Editorial

Editorial: Financial sector faces no immediate threats, but stability must be protected

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Euro area monetary policy and domestic fiscal and structural policies are supporting Finland's slowly recovering economy. In a weak cyclical environment, there are no signs of acute threats to financial stability. The low level of interest rates has the potential to increase the risk of over-indebtedness and further feed asset prices. This sort of development could add risks to the Finnish financial system and reinforce structural vulnerabilities. Close monitoring is necessary to preserve the stability of the financial markets. Addressing stability threats requires access for the authorities to an adequate set of macroprudential instruments, which must be created in good time.



In recent years, the euro area has witnessed a high degree of monetary accommodation, which

supports the price stability objective of the European Central Bank and economic growth in Monetary Union Member States. In addition, Finland has pursued an expansionary fiscal policy. These measures have underpinned the recovery of the Finnish economy. Nonetheless, Finland's economic situation remains difficult, and bringing the economy onto a sound footing will also require structural reforms.

The weak economic outlook is not providing incentives for corporate fixed investment. Growth-friendly economic policies – in particular, an accommodative monetary policy stance – may lead to excessive credit growth, assets may be channelled into financial investments and asset prices may rise rapidly in such a scenario. In Finland, there are currently no signs of cyclical overheating in asset prices or lending. However, against a backdrop of low interest rates, these risks cannot be ignored.

A precondition for stable economic activity is reliability and efficiency in the functioning of the financial system. Credit institutions must be well capitalised and the financial market infrastructure operationally reliable. Key to the stability of the Finnish financial system is preventing and monitoring a further build-up of vulnerabilities and an increase of risks within banks and the insurance sector as well as securing the smooth functioning of payment and settlement systems.

Financial markets in Finland are more concentrated than in most other euro area countries. Here, a few large financial sector companies hold significant market shares in banking, non-life insurance and earnings-related pension insurance sectors. This makes it necessary to ensure that, in all these sectors, there is a sufficient degree of competition forcing market participants to improve service and product development and enhance productivity. The competitive situation is changing, with the entrance of new financial sector enterprises onto the banking scene, in particular. Banks need to critically review their established business models, as competitors with new approaches and light operational structures seek to tap the same markets, making use of digital services.

The Finnish financial markets are in general undergoing structural change anyway. One of the largest banks is transforming its operations into a branch structure in Finland. This bank will simultaneously move outside single euro area banking supervision. All the consequences of this change are not yet apparent, but it will in any case require closer cooperation between euro area and Nordic authorities. This change reveals a shortcoming of EU legislation in relation to banking supervision. The relevant legal provisions fail to take account of a foreign branch with a highly significant market position and share within a Member State.

The Finnish banking sector is financially sound, and banks have posted record results in recent years, despite the protracted weakness of the economy. Although the loan stock has grown in both

household and corporate loans, the low level of interest rates is eroding banks' net interest income. From the stability perspective, it is also worth noting that large banks raise funding on the international financial markets and also operate actively in other Nordic countries. This interconnectedness could transmit to Finland financial stability risks materialising elsewhere.

The solvency of the Finnish insurance sector is good. The low level of interest rates and the weak economic situation have nevertheless also rendered this operating environment challenging. Earnings-related pension providers and life and non-life insurance companies manage large investment portfolios that provide coverage for future insurance commitments. With declining investment returns, risk appetite could grow – a trend that will require careful monitoring. The insurance sector is closely interlinked with other Nordic countries, and this dimension necessitates comprehensive supervision of the sector in cooperation with Nordic supervisors.

Macroprudential policy is a new segment of economic policy. It supplements fiscal and monetary policies and the supervision of financial institutions, which, by themselves, have been unable to prevent the accumulation of risks in the financial sector in the past. The financial crises of recent years have highlighted the importance of macroprudential policy on a global scale. Macroprudential policy is devised to eliminate the adverse side-effects of the other segments of economic policy and activity, and it focuses on the financial system as a whole. Key macroprudential tools include the capital buffer requirements for financial institutions and various lending restrictions.

In Finland, macroprudential policy and its tools entered into force at the beginning of 2015. Although the Board of the Financial Supervisory Authority is the decision-maker in this regard, macroprudential policy is conducted in close cooperation with other national authorities and the European Central Bank. The financial markets are seamlessly integrated, and it is therefore vital for Finnish authorities to have access to tools similar to those in other countries – notably in Nordic countries and the Baltic States.

The practice of amortizing housing loans has served Finnish households well. Loan repayment is particularly important, as household debt has continued to increase. It protects households in the event of housing prices taking a downward trajectory. This protection can be further supplemented with macroprudential tools related to the adequacy of debt-servicing ability. It is in Finland's own interests that the toolkit for addressing stability risks is put in order in good time. Experiences gained from the 1990s and international financial crises show what happens if such tools are not available. There is no time to complete the toolkit once a situation has already got out of hand.

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