Go to content

FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Start / Summary of the report Financial Trends 2015

10.11.2015

Summary of the report Financial Trends 2015

Financial stability outlook

The oil price fall is affecting the Norwegian economy. Lower demand from the petroleum sector has resulted in substantially lower activity levels and impaired profitability in industries that deliver goods and services to the sector. The ripple effects to the wider Norwegian economy have thus far been limited. Growth in the mainland (non-oil) economy has slowed and unemployment has risen somewhat, but activity levels in many non-oil-related sectors remain high. Fiscal policy and monetary policy are stimulating domestic demand through increased use of oil money and a lower interest rate. Household demand remains high, and a weaker NOK exchange rate has stimulated business and industry exposed to foreign competition.

The Ministry of Finance, Norges Bank, Statistics Norway and a number of other forecasting institutions all expect a moderate increase in unemployment and a relatively rapid recovery of growth in the mainland economy. At the same time they underscore the uncertainties inherent in the international economy and the oil price, and in ripple effects to the mainland economy ensuing from lower demand from the petroleum sector. The Norwegian economy could be hit far harder than assumed in the economic forecasts.

The likely path of the international economy is a matter of much uncertainty. Growth is moderate in the US and weak in the euro area, and has slowed in the emerging economies. In parts of Europe unemployment is high, as are public and private indebtedness. Quantitative easing and exceptionally low policy interest rates in the US and Europe have stimulated their economies, but may also have contributed to financial imbalances by way of increased asset prices and lower risk premiums. Hence considerable uncertainty attaches to the economic effects that will ensue when the extraordinary monetary policy measures are phased out.

Higher interest rates in the US may impact negatively on equity and bond markets causing capital outflow from emerging economies, reduced investment activity and impaired growth in these economies. Growth in China remains high, but there is a keen awareness of the risk that has accumulated in credit and real estate markets after a long period of rapid credit growth and heavy property investment. The Russian economy is in recession and subject to Western sanctions, and public finances are severely impaired by the low oil price.

Households' debt burden and house prices are at unprecedented levels. Because most residential mortgage loans carry a floating interest rate, an interest rate hike will rapidly lead to a larger portion of borrowers' incomes being devoted to debt servicing. Many households are very heavily indebted relative to income and have small financial buffers. Despite slower economic growth, higher unemployment, lower real wage growth and generally heightened economic uncertainty due to the oil price fall, household debt growth has continued to outstrip growth in household incomes. Twelve-month growth in house prices slowed this autumn, but it is too early to say whether this reflects a turnaround in the housing market.

Lower borrowing rates and expectations of long-lasting low interest rates are an important reason for this development. Real after-tax mortgage rates are now approximately zero. Although the turnaround in the Norwegian economy may in isolation dampen households' demand for loans, there is a danger that the rapid growth in household debt and house prices could last for some time. If it does, it will be more likely to trigger at some point a sudden turnaround in house prices and in household demand. An abrupt, hefty financial consolidation of the household sector will have major ripple effects to the economy. Experience shows the consequences of economic shocks to have been greater in situations of high household debt and housing market imbalances.

In the commercial real estate market, properties with stable rental earnings are attractive investment objects, and the proportion of foreign investors in the segment has risen. The fall in direct return (rental income relative to price) indicates a fall in risk premium on this type of investment. This could be due to 'search for yield' rather than to a fall in real risk. Norwegian and international experience alike has shown the market for commercial real estate to be highly cyclically sensitive. An economic setback will rapidly bring lower rental earnings and higher vacancy rates, and thus also lower property prices and mortgage values. Norwegian banks are heavily exposed to the housing and commercial real estate markets.

Direct exposures to oil-related industry account for a relatively small portion of Norwegian banks' aggregate lending, but there are differences between banks. If the turnaround in the Norwegian economy proves moderate, with temporarily impaired growth, Norwegian banks can expect to see somewhat increased losses and reduced earnings, but not a dramatic impairment of their capital adequacy. Even so, losses on individual exposures could be substantial. However, in the event of a severe setback affecting the Norwegian economy on a broad front the banks could suffer heavy losses across several parts of their loan books.

