

FINNISH BANKING IN 2018

An overview on the Finnish banking sector and its operating environment in 2018.

Contents

1 Economic environment	2
1.1 Economic development.....	2
1.2 Housing markets	3
1.3 Regulatory environment.....	5
2 Banks operating in Finland	7
2.1 Banking group employees and offices	7
2.2 Credit institutions' market shares	8
2.3 Capital adequacy and profitability	9
3 Household indebtedness	12

1 Economic environment

1.1 Economic development

Finland's GDP grew by 1.7% in 2018, which is notably slower than in 2017. Economic growth was slightly slower than the euro area average and changed structurally; it now relied more on domestic demand than exports and investments.

Exports did grow, by 1.1%, but this was a slowdown from last year's 7.6%. Total investments grew by 3%, also slower than before. Investments in construction, however, continued growing at a rapid rate. Private consumption accelerated to a growth of approximately 2%.

According to Statistics Finland, consumer confidence fell during 2018, mostly due to general economic uncertainty. Employment numbers grew by 67,000, which is a 2.7% increase. Most jobs were gained in health and social services, construction, and wholesale and retail trade. The overall rate of employment at the end of the year was 71.7%.

Finland's current account was nearly in balance in 2017, but now showed a deficit of €4.4 billion. This was caused by imports outmatching exports in their growth.

The good overall economic situation nevertheless improved public finances. In 2018, general government deficit increased to €1.8 billion, but in relation to GDP it remained unchanged at -0.8%. Moreover, Finland's debt-to-GDP ratio fell below the 60% mark and settled at 59.3%. Government tax revenue grew by 2.6% and so did total revenue¹ by 6.2%. The total tax ratio, i.e. the ratio of tax or tax-like payments to the GDP, fell to 42.4%, down by 0.9% from 2017.

Finance Finland releases a quarterly banking barometer, which surveys bank managers' views and expectations regarding the demand for credit and different forms of investment. While expectations were high in early 2018, towards the end of the year the positive and negative expectations balanced out each other. Loans for purchasing or renovating homes were still taken out a little more than a year earlier, but the general outlook was that the demand for households' investments and consumption would decline. The reasons given for this included the prominent public discussions on the risks of household indebtedness, predictions of rising interest rates, and poorer-than-expected housing prices. Car sales slowed down due to uncertainty concerning taxes and incentives. Demand on corporate loans, especially loans for investments, slowed down as well and are expected to continue so.

According to latest projections, Finland's economy has already passed the peak of the economic uptrend. Growth is expected to slow down in the coming years: Bank of Finland's current projections for 2019–2021 are 1.6%, 1.5% and 1.3%, respectively.

¹ Besides tax revenue, government revenue includes e.g. EU agricultural subsidies, gaming revenue from the regulated gambling market, dividend income and the sales of shares.

