FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

SUMMARY
Risk Outlook – November 2017

Global economic growth is picking up. According to the IMF, the risk related to economic and market developments has moderated somewhat since the previous assessment in spring 2017. Improved economic prospects and continued very low interest rates in most of the major economies have concurrently contributed to an increase in investors' risk propensity. Stock prices and property prices have risen significantly in many economies, and bond market risk premiums are low. Volatility in stock and bond markets is low throughout. There is concern that the rise in stock and property prices is higher than can be explained by changes in fundamentals.

After a period of weak growth in Norway's mainland (non-oil) economy since the oil price fall in 2014, the cyclical downturn now appears to be over. Low interest rates, a weak domestic currency and expansionary fiscal policy have helped to accelerate the rate of growth in the mainland economy. Unemployment has subsided.

High property prices and a high household debt burden render the Norwegian economy vulnerable to an economic turnabout. House prices and households' debt burden are historically high, and also high by international standards. House prices surged in 2016, but have fallen somewhat in the last half-year. The price fall is not dramatic, and the level of house prices remains high. The likely trend in the housing market ahead is uncertain. After a long period of steep house price growth, the possibility that we are entering a prolonged period of falling house prices cannot be ruled out. However, improved growth prospects and continued low interest rates could rekindle house prices.

Household debt growth continues to outstrip growth in household incomes. The turnabout in the housing market has thus far not translated into slower credit growth. Households' debt burden has accordingly risen further in 2017. Households' interest burden is low due to low residential mortgage lending rates. Norwegian borrowers have long preferred floating interest rates on their residential mortgages. This year's residential mortgage lending survey shows that the proportion of fixed-rate mortgages has fallen further, and is now as low as 4 per cent of new loans. Norwegian households will accordingly be hit rapidly by an interest rate hike, and this could have major negative repercussions for the Norwegian economy.

The Ministry of Finance tightened the residential mortgage lending regulations at the turn of 2017, after which banks have tightened lending practices. The residential mortgage lending survey shows that the requirements of a maximum loan-to-value ratio and a maximum debt-to-income ratio (capping mortgages at five times gross annual income) are binding for some borrowers. The maximum debt-to-income ratio appears to have had greatest effect in the Oslo area where house prices are particularly high relative to income levels. Finanstilsynet will advise the Ministry of Finance on possible amendments to the residential mortgage lending regulations by 1 March 2018.

Recent years have seen very high growth in consumer lending. Although consumer lending remains low in terms of households' overall debt, its rapid growth gives cause for concern. Many banks and finance companies market such loans very actively. Consumer lending rates are as a rule high, and the interest on such borrowing now accounts for about 14 per cent households' overall interest expenditure. Finanstilsynet has introduced guidelines for prudent consumer lending practices which financial institutions are expected to comply with as from the fourth quarter of the current year at the latest. Finanstilsynet has recently also tightened the capital requirements for consumer loan banks. The Storting (Norwegian parliament) has asked the Government to examine the possibilities of introducing an interest rate cap. Finanstilsynet will present its assessment to the Ministry of Finance by 1 March 2018.

Prices in some commercial property segments have risen markedly for several years, and at a faster rate than the growth in the economy as a whole. Price growth has been particularly rapid in the case of upmarket properties in major urban areas across the country. The keen interest shown by foreign investors in recent years may have fuelled the price hike, as witnessed in many European cities. Commercial property is more in the nature of investment objects than are dwellings, and commercial property prices are influenced to a greater extent than house prices by the economic cycle and interest rates. Norwegian banks are heavily exposed to commercial property companies. In recent years banks have tightened lending practices by imposing stricter requirements on pre-sales and pre-leases as well as on equity capital when financing development projects. This has contributed to reducing the risk of losses. A steep fall in prices would nonetheless impair commercial property company earnings, reduce the value of banks' collateral and thus increase the banks' loss risk. Finanstilsynet has intensified its oversight of banks' exposure to commercial property, and conducts stress tests of banks' exposure to such property.

