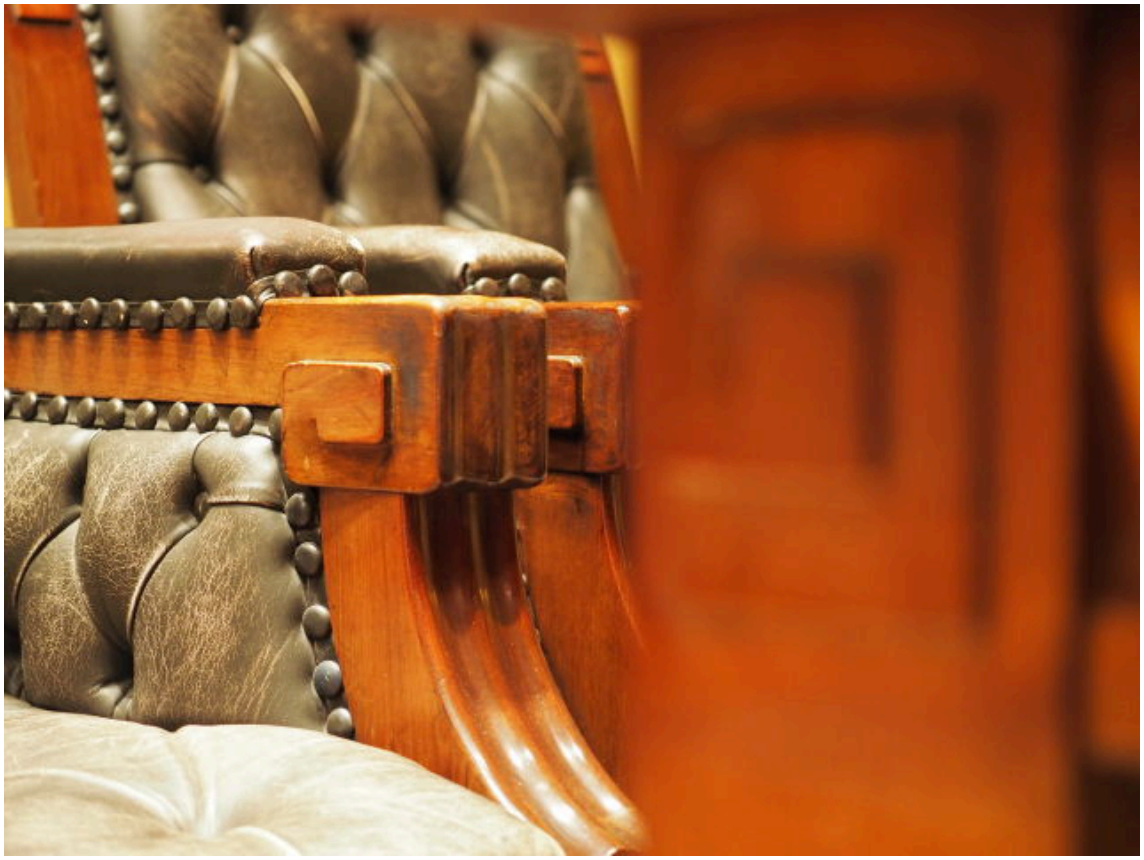
Editorial

Editorial: Exceptional condition of economy and financial markets poses unforeseen risks

Financial stability | 21 May 2015

Finland's financial markets are, on the whole, stable. Nevertheless, the concentrated nature of the banking system, the accumulation of housing debt and an environment of low interest rates expose the economy and the financial system to potential problems. Moreover, the exceptional economic and financial market situation brings new, unforeseen risks in addition to the already identified vulnerabilities. This requires particular vigilance from economic policy-makers and other authorities.



The stability of the financial system is essential to supporting the balanced development of the economy as a whole. At the same time, healthy competition is a basic requirement of an efficient financial system.

In assessing financial system vulnerabilities we must review particularly the operations of both the domestic banking and insurance sector and payment and settlement systems. Their resilience to risk is the guarantor of financial stability.

The financial crisis taught us that we must improve financial sector regulation, supervision and crisis resolution procedures. The European Union and its Member States have made substantial progress in line with international initiatives: Banking Union has been established and includes the Single Supervisory Mechanism, Single Resolution Mechanism and increasingly uniform requirements.

As financial sector regulation increases, it is vital to ensure that

- competition and useful innovations are not restricted, and a broad range of ways for financial intermediation is supported;
- regulation outside the Banking Union is also harmonised;
- regulations designed for financial institutions engaging in large-scale, complex activities can be applied in less restrictive form to companies involved in smaller-scale, low-risk activities.

New tools have been provided to safeguard stability. In addition to fiscal and monetary policy, there is now a new segment of economic policy: macroprudential policy. Within the Banking Union, responsibility for macroprudential policy has been divided between national authorities and the level of the euro area as a whole. This will make it easier to take account of international impacts and treat national financial markets in a uniform manner.

Although, since the financial crisis, financial market turbulence has gradually receded, the exceptional situation currently prevailing in the global economy and on global financial markets has taken us into uncharted waters. In addition to previously observed risks, there are now new, unforeseen risks and uncertainties. Hence economic decision-makers and other authorities must be vigilant in addressing the potential vulnerabilities.

Finland's financial system is still operationally strong, despite the difficult state of the economy. The weak economic developments increase the risks to the entire financial sector. The abundant liquidity is finding its way into financial assets due to the scarcity of fixed investment. The prolonged low interest rates tend to encourage search for yield both by increased risk-taking in existing operations and through new products and operations.

The Finnish banking system is profitable, with strong capital adequacy, but it is structurally vulnerable. The banking sector is exceptionally concentrated. It is also highly dependent on market funding from abroad. It is notable that the sector is highly interconnected with the banking systems of the other Nordic countries.

Banks operating in Finland have been able to improve their profitability both by cutting costs and by boosting income. Widening interest margins on loans even in times of weak credit demand can be a reflection of reduced competition.

It is essential to ensure competition within the sector in order to provide the benefits of efficient banking operations to the entire economy, the markets and both corporate and individual customers. Hence market entry by new domestic and foreign operators is to be welcomed.

The insurance sector is both profitable and solvent. Nevertheless, occupational pension, life and non-life insurance companies are all facing a difficult environment of low interest rates and slow economic growth. This combination is squeezing companies in the sector to make changes in products, services and business models. The environment of low interest rates is hampering investment activities and raising the current value of liabilities. Although the final effects on profitability and balance sheets will be visible only later, the solvency and investment activities of insurance companies should already be monitored with care.

The payment and settlement systems that underpin the financial markets have increasingly shifted from domestic operators to the care of international entities. The systems have continued to perform well from a Finnish perspective. The vulnerabilities of a digital world, including new cyber risks, require special vigilance from both operators and authorities.

Mortgage lending has grown steadily in recent years. There is, however, concern surrounding the growth of a large debt burden concentrated on a small group of households. These households are vulnerable both to developments in their own finances and in interest rates. Although the prolonged rise in house prices has tailed off, the housing market shows substantial variations regionally. Attention must already be paid to the vulnerabilities now, even though problems will not necessarily come to the surface as long as low interest rates prevail.

Helsinki 20 May 2015

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Keywords

financial stability, macroprudential instruments, macroprudential policy, threats to financial stability