



NORWEGIAN MINISTRY OF FINANCE

Meld. St. 29 (2015–2016) Report to the Storting (white paper) Summary

Financial Markets Report 2015

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*Recommendation of the Ministry of Finance of 22 April 2016,
approved by the Council of State on the same day.
(Government Solberg)*

1 Introduction

The Ministry of Finance annually submits a report to the Storting on developments in Norwegian and international financial markets. This year, selected sections of the report are made available in English.

Chapter 2 addresses the financial stability outlook in Norway. The chapter includes reviews and assessments of market conditions, risk outlook for financial institutions, and the solvency, liquidity and earnings of such institutions.

Chapter 3 discusses a holistic approach to financial markets policy. It covers topics such as structure and competition in the Norwegian financial market, and access to capital for Norwegian businesses.

Chapter 4 provides a summary of implemented regulatory changes in 2015.

Chapter 5 contains a review of Norges Bank's conduct of monetary policy and the Ministry's assessment of this. The chapter corresponds to section 6.5 of the Norwegian version of the report.

In addition to the chapters included in the English version, the Norwegian version of the report includes chapters on key legislative initiatives, and the activities of Norges Bank, Finanstilsynet and Folketrygdfondet (which manages the Government Pension Fund Norway).

2 Financial stability outlook

2.1 Introduction

The financial sector consists of financial institutions, financial markets and financial infrastructure. It provides a wide range of products and services, including savings products, mortgages, damage and personal injury insurance, pension saving, payment services, and commercial loans. Well-functioning financial markets are a prerequisite for economic growth and contribute to individual economic security.

Financial stability implies that the financial system is sufficiently resilient to receive deposits and other repayable funds from the public, arrange financing, make payments and reallocate risk in a satisfactory manner. This chapter shows that in 2015, financial institutions improved their ability to absorb losses without seriously weakening these important functions. Financial institutions also boosted their ability to function when access to new funding is reduced.

The financial stability outlook is affected by economic developments outside the financial sector. Losses among banks and other parties holding receivables from Norwegian households and businesses remained small in 2015. However, as the discussion of the macroeconomic picture, the market situation and risk developments shows, the risk of losses on loans to Norwegian households and businesses increased in 2015.

2.2 The macroeconomic situation

The decline in oil prices since the summer of 2014 has reduced growth and increased unemployment in the Norwegian economy. Lower interest rates are helping to maintain consumption and investment growth, while a weakened Norwegian krone is fuelling production among businesses competing abroad. Fiscal policy is now having an expansionary effect on the economy.

Growth among Norway's trading partners picked up slightly last year, driven by growth in the OECD countries. While the Eurozone

Box 2.1 Responsibility for financial stability

Responsibility for the safeguarding of financial stability in Norway is shared between the Ministry of Finance, Norges Bank (the central bank of Norway) and Finanstilsynet (the Financial Supervisory Authority of Norway). The Ministry of Finance has overarching responsibility for ensuring that the financial system functions well. Norges Bank and Finanstilsynet are tasked with promoting the robustness and efficiency of the financial system, and therefore with monitoring of financial institutions, securities markets and payment systems to identify stability threats. Moreover, Finanstilsynet supervises individual financial institutions and marketplaces. Norges Bank is the lender of last resort.

In 2006, so-called tripartite meetings were established between the Ministry of Finance, Norges Bank and Finanstilsynet. At these meetings, information is exchanged about Norwegian and international economic developments and the state of the financial markets. These meetings are held every six months, and more frequently when needed. Two such meetings were held in 2015.

recorded a modest increase, the Swedish economy grew strongly. The European Central Bank has ramped up its programme of expansionary measures. Sveriges Riksbank is also pursuing strongly expansionary monetary policy. In China, growth remains relatively high despite a slight slowdown, and the Chinese authorities are implementing expansionary budgetary and monetary policies. Russia and Brazil have been hit hard by low commodity prices. There is considerable uncertainty about future developments in China and other emerging economies. The situation in

the Middle East, refugee flows to Europe and the United Kingdom's referendum on EU membership also contribute to uncertainty.

Uncertainty about economic developments has fuelled market turbulence. International stock market indices recovered somewhat during the second half of February and March, after strong falls at the beginning of 2016. Several emerging economies have experienced capital outflows and sharp currency devaluations. Turbulence in international financial markets may undermine real economic growth going forward.

The weakening of the Norwegian krone and more moderate wage growth has improved competitiveness among Norwegian businesses. Some companies are reporting higher earnings due to the krone's depreciation. However, it may take time for improved profitability to raise activity levels, partly because firms are uncertain about future developments and partly because some businesses have hedged against large movements in the krone exchange rate. The volume of exports from the mainland economy has risen despite falling demand from the international petroleum industry. Increased competitiveness has also helped Norwegian exporters win many of the contracts linked to the development of the Johan Sverdrup oil field.

Although consumers became more pessimistic in their assessments of the economic outlook in 2015, household demand for goods and services continues to grow at a moderate pace.

While house price inflation has slowed somewhat, there are substantial geographical differences. For example, house prices rose by 8 percent in Oslo over the past year but fell by close to 5 percent in Rogaland.

Although the rise in registered unemployment declined in the first quarter, LFS unemployment has risen markedly so far this year. The difference between the two figures has also increased as a result. The rise in LFS unemployment in the first quarter is linked to an increase in the number of young job seekers. Since they are not entitled to unemployment benefits, they probably do not register as unemployed with the Norwegian Labour and Welfare Administration (NAV). Figures provided by NAV show that unemployment has primarily risen in counties with strong ties to the oil industry.

In the National Budget 2016, the Ministry of Finance forecast growth in mainland Norway GDP of 1.8 percent this year. Oil price developments have been significantly weaker than anticipated. This indicates that growth in the Norwe-

gian economy may be less than forecast in the budget published last autumn. The Ministry of Finance will present new estimates in the revised national budget in May.

2.3 Financial stability outlook

In 2015, the fall in oil prices and low interest rates were two main trends which potentially could affect financial stability in Norway.

Oil-related businesses account for a considerable proportion of the Norwegian economy.¹ The central role of the oil industry in the Norwegian economy means that falling oil prices may threaten financial stability. The fall in oil prices may impact financial stability both directly – when banks have to accept losses on loans to the oil industry – and indirectly in the form of weakened growth prospects for the Norwegian economy. Bank exposure to the oil sector is discussed in section 2.3.1. The drop in oil prices is also affecting activity levels in the Norwegian securities market, where the high-yield bond segment is dominated by companies with direct or indirect links to the oil sector; see section 2.3.6.

Internationally, interest rates have fallen since the financial crisis, and are now at record lows both in nominal and real terms. Key policy rates are close to zero in many countries, and in some cases negative; see Box 2.2. The experience of Norway and other countries thus far is that cutting the interest rate level helps reduce losses and defaults in bank lending portfolios, and that low interest rates boost demand for credit from banks without weakening banks' interest rate margins. Experience also shows that low interest rates may encourage excessive borrowing by households and businesses. To date, there are few signs that Norwegian businesses in general have reduced their capital ratios, despite low borrowing rates in recent years. However, highly indebted Norwegian households are vulnerable to economic shocks such as falling oil prices and rising unemployment. Issues relating to debt growth in Norway are discussed in section 2.3.3.

Pension funds and life insurance companies have generally refocused their sales and marketing in recent years, focusing on products and services which assign market risk to the insured parties. This transition began after the adoption of the

¹ Calculations show that petroleum industry demand amounts to between 12 and 17 percent of mainland Norway GDP. Source: Finanstilsynet, Financial Trends 2015.

Defined Contribution Pension Schemes Act in 2000. See also the discussion in section 2.3.5.

2.3.1 Bank exposure to the oil sector

Lower oil prices mean lower petroleum industry earnings. Lower earnings reduce the debt-servicing capacity of companies in the industry, in turn potentially requiring banks to accept larger losses on loans to the oil industry and oil-related sectors. The largest Norwegian banks are the primary lenders to the oil industry and oil-related sectors. In January 2015, Finanstilsynet gathered information on the credit exposures of the seven largest Norwegian banks to the oil industry and oil-related sectors and companies. The banks themselves estimated that lower oil prices would have a direct negative impact on between 5 and 25 percent of the individual banks' aggregate business-market portfolios. Four of the banks also specified their credit exposure to companies which are indirectly affected by oil prices. Among these banks, the proportion varied from 4 to 12 percent.²

A sensitivity analysis conducted by Finanstilsynet shows that, in an extreme but not unrealistic situation, several of the Norwegian banks with the highest oil exposures may achieve only a break-even pre-tax result due solely to loan losses on oil and oil-related exposures.³ The analysis shows that the banks with the greatest oil-sector exposures are most vulnerable to drops in oil prices. Since fewer projects are profitable when oil prices are depressed, such drops cause oil industry actors to cut investment. A decline in oil-related investments also increases the risk of losses on loans to companies which are less directly affected by oil prices, such as commercial real estate companies and consultancy firms. In 2015, bank losses remained small, even in the counties with the highest rates of oil-industry employment. However, credit risk has increased, and banks must also be prepared for increased losses on loans to companies less directly impacted by oil prices if low oil prices weaken longer-term growth in the Norwegian economy.

As part of its Financial Sector Assessment Program (FSAP), the IMF has analysed links and ripple effects between different sectors in the Norwegian economy.⁴ In particular, the IMF exam-

ined the impact of other industries on the development of the financial industry. The results of the IMF analysis indicate that approximately 30 percent of bank results can be explained by developments in oil-related activities and the effect of such activities on other mainland industries. This proportion is higher than indicated, in isolation, by the share of total lending accounted for by bank loans to the oil sector. The IMF analysis also shows that the outlook for the real estate sector depends on oil industry developments.

2.3.2 Improved bank solvency

The years after the financial crisis have been a period of prolonged strong development of the Norwegian economy. The economic growth has been a boon to Norwegian banks as it has contributed to low losses, high demand from borrowers, and easy access to financing. This has allowed banks to deliver strong results for several years. In 2015, banks achieved a pre-tax profit of more than NOK 57 billion – the highest ever annual profit and around 6 percent higher than in 2014. However, profits as a proportion of average capital under management dropped slightly, to 1.1 percent. The return on equity (calculated as the post-tax profit/loss relative to equity), was 12.2 percent in 2015, 0.6 percentage points lower than in the previous year; see Figure 2.2.

Net interest income, i.e. the difference between interest income and interest costs, accounts for approximately three-quarters of Norwegian banks' total revenues. The interest rates charged by banks on their loans have fallen in recent years, see Figure 2.6, although cheaper bank financing in the securities markets has helped reduce interest costs. A contributory factor is that creditor risk has declined, not least as a result of higher equity holdings among banks. Higher equity levels also help reduce the need for banks to debt finance their lending activities.

The need for monetary policy measures following the financial crisis has renewed interest in how the interest rate level and the shape of the yield curve, respectively, affect bank profits. On the one hand, low interest rates reduce defaults in the short term and increase securities gains, which in turn boost bank profits. Nonetheless, an empirical

² In the case of banks with no estimated exposures to companies indirectly affected by lower oil prices, Finanstilsynet estimates that lower oil prices will have an indirect negative impact on around 3.5 percent of the corporate loan portfolios of these banks.

³ Finanstilsynet, Financial Trends 2015.

⁴ The International Monetary Fund (IMF) regularly conducts thorough reviews of the financial systems of its member countries under its Financial Sector Assessment Program (FSAP). Norway was the subject of a review from the summer of 2014 to the summer of 2015; see Box 4.3.

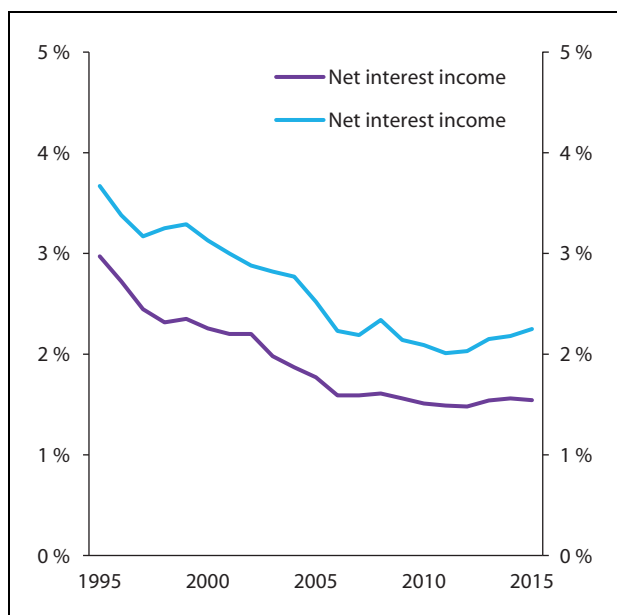


Figure 2.1 Net interest income as a proportion of average capital under management and interest rate margin. Percent

Source: Finanstilsynet

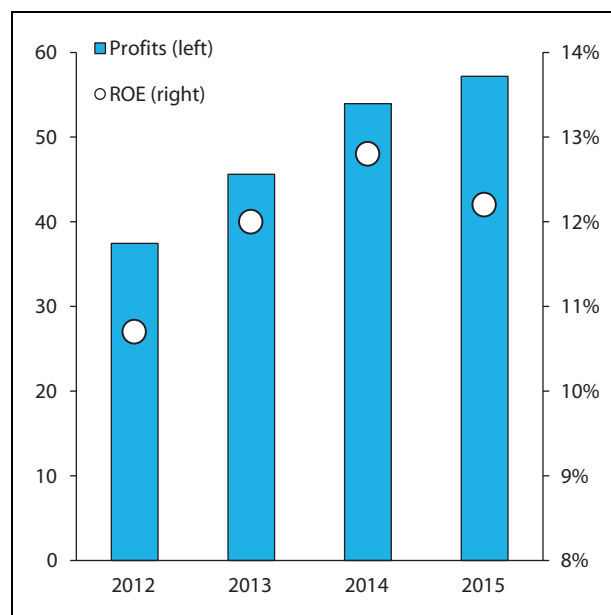


Figure 2.2 Profits of Norwegian banks in NOK billion (left axis) and return on equity (right axis)

Source: Finanstilsynet

study by the Bank for International Settlements (BIS) indicates that the positive contributions are insufficient to counter a reduction in banks' net interest income.⁵ In the case of banks, which convert liquid or short-term deposits into long-term loans (so-called maturity transformation), a flatter yield curve will, all other things being equal, also

⁵ BIS Annual Report 2015.

reduce net interest income. Moreover, a flatter yield curve and low interest rates may arise simultaneously, as at present in many European countries. The Bank for International Settlements finds that the links between the interest rate level and bank earnings are not linear, and that the negative effect on bank interest income is stronger as the yield curve flattens or the interest rate level approaches zero; see Box 2.2.

Box 2.2 Negative interest rates

After the financial crisis, key policy rates have reached very low levels, in many cases approaching zero. Four European central banks have introduced negative key policy rates since mid-2014. The primary motivations behind negative key policy rates have been to counter weak inflation (in the Eurozone and Sweden) and to depreciate a strong currency (in Switzerland and Denmark).

Economic literature has often assumed that the nominal interest rate level cannot fall (significantly) below zero because it will always be possible to achieve a nominal interest rate level of zero by holding cash. In reality, however, holding cash gives rise to costs (e.g. security

measures, transportation and insurance), and the effective lower bound therefore lies somewhat below zero. Countries with negative key policy rates have found that the money markets mostly track falling key policy rates. However, the deposit rates offered to customers by banks appear to correlate less closely, and demand for bank deposits has thus not dropped off markedly.

Negative interest rates have also presented practical challenges, including clarification of tax questions (Denmark), adjustment of settlement systems (Sweden) and changes in the contract terms of residential mortgages indexed to the key policy rate (Switzerland).

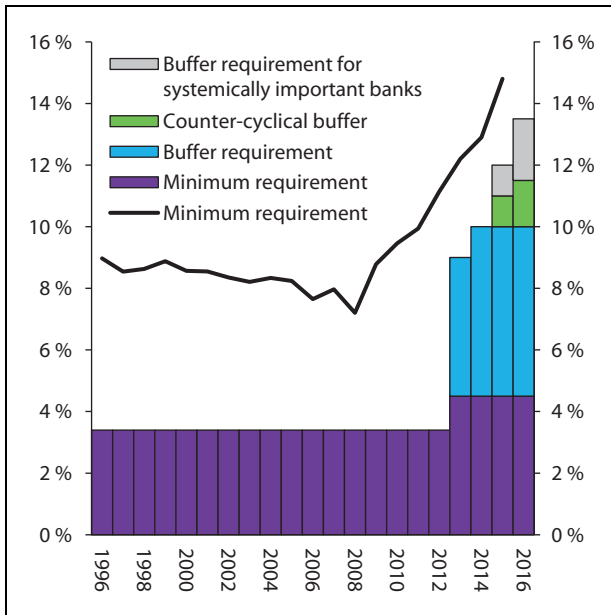


Figure 2.3 CET1 capital as a percentage of risk-weighted assets for Norwegian banks and banking groups, and CET 1 capital adequacy minimum and buffer requirements

Source: Finanstilsynet and the Ministry of Finance

Strong profits and moderate dividends have allowed Norwegian banks to improve their solvency in recent years by retaining profits. Their improved solvency means that Norwegian banks are now better equipped to absorb losses.

Only capital capable of protecting ordinary customers against losses may be approved as regulatory capital. However, regulatory capital consists of elements of differing quality (loss-absorption capacity). CET1 capital is the highest-quality part of the total capital, and is used first to cover any losses. CET1 capital largely comprises bank equity. The remainder of the total capital consists of tier 2 capital and other instruments which share characteristics with both debt and equity, and can only be used to cover losses if the CET 1 capital is lost.

Banks with substantial CET 1 capital have a lower risk of suffering financial difficulties due to losses. Such banks also present a lower risk of pre-empting potential problems by tightening lending practices during an economic downturn. The level of CET 1 capital is thus more important for the stability of the economy and the banking system than the level of other total regulatory capital. A particular stabilising factor is that systemically important banks have a strong ability to continue operating after making losses. If such a bank tightens its lending practices during a downturn,

Box 2.3 Losses and default

Loan losses were 4 percent higher in 2015 than in 2014, and amounted to 0.17 percent of the total lending balance. Losses amounted to 10 percent of banks' pre-loss profits, or 1.7 percent of their equity. The volume of defaulted loans was reduced by 5 percent in 2015, although it increased slightly in the fourth quarter. Defaulted loans accounted for 1.1 percent of total bank loans at the end of 2015, representing a drop of 0.2 percentage points from 2014; see Figure 2.4.¹

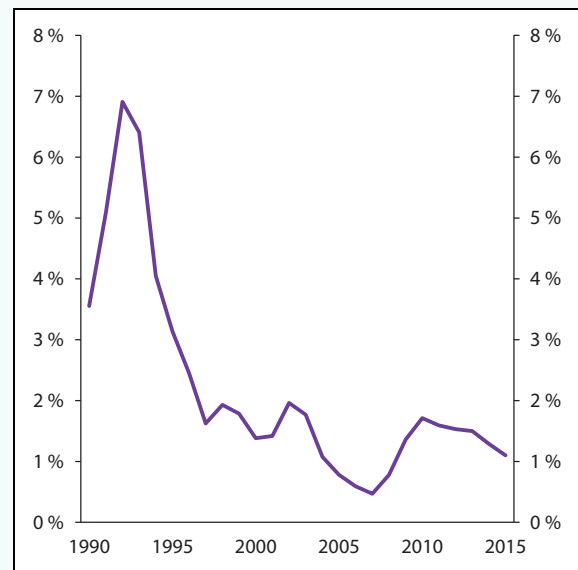


Figure 2.4 Defaults on loans from Norwegian banks. Percent of lending volume

Source: Finanstilsynet

¹ Classified as being in default no later than 30 days after the due date/date of overdrawing.

this alone may impact the economy in terms of accelerating and deepening the downturn. Solvent banks stabilise both one another and the economy during a downturn.

CET1 capital adequacy expresses a bank's CET 1 capital as a percentage of risk-weighted assets, and is the most important indicator for measuring and comparing the solvency of banks internationally and in Norway. Risk-weighting entails adjusting the value of an asset, such as a loan, based on the likelihood and size of the potential loss. CET 1 capital adequacy thus provides a figure designed to reflect loss-absorption capacity. However, this figure greatly simplifies compli-

Box 2.4 Counter-cyclical capital buffer requirement

The counter-cyclical capital buffer requirement is an element of the new capital requirements legislation introduced in Norway in 2013, which are based on the EU's new capital requirements rules (the CRR/CRD IV framework). The level of the counter-cyclical requirement is to be adjusted in view of developments in the Norwegian economy, and is set to ensure that banks reinforce their solvency in periods of economic growth. The requirement will vary between 0 and 2.5 percent of risk weighted assets. The purpose of the counter-cyclical capital buffer is to improve the capacity of banks to absorb loan losses during a future downturn and reduce the risk of banks amplifying an economic downturn through more restrictive lending practices. The counter-cyclical buffer requirement is a tool which shall be applied during periods of particularly high credit growth or other developments which increase cyclical systemic risk. If economic activity declines, the requirement may be

lowered or reduced to zero. Whereas an increase in the counter-cyclical buffer requirement normally has to be notified at least 12 months in advance, a reduction can be implemented immediately.

The Ministry of Finance sets the level of the counter-cyclical capital buffer every quarter. Norges Bank is mandated to provide supporting data and advise the Ministry on the appropriate level. The bank does this through both its monetary policy reports and separate letters of advice to the Ministry.

In December 2013, the Ministry of Finance decided that banks must meet a counter-cyclical capital buffer requirement of 1 percent of risk weighted assets as from 30 June 2015. The decision remained in force throughout 2014. In June 2015, in line with advice from Norges Bank, the Ministry decided that the counter-cyclical capital buffer requirement should be increased to 1.5 percent with effect from 30 June 2016.

cated interconnections, and may also be misleading if, for example, the risk weights are too low relative to real risk. Different risk-weighting of the assets of different banks may also produce considerable differences in CET 1 capital adequacy, without the banks necessarily having different risk levels.

Another key solvency indicator is the leverage ratio, i.e. a bank's tier 1 capital as a percentage of a non-weighted exposure measure (total assets and non-balance sheet items). There is some concern that risk weights internationally have fallen too low, and plans have therefore been made to introduce a leverage ratio requirement to prevent the absolute volume of loss-absorption capital from becoming too small; see further discussion in section 3.3.5.

The average risk-weighted CET 1 capital adequacy ratio of Norwegian banks was 14.7 percent at the end of 2015; see Figure 2.3, representing an increase of 1.8 percentage points from 2014. The CET 1 capital adequacy ratio for banks as a whole has risen steadily since 2008, by a total of 7.6 percentage points. The increase in the CET 1 capital

Box 2.5 Systemically important financial institutions

To reduce the likelihood of individual institutions experiencing financial problems with serious negative consequences for the financial system and the real economy, section 14-3 of the Financial Undertakings Act requires systemically important financial institutions to maintain a CET 1 capital buffer totalling 2 percentage points in addition to the minimum CET 1 capital requirement, the capital conservation buffer and the systemic risk buffer.

Every year, the Ministry of Finance is required to decide which financial institutions are of systemic importance in Norway. The Ministry identified DNB ASA, Nordea Bank Norge ASA and Kommunalbanken AS as systemically important financial institutions in May 2014, and reaffirmed their status in June 2015.

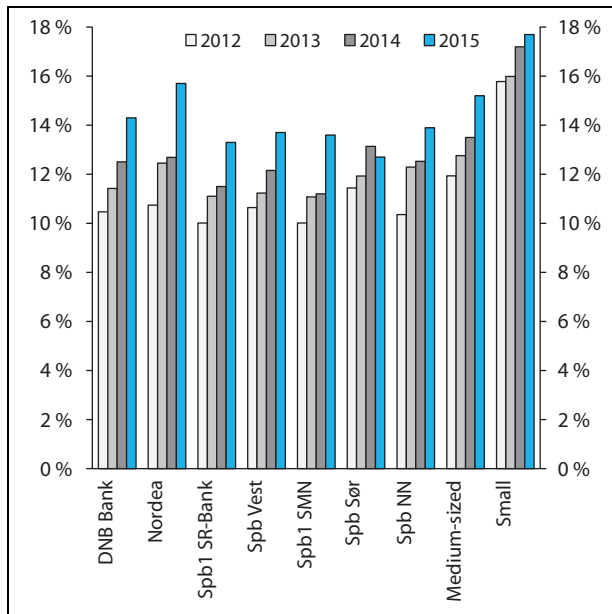


Figure 2.5 CET1 capital of Norwegian banks.¹
Percent of risk weighted assets

¹ Medium-sized banks are defined as banks with more than NOK 10 billion in capital under management. Small banks are banks with less than NOK 10 billion in capital under management.

Source: Finanstilsynet

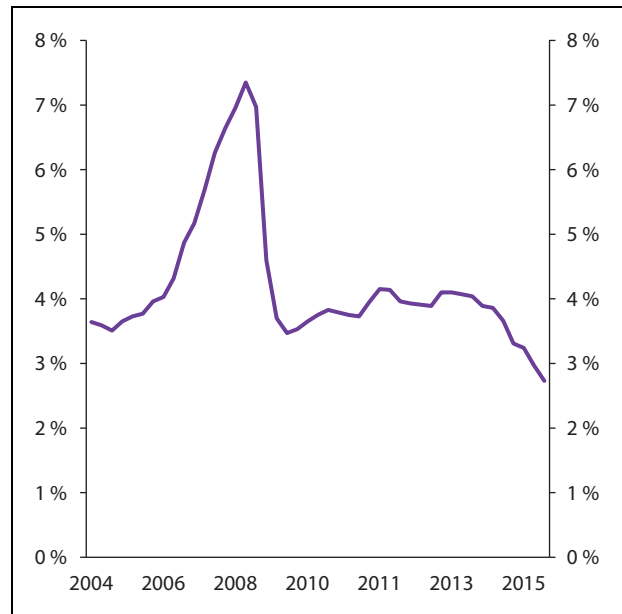


Figure 2.6 Interest rate on residential mortgages issued to private customers. Weighted average of all banks in Norway, including mortgage companies that can issue covered bonds. Percent

Source: Finanstilsynet

adequacy ratios of Norwegian banks following the international financial crisis indicates that Norwegian banks are now significantly better equipped to deal with a downturn in the Norwegian economy. The increase in the CET 1 capital adequacy ratio reflects stricter requirements, and all Norwegian banks met the current minimum requirements and buffer requirements at the end of 2015. The leverage ratio of Norwegian banks totalled 7.1 percent at the end of 2015. The difference between the (risk-weighted) CET 1 capital adequacy ratio and the leverage ratio has been increasing for several years.

2.3.3 Debt

2.3.3.1 Household debt growth

Loans from financial institutions represent debt in other sectors. Loans to households account for more than half of the total lending balance of Norwegian banks and mortgage companies, and over 90 percent of household debt consists of residential mortgages. Norwegian banks' credit risk is therefore closely linked with the ability of Norwegian households to pay interest and instalments on their residential mortgages. The actions of households also impact indirectly on bank credit risk, for exam-

ple through bank loans to businesses vulnerable to changes in household consumption.

The debt burden and the interest burden are indicators of the ability of households to service debt. The interest burden is interest expenditure as a percentage of disposable income. Due to low residential mortgage rates in recent years, the interest burden of Norwegian households has not been particularly high; see Figure 2.7. Average residential mortgage interest rates fell by 0.9 percentage points in 2015; see Figure 2.6. Interest rates are expected to remain low in the near future.

Low interest rates stimulate demand for loans, and Norwegian households' debt growth has outpaced their income growth among for several years, increasing the debt burden. According to Norges Bank, the debt burden (gross debts as a percentage of disposable income) now exceeds 215 percent – a high level both from a historical perspective and compared with other countries. Household indebtedness has been identified as one of the primary vulnerabilities of the Norwegian financial system not only by national authorities such as Finanstilsynet and Norges Bank, but also by international organisations like the IMF and OECD.

