FINANCIAL STABILITY ASSESSMENT

Finnish financial system exposed to risks in the real economy

4 Dec 2015 – Financial Stability Assessment – Financial stability

Threats to the stability of the euro area financial system relate to the risks to global economic growth – such as uncertainties around developments in China – and to the international financial markets. The profitability of the euro area banking sector has improved from the weak level witnessed previously, but the large amount of non-performing loans continues to weigh on banks' balance sheets. Risks to the Finnish financial system are associated with the weakness of the economy and household debt. In order to contain potential overheating on the housing loan market and household indebtedness, the authorities will need new additions to their toolbox.

Risks from emerging economies affect international operating environment

Slowing performance in the emerging economies is undermining the global economic prospects for 2015 and increasing uncertainties about the condition of the global economy. Uncertainty over the progress of structural changes in the Chinese economy, possible disruptions in the completion of financial market reforms and management of the financial stability risks from high indebtedness all pose challenges. Chinese economic developments will also have repercussions on other emerging economies, which will have to adjust to the considerable fall in commodity prices, tightening financial conditions and weaker foreign capital flows. Indebtedness in many emerging economies has grown in the years following the financial crises, particularly in the corporate sector, and this growth is partly in dollars. As a result, concerns have arisen over the risks of substantial debt burdens in times of weak economic growth and tightening financial conditions.

In the advanced economies, the real economy is recovering. According to the Bank of Finland's September forecast, the real economy in the EU22 (euro area, Sweden, Denmark, Great Britain) is expected to grow 1.7% in 2015, 1.8% in 2016 and 1.9% in 2017. The low price of oil, euro depreciation and a highly accommodative monetary policy have supported growth in the euro area. In addition, general government finances have improved and long-term growth potential is to be improved through structural reforms. The risks to the short-term growth prospects are mainly external, with the most significant arising from the condition of the emerging economies. Problems in the emerging economies may be passed on to the euro area not only through trade and financial links but also through financial market disruptions and weakened confidence among economic agents. The longer-term risks, in turn, relate to protracted weak nominal growth, which could jeopardise the debt sustainability of the public and private sectors.

During 2015, there has been occasional uncertainty on the international financial markets. In spring, there were strong market fluctuations in euro area longer-term interest rates; in early summer, fluctuations were caused by the situation in Greece; in August–September, the market was turbulent due to China. In autumn, volatility increased particularly on the stock markets, on the foreign currency markets of emerging economies and in commodity prices. Weakening market liquidity and increasing correlation of investor positions will, in turn, strengthen the impact of short-term market disruptions. The increased systemic importance of investment funds in the euro area financial system enhances fund management companies' role as possible intermediators, amplifiers or even originators of market fluctuations.

Economic recovery in the euro area will both enhance financial system stability in the area and strengthen the banking sector. A strengthening banking sector will, in turn, enhance monetary policy transmission to the real economy concurrently with banks' improved lending capacity and eased financial conditions. The profitability of euro area banks has increased (Chart 1) during 2015 from the poor level of previous years, and banks' capital adequacy has improved. However, the large number of non-performing loans still burdens balance sheets. The low level of interest rates and the small difference between long-term and short term interest rates (flat interest curve), in turn, weaken banks' expectations of future developments in net interest income.[1]Adjustment to increasingly tighter regulation and to changes in the operating environment also poses a

1. Bank Lending Survey 10/2015.

challenge to banks' business models as new market participants emerge, the shadow banking sector grows and digitalisation shapes financial services and client processes.

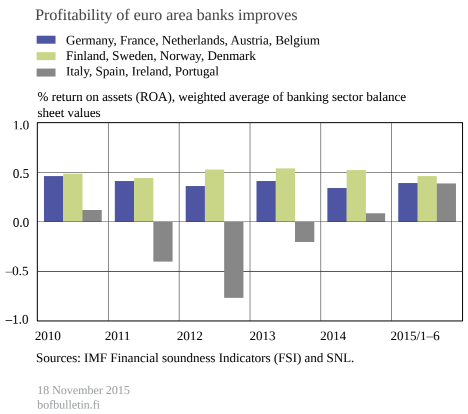

Chart 1

As banks consolidate their balance sheets, the role of other financial institutions in the euro area financial system has grown in recent years and the significance of capital market finance increased. Compared with the end of 2008, banks' share of corporate debt financing in the euro area has shrunk by 10 percentage points to 40% (Chart 2). These are positive developments, because diverse funding sources improve the availability of financing and reduce vulnerability to disruptions in the domestic banking sector. The aim of the new Capital Markets Union is to continue supporting these developments, particularly in small and medium-sized enterprises, although a lot of work remains to be done.

