Norwegian Ministry
of Finance

Summary

Meld. St. 34 (2016–2017) Report to the Storting (white paper)

Financial Markets Report 2016–2017

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Recommendation of the Ministry of Finance of 5 April 2017,
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. 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 and the risk, solvency and liquidity outlook for financial institutions.

Chapter 3 discusses a holistic approach to financial markets policy, with focus on access to capital for Norwegian businesses.

Chapter 4 addresses consumer loans, and includes a description of the consumer loan market in Norway, as well as an overview of important challenges in this market and relevant policy measures.

Chapter 5 provides a summary of implemented regulatory changes in 2016.

Chapter 6 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 the technological development in financial markets, 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 enterprises, financial markets and financial infrastructure. It provides a wide range of products and services, including savings products, mortgages, life and non-life insurance, pension savings, 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 satisfactorily manner.

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 the monitoring of financial enterprises, securities markets and payment systems to identify threats to financial stability. Moreover, Finanstilsynet supervises individual financial enterprises 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 2016.

2.2 The macroeconomic situation

Growth in the mainland economy is gradually picking up after a period of low growth as the result of the steep oil price decline and the reduction in demand from the petroleum sector. The last couple of year's downturn nonetheless continues to cast a shadow over the Norwegian economy, and the situation has been particularly challenging in Southern and Western Norway.

2.2.1 The world economy

Growth amongst Norway's trading partners was somewhat lower last year than in 2015 as the result of a lower growth rate for major trading partners such as Sweden, the United States and the United Kingdom. The European Central Bank is continuing its expansionary measures, and is thereby supporting the moderate rebound in the European economy. The Euro zone has seen a gradual decline in unemployment over the last three years, but unemployment still remains higher than before the financial crisis. China continues to register relatively high growth, although this has also declined in recent years. The Chinese authorities are conducting expansionary fiscal and monetary policy to support the necessary restructuring of the economy towards a greater focus on domestic consumption and services, as well as reduction of overcapacity, in addition to more sustainable debt development. Some emerging economies, such as Brazil and Russia, are also experiencing an economic rebound after deep recessions.

Both the United Kingdom's notice of withdrawal from the EU and unresolved questions as to the economic policy of the new US administration add to the uncertainty with regard to international developments in coming years. Mounting protectionism may impair growth in the world economy and serve to reduce demand for Norwegian exports. The risk of turbulence in financial and foreign exchange markets also adds an important element of uncertainty.

2.2.2 The Norwegian economy

Decisive economic policy has helped the Norwegian economy out of recession. Historically low interest rates and expansionary fiscal policy serve to boost domestic demand for goods and services. Norwegian krone depreciation, reduced wage growth and lower corporate taxes have strengthened the competitiveness of Norwegian businesses and laid a sound foundation for restructuring and renewed growth in the Norwegian business sector.

Both businesses and households are becoming more optimistic. Businesses have recently been reporting increased production and are anticipating further expansion. At the same time, the reduction in petroleum investments has abated. Resurgent optimism amongst households has served to increase housing demand; see the discussion of the housing market in Box 2.8, whilst a reduction in real wages has curtailed household consumption growth.

Last year, consumer price growth outpaced wage growth, and real wages declined by 1.8 percent. Lower income tax meant that real wages after tax declined somewhat less. Preliminary data show that annual wage growth last year was 1.7 percent. Wage growth was held back by, inter alia, employment reduction in high-wage industries, such as the petroleum industry. In March this year, the Norwegian Confederation of Trade Unions (LO) and the Confederation of Norwegian Enterprise (NHO) reached agreement in the wage bargaining process for the private sector, based on annual wage growth of 2.4 percent in manufacturing industry. Consumer prices were 2.5 percent higher in February this year than in February last year, after having increased by 3.6 percent in 2016. Adjusted for tax changes and excluding energy products, inflation was 1.6 percent in February, compared to 3.0 percent for 2016 as an average.

Unemployment has declined in the last year. LFS unemployment remains high despite the reductions in December and January, whilst registered unemployment is still relatively low in a historical perspective. Employment growth has been weak in recent years and has not kept up with population growth. There are still major regional differences in unemployment developments. The sum total of persons who are unemployed or on labour market programmes has declined in most counties in the last year. The situation remains challenging in Southern and Western Norway, but the unemployment increase appears to have been halted.

Mainland Norway GDP growth is estimated to increase from 0.8 percent in 2016 to 1.6 percent in 2017; see updated projections published by the Ministry of Finance in March.[1] Employment developments are forecast to improve, with a gradual reduction in unemployment. The Ministry of Finance will present new projections for the Norwegian economy and the world economy in its revised National Budget in May.

2.3 International financial market developments

International financial market developments are important to the Norwegian financial industry and to the Norwegian economy. We know from experience that international market turbulence often leads to increased funding costs for Norwegian banks and enterprises. If funding costs increase, Norwegian banks are likely to tighten credit practices and increase lending rates to maintain profitability. This may impede activity in the Norwegian economy, impair corporate profitability and reduce the ability of households to service debts. Reduced debt service capacity on the part of enterprises and households may result in higher losses on the part of banks. International market turbulence has had little negative impact on banks' funding costs in 2016, although uncertainty surrounding the UK referendum on EU membership and concern about Italian banks resulted in some volatility in the risk premiums on banks' unsecured long-term wholesale funding over the summer.

Norwegian banks generally have good access to wholesale funding, also from abroad, cf. section 2.6. However, fear of weaker economic development internationally led to increased risk premiums in the credit markets in the autumn of 2015 and for the first months of 2016, cf. Figure 2.1. Internationally, there was a tendency for the risk premiums on lending to the banking sector to increase relative to the risk premiums on lending to other sectors, and the prices of credit default swaps (CDS) for the banking sector increased steeply in the first weeks of 2016, cf. Figure 2.2. The prices of credit default swaps for the banking sector in Europe declined in the spring, before increasing

1 https://www.regjeringen.no/no/aktuelt/dep/fin/nyheter/2017/oppdaterte-anslag-for-norsk-okonomi/oppdaterte-anslag-for-norsk-okonomi/id2543146/

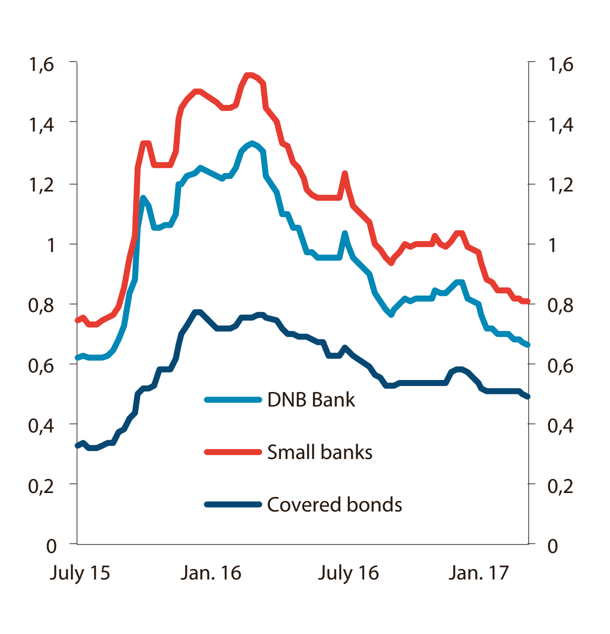

Figure 2.1 Indicative credit spread for 5-year bonds (DNB Bank, small banks with high ratings, and covered bonds). Difference against swap rates. Percentage points

Source: DNB Markets

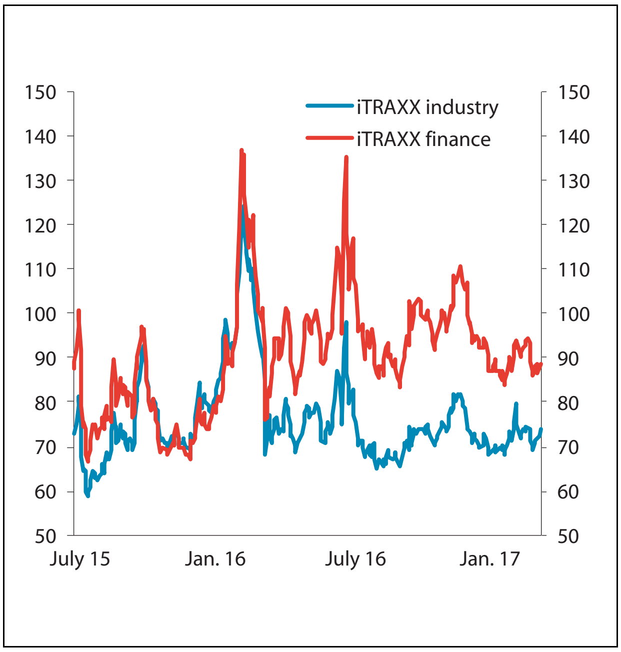

Figure 2.2 CDS prices in Europe.[1] Basis points

[1] CDS prices show the cost of insuring against a credit event. A CDS premium of 100 basis points implies that the annual cost of insuring a NOK 1 million investment is NOK 10,000. The finance category comprises 25 European banks/financial undertakings with credit ratings that are weighted equally. The manufacturing industry category comprises 125 companies with good credit ratings that are weighted equally.

Source: Bloomberg

steeply before and after the UK referendum on EU membership. However, the CDS price increase was short-lived, and prices remained fairly stable for the rest of 2016. In 2016, the European Central Bank's (ECB) asset purchase programme has contributed to lowering the risk premiums for covered bonds denominated in euros. This has also provided favourable funding terms for Norwegian banks. At the same time, the number of Norwegian residential mortgage companies issuing covered bonds in euros has increased.

Weak profitability makes the European banking sector vulnerable to any new negative shocks. The profitability of European banks is generally low, and generally significantly lower than that of Norwegian banks. Profitability is held back by a high cost level, declining interest rate spreads and weak economic growth. According to figures from the European Banking Authority (EBA), the average return on equity for selected European banks was just over 5 percent as at the third quarter of 2016. In comparison, Norwegian banks generated an average return on equity of 10.9 percent in 2016, cf. Box 2.5. Profitability is particularly poor, or even negative in Greece and Portugal. However, banks in larger economies, such as Italy, the United Kingdom and Germany are also struggling with weak profitability and banks in these countries deliver an average return on equity well below 5 percent.

Large holdings of non-peforming loans in a number of countries serve to impair European banks' solvency, profitability outlook and lending capacity; see Figure 2.3. The enfeebled lending capacity impairs European businesses' access to funding and impedes economic growth. In order to improve access to funding for European businesses, it is the ambition of the European Commission to establish a capital markets union (CMU) in Europe by 2019 for purposes of promoting investments and economic growth. The objective is more integrated and well-functioning securities markets, in which businesses can more readily get access to funding outside the banking system.

2.3.1 Brexit

London is one of the world's most important financial centres, and the most important financial centre in Europe. The United Kingdom in general, and London in particular, plays a key role in the single market for financial services in Europe.

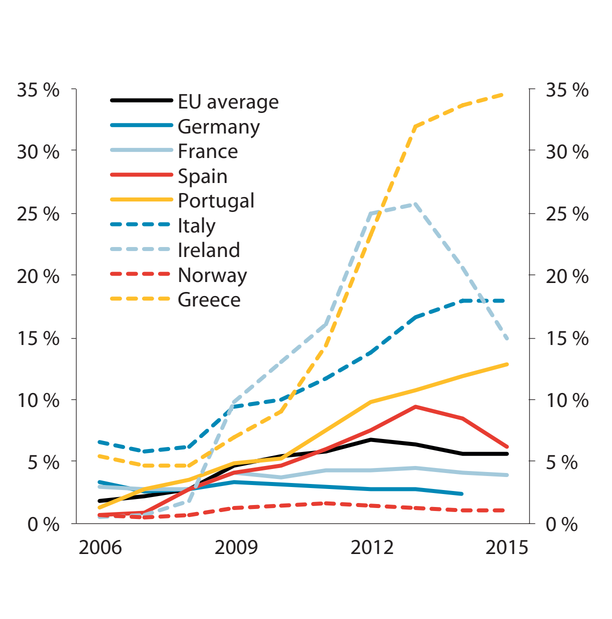

Figure 2.3 Defaulted loans as a proportion of gross lending in selected European countries.

Source: Norges Bank, IMF

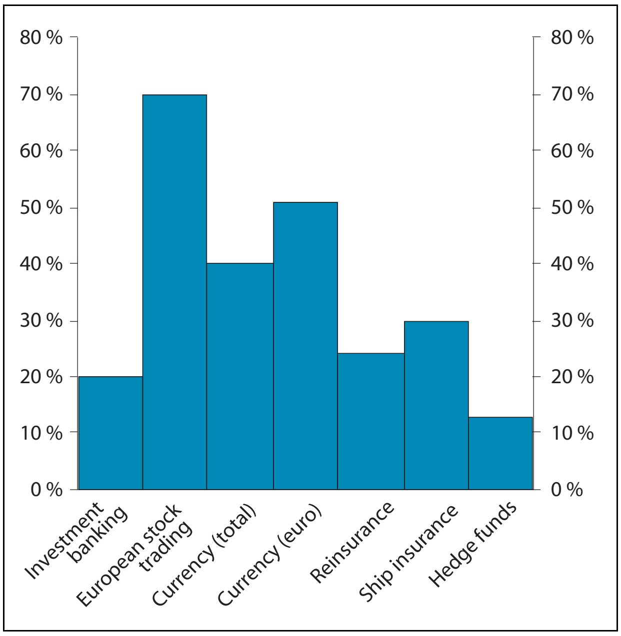

Figure 2.4 UK share of selected markets

Source: IMF

Measured by revenues, the UK financial sector accounts for about one fourth of the financial services produced in Europe.[2] However, in some fields its share is much larger. Almost half of the equity raised in the EU is raised in the United Kingdom. London also has a large market share within the wholesale funding of large enterprises in Europe. The United Kingdom also plays a dominant role within foreign exchange trading. About 40 percent of all foreign exchange trades worldwide and about half of all foreign exchange transactions in euros are effected via the UK market. Figure 2.4 shows the UK financial sector's global market share in selected markets.

The outcome of the referendum on EU membership caught investors by surprise and caused market turbulence at the outset. However, the market volatility was short-lived and did not trigger any major market events, apart from significant divestments in some UK property funds. The effects of a UK withdrawal from the EU are nonetheless uncertain. Given the key role of the United Kingdom in international and European financial markets, a UK withdrawal from the EU may also have implications for Norway in the longer run. The Norwegian financial industry obtains much of its funding via the market in London. Norwegian financial undertakings also have activities in the United Kingdom. DNB (banking group) had engagements in the United Kingdom of about NOK 105 billion as at yearend 2016, including lending to and receivables outstanding from customers and other financial undertakings of about NOK 17.9 billion and NOK 68.5 billion, respectively. Norwegian non-life insurance undertakings had premium revenues of just under NOK 340 million in the United Kingdom in 2015. Correspondingly, UK non-life insurance undertakings had activities in Norway in 2015, in the form of branch and cross-border activities, that brought in premium revenues of about NOK 2.2 billion and NOK 3.5 billion, respectively. UK life insurance undertakings had premium revenues of NOK 167 million and NOK 8 million, respectively, via branches and cross-border activities. A number of insurance brokers and agents are also engaged in cross-border insurance intermediation activities between Norway and the United Kingdom.

The uncertainty as to which forms of affiliation the United Kingdom will have with the EU/EEA following a UK withdrawal from the EU, may result in unpredictability on the part of Norwegian financial undertakings and investment firms. UK withdrawal from the EU may also affect financial regulatory developments in the EU and the EEA.

[2] Source: New Financial

2.4 Structural change in the Norwegian banking market

Through the EEA Agreement, Norway is part of the EU/EEA single market, and financial undertakings from across the EU/EEA are thus free to offer their services in the Norwegian market. Foreign providers have stepped up their presence in Norway in recent years. This development has served to increase diversity and competition amongst financial service providers, but also affects the ability of Norwegian authorities to influence the handling of risk in financial markets, since the foreign financial undertaking shall, as a main rule, be supervised and regulated from its home state. The Ministry of Finance outlined the structure of the Norwegian financial market in chapter 3 of the Financial Markets Report 2015. A key structural change in the Norwegian banking market was the branchification of the Norwegian bank subsidiary of Nordea from 2 January 2017; see Box 2.3.

An element of foreign bank presence may have a stabilising effect on credit supply in Norway in a situation in which the Norwegian economy suffers a setback. However, experience from international crises show that foreign banks will typically want to give priority to their home markets during periods of turbulence or weak growth internationally. Developments towards an increased presence of foreign branches in the Norwegian banking market may thus result in a banking structure that is less vulnerable to domestic shocks, but more vulnerable to international shocks.

2.5 Improved bank solvency

Favourable developments in the Norwegian economy have been a boon to Norwegian banks, paving the way for low loan losses, high demand, easy access to funding and strong performance. Although growth in the Norwegian economy has

Box 2.2 Stress testing of European banks

In 2016, the European Banking Authority (EBA) carried out stress testing of 51 European banks. The banks participating in the stress test represent 70 percent of total assets in the EU. The stress test provides information on banks' capacity to withstand economic shocks. The stress test was coordinated by EBA in collaboration with supervisory authorities, the European Central Bank, the European Systemic Risk Board (ESRB) and the European Commission. The findings will be used in the authorities' assessments of the capital needs of banks. The stress test shows that most banks have become more robust in recent years, although there are large differences between banks. DNB was the only Norwegian banking group participating in the stress test.

The stress scenario the banks were exposed to in the stress test reflects the four systemic risks held by the ESRB to pose the main threats to the stability of the European banking sector:

– Rapid increases in risk premiums, exacerbated by poor liquidity in the secondary market.
– Poor profitability outlook as the result of weak economic growth.
– Concern about whether the debt burden of the public and private sectors is sustainable as the result of weak economic growth.
– Potential stress in a rapidly growing shadow banking sector.

The banks participating in the stress test had an average CET1 capital adequacy ratio of 13.2 percent as at yearend 2015, up 2 percentage points from the previous year and 4 percentage points higher than in 2011. The average CET1 capital adequacy ratio declines to 9.4 percent as at yearend 2018 in the stress scenario. DNB performed well in the stress test, and the banking group's CET1 capital adequacy ratio remained unchanged in the stress scenario. In the stress test, the DNB Bank group's write-downs on lending increase to NOK 24 billion over the period 2016–2018. Net interest income and net gains on financial instruments decline steeply, and annual profits fall to NOK 1.1 billion in 2018.

Allied Irish Bank (4.3 percent) in Ireland and Monte dei Paschi di Siena (-2.2 percent) in Italy were the only banks with a CET1 capital adequacy ratio of less than 6 percent as at yearend 2018 in the stress scenario.

In February 2017, EBA announced that it will carry out new stress testing of European banks at the beginning of 2018. EBA has announced that the stress test methodology will take the implementation of the new IFRS 9 financial reporting standard into account.

Box 2.3 Branchification of Nordea

Nordea Bank AB was established in 2000 following a merger between the Finnish-Swedish Merita-Nordbanken,[1] the Danish Unibank and the Norwegian Christiania Bank og Kreditkasse (Kreditkassen), and is the largest financial group in the Nordic region. Since 2001, the activities of the group have been conducted under the brand name Nordea. As at yearend 2016, the Nordea group had total assets of EUR 616 billion, corresponding to about NOK 5,500 billion. Nordea Bank AB has been identified as a global systemically important bank by the Financial Stability Board. The banking group currently has activities in 16 countries, of which 8 are classified as so-called home markets.[2]

The group's activities in Norway have since the merger been conducted through its wholly-owned bank subsidiary Nordea Bank Norge. Nordea Bank Norge had prior to the branchification been identified by the Ministry of Finance as one of three systemically important financial institutions in Norway, cf. Box 2.6. The bank is the second largest in Norway, with lending market shares of about 14 percent in the corporate market and 6 percent in the retail market.

On 4 February 2016, Nordea Bank Norge applied to the Ministry of Finance for permission to merge with Nordea Bank AB, such as to turn the operations of the Norwegian bank subsidiary into a branch of the Swedish parent bank. Correspondingly, Nordea applied for permission from the authorities in Finland and Denmark to merge the bank subsidiaries in the respective countries with the parent bank.

On 20 December 2016, the Ministry of Finance granted Nordea Bank Norge permission to merge with Nordea Bank AB. Permission was granted on three conditions. In its decision to grant permission for the merger, the Ministry of Finance attached weight to Nordea Bank AB having committed to continue to cooperate closely with the relevant national authorities and to comply with national macroprudential regulations to ensure financial stability in Nordea's home markets. The Finnish and Danish authorities also granted permission for the mergers between the bank subsidiaries in the respective countries and the Swedish parent bank. The mergers were implemented on 2 January 2017.

On 19 December 2016, Denmark, Finland, Norway and Sweden signed a Memorandum of Understanding (MoU) intended to facilitate cooperation on cross-border banking groups that include significant branches. Several of the large Nordic banking groups have activities in neighbouring countries, either through a branch or directly without a permanent establishment. It is a joint objective to promote a level playing field for competition in the Nordic market, and to ensure effective supervision of branches. Ministries and supervisory authorities in the relevant countries have therefore prepared two separate MoUs on significant branches. The two documents pave the way for cooperation on banking groups that include significant branches.

[1] Merita-Nordbanken was established in 1998 via the amalgamation of Merita of Finland and Nordbanken of Sweden.
[2] Denmark, Finland, Norway, Sweden, Estonia, Latvia, Lithuania and Russia.

abated in recent years, banks have performed well. This development continued in 2016, although profits were somewhat lower than for the preceding year; see Box 2.4. The combination of healthy profits and moderate dividend payments has served to improve the solvency of Norwegian banks.

Robust banks with a lot of CET1 capital have a strong ability to withstand losses without having to scale back their activities.[3] A particularly stabilising factor is that systemically important banks have a strong ability to maintain their operations after making losses. If such a bank were to tighten its lending practices in a recession, this alone may have an impact on the economy, accelerating and exacerbating the downturn, cf. Box 2.6. The average (risk-weighted) CET1 capital adequacy ratio of Norwegian banks was 16 percent as at yearend 2016; see Figure 2.5. This is an increase of 1.2 percentage points since the end of 2015. For banks as a whole, the CET1 capital adequacy ratio has

[3] See, inter alia, Box 6.1, «What is CET1 capital adequacy ratio?» in Report No. 1 (2016–2017) to the Storting.

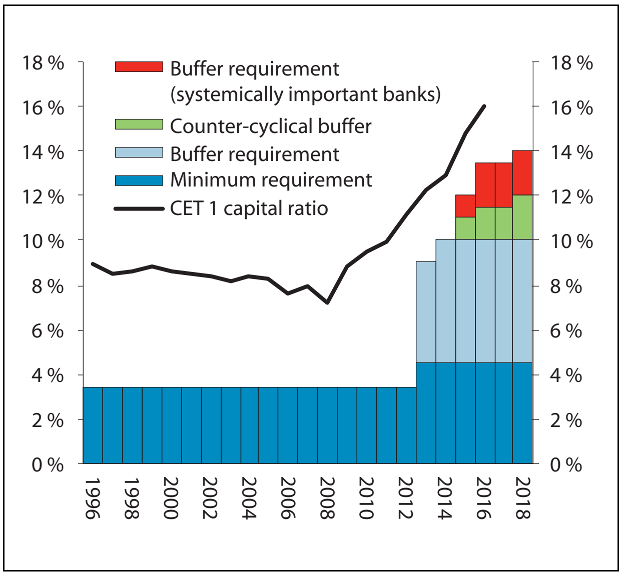

Figure 2.5 CET1 capital as a percentage of risk-weighted assets (CET1 capital adequacy ratio) for Norwegian banks and banking groups, and CET 1 capital adequacy ratio minimum and buffer requirements

Source: Finanstilsynet and Ministry of Finance

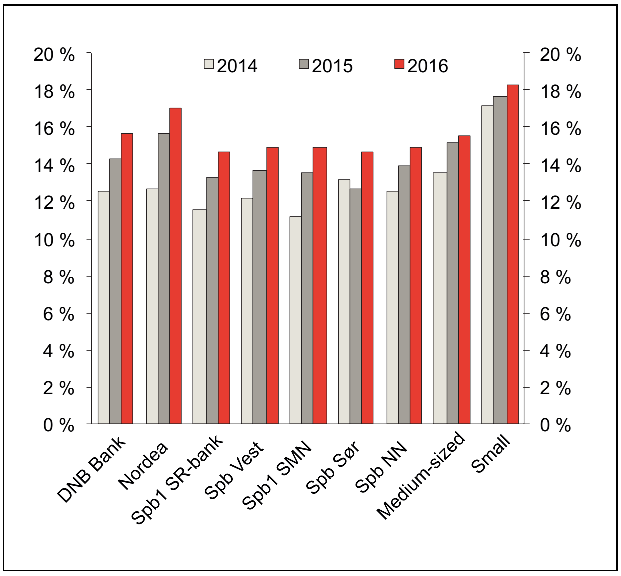

Figure 2.7 CET1 capital of Norwegian banks.[1] Percent of risk-weighted assets

[1] Medium-sized banks are defined as banks with total assets in excess of NOK 10 billion. Small banks are banks with total assets of less than NOK 10 billion.

