

# FINNISH BANKING IN 2017

Financial overview of Finnish banks

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## 1 Economic environment

### 1.1 Economic development

Finland's GDP grew by 2.8% in 2017, but it is not expected to reach the pre-recession level of 2008 until in 2018. This makes the recovery from the recession the longest in Finland's recent history.

Export growth also went up in 2017, settling at 6.7%. Investments accelerated the growth: their volume increased by 4.0%. Investment growth was particularly rapid in construction and equipment. Private consumption also grew at a rate of 2.0%.

Consumer confidence reached record-high figures, mostly due to improvements in employment. According to national accounts, the employment numbers grew by 29,700 people or 1.2% in 2017, with business services and the construction industry creating the most new jobs. It is possible that the Finnish Government's employment target of 72% will be reached during the current government's term.

Finland's current account balance showed a surplus of €1.4 billion after having shown a deficit for six years in a row. This means that Finland's economy no longer incurs foreign debt.

The favourable economic situation also improved public finances. In 2017, general government deficit decreased to €1.5 billion or 0.7% of the GDP. Moreover, the government debt ratio, i.e. Finland's debt-to-GDP ratio, is expected to fall below 60% next year. Tax revenue grew by 3.6% in 2017, bringing the total tax ratio, i.e. the ratio of tax or tax-like payments to the GDP, to 43.3%. This was down by 0.7% from 2016.

At the moment, the Finnish economy is booming, and economic growth is expected to continue across sectors. The growth rate is, however, expected to slacken slightly in the coming years. The Bank of Finland's growth forecasts for 2018–2020 stand at 2.9%, 2.2% and 1.7% respectively.

### 1.2 Regulatory environment

The regulatory environment was eventful both nationally and internationally. The Finnish Financial Supervisory Authority (FIN-FSA) made several decisions concerning the so-called macroprudential tools. Finland now uses most of the instruments specified in national legislation or EU regulation.

Macroprudential tools include the maximum loan-to-value ratio for housing loans, enforced in July 2016. This loan cap limits a housing loan to a certain percentage of the fair value of collateral at the time the loan is granted. At first, the loan cap was 95% for first-time home

buyers and 90% for others, but a stricter cap of 85% for others was introduced in July 2018. This change is expected to have relatively little effect on lending.

In 2017, the FIN-FSA decided that credit institutions using their own internal ratings-based (IRB) approaches would be set a 15% minimum level for the average risk weight on their mortgage portfolios. The risk weight floor took force in January 2018, bringing banks' capital adequacy ratios slightly down in the first quarter of 2018.

Additional capital buffer requirements for credit institutions that have systemic importance in the domestic financial market (O-SII buffers) took force at the start of 2016. The FIN-FSA originally imposed the additional buffers to four credit institutions: Nordea and OP Financial Group were required to meet additional capital buffers of 2.0%, and Municipality Finance and Danske Bank an additional 0.5%. The criteria for credit institutions that have systemic importance were, however, reassessed when Nordea decided to move its headquarters into Finland. In June 2018, the FIN-FSA Board decided to appoint Nordea a global systematically important institution (G-SII) and require it to meet an additional capital requirement of 1%. The Board also imposed a 2% additional capital requirement on Nordea and OP Group, and a 0.5% additional capital requirement on Municipality Finance due to their national systemic importance. The new G-SII/O-SII criteria will enter into force on 1 January 2019.

In 2017, national legislation was prepared to enable the introduction of the systemic risk buffer in Finland. The systemic risk buffer is an additional capital requirement determined on the basis of the financial system's structural characteristics, and it is based on the EU Capital Requirements Directive (CRD IV). A structural risk may entail, for example, housing loans forming a large part of banks' total lending or banks being significantly dependent on market funding. The requirement will take force on 1 July 2019 at the following rates: Nordea 3.0%, OP Group 2.0%, Municipality Finance 1.5% and other Finnish credit institutions 1.0%. However, the capital requirement will not be cumulate with the O-SII/G-SII buffer; instead, only the larger one will be imposed.

In addition to the above-mentioned macroprudential instruments, the FIN-FSA can impose a variable additional capital requirement, i.e. a countercyclical capital buffer (CCB). The CCB can be imposed if the cyclical risks in the growth or number of lending are deemed large. The requirement is currently at 0%, and it can reach a maximum of 2.5%.

The basis of these measures is either in Finnish legislation (loan cap) or in the EU Directives (CRD IV / CRR). For a few years now, EU authorities have prepared updates to both (CRD V / CRR II). This project is also known as the Risk Reduction Package, because its objective is to reduce risks in the banking sector so as to enable the completion of the Banking Union. According to several member states, implementing the final stage – the European deposit insurance scheme (EDIS) – requires that the banking sector is first restored into good condition. A key matter is solving the non-performing assets in banks'

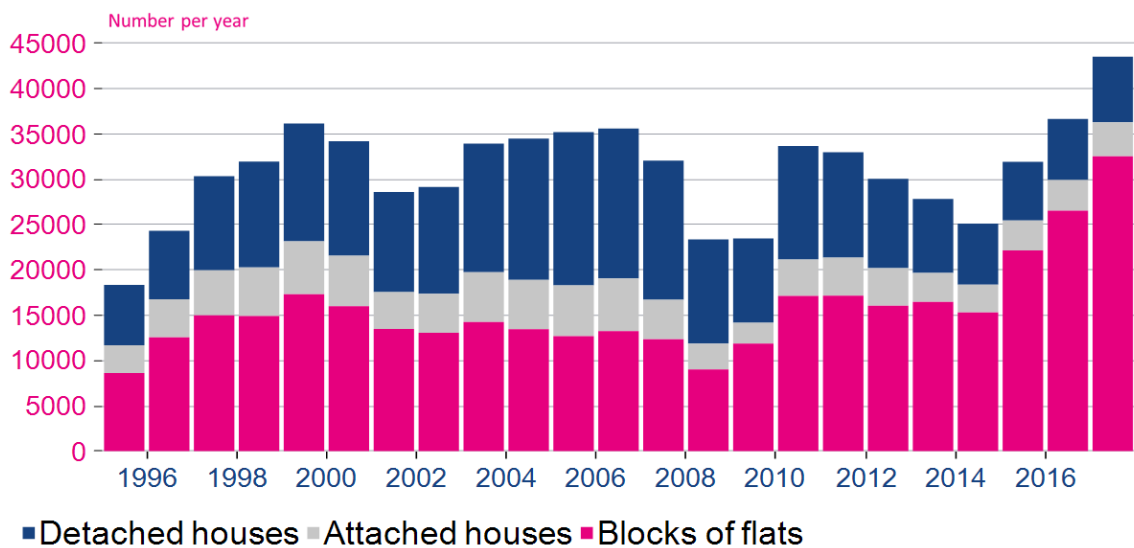
balance sheets. In Southern Europe especially, non-performing assets are at an alarming level, and EU authorities have taken several measures to remedy the situation.

