Summary

Outlook for financial stability in Norway

There is still considerable turbulence in global money and credit markets. In the wake of the crisis in some segments of the US housing market, banks became uncertain about their own and other banks' liquidity requirements. Interest rates on interbank loans increased. Risk premiums on money market loans remain high.

The uncertainty has contributed to a broad-based repricing of risk. Risk premiums in credit markets, which were very low up to last summer, rose sharply until mid-March. Credit premiums have since fallen back slightly. The reversal came when the Federal Reserve announced that it would implement measures to prevent the bankruptcy of the investment bank Bear Stearns.

Many foreign banks have recorded substantial loan losses and unrealised capital losses on bond holdings. As a result, they have had to raise new equity in order to maintain capital adequacy. Combined with more expensive funding, these losses have led to tighter credit standards both in the US and in Europe. Tighter credit standards in banks and more expensive funding in credit markets have curbed corporate and household demand. This will in isolation curb economic growth.

Even though there have been signs of improvement in credit markets, it is uncertain how long the turbulence will persist. The situation in money markets is still abnormal. If there are no more major negative surprises, confidence may be restored in the interbank market, and risk appetite can then increase. In turn, this will result in lower risk premiums in credit markets and make it easier for banks to obtain funding. Lower risk premiums will also reduce unrealised capital losses on bonds.

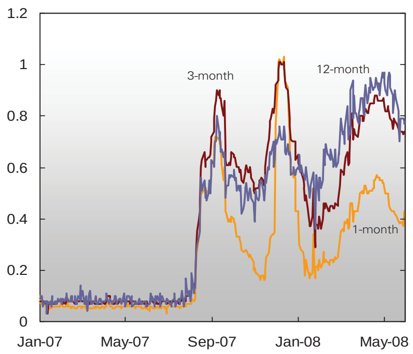
If developments follow this path, banks' need for tighter credit standards will be reduced, making it easier and cheaper for enterprises and households to obtain funding. On the other hand, negative news about losses in financial institutions would rapidly further erode confidence. This would prolong the period of turbulence, as would a deterioration in the situation in the US housing market.

The environment has also become more demanding for Norwegian banks. Nonethless, the outlook for the financial system in Norway is still satisfactory. After several years of high earnings, banks are well equipped to cope with a period of international turbulence and weaker results.

Norwegian banks are feeling the impact of the turbulence in money and credit markets in two ways:

First, funding costs have increased. Premiums paid by banks for long-term funding have risen considerably. As a result, banks have to a greater extent used short-term loans. But short-term money market funding has also become more expensive. More expensive market funding

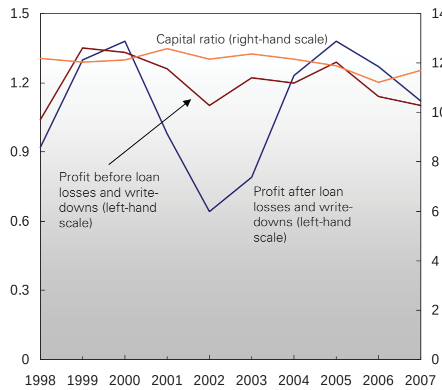
Chart 1 Spread between money market rates with different maturities and expected key policy rate[1]. Average for the US, the euro area and the UK. Percentage points. Daily figures. 1 Jan 07 – 29 May 08



[1] The expected key rate is represented by the Overnight Indexed Swap (OIS)

Sources: Bloomberg and Norges Bank

Chart 2 Banks' capital ratio and pre-tax profit as a percentage of average total assets.[1] Annual figures. 1998 – 2007



[1] Excluding branches of foreign banks in Norway

Source: Norges Bank

has led to intensified competition for customer deposits. Interest rates on deposits have increased. Thus, all forms of debt financing have become more costly.

Second, banks have had to record unrealised capital losses on bonds. The fall in bond prices is less serious for Norwegian banks than for many international banks. Bonds account for a limited share of Norwegian banks' assets. In addition, Norwegian banks have not been directly exposed to losses in the US subprime mortgage market, which resulted in substantial losses in foreign banks.

After falling for many years, banks' interest margins (lending rates minus deposit rates) have stabilised over the past year. Lending rates, however, have not kept up with money market rates, which have risen more than Norges Bank's key policy rate. Lending margins (the difference between lending rates and money market rates) are now very low. If the difference between the key rate and money market rates does not diminish, banks will probably raise lending rates. In addition, slower growth in the Norwegian and global economies may imply higher credit risk premiums in the period ahead. However, it will take time for all the loans to be fully repriced.

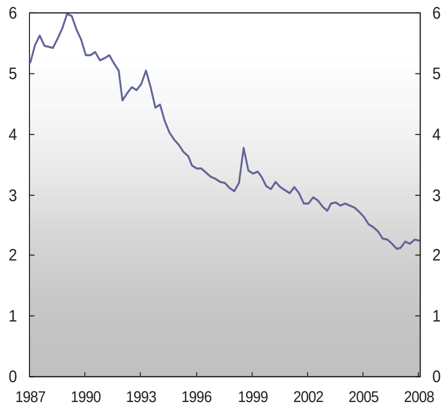
Increased competition for deposits will probably contribute to reducing the difference between deposit rates and money market rates (deposit margins). The financial turbulence may thereby affect both lending and deposit margins. In addition, household loan growth will probably moderate due to higher interest rates, a high level of debt in many households and slower house price inflation. It is also uncertain how long strong growth in lending to the business sector can persist. As a result, growth in banks' net interest income will probably be slower.

