The Performance of Financial Institutions in 1999

Introduction

This article presents a review of the profit and loss accounts, balance sheets and capital adequacy of commercial and savings banks, mortgage companies, finance companies and life insurance companies, with the main emphasis on developments in 1999 compared with one year earlier. Section 1 provides a general summary of 1999 as well as a box on the increased presence of and competition from foreign banks in the Norwegian financial market. Section 2 contains a detailed survey of the profit performance of banks, and a somewhat less detailed review of the profit trends of other financial institutions. Section 3 looks at developments in financial institutions' credit growth, balance sheets and financial strength. The article also contains a brief discussion of profit performance since the 1980s as well as a number of tables and charts related to financial institutions' operations in 1999.

1. Main features

Commercial and savings banks' results were favourable in 1999. However, maintaining this performance level will be a challenge for banks in the years ahead. Our analyses indicate that loan losses are rising. At the same time, competition in the banking sector has intensified and is expected to increase in the next few years.[1] Intensified competition is squeezing banks' earnings, making it difficult for the industry as a whole to compensate for increased loan losses by increasing income. Therefore, satisfactory profit performance will probably require a reduction in cost levels.

The most important aspects of financial institutions' performance in 1999 are as follows:

Profit performance

In 1999, *commercial banks'* (parent banks) pre-tax ordinary operating profit was NOK 8.0bn, corresponding to 1.11% of average total assets (ATA).[2] Corresponding figures in 1998 were NOK 4.8bn and 0.68%. This pronounced improvement is due primarily to a rise in capital gains on securities and a decline in recorded losses.

Savings banks' pre-tax ordinary operating profit came to NOK 7.1bn (1.59% of ATA) in 1999, compared with NOK 4.8bn (1.24% of ATA) in 1998. The improvement is due mainly to an increase in capital gains on securities.

Net interest income, measured as a share of ATA, rose slightly in commercial banks and declined somewhat in savings banks from 1998 to 1999. The rise in commercial banks is due primarily to a larger portion of operations being financed by customer deposits, which is a relatively inexpensive source of funding. The decline in savings banks' net interest income is mainly due to a reduction in the share of operations financed by customer deposits. Although the difference between the bank groups has diminished somewhat, net interest income is still considerably higher in savings banks than in commercial banks. Other operating expenses as a share of ATA were virtually unchanged in commercial banks and dropped slightly in savings banks from 1998 to 1999.

Recorded losses fell sharply in commercial banks and showed a weak rise in savings banks from 1998 to 1999. The commercial banks' improved situation may be ascribed to substantial losses on foreign loans incurred by one major bank in 1998. Commercial banks have, however, recorded an increase in losses and higher specified loan loss provisions for the Norwegian corporate market in 1999. Losses in both bank groups are still lower than what may be regarded as a normal level, however. If the banks' 1999 results are adjusted for a normalised loss level (interval) and 28% tax is deducted from normalised operating profits, the return on equity would be between 5.4% and 8.7% in commercial banks and between 6.7% and 9.6% in savings banks. This indicates that banks' underlying earnings are weak when loss levels are "normal".

Mortgage companies recorded a pre-tax ordinary operating profit of 0.78% of ATA in 1999, compared with 0.52% the year before. The corresponding figures for finance companies were 2.36% and 2.56%. Finance companies' weaker operating profit is partly ascribable to an increase in recorded losses. Finance companies' losses are now at the highest level recorded in the last five years. Life insurance companies' profit before distributions to insurance customers and taxes amounted to 3.44% of ATA in 1999, compared with 1.18% the year before. The improvement is mainly due to a considerable increase in net income from financial assets as a result of the advances in stock markets.

Credit growth, balance sheet trends and financial strength

After a slowdown in growth in 1998, domestic credit growth picked up somewhat again in 1999. From 1995 to 1999, banks' credit growth was substantially higher than growth in total domestic credit. However, the difference narrowed in 1999.

Growth in savings banks' lending to both the household and enterprise sectors has been appreciably higher than lending growth in commercial banks during the last year. At the end of 1999, savings banks' lending growth reached the highest level recorded in the entire decade.

