Low interest rates place a strain on the banks

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The current exceptionally low level of interest rates promotes price stability and economic growth in the euro area, but it also puts a strain on retail banking profitability. In Finland, the banks' most important source of income, net interest income, is now exposed to pressures from several different directions at once. Low interest rates have compressed the spread between lending and deposit rates. At the same time, loan and deposit stocks have increased only slowly. Low interest rates have reduced customers' debt-servicing expenditure, but may also mask risks.

Interest rate cut transmission has been quick in Finland

The European Central Bank (ECB) has launched a set of measures in pursuit of its price stability objective and in support of economic recovery in the euro area.[1] The decline of the key ECB interest rates has driven short-term market interest rates down, and they have exceptionally fallen below zero. For example, the 3-month Euribor has been in negative territory since spring 2015 and the most popular reference rate for housing loans in Finland, the 12-month Euribor, since February 2016.

The interest rate cut has passed through to interest rates paid and received by Finnish bank customers more quickly and more strongly than in the euro area on average. This is because, in Finland, the bulk of loans to households and non-financial corporations is linked to Euribor rates or banks' own reference rates, which normally follow market interest rates with a short lag. More than half of deposits from the public also carry variable rates.

The profitability of financial intermediation is largely based on the interest rate spread between funding and lending. Owing to different interest rate linkages, the interest rate spread between the deposit and loan stocks, i.e. the overall margin, typically widens in response to rising interest rates and narrows in response to falling interest rates (Chart 1). In Finland, this interest rate spread has remained historically small for a prolonged period, but has not narrowed significantly since autumn 2012. However, looking ahead, the spread may narrow further still if the average interest rate on the loan stock continues to fall but banks keep interest rates on retail deposits at a minimum of zero.

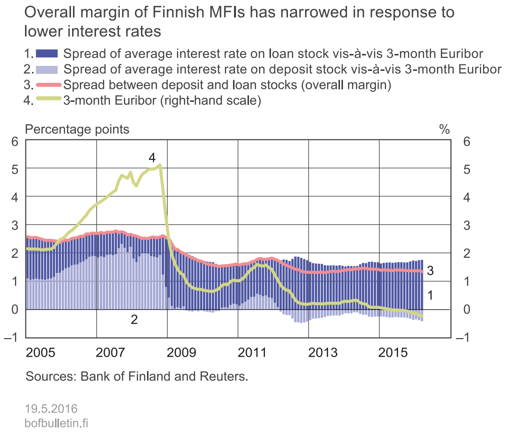

Chart 1

Banks' market-based funding has also become cheaper, which has helped mitigate the adverse effects of low interest rates on banking profitability. Lower yields on bonds issued by Finnish banks reflect both improved financial conditions on global financial markets and Finnish banks' good creditworthiness in the eyes of international investors. In recent years, the share of long-term debt instruments in bank funding has increased and that of short-term debt instruments decreased, whereas the share of deposits has remained virtually unchanged.[2]

Diminished net interest income still the most

1. See e.g. ECB Economic Bulletin, Issue 2/2016.

2. Financial Supervisory Authority (2016) Banking sector's capital adequacy strong, risks posed by the operating environment high.

importance source of income

In Finland, retail banking accounts for a large part of banks' business operations. For this reason, the margin between interest income and interest expenditure has a significant impact on banking profitability.

Net interest income has been subject to divergent pressures in recent years. The loan stock has grown only slowly in the economic downturn, despite exceptionally low interest rates. Growth in the deposit stock has also remained subdued, and in practice e.g. the household deposit stock has already been at a standstill for four years. Interest income on banks' liquidity buffers has also declined, as banks have increased the share of high-quality liquid assets in their buffers, as required by the liquidity coverage ratio (LCR).

The banking sector's net interest income has been falling without a break since autumn 2014, contracting by 5.4% in 2015. Net interest income peaked at EUR 4.5 billion in 2008, when interest rates were considerably higher than at present. In 2015, net interest income was only EUR 2.8 billion. Net interest income has also shrunk relative to the balance sheet size of the banking sector (Chart 2). This change reflects, in part, a decrease in the share of loans and deposits in the balance sheet and an increase in derivatives that generate other income.

Overall, however, Finnish banks' profitability has remained good, particularly relative to the difficult operating environment and other European banks. In Finland, banks have managed to offset lower net interest income by augmenting other income, which helped increase the sector's total income by 3.9% in 2015. This earnings growth was supported by higher levels of net income from trading and investment and net fee income. A further boost to other income has come from net income from financial and insurance conglomerates' insurance business.[3]

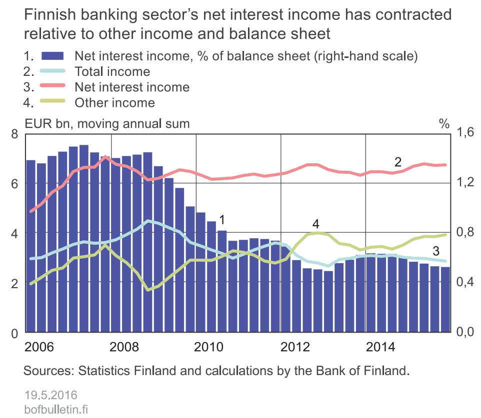

Chart 2

The low level of interest rates has contributed to the sustained relatively small amount of non-performing assets and loan losses, which has helped support bank profitability. Yet this also involves risks. Low interest rates, particularly in combination with interest-only

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3. Information released by the Financial Supervisory Authority on the domestic banking sector includes insurance business conducted by domestic financial and insurance conglomerates.

periods granted by banks to their borrower-customers, may lead to a situation where a possible weakening of customers' debt-servicing capacity remains concealed. Potential payment defaults will not materialise until interest rates rise and interest-only periods end.

Tags

low interest rate level, net interest income, profitability, banks