FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Risk Outlook – December 2020

Summary

Just like the rest of the world, Norway experienced an abrupt and sharp economic downturn when the Covid-19 pandemic triggered strict containment measures and extensive lockdowns in the spring. The Norwegian economy was also hit by low oil prices. Strong government measures helped to reduce financial market turmoil, curb the fall in demand and sustain household income. Lower contagion rates provided the basis for a gradual reopening of society through the summer and expectations of a faster normalisation of the economy than feared when the measures were introduced in March.

During the autumn, several countries have once again experienced a surge in the number of infected people. This has resulted in new lockdowns and other strict measures to slow the spread of the virus, especially in Europe.

Further developments in both the Norwegian and international economy are uncertain and will largely depend on the path of the contagion. In recent weeks, several vaccine manufacturers have announced that vaccines may soon be ready for approval. Access to vaccines will gradually provide a basis for lifting the comprehensive containment measures. Nevertheless, it may be long before economic activity returns to pre-pandemic levels. Some industries may also face lasting changes in demand.

Globally, there is less room for counteracting new economic shocks. High and rapidly increasing sovereign debt restricts the fiscal policy space of a number of countries, while very low key policy rates and the provision of significant liquidity from central banks provide less room for further monetary policy stimulus.

The debt burden of Norwegian households is at a very high level both historically and compared to other countries and constitutes a significant vulnerability for the Norwegian economy. The growth in household debt has slowed somewhat in recent years, but has picked up since the summer. This year's residential mortgage lending survey shows that a large and increasing proportion of new mortgages is taken out by borrowers with high total debt relative to income. Several borrowers also have large mortgages relative to their property's market value. These factors make a number of households vulnerable to declining incomes, rising interest rates and falling house prices.

House prices fell slightly in both March and April 2020, but have subsequently risen. In October, twelve-month growth was 7.1 per cent, which is clearly higher than in the preceding years. This trend must particularly be seen in light of the record-low interest rate level and fiscal policy measures to secure household incomes. As a result of low interest rates, increasing house prices and weaker growth in household income, households' total debt relative to income may grow further in the period ahead.

The Norwegian business sector is to varying degrees affected by the Covid-19 pandemic, the contention measures and the fall in oil prices. Extensive government measures have helped to keep up the level of economic activity in Norway and limited the decline in income for those parts of the business sector that have been most severely affected. Deferred payment of direct and indirect taxes and instalment payment

deferrals on bank loans have improved many companies' liquidity situation. The banks' earnings have declined slightly, but are still strong. The fall in interest rates has contributed to narrowing the deposit spread, and loan losses have increased, but thus far only moderately.

International accounting standards require banks to assess the risk of future losses on all loans in their portfolios. Banks' assessments of portfolio credit quality, excluding oil-related exposures, are largely unchanged compared with the start of the year. As major parts of the business sector have experienced a significant decline in income, there is a risk that potential losses may be underestimated in banks' loss allowances.

The banks' regulatory capital adequacy ratio is high and has risen over the past year. However, this increase can largely be attributed to regulatory changes that do not imply an actual improvement in the banks' financial soundness. Experience from previous crises has also shown that it may take time for the loan losses to be recognised in full in the banks' financial statements.

The banks are exposed to industries that are now directly affected by the Covid-19 pandemic. Parts of the commercial real estate sector, which represents the banks' largest corporate exposure, may also be impacted. In addition, the banks are exposed to other industries, such as the oil industry, that may face lasting changes and thus represent a higher risk of losses. Loans to vulnerable households may also be at risk.

The banks must factor in the possibility of a significant rise in loan losses in the coming period. The great uncertainty indicates that the banks should maintain their equity base by retaining profits to ensure that they are well able to provide loans to creditworthy customers even in a situation with high loan losses.

Deposits account for 45 per cent of Norwegian banks' funding. The low interest rate level has resulted in a significant reduction in banks' deposit spreads. As money market rates are close to zero, the loss of income due to the narrow interest margin must be expected to persist, since it is difficult to offer customers negative deposit rates. The low interest rate level will also reduce current returns on banks' liquidity portfolios. Overall, the banks' main source of income, net interest income, is likely to be lower than in the past given the current interest rate level.

