banks. The current rules have been criticised for resulting in low losses in good times. At the initiative of inter alia G 20, the IASB (International Accounting Standard Board) has since 2008 worked on developing a more forward-looking model focusing on expected losses. Developing this model has posed a challenge, and a number of different proposals have been put forward.

NEW IFRS ON FINANCIAL INSTRUMENTS, INCLUDING A MODEL FOR WRITE-DOWN OF LOANS

The IASB completed in July 2014 a new standard, IFRS 9, for the accounting treatment of financial instruments. A key change compared with the existing standard, IAS 39, is a new model for loan impairment write-downs. There also rule changes for classification and measurement, and for hedge accounting. The standard will apply as from 2018. For European companies, use of the standard requires EU approval, which is expected at the end of 2015.

The current rules on loan impairment write-downs (loss rules) are based on a so-called incurred loss model where losses are only recognised when there are objective indications of value impairment resulting from a loss event. Significant financial difficulties of a debtor are an example of such a loss event. During the financial crisis this model was criticised for resulting in loss provisions that were

⁴ Revisions to the Basel II market risk framework – final version: http://www.bis.org/publ/bcbs158.htm

⁶ Fundamental review of the trading book: outstanding issues – consultative document. http://www.bis.org/bcbs/publ/d305.htm

inadequate and accounted for too late.

The IASB now employs the assumption that part of the interest on a loan is compensation for the bank's expected losses on the loan. Under the current model, interest is recognised as income inclusive of the loss compensation on a continuous basis, whereas impairment write-downs are made only where a loss event exists. The requirement for loss provisioning on new, 'healthy' loans can be viewed as a counterweight to the systematic overvaluation of interest income entailed by the current model. In the case of new, 'healthy' loans a write-down must be made for expected credit loss resulting from an expected default in the coming 12 months. In the case of loans with the credit risk has risen significantly after establishment, expected credit loss must be written down over the term of the loans. Transition from 12-month expected loss to expected loss over the remaining life of the loan will increase the level of write-downs, both as a result of increased credit risk and of a longer calculation period. Hence the bank's assessment of whether an increase in credit risk is significant not will be at centre stage.

Current rules in IAS 39 have four main categories of financial assets and detailed rules on classification. The IASB has in IFRS 9 sought to lay down principled provisions for whether a financial asset should be measured at amortised cost or fair value. The standard employs three categories: (1) amortised cost, (2) fair value with value changes shown over other comprehensive income and (3) fair value with value changes shown through profit and loss. The firstmentioned category is confined to loans and other interestbearing financial assets where the entity's purpose is to receive contractual cash flows in the form of interest and instalments.

CONSULTATION DOCUMENT FROM THE BASEL COMMITTEE ON GUIDELINES FOR ACCOUNTING FOR EXPECTED LOSS

In February 2015 the Basel Committee circulated for comment a proposal for a new guidance on accounting for expected loss. The guidance comprises eleven principles for what the supervisory authorities should expect from the banks as regards management and control of credit risk related to calculations of expected loss. The principles attach importance inter alia to management's responsibility for assuring adequate risk management, the need for policies and procedures for validation of banks' own internal creditworthiness assessment models. The principles also impose requirements on the supervisory authorities' assessment of banks' methods for calculating loss provisioning and monitoring banks' credit risk assessments in terms of the level of banks' capital. Further, an annex to the guidance gives recommendations on three themes of the loss rules in IFRS 9: (1) on calculation of twelve-month expected loss, (2) on assessment of a significant increase in credit risk and (3) on the use of simplified calculations.

MEASURES TO STRENGHTEN COMPETITIVENESS IN FINANCIAL MARKETS – COVERED BONDS

On commission from the Ministry of Finance, Finanstilsynet has examined the links between banks and covered-bondissuing entities, and how those links affect banks' financial position, financial stability and competition for home mortgage borrowers. Finanstilsynet forwarded a report to the Ministry of Finance in March 2015. The report is based on two studies from 2012 and 2013 of the covered bond market in Norway which Finanstilsynet previously carried out on commission from the Ministry of Finance.

The financial links between banks and mortgage companies consist inter alia of equity capital, hybrid capital and subordinated debt, the funding of mortgage companies' overcollateralisation, drawing rights, liquidity facilities, guarantees, shareholder agreements and counterparty risk in derivatives contracts. The banks also invest in covered bonds issued by captive and other mortgage companies.

The links between owner banks and residential mortgage companies do not appear to have impacted negatively on the competition for borrowers. Information obtained by Finanstilsynet from covered bond issuing entities may indicate that small banks' access to the covered bond market, both through holy and partly owned covered bond issuing entities, has strengthened their competitiveness in the market for loans. There is little difference in funding costs between small and large wholly owned, and between wholly and partly owned, covered bond issuing enterprises compared with the difference in funding costs for senior bonds issued by DNB and equivalent bonds issued by small and medium-sized banks. Hence access to covered bonds has contributed to evening out the differences between banks' funding costs.

The scale of the linkages is directly linked to the scale of encumbered mortgages. In the study from 2013, Finanstilsynet gave an account of detrimental aspects of excessive encumbrance of mortgages. Three factors received particular emphasis. First, the high degree of encumbrance of banks' assets and reduced potential for further encumbrance may cause banks to lose flexibility in periods of financial turbulence, which may restrict the supply of unsecured funding. Second, a high level of encumbrance will increase the risk faced by unsecured creditors and depositors. Third, there is a danger that the low yield on covered bonds, and low risk weights on mortgages, may play a part in switching bank lending from commercial to residential borrowers and intensify the upturn in household debt and house prices. Links between parent bank and covered bond issuing entities may compound the detrimental effect of the parent bank's creditors' lack of understanding of the increased risk that ensues from this and of therefore not pricing the risk correctly. The link between banks and partly-owned covered bond issuing enterprises could produce contagion effects between banks.

Finanstilsynet has considered whether, in the interest of unsecured creditors and financial stability, measures should be introduced to reduce or compensate for links between parent banks and covered bond issuing entities, such as limiting the scope of drawing rights in liquidity facilities. Such limits could however impair covered bond issuing entities' rating, which may weaken covered bonds as a funding source in turbulent periods. Finanstilsynet is of the view that instead of establishing rules to restrict linkages, it would be more appropriate to influence the scale of linkages indirectly through Finanstilsynet's follow-up of the banks' level of transfers and mortgage encumbrance, and requirements on parent banks to hold sufficient capital and liquidity for their liabilities vis-a-vis residential mortgage companies. If the banks' levels of transfer and encumbrance are considered too high, Finanstilsynet could impose on the bank's stricter capital and liquidity requirements under Pillar 2 in the capital adequacy framework. Capital requirements could limit the scale of the liabilities. At the same time it is important for information on linkages to be clearly communicated to the market. Finanstilsynet will consider liquidity requirements for covered bond issuing entities in connection with the Ministry of Finance's assignment regarding introduction of liquidity requirements.

CHANGES IN THE RULES FOR THE SECURITIES AREA

RULES CONCERNING THE MARKET FINANCIAL INSTRUMENTS (MIFID II)

The Markets in Financial Instruments Directive (MiFID) are implemented in Norway through the Securities Trading Act and the Stock Exchange Act. In the EU a revision of this legislation has been adopted through the MiFID II Directive, and the MiFIR Regulation, which are to be implemented in the EU on 3 January 2017. Work is now being done on implementing Directives and Regulations, so-called level 2 rules.

MiFID II requires all trading in financial instruments to take place in the main on organised marketplaces to afford a level playing field and assure more transparent and efficient trading. Securities firms that have internal matching systems to execute orders on behalf of clients in shares, depositary receipts, ETFs, short-term paper and similar instruments, must have authorisation as a multilateral trading facility. Further, a new type of organised marketplace termed organised trading facility is introduced for trading in instruments other than equity capital instruments, such as bonds and derivatives. Changes are made to the definitions of financial instruments and derogations from the concession requirement. This is likely to cause more entities trading in commodity derivatives, in particular in the electricity field, to become subject to a requirement for authorisation as an investment firm. MiFID II introduces a common requirement for transparency for all types of financial instruments that are traded on an organised marketplace, in that information disclosure is to be required both prior to and after execution of trades. Further, limits are introduced to the size of the positions that can be held in commodity derivatives. It is up to national authorities to set position limits, but the European Securities and Market Authority (ESMA) will play a paramount role in this context.

MiFID II also strengthens investor protection rules through inter alia extended requirements on the information to be provided to the client before the entity provides investment services. Particular requirements apply to independent advice. The requirements on suitability testing and fit and proper testing are tightened, and stricter requirements are introduced for receipt of remuneration from parties other than the customer. There is also some tightening of the requirements to give the client the best terms and current market price. MiFID II also empowers national supervisory authorities and ESMA to prohibit or limit the distribution of certain financial instruments, either temporarily or on a permanent basis. The sale of structured products will be covered by the requirements for good conduct of business under MiFID II.