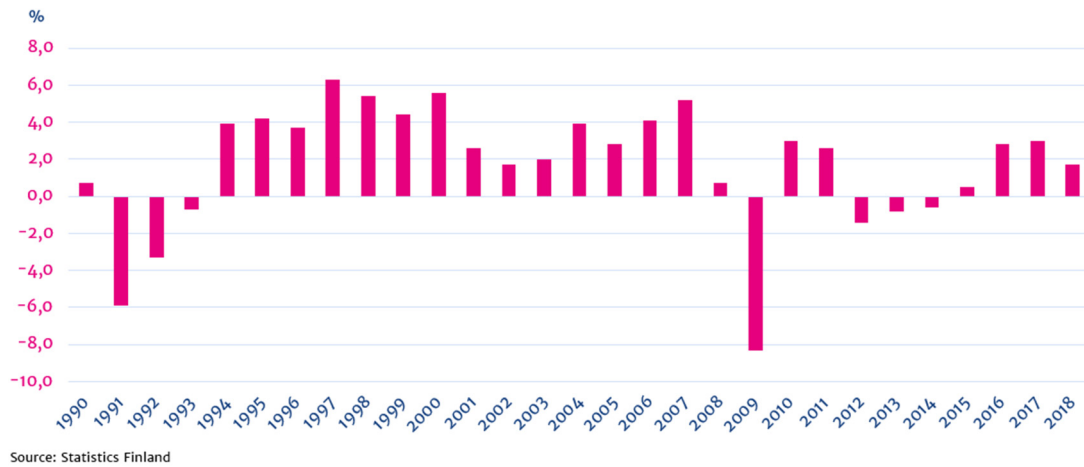


Figure 1. Annual change (%) in Finland's GDP

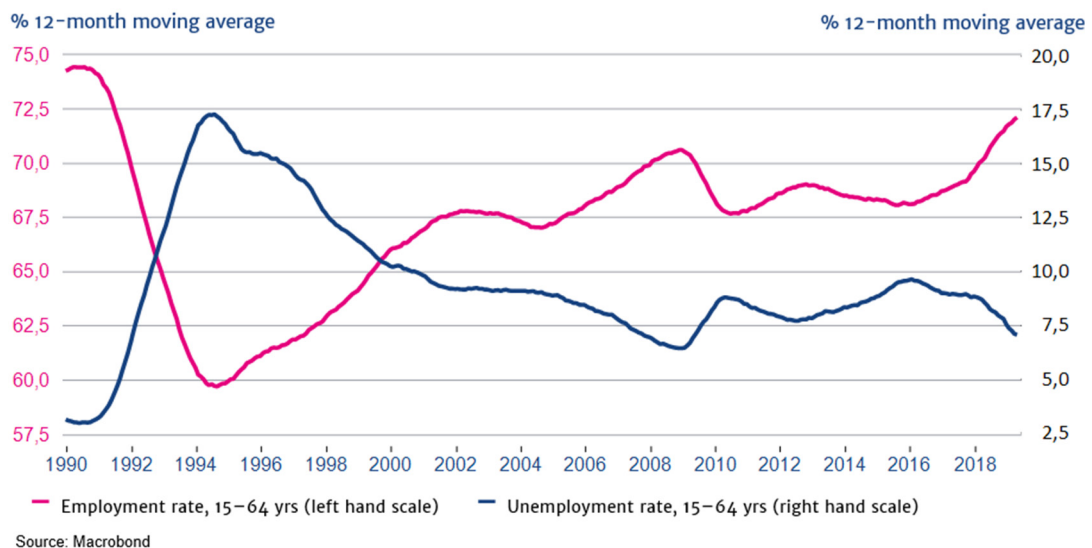


Figure 2. Employment in Finland

1.2

Housing markets

Construction continued to prosper in 2018, but slowed down in terms of growth towards the end of the year. According to Statistics Finland, construction was started on 45,355 new dwelling units, an increase of 2.1% from 2017. A strong emphasis was on apartment blocks. The number of new units is the highest in more than 25 years, and the number of completed dwelling units was also 20% higher than last year. However, 16.6% fewer building permits were granted in 2018, which will probably result in this type of construction slowing down in the future.

The high number of dwellings being built is reflected in the growing loan portfolios of housing corporations which, according to the Bank of Finland, have been growing at a rapid annual rate of approximately 10% since the turn of the millennium.

Finnish limited liability housing companies have certain unique characteristics that are also reflected in the credit statistics. In other countries, increased construction typically results in the corporate loan portfolio growing. Finland's housing corporation loans are included in the corporate loan portfolio in international statistics, but in national statistics the corporate loans and housing company loans are separate categories, which means the same does not happen here.

In general, loans taken out to construct residential buildings in Finland are recorded on the established housing company's balance sheet. The loan portfolio of housing companies therefore grows as a direct result of new construction. The term 'housing corporation' encompasses all corporation forms of housing units, not just housing companies.

At the end of 2018, the housing corporation loan portfolio was almost €32 billion, growing 12% from 2017. Some of this loan volume 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 households hold loans worth €21 billion. In recent years, households have carried an increasing proportion of housing corporation loans, which is also one of the main factors for households' increasing indebtedness.

The Finnish Financial Supervisory Authority (FIN-FSA) has looked into loan granting criteria and risks regarding housing corporation loans. Their conclusion was that the potential rise in the charge for financial costs, due to the possibility of rising interest rates, is generally not considered when granting a housing loan. Because of this, FIN-FSA made sure that housing corporation loans are also taken into account in the stress tests that evaluate customers' repayment ability. We take a closer look into household debts in Section 3.

Overall housing prices went up by 0.8% during 2018. As a result of urbanisation, the housing market continued to diverge: in the capital region, housing prices went up by 2.2%, whereas in the rest of Finland, prices fell by 0.6%. Compared to households' income, housing prices have remained stable overall, but with regional differences. Outside the Helsinki region, relative prices have in fact dropped by roughly 10% in the past decade.

