FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Report

Risk Outlook - Summary

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With the exception of the United States, economic growth has slowed somewhat in a number of advanced economies over the past year. Price inflation has declined significantly since its peak in 2022, and several central banks have reduced their policy rates. Lower interest rates and a favourable financial climate have stimulated prices of assets such as equities and other investments internationally. Moderate growth and somewhat lower interest rates are expected ahead.

Growth in the Norwegian economy was slightly higher in the first three quarters of 2024 than last year, with a moderate increase in unemployment. Forecasts indicate somewhat higher growth in the coming years, driven in part by higher private consumption and increased public demand. Norges Bank has kept its policy rate stable at 4.5 per cent, and the rate is expected to be cut in the first quarter of 2025.

Geopolitical tensions and political unrest create significant uncertainty about economic developments. Conflicts and extensive trade restrictions may lead to higher prices, weaken the basis for economic growth and heighten the risk of financial crises. There is little reflection of this uncertainty in the financial markets. High equity prices, low risk premiums in the bond markets and generally low market volatility indicate expectations of low interest rates and stable economic developments.

In many countries, sovereign debt is increasing from an already high level. High ambitions for a green transition and strengthening of the armed forces, coupled with an ageing population, make it challenging to reduce ongoing public sector deficits. Public debt, which accounted for more than 60 per cent of global GDP prior to the financial crisis, is estimated by the IMF to be more than 100 per cent of global GDP by 2030. This trend is driven primarily by increased debt in China and the United States. There is concern that further debt accumulation could lead to higher long-term government bond yields and reduced fiscal room for manoeuvre in many economies.

High household debt and elevated residential and commercial property prices remain the key vulnerabilities in the Norwegian financial system. Norwegian household debt has decreased over the past couple of years, measured in per cent of disposable income, and credit growth is moderate. Nevertheless, the debt burden remains high, and Finanstilsynet's residential mortgage lending survey shows that many borrowers take out large loans relative to income and the value of their property. Lower interest rates and the easing of the lending regulation could lead to a further increase in house prices and household debt in the future.

In spite of a significant increase in interest rates, there are few signs of serious debt servicing problems for the Norwegian household sector overall. The share of non-performing loans in the personal customer market has increased in recent years but is still below pre-pandemic levels. This development must be viewed in light of the continued high level of economic activity in Norway, with high employment and low unemployment.

Weaker operating earnings combined with higher interest expenses have resulted in lower profitability and impaired debt servicing capacity for a number of non-financial corporations. There are significant differences between industries. In industries such as retail trade and construction, the aggregate debt of corporations with weak debt servicing capacity was considerably higher last year than in the years prior to the pandemic. Parts of the manufacturing industry have benefited from a depreciated krone exchange rate and increased demand and have improved their debt servicing capacity.

Commercial real estate companies have high debt levels and can therefore be especially vulnerable to interest rate increases. The interest expenses of many of these corporations have risen more than operating earnings over the last couple of years. This has impaired their debt servicing capacity, and the proportion of high-risk debt has increased sharply. The estimated direct yield on offices in the most attractive areas of Oslo has shown an increase, though it is clearly lower than the yield on government bonds. If the yield on secure government bonds remains high, the proportion of high-risk debt may increase further if the risk premium is normalised. This will result in somewhat higher credit risk in the banks.

Norwegian banks enjoy very strong profitability, driven by high interest income and low losses. Competition for bank customers and reduced interest rates in the period ahead could cause a decline in banks' net interest income and a rise in losses. Several small banks have recorded higher losses on loans in the corporate market. These banks' loan portfolios are less diversified across industries and more geographically concentrated than the portfolios of large banks. They are thus more vulnerable to setbacks in their local business communities.

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.

Following the global financial crisis in 2007–2008, the regulation of banks and other financial institutions has been strengthened internationally. The final part of the post-financial crisis reforms (Basel III) is now in the process of being implemented, including in Norway. The defences that have been built up help reduce the risk of severe crises in the financial system. Many countries have experienced that financial crises could represent a high cost for society, and that a good defence system, including well capitalised banks, provides the basis for long-term economic growth.

Financial market regulation serves important purposes but has become very comprehensive and complicated. There is growing international pressure to relax key regulatory requirements. Finanstilsynet, together with the other Nordic financial supervisory authorities, has expressed concern over the increased complexity of the pan-European regulations. According to the Nordic supervisory authorities, greater emphasis should be placed on ensuring that the regulatory framework is simple without easing important requirements for the industry.

The banks' capital adequacy ratios have been virtually unchanged in recent years. Several Norwegian banks could end up with an increased margin to the capital requirement once the final part of the post-financial crisis reforms (CRR3) is implemented. If the banks use this opportunity to boost lending, it is important that their goal to increase lending volume does not compromise the quality of credit assessments.

Over the past 20 years, the number of savings banks in Norway has fallen from 127 to just over 80. This trend is probably due to various factors, including extensive digitalisation, more stringent regulations and, in recent years, greater differences between banks that calculate capital requirements using internal models and the standardised approach, respectively. In Finanstilsynet's opinion, there is still effective competition in the Norwegian banking market.

Norwegian life insurers and pension funds have strong profit and solvency levels. Rising equity prices contributed the most to the improvement in life insurers' returns in the first three quarters of the year. The insurance result for disability risk has shown a clearly negative development in recent years. If the increase in the number of disabled persons is not restrained, future premium payments are likely to rise.

For non-life insurers, the increased scope and severity of weather and natural disasters have led to weaker earnings and heightened risk. The undertakings have also had to deal with strong cost growth. Finanstilsynet expects all insurers to consider how climate change may impact the scope of damage. Insurers increasingly use data and advanced analytical methods based on artificial intelligence and machine learning. The use of advanced analytical methods can help ensure that the undertaking's premiums are proportionate to the risk assumed. However, this can also lead to more tailored pricing where certain customers and customer groups in practice are excluded from the insurance collective. It is important that the undertakings ensure equal distribution of risk between members of an insurance collective and contribute to financial inclusion.

Norway has made a commitment to reduce greenhouse gas emissions by 55 per cent from the 1990 level by 2030 and to be a net zero emission economy by 2050. The transition to a low-emission economy requires a significant shift in the Norwegian and international business sectors. Required investments and increased emission taxes, which are a key climate policy tool, may have a negative impact on the profitability of Norwegian businesses and lead to higher loan losses in Norwegian banks.

Overall, Norwegian banks have a moderate exposure to industries with high greenhouse gas emissions, which are especially exposed to transitional risk. This mitigates banks' climate risk. Climate-related risk has the most pronounced impact on banks' credit risk but also affects market risk, operational risk, liquidity risk and reputational risk. Finanstilsynet follows up the banks' management of climate-related risks through on-site inspections and assessments of the banks' overall risks and capital needs. Finanstilsynet expects the banks to include climate-related risks in their business strategy, internal governance and risk management framework.

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