FINANCIAL STABILITY ASSESSMENT

Stability of Finnish financial system cannot be taken for granted

7 Jun 2016 – Financial Stability Assessment – Financial stability

The Finnish financial system has operated smoothly amid the difficult economic conditions of the past few years. However, financial stability can never be taken for granted. Due to the structural vulnerabilities of the financial system – the concentration and interconnectedness of the financial sector – the consequences of financial crisis could be particularly serious in Finland. To strengthen the stability of the system, the macroprudential toolkit available to the Finnish authorities should be brought to an internationally comparable level.

The Finnish financial system has remained stable regardless of the overall weakness of the economy. Short-term risks related to lending, debt accumulation and asset price developments do not pose an imminent threat to financial stability. Financial institutions have strengthened their capital adequacy, thereby improving their lending and loss absorption capacity.

The ratios of household debt to disposable income and GDP, which were high to begin with, have continued on their long-term growth paths, albeit at a slower pace, whereas relative house prices have fallen close to their long-term averages.

The concentration, size, funding structure and Nordic interconnectedness of the Finnish banking sector makes it structurally vulnerable: banking crises and other serious problems of the financial system could spread rapidly through the Finnish banking system, causing substantial costs. The conversion of Nordea's Finnish subsidiary into a branch further increases the interconnectedness of the Nordic banking system.

The loan-to-value (LTV) cap for housing loans to take effect in July 2016 will enhance the stability of the Finnish financial system, as will the increase in housing loan risk weights prepared by the FIN-FSA Board. The means available to the Finnish authorities for mitigating the probability and consequences of financial crises are, however, insufficient in international comparison.

The experience gained from the global financial crisis and the 1990s crisis in Finland point to the need for putting in place the macroprudential toolkit in time to deliver effective early intervention in the event of an escalation of the risks to financial stability. The timing of macroprudential measures should be commensurate with the prevailing economic situation. Measures to tighten macroprudential policy should be scheduled so as not to excessively constrain access to credit and tighten lending criteria in weak cyclical conditions.

Subdued global growth causes accumulation of risks in the financial system

Finland's open economy and financial system are vulnerable to the risks of the global economy and international financial markets. Recent and future foreseeable developments in the global economy show some disquieting features from the perspective of financial stability.

The world economy has recovered slowly from the financial crisis witnessed in 2007–2009 and the euro area sovereign debt crisis following in its wake. In addition to the crises, at least population ageing in the advanced economies, fading technological development and a chronic shortage of global demand have been offered as explanations for the sluggish pace of global growth (Chart 1) (see article discussing the three explanators of the long period of slow growth, in Finnish).

Chart 1

The advanced economies have pursued a highly accommodative monetary policy to boost economic growth. However, investments have been channelled to the securities markets and in some countries also to the housing and commercial property markets, as well as to real investments. In emerging economies, indebtedness has increased particularly in the corporate sector.

The reversal of capital flows (Chart 2), depressed outlook for global growth and some other factors induced fluctuations on the international financial markets in the early months of 2016. The UK referendum on EU membership in summer 2016 may further heighten market unrest (see article 'What would Brexit mean for the financial markets?').

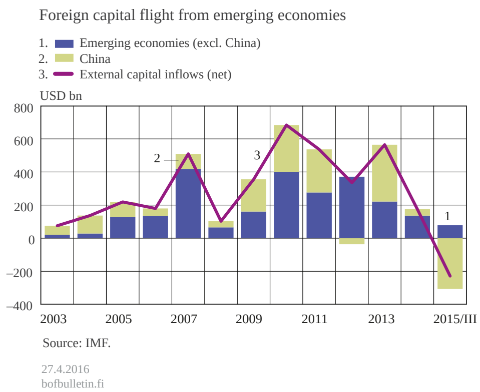

Chart 2

The European Central Bank has adopted several measures to promote price stability and economic growth. The measures are a necessary response to the very moderate inflation outlook. However, in some countries, the low level of interest rates and diverging economic developments across the euro area countries may result in a surge in asset prices and excessive credit growth. Such country-specific risks are contained by measures of national macroprudential policy.

