Summary of the Risk Outlook I 2017 report

After several years of weak economic growth in the industrialised countries and declining growth in emerging economies, there are now signs that growth overall is picking up. The International Monetary Fund (IMF) considers the risk of financial instability in the short term to be somewhat lower than it did in autumn 2016. However, risk in the somewhat longer term appears to have grown. Political uncertainty and signals of protectionism could put a brake on the development of international trade and economic growth ahead. Expansionary monetary policies have encouraged heavy debt incurrence and contributed to high asset prices in many countries. In most industrialised countries other than the US, the central banks have signalled continued expansionary monetary policies. This will help to maintain activity levels but could at the same time increase the risk of future financial instability by stimulating borrowing and contributing to higher property prices.

In Norway reduced activity in oil-related industries after the oil price fall in 2014 has impacted on other parts of the economy, although the contagion effects have thus far been limited. Growth in the mainland (non-oil) economy in 2016 was at its lowest point since the financial crisis. There are now signs that activity levels in the mainland economy are picking up. Unemployment rates have fallen in recent months.

House prices and household debt have risen rapidly for many years. House prices and the household debt burden are at unprecedented levels, and household debt is growing significantly faster than household incomes. The vulnerability of the financial system has increased. There is a danger that persistent low interest rates could encourage a continued rise in house prices and indebtedness, thereby further increasing the potential fall.

A turnaround in the form of an interest rate hike or increase in unemployment will most likely bring lower private consumption and falling house prices. The younger age groups in particular, with small financial buffers and high housing debt, are vulnerable. The record high indebtedness in the household sector will compound the negative effect of an interest rate hike and income lapse.

The growth in house prices has slowed somewhat in recent months, but from a very high level. Activity in the housing market remains intense. Stronger growth in the Norwegian economy and continued low interest rates could encourage further growth in house prices, but the growth is not sustainable. The Ministry of Finance tightened the residential mortgage lending regulations somewhat as from 1 January 2017. This brought a slight tightening of lending practices and may in isolation have dampened pressures in the housing market, yet growth in household debt has remained high in recent months. Finanstilsynet is monitoring households' debt incurrence, the housing market and banks' credit practices, and will throughout consider the merits of recommending a further tightening of the regulations to the Ministry of Finance.

Banks' are heavily exposed to commercial property, a segment accounting for about 40 per cent of overall lending to the corporate market. Prices in parts of the commercial property markets have risen sharply. In the event of a setback in the housing markets and financial consolidation in the household sector, the contagion effects to commercial property could be substantial and inflict heavy losses on the banks, as witnessed in Norway and elsewhere during earlier crises. Finanstilsynet monitors banks' exposures to commercial property as part of its on-site inspections.

Household borrowing in the form of unsecured loans carrying high interest has risen considerably in recent years. Consumer loans now make up a mere 3 per cent of household debt but accounted for close to 8 per cent of the overall increase in household debt in the twelve months to the end of this year's first quarter. The strong increase in consumer lending gives rise to concern. For many households consumer borrowing comes in addition to other debt, and can impose a heavy burden on individuals and households. Higher consumer debt will compound the effects of households' financial consolidation in the event of an economic setback. Finanstilsynet has expanded its supervision of consumer lending, and has raised the capital charges on consumer loans to already existing and new actors. Finanstilsynet has now issued guidelines for financial institutions with regard to consumer loans in order to encourage healthier lending practices.

Profit levels among Norwegian banks are good and considerably higher than the average of European banks. Banks' earnings fell somewhat in 2016 owing to higher losses on loans to the offshore industry, the large banks being those primarily affected. A considerable portion of the banks' offshore clients has been or will be subject to restructuring. It is uncertain how large the losses will ultimately prove to be, and Finanstilsynet keeps track of the banks' impairment provisioning through its on-site inspections and analyses.

Banks' risk-weighted tier 1 capital adequacy ratio has doubled since the financial crisis. Stricter regulatory requirements are in general met by profit retention. The larger banks use internal models (IRB models) to compute capital charges for various types of risk. Average risk weights for these banks have on the whole fallen. Finanstilsynet reviews the models at regular inspections and has instructed several banks to revise their calibration of risk models to render them more robust. Transitional rules in the form of a floor for risk-weighted assets have effect for Norwegian IRB banks and counter the likelihood of risk weights leading to an inappropriate fall in capital charges.