RULES ON OTC DERIVATIVES, CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES (EMIR)

EMIR, adopted across the EU in July 2012, introduces rules on mandatory clearing of OTC derivatives, a requirement to report derivative trades to trade repositories and common European rules for central counterparties. Rules have yet to be established regarding what OTC derivatives contracts are to be subject to the clearing obligation, and what requirements are to apply to provision of security between parties where there is no clearing obligation. Central counterparties from countries outside the EU (third countries) must be recognised by ESMA in order to be able to offer services to clearing members or marketplaces from the EU. Because the EU Commission has yet to finally consider whether relevant third countries' rules are in compliance with EMIR, ESMA has as yet not been in a position to recognise central counterparties. The EU Commission has for the same reason several times extended the transitional period for elevated capital requirements for credit institutions and investment firms as regards exposures to central counterparties that do not have authorisation or recognition under EMIR. The current transitional period lasts to 15 June 2015.

RULES ON SECURITIES SETTLEMENT AND CENTRAL SECURITIES DEPOSITORIES (CSD REGULATION)

In July 2014 the EU adopted a Regulation on improving securities settlement in the EU and on securities depositories. The greater part of the Regulation entered into force across the EU in September 2014. The Regulation contains rules on settlement discipline designed to secure a high settlement rate and speedier settlement of trades in financial instruments. In the case of delayed settlement the defaulting party will receive administrative fines. In the event of longer delays in the delivery of financial instruments, the defaulted trades will be forced through. Investment firms must take steps to reduce the number of settlements that cannot be completed. These measures must at least ensure that the investment firm's professional clients rapidly confirm trades entered into. The Regulation contains requirements on authorisation, organisation and execution of business for securities depositories. Securities depositories will be entitled to provide services in all member countries based on the home country's authorisation. Those securities depositories that offer services to issuers in the EU, including the Norwegian securities depository, will need to apply for authorisation/recognition under the new Regulation, probably by spring 2016. Until such time as the application for such authorisation recognition has been decided, securities depositories will be entitled to operate in compliance with the relevant national legislation.

ESMA is in the process of preparing a proposal for supplementary rules. Large parts of the Regulation, including the rules on fines and forced execution of trades in the event of delayed settlement, will only become effective once supplementary rules have entered into force. The proposals are to be forwarded to the EU Commission by 18 June 2015. It is not clear how long the EU Commission will need to adopt supplementary rules.

EUROPEAN CAPITAL MARKET UNION (CMU)

The EU Commission aspires to set the stage for a European capital market union (CMU). Future EU rules to facilitate a capital market union are considered to be EEA-relevant, and may acquire significance for the Norwegian capital market. The EU Commission presented a consultation document, a so-called "green book" for a CMU on 18 February 2015.

The establishment of a capital market union for all member countries is one of the EU Commission's main priorities. This is because business and industry in Europe, and in particular small and medium-sized enterprises, are far more dependent on funding from the banking sector than for example enterprises in the US which has a more developed capital market. Establishing a capital market union is a wide-ranging project, and a number of sets of rules to establish the basis for a common capital market union have already been adopted. This applies inter alia to MiFID (on markets for financial instruments), MAD/MAR (on market abuse) and EMIR (on OTC derivatives, central counterparties and trade repositories).

THEME I FINANCIAL VULNERABILITY IN THE EVENT OF LOWER INCOME AND HIGHER INTEREST RATES

INTRODUCTION

The Norwegian economy has fared well for a long time, interrupted only by a brief period of lower growth during the international financial crisis. Household debt and house prices have risen strongly for several years. The ratio of household debt to income has never been higher than now, and debt continues to rise more rapidly than incomes. House prices have also risen more than incomes, one reason being extraordinarily low Norwegian mortgage interest rates, driven by low international rates which in a number of countries are virtually zero.

Interest rates in Norway and elsewhere are expected to rise towards a normal level in the medium to long term. Even if central banks' key rates do not increase in the near future, there is a danger that risk premiums in the fixed income markets will rise sharply as a result of renewed turbulence in financial markets. In addition, uncertainty attends future income growth, which is closely tied to the oil price and to international demand for Norwegian goods and services. Substantial debt incurrence and increased house prices have spurred consumption growth, leaving the Norwegian economy more vulnerable to interest rate hikes and reduced income. Although the new normal interest rate level may be lower than prior to the financial crisis, an increase from today's low level towards a normal level could impact heavily on private consumption and on the housing market. There is a long way to fall. At the same time the steep reduction in the oil price and the expected fall in oil investments ahead make for greater uncertainty regarding the income trend than for a long time.

Part 2 of this theme chapter discusses the trend in household debt and house prices in a scenario where oil investments make a negative contribution, but where the overall Norwegian economy remains on a positive trend. Financial imbalances and risk are further intensified in this scenario. The analysis is performed using a macroeconometric model (box article). The model has been developed for stress testing of banks and analyses of financial stability. Part 3 analyses a scenario in which the Norwegian economy is on a sound trend through 2015, followed by a turnaround in 2016. The oil price is assumed to fall anew, impelled by a marked fall in international demand, oil investments are sharply reduced and risk premiums in the fixed income market rise as a result of turbulence and increased volatility in financial markets.⁷

SCENARIO 1 – CONTINUED GOOD, BUT IMBALANCED, TREND IN THE NORWEGIAN ECONOMY

Finanstilsynet does not prepare forecasts for the Norwegian economy. The projections below are accordingly not a forecast for the development of the Norwegian economy, but represent one possible development path in which the financial imbalances are intensified. The scenario described is not sustainable. Household debt rises substantially, and vulnerability deepens. Given such a path, the negative consequences of a subsequent turnaround in the economy, with reduced income and increased interest rates, will most likely be significantly more serious than a development in the Norwegian economy in which household debt growth and house prices are stabilised.

In order to analyse possible scenarios for the Norwegian economy the macroeconometric model, like most macroeconometric models, requires the model operator to set values for a number of (exogenous) variables in the projection period. In this case the period is the first quarter of 2015 to the fourth quarter of 2020. Once these variables are set, the model generates estimates and an uncertainty interval for important economic variables (endogenous) such as GDP, consumption, investment in Mainland Norway, unemployment, wages, credit growth, house prices, bank lending rates and banks' problem loans to households and firms etc.

The most important exogenous variables are the price of oil, oil investments, general government demand for goods and services, international demand, oil exports, international prices and international money markets rates. The oil price estimates in the projections are based on forward contracts for oil (Brent) in the period 2015 to 2020. These estimates rise gradually to about USD 75 per barrel in the fourth quarter of 2020. Norges Bank's key policy rate is set equal to Norges Bank's interest rate path to the end of 2018 and is thereafter held flat to the end of the projection period. The estimate for growth in general government consumption is identical to Statistics Norway's estimate to 2018, and maintained at the same rate of growth to 2020.

⁷ See Risk Outlook 2014 for presentation of a stress test in which the oil price falls sharply and banks' funding costs increase. The main emphasis was on assessing consequences for the banks' financial results and capital adequacy. On the present occasion, attention focuses on the danger of a further build-up of financial imbalances and consequences of financial consolidation, given a strong economic downturn.

Estimates for the trend in international demand and prices are set equal to projections made by the International Monetary Fund.⁸ International money market rates are represented by three-month euro rates. These are approximately zero in 2015 and 2016, rising gradually to between 0.5 and 0.6 per cent in 2020. The estimate for future oil exports is based on information on petroleum production on the Norwegian shelf in the 2015 National Budget, while oil investments are based on estimates from Statistics Norway.

Great uncertainty attends model projections. Chart I.1 shows some of this uncertainty in the case of the real interest rate. The uncertainty interval ranges from about 2 to 4 per cent in 2020, while the point estimate is just over 3 per cent.⁹ This interval represents uncertainty from random shocks (residual uncertainty) and from estimation of the model's parameters and illustrates that the historical data are consistent both with a higher and a lower interest rate level in the future than indicated by the point estimates in the projections. The real interest rate in 2014 is by the way low compared with levels through most of the 1990s and the start of the 2000s.

The model runs draw a positive picture of the Norwegian economy in the projection period. Unemployment remains low, growth in households' disposable income is good and Mainland Norway's GDP grows approximately on trend. Low international interest rates help to hold households' average borrowing rate low throughout the period. In 2020 the real after-tax interest rate is just under 2 per cent. Households' real cost of borrowing therefore remains low, and lays a basis in the model for increased debt and rising house prices.

Given the scenario outlined, households' domestic gross debt grows. Towards the end of the period the growth is estimated at almost 8 per cent, and for the entire period its lies significantly above the growth in households' disposable income. The model incorporates a financial accelerator whereby house prices and credit are mutually reinforcing in upturn and downturn alike. Increased house prices provide banks with a basis for granting credit and for households to borrow more. This mutual reinforcement is illustrated in chart I.4. In the long term, house prices and credit follow one another closely. In addition higher house prices lead to

I.1 Average real interest rate (bank loans)



I.2 Nominal growth in house prices, annualised



I.3 Households' credit growth, annualised



Sources: Statistics Norway og Finanstilsynet

⁸ From October 2014 with updates in January 2015.

⁹ The orange lines display a 95 per cent confidence interval. The intervals are dependent on correct model specification i.e. that the model describes the development in the economy without making systematic errors. The intervals do not capture the risk that the future may differ significantly from history, i.e. that the model's structure is not representative for economic developments. In other words, the uncertainty intervals do not contain information on potential developments in a future financial crisis or a powerful demand- or supply-driven shock. This type of risk is illustrated below.



Sources: Statistics Norway and Finanstilsynet





Sources: Statistics Norway and Finanstilsynet







Sources: Statistics Norway and Finanstilsynet





Source: Finanstilsynet

I.9 Banks' loans to firms, problem loan share



increased household consumption.¹⁰ Behind the house price upturn and the credit growth lie low real interest rates and good income growth.

