



**FINANSTILSYNET**  
THE FINANCIAL SUPERVISORY  
AUTHORITY OF NORWAY

## **SUMMARY**

### **Risk Outlook – December 2018**

In September 2008, the fourth largest investment bank in the United States, Lehman Brothers, filed for bankruptcy. The international financial crisis was triggered, resulting in large losses in the real economy. In some countries the public authorities had to take over banks' obligations to avoid a collapse of the financial system. A number of countries conducted expansionary monetary and fiscal policies for several years to mitigate the effects of the crisis. The repercussions are still felt in many countries in the form of spare capacity, low interest rates and high public and private debt levels.

Norway was less affected by the crisis than many other countries. One of the reasons for this was that Norwegian banks were relatively well capitalised and had limited exposure to international bonds whose value dropped significantly. In addition, the Norwegian authorities established support schemes to secure funding for the banks ("swap scheme") and the supply of equity (State Finance Fund). This helped to preserve confidence in the Norwegian banks and to maintain the supply of credit to firms and households.

In the years following the financial crisis the capital requirements for financial institutions have been raised, and quantitative liquidity requirements have been introduced. The new framework is designed both to enhance the resilience of all financial institutions and to curb systemic risk in the financial services industry.

Strong profitability, partly due to low loan losses, has enabled Norwegian banks to meet higher capital requirements largely through retained profits. Lower risk weights have also contributed to increasing measured capital adequacy. Norwegian banks have also raised their leverage ratios after the financial crisis. The banks meet the liquidity buffer requirements and have increased their long-term market funding. Norwegian banks are therefore better positioned to provide credit in the event of an economic setback and increased losses.

A number of Norwegian banks, especially the largest ones, still obtain their funding in the Norwegian and international money and capital markets. This makes the banks vulnerable to market turbulence. There has been a significant increase in banks' residential mortgage lending in recent years, both in absolute terms and as a share of total lending. This increase is largely financed through the issue of covered bonds (OMF). In addition, banks have invested heavily in covered bonds issued by other banks. Developments in house prices thus have a strong bearing on the banks' credit and liquidity risk. Finanstilsynet's stress testing of the liquidity of seven major banks illustrates how vulnerable the banks are should the covered bond market dry up.

The EU's capital requirements directive (CRD IV) and regulation (CRR) are expected to be incorporated into the EEA Agreement before long. The SME supporting factor will accordingly be introduced, and the floor for risk-weighted assets will be removed for banks using internal models to measure risk (IRB). Seen in isolation, the formal capital adequacy ratio will thus increase, though actual capital adequacy will not. In Finanstilsynet's assessment it is important to ensure that the implementation of CRR/CRD IV does not contribute to a general weakening of Norwegian banks' actual capital adequacy. When approving and following up internal models, Finanstilsynet will attach importance to robust calibration with satisfactory safety margins. When setting Pillar 2 add-ons, Finanstilsynet will also ensure that they cover risk that is not fully covered under Pillar 1. When assessing banks' capitalisation, Finanstilsynet places emphasis on the leverage ratio and will seek to ensure that the banks' financial position on this measure is not impaired in the period ahead.

The capital adequacy of life insurers has been strengthened, and they are compliant with the new solvency requirements (Solvency II) that came into effect in 2016. The low interest rate level has posed a challenge to institutions' ability to achieve the guaranteed return on their investments. Adapting to the new requirements has proven particularly challenging for life insurers with a large proportion of guaranteed liabilities. The transitional measure for technical provisions has been particularly significant for these institutions.

Finanstilsynet is concerned that the solvency rules should not encourage arbitrage-motivated transfers of loans between banks and insurers. Some assets are subject to relatively low capital requirements under Solvency II, including residential mortgages with a low loan-to-value ratio. The Norwegian authorities may, however, set a lower limit for estimated loss given default to ensure that insurers are subject to approximately the same capital requirements as banks for their exposure to mortgage loans. In October 2018, the Ministry of Finance asked Finanstilsynet to consider whether and, if so, how this scope of action should be used. The Ministry has asked Finanstilsynet to present its assessment and, if relevant, a consultation document and draft amending regulations by end-March 2019.

In June 2018, the Ministry of Finance established new solvency requirements for pension funds, which will enter into force next year. The new requirements are a simplified version of Solvency II aimed at capturing risks across the entire business. Overall, the pension funds are well positioned to meet the new solvency requirements.

The transition from defined-benefit to defined-contribution pension schemes with no guaranteed rate of return entails that the return risk is transferred from employers or pension institutions to the individual member covered by the pension scheme. It is important that institutions give their customers detailed information about expected returns, risk and costs related to the defined-contribution schemes. The transition to defined-contribution schemes may have consequences for the household saving rate if there is a fall in value of securities and real estate. If households increase their saving rate in connection with a cyclical downturn or falling values in securities markets to compensate for a reduction in the market value of their pension assets, this may have stronger negative effects than in a defined-benefit pension system.