Commercial banks' liquid assets, as a percentage of total assets, rose in 1999. At the same time, there was an increase in that portion of financing that must be seen as most stable, ie customer deposits from domestic sources. This implies that commercial banks reduced their liquidity risk. The situation was the opposite for savings banks. In addition, savings banks' foreign debt increased sharply in 1999. Most of the increase came in the form of foreign deposits, which must be seen as a relatively volatile form of funding. However, in relation to savings banks' total financing, foreign debt is still at a low level.

Developments in 1999 indicate that banks' credit risk has increased. This is due primarily to a large and growing exposure to the real estate industry as well as a negative trend in segments of this industry.

Commercial banks' capital adequacy has remained virtually unchanged the last three years, whereas savings banks' capital adequacy has gradually deteriorated. These ratios for financial strength are still higher in savings banks than in commercial banks, however, and both bank groups satisfy the minimum requirements by a good margin.

Finance companies' gross lending rose sharply and considerably more than banks' lending in 1999. Growth in lending at mortgage companies was on a par with lending growth at banks. Core capital ratios declined at finance companies and improved at mortgage companies in 1999. Life insurance companies' shareholdings increased while holdings of other securities and loans fell from 1998 to 1999. This means that life insurance companies' equity exposure has increased.

Increased competition from Nordic banks

Driving forces such as technological advances, deregulation, internationalisation and altered customer behaviour have contributed to increasing competition in the banking sector. Barriers to entry have been reduced and Norwegian banks are encountering intensified competition from securities markets, institutional investors and foreign banks.

There have been a number of mergers and acquisitions in the Norwegian financial services industry the last few years. A special feature of this development is that a number of banks from other Nordic countries have entered into alliances, bought up or made offers to buy Norwegian banks:

- Den Danske Bank has purchased Focus Bank
- Handelsbanken in Sweden has purchased Bergensbanken
- FöreningsSparbanken in Sweden has entered into a cooperation agreement with the Sparebank1 banks and has thus become part-owner in Sparebank 1 Group
- Finnish-Swedish MeritaNordbanken has made an offer to buy Christiania Bank

Den Danske Bank and Handelsbanken have substantially increased their presence in Norway through their acquisitions of Fokus Bank and Bergensbanken. For Den Danske Bank in particular, this means significantly greater market proximity in Norway. Both banks are focusing on a wide range of activities and will contribute to increasing the competition for most customer groups in a number of geographic areas. This will affect competitive conditions for a number of Norwegian commercial and savings banks. Competition, especially for medium-sized enterprises, is likely to increase sharply.

It is not clear whether MeritaNordbanken's bid for Christiania Bank will be accepted. MeritaNordbanken opened a branch in Oslo in 1999 and has signalled that they want to conduct extensive operations in all the Scandinavian countries and in Finland. The MeritaNordbanken Group has recently entered into an agreement to merge with Denmark's Unibank. Unibank has had operations in Norway for several years and has focused primarily on larger corporate customers.

In addition to the banks mentioned above, Sweden's SEB is also actively involved in Norway. However, SEB has chosen a more focused strategy in Norway than Handelsbanken and Den Danske Bank. SEB focuses mainly on larger enterprises and other customers who require relatively advanced services. In addition, SEB concentrates on the market for securities savings. Together with MeritaNordbanken, SEB is one of the financial groups that have invested most aggressively in the Internet as a distribution channel.

It must be assumed that the Nordic banks will not be content with what they have already purchased or wish to purchase, but will use this as a springboard for further expansion. The Nordic banks' operations in Norway can take advantage of the resources and competencies in their respective head offices. This will enable them to compete on product range, product development, product quality and price. Low prices may be a possible means of achieving growth in new market segments. All in all, the Nordic banks' expansion involves a major competitive challenge for Norwegian banks and will probably contribute to increased competition in the Norwegian banking market.

2. Profit performance

Developments in financial institutions' net interest income and operating profit during the 1980s and 1990s are shown in Charts 1a, 1b, 1c and 1d. Developments are also discussed in a separate box at the end of this article. A more detailed description of developments in 1999 follows.