Source: Finanstilsynet

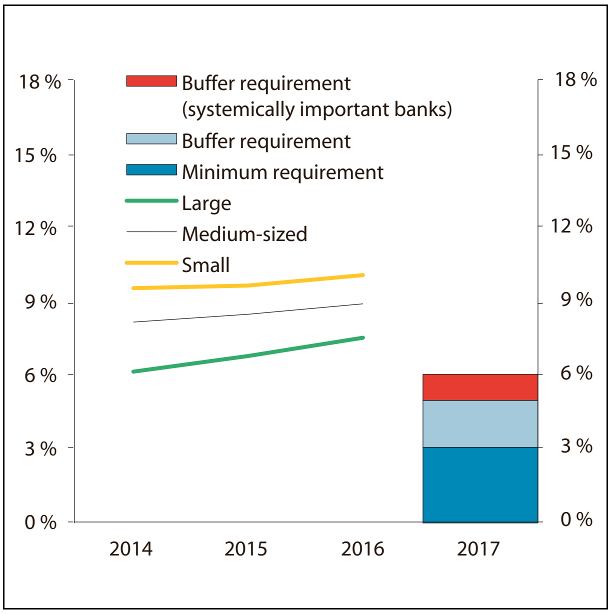

Figure 2.6 Leverage ratio of Norwegian banks and leverage ratio minimum and buffer requirements

Source: Finanstilsynet and Ministry of Finance

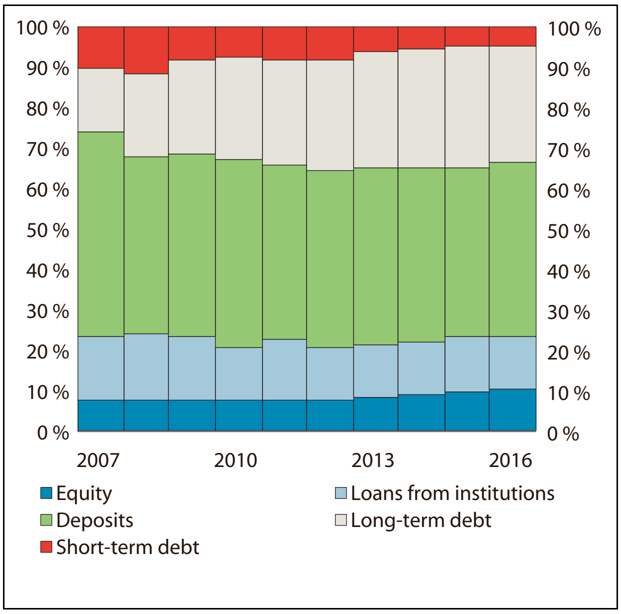

Figure 2.8 Composition of bank and mortgage company funding. Percentage of total assets

Source: Finanstilsynet

increased by a total of 8.8 percentage points since 2008. The increase in the CET1 capital adequacy ratio of Norwegian banks after the international financial crisis shows that the ability of Norwegian banks to handle a potential setback in the Norwegian economy has been improved considerably. On 20 December 2016, the Ministry of Finance laid down leverage ratio requirements applicable with effect from 30 June 2017, cf. the discussion in section 5.1.2 and section 3.3.5 of the Financial

Box 2.4 Bank performance in 2016

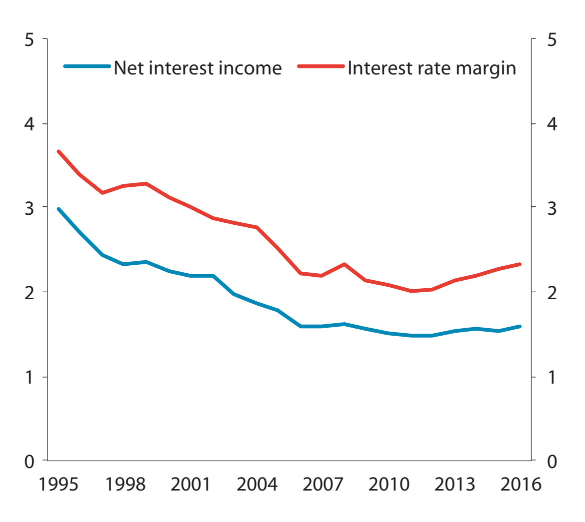

Figure 2.9 Net interest income as a proportion of average total assets and credit spread. Percent

Source: Finanstilsynet

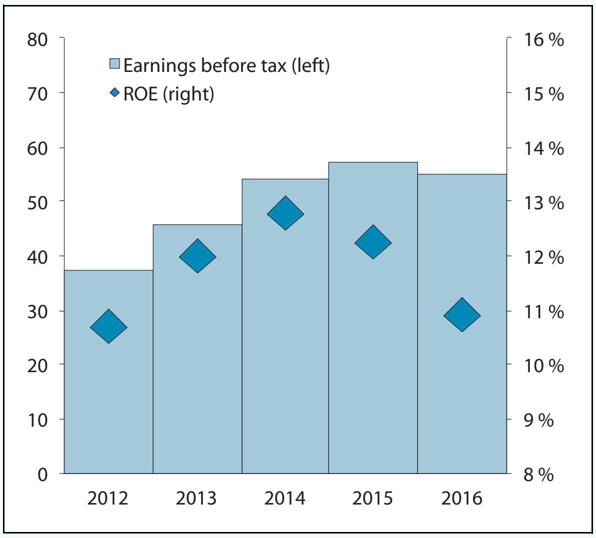

Figure 2.10 Profits of Norwegian banks in NOK billion (left axis) and return on equity in percent (right axis)

Source: Finanstilsynet

In 2016, banks registered pre-tax profits of NOK 55 billion, down from NOK 57 billion the previous year. The profit reduction was primarily due to loss on lending to petroleum-related industries. As a proportion of average total assets, profits declined from 1.12 percent to 1.08 percent. The return on equity (post-tax profit/loss as a percentage of equity) was 10.9 percent, a reduction of 1.3 percentage points from the previous year, cf. Figure 2.10.

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, and this development continued throughout 2016. Banks nonetheless increased their net interest income in 2016 as the result of reduced funding costs; see Figure 2.9.

Markets Report 2015. The average leverage ratio of Norwegian banks was 7.9 percent as at yearend 2016, an increase of 0.7 percentage points on the previous year. The large banks generally have a lower leverage ratio than the other banks; see Figure 2.6. At the same time, the large banks have increased their leverage ratios by the most since 2014. All Norwegian banks met the applicable minimum requirements and buffer requirements as at yearend 2016.

2.6 Improved liquidity

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 swiftly dried up when the crisis began. As access to new funding 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 2.7.

Banks are primarily funded by customer deposits and borrowing from the money and securities markets (wholesale funding). Customer deposits have proven to be a relatively stable source of funding, even during periods of market unrest because of, inter alia, the deposit guarantee scheme. However, the financial crisis demon-

Box 2.5 Counter-cyclical capital buffer requirement

The counter-cyclical capital buffer requirement is an element of the new capital adequacy regulations introduced in Norway in 2013, which are based on the new EU capital adequacy rules (the CRR/CRD IV framework). The level of the counter-cyclical buffer requirement is to be adjusted in view of developments in the Norwegian economy, and is set with a view to ensuring 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 exacerbating a potential recession through more restrictive lending practices. The counter-cyclical buffer requirement shall be applied during periods of particularly high credit growth or other developments that 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 shall normally be notified at least 12 months in advance, a reduction can be implemented with immediate effect.

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 of Finance.

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, the Ministry increased the level of the counter-cyclical capital buffer requirement to 1.5 percent with effect from 30 June 2016.

In a letter of advice on counter-cyclical capital buffer requirements in December 2016, Norges Bank stated that growth in the Norwegian economy is weak, whilst housing prices are increasing steeply. The high housing price growth contributes to high household borrowing, which makes many households more vulnerable and increases the risk of a sudden decline in demand and future loan losses for banks. High housing price growth and continued increases in household debt burdens indicate that financial imbalances are mounting. This suggests, according to Norges Bank, that the counter-cyclical capital buffer requirement should be increased.

In December 2016, the Ministry of Finance decided, in line with the advice from Norges Bank, to increase the level of the counter-cyclical capital buffer requirement to 2 percent from 31 December 2017.

strated that banks' access to wholesale funding can worsen when markets are turbulent. Wholesale funding for banks consists of bonds and short-term borrowing in the form of, inter alia, certificates, as well as covered bonds issued by mortgage companies.

The proportion of short-term wholesale funding has declined somewhat 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 funding, cf. Figure 2.8. A high proportion of long-term funding makes banks less vulnerable to market turbulence. At the end of 2016, covered bonds constituted 44 percent of wholesale funding, an increase of one percentage point compared to the preceding year. One reason why covered bonds have become a leading source of funding is that banks have profited from transferring residential mortgages with good collateral from their balance sheets to mortgage companies that 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 with maturities of less than 3 months increased slightly in 2016, and accounted for just over 20 percent of total wholesale funding as at yearend 2016. It is primarily the largest banks that obtain funding abroad, because size and credit rating are important for access to funding from foreign sources. The smaller Norwegian banks are indirectly exposed to international turbulence via funding from the largest banks.

Box 2.6 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 2-percentage point CET 1 capital buffer, in addition to the minimum CET 1 capital requirement, the capital conservation buffer, the counter-cyclical capital 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 on 20 June 2016. On 2 January 2017, Nordea Bank Norge ASA merged with its Swedish parent bank, cf. the discussion in Box 2.3.

2.7 Debt increases and housing price growth

2.7.1 Household debt increases

Lending to households accounts for about half of overall lending from Norwegian banks and mortgage companies. In addition, banks have been lending to businesses that largely sell goods and services to Norwegian households. The last two decades have seen sustained and, at times, steep increases in household debt. As at the end of January 2017, the twelve-month increase in household debt was 6.5 percent. Debt increases have outpaced income increases for a long period of time, thus increasing the household debt burden, cf. Figure 2.12. More than 90 percent of household debt is secured by residential real estate. Credit risk on household debt is therefore closely linked to the ability of Norwegian households to pay interest and instalments on their residential mortgages, and to the value of their homes.

The housing price growth in recent years has increased the borrowing demand of Norwegian households. Higher housing prices have also increased the value of homes as collateral, and thus also the access of households to borrowing. History provides several examples of such self-reinforcing housing price growth and debt increases continuing longer than is sustainable over time, and most financial crises internationally have occurred in the wake of periods of steep increases in asset prices and rapid debt accumulation. 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 such as the IMF and the OECD. On average, the debt of Norwegian households is more than twice their disposable income. This is a high level, both historically and compared to other countries.

In particular, households with large debts and low debt service capacity may experience financial difficulties in the event of loss of income or a decline in housing prices. In 2014, average debt in the 25–34 year age bracket was more than three and half times average disposable income. However, many households have much larger debts. The proportion of households with debts exceeding five times disposable income has increased significantly since the late 1990s; see Figure 2.13. In 2014, 14 percent of households had debts exceeding five times disposable income. These households also hold an increasing share of total debt. However, this group primarily comprises younger households and households with medium to high incomes.

The average residential mortgage rate declined by 0.2 percentage points in 2016, after having declined by 0.9 percentage points during 2015; see Figure 2.14. The low interest rates mean that the household interest burden, measured as interest expenditure as a percentage of disposable income plus interest expenditure, is relatively low, cf. Figure 2.12. In addition to paying interest, households also need to pay instalments. The debt service coverage ratio is a measure of what proportion of disposable income households devote to covering both interest and instalments, assuming that the debt is to be repaid over 18 years. Household debt servicing expenditure, as measured in this manner has, as illustrated by Figure 2.12, increased considerably since the mid-1990s. This increase is the result of the debt constituting a larger proportion of household income than before. The burden on households will, as shown in Figure 2.15, increase considerably in the event of a five-percentage point interest rate increase. These are average figures, and many households will also be vulnerable to smaller

Box 2.7 Liquidity coverage ratio requirements

In total, Norwegian banks and banking groups had a liquidity coverage ratio of 143 percent as at yearend 2016. The liquidity coverage ratio 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 coverage ratio indicates that banks and other credit institutions are well equipped to absorb a certain amount of stress. The reserves of large banks totalled 142 percent, while medium-sized and smaller banks had reserves of 152 and 145 percent, respectively; see Figure 2.11. The liquidity coverage ratio can be measured separately for individual currencies, or as a total across currencies. The Norwegian krone-denominated liquidity coverage ratio of Norwegian banks totalled 88 percent as at yearend 2016.

Under 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 ratio 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]

On 26 October 2016, the Ministry of Finance circulated for consultation a proposal from Finanstilsynet on liquidity coverage ratio requirements in significant currencies, with a deadline of 31 January 2017 for submitting consultative comments. Finanstilsynet proposes the introduction of general liquidity coverage ratio requirements in significant currencies, corresponding to the level applicable to all currencies as a whole, with the exception of Norwegian kroner for banks and mortgage companies that have euros and/or US dollars as significant currency. For such undertakings, Finanstilsynet proposes the introduction of a 50-percent LCR requirement in Norwegian kroner. For other banks and mortgage companies that principally have Norwegian kroner as significant currency, it is proposed that the general liquidity coverage ratio rules shall also apply specifically here.

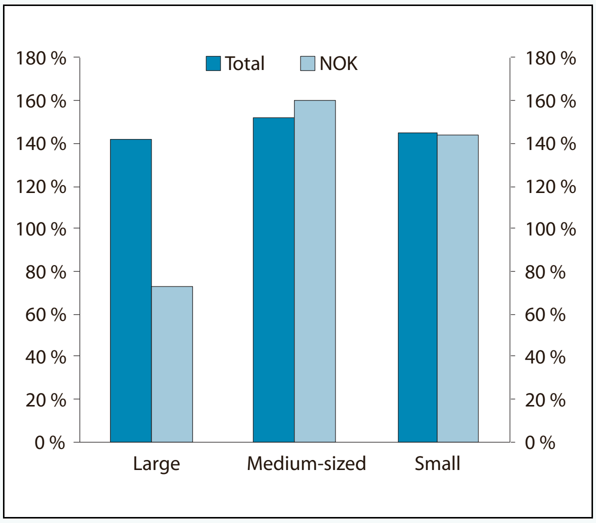

Figure 2.11 Liquidity coverage ratio (LCR) of Norwegian banks as at yearend 2015. Percent

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.

interest rate increases, whilst others can withstand much larger interest rate increases.

One of the risks of a high household debt burden is that many households will reduce consumption simultaneously, e.g. upon an interest rate increase. Experience shows that households often give priority to servicing their residential mortgages as long as possible, and that the impact on businesses can be severe even if losses on residential mortgages are relatively low. In order to counter an accumulation of systemic risk as the result of excessive household credit growth, the Ministry of Finance has laid down interim regulations stipulating requirements as to the lending practices of banks. The Ministry of Finance has outlined other macroprudential tools that may serve to reduce systemic risk in the financial markets in chapter 6 of Report No. 1 (2016–2017) to the Storting.

2.7.2 Regulation of lending secured by residential mortgage

The very steep housing price growth in recent years (see Box 2.8) has served to increase Norwegian households' loan demand. If banks' lending practices are imprudent during long periods of high loan demand, financial imbalances may

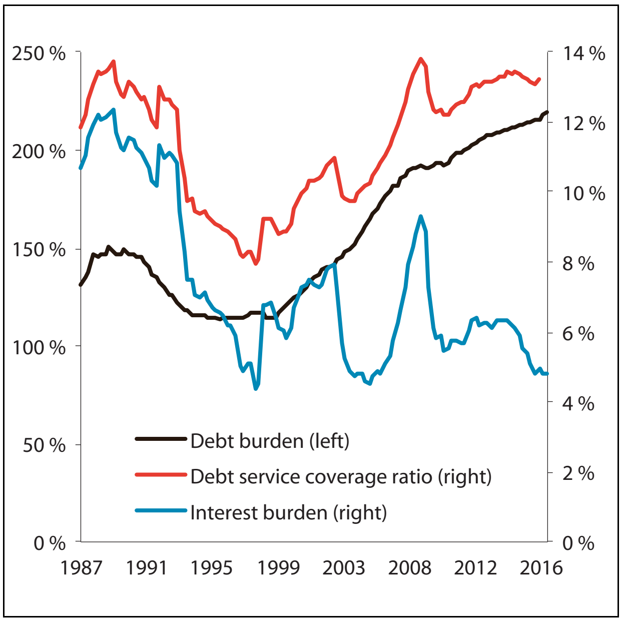

Figure 2.12 Household debt burden[1] (left axis), interest burden[2] and debt service coverage ratio[3] (right axis). Percent of disposable income

1 Debt burden is measured as total borrowing as a percentage of disposable income.
2 Interest burden is calculated as interest expenditure as a percentage of disposable income plus interest expenditure.
3 Debt service coverage ratio includes, in addition to interest expenditure, estimated instalments on the borrowing, based on an 18-year repayment period.

Source: Statistics Norway and Norges Bank

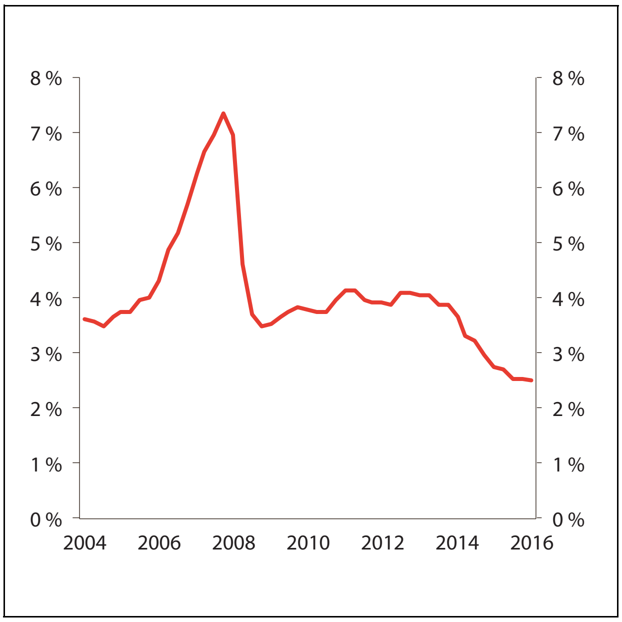

Figure 2.14 Interest rate on lending secured by residential mortgage to personal customers. Weighted average of all banks in Norway, including mortgage companies issuing covered bonds. Percent

Source: Finanstilsynet

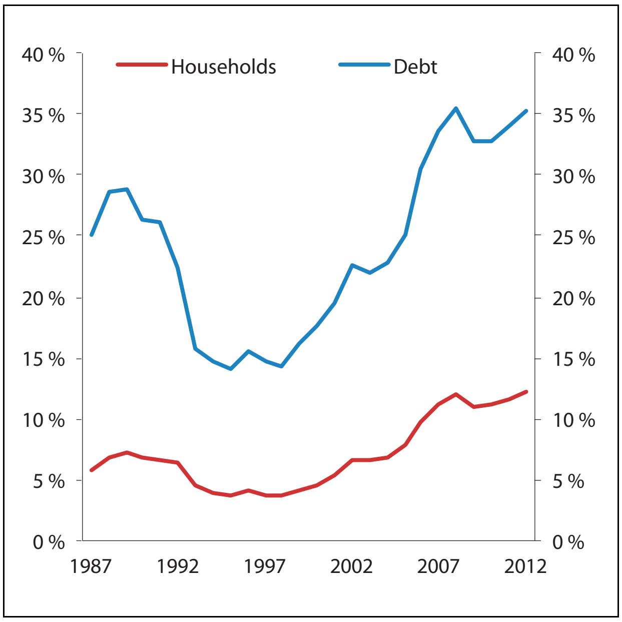

Figure 2.13 Households with debts in excess of five times disposable income. Proportion of households and debt

Source: Statistics Norway and Norges Bank

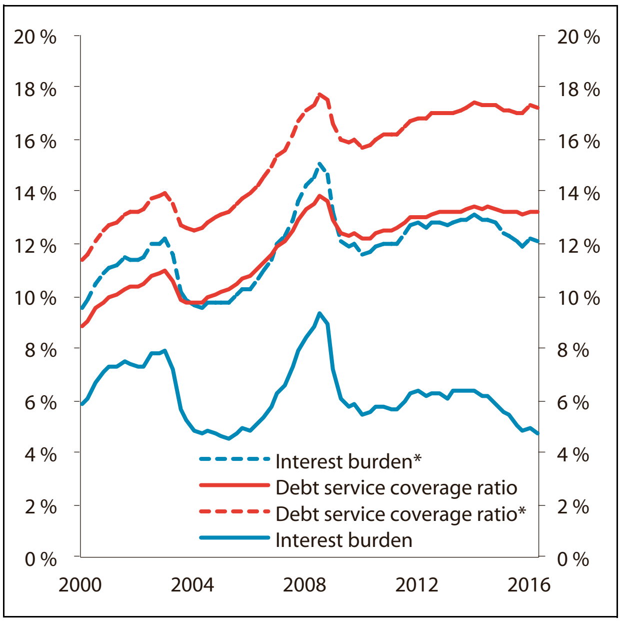

Figure 2.15 Household interest burden and debt service coverage ratio upon a five-percentage point interest rate increase. Percent

Source: Norges Bank

develop. Against the background of the steep increases in household debt and in housing prices, the Ministry of Finance therefore laid down, in interim regulations of 15 June 2015, requirements applicable to new lending secured by residential mortgage. The purpose of the regulations was to promote more balanced development in the housing and credit market. The regulations required banks to, inter alia, calculate the ability of the customer to service the residential mortgage, based on income and all relevant expenses, and to allow for an interest rate increase of 5 percentage points. The regulations applied until 31 December 2016.

The increase in housing prices and household debt continued in 2016. In response to this development, the Ministry of Finance laid down new interim regulations on 14 December 2016, stipulating requirements applicable to new lending secured by residential mortgage (the Residential Credit Regulations). The regulations entered into effect on 1 January 2017 and shall apply until 30 June 2018. The new Residential Credit Regulations include, inter alia, a new provision to the effect that no loan secured by residential mortgage shall be granted if the overall debt of the customer would, after such borrowing, exceed five times his or her gross annual income. See Box 2.10 for a more detailed presentation of the requirements applicable to residential mortgages.

Finanstilsynet reviews banks' residential mortgage practices annually. The most recent residential mortgage survey, from the autumn of 2016, shows that banks have tightened lending practices somewhat, but continue to grant a significant number of loans resulting in high borrower indebtedness; see Box 2.9.

The international financial crisis demonstrated that imprudent credit practices can cause financial instability. The European Parliament and the Council adopted the Mortgage Credit Directive on 4 February 2014, against the background of experience from the crisis.[4] The main purpose of the directive is to protect consumers in the EU and to integrate the European residential mortgage market. Before the summer, the Ministry of Justice and Public Security will propose, in a consultation paper, how Norway should implement the Mortgage Credit Directive.[5] The directive requires, inter alia, lenders in the EU to perform credit evaluations of customers based on a joint standard, whilst member states are required to ensure the establishment of reliable standards for the valuation of homes. The directive also includes provisions on mortgage credit information sheets for residential mortgages, rules on cancellation rights and cooling-off periods, as well as rules intended to reduce the risk of foreign currency mortgages for the customer.

2.8 Corporate debt

Around 30 percent of bank loans in Norway are made to corporate entities. Bank margins on corporate loans – measured as the difference between the lending rate and the three-month effective NIBOR rate – have fallen in the past three years, thus lowering, together with the declining interest rate level, corporate lending rates, cf. Figure 2.14. Banks had to take larger losses on corporate market lending in 2016 than in the preceding years. Losses nonetheless remain relatively low in an historical perspective.

The growth in lending from Norwegian banks to domestic corporate customers was just below 1 percent as at yearend 2016, down from 5.6 percent as at yearend 2015. If branches of foreign banks are included, growth in lending to corporate customers remained low, at 1.6 percent. Banks reported expectations of unchanged corporate credit practices in the first quarter of 2017 in the Norges Bank lending survey for the fourth quarter. Loans from credit institutions make up the majority of domestic corporate debt; see Figure 2.20. Bond liabilities of non-financial undertakings was unchanged in 2016.

The risk premium on bonds with a 5-year maturity issued by low-risk Norwegian corporations increased somewhat through the autumn of 2015. This development continued into the first quarter of 2016, and the risk premium was about 140 basis points as at the end of the quarter; see Figure 2.19. The premium declined over the remainder of the year, to a level of about 90 basis points as at yearend. The risk premium decline has continued into 2017. Risk premia for high-risk corporations in petroleum-related industries were high throughout 2016, and new bonds have not been issued for such corporations since the summer of 2015.

4 Directive 2014/17/EU

5 See also the discussion of the revision of the Financial Contracts Act and the rules on credit contracts under section 4.4., which will also largely apply to residential mortgages.

Box 2.8 Housing market developments

Housing prices have increased steeply in the last year. Nationwide, housing prices were on average 13 percent higher in February this year than in February last year. In Oslo, the increase was as much as 24 percent. Housing prices also increased by more than 10 percent elsewhere in Eastern Norway in the last year; see Figure 2.16A. These large price increases mean that an expected potential sales gain will exceed the cost of ordinary maintenance of the home and the servicing of debts. This may make price increases self-perpetuating.

High housing price growth may increase household debt as a proportion of disposable income and over time entail a mounting risk of financial instability. This is one of the reasons why the Ministry of Finance laid down, in December 2016, new Residential Credit Regulations with effect from 1 January 2017; see the discussion in section 2.7.2.

There are major regional differences in housing price developments. Lower activity in the petroleum industry and increased unemployment have in recent years served to depress housing prices in Stavanger. Housing prices in Stavanger were 1.4 percent lower in February this year than at the same time last year. Increased sales of existing homes, shorter sales periods and declining housing price reductions suggest that the Stavanger housing market is on the mend.

Housing construction has picked up over the last year and a half. In 2016, permission was granted for the construction of just over 36,000 new homes in Norway. This is a significantly higher figure than in preceding years, and housing construction is at its highest level since the early 1980s. It appears that housing construction will remain high in 2017 as well; see Figure 2.16C. This will over time serve to curtail housing price growth.