Well-functioning payment and settlement systems are crucial for financial markets. Norway's financial infrastructure has thus far proven itself to be robust, and confidence among actors is high. Thus far in 2017, however, a larger number of ICT events have been noted than in the whole of 2016. These events have been handled without significant consequences for the financial system. However, increased digitisation and interconnectedness among actors nationally and internationally require heightened awareness of the systemic risk attending ICT events. Were a systemically important financial institution, a key infrastructure undertaking or many banks simultaneously to be put out of commission for a period due to ICT systems' failure, financial stability could jeopardised. When events arise, Finanstilsynet monitors the institution's restoration of services and implementation of preventative measures with a view to pre-empting new events of a similar nature. The Financial Infrastructure Crisis Preparedness Committee (BFI), headed by Finanstilsynet, coordinates the national response to situations that pose a danger of major disruption to the financial infrastructure.

Norwegian banks have considerably expanded their equity capital since the financial crisis, largely due to substantial profit retention. The increase in capital ratios is due both to improved capitalisation and to the fact that residential mortgage lending, where risk weights are low, has grown more quickly than lending to corporates. In addition, the use of internal models (IRB models) has reduced average risk weights for several of the major banks. Finanstilsynet does not consider this reduction to be justified by a matching fall in risk, and a number of banks will be instructed to revise the assumptions underlying their models. Finanstilsynet is following up the banks' calibration of their IRB models.

Covered bonds (OMF) account for the largest share of the banks' market funding, The emergence of covered bonds has been of benefit to Norwegian banks. Covered bonds have thus far proven to be a secure and stable funding source. The high proportion of covered bonds is an important factor behind the increase in maturity of Norwegian banks' market funding. However, the increased issuance of covered bonds reduces the average quality of banks' remaining assets since a large proportion of the most secure residential mortgage loans are transferred to mortgage companies for inclusion in the covered bonds' cover pool. Since covered bond issuance is backed by residential mortgages, housing market developments are a significant risk factor. A house price fall could reduce the reserves available to banks for further covered bond issuance. A considerable portion of issued covered bonds is held by Norwegian banks and mortgage companies. The close interconnectedness brought about between actors through cross-ownership of covered bonds heightens the risk of contagion effects. The fact that all banks maintain a large holding of covered bonds as a part of their liquidity reserve could give rise to difficulties in a situation in which many actors are in need of liquid assets and are keen to divest covered bonds.

The banks have had ample access to market funding in recent years. Lower risk premiums have reduced funding costs. Banks' liquidity reserves exceed the minimum requirements by an ample margin, both in Norwegian and foreign currency. The banks are also well in excess of the minimum stable funding requirement whose introduction is proposed by the EU Commission from 2019 onwards.

The introduction of Solvency II in 2016 brought challenges for life insurers, mainly because it requires fair value measurement of liabilities and, to a greater extent than previously, sets capital requirements that reflect portfolio risk. Institutions have nonetheless, with one exception, thus far handled the transition to Solvency II through cost reductions, portfolio composition adjustments and changes in capital structure. Pension funds remain subject to the Solvency I framework, but are reporting stress tests based on fair value of assets and liabilities. Pension funds have strengthened their buffer capital in the first half-year, but several pension funds have buffer capital below the level considered necessary in stress tests. The financial position of pension funds with a high proportion of paid-up policies is particularly sensitive to the low interest rate level.

In Norway as elsewhere there is an awareness of the danger of renewed instability in financial markets bringing falling securities values, wider credit spreads and possible ensuing flight to government bonds. In such a scenario the risk-free interest rate will likely fall, accompanied by a rise in the value of insurance liabilities concurrent with falling market values of equities, non-government bonds and property.

Insurers' new sales are dominated by products without a guaranteed rate of return and without lifelong benefits, the corollary being that policyholders with a need to save for their pension are required to bear more of the risk themselves, which includes taking the consequences of their own investment choices. This places a major demand on policyholders' knowledge and understanding of the risk inherent in the products, and requires market actors to inform, and give sound advice to, customers on their investment choices. Both in Norway and across the EU, legislation is giving increasing prominence to consumer protection and to institutions' obligation to inform and guide the policyholder. Finanstilsynet monitors compliance with the information and advice requirements through thematic inspections and selective inspections at individual institutions.