

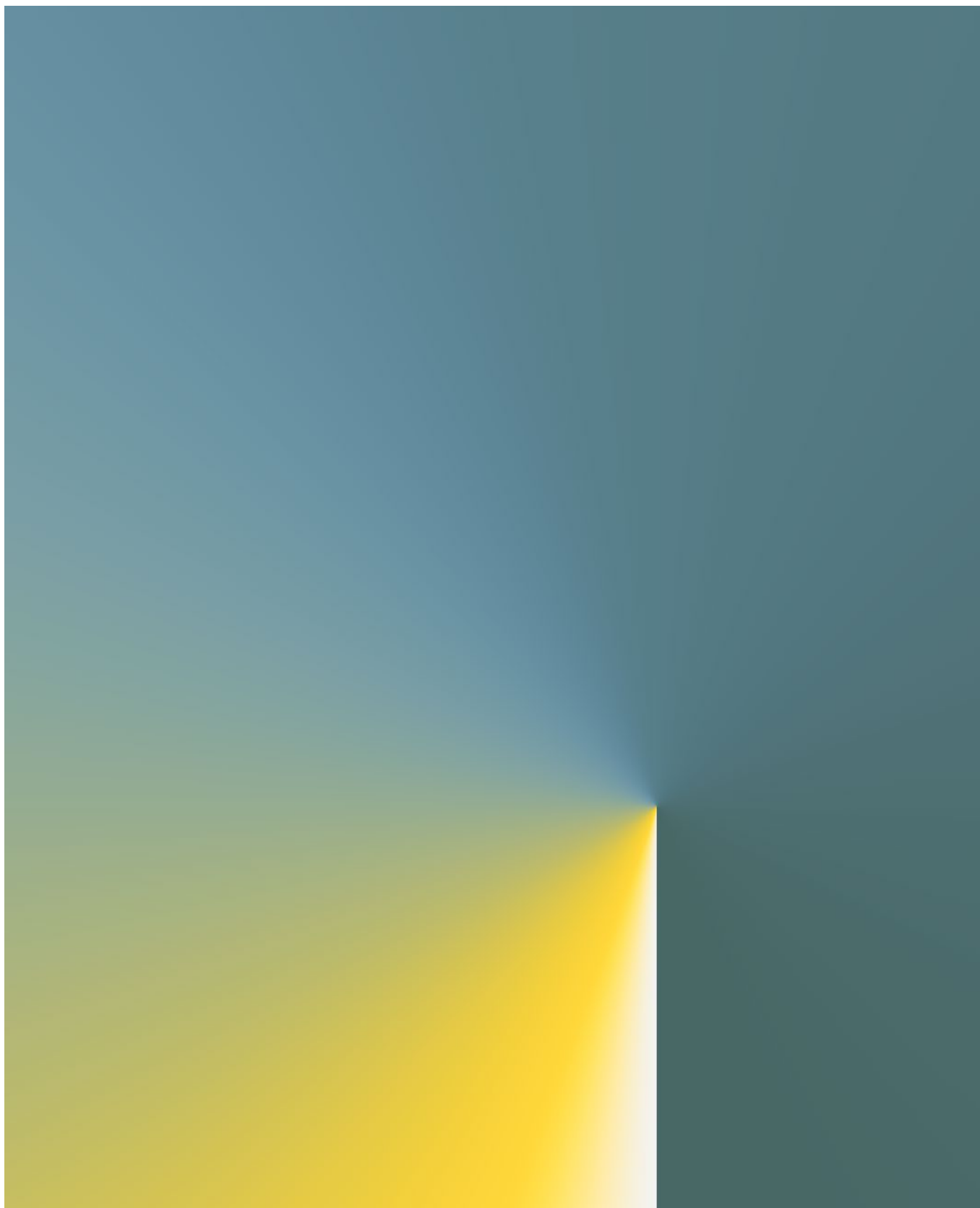


FINANSTILSYNET

THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

RISK OUTLOOK

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Risk Outlook

Finanstilsynet analyses and assesses stability in the Norwegian financial system. Its assessments are published in the report *Risk Outlook* twice yearly, in June and December.

SUMMARY

Activity in the Norwegian and international economies has quickly rebounded after the sharp downturn triggered by the Covid-19 pandemic. The economic upturn reduces the risk of financial instability in the short term, but considerable uncertainty remains about the future path of the pandemic. There are significant vulnerabilities in both the Norwegian and the international economy, and some countries and regions are particularly at risk.

High household debt and high property prices have long been, and still are, the key vulnerabilities in the Norwegian financial system.

The debt burden of Norwegian households is high, both in historical terms and compared with other countries. Debt growth is somewhat higher than before the pandemic. Many households have very high debt relative to income and the value of their property and are vulnerable to declining incomes, rising lending rates and falling house prices. If a large number of households have to reduce their purchases of goods and services at the same time, this could have major negative ripple effects in the economy and the financial system.

After a sharp rise in house prices from summer 2020, growth has slowed over the past six months. The price level is considerably higher than prior to the pandemic.

Commercial property prices have risen sharply over many years, and the banks have large portfolios of loans to commercial property companies. An unexpected rise in interest rates or significantly higher risk premiums on corporate bonds may lead to a substantial fall in commercial property prices and heightened credit risk for the banks. Increased focus on environmental requirements may cause greater uncertainty about the properties' market value, especially older buildings.

