FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

SUMMARY

High debt levels and high property prices pose a significant risk to economic and financial stability in Norway. The rise in household debt has for several years outstripped income growth, resulting in a higher than ever debt burden, as measured by the ratio of debt to disposable income. Many households have a very high debt burden and limited financial buffers. House prices in Norway have grown markedly over a long period and are now at roughly the same high level as before the price fall in 2017. Low interest rates, low unemployment, good income growth and low housing taxation are key factors behind the strong growth in debt and house prices over several years.

A large proportion of households are vulnerable to declining incomes and rising interest rates. High debt levels mean that even a moderate rise in interest rates will lead to a significantly higher interest burden. Most of the debt carries floating interest rates. An increase in interest rates will thus quickly reduce many households' financial flexibility. There is a risk that household debt will continue to grow faster than disposable income in the coming years. This would further increase households' debt burden and vulnerability.

The residential mortgage lending regulations have contributed to tighter lending practices. The growth in households' overall debt has nevertheless remained relatively high. The current regulations were adopted by the Ministry of Finance and remain in force until 31 December 2019. Finanstilsynet will advise the Ministry of Finance on whether the regulations should be continued and possibly amended.

The growth in households' consumer loans has slowed somewhat, although annual growth remains high. Non-performing loans and loan losses are on the increase. There is a risk that vulnerable households will take out consumer loans at high interest rates that they are subsequently unable to service. This could result in loan losses and loss of reputation for banks and a heavy personal burden for the individual borrower. Based on a proposal from Finanstilsynet, the Ministry of Finance established regulations on requirements for financial institutions' consumer lending practices on 12 February 2019. The regulations include requirements on the borrower's debt servicing capacity, maximum debt relative to income and monthly instalment payments. The regulations will remain in force up to and including 31 December 2020. In 2018, three entities were granted a licence to provide debt information services. Debt information will be available from the summer of 2019. Better information about customers' overall consumer debt will strengthen the basis for banks' credit assessments.

The debt levels of Norwegian non-financial firms, measured as a share of GDP, are at a historically high level. Commercial property prices have risen steeply for several years, especially in the Oslo region. Bank lending to commercial property companies represents a sizeable share of the corporate market portfolio. Higher interest rates will weaken the earnings of property companies and reduce the value of creditors' collateral.

Internationally, both public and private debt has increased, and there is a high debt burden in a number of countries. Recent years have seen particularly strong growth in emerging economies. An increasing proportion of corporate loans are taken out by entities with a weak financial position and earnings, and household debt has risen sharply in several countries in recent years. In the EU, low profitability in the banking sector also contributes to financial vulnerability.

Several incidents may trigger significant financial market turmoil and an international setback. The uncertainty

primarily relates to a possible further escalation of the trade conflicts between the US and other countries, as well as the unresolved situation regarding the UK's exit from the EU. The consequences of a negative shock could be reinforced by high debt levels and high property prices in many countries.

Financial markets and financial institutions are affected by both physical climate change and the transition to a low-emission society. The risk of financial instability depends on how suddenly climate change occurs and how quickly the transition to a low-emission economy takes place. The integration of climate risk in supervisory activity is high on the agenda of financial supervisory authorities in a number of countries, and work is in progress to develop supervisory tools to monitor climate risk. Finanstilsynet is involved in this work through the European supervisory cooperation and the Network for Greening the Financial System (NGFS).

Due to low loan losses and profitable operations, Norwegian banks have been able to meet higher capital requirements largely through retained profits. The banks' own funds as a share of total assets have increased over the past ten years, and the banks meet new liquidity requirements. The share of long-term market funding has risen. Norwegian banks are thus better positioned to provide credit in the event of an economic setback and increased losses.

A number of Norwegian banks, especially the largest ones, obtain a significant share of their funding in the Norwegian and international money and capital markets. This makes the banks vulnerable to market turbulence. There has been an appreciable increase in banks' residential mortgage lending in recent years, both in absolute terms and as a share of total lending. This increase is largely financed through the issue of covered bonds (OMF). In addition, banks have invested heavily in covered bonds issued by other banks. Developments in house prices thus have a strong bearing on the banks' credit and liquidity risk.