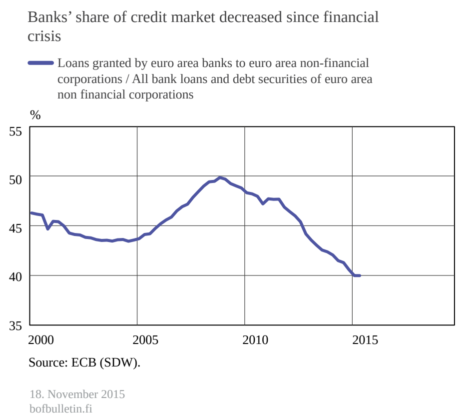

Chart 2

Smoothly running financial markets are important to Nordic banks, which are relatively dependent on market funding. As a result, maintenance of capital adequacy and high credit ratings are necessary to secure market participants' solid confidence in the Nordic banking sector. The Nordic countries have a large, cross-border, highly concentrated banking sector, which involves common risks and challenges. The risk factors in the Nordic financial system comprise primarily the substantial level of household indebtedness and the continuing house price rises in Sweden and Norway (Chart 3). Banks' vulnerability to problems on the housing market and with housing loans is increased by their dependency on mortgage-backed capital market funding.

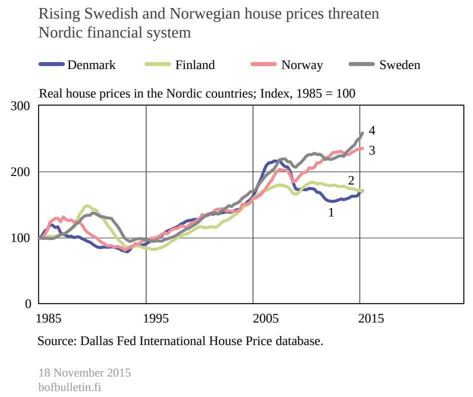

Chart 3

Finnish financial system exposed to risks from the real economy

In addition to risks from the international financial markets, stability risks to the Finnish financial market relate particularly to weak developments in the domestic real economy. To date, the economic recession in Finland has been seen on the housing market as a slight but protracted price slump. However, household debt has continued to accumulate and the related vulnerabilities represent both a considerable financial stability risk and a macroeconomic risk. The profitability of the Finnish banking sector has increased in 2015, and risk resilience in capital adequacy terms has improved.

Risks in the international economy and the financial markets would, if realised, pass through to Finland via both the real economy and the international investment position of Finnish market participants. A sharp decline in international stock market prices would also indirectly influence the investment position of households via, for example, investment funds and life and pension insurance companies.

Fluctuations on the international financial markets have in actual fact been the most important factor affecting the condition of the Finnish financial markets, and the value of the potential stress index has been growing slightly since mid-2014 (Chart 4).[2] During 2015, the value of the stress index has risen to a level close to its long-term average, although it is well below peak post-2007 levels. Among the sub-indices of the stress index, the stock and currency market indices have been rising. The monetary and bank market indices have remained unchanged during 2015, whereas the index describing the long-term interest rate market has fallen since an upswing in spring 2015.

Despite numerous uncertainties, such as fluctuations on the stock and currency markets, the Finnish financial sector has remained stable and there have been no significant disruptions either on the domestic financial markets or in financial intermediation. However, impaired investment securities have weakened the good average solvency ratios of insurance institutions at the same time as the investment income of these institutions has decreased. The challenging investment situation continues due to the

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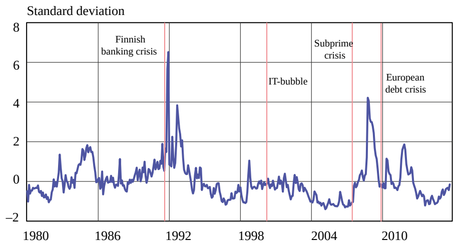
2. The stress index has been described in greater detail in the research article Huotari (2015) Measuring financial stress – A country specific stress index for Finland. Bank of Finland Discussion Papers 7/2006.

prevailing low interest rates.

Slight increase in stress on Finland's financial markets



Sources: Bloomberg, Datastream and calculations by the Bank of Finland.

17 November 2015
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Chart 4

Household debt increases vulnerabilities related to the housing market

The fragile situation in the Finnish real economy may increase risks to the domestic financial system, should the low level of loan losses to date begin to grow. The stock of loans to households, in particular, has grown at a faster rate than the economy for a prolonged period. In an environment of low interest rates, debt-servicing expenses connected with floating-rate loans remain under control, but a possible rise in the level of interest rates would rapidly increase household vulnerabilities.