Commercial banks

Commercial banks (parent banks and foreign-owned branches in Norway) posted a pre-tax ordinary operating profit of NOK 8.0bn (1.11% of ATA) in 1999, compared with NOK 4.8bn (0.68% of ATA) in 1998. The pronounced improvement from 1998 to 1999 may be ascribed primarily to an increase in other operating income. In addition, developments in recorded losses have been favourable. A closer look at the figures, however, indicates that banks' loan losses will increase in the long-term. Key profit and loss account figures are shown in Tables 1 and 2.

Net interest income rose both nominally and as a percentage of ATA last year. In 1999, net interest income came to NOK 14.6bn (2.03% of ATA), against NOK 13.7bn (1.97% of ATA) the year before.

The increase is due primarily to the fact that commercial banks financed a larger portion of operations with deposits and equity. An increased deposit-to-loan ratio is positive, since deposits are normally a less expensive form of financing than funding from the money market. Moreover, short-term financing is usually less expensive than long-term financing. Due to unrest in the capital market, however, short-term interest rates were far higher than long-term interest rates early in 1999. Later in the year, however, the 3-month NIBOR rate fell to about the same level as the yield on 10-year government bonds.

In addition to changes in banks' financing structure, interest rate margins also affect net interest income. Due to turbulence in the capital market early in 1999, both deposit and lending margins fluctuated sharply in the first two quarters. On the whole, however, the interest rate margin remained more or less unchanged. During the second half of 1999, however, the interest rate margin fell by 0.39 percentage point. At the end of the year, it was only 3.01%, which is the lowest level ever registered. Changes in the interest rate margin must be seen in connection with increasing competition in the traditional market for loans and deposits. Competition in the lending market in particular is squeezing banks' margins. If the interest rate margin on loans remains at such a low level over a longer period, commercial banks will increasingly be forced to find alternative sources of income to maintain earnings.

Other operating income rose noticeably last year. Other operating income amounted to NOK 8.0bn in 1999, an increase from 0.99% to 1.11% of ATA. The primary reason for this improvement was the upswing in Norwegian and international stock markets. Measured by the Oslo Stock Exchange's all-share index, the market capitalisation of listed companies rose by 46% in 1999, generating substantial capital gains on shares for commercial banks.

During the last few years, commercial banks have focused on operating expenses. In nominal terms, banks' operating expenses rose by NOK 0.4bn from 1998 to 1999. However, as a percentage of ATA and of total income (excluding capital gains on securities, foreign exchange and derivatives) costs declined marginally. In 1999, operating expenses came to 71.3% of income. Banks have reduced the number of branches and employees during the last year. Despite cutbacks in manpower, personnel expenses have increased. This is mainly due to banks' need for more highly skilled personnel and partly to the fact that the 1999 figures are affected by allocations for restructuring measures and future manpower cuts.

After several years with large reversals of loan loss provisions, the banks reported loan losses of 0.32% of gross lending in 1998. This figure dropped to 0.06 percent in 1999. The reduction from 1998 to 1999 is primarily due to substantial losses on foreign loans incurred by one large commercial bank in 1998. The largest commercial banks have stated that in 1999 they gave priority to improving the quality of their loan portfolios. This is one possible explanation for the reduction in unspecified loan loss provisions in 1999, in contrast to a considerable increase the year before. However, commercial banks have recorded increased losses and increased specified loan loss provisions for the Norwegian corporate market, (see Table 18). In relation to gross lending to the corporate market, the percentage of losses rose from 0.08% in 1998 to 0.19% in 1999. Losses rose especially in traditionally high-risk sectors such as construction, retail trade, hotels and restaurants. Commercial banks also reported less negative losses in the real estate industry.

In addition to the likelihood of higher loan losses, commercial banks must also anticipate increased taxes. Due to losses carried forward, commercial banks' taxes remained low in 1999. However, the source of this tax advantage is being exhausted, leading to an increase in the tax burden.