In January 2018, the long-prepared International Financial Reporting Standard IFRS9 entered into force. According to the standard, banks must record impairment losses from credits according to the expected credit loss model. If a credit risk is deemed to have increased significantly, the loan’s expected credit loss must be recorded for its lifetime. According to figures released in early 2018, the effects of these changes on the balance sheets of Finnish banks have remained very moderate.

### 1.3 Housing market

Construction continued to prosper in 2017. In total, 44,773 new dwelling units began to be built, which showed a 20.2% increase from 2016 and reached the highest number in 25 years. In particular, a lot of apartment blocks are being built. In comparison to last year,

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Source: Macrobond/Statistics Finland

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s were completed and 21.1% more building permits were granted.

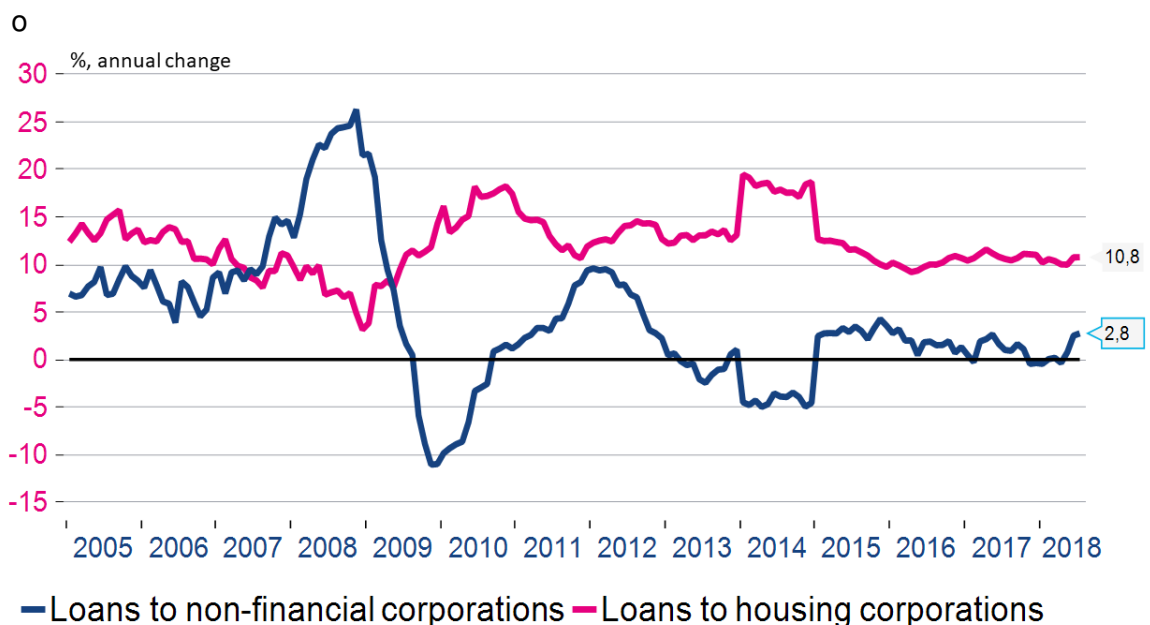
Figure 1. Dwellings being built according to house type

The high number of dwellings being built is directly reflected in the growing loan portfolios of housing corporations. The unique characteristics of the Finnish limited liability housing companies are also reflected in the credit statistics. In other countries, increased construction typically results in the corporate loan portfolio growing. In international statistics, Finland’s housing corporation loans are included in the corporate loan portfolio,

but in national statistics the corporate loans and housing company loans are separate categories.

In general, loans taken out to construct a residential building in Finland are recorded on the established housing company's balance sheet. As a direct result of new construction, the loan portfolio of housing companies grows. The loan portfolio has indeed experienced intensive growth: the annual growth rate has exceeded ten percent for almost a decade now. Other corporate loan portfolios have grown at a much slower pace. In 2014, Statistics Finland reformed its sector classification, expanding the definition of housing corporations and causing some of the corporate loan portfolio to be recorded under the housing corporation loan portfolio. For this reason, loan statistics spike by over €1 billion in early 2014, which is reflected in the annual growth figures. The term housing corporation encompasses all corporation forms of housing units, not just housing companies.

At the end of 2017, the housing corporation loan portfolio was almost €30 billion. Some of this loan is held by households, some by housing investment funds and other housing investors, and some by companies. The exact division of each sector's responsibilities is impossible to measure, but Statistics Finland has estimated that of this sum, households

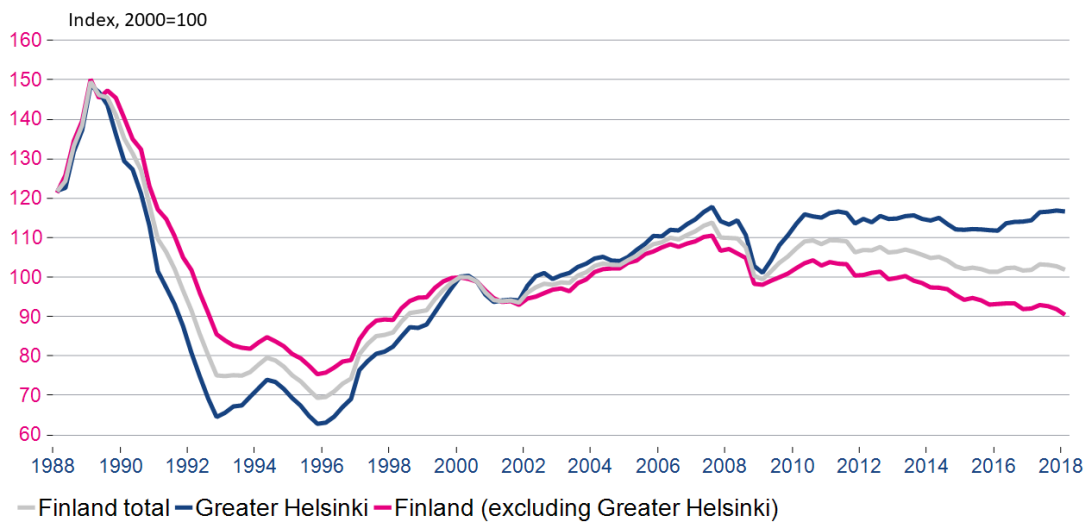


Source: Macrobond/Bank of Finland

9 billion. Chapter 3 looks more closely at household debts.

Figure 2. Corporate and housing corporation loans in Finland

As a result of urbanisation, the housing market continued to differentiate. In the capital region, housing prices went up by 2.7%, whereas in the rest of Finland, prices fell by 0.3%. However, the price of housing has remained moderate in relation to households' income level, and outside the capital region, relative prices have in fact dropped by roughly 10% in the past decade.



Source: Macrobond/Statistics Finland

Figure 3. Housing prices in relation to income level

## 2 Banks operating in Finland

### 2.1 Banking group employees and offices

At the end of 2017, there were 267 credit institutions operating in Finland. This is 12 fewer than at the end of 2016, mainly due to mergers within banking groups. Credit institutions include deposit banks and other credit institutions that do not take deposits, such as finance houses, credit card companies, mortgage credit banks, and Municipality Finance Plc.