High debt levels increase the vulnerability of households in the event of adverse economic

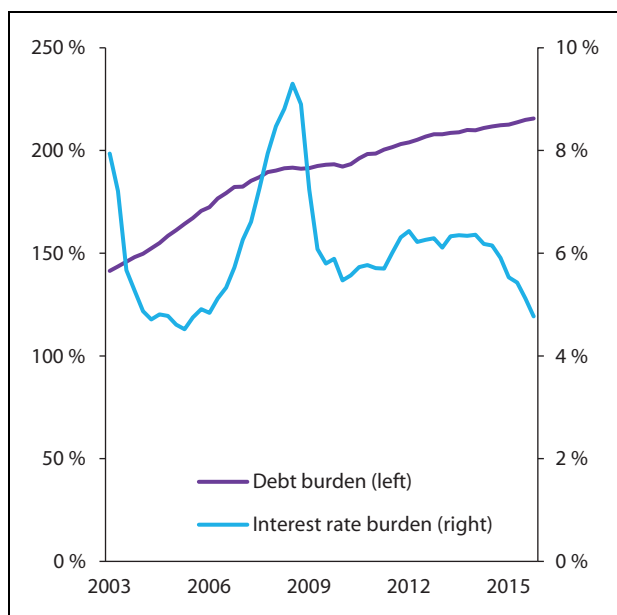


Figure 2.7 Household debt burden (left axis) and interest rate burden (right axis). Percent

Source: Statistics Norway and Norges Bank

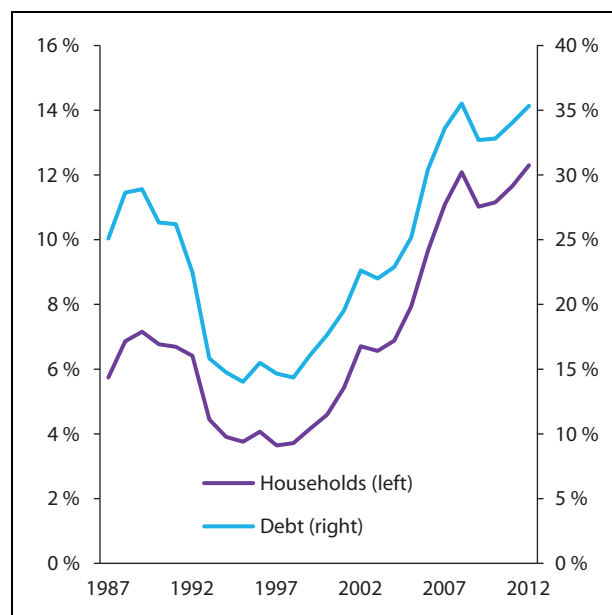


Figure 2.8 Households with debts exceeding five times disposable income. Proportion of households and debt

Source: Statistics Norway and Norges Bank

developments such as falling housing prices, and thus increase the likelihood of a subsequent cut in consumption. Debt growth more in line with household income growth may therefore promote a more stable growth in demand for goods and services. With the aim of more sustainable housing price and household debt growth, the Ministry of Finance adopted regulations on new residential mortgages on 15 June 2015; see section 4.1.2. There are signs of a slowdown in household credit growth. In February 2016, the annualized growth rate was 6.0 percent. Nevertheless, debt growth remains higher than income growth, and there is considerable uncertainty about future developments.

The proportion of households with debts exceeding five times disposable income has increased since the late 1990s; see Figure 2.8. These highly indebted households also hold an increasing share of total debt. However, this group comprises primarily younger households and households with medium to high incomes. Although a high debt burden renders households more vulnerable, it should generally be easier to handle for households with high incomes or expected income growth.

Thorough credit assessment and correct loan pricing may restrain households from amassing

more debt than they are able to service, and may therefore also assist in limiting the development of debt problems among households. Lenders require information about matters such as a borrower's total debt burden in order to run an optimal assessment process. A register of personal debt, available to lenders in the credit assessment process, could be a useful tool for providing such information. One measure proposed in the Government's strategy for the housing market, presented in the spring of 2015, was to permit the creation of such a debt register by private actors.

The risk of financial imbalances developing in households is particularly acute during a prolonged upturn or – as in recent years – when interest rates remain low and demand for loans remains high for a long period of time. If banks' lending practices are imprudent during such periods of high loan demand, major imbalances may develop in an economy. Finanstilsynet reviews banks' mortgage lending practices annually. The most recent residential mortgage survey, from the autumn of 2015, shows that banks have tightened lending practices somewhat but continue to grant a significant number of loans resulting in high borrower indebtedness; see Box 2.7.

Box 2.6 Consumer loans

Various financial institutions and some banks engage in consumer financing. Consumer loans are generally unsecured and entail high credit risk. Strong profitability has attracted new providers to the consumer loans market, and the growth in such loans has outpaced general household credit growth.

Household borrowing for consumption purposes accounts for a small, but increasing, proportion of total household debt. Demand for such loans has risen significantly in recent years; see Figure 2.9. Unsecured consumer loans accounted for approximately 3 percent of total household debt at the end of 2015. The annual consumer-lending growth rate of selected¹ banks and finan-

cial institutions was 12.4 percent at year-end 2015, up from 9.7 percent the previous year.

Losses on consumer loans were low in 2015, at 0.2 percent of lending volume, down from 1.3 percent in 2014; see Figure 2.10. The level of losses was on a par with the previous year (when adjusted for recognition of previous losses). However, the gross default rate on consumer loans increased from 4.5 percent at the end of 2014 to 5.3 percent at year-end 2015.

¹ The selected companies cover the majority of the market. The sample comprised 22 companies at the end of 2015 (12 banks and 10 finance companies). It includes both Norwegian companies and Norwegian branches of foreign entities.

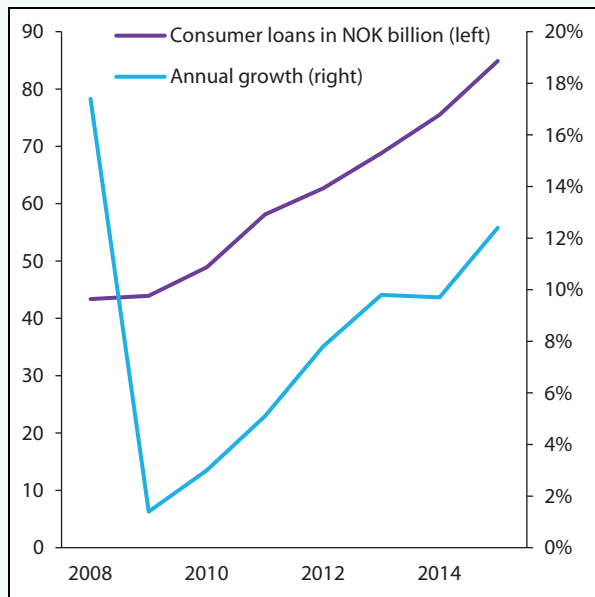


Figure 2.9 Consumer loans in NOK billion and annual growth in percent, selected banks and financial institutions

Source: Finanstilsynet

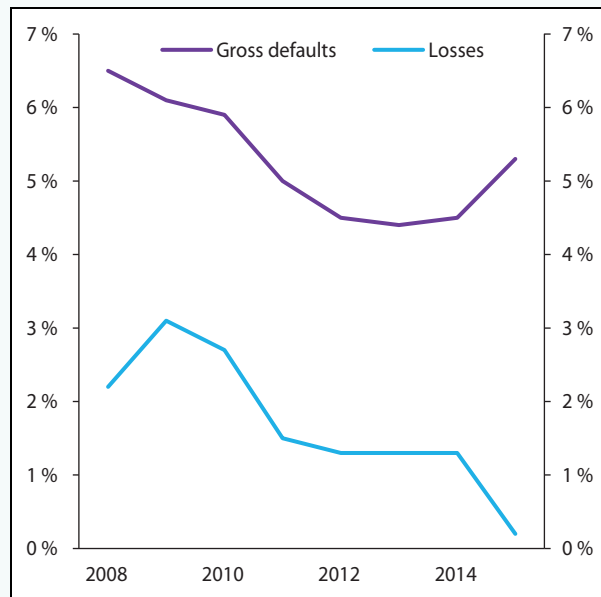


Figure 2.10 Gross defaults (90 days) as a percentage of consumer loans and loan losses as a percentage of lending volume

Source: Finanstilsynet

Box 2.7 Finanstilsynet's residential mortgage survey

Finanstilsynet reviews banks' issuance of residential mortgages every year. The most recent residential mortgage survey was conducted in the autumn of 2015. Among loans included in the survey, 30 percent related to housing purchases. Some 6 percent of these loans were used to buy a second home. The proportion of loans used for second-home purchases has remained unchanged since 2012. The remaining loans were linked to the refinancing of an existing mortgage from the same bank (60 percent) or another bank (10 percent).

The survey findings include that around 16 percent of new residential mortgages had an loan-to-value (LTV) ratio of more than 85 percent – a drop of 3 percentage points from the previous year; see Figure 2.11. Accounting for additional collateral, 7 percent of loans had an LTV ratio exceeding 85 percent. The average LTV ratio rose from 65 percent in 2014 to 68 percent in 2015. For loans used for house purchases, the average LTV ratio was 76 percent. Some 28 percent of loans used for housing purchases had an LTV ratio above 85 percent, while 12 percent had an LTV ratio exceeding 100 percent. When additional collateral is included, these figures drop to 13 percent and 1 percent respectively.

Banks had obtained additional collateral for about two-thirds of amortising loans with a LTV ratio above 85 percent – an increase of approximately 10 percentage points compared to the period 2012–2014.

Average indebtedness, measured as total debt relative to gross income, was 297 percent among borrowers taking up amortising loans secured by residential mortgage. This represents a drop of 8 percentage points from 2014. Average indebtedness among young borrowers under the age of 35 was 341 percent, a drop of 15 percentage points compared to the previous year.

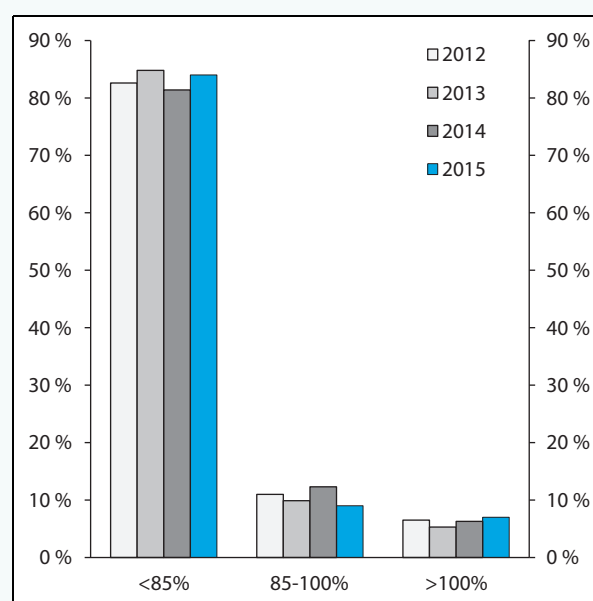


Figure 2.11 Distribution of loans by LTV ratio. Residential mortgage survey

Source: Finanstilsynet

2.3.3.2 Corporate debt

Around 30 percent of bank loans in Norway are made to commercial parties. The debt-servicing capacity of Norwegian businesses is therefore an important indicator of banks' credit risk.

The growth rate of bank lending in the domestic business market was 5.6 percent at the end of 2015, although the rate declined towards the end of the year, sinking by 2.3 percentage points in the fourth quarter. In Norges Bank's fourth-quarter lending survey, banks reported somewhat stricter corporate credit practice, including in relation to loans for the purchase of commercial real estate. Corporate debt growth has generally been lower after the financial crisis than in the years leading

up to the crisis. Corporate debt and corporate investment are more closely linked to the economic cycle than the debts and investments of households, and in a downturn banks typically tighten credit standards for businesses. Corporate debt growth is therefore more volatile than household debt growth. However, volatility has decreased since the financial crisis.

Bank margins on commercial loans – measured as the difference between the lending rate and the three-month effective Nibor rate – have fallen in the past two years. Together with the declining interest rate level, this has lowered corporate lending interest rates; see Figure 2.13. The premium on bonds with a five-year maturity issued by low-risk industrial enterprises fell

Box 2.8 Housing market developments

As an annual average, housing prices increased by 7.2 percent in nominal terms in 2015. Corrected for consumer price inflation, the increase was around 5 percent, clearly stronger than in 2014, when housing prices rose by 0.3 percent in real terms. House price inflation has slowed over the past half-year, presumably due to lower growth and higher unemployment in the Norwegian economy.

The high level of housing prices in Norway is linked to a preceding period of high income growth, strong population growth and low interest rates. Easy access to bank credit has also pushed up prices. Expectations of continued price inflation may also have contributed. In addition, factors such as a shortage of building plots, higher wage costs, stricter design requirements for new-builds and lower productivity in the construction industry have inflated building costs. Some of the cost increase has been rolled over into housing prices.

Increased urbanisation and differences in activity levels and income development have contributed to regional differences in housing price developments. Lower petroleum industry activity has resulted in rising unemployment in southern and western Norway. As a result, housing price growth has been significantly weaker in Stavanger than in other major cities over the past year; see Figure 2.12. Whereas housing prices in Oslo rose by 8.1 percent from February last year to February this year, in Stavanger they fell by 7.4 percent during the same period.

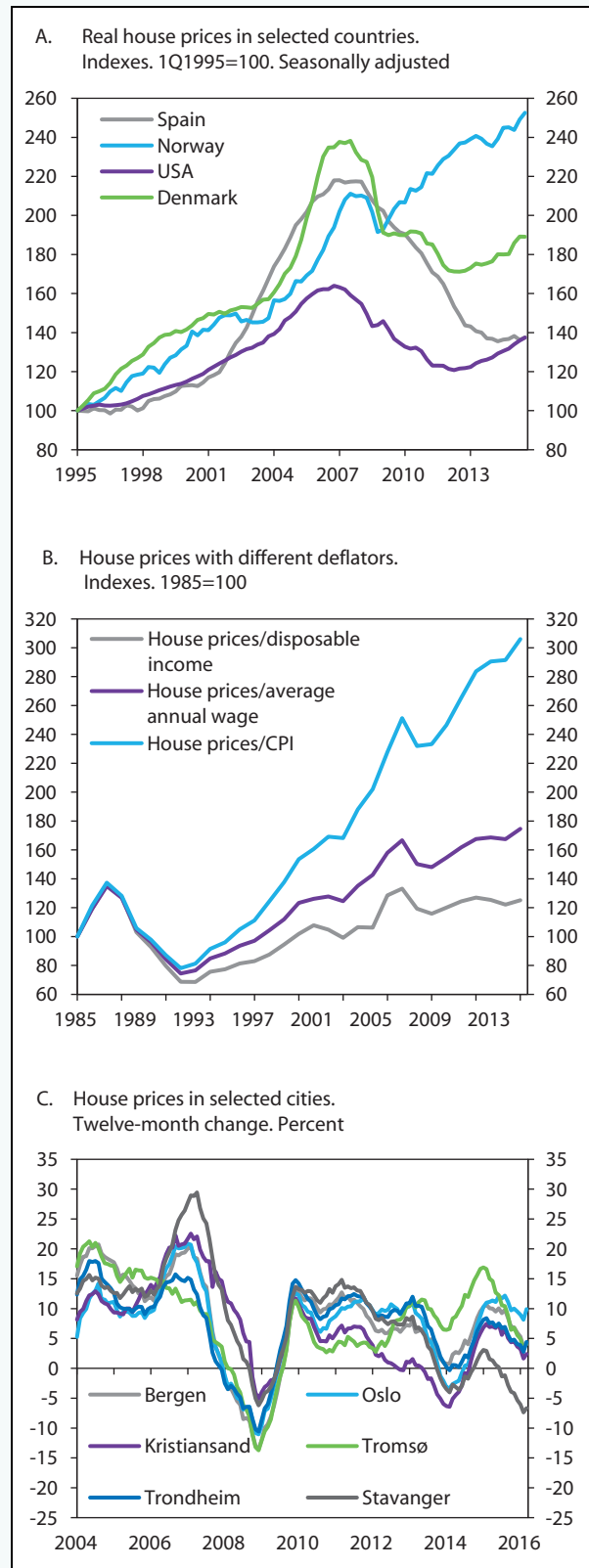


Figure 2.12 Housing price developments

Source: Real Estate Norway, Finn, Eiendomsverdi AS, Statistics Norway, Macrobond and Ministry of Finance

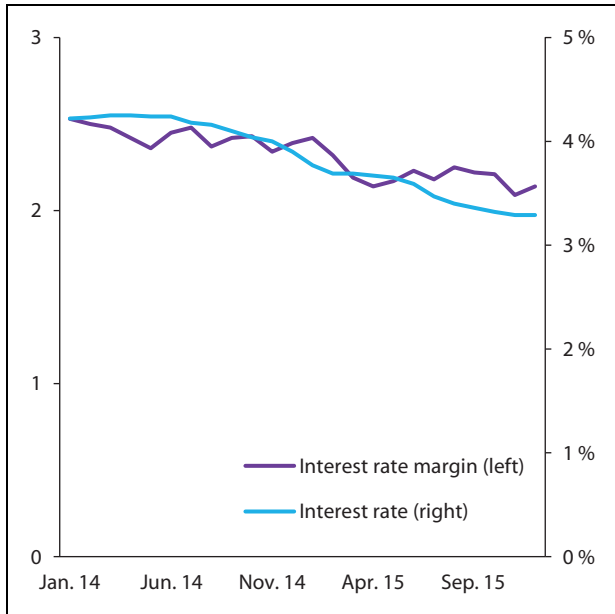


Figure 2.13 Margin on corporate loans in percentage points (left axis) and interest rate (right axis). Outstanding loans
Source: Norges Bank

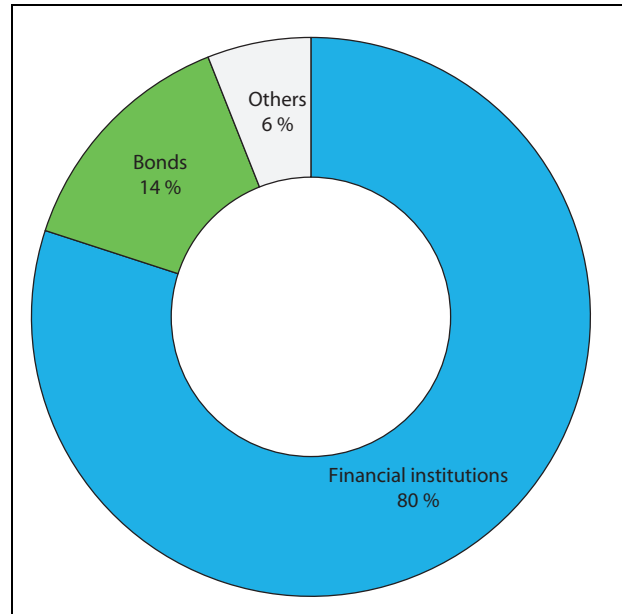


Figure 2.14 Domestic corporate debt by credit source
Source: Statistics Norway and Finanstilsynet

throughout 2014 before stabilising at a low level in the first half of 2015. The premium rose from around 60 basis points above three-month Nibor in the summer of 2015 to approximately 140 basis points by the end of the year.

Loans from credit institutions make up the majority of domestic corporate debt; see Figure 2.14. Norwegian corporate debt growth in Norway and abroad are highly correlated, indicating that corporate borrowing abroad is generally not the result of low supply in Norway, and vice versa. A lower share of foreign borrowing is taking the form of traditional loans from credit institutions; see Figure 2.15, which shows the distribution of total corporate debt at the end of 2014. It is typically large companies and smaller companies in oil and oil-related industries which are borrowing through the bond market. Following the drop in oil prices, companies in these industries have found it difficult to finance their securitised debts on maturity. In the years ahead, there will be a considerable need for refinancing in the Norwegian high-yield bond market; see Figure 2.26 and the discussion in section 2.3.6.

Loans to commercial real estate companies amount to approximately 46 percent of Norwegian-owned banks and mortgage companies' outstanding corporate loans. A further 10 percent of loans are linked to the construction and building industry. Changes in real estate prices are there-

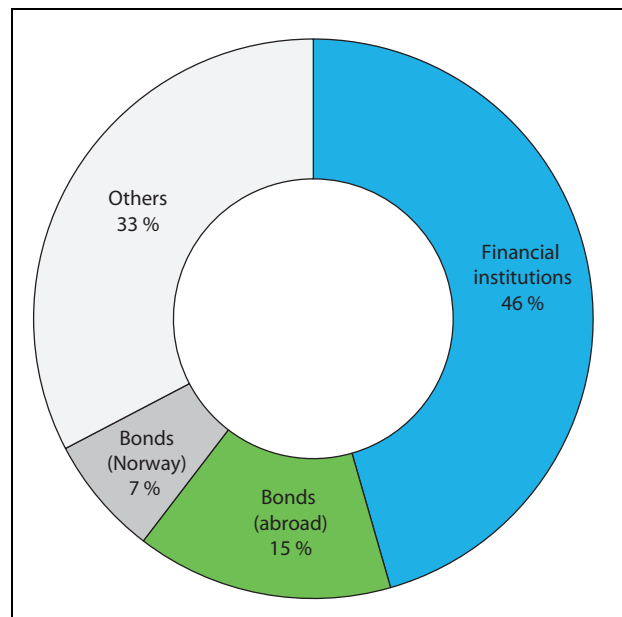


Figure 2.15 Total corporate debt by credit source
Source: Statistics Norway and Finanstilsynet

fore a substantial risk factor for Norwegian banks. Real prices for commercial real estate rose in 2015, but are sensitive to rental market developments and investors' required rates of return, and have historically fluctuated significantly in line with general economic trends. Economic down-

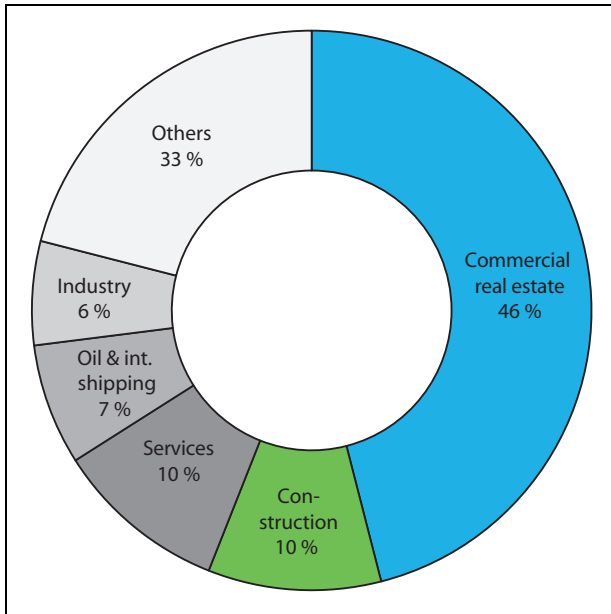


Figure 2.16 Lending by banks and mortgage companies by industry¹, as of June 2015

¹ The figures exclude loans to companies registered abroad.
Source: Statistics Norway and Finanstilsynet

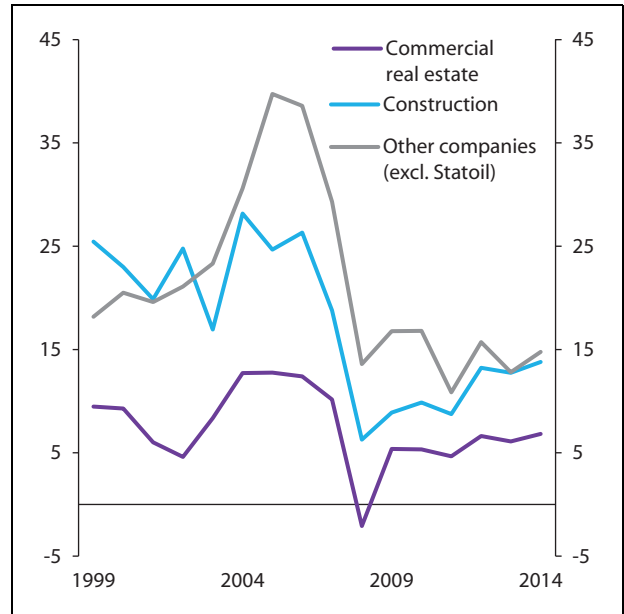


Figure 2.17 Corporate debt-servicing capacity. Defined as cash earnings as a percentage of interest-bearing debt

Source: Norges Bank

turns quickly lead to a reduction in commercial real estate rents and vacant premises, and thus lower prices and property values. The activity level in the commercial real estate market increased considerably in 2014, and continued to rise throughout 2015. The higher activity is due to several factors, including low financing costs and broader demand due to the weakened krone making Norwegian commercial real estate more attractive to foreign investors.

Corporate profitability and liquidity are important for debt-servicing capacity. The capacity of companies to service debt (cash revenues as a percentage of interest-bearing debt) improved in the early 2000s, but declined in the period leading up to the financial crisis. Since the crisis, corporate debt-servicing capacity has stabilised at a lower level. Debt-servicing capacity varies from industry to industry, and may change quickly if demand for an industry's products changes. For example, falling oil prices and the drop in oil-investment have contributed to a sharp reduction in the debt-servicing capacity of companies in the oil service industry. High household debt increases the risk of a sudden drop in the debt-servicing capacity of companies in industries which base their activities on demand from Norwegian households.

Debt-servicing capacity is generally lower in the commercial real estate sector than in other industries; see Figure 2.17. Real estate is consid-

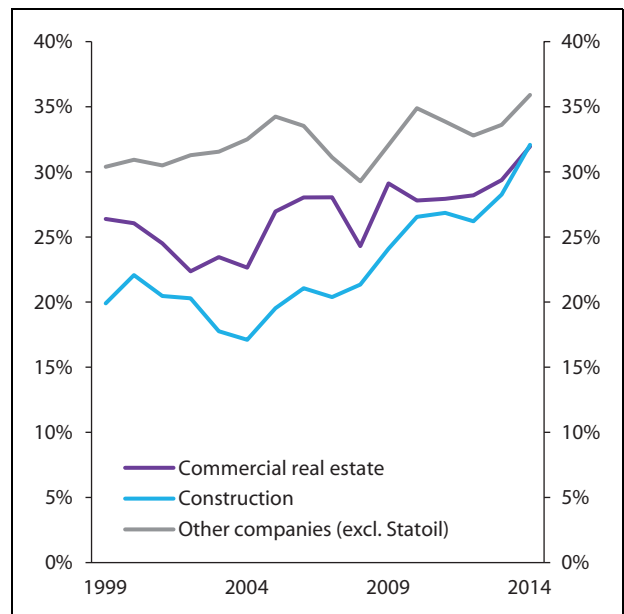


Figure 2.18 Corporate equity ratios. Equity as a percentage of total assets

Source: Norges Bank

ered a reliable form of collateral, and property owners thus have easier access to debt financing. Many real estate companies therefore have high interest-bearing debts.

Corporates' equity ratio is another important indicator of a company's ability to absorb eco-

conomic shocks. A high equity ratio can serve as a buffer during periods when earnings are weaker. Robust companies may also find it easier to get credit when economic uncertainty is high. Corporate equity ratios have risen since the financial crisis. Companies in the construction and building and commercial real estate sectors have typically had lower equity ratios than other companies. These sectors have experienced particularly strong equity ratio growth; see Figure 2.18. However, corporate equity in these sectors is sensitive to falling real estate prices.