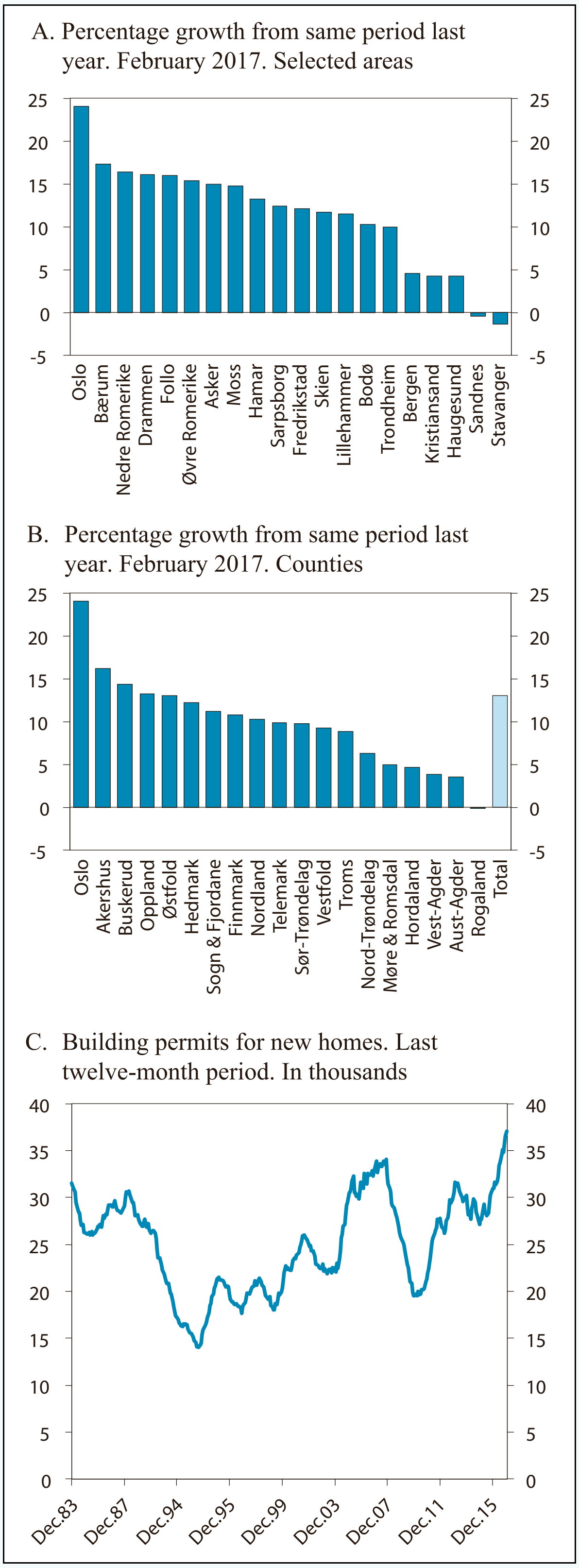

Figure 2.16 Housing price developments

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

Box 2.9 Finanstilsynet's residential mortgage survey

Every year, Finanstilsynet conducts a survey of how banks grant residential mortgages. The most recent residential mortgage survey was conducted in the autumn of 2016. Among amortising loans included in the survey, 35 percent related to housing purchases. Some 6 percent of these loans were used to purchase a second home. Purchases of a second home include the purchase of a home for the borrower's children and the purchase of a home as an investment, and these accounted for 2 and 4 percent of total new amortising loans, respectively. The proportion of residential mortgages used for second-home purchases has remained unchanged since 2012. The remaining residential mortgages were linked to the refinancing of an existing mortgage from the same bank (53 percent) or another bank (12 percent).

The survey shows, inter alia, that about 15 percent of new amortising loans secured by residential mortgage had a loan-to-value ratio (LTV ratio) in excess of 85 percent; a reduction of 1 percentage point from the previous year; see Figure 2.7. When additional collateral is taken into consideration, 5 percent of loans had an LTV ratio in excess of 85 percent; half of what it was in 2014. The average LTV ratio for amortising loans was 67 percent in 2016, down from 68 percent the previous year. The average LTV ratio for new residential mortgages was 74 percent. 12 percent of new residential mortgages had an LTV ratio in excess of 85 percent, including additional collateral.

Banks are required, under the Residential Credit Regulations, to calculate the ability of the customer to service the loan, based on the customer's income and all relevant expenses. If the loan customer does not have sufficient funds to cover ordinary subsistence expenses following a 5 percentage point interest rate increase, the loan shall not be granted. The residential mortgage survey for 2016 showed that banks granted, to a greater extent than in the preceding years, mortgages to borrowers that did not meet the requirement for a sufficient capacity to service such mortgages.[1] For amortising loans, the proportion increased to 4 percent; an increase of 2 percentage points from the previous year. Loans to young borrowers accounted for most of such increase.

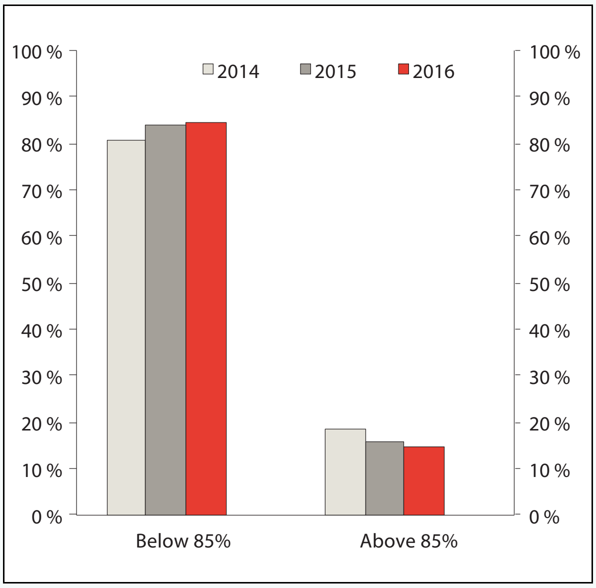

Figure 2.17 LTV ratios for amortising loans, without additional collateral

Source: Finanstilsynet

Average indebtedness, measured as total debt relative to gross income, was in the survey 323 percent for borrowers taking up amortising loans secured by residential mortgage, an increase of 26 percentage points compared to 2015. For young borrowers below 35 years, average indebtedness was 371 percent, an increase of 30 percentage points from the previous year. The residential mortgage survey shows that a large proportion of young borrowers below 35 years have an indebtedness in excess of 500 percent. 20 percent of young borrowers who took out a residential mortgage had an indebtedness in excess of 500 percent. The proportion was 14 percent for borrowers above 35 years.

[1] The borrower was warned pursuant to section 47 of the Financial Contracts Act in less than 60 percent of loan matters for which the borrower did not have a sufficient ability to pay. This is considerably lower than in previous years, when this proportion was about 80 percent. The duty to warn under the Financial Contracts Act requires the loan customer to be informed in cases where such customer should seriously consider refraining from taking out the loan.

Box 2.10 Regulation of residential mortgage practices

	Guidelines			Regulations
	3 March 2010 – 30 November 2011[1]	1 December 2011 – 30 June 2015[2]	1 July 2015 – 31 December 2016	1 January 2017 – 30 June 2018
Maximum LTV ratio, amortising loans	90 pct	85 pct	85 pct	85 pct
Maximum LTV ratio, credit lines	75 pct	70 pct	70 pct	60 pct
Maximum LTV ratio, non-amortising	Not specified[3]	70 pct	70 pct	60 pct
Maximum indebtedness	300 pct[4]	-	-	500 pct
Stress testing of ability to pay upon interest rate increase	Not specified	5 pp	5 pp	5 pp
Maximum proportion of loans that may exceed the requirements per quarter[5]	-	-	10 pct	10 pct (8 pct in Oslo)
Maximum LTV ratio, second home in Oslo	90 pct	85 pct	85 pct	60 pct

1 Circular 11/2010
2 Circular 29/2011
3 «Loans that entail a high LTV ratio should normally be established with the payment of instalments, such as to accumulate a more satisfactory safety buffer.»
4 «If the bank uses indebtedness (total debt relative to gross income) as decision-making criterion, the loan should normally not exceed three times the total gross income.
The bank shall internally stipulate a scale for maximum loan relative to total gross income. In addition, the bank shall consider the implications of an interest rate increase.»
5 The guidelines stipulate that «[if the bank] deems it appropriate to deviate from its internal guidelines based on these minimum requirements, such decision shall be made at a higher level than would ordinarily be authorised to grant residential mortgages».

2.8.1 Banks' exposure to petroleum-related industries

It is especially on loans to petroleum-related industries, including the offshore and supply industry, that banks have had to take losses in 2016. The oil price decline has reduced revenues and impaired the debt service capacity of businesses in petroleum-related industries. The overall exposure of Norwegian banks to petroleum-related businesses was in excess of NOK 200 billion as at yearend 2015. The debt levels of petroleum-related businesses are premised on a different market situation than the current one, and it is likely that banks will have to take further losses on loans to this industry. Loans to petroleum-related businesses have predominantly been granted by the largest Norwegian banks. Numerous foreign banks have also made loans to Norwegian petroleum-related businesses.

Norges Bank states, in its report «Financial Stability 2016», that loan losses may increase significantly in the event of a lengthy downturn in petroleum-related activities. Norges Bank notes that banks have in several instances extended maturities and deferred instalment payments on loans to the industry as part of the restructuring in the wake of the oil price decline. It is likely that a lengthy downturn will necessitate new rounds of restructuring for a number of businesses, which may entail significant losses for banks. Norges Bank notes, moreover, that the potential loss on petroleum-related lending may exceed banks' estimates. Norges Bank notes, in its report, that the

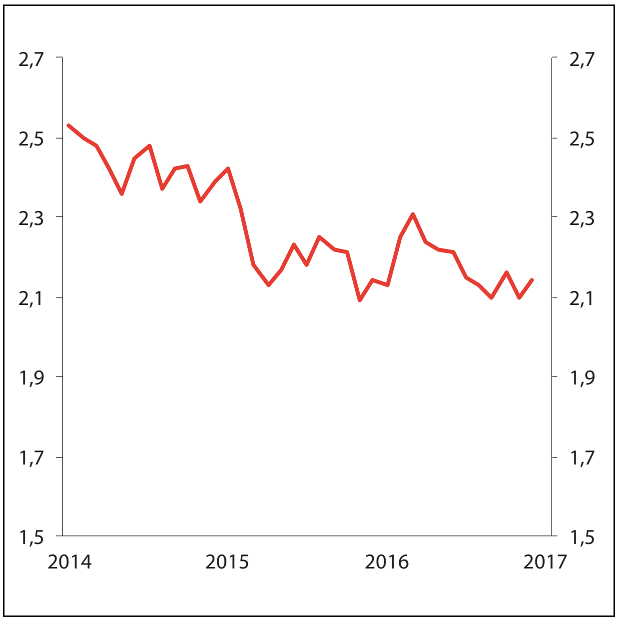

Figure 2.18 Lending margin, total outstanding loans to non-financial undertakings. Percentage points

Source: Statistics Norway

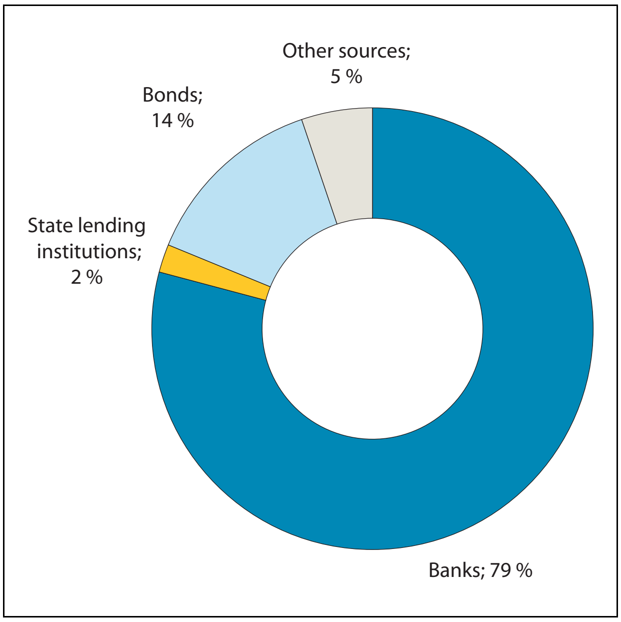

Figure 2.20 Domestic corporate debt by credit source

Source: Statistics Norway and Finanstilsynet

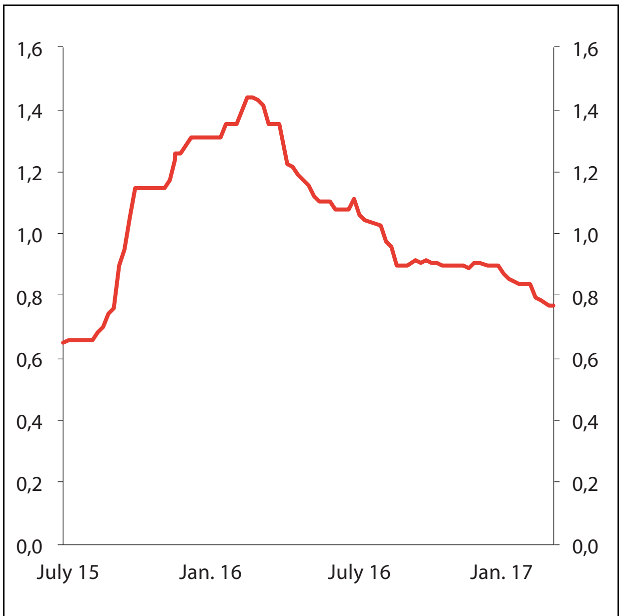

Figure 2.19 Indicative credit spread for 5-year bonds. Low-risk Norwegian corporations. Percentage points

Source: DNB Markets

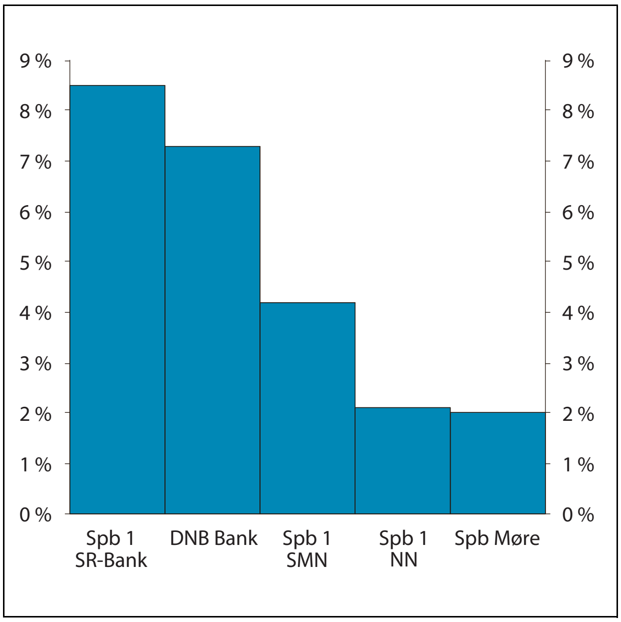

Figure 2.21 The exposure of selected large banks to petroleum-related businesses, measured as a proportion of overall credit exposure. Percent

Source: Norges Bank

largest registered loan losses for a single industry in Norway was within aquaculture over the period 2002–2006, when accumulated losses represented 23 percent of lending to the industry over that period. According to Norges Bank, banks will nonetheless achieve healthy profits over a five-year period, even if petroleum-related loan losses were to reach a corresponding level, provided that other earnings remain at the 2015 level. This suggests that bank solvency will only come under

Box 2.11 IFRS 9

Norwegian banks that have issued listed securities shall prepare consolidated financial statements in accordance with IFRS (International Financial Reporting Standards). These are international financial reporting standards issued by the International Accounting Standards Board (IASB).

A new standard for financial instruments (IFRS 9) achieved EU approval on 22 November 2016, and its application is mandatory for financial years commencing on 1 January 2018 or thereafter. This standard includes new impairment rules that will represent a major change to the regulations on loan write-downs, in that it requires any expected credit loss to be estimated on all loans. The current impairment rules imply that write-down only takes place when there are objective impairment indications («incurred loss»). A criticism levelled from several quarters during the financial crisis was that the regulations resulted in the overestimation of interest income over the periods prior to the occurrence of a loss event, and in losses being recognised too late. The new impairment rules laid down in IFRS 9 are more forward-looking in their design, and are intended to identify expected losses in the financial statements at an earlier date.

pressure if the downturn in petroleum-related activities has spillover effects on other industries.

In the second quarter of 2016, Finanstilsynet examined the exposure of five Norwegian banks to offshore sector companies. The overall exposure of such banks to supply and rig companies was NOK 90 billion as at the end of the first quarter, corresponding to 6 percent of banks' overall exposure to the corporate market.[6] An update as at yearend 2016 shows that the overall exposure of these five banks to this sector is NOK 88 billion. Aggregate write-downs have been increased by NOK 4.3 billion from the end of the first quarter to the end of the fourth quarter, and amount to NOK 6.4 billion, corresponding to 7.2 percent of overall exposure.

6 Measured as EAD (Exposure at Default).

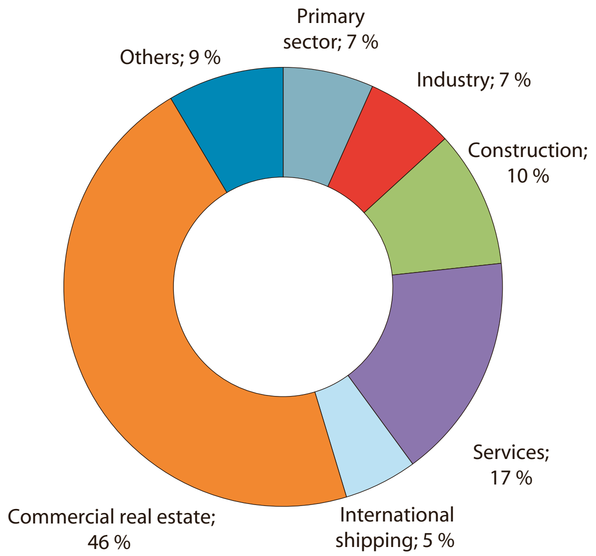

Figure 2.22 Lending from banks and mortgage companies, by industry, as at June 2016

Source: Norges Bank

2.8.2 Banks' commercial real estate lending

Commercial real estate is the one industry to which banks have the largest exposure. Loans to commercial real estate undertakings account for approximately 46 percent of corporate market loans from Norwegian-owned banks and mortgage companies issuing covered bonds, cf. Figure 2.22. A further 10 percent of loans are linked to the construction and building industry.

Low interest rates have in recent years contributed to high commercial real estate prices. After having increased in 2015, the real price of commercial real estate continued to increase throughout 2016. However, commercial real estate prices are sensitive to rental market developments and investors' required rates of return, and have historically fluctuated significantly in line with general developments in the economy. Economic downturns quickly lead to lower commercial real estate rents and vacant premises, and thus lower prices and property values. Real estate is considered 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. Debt service capacity is generally lower in commercial real estate than in other industries.

Norges Bank has developed a new empirical model for analysing credit risk in the corporate sector. The model uses bankruptcy data, accounting data, credit rating information and economic indicators to estimate individual bankruptcy probabilities for Norwegian-registered non-financial undertakings. Corporate sector risk can be assessed by classifying undertakings into risk classes based on estimated bankruptcy probability and thereafter calculating how much bank debt belongs to each risk class. Despite a large proportion of corporate bank debt being in commercial real estate, the industry's contribution to the high risk class is relatively low. This reflects, according to Norges Bank, the small number of bankruptcies and the low losses on commercial real estate loans over the estimation period.

2.9 Insurance and pensions

The IMF believes that insurance activities, and especially life insurance activities, to a greater extent than before, contribute to systemic risk internationally.[7] According to the IMF, the increased systemic risk contribution reflects that insurance undertakings are increasingly exposed to the same types of risk as other financial market participants. This is partly because the interest rate sensitivity of insurance companies has increased,

7 IMF Global Financial Stability Report, April 2016.

Box 2.12 Building reserves to address higher life expectancy

Life expectancy in Norway is on the increase. Since 1980, female life expectancy has increased by five years, whilst male life expectancy has increased by more than eight years; see Figure 2.23. The higher life expectancy means that life insurance companies and pension funds need to set aside more capital to meet their existing pension liabilities.

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 higher 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 companies have been given up to seven years from 2014 to complete such expansion of reserves. 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, if any, are equal to the return on the collective portfolio in excess of the interest rate the company has guaranteed to customers. Companies themselves must provide at least 20 percent of the increase in reserves.

Providers have over the last four years completed the predominant part of their required reserve building. As at yearend 2016, life insurance companies had set aside a total of about NOK 39 billion for expanding reserves in response to higher life expectancy. The remaining reserve expansion need of life insurance companies was about NOK 2 billion as at yearend 2016. Pension funds had by the end of 2016 set aside a total of about NOK 11.2 billion for expanding reserves. The remaining reserve expansion need of pension funds is about NOK 300 million. The majority of pension funds have completed their reserve expansion.

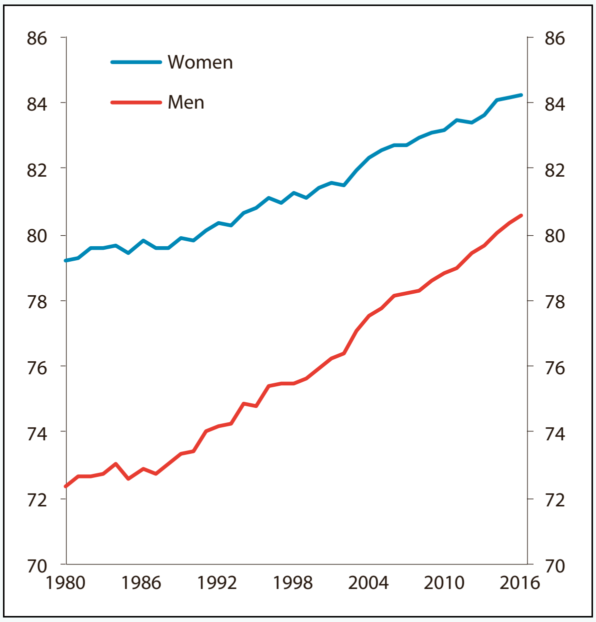

Figure 2.23 Female and male life expectancy at birth

Source: Statistics Norway

Box 2.13 The solvency of life insurance companies and pension funds

The capital adequacy requirement for life insurance undertakings and pension funds was abolished with effect from 1 January 2016. For life insurance undertakings, the capital adequacy requirement was replaced by the solvency capital requirement and the minimum capital requirement under the Solvency II regulations. Pension funds remain subject to solvency margin requirements (Solvency I) and stress test reporting.

The new Solvency II capital requirements, which better reflect the risks assumed by insurance companies than did the former requirements, are discussed further in Box 2.11 of the Financial Markets Report 2015. If the capital of an undertaking is less than the calculated capital requirement, i.e. a solvency capital ratio of less than 100 percent, such undertaking is not in compliance with the requirements under the solvency regulations. Life insurance companies may invoke a transitional provision permitting the increase in the level of actuarial reserves resulting from the transition to Solvency II to be phased in gradually over a period of 16 years. As at yearend 2016, the solvency capital ratio of life insurance companies totalled 222 percent, including use of the transitional provision. This is 16 percentage points higher than at the beginning of 2016. As at yearend 2016, the solvency capital ratio without invoking the transitional provision was 183 percent. The significance of the transitional provision for the solvency capital ratio varies between companies.

Pension funds improved their solvency during 2016. Buffer capital utilisation, which is an indicator of potential loss as a proportion of buffer capital, was under Stress Test I reduced from 101 percent to 88 percent over the year. A buffer capital utilisation in excess of 100 percent indicates that the overall potential loss exceeds the available buffer capital.[1.]

[1] Pension undertakings shall periodically conduct and report on two stress tests defined by Finanstilsynet (Stress Test I and Stress Test II). Stress Test I is based on the fair value of assets and liabilities and a definition of buffer capital under the assumption that the undertaking is liquidated. Finanstilsynet is of the view that the stress test better reflects underlying risk than the applicable solvency requirements by, inter alia, showing how the value of liabilities is affected by a low interest rate level.

and partly because of higher correlation across asset classes.

Norwegian banks and mortgage companies obtain a considerable portion of their wholesale funding from life insurance providers and pension funds. Problems on the part of life insurance companies and pension funds may thus affect banks' access to wholesale funding, whilst problems on the part of banks may impose losses on life insurance companies and pension funds. In addition, most private life insurance companies belong to banking groups. The authorities have over time focused on introducing rules to promote solvency among insurance companies and pension funds.[8] Furthermore, solvent pension providers are a prerequisite for secure and predictable pension savings by individual customers.

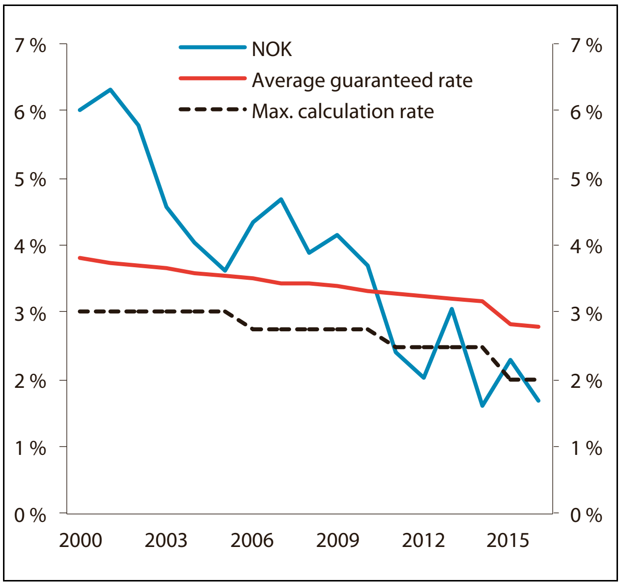

Figure 2.24 Developments in the average guaranteed rate amongst Norwegian life insurance providers, long-term interest rates (10-year government bonds) and maximum calculation rate

Source: Finanstilsynet

[8] The Ministry of Finance has discussed the introduction of new solvency regulations for life insurance undertakings (Solvency II) in previous Financial Markets Reports; see, inter alia, Box 2.10 of Financial Markets Report 2014 and Box 2.11 of Financial Markets Report 2015.

Box 2.14 Performance and profitability of insurance companies and pension funds

Life insurance companies generated pre-tax profits of NOK 7 billion in 2016, a reduction of NOK 1.2 billion on their profits in 2015. Value-adjusted pre-tax profits, which include unrealised capital gains, totalled NOK 12.5 billion, an increase of NOK 2.7 billion from the previous year. Value-adjusted profits represented 0.9 percent of average total assets, up from 0.8 percent the previous year.

Pension funds earned pre-tax profits of NOK 3.8 billion in 2016, up from NOK 2.7 billion in 2015.[1] Measured as a proportion of average total assets, profits increased from 1 percent in 2015 to 1.3 percent in 2016. Fluctuation reserves increased more in 2016 than in 2015, which contributed to the increase in value-adjusted profits from NOK 3.6 billion in 2015 to NOK 5.7 billion in 2016.

Non-life insurance companies delivered pre-tax profits of NOK 9.6 billion in 2016, an increase of NOK 1.7 billion over the previous year. The profit improvement was primarily caused by higher financial income.

The sum total of claim payments and other insurance-related operating costs for own account, measured as a percentage of premium revenues for own account (the combined ratio) indicates how profitable the actual insurance activities are. If this ratio exceeds 100 percent, the undertaking needs other income than premium income to break even, for example financial income. In 2016, the combined ratio of non-life insurance undertakings was 86.5 percent, cf. Figure 2.25. This was 0.3 percentage points higher than the previous year. The claims ratio, i.e. claim payments as a percentage of premium income, increased by about 0.9 percentage points over 2015 and was 69.9 percent in 2016. The cost ratio, i.e. operating expenses as a percentage of premium income, declined by 0.7 percentage points and was 16.6 percent in 2016.

