FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

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Summary of the report Financial Trends 2012

Summary and assessments

Economic developments and risk

The world economy remains in the grip of the financial crisis and the severest economic setback in many decades. After weakening through 2011, growth picked up at the start of 2012. However, the upturn was short lived, and growth slowed in the spring. An important factor behind the weak growth picture in the industrialised world is persistent low consumption and investment in the private sector. The situation in the euro area is in addition coloured by the sovereign debt crisis of southern European countries, where unemployment is very high. The substantial gap in growth levels between the industrialised world and the emerging economies persists, but there are clear signs that growth is also slowing in several emerging countries. This must be viewed inter alia in light of weaker growth among their trading partners. Overall the stage is set for lower global growth in 2012, and growth estimates for 2013 have been revised down in the past half-year, in particular for exposed countries in the euro area. Uncertainty about economic developments ahead has led to turbulent financial markets. Measures announced by the Federal Reserve and the European Central Bank in September appear to have dampened the turbulence somewhat.

The Norwegian economy has thus far been little affected by the international downturn. Capacity utilisation across much of the economy is high and unemployment low. Continued rapid growth is expected in the mainland (non-oil) economy. Demand is spurred by low interest rates and high real wage growth, and the petroleum sector and the supplier industry are benefiting from the persistent high oil price. In addition new sizeable oil finds have spurred renewed optimism and increased activity. However, many firms face challenges in the shape of lower demand, higher cost growth than among Norway's trading partners and a stronger Norwegian currency in 2012.

The Norwegian economy is solid and better placed than most others to tackle a further deterioration in the international economy. However, should the world economy enter a sharp downturn, the Norwegian economy would be affected. Parts of the competitively exposed sector would weaken further. A sharp dip in the oil price would be particularly detrimental to the Norwegian economy through lower demand from the petroleum sector, which would hit the oil supplier industry on a broad front. Moreover, the profit outlook for shipping remains weak. A setback in the Norwegian economy can be expected to inflict heavier loan losses on banks.

High house prices and heavily indebted Norwegian households pose a risk to the stability of the Norwegian economy and the Norwegian financial sector. Household finances have been marked by a growing debt burden in recent years. Household debt and house prices have shown a high degree of convergence and have risen to a very high level. House prices and household debt continue to grow at a faster rate than household income.

The international economic setback has been met with hefty monetary policy stimuli. International interest rates are expected to remain low for some time, an expectation that is reflected in Norwegian rates. This, combined with high income growth, low house taxation and a positive belief in the future, is holding up household demand for credit. Indebtedness has risen most among the youngest borrowers, who are also those with the highest loan-to-value ratios on their mortgages. Finanstilsynet's home mortgage loan survey shows that in the case of homebuyers under the age of 35, 43 per cent of mortgages had a loan-to-value ratio in excess of 85 per cent, and one in five of these mortgages were on a par with or above property value. The home loan survey and the thematic inspections of home loans conducted by Finanstilsynet show that the number of loans with a high loan-to-value ratio has declined.

Finanstilsynet's guidelines for prudent mortgage lending are largely complied with by the banks in their own guidelines and credit practices. There is nonetheless room for improvement on the banks' part, and Finanstilsynet will follow this up in its oversight of individual banks.

The growth in household debt is driven by high demand. In periods of heavy credit demand it is particularly important for banks to apply level-headed credit assessments that safeguard long-term considerations for the borrower, the individual bank and the banking system alike. Even so, measures to support sound lending practices can only limitedly mitigate demand-side effects on debt growth.

The large and growing debt burden increases the household sector's vulnerability in the event of unemployment, income loss or interest rate hikes. A combination of a further setback in the international economy and an oil price plunge could reduce domestic demand. This may reverse household expectations of future incomes and house prices, bringing a marked decline in house prices. Experience gained in Norway and elsewhere shows that if households are obliged to significantly tighten consumption as a result of high debt and falling house prices, there will be large knock-on effects to the wider economy.

Banks' financial soundness and liquidity position

Norwegian banks have posted sound profits throughout the international financial crisis. Loan losses are at a low level. Capital adequacy has been bolstered by profit retention and issue of fresh equity capital. The international economy and financial markets are marked by great uncertainty, and the Norwegian economy may be harder hit by international financial turbulence and economic setback than has been the case thus far. It is important for banks to build up reserves in good times to ensure that they are well placed to withstand increased losses and to continue to provide credit in the wake of a cyclical turnaround. It is also important that they maintain prudent creditworthiness assessments in times of heavy demand for credit.

Finanstilsynet expected all Norwegian banks and finance companies to have a common equity tier 1 ratio of at least 9 per cent by 30 June 2012, as recommended by the European Banking Authority in the case of major European banks. Finanstilsynet expects the banking industry to further strengthen its financial position in the period ahead.

Norwegian banks obtain much of their funding in international money and credit markets. The financial turbulence in autumn 2008 showed that market conditions bearing on liquidity change rapidly, that refinancing during a crisis of confidence is difficult and that risk premiums rise sharply. Liquidity risk is much in focus among banks, supervisory authorities and money market participants. Increased liquidity buffers and longer-term funding have put Norwegian banks in a better position to tackle a tightening of liquidity.