House prices have risen considerably more on earlier occasions than they do in the model projections, and there is less variation in price growth ahead than historically (chart 1.2). The accumulated increase in house prices, given this positive trend, is relatively high, and higher than the growth in households' disposable income. Growth in credit to households is high in the projections, but significantly lower than in the period prior to the financial crisis (chart 1.3).

The debt ratio in the Norwegian economy continues to increase in the projection period (chart 1.5).¹¹ For the end of 2020 the municipal and non-financial private sector's gross domestic debt is estimated at 210 per cent of GDP for Mainland Norway. While it is above all the growth in household and municipal debt that pushes up this percentage, firms' domestic gross debt also rises more rapidly than nominal Mainland GDP. The Norwegian economy's debt ratio increases throughout the projection period, entailing growing vulnerability in the event of a turnaround.

Given this "good" trend in the Norwegian economy, house prices continue to rise. At the end of 2020 house prices are estimated to be about 40 per cent higher than in 2014, while prices deflated by the consumer price index have risen by close to 25 per cent. House prices also increase relative to wages and disposable income in the projections.

The household debt burden is defined as the ratio of gross debt to disposable income.¹² This ratio is estimated to rise from 214 per cent in 2015 to almost 245 per cent in 2020 (chart I.6). Households' interest expenditure in 2014 is estimated at about 8 per cent of disposable income before interest expense deductions. Due to strong credit growth and a somewhat higher level of interest rates, interest expenditure as a share of disposable income before interest expense deductions is put at somewhat more than 10 per cent in 2020 (chart I.7). Many households pay relatively small instalments. Other borrowers only pay interest in the initial years. Assuming an average maturity of household debt of 25 years, the interest and instalment burden is estimated to rise from 16 to 19 per cent from 2014 to 2020. Strong debt growth in the period leads both to higher interest and instalment payments. A large portion of income is tied up in servicing debt.

¹⁰ The consumption function in the macro model contains a wealth effect.

I.10 Average bank lending rate, nominal



Sources: Statistics Norway and Finanstilsynet

I.11 Change in private consumption, annualised



Sources: Statistics Norway and Finanstilsynet

The estimated interest rate burden in 2020 remain significantly lower than in 1990, but on that occasion the interest rate level was also higher than at present, at the same time as the debt burden was lower. Households are already vulnerable to interest rate hikes and income lapses. Given these projections, vulnerability will increase further in the years ahead.

Banks' problem loans are defined as the sum of nonperforming loans and performing loans that are written down. Problem loans as a proportion of total bank loans to households is extremely low, and remains low in the projections (chart I.8).

This proportion is also low in the case of firms, and remains low up to 2020 (chart I.9). This is consistent with the positive trend in the scenario, but disguises the continuing growth of financial imbalances. The trend in this scenario is therefore not sustainable.

 $^{^{11}}_{12}$ I.e. the debt ratio in the private sector.

¹² Debt to domestic sources.



Sources: Statistics Norway and Finanstilsynet





Sources: Statistics Norway and Finanstilsynet



 $\ensuremath{\mathsf{I.14}}$ Growth in credit to households, firms and municipalities, annualised



I.15 Credit (C2) relative to GDP Mainland Norway

SCENARIO 2 – FURTHER FALL INN OIL PRICES AND RENEWED DOWNTURN IN INTERNATIONAL DEMAND

As in the case of Scenario 1, the stress scenario described in the following does not represent a forecast for the international or the Norwegian economy. The aim is to illustrate possible consequences for the Norwegian economy of a further fall in the oil price, a strong reduction in international demand and trade and higher interest rates.

The path of the Norwegian economy is closely tied to that of the international economy, which is marked by great uncertainty. This negative scenario incorporates a continued sound trend in the Norwegian economy during 2015, and a further build-up of financial imbalances. However, in 2016 international demand is assumed to fall markedly, pulling down the oil price to USD 40 per barrel. Norwegian oil exports are reduced in step with the decline in international demand. The reduced oil price brings a strong decline in oil investment, which falls to about 70 per cent of the oil investments in the baseline scenario. Concurrently international money market rates rise by 3 percentage points as a result of increased uncertainty in financial markets. A further assumption is that general government purchases of goods and services increases by 4.5 per cent in both 2016 and 2017 in order to dampen the setback in the Norwegian economy. Norges Bank's key policy rate approaches zero in this scenario, but is counteracted by higher risk premiums. In this scenario the increase in international money market rates immediately feeds through to the corresponding Norwegian rates and spreads further to the banks' lending rates, which increase by 2.5 percentage points from about 4 per cent in 2015 to about 6.5 per cent in 2020 (chart I.10).

In the stress scenario higher interest rates, lower oil price and reduced international demand have considerable negative spillover effects on the Norwegian economy. Firms

Sources: Statistics Norway and Finanstilsynet



I.16 Households' debt burden

are affected, and growth in household consumption turns from positive to negative, before picking up somewhat again at the end of the period (chart I.11). The weak trend in consumption coincides with a strong increase in unemployment (chart I.12), declining wage and income growth, increased interest expenses and a need for financial consolidation. Oil investments (exogenous) and investments in Mainland Norway (endogenous) both fall sharply. Growth in Mainland Norway's GDP is low (chart I.13).

The negative trend in the Norwegian economy causes a marked decline in growth in credit to the municipal and non-financial private sector (chart I.14). The growth in gross debt is reduced in the case of municipalities, firms and households alike. Despite slower growth in gross debt, the ratio of domestic gross debt to Mainland Norway's GDP continues to rise in the projection period (I.15) in as much as production in Mainland Norway falls faster than gross debt. Only towards the end of the period does the ratio level off. In such a perspective the Norwegian economy does not come over as particularly solid, despite the financial consolidation taking place in the period. It will take time to scale back the debt ratio to a more sustainable level. The imbalances have been allowed to build up over a long period, and an economic crisis accompanied by financial consolidation does not remove the imbalances within this analysis horizon.

The household debt burden rises from 212 to 220 per cent in the stress scenario, which is considerably less than outlined in the previous scenario in which the debt ratio rose to about 245 per cent (charts I.6 and I.16). This is due to the large reduction in credit growth in the stress scenario.

The increased debt ratio and higher interest rates both contribute to the strong increase in households' interest and instalment burden to approximately the same level as I.17 Households' interest and principal burden



Sources: Statistics Norway and Finanstilsynet





Sources: Statistics Norway and Finanstilsynet

I.19 Nominal growth in house prices, annualised



Sources: Statistics Norway and Finanstilsynet











I.22 Banks' loans to households, problem loans share

Source: Finanstilsynet

L23 Banks' loans to firms, problem loan share



during the banking crisis in the early 1990s (chart I.17). The interest and instalment burden also rose considerably in the positive scenario described above. The increase was in the main describable to the faster growth in credit than in incomes.

The marked decline in households' credit growth also has a bearing on the trend in nominal house prices by way of the financial accelerator effect (charts I.18 and I.19). House prices are also driven down by high interest rates, increased unemployment and lower income growth. Between the end of 2015 and the end of 2020 house prices are estimated to fall by about 24 per cent (chart I.20).

Because consumer prices rise in the projection period, real house prices fall by an even wider margin than the nominal fall (chart I.21). Over the period real house prices fall by about 30 per cent. Residential property is households' largest asset item. A marked fall in real house prices reduces household consumption to a level below that due to increased unemployment, lower income growth and greater uncertainty about the future. Higher house prices provide a basis for increased consumption. Households perceive themselves to be wealthier. A reduction in housing wealth has the opposite effect.

The proportion of problem loans in banks' loan portfolios rises strongly when demand weakens, unemployment rises, income growth slows and interest expenses rise (charts I.22 and I.23).

For the retail market portfolio, the proportion of problem loans increases from 1 per cent to almost 12 per cent, and for the corporate portfolio from about 1.5 per cent to 11 per cent. The proportion of problem loans rises to almost the same level as during the banking crisis in the early 1990s. Such a development could inflict considerable loan losses on the banks, leading to a significant fall in capital adequacy, which in turn may further reduce credit growth, house prices and activity levels in the economy. This type of feedback effect has not been modelled.

CONCLUSION

The level of debt in Norway is high relative to production, and has never been higher than at present. Growth in household debt in particular has outstripped growth in incomes by a wide margin. Concurrently house prices have risen steeply. The debt build-up started after the banking crisis in the early 1990s. House prices began to gather momentum at the same time. Apart from a spell during the international financial crisis, households' debt burden (debt relative to disposable income) and house prices have largely risen throughout the period. For firms too, the ratio of domestic gross debt to Mainland GDP is higher than it was at the start of the banking crisis, but somewhat lower than immediately prior to the onset of the international financial crisis.

The projections in the first part of this theme chapter show that the imbalances may continue to build up in the next few years, given a relatively sound trend in the Norwegian economy and absence of new, negative shocks internationally. Important underlying assumptions are that interest rates remain low, that international demand develops as assumed by the IMF and that the oil price shows some increase from the current level. In that scenario it is likely that unemployment remains low, that incomes increase and that both household debt and housing prices continue to rise faster than incomes. The interest and instalment burden rises, mostly due to high debt growth, but also because interest rates increase somewhat towards the end of the projection period. Firms' domestic gross debt relative to production in the mainland economy also rises by a relatively wide margin, reaching a level substantially above the level seen during the banking crisis. The proportion of problem loans among the banks remains low, and does not reflect a steadily longer way to fall.