2.3.4 Bank financing and liquidity

One of the most important banking functions in any economy is the conversion of short-term deposits into long-term loans to customers. In such maturity transformation, banks assume funding risks. Banks are primarily financed by customer deposits and borrowing from the money and securities markets (wholesale funding). Customer deposits have proven to be a relatively stable source of financing, even during periods of market unrest. This is partly due to the deposit guarantee scheme. Nonetheless, the financial crisis has shown that banks' access to wholesale funding can worsen when markets are turbulent.

Wholesale funding for banks consists of bonds and shorter-term borrowing in the form of certificates, as well as covered bonds issued by mortgage companies. Mortgage companies are often members of banking groups. Wholesale funding allows banks to manage their liquidity risk in a way which deposits do not permit. However, if banks operate on the assumption that new financing will always be available in the market on short notice, their liquidity risk may increase rapidly and substantially if relevant markets become less liquid.

Approximately 40 percent of the total financing of Norwegian banks and mortgage companies comprises customer deposits; see Figure 2.19. The proportion of short-term wholesale funding has declined in recent years, while long-term wholesale funding (covered bonds and other bonds with maturities exceeding one year) accounts for an increasing share of total financing. At the end of 2015, covered bonds constituted 43 percent of wholesale funding, an increase of one percentage point compared to the previous year. One reason why covered bonds have become a leading source of financing is that banks have profited from transferring residential mortgages with good collateral from their balance sheets to

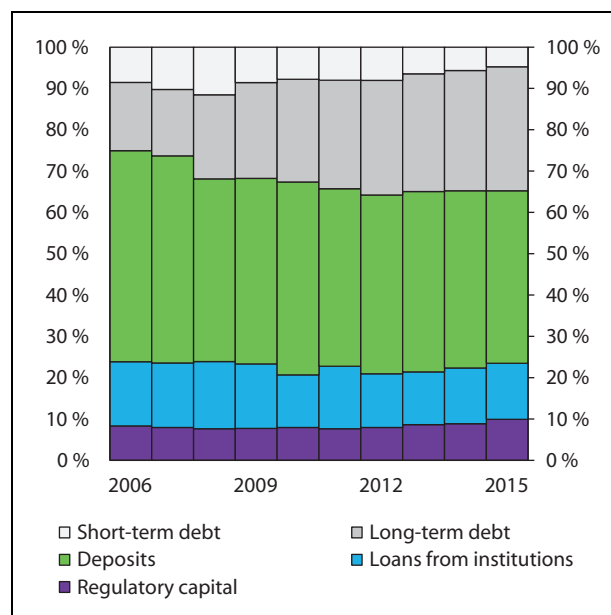


Figure 2.19 Composition of bank and mortgage company financing. Percentage of capital under management

Source: Finanstilsynet

mortgage companies which can issue covered bonds. Around 60 percent of the wholesale funding of banks and mortgage companies is denominated in a foreign currency. Short-term foreign debt, i.e. with maturities less than three months, accounted for 20 percent of total wholesale funding at the end of 2015.

Norwegian banks have good access to wholesale funding, although the financial terms on which new financing can be obtained have developed unfavourably recently. Risk premiums on new financing were higher at the beginning of 2016 than the average margins on banks' outstanding bond financing. If the risk premiums remain at this level, the average margin on banks' outstanding bank financing will rise somewhat going forward.

Fears of weaker economic growth internationally contributed to increased risk premiums in credit markets in the autumn of 2015 and the first months of 2016. Risk premiums rose for companies across industries and countries. However, in the banking sector, risk premiums increased more than in other sectors, and credit insurance premiums for banks rose sharply in the first weeks of 2016. In the autumn of 2015, the increase in risk premiums was somewhat higher for Norwegian banks with substantial exposure in regions with extensive petroleum-related activity than for other Norwegian banks.

Box 2.9 New liquidity coverage requirement

At the end of 2015, Norwegian banks and banking groups had a total liquidity reserve of 132 percent. The liquidity reserve is measured as liquid holdings as a percentage of net liquidity outflows during a given stress period of 30 calendar days. In other words, a high liquidity reserve indicates that banks and other credit institutions are well equipped to absorb a certain amount of stress. The reserves of larger banks totalled 133 percent, while medium-sized and smaller banks had reserves of 119 percent and 129 percent, respectively; see Figure 2.20. The liquidity reserve can be measured separately for individual currencies, or cumulatively for currencies. The Norwegian krone-denominated liquidity reserve of Norwegian banks totalled 66 percent at year-end 2015.

In accordance with regulatory provisions adopted by the Ministry of Finance in November 2015, systemically important banks in Norway (DNB, Nordea and Kommunalbanken) are required to meet a minimum liquidity coverage requirement of 100 percent as from 31 December 2015. A corresponding requirement for other banks will be phased in over a period of two years.¹

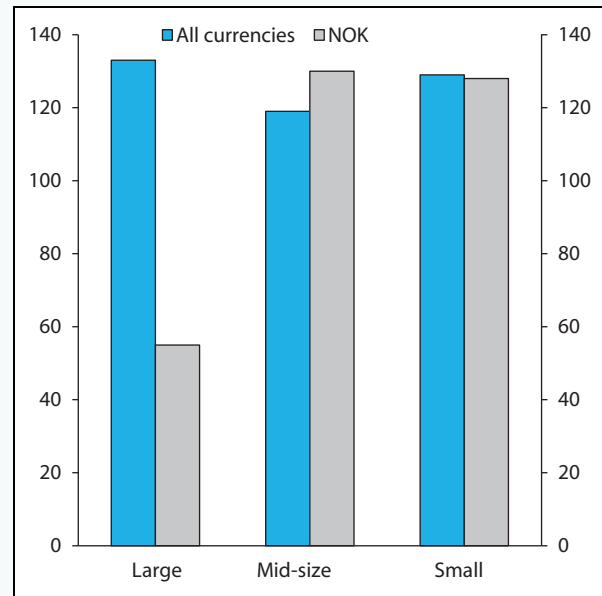


Figure 2.20 Liquidity reserve (liquidity coverage ratio) of Norwegian banks at the end of 2015. Percent

Source: Finanstilsynet

¹ The requirement is 70 percent from 31 December 2015, 80 percent from 31 December 2016 and 100 percent from 31 December 2017.

Management of liquidity risk is important for banks. During the financial crisis, many banks and other financial institutions experienced liquidity problems because they had become too dependent on short-term wholesale funding, which subsequently dried up when the crisis began. As access to new financing dropped, many banks rapidly and simultaneously experienced serious liquidity problems. Pursuant to new EU rules, new requirements have been introduced which limit permitted liquidity risk; see Box 2.9.

2.3.5 Insurance and pensions

Problems experienced by insurance companies and pension funds do not normally represent a direct threat to financial stability. Traditional insurance activity generates little systemic risk, but potential problems in life insurance companies and pension funds may impact financial stability indirectly, including through such companies' investments in debt securities issued by banks,

such as covered bonds. Any uncertainty relating to large life insurance companies may also spread to other financial institutions and affect confidence in these, as illustrated by experiences from the financial crisis. The authorities have therefore introduced rules to promote solvency among insurance companies and pension funds. Furthermore, solvent pension institutions are a prerequisite for secure and predictable pension saving by individual customers.

Life insurance companies and pension funds promise insured persons a benefit if a defined event occurs, for example if the insured person becomes disabled or reaches retirement age. The monetary value of these commitments constitutes the most important liability of life insurance providers and pension funds. The risk borne by such companies is linked to the types of insurance policies held by customers and how contracts are designed.

Interest rates have fallen in recent decades, and are at present at historical lows. Life insurance companies and pension funds have gradually reori-

Box 2.10 Stress testing of pension funds

Modelling different crisis scenarios allows central banks, supervisory authorities and others to improve their insight into how well banks, insurance companies and pension funds are equipped to deal with potential periods of weaker economic growth and financial instability.

In 2015, the European Insurance and Occupational Pensions Authority (EIOPA) stress-tested pension institutions subject to the Institutions for Occupational Retirement Provision Directive. The participating pension funds had a market share of over 50 percent (measured by capital under management) in the countries covered by the test. During the test, assets were stressed in two different scenarios featuring share and real estate price falls as well as changes in the interest rate and foreign exchange markets. Liabilities were stressed in a separate scenario featuring rising life expectancy due to a 20 percent drop in the mortality rate.

Pension institutions from 17 countries were stressed in the test, which was the first of its kind. Finanstilsynet was responsible for the conduct of the stress tests in Norway. The seven largest pension funds, which account for almost 60 percent of total capital under management in Norwegian pension funds, participated in the part of the stress test covering defined-benefit occupational pensions.

The results of the stress tests were published on 26 January 2016. The results show that there are substantial shortfalls in many European pension funds, even before these are subjected to negative shocks. Norwegian pension funds performed relatively well during stress testing compared to funds in most other countries. Norwegian authorities have long given high priority to applying identical solvency rules to parties which assume identical risk, including through identical regulation of pension funds and life insurance companies.

ented their business models during this period, transferring risk to insured persons in exchange for greater personal influence over how pension assets are managed. This applies particularly to market risk, where the sale of products in which the insurance providers bear risk has ceased almost completely. The authorities facilitated the development of markets for new products with different risk properties when they granted defined-contribution pension schemes the same preferential tax treatment as guaranteed (defined-benefit) pension products in the year 2000.

However, life insurance policies are generally long-term agreements, and contracts specifying an annual guaranteed rate continue to make up a material proportion of the liabilities of Norwegian pension institutions. The low international interest rate level is a challenge for providers with a high proportion of guaranteed products. The average guaranteed rate among life insurance providers was just over 3.1 percent at the end of 2015; see Figure 2.21. The market rate on most government bonds is now lower than the average guaranteed rate, and continuing low interest rates may make it difficult to achieve a return exceeding the guaranteed rate. Providers currently hold many bonds purchased when the interest rate level was higher, and when

these mature they will have to be replaced by new bonds carrying lower interest rates.

Subject to certain exceptions, for example paid-up policies, companies can charge a guaranteed rate premium for pension products offering a guaranteed rate. Life insurance companies have in recent years collected approximately NOK 1 billion in annual guarantee rate premiums from private-sector enterprises, as well as a corresponding amount from the municipal sector. This does not include guaranteed rate premiums collected by pension funds. The ability to change the premium from year to year allows the premium to be adjusted in line with developments in return prospects.

Companies' interest risk can also be reduced by lowering guaranteed rates. To limit risk-taking by companies, the authorities have long capped the guaranteed rate companies are permitted to offer customers. Companies have always had discretion to decide whether to offer the maximum guaranteed rate permitted or a lower one. In view of low interest rates and weak return prospects, Finanstilsynet reduced the maximum guaranteed rate from 2.5 percent to 2.0 percent as of 1 January 2015; see Figure 2.21. The decision only affects the guaranteed rate for subsequent pension accruals. Accordingly, if companies have

already concluded contracts and received premiums relating to pension accruals subject to a higher guaranteed rate, the higher guarantee will continue to apply to the insured person.

A lower guaranteed rate means that premium payments for a given benefit must be increased. Together with the increased guaranteed rate premium for previous accruals, this makes schemes offering agreed benefits more expensive for employers to finance when interest rates fall. Many private-sector enterprises have shifted to defined-contribution schemes in recent years; see Figure 2.22. Defined-contribution schemes do not offer a fixed level of future payments. Instead, these depend on the return achieved during the accruals period. Switching from defined-benefit schemes to defined-contribution schemes shifts risk away from employers and insurance companies. Instead the insured persons carry risk by increasing their exposure to the securities markets. As stated above, in return the insured persons usually gain greater influence over the management of their pension assets.

However, for insurance companies an undertaking's shift from a defined-benefit pension scheme to a defined-contribution pension scheme often means the conversion of assets saved

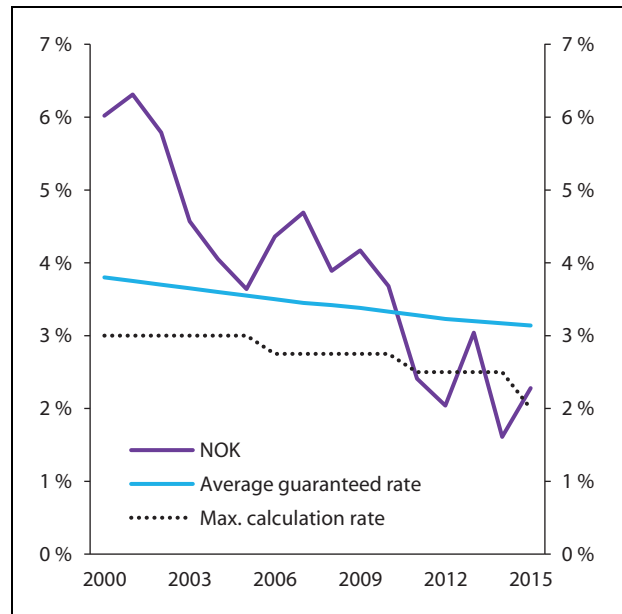


Figure 2.21 Development of average guaranteed rate among Norwegian life insurance companies, long-term interest rates (10-year government bonds) and maximum calculation rate

Source: Finanstilsynet

Box 2.11 Capital requirements in the Solvency II framework

To calculate solvency capital under the Solvency II framework, liabilities and assets are to be valued at the amount for which they can be traded in a transaction at arm's length between well-informed parties ("fair value" or "market value"). In the absence of market prices, the value of insurance liabilities must be set as the expected value of future cash flows linked to each individual insurance liability, discounted using risk-free market rates and based on a probability assessment of different levels of future cash inflows and outflows. Finally, a risk margin must be added.¹

Solvency II contains two new capital requirements: the solvency capital requirement (SCR) and the minimum capital requirement (MCR).

The solvency capital requirement is designed to take into account all types of quantifiable risk, and to cover unanticipated losses in existing operations as well as losses which may arise in operations established in the next 12 months. Account must be taken of the effect of

risk-reduction measures, diversification and correlation between different risks. Solvency capital must total at least an amount that is 99.5 percent likely to exceed the undertaking's total losses over a period of 12 months, calculated in accordance with a standard method or using internal models. The minimum capital requirement must be calculated as a linear function of insurance-related provisions, written premiums, capital-at-risk, deferred tax and administrative expenses. The minimum capital must total at least an amount that is 85 percent likely to exceed the undertaking's total losses over a period of 12 months, and may not be lower than 25 percent or higher than 45 percent of the solvency capital requirement.

¹ The risk margin is intended to ensure that the valuation is not excessively low, and must be set as an amount corresponding to the cost of holding capital to meet the solvency capital requirement linked to the liabilities in question over the lifetime of these liabilities.

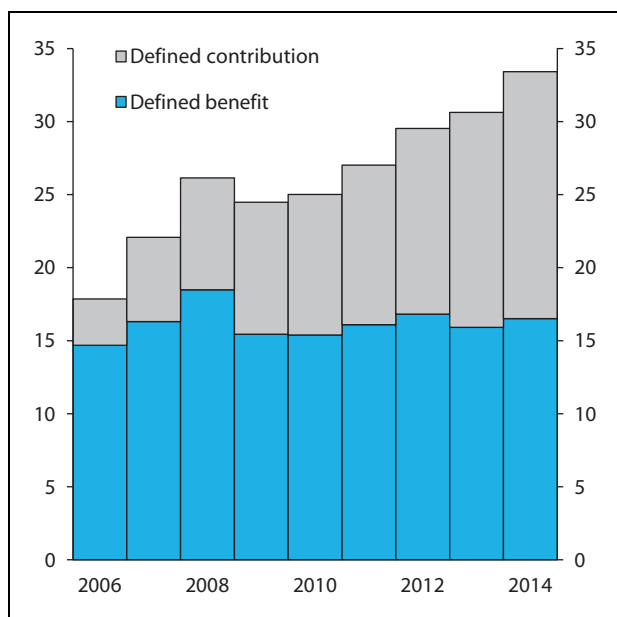


Figure 2.22 Gross payable premiums in defined-benefit and defined-contribution pension schemes in Norwegian life insurance companies. NOK billion

Source: Finance Norway

through the old scheme into paid-up policies. Paid-up policies are fully paid insurance policies which confer entitlement to a future pension without the employer having to make further premium payments. The winding-up of defined-benefit schemes has increased the volume of paid-up

policies, which now account for around 20 percent of life insurance company liabilities. In the municipal sector, defined-benefit schemes may not be converted into defined-contribution schemes, and thus no paid-up policies are issued.

Insurance companies are not permitted to charge a guaranteed rate premium for paid-up policies or individual insurance policies established before 2008. Instead, companies are entitled to a share of any excess return from asset management. An excess return exists if the return is higher than the guaranteed rate. This makes life insurance companies and pension funds vulnerable if they have accumulated inadequate net asset buffers before a period of low returns.

New statutory and regulatory provisions effective as of September 2014 allow insurance companies and paid-up policy holders to conclude voluntary agreements to convert paid-up policies into paid-up policies with investment choices. With such voluntary conversion into a new contract, the paid-up policy holder surrenders the guaranteed rate and is therefore no longer entitled to a specified annual benefit upon reaching retirement age. In return, the holder of the paid-up policy can decide how capital is to be managed, and keeps all returns. Currently, most paid-up policy holders have a guaranteed rate which far exceeds what can be achieved through low-risk investments in the market. For many holders of paid-up policies it is therefore in principle most profitable to keep

Box 2.12 Building reserves to address rising life expectancy

Life expectancy in Norway is rising. In 2013, Finanstilsynet introduced a new minimum requirement for the so-called mortality table (K2013) to help life insurance companies and pension funds allocate sufficient capital to address increased life expectancy. The switch to the new mortality table requires insurance companies to raise premiums for retirement pensions in collective pension schemes. Financial provisions in respect of already accrued retirement pensions also have to be increased. Life insurance providers have been given up to seven years from 2014 to implement such reserve building. Providers may use any profits from their management of customer assets – which should in principle be credited to customers – to fund up to 80 percent of reserve building. Such profits are equal to the return on the collective

portfolio exceeding the interest rate the company has guaranteed to customers. The providers themselves must provide at least 20 percent of the reserves.

Providers have built up most of their required reserves over the past three years. Life insurance providers built up reserves in respect of increased life expectancy of approximately NOK 7.4 billion in 2015, leaving an outstanding reserve building need of just under NOK 6 billion at year-end. In total, pension funds allocated around NOK 10.5 billion to reserve building by the end of 2015. The majority of pension funds are fully provisioned, and Finanstilsynet's stress tests as of Q4 2015 showed that the funds have a remaining reserve building need of just under NOK 500 million.

Box 2.13 Profits and profitability among insurance companies and pension funds

Life insurance companies generated pre-tax profits of NOK 8.2 billion in 2015, an increase of NOK 2.3 billion on 2014. The value-adjusted pre-tax profits, which include unrealised capital gains, totalled NOK 9.8 billion, significantly less than the 2014 figure of NOK 20.2 billion. The decline is due to factors including weaker stock market growth in 2015 than in 2014.

The pre-tax profits of pension funds were NOK 3.1 billion in 2015, up from NOK 1.9 billion in 2014.¹ The fluctuation reserves grew by less in 2015 than in 2014, amplifying the drop in value-adjusted profits from NOK 6.6 billion in 2014 to NOK 4 billion in 2015.

Non-life insurance companies achieved pre-tax profits of NOK 7.8 billion in 2015 – a drop of NOK 2.3 billion compared to the previous year. The decline is primarily due to a fall in financial income of more than 50 percent.

The combined ratio of non-life insurance companies – measured as incurred losses and expenses over earned premium – was 86.2 percent in 2015; see Figure 2.23. This was one percentage point higher than the previous year. A combined ratio in excess of 100 percent means that the company needs other income than premium income to break even; for example financial income. The claims ratio, i.e. claim payments as a percentage of premium income, increased by around 0.6 percentage points from 2014, to 68.9 percent in 2015.

The cost ratio, i.e. operating expenses as a percentage of premium income, rose by 0.4 percentage points in 2015, to 17.3 percent.

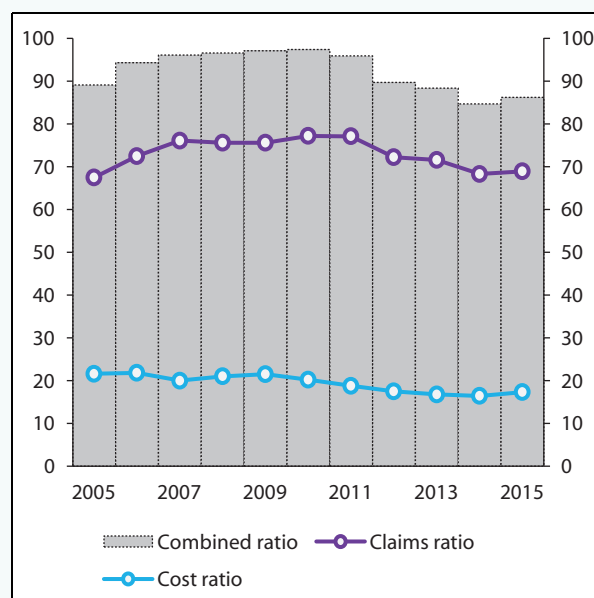


Figure 2.23 Developments in the combined, claims and cost ratios of Norwegian non-life insurance companies. Percent

Source: Finanstilsynet

¹ The figures relate to the 48 largest pension funds in Norway, which represent around 95 percent of total capital under management by pension funds.

the paid-up policy and instead adjust the remaining portfolio, for example to assume more risk to achieve a higher expected return. The positive value of the guaranteed rate to customers is accompanied by a corresponding negative value for companies. This may give companies excessive incentives to conclude agreements on investment choices. Consequently the authorities have introduced strict statutory requirements relating to the advice companies give to customers.

Due to rising life expectancy, life insurance companies and pension funds have to set aside more capital to cover their pension liabilities. Such reserve building has largely been completed; see Box 2.12. The Ministry of Finance has introduced a requirement that paid-up policies must be fully provisioned before they are converted into paid-up policies with investment choices.

Using different buffer fund mechanisms, life insurance companies can smooth return and risk results over several years. The use of such buffer funds allows companies to use strong results in certain years to make up for weaker returns in others. The size of these buffer funds is an indicator of the companies' ability to absorb weak returns and higher risk in the future. At the end of 2015, the buffer funds of life insurance companies totalled NOK 82 billion, equivalent to 9.4 percent of insurance liabilities.

All life insurance companies met the capital adequacy requirement of 8 percent at year-end 2015. On 1 January 2016, the capital adequacy requirement was replaced by the solvency capital requirement and the minimum capital requirement in the Solvency II framework. The new Solvency II capital requirements are designed to

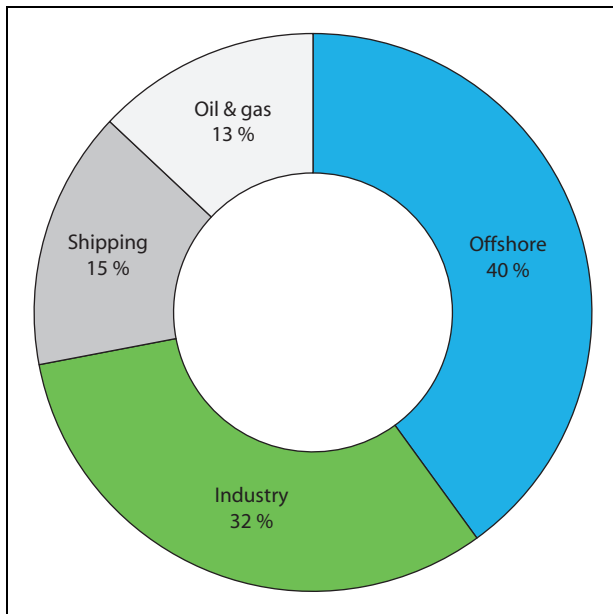


Figure 2.24 Outstanding volume of high-yield bonds, by sector at the end of 2015

Source: Finanstilsynet

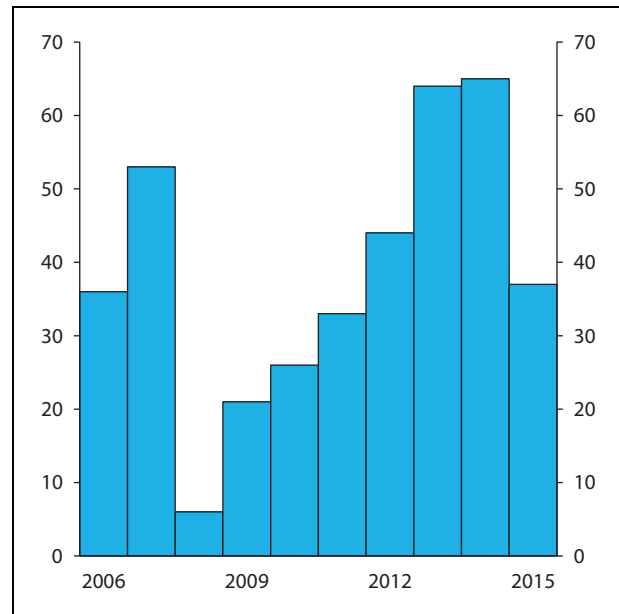


Figure 2.25 High-yield bonds issued in the Norwegian market. NOK billion

Source: Stamdata

reflect the risks assumed by companies better than the former requirements; see Box 2.11. In the period 2008–2015, insurance companies have reported stress test results based on a simplified variant of the solvency capital requirement in Solvency II. The stress tests provide information on the size of so-called loss potential relative to a company's loss-absorption capital (buffer capital). If this ratio – referred to as buffer capital utilisation – is *100 percent or lower*, the company can be said to be compliant with a simplified variant of the solvency capital requirement in Solvency II. At the end of 2015, average buffer capital utilisation was 116 percent among life insurance companies as a whole. However, if account is taken of a key transitional provision in the Solvency II framework (stating that any increase in the value of insurance liabilities due to a change to a new valuation under the Solvency II rules can be phased in over a period of 16 years), the estimated average buffer capital utilisation was 75 percent.

2.3.6 The securities markets

Oslo Stock Exchange is a small financial marketplace in global terms. The stock exchange and other marketplaces facilitate matching of the capital needs of businesses with the investment needs of capital owners. Information and transparency in the marketplace allow professional parties to evaluate risk and where capital can achieve the highest returns.

The Norwegian State owns a relatively large proportion of the securities listed on Oslo Stock Exchange. Around 66 percent of the assets on the exchange are privately held, with international owners accounting for approximately 37 percent of private sector holdings. The Norwegian market for high-yield bonds, i.e. bonds issued by companies with weaker credit ratings, is an example of a sub-market with a considerable proportion of international investors. Oslo Stock Exchange is the largest Nordic market for such securities. It is an internationally important marketplace for industries such as seafood, energy, oil service and shipping. Energy-sector companies accounts for approximately 27 percent assets listed on Oslo Stock Exchange, which is home to the greatest number of energy-related companies of any exchange in Europe. Oil service has become a key energy-sector segment in recent years. Measured by number of listed companies, Oslo Stock Exchange is the second-largest oil-service exchange in the world. It is also the world's second-largest financial shipping marketplace, and the world's largest marketplace for seafood companies.