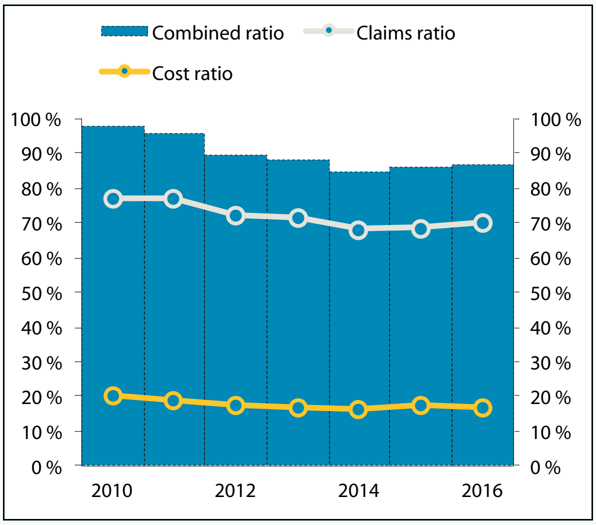

Figure 2.25 Developments in the combined ratio, claims ratio and cost ratio of Norwegian non-life insurance companies. Percent

Source: Finanstilsynet

[1] The figures relate to the 48 largest pension funds in Norway. These pension funds account for about 95 percent of the aggregate total assets of pension funds.

The key challenges for the traditional business model of life insurance companies and pension funds have in recent years been the increased life expectancy (see Box 2.12) and the declining interest rate level. Life insurance companies and pension funds have largely adapted their business models to a lower interest rate level and higher life expectancy. Prices have been changed, and new insurance sales have changed to contracts under which the insured carries more risk, and the insurance company carries less risk. In addition, insurance comapnies have reduced costs and expanded reserves to cover higher liabilities. The Ministry of Finance has in section 2.3.5 of the Financial Markets Report 2015 explained how the authorities have paved the way for undertakings to adapt their operations to a lower interest rate level and higher life expectancy.

Contracts specifying an annual guaranteed rate continue to make up a material proportion of the liabilities of Norwegian pension providers. For life insurance companies, the average recognised return on collective portfolio assets was 4.8 percent in 2016, up from 4.2 percent in 2015. The collective portfolio is predominantly comprised of defined-benefit pensions, paid-up policies and other contracts under which customers are guaranteed an annual minimum return. Undertakings hold a large number of bonds that were purchased when the interest rate level was higher

Box 2.15 Examination of potential changes to private occupational pensions

In connection with the front-runner industry mediation between the Norwegian United Federation of Trade Unions/Norwegian Confederation of Trade Unions (LO) and the Federation of Norwegian Industries/Confederation of Norwegian Enterprise (NHO) in the 2016 wage bargaining process, the National Mediator sent a communication to the Prime Minister, stating, inter alia, that there appeared «to be agreement between the parties that it would be desirable to initiate a legislative effort with a view to modernising private sector pension schemes». The Prime Minister replied to such communication by stating that the Government is prepared to examine the need for making adjustments to laws and regulations governing private sector occupational pensions.

A working group was appointed, in consultation with the two sides of industry, to examine the relevant issues. The working group comprised members from the Ministry of Finance, the Ministry of Labour and Social Affairs and Finanstilsynet. A reference group was established for this effort, with participants from the Federation of Norwegian Professional Associations, the Employers' Association Spekter, Finance Norway, the Norwegian Consumer Council, the Enterprise Federation of Norway, the Norwegian Confederation of Trade Unions, the Confederation of Norwegian Enterprise, the Norwegian Association of Pension Funds, the Confederation of Unions for Professionals and the Confederation of Vocational Unions. The working group submitted its report in December 2016.

The working group examined, within the scope of the Defined-Contribution Pensions Act, issues such as a right for individual employees to establish a personal pensions account with a pensions provider selected by the employee and/or encompassing pension savings from different sources (individual pensions account). The working group also examined issues relating to a right to individual supplementary pension savings, as well as the implications of lowering the thresholds for the right to make pension accruals in occupational pension schemes (minimum age and percentage employment for membership of a pension scheme, minimum income limit for accruals, as well as requirements as to the duration of employments that qualify for pension rights). These issues extend from major systems changes to minor adjustments within the current regulatory framework.

The working group examined alternatives for, and implications of, changes in relation to the relevant issues, but has not concluded on, or recommended, specific solutions. The Government has not reached any decision on the measures addressed in the report from the working group. Implementation of one or more of these measures would require further examination.

than at present, and these will have to be replaced by new bonds upon reaching maturity. The average guaranteed rate amongst life insurance companies was just below 2.8 percent as at yearend 2016; cf. Figure 2.24. The market rate on most government bonds is now lower than the average guaranteed rate.

Higher market rates or lower guaranteed rates will both reduce the rate risk of insurance companies. Providers set their own guaranteed rates, but since life insurance policies represent long-term liabilities it will take a long time from providers reduce their guaranteed rates on new premium payments until such changes have a material impact on the average guaranteed rates of insurance companies The reductions in the guaranteed rates on new premium payments in recent years mean that the average guaranteed rates of life insurance companies are declining slowly; see Figure 2.24.

Subject to certain exceptions, for example paid-up policies (which are fully paid-up contracts), providers may collect a guaranteed rate premium for pension products offering a guaranteed return. 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 guaranteed rate premium from year to year allows the premium to be adjusted in line with developments in return prospects.

Using different buffer fund mechanisms, life insurance companies can even return and risk performance out over several years. The use of such buffer funds allows companies to use strong performance in certain years to make up for weaker performance in other years. The size of these buffer funds is an indicator of undertakings' ability to absorb weak return and risk performance in the future. At the end of 2016, the buffer funds of life insurance companies totalled NOK 97 billion, equivalent to 10.6 percent of insurance liabilities.

2.10 Securities markets

Securities markets serve an important function in society by channelling capital from households and institutions with savings and investment needs to businesses with funding needs. Equity from stock markets and debt from bond markets contribute to the funding of businesses, and well-functioning markets are a prerequisite for growth and innovation.

In 2016, securities markets in Norway contributed close to NOK 28 billion in equity. Securities markets also provide business and public sector funding in the form of bonds and certificates. Bond markets also facilitate the issuance of bond liabilities by banks and mortgage companies, thus enhancing their capacity for granting loans to households, municipalities and businesses. Access to bank funding is of particular importance to businesses that do not have access to the bond market.

A reduction in the number of listed companies is a general trend in Europe. The main European stock exchanges currently have more than 40 percent fewer companies listed than in 2000. In Norway, on the other hand, the number of listed companies has remained stable over the same period. In the Norwegian bond market, the number of issuers has doubled and the outstanding amount tripled over the last decade. Three distinctive characteristics have contributed to a well-functioning bond market in Norway: access to unofficial ratings, use of a trustee arrangement to attend to the rights of bondholders, and independent pricing services.

Nordic securities market participants have made extensive use of unofficial ratings, so-called shadow ratings. This has stimulated growth in the Norwegian securities market as a source of funding. Official credit ratings, predominantly from three global rating agencies,[9] may represent a significant cost and be considered challenging, especially for smaller companies. Consequently, official ratings are almost exclusively the preserve of the largest industrial groups. From 2013 to 2015, less than 10 percent of all corporate bond issues had official ratings, whilst almost 70 percent had unofficial ratings. The same applies in the financial sector, where only the main banks have been officially rated, whilst virtually all banks have been shadow rated. Many asset managers and private investors have used shadow ratings in making investment decisions or formulating investment mandates. Unofficial rating practices appear to have enabled more issuers to make use of the bond markets, whilst investors have been better

Box 2.16 Securities funds

Securities funds are collective investment vehicles through which 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 how the capital is to be invested. The most common fund types in Norway are equity funds, money market funds, fixed-income funds and combination funds.[1]

Net subscriptions in the securities funds of Norwegian fund management companies increased from NOK 11.7 billion in 2015 to NOK 39.2 billion in 2016. Fixed-income funds accounted for NOK 27 billion and equity funds accounted for NOK 13.4 billion of this, whilst combination funds and other fund types had negative net subscriptions of NOK 1 billion and NOK 0.3 billion, respectively. Total net subscriptions, combined with net price increases over the year, resulted in the aggregate total assets of Norwegian securities funds amounting to NOK 981.6 billion as at yearend.

1 Combination funds invest in both equities and fixed-income instruments, but are not permitted to invest more than 80 percent of their assets in equities. Fixed-income funds invest in various fixed-income securities. Money market funds are interest rate funds which invest in short-term interest-bearing securities, i.e. certificates and bonds.

9 Moody's, Fitch and Standard & Poor's

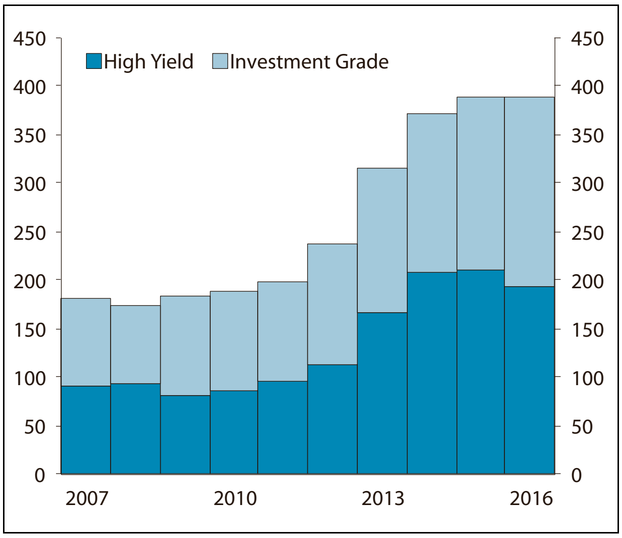

Figure 2.26 Outstanding amount. Bonds issued in the Norwegian bond market. NOK billion

Source: Stamdata

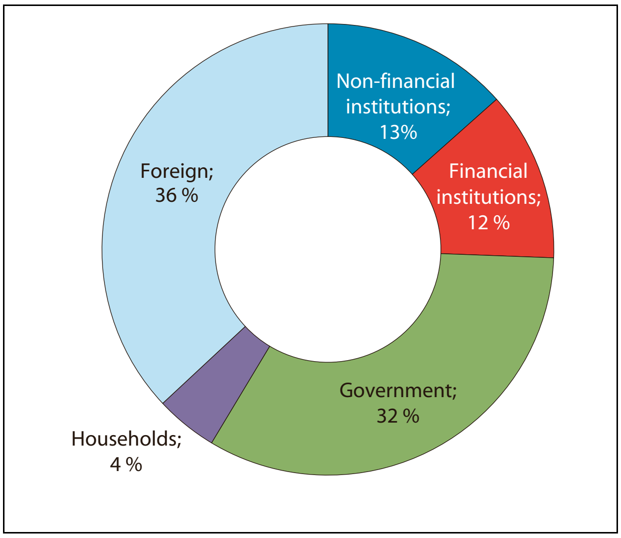

Figure 2.28 Holders of listed equity instruments registered in the VPS

Source: Finanstilsynet, Statistics Norway

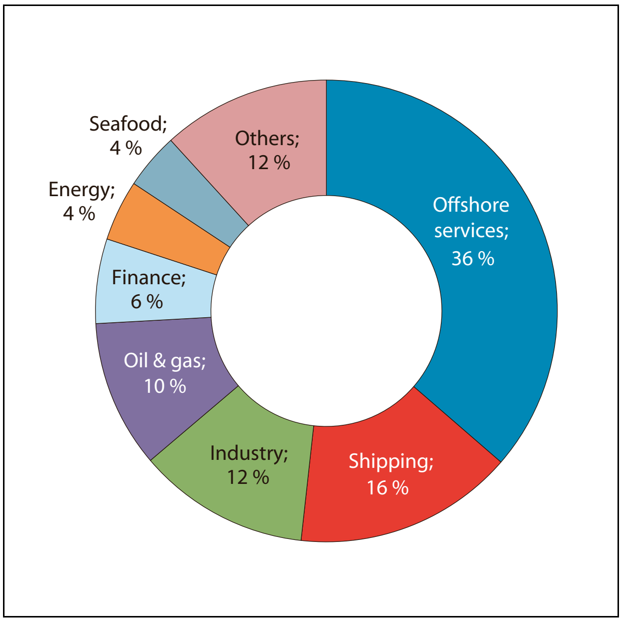

Figure 2.27 Outstanding volume of high-yield bonds, specified by sector, as at yearend 2016

Source: Stamdata, Finanstilsynet

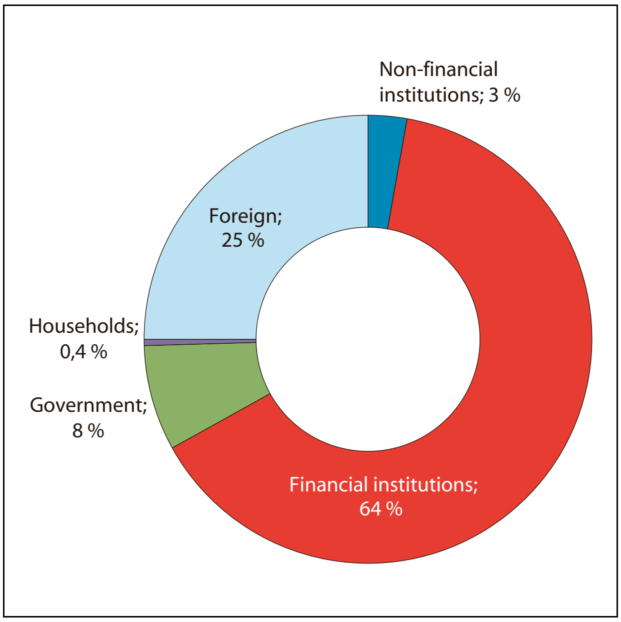

Figure 2.29 Holders of bonds and certificates of deposit registered in the VPS

Source: Finanstilsynet, Statistics Norway

placed to assess credit quality, thus facilitating more correct pricing of securities.

In 2016, the European Securities and Markets Authority (ESMA) examined the shadow rating activities of some of the Nordic market participants from the perspective of the European regulations on credit rating agencies. This resulted in the financial institutions choosing to no longer provide shadow ratings. Market participants have sought to establish alternative solutions to ensure that smaller companies can also continue to make use of the securities markets without high risk premiums as the result of incomplete credit information on the part of investors. In February 2017, the trustee company Nordic Trustee announced that it is raising capital to establish a Nordic rating agency, Nordic Credit Rating. When such capital has been raised, the company will apply for a

Box 2.17 Investment firms

Investment firms arrange purchases and sales of financial instruments and provide investment advice in connection with such transactions. Investment firms 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 as a whole have been corporate finance activities and the brokering of equity instruments.

Investment firms that are not integrated into banks registered operating income of NOK 5.73 billion in 2016, a reduction of about NOK 100 million from the previous year. Total operating profits were in excess of NOK 1 billion, an increase of NOK 87 million compared to 2015.

Investment firms that are integrated into banks generated total revenues from investment services of around NOK 9.1 billion in 2016, an increase of 28 percent from the previous year. Branches of foreign investment firms registered revenues of NOK 3.2 billion in 2016, an increase of about 27 percent from 2015.

credit rating agency licence from the ESMA. The plan is for this rating agency to provide approved rating services in the first half of 2018. In March 2017, the German rating agency Scope Ratings AG announced that it is establishing operations in Norway to meet increased demand for public ratings in the Nordic market.

The use of trustee services for certificate and bond loans is another key contributor to the growth in the securities market in Norway. The trustee monitors issuers' compliance with loan covenants and attends to the creditor rights of all investors vis-à-vis the issuer. Over time, this arrangement has also resulted in increased standardisation of the contractual framework. This simplifies proceedings for issuers and provides additional comfort for investors. In particular, said arrangement eases access to the bond markets for small issuers.

In recent years, services for third-party pricing of fixed-income instruments have also been established. Especially for fixed-income instruments that are not frequently traded, often from small issuers, independent market price estimates will improve price transparency, reduce risk premiums resulting from uncertain price formation and result in lower funding costs.

Figure 2.26 shows that almost half of bond issues in Norway are high-yield issues. This is a significantly higher proportion than in the main European and North American markets. Some of this can be attributed to the industrial structure, since enterprises in sectors presumed to be more stable will often have higher ratings than enterprises in more volatile sectors, such as oil services and shipping. Figure 2.27 shows that the said sectors account for a majority of high-yield issues in Norway. In addition, large companies will in many cases be able to achieve a higher rating than corresponding small companies because of geographical scope and product diversification. The high proportion of high-yield bonds indicates that the Norwegian bond market is the result of distinctive characteristics of the Norwegian business sector, and that the bond market is not the exclusive preserve of the largest enterprises or the most stable sectors. It is likely that this has been facilitated by access to unofficial ratings, the trustee arrangement and independent pricing.

Whilst the Norwegian securities market has facilitated the involvement of small participants on the issuer side, the holder side is characterised by little involvement from individuals compared to other countries. The direct holdings of households account for only 4 percent of equities, and less than 1 percent of the bond liabilities listed on the Oslo Stock Exchange, as shown in Figures 2.28 and 2.29. The modest direct holdings of households on the Oslo Stock Exchange may be the result of many personal investors channelling their equity investments through holding companies. In 2017, the Government has introduced an equity savings account scheme, which will make it easier for individuals to reallocate equity savings. The scheme means that gains on equities are not taxed upon the divestment of such equities, but only when the capital is withdrawn from the account. A proposal for the technical structuring of such a scheme, as well as who shall be permitted to provide the service, has recently been circulated for consultation by the Ministry.

On the other hand, households hold shares of securities funds, which themselves invest in the Norwegian securities markets, as well as growing indirect holdings in the form of defined-contribution pensions. Consequently, more individuals are exposed to the securities market than before. Although this proportion remains low, it is expected that both the number of households exposed to the securities market, and the weight of such exposure, will increase in coming years, in line with the general switch from defined-benefit pensions to defined-contribution pensions, cf. the discussion in section 2.9.

2.11 Operational risk in financial undertakings

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, and may be caused by, for example, inadequate procedures, defective information and communications systems (ICT 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 vulnerabilities, for example weaknesses in credit rating processes.

Important measures for reducing operational risk include identification of vulnerabilities and subsequent preventive efforts to make financial undertakings 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 strategic overview and coordinated measures. The Financial Infrastructure Crisis Preparedness Committee (BFI) is mandated to promote information exchange and coordination of financial infrastructure preparedness efforts. The Committee evaluates operational stability, risk and vulnerability in the financial infrastructure, and can be convened in the event of a serious incident. In 2016, the Committee held three regular meetings and conducted two emergency preparedness exercises (one convening exercise and one scenario exercise).

Norges Bank and Finanstilsynet annually publish one report each on financial infrastructure. Norges Bank's Financial Infrastructure report discusses developments in customer-oriented payment systems and in interbank systems, whilst Finanstilsynet's Risk and Vulnerability Analysis report addresses the use of information and communications technology in the financial sector.

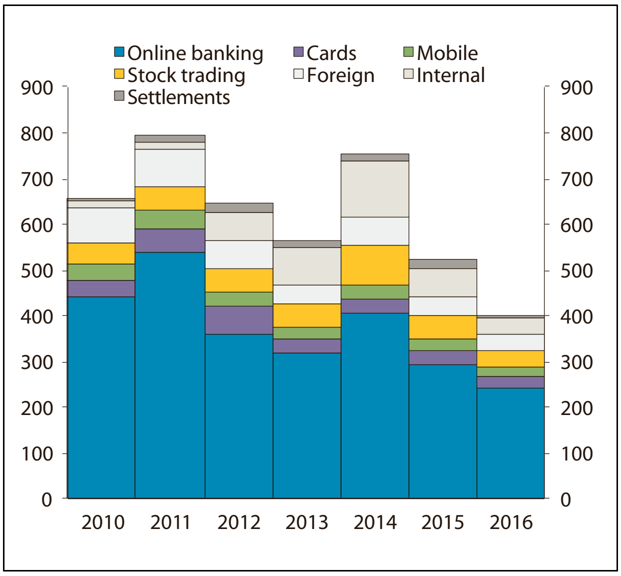

Figure 2.30 Impact-weighted adverse events and errors in Norwegian financial undertakings[1]

[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 on 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 (personal and corporate), payment cards, mobile payments, equity 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

Promoting and requiring good preparedness in the payment system is an important government priority. The regulatory framework governing payment services and payment systems stipulates extensive requirements, with compliance being supervised by Norges Bank and Finanstilsynet. The regulatory framework is designed with a view to averting unwanted events, and imposes a number of requirements on licensed undertakings. Such requirements are laid down in, inter alia, the Payment Systems Act and the ICT Regulations. The regulatory framework requires systems to be organised such as to maintain a low probability of unwanted events. Norges Bank supervises interbank systems, whilst Finanstilsynet is responsible for the supervision of payment services and securities settlement systems.

Responsibility for the stability of the services and systems lies with the party licensed to provide payment services or operate key systems. Unwanted events in payment systems are followed up by Finanstilsynet. When serious unwanted events occur, it is important to uncover their causes, and to take the measures necessary to prevent the reoccurrence of such problems. Finanstilsynet may, if needed, order the undertaking to make changes.

The electronic payment system in Norway handles a large number of transactions on a daily basis. The system is generally stable and secure to use, and losses resulting from misuse and fraud are small. The Norwegian National Security Authority (NSM) notes, in its report General Risk Outlook 2016, that theft of monetary assets via digital platforms is a mounting threat. This may threaten banks, but also payment service users through the theft of their login details. The financial industry may also be vulnerable to attacks that are not mounted to attain financial gain, but to obtain access to information such as e.g. personal data. New technology has made financial service provision more effective and enabled the financial industry to provide new services within, inter alia, payment systems. However, the introduction of new services, either via known platforms or new channels, may serve to increase risk. Undertakings need to ensure that innovations are not detrimental to security.

The electronic payment system is vulnerable to technical failure and external threats. Banks and other market participants devote considerable resources to ensuring stable operations and to avert attacks. It is to some extent unavoidable that errors may occur in complex electronic systems. Frequent or lengthy service interruptions may have major implications for customers and the economy as a whole. It is therefore important that banks and other market participants have systems which ensure that downtime is minimised upon unwanted system events. Figure 2.30 shows that the financial infrastructure generally suffered fewer and less serious events in 2016 than in previous years. However, there has been an increase in the number of events thus far in 2017.

Outsourcing of the operation and development of ICT systems may give rise to new and unknown vulnerabilities and challenges for those charged with assessing and monitoring operational risk on the part of undertakings. Until around 2000, all Norwegian banks were running their ICT operations in Norway. A major part of the ICT and operational activities of Norwegian banks and Norwegian branches of foreign banks have now been moved outside Norway. A large portion of securities-related ICT activities are also operated abroad. Outsourcing of ICT activities may affect systems quality and stability, whilst at the same time reducing the scope for insight into, and monitoring of, the vulnerabilities in the systems that undertakings rely on in running their operations. It is important that the outsourcing of ICT duties is organised in a prudent manner, both for individual financial undertakings and for the financial system as a whole. Finanstilsynet attaches considerable weight, in its supervisory follow-up, to the need for undertakings to perform thorough risk analyses and assessments in relation to new or modified outsourcing. A legislative amendment in 2014 brought stricter rules on which duties financial undertakings may outsource, and Finanstilsynet is authorised to check outsourcing and take measures against imprudent outsourcing.

3 A holistic approach to financial markets policy

3.1 Introduction

The Financial Markets Report includes, for the third year running, a chapter on a holistic approach to financial markets policy. Regulation of the financial sector is typically justified by financial stability considerations and safeguarding of the customers of financial institutions. The discussions of a holistic approach to financial markets policy have addressed how policy can also influence – and be influenced by – financial sector structures, profitability and employment, as well as economic developments.

The discussions in the various reports have focused on shedding light on various aspects of the relationship between policy and the sector. The Financial Markets Report 2014 included, inter alia, a discussion of some of the policy tools used by the authorities to stimulate proper risk management and strong customer protection in the financial market, how the financial sector can support effective use of resources in the economy and the conditions for the production of financial services in Norway. The Financial Markets Report 2015 provided an assessment of, inter alia, the structure of, and competition in, the Norwegian financial markets and Norwegian businesses' access to capital from financial undertakings and the securities markets. It also provided a brief overview of certain issues relating to the financial sector's contributions to the green shift, as well as financial sector manpower and knowhow, along with an overview of Norwegian financial undertakings' activities in foreign financial markets. The previous Financial Markets Report also provided an account of the solvency regulation of financial undertakings.

The discussion of an integrated approach to financial markets policy in this year's report supplements the discussions in earlier reports. This year's report takes a closer look at the business sector's access to funding from financial undertakings and the opportunities and challenges of potentially facilitating the expanded use of private pension assets for less liquid investments in, inter alia, infrastructure.

3.2 Funding of the business sector

3.2.1 General observations

The growth capacity of the economy is impaired if profitable projects do not get access to capital at prices that reflect the risk involved. The general impression is that Norwegian securities markets are well functioning, that Norwegian financial undertakings are robust and liquid, and that we have appropriate government schemes for funding projects that will not readily get access to ordinary wholesale funding. Norwegian banks and large Norwegian businesses can 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 funding options. Although funding options are diverse at the outset, it may be difficult for businesses to switch quickly from one source of funding to another. New and small businesses may also be faced with limited funding options at the outset, and be more focused on Norwegian and local sources of capital.

The European Commission is seeking to strengthen the role of securities markets in the funding of European businesses through the establishment of a capital markets union. This initiative is, among other things, intended to give small and medium-sized businesses easier access to wholesale funding, and to encourage increased integration of European securities markets. The effort to establish an EU capital markets union also includes measures to facilitate increased use of private pension assets as investment capital for, inter alia, infrastructure projects, cf. the discussion on section 3.4.3 below. The EU effort should be considered in view of the major problems experienced by the EU banking sector in recouping its solvency and its role in society in the wake of the international financial crisis.