Securitisation of bank loans is not widespread in Norway, partly due to the fact that securitised loans are subject to ordinary capital requirements under Norwegian regulation. The EU Securitisation Regulation will be be implemented in Norwegian law. Securitisation may in principle entail a transfer of risk from banks to investors who purchase financial instruments issued on the basis of the securitised loan portfolio. However, history has shown that securitisation may contribute to financial instability. Securitisation requires a clear framework for risk transfers in order to ensure that banks' position is not weakened. The introduction of this regulation in Norway therefore makes heavy demands on supervisory activity.

The EU's capital requirements directive (CRD IV) and regulation (CRR) were incorporated into the EEA Agreement on 29 March 2019. Norway, Iceland and Liechtenstein have all made the reservations that their legislative assemblies have to agree to the transposition into national law. The Ministry of Finance assumes that the legislation may enter into force during the second half of 2019. With the implementation of CRD IV and CRR in Norwegian law, loans to small and medium-sized enterprises will receive lower capital charges (SME supporting factor), and the Norwegian floor for risk-weighted assets based on internal risk models (Basel I floor) will be dispensed with. Seen in isolation, the measured capital adequacy ratio will thus increase, though banks' actual capital adequacy will not.

In Finanstilsynet's assessment it is important to ensure that the implementation of CRR/CRD IV does not contribute to a general weakening of Norwegian banks' actual capital adequacy. 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. When assessing banks' capitalisation, Finanstilsynet places emphasis on the leverage ratio. In Finanstilsynet's view, the banks' financial position on this measure should not
be impaired in the period ahead.

Finanstilsynet's stress test for 2019 shows that many banks may be strongly affected in the event of a serious setback in the Norwegian economy. In the stress scenario, a deep international recession is assumed to result in a decline in Norwegian traditional exports, a pronounced and protracted fall in oil prices and a strong decline in investments on the Norwegian shelf. This is assumed to contribute to weaker confidence in the Norwegian economy, depreciation of the Norwegian krone and a strong increase in risk premiums on Norwegian capital assets. The stress test shows that several banks will not be compliant with the regulatory capital requirements at the end of the stressed period. The impaired financial strength is due mainly to increased loan losses, in particular on loans to non-financial firms.

The capital adequacy of life insurers has been strengthened in recent years, and they are compliant with the Solvency II requirements that came into effect in 2016. It has been challenging for insurers to achieve the guaranteed return on their investments due to the low interest rate level. Long-term interest rates are still low, and the EIOPA stress test 2018 shows that the European insurance sector is vulnerable to negative market developments. The risk of declining prices and higher risk premiums in financial markets is of particular consequence to insurers with a large proportion of paid-up policies in their portfolios.

Some assets held by insurers are subject to relatively low capital requirements under Solvency II, including residential mortgages with a low loan-to-value ratio. The Norwegian authorities may, however, set a lower limit for estimated loss given default to ensure that insurers are subject to approximately the same capital requirements as banks for their exposure to mortgage loans. On commission from the Ministry of Finance, Finanstilsynet forwarded in March 2019 a proposal for changes in capital requirements for residential mortgages for insurers. Finanstilsynet's proposal entails that a 30 per cent floor is set for the calculation of loss given default to ensure that the potential for arbitrage-motivated transfers of loans between banks and insurers is reduced. A corresponding amendment has been proposed for pension funds. The Ministry of Finance circulated the proposed amendment to the regulations for comment with the deadline for response set at 15 August 2019.

New solvency requirements for pension funds entered into force on 1 January 2019. The new requirements are a simplified version of Solvency II aimed at capturing risks across the entire business. This will provide a better basis for the pension funds' risk management and assessment of capital needs. Overall, pension funds meet the new solvency requirements, although there are wide differences between the pension funds.