The commercial bank group includes nine branches of foreign banks. In recent years, foreign branches have recorded a somewhat weaker result as a percentage of ATA than Norwegian commercial banks, (see Table 2). This is primarily due to higher net interest income in Norwegian banks than in foreign branches.

Profits as a percentage of ATA were somewhat better in Norway's three largest commercial banks than in the other commercial banks (including branches of foreign banks) in 1999. Cost levels in the three largest commercial banks were higher than in the other banks, but this was more than offset by higher net interest income and other operating income, as well as lower loan losses.

Commercial banks have recorded low loan losses the last few years. In 1999, loan losses were only 0.04% of ATA. It is assumed that a "normalised" loan-loss level is between 0.5% and 0.9% of gross lending. With the current loan portfolio, this would have resulted in recorded losses of between 0.4% and 0.7 % of ATA. If the 1999 results are adjusted using a normalised loss level and 28% tax on normalised ordinary operating profit, commercial banks would have recorded an after-tax ordinary operating profit of 0.35% of ATA with the highest loan-loss ratio, and 0.57% with the lowest ratio. This would have yielded after-tax returns on equity of 5.4% and 8.7% respectively. This implies that if losses are normalised, banks must improve their underlying earnings to satisfy shareholders' required rate of return.

Savings banks

Savings banks recorded a pre-tax ordinary operating profit of NOK 7.1bn in 1999 (1.59% of ATA), compared with NOK 4.8bn in 1998 (1.24% of ATA). As with commercial banks, savings banks' improved results are primarily due to higher capital gains on securities. Savings banks posted higher loan losses than commercial banks in 1999. Savings banks' loan losses, as a percentage of ATA, rose by 0.02 percentage point from 1998 to 1999. Tables 4 and 5 show key figures for the profit and loss account.

Savings banks' net interest income rose from NOK 11.1bn in 1998 to NOK 12.7bn in 1999. However, as a percentage of ATA, net interest income declined marginally. In 1999, savings banks' net interest income was about 0.8 percentage point higher than commercial banks' net interest income, in part because savings banks as a group have access to less expensive customer deposits and equity financing than commercial banks. However, the difference between savings banks' and commercial banks' net interest income has narrowed this past year primarily because savings banks' deposit-to-loan ratio has declined.

Like commercial banks, savings banks experienced some fluctuations in deposit and lending margins due to unrest in the capital market early in 1999. The total interest margin has been relatively stable throughout 1999, however, and was 3.34% at year-end. Both deposit and lending margins were higher for savings banks than for commercial banks in 1999.

Savings banks' other operating income rose sharply from 1998 to 1999, 70% in nominal terms, due primarily to contributions from securities trading operations. In 1998, savings banks reported losses on securities trading amounting to NOK 298m, whereas in 1999, they reported profits of NOK 833m, partly reflecting the upswing in Norwegian and international securities markets.

In nominal terms, savings banks' operating expenses rose by 12% from 1998 to 1999. As a percentage of ATA, however, expenses declined markedly. Cost levels are still higher in savings banks than in commercial banks, but the difference has narrowed this past year, reflecting, among other things, the different composition of balance sheets for the two bank groups. Savings banks have a larger number of small commitments compared with commercial banks, which in isolation leads to a higher cost level in relation to ATA. However, the cost/income ratio (excluding income from securities, foreign exchange and derivatives transactions) is considerably lower for savings banks' than for commercial banks. In 1999, savings banks' operating expenses came to 58.8% of income, compared with 71.3% for commercial banks. Savings banks also recorded a greater reduction in costs than commercial banks from 1998 to 1999.

Savings banks' recorded loan losses increased from NOK 0.8m in 1998 to NOK 1bn in 1999. Loan losses are substantially higher in savings banks than in commercial banks, measured both in relation to ATA and gross lending. Loan losses in the retail segment are also low for savings banks. Recorded and specified losses primarily refer to the Norwegian corporate market. These losses increased from NOK 479m in 1998 to NOK 587m in 1999, corresponding to 0.39% and 0.41% of gross lending to the corporate market (see Table 19). For savings banks, the increase in loan losses has primarily related to the manufacturing and transport industries. In addition, savings banks recorded substantial losses in the real estate sector as well as in retail trade, hotels and restaurants. In 1999, savings banks increased their unspecified loan loss provisions by NOK 590m, which was nearly NOK 200m more than the increase in 1998.