House prices and household debt in Norway are at historically high levels, which is partly due to ample access to credit at low interest rates. Household debt growth has for several years been significantly higher than income growth, making the debt burden higher than ever. There is a risk

that household debt will continue to grow faster than disposable income in the coming years. If so, this will further increase the debt burden.

Households are vulnerable to declining incomes and rising interest rates. A high debt burden means that even a relatively moderate rise in interest rates will lead to significantly higher interest expenses. As most loans carry floating interest, an interest rate rise will almost immediately reduce households' disposable income.

Finanstilsynet conducts an annual survey of new residential mortgages among a selection of banks (residential mortgage lending survey). The survey conducted in the autumn of 2018 shows a significant increase in the average debt burden of borrowers who have taken out new mortgages. Compared with last year's survey, there was a certain increase in both the proportion of new instalment loans raised by borrowers whose total debt exceeds five times gross annual income and the proportion of loans with a loan-to-value ratio above 85 per cent. The greatest increase is registered for borrowers in the younger age groups. These proportions are nevertheless lower than before the residential mortgage lending regulations were tightened in January 2017.

In Finanstilsynet's view, the residential mortgage lending regulations have generally worked well. The tightening of the regulations as from January 2017 has contributed to tighter lending practices. Even so, the growth in household debt has remained high. The Ministry of Finance issued new residential mortgage lending regulations in June 2018, which were a continuation of the previous regulations with a few minor changes. The regulations will remain in force until 31 December 2019.

Consumer loans, i.e. unsecured loans to personal borrowers, are actively marketed by banks and financial institutions. The increase in consumer lending has slowed somewhat, but is still high. There is a risk that financially vulnerable households will take out consumer loans at high interest rates that they are subsequently unable to service. This could result in a heavy personal burden for the individual borrower, and in loan losses and loss of reputation for banks. In June 2017, Finanstilsynet issued guidelines on consumer lending practices and sent a consultation document with a draft regulation, based on these guidelines, to the Ministry of Finance in August 2018. The Ministry of Finance has circulated the matter for comment. The deadline for response is 6 December 2018.

The prices of high-quality commercial properties at prime locations have risen significantly over several years, especially in the Oslo region. A substantial share of property companies' financing is provided by banks. More recently, the companies have based a larger share of their financing on the issue of bonds, while the share of bank loans has been somewhat reduced. Nevertheless, bank lending to commercial property companies still represents approximately 40 per cent of the corporate market portfolio. Higher interest rates will weaken the earnings of property companies and reduce the value of creditors' collateral. In the autumn of 2018, Finanstilsynet is conducting a thematic inspection to identify banks' exposure to commercial property. The results from the thematic inspection will be used when following up the individual banks.

A number of international risk factors may, if they materialise, exacerbate market conditions for Norwegian financial institutions. The risk factors may also lead to a strong rise in interest rates, a correction in property prices and a marked deterioration in many households' financial situation. A decline in disposable income may lead to a sudden and strong financial consolidation among

households. An experience gained from the banking crisis is that such a development leads to reduced consumption, weaker earnings for parts of the business community and heavy losses on banks' corporate loans.

According to the International Monetary Fund (IMF), the downside risk for global growth has risen of late, while there is less potential for positive surprises. An important risk factor concerns trade barriers and future growth in international trade. The United States has already started pursuing protectionist trade policies, and China has responded. There is a danger that this may develop into a more comprehensive trade war that could have serious consequences for global trade.

Another risk factor relates to developments in the financial markets. The market may experience a sharp correction if, for example, trade tensions escalate or the Federal Reserve increases its key policy rate more than expected. The latter could be a response to unexpectedly high price inflation, and could lead to reduced share and property prices, higher risk premiums in the bond markets and the outflow of capital from emerging markets.

Reduced global trade and financial turmoil will have consequences for the Norwegian economy, with a negative impact on both the earnings of non-financial firms and households' disposable income. There might be an appreciable reduction in the prices of shares, bonds and real estate, which could contribute to a further economic setback. Lower activity levels and higher unemployment may cause a marked increase in banks' loan losses as borrowers' debt servicing capacity deteriorates parallel to a reduction in value of collateral pledged to the banks. In such a situation, it will take time for households to reduce their debt burden and for the demand for goods and services to pick up again. The household sector's historically high debt burden may therefore contribute to reinforcing and prolonging a downturn in the Norwegian economy.

Climate change and the transition to a low-emission society entail risk for the financial services industry. There is a link between climate risk and credit, counterparty and market risk as climate change affects the profitability of certain types of businesses or the value of assets. Climate risk may also subject firms to reputational risk if investors and customers start questioning their corporate image and business model. Climate risk is particularly relevant for non-life insurance companies and for lending and asset management operations.

Financial supervisory authorities play an important role in preventing disruptions to the financial system caused by climate change. As in the case of other risk factors, this is handled primarily through the supervision of financial institutions' risk assessments and capital adequacy. Increased uncertainty generally requires higher buffers. The Government Budget for 2019 states that Finanstilsynet will be responsible for charting and analysing the possible consequences of climate change for the financial services industry as well as related risks.