Financial Stability Assessment

Financial stability assessment: Finland's banking sector expands – Banking Union mitigates risks

Financial stability | 13 December 2017

There are no immediate threats to the stability of the Finnish financial system. The relocation of Nordea's corporate headquarters will, however, increase the banking sector's exposure to structural vulnerabilities. The regulatory and supervisory reforms already implemented and participation in the European Banking Union will serve to mitigate the risks associated with the expansion of the banking sector, but adoption of a common European Deposit Insurance Scheme remains an important measure yet to be implemented within the Banking Union. An income-related cap on loans is needed to rein in the increase in household indebtedness.



The expansion of Finland's banking system increases structural risks

Finland's banking system is set to expand, as Nordea's shareholders are expected to ratify the relocation of its corporate headquarters to Finland in their general meeting in March 2018. Following this, the largest banks operating in Finland will fall under the Banking Union's Single

Supervisory Mechanism. This will serve to harmonise supervision and competition within the Finnish banking sector. Danske Bank, in turn, is in the process of merging its subsidiary in Finland with the Danish parent company. Danske Bank will operate as a branch in Finland from the start of 2018 and its supervision will fall largely under the remit of the Danish Financial Supervisory Authority.

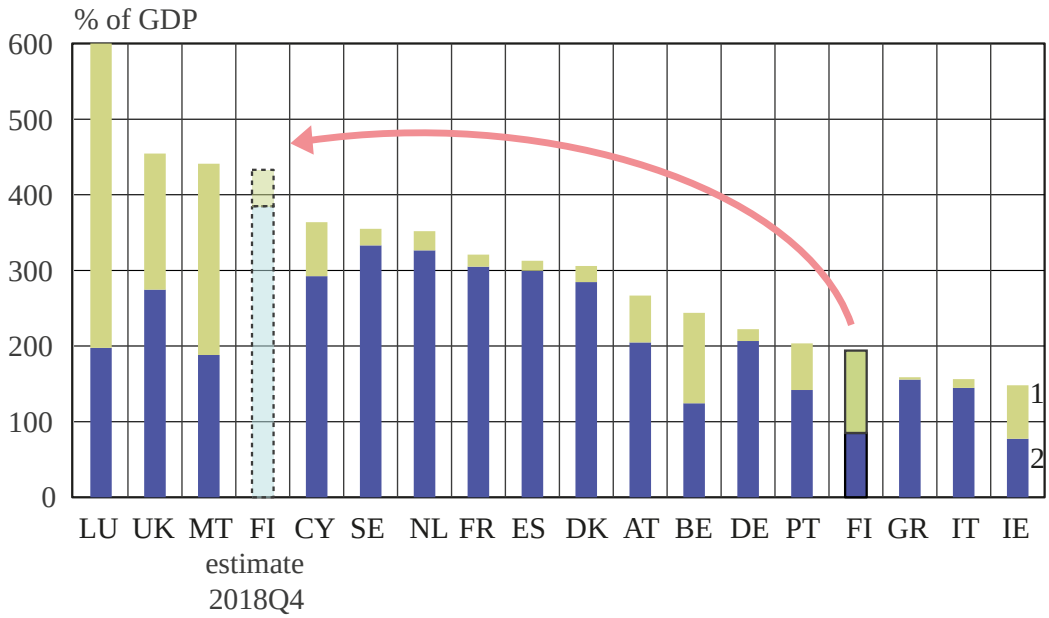
The domicile of a financial institution does not necessarily impact the services offered to its customers. Instead, geographical location is essential in determining which roles different authorities have in supervising these multinational institutions and managing possible crises. The relocation of a large bank can alter the structure and systemic risks of the entire banking sector on a national level.

It is estimated that the relocation of Nordea's head office to Finland will quadruple the size of Finland's banking sector relative to the economy (Chart 1).[1] As a result, the banking sector will be not only larger but also increasingly concentrated and interlinked.

Chart 1.

Size of the banking sector in selected EU countries

1. Balance sheets of foreign-owned subsidiaries and branches, total
2. Balance sheets of domestic banks, total



LU=1.560%, chart cut off for reasons of presentation.
Sources: ECB and calculations by the Bank of Finland, 2017Q2.

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While there are risks associated with expansion of the banking system, the size of the banking sector does not increase the likelihood of a banking crisis per se. However, comparatively large banking systems can result in significant costs, relative to the overall capacity of the economy, if the banks fall into a crisis. These costs have typically been the consequence of recessions caused, or exacerbated, by banking crises and public bail-outs of banks.