The savings bank group consists of 130 banks that vary considerably in size. We have split up the banks (see Table 5) to provide a clearer picture of developments. Pre-tax ordinary operating profits developed more favourably for the smallest savings banks, which recorded a somewhat better result. This is primarily because the largest savings banks have far lower net interest income than the smaller banks. The largest banks compensate somewhat for this with higher income from areas other than traditional deposit and loan activities. The largest banks also have somewhat lower expenses and loan losses as a percentage of ATA than the smaller banks.

If savings banks' profits are "normalised" in the same manner as commercial banks' profits, ordinary operating profits after tax would be 0.6% of ATA with loan losses of 0.9% of gross lending and 0.9% of ATA with loan losses of 0.5%. This corresponds to after-tax returns on equity of 6.7% and 9.6% respectively and reflects somewhat better underlying earnings than in commercial banks and a marginal improvement compared with a similar analysis a year ago. Nevertheless, savings banks' underlying earnings must be regarded as somewhat weak compared with return requirements of holders of primary capital certificates.

Mortgage companies

At year-end 1999, there were 10 mortgage companies in Norway, including one foreign branch. Mortgage companies recorded pre-tax ordinary operating profits of NOK 1.2bn in 1999 (see Table 6), corresponding to 0.78% of ATA, compared with 0.52% in 1998. This improvement may primarily be ascribed to an increase in net interest income. As a percentage of ATA, net interest income rose from 0.74% to 0.87%, which corresponds to a nominal increase of NOK 0.4bn. Mortgage companies' loan losses remain low. In 1999, loan losses amounted to NOK 20m, or 0.01% of ATA.

Finance companies

Finance companies recorded pre-tax ordinary operating profits of NOK 1.2bn in 1999 (see Table 6), corresponding to 2.36% of ATA, compared with 2.56% in 1998. The less favourable result is due to increases in both other operating expenses and loan losses and a decrease in other operating income as a percentage of ATA. This was partly offset by a rise in net interest income. Recorded losses increased from 0.38% of ATA in 1998 to 0.61% in 1999, ie the highest figure for finance companies during the last five years.

Life insurance companies

Life insurance companies' profits improved substantially from 1998 to 1999. Profits before distributions to insurance customers and taxes amounted to NOK 11.5bn in 1999 (see Table 7), corresponding to 3.44% of ATA, compared with 1.18% last year. The improvement is mainly due to as a substantial increase in net income from financial assets as a result of advances in stock markets. Net income from financial assets amounted to NOK 46.3bn in 1999, compared with NOK 8.4bn the year before. Corrected for changes in unrealised capital gains, profits came to NOK 33.1bn in 1999. The companies reported a deficit of NOK 3.4bn in 1998. The positive trend in stock markets in Norway and abroad has contributed to a substantial increase in life insurance companies' unrealised capital gains. At the end of 1999, unrealised capital gains amounted to NOK 27.1bn, compared with NOK 5.5bn one year earlier.

3. Credit growth, balance sheet trends and financial strength

Credit growth

After declining growth throughout 1998, growth in domestic credit picked up somewhat again in 1999 (see Chart 2). However, year-on-year growth was lower at the beginning of 2000 than at the beginning of 1998, when it reached a peak for the 1990s. The increase in domestic credit growth towards the end of 1999 partly reflects the decline in foreign credit growth. This change is primarily due to developments in the krone exchange rate and lower interest rate differentials between Norway and other countries this past year. In addition, lending to the household sector has increased the last few months, which partly reflects high turnover and sharp price inflation in the real estate market and growth in car sales.[3] Norwegian banks also increased their lending to the enterprise sector towards the end of 1999 (see below). Chart 2 shows that growth in bank lending was substantially higher than growth in total domestic credit during the period 1995 to 1999. However, the difference narrowed last year.