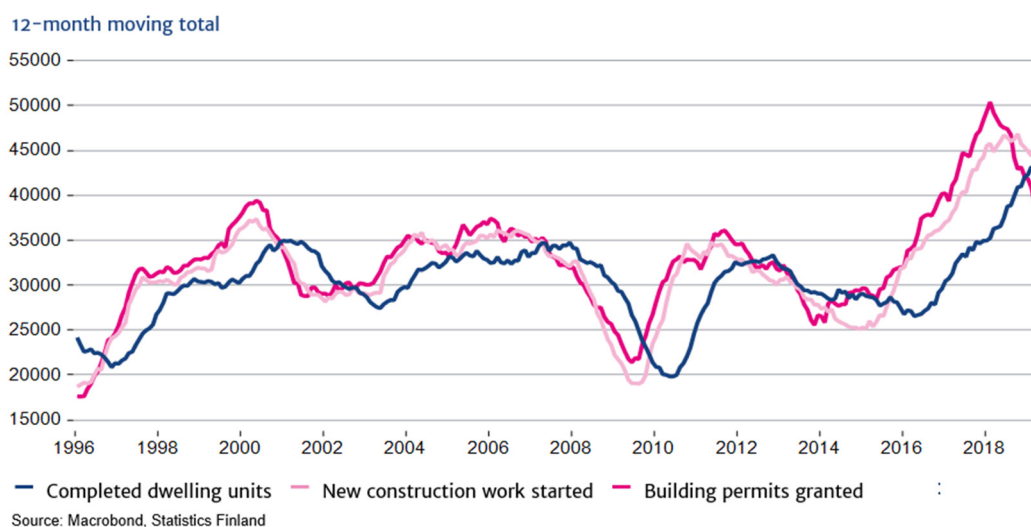


Figure 3. Housing supply in Finland

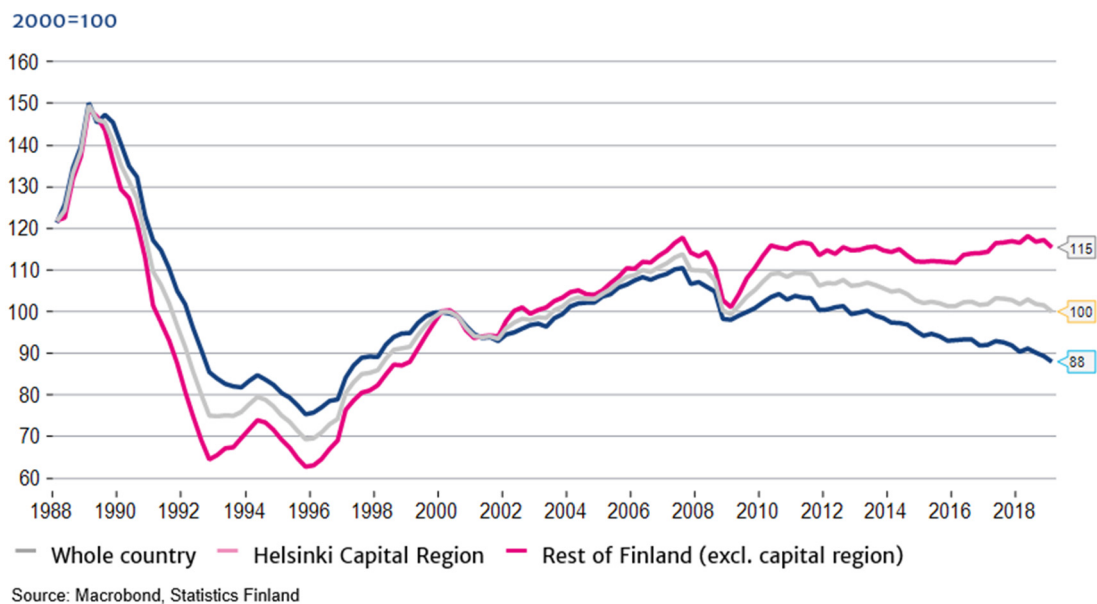


Figure 4. Housing prices in relation to income level

1.3 Regulatory environment

As it has for many years now, the regulatory environment was eventful both nationally and internationally. In Finland, the FIN-FSA board made several decisions concerning macro-prudential tools related to new capital requirements and household indebtedness.

A decision on increased risk weighing on housing loans entered into force in early 2018. In it, the FIN-FSA board set a 15% minimum level for the average risk weight on mortgage portfolios for credit institutions that use their own internal ratings-based models. In practice, the risk weights determine how much own funds the credit institutions need to have to protect against possible credit losses from housing loans. The decision was based on the EU Capital Requirements Regulation (CRR) Article 458.

The new International Financial Reporting Standard, IFRS 9 Financial Instruments also entered into force in early 2018, after being prepared for a long time. The standard dictates that banks must recognise initial expectation of credit losses on loans according to the expected credit loss model. If credit risk has increased significantly, the full lifetime expected credit loss must be recognised in the bank's profit or loss. This change increased volatility in the banking sector's results.

The FIN-FSA board also imposed a systemic risk buffer for credit institutions. It is determined by structural characteristics of the funding system and based on the EU Capital Requirements Directive (CRD IV). Structural risk can mean, for example, a large proportion of housing loans in the total loan portfolio, or banks' dependence on market funding. The buffer aims to strengthen credit institutions against structural systemic risks. The new requirements are 3% for Nordea, 2% for OP Financial Group, and 1.5% for Municipality Finance – as the three institutions were determined to have a more significant impact on systemic risks – and 1% for other Finnish credit institutions. Within the banking union, the

3% requirement is the highest level that exists. The new requirements entered into force in July 2019.

In mid-2018, FIN-FSA also decided on additional capital requirements for global (G-SII/B) and national (O-SII) systemically important institutions. FIN-FSA classified Nordea as a global systemically important institution, which means an additional capital requirement of 1%, but the decision was reversed in December because Nordea no longer fulfilled the G-SII/B criteria.

The additional capital requirements for national systemically important institutions (O-SIIs) have already been in force since 2016. FIN-FSA has set additional requirements of 2% for Nordea and OP Financial Group, and 0.5% for Municipality Finance. Different requirements for individual institutions are not cumulative, however; only the largest requirement is binding (see Figure 5).