The Norwegian market for high-yield bonds attracts substantial interest from international investors. Norway's strong position in industries like oil, shipping and seafood explains some of the growth in this market, in addition to simpler legal requirements than elsewhere in Europe and the

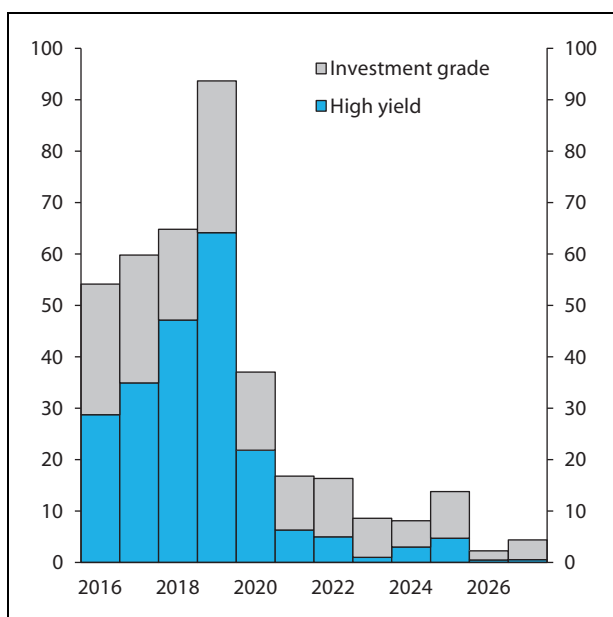


Figure 2.26 Maturity structure of corporate bonds in NOK billion

Source: Stamdata

US. It is difficult to estimate the market's size, since there are no mandatory reporting requirements. Moreover, as issuers are not credit-rated, the availability of market data depends on a range of assumptions relating to the relevant part of the market.

Figure 2.25 provides an overview of the volume of high-yield bonds issued in the Norwegian high-yield bond market from 2006 to present day. In 2015, the high-yield bonds issued in the Norwegian bond market totalled approximately NOK 37.5 billion, a decrease of more than NOK 27 billion compared to 2014. Figure 2.24 shows that, measured by outstanding volume, 40 percent of the high-yield bonds are related to offshore service, 32 percent to manufacturing and 15 percent to shipping. These are sectors which have historically been affected by fluctuations in oil prices. In the years ahead, there will be a considerable need for refinancing in the high-yield bond market; see Figure 2.26. It is uncertain how the market will meet this need going forward.

2.4 Operational risk in financial institutions

Operational risk is the risk of loss as the result of incomplete or inadequate internal processes, systems failure or human error. Operational risk includes legal risk and reputational risk. The

Box 2.14 Mutual funds

Mutual funds are a collective investment where many savers (unit holders) jointly invest their funds in the securities market. Management is undertaken by a fund management company based on a defined mandate which specifies the markets and segments in which capital is to be invested, and how. The most common fund types in Norway are equity funds, money market funds, bond funds and combination funds. At the end of 2015, Norwegian-registered mutual funds had NOK 904 billion in capital under management. Net new subscriptions in 2015 show that demand for equity funds has fallen considerably in favour of combination funds and money market/bond funds.¹ Net equity-fund redemptions totalled NOK 24 billion in 2015, while net subscriptions amounted to NOK 4.5 billion and NOK 30 billion, respectively, for combination funds and money market and bond funds.

¹ Combination funds invest in both shares and the interest rate market, but are not permitted to invest more than 80 percent of their assets in shares. Bond funds invest in different debt securities. Money market funds are interest rate funds which invest in short-term interest-bearing securities, i.e. certificates and bonds.

causes may, for example, be inadequate procedures, defective information and communications technology systems (IT systems), regulatory violations, fire, attacks and breaches of duty by employees. Delimitation against other types of risk is not precise, and losses classified under credit risk or market risk may be caused or exacerbated by operational vulnerability, for example weaknesses in credit evaluation processes.

Important instruments for reducing operational risk include identification of vulnerabilities and subsequent preventive efforts to make financial institutions and financial markets less vulnerable and ensure adequate preparedness for dealing with risk events. Although much of this work must be done at the individual company level, there is also a need for a strategic overview and coordinated measures. The Financial Infrastructure Crisis Preparedness Committee (BFI) is mandated to promote coordination of financial infrastructure preparedness efforts. The Committee evaluates operational stability, risk and vulner-

Box 2.15 Investment firms

Investment firms arrange the buying and selling of financial instruments and provide investment advice in connection with such transactions. They also advise companies and facilitate mergers and acquisitions. Investment firms analyse and advise on the risk and return prospects of investment projects. Over the past 15 years, the most important revenue sources for investment firms have been corporate finance activities and the brokering of equity instruments. Figure 2.27 illustrates the relative development of these two revenue sources among investment firms that are not integrated into banks. During this period, corporate finance activities have become far more important than the revenues generated by brokering equity instruments.

Investment firms that are not integrated into banks registered operating income of NOK 5.85 billion in 2015, approximately NOK 0.6 billion less than in 2014. Total operating profits were just under NOK 1 billion, NOK 446 million less than in the previous year. The main reason for the decline is structural changes in the industry following the entry into force of the AIF Act – a new act relating to the management of alternative investment funds (AIFs) – and the fact that a number of investment firms have thus become AIF managers.

Investment firms that are integrated into banks generated total revenues from investment services of around NOK 7.1 billion in 2015,

approximately NOK 200 million more than in the previous year. This equates to an increase of 3 percent from 2014 to 2015.

Norwegian branches of foreign investment firms achieved revenues of NOK 2.5 billion in 2015, approximately 3 percent more than in the preceding year.

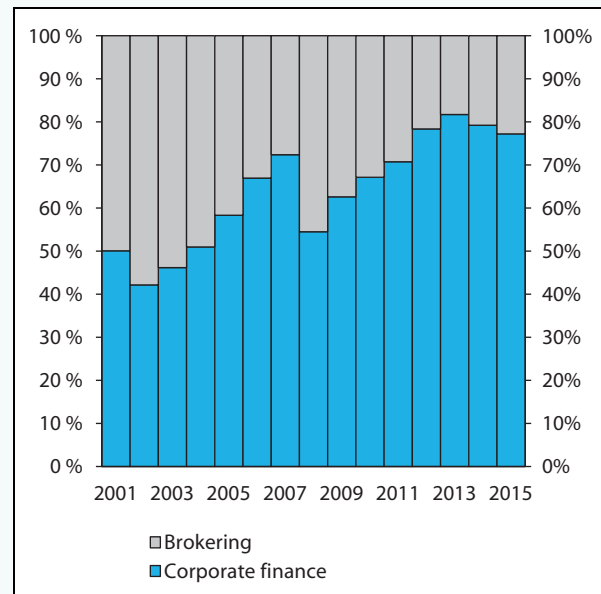


Figure 2.27 Relative development of the two traditionally most important revenue sources of investment firms not integrated into banks, 2001–2015

Source: Finanstilsynet

ability in the financial infrastructure, and can be convened in the event of a serious incident. In 2015, the Committee held three regular meetings and conducted one emergency preparedness exercise.

Systemic stability in the Norwegian financial infrastructure is good, and losses as the result of misuse and fraud are small. The infrastructure is nonetheless vulnerable to technical failure and external threats. Figure 2.28 shows that there were generally fewer problems with financial infrastructure systems in 2015 than in 2014 and previous years. This improvement was achieved despite several financial institutions changing their operational locations and suppliers in 2015, which entailed some risk of problems and disruptions. Attacks and other adverse events relating to

financial infrastructure have only resulted in small direct losses thus far. Much of the reason for this lies in the measures and precautions taken by individual companies, as well as the joint efforts of the stakeholders.

New technology has rationalized financial service provision and enabled the financial industry to offer new services. In recent years, many new internet-based and mobile solutions and products have been introduced in the area of payment services. New technology, new services and outsourcing of IT systems operation and development may give rise to new, previously unknown, vulnerabilities and challenges for those tasked with evaluating and monitoring operational risk in the financial system. Until around the year 2000, the IT operations of all Norwegian banks were

located in Norway. Today, a majority of the IT operations of Norwegian banks and branches have been relocated abroad. Outsourcing of IT operations may alter the quality and stability of systems and weaken oversight and control of vulnerabilities in systems which underpin companies' operations. It is important that IT tasks are outsourced responsibly, bearing in mind the situations of both the individual financial institution and the financial system as a whole. Accordingly, in 2014 the Government proposed new statutory rules defining what kinds of tasks financial institutions may outsource as well as laying down rules granting Finanstilsynet power to monitor outsourcing and implement measures to address irresponsible outsourcing. The rules were adopted by the Storting on 20 June 2014, and entered into force on 1 July 2014.

Norges Bank and Finanstilsynet publish annual reports on financial infrastructure. Norges Bank's Annual Financial Infrastructure Report reviews developments in the areas of retail payment services and interbank systems, while Finanstilsynet's Risk and Vulnerability Analysis examines the use of information and communications technology in the financial sector.

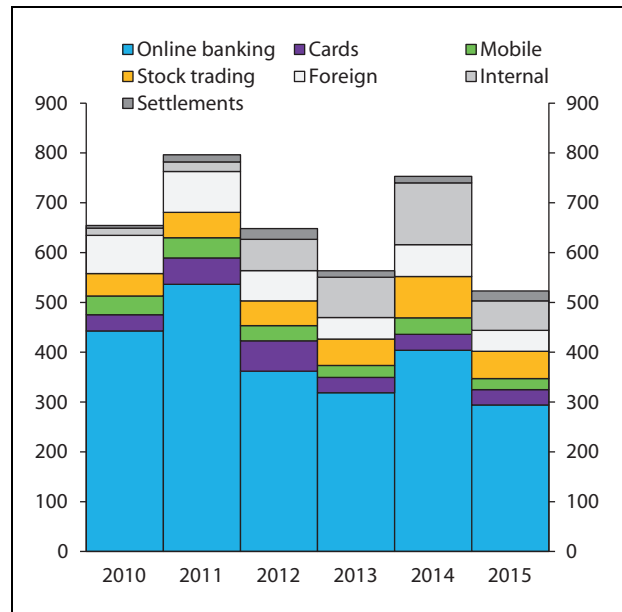


Figure 2.28 Impact-weighted adverse events and errors in Norwegian financial institutions¹

¹ The data in the figure are taken from mandatory reports on adverse events and errors to Finanstilsynet. Finanstilsynet has developed a database of information about such events which it uses in its supervisory activities. Thus far, few international statistics are available for use in comparing the quality and availability of the Norwegian systems with other countries' systems. The reports received by Finanstilsynet only provide information on developments from year to year in Norway. The values along the vertical axis express a weighted cumulative appraisal of the scale of damage caused by events affecting certain services. These services are online banking (private and corporate), payment cards, mobile payments, securities trading, cross-border payments, internal services and settlement. The scale of damage is derived from the number of users affected, the duration of each event and a discretionary assessment of the impact of the event on users.

Source: Finanstilsynet

3 A holistic approach to financial markets policy

3.1 Introduction

Banking and financial services are a key component of society's infrastructure. A healthy financial industry is crucial for financial stability, and promotes economic growth, value creation, productivity growth and restructuring. An *unhealthy* financial industry may foster structural challenges, financial instability and major economic challenges.

During its consideration of the National Budget 2015, the Storting asked the Government to "put forward a proposal for a holistic policy for the financial industry as part of the Financial Markets Report". In chapter 3 of the Financial Markets Report 2014, the Government identified important features of Norwegian financial market policy and pointed out that other policy areas also have a significant impact on the conditions for Norway's financial industry. The report also discussed some of the instruments the authorities use to ensure proper risk management and strong customer protection in the financial market, how the financial sector supports effective resource use in the economy and the conditions for the production of financial services in Norway. In section 3.6 of the report, the Ministry listed a number of topics to be examined in future reports.

This chapter discusses certain topics by way of follow-up of last year's Financial Markets Report, including the structure of and competition in Norway's financial markets and Norwegian businesses' access to capital from financial undertakings and the securities markets.

3.2 The objectives of Norwegian financial markets policy

The financial markets and the financial system are important in all modern economies. The financial sector channels capital from savers to investors, and from sellers to buyers. The financial system reallocates risk between different sectors of the economy. Successful use of the capital distributed by the financial sector encourages saving and

reinforces economic growth capacity. History shows that serious miscalculations and problems in the financial sector can trigger severe, prolonged economic downturns. Accordingly, a successful financial market policy is an important element in a holistic economic policy.

The Government wants the financial sector to promote the greatest possible value creation in the Norwegian economy over time. The financial industry's contribution to total value added in the Norwegian economy has two main components:

1. Direct value creation: the financial sector pays wages to employees, dividends to owners, interest to creditors and taxes to the Treasury.
2. Indirect value creation: financial services such as credit, insurance and payment services provide a foundation for value creation in the rest of the economy.

Around 50,000 persons are employed in the Norwegian financial sector. The sector accounts for just over 5 percent of mainland Norway GDP and has in recent years generated between around 15 percent and 30 percent of total corporation tax revenues (excluding petroleum, etc.). The contribution of the financial sector to valued added in other sectors is difficult to quantify. The complicated underlying structure of a modern economy demands a comprehensive range of financial services. High-quality financial services can help to ensure the correct allocation of capital and high value creation in non-financial sectors. Quick, cheap and secure payment solutions improve trading conditions, among other things. The quality of relatively simple financial services, such as payments services, can be measured. Payment services in Norway perform well in international comparisons; see further discussion in section 3.4.3 of the Financial Markets Report 2014. The quality of other financial services – such as investment advice, savings products and loans – is closely linked with the quality of assessments of potential returns and risk. Accurate return and risk assessments can help reduce the number of bad investments and

promote good risk diversification. Satisfied customers, low prices, strong competition and high innovation in financial service provision may indicate that such services are of high quality. However, it can take many years for the full economic consequences to emerge after products are developed, marketed and sold. Even then, it may be difficult to determine the connection between the outcome and the quality of the services provided. An illustrative international example is the development of the sub-prime market in the US and subsequent financial crisis.

Financial marketplace quality can be assessed by reference to opening times, regularity, liquidity and number of regulatory breaches, etc., as well as whether the prices achieved by buyers and sellers are correct. The so-called efficient markets hypothesis is well-known in the field of financial economics, and states that a market is efficient if securities prices reflect all available information. Public regulation may thus aim to facilitate marketplace efficiency, among other things. The closer to efficiency the marketplace comes, the simpler it becomes to compose strong investment products, give good investment advice and evaluate returns and risk for investors. However, it is difficult to evaluate whether, and to what extent, securities markets are efficient. If it is assumed that securities markets are inefficient, it becomes more difficult to assess the quality of financial services and advice. Providers of financial services may have a vested interest in stating that markets are inefficient and that they have knowledge which is not already reflected in market prices.

One of the primary advantages of a well-functioning, well-regulated financial sector with regard to value creation in the rest of the economy is a reduced likelihood of financial crises. This can have substantial economic benefits. Experience from Norway and other countries strongly indicates that the sharp reduction in the range of available financial services which often follows a financial crisis can have a very severe and long-lasting negative impact on value creation in other sectors. The discipline of economics has made a major contribution in terms of systematising and researching lessons in this area, and the effects of financial crises are therefore far better known and mapped than previously. Nonetheless, this field of research is also in constant development.

The Government wishes to reduce the threat to the Norwegian economy's growth capacity

presented by disruptions to the financial system. First and foremost, this entails ensuring good solvency among financial undertakings to prevent losses or weaker earnings from causing or intensifying economic downturns. This policy contrasts with the policy pursued in some countries in the years preceding the international financial crisis, under which risk levels were inflated by a combination of weak solvency requirements and rapid growth in the financial sector. When losses arose, financial undertakings were too weak to absorb these while still providing their services to the rest of the economy. It is important that solvency requirements, etc. are not eased to promote short-term growth in the financial sector. In Norway, there has long been broad political agreement on the importance of strong financial sector solvency, and both experiences and research have underlined the importance of robust regulation. The financial services produced by the Norwegian financial sector could have been imported from abroad. However, the existence of an independent domestic financial sector has several advantages, and generates added value beyond the individual services and direct value creation. It is also generally desirable to have a diversified business sector which includes the production of financial services.

The acceptable levels of stability and quality in the provision of financial services may vary from country to country, based on factors such as adopted priorities and risk tolerance. Views may also differ on how best to achieve a given level of stability and quality in service provision. Norwegian financial market policy is designed to secure a high level of stability and quality through requirements relating to solvency and the conduct of financial undertakings which are frequently stricter than international minimum requirements. Norwegian policy emphasises confidence, security and long-term growth. The supply side as a whole should be able to resist external disruptions without encouraging the development of imbalances or other risks capable of triggering problems. The supply side should be diversified, but identical risks should be regulated identically, irrespective of factors such as type of entity. Regulatory provisions should be tailored to structural circumstances and special risks in the Norwegian economy, like industry structure, household debt level, vulnerability to changes in the prices of oil and other commodities, etc. Cyclical factors should also be taken into account when developing requirements for financial undertakings.

Finally, it is important that consumer interests are properly safeguarded.

Regulation of financial institutions' solvency is necessary in the interests of financial stability. Regulatory provisions should help give households and businesses continuous access to a reliable range of savings and loan products. When formulating financial markets policy, a balance should be sought between different considerations. For example, it is not an objective to skew the granting of credit towards or away from different aims, groups or risk categories, or to influence the intertemporal saving and investment decisions of businesses and households. Accordingly, if capital requirements skew, increase or reduce access to capital for businesses or households beyond such stabilisation, this is in principle undesirable.

Further, the interests of producers of financial services must be balanced with factors such as the need for financial and economy stability, customer security and cheap services produced through competition as free as possible. Regulation and other aspects of financial market policy also help to safeguard the interests of financial service producers, in various ways. For example, solvency requirements, liquidity requirements and insurance schemes improve the stability of the financial sector. This in turn may increase the long-term value of relevant undertakings. When the authorities introduce and enforce requirements, this raises confidence among customers, investors and other counterparties that financial undertakings will meet their obligations. This is important, especially during periods of financial market turbulence.

The Norwegian economy faces challenges in the years ahead, and the importance of having a financial sector capable of supporting necessary restructuring to address weaker economic development has seldom been as high. Banks and other parts of the Norwegian financial sector have improved their solvency in recent years, on the back of very high banking sector profitability. Future developments may increase losses and reduce solvency at the same time as demand for capital-intensive loans remains high in the economy. Unless Norway's financial sector is robust, businesses, households and authorities may find it difficult to deal with the shift in the Norwegian economy. The Government will therefore continue to give priority to satisfactory financial sector solvency in its financial market policy. This is also the best way of ensuring the long-term strength and competitiveness of the financial sector.

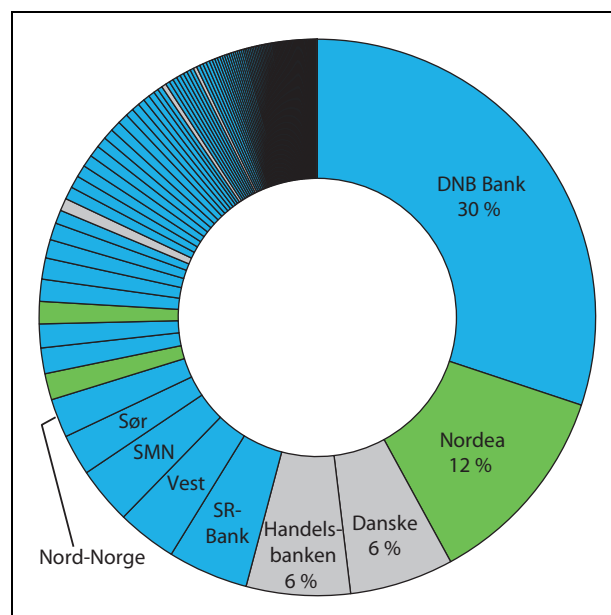


Figure 3.1 Lending to customers in Norway by all banks, mortgage companies and branches at the end of 2015. Norwegian institutions, subsidiaries and branches of foreign institutions are marked in blue, green and grey, respectively.

Source: Finanstilsynet

3.3 Structure and competition in the Norwegian financial market

3.3.1 Actors

In Norway, the financial sector comprises a smaller part of the economy than in many other countries. One reason for this is that the operations of Norwegian financial undertakings focus primarily on service provision in the domestic financial markets. Through the EEA Agreement, Norway is part of the EU/EEA common market, and financial undertakings from across the EU/EEA are thus free to offer their services in the Norwegian markets. Foreign entities have gradually increased their presence in Norway in recent years, through both acquisitions and organic growth. While this trend has boosted diversity and competition among financial service providers, it has also impacted the influence Norwegian authorities can exercise over the management of risk in the financial markets, since foreign financial undertakings are in principle subject to supervision and regulation in their home state.

Banks and mortgage companies make up a substantial proportion of the supply side of the Norwegian credit market. DNB is the largest actor with its market share of around 30 percent; see Figure 3.1. It is followed by Nordea (a subsidi-

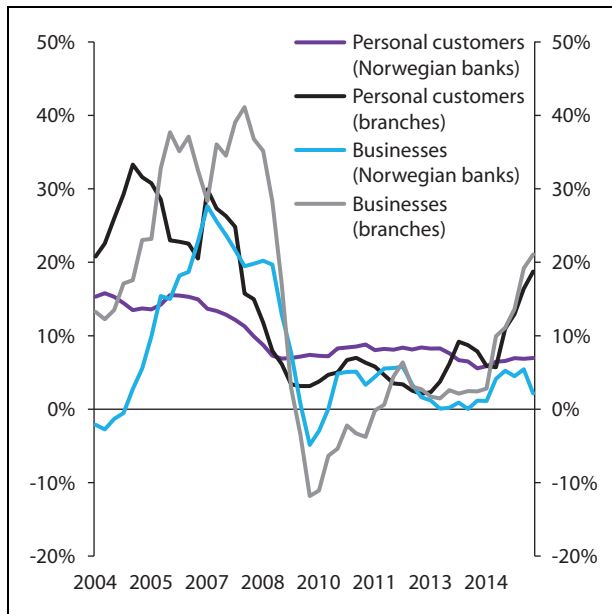


Figure 3.2 Lending growth among Norwegian banks and branches of foreign banks

Source: Finanstilsynet

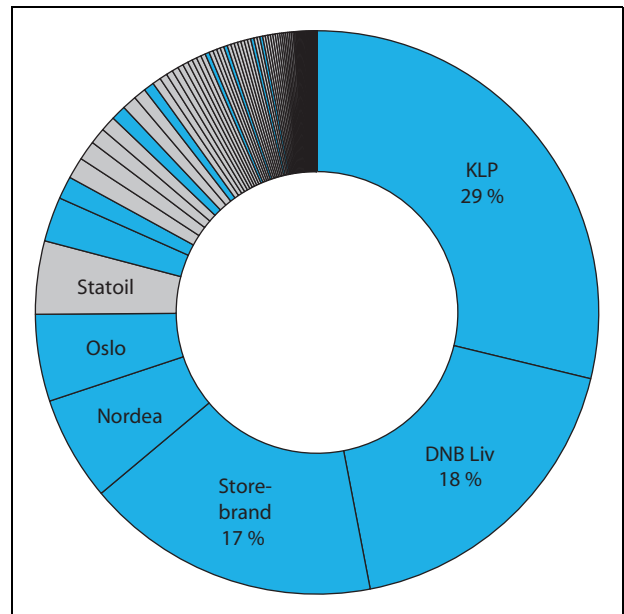


Figure 3.3 Capital under management of life insurance companies (blue) and pension funds (grey) at the end of 2015

Source: Finanstilsynet

ary of a foreign bank), two medium-sized branches of Danish and Swedish banks, and a handful of medium-sized Norwegian savings banks. The rest of the market comprises various smaller Norwegian savings and commercial banks, as well as some subsidiary banks and branches of foreign banks. The foreign branches had a total market share of approximately 13.5 percent in 2015, and have in recent years recorded higher lending growth than other actors in both the residential mortgage market – in which foreign branches generally have to follow “Norwegian” capital requirements – and the commercial lending market, in which branches are subject to the capital requirements of their home states; see Figure 3.2.

When the Norwegian banking crisis occurred in the early 1990s, there were few foreign actors in the Norwegian credit market who could compensate for the loss of credit supply from affected Norwegian banks. Branches of foreign banks can help diversify the supply side of the Norwegian credit market, and help ensure that not all institutions are equally vulnerable to fluctuations with a particular impact on the Norwegian economy. Accordingly, foreign branches can have a stabilising effect on credit supply in Norway during a downturn in the Norwegian economy. The effects may differ in the event of a broad international crisis or a crisis in a branch’s home state.

As Figure 3.2 shows, branches of foreign banks recorded higher growth in lending to businesses and personal customers than Norwegian banks in the years preceding the international financial crisis, although the growth rate slowed materially once the crisis hit. Although this trend does not necessarily mean that the foreign banks were less solvent (since the observed developments may also be explained by other factors), the approach taken is the one less solvent banks can be expected to adopt in such situations. Foreign banks may also wish to prioritise their home markets during periods of turbulence or weak international growth. The design of the EU common market for financial services does not take into account that banks may tend to give priority to activities in their home states rather than host states in times of economic unrest.

The Norwegian financial market benefits when the supply side is structurally diverse. Local savings banks, regional savings banks, Norwegian commercial banks and foreign banks play different roles, and compete with one another.

The Norwegian life insurance and pensions market is among the most concentrated in Europe, and is primarily served by a small number of life insurance companies and various pension funds; see Figure 3.3. The three largest life insurance companies hold around 64 percent of the total capital under management in the market.

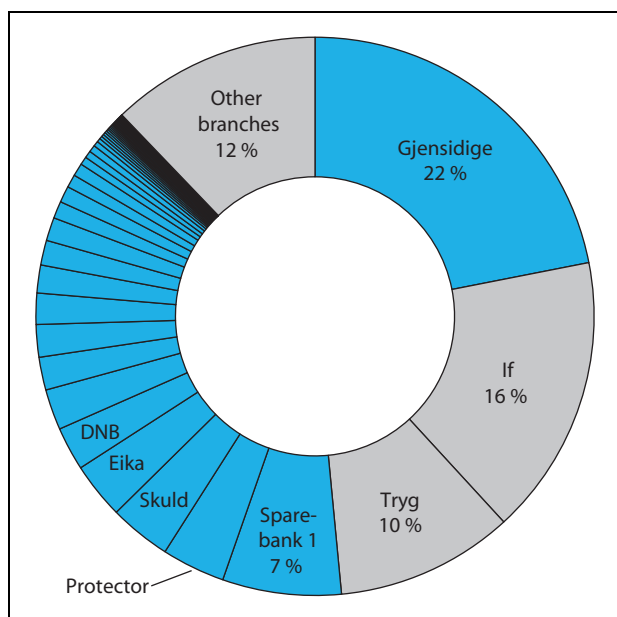


Figure 3.4 Gross premiums payable to non-life insurers in 2015. Norwegian undertakings (blue) and branches of foreign undertakings (grey)

Source: Finanstilsynet

The industry currently faces challenges, particularly linked to higher life expectancy and low interest rates. These factors are impacting, for example, earnings, competition and customers' switching opportunities.

The structure of the non-life insurance market is more similar to that of the credit market, with one large actor, two large branches of foreign undertakings and several smaller Norwegian and foreign actors; see Figure 3.4. There is considerable competition between the undertakings in the Norwegian non-life insurance market, and a low threshold for new actors to enter the market.

Although market concentration can be measured in different ways, the Herfindahl-Hirschmann Index (HHI) is a commonly used method when concentration is to be used to shed light on competition conditions. HHI is the total of the squared market shares of suppliers in a given market, and falls into the range 0 to 1, where a value close to 0 indicates low market concentration and a value close to 1 signifies that there is only one supplier, i.e. a monopoly. The higher the HHI figure, the higher the market concentration. Figure 3.5 shows developments in HHI since 1998 based on market shares in the Norwegian markets for residential mortgages (banks), life insurance (life insurance companies) and non-life insurance (non-life insurers). The figures indicate that market concentration has fallen somewhat in all

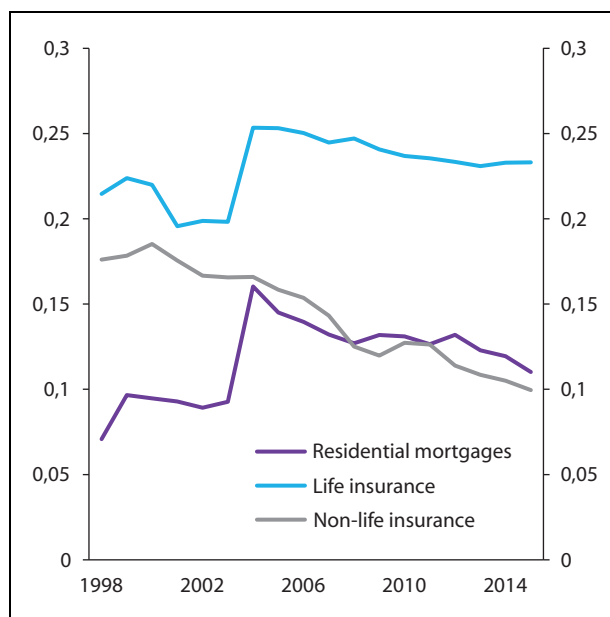


Figure 3.5 Herfindahl-Hirschmann Index for three Norwegian financial markets

Source: Finanstilsynet

three markets in recent years, and that concentration is generally higher in the life insurance market than in the other markets.¹

3.3.2 Innovation in financial services

The Norwegian financial industry is an international leader in the use of cost-effective electronic solutions throughout the value chain. The financial industry has long been an example for other Norwegian business sectors in relation to restructuring and the ability to develop and use new technology. Technology development, digitisation and regulatory changes facilitate increased efficiency and value creation.