Participation in Banking Union mitigates risks

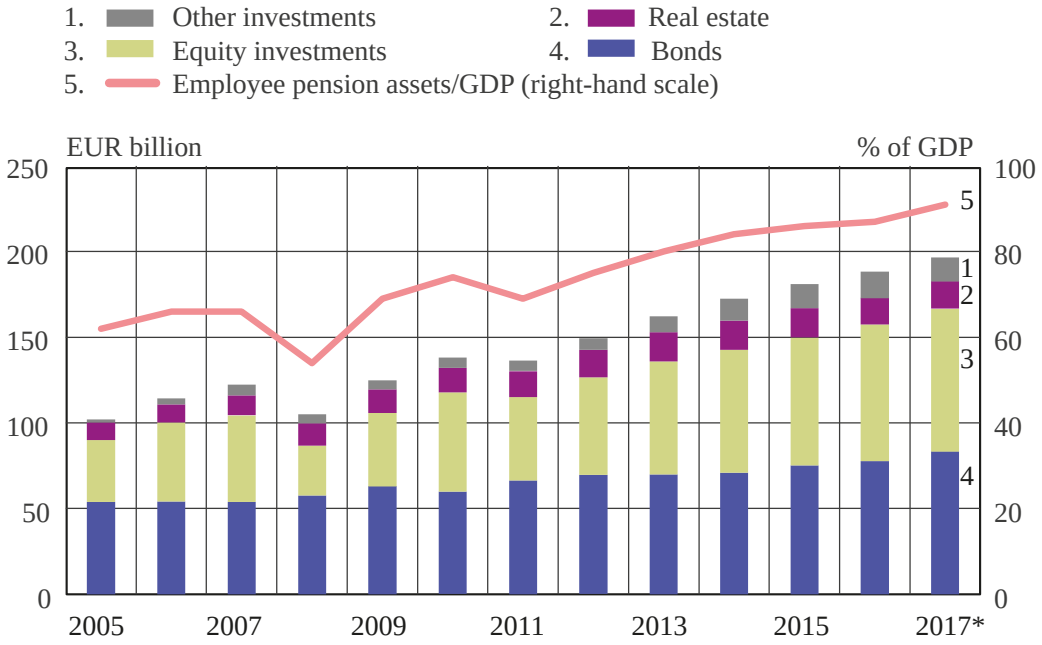
After the relocation of Nordea, Finland's banking sector will become one of the largest in Europe relative to the size of the national economy (Chart 2).[2] Participation in European Banking Union[3] and the regulatory and supervisory reforms implemented in recent years mitigate the added risk brought by the expansion of the banking sector, compared with the scenario where Finland was not a part of the Banking Union.

The European Central Bank (ECB) is responsible for the direct supervision of banks whose operations are deemed critical to the stability of the financial system. Banking supervision is built on determined intervention in the event of excessive risk-taking or neglect. In addition, supervisors have been equipped with more comprehensive policy tools to intervene at an early stage before a bank's solvency or liquidity are called into question.

Yet, despite enhancements in supervision, it stills remains distinctly possible that systemically important banks may end up in situations where they require outside assistance. Banking Union's Single Resolution Board is tasked with managing the operations, capital and liabilities of legacy banks in such a way that financial stability is not compromised and critical financial services remain unimpaired. According to the bail-in principle, bank shareholders and creditors assume primary liability for resolution costs.[4] Small legacy banks, on the other hand, are generally allowed to fall under the remit of normal bankruptcy proceedings when their insolvency is not deemed a threat to financial stability.

Chart 2.

Growth in employee pension assets



*2017's pension asset/GDP figure is based on 2016 GDP.
Sources: Tela and Financial Supervisory Authority.

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The substantial expansion of the banking sector will add to the liabilities covered by Finland's

deposit insurance scheme. It will not, however, impact the deposits covered by the scheme: retail deposits are fully guaranteed up to EUR 100,000. The EU's new resolution regulation and the Banking Union's Single Resolution Mechanism reduce the risk that deposits might have to be refinanced through Finland's deposit insurance fund, as the role of investor responsibility has been significantly increased in handling resolution costs.

Despite advances in regulation, supervision and resolution policy, financial crises may still saddle society with enormous costs as a result of contractions in output, dwindling economic activity and a collapse in asset prices. The seeds of financial crises are often sown during economic upswings, when the economy enjoys rapid growth while asset prices rise and risk awareness diminishes.

It is therefore essential that the Finnish authorities have adequate macroprudential tools at their disposal to manage the stability of the financial system. A comprehensive array of policy tools allows authorities to effectively reduce both cyclical and structural systemic risks and support the stability of the entire financial system.[5]

The Finnish Parliament approved a Government proposal in November 2017 amending the Credit Institutions Act to include a systemic risk buffer. Beginning from 2018, the Board of the Financial Supervisory Authority will, after a transition period, be able to impose an additional capital requirement of up to 5% on credit institutions and investment firms based on the structural vulnerability of the financial system. The systemic risk buffer is based on EU legislation and has been adopted by virtually every EU Member State through national legislation.

The international financial markets have been stable in 2017 and market volatility has remained muted across a broad spectrum of assets.[6] Moreover, there are no immediate threats to the international financial system which might significantly endanger the stability of the Finnish system. On a cautionary note, however, extended periods of low volatility can incentivise to increased risk-taking and thereby increase the vulnerability of the financial system.

Banking Union needs complementing with a common deposit insurance scheme

A common deposit insurance scheme, the third pillar of European Banking Union, has not yet been implemented. The aim of such a scheme is to reduce the risk of bank runs. A common deposit insurance scheme would increase confidence in the banking system, especially in the event of financial crises, and would ease the resolution of international banks. The system would also help offset the interdependence between banks and their home countries, which proved to be particularly problematic during the European debt crisis. The scheme is particularly important for

countries whose banking sectors are concentrated and large in proportion to their economies.

The European Commission proposed a new framework in October 2017 for implementing a European Deposit Insurance Scheme. The latest proposal contains two phases: a reinsurance phase set to take place during 2019-2021, followed by a co-insurance phase beginning from 2022 at the earliest. In the first phase the common scheme is designed to guarantee the liquidity of the national deposit insurance systems, while in the latter the common system would gradually also cover possible losses of national deposit insurance systems. To this end, the Single Resolution Board[7] would manage a common deposit insurance fund.

The most noteworthy amendment compared with previous proposal[8] is to be found in the provisional steps proceeding full implementation of the system. Advancing to the second phase of the scheme requires, among other provisions, measures to reduce the banks' non-performing loans and a targeted asset quality review of the banks. Furthermore, the Commission reiterates the importance of further harmonising the national deposit insurance systems.

There are good grounds for adopting a common deposit insurance scheme, whether viewed from the stability of the euro system as a whole or the Finnish financial system. It is, however, essential that the legacy risks associated with the recent financial crisis in the European banking sector are reduced before a common insurance scheme is adopted.