Loan-to-value ratio was made stricter for all housing loans except those taken out for first homes. In July 2016, the ratio had been set at 95% for first homes and 90% for others. In July 2018, the latter category was lowered from 90% to 85%. FIN-FSA justified this change with the high indebtedness of households, which makes the national economy more sensitive to cyclical fluctuations. FIN-FSA stated that the purpose was to curb household indebtedness and that the change was estimated to have only a slight effect on lending.

In late 2016, the European Commission published a legislative proposal, the risk reduction package, which was aimed to reduce risks in the banking sector so that the final stages of the banking union could be completed. The package contained numerous changes and additions to the Capital Requirements Regulation (CRR II), Capital Requirements Directive (CRD V), Bank Recovery and Resolution Directive (BRRD II) and Single Resolution Mechanism Regulation (SRMR II). EU reached a consensus on the package in early 2019, and the new rules entered into force in mid-2019.

The last building phase of the banking union is the European Deposit Insurance Scheme (EDIS). The opinion of several member states is that the implementation of EDIS requires that the banking sector is first restored into good condition. A key issue is solving the non-performing assets in banks' balance sheets. In Southern Europe especially, non-performing assets are at an alarming level. EU authorities aim to remedy this situation with the aforementioned risk reduction package and a separate NPL action plan.

	Nordea	OP Financial Group	Municipality Finance	Other
G-SII/B additional capital requirement	1%			
O-SII additional capital requirement	2%	2%	0.5%	
Systemic risk buffer	3%	2%	1.5%	1%
Binding additional capital requirement	3%	2%	1.5%	1%

Source: FIN-FSA

Figure 5. Additional capital requirements set by FIN-FSA in summer 2018

2 Banks operating in Finland

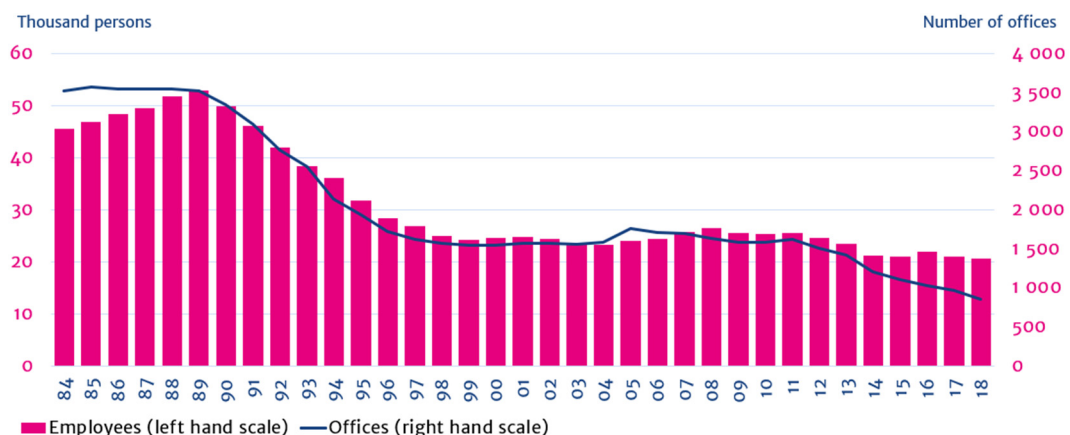
2.1 Banking group employees and offices

At the end of 2018, there were 255 credit institutions operating in Finland if group structures are ignored. This is 12 fewer than at the end of 2017, 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 2018. Nordea, OP Financial Group and Municipality Finance are under direct supervision of the European Central Bank (ECB), while other credit institutions in Finland are supervised by FIN-FSA.

In October 2018, Nordea relocated its headquarters from Sweden to Finland. In terms of its balance sheet, Nordea is the world's 20th largest bank, and has earlier been classified as a global systemically important bank (G-SIB). Since Finland is a member of the banking union, the entire Nordea group now falls under the supervision of the ECB. Moving to Finland also meant that the Swedish parent company, Nordea Bank AB, merged into Nordea Bank Plc which was established in Finland. The parent company's Finnish branch was terminated and its assets transferred over to Nordea Bank Plc. In Sweden, Denmark and Norway, Nordea's operations are in the future carried out by Nordea's local branches. The move made Finland's banking sector balance grow to 3.4 times the annual GDP, and the combined amount of Finnish banks' balance sheets went up by nearly 180%. In 2018, Nordea Group's balance sheet amounted to €551 bn; in contrast, the OP Financial Group's balance sheet was €140bn. Finland's banking sector is now one of Europe's largest relative to the size of the national economy.

Finnish banking groups and foreign deposit-taking banks' Finnish branches employed a total of 20,700 people at the end of 2018, which is about 300 fewer than at the end of 2017. Finnish banking groups had 854 offices in Finland, which is 116 fewer than the year before. Compared to 2017, the rate of reduction was slower for the number of employees but faster for the number of offices. The reductions are the result of mergers, improved efficiency of functions, increased automation, and customer service moving to digital channels.