Banks are responsible for the largest share of total domestic credit (see Chart 3). At the end of 1999, banks' share of total domestic credit was more than 63%. State lending institutions still account for a relatively large share of the credit supply, about 15% at the end of 1999. Bond and certificate markets accounted for only 7.5%, while mortgage companies and finance companies accounted for 7.2% and 4.5% respectively. There were minor changes in these shares from 1998 to 1999. In nominal terms, the credit supply from all sources increased during this period.

Growth in commercial banks' lending declined sharply from the beginning of 1998 to mid-1999, but picked up again towards the end of the year (see Chart 4). The largest commercial banks were primarily responsible for the reduction in lending growth. Lending growth at other commercial banks has been relatively high the last two years. Savings banks' lending growth fell somewhat from the beginning of 1998 to mid-1999, but increased sharply thereafter (see Chart 4). This is partly due to Sparebanken NOR's purchase of Gjensidige Bank. At the end of 1999, savings banks' lending growth was at the highest level recorded in the 1990s.

Growth in loans to both the household and enterprise sectors slowed in commercial banks from 1998 to mid-1999 (see Chart 5 and Chart 6). Slower growth in lending to the enterprise sector is due in part to lower corporate profitability and a decline in corporate investment. Growth in commercial banks' lending to the household and enterprise sectors picked up again towards the end of 1999. Growth in savings banks' lending to the household and enterprise sectors continued through the year (see Chart 5 and Chart 6). Growth in loans to both the household and enterprise sectors has been more pronounced in savings banks than in commercial banks the last year.

Liquidity trends

Table 20 and Table 21 show developments in the banks' main balance sheet items from 1998 to 1999. In relation to total assets, commercial banks' liquid assets and deposits in financial institutions rose by 2.3 percentage points in 1999, whereas the shares for customer deposits and equity increased by 1.5 and 0.8 percentage points respectively. In isolation, this indicates that commercial banks reduced their liquidity risk. The situation was reversed for savings banks. Their liquid assets and deposits increased marginally as a percentage of total assets, while the shares for customer deposits and equity declined by 2.7 and 0.5 percentage points respectively. Another indication of banks' liquidity risk is the change in the share of foreign funding, since this type of financing is assumed to be more volatile than other types of funding. Commercial banks' total foreign debt increased by 4% in nominal terms from 1998 to 1999 (see Chart 7). However, foreign debt in the form of deposits was reduced in relation to total assets. Savings banks' total foreign debt increased by nearly 50% in 1999 (see Chart 8). Deposits from abroad accounted for the majority of the increase. This is a further indication that savings banks' liquidity risk rose in 1999. All in all, however, foreign funding only accounted for 14% of savings banks' total financing at the end of the year.

Credit risk

Credit risk rose substantially in parts of the enterprise sector in 1999 (see Financial Sector Outlook in Economic Bulletin 1999/2). Trends were particularly negative in the real estate (ie sale and rental of real property) and shipping/pipeline transport sectors. High-risk enterprises in these sectors accounted for a much larger share of enterprises' total long-term debt at the end of 1999 than one year earlier. The term "high-risk enterprises" refers to enterprises with negative earnings and an equity ratio of less than 20%.

At the end of 1999, the real estate sector accounted for 41.8% of banks' long-term loans to the enterprise sector (see Table 22). Banks are therefore heavily affected by developments in this sector. By comparison, banks' loans to retail trade, hotels and restaurants only amounted to 15% of banks' total lending.

Despite a sharp increase in the long-term debt of high-risk real estate enterprises in 1998 (see Table 23), banks nonetheless increased their lending to this industry in 1999. Developments were similar in shipping/pipeline transport and other industries (mainly primary industries, construction, power and water supply). In other industries, there were only minor changes in the enterprises' risk level and banks' lending.