Finnish banks' capital adequacy remains strong

Capital adequacy is a prerequisite for banks to be able to carry out their core function as financial intermediaries throughout all the phases of the business cycle.

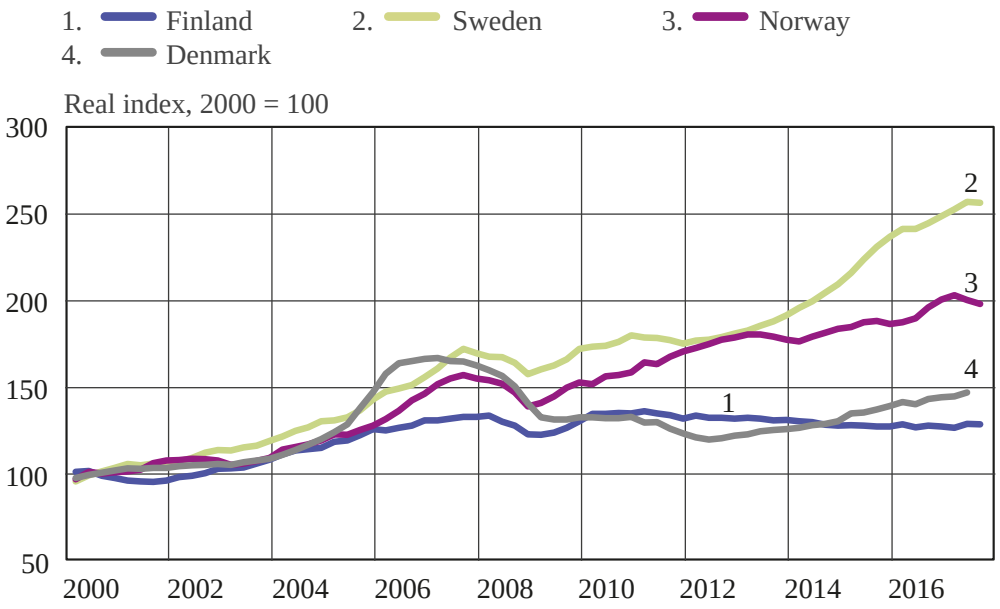
Capital adequacy in the Finnish banking sector[9] has remained strong, albeit slightly weakened by structural changes that took place in the beginning of 2017. The Common Equity Tier 1 (CET1) capital ratio, stood at 20.1% in June 2017, compared with a ratio of 22.1% at the end of 2016. The total capital ratio in turn fell from 24.6% to 22.6% (Chart 3). The CET 1 capital ratio was weakened by Nordea's cross-border merger, which converted its Finnish subsidiary bank into a branch of its Swedish parent company and subsequently eliminated it from the Finnish banking sector's key indicators. The capital adequacy ratio was also weakened by the ECB's decision to set a minimum level for OP Financial Group's risk weights on housing loans for a fixed period. An increase in banks' own funds helped offset an overall decline in the capital ratios. Overall, the Finnish banking sector enjoys robust capital adequacy compared with the European average.

Furthermore, the profitability of the Finnish banking sector has remained at a good level. Banks saw their key income items grow during the first half of 2017. Strong capital markets, increased

demand for credit, and a decline in interest expenses all worked toward increasing net profits; however, growth in operating costs did outpace profit growth. The largest contributors to increased operating costs were related to IT systems, consultancy and training.

Chart 3.

Nordic countries have differing trends in house prices



Sources: OECD, Macrobond, Valueguard and calculations by the Bank of Finland.

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Since late 2016, the Financial Supervisory Authority has set discretionary additional capital buffer requirements (Pillar 2 requirements) on banks under its supervision. These Pillar 2 requirements must be met with Common Equity Tier 1 capital. This follows in the footsteps of the ECB's practice of setting discretionary capital buffer requirements on significant banks that fall under its supervision. Discretionary requirements are unique to each bank, following a thorough, individual assessment.

Capital adequacy can also be tightened by adjusting the minimum levels set for risk weights. In June 2017, the Board of the Financial Supervisory Authority decided to raise the average minimum risk weight on mortgage loans to 15% for banks that use an Internal Ratings Based approach. This higher requirement will enter into force on 1 January 2018. Overall, increasing risk weights is an effective means to reinforce the stability of the financial system.

Insurance sector solvency strengthened by investment return and higher interest rates