Despite strengthened risk-weighted capital ratios, the banks' equity ratio is not significantly higher now than in the mid-1990s. Financial institutions are required to meet the leverage ratio requirement as from 30 June 2017. This capital target ratio is not affected by changes in banks' risk models and risk-weighted assets. Norwegian banks had a leverage ratio of 7.3 per cent at the end of the first quarter this year, which is significantly higher than the anticipated minimum requirement in the EU.

Finanstilsynet conducts stress tests of Norwegian banks' results and capital ratios. The stress tests support assessments of financial stability, and are a tool supporting discretionary assessments of individual banks' future capital needs. As in previous years, the stress scenario in 2017 involves a serious shock to the Norwegian economy and Norwegian banks. The likelihood of this scenario taking place is low, but it is not unrealistic. The calculations illustrate that a high debt ratio among households and banks makes a number of banks vulnerable in the event of a protracted shock. For several banks, capital adequacy falls below the regulatory requirements. The stress tests underline how important it is for banks' capital planning to make allowance for an unfavourable outturn in the Norwegian and international economies. Finanstilsynet will follow up on these matters under the Pillar 2 process.

Norwegian banks obtain a large share of their funding in the wholesale market, much of it raised abroad. Norwegian banks are thus dependent on confidence in the international money and capital market and on an absence of general turbulence in these markets. The regulatory requirements on liquidity reserves and stable funding have risen in recent years. The banks hold liquidity reserves enabling them to honour their commitments during a brief period of market stress, and a relatively high proportion of stable funding which helps to reduce liquidity risk in a longer-term perspective. However, conditions can change rapidly in these markets, and refinancing is likely to be costly and difficult to obtain in turbulent markets. Liquidity risk in the banking system is an important aspect of the supervisory follow-up of the banks.

A large proportion of the banks' market funding is in the form of covered bonds (OMF). This source of funding has benefited Norwegian banks and has contributed to longer funding maturities, but ties Norwegian banks' funding risk to a greater degree than previously to developments in the housing market. Sharp growth in house prices over a long period has heightened the potential fall. Covered bonds also account for a large proportion of Norwegian banks' liquidity reserve. These factors contribute to intensifying the interconnectedness between banks' credit, liquidity and funding risk and make for increased systemic risk.

The rise in long-term interest rates from the record-low level in autumn 2016 helped to improve prospects somewhat for life insurers and pension funds internationally, but the low long-term interest rate level remains a challenge to institutions' earnings and financial position. Pension providers are also exposed to risk related to a combination of low risk-free interest rates and falling values on the asset side of the balance sheet. Higher risk premiums on fixed-income securities will reduce the value of bond portfolios, and share and property values could plunge. The European Insurance and Occupational Pensions Authority (EIOPA) also stressed this point in its summary of the results from the stress test of European insurers in 2016.

The introduction of a fair-value-based solvency regime has been demanding for life insurers in a period of historically low interest rates and a substantial proportion of commitments carrying guaranteed interest. Transitional arrangements have been made available to ease the switch to a new body of rules. Institutions have at the same time cut costs and made adjustments on the asset side. In addition, they are converting insurance schemes from a defined benefit to a defined contribution footing, bringing a reduction in insurers' market risk and, by the same token, in their capital requirements. Norwegian life insurers, with one exception, meet the requirements by a relatively ample margin both with and without transitional rules. In addition to fulfilling the regulatory requirements at any and all times, institutions must also assess their capital needs and capital targets with which to meet future capital needs. Finanstilsynet has made it clear to some institutions that their capital targets appear to be low. This has prompted some institutions to raise their internal targets with a view to achieving a satisfactory solvency coverage ratio.

Silver Pensjonsforsikring AS was placed, as the first Norwegian life insurer, into public administration in February 2017. This was necessary in order to assure equal treatment of policyholders' insurance claims and to protect policyholders' best interests. Silver's portfolio represents a relatively small proportion of the overall paid-up policy portfolio in Norway. The substantial undercoverage at Silver is detrimental to the company's policyholders. The insolvency has however not led to general unease in the Norwegian insurance market.