Although production, employment and incomes rise steadily ahead, these projections show that this is not a sustainable trend for the Norwegian economy. The financial imbalances are reinforced, and the future negative consequences of a possible income lapse and interest rate hike could deepen substantially.

The stress scenario incorporates a continued good trend in the Norwegian economy for the rest of 2015, followed by a turnaround in 2016.¹³ Unemployment rises considerably,

¹³ A scenario in which the imbalances are allowed to accumulate over a long period, followed by a sharp, negative international demand shock could have had larger negative consequences for the Norwegian economy. It would technically speaking be simple to draw up such a scenario, but the projection period would probably need to be extended beyond 2020 in order to capture the accumulated negative effects. The uncertainty growth in incomes and credit slows and house prices fall. Increased unemployment and financial consolidation also lead to falling household consumption. Reduced consumption results in lower production in goods and services industries. These are industries to which the banks are heavily exposed, both directly and indirectly. Despite a strong reduction in credit growth, debt ratios remain high among households and firms alike. The imbalances that have developed over a long period do not disappear in the projection period. There is a considerable risk that high debt and financial consolidation would restrict growth for a long time ahead. The number of non-performing loans among the banks rises, bringing heavier loan losses, and, all else equal, weakening banks' capital adequacy. This could contribute to further a weakening of credit growth.

In order to limit the harmful effects of reduced demand for Norwegian goods, a lower oil price and higher interest rates, it is important for banks' capital adequacy to be sound and to reflect the risk of a possible setback. The risk of financial market turbulence also requires banks to maintain sufficient liquidity reserves and stable long-term funding of long-term assets. Banks' credit practices should be geared to the risk of a further build-up of financial imbalances in the economy. Tighter regulation of new mortgages, as proposed by Finanstilsynet, can help to dampen the growth in house prices and credit to households.

attending model projections far ahead in time is so large that this has not been considered a viable option. The period to 2020 is at the outset relatively long.

The macro model NAM-FT 2¹⁴

The macroeconometric model NAM-FT 2 is based on the Norwegian Aggregate Model (NAM) and was developed by economics professors Gunnar Bårdsen and Ragnar Nymoen. NAM-FT 2 was developed particularly with a view to stress testing banks and analysing financial stability.

A number of sources of historical data are used in estimating the equations in the model. Most important among them is Statistics Norway's quarterly national accounts. Quarterly statistics provide somewhat greater volatility in historical time series than annual figures. One reason for this is that the number of working days in the respective quarters varies from year to year due to movable holidays. Variation in the projected variables is however significantly smaller than in the historical data. This is because random "shocks" die out in the projection period as the model results approach equilibrium.

NAM-FT 2 explains credit and house price developments, along with wage and price inflation, exchange rates and interest rates. The model contains some disaggregation on both the supply and demand side. Overall demand is defined as the sum of private consumption, public consumption, public investment, private investment in housing capital, private investment in firms, investment in the petroleum sector, investment in foreign trade, exports, and increase in inventories. Overall supply is defined as the sum of gross national product for Mainland Norway, gross product for the petroleum sector, gross product for shipping and imports. Gross domestic product for Mainland Norway is split into gross products for public administration and the three private sectors: (i) Manufacturing and mining, (ii) Other goods production and (iii) Services.

With its more detailed model structure, NAM-FT 2 is better suited than the previous version, NAM-FT 1, for use in combination with the SEBRA model and the bank model. Finanstilsynet uses the SEBRA model to predict nonfinancial firms' probability of default, and to analyse banks' credit risk on loans to non-financial firms. There is also work ongoing on modelling growth in gross product for sectors beyond those included in NAM-FT 2. These models are an adjunct to NAM-FT 2 since the modelled variables are not explanatory variables included in NAM-FT 2. The models are used to make projections of more disaggregated (sector-wise) gross products than is possible using NAM-FT 2 alone. Use of more disaggregated gross products as input data in the SEBRA model will permit more reliable calculations of non-financial firms' probabilities of default. Thus far, gross national product has been used to calculate

¹⁴ See also Financial Outlook 2014 for a description of the model.

probabilities of defaults in the SEBRA model. The bank model is used to project income statements, balance sheets and capital adequacy for individual banks and bank aggregates.

NAM-FT 2 explains 159 variables (endogenous), while only 14 variables need to be determined exogenously. The most central exogenous variables are foreign demand for Norwegian-produced traditional goods and services, foreign consumer and producer prices, foreign money market rates, crude oil prices, Norwegian petroleum exports, investments in the petroleum sector and public demand for goods and services.

Several of the variables included in the model follow estimated equilibrium paths. However, in financial crises behaviour can change, and established model structures may break down. NAM-FT enables account to be taken of behavioural changes, for example by disengaging equilibrium correcting factors or using dummy variables to represent regime changes. In addition, non-linear effects are activated if certain variables reach predefined threshold values. Such threshold values are included in the equations for private consumption, house prices and problem loans for households and non-financial firms. This is particularly useful in connection with stress testing, which is an important application of the model for Finanstilsynet.

In NAM-FT 2 domestic credit (C2) is modelled on a disaggregated basis for households, non-financial firms and municipalities. This is new compared with the previous version.

The model contains a wealth effect for private consumption whereby higher house prices contribute to increased private consumption through higher housing wealth. Household debt increases with rising disposable income and house prices and with lower lending rates. The model contains an accelerator mechanism whereby higher house prices, contributing to higher collateral values, lead to heavier household debt, which in turn fuels a further increase in house prices, and thereby even heavier borrowing by households. This mutual effect between credit and house price growth may help to improve the modelling of financial imbalances in the household sector over time. Households' interest burden is determined by the lending rate and household debt. An increase in the debt burden will tighten households' liquidity, thereby reducing housing demand. The proportion of problem loans among households depends on both the interest burden and unemployment.

Growth in credit to non-financial firms is determined in the model by Mainland Norway GDP, wage costs, real exchange rates and domestic stock prices. Increased wage costs reduce credit among non-financial firms, because poorer profitability impairs debt servicing capacity. Increased Mainland Norway GDP improves firms' debt servicing capacity, and provides a basis for higher debt. The same is true of a higher real exchange rate (strengthened competitiveness). The model contains an accelerator mechanism on the firm side too, since there is a mutual effect between the market value of non-financial firms and the latter's incurrence of debt. The proportion of problem loans among non-financial firms is determined by bank lending rates, unemployment and the real exchange rate.

Money market rates and bank lending rates are determined in the model by Norges Bank's key policy rate and foreign money market rates. Risk premiums vary with market participants' view of uncertainty in the economy and investors' risk aversion, and are not modelled.

The banks' market funding as a proportion of total funding declines with the spread between the yield on bank bonds and banks' deposit rate, i.e. the excess return banks must pay for funding through issuance of fixed income securities relative to the interest banks pay on deposits. Further, the market funding proportion increases with rising real disposable income for Norway and declines with increasing unemployment, so that in a cyclical upturn banks will increasingly fund growth in credit to the municipalities and non-financial private sector by issuing bonds or short-term paper. In the model, household debt, and thus also house prices, are rising in the banks' market funding proportion. Banks' market funding was included in the macro model earlier this year (version 2) and provides input to the Bank Model used by Finanstilsynet in its stress testing of banks and mortgage credit institutions.

THEME II CREDIT RISK IN NORWEGIAN-REGISTERED NON-FINANCIAL GROUPS

This theme article analyses credit risk in Norwegianregistered non-financial groups. The analysis shows that equity ratios and debt servicing capacities are at far lower levels for the groups than for the Norwegian-registered parents and subsidiaries in isolation. This applies across most main industries. The analysis also indicates that groups' debt servicing capacity is much weaker now than it was prior to the financial crisis, and not significantly better than in 2002. Although the groups' overall equity ratio is far lower than that of parents and subsidiaries in isolation, it was still at a relatively high level at the end of 2013. This indicates that the groups' capital buffers are in general relatively robust. All main industries showed impaired debt servicing capacity during the dotcom crisis and the financial crisis, indicating limited sectoral diversification gains when it comes to credit risk.

INTRODUCTION

Norwegian companies have seen economic good times for many years, as reflected in very low default rates and low loan losses among Norwegian banks. Traditional economic key figures and probabilities of default (PDs) based on parents' and subsidiaries' non-consolidated company accounts also indicate low credit risk.

However, uncertainty attends the companies' financial position and how far they are equipped to tackle harder economic times. Although Norwegian companies' finances in general are sound, many have both poor earnings and little equity capital. It is also uncertain how well credit analyses based on non-consolidated company accounts capture credit risk in Norwegian business and industry.

This theme article presents a closer analysis of the above factors. Its main purpose is to assess credit risk and developments in Norwegian business and industry as a whole, not Norwegian banks' credit risk directly. The first section analyses credit risk faced by Norwegian-registered non-financial parents and subsidiaries based on company accounts. The next section analyses development in Norwegian-registered non-financial groups based on consolidated accounts, followed by a summary of the findings.