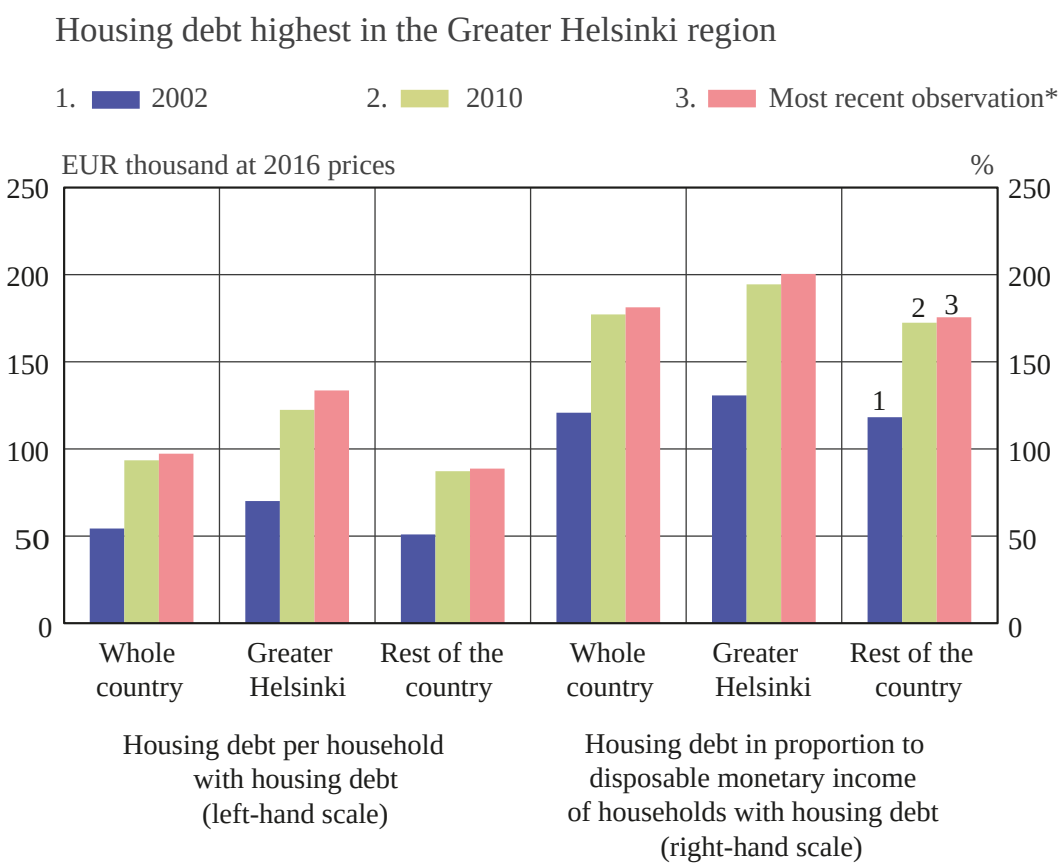
Pension companies and life insurance companies enjoyed positive growth in solvency in the first half of 2017, while the position of non-life insurance companies remained more or less unchanged. The insurance sector has considerable investments in equity, and investment returns developed favourably owing to upbeat stock markets.

Long-term interest rates rose during the same period, which decreased life insurance companies' market-consistent technical provisions and boosted capital adequacy ratios. However, growth in insurance premiums appears to have plateaued, with market space being eroded by competing investment products. New sales continue to account for a dwindling share of premium revenues.

The non-life insurance sector has also seen a similar plateau in premium growth. The growth of the insurance premiums of statutory insurance, a significant source of total premiums, experienced the largest relative decline. For example, the new Motor Liability Insurance Act has tightened competition between insurance providers. Nevertheless, solvency still remains robust in the non-life sector and is double the minimum regulatory requirement.

Pension providers' solvency strengthened in the first half of 2017 as investment returns surpassed required rates of return. Private and public sector earnings-related pension assets have reached historically unprecedented levels, totalling over 90% of GDP (Chart 4). Over the years, these assets have not only been bolstered by increased returns on investment, but also by the high level of pension contributions, which surpassed pension expenditure until 2013. Since 2014, however, this equation has reversed, and growth in pension assets has become dependent on investment yields.

Chart 4.



*Euro amount in 2016, in proportion to income in 2015.
Sources: Statistics Finland and calculations by the Bank of Finland.

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Household debt casts a shadow on financial stability

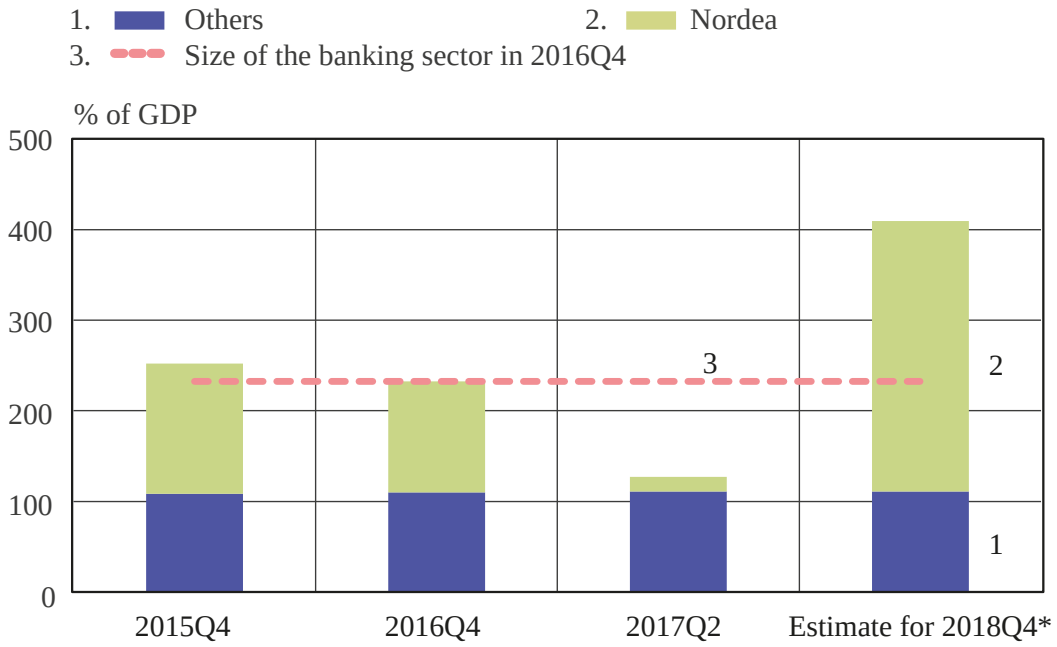
Household indebtedness is high in the Nordic[10] countries both by international comparison and in each country's historical perspective. At the end of 2016, household debt in proportion to annual disposable income was 268% in Denmark, 215% in Norway and 177% in Sweden (Chart 5). Apart from Denmark, these debt ratios were record-high. This means that debt has increased in the long term faster than the income available for repayment, consumption and savings.

