FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

SUMMARY

Risk Outlook – June 2018

The growth in the world economy continues, and is broad-based. However, much uncertainty attends the effects of increased protectionism, Brexit and tensions in international politics.

The cyclical trough in the Norwegian economy bottomed out just over a year ago. The subsequent upturn is largely attributable to international economic growth, low interest rates, improved competitiveness and expansionary fiscal policy. Norges Bank has given notice of an increase in its key policy rate in early autumn this year, followed by a gradual stepping up to about 2 per cent in 2021.

Global interest rates are on the way up. The international upturn has encouraged market actors to revise upwards their expectations of central banks' key policy rates. Long-term interest rates have also risen. After a prolonged period of very low rates there is a risk that financial imbalances have built up. High risk exposure in financial markets, high asset prices and a high debt burden render the economy vulnerable in the event of an unexpectedly strong interest rate hike and rising risk premiums in financial markets. The IMF and other international institutions cite these factors as the most important risk drivers at the present time.

Higher risk premiums and rising interest rates in international financial markets will affect Norwegian borrowers and financial institutions. Experience shows that contagion from international money and bond markets is also likely to affect the general interest rate level and risk premiums in a situation where the Norwegian economy and Norwegian banks at the outset are not impaired. It is imperative for borrowers and financial institutions to maintain sufficient buffers to withstand a stronger-than-expected interest rate hike in tandem with falling equity, bond and property prices.

Norwegian households' debt burden is high on average and, for a large proportion of households, very high. Inasmuch as almost all household debt carries floating interest, households are highly vulnerable to interest rate hikes. Younger borrowers generally have small financial buffers and are particularly vulnerable. As experienced on earlier occasions, hefty interest rate hikes and unemployment are likely to prompt financial consolidation among households and to impair the earnings and financial position of Norwegian firms and financial institutions. This is a particular vulnerability of the Norwegian economy.

House prices have risen steeply for a number of years. Regardless of how house price growth is measured, house price growth in Norway is high compared with other Nordic countries and the OECD area. The temperature of the housing market declined in 2017. The price fall was strongest in Oslo, where the price rise in 2016 had been most marked. However, price growth has picked up again in the current year. The further path of the housing market is uncertain. Improved growth prospects and continued low interest rates could contribute to continued house price growth for a time. That would heighten the potential fall in the housing market and add to the risk of financial instability.

In November 2017 the Ministry of Finance asked Finanstilsynet to consider whether the residential mortgage lending regulations should continue in their current form, or be revised or revoked. In Finanstilsynet's view the residential mortgage lending regulations have worked well. The tightening of the regulations as from 1 January 2017 contributed to tighter lending practices. Growth in household debt has nonetheless remained high due to continuing high demand for mortgages.

In its recommendation of 28 February to the Ministry of Finance, Finanstilsynet proposed continuing the residential mortgage lending regulations indefinitely after the expiry of the current regulations on 30 June 2018, but with some amendments made. It recommended dispensing with the requirement of a maximum loan to value ratio of 60 per cent for mortgages for second homes in Oslo, and that the scope allowed for banks to grant residential mortgages that are not compliant with all requirements of the regulations should be set at 8 per cent nationwide. In the period since Finanstilsynet submitted its recommendation to the Ministry of Finance, house price growth has picked up, contributing to continued high borrowing by the household sector. In Finanstilsynet's assessment, this strengthens the rationale for continuing the regulation of residential mortgage lending as proposed.

The growth in consumer lending, i.e. financial institutions' unsecured loans to personal customers, has slowed somewhat, but remains high. Such loans are actively marketed by banks and finance companies. There is a risk of financially vulnerable households taking out consumer loans at high interest that they are subsequently unable to service. This could result in a heavy personal burden for the individual borrower, and in loan losses and loss of reputation for banks. A number of steps have been taken in the past year to regulate consumer lending. In June 2017 Finanstilsynet adopted guidelines on consumer lending practices. A survey of institutions' implementation of the guidelines as of the fourth quarter of 2017 shows that many banks have yet to bring their lending activity into line with the guidelines. This is not a satisfactory situation, and Finanstilsynet will monitor banks' compliance with the guidelines in the period ahead. Supervisory activity vis-à-vis banks specialising in consumer has been stepped up, as have the capital charges set.

Prices in certain commercial property segments have risen markedly for several years. Foreign investors have shown increasing interest in recent years. This may have contributed to the rise in prices and the decline in direct return. Commercial property prices are more cyclically sensitive than house prices, and reduced rental income and/or higher interest rates could bring a marked fall in commercial property prices. Norwegian banks and insurers are heavily exposed to commercial property companies. Although banks have implemented risk-mitigating measures, including requirements on pre-leases and on equity capital when financing development projects, a steep price fall would impair commercial property company earnings and reduce the value of banks' collateral. Finanstilsynet attaches importance to prudent assessment of borrowers' debt-servicing capacity and collaterals and will conduct a thematic inspection of lending to the commercial property sector in the second half of 2018.