The emergence of new actors who are using technology to provide financial services in new ways is observable both internationally and in Norway. The rise of financial technology, or Fin-Tech, as a separate industry may also imply changes in the supply side interfacing with customers in Norwegian markets. For example, in the payment services and financing segments, new actors are entering the market and offering financial services outside the established financial system, at the same time as financial undertakings

¹ The strong jump in HHI for residential mortgages and life insurance between 2002 and 2004 is linked, among other things, to the merger of DNB and Gjensidige NOR.

are developing competing services within the system. This trend has similarities with the emergence of the so-called sharing economy in other areas, where service provision largely entails arranging for private persons to trade services directly with one another.

Developments in the area of financial technology primarily offer opportunities for the Norwegian financial industry, which has a tradition of innovation and productive technology exploitation. New business models can provide new revenue opportunities for the industry. However, these developments also come with challenges, which must be handled appropriately.

When financial services are provided in new ways and outside the established systems, questions arise in relation to matters such as regulatory adjustments, data and consumer protection and financial stability consequences. The financial industry, new actors, customers and the authorities have to address changes in risk and vulnerability. An important task for the authorities is to ensure that innovation in the context of financial service provision does not undermine customer confidence through weaker solvency and security requirements for actors, irrespective of whether services are provided within or outside the established, regulated financial system.

3.3.3 Solvency requirements set at the national level

The regulations applicable to financial undertakings are growing in scope and complexity, and are increasingly based on international rules. International cooperation is particularly close in the EU/EEA, where the aim is to develop a single rule book for the common market. International cooperation and binding commitments can help improve regulatory systems and supervision in countries in which national standards have been weak, reduce protectionism and favourable treatment of domestic financial industry, improve comparability and transparency, and intensify supervisory collaboration.

The quality of the EU financial markets legislation has improved in recent years, but much work remains to be done. The need for national rules in addition to minimum requirements has therefore declined. Nonetheless, financial markets regulation should be deliberate and knowledge-based, and national authorities should always assess whether the desired result is being achieved, even when minimum requirements have been introduced.

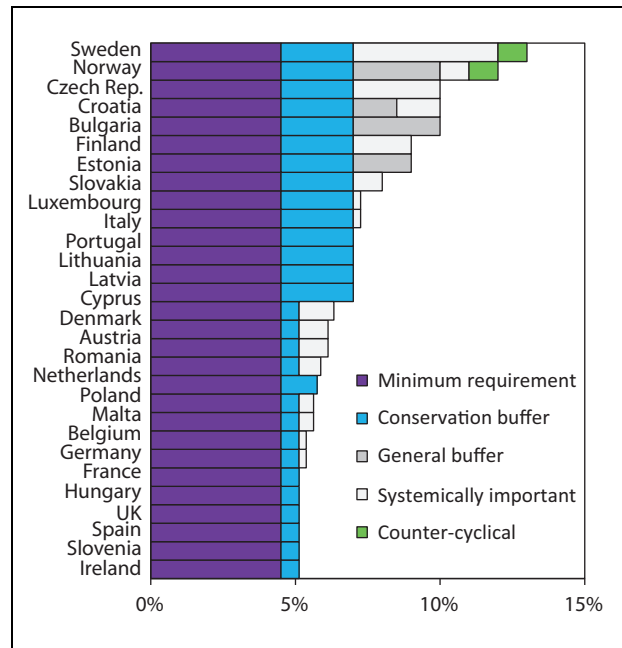


Figure 3.6 CET1 capital adequacy requirements (risk-weighted) in the EU and Norway as at 1 January 2016

Source: ESRB

International committees and other cooperation bodies cannot be expected to investigate and consider the specific consequences in individual countries of the regulations they recommend or adopt. In any event, national authorities will usually be in the best position to assess the consequences of such regulations for their markets. National authorities may also have fiscal motivations to introduce stricter requirements in order to reduce the risk of financial crises and downturns in the national economy, not least to protect their taxpayers. For example, problems in the banking sector may develop quickly, forcing the authorities to implement costly measures to protect the rest of the economy. The costs associated with problems in the financial sector are primarily borne by the country in which the problems arise.

The new EU capital requirements for banks, the CRR/CRD IV framework, offer significant scope for national authorities to increase solvency requirements above the minimum requirements, including through the use of different permanent and temporary capital buffer requirements. There are considerable differences in how the EU/EEA member states have utilised this scope; see Figure 3.6, which shows CET 1 capital adequacy requirements (risk-weighted) as at 1 January 2016. Most EU member states are phasing in stricter requirements over several

Box 3.1 Risk-weighting, capital requirements and floor rules

The solvency requirements applicable to banks and other credit institutions in Norway are based on the EU capital requirements regulations (the CRR/CRD IV framework), which in turn reflect recommendations made by the Basel Committee on Banking Supervision. Simply put, the requirements are formulated as minimum requirements for bank equity as a percentage of bank assets. According to the rules, assets must be risk-weighted based on assumed loss risk. Previously, regulations specified the risk weights to be used for different types of assets. For example, a typical residential mortgage was to be weighted at 50 percent of its value. Since 2007, banks operating internationally and in the EU/EEA have been permitted to use their own models to calculate risk weights (the IRB approach). To prevent such modelling from producing excessively low risk weights, the Basel Committee recommended a floor, i.e. a minimum permitted total value of the risk-weighted assets (RWAs). This value was not allowed to be lower than 80 percent of what it would have been under the old rules (the Basel I rules), which had fixed weights for different asset types. This is the so-called Basel I floor.

The percentage capital requirement for banks – expressed as a minimum of 8 percent of RWAs – was not amended in 2007. Accordingly, it was insignificant for the actual floor requirement whether it was formulated as (1) a floor for risk-weighted assets or (2) a floor for the nominal capital requirement. Both these variants of the Basel I floor required banks to have at least 80 percent of the capital they would have had to have under the old Basel I rules. However, the different variants of the floor rule affect banks' capital adequacy figures. When the floor relates to risk-weighted assets, capital adequacy may fall because the same capital is divided by a higher number. In the EU rules, the floor rule was implemented in a way that gave individual countries scope to choose which variant they wished to use. The Norwegian authorities chose to use the Basel I floor for risk-weighted assets.

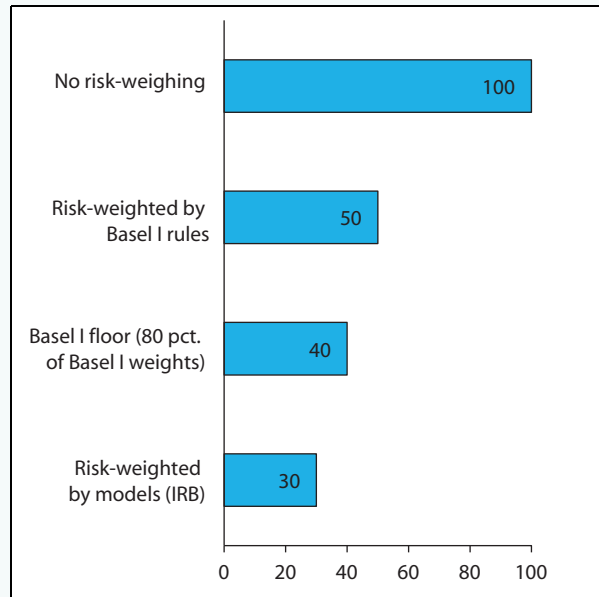


Figure 3.7 Example of risk-weighting of bank assets. NOK billion

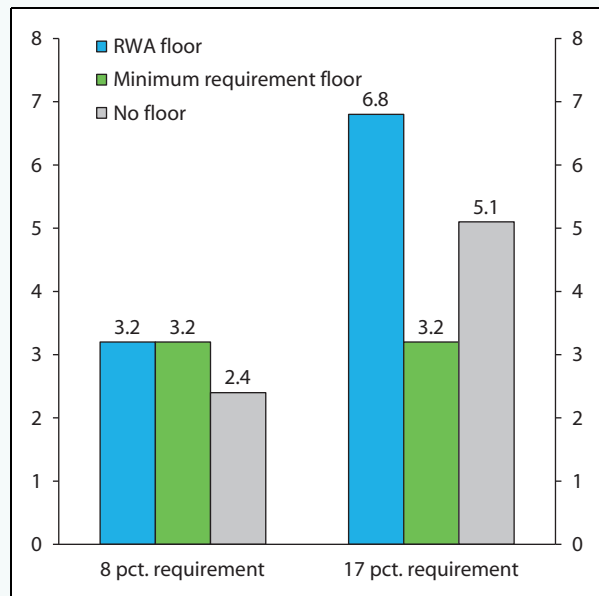


Figure 3.8 Capital requirement for an example bank, with and without different variants of the Basel I floor. NOK billion

Box 3.1 (cont.)

The percentage capital requirement applicable to banks in the EU/EEA was raised after the financial crisis, and is now around 11–18 percent, depending on the capital buffer requirements adopted by different countries. Therefore, it is now significant whether the floor relates to risk-weighted assets or the nominal capital requirement. For many banks, a floor for the capital requirement will have no effect, even if a bank uses very low risk weights, since the percentage capital requirement has increased.

Figures 3.7 and 3.8 illustrate the difference in the case of an example bank with NOK 100 billion in assets. In the example, risk-weighting in accordance with the Basel I rules results in NOK 50 billion in RWAs, while the bank's internal models produce NOK 30 billion in RWAs. If the capital requirement is 8 percent, the bank's capital requirement will thus be NOK 3.2 billion irrespective of which floor variant applies, because both floor rules provide that the requirement must total at least 80 percent of the capital requirement calculated under the Basel I rules. In the absence of any floor rule, the capital requirement would be 8 percent of the RWAs calculated using the bank's internal models, i.e. NOK 2.4 billion. If, instead, the capital requirement is 17 percent,¹ the two variants of the Basel I floor will produce different results. The more lenient variant (based on the nominal capital requirement) produces the same result as before, namely 80 percent of the capital requirement calculated in accordance with the Basel I rules, i.e. NOK 3.2 billion. The second variant of the floor is based on 80 percent of the RWAs calculated under the Basel I rules, and sets the requirement at 17 percent of this amount, i.e. NOK 6.8 billion. The more lenient variant of the floor has no effect in this example, since it results in a lower capital requirement than 17 percent of the RWAs produced by the bank's internal models, i.e. NOK 5.1 billion.

As stated, Norway applies the Basel I floor for RWAs, and the level of the capital requirement is set on the basis that risk weights should not be too low. This application of the floor rule is closest to the variant adopted by the Basel Committee in the Basel II recommendations from 2005.² Sweden and Denmark are among the countries which use the other variant of the Basel I floor, and banks in those countries are therefore able to report relatively high capital adequacy figures based on low risk weights. Since the rules on risk-weighting of assets differ, it is important to highlight actual bank solvency; see section 3.3.5.

The Basel Committee is currently working on new floor rules to be implemented in the EU/EEA in a few years' time; see e.g. the discussion in Box 3.5 in the Financial Markets Report 2014. New floor rules may stimulate more uniform practice across countries and more accurate minimum requirements. In addition, the EU is working on a non-risk-weighted capital requirement (leverage ratio), which is intended to function as an additional floor for risk-weighted requirements and promote transparency and comparability.

¹ Since 1 July 2016, the total capital adequacy requirement for systemically important banks in Norway has been 17 percent, including a counter-cyclical capital buffer requirement of 1.5 percent.

² See the Basel Committee on Banking Supervision (2005), "International Convergence of Capital Measurement and Capital Standards – A Revised Framework". The floor rule is described in several stages in paragraphs 46 to 49 of the document. According to the Basel Committee's description, banks were first to calculate the capital requirement of 8 percent under the old (Basel I) and new (Basel II) rules. If 80 percent of the old capital requirement (Basel I) was higher than 100 percent of the new capital requirement (Basel II), the difference between the two amounts was to be multiplied by 12.5 and added to the bank's risk-weighted assets. This entailed increasing the RWAs to 80 percent of the Basel I level if it exceeded 100 percent of the Basel II level. Multiplication by a factor of 12.5 – the inverse of 8 percent (such that $12.5 \times 8 = 100$) – is a technical solution which "translates" the capital requirement of 8 percent of the RWAs into the RWAs as a whole.

years, and some countries have only just begun.² One difficulty inherent in risk-weighted capital requirements is that risk-weighting can vary between banks and between countries without necessarily reflecting underlying risk factors; see Box 3.1.

Norway is among the countries which have chosen to adopt solvency requirements which are stricter than international minimum requirements, and economic developments in Norway have allowed quicker introduction of new requirements in Norway than provided for in the EU's phasing-in plans. The Norwegian authorities have long emphasised that the requirements are to support economic stability and growth over time, and that regulations which promote bank solvency and financial stability offer substantial economic gains. As discussed in section 3.3.4, however, it may be difficult to achieve this if Norwegian and foreign banks are subject to materially different requirements.

Several studies have estimated the net economic benefits from increased bank solvency. The results show that banks should generally have considerably more capital than the levels prescribed by Basel Committee standards and EU rules; see further discussion in e.g. Box 2.9 of the Financial Markets Report 2011.

EU/EEA law makes a fundamental distinction between domestic financial undertakings and branches of financial undertakings from other EU/EEA countries. In principle, foreign branches are subject to the regulatory and supervisory jurisdiction of their home states, although some non-mandatory components of the EU capital requirements regulations are applicable to all actors operating in the country which sets the requirements. An example is the counter-cyclical capital buffer requirement, which is intended to strengthen banks during periods when imbalances may develop. National authorities also have less influence over banks which are members of groups based in other EU/EEA countries, particularly as regards supervisory follow-up of internal risk models and systems. As in the case of branches of foreign banks, the supervisory authority of the home state has the final say on the approval of e.g. internal models for calculating

capital requirements for such subsidiaries, even if the host country's supervisory authority participates in the evaluation.

Supervisory follow-up of internal models and systems has become a more important aspect of solvency regulation post-2007, as many banks have begun using internal models to calculate capital requirements. The methods and assumptions banks are permitted to adopt in their calculations have a considerable effect on the risk-weighting of assets, and thus also on the actual level of the capital requirements; see Box 3.1. The impact of supervisory follow-up of such matters can be illustrated by new requirements introduced by Finanstilsynet in 2014 relating to banks' calculation of residential mortgage risk. The new requirements imply that banks' models may not produce risk weights for residential mortgages below approx. 20–25 percent. Previously, risk weights could be as low as 10 percent. In principle, doubling the risk weight also means doubling the capital requirement (ignoring the effect of floor rules, etc.)

3.3.4 Identical requirements for sub-markets

Identical risk should be regulated identically, irrespective of what type of financial undertaking assumes the risk. The aim is to prevent risk from accumulating where it is the least regulated. For example, two identical residential mortgages issued in the same market should trigger identical capital requirements for the lenders. If the capital requirements are sufficiently high, this will promote robust solvency and competition among providers in the market. If there are differences in the regulation of the same risk in a market, less regulated actors will win market share and thus undermine the solvency of the financial system in question. In some areas, inconsistencies have developed between the different parts of the EU regulatory framework; see below.

Following the introduction of the Solvency II framework in January 2016, risk management in European insurance markets has become far more uniform than before. The new insurance framework strongly emphasises harmonisation, although it also permits the use of internal models for capital requirement purposes, much like the EU banking rules. It is too early to conclude on how the opportunity to use internal models in the insurance sector will impact actual solvency requirements in national insurance markets.

As stated, solvency regulations in the banking sector vary widely due to differing levels of capital

² For example, all countries must have a so-called capital conservation buffer requirement of 2.5 percent in place no later than 1 January 2019. The requirements applicable in Norway are also to be increased beyond what is shown in the figure. The buffer requirement applicable to systemically important banks is to be increased by one percentage point on 1 July 2016. The counter-cyclical capital buffer requirement will increase from 1 to 1.5 percent as of the same date.

requirements and differing national requirements relating to modelled risk weights. The Government is focused on ensuring that actual solvency requirements applicable to banking operations in Norway are as identical as possible for Norwegian and foreign actors and reflect risk factors in the Norwegian market. If different groups of actors in the Norwegian market are subject to different solvency requirements, this may have a negative impact on competition, advantage the most weakly regulated actors and create challenges for Norwegian financial undertakings. As stated, this in turn may undermine the solvency of the financial system as a whole and increase the risk of financial instability.

Developments in this area are going in the right direction. For example, the counter-cyclical capital buffer requirement under the EU rules is to be set by the respective national authorities, and will apply to all banks operating in a given country, including branches of banks resident in other EU/EEA member states. The EU is discussing whether this principle should apply more generally to bank solvency requirements, so that the requirements of the country in which a bank operates more often take precedence over the requirements of the country in which the bank has its head office. The European Commission recently released for consultation a document on the effects and need for improvement of EU financial markets regulations. Among other things, it identified “inconsistencies and gaps” in the regulations applicable to financial undertakings, including differing regulation of different types of financial undertakings, such as banks and insurance companies. The Ministry of Finance has submitted comments,³ not least emphasising the importance of sufficiently strict requirements and that each individual country should in relevant cases be permitted to set stricter requirements for all actors in its market:

“In recent years, much of the new or revised EU/EEA legislation on financial services has prescribed a greater deal of harmonisation of rules in the internal market, and generally stricter prudential requirements. In some areas, however, the EU/EEA legislation may open for practises that may be deemed too lax for some countries seeking to ensure strong and robust financial institutions. The result may be uneven playing fields, and market pressure to lower prudential requirements down to

the EU/EEA minima. We hope that the Commission will continue its efforts to promote better and more harmonised rules, both at the national and EU/EEA level. If harmonisation of appropriately prudent requirements is not feasible at the EU/EEA level, the legislation should allow for stronger rules at the national level, as well as a greater degree of harmonisation between some countries, making host-country-determined rules applicable for both domestic and foreign institutions’ operations in the country in question.”

Most foreign actors in the Norwegian banking market are based in other Nordic countries. The authorities in the Nordic region cooperate effectively in the area of financial markets supervision. Among other things, this has facilitated agreement among the Scandinavian supervisory authorities that Finanstilsynet’s stricter requirements relating to internal models for residential mortgages should also apply to the operations of Swedish and Danish banks in Norway. This is an important contribution to uniform solvency requirements and robust, equal competition in the Norwegian residential mortgage market.

As stated in Box 3.1, work is also ongoing internationally to define new “floors” for bank solvency based on simpler and more transparent rules than those applicable under general solvency regulations. Such floor rules may mean significantly stricter requirements for banks which are currently permitted to apply low risk weights to different types of loans.

The Government will continue to promote effective competition between banks and financial undertakings. As the international financial crisis has demonstrated, requirements which facilitate effective competition within a framework of financial stability are policies which support economic growth capacity. The Government has discussed competition in the Norwegian financial markets on previous occasions, including in section 2.8 of the Financial Markets Report 2013 and section 3.4.2 of the Financial Markets Report 2014.

3.3.5 Visible solvency

The solvency requirements applied to banks vary from country to country, both in formal terms and in practice. Differences may be due to differing national practice regarding the types of internal models banks are permitted to use to calculate risk and capital requirements. In some countries, the supervisory authorities permit banks to rely

³ Letter of 29 January 2016 from the Ministry of Finance to the European Commission.

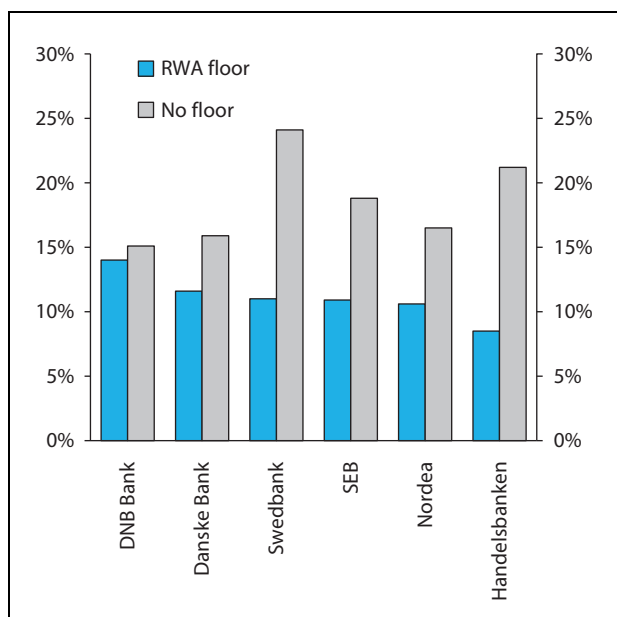


Figure 3.9 CET1 capital adequacy (CET1 capital as a percentage of risk-weighted assets) among the largest Nordic banks at the end of 2015. With and without application of the Basel I floor on risk-weighted assets

Source: Finanstilsynet

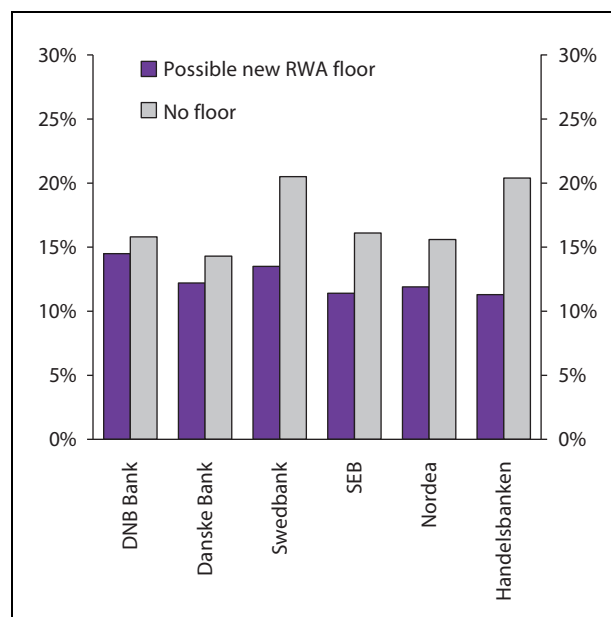


Figure 3.10 Estimated CET1 capital adequacy of the largest Nordic banks at the end of 2015. With and without application of a potential new Basel Committee floor rule to the calculation basis (risk-weighted assets)

Source: Deutsche Bank

primarily on their own data and experience when performing such calculations, while other supervisory authorities require banks to allow for more frequent and larger losses, for example on loans.⁴ Moreover, differing application of floor rules may produce different capital adequacy figures for a given undertaking; see Box 3.1 above. Such differences in rules and practice make the use of official figures to compare actual solvency across banks challenging. In addition, changes in rules and practice may make it difficult to evaluate solvency developments over time.

The solvency of banks impacts their funding costs.⁵ Investors in the capital markets accept lower rates of interest on loans to more solvent banks than on loans to less solvent banks. If there is uncertainty about the true solvency of a bank, that bank's borrowings may be incorrectly priced. Such pricing errors may be favourable or unfavourable to individual banks.⁶ To promote correct pricing of banks' funding, it may therefore be

⁴ The latter means that loans must be assigned higher risk weights when calculating a bank's capital adequacy and capital requirements. Accordingly, if the supervisory authority has decided that the bank must apply more conservative assumptions in its internal models, capital adequacy may be lower for a given undertaking and a given volume of bank capital.

important to make properly visible banks' true solvency.

Norway is one of the countries with somewhat higher bank solvency requirements than implied by international minimum standards, both in formal terms and in practice. Among other things, Norwegian banks which use internal models to calculate risk and capital requirements must apply slightly more conservative assumptions than banks in certain other countries. In addition, Norway's implementation of the Basel I floor means that the value of risk-weighted assets cannot fall below a certain level under any circumstances; see Box 3.1. In some cases, the result is that a

⁵ See for example Box 2.9 in the Financial Markets Report 2011 for a discussion of the benefits and costs of higher bank capital. Note also that the Modigliani-Miller theorem, which states that cost increases due to higher capital are countered by lower required rates of return on capital and lower borrowing rates, may become more applicable as new rules on the treatment of banks in crisis are adopted and implemented. The EU Crisis Management Directive contains, among other things, rules designed to ensure that bank owners and investors bear the majority of losses suffered by banks in crisis.

⁶ For example, more solvent banks may have to pay more for their borrowings than indicated by the risk involved, while less solvent banks may get away with paying a lower rate of interest than investors should actually receive in view of the risk they assume.

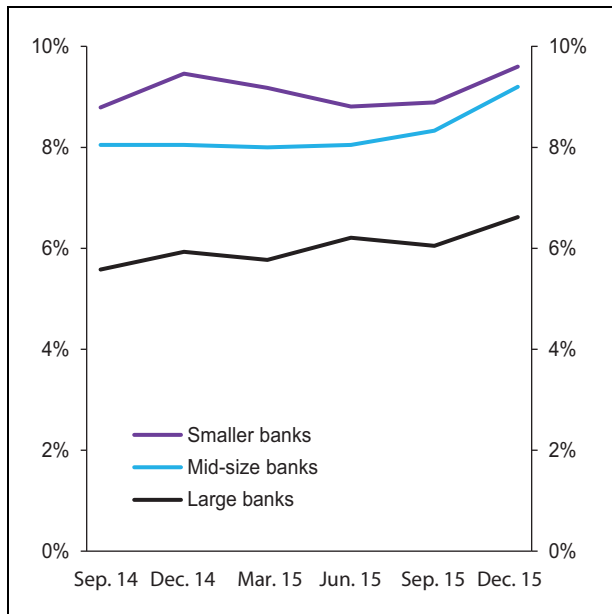
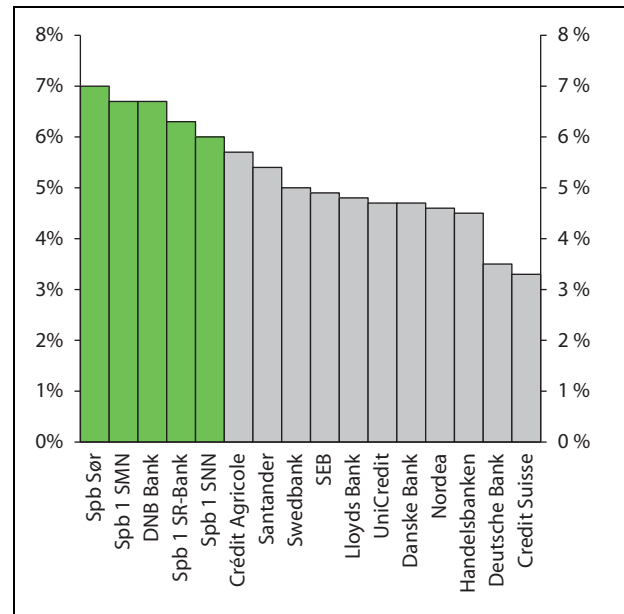


Figure 3.11 Leverage ratios of Norwegian banks

Source: Finanstilsynet

Figure 3.12 Leverage ratios of selected European banks at the end of 2015¹

¹ The leverage ratios are taken from the banks' annual reports. Some banks may have applied slightly different definitions of this indicator.