Consumer price inflation has risen considerably in a number of countries over the past six months. Demand for goods and services has increased parallel to a weakening of globally important production chains. Shipping costs and commodity prices have

risen steeply, and there is a shortage of input factors in some sectors. Adverse weather conditions have reduced crops and contributed to higher food and energy prices. It is uncertain whether the elevated level of inflation proves to be temporary. If inflation remains at the current level or rises, there may be a need for significant monetary tightening in a number of countries. If so, this will also affect the Norwegian economy and the Norwegian financial system, which is vulnerable to a sharp rise in interest rates.

The stock markets recovered rapidly, and stock market indices in most countries are significantly higher than prior to the pandemic. Yields on bonds with long maturities have risen and are approximately on a level with the beginning of 2020. The increase may be due to rising inflation, expectations of higher economic growth and indications from central banks of higher key policy rates and a reduction in securities purchases.

Norwegian industries were affected in different ways by the pandemic. Owing to increased energy, input, shipping and inventory costs, there has been a recent weakening of many firms' profitability. The phasing out of support measures may result in a further decline in earnings. The share of interest-bearing debt in firms with weak debt servicing capacity has increased, and the debt servicing capacity of parts of the business sector will deteriorate markedly if operating and interest expenses rise.

The risk of cybercrime is steadily increasing, but has so far not resulted in serious incidents in Norwegian financial institutions. Close interconnectedness in the financial system raises the risk that individual incidents will escalate, affect more market players and lead to financial instability.

The profitability of Norwegian banks is virtually back to pre-pandemic levels. On average, banks' loan losses have been moderate, but losses on consumer loans remain high.

The Ministry of Finance's request to Norwegian banks to restrict dividend payments etc. remained in force through September 2021. Several banks have announced that they will distribute additional dividends during the fourth quarter. Finanstilsynet expects banks' capital planning to factor in the

considerable uncertainty that prevails about future economic developments. It is vital that the banks are well capitalised to be able to absorb loan losses and provide loans to creditworthy customers during an economic downturn.

Partly as a consequence of less stringent capital requirements from year-end 2019 and a reduction in the counter-cyclical capital buffer requirement in spring 2020, the banks' capital far exceeded the regulatory requirements at the onset of the pandemic. Reduced capital requirements may gradually have an adverse impact on the banks' financial position, which will be unfortunate in light of the risk in the Norwegian financial system. The scope of action within European legislation should therefore be used to counteract such a development.

The profitability of pension institutions has improved thus far in 2021, backed by the positive stock market trend. The low interest rate level remains challenging for pension institutions with a large proportion of guaranteed products and may cause them to raise the proportion of high-risk and less liquid investments in order to increase expected returns. Sizeable financial market investments make the pension institutions vulnerable to a reduction in the prices of equities, bonds and real estate. Norwegian life insurers are highly exposed to the banking sector and have also increased their investments in green bonds. At end-September 2021, life insurers' solvency ratio was somewhat higher than prior to the pandemic, while the ratio has declined somewhat for pension funds (at end-June).

Non-life insurers achieved an unusually strong insurance result in the first three quarters of 2021. Lower economic activity levels and reduced travel brought down the claims frequency. The solvency of non-life insurers improved in 2021, but their solvency ratios are still below pre-pandemic levels. This is partly due to dividend payments.

Climate change and the transition to a low-emission society will entail a significant restructuring of the Norwegian economy and cause a decline in earnings in industries and firms that are negatively affected by the changes. This may subject banks and other financial institutions to losses. In addition, non-life

insurers are particularly exposed to physical climate risk.

Based on climate scenarios from the Network for Greening the Financial System and Bank of England, Finanstilsynet has analysed two possible pathways for the Norwegian economy. In the first scenario, the transition to a low-emission society starts immediately and takes place with no major costs to the real economy. In the alternative scenario, the restructuring starts later and is characterised by a sudden and disorderly transition both in Norway and internationally. This heightens the risk of misinvestment and a fall in the value of existing production equipment. Finanstilsynet's calculations indicate that in such a scenario, banks will suffer significant losses on corporate loans. Estimated losses are nevertheless considered to be manageable for Norwegian banks.

Low interest rates and ample access to liquidity in global markets have stimulated investors' risk appetite for a long period. Historically high prices heightens the potential fall in the stock markets. Valuations are particularly high in the technology sector, where recent years' increases are a key factor behind total global returns.

The number of new firms listed on Oslo Børs has risen further in 2021. The high level of activity reflects ample access to capital for startups. Many of these firms have no or little turnover. Access to capital has been particularly good for technology and renewable energy firms. In recent years, there have been strikingly few initial public offerings on Oslo Børs, while many startups have chosen to apply for admission to trading on Euronext Growth. There is considerable risk associated with investments in startups.

Many households have significantly increased their financial risk exposure by investing both directly in the equity market and through equity funds, and there has been a sharp rise in the number of private individuals owning equities in individual companies. Both in Norway and internationally, there is great interest in new investment opportunities, such as virtual currencies and other crypto assets. Such investments entail a high level of risk for the individual investor. Blockchain technology can facilitate the

streamlining of many processes in a modern financial system, but the growth in the crypto market has so far had little impact on payment and settlement systems. Cryptocurrencies can make it harder to fight crime and have a negative effect on the financial system. Several international initiatives have therefore been taken to regulate crypto markets.

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