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

In Finanstilsynet's view, there is a heightened risk of financial instability in the period ahead. There is high capacity utilisation in Norway and several other countries, with low unemployment and labour shortages in a number of sectors. However, high inflation, the war in Ukraine and the impact of the Covid-19 pandemic give rise to considerable economic and financial uncertainty.

The crisis in the energy markets and supply chain disruptions, coupled with high demand for goods and services, have contributed to a sharp rise in global consumer price inflation. Central banks in several countries have raised their policy rates considerably and announced further rate hikes. In addition, central banks are tightening monetary policy by scaling back their bond holdings. There is an increased risk of stagnant economic activity coupled with high consumer price inflation, so-called stagflation. In the event of stagflation, fiscal and monetary policy authorities will have limited opportunities to counteract an economic downturn by stimulating demand for goods and services.

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

Households’ debt burden is high both in historical terms and compared with other countries, and the share of households with a particularly heavy debt burden has increased in recent years. Only a small proportion of household debt carries fixed interest rates. Higher interest rates will therefore quickly be reflected in rising interest expenses. This means that many Norwegian households are particularly vulnerable to a sharp rise in interest rates, loss of income and declining house prices. Debt problems in the household sector will have major economic and financial repercussions.

House prices in Norway have risen considerably over a long period of time and significantly more than disposable income per capita. In recent months, there has been a major shift in the housing market. Both Norges Bank and Statistics Norway expect house prices to edge down over the next year, but to a level that is still higher than prior to the pandemic. Interest rate increases and economic uncertainty nevertheless entail a heightened risk of a sharp fall in house prices.

Commercial property prices have risen markedly over the past decade as a result of increasing rental prices and low required rates of return. The banks have a significant loan exposure to commercial property companies. In the past, both Norwegian and international banks have suffered substantial losses on commercial property exposures during severe downturns. A strong rise in interest rates and higher risk premiums may lead to a substantial fall in commercial property prices and increased credit risk for the banks. Commercial property companies also have large volumes of debt falling due over the next few years, which entails a considerable refinancing risk.

Very low interest rates over several years are a factor behind the substantial debt accumulation both in Norway and internationally. In many countries, sovereign debt has

increased considerably in recent years. Large budget deficits must be financed by additional borrowing. A weaker economic trend may create uncertainty about the sustainability of fiscal policy in some countries and contribute to higher risk premiums on these countries' sovereign debt. Sovereign debt default could have serious negative repercussions for global financial markets.

Yields on long-term bonds have risen. At the same time, there has been a significant decline in equity prices on several of the world's stock exchanges. Equity prices in a number of technology companies, which have previously increased strongly, have shown the most pronounced decline. There has also been a sharp reduction in the value of cryptocurrencies over the past year, with increased turmoil in the wake of the collapse of the crypto company FTX. The Norwegian stock market has held up, partly due to the large proportion of oil and gas-related companies on the stock exchange. Financial market turbulence and a lower level of activity may contribute to a further fall in securities prices.

As a consequence of high energy prices, prices of energy derivatives traded on Nasdaq Oslo have risen and become more volatile. Energy prices rose sharply in late August, and margin calls increased considerably for energy producers and other players who had sold their future production in the futures market. This triggered a significant liquidity shortfall, entailing a risk that the parties to derivatives contracts would fail to meet their obligations. After contracting in September and October, there has recently been a new significant increase in energy prices. Developments show that there is still considerable uncertainty in the energy market. Experience gained this autumn shows the importance of monitoring the inherent systemic risk in the derivatives markets.

Pension institutions have substantial investments in the financial and property markets. Higher interest rates and the stock market decline have thus contributed to negative returns and weaker profits. On the other hand, a higher interest rate level has helped improve solvency, as the present value of the institutions' future liabilities has fallen more than the value of their assets. However, it must be taken into account that the increase in interest rates may be short-lived and that interest rates may decline in the longer term and approach the low level observed in recent years.

The war in Ukraine and several attacks on infrastructure in Europe, as well as general geopolitical uncertainty, place greater demands on emergency preparedness, also in the financial sector. The risk of major cyber incidents with serious consequences has increased. Such incidents may have a strong impact on the financial infrastructure, especially if they affect critical functions in the financial system.

Norwegian banks meet the regulatory capital requirements by a margin. Their profitability has improved since 2020, partly due to low loan losses. Higher interest rates and weaker economic developments increase the risk that loan losses may rise in the period ahead. The stress test of Norwegian banks presented by Finanstilsynet in June and an updated stress test presented in this report show that the banks may suffer substantial losses and be required to draw on their capital. Finanstilsynet expects Norwegian banks' capital planningto factor in losses that may arise in a stagflation scenario featuring a sharp rise in interest rates, higher unemployment and a property market crash.

In September, the European Systemic Risk Board (ESRB) issued a warning to the member states on increased vulnerabilities in the financial system. The ESRB stressed the importance of preserving or enhancing the resilience of the financial sector so that it can continue to support the real economy if and when serious incidents occur. On 3 October, Finanstilsynet sent a letter to the Ministry of Finance proposing a tightening of the lending regulations to limit the borrowing of vulnerable households. In a letter to the Ministry of Finance on 31 October, Finanstilsynet has also proposed increasing the floors for risk weighting of residential and commercial mortgages for banks that have permission to use IRB models to calculate capital requirements. Finanstilsynet has further recommended that the Ministry of Finance retain the 100 per cent risk weight for commercial mortgages for banks using the standardised approach. In its assessment of the systemic risk buffer rate, which was sent to Norges Bank on 1 November, Finanstilsynet stated that the Ministry of Finance should consider expanding the basis for calculating the systemic risk buffer to include exposures abroad. It is vital that the banks are well capitalised to be able to absorb higher loan losses and provide loans to creditworthy customers even during bad times.

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