Source: Finanstilsynet

Norwegian bank may need more capital to achieve a given capital adequacy ratio than a similar bank in another country.

The Ministry of Finance is focused on the visibility of the true solvency of Norwegian banks. This is important to maintain strong international confidence in the Norwegian financial system, and may also promote correct pricing of Norwegian banks' borrowings in the capital markets. The Ministry of Finance has discussed the realities behind bank capital adequacy figures in various contexts over many years, including in white papers and in its dialogue with foreign authorities and market participants.⁷ The Ministry has also urged the Norwegian financial industry to highlight and compare actual bank solvency in banks' reports and presentations to market participants and the general public.

The Ministry of Finance and Finanstilsynet have pointed out what the CET1 capital adequacy ratios of the largest Nordic banks would be with and without Norway's implementation of the Basel I floor (i.e. a floor for the value of risk-weighted assets). Figure 3.9 shows the situation at the end of 2015. At that time, the Norwegian

bank DNB had a CET1 capital adequacy ratio of 14 percent. If the other major Nordic banks had been subject to the same Norwegian Basel I floor as DNB, none of them would have had a CET1 capital adequacy ratio higher than 11.6 percent. However, since Swedish and Danish banks are not subject to such a floor rule, they may in some cases report CET1 capital adequacy ratios more than twice as high as the Norwegian rules would permit.

A new floor rule may contribute to more uniform practice across countries, and more accurate minimum requirements. In last year's financial markets report, the Ministry of Finance discussed the Basel Committee's work on a new floor rule to replace the current – varyingly applied – Basel I floor; see Box 3.5 of the Financial Markets Report 2014. In the box, the Ministry referred to the fact that Deutsche Bank had calculated the effects of a new floor rule based on one potential variant of the rule (the Basel Committee had not formulated the rule in detail in its consultation document). Figure 3.10 reproduces the results for the major Nordic banks, and again shows that the Norwegian bank has the highest solvency when a floor is set for the value of the risk-weighted assets.

The EU is planning to introduce a non-risk-weighted capital requirement, referred to as the leverage ratio requirement. This requirement is

⁷ See for example Box 3.4 and Box 3.5 in the Financial Markets Report 2014, section 3.4.2 of the National Budget 2016 and section 2.4.2 of the Financial Markets Report 2013.

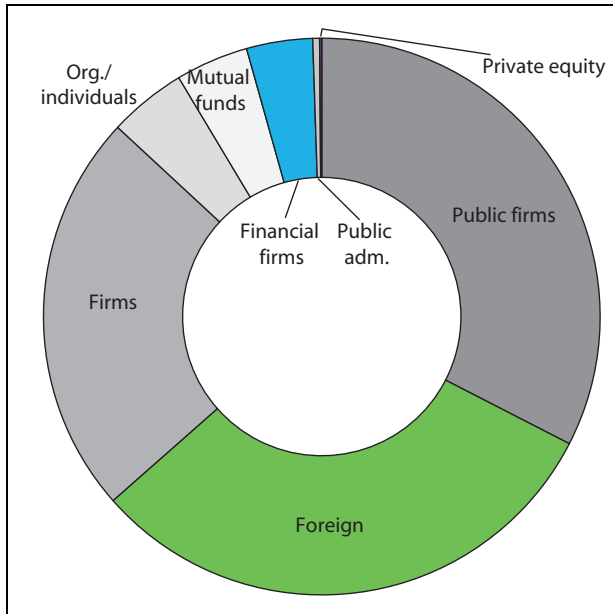


Figure 3.13 Owners of shares issued by non-financial undertakings registered in VPS at the end of 2015

Source: SSB

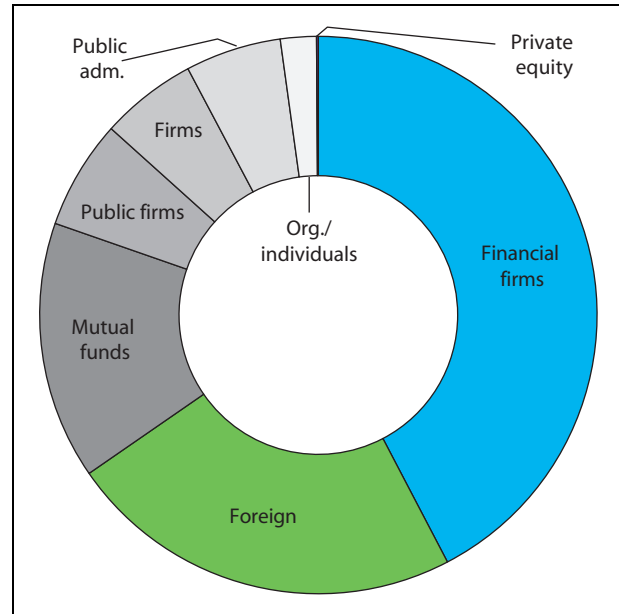


Figure 3.14 Owners of bonds and certificates issued by non-financial undertakings registered in VPS at the end of 2015

Source: SSB

likely to be defined as a bank's tier 1 capital⁸ as a percentage of a non-risk-weighted exposure measure comprising total assets and certain non-balance sheet items. The leverage ratio provides a simple and easily comprehensible picture of a bank's capacity to absorb losses, but provides little information on risk. Nonetheless, studies have shown that it may be a better indicator of bank performance during financial crises than risk-weighted measures of solvency.⁹

According to EU plans, a leverage ratio requirement may be introduced effective as of 1 January 2018, as a supplement to the risk-weighted requirements. The Ministry of Finance has circulated for comments a draft version of a Norwegian leverage ratio requirement of 6 percent for banks (and 3 percent for mortgage companies). It will be permissible to use the same tier 1 capital to meet both this requirement and the risk-weighted capital requirement, and generally only one of the requirements may constitute the effective minimum tier 1 capital requirement for a given bank. In principle, a leverage ratio require-

ment of around 6 percent will not require Norwegian banks to hold more tier 1 capital; see Figure 3.11. In setting the leverage ratio requirement, the Ministry will seek to find a level which in principle does not increase capital requirements faced by Norwegian banks. Figure 3.12 shows that Norwegian banks have high leverage ratios compared to selected banks in other European countries.

Under the current CRR/CRD IV framework, banks in the EU/EEA are required to report on and publish their leverage ratios together with information on their compliance with the risk-weighted capital requirements.¹⁰ This makes it easier for market participants and other parties to compare the solvency ratios of different banks. Norwegian banks perform well in such comparisons. However, market participants also emphasise official requirements, and strict requirements in real terms promote market confidence in the banking sector's solvency.

A leverage ratio requirement which is materially higher than the requirements currently being discussed in the EU will clearly signal that Norwe-

⁸ This is a somewhat wider term than CET1 capital.

⁹ See Norges Bank's *Financial Stability Report 2015* and e.g. Haldane, Andrew and Vasileios Madouros (Bank of England), "The dog and the frisbee", prepared for the Federal Reserve's symposium at Jackson Hole on 31 August 2012.

¹⁰ Currently, the EU regulations do not contain a final definition of the leverage ratio, and the relationship between the reported figures and the final definitions is still somewhat unclear.

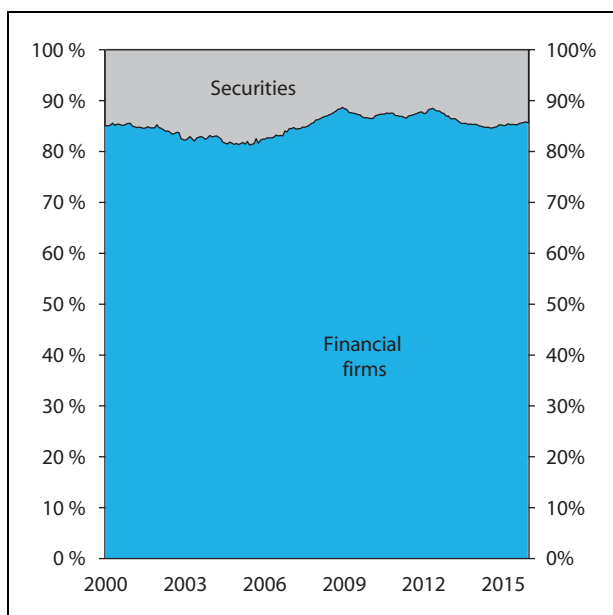


Figure 3.15 Gross domestic debt of non-financial undertakings – main sources

Source: SSB

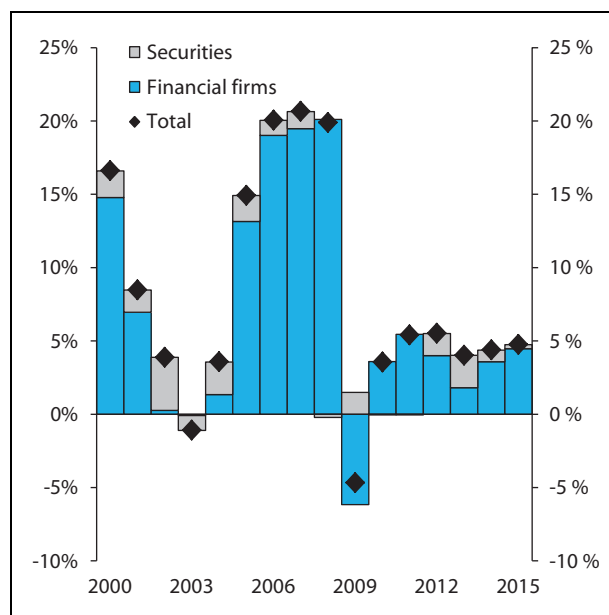


Figure 3.16 Growth in gross domestic debt of non-financial undertakings

Source: SSB

gian banks hold substantial amounts of high-quality capital.

The Ministry of Finance will continue its efforts to make visible the solvency of Norwegian banks vis-à-vis customers, market participants, analysts and others. This work is made easier by the fact that studies and comparisons of the true solvency of European banks consistently show that Norwegian banks are among the most solvent in Europe, particularly when more conservative and robust solvency indicators, in which banks' own assumptions play a lesser role, are applied.

3.4 Access to capital for Norwegian businesses

3.4.1 Source of capital

Equity accounts for approximately 40 percent of the financing of the companies listed on the Oslo Stock Exchange. The remainder comprises various forms of debt. Figure 3.13 shows VPS-registered owners of capital in the form of shares at the end of 2015. The public administration and foreign nationals owned some 30 percent each, while other Norwegian undertakings owned approximately one-quarter. Norwegian securities funds and financial undertakings accounted for around 4 percent each, while investment companies and private equity funds owned 0.13 percent. Although their ownership share is very small,

investment companies and private equity funds can play an important role in the financing of, for example, start-ups, and can support restructuring in the business sector.

About 4 percent of the shares listed on the Oslo Stock Exchange are held by Norwegian private individuals. The Government is of the view that private Norwegian ownership should be boosted as part of improving the competitiveness of the Norwegian business sector.¹¹ It should be more profitable to start businesses, work, save and invest, and the Government is working to strengthen private ownership through a broad set of measures. These include changes to the tax system, simplification of requirements and regulations, investment in research and the facilitation of increased entrepreneurship. The Government is also following up on the Storting's petition resolutions relating to employee co-ownership and accounts for long-term share investment (KLAS),¹² and working on a new white paper on industrial policy.

Figure 3.14 shows the owners of debt instruments (bonds and certificates) issued by non-financial undertakings as at the end of 2015. The

¹¹ See the discussion in the Government's political platform (the Sundvolden platform) and the white paper *Diverse and value-creating ownership* (Meld. St. 27 (2013–2014)).

¹² Resolution nos. 398 and 399 (2014–2015) of 5 February 2015. The Government will consider the two questions together and come back to the Storting at a later date.

Box 3.2 Innovation Norway, Export Credit Norway and the Norwegian Export Credit Guarantee Agency (GIEK)

Innovation Norway is owned by the Ministry of Trade, Industry and Fisheries and county authorities, and has a broad mandate. Its core task is to promote value creation by stimulating commercially and socially profitable business development all over Norway. Innovation Norway provides financing, skills-building, advisory, networking and promotional services. In 2014, Innovation Norway distributed NOK 6.1 billion in loans, grants and similar support measures to businesses, funded by allocations from ministries, county authorities and other public enterprises. This support helped release both substantial investment by businesses themselves and other financing, resulting in the investment of some NOK 15.7 billion in relevant innovation activities in 2014.

Export Credit Norway is owned by the Ministry of Trade, Industry and Fisheries, and provides loans to Norwegian and foreign businesses which purchase goods and services from Norwegian exporters. Export Credit Norway issues so-called Commercial Interest Reference Rate (CIRR) loans and CIRR-qualified market loans on commercial terms. CIRR loans are fixed-rate loans granted in accordance with the OECD Arrangement on Officially Supported

Export Credits. All loans provided by Export Credit Norway must either be guaranteed by a state export guarantee institution and/or a financial institution with a good credit rating, or be otherwise secured in accordance with Export Credit Norway's credit policy. At the end of 2015, Export Credit Norway's lending balance totalled approximately NOK 76.5 billion.

The Norwegian Export Credit Guarantee Agency (GIEK) is a subordinate body of the Ministry of Trade, Industry and Fisheries, and is mandated to promote Norwegian exports and investments abroad by issuing guarantees on behalf of the Norwegian State. GIEK primarily provides guarantees to undertakings which make loans to purchasers of Norwegian export goods and services, and in doing so assumes the risk of purchaser non-payment. GIEK also issues building loans and energy guarantees, and performs a number of administrative tasks. GIEK's guarantee schemes, including any primary capital, must break even in the long run, and guarantees are generally issued on terms identical to those offered by banks in the commercial market. At the end of 2015, GIEK's outstanding guarantee liability under all schemes totalled around NOK 100 billion.

holdings of Norwegian financial undertakings and securities funds are larger in this context – 42 percent and 23 percent, respectively. As in many other European countries, however, bank loans are the most important source of credit for businesses in Norway. More than 80 percent of non-financial undertakings' domestic debt is held by banks and other financial undertakings; see Figures 3.15 and 3.16. This proportion has been relatively stable over time. The bond and certificate markets are discussed further in chapter 2.3.6.

In addition to the ordinary funding markets, various public schemes provide Norwegian businesses with capital. These include Innovation Norway and Export Credit Norway; see Box 3.2.

Surveys show that investors invest more in the equity of companies in their home states than implied by a globally diversified investment portfolio. This phenomenon – i.e. investors preferring to invest in “local” equity – is referred to as “home

bias”. Although observable in Norway, surveys suggest that a “home bias” is not particularly strong among Norwegian investors.¹³

The Norwegian Securities Dealers Association has gathered data on the purchasers of equity instruments in selected (74) equity issues in the period 2011–2015, for companies on Oslo Stock Exchange. The equity portion purchased by foreign investors generally increased with the size of the issue; see Figure 3.17. In smaller issues (less than NOK 200 million), Norwegian owners provided the majority of capital, although there was a wide spread; see Figure 3.18. The figures suggest that equity issues by Norwegian businesses are

¹³ See for example Figure 4 in Shinagawa, Yoko (2014), “Determinants of Financial Market Spillovers: The Role of Portfolio Diversification, Trade, Home Bias, and Concentration”, *IMF Working Paper*. The figure shows that investor “home bias” is higher in certain other countries, including Denmark and Sweden, than in Norway.

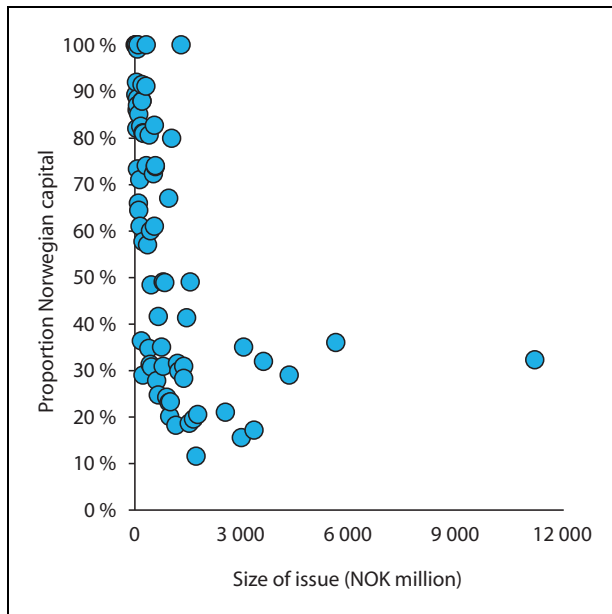


Figure 3.17 Proportion of equity purchased by Norwegian owners in selected equity issues on Oslo Stock Exchange in the period 2011–2015

Source: Norwegian Securities Dealers Association

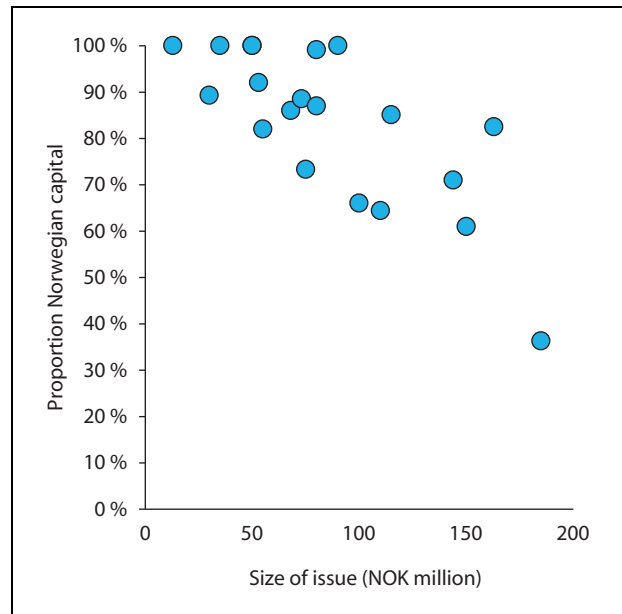


Figure 3.18 Proportion of equity purchased by Norwegian owners in selected smaller equity issues (less than NOK 200 million) on Oslo Stock Exchange in the period 2011–2015

Source: Norwegian Securities Dealers Association

attractive investment objects for foreign investors, but also that Norwegian private ownership is an important source of capital for Norwegian businesses, particularly those that have relatively modest market funding needs. Most businesses in Norway are significantly smaller than the listed businesses included in the two figures provided by the Norwegian Securities Dealers Association.

3.4.2 Stable and diversified credit supply

Economic growth capacity and value creation depend, among other things, on whether profitable projects and businesses in general have access to capital at prices which reflect the risk levels of individual undertakings. Norwegian businesses have varying access to capital from different sources. The Norwegian securities market is well-functioning, Norwegian financial undertakings are solvent, and Norway has appropriate public schemes for the financing of projects for which it is difficult to secure ordinary wholesale funding. Moreover, larger businesses obtain capital in foreign securities markets and from foreign financial undertakings. Together, the Norwegian supply side and integration with foreign markets give businesses access to a diverse range of financing options. New and smaller businesses may find

supply to be more restricted and concentrated around Norwegian and local sources of capital.

The European Commission is seeking to strengthen the role of the securities markets in the financing of European businesses by establishing a so-called capital markets union. This measure is intended to give small and medium-sized businesses easier access to wholesale funding, and to encourage increased integration of European securities markets. The Government has responded positively to the Commission's aims, including in a consultation statement from the Ministry of Finance.¹⁴ In its comments, the Ministry also pointed out that Norway and the other Nordic countries have well-developed bond markets, and that the Norwegian bond market is characterised by an efficient market structure featuring

- low costs;
- flexible, standardised and simple issuance and listing processes;
- transparency in the secondary market; and
- appropriate infrastructure and investor support functions, such as trustee services and digital trading platforms.

¹⁴ Letter of 13 May 2015 from the Ministry of Finance to the European Commission.

The Ministry also pointed out the role of the Norwegian high-yield bond market in meeting demand for cost-effective and simple non-bank financing. In January 2016, the Oslo Stock Exchange launched a new marketplace (Merkur Market) designed specifically for trading in shares and equity certificates issued by small and medium-sized businesses. Among other things, the listing requirements are less stringent than for ordinary listings. By the end of Q1 2016, equity instruments valued at approximately NOK 2 billion were listed on Merkur Market.

The securities markets may become a more important source of financing for Norwegian businesses in the years ahead, not least due to measures implemented as part of the EU capital markets union project. As shown above, however, bank financing is the most important source of credit for Norwegian businesses, and banks and other financial undertakings will remain key credit providers going forward. Solvency is a crucial prerequisite for banks to be able to extend credit to businesses and other borrowers. If solvency insufficiently reflects bank risk levels, there is a high risk that banks will have to cut back lending in future. As stated in section 3.3, the Government is focused on ensuring robust solvency throughout the supply side of the Norwegian banking market.

The EU capital requirements for banks (the CRR/CRD IV framework) contain a transitional provision on loans to small and medium-sized enterprises (SMEs) which provides for a reduction of approximately 24 percent in banks' capital requirement linked to such loans. The provision is often referred to as the "SME discount", and is to be evaluated by the EU shortly. The provision was included in the EU rules in response to the difficult economic situation in many European countries, and has not been implemented in Norway. Such a reduction in the capital requirement will not alter the actual risks associated with lending activities. Implementation of the provision may give SMEs easier access to bank loans in the short term, but this will not necessarily be the case if banks take the actual risks attaching to such loans into account. This type of reduction in the capital requirement may weaken bank solvency over time.

The most important contributions to good, stable capital access for Norwegian businesses are a solvent financial sector and well-functioning securities markets. It is particularly important that bank solvency is not diminished at times when the Norwegian economy has weaker growth prospects.

As well as being credit providers, banks are important financial advisers to Norwegian businesses. The advice and guidance banks give to customers and potential borrowers should include the suitability of different financing forms for different businesses, and how individual businesses should proceed to secure appropriate financing. Banks therefore often play an important role as a financial adviser, beyond the simple granting of credit.

3.4.3 Private pension savings as a source of investment capital

As at 2015, life insurance companies and pension funds were managing approximately NOK 1,200 billion on behalf of customers. A large proportion of this sum comprises assets intended to fund future pensions and may thus be suitable for long-term, less liquid investment. Infrastructure investments may in some cases be well suited to provide long-term, stable returns for life insurance companies and pension funds.

Insurance companies are generally prohibited from borrowing capital, and their assets therefore correspond to either customer claims or equity. While capital management is largely unregulated, the management of funds corresponding to customer claims is subject to quantitative restrictions – not least to maintain confidence in management – including requirements for investments to be adequately diversified and liquid. Norwegian insurance companies have previously pointed out that liquidity requirements may reduce investment in infrastructure by life insurance companies. In response, the Norwegian authorities facilitated increased investment of customer funds in infrastructure in 2011, among other things by establishing a separate asset class for infrastructure investments and generally reducing the liquidity requirement applicable to customer portfolios.

In 2012, the Ministry of Finance commissioned a survey of the regulation and scale of infrastructure investment by pension providers in Sweden, Finland, Denmark, Germany, the United Kingdom, Italy and France. The survey, which was conducted by Finanstilsynet, showed that these countries lacked a clear definition and overview of insurance company investments in infrastructure. Generally speaking, the scale of such investments appeared limited, and no country other than Norway had a regulatory provision granting especially broad permission to invest in infrastructure.

If entire industries are characterised by companies in which ownership is concentrated, institutional investors may find it difficult to secure a sensible stake in a given industry. Investors seeking control of a limited stake may face particular difficulties. Accordingly, it is entirely possible that the general prohibition which prevents Norwegian insurance companies from owning more than 15 percent of the undertakings in which they invest may impact ownership by insurance companies. Some actors have claimed that it is challenging for insurance companies to achieve sensible ownership interests in the infrastructure sector solely by taking stakes of less than 15 percent.

Following the introduction of Solvency II, quantitative investment restrictions have been replaced by qualitative prudential requirements and capital requirements dependent on invest-

ment risk. In connection with the development of an EU capital markets union, the European Commission has given notice of changes in the Solvency II implementation provisions to encourage investment in infrastructure by insurance companies and pension funds. The changes include the establishment of a separate asset class for qualifying infrastructure investments, which will be assigned a lower risk classification than such investments would otherwise be given. This in turn will reduce the capital requirements applicable to such investments.

The Ministry of Finance will consider possible amendments of the regulatory framework to facilitate increased investment of private pension capital in infrastructure. This must be balanced with customer pension security.

4 Regulatory amendments in 2015

4.1 Regulatory developments

This chapter provides an overview of the most important financial market regulatory amendments in 2015. It also details key licences granted during the year, with a brief discussion of each case.

The overarching objective of regulatory amendments within the financial markets area in 2015 was to promote financial stability and well-functioning markets.

4.1.1 Financial undertakings and financial groups

The Act relating to financial undertakings and financial groups (Financial Undertakings Act) was adopted by the Storting on 10 April 2015, and entered into force on 1 January 2016. The Savings Banks Act, the Commercial Banks Act, the Guarantee Schemes Act and the Financial Institutions Act were repealed as of the same date. Existing regulations under these acts will continue to apply until further notice. The Financial Undertakings Act contains rules on licensing, organisational rules, general operational rules and rules on guarantees schemes and solvency failure, as well as provisions on penalties for banks, insurance companies and other financial undertakings. The Act made considerable changes to the Insurance Activity Act. The Act of 4 December 2015 No. 96 relating to changes to finance legislation, etc. remedied a number of oversights in the Act and authorised the Ministry to require banks to provide links to the *Finansportalen* financial services portal.

On 17 November 2015, the Storting adopted amendments to section 9 of the Act of 7 December 1956 No. 1 relating to supervision of financial undertakings, etc. (the Financial Supervision Act) on the allocation of Finanstilsynet's expenses. The Act retains the general principle that Finanstilsynet's expenses must be distributed among the institutions which are subject to its supervision according to the amount of supervisory work. The amendments have simplified the system for allocating such expenses and reduced the amount of

discretion which can be exercised. The arrangement that Finanstilsynet's allocation proposal requires the Ministry's approval has been dropped. The statutory rules authorise the Ministry to issue supplementary provisions in allocation regulations. The Ministry has issued regulations setting out rules for the distribution of expenses between institutions. Both the new statutory provisions and the regulations entered into force on 1 January 2016.

On 18 December 2015, the Ministry of Finance issued new regulations relating to consolidation, etc. in cross-sector financial groups. The Ministry has also adopted new consolidation rules for bank- and insurance-dominated financial groups by amending the CRR/CRD IV Regulations and Solvency II Regulations, respectively. A financial group is formed when a financial undertaking, investment firm, securities fund management company or holding entity in a financial group has a capital interest in or is subject to joint management with another undertaking. Financial groups must meet solvency requirements on a consolidated basis, as though the entire group's operations were located in a single undertaking, although capital requirements apply to each individual financial institution in the group. Previously, the Norwegian consolidation rules were identical for all types of financial groups. The regulations adopted on 18 December 2015 adjusted the consolidation rules to ensure consistency with the Solvency II Regulations and CRR/CRD IV Regulations, and introduced dedicated rules for bank-dominated financial groups, insurance-dominated financial groups and cross-sector financial groups, respectively. The new regulatory provisions entered into force on 31 January 2016.

Also on 18 December 2015, the Ministry of Finance adopted regulations relating to the allocation of supervisory expenses pursuant to section 9 of the Act relating to supervision of financial institutions (the Financial Supervision Act). The regulations govern the distribution of Finanstilsynet's expenses among the different groups which are subject to its supervision, and state that supervision expenses must be distributed among the

institutions which are under supervision at the end of the fiscal year and that a minimum amount must be set for undertakings which become subject to supervision during the course of the fiscal year. The regulations permit Finanstilsynet to set annual minimum and maximum amounts for allocation to the individual entities subject to supervision. Further, a licence application processing fee has been introduced for payment institutions and electronic money institutions. The regulations entered into force on 1 January 2016.

