Summary

Outlook for financial stability in Norway

The general outlook for financial stability is still considered to be satisfactory. After several years of high earnings, banks are solid and well equipped to cope with a period of weaker results.

Banks' strong financial position is due to the solid debt-servicing capacity of both households and enterprises. This has resulted in very low loan losses. Household debt is growing rapidly. Higher interest rates and somewhat lower income growth may make it more difficult to service debt ahead. Slower growth in the Norwegian and global economies may also curb growth in corporate earnings, making it more demanding to service rising debt. Overall, banks' loan losses are therefore expected to rise somewhat ahead.

Strong competition for customers will continue to put pressure on banks' interest margins. In addition, growth in lending to households will probably moderate due to higher interest rates, an already high level of debt and slower house price inflation. It is also uncertain how long strong lending growth to the corporate sector can continue, and growth in banks' net interest income will probably be slower. Due to the turbulence in money and credit markets this autumn, funding costs and losses on securities have increased, although for Norwegian banks the impact has so far been limited.

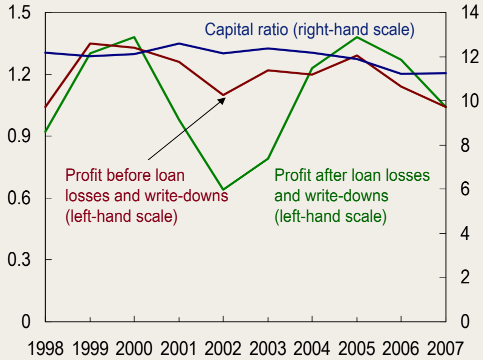
The prospect of higher losses and lower net interest income growth will put pressure on banks' profits ahead. Profits as a percentage of total assets may be somewhat weaker in the next few years than in 2004–2007, which was a very favourable period for banks. These developments may place greater demands on banks' cost management.

Risk outlook

The overall risk of financial instability appears to have increased somewhat since the June report, primarily due to increased uncertainty about international economic developments. We will focus on four developments in particular:

Owing to the problems in the US mortgage market and the ensuing turbulence in money and credit markets, coupled with very high oil prices, the risk of an international recession has increased somewhat since the June report. Banks in other countries have had to carry doubtful loans on their own balance sheets. As a result, capital needs will increase and banks will probably be more reluctant to extend loans. An international recession could affect Norwegian banks through higher losses as a result of weaker earnings for

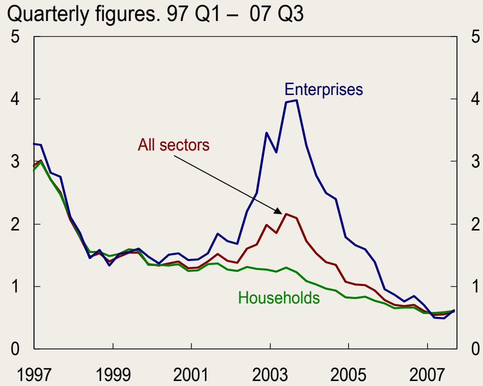
Chart 1 Banks' capital ratio and pre-tax profit as a percentage of average total assets.[1)] Annual figures. 1998 – 2006 and at 2007 Q3



[1)] Excluding branches of foreign banks in Norway

Source: Norges Bank

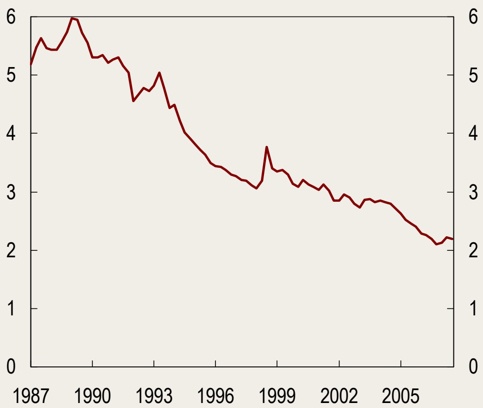
Chart 2 Banks'[1)] gross stock of non-performing loans. Percentage of gross lending to sector. Quarterly figures. 97 Q1 – 07 Q3