The past year has seen renewed heavy turbulence in European funding markets, and at times it has been difficult to achieve long-term funding without collateral in the form of low-risk loans. Covered bond issues have accordingly helped banks through a difficult period during the financial crisis. The significance of such funding has risen strongly in recent years and helped to mitigate banks' liquidity risk. A favourable trend in the Norwegian economy, ample liquidity and high capital ratios are among the reasons why Norwegian banks have enjoyed a relatively good standing in international lending markets. However, the trend in money and credit markets ahead is highly uncertain. If they are to be able to tackle future challenges, banks need to further improve their financial position and exploit opportunities to secure even more robust and long-term funding.

There was no severe credit contraction in Norway in the wake of the international financial crisis. Growth in lending to the business sector was nonetheless very low and, for a period, negative, while growth in lending to households remained relatively high. The interest rate paid by banks' residential mortgage companies on covered bonds is significantly lower than the rate paid by banks when issuing senior bonds. This is primarily because the risk associated with investments in covered bonds is lower than the risk associated with investments in bank bonds. Moreover, covered bonds have met investors' need for secure and liquid investment in Norwegian securities, and this has enabled mortgage companies to issue covered bonds on particularly good terms.

Banks' access to relatively favourable funding of home loans on the covered bond market may thus have spurred growth in mortgage lending and intensified price pressures in the housing market. A relatively low rate of return requirement on covered bonds and significantly lower risk weights on home loans than on business loans may have incentivised, and continue to incentivise, banks to steer lending growth in the direction of homebuyers as opposed to businesses. Banks' perception, due to the financial crisis, of equity capital financing as costly and difficult to access, may have added to such distortion. Finanstilsynet will give much attention to this systemic risk in its assessment of banks' capital needs and funding.

Mortgaging of assets to fund operations is a growing trend among financial institutions in Europe. During financial turbulence it is natural for investors to seek a safe haven, but this trend may have a detrimental aspect. The volume of assets available to cover unsecured funding is reduced and the quality of remaining assets is impaired. In a crisis situation depositors and investors carry a larger portion of the risk in the financial system. A higher rate of return is required on unsecured financing. Over-mortgaging exacerbates the situation for unsecured creditors, and in bad times the need to over-mortgage is likely to increase further. In a bank liquidation the amount recovered by unsecured creditors may be significantly lower than would have been the case in periods where mortgaging is less widespread.

A number of other issues arise in relation to financial institutions' mortgaging of assets. Increased mortgaging reduces flexibility in asset-liability management. The more assets that are mortgaged, the fewer will be available as collateral for funding in the future. As a result the supply of mortgageable assets is smallest when such access is most needed. There is also a danger that financial institutions will run out of mortgageable assets at some point in the future.

The volume of covered bonds has risen to a very high level in the space of a few years. A large volume of covered bonds may give rise to structural weaknesses in banks' funding and to detrimental incentives in their lending activities. Finanstilsynet is of the view that consideration should be given to introducing limits on the proportion of assets that can be posted as collateral for covered bond issues. Irrespective of the outcome of any such assessment, Finanstilsynet expects Norwegian financial institutions to consider the level of such transfers as part of the Pillar 2 process. If, in Finanstilsynet's view, the level of transfer is too high, an appropriate response may be to impose on individual institutions higher capital charges or restrictions on access to covered bond funding. Any such response would be based both on institution-specific risk and systemic risk.

Finanstilsynet notes that banks look set to expand further in the retail market in the years ahead. There is a danger that banks individually underestimate the systemic risk posed by such a development. Banks' home loan portfolios comprise a very large number of small loans, giving the impression of high diversification for the individual bank. Finanstilsynet is following developments closely and is aware of the vulnerability associated with banks' home loan portfolios. A slump in the housing market may have serious consequences for the Norwegian economy. Parent banks may be obliged to transfer further home loans to their mortgage companies. Covered bonds and/or mortgage companies may see their credit rating downgraded by rating agencies, and an increased volume of mortgaged loans may exacerbate the situation of banks' unsecured depositors and investors. This could lead to a funding shortfall for banks, and, at worst, prompt a severe credit contraction.

A series of new rules have been proposed in the financial area designed to improve stability in financial markets and financial institutions. A new capital adequacy regime for credit institutions and investment firms, CRD IV, is scheduled to go live on 1 January 2013. The new rules will impose stricter requirements both on common equity tier 1 capital (equity capital) and core capital, and requirements are to be introduced on capital buffers in excess of the minimum capital adequacy requirements. Impact studies carried out at a number of Norwegian banks show that they meet the minimum capital requirements. Supervisory practice in Norway has in general been stricter than in other countries, both with regard to the quality of core capital and what portion of it should comprise own funds.