The EU capital requirement regulations for banks include a transitional provision on lending to small and medium-sized enterprises, which implies that banks' capital requirements for such loans shall be reduced by about 24 percent, often

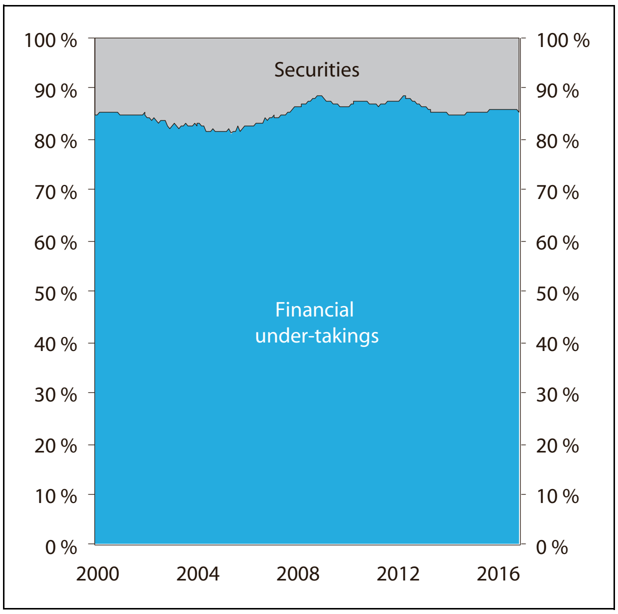

Figure 3.1 Gross domestic debt of non-financial undertakings – main sources

Source: Statistics Norway

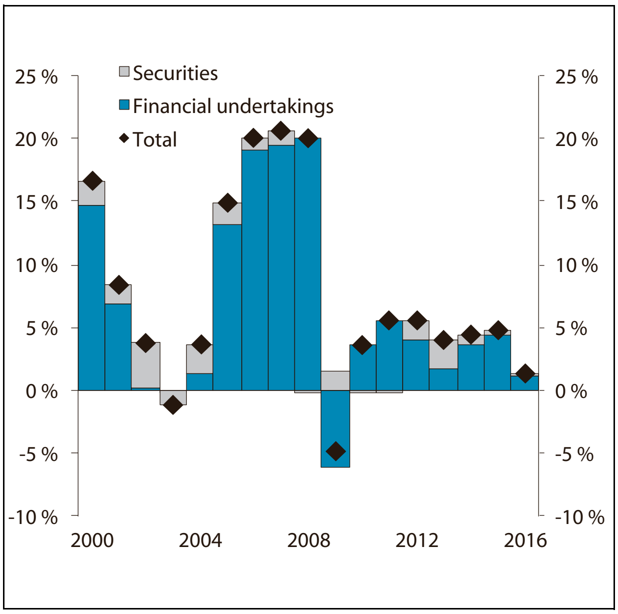

Figure 3.2 Growth in the gross domestic debt of non-financial undertakings

Source: Statistics Norway

referred to as the «SME discount». The said provision was included in the EU regulations as a result of the difficult economic situation in a number of European countries. Thus far, the regulation authorising the provision has not been implemented in Norway. The European Commission has evaluated this provision and proposed that it be retained and to some extent expanded. The Government intends to introduce an SME discount in the calculation of the capital requirement for Norwegian banks when the EU regulation containing the SME discount provisions has been incorporated into the EEA Agreement.

The most important contributions to good, stable capital access for Norwegian businesses are a solvent financial sector and well-functioning securities markets. Norwegian authorities will continue to pursue regulation that result in Norwegian banks remaining sufficiently robust to provide funding for businesses, including during periods of economic uncertainty.

3.2.2 Sources of capital

It is of major importance, especially in the event of a setback in the economy, whether businesses and financial undertakings are largely funded by equity or debt. Equity accounts for just below 40 percent of the funding of companies listed on the Oslo Stock Exchange. The remainder is comprised of various forms of debt.

Section 2.10 provides an overview of who held equity instruments, bonds and certificates of deposit registered in the VPS as at yearend 2016. The public sector and foreign investors held slightly more than and slightly less than 1/3 each, respectively, of the equity instruments, whilst other Norwegian enterprises held almost one fourth. Norwegian securities funds and financial undertakings accounted for about 4 percent each, whilst so-called investment companies and private equity funds held less than 1 percent of the equity instruments. Although their percentage holding is very small, investment companies and private equity funds can play a significant role in the funding of, inter alia, start-ups and business restructurings. About 4 percent of the equities on the Oslo Stock Exchange are directly held by Norwegian individuals. The Government's efforts to strengthen Norwegian private ownership are discussed in the Financial Markets Report 2015.

Norwegian financial undertakings and securities funds account for about 64 percent of debt funding, in the form of bonds and certificates of deposit, for non-financial undertakings. Bank loans are by far the most important source of credit for businesses in Norway, and more than 80 percent of the domestic debt of non-financial undertakings is owing to banks and other financial undertakings; see Figures 3.1 and 3.2. This proportion has remained fairly stable over time. Securities markets may become a more important source of funding for the Norwegian business sector in coming years as a result of, inter alia, measures under the EU capital markets union project, but banks and other financial undertakings will remain a key source of credit in future as well.

In addition to ordinary financial markets, access to capital for the Norwegian business sector is provided through various government schemes, including, inter alia, Innovation Norway and Export Credit Norway, see the discussion in Box 3.2 of the Financial Markets Report 2015.

3.2.3 Private pension savings as a source of investment capital

It was announced in the Financial Markets Report 2015 that the «Ministry of Finance will consider amendments to the regulatory framework to facili-

Box 3.1 Grid companies

The transmission of electrical power through an electricity grid can be characterised as a natural monopoly. About 140 companies are engaged in such activities in Norway, with operations in various geographical areas.

Investments of about NOK 140 billion in the power grid are expected over the next decade, as the result of a need for enhanced security of supply in some areas, reinvestment in the existing grid, the introduction of smart metering, connection of consumption and renewable power generation, as well as changes in residence patterns, cf. Figure 3.3.

Each grid company decides its own grid investments, operates the electricity grid and determines the various rates paid by customers. The activities of grid companies are subject to comprehensive government regulation in order to prevent grid companies from abusing their monopoly power vis-à-vis electricity customers. Grid companies are financially regulated by way of annual revenue limits stipulated by the Norwegian Water Resources and Energy Directorate (NVE). The revenue limits stipulated by the NVE, cap the amount that grid companies can charge for the transmission of electrical power. The limit is based on estimated network capital (in 2015 this came to a total of about NOK 85 billion for all network companies), together with an interest rate (the NVE rate). The aggregate returns of companies will vary over time, cf. Figure 3.4, but the limit is defined such as to provide companies, in total and over time, with a reasonable return on invested capital. In addition, the return on capital of different grid companies will vary with the cost effectiveness of the operations of such companies.

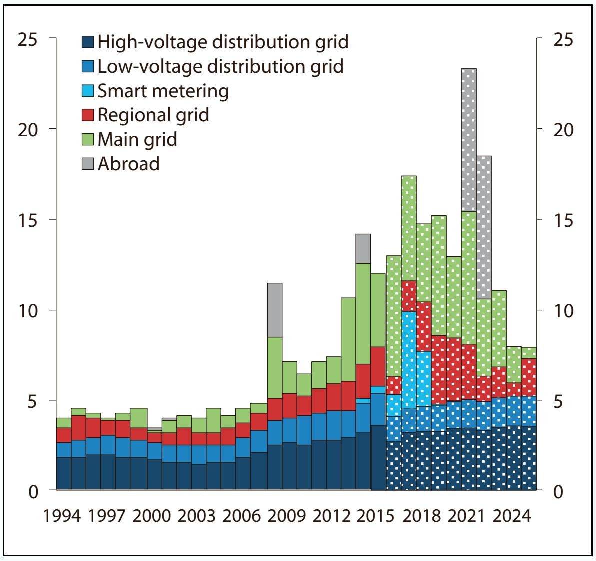

Figure 3.3 Historical and planned electricity grid investments (provisional figures for 2015)

Source: NVE

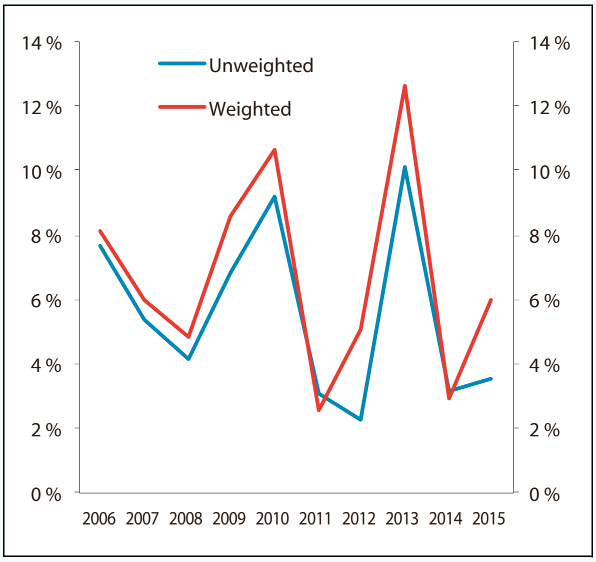

Figure 3.4 Aggregate return on the capital of grid companies (excl. Statnett facilities)

Source: NVE

tate more investment of private pension savings in infrastructure». Such amendments have now been made through the Norwegian implementation of Solvency II. Said amendments imply, inter alia, the establishment of a separate asset class for qualifying infrastructure investments, and the facilitation of investments in European long-term investment funds (ELTIF), which may include infrastructure funds. Such investments are given lower risk classifications than would otherwise have applied, thus resulting in lower solvency capital charges for such investments. These amendments were included in the EU Solvency II regulations as part of the capital markets union process.

Corresponding amendments have not been made for Norwegian pension funds, because these are still subject to the not particularly risk-sensitive solvency regulations implied by the Solvency I regime. Proposed new solvency regulations prepared by Finanstilsynet, on the basis of a simplified version of the Solvency II rules, have been circulated for consultation by the Ministry of Finance. The consultative bodies were specifically requested, in the consultative round, to express their views on whether to facilitate infrastructure investments by lowering capital requirements for the infrastructure investments of pension funds. The proposal is currently being deliberated by the Ministry.

Life insurance undertakings and pension funds invest in various forms of businesses engaged in non-insurance activities, but can themselves only engage in insurance activities. In Norwegian law, the prohibition against engaging in non-insurance activities is operationalised such that the investment of customer assets in ownership stakes of up to 15 percent of the ownership interests of enterprises engaged in non-insurance activities, falls outside the scope of the prohibition against engaging in non-insurance activities.

Insurance undertakings and infrastructure industry enterprises have argued that it is difficult for insurance undertakings to achieve appropriate holdings in certain types of infrastructure via ownership stakes that are limited to 15 percent. Insurance undertakings may apply for exemptions from this rule, but this is rarely done.

Life insurance undertakings are, as mentioned, subject to the Solvency II regulations. This implies, inter alia, that the quantitative investment restrictions previously applicable to the management of customer assets have been replaced by qualitative prudence requirements and capital requirements that depend on the risk associated with the investments.

The Ministry is of the view that the introduction of more risk-sensitive capital requirements for insurance undertakings has reduced the need for a quantitative operationalisation of the prohibition against engaging in non-insurance activities. Against this background, the Ministry has requested Finanstilsynet to consider whether this rule should be abolished, as well as to prepare a consultation paper on abolition of the said rule. The Ministry will thereafter be circulating the draft for consultation.

4 Consumer loans

4.1 Introduction

The market for unsecured credit has been growing steeply in recent years, and a number of new providers have focused on this part of the loan market. Consumer loans continue to represent a small proportion of overall household debt, but the interest burden on such loans is high.

4.2 Description of the consumer loan market

By consumer loans are meant loans obtained by consumers without being secured by residential mortgage, but the term «consumer loan» is not defined in the legislation or in official statistics, and there are varying definitions of this term. In the Norwegian context, it is customary to include credit card debt under the term «consumer loan», but to exclude e.g. car finance and car leasing. The following discussion will use the term «consumer loan» to address unsecured consumer debt, including credit card debt.

Consumer loans amounted to about NOK 90 billion, i.e. about 3 percent of overall household loans as at yearend 2016. Interest rates on consumer loans are highly variable, but are in most cases higher than on loans secured by mortgage. Norges Bank has estimated that the average interest rate on consumer loans has been above 12 percent since 2008, and the payment of interest on consumer loans accounted for about 12 percent of household interest expenditure in 2016.[1]

The consumer loan market is growing rapidly. Overall annual growth in consumer loans to Norwegian households for a selection[2] of banks and other financial undertakings was about 15 percent from the end of 2015 until the end of 2016, whilst growth was 10 percent from the end of 2014 until the end of 2015. Growth in outstanding consumer loans has been 8–9 percent or more in recent years. In comparison, growth in total household debt has remained fairly stable at around 6 percent in the last couple of years; see Figure 4.1. Credit card providers tend to offer credit with an interest-free period, and credit card loans accounted for about 55 percent of consumer loans to Norwegian households as at yearend 2016, compared to approximately 60 percent the previous year. About 70 percent of credit card loans were interest bearing as at yearend 2016, about the same proportion as the preceding year.

Consumer loans are provided in the Norwegian market by both banks and other financial undertakings. A number of new providers have emerged over the last decade, and market growth is largely associated with the relatively new arrivals. The new providers of consumer loan have generally registered higher growth than traditional banks, and several of these had lending growth in excess of 20 percent in 2016. Banks that are predominantly engaged in consumer loans have also, according to Finanstilsynet, delivered high deposit growth and significantly higher deposit rates than other banks.[3]

Defaults and losses on consumer loans are higher than for other types of loans for individuals. Loan losses on consumer loans have increased somewhat, from 0.4 percent of lending volume as at yearend 2015 to 1.5 percent of lending volume as at yearend 2016. The gross default rate has over the same period increased from 5.0 percent to 5.2 percent; see Figure 4.2.

Access to consumer loans can be useful for households. However, the interest rate is so high that large interest-bearing consumer loans are rarely compatible with good financial planning on the part of households. The rejection rate for con-

1 See Financial Stability 2016.

2 The selection of companies encompasses the main part of the market. The selection comprises 27 companies as at yearend 2016 (15 banks and 12 other financial undertakings). Both Norwegian companies and foreign branches in Norway are included in the selection.

3 Data from Finanstilsynet show that medium-sized Norwegian banks registered 8.6 percent deposit growth in 2016. The high deposit growth of medium-sized banks was partly caused by those predominantly engaged in consumer loans. If these are excluded, the deposit growth of medium-sized banks was 5.3 percent. Large banks increased their deposits by 2.6 percent over the same period.

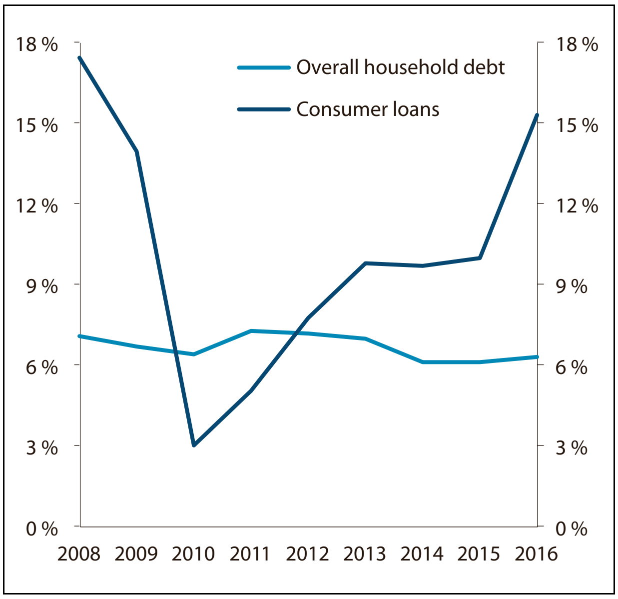

Figure 4.1 Annual growth in overall household debt and consumer loans

Source: Finanstilsynet, Statistics Norway and Ministry of Finance

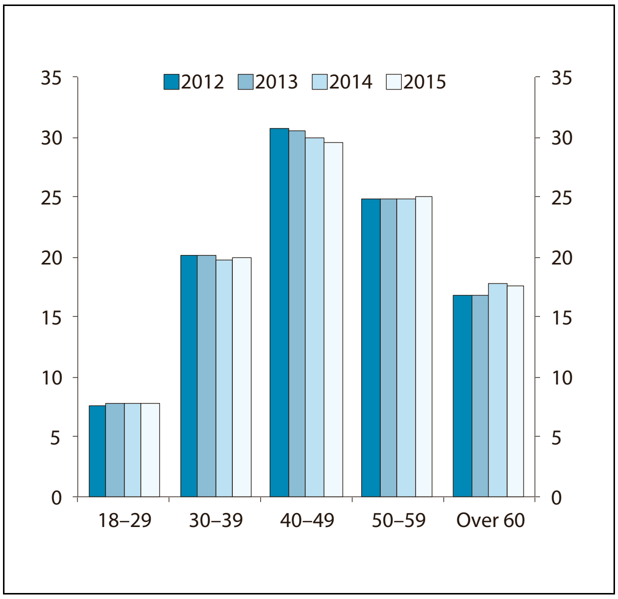

Figure 4.3 Consumer loans by age bracket, as a percentage of total loans

Source: Finanstilsynet

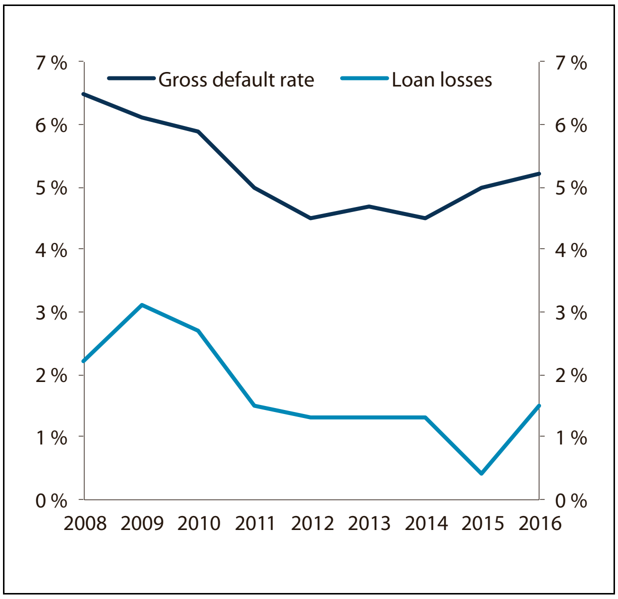

Figure 4.2 Gross default rate and loan losses as a percentage of consumer loans

Source: Finanstilsynet

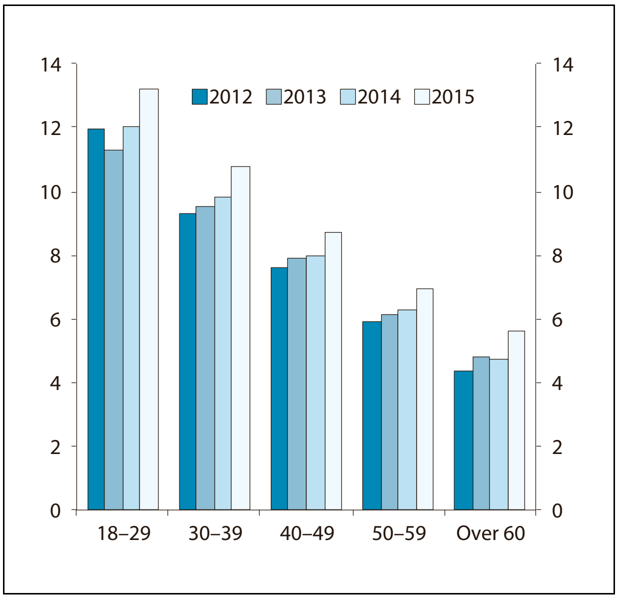

Figure 4.4 30-day default by age bracket, as a percentage of outstanding loans

Source: Finanstilsynet

sumer loan applications is generally high. The evaluation of individual loan applications is largely based on models.

Finanstilsynet has gathered statistics for 2016, which show that 61 percent of loan applications were rejected. The rejection rate for credit cards was 40 percent, whilst it was 80 percent for other consumer loans. Credit card loan applications are more likely to be submitted by individuals who are already customers of the undertakings. The rejection rate for credit card loans is therefore generally lower because undertakings have more detailed knowledge of such customers, in the form of better data and more payment history. Other consumer loans are to a larger extent offered via external agents/intermediaries. This means that less information is available concerning the borrower, thus implying stricter credit evaluations on the part of the undertakings.

We have more knowledge of those who obtain consumer loans, than of those whose applications are rejected. Consumer loans are rarely obtained by borrowers below the age of 30 years (loans to this age bracket represent 8 percent of loans). About 30 percent of loans are granted to borrowers in the 40–49 year age bracket, whilst approximately 25 percent of loans are granted to borrowers in their fifties.[4] The proportion of loans in default is, at the same time, largest amongst borrowers below the age of 30 years, and the default rate is inversely correlated with age; see Figures 4.3 and 4.4.

One provider of consumer loans (Santander) states that applicants whose consumer loan applications (not including credit card) are rejected, are more likely to have low income, to not own their own home, and to not be in a relationship, compared to those whose loan applications are successful. A majority of those whose consumer loan applications were rejected had gross income of less than NOK 400,000. In 2016, the average applicant for the said provider was 42 years (37 years for credit cards), and the average age was said to have increased in recent years. Young people below the age of 24 years represented a very minor part of applicants for this provider.

An analysis for the Centre for the Study of Equality, Social Organization and Performance (ESOP) at the University of Oslo finds that about 30 percent of Norwegian households had consumer debt in 2011.[5] [6] [7] The proportion was especially high amongst households with higher education and income. However, the proportion was also high amongst more vulnerable groups, such as households indicating that they find it difficult to make ends meet, temporary employees, the unemployed, sole providers and households that rent their home. Moreover, in excess of 9 percent of households with consumer debt, or close to 3 percent of all households, reported that they had been in arrears with payments relating to consumer debt. The findings for Norway were in line with figures for other European countries, but Norway had a fairly high incidence of payment arrears.

In a more recent survey from SIFO,[8] 7 percent of Norwegian households reported to have encountered payment problems in 2016.[9] About half of these had also defaulted on loans in 2016.[10] In corresponding surveys in 1991 and 2013, 13 and 5.3 percent, respectively, reported payment problems.

In the SIFO survey, households were also asked to specify the causes of their payment problems. The respondents in 2016 referred to life events, such as unemployment, illness and relationship breakup, as the prime causes of their payment problems. Furthermore, about 40 percent of households with payment problems reported that inadequate planning was a prime or contributing cause of their payment problems, and about 28 percent identified excessive borrowing as a cause. The SIFO survey also found that the average consumer loan for households in the 2016 survey was NOK 129,000, compared to NOK 96,000 in 2013.

4.3 Challenges in the consumer loan market

Well-functioning credit markets promote growth and welfare. Savings products and access to credit provide households with financial freedom, and scope for evening out the effects of income or expense shocks over time. Certitude about access to credit may thus be of positive value, also for households that choose not to take up the offer.

The volume of consumer loans is relatively small compared to households' overall loans, expenses and incomes. Consumer loans are therefore, when taken in isolation, of limited importance to financial stability compared to, for example, residential mortgages. However, the steep growth in outstanding consumer loans may be an indicator of an accumulation of risk. Historical experience has taught us that periods of high

4 See Financial Outlook 2016.

5 Solberg-Watle, Kristin (2015). «Consumer credit and arrears among Norwegian households». Unpublished memorandum, ESOP, Department of Economics, University of Oslo.

6 The analysis is based on panel data from questionnaires. The data source is EU-SILC. The sample data have been weighted to reflect population numbers.

7 Consumer debt here includes credit card debt, consumer loans and hire purchases, and possibly also other corresponding loan types. Part of the credit card debt must be assumed to be non-interest bearing.

8 The SIFO survey is based on a sample of about 2000 observations. The sample is reported to be representative of the Norwegian population in the 18-80 year age bracket.

9 SIFO (2016). «Financial Vulnerability 2016». Commissioned Report No. 13-2016.

10 The group having defaulted on loans being smaller than the group experiencing general payment problems is the result of many households according higher priority to debt claims (and especially residential mortgages) than to various other types of bills.

credit growth tend to be followed by periods of higher losses. Risk assessments play a key role in the loan market. Numerous new market participants means that a number of these have not yet been through a recession, and the highest growth is currently registered by the providers with the briefest market experience. Providers may be in danger of underestimating the risk. An increase in defaults and losses on consumer loans must be expected in the event of a setback in the economy, which may cause problems for those providers that are primarily engaged in consumer loans. If a growing component of consumer demand is funded by borrowing, and such component subsequently declines steeply, this may also pose a challenge to the economy as a whole.

There may also be a risk that providers are currently overestimating the long-term profitability of providing consumer loans. The profitability of providing consumer loans has been high in recent years. This may indicate that price competition in the market has been weak. Although a number of new participants have entered the market, measured profitability has thus far remained high. This may be because the new providers have largely chosen not to compete on price, having instead opted for focusing on marketing and on highlighting other aspects of the product. However, consumer credits are fundamentally fairly homogeneous products, for which the consumer should be able to attach considerable weight to price. Over time, increased competition may therefore result in lower prices for consumers, and lower margins and profitability for providers. However, it cannot be taken for granted that the consumer credit market will move towards lower margins, and it may be that price competition will also be limited over time due to, inter alia, informational asymmetries.

It is challenging for lenders to distinguish between individuals who represent high and low risk. A particular concern in recent years is that the lender is unable to form a definite impression of the actual indebtedness of the loan applicant. Information can be obtained on mortgages and certain other types of loans, but lenders have to rely on loan applicants themselves disclosing any consumer loans. Inadequate information about consumers' indebtedness means that customers who should not have obtained consumer loans may nonetheless be granted such loans. Uncertainty as to whether the disclosed details are correct may also result in customers who should have obtained consumer loans not being granted such loans.

The current consumer loan market is characterised by extensive and aggressive marketing, which tends to appeal to the impulsiveness of consumers. Consumers with weak self-control may be tempted into accelerating consumption by way of expensive consumer loans, thus adopting an excessively short-term approach. They may in the worst-case scenario accumulate more debt than they are able to service. To the extent that current marketing has such consequences, this marketing represents a problem.

4.4 Policy measures

The Government is committed to facilitating well-functioning credit markets. One aspect of this is to ensure that undertakings engaged in consumer loans are robust. Robustness requirements are reflected in, inter alia, Finanstilsynet's practising of the capital requirement regulations in relation to banks that are primarily engaged in consumer loans; see Box 4.1.

