# Concentrated banking system amplifies banking crises

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The consequences of a banking crisis could be exceptionally severe in Finland's concentrated banking system. Regulatory means must therefore be deployed to ensure the capital adequacy and liquidity of Finnish banks remain strong under all circumstances.

## Structural vulnerabilities require strong capital adequacy

The structural vulnerabilities of the Finnish banking sector are substantial when assessed against generally applied criteria. Because of these vulnerabilities and the related risks, Finland should consider whether the additional capital adequacy requirements that are possible under EU regulations should be imposed on the banking sector (see the article 'A broader set of tools needed to prevent financial crises'). One factor speaking in favour of strengthening the capital adequacy requirements is that the estimated effects of higher capital requirements on bank lending margins are very small (see the article 'Tightening regulation has only a limited impact on loan margins').

## Costs of banking crises can be substantial

The Finnish banking system contains long-term structural vulnerabilities that could make the costs of banking crises higher in Finland than would normally be expected.

Banking crises can cause particularly high costs for society in countries where

- the banking sector is large relative to the size of the national economy
- banks play a key role in the provision of credit to the private sector,
- the banking sector is strongly concentrated,
- banks have significant concentrations of risk in their lending, funding or other business activities, and
- banks are highly interconnected.

To date, there is only a small amount of evidence on how precisely the size or degree of concentration of a banking sector affect the probability and costs of banking crises. The relative scale of such risks can, however, be estimated by comparing indicators of the banking sector's structural vulnerability 1) over the long term in an individual country, or 2) in different European countries at a specific moment in time.

## Finnish banking sector exceptionally concentrated

In a strongly concentrated banking system, insolvency or other serious difficulties at a single large bank will lead to a substantial reduction in lending and the amount of other services offered by banks in general, making it harder to acquire a loan and contributing to a contraction in investment and aggregate demand. Based on values derived from the Herfindahl index, the Finnish banking sector is the most concentrated in the EU (Chart 1).

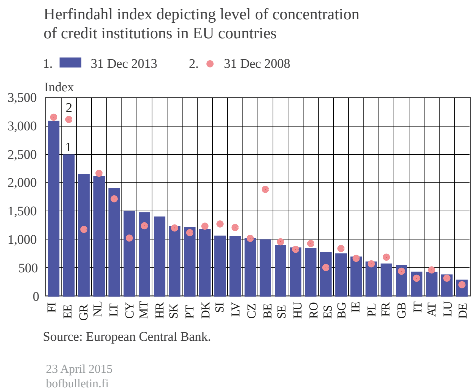

Chart 1

## Strong growth in size of sector

When examining the significance of the banking sector in an economy, the simplest and most commonly used indicator is the size of banks' aggregate balance sheets relative to the economy's nominal GDP. The macroeconomic effects of banking crises can be assumed to be larger, the larger the banking sector is relative to the size of the economy.

As in most other advanced economies, the banking sector in Finland grew strongly relative to GDP prior to the onset of the global financial crisis in 2008 (Chart 2). In terms of its relative size, the Finnish banking sector is close to the EU average.

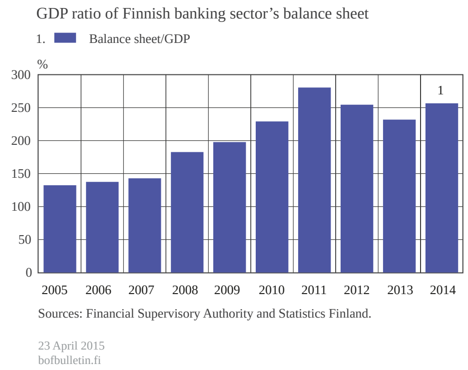


Chart 2

## Strong linkage to Nordic banking system

The more strongly banks are interlinked, for instance via mutual lending or ownership structures, the more easily the problems of an individual bank can spread to other banks.

Subsidiaries and branches of foreign banks comprise a large part of Finland's banking sector (Chart 3). Foreign ownership can have both positive and negative effects on the stability and efficiency of a country's banking system. The risk is that serious problems within banking groups in other countries could also hamper the operations of group units located in Finland.

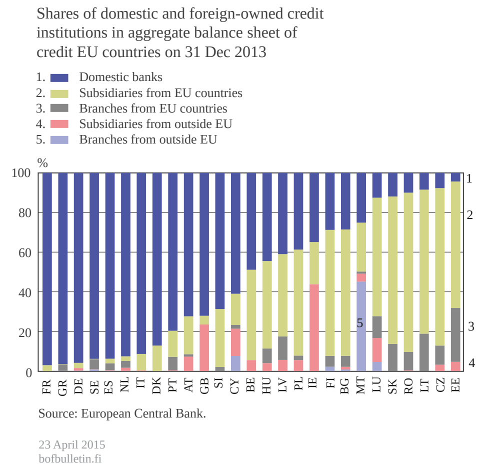


Chart 3

## Banking sector dependent on market funding

Finnish banks' deposit deficit – the difference between loans to the public and retail deposits – is one of the largest in the EU (Chart 4). Banks fund their deposit deficits through funding from the financial markets. During crises, short-term market funding, in particular, can rapidly dry up. The relative share of short-term market funding in Finnish banks' funding acquisition has, however, declined in recent years, among other things on account of regulatory changes.

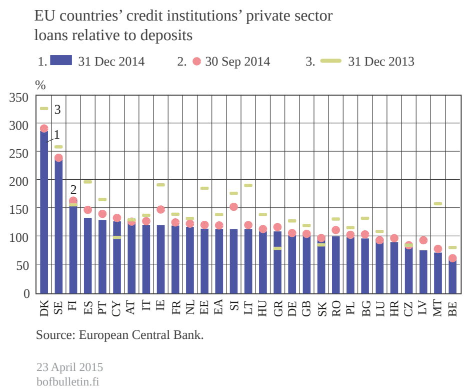


Chart 4

## Major risk concentration in housing loans

If a large proportion of bank loans are granted to some specific group of borrowers, possible serious problems within this group could, in a worst-case scenario, cause large loan losses for many banks simultaneously. Correspondingly, a large shared dependency on the same source of funding could simultaneously undermine the liquidity position of the entire banking sector.

Housing loans' share of bank lending in Finland is one of the largest in Europe (Chart 5). Banks' direct loan losses from housing loans remained relatively small during Finland's economic crisis in the 1990s. However, large housing market crises often lead to recessions that generate loan losses from corporate lending, too, and undermine banking profitability.

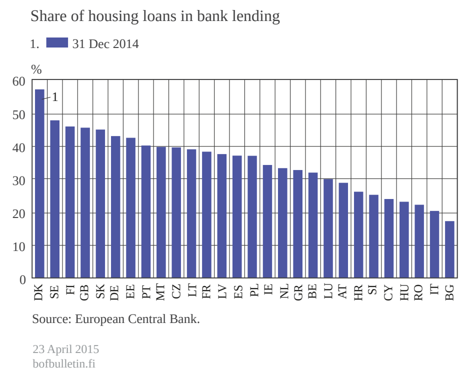


Chart 5

### Tags

systemic risks, indicators, banking crises, banks