The debt of Finnish households is also record-high by the country's own standards.[11] In mid-2017, debt in proportion to disposable income was 128%, i.e. higher than in most euro area countries.

Debt in Finland has been increasing for many years, and is concentrated on only a proportion of households.[12]

Chart 5.

Nordea's relocation will expand Finland's banking sector



*The conversion of Danske Bank in Finland into a branch has not been factored into the estimate for 2018Q4.
Sources: Financial Supervisory Authority and calculations by the Bank of Finland.

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As a result of the increasing level of debt, the Nordic financial and economic system is exposed in many ways to housing loan and housing market risks. Owner-occupation is common, and household wealth tends to be tied up in housing assets. Loans secured by housing assets and granted by Nordic credit institutions account for a considerable proportion of household debt.

Housing loan receivables, meanwhile, constitute one of the greatest risk concentrations for credit institutions. Housing loans are also the most important type of collateral for credit institutions' secured long-term market funding – covered bonds. This means that funding depends on international investors' trust in both the credit institutions' creditworthiness and the housing market. Nordic financial and insurance corporations' investments in covered bonds issued by

banks in the region increase the interconnectedness of the Nordic financial sector and any related risks.

The risk in terms of economic development is that high indebtedness makes households more likely to reduce their consumption during an economic downturn or recession. Households in heavy debt in proportion to their income and wealth are vulnerable in the face of higher unemployment and falling house prices. Higher interest rates may also be a problem for borrowers if they have not prepared sufficiently for higher debt servicing costs.

Vulnerabilities related to credit and indebtedness affecting financial stability tend to increase gradually during an upswing or economic boom. Changes in loan terms, such as longer repayment periods and interest-only periods, increase indebtedness over time. During a downswing, households' debt servicing problems usually increase, and if a crisis occurs, the far-reaching consequences of excessive debt may be exposed at very short notice.

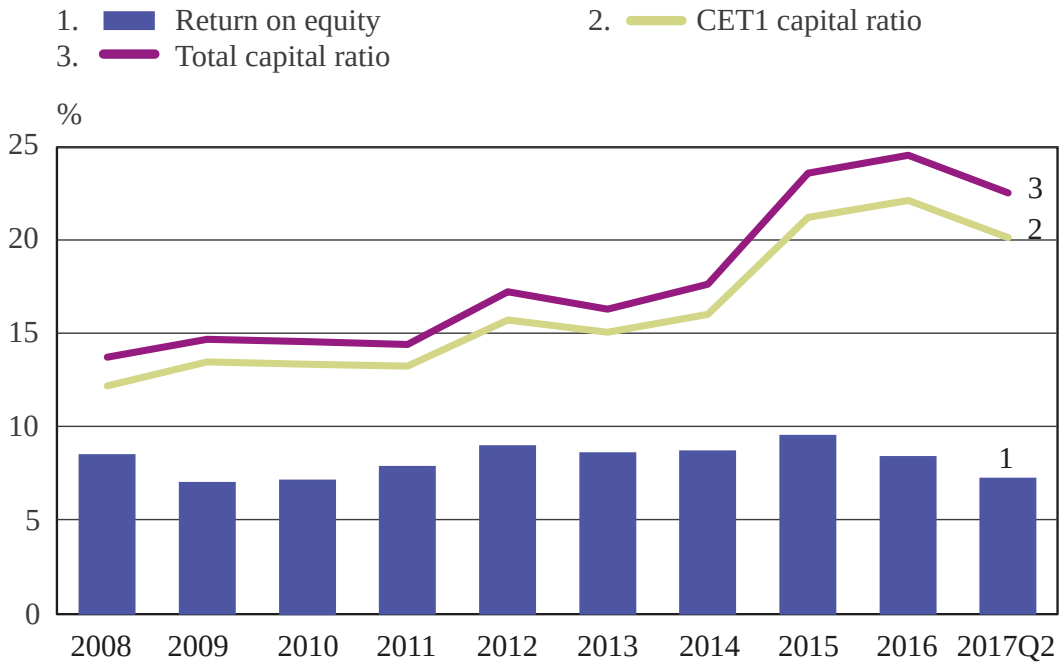
We must be prepared for the risks of higher indebtedness

The European Systemic Risk Board (ESRB), which oversees the stability of the financial system of the European Union, warned Finland, Sweden, Denmark and five other EU countries about their levels of household indebtedness and other medium-term vulnerabilities on the housing market. The vulnerabilities related to indebtedness in these countries have remained high or increased in recent years.

One symptom of housing market imbalances is a steep rise in house prices. These vulnerabilities have increased in recent years, especially in Sweden and Norway, where house prices are much higher than they were at the beginning of the decade, for example (Chart 6). Real house prices in Norway have declined since spring 2017. In Sweden, house prices have declined during the period September–October 2017.

Chart 6.

Capital adequacy of Finnish banking sector remains strong



Source: Financial Supervisory Authority.

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In its assessment, the ESRB stressed that if the housing market risks are realised, they may spread from one banking system and national economy to another, especially in the closely connected Nordic and Baltic countries. Losses made by international banks in one country may affect funding and the supply of credit in the other countries.

Macroprudential policy measures have been applied in recent years in the Nordic countries to reduce the risks in the financial system arising from household indebtedness. A number of policies have been implemented – such as imposing more stringent loan terms – to prevent excessive indebtedness and improve households' ability to cope with financial shocks.

Many Nordic countries impose a maximum loan-to-value ratio, restricting the maximum amount of new housing loan in proportion to the value of the house bought or, in the case of Finland, the loan's real collateral. The loan cap is 90% in Finland (95% for first-time buyers), 85% in Sweden and Norway and 95% in Denmark. How binding the loan cap regulation is and any possibility to deviate

from it varies from country to country, and in Norway also from region to region.[13]

Finland should consider changing its loan cap system from one that is relative to the value of the real collateral to one that is relative to the value of the property purchased. Finland should also evaluate whether deviations to the loan cap limitation should be allowed for a specifically defined proportion of new housing loans granted. This would make the practical implementation of the loan cap easier and improve the limit's effect as a macroprudential tool.