In order to improve the consumer credit market and strengthen the position of consumers, the Government will perform a full revision of the credit contract provisions in the Financial Contracts Act, conduct a thorough review of the regulations on the marketing of credit with a view to adopting new provisions by the summer of 2017, as well as submit a proposal for an Act relating to Debt Information. The key measures considered by the Government for improving the consumer credit market and the legislative provisions addressing this will be discussed in the following. This effort is being pursued in several ministries, and the overview is not exhaustive.

Price information

Price transparency is important to promote effective price competition. Information about prices and other terms should be readily available to the customer both before and during the conclusion of credit contracts. The customer may settle his or her liabilities at any given time, thus terminating the credit contract – also when a fixed interest rate has been agreed.

The Financial Contracts Act includes provisions stipulating a duty of disclosure with regard to key contract terms, including price information regarding interest rates and other credit costs. The consumer shall in most cases receive such information in the form of a standardised mort-

Box 4.1 Capital requirements and consumer loans

In order to make banks and other financial undertakings able to withstand loan losses, these are subject to capital requirements, which shall reflect the presumed and estimated risk associated with their activities. Since consumer loans are presumed to entail higher risk than, for example, residential mortgages, these also carry more weight in the calculation of government-imposed capital requirements. The capital requirement regulations require, under the standard method in Pillar 1, that unsecured loans be risk-weighted 100 percent.[1] About one fourth of consumer loans are dealt with in accordance with the IRB method in the capital requirement regulations, with risk weights depending on measured risk.

The aggregate minimum requirement and buffer requirement for non-systemically important undertakings is a CET1 capital adequacy ratio of 11.5 percent. With a risk weight of 100 percent, financial undertakings need about NOK 11.50 of CET1 capital (equity) for each NOK 100 of consumer loans. In comparison, well-secured residential mortgages carry a risk weight of 35 percent, which corresponds to NOK 4 of equity per NOK 100 of lending. In addition, there are Pillar 2 requirements from Finanstilsynet and a certain margin on top of this. Bank start-ups whose activities are primarily focused on consumer financing have, moreover, been subjected to a 4-percent supplementary requirement on top of the general capital requirements in respect of risk associated with, inter alia, their business model. This further increases the CET1 capital requirement.

[1] If a portfolio of such loans meets the mass-market engagement requirements, unsecured loans can be risk-weighted at 75 percent under the standard method.

gage credit information sheet. How to calculate the effective interest rate and how to present the effective interest rate is addressed in the Regulations relating to Credit Contracts, etc. The legislation regulates, inter alia, the right to repay the loan before the agreed maturity date, how interest rates and other terms may be changed, requirements as to how customers shall be informed of transactions and outstanding balances, as well as accrued interest, charges and other costs in revolving credit contracts. The duty of disclosure also extends to any terms and costs in relation to supplementary benefits, for example insurance. The lender is obliged to provide the consumer with a detailed explanation, thus enabling the consumer to assess the implications of, inter alia, default. The Government wishes to further strengthen consumer protection, and the regulation of credit contracts in the Financial Contracts Act is therefore currently under revision.[11] Examples of issues under consideration are how the effective interest rate and other details are communicated, both in the marketing and in the contract terms, as well as the introduction of standardised wording (terminology) – in order to facilitate comparison of prices and other credit terms on the part of the consumer.

The *Finansportalen* financial services portal, which is operated by the Norwegian Consumer Council, has been established to provide consumers with good and comparable information about financial market products. Financial undertakings are obliged to report their prices to the portal, and consumers may use it to compare, inter alia, effective interest rates and monthly down payments on a number of different consumer loans and credit cards. Such a service improves transparency in the consumer loan market, and makes it easier for consumers to make good decisions on the extent of their borrowing and their choice of provider.

Requirements relating to credit evaluation and highlighting of the credit provider's liability for damages

The Government will submit proposed requirements for the lender's performance of a credit evaluation. It is currently a requirement that the customer be warned against obtaining a loan if the credit evaluation is negative. It is now being considered, inter alia, whether to introduce an obligation to refrain from granting a loan in such cases. The credit provider's liability for damages vis-à-vis the customer will be highlighted.

[11] The Ministry of Justice and Public Security's proposed amendments to the Financial Contracts Act will be circulated for consultation in the spring of 2017.

Debt information undertakings

Better and more complete credit evaluations may serve to curtail the debt problems of private households. It is likely that more precise evaluations can also bring about lower credit prices. The Government will be submitting a legislative proposition to the Storting for an Act relating to Debt Information (Legislative Proposition 87 (2016–2017) to the Storting), as part of the effort to improve the ability of lenders to perform sound and correct credit evaluations of customers who apply for loans and credits. The legislative proposition authorises private parties to establish designated undertakings for purposes of passing on debt information between banks and other credit providers for credit evaluation purposes. Such undertakings will both require a government licence and be subject to government supervision. To begin with, the legislation authorises the sharing of consumer credit information, but it is also proposed that the legislation shall allow for subsequent regulations to extend the scope of the legislation to secured credit such as, for example, residential mortgages.

The Government will revise the provisions on credit evaluation of customers in order to prevent debt problems from getting out of hand. The Government will, inter alia, consider whether to introduce provisions to ensure that the credit provider does not exclusively rely on information from the customer itself and its own information about the customer. The customer may in some cases have lost track of his or her own financial situation, which may be both an indicator and a cause of debt problems. Consequently, the customer should not have sole responsibility for the information used by the credit provider in its credit evaluations when such information is also available from other sources.

Box 4.2 Interest rate restrictions

Some countries have introduced price regulation in the consumer loan market, typically in the form of one or more caps on the effective interest rate, etc. Capping of the interest rate may be structured in different ways, but it will in any event involve the introduction of rules that limit the interest rate that can be charged by loan providers. Variants of interest rate capping have been introduced, or considered introduced, in a number of countries, including, inter alia, the United Kingdom, Sweden and Finland. The purpose is typically to cap the interest rate charged on unsecured consumer loans with very short maturities or involving very small amounts. Denmark has considered capping the interest rate on so-called quick loans, but has decided that such measure should not be introduced at present.[1]

Direct price regulation is an invasive policy tool. Unintended effects of capping the interest rate are, inter alia, that it may serve to reduce the supply of credit, expand unlawful lending, make the overall cost of loans less transparent, reduce product diversity and competition, and increase the demand for consumer loans. A report from the World Bank concludes that there are, in the long run, more effective methods of reducing the general interest rate level than capping the interest rate.[2] It highlights, inter alia, an effective consumer protection framework, transparent prices, personal finance knowhow on the part of consumers and good access to credit information (for both loan providers and consumers). The World Bank states that capping the interest rate, if considered, should be only one element of an integrated policy approach.

1 Danish Competition and Consumer Authority (2015). The Market for Quick Loans.
2 World Bank (2014). *Interest Rate Caps around the World*. Policy Research Working Paper No. 7070.

Invoicing of credit card debt

Finanstilsynet has laid down guidelines for the invoicing of credit card debt, which have over time been made stricter and more specific as the result of inadequate compliance on the part of a number of financial undertakings. The guidelines stipulate, inter alia, that the amount specification on the invoice shall set out the total outstanding credit amount, and that the financial undertaking shall not increase the credit limit of existing customers other than upon application from the relevant customer. On 4 April, the Ministry of Finance laid down Regulations relating to the Invoicing of Credit Card Debt, etc. The regulations stipulate requirements as to the financial undertaking's wording of payment communications which imply, inter alia, that the financial undertaking shall specify the total outstanding credit amount as the suggested amount to be paid by the consumer. It shall be an active choice if he consumer opts for deferring down payment.

Capping the interest rate

Capping the interest rate has been proposed as a measure to reduce the price of consumer credit. Capping the interest rate is an intrusive measure, which it is complex to structure prudently, and it is uncertain whether such a measure will reduce the interest rate level in the long run; see Box 4.2. Moreover, a number of other measures targeting economically undesirable uses of consumer loans are currently being considered and introduced. The Ministry of Finance will assess the effect of such measures before potentially examining more closely the capping of interest rates.

Marketing of consumer loans

In a well-functioning credit market, the credit customer will make reasoned consumer credit decisions based on sufficient available information. It is for this reason important for credit marketing to convey sober information, without the attention of the customer being diverted from the credit terms. Misleading and unreasonable marketing of credit is an obstacle to a well-functioning credit market, and will also result in some contract decisions being made on false premises.

The Consumer Ombudsman has documented instances of highly aggressive and persistent credit marketing. The Alliance for Victims of Debt and legal aid organisations such as JUSBUSS and Legal Aid for Women (JURK) note that such marketing is a contributory cause of debt problems. The Government wishes to prevent unreasonable trading practices, including marketing in violation of good marketing practice, from resulting in debt problems. The Ministry of Justice and Public Security has therefore embarked on a process to introduce specific regulation of certain aspects of credit marketing – which will supplement the general provisions of the Marketing Act and the Financial Contracts Act. Proposed Regulations relating to Sound Credit Marketing, launched in the report «Credit Marketing Rules», were discussed in a consultative meeting on 16 March 2017. The proposal implies, inter alia, that credit marketing shall not focus on how swiftly the credit can be obtained or how readily accessible it is, or on how soon one can get a reply to the credit application, or highlight that the threshold for obtaining credit is especially low or how simple the application process is. Nor shall the marketing leave the customer with a misleading impression that the credit provider has a particularly favourable form of credit evaluation of the customer. The proposal also involves stricter regulation of certain forms of marketing aimed directly at the customer, as well as a prohibition against using supplementary benefits as a tool in the marketing of credit.

Against the background of the said proposal and the comments submitted in the consultative round, which are being considered by the Ministry of Justice and Public Security, the Government will lay down Regulations relating to the Marketing of Credit to Physical Persons before this summer. The consultative round has also generated extensive feedback on the marketing of credit and other measures that may be suited for countering debt problems. There has, inter alia, been identified a need for considering the regulation of marketing in social media and marketing carried out by financial agents, as well as the credit provider's affiliates and other partners. Others have identified a need for regulating unreasonable terms in credit contracts, for example the use of supplementary benefits in credit contracts and usurious interest rate clauses. The Ministry of Justice and Public Security will in a consultation paper before this summer also address these proposals in further detail. The Government therefore does not rule out the possibility that further regulation of credit marketing may be introduced shortly.

The industry itself has also moved to clean up the marketing of unsecured debt – Finance Norway and the Association of Norwegian Finance Houses (FinFo) have recently adopted an industry norm for the marketing of credit cards and consumer loans, which will apply to all of their members; see Box 4.3.

The responsibilities of financial undertakings when using agents, etc.

Consumer loans are to some extent marketed by enterprises that are not themselves subject to the Financial Undertakings Act, licence requirements or supervision by government authorities. The Government is seeking to strengthen the legislation on the marketing and intermediation of unsecured credit, also where activities are carried out by other entities than the financial undertaking which will act as lender. The measures under consideration include, inter alia, the introduction of new qualification requirements for brokers and agents that serve as credit intermediaries, as well as further detailing of the good business practice requirements under the Financial Contracts Act.

Box 4.3 New industry norm for the marketing of credit cards and consumer loans

Finance Norway and the Association of Norwegian Finance Houses (FinFo) have adopted a designated industry norm for the marketing of consumer loans and credit. The industry norm has been forwarded to Finanstilsynet and the Norwegian Competition Authority for approval. Once approval has been obtained, all members of Finance Norway and FinFo will be obliged to comply with the standard as a minimum requirement for their marketing. Moreover, Finance Norway and FinFo support the effort to introduce new and clearer statutory requirements.

The industry norm aims to contribute to consumers being well aware of terms and conditions, contractual matters and financial liabilities before the conclusion of any credit agreement, to consumers not being recommended or motivated to conclude credit agreements that are not suited to their financial situation, and to the marketing of consumer loans and credit cards not being aggressive and intrusive.

The industry norm includes, inter alia, a requirement that the marketing of credit shall not focus on how quickly or readily available the credit is, or on how low the threshold for obtaining credit is. There is also a requirement that the marketing of consumer loans shall not be aimed directly at consumers in the age bracket below 25 years.

The responsibility of financial undertakings for ensuring that marketing via agents, accessory agents, affiliates[1] and other partners is effected in compliance with applicable law and the industry norm is also highlighted. The industry norm is required to form part of the agreement between the financial undertaking and its marketing partners, also if such partners operate from abroad.

Finance Norway is the main confederation for the financial industry in Norway and represents about 240 finance businesses. FinFo is a special interest association for finance companies, banks and other enterprises engaged in financing activities in Norway.

1 Affiliates are defined in the industry norm as companies engaged to sell or market products in return for commission on order value or some other form of measureable action.

Source: Finance Norway and FinFo

There is also an effort to highlight the responsibilities of financial undertakings when using agents in the marketing of unsecured credit. It is also intended to strengthen the supervisory authority and sanctioning powers of the Consumer Ombudsman with regard to violations of the marketing provisions governing the marketing of consumer loans. This forms part of the Ministry of Justice and Public Security's current revision of the Financial Contracts Act, and will, together with new marketing provisions, serve to clean up the marketing of unsecured credit.

Cooling-off period and right of cancellation

The Government will consider whether a mandatory cooling-off period should be introduced when, inter alia, establishing so-called express credit.[12] Such a cooling-off period may serve to create some space for quiet reflection, which may make the consumer's decision to obtain credit less prone to be based on impulsiveness. A mandatory cooling-off period will not prevent a consumer from obtaining desired credit, but will give the consumer time to consider the need for the loan, and to check the market for alternative sources of funding. The Government will also consider whether there is a need for strengthening the right of cancellation for credit contracts. This may serve to avert expensive express loans.

Personal finance knowhow

An understanding of personal finance is important to prevent debt problems. Consumers with a good understanding of personal finance will be better placed to evaluate the various products and services available in financial markets, and to make appropriate use of these. The Government believes that schools are an important arena for training and prevention, and has supported the Consumer Ombudsman and Finance Norway in a collaborative effort to develop *Økonomilappen*, a web-based personal finance learning tool. Finance Norway and Young Entrepreneurship have also developed the training programme «In Charge of My Own Life!» for upper secondary schools. The autumn of 2016 also saw the launch of the website www.skolemeny.no. This is a website featuring

12 Such a cooling-off period has, inter alia, been introduced in Denmark for «quick loans», defined as unsecured loans with a maturity of up to three months. The cooling-off period in Denmark is 48 hours, and the loan provider cannot contact the customer in connection with an already existing loan offer during such period.

Box 4.4 Guidelines for the processing of consumer loan applications

Finanstilsynet has prepared draft guidelines on financial undertakings' processing of consumer loan applications. Finanstilsynet proposes, in its draft, guidelines that, inter alia, require financial undertakings to document that any granting of, and increase to, consumer loans is based on an adequate credit evaluation. Moreover, it is a requirement in the draft that debt information and any negative credit history be checked against relevant registers. Guidelines for financial undertakings' evaluation of customer's ability to pay are also proposed, with such evaluation allowing, inter alia, scope for an interest rate increase of no less than 5 percentage points. Finanstilsynet also proposes that financial undertakings shall refrain from granting any consumer loans that would result in total debt representing more than five times gross annual income. It is furthermore proposed that consumer loans shall be subject to instalment payment requirements and maximum maturity requirements, and that loans with a maturity in excess of five years shall not normally be granted. It is also proposed that financial undertakings shall report on their compliance with these guidelines to their boards of directors.

The draft was circulated for consultation to the associations representing financial undertakings and to the consumer authorities on 28 March 2017, with 19 April 2017 as the deadline for submitting consultative comments.

various personal finance training tools and training programmes for use in schools. The website has been developed by Finance Norway and a network of private and public parties that are focusing on this topic. 2009 saw the establishment of 800 GJELD [«DEBT»], a free nationwide phone-based financial advisory service, which also has a chat function. The service is operated through the Norwegian Labour and Welfare Administration (NAV), and is available via its website.

Differentiation of the fees payable to the Norwegian Banks' Guarantee Fund

Banks that are primarily engaged in consumer loans have also, as noted in section 4.2, registered high deposit growth and offered significantly higher deposit rates than other banks. It may appear that banks with higher borrowing costs in the market because of their risk profiles reap particular benefits from attracting deposits that for customers are secured via such banks' membership of the Norwegian Banks' Guarantee Fund. The Norwegian Banks' Guarantee Fund is an important tool for ensuring financial stability. It is unfortunate if this serves to raise cheap funding for unsecured loans.

The Ministry of Finance has received the Banking Law Commission's report NOU 2016:23 on Deposit Guarantees and Crisis Management in the Banking Sector. The Ministry will, in its follow-up of the said report, attach weight to ensuring that the deposit guarantee scheme does not provide cheap funding for consumer loan banks with high borrowing costs.

5 Regulatory amendments in 2016

5.1 Regulatory developments

5.1.1 Financial undertakings and financial groups

On 9 December 2016, the Ministry of Finance laid down Regulations relating to Financial Undertakings and Financial Groups, etc. The said regulations supplement the Financial Undertakings Act and replace 50 earlier regulations, thus making key parts of financial market regulations more readily accessible and user friendly. Certain major regulations under the Financial Undertakings Act were not incorporated into the Financial Undertakings Regulations, and are retained separately with necessary adaptations to the Financial Undertakings Act. Insurance undertakings have been made subject to rules supplementing the Financial Undertakings Act, via the Solvency II Regulations, which are following up the EU rules in this field. The CRD IV rules for banks follow, correspondingly, from the CRR/CRD IV Regulations. Rules falling within the scope of the said regulations (solvency, liquidity, management and control, etc.) do not form part of the joint regulations.

5.1.2 Banking

On 27 June 2016, the Ministry of Finance laid down Regulations relating to Interchange Fees for Card-Based Payment Transactions, etc. The regulations regulate maximum interchange fees for card-based payment transactions, and will implement rules corresponding to the EU regulation on interchange fees. The interchange fee is the fee that the cardholder's bank may charge the bank of the point of sale (the shop) to process payment transactions by various card solutions. The interchange fee regulations are EEA relevant, but have thus far not been incorporated into the EEA Agreement. Adoption of the Regulations relating to Interchange Fees for Card-Based Payment Transactions, etc., implied that rules corresponding to those under the regulation were introduced in Norwegian law prior to the occurrence of the implementation obligation under EEA law.

On 14 December 2016, the Ministry of Finance laid down new Regulations relating to Requirements Applicable to New Loans Secured by Residential Mortgage (the Residential Credit Regulations). The purpose of the said regulations is to promote more balanced development in the housing and credit markets. Under the regulations banks are required to, inter alia, calculate the ability of the customer to service the residential mortgage, based on income and all relevant expenses, and to allow for a 5 percentage point interest rate increase. Loans shall not be granted if the customer's overall debt exceeds five times gross annual income. Amortising loans secured by residential mortgage shall not exceed 85 percent of the value of the home, whilst lines of credit shall not exceed 60 percent of the value of the home. Loans secured by mortgage on a second home in Oslo shall, moreover, not exceed 60 percent of the value of such home. These requirements may be met by satisfactory additional collateral in the form of a mortgage secured on other real estate, surety or guarantee. Instalment payment is required for amortising loans in excess of 60 percent of the value of the home. It is important for banks to retain sufficient flexibility to be able to grant loans to creditworthy customers who do not meet all requirements under the regulations. It is therefore permitted for up to 10 percent of the volume of a bank's granted loans per quarter to be loans that do not meet the regulatory requirements on ability to pay, indebtedness, LTV ratio or instalment payment. In Oslo, the scope for banks to grant loans that do not meet one or more of the requirements is limited to up to 8 percent of the value of granted loans secured by residential mortgage in Oslo per quarter, or NOK 10 million per quarter if higher. The regulations entered into force on 1 January 2017 and shall apply until 30 June 2018.

On 15 December 2016, the Ministry of Finance decided to increase the level of the counter-cyclical capital buffer requirement. The level is to be increased from 1.5 percent to 2 percent. The amendment shall apply from 31 December 2017 and is in line with the advice of Norges

Bank for the 4th quarter of 2016. The purpose of the counter-cyclical capital buffer is to make banks more solvent and robust in relation to loan losses, as well as to reduce the risk that banks will curtail their granting of credit in a recession.

On 28 September 2016, the Ministry of Finance adopted amendments to the rules on the calculation of counter-cyclical capital buffer, which largely implemented the system for the determination of counter-cyclical capital buffer stipulated in the Basel Committee's revised capital requirement standards, etc., (Basel III) and the EU rules (Directive 2013/36/EU (CRD IV)). The regulatory amendments entered into force on 1 October 2016. The amendments imply that Norwegian undertakings shall apply, in full, the counter-cyclical capital buffer determined by other EEA states for such part of their activities as are carried out in the relevant state, for purposes of calculating their enterprise-specific capital buffer. For EEA states that have not determined any counter-cyclical capital buffer rate, the Norwegian rate shall apply, unless the Ministry of Finance has stipulated a different rate. For engagements in third countries (non-EEA states) that have stipulated a capital buffer, the counter-cyclical capital buffer rate stipulated by the authorities in the relevant jurisdiction shall, as a general rule, be applied. For third countries that do not have a system for the determination of counter-cyclical capital buffer, the Norwegian rate shall apply unless the Ministry of Finance stipulates a different rate. The Ministry intends, generally speaking, to adhere to the recommendations of the European Systemic Risk Board (ESRB) of 11 December 2015 on how the counter-cyclical capital buffer shall be calculated for engagements in states that fall outside the scope of the EEA Agreement. The Ministry of Finance will draw on advice from Norges Bank in determining the rates.

On 20 December 2016, the Ministry of Finance stipulated leverage ratio requirements applicable from 30 June 2017. The stipulated minimum leverage ratio requirement is 3 percent. In addition, all banks shall have a non-weighted tier 1 capital buffer of no less than 2 percent. On top of this, systemically important banks shall have a leverage ratio buffer of no less than 1 percent.

On 16 December 2016, the Ministry of Finance laid down regulations on amendments to the Annual Financial Statement Regulations for Banks. The amendments are of a technical nature and are intended to bring the terminology, etc., into line with the Financial Undertakings Act.

On 19 September 2016, the Ministry of Finance laid down regulations on amendments to Regulations relating to the Payment of Fees to the Norwegian Banks' Guarantee Fund. The amendment implies a right to deductions in the fees paid to the Norwegian Banks' Guarantee Fund upon withdrawal from the Fund. Banks have not previously been entitled to deductions in paid fees upon withdrawal, and this resulted, after the introduction of a new financial reporting standard in 2015, in banks, whose practice had before that been to recognise the fees payable to the Norwegian Banks' Guarantee Fund in their accounts on an accrual basis, being required to expense the entire fee in the first quarter. The regulatory amendment implies that banks can continue their earlier accounting practice. These rules have now been incorporated into the Regulations to the Financial Undertakings Act.

5.1.3 Insurance and pensions

On 11 May 2016, the Ministry of Finance laid down regulations on amendments to regulations under the Occupational Pension Schemes Act. The amendments permit employers operating pension schemes for their employees under the Occupational Pension Schemes Act to cap the size of the pension scheme adjustment reserve. The adjustment reserve cap cannot be less than 5 percent of pension assets for active members and any excess funds shall be added to the employer's premium reserve.

On 17 June 2016, the Ministry of Finance laid down regulations on amendments to the Asset Management Regulations. The regulations require pension funds to perform risk analyses to uncover how unusual market conditions will affect the financial position of the pension fund. Such risk analyses shall be based on both the book value and the fair (market-based) value of assets and liabilities. The pension fund shall consider measures if the risk analysis based on book value gives reason to believe that the future financial position of the pension fund will be vulnerable. The amendment implies that such obligation to consider measures shall also apply when the risk analysis is based on fair value. The amendment has now been included in new joint regulations for pension undertakings, cf. the description below.

On 9 December 2016, the Ministry of Finance laid down joint regulations on pension undertakings. The regulations address reserve and capital requirements, as well as asset management, supervision and control requirements and actuarial requirements. The background is that a number of regulations that are no longer applicable to life insurance undertakings, following the introduction of Solvency II, shall be retained for pension undertakings. These regulations have now been brought together in the said joint regulations.

On 9 December 2016, the Ministry of Finance laid down regulations on amendments to regulations under the Insurance Activity Act. The amendments are technical in nature, and are intended to adapt the regulations to the amendments made to the Insurance Activity Act upon the enactment of the new Financial Undertakings Act. On 16 December 2016, the Ministry of Finance laid down regulations on amendments to the Annual Financial Statement Regulations for Non-Life Insurance Undertakings, Life Insurance Undertakings and Pension Undertakings. The amendments are technical in nature, and are intended to bring terminology, etc., into line with the Financial Undertakings Act.

On 21 December 2016, Finanstilsynet adopted amendments to Regulations relating to Rules Supplementing the Solvency II Regulations. The said regulations set out rules corresponding to Commission Regulation (EU) 2015/35, with a modification pertaining to the capital requirement in relation to exposure to Norwegian municipalities and counties. The amendments to the regulations correspond to the amendments to Commission Regulation (EU) 2015/35 laid down in Commission Regulation (EU) 2016/467. The main amendment concerns special rules for infrastructure investments in the calculation of the solvency capital requirement.

5.1.4 Securities trading, securities funds and alternative investment funds

By Act of 16 December 2016 No. 90, the Storting adopted amendments to the Securities Funds Act, etc. (UCITS V Directive, etc.). The amendments concerned four different aspects of the financial market legislation. Firstly, amendments were adopted to the Securities Funds Act to implement future EEA obligations corresponding to the UCITS V Directive into Norwegian law (Directive 2014/91/EU). The purpose of the UCITS V Directive is to adapt securities fund rules to market developments, and to harmonise and strengthen the rules on the duties and responsibilities, as well as the remuneration arrangements and sanctions, of custodians. Secondly, a new perfection provision was adopted in section 4 a) of the Act relating to Financial Collateral with regard to security interests in banks' lending portfolios, with underlying collateral, to secure their loans from Norges Bank. The purpose is to facilitate the swift payment of extraordinary liquidity loans from Norges Bank, cf. section 19 and section 22 of the Central Bank Act, to prevent liquidity problems in, for example, one bank from spreading and creating financial instability. Thirdly, amendments were adopted to section 9-21 of the Securities Trading Act on the consolidation of capital and solvency requirements. The amendment implies a joint consolidation provision for large engagements and for capital adequacy, and will bring the provisions into line with the EU capital requirements regulation, CRR. Fourthly, new provisions were adopted in section 10-16 b of the Securities Trading Act and section 1-5 of the Securities Funds Act, which authorise the Ministry to lay down regulations stipulating that investment firms and fund management companies for securities funds shall establish links to pricing information in web-based pricing portals. All of the legislative amendments entered into force on 1 January 2017, with the exception of the amendments to the Securities Funds Act, which have not yet entered into force.