On 18 December 2015, the Ministry of Finance adopted regulations relating to holding entities in insurance groups. The regulations provide that holding entities in insurance groups are deemed to be insurance companies for the purposes of the Financial Undertakings Act and must meet a minimum capital requirement equal to 45 percent of the solvency capital requirement under Solvency II. The regulations entered into force on 31 January 2016.

On 21 December 2015, the Ministry of Finance issued regulations containing transitional rules to supplement the Financial Undertakings Act. The transitional rules are based on a discussion document from Finanstilsynet, and represent an interim solution until the issue of comprehensive, updated regulations.

4.1.2 Banking

On 15 June 2015, the Ministry of Finance adopted regulations setting out requirements for new residential mortgages. The regulations are based on guidelines previously issued by Finanstilsynet. The purpose of the regulations is to promote more balanced development of the housing and credit markets. Among other things, banks are required to calculate a customer's ability to service a mortgage based on income and all relevant expenses, and to include a potential interest rate rise of 5 percentage points in the calculation. Amortising loans secured by residential mortgage may not exceed 85 percent of a property's value, while home equity credit lines may not exceed 70 percent of the property value. These requirements may be satisfied by providing additional security in the form of a mortgage over other real estate or a personal guarantee. Residential mortgages exceeding 70 percent of property value must be amortising. To ensure that banks retain sufficient flexibility to make loans to creditworthy customers who do not meet all the regulatory requirements, the regulations permit up to 10 percent of loans granted each quarter to be loans which do

not meet the regulatory requirements relating to servicing capacity, leverage ratio or amortisation. The regulations entered into force on 1 July 2015, and are due to be evaluated in light of developments in the housing market, household borrowing and any effects on inter-bank competition. The regulations will remain in effect until the end of 2016 unless the evaluation reveals a need for continued application.

Through the Act of 19 June 2015 No. 45 relating to amendment of the Norges Bank Act (the organisation of Norges Bank), the Storting made the following changes to the Act of 24 May 1985 No. 28 relating to Norges Bank and the Monetary System, etc. (the Norges Bank Act): the number of deputy governors was increased from one to two. Both deputy governors are members of the Executive Board. The total number of members of the Executive Board was increased from seven to eight to maintain the existing number of external members. The system of personal substitutes for members of the Supervisory Council was replaced by an arrangement under which the Storting appoints two permanent substitute members. The Executive Board was also granted power to establish subsidiaries as part of the management of the Government Pension Fund Global. The changes took effect on 1 January 2016.

The Regulations relating to relationships between members of Norges Bank's Executive Board and other credit institutions and enterprises were amended with effect from 1 January 2016 to take account of the inclusion of two deputy governors in Norges Bank's Executive Board as of that date. A further change was the replacement of "private undertakings" with "undertakings engaged in commercial activities" in section 1 of the regulations.

On 25 November 2015, the Ministry of Finance adopted regulations relating to amendment of the CRD IV Regulations containing provisions on a liquidity coverage requirement (LCR). These entered into force on 31 December 2015. Finanstilsynet adopted supplementary rules on 22 December 2015.

4.1.3 Insurance and pensions

By Act of 22 May 2015 No. 31, the Storting made amendments to the Occupational Pension Schemes Act concerning detailed limits and rules for disability pensions under private occupational pension schemes which are afforded preferential tax treatment. The changes adapt the regulatory framework governing private-sector disability

pension schemes to the new disability insurance rules under the national insurance scheme. The new rules took effect on 1 January 2016. On 15 December 2015, the Ministry of Finance adopted regulations setting out transitional rules and a number of specific provisions on the calculation of disability pensions and transfers to undertakings' premium funds; see the Regulations of 15 December 2015 No. 1640.

On 25 August 2015, the Ministry of Finance issued regulations to implement detailed rules corresponding to the new EU solvency regulations for insurance companies (Solvency II). The main rules under the new Solvency II regime have been incorporated into the Financial Undertakings Act. The Solvency II Directive is supplemented by implementation provisions, technical standards and recommendations. The regulations contain more detailed rules and transitional provisions (applicable for up to 16 years) relating to the new requirements. The Act and the regulations both entered into force on 1 January 2016, the date Solvency II became effective in the EU.

On 18 December 2015, the Ministry of Finance adopted regulations relating to the annual accounts of non-life insurance companies, and regulations relating to the annual accounts of life insurance companies. These regulations replace the Regulations of 16 December 1998 No. 1241 relating to annual accounts, etc. of insurance companies. The regulations entered into force on 1 January 2016, with effect for financial years beginning 1 January 2016 or later.

On 21 December 2015, Finanstilsynet issued regulations containing rules supplementing the Solvency II Regulations. The new regulations include provisions corresponding to Commission Delegated Regulation (EU) 2015/35 which adjust the capital requirement in connection with exposures to Norwegian municipalities and county authorities. The regulations are framed as an interim solution since the Commission regulation has not yet been incorporated into the EEA Agreement.

4.1.4 Securities trading, securities funds and alternative investment funds

Through the Act of 4 December 2015 No. 96 relating to changes to finance legislation, etc., the Storting made changes to instruments including the Act of 25 November 2011 No. 44 relating to securities funds (the Securities Funds Act). First, a new provision was adopted on the ability of securities funds to combine different investments vis-

à-vis a single issuer. This change took effect on 1 January 2016. Second, the provision in the Securities Funds Act on the power of securities fund management companies to lend financial instruments on behalf of the securities fund was repealed and replaced by a regulatory power permitting rules to be issued by regulation on the use of portfolio management techniques. Lending of financial instruments is considered one of several such techniques. A change was also made to the Securities Funds Act which permits securities fund management companies to provide fund assets on behalf of the fund as security for contracts concluded to achieve efficient portfolio management. These changes will take effect on 1 July 2016.

On 17 April 2015, the Ministry of Finance adopted amendments to the Regulations of 29 June 2007 No. 876 under the Securities Trading Act (the Securities Trading Regulations). The amendments allow undertakings listed in a regulated Norwegian market to apply standard Chinese, Canadian or South Korean accounting principles in their financial reporting, since these are deemed consistent with International Financial Reporting Standards (IFRS) adopted pursuant to Regulation (EC) No. 1606/2002. The amendments implement EEA rules corresponding to Commission Implementing Decision 2012/194/EU.

On 1 September 2015, the Ministry of Finance made changes to the Regulations of 29 June 2007 No. 876 under the Securities Trading Act, the Regulations of 21 December 2011 No. 1467 under the Securities Funds Act and the Regulations of 26 June 2014 No. 877 under the Act relating to the management of alternative investment funds. The changes require investment firms and securities fund management companies to submit reports on their operations to Finanstilsynet every six months instead of every quarter. Managers of alternative investment funds are now also required to report on their operations to Finanstilsynet every six months. The changes came into force on 1 October 2015.

Through the Regulations of 3 September 2015 No. 1022, the Ministry of Finance introduced amendments to the Regulations of 21 December 2011 No. 1467 under the Securities Funds Act. The changes related to manager registration of securities fund ownership interests in a fund's register of ownership interests. The amendments permit managers – instead of maintaining a running overview of the beneficial owners of security fund ownership interests – to ensure by means of agreement that sub-managers meet the duty to

register beneficial owners and provide information to the securities fund management company on request. The regulatory amendments make no changes to other manager duties, such as the duty to provide information on beneficial owners to the tax assessment authorities. The reason for the regulatory amendments was that the duty of managers to register beneficial owners on an ongoing basis created difficulties for both foreign managers and the export-focused segment of the Norwegian industry which wished to market its funds via European fund platforms. The changes took effect on 1 January 2016.

The Act relating to the setting of benchmark rates was adopted on 4 December 2015. In the Regulations of 4 December 2015 No. 1410, the Ministry of Finance introduced rules on a transitional scheme and entry into force. The Act became effective on 1 January 2016 and will apply, among other things, to the setting of the Norwegian money market rate Nibor (Norwegian Interbank Offered Rate). The regulations provide that administrators of benchmark rates must satisfy statutory and any regulatory requirements by 1 July 2016 and submit authorisation applications by the same date.

4.1.5 Estate agency

Through the Regulations of 9 June 2015 No. 618, the Ministry of Finance made amendments to the Regulations of 23 November 2007 No. 1318 repealing the provision setting out detailed requirements applicable to the qualifying examination for estate agents. Following the amendments, estate agency students are subject to university colleges' own programme and examination regulations, like other students. The changes entered into force on 1 July 2015.

By means of the Regulations of 11 December 2015 No. 1466, the Ministry of Finance made a number of changes to the Regulations of 23 November 2007 No. 1318 relating to estate agency. The changes concerned practical experience requirements for personal estate agency authorisation. The changes took effect on 1 January 2016.

4.1.6 Accounting, auditing and bookkeeping

On 30 June 2015, Finanstilsynet approved an amendment to the Regulations relating to the authorisation of accountants, etc. The amendment concerned the content of the aptitude test requirement in the case of applicants with professional

qualifications from other EEA member states (Directive 2005/36/EC). The amendment harmonises the professional content of the aptitude test with the concentration requirement in the educational requirement for authorised accountants (recommended plan for the bachelor's degree in economic and business administration with concentration in external accounting).

On 21 August 2015, the Ministry of Finance adopted changes to the Regulations of 17 December 2004 No. 1852 relating to implementation of EEA rules on adopted international financial reporting standards. The purpose of the regulatory amendments was to incorporate into Norwegian law EEA rules corresponding to three European Commission regulations concerning changes to international financial reporting standards (respectively 2014/1361, 2015/28 and 2015/29).

Changes to the Accounting Act relating to social responsibility reporting entered into force on 1 June 2013. The Ministry of Finance introduced transitional rules pending regulatory provisions on such reporting in accordance with international standards. On 9 December 2015, the Ministry adopted amending regulations which extended the transitional rules to the financial years 2016 and 2017. The transitional rules permit reporting under the Global Compact and the Global Reporting Initiative (GRI) to replace the social responsibility statement required by section 3-3c, first paragraph, of the Accounting Act.

4.1.7 Miscellaneous

In June and December of each year, the Ministry of Finance sets a late payment interest rate for the next six-month period; see section 3 of Act of 17 December 1976 No. 100 relating to Late Payment Interest, etc. (the Late Payment Interest Act). The rate equals the Norges Bank key policy rate, with a surcharge of no less than eight percentage points. On 22 June 2015, the late payment interest rate for the second half of 2015 was fixed at 9.00 percent p.a.; see the Regulations of 22 June 2015 No. 729 relating to late payment interest. At the same time, the Ministry of Finance stipulated a standard debt collection cost compensation amount of NOK 330; see section 3a of the Late Payment Interest Act. The late payment interest rate for the first half of 2016 was set at 8.75 percent p.a.; see the Regulations of 17 December 2015 No. 1694. The same regulations set the standard debt collection cost compensation amount for the first half of 2016 at NOK 370.

On 16 June 2015, the Ministry of Finance adopted regulations permitting all central counterparties to be deemed “qualified” pursuant to the provisions of the Capital Requirements Regulations until 15 December 2015. This transitional arrangement corresponds to the rules adopted by the European Commission in Regulation (EU) 2015/880. The transitional arrangement was extended until 15 June 2016 by regulatory amendment of 14 December 2015. This corresponds to the rules adopted by the European Commission on 11 December 2015 in Regulation (EU) 2015/2326.

4.2 Enacted regulations

In total, the Ministry of Finance and Finanstilsynet enacted 40 sets of financial market regulations in 2015:

Regulations of 17 April 2015 No. 384 relating to amendment of regulations under the Securities Trading Act (the Securities Trading Regulations)

Regulations of 9 June 2015 No. 618 relating to amendment of the Regulations relating to estate agency

Regulations of 15 June 2015 No. 634 relating to requirements applicable to new residential mortgages

Regulations of 16 June 2015 No. 661 relating to amendment of the Regulations of 14 December 2006 No. 56 relating to capital requirements for commercial banks, savings banks, financial undertakings, financial group holding companies, investment firms and securities fund management companies, etc.

Regulations of 18 June 2015 No. 691 relating to amendment of the Regulations relating to the level of counter-cyclical capital buffers

Regulations of 19 June 2015 No. 712 relating to amendment of the Regulations relating to mortgage companies which issue covered bonds secured on public loans, residential mortgages or other real estate

Regulations of 22 June 2015 No. 729 relating to interest in connection with late payment and compensation for collection costs (second half of 2015)

Regulations of 30 June 2015 No. 822 relating to amendment of the Regulations relating to the authorisation of accountants, etc.

Regulations of 21 August 2015 No. 975 relating to amendment of the Regulations of 17 December 2004 No. 1852 relating to implementation of the

EEA provisions on adopted international financial reporting standards

Regulations of 25 August 2015 No. 999 under the Financial Undertakings Act relating to implementation of the Solvency II Directive (the Solvency II Regulations)

Regulations of 1 September 2015 No. 1016 relating to amendment of regulations under the Act relating to the management of alternative investment funds

Regulations of 1 September 2015 No. 1017 relating to amendment of regulations under the Securities Trading Act

Regulations of 1 September 2015 No. 1018 relating to amendment of regulations under the Securities Funds Act

Regulations of 3 September 2015 No. 1022 relating to amendment of regulations under the Securities Funds Act

Regulations of 30 September 2015 No. 1137 relating to amendment of the Regulations relating to the disclosure duty of insurance companies in respect of agreements concerning insurance other than life insurance

Regulations of 2 October 2015 No. 1144 relating to amendment of the Regulations relating to relationships between members of Norges Bank’s Executive Board and other credit institutions and enterprises (Regulations of 7 August 2000 No. 809)

Regulations of 9 October 2015 No. 1175 relating to amendment of regulations under the Act of 24 November 2000 No. 81 relating to defined-contribution pension schemes in employment relationships (the Defined-Contribution Pensions Act)

Regulations of 9 October 2015 No. 1177 relating to amendment of regulations under the Occupational Pension Act

Regulations of 30 October 2015 No. 1247 relating to amendment of regulations relating to the jurisdiction of the Norwegian Labour and Welfare Administration (NAV) to determine pensionable income and social security contributions

Regulations of 25 November 2015 No. 1357 relating to amendment of the Regulations relating to capital requirements and national adaptation of CRR/CRD IV (the CRR/CRD IV Regulations)

Regulations of 25 November 2015 No. 1358 relating to amendment of the Regulations relating to appropriate liquidity management

Regulations of 1 December 2015 No. 1375 relating to approval of amendments to the articles of

- financial undertakings and financial foundations
- Regulations of 1 December 2015 No. 1376 relating to approval of amendments to the articles of financial undertakings and financial foundations
- Regulations of 4 December 2015 No. 1410 under the Act on the setting of benchmark rates (the Benchmark Rate Regulations)
- Regulations of 9 December 2015 No. 1432 relating to amendment of the Regulations of 3 June 2013 No. 568 relating to transitional provisions supplementing the Act of 19 April 2013 No. 15 relating to amendments to the Accounting Act and certain other statutes
- Regulations of 11 December 2015 No. 1464 relating to amendment of the Regulations relating to capital requirements and national adaptation of CRR/CRD IV (the CRR/CRD IV Regulations)
- Regulations of 11 December 2015 No. 1466 relating to amendment of the Regulations relating to estate agency
- Regulations of 15 December 2015 No. 1640 relating to amendment of regulations under the Occupational Pension Schemes Act
- Regulations of 17 December 2015 No. 1694 relating to interest in connection with late payment and compensation for collection costs (first half of 2016)
- Regulations of 18 December 2015 No. 1760 relating to amendment of the Regulations of 14 December 2006 No. 56 relating to capital requirements for commercial banks, savings banks, financial undertakings, financial group holding companies, investment firms and securities fund management companies, etc.
- Regulations of 18 December 2015 No. 1762 relating to amendment of the Regulations relating to capital requirements and national adaptation of CRR/CRD IV (the CRR/CRD IV Regulations)
- Regulations of 18 December 2015 No. 1763 relating to amendment of the Regulations relating to implementation of the Solvency II Directive (the Solvency II Regulations)
- Regulations of 18 December 2015 No. 1764 relating to consolidation, etc. in cross-sector groups
- Regulations of 18 December 2015 No. 1765 relating to capital requirements for holding companies in financial groups primarily comprising insurance companies
- Regulations of 18 December 2015 No. 1775 relating to the annual accounts of non-life insurance companies
- Regulations of 18 December 2015 No. 1776 relating to the settlement of supervision costs
- Regulations of 18 December 2015 No. 1780 relating to repeal of the Regulations relation to application of robustness provisions on a consolidated basis, etc.
- Regulations of 21 December 2015 No. 1807 relating to provisions supplementing the Solvency II Regulations. Adopted by Finanstilsynet pursuant to the Regulations of 25 August 2015 No. 999 under the Financial Undertakings Act relating to implementation of the Solvency II Directive (the Solvency II Regulations)
- Regulations of 18 December 2015 No. 1824 relating to the annual accounts of life insurance companies
- Regulations of 21 December 2015 No. 1794 relating to transitional provisions, etc. supplementing the Act of 10 April 2015 No. 17 relating to financial undertakings and financial groups (the Financial Undertakings Act)
- Delegation of 21 December 2015 No. 1803 of the Ministry's powers under the Financial Undertakings Act to Finanstilsynet

5 Implementation of monetary policy

5.1 Monetary policy guidelines

Pursuant to section 1 of the Norges Bank Act, Norges Bank shall be an executive and advisory body for monetary, credit and foreign exchange policy. The Bank shall issue banknotes and coins, promote an efficient payment system and monitor the money, credit and foreign exchange markets.

The current monetary policy guidelines were introduced by regulation on 29 March 2001; see Box 6.1. The guidelines were explained and expanded on in Report No. 29 (2000–2001) to the Storting on economic policy guidelines, published the same day.

According to the regulations, Norges Bank's implementation of monetary policy must focus on low, stable inflation, defined as annual growth in consumer prices which over time is close to 2.5 percent. Report No. 29 (2000–2001) further stated that Norges Bank must adopt a forward-looking approach when setting the interest rate, and take sufficient account of uncertainty associated with macroeconomic forecasts and assessments. When the Executive Board of Norges Bank sets the interest rate, it must take into account that it may take time for changes in policy to take effect.

The long-term task of monetary policy is to help give the economy a nominal anchor point.

Box 5.1 Regulation on monetary policy

Established by Royal Decree of 29 March 2001 pursuant to section 2, third paragraph, and section 4, second paragraph, of the Norges Bank Act.

Section 1

Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank is responsible for the implementation of monetary policy.

Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 percent over time.

In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

Section 2

Norges Bank shall regularly publish the assessments that form the basis for the implementation of monetary policy.

Section 3

The international value of the Norwegian krone is determined by the exchange rates in the foreign exchange market.

Section 4

On behalf of the State, Norges Bank communicates the information concerning the exchange rate system ensuing from its participation in the International Monetary Fund; see section 25, first paragraph, of the Act on Norges Bank and the Monetary System.

II

This regulation comes into force immediately. Regulation No. 0331 of 6 May 1994 on the exchange rate system for the Norwegian krone is repealed from the same date.

The regulations established flexible inflation targeting as a guideline for monetary policy. In the short and medium term, Norges Bank must balance the consideration of low, stable inflation with the consideration of stability in output and employment. Often, there is no conflict between these two considerations. If a conflict arises, Norges Bank must exercise discretion and weight the two considerations against one another.

5.2 Instruments and balancing exercises in the context of monetary policy

The most important instrument in the conduct of monetary policy is the key policy rate, i.e. the interest rate on banks' overnight deposits with Norges Bank. In normal circumstances, changes in the key policy rate have a strong effect on the very short-term money market rates. Market rates for loans and investments with longer terms are influenced by the level of the key policy rate and by the expectations of market participants regarding the future development of the key policy rate.

Market expectations regarding the key policy rate depend on the market participants' beliefs concerning economic developments, particularly in relation to growth and price rises, and their view on the central bank's future actions. Market rates influence the krone exchange rate, the prices of securities, housing prices and demand for loans, investment and consumption. Norges Bank's key policy rate also influences expectations regarding economic developments and future inflation. Through all of these channels, the interest rate influences the total demand and output situation, as well as prices and wages.

In its 2015 Annual Report, Norges Bank wrote, among other things, the following about flexible inflation targeting:

Norges Bank seeks to maintain inflation close to 2.5% over time. In its conduct of monetary policy, Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment when setting the key policy rate.

Norges Bank publishes their Monetary Policy Report four times a year, simultaneously with the interest rate decisions of the Executive Board. In the reports, Norges Bank analyses the economic situation and developments. The reports also con-

tain Norges Bank's assessments of the counter-cyclical capital buffer; see the discussion in chapter 2.

Norges Bank publishes forecasts of future developments, including forecast for the key policy rate. The bank describes how different monetary policy considerations are balanced. If Norges Bank's monetary policy actions are regarded as stable and credible, the effect of monetary policy is also strengthened. Norges Bank has developed a set of criteria for what the bank considers to be a good future development of the interest rate. The criteria are discussed in the Monetary Policy Reports.

The implementation of monetary policy requires good access to information about economic developments. Since 2002, Norges Bank has gathered information about output and price trends and planned investment and employment levels from its own regional network of firms and public enterprises. Around 1,500 contacts are linked through this network. Along with available official statistics, the reports from the regional network constitute an important part of the Bank's decision-making basis.

5.3 Implementation of monetary policy in 2015

Monetary policy takes effect with a time lag. Developments in inflation, output and employment in 2015 are therefore also influenced by the monetary policy pursued in preceding years.

At the interest rate meeting in December 2014, Norges Bank reduced the key policy rate by 0.25 percentage points, to 1.25 percent. The key policy rate strategy adopted by the Executive Board in the December 2014 Monetary Policy Report was that the interest rate should lie in the interval $\frac{3}{4}$ – $1\frac{1}{4}$ percent in the period until publication of the next report in March 2015, unless the Norwegian economy was exposed to major new shocks.

Prior to the March interest rate meeting, several central banks, including the European Central Bank (ECB) and Sveriges Riksbank, implemented further monetary policy easing. Growth among trading partners was moderate, and approximately as forecasted in the December 2014 Monetary Policy Report. Both oil prices and the Norwegian krone developed somewhat weaker than anticipated. According to Norges Bank, the Norwegian economy developed generally as expected, although the future outlook was weaker than previously assumed. At the interest

rate meeting in March, Norges Bank emphasised that the key policy rate had been cut in December 2014 to counter the risk of a sharp weakening of the Norwegian economy due to falling oil prices. Until then, the impact on the real economy had been relatively small. Following an overall assessment, the Executive Board decided to keep the key policy rate unchanged at 1.25 percent. In Monetary Policy Report 1/15 (PPR 1/15), the bank presented a key policy rate projection indicating that the rate would lie around 1 percent for the next few years, before increasing gradually. The key policy rate projection was lower than in December 2014, for the entire projection period.

During the spring, growth among trading partners was slightly weaker than forecasted in PPR 1/15. Nevertheless, growth in the Norwegian economy was about as expected. The outcome of the wage settlement process indicated that wage growth in 2015 would be lower than estimated. Housing prices had continued to rise, and household debt growth was higher than expected. Consumer price inflation was close to 2.5 percent, approximately as forecasted. At the interest rate meeting in May, the Executive Board decided to keep the key policy rate unchanged at 1.25 percent.

Prior to the interest rate meeting in June, growth among trading partners was weaker than anticipated. In June, oil prices lay between USD 60 and USD 65 per barrel, i.e. a little higher than assumed in the March Monetary Policy Report. Thus far in the quarter, the Norwegian krone had developed as projected by Norges Bank in PPR 1/15, although it depreciated in the weeks preceding the interest rate meeting. New information indicated that growth in the Norwegian economy was a little weaker than expected, and Norges Bank also considered the future outlook to have weakened. Consumer price inflation had fluctuated between 2 and 2.5 percent recently. Norges Bank pointed out that the depreciation of the krone was likely to raise inflation for a period of time, but that longer-term inflation would be dampened by the drop in the wage growth. At the June interest rate meeting, Norges Bank emphasised that longer-term growth prospects and inflation drivers had weakened. Following an overall assessment, the Executive Board decided to cut the key policy rate by 0.25 percentage points, to 1.0 percent. In Monetary Policy Report 2/15, the bank presented a key policy rate projection indicating that the rate would lie just above $\frac{3}{4}$ percent for the next year, before increasing gradually. The key policy rate projection was somewhat lower than in March 2015 for the period until the second

half of 2017, but a little higher towards the end of the projection period.

Oil prices fell throughout the summer. The Norwegian krone depreciated sharply, and was weaker than forecasted in the June Monetary Policy Report. Estimated growth among Norway's trading partners was somewhat lower than in June, and prices in the interest rate market indicated further postponement of the expected rise in foreign interest rates. Growth in the Norwegian economy was approximately as predicted in PPR 2/15, although the future growth outlook appeared weaker. Consumer price inflation was higher than forecasted by Norges Bank in June. At the interest rate meeting in September, the Executive Board of Norges Bank emphasised that the decline in oil prices would slow the growth in the Norwegian economy. It was pointed out that the krone depreciation was likely to boost consumer price inflation in the short term, but that inflation was expected to fall in the longer term. At the September interest rate meeting, the Executive Board decided to cut the key policy rate by 0.25 percentage points, to 0.75 percent. The bank also published a projection for the key policy rate indicating that it would fall to just over $\frac{1}{2}$ percent in 2016. The key policy rate projection was lower than in June 2015, for the entire projection period.

In the period leading up to the November interest rate meeting, trading partners' growth was approximately as forecasted in Monetary Policy Report 3/15. Several central banks had signalled further monetary policy easing. Oil prices developed generally as expected by Norges Bank, although the krone was weaker than forecasted in PPR 3/15. Growth in the Norwegian economy was slightly weaker than anticipated. At the interest rate meeting in November, following an overall assessment, Norges Bank decided to keep the key policy rate unchanged, at 0.75 percent.

Oil prices continued to decline after the November interest rate meeting, falling just below USD 40 per barrel in December 2015. There were prospects of slightly higher growth among trading partners, about as forecasted in PPR 3/15. The Norwegian economy's growth in December was in line with Norges Bank's September estimates. However, there were signs that the oil-price drop was having an impact on other sectors of the Norwegian economy; ones which had continued to grow thus far. On the other hand, the krone's depreciation improved the profitability of exporters and import-competing industry. Consumer price inflation was approximately as forecasted by

Table 5.1 Interest rate decisions of the Executive Board of Norges Bank in 2015

Interest rate meeting	Change in percentage points	Key policy rate post-meeting	Projection for the average of the key policy rate in 2017
March	0.00	1.25	1
May	0.00	1.25	–
June	-0.25	1.00	1
September	-0.25	0.75	½
November	0.00	0.75	–
December	0.00	0.75	0.4

Source: Norges Bank

Norges Bank in September. At its December interest rate meeting, the Executive Board emphasised that the Norwegian economy had developed generally as predicted in PPR 3/15. The future growth outlook was a little weaker than expected. However, the Executive Board also stated that uncertainty about the effect of monetary policy suggested that a gradual approach should be adopted in the interest rate setting. Following an overall assessment, Norges Bank decided to keep the key policy rate unchanged, at 0.75 percent. In Monetary Policy Report 4/15, the bank presented a projection for the key policy rate indicating that it would decline to just under ½ percent in 2016. The key policy rate projection was lower than in September.

Figure 5.2 shows changes in the projected key policy rate from Monetary Policy Report 4/14 to Monetary Policy Report 4/15. Norges Bank reduced its key policy rate projection for the next three years throughout 2015. The bars show the individual contributions of different factors to changes in Norges Bank's interest rate projection. The prospect of lower domestic demand and reduced wage growth both pulled the interest rate projection down during the course of the year, while the depreciation of the krone had the opposite effect.