Sweden and Norway have also introduced requirements on the repayment of new housing loans. In Sweden, the government approved in November 2017 Finansinspektionen's proposal that these requirements be made tighter in cases where the loan amount is high in proportion to income.[14] The new requirement is due to enter into force in March 2018. Denmark has issued guidelines on new lending that vary from region to region and are based on the loan amount in proportion to the borrower's income.

In Finland, housing loans have traditionally been repaid more quickly than in other Nordic countries. In order to maintain stability on the housing market and prevent overindebtedness, Finland should maintain this practice. Long repayment periods should be avoided, as should long interest-only periods granted without a special reason.

The macroprudential tools available in Finland should be supplemented with tools that can limit the amount of a housing loan or the maximum debt-servicing costs in relation to income. The IMF, ESRB and ECB have recommended that these demand-side tools be added to Finland's macroprudential toolbox. A maximum maturity for housing loans and an amortisation requirement would supplement these tools.

Tools targeted at lending should apply to all credit regardless of who is providing it, in order to prevent an incentive to incur debt outside the banking sector. The loan cap should also be developed to apply to all providers of housing loans. Comprehensive application of such limitations may become more important in the future if providers of credit outside the banking sector increase their share of the housing loan and other loan markets. One of the objectives of developing such tools is to ensure that the regulation and competitive environment is uniform for everyone operating on the same market.

Finnish housing market divided in a number of ways

The recession of 2009 and the 2010s can still be felt on the Finnish housing market. The sale of old-stock housing is still quieter than the average since the turn of the millennium. On the other hand, sales of new dwellings have grown rapidly as a result of an increase in housing construction,

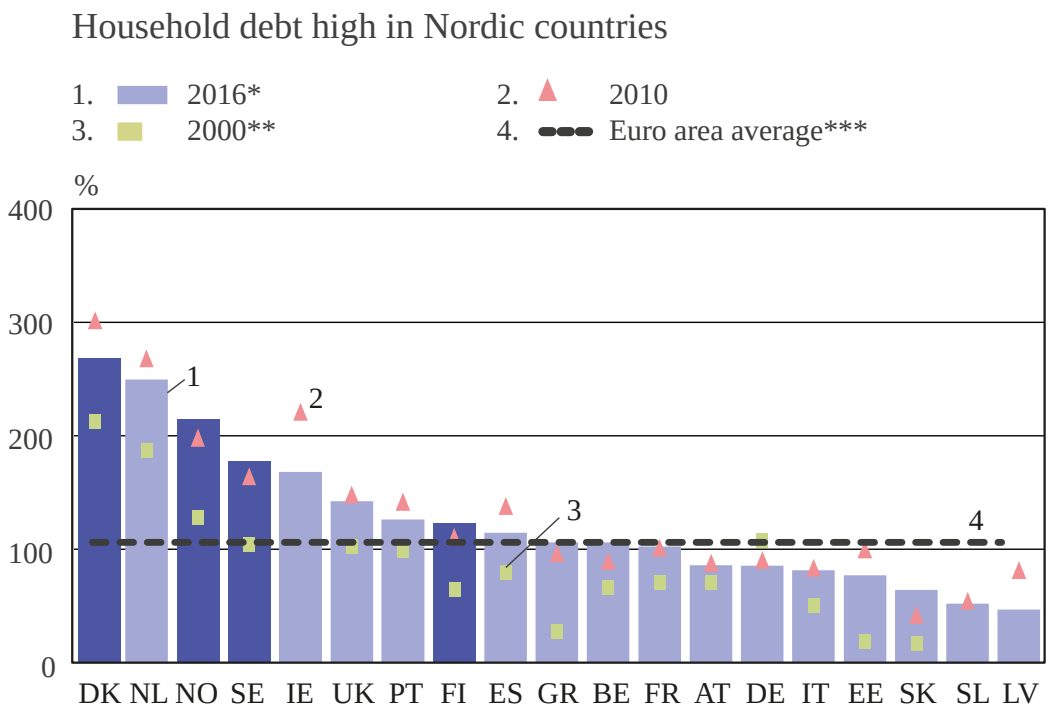
and are exceptionally brisk at the moment.

Residential investment began to grow in late 2015, becoming one of the engines for economic growth since then. During the past 12 months, residential investment has accounted for a higher percentage of GDP than the average in the new millennium. Construction of blocks of flats, in particular, has increased.[15] Repair construction has also increased, as the housing stock is ageing, and demand for such work will continue in the coming decades regardless of economic cycles.

The real prices of dwellings in housing companies are on average lower across the country as a whole than at their highest point in 2010. In proportion to rents and wage and salary earnings, house prices are at a long-term average level. In the light of these indicators, there are no signs at the national level of an excessive debt-driven increase or comprehensive overvaluation of house prices.

Average developments in the country as a whole do, however, hide the fact that house prices have diverged in the 2010s on the basis of location, type, size and age, for example. Real house prices in areas with a positive net migration rate have remained the same or increased moderately as a rule, while in areas with a negative net migration rate prices have fallen. House prices have increased most in Helsinki and other major or growing cities, especially in the city centres and with regard to small apartments (Chart 7).

Chart 7.