The new Act relating to the Determination of Benchmark Rates entered into force on 1 January 2016. The act requires the determination of generally used benchmark rates such as Nibor to be organised in a sound manner. The administrator (the entity responsible for determining the benchmark rate) and the organisation of benchmark rate determination shall require the approval of the Ministry of Finance. Finanstilsynet shall supervise the administrator and its activities. A transitional provision adopted by the Ministry of Finance required the administrator to comply with the requirement laid down in or pursuant to the Act from 1 January 2017 onwards, and to apply for approval by the said date. On 16 November 2016, the Ministry of Finance laid down Regulations No. 1333 under the Act relating to the Determination of Benchmark Rates (the Benchmark Rate Regulations). The Benchmark Rate Regulations stipulate detailed requirements for the administrator's organisation, checking and monitoring of the determination of benchmark rates.

The Ministry of Finance adopted, in regulations of 28 June 2016, amendments to regulations of 21 December 2011 under the Securities Funds Act. The amendments concerned effective portfolio management techniques. The purpose of the amendments to the Regulation was to make the regulatory framework reflect how the loan market works in practice, and to bring it into line with developments in the EEA. The amendments entered into force on 1 July 2016.

The Ministry of Finance adopted, in regulations of 6 October 2016, amendments to regulations of 26 June 2014 under the Act relating to the Management of Alternative Investment Funds. The amendments imply that EEA obligations corresponding to five implementation regulations under the AIFM Directive have been incorporated in the form of regulations. The regulatory amendments entered into force immediately.

5.1.5 EEA financial supervision, etc.

In the spring of 2016, the Ministry of Finance negotiated draft EEA Joint Committee Decisions and prepared Proposition 100 (2015–2016) to the Storting, proposing that the Storting consent to participation in the EEA Joint Committee Decisions on the legal acts establishing the EU financial supervisory system and certain other legal acts. The proposition was submitted on 15 April 2016. Proposition 101 (2015–2016) to the Storting on consent to certain amendments to the agreement between the EEA/EFTA states on the establishment of the EFTA Surveillance Authority and the EFTA Court was submitted at the same time. The Government took the view that the EEA Joint Committee Decisions encompassed by the proposed consent implied a transfer of powers to the EFTA Surveillance Authority of such nature that the consent of ¾ of the Storting should be obtained, with a minimum of $^2/_3$ of representatives in attendance, cf. the requirement in Article 115 of the Constitution. The Storting decided to grant consent on 13 June 2016.

On 11 May 2016, the Ministry of Finance submitted Legislative Proposition 127 (2015–2016) on a new Act relating to EEA Financial Supervision and amendments to the Act relating to Credit Rating Agencies, as well as amendments to the Securities Trading Act for implementation of the Short Selling Regulation (EU) No. 236/2012 and EMIR (EU) No. 648/2012 (regulation on OTC derivatives, central counterparties and trade repositories). The new act and the legislative amendments were enacted by the Storting on 13 June 2016.

On 30 September 2016, the Ministry of Finance submitted Legislative Proposition 166 (2015–2016) on amendments to the Act relating to EEA Financial Supervision, the Act relating to Credit Rating Agencies, the Act relating to the Management of Alternative Investment Funds and the Securities Trading Act (follow-up of EEA financial supervision) in order to simplify and structure incorporation of EEA provisions into Norwegian legislation. The amendments were adopted by the Storting on 16 December 2016.

The Act relating to EEA Financial Supervision, the amendments to the Act relating to Credit Rating Agencies and new Regulations relating to Credit Rating Agencies entered into force on 3 October 2016. The amendments to the Securities Trading Act and the Securities Regulations which implement the Short Selling Regulation with associated commission regulations entered into force on 1 January 2017. The amendments to chapter 13 of the Securities Trading Act, etc., on implementation of EMIR have not entered into force.

5.1.6 Estate agency

On 9 December 2016, the Ministry of Finance laid down regulations on amendments to Regulations of 23 November 2007 relating to Estate Agency. The amendments concerned extrajudicial dispute resolution arrangements under the Estate Agency Act. The amendments are the result of Act of 17 June 2016 No. 29 relating to Consumer Complaint Bodies. The amendments to the Estate Agency Regulations entered into force on 1 January 2017.

5.1.7 Accounting, auditing and bookkeeping

On 3 March, 31 March and 11 May 2016, respectively, the Ministry of Finance adopted amendments to 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 incorporation into Norwegian law of EEA rules corresponding to six European Commission regulations on amendments to international financial reporting standards (2015/2173, 2015/2231, 2015/2343, 2015/2406, 2015/2441 and 2015/2113, respectively).

On 20 December 2016, the Ministry of Finance adopted amendments to Regulations of 1 December 2004 No. 1558 relating to Bookkeeping. The amendments to the Bookkeeping Regulations were made to adapt the rules to the new regulatory provisions on cash systems, which entered into force on 1 January 2017. Said regulatory provisions will make it harder to hide cash sales through the manipulation of cash systems. The amendments to the Bookkeeping Regulations include, in particular, rules on the documentation of cash sales, and exemptions from the requirements for documentation of cash sales. The amendments to the Bookkeeping Regulations will enter into force on 1 January 2019.

5.1.8 Miscellaneous

In June and December of each year, the Ministry of Finance sets a late payment interest rate for the next six-month period, cf. section 3 of Act of 17 December 1976 No. 100 relating to Late Payment Interest, etc. (the Late Payment Interest Act). The rate shall equal the Norges Bank key policy rate, with a surcharge of no less than 8 percentage points. On 23 June 2016, the late payment interest rate for the second half of 2016 was fixed at 8.50 percent p.a., cf. section 1 of Regulations of 23 June 2016 No. 784 relating to Late Payment Interest and Debt Collection Cost Compensation. At the same time, the Ministry of Finance stipulated a standard debt collection cost compensation amount of NOK 370, cf. section 3a of the Late Payment Interest Act. The same late payment interest rate was fixed for the first half of 2017, see section 1 of Regulations of 15 December 2016 No. 1583 relating to Late Payment Interest and Debt Collection Cost Compensation. The same regulations set the standard debt collection cost compensation amount for the first half of 2017 at NOK 360: see section 2.

On 21 December, the Ministry of Finance adopted amendments to Regulations relating to the Allocation of Supervision Expenses. The amendments introduce new allocation principles for calculating the supervision fees for the supervision categorises managers for alternative investment funds (AIF managers) and fund management companies for securities funds. Under the new rules, supervision fees for AIF managers and fund management companies for securities funds will be calculated on the basis of the revenues of the undertaking. The regulations authorise the stipulation of an annual minimum and maximum amount to be paid by each entity. The regulations entered into force on 1 January 2017.

On 22 December 2016, the Ministry of Finance laid down regulations on amendments to Regulations relating to Country-by-Country Reporting (CCR), which apply to large accounting entities above certain thresholds, as well as to issuers of listed securities, engaged in extraction industries and/or logging in primary forests. The new regulatory provisions require the CCR report to include further key details in relation to the activities of the reporting entity, including full cost details, as well as certain specific tax details. Such details shall be reported for each country in which the enterprise is established. Moreover, new provisions have been adopted with regard to the object of the regulations and the publication of the report.

5.2 Enacted regulations

In total, the Ministry of Finance and Finanstilsynet enacted 40 regulations relating to the financial market in 2016:

Regulations of 3 March 2016 No. 211 on amendments to Regulations of 17 December 2004 No. 1852 relating to Implementation of EEA Rules on Adopted International Financial Reporting Standards

Regulations of 31 March 2016 No. 333 on amendments to Regulations of 17 December 2004 No. 1852 relating to Implementation of EEA Rules on Adopted International Financial Reporting Standards

Regulations of 22 April 2016 No. 403 relating to links to the *Finansportalen* Financial Services Portal

Regulations of 11 May 2016 No. 487 on amendments to Regulations of 17 December 2004 No. 1852 relating to Implementation of EEA Rules on Adopted International Financial Reporting Standards

Regulations of 11 May 2016 No. 488 on amendments to Regulations of 27 June 2014 No. 885 under the Occupational Pension Schemes Act

Regulations of 17 June 2016 No. 786 on amendments to Regulations of 17 December 2007 No. 1457 relating to the Asset Management Activities of Life Insurance Companies and Pension Undertakings (the Asset Management Regulations)

Regulations of 23 June 2016 No. 784 relating to Late Payment Interest and Debt Collection Cost Compensation [second half of 2016]

Regulations of 24 June 2016 No. 797 on amendments to Regulations of 21 December 2015 No. 1794 relating to Transitional Provisions, etc., under Act of 10 April 2015 No. 17 relating to Financial Undertakings and Financial Groups (the Financial Undertakings Act)

Regulations of 27 June 2016 No. 827 relating to Interchange Fees for Card-Based Payment Transactions, etc.

Regulations of 28 June 2016 No. 832 on amendments to Regulations of 21 December 2011 No. 1467 under the Securities Funds Act

Regulations of 28 June 2016 No. 864 on amendments to Regulations of 4 December 2015 No. 1410 under Act relating to the Determination of Benchmark Rates (the Benchmark Rate Regulations)

Regulations of 19 September 2016 No. 1075 on amendments to Regulations of 6 May 1997 No.

429 relating to the Payment of Fees to the Norwegian Banks' Guarantee Fund
Regulations of 22 September 2016 No. 1095 relating to the Execution of Securities Settlement
Regulations of 28 September 2016 No. 1148 on amendments to Regulations of 12 December 2013 relating to the Level of the Counter-Cyclical Capital Buffer
Regulations of 28 September 2016 No. 1149 on amendments to Regulations of 22 August 2014 No. 1097 relating to Capital Requirements and National Adaptation of CRR/CRD IV (the CRR/CRD IV Regulations)
Regulations of 3 October 2016 No. 1174 relating to Credit Rating Agencies
Regulations of 6 October 2016 No. 1177 on amendments to Regulations of 26 June 2014 No. 877 under the Act relating to the Management of Alternative Investment Funds
Regulations of 16 November 2016 No. 1333 under the Act relating to the Determination of Benchmark Rates (the Benchmark Rate Regulations)
Regulations of 25 November 2016 No. 1366 on amendments to Regulations of 29 June 2007 No. 876 under the Securities Trading Act (the Securities Regulations)
Regulations of 9 December 2016 No. 1470 on amendments to Regulations of 23 November 2007 No. 1318 relating to Estate Agency
Regulations of 9 December 2016 No. 1502 relating to Financial Undertakings and Financial Groups (the Financial Undertakings Regulations)
Regulations of 9 December 2016 No. 1503 relating to Pension Undertakings
Regulations of 9 December 2016 No. 1504 on amendments to Regulations of 30 June 2006 No. 869 under the Insurance Activity Act (Life Insurance, etc.)
Regulations of 9 December 2016 No. 1528 on amendments to miscellaneous regulations relating to financial undertakings, etc.
Regulations of 9 December 2016 No. 1544 on amendments to Regulations of 1 December 2004 No. 1558 relating to Bookkeeping
Regulations of 14 December 2016 No. 1581 relating to Requirements Applicable to New Loans Secured by Residential Mortgage (the Residential Credit Regulations)
Regulations of 15 December 2016 No. 1583 relating to Late Payment Interest and Debt Collection Cost Compensation [first half of 2017]
Regulations of 15 December 2016 No. 1601 on amendments to Regulations of 12 December 2013 No. 1440 relating to the Level of the Counter-Cyclical Capital Buffer
Regulations of 16 December 2016 No. 1637 on amendments to Regulations of 18 December 2015 No. 1775 relating to Annual Financial Statements for Non-Life Insurance Companies
Regulations of 16 December 2016 No. 1656 on amendments to Regulations of 18 December 2015 No. 1824 relating to Annual Financial Statements for Life Insurance Companies
Regulations of 16 December 2016 No. 1657 on amendments to Regulations of 20 December 2011 No. 1457 relating to Annual Financial Statements for Pension Undertakings
Regulations of 16 December 2016 No. 1658 on amendments to Regulations of 16 December 1998 No. 1240 relating to Annual Financial Statements, etc. for Banks, Financial Undertakings and their Parent Companies
Regulations of 16 December 2016 No. 1662 on amendments to Regulations of 9 December 2016 No. 1502 relating to Financial Undertakings and Financial Groups (the Financial Undertakings Regulations)
Regulations of 16 December 2016 No. 1707 on amendments to Regulations of 29 June 2007 No. 876 under the Securities Trading Act (the Securities Regulations)
Regulations of 20 December 2016 No. 1752 on amendments to Regulations of 1 December 2004 No. 1558 relating to Bookkeeping
Regulations of 20 December 2016 No. 1824 on amendments to Regulations of 22 August 2014 No. 1097 relating to Capital Requirements and National Adaptation of CRR/CRD IV (the CRR/CRD IV Regulations)
Regulations of 21 December 2016 No. 1832 on amendments to Regulations of 22 October 1990 No. 875 relating to Minimum Capital Adequacy Requirements for Banks, Mortgage Companies, Financial Undertakings, Financial Group Holding Companies and Investment Firms using the IRB or AMA method
Regulations of 21 December 2016 No. 1849 on amendments to Regulations of 18 December 2015 No. 1776 relating to the Allocation of Supervision Expenses
Regulations of 21 December 2016 No. 1850 on amendments to Regulations of 21 December 2015 No. 1807 relating to Rules Supplementing the Solvency II Regulations
Regulations of 22 December 2016 No. 1861 on amendments to Regulations of 20 December 2013 No. 1682 relating to Country-by-Country Reporting

6 Implementation of monetary policy

6.1 Monetary policy guidelines

Pursuant to section 1 of the Central 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 regulations of 29 March 2001, cf. Box 6.1. The guidelines were explained and expanded on in Report No. 29 (2000–2001) to the Storting on economic policy guidelines, published on the same date.

According to the regulations, Norges Bank's operational implementation of monetary policy shall 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) to the Storting further stated that Norges Bank must adopt a forward-looking approach when setting the interest rate, and pay sufficient heed to uncertainty associated with macroeconomic forecasts and assessments. When the Exec-

Box 6.1 Regulations relating to Monetary Policy

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

I

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 operational implementation of monetary policy.

Norges Bank's operational 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, any direct effects on consumer prices as the result of changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

Section 2

Norges Bank shall publish the assessments that form the basis for the operational implementation of monetary policy on a regular basis.

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 relating to Norges Bank and the Monetary System.

II

These regulations shall enter into force immediately. Regulations No. 0331 of 6 May 1994 relating to the exchange rate system for the Norwegian krone are repealed from the same date.

utive 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 role of monetary policy is to provide the economy with a nominal anchor point. The regulations established flexible inflation targeting as a guideline for monetary policy. In the short and medium term, Norges Bank must balance consideration for low, stable inflation with consideration for stability in output and employment. There will often be no conflict between these two considerations. If a conflict arises, Norges Bank must exercise discretion and weigh the two considerations against one another.

6.2 Monetary policy tools and trade-offs

The most important tool 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 maturities are influenced by the level of the key policy rate and by the expectations of market participants regarding future developments in the key policy rate.

Market expectations regarding the key policy rate depend on market participants' beliefs concerning economic developments. In addition, rate expectations will be affected by market participants' views on how the central bank operates. Market rates influence the Norwegian krone exchange rate, securities prices, investment, consumption, housing prices and loan demand. Norges Bank's key policy rate can in itself influence economic development expectations. Through all of these channels, the key policy rate influences the total demand and output situation, as well as prices and wages.

In its 2016 Annual Report, Norges Bank wrote, inter alia, the following concerning flexible inflation targeting:

> The operational monetary policy target is annual growth in consumer prices which over time is close to 2.5 percent. In its conduct of monetary policy, Norges Bank operates a flexible inflation targeting regime, with weight being attached to both variability in inflation and variability in output and employment when setting the key policy rate.

Norges Bank holds six monetary policy meetings a year. Norges Bank publishes a «Monetary Policy Report with financial stability assessment» in connection with four of the meetings. In these reports, Norges Bank examines the economic situation and outlook. Moreover, the reports present assessments from Norges Bank in relation to the counter-cyclical capital buffer, cf. the discussion in chapter 3.

Norges Bank publishes forecasts for future developments, including key policy rate forecasts. The Bank outlines how various monetary policy considerations are balanced against each other. If Norges Bank's monetary policy actions are regarded as stable and credible, monetary policy also becomes more effective. Norges Bank has published criteria for good future interest rate developments, which are discussed in the Monetary Policy Reports.

6.3 Monetary policy conduct in 2016

Monetary policy takes effect with a time lag. Developments in inflation, output and employment in 2016 are therefore also influenced by the monetary policy pursued in preceding years.

The key policy rate was kept unchanged at 0.75 percent in the monetary policy meeting in December 2015. In the Monetary Policy Report published at the time of that meeting, it was estimated that the key policy rate would be reduced to less than 0.5 percent in 2016.

As the monetary policy meeting in March was approaching, there was some weakening in the growth outlook for our trading partners. In January, the oil price declined to its lowest level since 2003, but it increased again later in the quarter. Growth in the Norwegian economy was somewhat lower than anticipated by Norges Bank, and information from its regional network indicated that the weak growth would continue. Unemployment had increased somewhat, and Norges Bank estimated that it would continue to increase. On the other hand, wage growth in 2015 turned out to be slightly higher than had been estimated by Norges Bank in December, and consumer prices had increased somewhat more than estimated. In the monetary policy meeting in March, Norges Bank emphasised that the outlook for the Norwegian economy as a whole was somewhat weaker and that unemployment was expected to increase. Norges Bank also noted that low wage growth may contribute to a reduction in price growth over time. Both inflation target considerations and capacity utilisation considerations suggested, according to Norges Bank, that the key policy rate should be reduced. Norges Bank decided to reduce the key policy rate by 0.25 percentage points, to 0.5 percent. In Monetary Policy Report 1/16 (MPR 1/16), Norges Bank presented a forecast implying that the key policy rate might be further reduced over the course of 2016.

Into the spring, developments on the part of trading partners were more or less as estimated in MPR 1/16. The oil price increased somewhat more than expected, whilst the Norwegian krone appreciated and was stronger than had been estimated by Norges Bank. In phone calls to the regional network, contacts reported that the outlook was much as before. Consumer price inflation also development more or less as had been anticipated by Norges Bank. In the monetary policy meeting in May, the Executive Board decided to keep the key policy rate unchanged at 0.5 percent.

Developments for trading partners in the lead-up to the monetary policy meeting in June were largely in line with estimates. The oil price continued to increase into the spring, and the Norwegian krone appreciated more than had been expected. At the same time, the money market spread remained higher than Norges Bank had estimated in March. All in all, developments in the Norwegian economy conformed well to Norges Bank's estimates from MPR 1/16. The labour market developed slightly better than had been estimated by Norges Bank, but large deviations between registered unemployment and LFS unemployment added uncertainty to the capacity utilisation assessment. In the monetary policy meeting in June, Norges Bank attached weight to the continued weakness of growth in the Norwegian economy, although the oil price increase might serve to reduce uncertainty. It was emphasised, at the same time, that continued high housing price growth might make households more vulnerable and increase the risk of a steep future decline. It was also noted that lower wage growth and a somewhat stronger Norwegian krone would serve to curtail inflation further ahead. The Executive Board decided, based on an overall assessment, to keep the key policy rate unchanged at 0.5 percent. In Monetary Policy Report 2/16 (MPR 2/16), the Bank presented a key policy rate forecast suggesting that said rate would be reduced to about 0.25 percent as at yearend 2016.

International financial markets were strongly impacted by the outcome of the referendum on EU membership in the United Kingdom in June, but the volatility declined over the course of the summer. By September, market participants' expectations as to key policy rates abroad had declined somewhat since MPR 2/16. Growth in the Norwegian economy was somewhat higher than had been estimated by Norges Bank in June. At the same time, contacts in the Norges Bank regional network reported that growth was likely to pick up somewhat more rapidly ahead than had previously been anticipated. Consumer price growth increased over the summer, and Norges Bank's inflation estimate was adjusted upwards. The Norwegian money market spread had increased again, and was higher than had been estimated by Norges Bank in MPR 2/16. In the monetary policy meeting in September, Norges Bank attached weight to consumer price inflation over the last few months having been unexpectedly high, and to indications of somewhat stronger growth in the Norwegian economy than had been assumed in June. It was also noted that low interest rates might serve to fuel the housing price growth and increase vulnerability in the financial system. On the other hand, economic growth remained moderate, and it was likely that modest cost increases and appreciation of the Norwegian krone would serve to curtail consumer price inflation over time. It was decided, based on an overall assessment, to keep the key policy rate unchanged at 0.5 percent. At the same time, the Norges Banks rate forecast was adjusted upwards. The new rate path implied that the key policy rate would remain close to 0.5 percent over the next few years.

In the lead-up to the monetary policy meeting in October, the growth of trading partners was much as estimated in Monetary Policy Report 3/16 (MPR 3/16). The oil price performed somewhat stronger than had been assumed by Norges Bank, and the Norwegian krone was stronger than had been anticipated. Overall capacity utilisation in the Norwegian economy was, according to Norges Bank, more or less in line with expectations. Consumer price inflation was lower than had been estimated by Norges Bank, whilst housing prices increased more than expected. In the monetary policy meeting in October, the Executive Board emphasised that overall developments in the Norwegian economy were much as had been assumed in MPR 3/16, and decided to keep the key policy rate unchanged.

Towards the end of the year, trading partners experienced somewhat stronger growth than had been estimated by Norges Bank in September, as the result, inter alia, of growth in the United King-

Table 6.1 Key policy rate decisions of the Executive Board of Norges Bank in 2016

Monetary policy meeting	Change in percentage points	Post-meeting key policy rate	Average key policy rate forecast for 2018
March	-0.25	0.50	0.2
May	0.00	0.50	–
June	0.00	0.50	0.3
September	0.00	0.50	0.4
October	0.00	0.50	–
December	0.00	0.50	0.4

Source: Norges Bank

dom having kept up better than expected in the wake of the referendum on EU membership. The oil price was slightly higher than had been assumed in MPR 3/16 in the lead-up to the monetary policy meeting in December, and the Norwegian krone had appreciated. There were indications that activity in the Norwegian economy was picking up somewhat more slowly than had been estimated in September, and capacity utilisation was held to be slightly lower than had been anticipated. Consumer prices increased by less than had been estimated by Norges Bank. In the monetary policy meeting in December, Norges Bank emphasised that inflation was expected to undershoot the inflation target over the next few years. It was highlighted, at the same time, that inflation expectations some years into the future appeared to be well anchored close to the inflation target. Capacity utilisation was below a normal level, and the outlook was for growth in the Norwegian economy to pick up somewhat more slowly than had been estimated in September. On the other

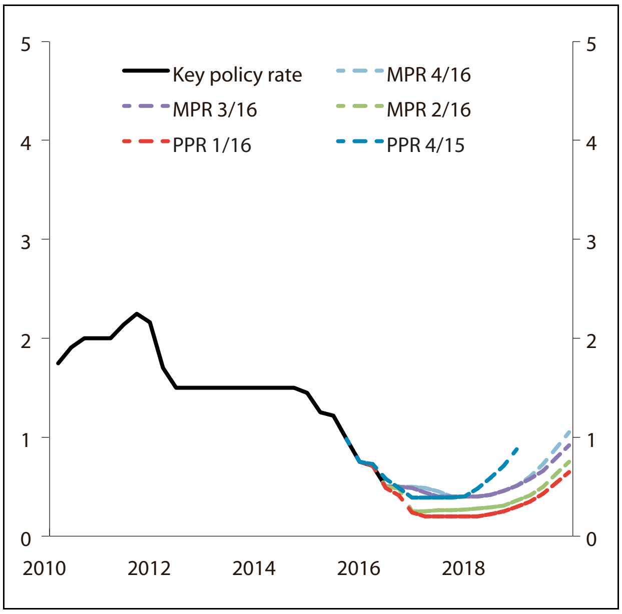

Figure 6.1 Key policy rate forecasts in various monetary policy reports. Percent. Q1 2010 – Q4 2019[1]

[1] Figure 6.1 is identical to Figure 1.4 in Norges Bank's annual report for 2016.

Source: Norges Bank

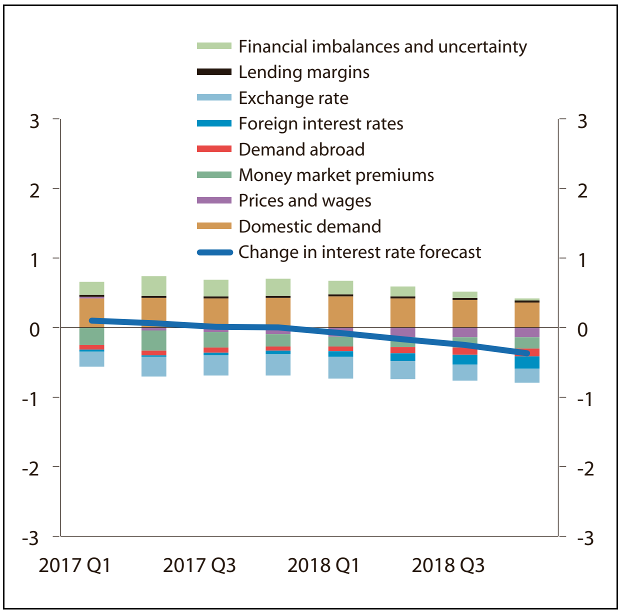

Figure 6.2 Changes in the key policy rate forecast from Monetary Policy Report 4/15 to Monetary Policy Report 4/16. Percentage points. Q1 2017 – Q4 2018[1]

[1] Figure 6.2 is identical to Figure 1.5 in Norges Bank's annual report for 2016.

Source: Norges Bank

hand, strong growth in housing prices and household debt increased the risk of a steep future decline in demand for goods and services. In the monetary policy meeting in December, Norges Bank decided, based on an overall assessment, to keep the key policy rate unchanged at 0.5 percent. In Monetary Policy Report 4/16, the Bank presented a forecast for the key policy rate which suggested that it would remain close to 0.5 percent for the next few years. At the same time, the forecast implied that there was a slightly higher probability that the rate would be reduced than increased over the coming year.