Cyclical risks to financial stability moderate in Finland

Disruptions in the international economy and financial system may spill over to Finland not only through the financial markets but also e.g. via exports, interest rate developments and the links between Nordic banks.

In the assessment of the Bank of Finland, the cyclical risks to financial stability facing the Finnish financial system are currently low. Cyclical risks to financial stability are typically associated with exceptionally fast growth in – or high levels of – lending, indebtedness and asset prices. The early warning indicators[1] employed by the Bank of Finland and FIN-FSA in macroprudential analysis do not currently signal any significant increase in these stability threats in Finland.

In light of empirical studies, exceptionally high values of the trend deviation of the ratio of private sector credit to GDP (credit-to-GDP gap) have mirrored an increase in the probability of a banking crisis with high reliability.[2] In Finland, values of the credit-to-GDP gap have generally declined in recent years (Chart 3), reflecting the sluggish pace of credit growth.

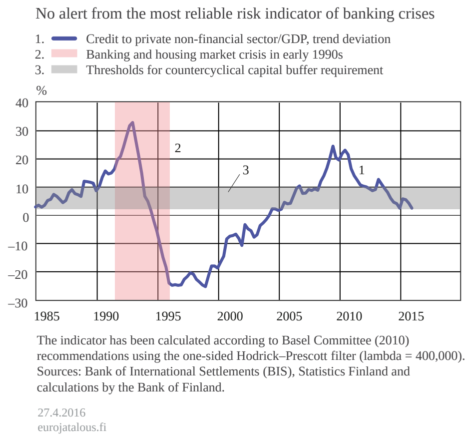

Chart 3

If the value of the credit-to-GDP gap exceeds a defined trigger level, national authorities must take the imposition of a countercyclical capital buffer requirement on credit institutions under special consideration. In Finland, values of the credit-to-GDP gap have been above the trigger level in recent years, but in light of other risk indicators and the comprehensive assessment of the authorities, the risks of lending have not given cause for adoption of measures to increase the countercyclical capital buffer requirement.

As regards the other major risk indicators, e.g. annual growth rates of banks' household and corporate loan stocks are much slower than just a few years ago (Chart 4).

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1. Early warning indicators are indicators whose exceptional values have delivered the most reliable and timely warnings of future banking crises.
2. For a more detailed discussion on the calculation of the credit-to-GDP gap and its important role in macroprudential policy, see an article on the calculation of the aggregate credit risk indicator (in Finnish) http://www.suomenpankki.fi/fi/julkaisut/selvitykset_ja_raportit/makrovakausraportti/Pages/2015-nro-2-erillisraportti.aspx.

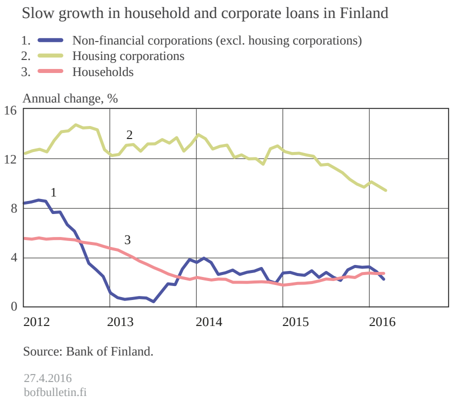

Chart 4

Similarly, house prices do not show any signs of overvaluation in Finland as a whole. In recent years, house prices relative to rents and wage and salary earnings have declined close to their long-term averages (Chart 5). There are, however, large regional differences in housing price developments.