Most Finnish credit institutions are part of a banking group or amalgamation. Calculated by group, there were 12 Finnish banking groups or amalgamations (excluding foreign branches) at the end of 2017.

The largest Finnish banking group by its market share is OP Financial Group, which is under the ECB's direct supervision.

The second largest banking group at year-end 2017 was Nordea. Since the beginning of 2017, Nordea has operated as a branch in Finland. In 2018, Nordea will move its headquarters from Sweden to Finland, making it Finland's largest bank in terms of its balance sheet. The process also involved the founding of Nordea Mortgage Bank Plc, which issues mortgage-backed covered bonds.

In late 2017, Danske Bank Finland Plc became Danske Bank's Finland branch. The process also involved the founding of Danske Mortgage Bank Plc, which issues mortgage backed covered bonds. Danske Bank and Municipality Finance are nearly equal in terms of their market shares in lending. Municipality Finance is under the direct supervision of the ECB, but Danske Bank's supervision now lies with the Danish Financial Supervisory Authority, with the exception of Danske Mortgage bank, which is a Finnish subsidiary.

Except for Nordea, OP Financial Group and Municipality Finance, all the other credit institutions in Finland are under the direct supervision of the FIN-FSA.



Finnish banking groups and foreign deposit-taking banks' Finnish branches employed a total of 20,999 people at the end of 2017, which is approximately one thousand fewer than at the end of 2016. At year-end 2017, Finnish banking groups had 970 offices in Finland, which is 69 fewer than the year before (Figure 4). The pared down number of offices is the result of mergers, improved efficiency of functions, and customer service moving to digital channels.

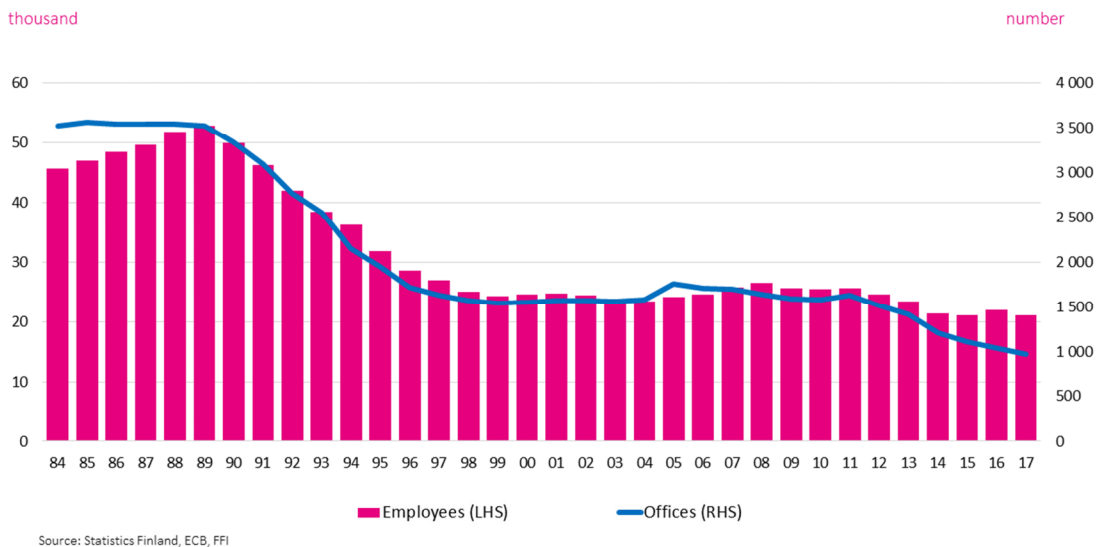
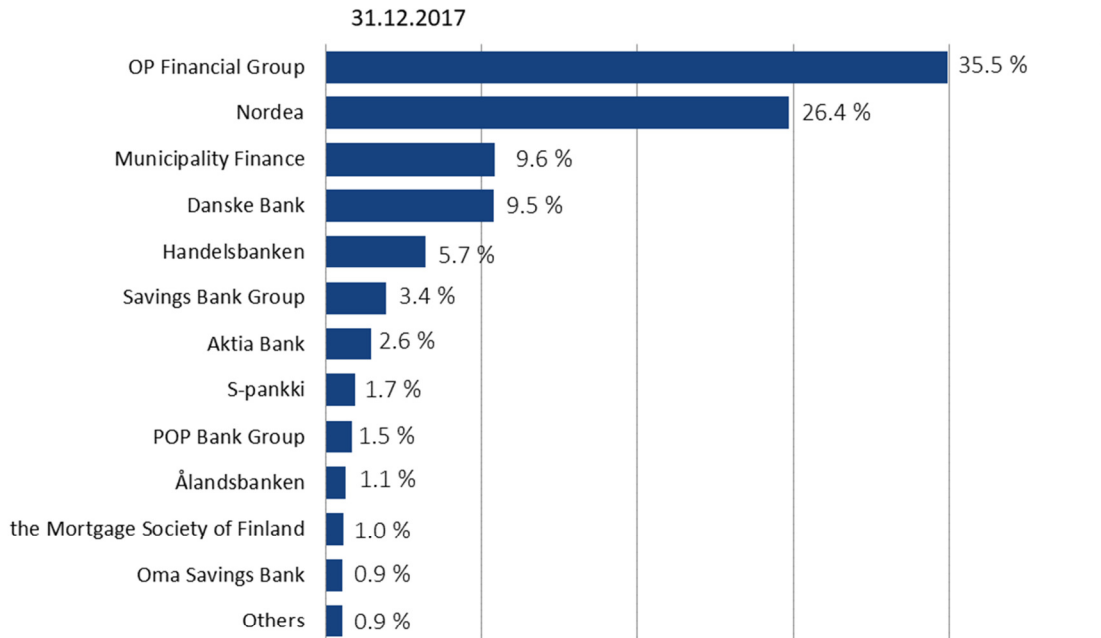