Although we may assume that a large portion of the new loans to the real estate industry relates to low-risk enterprises, banks' total credit risk has probably increased, because the real estate industry already accounts for a very large share of banks' total lending (see Table 22) and has a considerable element of high-risk enterprises. If this industry experiences a negative trend, as it did at the end of the 1980s, banks will be especially hard hit. Therefore, an excessive exposure to this industry may be unwise. Turnover and price trends in the resale market for commercial property indicate, however, that there are no tendencies towards imbalance in the market. Moreover, there is reason to believe that banks are now better equipped to cope with a negative trend. Banks have, among other things, improved their risk management systems and are also more diversified than they were 10 years ago.

Banks also increased their short-term exposure to the enterprise sector in 1999. At the end of the year, banks had granted more than NOK 200bn in different forms of operating credit (see Chart 9), a 10% increase compared with 1998. The utilisation ratio (ie credit used in relation to credit granted) declined marginally, however, in 1999. In isolation, this implies that liquidity in the enterprise sector improved and banks' credit risk declined. The utilisation ratio differed considerably across industries, however. Therefore, it is difficult to make any generalisations about trends in banks' credit risk based on this information alone.

Banks' housing loans increased from NOK 384bn to NOK 429bn in 1999 (see Chart 10). The degree to which this has affected banks' credit risk in the housing loan sector will depend on developments in the housing market and loan customer's debt-servicing capacity. One indicator of the credit risk in this sector is the debt-to-asset ratio. Chart 10 shows that the percentage of housing loans that were within 60% of a sound valuation was approximately the same in 1998 and 1999. At the end of 1999, more than 80% of banks' total housing loans were within 60% of a sound valuation. Therefore, it appears that banks have a relatively good safety margin on their housing loans. This is conditional on the calculation of a sound valuation. If the valuation is too high, the safety margin will be lower than shown in Chart 10.

So far, the increase in credit risk has not had a major effect on non-performing loans. Commercial banks' gross non-performing loans declined from NOK 11.2bn to NOK 10.7bn in 1999, whereas in savings banks, they rose, from NOK 6.5bn to 6.9bn. Commercial banks reduced their specified loan loss provisions, from NOK 5.3bn to NOK 4.6bn, which resulted in an increase in net non-performing loans, from NOK 5.9bn to NOK 6.1bn during the year (see Chart 11). Savings banks increased their specified loan loss provisions, from NOK 3.2bn to NOK 3.3bn. This resulted in a net increase in net non-performing loans, from NOK 3.3bn to NOK 3.6bn.

Chart 12 shows developments in high-risk loans in five of the largest Norwegian banks.[4] These banks reduced gross high-risk loans considerably from 1998 to 1999. Specified loan loss provisions were virtually unchanged, resulting in a substantial decline in net high-risk loans. Developments indicate that these banks expected lower loan losses at the end of 1999 than a year earlier.

There may be several factors that explain why the sharp increase in credit risk in parts of the enterprise sector has not resulted in a more pronounced rise in non-performing loans. One reason may be that it takes a long time before an increase in credit risk results in default. It was not until 1998 that credit risk increased in earnest. An enterprise with earnings problems can avoid default if the owners infuse new equity. However, there is a limit to how long this can continue with no improvement in underlying earnings. In addition, it is usually easier to negotiate an extension and refinancing during an upswing than during a downturn, especially if the value of the underlying collateral increases. The reduction in commercial banks' loan loss provisions and the sharp price increases in parts of the real estate sector indicate that the value of the underlying collateral has gone up. Improved opportunities for extensions and refinancing may have contributed to postponing the defaults. Other reasons for the low increase in defaults may be that the situation for high-risk enterprises has improved since 1998 (1999 figures are not yet available) or that Norges Bank's risk classification model overestimates the risk in the enterprise sector.

Financial strength

Commercial banks' total capital adequacy and core capital ratios were 10.9% and 8% respectively at the end of the last three years (see Table 13). Savings banks' total capital adequacy and core capital ratios have, however, gradually deteriorated the last few years (see Table 14). At the end of 1999, they were 13.7% and 11.2% respectively. The decline was somewhat greater in 1999 than in the other years, which is partly due to fairly solid growth in savings banks' lending to the enterprise sector. Both commercial banks' and savings banks' capital adequacy ratios continue to be well above the minimum requirements.