On the back of the weak economic developments in Finland, growth in households' disposable income has been muted. At the same time, households have continued to accumulate debt, albeit at a fairly modest pace. The household indebtedness ratio – debt relative to annual disposable income – rose in June 2015 to an unprecedented 123.2%, compared with 120.5% a year earlier.[3]

The increase in household indebtedness is due to growth in all key debt items. The stock of housing loans has grown at a slightly faster rate in 2015, following more sluggish dynamics in the past few years. In addition to growth in new drawdowns of euro-denominated housing loans, the expansion of the housing loan stock has been underpinned by an increased use of interest-only periods and other flexible debt-servicing arrangements granted by banks.[4] However, the recent growth in the housing loan stock has been modest relative to the figures recorded in the first decade of the new millennium. In September 2015, for example, the housing loan stock increased at a rate of over 2% per annum. Consumer credit has grown at a slightly faster pace.

Nevertheless, the significance of housing-related debt has increased further. The stock of credit granted to housing corporations and housing companies, in particular, has recently grown at a much faster rate than the stock of housing loans to households. In June 2015, households' loans via housing companies amounted to almost EUR 14 bn, which was 17% more than a year earlier. These loans account for over 10% of the total stock of household debt.[5]

3. Financial Accounts 2015, 2nd quarter. Statistics Finland.

4. Bank barometer III/2015. Federation of Finnish Financial Services.

Despite the weaker economic situation, the debt-servicing capacity of households with housing loans has remained good on average, and banks' non-performing assets arising from housing loans have remained low relative to the loan stock. At the end of June 2015, banks' non-performing housing loans totalled over EUR 1 bn, i.e. 1.2% of the stock of housing loans.[6] The situation for consumer credit is slightly weaker: non-performing consumer credit accounted for 3.3% of the volume of consumer credit in June 2015. There are also signs of an increase in consumer credit-related payment defaults. Overall, the share of non-performing household and corporate loans is among the smallest in the euro area. However, a rise in the level of interest rates in the euro area, combined with the subdued long-term outlook for the Finnish economy, could be rapidly reflected in a growth in the volume of banks non-performing loans from the current low level.

Indicators reflecting current developments on the housing loan and housing markets do not signal marked changes in threats to the stability of the financial system, nor do they imply a marked increase in problems in the near future. For instance, house prices relative to the level of earnings and rents are close to their long-term average (Chart 5). In addition, there are no clear signs of overpricing in the whole country on average. Relative to consumer prices, however, house prices are expensive in historical terms. There are also large regional differences in house price developments and accumulation of housing loan-related debt, especially between growth centres and the rest of the country.

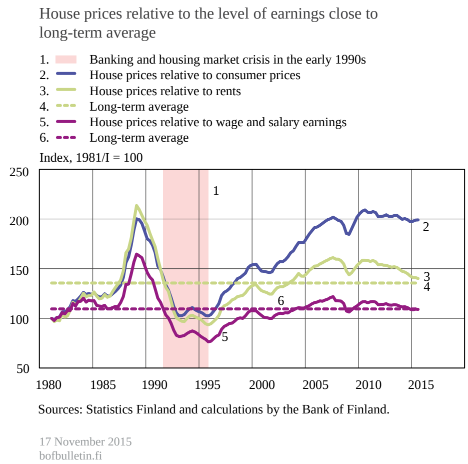

Chart 5

Improvement in banking sector profitability and capital adequacy

Despite the recession in the Finnish economy, the profitability of Finnish banks has remained good on average and capital adequacy ratios have improved slightly in the course of 2015. Impairment losses on loans and the amount of non-performing assets relative to the credit stock have remained low.

5. Financial Accounts 2015, 2nd quarter. Statistics Finland.

6. Financial position and risks of supervised entities 2/2015. Financial Supervisory Authority.

The low level of interest rates has reduced the relative importance of net interest income in banks' income structures, while the relative importance of other income sources, such as securities-related and other fee income, has increased. Banks' profitability and income structures have become increasingly risky, and banks are more prone to disruptions on the securities markets.

The capital adequacy of banks improved in the first half of 2015. At the end of June 2015, the Common Equity Tier 1 (CET1) ratio was 17.5%, compared with 15.3% a year earlier. Equally, the total capital adequacy ratio improved in 2015, to 19.0% in June (17.3% in June 2014). CET1 capital accounted for 92% of own funds, meaning the quality of own funds has remained good.[7] The improvement in capital adequacy was primarily the result of equity issues and growth in accumulated profits. Banks have also increasingly applied internal models for the assessment of credit risks, which has decreased the amount of risk-weighted assets and hence improved banks' capital adequacy ratios.