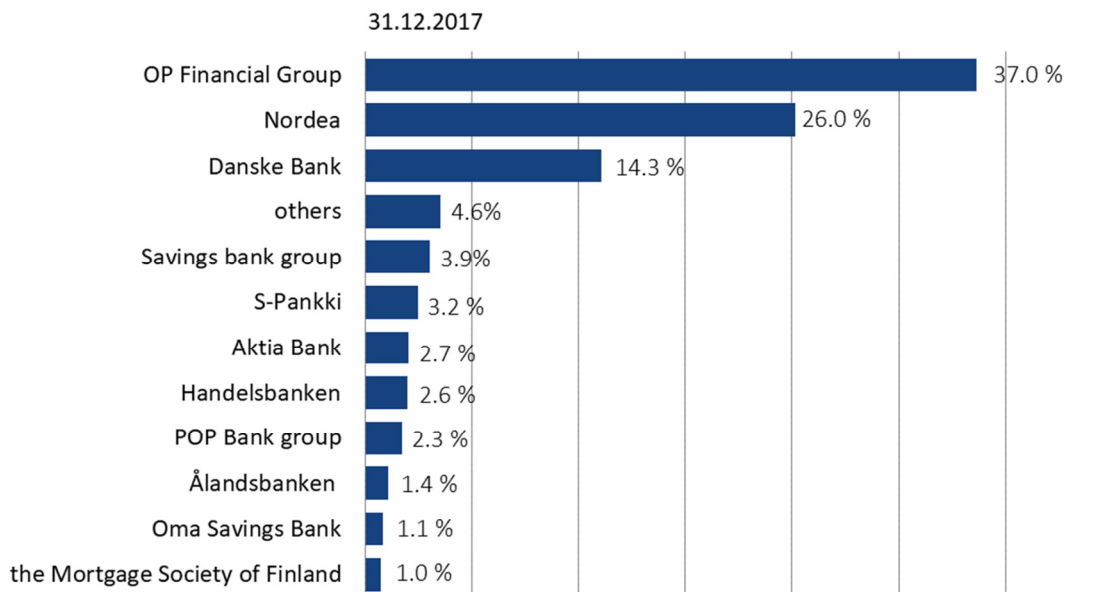
Figure 4. Bank employees and offices

## 2.2 Market shares of credit institutions in Finland



Source: Bank of Finland

Figure 5. Credit institutions' non-MFI loans in Finland, market shares on 31 Dec 2016



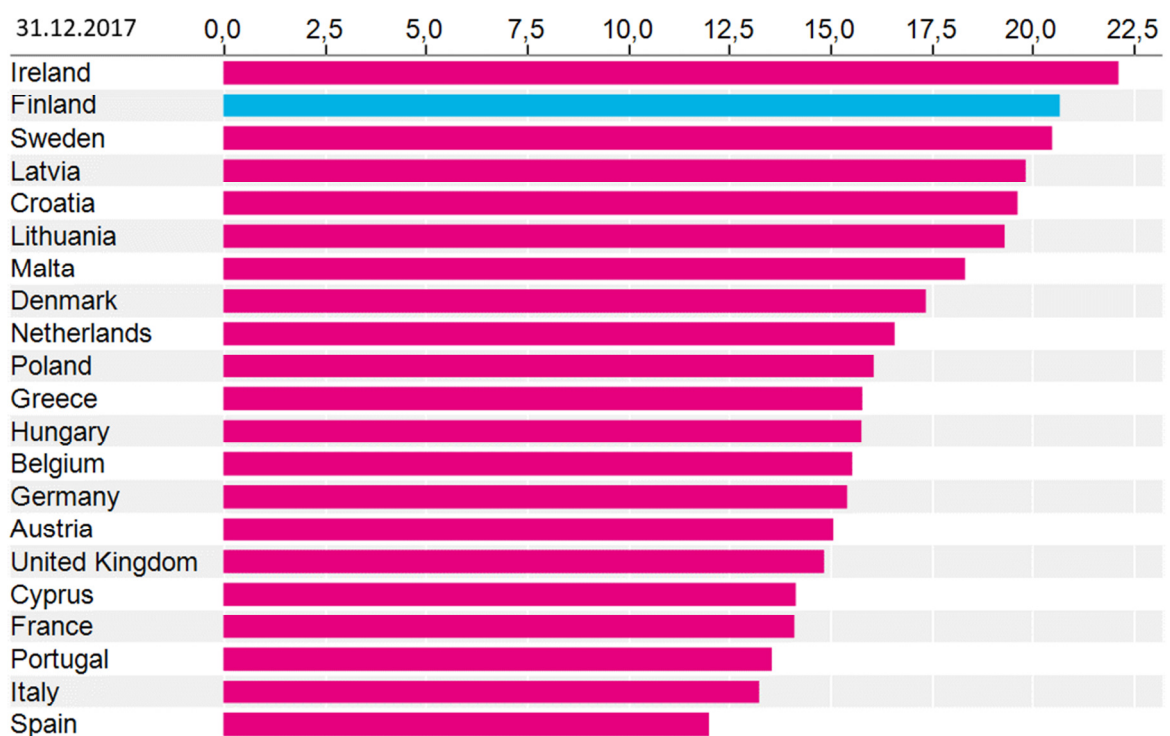
Source: Bank of Finland

Figure 6. Credit institutions' non-MFI deposits in Finland, market shares on 31 Dec 2017

### 2.3 Capital adequacy and profitability

At the end of 2017, the overall capital adequacy ratio of the Finnish banking sector was 23.4%, and most of Finnish banks' equity was comprised of the highest-quality core capital. The sector's Common Equity Tier 1 (CET1) ratio was 21.0% and the leverage ratio was 6.8%. The capital adequacy of the Finnish banking sector was well above the EU average.

The leverage ratio measures the ratio of the bank's equity to its balance sheet and certain off-balance-sheet items, not considering the riskiness of the balance sheet. It will become binding when the Capital Requirements Regulation and Capital Requirements Directive (CRR II/CRD V), currently under negotiation, enter into force. It looks likely that the requirement will settle at 3% and enter into force during 2019. Banks with global systemic importance (G-SIB) are also proposed an additional capital buffer in addition to the 3% requirement. The negotiations about the size of the buffer are still underway, but it is likely to be set at 50% of the bank's G-SIB buffer requirement.



Source: Macrobond/ECB

*Equity Tier 1 ratio (%) CET1 on 31 December 2017*

The structural changes<sup>1</sup> in the banking sector had a significant impact on the sector's results and key figure comparisons in 2016–2018. For this reason, the main sources are the FIN-FSA's figures, from which the effects of the structural changes have been erased.

In 2017, the aggregate operating profits of the Finnish banking sector totalled approximately €2.1 billion. The figure improved slightly from last year, when compared to figures from which the structural changes (Nordea) have been removed. The key sources of income on the income statement developed positively in 2017, but operating costs rose due to sizeable IT development projects.

Net interest income continues to be the banking sector's most substantial source of income, although commission income has increased its share of the total returns. However, net interest income's proportion of the total profits varies greatly between banks. In some banks, net interest income remains the main source of income, and in others, the main source of income is commission income. Net interest income strengthened by approximately 4% from the previous year thanks to the growth in the credit portfolio and the low costs of funding. Comparable commission income also increased from the previous year, especially in securities trading and asset management.

Operating costs went up by 9% in 2017. Personnel costs remained fairly level, but development costs rose. Banks made major investments in IT projects and digitalisation, which were possible thanks to strong profitability.

Approximately two-thirds of Finnish banks' funding comes from non-MFI deposits, whose average interest was close to zero in 2017 (Figure 8). However, the numbers vary greatly between credit institutions: some fund their operations almost entirely with deposits, while others do not take deposits at all<sup>2</sup>.