The letter 'M' following the respective key figures means that they are based on the unconsolidated company accounts of Norwegian-registered parents and subsidiaries. In subsequent charts the letter 'K' appears after the respective key figures. This means that the key figures are based on the consolidated accounts of the Norwegian-registered non-financial groups. Source: Finanstilsynet

CREDIT RISK AT NORWEGIAN NON-FINANCIAL PARENTS AND SUBSIDIARIES

A non-financial company (hereafter termed a company) is dependent on:

(i) Sufficient revenues to cover various expenses and other obligations including repayment of debt, their own portion of new investments, any increase in working capital needs, and dividend payments to stockholders. The key ratio RES is used in this analysis as a measure of companies' long-term debt servicing capacity.¹⁵

(ii) Sufficient liquidity to allow for the fact that the timing of cash inflows is not as a rule synchronised with cash outflows. Liquidity is measured by the key ratio AK.¹⁶

(iii) Sufficient capital for the company to have a buffer in bad times. The capital buffer is represented here by the key ratio EK.¹⁷

These three ratios, or various versions of them, are important explanatory variables in many traditional risk classification systems and credit risk models. Chart II.1 shows the development in key ratios and in debt weighted PD in Finanstilsynet's SEBRA model.¹⁸ All parents and

Finanstilsynet's SEBRA model predicts the probability of default for non-

¹⁵ RES = pre-tax profit in per cent of total debt. Impairments and writedowns are included in order for the ratio to be an indicator of the companies' long-term debt servicing capacity. The ratio does not capture all factors related to (i).

¹⁶ AK = companies' current assets minus short-term liabilities in per cent of total operating revenues.

¹⁷ EK = companies' booked equity capital minus goodwill and other nontangible assets in per cent of total assets minus goodwill and other nontangible assets.

subsidiaries that delivered annual accounts (company accounts) to the Brønnøysund Register Centre are included in the calculation of key ratios. For the years 1981-1987 the selection contains only listed companies and companies that were exposed to the former Regional Development Fund. The debt weighted PD selection includes all limited companies whose PD was estimated in the SEBRA model.

Norwegian-registered parents' and subsidiaries' pre-tax result for the year in per cent of total debt, RES-M, is sensitive to changes both in result and in debt. RES-M fell both during the banking crisis (1991-1992), the Asia crisis (1997-1998), the dotcom crisis (2000-2002) and the financial crisis (2007-2008). The fall during the financial crisis was particularly large, but from a high level. At the end of 2013 debt servicing capacity was considerably lower than prior to the financial crisis.

The trend for listed companies, which historically speaking has fairly closely resembled the trend among unlisted companies (chart 1.29 in chapter 1), indicates that debt servicing capacity weakened in 2014, in particular towards year-end.¹⁹ In light of the more challenging times now facing Norwegian business and industry, there is a risk that the debt servicing capacity of Norwegian firms in general will continue to weaken in 2015 and in ensuing years.

Parents' and subsidiaries' liquidity, here measured by the key ratio AK-M, declined after the financial crisis. However, liquidity improved in 2013, bringing AK-M to a historically high level at year-end.

The companies' capital buffer at end-2013 was 42 per cent, the highest level in the period 1981-2013. At the start of the banking crisis at the end of the 1980s, EK-M was a mere 13 per cent. However, as discussed further in the next section, it may be questioned whether the real capital buffer has increased by as much as EK-M in chart II.1 indicates. Many companies have a negative or weak equity ratio, despite the increase in the weighted average. At the end of 2013 16 per cent of parents and subsidiaries were in a negative equity capital position, while 13 per cent had both negative equity and negative debt servicing capacity. During the banking crisis at the start of the 1990s the corresponding figures were 32 and 23 per cent.

Debt weighted PD in the SEBRA model was just under 1 per cent at the end of 2013, the second lowest level measured in the period 1988-2013. Only in 2006, prior to the financial crisis, was debt weighted PD marginally lower. An important reason for the low level of debt weighted PD is a high equity ratio. Debt servicing capacity - the other of the two most important explanatory variables in the SEBRA model - was however lower in 2013 than prior to the financial crisis.

Traditional key ratios and default probabilities based on the non-consolidated company accounts of Norwegianregistered non-financial parents and subsidiaries indicate that credit risk in general is low. However, uncertainty attaches both to the key ratios and default probabilities.²⁰ In addition to the general uncertainty invariably attending such indicators, important information may be concealed or over-/underestimated if the analyses rest on company accounts alone. Analyses based on consolidated accounts in the next section provide fuller information on the financial position of Norwegian business and industry in general.

ANALYSES BASED ON CONSOLIDATED ACCOUNTS

GENERAL NOTES ON CONSOLIDATED AND COMPANY ACCOUNTS

As in the case of banks and other financial institutions, it is important to analyse both consolidated and company accounts of non-financial companies and groups. Important factors related to credit risk are only partially captured if only company accounts are used. At worst, credit risk analyses may give a misleading picture both of the level and development of credit risk. As discussed below, it is important to be aware that there may be considerable differences between the bases for comparison. That is why it is difficult to compare groups with parents and subsidiaries directly.

Most large companies, and also many small ones, are part of a group. A group comprises, besides the parent company, one or more subsidiaries and/or other associated entities. The companies in the group may be engaged in business in different sectors, geographical areas and countries. Credit risk may develop differently in the various areas of the group.

Consolidated accounts are prepared by amalgamating the accounts of the parent and the subsidiaries. The purpose is to show the group's position as a single economic entity.²¹ In the preparation of consolidated accounts, all intra-group transactions and balances must be eliminated. For example, intra-group debts are eliminated, leaving only the companies' external debt to appear in the accounts. The

financial parents and subsidiaries based on unconsolidated company accounts. The three most important explanatory variables in the model are variables that are very similar to the key ratios RES, AK and EK.

The 2014 annual accounts for unlisted companies are not yet available.

²⁰ There may for example be uncertainty related to erroneous reporting, selection issues and how far the indicators reflect the past and not least the future. In the case of PD models there is in addition model uncertainty. for example related to parameter estimation and functional form.

Entities coming under the Accounting Act's definition of small entities may as a general rule omit to prepare consolidated accounts. Nor will a parent be obliged to prepare consolidated accounts if the subsidiaries, both individually and collectively, are little significance to the parent. Source: Altinn.

company accounts of a parent or subsidiary include only the business of the legal entity. There may be wide differences between the financial results, debt servicing capacity, equity ratios and other financial key figures and ratios of a group and its underlying legal entities.

Norwegian listed groups have since 2005 been required to present consolidated accounts under international accounting standards whereas other Norwegian companies are permitted to choose between different accounting languages. Use of different accounting languages may produce differences between the financial key figures of the groups and those of the parents and subsidiaries.

The relation between group and parent and subsidiary may also be of significance for Norwegian banks' risk exposure. Most Norwegian banks have little direct exposure to foreign subsidiaries of Norwegian groups, but a negative development among such subsidiaries could impact on the banks since a weak development among the foreign subsidiaries would hit the group of which they are part.

Many of the largest Norwegian-registered groups and appurtenant companies have considerable bond funding.²² Bonds usually rank behind bank loans. Further, a company in a Norwegian-registered group may have raised loans from foreign banks. Hence, changes in Norwegian groups' credit risk do not necessarily entail a corresponding change in the credit risk of Norwegian banks. A considerable portion of Norwegian banks' loans to non-financial companies are, moreover, to companies that are not part of an official group, for example small and medium-sized companies that are not required to prepare consolidated accounts. This receives no further attention in the present article.

In addition to the challenges associated with corporate constellations, other factors can cause the use of nonconsolidated company accounts to give misleading results. For example, cross-ownership between the companies in a group or grouping may lead to overstatement of equity ratios in the corporate accounts. A parent may for example incur a bank loan which it uses to invest in shares in a newly established subsidiary. In isolation this will impair the equity ratio of the parent. At the same time, however, a new company with for example 100 per cent equity capital funding will be established. When the two companies' overall equity is summated and divided by the companies' total capital, the weighted book equity ratio will be higher than the equity ratio of the parent company prior to the transaction. If the bank had loaned directly to the subsidiary, the weighted equity ratio of the two companies would not have increased correspondingly. It might on the

²² In aggregate, however, bonds and short-term paper account for only 5.5 per cent of the non-financial groups' total debt.

contrary be reduced. Hence in this example the book equity ratio is inflated at the aggregated level. Such inflation of the equity ratio would be eliminated in the consolidated accounts for the two companies.

Box 1: Analyses of groups among the banks

According to the regulations on credit institutions' and investment firms' large exposures, banks are required to count two or more counterparties as a single customer grouping where determinative influence or economic relations between them are such that financial problems on the part of one will likely cause payment difficulties for the one or the other. All companies belonging for accounting purposes to a group must normally be regarded as a single customer grouping. However, companies not coming under the accounting definition of group affiliation may also have to be included. Finanstilsynet follows up on banks' reporting of major exposures on a quarterly basis.

Banks often employ a risk category and/or PD for each of the companies in a customer grouping (based inter alia on the company accounts) and a common risk category and/or PD for the customer grouping as a whole (not necessarily based on the official consolidated accounts). If the customer grouping's key figures and PD capture the customer grouping or group dimension in a satisfactory manner, this will generally provide a more correct estimate of the development in credit risk than if only individual company accounts are utilised.

However, it may be difficult to quantify the overall credit risk of a customer grouping in an appropriate manner. If the customer grouping is a group, and it is the official and audited consolidated accounts that underlie the quantification of credit risk, the customer grouping or group dimension will probably be taken into account satisfactorily. However, a customer grouping in a bank often includes, as mentioned, more companies than are included in the official consolidated accounts.

