Financial Stability Assessment

# Financial stability assessment: Nordic interconnectedness and indebted households pose a risk to financial stability

Financial stability | 29 May 2017

The Finnish financial system has operated reliably. The probability of serious disruptions related to economic and credit cycles is small in the immediate future. The structural vulnerabilities of the Finnish financial system have, however, increased, against a backdrop of household debt accumulation and changes in the structure of the banking system.



## The European banking system still subject to risks

The global economy is expected to grow at a stable rate, which will support the stability of the international financial system. The increase in investor optimism and risk appetite have contributed to a rise in the share prices of financial institutions (Chart 1) and lowered the risk

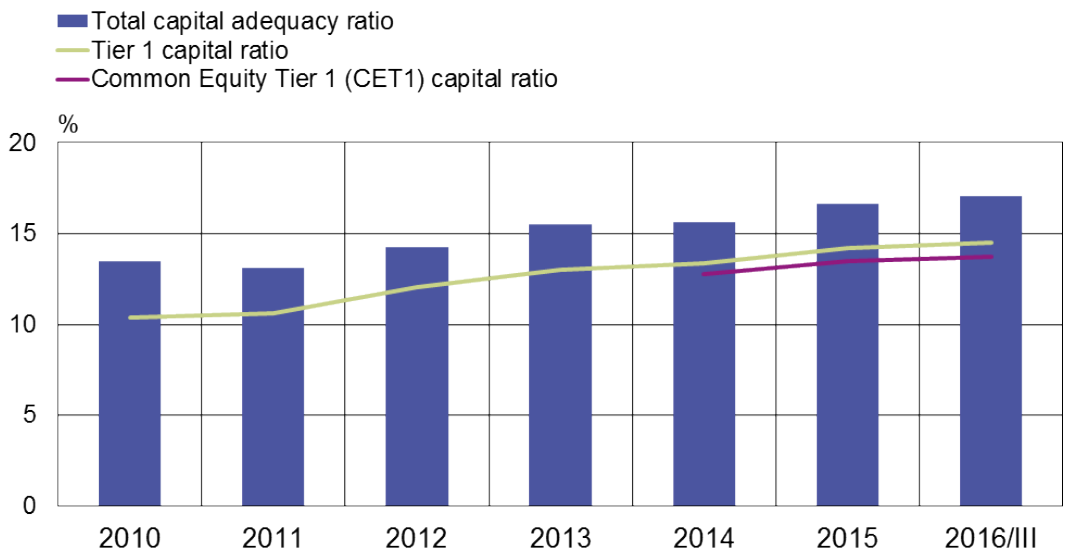
premia on bonds issued by financial institutions.

The forecast for the global economy is, however, subject to significant downside risks. These relate to increased restrictions on global trade, a sharper-than-forecast slowdown in China's debt-led growth and, in certain countries in Europe, the weak condition of the banking sector and public finances.

There is also a risk that investor optimism will turn rapidly into risk aversion in the event of an increase in global economic or geopolitical uncertainty. This could trigger major price changes on the securities markets and push up the cost of market funding for banks, non-financial corporations and governments (see 'Most significant international threats to stability relate to securities markets').

Chart 1.

Capital adequacy of euro area banks has strengthened further




Source: European Central Bank.
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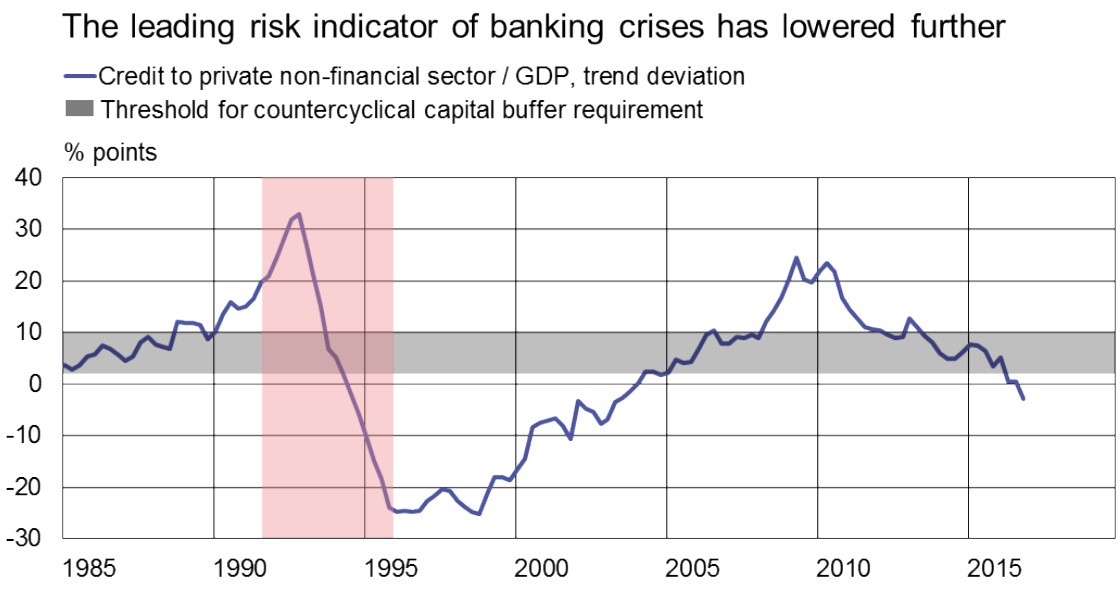
The exceptionally accommodative monetary policy of the European Central Bank has fed through to euro area banks' lending rates in an even broader manner. The average lending rates on new corporate and household loans have decreased in the euro area, and the interest rate spread between the countries that suffered most from the debt crisis and countries with high credit ratings has narrowed. Credit standards have eased, which improves the conditions for euro area economic growth, even though the decline in lending rates has not yet been reflected much in corporate investment.