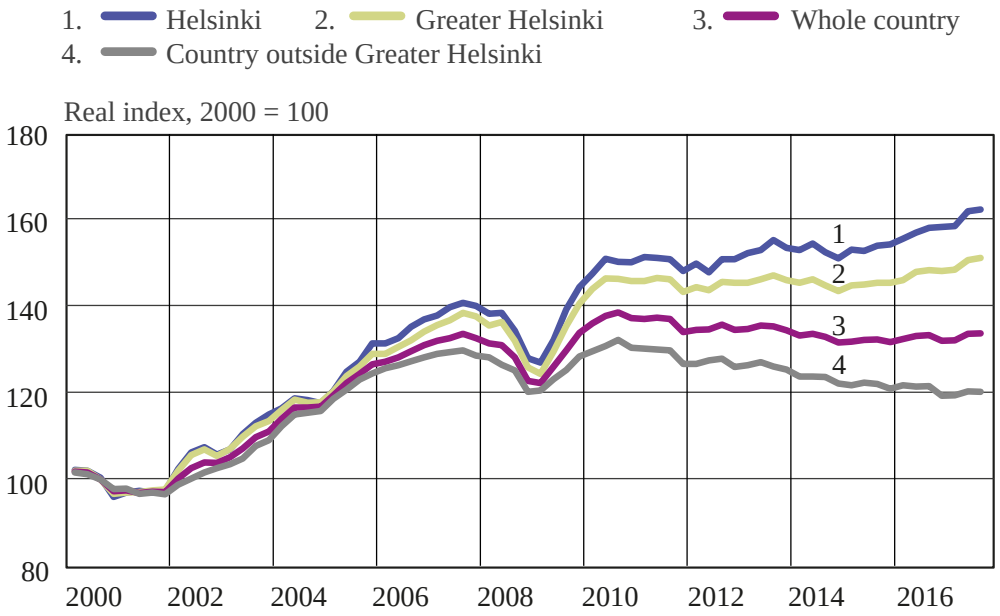
Household debt in proportion to annual disposable income.
*2015 for some of the countries. Nordic countries marked with blue colour.
**Missing for some countries. ***For the 15 euro area countries in the chart.
Sources: OECD, Macrobond and calculations by the Bank of Finland.

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The regional diversification of the housing market can also be seen in the differences in how much debt households have. Housing debt is higher in growth centres, where houses are on average more expensive than elsewhere in Finland. In the Greater Helsinki region, for example, the average housing debt per household in 2016 was about EUR 134,000, while elsewhere in Finland it was about EUR 89,000, with the country average at EUR 97,000. In Greater Helsinki, households with housing debt also have more housing debt in proportion to their disposable income (Chart 8).

Chart 8.

Regional differences in Finnish house prices



Source: Statistics Finland.

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Housing company loans and consumer credit rising steeply

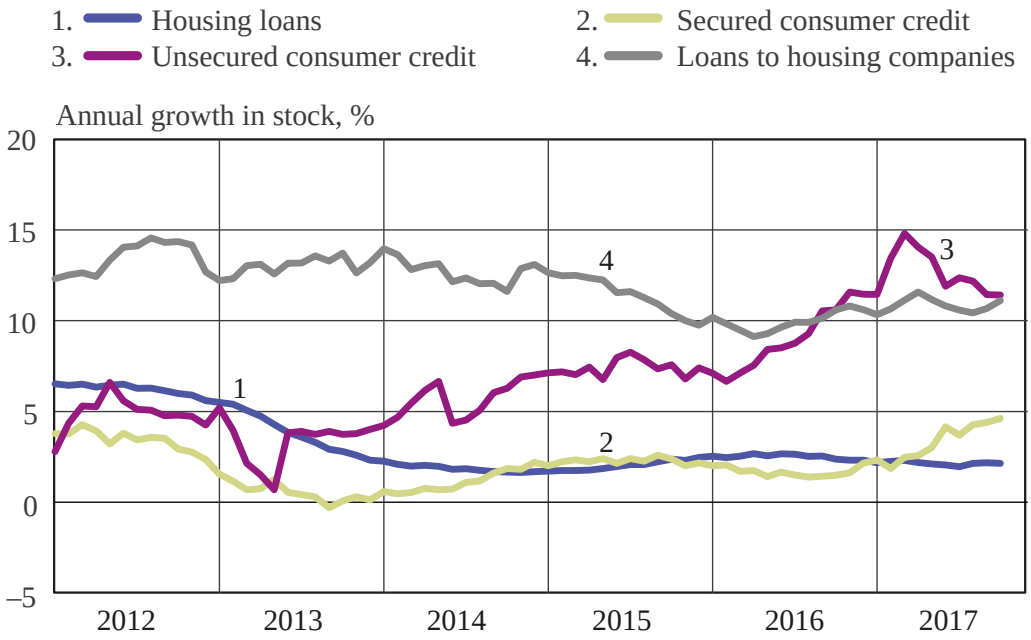
The majority of Finnish households' loans are related to housing, in the form of variable-rate long-term loans. The housing loan stock (EUR 95.8 billion at the end of October 2017) has been growing slowly in recent years, at an annual rate of a little over 2% (Chart 9). However, loans to housing companies have increased considerably. According to Statistics Finland, almost two thirds of the housing company loan stock (EUR 17.6 billion at the end of June 2017) concerns loans to housing companies owned by households, i.e. effectively household debt.

Shareholders in a housing company repay the company loans and loan interest by means of a monthly charge for financial costs. Housing company loan volumes have gone up steeply in the 21st century as a result of both new construction and renovation work. The sales price of new housing is typically much lower than the debt-free price. It is also common with new housing that the shareholder only pays interest on the company loan for the first year or two. When taking on a loan, households must be prepared for higher debt-servicing costs later on.