5.4 Development of money-market risk premiums

Risk premiums in the Norwegian money market rose from 2014 to 2015. Measured as the difference between the three-month money market rate on loans denominated in Norwegian kroner and market participants' expected key policy rate in

the same period, the average premium was just above 30 basis points in 2015.

In its 2015 Annual Report, Norges Bank wrote the following regarding the reason for the increase in the risk premium:

Nibor panel banks base their daily Nibor quoting on a USD interest rate intended to reflect the banks' cost of borrowing USD in the unsecured interbank market. The USD interest rate is adjusted for the forward premium between USD and NOK. With this construction of Nibor as a currency swap rate, external factors can

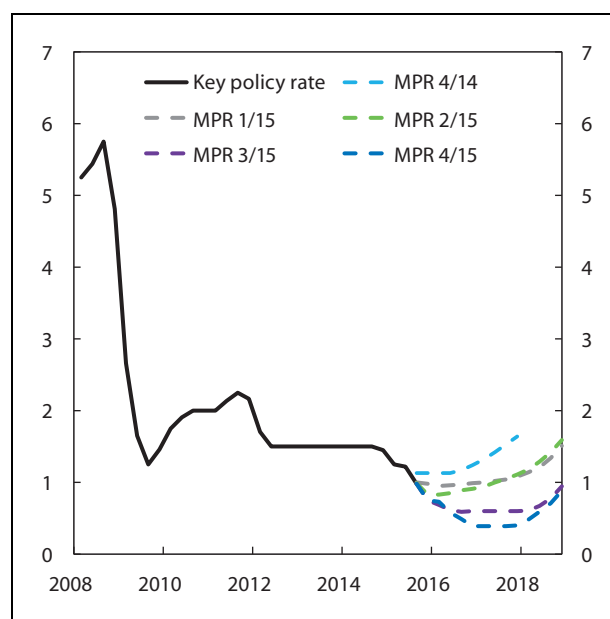


Figure 5.1 Projections for the key policy rate in various monetary policy reports. Percent. 2008 Q1 – 2018 Q4¹

¹ Figure 5.1 is identical to Figure 1.2 in Norges Bank's annual report for 2015.

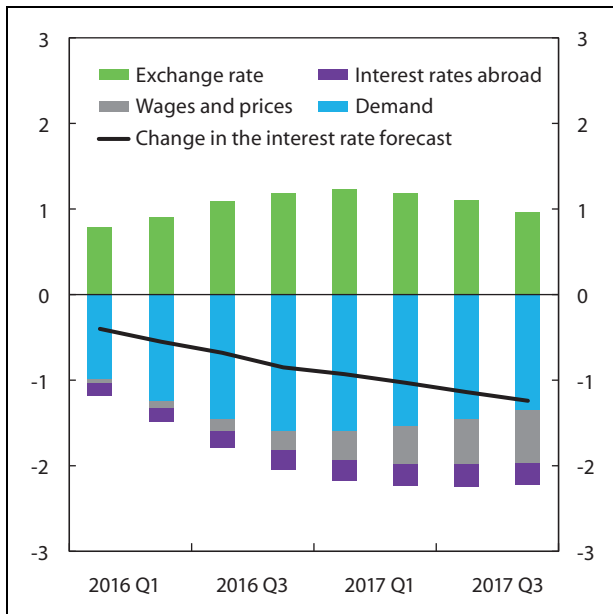


Figure 5.2 Factors behind changes in the interest rate forecast between MPR 4/14 and MPR 4/15. Percentage points. 2016 Q1 – 2017 Q4¹

¹ Figure 5.2 is identical to Figure 1.7 in Norges Bank's annual report for 2015.

Source: Norges Bank

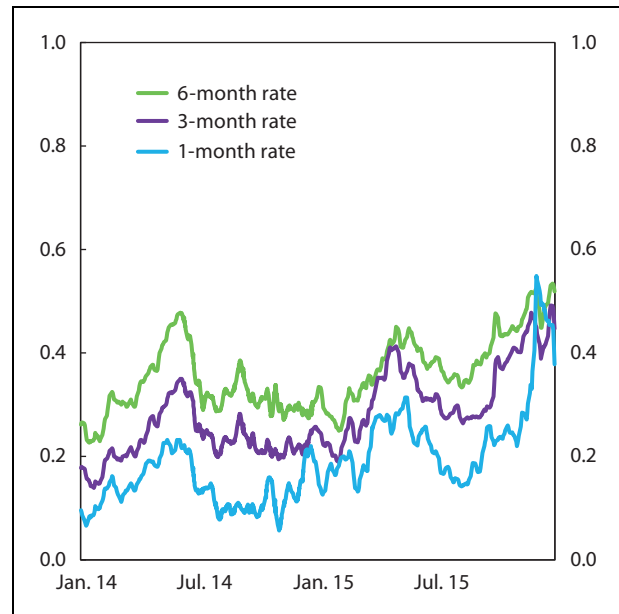


Figure 5.3 Spread between money market rates and expected key policy rate. Percentage points. 5-day moving average. 1 January 2014–31 December 2015¹

¹ Figure 5.3 is identical to Figure 3.4 in Norges Bank's annual report for 2015.

Source: Norges Bank

have a contagion effect on Norwegian money market rates.

In 2015, the European Central Bank (ECB) decided to increase its securities purchases. This increased the supply of EUR relative to USD and raised the cost of swapping EUR for USD in the FX forward market. This indicates a higher premium in the Klem USD interest rate, on which Nibor is based.

The forward premium between USD and NOK is influenced by the relative supply of USD and NOK. Low structural liquidity may make banks more uncertain of their own NOK liquidity situation. Periodically low structural liquidity, particularly towards the end of the year, is therefore likely to have contributed somewhat to the increase in premiums in 2015.

In recent years, the risk premium in the Norwegian money market has been higher in Norway than in many other countries. This fact is an important driver of the authorities' efforts over several years to introduce structural measures for the Norwegian money market.

Rules on the setting of Nibor and corresponding interest rates in other countries have largely been left to the involved banks and their organisations. However, misuse and manipulation have been uncovered in various other countries, and the credibility of Nibor has also been questioned. By Royal Decree of 4 December 2015, it was decided that the Act relating to the setting of benchmark rates (the Benchmark Rate Act) would be introduced on 1 January 2016. The Act is based on a consultation paper prepared by the Financial Supervisory Authority of Norway (Finanstilsynet), and its purpose is to make the setting of Norwegian benchmark rates subject to public regulation and supervision. The new act requires appropriate organisation of the setting of generally used benchmark rates, and approval of the administrator (the party responsible for setting the benchmark rate) and organisational arrangement by the Ministry of Finance. Finanstilsynet will supervise the setting of benchmark rates, and may order changes if such setting is found to be improper or otherwise contrary to the rules.

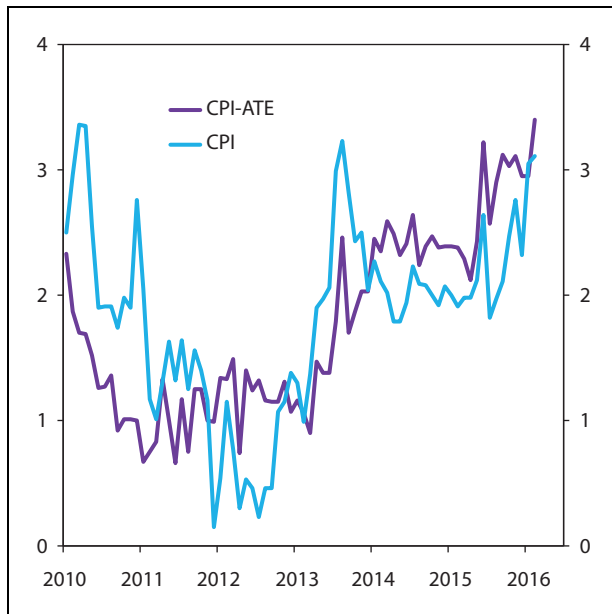


Figure 5.4 CPI and CPI-ATE. Twelve-month change. Percent. January 2010 – February 2016¹

¹ Figure 5.4 is almost identical to Figure 1.33 in Norges Bank's Monetary Policy Report 1/16.

Source: Norges Bank.

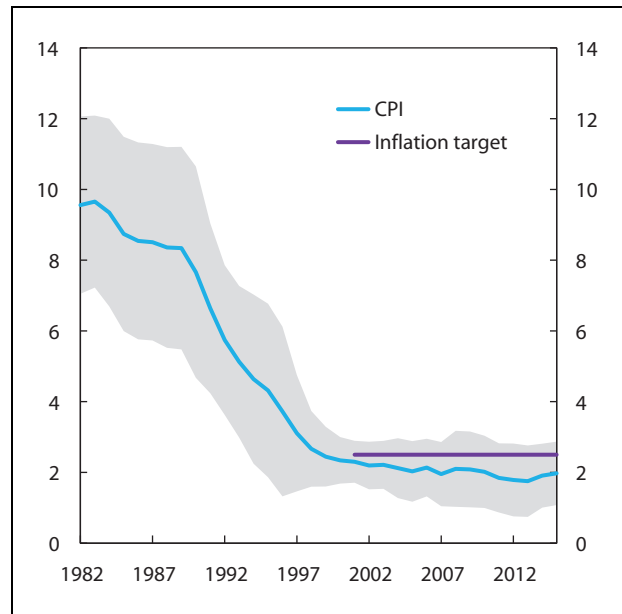


Figure 5.5¹ Inflation. 10-year moving² average and variation³ in CPI. Percent. 1982 – 2015

¹ Figure 5.5 is identical to Figure 1.3 in Norges Bank's annual report for 2015.

² The moving average is calculated over a ten-year period.

³ The band around CPI is the variation in CPI in the averaging period, measured by +/- one standard deviation.

Source: Norges Bank

5.5 Developments in inflation, production, employment and the exchange rate

The consumer price index (CPI) may vary considerably from one month to the next, for example as a result of large fluctuations in electricity prices. Different indicators of underlying price growth attempt to eliminate consumer price changes occasioned by temporary disruptions. Consumer price inflation adjusted for tax changes and excluding energy products (CPI-ATE) is one such measure. Since 2008, Norges Bank has also calculated the CPIXE indicator of underlying inflation, in which CPI is adjusted for tax changes and temporary changes in energy prices. CPIXE seeks to incorporate any applicable energy price trends.

Consumer price inflation (CPI) totalled 2.1 percent from 2014 to 2015, up from 2.0 percent the previous year. The increase in CPI-ATE was 2.7 percent in 2015. Over the past five years, CPI has increased by an average of 1.7 percent per year. Figure 5.4 shows consumer price inflation in recent years.

In its 2015 Annual Report, Norges Bank wrote the following regarding the development of inflation over time:

Experience of flexible inflation targeting in Norway has been favourable. (...) Over the past 15 years, inflation has averaged somewhat below, but close to, 2.5%. The deviation from the inflation target may reflect a number of the supply-side characteristics of the 2000s, such as solid productivity growth, high labour immigration and a low rise in prices for imported consumer goods.

If participants in the economy have confidence that the central bank will achieve its inflation target, they will expect inflation to equal the target in the long run. In its 2015 Annual Report, Norges Bank stated the following:

The stabilising effect of monetary policy on developments in output and employment is dependent on confidence that the inflation target will be achieved. Inflation will not be at target at all times, but if there is confidence in monetary policy, expected inflation will be close to the inflation target over time, which in itself helps to stabilise inflation.

Norges Bank has engaged Epinion to conduct quarterly surveys on topics including expected

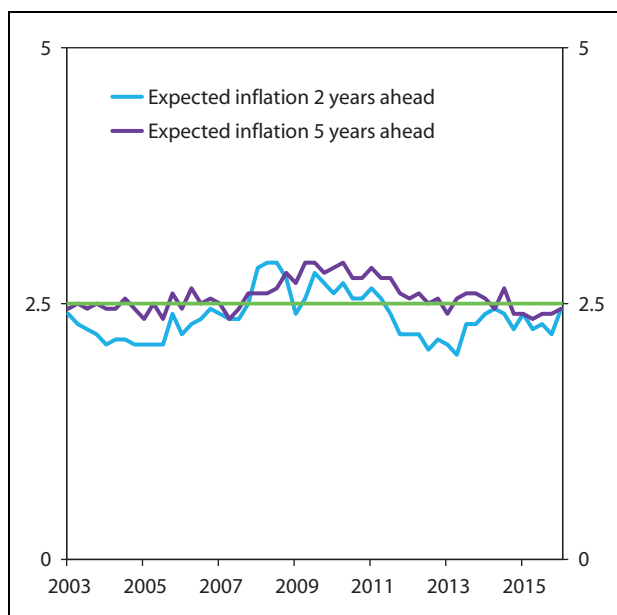


Figure 5.6 Expected consumer price inflation 2 and 5 years ahead.² Percent. 2003 Q1 – 2016 Q1¹

¹ Figure 5.6 is identical to Figure 2.2 in Norges Bank's Monetary Policy Report 1/16.

² Average of the expectations of social partners and economists in the financial industry and academia.

Source: Norges Bank

inflation. Figure 5.6 shows the development in expected price growth in recent years. In the first quarter of 2016, economists expected consumer price inflation to be 2.3 percent in two years' time and 2.2 percent in five years' time. The social partners expected price growth of 2.6 percent in two years' time and 2.7 percent in five years' time. Households' expectations for the price growth have normally been somewhat higher.

Norges Bank uses measures including a calculated output gap to express its assessment of total capacity utilisation in the economy. The output gap illustrates deviations between mainland Norway GDP and a calculated normal level. Figure 5.7 shows Norges Bank's calculated output gap and the variation in the output gap from 1982 to 2015. In its 2015 Annual Report, Norges Bank wrote that, by this measure, fluctuations in the economy have been reduced over time.

Considerable uncertainty attaches to the calculation of the output gap. Norges Bank Staff Memo 8/12 stated the following, among other things:

Potential output is not observable and has to be estimated. There is thus uncertainty surrounding the output gap not only today and ahead,

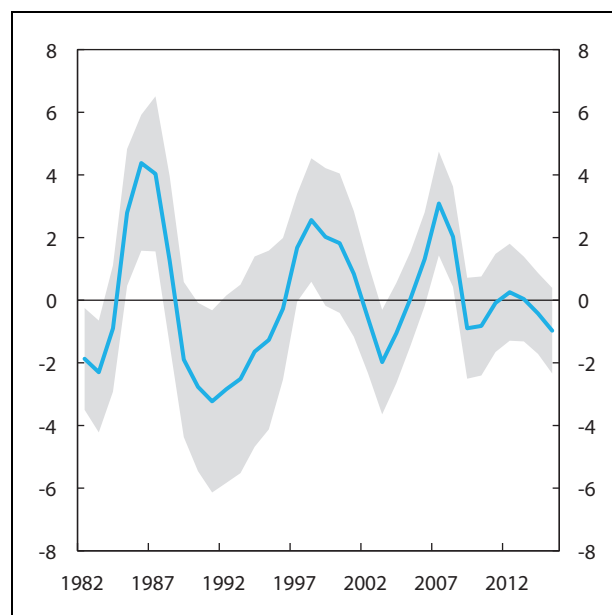


Figure 5.7¹ Estimated output gap². Level and variation³. Percent. 1982 – 2015

¹ Figure 5.7 is identical to Figure 1.4 in Norges Bank's annual report for 2015.

² The output gap measures the difference between GDP and the calculated potential mainland Norway GDP.

³ The band indicates variation in the output gap measured by +/- one standard deviation. The standard deviation is calculated over a ten-year period.

Source: Norges Bank

but also historically. Sources of uncertainty are whether the model chosen is appropriate for estimating potential output and the output gap (model uncertainty), the parameters in the various approaches have to be projected or estimated (parameter uncertainty), and the historical figures and the estimates on which the output gap is based may be revised ex post (data uncertainty). For example national accounts are often revised.

Norges Bank therefore considers that other indicators must also be employed when evaluating capacity utilisation in the economy. Examples of such indicators include developments in unemployment, employment and capacity utilisation reported by Norges Bank's regional network.

5.6 Other parties' assessments of Norges Bank's conduct of monetary policy

Several reports have been made on how monetary policy in Norway has been applied in the period following the presentation of the Financial Mar-

kets Report 2014 in April 2015. The following section briefly discusses the assessments in the following reports:

- “Norges Bank Watch 2016”, a report by a group of experts appointed by the Centre for Monetary Economics (CME) at BI Norwegian Business School. The Ministry of Finance contributes in the funding of these reports
- The OECD’s country report on Norway, which was published on 18 January 2016.
- The IMF’s report from September 2015, which was prepared in connection with an Article IV consultation.
- “Økonomisk utsyn over året 2015” (Economic perspectives 2015) by Statistics Norway, which was published on 10 March 2016.

The Norges Bank Watch report includes the following assessment on Norges Bank’s conduct of monetary policy in 2015:

On the surface, monetary policy execution has been very successful this year. The Norwegian currency weakened sharply in 2013 and 2014, and this has continued during the year. The downturn has not markedly spread to industries and regions not directly hit by the oil price tumble, but we do not know to what extent this is a result of monetary policy or simply is the result of currency markets reacting to the weaker prospects of the Norwegian economy.

While we applaud the gradual lowering of the interest rate itself and the interest rate forecast path, we have some critical remarks on Norges Bank’s communication with the public during the year. This has both to do with the communication given more continuously in monetary policy reports and otherwise, but we also wonder about to what degree Norges Bank’s mandate and the Bank’s own interpretation of the mandate in policy making enlightens us about what to expect when the economy enters uncharted terrain.

The Norges Bank Watch group is critical of Norges Bank’s monetary policy communications in connection with certain interest rate meetings in 2015. This applies particularly to the March meeting, when market participants and analysts expected Norges Bank to reduce the key policy rate but the rate was instead kept unchanged. The group comments as follows:

It is hard to avoid the conclusion that 2015 was a bad year for Norges Bank in terms of predict-

ability and consistency. It made a decision in March which few understood and no one foresaw. The meeting made it clear that shifts in risk assessment are not possible for outsiders to follow.

The group has put forward several proposals for improving monetary policy communications. For example, the group takes the view that, in connection with meetings after which no monetary policy report is published, Norges Bank should state more clearly whether new information indicates higher or lower future interest rates. The group also considers that information about whether the bank considered making a different decision at an interest rate meeting should be published in writing, not simply be provided orally at the press conference.

The Norges Bank Watch group is also of the opinion that adopting a more explicitly formulated monetary policy mandate could help to make monetary policy more foreseeable. The group has discussed whether the mandate should define more explicitly how structural shocks and temporary disruptions are to be dealt with in the monetary policy context. Theoretically, there are good reasons why monetary policy should aim to stabilise domestic inflation. Nevertheless, the group argues that the forward-looking inflation target should be linked to consumer prices, as at present. The group’s arguments include that a consumer price inflation measure is easier to communicate, and that it is difficult to split inflation into a foreign and a domestic component. Monetary policy should nonetheless be applied in such a manner that total inflation may deviate from the inflation target for a period when the economy is hit by structural shocks and temporary disruptions. The group argues that, in the present situation, it is sensible for monetary policy to permit a considerable proportion of the adjustment of the real exchange rate to lower oil prices to occur through krone depreciation and temporary higher inflation. In the report, the group writes the following:

We think – 15 years after the current macroeconomic regime was introduced in Norway – it is time to evaluate the mandate and see if it needs to be reformulated. As mentioned, we think the current price flexible interpretation of the mandate is sound in the present economic circumstances. Norges Bank states that it will abstract from “temporary disturbances” when setting its policy rate. Supply-driven high or low inflation lasting a few years, as the low inflation fol-

lowing the China-shock and today's oil-price shock, could perhaps be denoted temporary disturbances. A sharper formulated mandate could make monetary policy more predictable, and the impact of monetary policy on the economy is often thought to depend critically of the public to anticipate future policy.

According to the group, Norges Bank exercises excessive discretion in taking robustness and financial stability into account when setting the interest rate path. In this regard, the group considers that the monetary policy mandate should be amended to state more clearly whether and how monetary policy should promote financial stability and robust economic development. The group also questions whether the inflation target should be reduced from 2½ to 2 percent.

In its most recent Economy Survey of Norway, which was published on 18 January 2016, the OECD writes the following:

Norway's flexible inflation-targeting regime has a good track record in delivering low and stable inflation. In parallel with many economies, the policy rate has been notched down in recent months; as of September 2015 the policy rate has been 0.75%. Within the current macro-economic context, both globally and domestically, this further monetary easing has been warranted, reflecting renewed fears about the strength of the global economy generally, and in particular for Norway, in view of the oil price declines. There remains further room to manoeuvre. Inflation is temporarily boosted by currency depreciation but otherwise is contained by remaining economic slack and inflation expectations appear well anchored. Monetary policy should therefore remain supportive for some time, but eventually tighten when growth picks up further.

The IMF has commented as follows in a September 2015 report linked to an Article IV consultation:

Directors supported the current monetary policy stance, while urging a careful monitoring of inflation and financial stability risks. They agreed that monetary policy should be the first line of defense if growth turns out significantly weaker than projected, as long as inflation expectations remain well anchored. They recommended the timely implementation of macroprudential measures to contain rising household credit, in order to leave room for mone-

tary policy to support growth while pursuing the inflation target.

In "*Økonomisk utsyn over året 2015*" (Economic perspectives 2015), Statistics Norway states that the key policy rate was reduced twice in 2015 and that money market rates are at record lows. It also stated that:

Increasingly expansionary monetary policy is also an important reason why the decline has not been greater. Combined with the fall in oil prices, lower interest rates have contributed to the krone's depreciation by almost 30 percent from its peak at the start of 2013 until the end of last year. This entails a major improvement in cost competitiveness, which in turn is easing the situation for all Norwegian businesses competing internationally.

Financial stability is discussed further in chapter 2 of this report.

5.7 The Ministry's assessment

The monetary policy guidelines were adopted on 29 March 2001, and there was broad agreement in the Storting on these. Market participants, academics and the general public all appear to have confidence in Norwegian monetary policy. Norges Bank is mandated to exercise case-by-case discretion within the framework of the guidelines. In the Ministry's view, the division of responsibility between the political authorities and Norges Bank achieves the desired purpose.

The Ministry is of the opinion that the framework for Norges Bank's conduct of monetary policy is reliable and has proven itself to be robust even during the financial crisis. The guidelines enabled Norges Bank to cut interest rates sharply when inflation expectations and output dropped in the autumn of 2008. Expansionary monetary policy helped to stabilise the development of the Norwegian economy. The framework is highly consistent with practice in other countries which employ flexible inflation targeting

The framework has also coped well with the sharp drop in oil prices since June 2014. Norges Bank reduced the key policy rate to 0.75 percent in 2015, and further to an all-time low of 0.50 percent in March 2016. Combined with falling oil prices, these interest rate cuts have caused a marked depreciation of the krone and improved the competitiveness of Norwegian businesses.

These developments have helped curb the slowdown in the Norwegian economy's growth rate and rising unemployment.

In April 2015, an official commission was appointed to consider modernisation of the Norges Bank Act. The commission is due to deliver its report by 10 April 2017. Parallel to the commission's work, the Ministry will evaluate the need to modernise the Regulation on Monetary Policy.

The Regulation states that Norges Bank's implementation of monetary policy shall be oriented towards low and stable inflation, defined as annual consumer price growth of approximately 2.5 percent over time. In the short and medium term, monetary policy shall balance the objective of low and stable inflation with the objective of stable output and employment.

Monetary policy is the first line of defence in the context of stabilisation policy. Monetary policy instruments can quickly be changed if the economic outlook changes.

Monetary policy must be forward-looking. Norges Bank sets the interest rate with the aim of stabilising inflation close to the 2.5 percent target in the medium term. The time horizon depends on the disruptions to which the economy is exposed, and on what effects such disruptions have on inflation and the real economy looking forward. In its conduct of monetary policy, Norges Bank is required to balance the objective of stable inflation with the objective of stable output and employment in the short to medium term.

When evaluating price trends over time, the key measure is the development in total CPI. Over the past 15 years, inflation has averaged out at somewhat less than, but close to, 2.5 percent. Increased global division of labour has resulted in low growth and, at times, falling prices for imported consumer goods during this period. This has strengthened the purchasing power of Norwegian households and helped maintain profitability among Norwegian businesses.

There appear to be firm expectations that inflation will be close to target for several years to come; see section 5.5 above. Such confidence in the inflation target makes it easier for Norges Bank to contribute to stability in output and employment.

Total CPI development varies significantly from year to year, not least due to large fluctuations in electricity prices. When assessing current inflation and the future outlook, therefore, CPI does not provide the best assessment basis. Underlying inflation cannot be observed directly, and must thus be calculated. Norges Bank uses

several indicators to obtain a picture of underlying inflation. Consumer prices adjusted for tax changes and excluding energy products (CPI-ATE) is a key index. Norges Bank also calculates the CPIXE index, which has methodological similarities to CPI-ATE but takes account of trends in the development of energy prices. No single indicator can provide a complete answer to the question of what underlying price inflation is or will be in the near future. Using several different indicators of this quantity, as Norges Bank does, helps to improve the assessment basis.

The Norwegian krone has depreciated markedly in recent years. Measured by the import-weighted krone exchange rate, the krone weakened by 5.1 percent in 2014 and 9.4 percent in 2015. The weakening of the krone is linked to the drop in oil prices and the weakened growth prospects of the Norwegian economy. The krone's depreciation has been supported by Norges Bank's interest rate cuts. In a floating exchange-rate system, the exchange rate must be expected to vary. This can help to stabilise economic developments and ease economic restructuring. The recent depreciation of the krone has helped improve the situation for enterprises in Norway engaged in international competition at a time when demand from the oil industry has fallen sharply.

Clear communication of the intentions behind the orientation of monetary policy helps to stabilise expectations among participants in the economy. Norges Bank's publication of its own future interest rate path is important in this respect.

Norwegian monetary policy seeks to be robust and to address the risk of especially unfavourable economic outcomes. Norges Bank has stated that monetary policy should help to counteract the development of financial imbalances. When there is particular uncertainty about future economic developments, it may be right to focus monetary policy on avoiding or alleviating the most unfavourable outcomes. In such situations, more proactive monetary policy may also be indicated.

Robustness is not an independent objective, but Norges Bank emphasises that robustness may lead to a better development in inflation, output and employment over time.

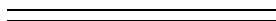
Responsibility for the safeguarding of financial stability is shared between the Ministry of Finance, Norges Bank and the Financial Supervisory Authority Of Norway (Finanstilsynet). Norges Bank and Finanstilsynet are charged with verifying that the financial system is robust and efficient, and therefore monitor financial institutions, securities markets and payment systems to identify stability

threats. Norges Bank is the lender of last resort for banks. Norges Bank is mandated to prepare a decision-making basis and advise the Ministry on the size of the counter-cyclical capital buffer requirement for banks. The bank does this through both its quarterly monetary policy reports and separate letters of advice to the Ministry. The Ministry of Finance has no comments on the form of the decision-making basis or the way in which Norges Bank explains its advice relating to the counter-cyclical capital buffer requirement for Norwegian financial institutions. Chapter 2 of this report contains further discussion of financial stability efforts. The counter-cyclical capital buffer is discussed in Box 2.4.

To allow households and other participants in the economy to make appropriate adjustments, it

is important that Norges Bank provides clear information on its monetary policy assessments. The bank has published its own interest rate projections since the autumn of 2005. The bank has attracted international attention due to its transparency and reliable communication of the assessments behind the application of monetary policy. Norges Bank also reports on the factors emphasised by the Executive Board when preparing interest rate decisions. The Ministry considers that, overall, Norges Bank communicates assessments relating to the use of monetary policy instruments clearly.

The Ministry sees no grounds for commenting on Norges Bank's conduct of monetary policy in 2015.



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