The pick-up in the global economy and European economies has, however, not eliminated the problems in the European banking system. Data compiled by the European Banking Authority (EBA) show that the average profitability of large European banks is fairly low and continued to weaken in 2016. Banks are burdened by the low level of net interest income, the decline in fee income and, in some countries, overcapacity in the banking sector and a large amount of non-performing loans.

Longer term risks may arise from the as yet unspecified plans put forward by particularly the US administration to roll back financial regulation. Easing back on bank regulation and a weakening of global regulatory cooperation could in the short term decrease the costs for financial institutions, but in the longer term would increase the threat of financial crises.

The resilience of the European and euro area banking system has been enhanced considerably in recent years. Banks' average capital ratios have increased further (Chart 2) and banks have built up their liquidity buffers as a protection against liquidity crises. Moreover, a growing share of bank funding is accounted for by deposits and long-term bonds, which do not dry up as easily as short-term market funding in a market disruption. The Banking Union, which was launched in 2014, has strengthened and harmonised banking supervision and crisis management in the euro area.

Chart 2.




Sources: Bank for International Settlements (BIS), Statistics Finland and calculations by the Bank of Finland.
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The integration of the Nordic banking system increases the risk of cross-border spillover of

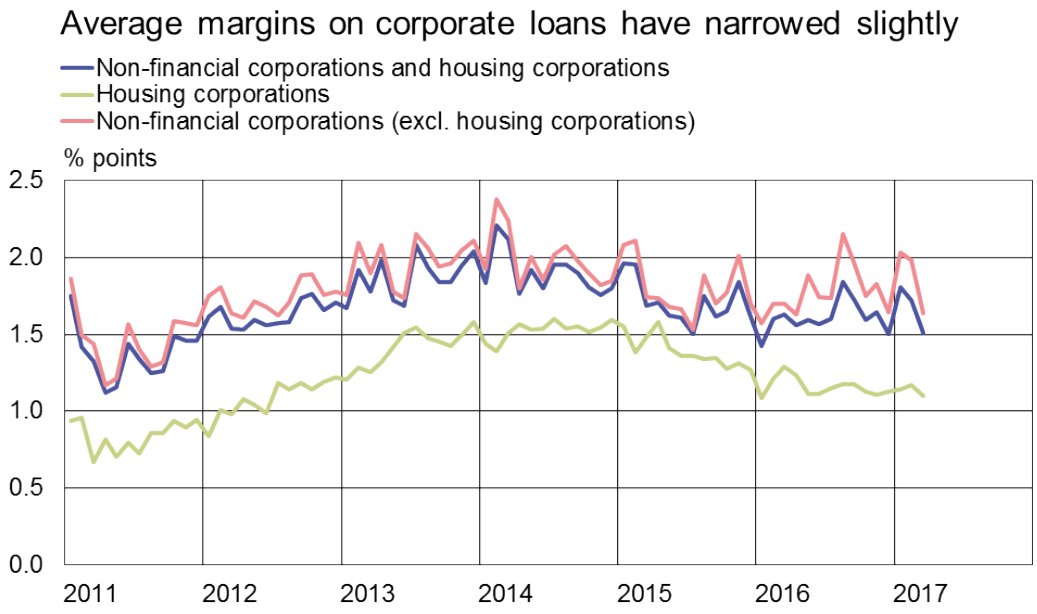
banking crises and other serious problems of financial institutions. Developments in the other Nordic economies and financial systems are therefore even more important for Finland than before.

The Nordic banking and financial systems are currently in a good condition, but there are significant structural vulnerabilities. The vulnerabilities of the Nordic banking sector are its large size, degree of concentration, interconnectedness and the major role of home loans in the financial system, and also the banks' dependence on international market funding.

Nordic households have a considerable amount of debt relative to their income. There are, however, considerable differences between countries in terms of household debt, due, among other things, to differences in mortgage repayment practices.

Uneven economic growth is also reflected in a divergence in housing market cycles. There have been signs of overheating on the housing market in Sweden and Norway, for example, where house prices have in recent years risen strongly in real terms (Chart 3).

Chart 3.