Banks' loan customers are financially sound. Corporate earnings have been high for a long period. Due to slower growth in the Norwegian and global economies, corporate earnings ahead will be more moderate. Higher funding and labour costs are having the same effect, and will reduce enterprises' debt-servicing capacity. The commercial property market has previously reflected considerable optimism and sharply rising prices. Commercial property prices have fluctuated widely and in pace with capacity utilisation in the economy. Lower economic activity will reduce property companies' earnings.

Households' overall financial position is sound. Income growth is holding up, and unemployment is low. However, household saving has been low, and debt is still expanding rapidly. House price inflation slowed in autumn 2007 after several years of sharp increases. Higher interest rates and high debt in many households may reduce their debt-servicing capacity.

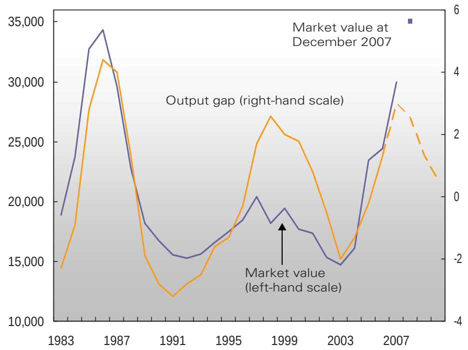
With somewhat lower household and corporate debt-servicing capacity, banks' loan losses will probably increase somewhat in the years ahead, albeit from unusually low levels. Along with lower growth in net interest income,

Chart 3 Banks' interest margin. Percentage points. Quarterly figures. 87 Q1 – 08 Q1



Source: Statistics Norway

Chart 4 Market value for offices in Oslo[1]. Price per square metre at constant 2007 NOK. Output gap[2]. Per cent. Annual figures. 1983 – 2010



[1] Average value for high-standard offices in central Oslo. Value as at June.
[2] Projections for 2007 – 2010

Sources: OPAK and Norges Bank

this will probably result in lower profits as a percentage of total assets than in 2004–2007, which was a very favourable period for banks.

Risk outlook

The risk of financial instability in Norway seems on balance to have increased since the previous report. This is primarily due to developments in global money and credit markets and uncertainty about the effects on domestic and global activity. We will focus on four developments in particular:

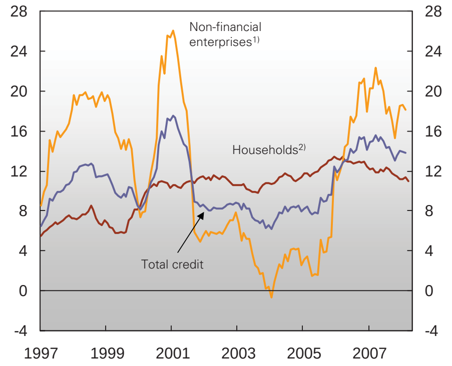
Market turmoil challenges banks' liquidity management. Short-term loans account for a substantial share of banks' funding, and must be rolled over regularly. The scale of short-term funding has increased somewhat in the past year due to limited access to long-term funding, which increases liquidity risk.

The problems in the US housing market and the ensuing turmoil in money and credit markets, along with tighter bank credit standards, increase the uncertainty about global economic developments. A global downturn might lead to lower earnings in Norwegian firms and higher losses in Norwegian banks.

Household debt is still growing rapidly. Low saving and uncertainty in the housing market entails a risk of an abrupt rise in the saving ratio. A sudden change in household expectations about their own financial position ahead may also lead to a change in saving behaviour, which will reduce corporate earnings.

Banks have sizeable loans to the property industry. Market prices for commercial property have risen substantially in the past few years, partly based on expectations of continued solid growth in rental income. If these expectations are not met, property companies' profitability may be reduced. The optimism and the rise in prices in the commercial property market seem, however, to have abated since 2007. Banks have become more reluctant to lend to the property industry. Combined with any weaker developments in the housing market, this may also reduce activity and earnings in the construction industry.

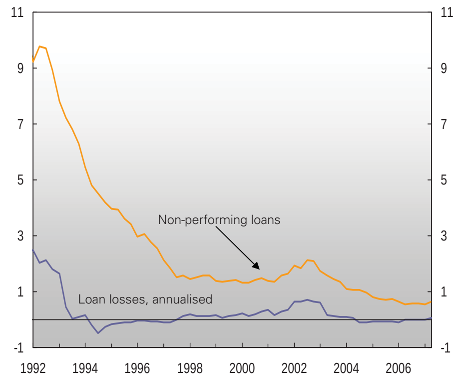
Chart 5 12-month growth in credit to mainland Norway. Per cent. Jan 1997 – Mar 2008



[1] All foreign credit to mainland Norway is assumed granted to enterprises
[2] Household domestic credit

Source: Statistics Norway

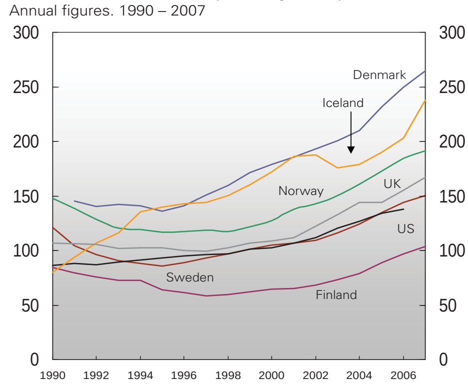
Chart 6 Banks' gross stock of non-performing loans and reported loan losses[1]. Percentage of gross lending. Quarterly figures. 92 Q1 – 08 Q1



[1] Excluding branches of foreign banks in Norway

Source: Norges Bank

Chart 7 Household debt as a percentage of disposable income. Annual figures. 1990 – 2007



[1] The figures are not necessarily comparable because of different definitions and institutional arrangements

Sources: OECD, Sveriges Riksbank, Danmarks Nationalbank, Sedlabanki Island, Finlands Bank and Norges Bank