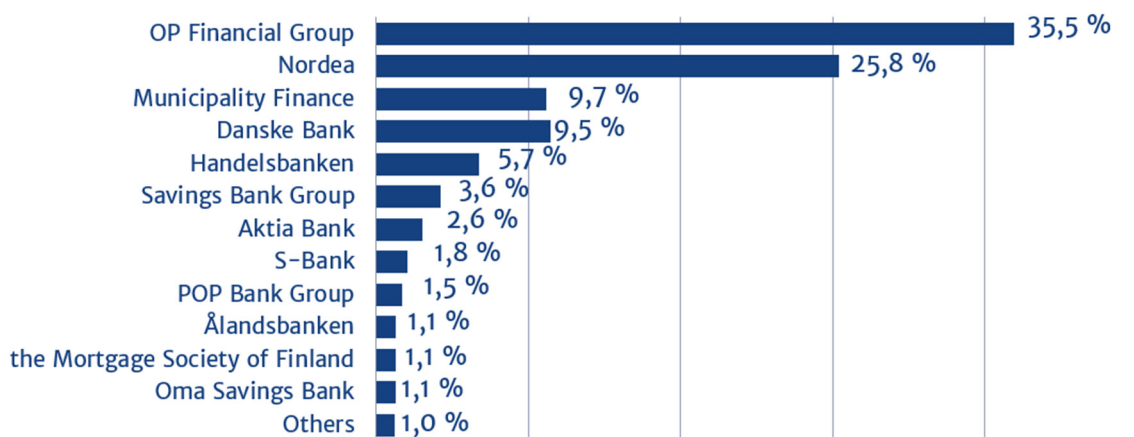
Sources: Statistics Finland, Finance Finland, Bank of Finland, FIN-FSA

Figure 6. Bank employees and offices

2.2 Credit institutions' market shares

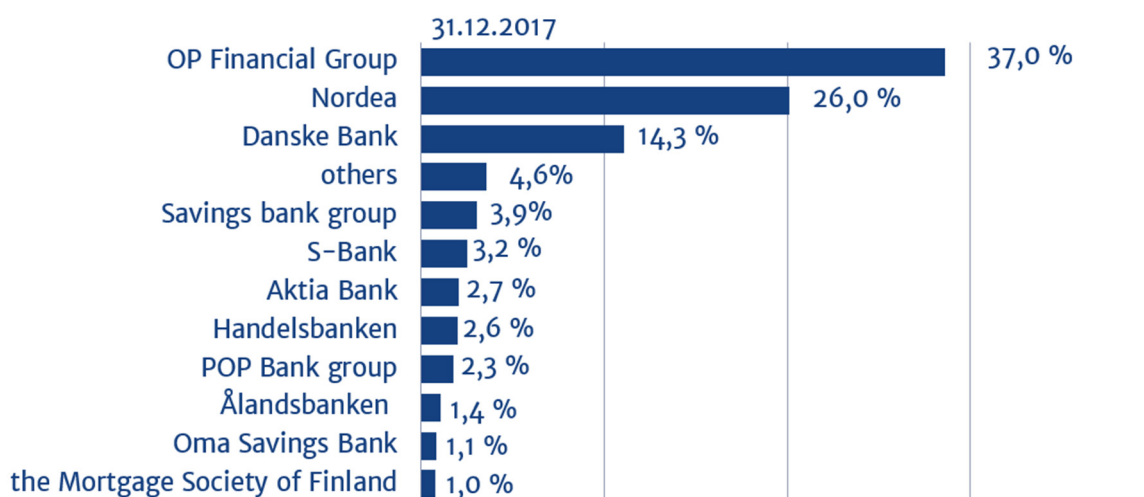
The largest Finnish banking group in terms of market share is OP Financial Group, which is under the ECB's direct supervision. OP Financial Group commands a market share of 38–40% in deposits, housing loans and corporate loans alike. At the end of 2018, the second largest group was Nordea with market shares of 27–30%.

Credit institutions' market shares have not changed much in recent years. In granted loans, changes were very small (at most 0.5%) in 2018. In deposits, on the other hand, OP and Nordea gained more than 1% in market share while Danske Bank lost 2%.



Source: Bank of Finland

Figure 7. Credit institutions' non-MFI loans in Finland, market shares on 31 Dec 2018



Source: Bank of Finland

Figure 8. Credit institutions' non-MFI deposits in Finland, market shares on 31 Dec 2018

2.3 Capital adequacy and profitability

At the end of 2018, the overall capital adequacy ratio of the Finnish banking sector was 20.9%, down by 2.5% from 2017. The sector's Common Equity Tier 1 (CET1) ratio decreased 3.8% to 17.2%, and the leverage ratio by 1% to 5.8%. These numbers changed mainly because of Nordea's headquarters relocation to Finland, and the capital adequacy of the Finnish banking sector remained well above the EU average.