Most deposits come from households. The average interest rate for household deposits fell to 0.14% at the end of 2017, and it has continued to decrease since. This means that

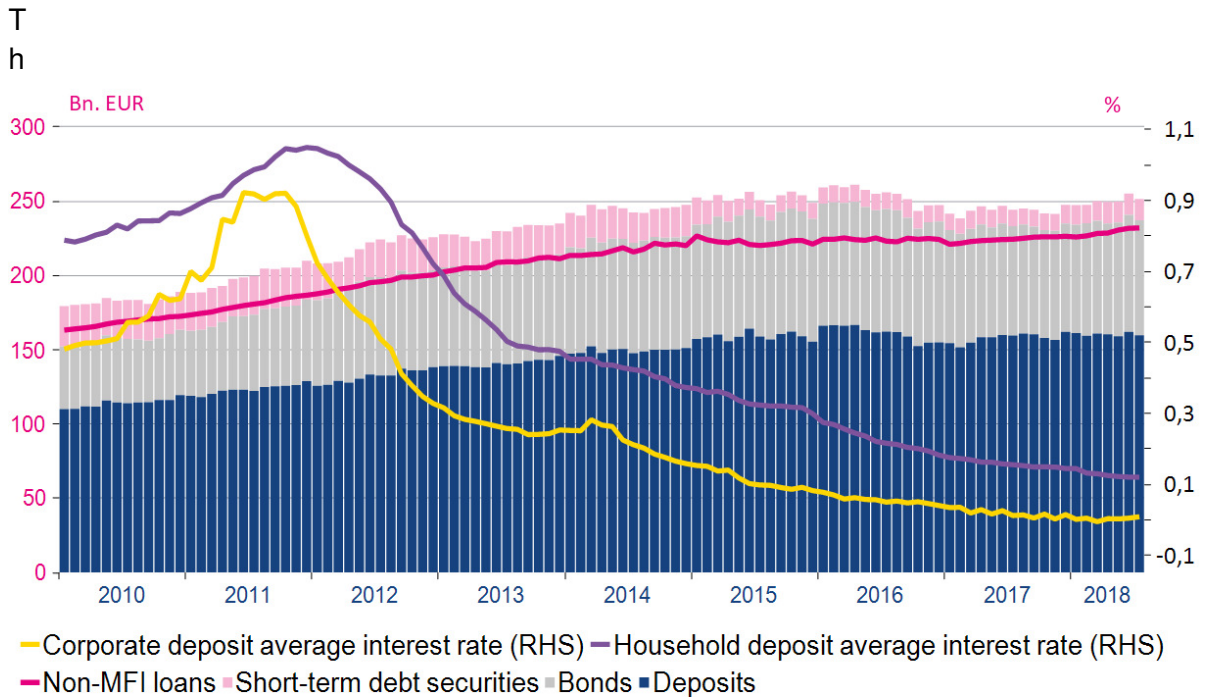
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<sup>1</sup> Nordea became a branch on 2 January 2017 and Danske Bank on 31 December 2017. Nordea has decided to move its headquarters to Helsinki in 2018.

<sup>2</sup> Finance houses, mortgage banks and Municipality Finance Plc.

deposit funding has been exceptionally inexpensive, although there is very little room for further decrease. Corporate deposits<sup>3</sup> have partly been charged negative interests, and the average interest rate for corporate deposits became negative in March 2018. This compensates for the strain negative interests in central bank deposits have put on banks.

The average maturity of banks' funding has been lengthening for years, with banks preparing for upcoming regulation. The stock of bonds with a short maturity period of less than a year has been shrinking since 2008. The current proposals to amend banking sector regulation (CRR II/CRD V) include a binding Net Stable Funding Ratio (NSFR) requirement for European banks, which steers banks to focus their funding in long-term debt securities.



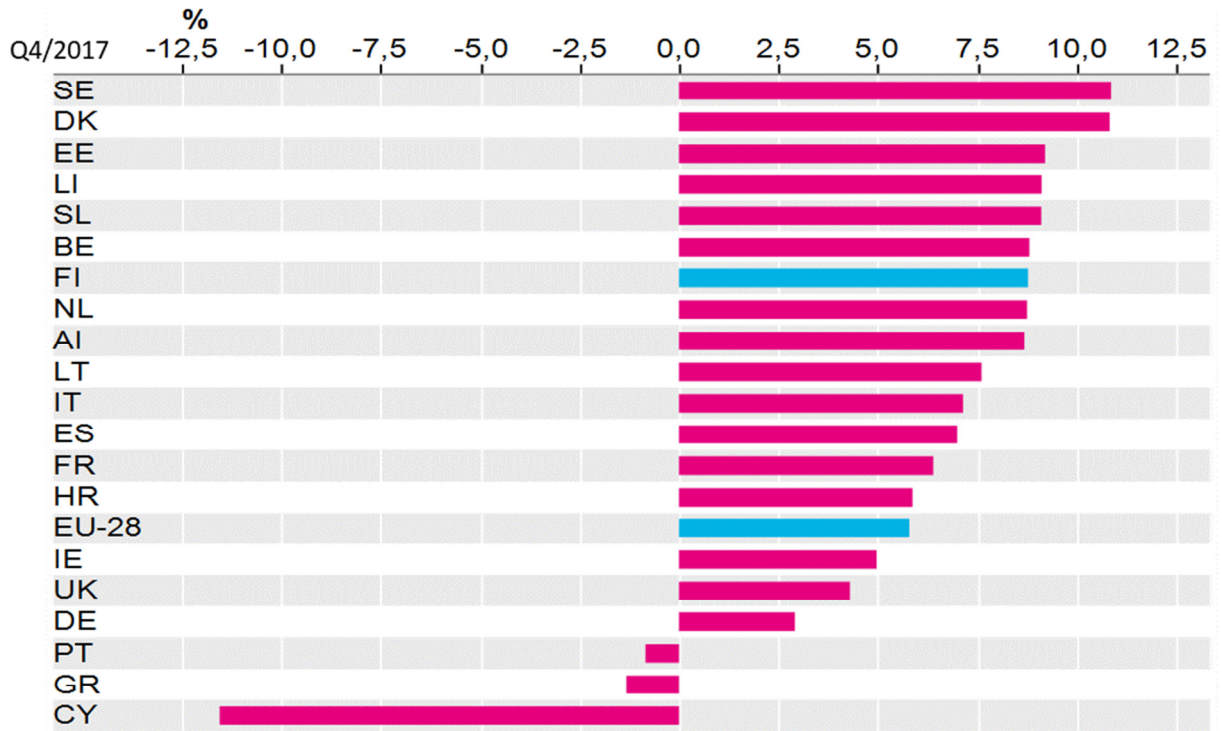
Source: Macrobond/Bank of Finland

ng requirement is expected to take force in 2019.

Figure 8. Credit institutions' funding (excl. interbank deposits)

<sup>3</sup> Incl. housing corporations.