Source: Calculations by the Bank of Finland.
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## Cyclical risks to financial stability in Finland are small

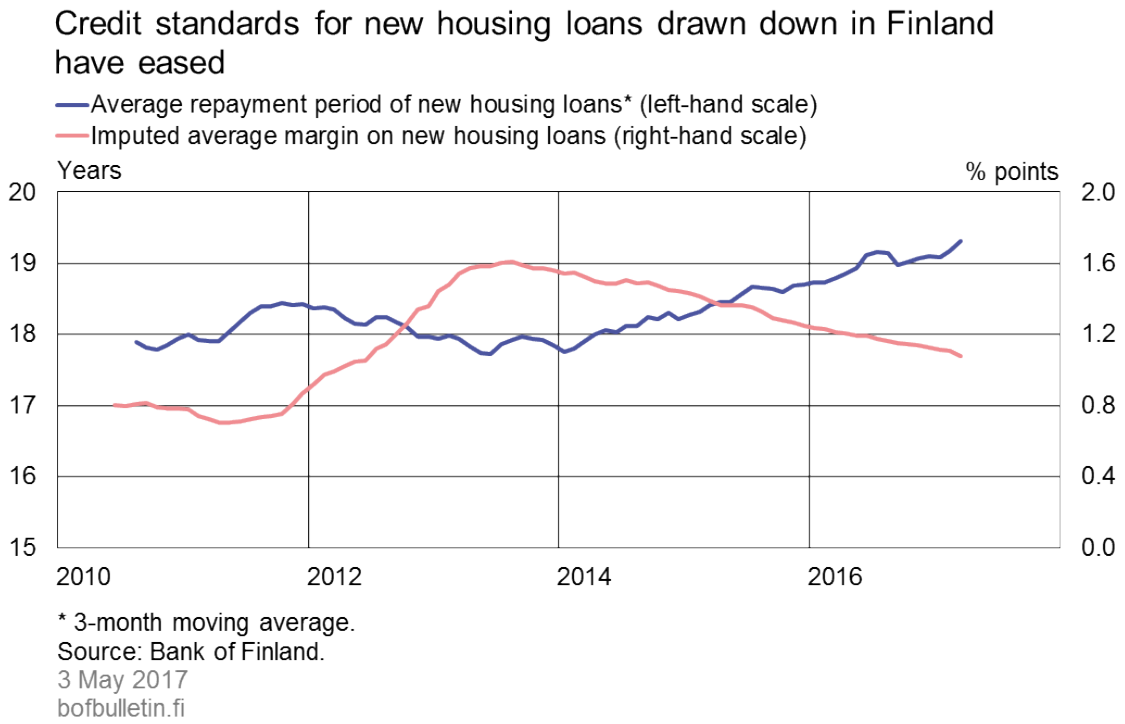
The Finnish economy has finally left behind the protracted downturn. The downside of a pick-up in

economic growth has often been that stability risks associated with growth in lending have increased.

The near-term stability risks relating to Finnish economic and credit cycles are still assessed as small. In their macroprudential analyses, the Bank of Finland and the Financial Supervisory Authority (FIN-FSA) monitor developments in leading risk indicators. These indicators suggest that the probability of serious disruptions in the financial system is small in the near term.

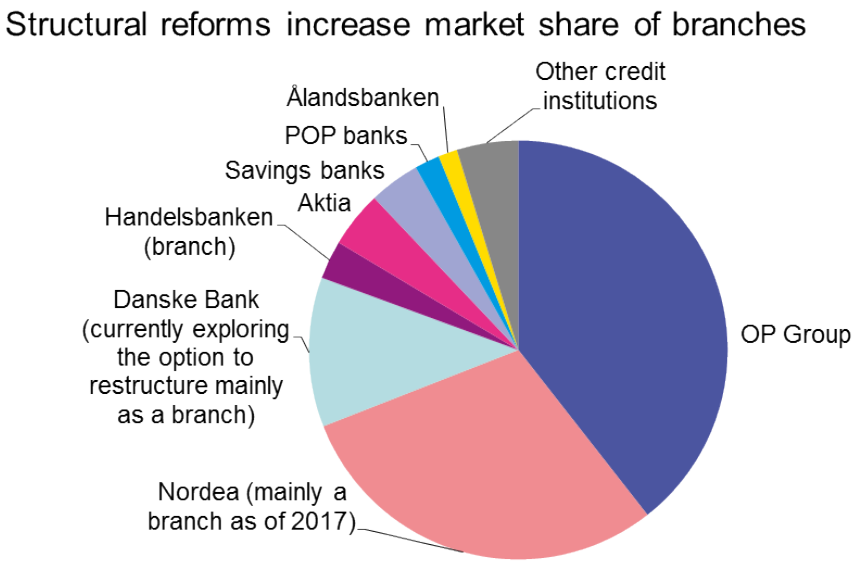
The trend deviation of the ratio of private sector credit to GDP (credit-to-GDP gap) is internationally the most observed leading indicator of banking crises. The value of the credit-to-GDP gap is currently lower than normal in Finland (Chart 4).

Chart 4.




House prices have continued to develop moderately in Finland, but price differences between the Helsinki metropolitan area and the rest of the country have increased. House prices relative to wage and salary earnings are close to the long-term average (Chart 5). The annual growth rate in lending for house purchase was at the beginning of 2017 around 2%.

Chart 5.