Norway's banking industry has seen creditable performances in the years since the international financial crisis, and profit retention has contributed to banks' increased capital adequacy ratios. Norwegian banks are therefore well positioned to provide credit in the event of an economic setback and increased losses.

Finanstilsynet's stress test for 2018 shows that many banks see a considerable reduction in CET1 capital adequacy in the event of a severe negative shock in the Norwegian economy. In the stress scenario world trade declines dramatically, oil prices fall and risk premiums rise concurrent with falling equity and property prices. The likelihood of this scenario materialising is low, but not unrealistic. Several banks are not compliant with the regulatory capital requirements at the end of the stressed period. The impairment of financial positions is due mainly to increased loan losses, in particular on loans to non-financial firms. The results of the stress test underscore how important it is for banks to ensure that their capital planning makes allowance for an unfavourable outturn in the Norwegian and international economies. Finanstilsynet will follow up on this as part of the Pillar 2 process.

The EU's capital requirements directive (CRD IV) and regulation (CRR) are expected to be incorporated into the EEA Agreement shortly. Adapting to CRR / CRD IV will in some areas involve the setting of less stringent capital charges under Pillar 1 than under the current Norwegian requirements. Full implementation of CRR / CRD IV will in isolation permit Norwegian banks to report higher capital adequacy ratios without this reflecting improved solvency.

In Finanstilsynet's assessment it is important to ensure that bringing Norwegian capital adequacy rules into line with CRR / CRD IV does not contribute to a general weakening of Norwegian banks' capital adequacy in real terms. When approving and following up on internal models, Finanstilsynet will attach importance to robust calibration with satisfactory security margins. When setting Pillar 2 add-ons, Finanstilsynet will also ensure that they cover risk that is not fully covered under Pillar 1.

Since the international financial crisis Norwegian banks have increased their capital ratios both in terms of the risk-weighted ratio and the leverage ratio. When assessing banks' capitalisation, Finanstilsynet places emphasis on the leverage ratio, and it will contribute to enabling the banking industry to avoid impairment its financial position on this measure ahead.

The banks have enjoyed ample access to funding in recent years, including funding from foreign sources. They meet the liquidity buffer requirements and have also raised their share of long-term funding. However, they continue to fund a substantial portion of their business in the money and capital markets both in Norway and elsewhere, rendering them vulnerable to increased global uncertainty. The fact that the banks obtain much of their funding through covered bonds (OMF), while at the same time cross holding substantial volumes of one another's covered bonds as part of their liquidity holding, renders the industry more vulnerable to a negative development in the housing market.

In the period since Solvency II entered into force in 2016, insurers' solvency has strengthened, although some insurers face challenges. The new solvency framework captures insurers' risk more effectively than the preceding framework, thus encouraging a better match between institutions' risk taking and their risk-bearing capacity. Adapting to the new requirements has proven particularly challenging for life insurers with a large proportion of guaranteed benefits. The transitional measure for technical provisions has been particularly significant for these institutions. Silver Pensjonsforsikring AS was not in a position to meet the new requirements under Solvency II and was placed into public administration in February 2017. The portfolio of Silver Pensjonsforsikring AS was transferred to Storebrand Livsforsikring AS in January 2018. The public administration does not appear to have affected public confidence in the life insurance industry.

The low interest rate level has posed a challenge to institutions' ability to achieve sufficient return on their investments. Solvency II has in isolation given insurers an incentive to place their funds in less risky investments as a step in adjusting their risk taking to their risk-bearing capacity. However, no significant changes have been noted in the institutions' investment pattern following the introduction of Solvency II.

Norwegian life insurers invest fairly heavily in property compared with insurers elsewhere in Europe. Some assets are treated relatively favourably under Solvency II, including residential mortgages with a low loan to value ratio. In the last two years the largest life insurers have taken over residential mortgage portfolios from banks within the same group. Norwegian authorities are concerned that solvency rules should not encourage arbitrage-motivated migration between banks and insurers. Upon the incorporation of the Solvency II into the EEA Agreement, the adaptation text permits Norwegian authorities to set capital requirements for life insurers' residential mortgages in line with the capital requirements applying to banks' residential mortgages.

The proportion of paid-up policies residing in pension funds is rising. Pension funds are however not subject to risk-sensitive capital requirements equivalent to Solvency II. Finanstilsynet's proposal for the introduction of such rules is under consideration by the Ministry of Finance.

Several non-life insurers are giving closer attention to developing digital processes, inter alia with a view to claims settlements and purchase of insurance. Increasing digitisation and simplification of processes is expected to contribute to lower costs. However, automating and digitising more solutions may well heighten operational risk ahead.