Alongside stricter capital rules, the new regime includes new requirements on liquidity and stable funding. The financial crisis showed that robust funding and a good liquidity position are key to financial stability. Two new quantitative minimum requirements on liquidity are proposed in the new body rules, linked respectively to institutions' liquidity buffers (Liquidity Coverage Ratio) and long-term funding (Net Stable Funding Ratio). Surveys show that it will be simpler for Norwegian banks to meet the NSFR requirements than the LCR requirements. An important reason is the Norwegian market's limited supply of securities that meet the liquidity requirement necessary for inclusion in the LCR.

The financial crisis brought to light weaknesses in several countries related to crisis management of financial institutions that were no longer able to honour their commitments. In order to secure financial stability, continue systemically important functions in banks in liquidation, protect public assets during financial crisis and protect customer assets held in banks, the EU Commission has drafted a crisis management directive. This proposes the establishment in each country of a crisis management authority and a crisis management fund, and a range of tools are specified for winding up crisis-stricken institutions.

Challenges to life insurers

A very large proportion of life insurers' and pension funds' obligations are linked to annual rate of return guarantees. Low interest rates are making it difficult to achieve sufficient return on client assets. The challenges are particularly clear for paid-up policies where the increased interest rate risk cannot be priced into future premium payments. In the case of collective defined benefit pensions, the interest rate fall causes employers' pension premiums to rise, which in turn increases the risk that these pension schemes will be terminated and converted to paid-up policies. The Bank Law Commission, at the request of the Ministry of Finance, has accordingly tabled measures to check the growth in the volume of paid-up policies with a rate of return guarantee by permitting voluntary conversion to unit-linked pension agreements and raising the minimum amount for issuing a paid-up policy. The challenges related to insurers' guaranteed return are in varying degrees common to most countries in western Europe.

Work is in progress in the EU to enable the new European solvency regime for insurers, Solvency II, to enter into force on 1 January 2014. Solvency II brings into greater relief the risk associated with insurers' rate of return guarantees and significantly raises the capital buffer requirement in respect of such guarantees. In contrast to the present regime, pension commitments under Solvency II will be assessed at fair value. The challenges posed by low interest rates and the limited opportunity to match the duration of liabilities and investments are made clearer.

Longevity in the population is rising more quickly than previously assumed, and life insurers have made insufficient allowance for the fact. Although new mortality tariffs effective from 2008 onwards prompted sizeable provisions in 2007, technical provisions need to be further strengthened in view of increased life expectancy.

The Bank Law Commission has proposed a new regime for occupational service pensions that is geared to the principles underlying the new national insurance scheme. The reorganisation is intended to provide a more balanced distribution between client and pension manager of the risk posed by rising longevity and future rate of return. Finanstilsynet supports the Bank Law Commission's proposal. It is important for the Commission in its continuing work to attach due importance to appropriate transitional arrangements. It is also important to put in place a new buffer arrangement for life insurers that better enables them to handle annual variations in rate of return and to achieve better rates of return for clients through a long-term approach to the management of insurance assets.

Consumer protection

Consumer protection is at centre stage of financial market regulation and of the supervision of providers of financial services such as banks, insurance companies and investment firms. Consumer protection has a broad compass. Financially sound, well capitalised financial institutions and well-functioning financial markets are crucial for society and the individual consumer alike. A significant portion of consumer protection is accordingly provided through the regulation and supervision of solvency and financial positions at the above institutions and through various guarantee schemes, for example the depositor guarantees provided by banks. Supervision of financial institutions therefore indirectly entails protection of consumer interests. In addition consumer interests are directly protected through monitoring of compliance with specific rules. It is important that consumers enjoy good protection in the purchase and sale of financial products and property, and that they are able to base their decisions on sound information and impartial advice.

Finanstilsynet's home mortgage lending guidelines give due consideration to consumer protection. Consideration for the consumer and for financial stability make it vital to promote robust home financing and greater stability in the housing market. Debt problems can hit individuals hard, and banks' creditworthiness assessments must prevent the risk of individuals taking out loans that they are subsequently unable to service.

In 2012 Finanstilsynet has conducted several thematic inspections as part of its tasks related to consumer protection in the financial sphere. It has inter alia surveyed life insurers' information and advice when selling savings products, insurance agents' commission arrangements when selling non-life insurance and financial institutions' offering of complex products. In the supervision of estate agency firms, compliance is checked with rules that are of particular importance for the consumer. In the event of gross rule breaches, licences are withdrawn, as happens to a number of estate agencies on an annual basis. Finanstilsynet has also conducted checks of investment advice given by investment firms, and of their compliance with conduct of business rules. Thus far in 2012 Finanstilsynet has resolved to withdraw the licences of two investment firms, one of the reasons being breach of the conduct of business rules. These decisions have been appealed to the Ministry of Finance and will not be enforced until a ruling has been made on the appeals.

In the course of 2012 Finanstilsynet has asked 25 banks for an evaluation of their product packages' compliance with relevant regulations. Most banks halted or revised their product packages (tied and/or bundled) following Finanstilsynet's initial approach. Finanstilsynet considers that the banks have insufficiently documented and described cost savings on cross sales that qualify for exemption from the prohibition against product packages. Finanstilsynet has in six instances instructed banks to halt their marketing and sale of product packages.

Press release 30/2012:
Norwegian financial industry well positioned to meet international turbulence