Finnish MFIs' market shares of lending for house purchase at the end of 2016.
Sources: Federation of Finnish Financial Services and housing loan data made available to it by the Bank of Finland.
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## Mixed signals on corporations' access to finance

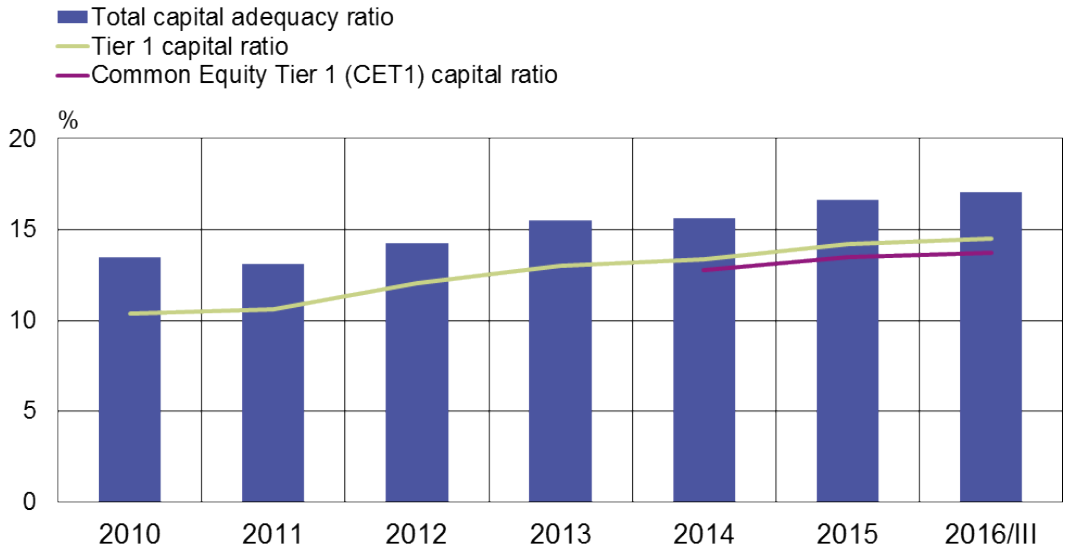
Small and medium-sized enterprises (SMEs) are important employers in Finland. Young SMEs, in particular, are significant in creating jobs.

From the perspective of economic growth, it is important that weak access to finance does not prevent companies from growing and creating jobs. From the perspective of financial stability, in turn, it is important that access to finance does not fluctuate strongly with economic cycles and that the price of finance corresponds to the risks taken.

Access to finance for SMEs in Finland has remained good, on average, relative to recent years' weak economic developments, and better than the euro area on average.[1] Average margins on new bank loans to non-financial corporations have fluctuated around 2% (Chart 6). The stock of banks' corporate loans has also grown at a reasonable pace relative to economic developments.

Chart 6.

Capital adequacy of euro area banks has strengthened further




Source: European Central Bank.
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Corporate surveys show, however, that a relatively high share of SMEs have had difficulties in accessing finance.[2] Collateral requirements on bank loans have tightened in all euro area countries in the years since the global financial crisis, including Finland. On the other hand, this tightening has recently been flattening out.

Banks' lending capacity has been strengthened in recent years by capital adequacy regulation. Tighter regulation has somewhat tightened banks' corporate lending standards. Crisis experiences show, however, that only solvent and strong banks can offer the corporate and other economic sectors sufficient funding even under difficult economic conditions.

## Effects of indebtedness revealed in crisis situations

Due to its structural vulnerabilities, the Finnish credit institutions sector is permanently exposed to risks from lending and funding. The structural vulnerabilities of the sector include the high volume of lending for house purchase relative to credit institutions' own funds and other lending, and credit institutions' dependence on international wholesale funding that is partly collateralised by home loan mortgages.

Because of the concentration and interconnectedness of the credit institutions sector, financial stability shocks could have particularly serious implications for Finland. Systemic risks associated

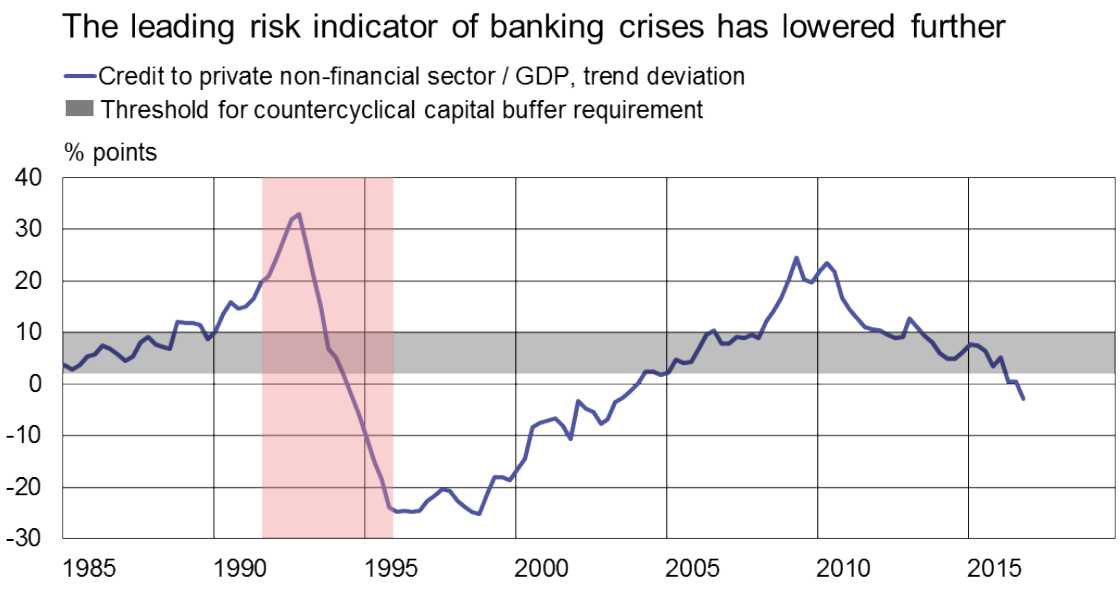
with lending could, if materialised, disrupt financial intermediation and economic growth in the event of e.g. growth in credit losses, difficulties in funding by credit institutions and a shrinkage in lending. This would reduce private consumption and investment.