The banks have a high proportion of market funding. The market turmoil this spring triggered extraordinary liquidity measures from a number of central banks, including Norges Bank. According to Finanstilsynet, the regulations allow banks, if necessary, to draw on their liquidity reserves in a stressed market situation, but no Norwegian banks have thus far needed to avail themselves of this opportunity. After rising throughout the first quarter, risk premiums on the banks' funding declined towards pre-pandemic levels during the second and third quarter.

The volume of consumer loans, which grew rapidly for many years, is now declining sharply. There could be several reasons for this. In addition to the economic setback, the introduction of debt registers is probably a contributing factor. An increasing number of loan applications from customers with weak debt servicing capacity are now rejected, as institutions have a better overview of the customer's finances. Parallel to this, the share of non-performing consumer loans is still on the rise. This must be viewed in light of the fact that it may take some time from the loans are taken out until an event of default is identified.

Norges Bank is one of several central banks that have lowered their key policy rate to 0. In consequence of the low interest rate level, investors and small-scale savers seek investments with higher expected returns, but also higher risk. This may lead to the build-up of financial imbalances, with the risk of a subsequent major correction.

A number of Norwegian banks, pension institutions and mutual funds use the derivatives markets to reduce interest rate and exchange rate risk related to funding and investments. The requirement for margin payments to minimise counterparty risk in derivative contracts resulted in significant liquidity challenges for several market participants after the abrupt and sharp depreciation of the Norwegian krone in March 2020. The need for rapid sales of securities may have contributed to reinforcing the impacts on the market.

Pension institutions' performance was severely affected by the fall in equity prices in the spring of 2020. Subsequent strong price increases gave a certain improvement in profits, but the return on the institutions' collective portfolios for the first three quarters of the year is nevertheless weaker than in the corresponding period of 2019. The decline in interest rates makes it challenging to achieve excess returns on guaranteed rate products. Pension institutions have sizeable commercial property investments. Reduced demand for office space, hotel accommodation and to some degree shop premises weakens the current earnings of commercial property companies and may lead to lower property values.

As from 2021, 1.5 million Norwegians who have defined-contribution pensions will get an individual pension account. The aim is to give individuals a better overview of their pensions and to reduce total costs. The scheme may lead to intensified competition and lower prices in the defined-contribution pension market because employers, who will cover asset management costs for active defined-contribution schemes, are expected to be in a better negotiating position than individual holders of pension capital certificates. The introduction may result in extensive transfers of assets between different managers of pension products, and it is important that the institutions have a good infrastructure for handling such transfers without delay and with minimal operational risk. The Ministry of Finance has therefore established transitional rules allowing the transactions to take place over a period from 1 May to end-December 2021.

Overall, non-life insurers enjoy a sound level of profits in spite of the fact that some undertakings have experienced a increase in claims payments related to travel insurance this year. Favourable winter conditions and corona-related reductions in car travel and rush hour traffic have given a rise in profitability within motor vehicle insurance.

The Paris Agreement's aim to mitigate climate change requires a fundamental restructuring of global energy use. For financial institutions and investors, it is important to gain good insight into companies' exposure to transition risk. Finanstilsynet's survey of listed companies' sustainability reporting shows that Norwegian companies provide little information about the risk of changes in future profit levels as a result of the transition to a low emission society. Finanstilsynet will follow up companies' future sustainability reporting.

Internationally, a number of processes are underway to establish classification systems for green investment products and ensure that investors and lenders receive the necessary information. Finanstilsynet will contribute to ensuring that relevant EU legislation is implemented in Norwegian law and will follow up the institutions' adaptations to new regulations in this area. Strong growth in investments in green financial instruments has heightened the risk of overpricing and financial bubbles in this segment.

The Covid-19 pandemic has speeded up the ongoing digitalisation of society. This has several positive aspects, both in the short and long term, but also increases the vulnerability to outages and digital crime. Private individuals, companies and government authorities all risk that their assets or sensitive information are stolen or corrupted. The scale of digital attacks has increased both internationally and in Norway during the pandemic.