Most of the largest banks improved their total capital adequacy and core capital ratio in 1999 (see Chart 14). Some banks, however, had relatively low core capital ratios combined with high lending growth in 1999. Even so, the core capital ratio in these banks was well above the minimum requirement at year-end. The core capital ratio in financial groups (commercial banks) was also well above the minimum requirement. At the end of 1999, the core capital ratio was 8.4% and the total capital adequacy ratio was 11.5%. This was somewhat higher than comparable figures for commercial banks' parent banks.

Developments in other financial institutions

Mortgage companies' and finance companies' total assets and gross lending continued to increase in 1999 (see Table 24). In 1999, gross lending rose by 8% in mortgage companies and 27% in finance companies. Finance companies' net non-performing loans increased sharply in nominal terms in 1999. At the end of the year, this figure was considerably higher than in mortgage companies. As a percentage of total lending, however, net non-performing loans declined both in mortgage companies and finance companies.

Mortgage companies improved their core capital ratio from 12.8% to 13.3% in 1999, whereas finance companies' core capital ratio deteriorated from 12.5% to 10.9%. The deterioration in finance companies' core capital ratio is related to the sharp increase in gross lending, which contributed to a 35% increase in the companies' basis of measurement during the year. Part of the increase may be attributed to the transfer of a large loan portfolio to this group of institutions. Mortgage companies' basis of measurement only rose by 3% in the same period.

Life insurance companies further increased their shareholdings in 1999 (see Table 12). At the same time, they reduced their lending and holdings of other securities. This means that life insurance companies have increased their exposure to the stock market at the expense of their interest rate and lending exposure. The companies' "buffer capital" (ie equity and subordinated loan capital greater than 8%, supplementary provisions and unrealised capital gains) rose from 11% to 19.6% of the trading portfolio in 1999. Life insurance companies have thus strengthened their ability to withstand a decline in the value of their securities portfolio. The capital adequacy ratio declined from 11.8% to 11.5% in 1999.

Financial institutions' profit performance since the 1980s

a) Commercial banks

Commercial banks' operating profit after losses peaked in 1983, but declined thereafter until 1991 (see Chart 1a). In 1991, post-loss operating results troughed as a result of major losses and write-downs on fixed assets. Since 1993, commercial banks have had a positive operating profit after losses. Operating profit both before and after losses was higher in 1999 than in 1998. This is primarily due to higher other operating income and lower losses.

b) Savings banks

Savings banks' post-loss operating profit peaked in 1982, but declined steadily until 1991 (see Chart 1b). Like the commercial banks, savings banks recorded heavy losses and had major write-downs on fixed assets in 1991. Since 1992, savings banks have posted positive operating results after losses. Operating profit both before and after losses was higher in 1999 than in 1998 as a result of higher other operating income.

c) Mortgage companies

Mortgage companies as a group had positive operating results after losses throughout the 1980s (see Chart 1c). During the period 1990-1992, operating results were negative due to substantial losses. Since then, mortgage companies have reported positive operating results after losses. As in banks, operating profit after losses was higher in 1999 than in 1998 due to higher net interest income and other operating income.

d) Finance companies

In the early 1980s, finance companies' operating results after losses were on a par with the level recorded by banks (see Chart 1d). Finance companies encountered problems earlier than banks in the 1980s and reported negative operating results after losses in the period 1986-1990. Since 1991, finance companies have posted positive operating results after losses. Operating profit after losses was lower in 1999 than in 1998, partly because of higher losses. Operating profit before losses was somewhat higher in 1999 than in 1998.

[1] Box 1 discusses competitive conditions, with emphasis on competition from Nordic institutions.
[2] In the article, we focus primarily on items in the profit and loss account as a percentage of ATA. Due to growth in the balance sheet, many of the items show an increase in NOK.
[3] This is described in more detail in Norges Bank's Inflation Report 1/2000.
[4] These banks accounted for about 60% of banks' total lending to non-financial customers at the end of 1999.