The European Systemic Risk Board (ESRB) warned Finland in the latter part of 2016 about the high level of household indebtedness and the associated medium-term risks. Finnish household indebtedness relative to income is at a record high. This debt has been accumulating for a prolonged period; it is primarily tied to variable interest rates, and mortgage-related debt is strongly concentrated on particular households (see 'Risks in long-term and large loans – Sweden's worry is also ours').

Excessive household indebtedness has historically been one of the key factors underlying financial and economic crises. High debt accumulation increases households' tendency to reduce consumption in a situation of weaker-than-expected economic developments. Moreover, households that are strongly indebted relative to income are particularly vulnerable to higher interest rates and income losses, such as unemployment. Households that are strongly indebted relative to their assets, in turn, are vulnerable to falling house prices.

The moderation of household debt accumulation in the 2010s has been positive for financial stability. At the end of 2016, household debt relative to annual disposable income – the debt to income (DTI) ratio – was 126.9%, compared with 124.5% a year earlier (Chart 7). Debt and the related risks are, however, very unevenly distributed among households. Slightly over half of households have debt granted by financial institutions. Half of this debt is borne by households that have debt over three times their annual disposable income, i.e. whose DTI ratio is over 300%. These households account for about 10% of all households and one fifth of indebted households.

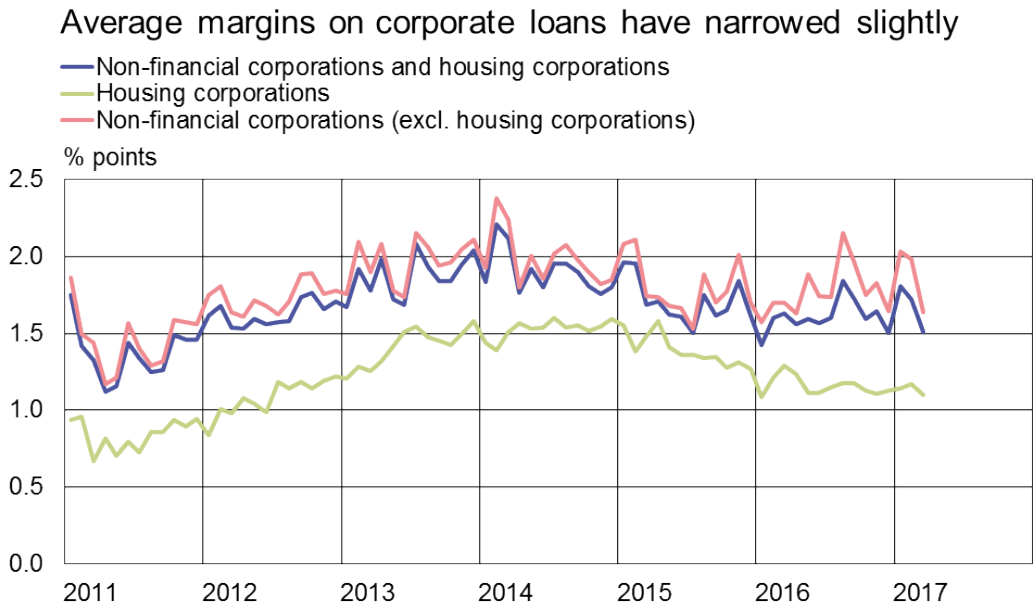
Chart 7.




Sources: Bank for International Settlements (BIS), Statistics Finland and calculations by the Bank of Finland.
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Average maturities of new housing loans have lengthened slightly in recent years. The average margins have, in turn, contracted (Chart 8). Longer maturities and narrower margins can encourage households to take out larger loans (see 'Risks in long-term and large housing loans – Sweden's worry is also ours'). Further lengthening of loan maturities is not welcome from the perspective of the stability of housing markets.

Chart 8.




Source: Calculations by the Bank of Finland.
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Regular and (compared with other Nordic countries) rapid amortisation of housing loans should continue in Finland. Loan amortisation is particularly important at the beginning of the loan term. This way households with mortgage debt can increase their financial margin and housing equity buffer for protection against increasing interest rates or falling house prices.

Annual interest expenses on home mortgages are exceptionally low at present. However, households also have various forms of short-term consumer credit with higher interest rates that are in part not covered by regulation and statistics. Difficulties in servicing these debts have contributed to increasing payment defaults. Establishment of a positive credit register would help in obtaining a more comprehensive overall picture of the level and quality of household debt (see 'The overall picture of debt accumulation gets blurred as provision of consumer credit becomes diversified').

## Stable financing conditions benefit the economy at large

The European Systemic Risk Board (ESRB) and the International Monetary Fund (IMF) have drawn attention to Finnish authorities' insufficient tools to tackle risks from household indebtedness. The ESRB considered the measures taken so far in Finland to mitigate indebtedness-related risks as appropriate but possibly insufficient.

