FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Report

Risk Outlook - Summary

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Global economic growth has slowed in recent years, but activity levels remain relatively high. A number of central banks raised their policy rates sharply through 2022 and 2023 in an effort to curb inflation. Inflation has declined significantly from very high levels. There are expectations of moderate growth and somewhat lower interest rates ahead, but the timing of interest rate cuts has been postponed.

The full effects of the higher interest rates have probably not yet materialised, especially in economies with a high proportion of fixed-rate loans. If inflation remains high, it will prolong the period of higher interest rates. This may pose increased challenges for households, non-financial corporations and governments with high debt levels.

Geopolitical unrest and tensions, particularly Russia's attack on Ukraine and the war in Gaza, create uncertainty, also concerning economic developments. An escalation of geopolitical tensions could have a sudden impact on commodity prices and trade restrictions, increase inflation and cause turbulence in global financial markets. Sophisticated cyberattacks may have consequences for financial stability.

Growth in the **Norwegian economy** has also abated. Unemployment is still at a low level. In the coming period, moderate growth, declining inflation and a slight rise in unemployment are expected. The interest rate level has risen, and the policy rate is expected to remain at the current level for some time.

High household debt and elevated residential and commercial property prices are still the key vulnerabilities in **the Norwegian financial system**. **Norwegian households** have a high level of debt relative to income, both in a historical perspective and compared with other OECD countries. Lower credit growth and higher nominal income growth have contributed to a certain reduction in households' debt burden over the past two years, which may indicate that this financial vulnerability is not building up further.

Households' financial resilience varies significantly. So far, there are few signs of serious debt servicing problems for the household sector overall. Low unemployment and financial buffers have contributed to dampening the effects of high inflation and rising interest rates. Households' demand may decline, and their debt servicing capacity may be impaired if economic developments prove to be weaker or interest rates higher than expected. Reduced household demand will contribute to reducing corporate earnings.

House prices have risen so far in 2024 after flattening out in 2023 and are at a historically high level measured as a share of household income. Debt levels and house prices may show increased growth if inflation and interest rates decline in the years ahead. Low housebuilding activity, high employment, rising household income and population growth in urban areas may push up house prices. Higher collateral values may contribute to further debt growth and increased vulnerabilities in the household sector.

Losses on loans to non-financial corporations are a risk factor for Norwegian banks. Profit levels in several main industries were down in 2022 and 2023. The decline in profits in a number of listed companies has continued in 2024. The weaker performance can be attributed to a combination of higher operating expenses and interest expenses and lower demand. Lower household demand, combined with continued high expenses, may amplify the challenges facing non-financial corporations.

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 CRE 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 companies with weak interest servicing capacity has

risen. The yield on commercial real estate is still low compared with the interest rate on risk-free investments. If risk premiums normalise and interest rates remain high, the share of high-risk debt may increase further and elevate banks' credit risk.

Relatively high activity and low unemployment have helped ensure low credit losses in **Norwegian banks**. Combined with an increase in net interest income, this has led to very high profits in this industry. Banks' net interest income must be expected to decline somewhat again, and loan losses may increase. This could put a damper on Norwegian banks' profitability.

The banks' record-high profits have led to questions about whether there is sufficient competition. In Finanstilsynet's opinion, there is effective competition in the Norwegian banking market. At the same time, Finanstilsynet has proposed measures that can help strengthen the position of consumers and has been commissioned to review some of these. In an advisory opinion, the EFTA Court has pointed out that contractual terms for interest rate adjustments must be clear and concise and enable consumers to understand the functioning of the method used for calculating interest rate adjustments. Finanstilsynet expects the banks to review their practices in light of this opinion.

In recent years, the share of Norwegian banks' loans with a significant increase in credit risk has risen, particularly in small banks. Total non-performing loans have been stable over the past year, but there has been an increase in the share of loans on which payments are up to 31 days past due. At the same time, banks' impairment losses on loans with heightened credit risk (provision rate) have declined. It is important that banks take sufficient account of the losses that may arise in the future.

Financial crises can generate significant economic costs. Banks' ability to bear risk and provide new loans to creditworthy customers during downturns requires that they have sufficient equity to absorb substantial loan losses. Over the past couple of years, the improvement in banks' solvency position has subsided. Norwegian banks should meet regulatory requirements by an ample margin.

The use of so-called **macroprudential measures** should help strengthen the resilience of the financial system. In spring 2024, Finanstilsynet assessed the design and level of the systemic risk buffer. Furthermore, Finanstilsynet has provided advice on which financial institutions should be regarded as systemically important, and has prepared a consultation document with proposals for the implementation of expected changes to the Capital Requirements Regulation (CRR3). In the consultation document, an assessment has also been made of risk weights for residential and commercial mortgages. In addition, Finanstilsynet has set entity-specific capital requirements (Pillar 2 requirements) for a number of banks.

Finanstilsynet's annual stress test of Norwegian banks shows that the banks on average are financially sound, but that their capital adequacy levels may deteriorate during a severe downturn. In the stress scenario, the intensification of geopolitical conflicts leads to higher inflation and interest rates both in Norway and internationally, a decline in GDP, higher unemployment and a fall in residential and commercial property prices. Banks' loan losses rise, particularly on corporate loans but also on loans to personal customers. Losses are high but significantly lower than the banks' losses during the banking crisis in the early 1990s.

Norwegian life insurers and pension funds have strong profit and solvency levels. The higher interest rate level has also improved life insurers' solvency position. An increase in share income and interest income helped raise life insurers' returns in 2023 and the first quarter of 2024. Life insurers have a significant share of their investments in real estate-related equities and loans. Finanstilsynet expects the pension institutions' capital planning to factor in the risk in the real estate market. For **non-life insurers**, the increased scope and severity of weather and natural disasters, in addition to higher claims for own account under reinsurance contracts, have led to weaker earnings and heightened risk.

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