[1)] All banks in Norway

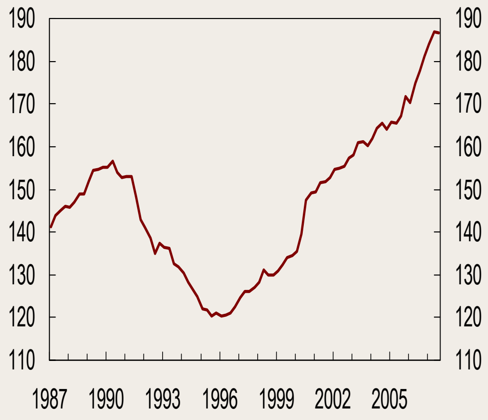
Source: Norges Bank

Chart 3 Banks' interest margin. Percentage points. Quarterly figures. 87 Q1 – 07 Q3



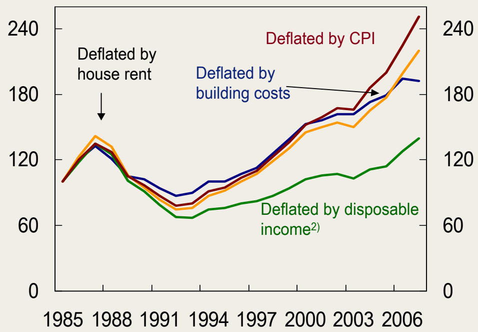
Source: Norges Bank

Chart 4 Credit to mainland Norway as a percentage of mainland GDP. Quarterly figures. 87 Q1 –07 Q3



Sources: Statistics Norway and Norges Bank

Chart 5 Real house prices. Indices. 1985 = 100. Annual figures. 1985 – 2007[1)]

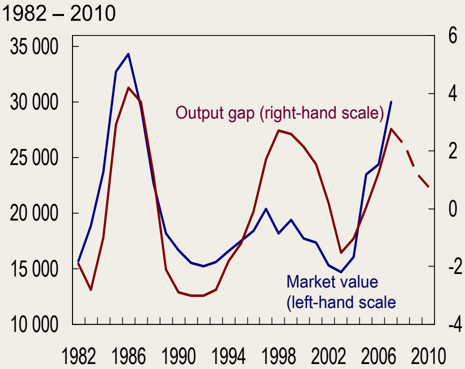


[1)] First half of 2007

[2)] Disposable income less estimated reinvested dividends for the period 2000-2005

Sources: Association of Norwegian Real Estate Agents, ECON Pöyry, Finn.no, Association of Real Estate Agency Firms, Statistics Norway and Norges Bank

Chart 6 Market value for offices in Oslo[1)] and output gap. Price per square meter at constant NOK-2007. Annual figures. 1982 – 2010



[1)] Average value for high-standard offices in central parts of Oslo. At 30 June 2007

Sources: OPAK and Norges Bank

Norwegian enterprises. In addition, banks' earnings may be reduced due to lower growth in lending and demand for other bank services in pace with lower economic growth.

The turmoil in money and credit markets has resulted in higher funding costs. If the turmoil persists or is amplified, gaining access to long-term funding could still be difficult, which will result in higher liquidity risk for Norwegian banks. Similarly, an economic crisis in the Baltic countries may have an impact on funding costs for all the large Nordic banks, including banks that are not directly affected to any extent.

Norwegian households' high debt burden and negative saving increase the risk of an abrupt rise in the saving ratio, with potentially substantial effects on corporate earnings. One factor that may trigger changes in the saving ratio is falling house prices. In addition, the behaviour of many high-debt households has made them vulnerable to a rise in interest rates or a loss of income.

Developments in the commercial property market reflect considerable optimism. Market prices have risen substantially in the past year, partly based on expectations of continued solid growth in the Norwegian economy. If this does not materialise or interest rates are higher than participants have assumed, property companies' profitability may be reduced, resulting in higher losses for banks. Banks have substantial loans to the commercial property industry.

The report presents stress tests that illustrate the possible consequences if some of the risk factors referred to above are triggered. The tests show that banks could incur substantially higher loan losses than in the baseline scenario. The extent of the impact on banks' capital adequacy will partly depend on the pricing of risk and on lending growth. The stress test indicates that, due to their current financial strength, banks have a generous margin before capital adequacy falls below the minimum requirement.