The Finnish authorities do not have access to macroprudential tools implemented in some countries, the primary purpose of which is to ensure the loan applicant's sufficient repayment capacity of home loans in terms of income. These tools include an income-linked loan cap, maximum mortgage maturity and an amortisation requirement.

The measures highlighted by the ESRB and the IMF would complement the current Finnish macroprudential toolkit and help maintain traditional and well-established lending practices. Prevention of housing price bubbles and the bursting thereof is in the interests of current and future households with mortgage debt, home owners and the economy at large.

The Bank of Finland and the Financial Supervisory Authority agree with the ESRB's view on the risks from household indebtedness. The authorities have long emphasized the need to diversify and supplement the tools to tackle, when necessary, growth in risks and vulnerabilities threatening financial stability.

The Finnish Ministry of Finance emphasized in its response to the ESRB that the warning on risks relating to household indebtedness is taken seriously. The Government and authorities continue to monitor the situation and stand ready to take additional measures.

In addition to the mandatory macroprudential tools based on EU legislation, it is also possible to include other discretionary macroprudential tools in national legislation. The Ministry of Finance is currently drafting legislation to enable an additional capital requirement – the systemic risk buffer – on credit institutions on the basis of structural vulnerabilities in the credit institutions sector. The systemic risk buffer is already in use in some other countries.

A maximum loan-to-value ratio relative to the collateral provided for the loan – the loan cap – is based on Finnish national legislation and was effected in July 2016. The purpose of the loan cap is to ensure the appropriate size of home loans relative to assets used as loan collateral and to the fair value of institutional guarantees.

However, the collateral-linked loan cap for new home loans is insufficient on its own to prevent household over-indebtedness, nor is the aim of mitigating overheating of the housing market realised optimally. Application of the current loan cap provisions would barely help in dampening a hazardous spiral in which sharp rises in house prices and collateral values leads to households taking out increasingly larger home loans (see 'How can we dampen the build-up of house price bubbles?').

## Strong banking sector bolsters economic recovery

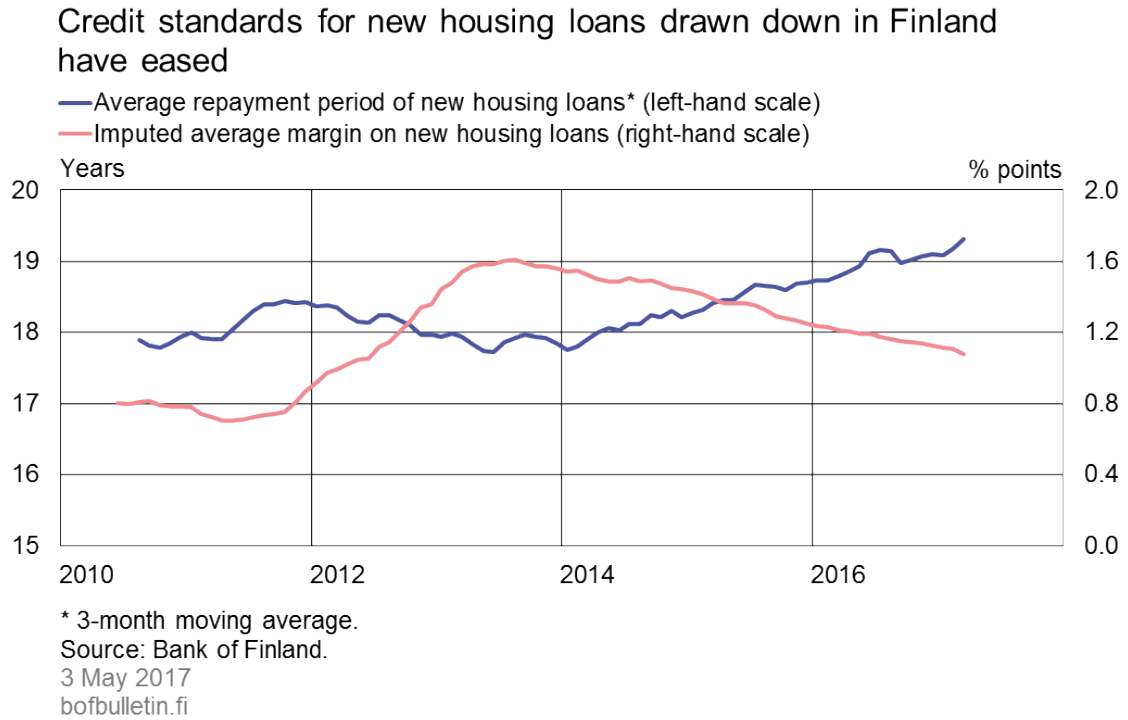
Capital adequacy in the Finnish banking sector has remained strong in recent years. The total

capital ratio for the banking sector, measured as a ratio of own funds to calculated total risk exposure, stood at 23.9% at the end of 2016, against 23.1% a year earlier (Chart 9). The Common Equity Tier 1 (CET1) ratio calculated on capital of the highest quality was 21.7% (against 21.0% a year earlier).

The improvement in capital adequacy was related to both retained earnings and new capital acquisition, which both also strengthened the leverage ratio, i.e. the ratio of own funds to balance sheet assets.