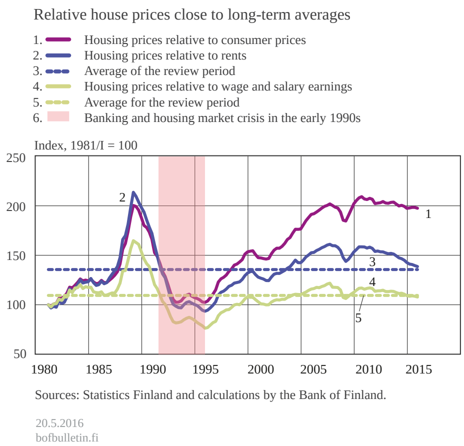

Chart 5

Overall, against a backdrop of sluggish credit growth, there is currently no need to deploy macroprudential tools to mitigate the risks of credit growth.[3] Accordingly, the Finnish macroprudential authority, FIN-FSA, whose Board takes the macroprudential decisions in Finland, has refrained from increasing the countercyclical capital buffer requirement from 0%.[4]

Banking sector financially solid but structurally

3. Macroprudential instruments are mainly regulatory instruments whose primary objective is to prevent financial crises by dampening credit cycles and strengthening the loss absorption capacity of financial institutions.For a more detailed discussion on the macroprudential instruments available to the Board of the FIN-FSA, see http://www.finanssivalvonta.fi/en/Supervision/Macroprudential_supervision/macroprudential_instruments/Pages/Default.aspx.

4. In its capacity as ultimate macroprudential supervisor within the Banking Union, the European Central Bank has the right to tighten the countercyclical capital buffer requirement or other macroprudential instruments used in Finland (excl. the LTV cap for housing loans) from the level proposed by the Board of the FIN-FSA. However, the ECB has not yet exercised this right.

vulnerable

There are significant longer-term *structural* risks present in the Finnish financial system.

The high concentration and large size of the banking sector relative to the economy push up the costs of banking crises, while Finnish banks' high reliance on market-based sources of funding exposes them to disruptions in the international financial system. In addition, the Nordic links of the banking and insurance sector make the Finnish financial system vulnerable to the problems of Nordic banks and to fluctuations in the Nordic housing markets (see article 'Nordic financial sector vulnerable to housing market risks').

Activation of the macroprudential tools to address the structural vulnerabilities and risks of the banking sector may also be justified under adverse cyclical conditions. The banks are by far the most important source of external finance for households and non-financial corporations in Finland. Therefore, the authorities must adopt regulation to ensure the strong capital adequacy and lending capacity of banks under all circumstances.

The FIN-FSA Board strengthened the risk resilience of the credit institutions identified as significant for the Finnish financial system (O-SIIs) by imposing on them additional capital requirements to be fulfilled as of the beginning of 2016.[5] In the course of 2014 and 2015, Finnish banks have increased their own funds substantially (Chart 6), not least in response to the tighter capital requirements introduced (see the article 'Reform of bank capital regulation enters final phase').

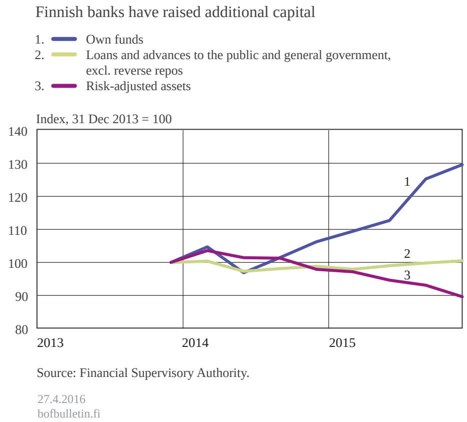

Chart 6

Finnish law does not allow for the imposition on banks of a Systemic Risk Buffer (SRB) requirement, which is applied by nearly all other EU countries. The SRB is designed to mitigate systemic risks arising from the large size or vulnerable structure of the banking system. An expert group that reviewed the necessity of the SRB in Finland cited the concentration of the Finnish banking sector and its key role as a source of funding for the private sector as arguments in favour of incorporation of the SRB into Finnish national legislation.[6]

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5. The O-SIIs and the additional capital requirements imposed on them are: Nordea Bank Finland (2%), OP Group (2%), Danske Bank (0.5%) and Municipality Finance (0.5%).