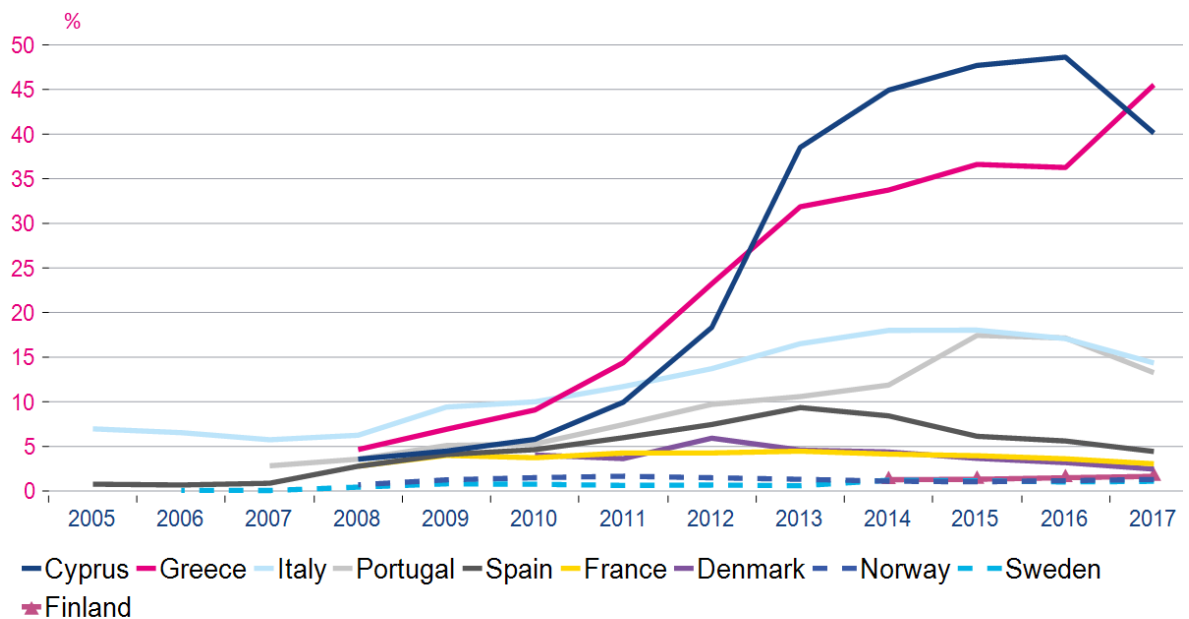
The Finnish banking sector's return on equity (ROE) was 8.8%, well above the average ROE for all EU banking sectors (5.8%). In some Southern European countries in the grip of the debt and banking crisis, the banking sector has been unprofitable for years. However, German banks also continue to struggle with profitability issues.



Source: Macrobond/ECB

Figure 9. Banks' profitability (ROE) on 31 December 2017

Non-performing assets have burdened the European banking sector after the financial crisis, and Southern Europe in particular has wrestled with problem loans. European authorities have initiated several measures that seek to tidy the balance sheets of banks. Italian banks have recently sold their problem loans to non-financial companies. In Finland, non-performing assets have never become a problem. At the end of 2017, they remained at a low level, comprising about 1.4% of the loan portfolio.



Source: Macrobond/IMF

Figure 10. Non-performing assets in relation to the loan portfolio

The Finnish banking sector's short-term liquidity is strong. At the end of 2017, the sector's Liquidity Coverage Ratio (LCR), which is the EU's binding requirement, was 138%. The LCR is calculated by comparing the liquidity buffer with net cash outflows during a 30-day stress scenario. In 2017, the minimum LCR requirement was 80%, but this was increased to the full extent of 100% from the beginning of 2018.

The liquidity buffer of Finnish banks totalled €40.6 billion and consisted mainly of central bank deposits (56%) and high-quality covered bonds (17%). Banks paid negative interest for their central bank deposits. The ECB's deposit facility rate has been negative since summer 2014, and at the moment, the rate is negative 0.4%. In 2017, banks paid the ECB over €90 million in deposit interests.

### 3 Households' indebtedness

Most of the macroprudential instruments implemented in Finland are either directly or indirectly linked to households' indebtedness. Household indebtedness is measured by comparing households' loan debts to their disposable annual income. This ratio rose quickly in Finland in the early 2000s, but the pace has steadied in recent years. At the end of 2017, the ratio of household debt to income was at 128%, an all-time high. Compared to other Nordic countries, the figure is still moderate, although it exceeds the EU average.

A country's level of household indebtedness is influenced by how common it is to own a home, how long it takes to pay back a housing loan, how price of housing develops, how much living space people want, and which funding systems are in place. For example, the Netherlands has typically favoured single-payment housing loans, meaning that instead of paying the loan off in instalments, households save up and then eventually pay the whole loan off in a single payment. In Denmark and Sweden, indebtedness has increased due to so-called perpetual mortgages, granted up until a few years ago before regulation grew stricter. The Danish also have the most living space in Europe, which ties in with sizeable housing loans.