DEVELOPMENT OF CENTRAL KEY FIGURES FOR NORWEGIAN-REGISTERED NON-FINANCIAL GROUPS

Balance sheet structure

Ordinary property, plant and equipment make up almost half of the groups' assets, while short-term assets that are part of the working capital (goods, receivables and liquid assets) make up almost 30 per cent (charts II.2a and II.2b).²³ Property, plant and equipment should in principle be funded by long-term debt and equity capital. Further, short-term assets should exceed short-term debt. The figures indicate that groups' funding structure overall was relatively robust at the end of 2013. There are however wide differences between industries and groups. This is analysed further in the following.

Cash earnings and profit

The groups' aggregate cash earnings before tax, i.e. profit for the year plus depreciation and write-downs, measured 8.0 per cent of total assets in 2013, while the profit for the year after tax measured 2.9 per cent. This is far lower than the levels in 2006, which were respectively 15.0 and 7.3 per cent. Groups' cash earnings in 2013 were only marginally higher than in 2002, but the profit was considerably better, partly due to substantial extraordinary write-downs in connection with the dotcom crisis. The levels of the groups' cash earnings and profit per year were in 2013 below the average for the period 2000-2013. The cash earnings and financial results of the listed non-financial groups fell somewhat in 2014. If the unlisted groups have shadowed the listed groups and there is a further weakening in 2015, the levels of cash earnings and profit may fall to levels not much higher than in 2002.

Comparison of groups and parents and subsidiaries

At the end of 2013 the groups' equity ratio (EK-K) was 12.2 percentage points' below that of the parents and subsidiaries (EK-M) (chart II.3).²⁴ This is a substantial difference, which has widened in recent years. The groups' equity ratio was nonetheless as high as 29.6 per cent at the end of 2013.

One reason for the difference in equity ratio levels between groups on the one hand and parents and subsidiaries on the other is that the effects of cross-ownership, i.e. owner interests in subsidiaries and the like, are eliminated in the consolidated accounts. The consolidated accounts therefore

²⁴ Note that here EK is shown less goodwill and other intangible assets, since these items may be of little value in a crisis situation.

II.2a (Assets) and II.2b (Liabilities and equity capital): the main items in the balance sheet of Norwegian-registered non-financial groups (exc. Statoil)





Source: Finanstilsynet





The letters "M" and "K" after the key figure refers respectively to parent and subsidiary (based on company accounts) and group (based on consolidated accounts). Source: Finanstilsynet

²³ The figures are based on consolidated accounts. The years 2002 and 2006 are chosen because they represent, respectively, the weakest and the best year in Norwegian business and industry in the period 2000-2013. Items in red and orange show long-term balance sheet items, while items in blue show short-term balance sheet items. Equity capital (in green) includes here goodwill and other intangible assets.

II.4 Number of groups and share of debt in groups with negative equity capital and debt servicing capacity. Norwegian-registered non-financial groups (exc. Statoil). Per cent



Source: Finanstilsynet

normally provide a more correct picture of the book equity ratio than do the company accounts. Another possible reason for the differences in level is that groups' foreignregistered business may have a lower book equity ratio than the Norwegian-registered part of the business. This receives no further attention in the following. Further, use of different accounting languages may have a bearing. In the calculation of the equity ratio (EK), however, an important source of such accounting differences, namely goodwill and other intangible assets, is excluded.

The groups' long-term debt servicing capacity (RES-K), as measured here, was only just over half as large as that of the parent companies (RES-M) at the end of 2013, respectively 6.9 per cent and 12.0 per cent. Debt servicing capacity also weakened more among groups than among parents and subsidiaries in the wake of the financial crisis.

In contrast to the other two ratios, the AK ratio is better for the groups than for the parents and subsidiaries. The groups' liquidity (AK-K) has however weakened markedly since 2010, despite a marginal improvement in 2013. This differs from the parents and subsidiaries whose key ratio (AK-M) has strengthened markedly since 2010. Here it should be pointed out that it is difficult to measure companies' liquidity in a reliable manner using only information from the annual accounts.

Analysis of the groups most exposed to risk

It is important in the credit risk context to analyse the entities most exposed to risk, especially those with weak equity capital and debt servicing capacity.

A far larger proportion of the groups had negative long-term debt servicing capacity (RES-K) in 2013 (22.8 per cent) than in 2006 (12.7 per cent). Concurrently groups with negative

debt servicing capacity increased their proportion of total debt from 6.1 to 19.7 per cent. At parents and subsidiaries this period showed a reduction in this proportion from 10.3 to 8.5 per cent (not shown in chart), indicating that a larger proportion of the groups' aggregate debt now resides in financially weak groups.

At the end of 2013, 13.3 per cent of the groups had negative equity capital, while 12.6 per cent of the total debt resided in groups with negative equity capital (chart II.4). These percentages are not much different from 2002 and 2006. The proportion of parents and subsidiaries with negative equity capital was fairly identical to that among the groups in 2013. However, the proportion of debt in parents and subsidiaries with negative equity capital was far lower among parents and subsidiaries than among the groups at the end of 2013, respectively 3.0 and 12.6 per cent.

At the end of 2013, 7.0 per cent of the groups had both negative debt servicing capacity and negative equity capital, while 5.0 per cent of the total debt resided in such groups. This is a substantial increase from 2006, and about the same as in 2002. Norwegian business and industry enjoyed a very good period in the wake of the dotcom crisis. If business and industry encounter more difficult economic times in the coming years, the proportion of debt at the weakest groups may increase to far higher levels than in 2002. At parents and subsidiaries the proportion of debt at companies with both negative debt servicing capacity and negative equity capital was 2.0 per cent in 2013, i.e. far less than for the groups.

Box 2: Further details on the selection of Norwegianregistered non-financial groups

The selection comprises virtually all Norwegian-registered non-financial groups that have delivered annual accounts to the Brønnøysund Register Centre. In 2013 the selection consisted of 3,755 groups, accounting altogether for NOK 3,015 billion in total debt. The selection ranges from the largest listed groups (excluding Statoil) to very small groups. In 2013 the largest group had assets totalling NOK 104 billion, while the smallest had total assets of just NOK 52,000.

In analyses of credit risk it is important to be well acquainted with the data basis. Do, for example, a few large observations dominate, thereby causing the selection to provide an unrepresentative picture of the other observations, or is the selection relatively homogeneous?



II.5a and II.5b Average and dispersion. Norwegian-registered non-financial groups. Per cent

The key figures in the analysis may acquire extreme values in both directions. The exception is the equity ratio which is capped at a maximum of 100 per cent. Hence little purpose is served by analysing various measures of statistical dispersion using arithmetic means alone.²⁵ It is important to supplement these with other statistical measures and to weight the observations by 'importance'. In this analysis weighted RES is defined as the sum of profit for the year divided by the sum of total debt (excl. intangible assets).

Charts II.5a and II.5b show the median (horizontal black line) and the weighted average (horizontal red line) for the key ratios RES-K and EK-K. The yellow boxes include 50 per cent of the observations for each year, their extremities representing respectively the 25 and 75 percentiles. The extremities of the black, vertical, lines represent respectively the 5 and 95 percentiles, while the outlying observations (points/circles) are considered extreme observations.

Both the development and level of the key ratio RES-KR are somewhat similar measured by the median and the weighted key ratio. Since 2008 the median and the weighted key ratio for RES-K have been almost identical. The dispersion increased in the initial years of the financial crisis in 2007-2008, and has been relatively stable since 2009.

There are somewhat wider differences between the median and weighted key ratio for EK-K at the start of the period. However, since 2009 the median and the weighted key figure have been almost identical at around 28 per cent. The dispersion also showed small changes in these years. The

 $^{\rm 25}$ ldeally key figures should be transformed to a scale from 0 to 1, as for example in the SEBRA model.



median and the weighted key figure AK-K have also been relatively alike in recent years (not shown in chart).

Small differences between the median and the weighted average of the key figures indicate that the results are not strongly affected by extreme observations. There are extreme observations at both ends of the distribution, but this is natural since there will always be some companies and groups that are particularly strong or weak.

Sectoral differences

Long-term debt servicing capacity (RES-K) varied fairly widely over the period 2000-2013 in all main industries (charts II.6a and II.6b).²⁶ Moreover, some years have seen wide differences between many of the industries. However, in 2013 a convergence was noted with all main industries showing a long-term debt servicing capacity between 5 and 10 per cent.

In the same way as for the groups overall (see Box 2), the median and the weighted variable of the key figure RES-K broadly shadowed one another within the various industries in the period 2000-2013. This indicates that over time large and small groups develop fairly identically within the main industries too. In most industries, however, the weighted key ratio has weakened (strengthened) more than the median in poor (good) periods. All industries showed a fall in debt servicing capacity during the dotcom crisis and the financial crisis, measured both by the weighted key

²⁶ The sectoral figures may be affected by mergers/demergers, acquisitions change of industry code and other factors. The figures must therefore be treated with caution.



II.6a and II.6b Debt servicing capacity (RES-K) in Norwegian-registered non-financial groups. Selected industries 2000-2013

Source: Finanstilsynet

Source: Finanstilsynet







figure and the median value. This indicates limited sectoral diversification gains in terms of credit risk.