The Ministry of Finance issued, effective from 1 July 2015 onwards, regulations on banks' residential mortgage lending practices. The object is to promote prudent lending practices and thereby dampen the strong credit growth and the pressures in the housing market. The regulations start out from the requirements enshrined in Finanstilsynet's previous guidelines, including a maximum loan-to-value ratio of 85 per cent for amortising loans and the continued ability to service debt after a mortgage rate increase of 5 percentage points. An additional requirement of principal repayments applies to mortgages with a high debt-to-value ratio. Under the regulations no more than 10 per cent of total mortgages secured on residential property per quarter can comprise mortgages that are not compliant with the requirements.

Finanstilsynet's home mortgage loan survey, based on a sample of recent mortgages, indicates a decline in the past year in the proportion of mortgages in excess of the maximum loan-to-value ratio of 85 per cent. A reduction is also noted in mortgages where the banks predict the borrower's inability to service their mortgage following a mortgage rate increase of 5 percentage points. However the survey shows the debt-to-income ratio, measured as debt relative to gross income, to be high, and particularly so in the case of young borrowers.

Banks have recorded good profits in the years following the financial crisis. Earnings remain good thus far into 2015. Defaults and loan losses remain low, and banks have seen no need to increase their loss provisions to any appreciable degree. The capital adequacy ratio has risen in the period since the financial crisis. The leverage ratio has however risen far less, and remains no higher than it was at the start of the 2000s. This is because growth in total assets has far outstripped growth in risk weighted assets.

The new European capital adequacy regime was introduced in Norway in 2013, with a gradual introduction of new buffer requirements along with a requirement for banks to hold capital against risks not covered by the minimum and buffer requirements. The buffer requirements increased in 2015 and are increasing further in 2016 due to a higher buffer requirement for systemically important institutions and a higher countercyclical capital buffer requirement.

Weaker growth in the Norwegian economy, high household indebtedness and the danger of imbalances in property markets call for banks to continue to improve their financial positions to enable them to grant credit to creditworthy customers in bad times. If not, the downturn could be exacerbated by credit drought. The banks must retain a significant portion of their profits to increase their common equity tier 1 capital ratios. This will require moderate dividend payouts.

The share of wholesale funding among banks is significant, and much of it is denominated in foreign currency. A substantial portion of both Norwegian and international market funding has a term below three months. Risk premiums rose on most types of bonds in the third quarter. The increase was particularly large in the case of bonds issued by companies in the oil and offshore industry, but risk premiums on senior bank bonds and covered bonds also rose. This suggests that market actors view the future as more uncertain. As witnessed during the international financial crisis in 2008, Norwegian banks are vulnerable to turbulence in international money and capital markets. They therefore need to continue to increase their liquidity reserves and to ensure that their long-term assets are funded on a long-term basis. Funding via covered bonds has helped to reduce liquidity risk, but may have made banks more vulnerable to a setback in the economy and the housing market. Asset encumbrance must consequently be kept to a prudent level.

The low interest rate level and prospects of low rates for a long period ahead pose a major challenge to pension providers. A significant portion of their liabilities comprises contracts carrying an annual guaranteed rate of return at a level in excess of the current market interest rate. Achieving sufficient return on pension assets in a low interest rate regime is difficult. Moreover, rising longevity requires higher technical provisions.

A period of up to seven years is now allowed to meet the increased provisioning required by rising longevity, and return surplus – which is otherwise allotted to the policyholder – can be used to bolster provisioning. Pension providers will cover at minimum 20 per cent of such provisioning out of their equity capital. Should pension providers' return prove lower than that needed to meet the annual guaranteed rate of return and policyholders' share of the increase in reserves, the companies will need to cover a larger proportion than 20 per cent.

The introduction of Solvency II on 1 January 2016 will better reflect the risk inherent in the insurance business than previous solvency requirements. This will be particularly evident in the case of life insurers whose insurance liabilities under the new solvency regime will be recognised at market value. Given the current low interest rate level, this will in some respects entail a considerable increase in the value of their liabilities compared with the current regime. Life insurers are granted a transitional arrangement lasting 16 years in which to complete their technical provisioning. This will ease the solvency requirement for life insurers for a period, although there is no change in the underlying risk picture.

PRESS RELEASE

Financial trends 2015

Did you find what you were looking for?

Yes No

What did you look for?

Send feedback