Low level of interest rates weighs on banks' and insurance companies' profitability

The depressed level of interest rates has rapidly passed through to the rates on housing, consumer and corporate loans in Finland. If protracted, low interest rates and the weakness of the economy will place a strain on the banks, whose profitability is, to a significant extent, dependent on the demand for new loans and the margin between deposit and lending rates (see article 'Low interest rates place a strain on the banks').

In fact, the high profitability of the banking sector can be partly attributable to e.g. fee and trading income, whereas income from lending has declined. Those Finnish banks in particular that raise a significant share of their funding on the markets have, nevertheless, benefited from the fall in interest rates. The profitability of banks has also been bolstered by low amounts of impairment losses (Chart 7) and non-performing loans.

Increased use of interest-only periods on housing loans has helped sustain domestic demand in the severe economic conditions experienced in Finland. The more widespread use of interest-only periods on housing loans should not, however, be encouraged to result in a considerable extension of loan repayment periods or major changes to current amortisation practices.

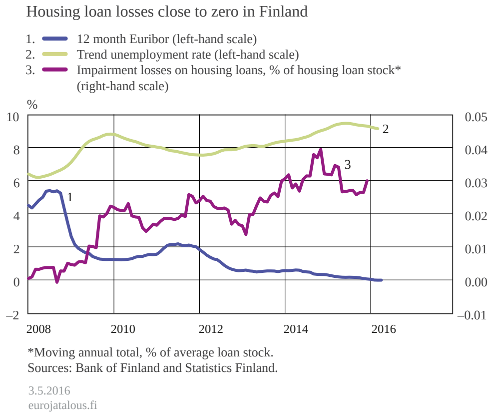

Chart 7

The Finnish insurance and banking business is concentrated in the hands of a few large financial and insurance conglomerates (see article 'Reform of insurance sector regulation'). Considering that the Finnish earnings-related pension providers and life and non-life insurance companies manage large investment portfolios, attention should be focused on potential systemic risks transmitted by the insurance companies.

The market fluctuations witnessed in the early part of 2016 were reflected notably in earnings-related pension providers' financial results for the first quarter of 2016. However, the investments of insurance companies and pension providers are rather broadly diversified, and solvency in the sectors is good. If prolonged, the low level of

6. Report on the necessity of introducing a Systemic Risk Buffer requirement in Finland. Ministry of Finance publications 4/2016 (in Finnish with English abstract).

interest rates will also weigh on the profitability and solvency of insurance companies, given that a significant share of their investments are fixed-income investments. When the investments mature, the assets must be reinvested at a lower interest rate, which reduces interest income and impairs achievement of the companies' return objectives.

The profitability of life and non-life insurance companies is also reduced by an increase in the value of market-based technical provisions in response to falling interest rates. In addition, the profitability of life insurers is eroded by the guaranteed-return policies currently featuring a guaranteed rate of interest above average returns on fixed-income investments. However, sales of guaranteed-return life policies were largely discontinued in Finland some time ago. The majority of new policies sold represent unit-linked policies, where the investment risk is born by the customers.

Structural stability risks related to lending for house purchase remain elevated

High household indebtedness also represents a structural vulnerability of the banking sector. The risks related to lending for house purchase and accumulation of debt increased in the first decade of the new millennium largely for two structural reasons: an increase in average housing loan sizes and a significant extension of average loan repayment periods.

Household indebtedness relative to disposable income has more than doubled over the past twenty years (Chart 8). International experience shows that indebted households cut back their consumption strongly in times of economic crisis, which further aggravates the crisis (see blog on housing loans and the Great US Recession [in Finnish]). Household vulnerability relative to housing market risks is heightened by the concentration of household assets in housing. There are also large regional differences within the housing market.