Banks' potential risks and vulnerabilities have remained largely unchanged. The Finnish banking system is among the most concentrated in the euro area, with a significant level of interconnectedness between banking and insurance business. Problems can rapidly spread from one to the other via ownership structures and investment linkages. Furthermore, international comparisons show that the Finnish banking sector is more dependent on market-based funding than banking sectors in other countries on average. For this reason, disruptions in international capital markets can pass through to the domestic financial sector fairly rapidly.

Finnish banks' funding and liquidity situation has so far remained good and they have encountered no problems in acquiring market-based funding. In future, banks' exposures to disruptions in the acquisition of funding will also be mitigated by the new phase-in requirements according to which banks must have an adequate reserve of liquid assets that can be easily converted into cash (expressed as a liquidity coverage ratio, LRC) as well as maintain a stable funding profile based on adequately diversified long-term funding (measured as a net stable funding ratio, NSFR). The LRC entered into force in the EU in October 2015 and was first set at 60%. The full requirement (100%) will enter into force at the beginning of 2018.[8]

The Finnish financial markets have seen the emergence of new players operating outside the banking system ('shadow banks') which do not take deposits but intermediate funds from investors to businesses and private persons in need of funding. These players are as yet of low importance in financial intermediation relative to the importance of the mainstream banks, but more diversified funding sources may, in the longer term, deliver benefits, for instance via risk diversification and new innovations. However, the growth in shadow banking may entail new risks, since operations not subject to supervision are non-transparent, nor are the magnitude of shadow banking business and its interlinkages with other players on the financial markets precisely known.

7. Financial position and risks of supervised entities 2/2015. Financial Supervisory Authority.
8. For more information, see Commission Delegated Regulation (EU) 2015/65 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to the liquidity coverage requirement for Credit Institutions.

Completion of Banking Union important

The first pillar of EU Banking Union, the Single Supervisory Mechanism (SSM), began operations in November 2014. All significant credit institutions in the euro area (in Finland, Nordea Bank Finland, OP Group, Danske Bank and, as of 2016, Municipality Finance) are subject to direct supervision by the ECB. The second pillar of Banking Union is the Single Resolution Mechanism (SRM), for which the regulatory framework is now in place. The key body within the SRM, the Single Resolution Board (SRB), will become operational at the start of January 2016. According to the key principle of bail-in applied by the SRM, owners and creditors will primarily bear the losses of a failed bank. Banks will contribute to a Single Resolution Fund (SRF), which will be gradually built up to the target level of around EUR 55 billion by 2024. The countries participating in Banking Union have agreed that each member country will pay extraordinary contributions to the Fund during a transitional period if the financial resources of the Fund are not sufficient to resolve any situation at hand.

The third pillar of Banking Union will comprise a common European deposit insurance system. Reform of the deposit guarantee scheme is necessary to ensure a fully effective Banking Union. The current decentralized deposit guarantee based on national schemes is problematic due to the uncertainties surrounding its effective operation in a widespread systemic crisis. In the face of a large-scale crisis, we should ensure that all Member States participating in Banking Union are able to guarantee their citizens the agreed deposit guarantee of EUR 100,000. The proposal of the European Commission of November 2015 for a new European Deposit Insurance Scheme (EDIS) will be implemented in three phases by 2024. The proposal includes several mechanisms for reduction of the risks of the deposit insurance scheme until the conditions for a fully operational single scheme are in place. In parallel with EDIS, many other regulatory initiatives designed to increase the stability of the European banking system are underway.

The reforms of banking supervision and the principles of bank resolution carried through as part of the Banking Union initiative serve to considerably strengthen the authorities' powers of intervention and protect taxpayers against the costs of bank bailouts. However, to promote financial stability and mitigate the adverse effects of future banking crises, the completion of all elements of Banking Union is vital.

Capital Markets Union will complement Banking Union

At the end of September 2015, the European Commission adopted an action plan on Building a Capital Markets Union for Europe. The action plan was a follow-up on the public consultations launched in February, in which the creation of a Capital Markets Union received widespread support.

One aim of Capital Markets Union is to diversify sources of funding to also include non-bank sources. This would improve the availability of finance notably for SMEs and promote long-term infrastructure investment. The Commission proposes adoption of a total of 33 different measures by the start of 2019. In 2017, the Commission will evaluate progress in achieving the aims of Capital Markets Union and weigh potential priorities.