The leverage ratio measures the ratio of a bank's equity to its balance sheet and certain off-balance-sheet items without considering the riskiness of the balance sheet. The recently adopted risk reduction package makes the requirement part of binding legislation.

Structural changes in the banking sector affect the comparability of the results and key figures substantially for 2016–2018. Nordea and Danske Bank changed from subsidiaries to branches in Finland in 2017, and Nordea's headquarters were relocated from Sweden to Finland in 2018. Statistically speaking there is a significant difference: subsidiaries have their own balance sheets while branches don't.

In 2018, the aggregate operating profits of the Finnish banking sector totalled approximately €5.4 billion. If the effects of the structural changes are eliminated and the figures thus made more comparable, we can see there was a slight dip in profits. Net interest income did develop positively during 2018 thanks to growing credit volumes and affordable funding, but commission income, for example, decreased slightly. The most negative effect for the overall results came from investments. Personnel costs shrank substantially, while other costs increased instead – most notably due to business development expenses.

Net interest income continues to be the banking sector's most substantial source of income, although commission income has grown slightly in proportion. Net interest income currently contributes nearly half of all income in the sector. The structure of total profits varies greatly between banks, however. In some banks, net interest income is the constant, main source of income, and in others, the main source of income are commissions. Other sources of income include investment activities, which include banks' dealing on own account.

Non-recurring costs included, banks' operating expenses rose somewhat compared to 2017. Development costs increased while personnel costs decreased. On the other hand, depreciations increased in the accounting period as banks implemented development projects that had been brought on balance sheet as intangible assets. For some banks, system changes and related expenses are still to come. In recent years, banks have invested strongly in IT projects and digitalisation; the investments have been possible thanks to strong profitability.

A substantial portion of Finnish banks' funding comes from non-MFI deposits, whose average interest was close to zero in 2018. However, the numbers vary greatly between credit institutions: some fund their operations almost entirely with deposits, while others² do not take deposits at all.

Most deposits come from households. The average interest rate for household deposits fell to 0.11%, down from the previous year's 0.14%. This means that deposit funding has been exceptionally inexpensive, although there is very little room left for further decrease. Corporate deposits have partly been charged negative interests, and the average interest

² Finance houses, mortgage credit banks and Municipality Finance plc.

rate for corporate deposits temporarily dipped below zero in 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 as banks prepare for upcoming regulation. The stock of bonds with a short maturity period of less than a year has been shrinking since 2008. Bank's risk reduction package includes a binding Net Stable Funding Ratio (NSFR) requirement for European banks, which steers banks to focus their funding in long-term debt securities. The NSFR requirement entered into force in 2019.

The Finnish banking sector's return on equity (ROE) was 8.5%, well above the average ROE for all EU banking sectors (6.2%). In some Southern European countries in the grip of the debt and banking crisis – Cyprus and Greece, for example – the banking sector has been unprofitable for years. However, German banks also continue to struggle with profitability issues.

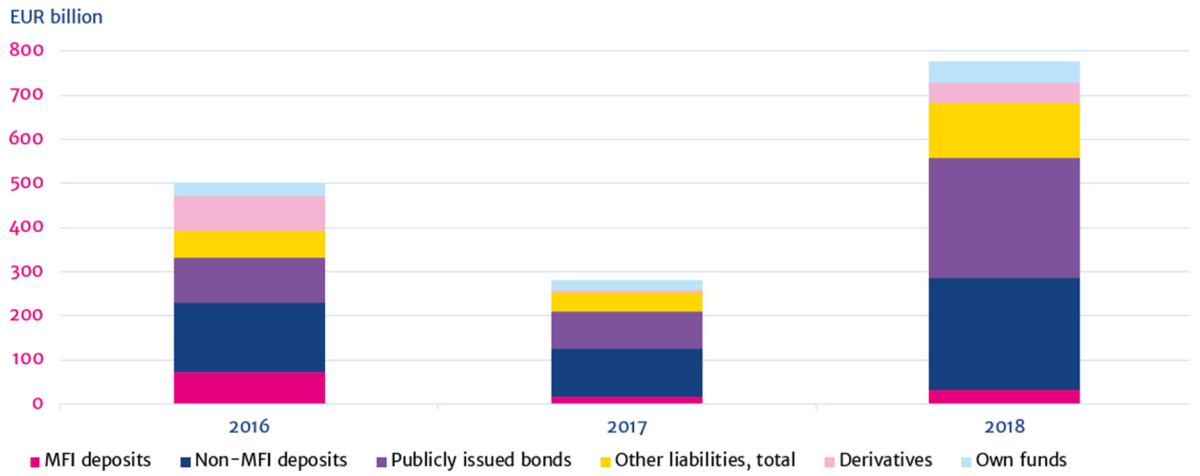
As noted, non-performing assets and problem loans have burdened the European banking sector after the financial crisis, some areas more than the others. European authorities have initiated several measures to clean up the balance sheets of banks. One of them is ECB's addendum to its guidance to banks on non-performing loans. Another is the regulation regarding minimum loss coverage for non-performing exposures that was issued in April 2019.