Figure 6.2 shows the changes in the key policy rate forecast from Monetary Policy Report 4/15 to Monetary Policy Report 4/16. The rate forecast was revised downwards from Monetary Policy Report 4/15 to Monetary Policy Report 1/16. The rate forecast was thereafter gradually revised upwards through 2016. The bars provide an indication of how various factors contributed, when taken in isolation, to changes in the Norges Bank rate forecast. Norwegian krone appreciation, higher money market spread, lower rates abroad and a negative foreign demand outlook served to reduce the rate forecast over the year. Higher domestic demand and consideration for financial imbalances and uncertainties had the opposite effect.

6.4 Development in money market risk premiums

Risk premiums in the Norwegian money market rose from 2015 to 2016. 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 0.55 percentage points in 2016.

In its 2016 Annual Report, Norges Bank wrote, inter alia, the following regarding the reason for the increase in the risk premium:

> The premium increase was primarily caused by an increase in the dollar rate used by banks in determining Nibor. Adaptations to new regulations on US money market funds, which were implemented in October, served to further increase the dollar rate. Increased euro supply as the result of financial asset purchases by the European Central Bank (ECB) are also a likely explanation of why the dollar rate premium remained high in 2016. The ECB has been purchasing financial assets since 2015. This increases the supply of euros relative to dollars and makes it more expensive to swap euros for dollars in the currency swap market.

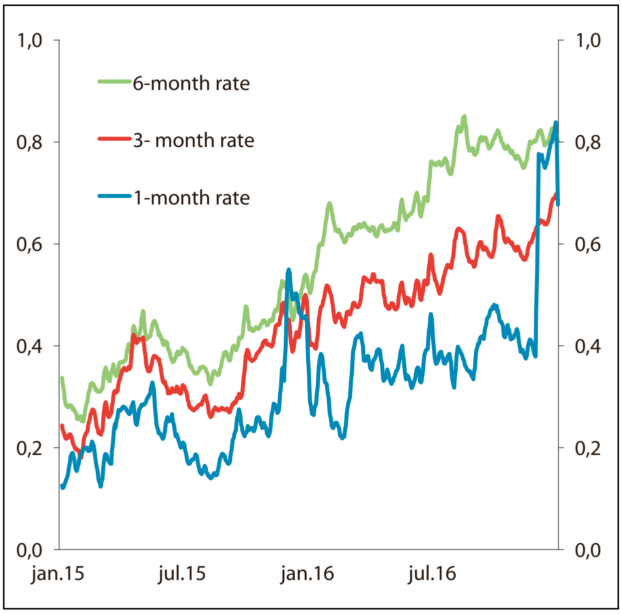

Figure 6.3 Spread between money market rates and expected key policy rate. Percentage points. Five-day moving average. 1 January 2015 – 31 December 2016[1]

[1] Figure 6.3 is identical to Figure 1.11 in Norges Bank's annual report for 2016.

Source: Bloomberg and Norges Bank

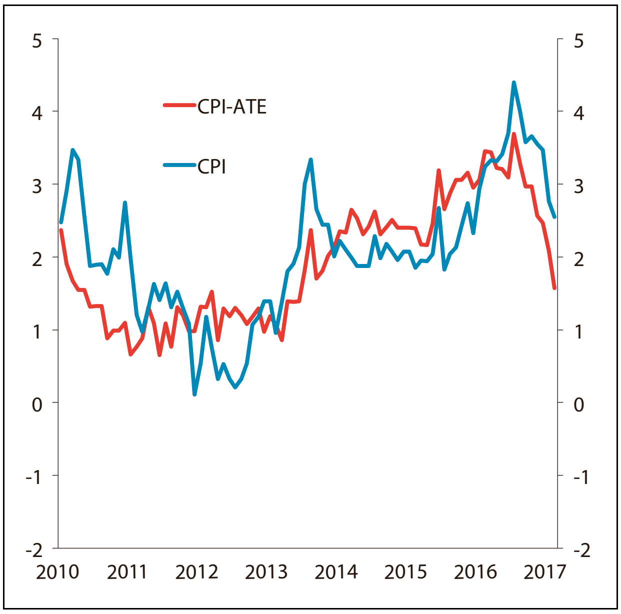

Figure 6.4 CPI and CPI-ATE. Twelve-month change. Percent. January 2010–February 2017[1]

[1] Figure 6.4 is almost identical to Figure 3.27 in Monetary Policy Report 1/17 from Norges Bank.

Source: Statistics Norway and Norges Bank

There is reason to believe that banks' financial adaptations served to further fuel the increase in the rate premium towards the end of the year via increased demand and rates for US dollars and Norwegian?kroner in the currency swap market as the year came to a close.

6.5 Developments in inflation, output, employment and exchange rates

The consumer price index (CPI) may vary considerably from one month to the next. This may, for example, be the 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. The said indicator adjusts CPI for tax changes and temporary changes in energy prices, whilst seeking to capture any applicable energy price trends.

Consumer price inflation (CPI) was 3.6 percent from 2015 to 2016, up from 2.1 percent the previous year. CPI-ATE increased by 3.0 percent in 2016. Over the last five years, CPI has increased by an average of 1.6 percent per year. Figure 6.4 shows consumer price inflation in recent years.

In its 2016 Annual Report, Norges Bank wrote, inter alia, the following regarding inflation developments over time:

> Experience with flexible inflation targeting in Norway has been favourable. (…) Inflation has been somewhat below, but close to, 2.5 percent over the last 15 years. Inflation having been below 2.5 percent has to do with, inter alia, a number of characteristics on the supply side of the economy in the 2000s, such as good productivity growth, high labour immigration and low price growth on imported consumer goods. In recent years, consumer price inflation has picked up, primarily as the result of the significant depreciation of the Norwegian krone.

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 2016 Annual Report, Norges Bank stated, inter alia, the following:

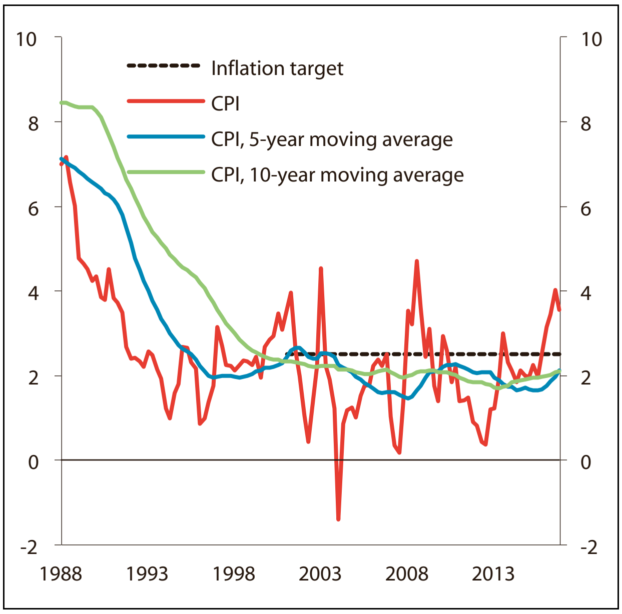

Figure 6.5 Consumer price inflation. Four-quarter change. Percent. Q1 1988 – Q4 2016[1]

[1] Figure 6.5 is identical to Figure 1.1 in Norges Bank's annual report for 2016.

Source: Statistics Norway and Norges Bank

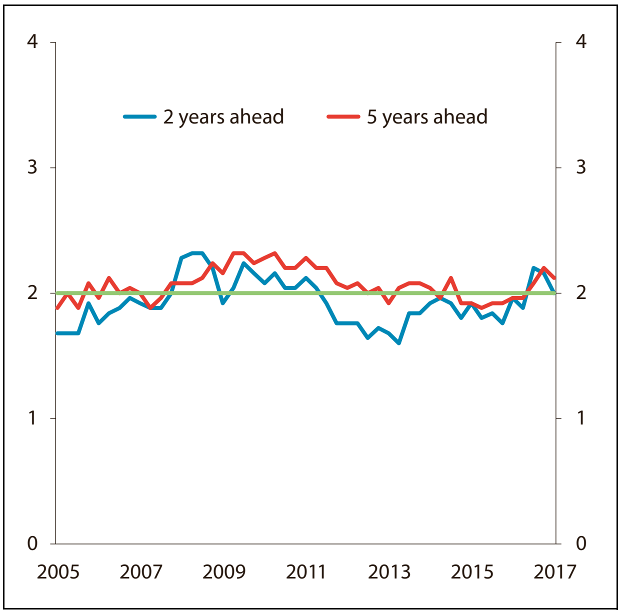

Figure 6.6 Expected consumer price inflation two and five years ahead.[1 2] Percent. Q1 2005 – Q1 2017

[1] Figure 6.6 is identical to Figure 3.36 in Monetary Policy Report 1/17 from Norges Bank.

[2] Average of the expectations of associations representing the two sides of industry, as well as economists in the financial industry and academia.

Sources: Epinion and Norges Bank

> 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 various topics, including expected inflation. Figure 6.6 shows expected price growth developments in recent years. Inflation expectations have increased somewhat in recent months. The survey nonetheless indicates that respondents continue to expect consumer price inflation of about 2.5 percent over the next few years.

Norges Bank uses, inter alia, an output gap to express the Bank's assessment of total capacity utilisation in the economy. The output gap illustrates deviations between mainland Norway GDP and an estimated normal level. Figure 6.7 shows Norges Bank's estimated output gap and the variation in such output gap from 1982 to 2016. In its 2016 Annual Report, Norges Bank wrote that, by this measure, fluctuations in the economy have been reduced over time.

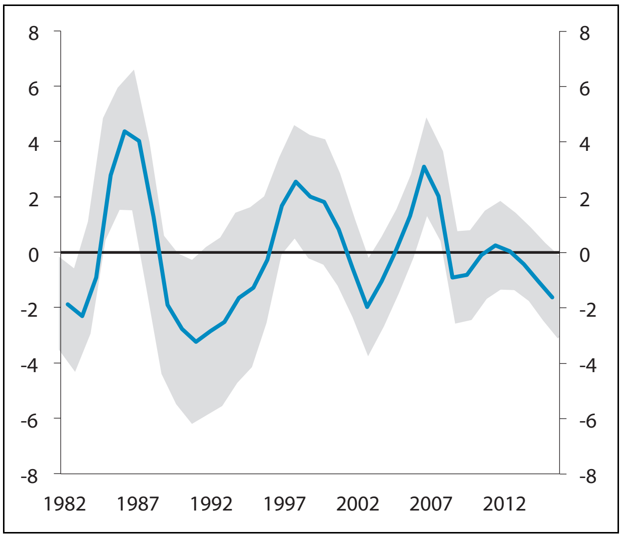

Figure 6.7 Estimated output gap[1]. Level and variation[2]. Percent. 1982–2016[3]

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

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

3 Figure 6.7 is identical to Figure 1.2 in Norges Bank's annual report for 2016.

Source: Norges Bank

Norges Bank's output gap estimates are based on a trend calculation of mainland Norway GDP. Considerable uncertainty attaches to the calculation of the output gap. Norges Bank Staff Memo 7/12 stated, inter alia, the following:

> Potential output is not observable and has to be estimated. There is thus uncertainty surrounding the output gap not only today and ahead, 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). National accounts are, for example, often revised.

Norges Bank therefore believes 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.

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

Several reports have been made on how monetary policy in Norway has been conducted in the period following the presentation of the Financial Markets Report 2015 in April 2016. The following section briefly discusses the assessments in the following reports:

- Norges Bank Watch 2017, 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 to the funding of this report
- The IMF's report from May 2016, which was prepared in connection with an Article IV consultation

The Norges Bank Watch (NBW) report includes the following assessment of Norges Bank's monetary policy conduct in 2016:

> All rates decisions in 2016 were in line with most analysts' expectations. They include the decision not to cut in September, contrary to signals given in June. Additionally, neither the

> decision nor the forward guidance triggered major market movements. The one exception was NOK's rapid strengthening on the September meeting, but as long as reactions in interest rates were rather moderate, one should probably not see this as a big surprise.
>
> One could therefore argue that Norges Bank's forward guidance in 2016 worked rather well. Still, Norges Bank's communication was not really tested in 2016. Verbal statements were very much about the lower bound and risk connected to too low interest rates. Since news rather pointed to higher rather than lower interest rates throughout the year, the lower bound was never tested with the potential communications problem that could have arisen.

Developments in unemployment as measured by the Statistics Norway labour force survey (LFS) have differed very considerably from developments in registered unemployment in NAV offices since the oil price decline in 2014. Whilst LFS unemployment was high in 2016, registered unemployment was relatively low in historical terms. This difference adds to the uncertainty regarding labour market and capacity utilisation developments in the Norwegian economy. The NBW group states that the changes to the rate path during last year indicate that Norges Bank has attached the most weight to the data on registered unemployment in its assessments of capacity utilisation in the economy. The group endorses the said assessment, but notes, at the same time, that the Bank appears to have been uncertain about how much weight to attach to the LFS data, and that such weighting changed somewhat over the year. The group is of the view that Norges Bank should have been more transparent in discussing such uncertainty and how it weighted the information from the two measures against each other.

The NBW group states that Norges Bank communicates well, although it believes that there is still room for improvement. It notes, inter alia, that it was difficult to interpret the so-called interest rate account, which is a numerical specification of how various factors contribute to changes in the rate path, in MPR 4/16. The NBW group believes, based on how Norges Bank has previously reacted to new information, that new information after the monetary policy meeting in September pointed towards a lower interest rate. Norges Bank nonetheless chose to keep the rate path more or less unchanged, and explained this by introducing a new factor in the interest rate account («Financial imbalances and uncertainty»). The NBW group is of the view that the Bank should have been clearer in MPR 4/16 about how to interpret the new factor, and stated, inter alia, the following:

> That the factor not only reflected changes, but in one way also levels, was clarified at a meeting Norges Bank held with analysts. We think this information is important for Norges Bank's forward guidance and therefore Norges Bank should have explained it in more detail in the report.

The group concluded, inter alia, as follows:

> NBW has met with analysts to discuss whether the whole interest rate account should be omitted from the monetary policy reports. The view seems to be that Norges Bank should keep the account, partly because it forces the Bank to act with some degree of consistency. It is also an effective way to communicate Norges Bank's views on what are important disturbances to the output gap and the rate of inflation. But the Bank should clarify the role of the interest rate account.

Like a number of previous NBW groups, this year's group would also like Norges Bank to publish some form of minutes of the meetings of the Executive Board.

Moreover, the NBW group assessed Norges Bank's criteria for a good rate path. The criteria have changed somewhat on several occasions since Norges Bank started publishing the rate path in 2005, in order, inter alia, to reflect that inflation targeting has become more flexible over time. There are currently three criteria. The first criterion makes it clear that the inflation target shall be met, whilst the second criterion emphasises that inflation targeting is flexible, thus implying that monetary policy shall also attach weight to stable economic development.

The third criterion is that monetary policy shall be robust. Robustness is not, according to Norges Bank, an objective in itself, but has been included because if may deliver better inflation, output and employment development over time.

The NBW group is sceptical about Norges Bank's statements in relation to the robustness criterion. The group addresses, in particular, three issues of relevance to this criterion: financial stability considerations, uncertainty about the effect of monetary policy when rates are low and the lower bound on the key policy rate.

The NBW group argues that financial turmoil may in itself entail costs for society, even if the central bank is able to stabilise the output gap. One reason for this can be that financial turmoil may prevent economically profitable investments from obtaining funding. The group is therefore of the view that financial stability is a justified objective in its own right. The group states, inter alia, the following:

> We argue that financial stability should be an objective in itself and we encourage the Bank to develop further their understanding of the relationship between policy rates and the probability and the strength of financial turmoil.

Furthermore, the NBW group discusses what is the optimal monetary policy response when the key policy rate is low. A commonly held view is that the effect of rate changes on the economy is more uncertain when the rate is low, and that the central bank should therefore be more cautious about changing the interest rate than in other circumstances. The NBW group takes the view that low rates suggest that rate changes will have less of an impact on the economy than would otherwise be the case, and that one may therefore argue in favour of adopting the opposite approach. The group states, inter alia, the following:

> NBW is not convinced that uncertainty about the monetary policy transmission mechanism calls for a more cautious reaction by the central bank when policy rates are low. If the central bank fears that the policy rate has a weaker effect on real economic activity than before, they should use the instrument more, not less, we think.

Since MPR 3/2015, Norges Bank has stopped publishing isolated rate paths for each of the three criteria for good future rate developments. The background was that focusing exclusively on the first two criteria resulted in significant negative key policy rates. The NBW group is sceptical about Norges Bank's change in this regard:

> There is a lower bound on policy rates, but the bound is not zero. NBW think [sic] Norges Bank should consider computing implied policy rates from the two first criteria, but under the condition of a somewhat negative lower bound. This will help market participants to understand the reaction pattern of the Bank at low rates.

The IMF states, in a report from May 2016 in connection with an Article IV consultation, the following:

Monetary policy should stay accommodative. The current monetary stance is appropriately supportive and should remain so given the slack in the economy and the stable inflation outlook. The policy tradeoff between different objectives arguably has eased; however, potential second-round effects on domestic inflation merit continued monitoring. Provided that inflation expectations remain well-anchored, further easing could be considered should growth turn out significantly weaker than projected. While financial vulnerabilities suggest greater caution may be warranted as the policy rate is lowered, financial stability concerns should be addressed primarily through macroprudential and other measures in the first instance.

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

6.7 The Ministry's assessment of Norges Bank's monetary policy conduct

The monetary policy guidelines were adopted on 29 March 2001. 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 scope of the guidelines.

The regulations state that Norges Bank's operational implementation of monetary policy shall be oriented towards low and stable inflation, defined as annual consumer price growth of close to 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 shall be forward-looking. Norges Bank sets the rate with the aim of stabilising inflation close to the 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.

Monetary policy is the first line of defence in stabilisation policy. Monetary policy can react swiftly if the economic outlook changes.

In April 2014, a public commission was appointed to examine the Central Bank Act. The commission shall submit its report by June 2017. It was announced, in the Financial Markets Report 2015, that the Ministry will consider the need for modernisation of the monetary policy regulations in parallel with the commission's deliberations. The Ministry requested, as part of this effort, an assessment from Norges Banks of monetary policy since 2001. The Ministry received a reply from the Bank on 31 January 2017.[1] The Bank states, inter alia, the following in its reply:

> The monetary policy framework has been effective. The inflation target has anchored inflation expectations. At the same time, the scope for flexibility and the exercise of judgement has been sufficient to enable monetary policy to dampen the impact on output and employment of the shocks that have occurred, particularly in the years since 2005.
>
> The shocks that have hit the Norwegian economy have primarily originated abroad. There have been substantial changes in Norway's terms of trade and Norway has felt the effects of pronounced international cyclical fluctuations. There has been a persistent decline in interest rates abroad and labour immigration to Norway has been high. Facing these kinds of shocks and developments, the conduct of monetary policy has had to involve a trade-off between stabilising inflation and stabilising output and employment. In addition, the risk that financial imbalances could lead to an abrupt shift in demand further ahead has entailed a trade-off with regard to the appropriate horizon for returning inflation to target.
>
> To achieve a reasonable balance between the various monetary policy considerations, a sufficiently long and flexible horizon for the inflation target is crucial. When inflation targeting was introduced, Norges Bank decided on a horizon that would normally extend over two years. The horizon was thereafter changed to one to three years and subsequently to «medium-term». The trend towards a longer and more flexible time horizon has also been evident among other inflation-targeting central banks, and it does not seem to have weakened the anchoring of inflation expectations in Norway.
>
> Inflation has largely been low and stable since 2001. Average annual consumer price inflation has been close to, albeit somewhat below, 2.5 percent, reflecting the fact that of the shocks that have occurred, more have exerted downward pressure than have exerted upward pressure on inflation. In addition, Norges Bank decided to bring inflation back to target over a longer horizon in order to contribute to stability in output and employment. Inflation volatility has been lower than was the case in the 1970s and 1980s, at about the same level as in other inflation-targeting advanced economies. The deviations in inflation from the 2.5 percent target have nonetheless been larger than anticipated by Norges Bank when the inflation target was introduced. This reflects the greater severity of more recent economic shocks than of those occurring in the 1990s, and the more difficult trade-offs made in the context of developments such as substantial changes in the terms of trade and the build-up of financial imbalances.
>
> Against the background of Norway's experience since 2001, some variability around the inflation target must be expected in the future. As long as there is confidence that the central bank will gradually bring inflation back to target after a deviation has occurred, some variability in inflation is not likely to involve appreciable costs to society. Such fluctuations will to some extent reflect the monetary policy objective of stabilising output and employment in addition to inflation.
>
> Employment has consistently been more stable since 2001 than in the 1970s and 1980s. In spite of severe shocks, output volatility has not been higher than in the relatively stable 1990s. There have also been challenges related to the phasing-in of oil revenues and real appreciation in much of this period. Monetary policy has had a stabilising effect on output and employment. Even though there have been long periods when monetary policy has had to strike a balance between achieving the inflation target and stabilising output and employment, monetary policy has had a clear tendency to dampen cyclical fluctuations. This was particularly apparent during the financial crisis and in the wake of the fall in oil prices in 2014. As confidence in the inflation target has become more firmly established, it has been possible to give more weight to stabilising output and employment.

[1] See Norges Bank Memo No. 1/2017, which is available on the Norges Bank website.

There has been an international trend towards lower interest rates, and in a number of countries the room for manoeuvre in monetary policy has been constrained by the lower bound on the interest rate.

A prolonged period of very low interest rates may lead economic agents to underestimate risk and based their decisions on a belief that interest rates will remain very low for a long time. Persistently low interest rates may lead to asset price inflation and debt growth that could increase the vulnerability of households and enterprises. Experience shows that high house price inflation and credit growth can increase the risk of future financial crises.

Monetary policy cannot assume the main responsibility for counteracting financial imbalances. Regulation and monitoring of financial institutions should be the first line of defence against shocks to the financial system. The effect of macroprudential instruments and other more targeted measures is, however, uncertain, and the active use of such instruments may involve a variety of costs. Situations may therefore arise where monetary policy should also contribute to counteracting the build-up of financial imbalances, to the extent these situations are assessed as a threat to stability in inflation, output and employment further ahead.

In a world of high capital mobility and extensive trade, monetary policy's room for manoeuvre in a small open economy such as Norway is limited. With a floating exchange rate, the domestic interest rate can differ from interest rates abroad, but an interest rate differential that becomes too wide can have such substantial effects on the exchange rate that it gives rise to instability in inflation, output and employment. Thus, the domestic interest rate will also be influenced by external rates to a large extent under an inflation-targeting regime. The room for manoeuvre in monetary policy will be further constrained in periods when external interest rates are close to or below zero.

Even though the domestic interest rate cannot differ too widely from trading partners' rates, the exchange rate has an important role in cushioning the effect of shocks – particularly when there are changes in the terms of trade. In periods when oil prices have fallen and the economy has entered a period of contraction, the krone exchange rate has depreciated, strengthening competitiveness and preventing inflation from becoming too low. As long as economic agents have confidence in the inflation target, monetary policy can support changes in the krone exchange rate that have a stabilising effect on the business cycle. At the same time, developments in the krone exchange rate have been relatively stable compared with other inflation-targeting countries that are heavily reliant on commodity-based exports.

Monetary policy's main task is to provide the economy with a nominal anchor. When inflation is firmly anchored, monetary policy can also contribute to stable developments in the real economy. But experience has shown that monetary policy alone cannot fully counteract economic fluctuations, especially when the economy is affected by substantial shocks from abroad. The extent to which monetary policy in a small open economy can contribute to counteracting financial imbalances is also limited. Experience from the 1970s and 1980s shows that the nominal anchor can slip if monetary policy is expected to place too great an emphasis on pursuing objectives other than low and stable inflation.

On 16 January 2016, the Ministry of Finance held, as part of its effort to modernise the regulations, a mini conference on experience with inflation targeting of monetary policy. The presentations made at the said conference have been collected in Working Paper 2017/4 from the Ministry of Finance.[2]

A brief assessment of Norges Bank's exercise of its discretionary monetary policy powers in 2016 will be provided in the following.

Norges Bank reduced the key policy rate to 0.75 percent during 2015, and reduced the rate further to a record low 0.5 percent in March 2016. The rate reductions, which were made in response to the setback in the Norwegian economy in the wake of the oil price decline in 2014, contributed to a marked depreciation of the Norwegian krone and an improvement in the competitiveness of Norwegian businesses. It has served to curtail the downturn in the Norwegian economy, as well as the unemployment increase.

2 Contributors were John Murray, former Deputy Governor of the Bank of Canada, Øistein Røisland, Research Director at Norges Bank, Professor Knut Anton Mork, Anders Vredin, Head of the General Secretariat of Sveriges Riksbank, Professor Ragnar Torvik, Professor Steinar Holden, Professor Hilde Bjørnland and Professor Øystein Thøgersen. See www.regjeringen.no/arbeidsnotater.

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, cf. section 6.4.2 above. Such confidence in the inflation target makes it easier for Norges Bank to contribute to stability in output and employment.

The Norwegian krone is significantly weaker than before the oil price decline in 2014. This is linked to the drop in oil prices and the weakened growth prospects of the Norwegian economy. The Norwegian krone depreciation has been supported by Norges Bank's 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 depreciation of the Norwegian krone in recent years has helped improve the situation for enterprises in Norway that are exposed to international competition, at a time when demand from the petroleum industry has fallen sharply.

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

Norwegian monetary policy seeks to be robust and to address the risk of especially unfavourable economic outcomes and uncertainty about the functioning of the economy. This suggests, inter alia, that monetary policy should help to counteract the accumulation of financial imbalances.

Responsibility for the safeguarding of financial stability is shared between the Ministry of Finance, Norges Bank and 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. Besides, Norges Bank is the lender of last resort for banks. Efforts to safeguard financial stability are discussed in chapter 2 of this report.

In October 2013, the Government laid down regulations relating to a counter-cyclical capital buffer. This is one of several elements of the new regulatory framework on capital adequacy for banks adopted by the Storting in June 2013. The buffer requirement shall normally be between0 and 2.5 percent of the risk-weighted assets of banks. The Ministry of Finance stipulates the level of the counter-cyclical capital buffer each quarter. Norges Bank is charged with preparing an informational basis and advising the Ministry on the level. The informational basis is presented by Norges Bank in the monetary policy reports, at the same time as the Bank sends the advice in a separate letter to the Ministry of Finance. The counter-cyclical capital buffer is discussed in chapter 3.

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 forecasts 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 notes that the Bank has developed and, at the same time, modified various elements of its monetary policy communication.

The Ministry has no comments on Norges Bank's conduct of monetary policy in 2016. The Ministry is of the view that monetary policy in Norway is well aligned with practice in other countries with flexible inflation targeting.

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