However, capital ratios for the domestic banking sector will change during the course of 2017. In February 2017, OP Group published information on the European Central Bank's (ECB) decision to increase risk weights on the Group's retail exposures for a fixed term of 18 months. In addition, the restructuring of Nordea Group is expected to cause a deterioration in the average capital ratios reported by the Finnish banking sector, as compared with the levels in 2016.[3]

Chart 9.




At the end of 2016, average capital adequacy in the Finnish banking sector fulfilled the total minimum Common Equity Tier 1 (CET1) requirements of 7–9% for credit institutions, by a clear margin. Credit institutions must maintain a minimum CET1 ratio of 4.5%, a capital conservation buffer of 2.5%, and an institution-specific additional capital buffer of 0–2% based on the systemic importance of the institution for the national financial system (O-SII buffer). For some banks,

capital requirements are higher due to countercyclical capital buffers set by other countries for exposures to these countries.

As well as the additional capital requirements set for macroprudential reasons, institution-specific capital requirements may also be set for credit institutions based on the Supervisory Review and Evaluation Process (SREP).

In December 2015, the FIN-FSA Board stated that the mortgage loan risk weights of credit institutions using the Internal Ratings Based (IRB) Approach to calculate capital requirements are low, given the estimates of unexpected loan losses suffered in several consecutive years in a potential crisis. In March 2017, the Board decided to make preparations for setting a minimum risk weight of 15% for those credit institutions that have adopted the IRB Approach for the calculation of capital requirements for residential mortgage loans. The minimum level applies to the average risk weight on a credit institution's residential mortgage loan portfolio, and the aim is to have the minimum risk weight in force as from 1 January 2018.

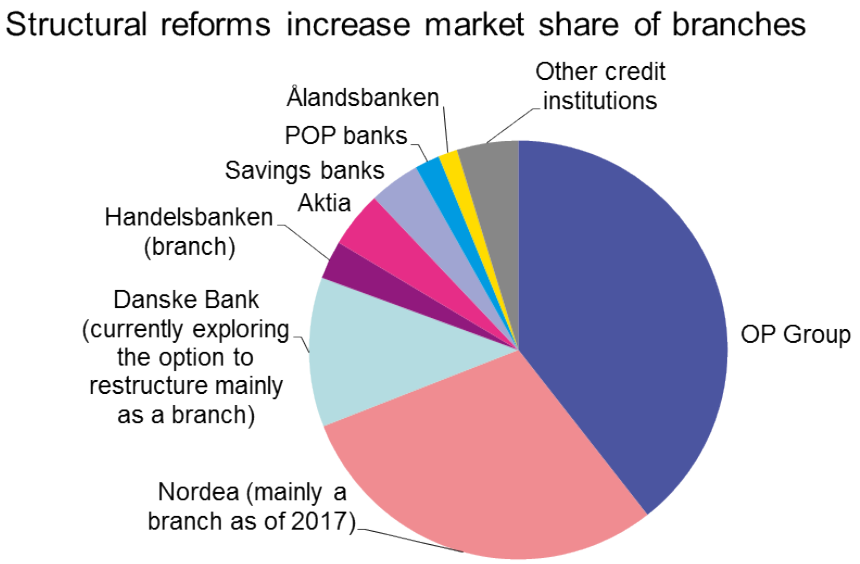
Strong capital adequacy and good asset quality in the banking sector have contributed to maintaining well-functioning financial intermediation in Finland. Although the low level of interest rates and rising expenses have weighed on banks' earnings, the profitability of banking has, nevertheless, remained rather good in international comparison. The share of nonperforming assets in the credit stock was still very low, at 1.6%, at the end of 2016.

## Stronger interconnectedness and changes in supervisory responsibilities as banks rethink corporate structures

The conversion of Nordea Bank Finland from a Finnish subsidiary into a branch of the Swedish parent company at the beginning of 2017 designates a significant change in the Finnish financial system. The unveiling of similar restructuring plans by Danske Bank serves to reinforce this trend.

Following such changes, banking groups that operate mainly through branches in Finland would hold an estimated market share in excess of 40% of household mortgage loans, other household and corporate loans, and deposits (Chart 10). A combined market share for branches as large as this is highly exceptional in an EU country.[4]

Chart 10.




Finnish MFIs' market shares of lending for house purchase at the end of 2016.
Sources: Federation of Finnish Financial Services and housing loan data made available to it by the Bank of Finland.
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Reforms of banks' corporate structures do not, as such, present a threat to the stability of the financial system, but the resulting stronger interconnectedness between the Nordic countries will facilitate more direct spillover of potential problems across the countries.

The volume of credit supplied in one country by banks operating through branches is highly dependent on their business in other countries, as banks tend to optimise capital use and lending at the group level. Not only crises but also, for example, changes in regulatory frameworks or macroprudential policy in one country may have an impact on lending elsewhere (see 'Finland, the land of branches – the landscape of the Nordic banking sector').[5]

In March 2017, Nordea's management announced that they were contemplating a move of their head office away from Sweden. Nordea is the only Nordic bank designated as a Global Systemically Important Institution (G-SII). A relocation of Nordea's head office to Finland would make it subject to the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) of the Banking Union. Transfer of supervisory responsibility for Nordea to the ECB would increase the number of significant banks operating in Finland supervised by the SSM according to agreed harmonised criteria.

