FINANSTILSYNET
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Summary

High debt levels among households and high property prices are vulnerabilities posing a significant risk to financial stability in Norway. Since the mid-1990s, growth in household debt has exceeded income growth. The debt burden, measured by the ratio of debt to disposable income, has reached a historically high level and is higher than in the majority of other countries.

Many households have a very high debt burden and limited financial buffers. Finanstilsynet's residential mortgage lending survey for 2019 shows that as much as 45 per cent of new instalment loans were taken out by borrowers with debt above 400 per cent of gross annual income, versus 41 per cent in 2018. First-time homebuyers and borrowers in the younger age groups have the highest debt-to-income and loan-to-value ratios and are particularly vulnerable to rising interest rates and declining incomes.

On 15 November 2019, the Ministry of Finance adopted new residential mortgage lending regulations that will remain in force for one year as of 1 January 2020. The requirements of the current residential mortgage lending regulations have largely been retained in the new regulations.

In September 2019, the European Systemic Risk Board (ESRB) published a warning to the Norwegian authorities, stating that the high debt burden of households and high house prices are vulnerabilities posing the greatest risk to financial stability in Norway. The growth in household debt has gradually abated and is now roughly in line with the increase in households' disposable income. If the level of interest remains low, there is a risk that vulnerabilities will build up in households and firms in the period ahead.

High debt levels mean that even a moderate rise in interest rates will lead to a significantly higher interest burden. As most of the debt carries a floating interest rate, there will be a rapid increase in the interest burden.

The debt levels of Norwegian non-financial firms have increased significantly since the mid-1990s and are now far higher measured as a share of GDP for Mainland Norway than before the Norwegian banking crisis in the early 1990s. Many Norwegian firms will be severely affected by a sharp rise in interest rates and risk premiums, for example as a result of international financial turmoil, or a reduction in income in consequence of an economic setback.

Internationally, both public and private debt has increased, and there is a high debt burden in a number of countries. Recent years have seen particularly strong growth in emerging economies. Household debt has risen in several countries over the last few years, and an increasing proportion of corporate loans is taken out by entities with a weak financial position and earnings. Low profitability in the banking sector also contributes to financial vulnerability in a number of European countries.

Global economic growth has abated during the current year. Central banks in several countries have cut their key policy rates, and market rates have declined. The IMF now expects the interest rate level to remain lower over a protracted period. Global economic growth is expected to pick up slightly in 2020. However, great uncertainty attends international developments. An escalation of the trade conflicts between the United States and other countries could trigger an economic setback and financial market turmoil. The consequences of a UK exit from the EU are still difficult to foresee.

Low key policy rates and extraordinary monetary policy measures undertaken by several central banks have probably contributed to reduced risk premiums and high prices on equities, corporate bonds and real estate. If global economic developments turn out to be considerably weaker than expected, there could be strong price corrections. This will have a pronounced impact on investors and could make it difficult and expensive for both financial institutions and non-financial firms to raise new capital in the money and capital markets.

There is a great risk that 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 loan losses and loss of reputation for the banks. The concentration of unsecured debt in vulnerable households may also contribute to systemic risk. Based on a proposal from Finanstilsynet, the Ministry of Finance adopted regulations on requirements for financial institutions' consumer lending practices on 12 February 2019. The regulations will remain in force up to and including 31 December 2020. The regulations include requirements on the borrower's debt servicing capacity, maximum debt relative to income and monthly instalment payments.

The growth in households' consumer loans has slowed somewhat during the past few years, with the most pronounced decline in 2019. At end-September 2019, the twelve-month growth in consumer loans, including defaulted loans sold to finance companies for recovery, was on a level with the increase in total household debt.

The first debt information undertakings started operations in 2019. Improved information about customers' overall consumer debt will ensure a better basis for banks' credit assessments and help to provide a more complete picture of developments in household consumer debt.

Defaults on consumer loans are higher than for other types of loans, and there has been a marked increase in the default level in recent years. At end-September 2019, the level of default was 9.4 per cent for the undertakings included in Finanstilsynet's survey, whereas it was 0.9 per cent for banks' total loans. The actual level of default for consumer loans is higher, since banks also sell defaulted loans to finance companies.

Due to profitable operations, Norwegian banks have been able to meet higher capital requirements largely through retained profits. The banks' Tier 1 capital as a share of total assets has increased over the past ten years, and the banks meet the liquidity requirements. The share of long-term market funding has risen. Norwegian banks are thus better positioned to provide credit in the event of an economic setback and increased loan losses. Norwegian banks' common equity Tier 1 capital ratios and leverage ratios are slightly above the average for European banks.

Net interest income constitutes the predominant part of Norwegian banks' operating income and is thus vital to the banks' profitability. Figures from the European Banking Authority (EBA) for the largest banks in each country show that Norwegian banks' net interest income as a share of total income is considerably higher than in many other European countries, where negative interest rates have put pressure on the interest margin.

A number of Norwegian banks, especially the largest ones, obtain a significant share of their funding in the Norwegian and international money and capital markets. The banks are thus vulnerable to market turbulence. There has been an appreciable 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. 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.

The Ministry of Finance has adopted regulatory changes that implement the EU's capital requirements directive (CRD IV) and regulation (CRR) in Norwegian law with effect from 31 December 2019. Seen in isolation, the measured capital adequacy ratio will consequently increase, although the banks' financial soundness will remain unchanged. In Finanstilsynet's opinion, it is important to ensure that the implementation does not contribute to a general weakening of Norwegian banks' financial strength. When approving and following up internal models, Finanstilsynet will attach importance to robust calibration with satisfactory safety margins, and will, when setting Pillar 2 requirements, emphasise that these requirements should also capture risk that is not fully covered by the Pillar 1 requirement. When assessing banks' financial soundness, Finanstilsynet gives emphasis to the leverage ratio. In Finanstilsynet's view, the banks' financial position on his measure should not be impaired in the period ahead.

The capital adequacy of life insurers has been strengthened in recent years, and they are compliant with the Solvency II requirements. The low interest rate level poses a challenge to institutions' ability to achieve the guaranteed return on their investments. The risk of declining equity prices and higher risk premiums in financial markets is of particular consequence to insurers with a large proportion of paid-up policies in their portfolios. New solvency requirements for pension funds came into force on 1 January 2019. Pension funds meet the new solvency requirements, although there are wide variations in their financial soundness.

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.

Both physical climate change and the transition to a low emission society will have an impact on financial markets and financial institutions. The risk of financial instability depends on how suddenly climate change occurs and how quickly the transition to a low-emission economy takes place. The integration of climate risk in supervisory activity is high on the agenda of financial supervisory authorities in a number of countries, and work is in progress to develop supervisory tools to monitor firms' handling of climate risk. Good reporting of relevant information from the firms is of significance to financial institutions' risk assessments and the supervisory authorities' assessment of the financial soundness of individual firms and in the financial system as a whole. The Ministry of Finance has announced that the need for Norwegian regulatory changes will be assessed in light of how the recommendations of the Task Force on Climate-related Financial Disclosures are followed up in the market and on the basis of new EU regulations reflecting the follow-up of the action plan on sustainable finance.