FINANSTILSYNET

THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

RISK OUTLOOK
DECEMBER 2023

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

In Norway and several other countries, economic activity has remained relatively high through 2023, and unemployment is still low. This is reflected in low loan losses in the banks. Combined with an increase in net interest income, the low losses have contributed to high profits for the banks. The higher interest rate level has also improved life insurers' solvency position.

Key forecasters expect a gradual slowdown in economic activity, a further decline in inflation and moderately higher unemployment in the period ahead. The interest rate level is expected to remain higher than the very low level prior to the interest rate hikes. Such developments will probably result in a slight increase in loan losses and lower net interest income for Norwegian banks, but no serious disruptions to the financial system. A higher interest rate level will also reduce the risk of a further build-up of financial imbalances. If developments turn out to be in line with the forecasts, the Norwegian economy will have fared well through the serious disruptions of recent years.

Future developments are highly uncertain. Owing to many years of low interest rates and ample access to credit, the debt burden of households and non-financial corporations has increased both in Norway and internationally, as has the debt burden of central and local government in a number of countries. This has resulted in vulnerabilities in the economies and a greater risk of financial instability. Even if inflation declines and approaches the central banks' inflation targets, interest rates may remain at the current level for a long period or may have to be raised further. There is a risk of an economic downturn combined with persistently high inflation, so-called stagflation. The uncertainty is exacerbated by geopolitical tensions.

Experience from Norway and other countries shows that crises in the financial system can occur suddenly and spread rapidly among market participants, both nationally and internationally. An international downturn could lead to financial market turbulence and increase the risk of financial instability, also in Norway. Norwegian banks and insurers could thus be severely affected.

In September 2023, the three European Supervisory Authorities EBA, EIOPA and ESMA warned of continued high economic uncertainty and advised financial institutions and national financial supervisory authorities to be vigilant to the risk of financial instability. In autumn 2022, the European Systemic Risk Board (ESRB) also warned of increased vulnerabilities in the financial system and urged public authorities to preserve or enhance the resilience of the financial sector. This message was repeated in November 2023.

High debt in Norwegian households and elevated residential and commercial property prices are the key vulnerabilities in the Norwegian financial system.

Norwegian households have high debt relative to income. Lower credit growth and higher nominal income growth have contributed to a certain reduction in the debt burden over the past year. Finanstilsynet's residential mortgage lending survey from autumn 2023 also shows a decline in the average debt-to-income (DTI) ratio of borrowers who took out new debt and a reduction in the share of loans granted to borrowers with high DTI ratios. Norwegian households nevertheless have the highest debt burden in the OECD area, and many borrowers have high total debt. Households' interest burden has increased significantly. Many households with high debt are vulnerable to a further rise in interest rates, loss of income or declining house prices.

The banks assess that household credit risk has risen. So far, there are few signs of serious debt servicing problems among households. Household saving was high during the Covid-19 pandemic, and the labour market has so far held up well. Higher policy rates also feed through to households' borrowing rates, subject to a lag. A number of households have scaled down consumption. Households' demand may decline, and

their debt servicing capacity may be further impaired in the coming period, especially if economic developments prove to be weaker or interest rates higher than expected.

There has been strong growth in **house prices in Norway** over a protracted period. Although the rate of growth has slowed, prices are at a high level relative to households' disposable income. Experience from Norway and other countries shows that periods of rapid house price growth may be succeeded by a sharp drop in prices which amplifies and prolongs an economic downturn. The risk of such a development is greater if interest rates have to be kept high for longer than expected or be further increased. Lower house prices reduce banks' collateral values.

Non-financial corporations in a number of main industries showed a weaker performance in 2022. For most non-financial corporations, interest expenses increased considerably parallel to a rise in prices of important input factors. Reduced demand and and asset write-downs were other factors behind the weaker profits in some industries. Thus far in 2023, the number of corporate bankruptcies has been far higher than during the same period last year, although the level is still not higher than in the years prior to the Covid-19 pandemic. Some industries, such as the construction industry, are particularly hard hit. Lower household demand may amplify the challenges facing non-financial corporations and contribute to higher loan losses among banks.

Higher interest rates have led to a fall in the value of commercial properties and reduced earnings in commercial real estate (CRE) companies. A number of these companies have high debt, and a substantial share of their debt matures and must be refinanced in the coming years. The share of debt in CRE companies with weak interest servicing capacity has increased markedly, measured as a share of the industry's total debt. If interest rates remain high, the share of high-risk debt may increase further and elevate banks' credit risk.

Several of the largest CRE companies have written down the value of their real estate portfolios over the past year. The pricing of CRE companies in the stock market may indicate that market participants expect further write-downs.

Equity capital is crucial for **banks**' risk-bearing capacity and their ability to extend new loans to creditworthy customers during economic downturns. During severe downturns, banks in Norway and internationally have recorded substantial losses on loans, including loans secured on commercial real estate. If large losses were to occur and it becomes necessary to draw on capital buffers, experience shows that banks can rapidly lose market confidence and experience liquidity problems. Norwegian banks should therefore meet regulatory requirements by an ample margin.

Due to their high level of profitability, Norwegian banks are in a good position to increase their capital adequacy ratios. This will improve the banks' capacity to provide loans to creditworthy customers in periods of higher loan losses. Finanstilsynet expects Norwegian banks to thoroughly assess the risk in their loan portfolios and the need for impairment losses, and to apply caution with respect to dividend payments and share buybacks. The European Supervisory Authorities have expressed a similar expectation with respect to banks in the EEA.

Sound competition between providers of banking services in Norway is a prerequisite for a well-functioning market and efficient capital allocation. In light of the interest rates increases and the banks' level of profitability, Finanstilsynet has been commissioned by the Ministry of Finance to assess the competitive situation in the Norwegian banking market.

Norwegian insurers and pension funds meet prevailing solvency capital requirements. The fall in CRE prices and weaker earnings in CRE companies have a particularly negative impact on Norwegian life insurers. Overall, life insurers have a higher exposure to real estate than corresponding undertakings in most other European countries. A number of undertakings recorded losses on their real estate portfolios in the third quarter, and a further decline in real estate values will reduce their capital buffers. For non-life insurers, more extreme weather coupled with a more challenging reinsurance market entail weaker earnings prospects and heightened risk in the coming period.

FINANSTILSYNET
Revierstredet 3
P.O. Box 1187 Sentrum
NO-0107 Oslo

Tel. +47 22 93 98 00
post@finanstilsynet.no
finanstilsynet.no