At the end of 2013 the groups in manufacturing and mining, electricity and water supply and commercial real estate rental had the highest equity ratio (charts II.7a and II.7b). In the period 2000-2013 the equity ratio varied most in the sectors oil and gas, transport (exc. maritime transport) and information and communication. The latter industry also had the clearly lowest equity ratio at the end of 2013, at -3.7 per cent. This is largely due to some large groups having booked a high proportion of intangible assets. With intangible assets included, the equity ratio of many of these groups is positive.

It is not unnatural for an industry such as information and communication to have a relatively high proportion of intangible assets. Companies and groups in such an industry often have little in the way of tangible assets such as property and buildings. A relatively large proportion of their balance sheet is often in the form of brand names, goodwill, rights, long-term contracts and other non-material assets. In a crisis situation such assets are likely to be of less value than material assets such as property and buildings. Hence in the credit risk context it may be relevant to omit intangible assets, as is done in this theme analysis. However, since some intangible assets may retain their value in a crisis situation it will not invariably be correct to omit such assets.

Source: Finanstilsynet

There were in general no large sectoral differences between the number of groups and proportion of debt in the weakest groups at the end of 2013. There are however some exceptions:

- Manufacturing and mining along with maritime and pipeline transport single themselves out with a high number of groups and a high proportion of debt in groups with negative long-term debt servicing capacity. At the end of 2013 about one-third of the total debt in these two sectors resided in groups with negative long-term debt servicing capacity.
- Information and communication single themselves out with a high number of groups and the high proportion of debt in groups with a negative equity ratio. At the end of 2013, 37 per cent of total debt in this sector resided in groups with a negative equity ratio. This is largely due to the groups mentioned above, with a high proportion of intangible assets.
- Information and communication also singled themselves out with a high number of groups and a high proportion of debt in groups with both negative debt servicing capacity and a negative debt ratio at the end of 2013, respectively 19 and 12 per cent. In 'other transport' 12 per cent of debt also resided in groups with both negative debt servicing capacity and a negative equity ratio at the end of 2013.

SUMMARY AND ASSESSMENTS

Traditional financial key figures and default probabilities based on the Norwegian non-financial parents' and subsidiaries' accounts indicate that credit risk is low at the start of a more challenging period for Norwegian business and industry.

However, analyses based on consolidated accounts show that important financial key figures are weaker in groups and in parents and subsidiaries. The proportion of total debt in the weakest groups is also in general higher in groups than in parents and subsidiaries. This also applies to most main sectors.

Groups' financial position is now considerably weaker than it was prior to the financial crisis. A weakening matching that seen during the financial crisis could cause long-term debt servicing capacity to fall to low levels. This theme article analysis indicates that sectoral diversification gains are limited when it comes to credit risk.

Although the groups' equity ratio is considerably lower than for parents and subsidiaries in isolation, the analysis indicates that the Norwegian-registered non-financial groups' capital buffers overall are relatively robust. For example, both the median and the weighted equity ratio (exc. intangible assets) stood at almost 30 per cent at the end of 2013.

An erroneous assessment of credit risk in Norwegian business and industry does not automatically entail an erroneous assessment of Norwegian banks' credit risk. One reason is that parts of the debt of Norwegian groups, for example the portion residing in foreign subsidiaries, was raised from foreign banks or as bond debt. However, Norwegian banks may be indirectly affected by a weaker situation among Norwegian-registered groups' foreign subsidiaries.

THEME III PENSION SAVING - UNIT-LINKED PENSION PRODUCTS

Changes in the pension system will require the individual policyholder to adopt a more proactive approach to pension saving and to personally assess the consequences of the choices made. Defined benefit schemes are now being phased out and replaced by various types of defined contribution schemes and individual saving. This could lead to changes in consumer saving behaviour, and will bring a major need for information and guidance. The changes are also likely to affect the management of pension assets, including their distribution on asset classes and risk profile in addition to choice of managers. Saving in equities, bonds and mutual funds is more relevant now than formerly, which could increase the significance of alternative savings products originating in other markets, such as real estate and commodities.

CHANGES IN THE MARKET

The volume of unit linked pension contracts is growing rapidly. At the end of 2014 this portfolio accounted for 16 per cent of life insurers' overall insurance liabilities compared with 13 per cent the previous year. The bulk of all new pension scheme subscription is of the (unit linked) defined contribution type. In 2014, for the first time, gross premium fallen due in defined contribution schemes accounted for more than 50 per cent of overall gross premium fallen due in private collective pension schemes. This development mirrors that in many other European countries.

In the last 10 years active membership of defined benefit occupational pension schemes has virtually halved. Accounting rules require to a larger degree than previously pension liabilities to be recognised in the balance sheet. This, in addition to increased pension premiums, may have contributed to making defined benefit schemes a heavy burden for firms. Weaker return prospects and rising longevity have necessitated changes in insurers' tables, resulting in higher annual defined benefit pension premiums.

More and more firms are closing or phasing out defined benefit schemes, switching to defined contribution pension schemes instead. Most defined benefit schemes in the private sector are now closed to new members. Gross premium fallen due paid into collective, private defined benefit schemes between 2007 and 2014 has shown virtually no growth. In the same period, gross premium to



Source: Finanstilsynet

III.2 Gross premium due distributed on private definedbenefit and defined-contribution pensions



defined contribution schemes has risen by more than 17 per cent annually.

The low interest rate level poses a significant challenge to pension providers since a number of insurance products carry an interest rate guarantee. In addition, rising longevity is compelling pension providers to make extra provision for future liabilities. New mortality tables became effective on 1 January 2014. A sound financial position is important for pension providers to have the capacity needed to invest in securities providing satisfactory return over time and concurrently cope with the underlying risk in investments. Pension providers meet the requirements of the current solvency framework, but will face challenges meeting coming capital requirements under Solvency II (see chapters 3 and 4 for further details).

In defined contribution schemes the policyholder bears the risk associated with investments, and also the longevity risk since defined contribution schemes do not as a rule provide lifelong benefits. A high equity is component may provide

III.1 Insurance liabilities by type of contract at 31.12.2014



III.3 Households' financial assets at 31.12.2014





Source: Statistics Norway

high long-term return but also entails larger risk. This heightens the need for policyholders to be informed of expected return, risk, the relationship between equity component, risk and age, and management costs. Independent advice based on the policyholder's income and wealth position in general and the number of years to retirement age is therefore important.

As from 1 January 2014 provision was made for a new occupational pension product allowing for investment choice. The new product was devised as an alternative to defined contribution pension for firms not prepared to continue with defined benefit schemes. No special transitional arrangements between the schemes have been set, and insurers must issue paid-up policies to employees who withdraw from a defined benefit arrangement.

Provisions of the Defined Benefit Pension Schemes Act concerning unit linked paid-up policies entered into force on 1 September 2014. They provide a further opportunity to reduce the proportion of guaranteed products, which will also help to improve insurers' financial position under Solvency II. When paid-up policies are converted to unit linked status, the paid-up policyholder loses his/her guarantee of previously accumulated pension rights. Hence the assumption is that conversion to unit linked is best suited to young members with many years to go of their accumulation period.

Changes in the pension system, both as regards national insurance and occupational pensions, will require policyholders to adopt a more active approach to pension saving. In the pension system of the future, policyholders will themselves be able to assess the consequences of the choices made. Decisions on pension saving often have a long time horizon and are irrevocable, creating a major need for guidance from authorities and pension providers alike. A Source: Statistics Norway

more mindful attitude to investment choice in pension saving could also impact on investment behaviour in respect of other saving.

Common to all unit linked insurance products is the fact that insurance liabilities are at any given time linked to the value of the investment portfolio accompanying the individual contract. It is the life insurer that owns the investment portfolio, while the customer has a claim on the insurer. Unit linked customers can however choose, and subsequently change, the composition of their investment portfolio. Depending on the product's design, customers could be charged an annual risk premium and administration costs.

According to the asset management legislation it is up to the individual life insurer to decide which management companies to collaborate with, and what securities funds and other underlying assets their customers can choose between.

SIZE OF THE SAVINGS MARKET

Households' overall holding of financial assets totalled NOK 3,815 billion at the end of 2014 of which pension capital accounted for 33 per cent. Pension capital consists largely of technical reserves.

Since 2008 Norwegian households have increased their holding of financial assets by NOK 1,162 billion, of which the increase in pension capital accounts for about half. In the same period household debt has risen by NOK 846 billion.

DEVELOPMENTS IN THE MARKET FOR PENSION PRODUCTS

Individual life insurance products such as life annuities and individual pension agreements under the Tax Act (IPA) were popular in the market up to May 2006 when the exemption from wealth tax was removed. Individual pension saving (IPS) followed IPA but has not gained much currency. Both the loss of the 'skjermingsfradrag' (deductible risk-free return) and extra costs compared with alternative forms of saving have contributed.

The Defined Contribution Pensions Act, into force in 2001, enabled banks and management companies to offer defined contribution pensions in competition with life insurers. This, together with the introduction of mandatory occupational service pension in 2006, led to numerous new entrants to the industry. Since that time banks and management companies have largely withdrawn from the market for defined contribution pensions, which are now offered mainly by life insurers. The pension system is connected to the wage system, and sizeable administrative costs are involved in a company switching pension provider. Wide-ranging system requirements enable economies of scale which, together with low customer mobility, create high barriers to establishment.