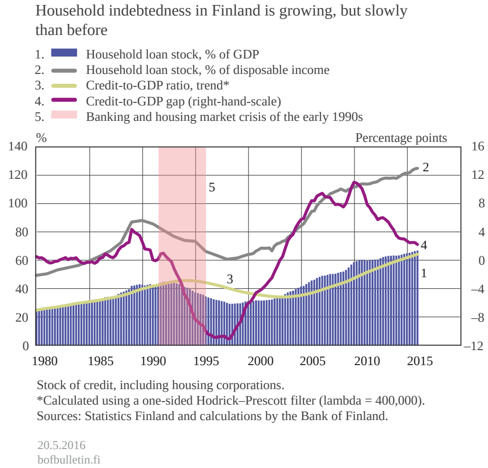

Chart 8

The Finnish financial system's vulnerability to the risks of lending for house purchase and the housing market is increased by the large share of housing loans in the banks' aggregate lending volumes and the low risk weights assigned to housing loans in their internal risk-weighting models (see article 'High housing debt increases risks to financial stability'). Furthermore, mortgage-backed bonds play a major role as sources of funding and investment for Finnish and Nordic banks (Chart 9).

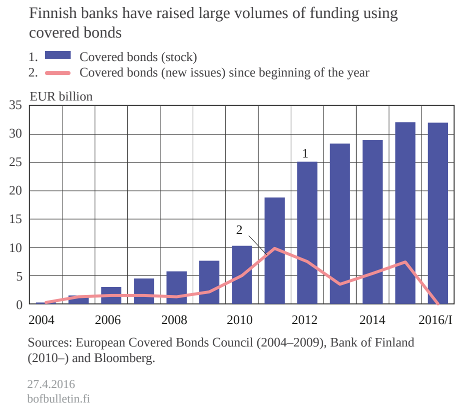

Chart 9

As regards the stability of the financial system we can, however, make the positive observation that the increase in some vulnerabilities related to household indebtedness has moderated in recent years, or vulnerability has even declined. Although household indebtedness has continued to grow, the rate of growth has moderated below trend (curve 4, Chart 8).

The most highly indebted mortgage holders – with a ratio of debt to disposable income above 400% – have decreased in number since 2010, as has their share of aggregate housing debt. Moreover, the share of housing loans in banks' lending to households and non-financial corporations has contracted in response to the slow growth in the housing loan stock (see Charts 3 and 5 in article 'High housing debt increases risks to financial stability').

Authorities need internationally comparable macroprudential instruments

The exceptionally low level of interest rates conceals the risks related to the high level of household indebtedness. Although accumulation of debt has helped sustain household consumption and, by extension, domestic demand in recent years, a renewed strong acceleration of debt accumulation would be a risk for the Finnish economy, with an ageing population and a weak long-term growth outlook.

The legal provisions on the loan-to-value (LTV) cap will take effect in July 2016, which is positive in terms of financial stability. In Finland, the effectiveness of the LTV cap as a macroprudential instrument is, nevertheless, compromised by the exceptionally liberal method of calculation.

In contrast to most other countries, a wide range of items other than the object of purchase are also recognised as eligible collateral in the calculation of the LTV ratio. For some loan applicants, this collateral treatment may result in rather high effective LTV ratios, even exceeding the value of the object purchased.

In order to improve the effectiveness of the LTV ratio and its international comparability, a modification of the LTV calculation formula as defined in the Credit Institutions Act should be considered.

At the end of 2015, the Board of the FIN-FSA stated that housing loan risk weights are low from a macroprudential perspective and decided to begin preparations for an increase in risk weights to also capture the systemic risks arising from lending for house purchase. Housing loan risk weights serve to define the amount of capital buffers to be held by banks to cover exceptionally large unexpected losses on housing loans.

The introduction of higher risk weights on housing loans primarily serves to strengthen banks' resilience to housing loan losses. However, the Finnish authorities do not have access to sufficient and internationally comparable instruments for containing the risks associated with household indebtedness and the housing markets by using macroprudential tools targeted at demand factors.

In light of international experience, restriction of the maximum loan size relative to the borrower's disposable income would be an effective instrument for this purpose. The Finnish authorities should also have recourse to means for restricting, where necessary, maximum loan maturities and introducing loan amortisation requirements. If necessary, the FIN-FSA may also issue recommendations on lending for house purchase to the banks.