Such relocation would lead to a considerable expansion of the size of the Finnish banking sector relative to GDP. Provision should be made for an increase in the structural risks related to the

expansion of the sector. The Nordic interconnectedness of the banking sector will, in any case, remain crucial and require close cooperation between the authorities responsible for banking and macroprudential supervision.

The Nordic authorities have already enhanced mutual cooperation and the preconditions for financial stability by entering into Memoranda of Understanding on the supervision of systemically important branches and on other cross-border operations.

The European regulatory framework does not adequately cater for the information needs of host country supervisors of systemically important branches, or the information sharing needs of the different supervisory authorities. Consequently, the framework should be reformed in this respect so as to better address the needs of host country supervisors. Furthermore, supervisors of branches also do not participate in group-level decisions on the consolidated supervision of a banking group, although such decisions have major implications for the stability of the host country's financial markets.

The third pillar of Banking Union, the European Deposit Insurance Scheme (EDIS), currently under construction, would also serve to promote financial stability. However, before migration to EDIS can take place, a sufficient asset quality of the participating banks must be ascertained and their capital adequacy tested.

## Insurance companies and earnings-related pension providers financially solid

Finnish life and non-life insurance companies have remained financially solid, fulfilling the new solvency requirements introduced at the beginning of 2016, by a clear margin.[6] Solvency has been underpinned by investment income, while the asset allocation shows no signs of a search for higher yield.

In the stress tests carried out on insurance companies in 2016, the solvency of the Finnish insurance sector withstood the two adverse scenarios employed. The low level of interest rates weighs much less on Finnish life insurers than on their EU counterparts, on average, as more than two-thirds of Finnish technical provisions are unit-linked, with a relatively minor share of technical provisions tied to a given rate of return.

Finnish earnings-related pension providers are also on a stable footing, and earnings-related pension funds were expanded by investment income in 2016. The amendments introduced at the beginning of 2017 improved the prospects of individual pension providers to take on more equity risk. Higher equity weights increase the volatility of investment income. Against the background

that investment risks are increasingly diversified across the earnings-related pension scheme as a whole, it is important to assess the build-up of risks in the earnings-related pension sector overall.

## Smooth functioning of infrastructure must be ensured nationally

The proper functioning of payment systems and securities clearing and settlement systems is a precondition for the stability of the financial system. This financial market infrastructure has functioned reliably.

Developments in recent years have made Finland dependent on many international systems. This calls for better national preparedness for situations where international data communications or systems are unavailable (see 'Payments must operate smoothly under all circumstances').

The digitalisation of financial services is also reshaping the payments scene and payment behaviour. Payments are becoming increasingly real time, while payment execution is getting easier and less visible. The emergence of new methods of payment further underscores the importance of consumers' financial literacy: running out of banknotes and coins in the wallet does not serve as a budget constraint, which increases the chances of living beyond one's means (see 'Payments becoming increasingly real time and less visible').

## Financial stability policy gathers no moss

The winds of change are not blowing in Finland or the Nordic countries alone. The UK's withdrawal from the EU, or Brexit, will have implications for the European financial markets in the immediate years ahead as the UK-based financial corporations that face exclusion from the EU reorganise their operations.

At this juncture, common European regulation, harmonized supervision and comprehensive coverage of macroprudential policy and tools are becoming increasingly relevant (see 'EU macroprudential policy lays emphasis on residential mortgage loans and the banking sector's structural risks'). EU Member States seeking a competitive edge with lighter regulation and supervision would jeopardise the premise of financial stability and a level playing field on the EU financial markets.

Regulatory and supervisory coverage of credit institutions should be commensurate with the scope of the institution's business and its significance for financial stability. It would be justified to consider granting minor, less significant credit institutions some concessions, for example from reporting requirements.

An important objective of the EU's Capital Markets Union is to diversify the funding sources available to businesses and, thereby, bolster investment and economic growth (see 'Capital Markets Union supports economic growth and employment'). Growth in non-bank financial intermediation must be closely monitored to identify any emerging new vulnerabilities to the financial system.

The macroprudential instruments currently in place can be used mainly to regulate credit institutions' capital requirements and credit standards. Going forward, macroprudential policy and the macroprudential toolkit should be developed so as to ensure that the measures could, where necessary, be applied to key financial functions in terms of stability, such as lending, rather than to an individual group of institutions. This would enable application of macroprudential measures to all the providers of the service in question, whether credit institutions or other service providers.

Regulation and supervision must keep pace with the changes occurring in the financial system. This is best ensured when reforms of legislation and macroprudential policy continue to be guided by practical experience and based on regular reviews and global cooperation.

## Notes

1. See The European Central Bank's biannual survey on the access to finance of euro area enterprises. ↑
2. Pk-yritysbarometri 1/2017 ('The SME barometer 1/2017') of the Federation of Finnish Enterprises, Finnvera and the Ministry of Employment and the Economy [in Finnish only]. ↑
3. Financial Supervisory Authority (2017) Financial position and risks of supervised entities 1/2017. ↑
4. See ESRB, p 54, Figure B. 3. ↑
5. See also Conversion of Nordea subsidiaries into branches – Nordic interconnectedness increases. ↑

## Keywords

financial stability, macroprudential policy, macroprudential stability, systemic risks, threats to financial stability