The number of paid-up policies has risen in recent years. Paid-up policy issuance is driven by firms winding down or closing their defined benefit schemes, in addition to change of employer. The growth in pension rights certificates is driven by employees switching job. There are more than 1.1 million members of defined contribution schemes. Assuming that an average employee has 3-6 employers in an occupationally active life of 40 years, between 83,000 and 165,000 pension rights certificates will be issued each year in connection with changes of employer.

MORE ON PENSION RIGHTS CERTIFICATES

According to Finance Norway pension liabilities totalling NOK 590 billion had been set aside to individual capital and pension insurance, pension rights certificates, paid-up policies and collective pension schemes in the private sector (private pension funds not included) at the end of 2014, of which paid-up policies and pension rights certificates accounted for 36 and 6 per cent respectively.

A pension rights certificate denotes an account containing accumulated pension from a previous employment relationship. The owner of a pension rights certificate is entitled to free choice of investment from the mutual fund menu offered by the pension provider and personally bears responsibility for the costs and the investment risk.

Most private sector employees change jobs several times in the course of their working career and thus receive several pension rights certificates. In view of the administrational costs, it is rational both for the individual pension rights certificate holder and for pension providers to assemble all pension rights certificates with a single provider. Pension providers offer simple internet transfer using BankID. Disbursement from a pension rights certificate is based on the paid-in amount plus net return after costs. Awareness of costs charged to the customer is therefore important. Lower net return may reduce the disbursed pension considerably.

Finanstilsynet has conducted a survey of information disclosed on administrational costs by providers on their websites. Not all pension providers have readily available information on such costs, despite the facilities available for direct transfer via the providers' webpages. However, all providers offer contact by e-mail or telephone, and also face-to-face meetings, with an adviser etc. Management costs for equity funds offered also vary, which will have a large bearing on the disbursed pension. One provider charges annual administrational charges of 0.4 per cent of the pension capital, while other providers charge 0.5 per cent of the basic amount available under the national insurance scheme, which corresponds to 0.09 per cent for a pension rights certificate worth NOK 500,000.

REQUIREMENTS FOR INFORMATION AND PRUDENT CAPITAL MANAGEMENT PRUDENT CAPITAL MANAGEMENT

Life insurers are subject to a prudent capital management requirement. The Insurance Activity Act and the Asset Management Regulations contain rules governing insurers' investment of policyholders' assets, and thus also limits for policyholders' choice of investments. The asset management legislation does not impose specific requirements as to the risk profile and diversification of assets in a unit linked portfolio. Only overarching, general and quantitative requirements for prudent asset management are imposed. The insurer is subject to an overarching prudential requirement.

The legislation also requires insurers to exhibit good business conduct. They must have in place policies for choice of assets and changes to the portfolio to avoid conflicts of interest arising between customers and company. In the event of such conflicts, the customers' interest must take precedence.

INFORMATION

Where defined benefit schemes are phased out and replaced by unit linked pension schemes, the individual must to a greater degree than previously adopt an active stance on pension saving. The policyholder must him/herself assess the consequences of the choices made, and this entails stringent advisory and information requirements for providers of pension products.

The Insurance Contracts Act requires an insurer when writing an insurance contract to ensure as far as possible that the policyholder receives advice on meeting his/her insurance needs. This means that the insurer must analyse the customer's needs, and thereafter provide advice on what types of insurance the insurer can offer to meet those needs. The insurer must also inform the policyholder of "important aspects" of the insurance and of "significant limits" to the cover compared with what the policyholder can reasonably expect to be covered. In products where the policyholder bears the return risk, factors affecting expected return, such as risk and costs associated with the product, will be "important aspects" of the product.

Supplementary regulations concerning information requirements with regard to life insurance contracts have been laid down pursuant to the Insurance Contracts Act. Information must be disclosed to the policyholder when the contract is signed at the latest. Information must as the main rule be given in writing and in Norwegian. It must also be precise and unambiguous.

In the case of unit linked life insurance contracts, the insurer must provide the policyholder with information on the particular investment funds on which the insurance contract is based, and on the means by which the policyholder will receive information on movements in the value of the fund units.

Where taking out of unit linked life insurance is concerned, the Assets Management Regulations require information to be given on the risk posed by the investment is chosen, as well as on commissions and other charges accruing upon establishment, management, transfer and repurchase. The policyholder must be informed that he/she has the right to receive information on prospectuses and key information on mutual funds included in the portfolio.

The information provisions regulate information to policyholders, which in collective schemes are the employer and not individual members. The Defined Contributions Pension Act regulates information to the employees. Regulations to the Act require the insurer to provide the employer with sufficient basis material to enable the employer to meet its information requirement vis-a-vis the employees. The regulations also contain rules detailing the content of the information to be given. Information must be provided inter alia on risk and risk effects associated with the investment choice made for the pension scheme.

Sufficient information must be given to enable the employees to make well-informed investment choices. Information must also be provided on the investment choices available to the employee at a later stage. In other words, the information requirement is not confined to the unit linked portfolio allocated to the employee upon admission to the pension scheme: an information requirement also applies while the contracts are running. A key provision requires the dispatch of an annual statement of account to the policyholder, while the Asset Management Regulations require semi-annual information to policyholders on movements in the value of their insurance contract.

PROVISIONS ON INFORMATION AND ADVICE RELATED TO CONVERSION OF PAID-UP POLICIES

A paid-up policy is proof of pension rights accumulated in an employment relationship in the private sector. A paid-up policy is issued where an employee retires from a company with a defined benefit occupational pension scheme without concurrently drawing pension from that scheme, where a company opts to wind down its defined benefit scheme in favour of a defined contribution scheme or in the event of the company's closure.

According to amendments to the Company Pensions Act, into force on 1 September 2014, a paid-up policyholder can opt to convert his/her paid-up policy to unit linked. Conversion entails termination of the interest rate guarantee, and the paid-up policyholder will bear the risk of reduction of the value of the unit linked portfolio. All return will accrue to the paid-up policy account. The costs of administration and management are borne by the paid-up policyholder, and longevity risk is partially transferred from the pension provider to the paid-up policyholder.

The Company Pensions Act imposes requirements on what an investment portfolio can include, such as units in securities funds, units in a dedicated investment portfolio and cash or equivalent liquid assets. The employee cannot choose to invest directly in individual equities, only in equities as part of a portfolio.

A comprehensive set of rules has been established governing information and advice to be provided before an agreement to convert a paid-up policy is signed. Finanstilsynet will conduct a thematic round of inspections in 2015 focusing on companies' compliance with regulatory requirements on information and advice. In Finanstilsynet's strategy document 2015-2018, advice related to unit linked paid-up policies is highlighted as an area of high priority for supervision.

Further, corporate members of Finance Norway have adopted an industry agreement imposing requirements on information and advice given upon conversion to unit linked paid-up policies. All life insurers that manage paid-up policies have acceded to the agreement, which makes it clear that the financial industry's rules on good advisory practices and the rules governing authorised financial advisers also apply to advice given upon conversion of paidup policies. The industry agreement employs expected return and risk in accordance with Finance Norway's industry agreement on rate-of-return forecasts, so as to assure identical forecasts. The agreement also gives paid-up policyholders 14 days' right of cancellation, irrespective of mode of distribution and location. Insurers are also subject to a dissuasion obligation requiring them to actively advise against a switch to the product if doing so is clearly not in the customer's interests.

FINANSTILSYNET'S FOLLOW UP

In 2012 Finanstilsynet conducted a broad-based survey of sales of individual unit linked life insurance products. The main purpose was to map the means by which insurance providers ensure that the customer receives mandatory information and advice on the insurance contract, on alternative investments and on costs accruing in the insurance period, and how they ensure that recommended products are suited to the customer's needs. The main impression gained was that life insurers ensured provision of information and advice prior to sale. However, there was room for improvement in the information a number of companies provided prior to sale on costs that will accrue. There was also a lack of comparable information on historical return and historical cost level in the various product categories and individual products. As part of its follow-up to the report, Finanstilsynet prepared in 2014 a guidance which clarifies insurers' advisory obligations.

In 2014 Finanstilsynet investigated the use made of commission rebates between management companies and life insurers. The object was to assess whether life insurers properly safeguard policyholders' interests in the choice of securities funds. The survey showed that insurers often receive a commission rebate from the management company, either because the insurer is a large-volume customer (rebate) or as payment for distribution of mutual funds. When commission rebates are being considered, an eye must be had to the principle that unit holders must be equally treated and charged the same management fee. Management companies do however have a certain right to share their income with policyholders.

Where a commission rebate is payment for marketing and distribution, the basic rule is that a management company can buy these services from other parties, for example an insurer. However, where the distributor is also a unit holder, the management company must see to it that the payment is not, or does not appear to be, a refund of a management fee, such that unit holders are subject to differential treatment. The payment must reflect the costs incurred by the insurer in marketing the securities funds. Wide differences exist between companies in terms of commission rebates received. In Finanstilsynet's assessment it is important for policyholders to be informed whether or not life insurers receive commission rebates and how much they receive. There are currently no rules requiring life insurers to disclose such information. The investigation also showed that there are no, or only a small proportion of, index funds in unit linked portfolios, including in the open mutual fund menu. There could be a potential conflict of interest between insurer and policyholders if the insurer prefers funds with high management fees. For Finanstilsynet it is important that the policyholder's interests are safeguarded, and that the low proportion of index funds is due to factors other than low management fees.
FINANSTILSYNET

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