The consumer credit stock issued by credit institutions has grown in the past 12 months faster than previously, at an annual rate of a little over 5%. At the end of October 2017, the stock of household consumer credit totalled EUR 15.2 billion. Almost a third of this consisted of account overdrafts and card credit. Of other consumer credit, 56% was secured, while the rest had no or limited collateral. Unsecured consumer credit has grown much faster in recent times than secured credit.

Chart 9.

Consumer credit and housing company loans growing rapidly



Euro-denominated loans by credit institutions operating in Finland.
Source: Bank of Finland.

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Household saving has been historically low in the current decade. Since autumn 2014, the net savings rate has actually been negative, meaning that household consumption expenditure has been higher than disposable income. Moderate wage developments have slowed income growth, and households have financed their consumption by taking a loan or realising their assets. Low interest rates and stronger consumer confidence have contributed to debt accumulation and a growth in private consumption.[16] If risks to financial stability related to lending growth should

increase as a result of stronger economic growth and consumer confidence, the authorities are prepared to deploy macroprudential tools to address cyclical risks.

The entry of new providers of credit on the loan market and an increase in payment defaults have led to a suggestion that a positive credit register be set up in Finland. This would provide an overall picture of the level of indebtedness in the country. Such a register would bring together data on all loans taken out by each borrower. Creditors would benefit from the register by being able to make more informed decisions. This would also result in the appropriate pricing of credit depending on the risk level of each borrower, which could in turn prevent overindebtedness. The authorities in turn could use the register to monitor the credit market and apply appropriate regulation.

Digitalisation to change financial sector

Competition from outside the banking sector is putting pressure on banks to change their organisational culture rapidly. For banks, digitalisation means a simultaneous change of strategy, organisation, staff competence requirements and IT systems.

Compared with many of its European competitors, the Finnish banking sector is in a better position to respond to this challenge: banks have already been streamlining their operations for two decades, their basic business is profitable, and they have the financial capacity to make the necessary investments. Extensive use of electronic services in the Nordic countries indicates that both consumers and the infrastructure are reasonably ready for a new kind of digitalised financial services.

The market entry of new players is first manifested in less-regulated services, such as payment and other transaction-based services. These markets will be shared by several players. In contrast, no major changes are likely to occur in the near future in lending. Traditional banks can retain their competitive edge thanks to their competitively priced funding, among other factors. Digitalisation can initially introduce only functional changes into lending, rather than changes in entire business models. The markets are still small for peer-to-peer lending and crowdfunding services.

As the financial system becomes digitalised, authorities and market players must ensure that IT systems are protected against cyber threats. Confidence in the financial system must remain a cornerstone even as digitalisation reshapes the sector.

Digitalised financial services with their new products and operating models will make financial literacy an increasingly important skill. Sufficient financial literacy – promoted through extensive cooperation – across all population groups can help to prevent a range of unpleasant phenomena, such as overindebtedness, that could have major financial and social consequences.

Notes

1. This estimate is based on transferring Nordea's entire balance sheet into the domain of the Finnish banking sector, although the foreign subsidiaries (such as mortgage banks) will not be relocated to Finland. Excluding foreign subsidiaries, Finland's banking system will grow to an estimated 320% relative to the size of the economy. ↑
2. When comparing Charts 1 and 2, the Finnish banking sector appears slightly larger in the former. This is because the data in Chart 1 includes insurance providers owned by banking groups and foreign-owned credit institutions licensed to operate in Finland. ↑
3. The Banking Union's current members are all the Member States in the euro area. ↑
4. Bail-in means that the losses occurred by an ailing bank are first and foremost covered by the bank's own capital, such as by writing down its share value. Furthermore, general creditors (including owners of unsecured bonds) may also lose part, or even all, of their nominal investment, if this is deemed necessary for the implementation of resolution measures. The nominal value of a bank's outstanding debt may also be trimmed or restructured into shares, in an attempt to maintain a sufficiently strong capital adequacy for operations to continue. ↑
5. See macroprudential decisions in Finland http://www.finanssivalvonta.fi/en/Supervision/Macroprudential_supervision/decision_making/Pages/Default.aspx. ↑
6. See Helinä Laakkonen (in Finnish only): https://www.eurojatalous.fi/fi/2017/artikkelit/pitaisiko-rahoitusmarkkinoiden-matalasta-volatiliteetista-huolestua/. ↑
7. The Single Resolution Board (SRB) is the European Banking Union's resolution authority. ↑
8. See Jyrki Haajanen, New European Deposit Insurance Scheme to be introduced soon. Bank of Finland Bulletin 2/2016. ↑
9. Here, the Finnish banking sector refers to Finnish banks and banking groups (excluding branches of foreign banks) and other domestic credit institutions (Municipality Finance, Nordea Mortgage Bank, Nordea Finance, Handelsbanken Finance). ↑
10. Iceland is not included in the assessment. ↑
11. Corporate indebtedness in Finland, access to finance and financing problems are discussed in Eero Savolainen's article Yritysrahoitus pankkikeskeistä mutta monipuolista (in Finnish only). ↑
12. For more detail, see Hanna Putkuri, Risks in long-term and large home loans – Sweden's worry is also ours. Bank of Finland Bulletin 2/2017. ↑
13. See https://www.esrb.europa.eu/national_policy/other/html/index.en.html. ↑
14. http://www.fi.se/en/published/news/2017/proposal-for-a-stricter-amortisation-requirement-for-households-with-high-loan-to-income-ratios/. ↑
15. https://www.eurojatalous.fi/fi/2017/artikkelit/lokakuun-talouskatsaus-talous-kasvaa-laaja-alaisesti-ja-vienti-vetaa/ (in Finnish only). ↑
16. https://www.bofbulletin.fi/en/2017/3/household-savings-historically-low/. ↑

Keywords

banking union, deposit insurance, financial stability, households, indebtedness, macroprudential policy, mortgages