Italian banks have recently sold their problem loans to non-financial companies, and US-based venture capitalists and investment banks have purchased more European problem loans than before. In Finland, non-performing assets have never been a problem. At the end of 2018, they remained at a low level, comprising about 1.7% of the loan portfolio, although it should be noted that this is a 0.3% increase. The relocation of Nordea's headquarters from Sweden to Finland resulted in the volumes of corporate non-performing loans increasing and non-performing household loans decreasing.

The Finnish banking sector's short-term liquidity is strong. At the end of 2018, the sector's Liquidity Coverage Ratio (LCR), which is the EU's binding requirement, was 175%, rising substantially from the previous year's 138% due to Nordea's headquarters relocation. The LCR is calculated by dividing a bank's high-quality liquid assets by its total net cash flows over a 30-day stress period. In 2017, the minimum LCR requirement was 80%, but as of 2018 this was increased to its full level of 100%. The average LCR in the EU is 146%.

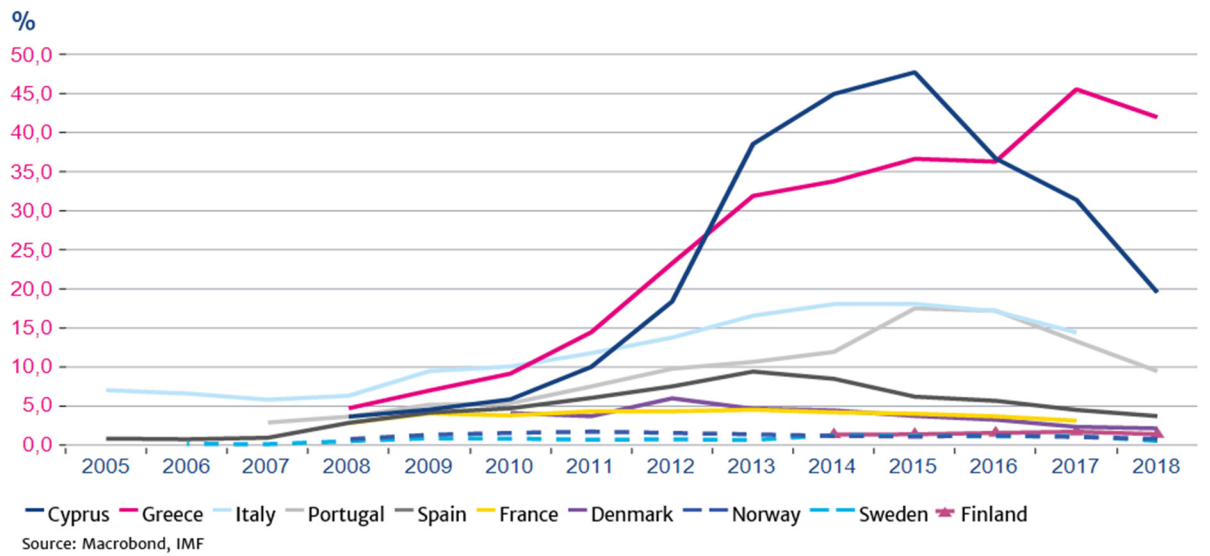
The liquidity buffer of Finnish banks totalled approximately €130 billion and consisted mainly of central bank deposits (37%) and high-quality covered bonds (25%). As much as 96% of the liquidity reserves consist of level 1 assets, in other words the most liquid assets. The main difference between Finnish and European reserves are that the reserves of euro area banks on average have a much lower level of high-quality covered bonds (3.6%).

Banks paid negative interest for their central bank deposits. The ECB's deposit facility rate has been negative since mid-2014, and at the end of 2018 the rate was negative at -0.40%.



Source: FIN-FSA

Figure 9. Finnish banking sector's combined balance sheet in December 2018



Source: Macrobond, IMF

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

3 Household indebtedness

Most of the macroprudential instruments implemented in Finland are either directly or indirectly linked to household 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 2018, the ratio of household debt to income was at 127% (one percent less than in 2017). Although higher than the EU average, the figure is still moderate compared to other Nordic countries.

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 what 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 there being no time limit on mortgage duration, up until a few years ago before regulation grew slightly stricter. The Danish also have the most living space in Europe, which ties in with sizeable housing loans.