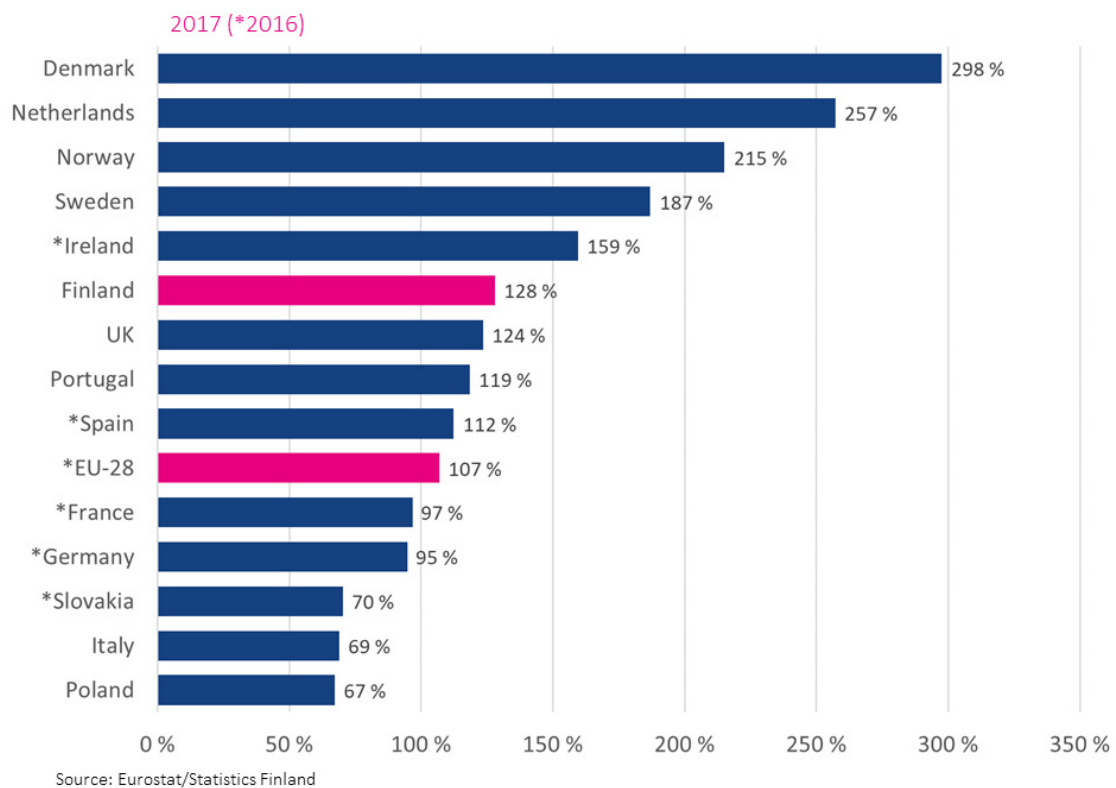
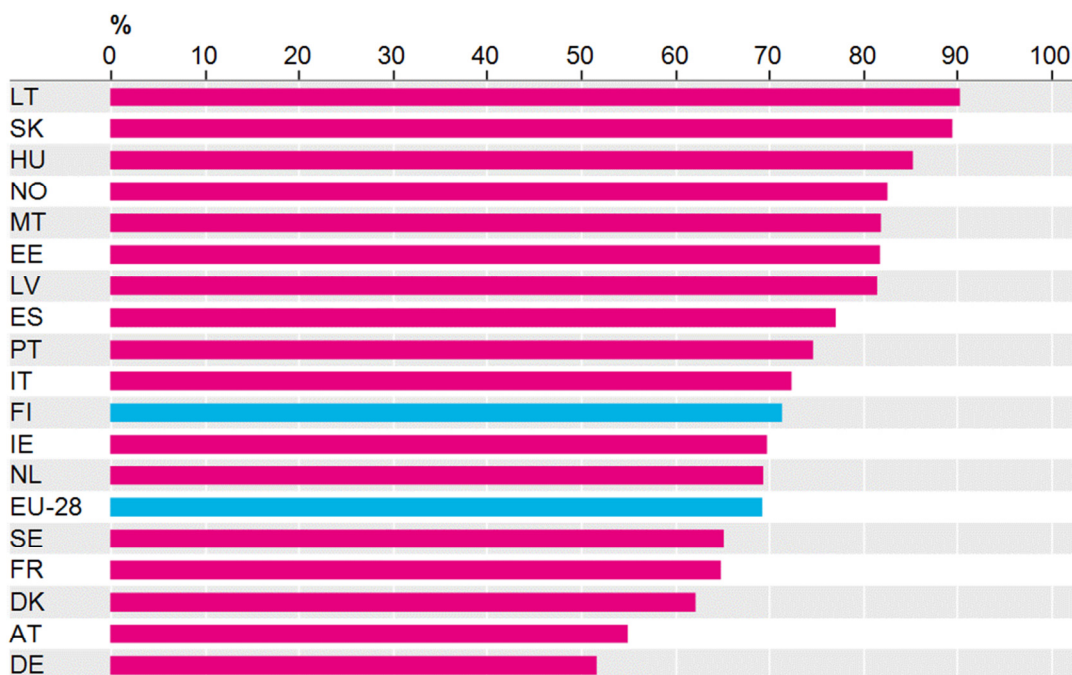


Figure 11. Households' ratio of debt to income on 31 December 2017 (\*31 December 2016)



In Finland, 71.4% of households owned their home at the end of 2017. In 2008, the figure was 73.2%, so in a decade, renting has become slightly more popular. In comparison, only slightly over a half of German households (51.7%) own their home, so the German rental market is much larger. In Eastern Europe, the majority of the population own their homes and have no debt, but in these countries, living conditions are cramped and of lower grade (according to Eurostat criteria). On average, 69.3% of all EU households own their home.



Source: Macrobond/Eurostat

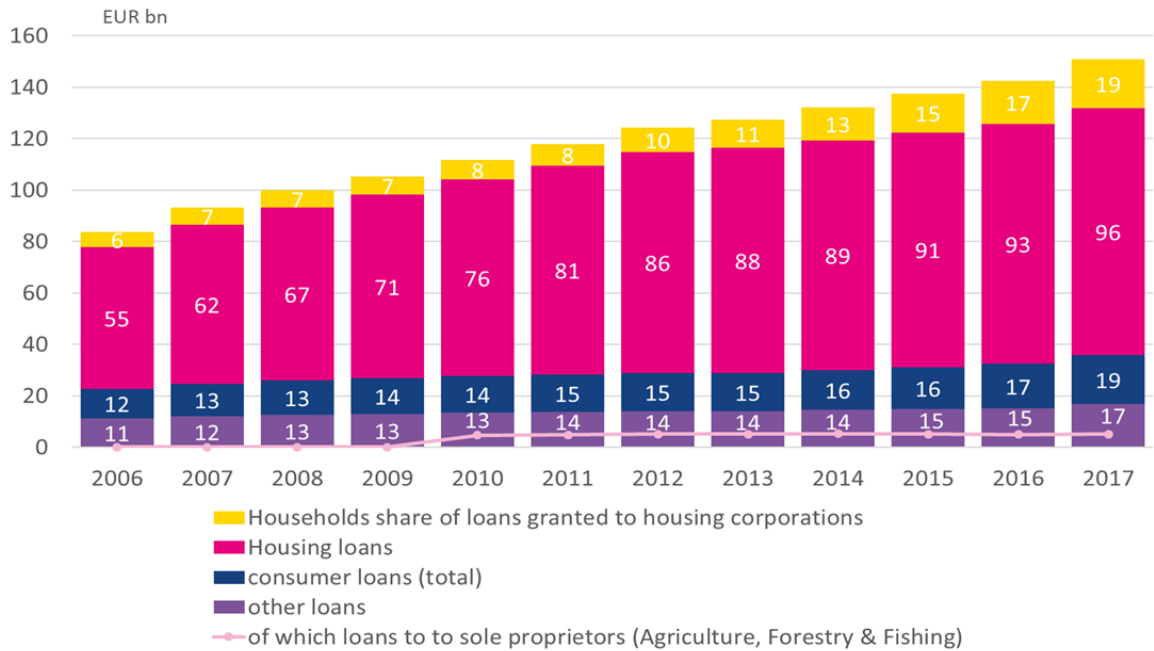
Figure 12. Home ownership in Europe on 31 December 2017

At the end of 2017, the loan debts of Finnish households totalled €148 billion. Housing loans formed the majority of all loans at €96 billion, with consumer credit taking second place with €19 billion. This includes all consumer loans, also those granted by other institutions than credit institutions, such as payday loans. In recent years, especially unsecured consumer credit has increased rapidly. This has given cause for concern because most cases of bad payment history are due to unpaid consumer credits.