Capital Markets Union is an important initiative for Europe. In its action plan, the Commission assesses that if the venture capital markets of Europe were as deep as in the United States, more than EUR 90 billion of funds would have been available to finance companies between 2009 and 2014. Securitisation, in turn, is assessed to provide additional credit to the real economy of more than EUR 100 billion. If implemented optimally, Capital Markets Union would deliver concrete benefits for the European real economy.

From a Finnish perspective, diversification of the funding sources of SMEs in particular would be beneficial as it could help these enterprises grow. At the same time, the easing of competition in the provision of investment services and insurance policies to private persons, especially on a cross-border basis, could reduce prices and facilitate a more effective allocation of the funds held in deposit accounts.

Wider range of tools needed to address housing market risks

The purpose of macroprudential policy is to prevent excessive exuberance and crises in the financial system. The board of the Financial Supervisory Authority (FIN-FSA) is the macroprudential decision-maker in Finland. It takes decisions from a macroeconomic perspective and drawing on the expertise of key authorities. In the euro area, the ECB Governing Council takes macroprudential decisions with a view to the financial stability of the euro area as a whole. For financial stability to be achieved it is essential that decision-makers have access to sufficient instruments, i.e. macroprudential tools, in good time before risks emerge. Adoption of legislation on new tools does not, however, mean their immediate activation; the macroprudential authority must assess on a case-by-case basis the timing and appropriateness of deploying the tools, with due consideration to the cyclical conditions.

As of 2015, FIN-FSA has had the power to decide each quarter on the imposition of a countercyclical capital buffer requirement of 2.5%, at the most, on banks (Table), but use of this macroprudential tool is not appropriate under the prevailing cyclical conditions. Although the Finnish banking sector is currently sound despite the weakness of the economy overall, banks are, nevertheless, vulnerable to potential problems on the housing market. Due to the low risk weights on housing loans employed in banks' capital adequacy analyses, the buffers built up against housing loan losses are relatively small. Risk weights should be set so as to also capture any systemic risks stemming from lending for house purchase.

The macroprudential tools available under existing legislation designed to control lending for house purchase, i.e. the loan-to-value (LTV) ratio and higher risk weights on housing loans, are designed primarily to support banks' resilience. However, a broader set of macroprudential tools is necessary to contain, where necessary, potential overheating on the housing market and household over-indebtedness. In the light of international experience, restriction of the loan-to-income ratio has been assessed as an effective tool to this end. It makes sense to develop the tools in the cyclical conditions prevailing before the risks to financial stability actually materialise. Extension of housing loan maturities and widespread use of interest-only housing loans in the context of an exceptionally high degree of monetary policy accommodation also augment the risks on the housing market. The authorities should be equipped with powers to restrict, where necessary, both the maximum size of new housing loans relative to the borrower's debt-servicing capacity and loan maturities, and to impose requirements for loan amortisation.

Table.

Macroprudential decisions taken in Finland

Quarter	Date of decision	Countercyclical capital buffer	O-SII buffer
I/2015	16 Mar 2015	0% set	
II/2015	30 Jun 2015	0% set	
II/2015	6 Jul 2015		Additional capital requirement imposed on four credit institutions to take effect on 7 Jan 2016.
III/2015	29 Sep 2015	0% set	

Source: Financial Supervisory Authority.

Nordic link of Finnish banking sector poses a challenge for macroprudential policy

Despite the close interlinks between the Finnish banking sector and the other Nordic countries, macroprudential toolkits vary across the Nordic region. Furthermore, Finland is the only Nordic country participating in Banking Union. These differences may become more salient in the immediate years ahead, if Nordea, the largest Finnish bank in balance sheet terms, goes ahead with a proposed change of group structure that will put more than a third of the Finnish banking market in the hands of branches of foreign banks.

This would be a significant change for Finland, considering that responsibility for both the supervision and the resolution of a systemically important bank would transfer to Sweden, outside the area of Banking Union and the Eurosystem. In such a case, a large part of the Finnish banking sector would be subject to the Swedish Resolution Mechanism, which is different to that of the euro area, and possibly to a different deposit guarantee scheme. This might change the competitive market position of the banks operating in Finland.

The deployment of macroprudential tools to address structural systemic risks would also be more difficult, as the change would lead to a shift of competence to the Swedish Financial Supervisory Authority. In addition, mutual cross-border recognition of macroprudential measures to address structural systemic risks is voluntary or without foundation in law. This potential significant change in the Finnish banking system highlights the need for close convergence of the macroprudential toolkits of Finland and Sweden. In addition, the reciprocity principle should be effectively and comprehensively applied between EU countries.

Tags

systemic risks, macroprudential policy