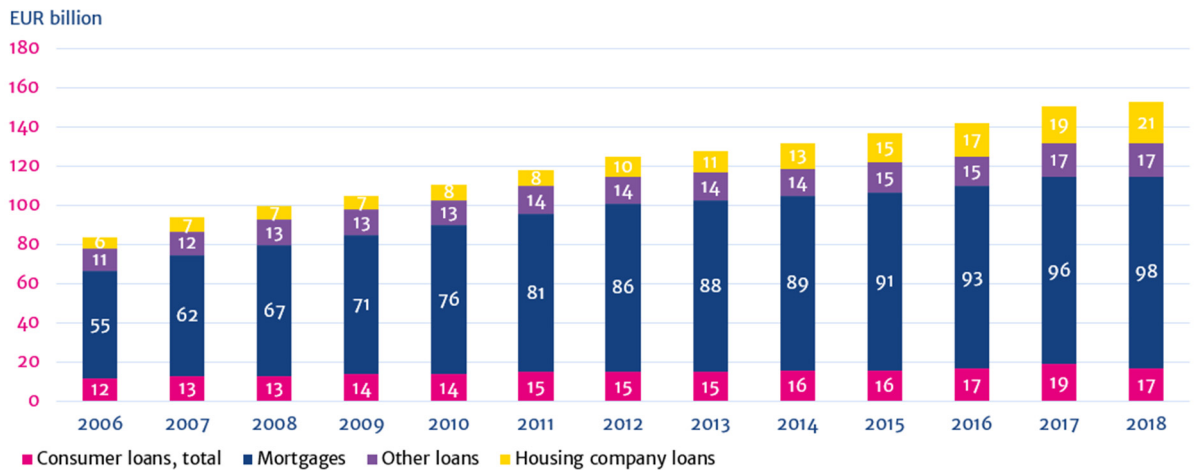
In Finland, 71.6% of households owned their home at the end of 2018. Ten years earlier in 2008, the figure was 73.2%, so in a decade, renting has become slightly more popular. In comparison, the German rental market is much larger with only slightly over a half of German households owning their home. 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.

At the end of 2018, the loan debts of Finnish households totalled €153 billion. Housing loans formed the majority of all loans at €98 billion, with consumer credit taking second place with €17 billion. It should be noted, however, that the statistical data on consumer loans is not complete. In recent years, unsecured consumer credits, such as payday loans, have 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 €9 billion in loans taken by sole traders, such as farmers. Some of them have therefore been taken out purely for business purposes, which should be considered when looking at the overall indebtedness of households.

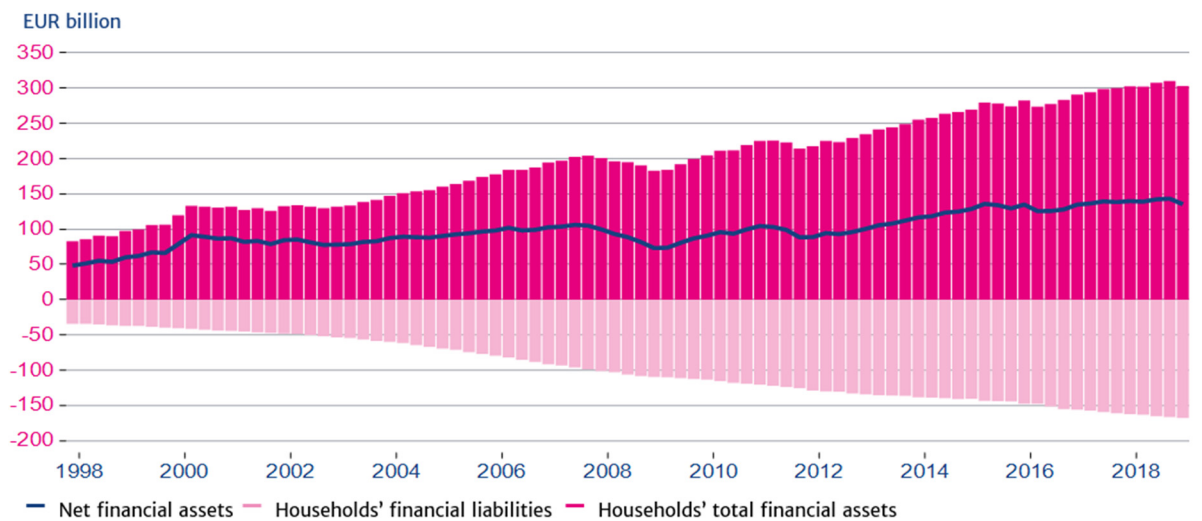
Housing company loans are the hardest to compile statistics on. As described in Section 1.2, loans are recorded on the housing company's balance sheet, and not directly on the household or company that is the owner. According to an estimate by Statistics Finland, households held €21 billion in housing company loans at the end of the year. In total, the housing corporation loan portfolio amounted to some €32 billion, leaving €11 billion for companies and other parties. However, this estimate should be treated with caution. As described in Section 1.2, 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 in the growing loan amounts than before.

As counterbalance to their debts, households also have a great deal of wealth. At the end of 2018, households held €302.9 billion in financial assets³ and €167.8 billion in financial liabilities⁴. Their net assets thus totalled €135.1 billion, which is €100 billion more than 20 years ago. In addition to financial assets, households also have real assets, such as housing wealth, which make up for the majority of household assets.



Source: Bank of Finland

Figure 11. Households' total loan debt



Source: Macrobond, Statistics Finland

Figure 12. Households' net financial assets

³ Deposits, shares, fund units, insurance savings and other receivables

⁴ Loans and other debts

Finance Finland
Itämerenkatu 11-13
FI-00180 Helsinki
Finland
www.financefinland.fi