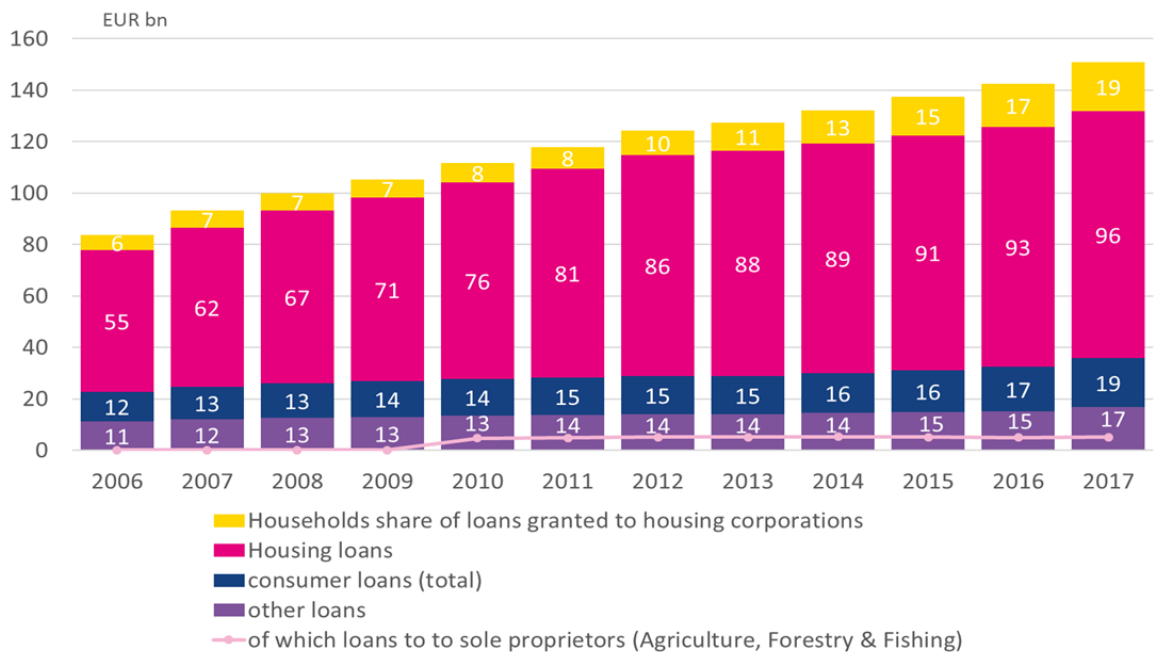
Other loans totalled €17 billion. These include loans taken by sole traders, such as farmers, which made up for €8.8 billion. Therefore, some of them have been taken out purely for business purposes, which should be considered when looking at the overall indebtedness of households.

Housing company loans are the hardest to account for. As described in Chapter 1.3, loans are recorded on the housing company's balance sheet, and not directly on the owner, i.e. a household or a company. According to an estimate by Statistics Finland, households held

€19 billion in housing company loans at the end of the year. In total, the housing corporation loan portfolio amounted to some €30 billion, leaving €11 billion for companies and other parties. However, this estimate should be treated with caution. As described in Chapter 1.3, new construction directly increases the loan portfolio of housing corporations. Traditionally, the majority of this growth has owed to households, but in recent years, the number of investors in new acquisitions has grown exceptionally large, meaning that housing funds and housing investment companies probably have a greater role than estimated.



Source: Bank of Finland and statistics Finland



Source: Bank of Finland and statistics Finland

Figure 13. Household loan debt total

In exchange to their debts, households also have a great deal of wealth. At the end of 2017, households held €307 billion in financial assets<sup>4</sup> and €161 billion in financial liabilities<sup>5</sup>. Their net assets thus totalled €146 billion, which is €100 billion more than 20 years ago. In addition to financial assets, households also have real assets, such as housing wealth, that make up for the majority of household assets.

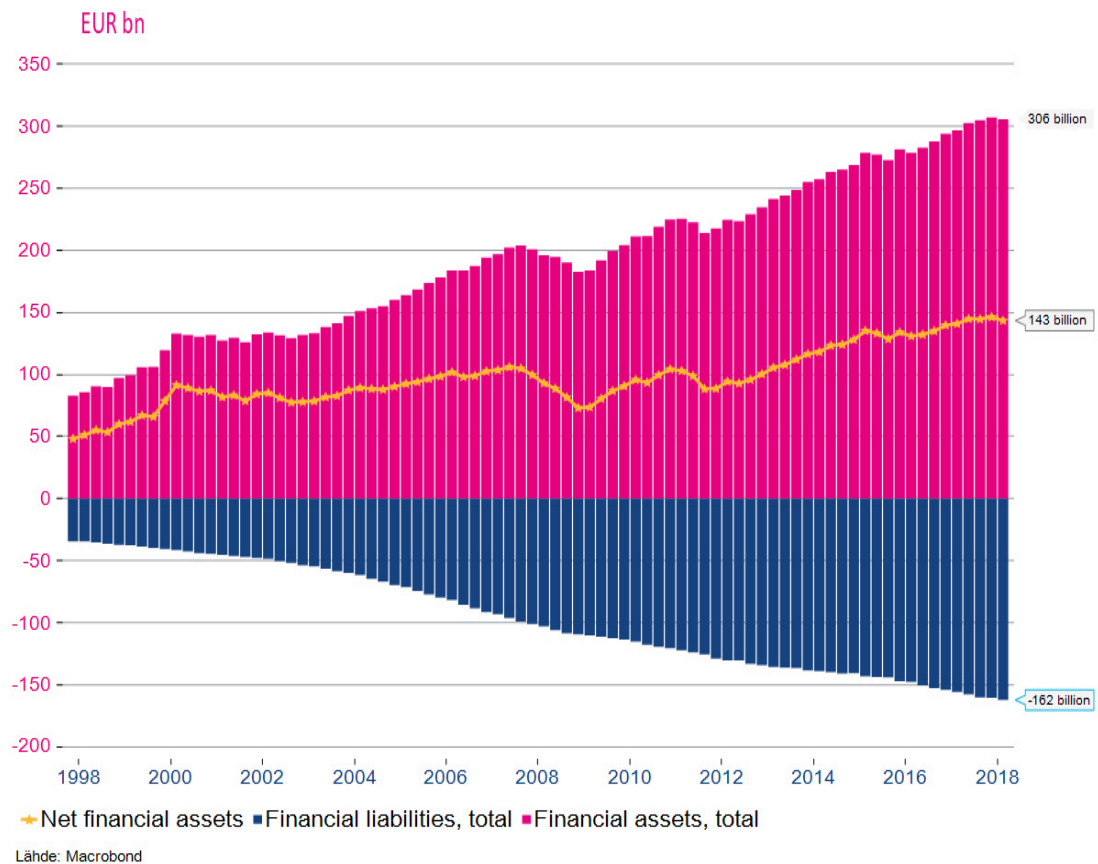


Figure 14. Household net financial assets

<sup>4</sup> Deposits, shares, mutual funds shares, insurance savings and other receivables.

<sup>5</sup> Loan debts and other debts.

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