Adoption of macroprudential measures is subject to careful consideration in Finland and macroprudential decisions are always taken with due regard to the prevailing economic conditions, the tightness of other regulation and the estimated effects of the measures on lending, financial institutions and the macro economy. Macroprudential policy should also be sufficiently transparent and consistent in order to avoid the emergence of unnecessary uncertainty on the markets.

Structural changes and new financial participants shaping the financial system

The structure of the Finnish banking sector is about to change as Nordea converts its Finnish subsidiary into a branch. In this process, supervision of the bank's Finnish operations will be taken over by the Swedish supervisory authority, customer deposits will become subject to the Swedish deposit guarantee scheme and resolution responsibility will be assigned to the Swedish resolution authority, outside the EU's Banking Union (see article 'Conversion of Nordea subsidiaries into branches – Nordic interconnectedness increases').

The restructuring of Nordea will create an exceptional situation in a European context, too, as supervisory and resolution responsibility for a deposit bank of national systemic importance is transferred away from the national authorities.

The restructuring of Nordea makes it increasingly important for the Nordic countries to have in place as consistent a macroprudential toolkit as possible. The Finnish macroprudential toolkit is currently narrower in scope than that of most of its neighbours (see article 'Finland's neighbours rein in lending for house purchase').

Traditional banking is also being shaped by new financial participants that are taking advantage of digitalisation in the provision of banking, payment and asset management services (see article 'Will digitalisation transform the financial sector, too?'). The emergence of new participants and business models will step up competition in – and increase the supply of – financial services.

However, some of the new quasi-banking business may find its way outside banking regulation or be subject to lighter regulation than banks per se. The transformation of the banking and financial business is also subject to close scrutiny in Finland. We know from economic history that a crisis can build up in the supervisory dead zone outside traditional banking.

Financial stability needs an operationally reliable infrastructure

Financial stability analyses are often undertaken under the assumption of a smoothly functioning financial infrastructure. This assumption is as such well-founded, considering that no problems were identified in the financial infrastructure – payment systems and securities clearing and settlement systems – during the global financial crisis of 2007–2009. Reliable systems help to keep the wheels of the economy turning (see article 'Market infrastructures – the pillars of financial stability').

Market infrastructure connects financial system participants to each other, and disruptions in the infrastructure may rapidly spill over to the financial system as a whole. For example central counterparties on the one hand promote risk management but may on the other hand also themselves act as sources of risk (see article 'Central counterparties can both prevent and cause risks').

The infrastructure must be built to withstand a wide range of disruptions both in normal times and in times of crisis. The national exercise for testing preparedness and contingency arrangements in the financial and insurance sectors carried out in autumn 2015 showed that the increasingly international infrastructure presents a huge challenge in the preparation of national contingency plans.

Completion of Banking Union and establishment of Capital Markets Union consolidate EMU

Economic and Monetary Union (EMU) cannot operate without a stable European financial system. Completion of Banking Union with the European Deposit Insurance Scheme (EDIS, see article 'New European Deposit Insurance Scheme to be introduced soon') and the creation of a single Capital Markets Union will serve to distribute risks and hence promote stability.

The changeover to a European Deposit Insurance Scheme is, however, justified only when the balance sheets of the banks' participating in Banking Union have been reliably cleansed of old problems and the sufficiency of their capital adequacy has been ensured.

The key objective of the Capital Markets Union is to diversify the funding sources of small and medium-sized businesses in particular and hence improve their growth potential. The establishment of a Capital Markets Union also adds to the necessity for developing macroprudential tools designed for financial corporations other than banks.

A positive development in terms of a revival of the Finnish capital markets is the upward trend in Helsinki stock exchange listings witnessed over the past few years. Although the amount of new capital raised via the stock exchange is small from the perspective of the economy overall, it is significant for the businesses themselves. New capital contributes to supporting their potential new investment projects.

Tags

threats to financial stability, systemic risks, macroprudential policy