FINNISH BANKING 2019

An overview of the Finnish banking sector and its operating environment, the housing market, and household indebtedness in 2019.

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FINANCE FINLAND

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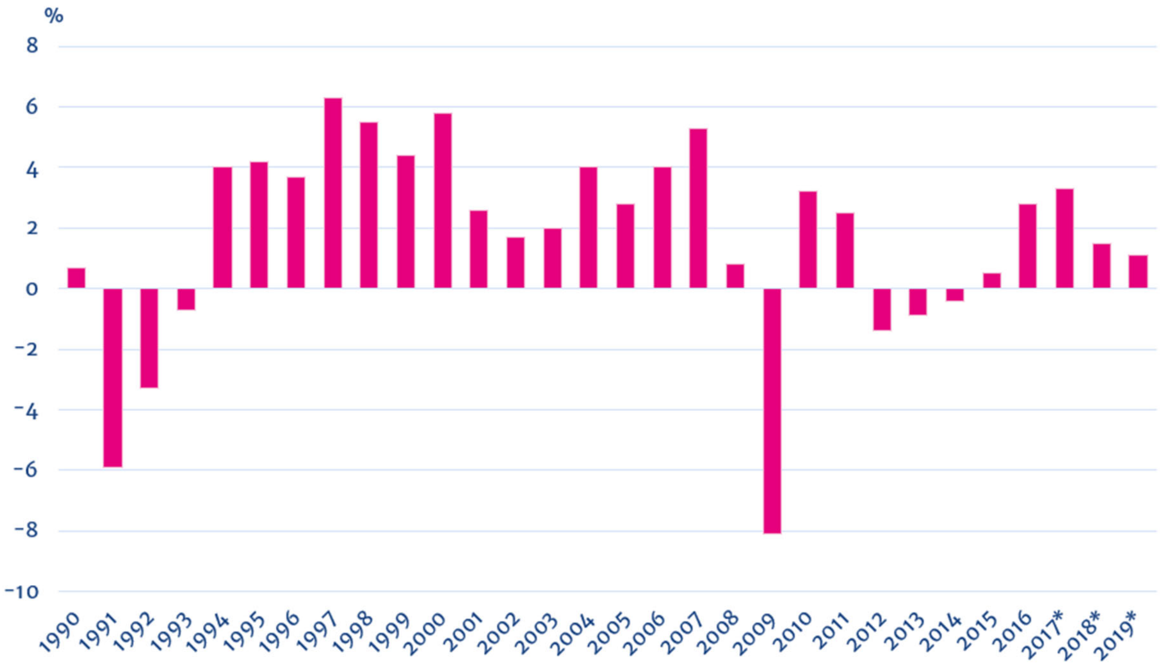
1 Economic environment

1.1 Economic development

Finland's GDP grew by 1.1% in 2019, which is slightly slower than in 2018. Growing uncertainty in the global economy and the weakening economic outlook in the euro area were reflected in the Finnish economy. The manufacturing industry's economic conditions weakened and the growth of investments slowed down. Private consumption also grew only moderately.

Figure 1. Annual change of Finnish GDP (%)



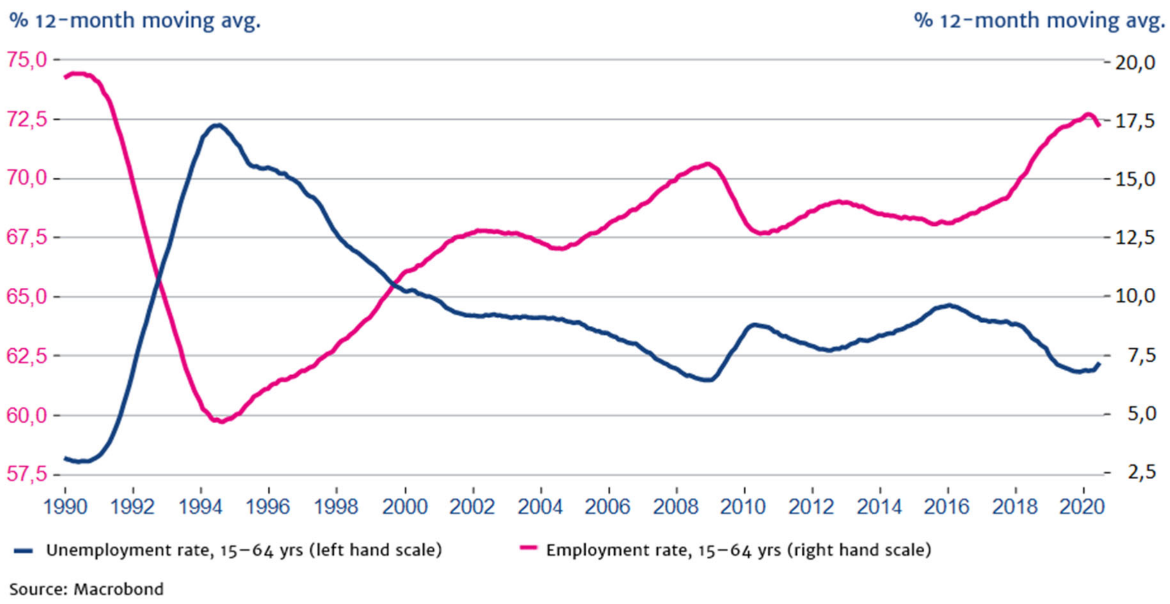
Source: Statistics Finland

The value of Finnish exports totalled €96 billion, which was a growth of 7.2% from the previous year. The volume of exports grew by 7.5%. Total exports increased as a consequence of strong growth in service exports and ship orders supplied abroad. Finland's current account nevertheless showed a deficit and weakened by more than a billion euros. The value of investments grew by 1.8% to €57 billion, but their volume sank by 0.8%. Private consumption accelerated 2% to a total of €126 billion.

According to Statistics Finland, consumer confidence fell in the second half of 2019, mostly due to general economic uncertainty.

Employment numbers grew by 17,000, which is a 0.9% increase. Most jobs were gained in health and social services, wholesale trade, information and communication, and accommodation and food service activities. The national employment rate was 72.6% at year-end.

Figure 2. Employment in Finland.



In 2019, general government deficit increased to €2.7 billion. General government EDP debt, or consolidated gross debt, was 59.4% relative to gross domestic product at the end of 2019. This is just under the 60% debt-to-GDP limit set in the EU Treaty on the Functioning of the European Union. Government tax revenue grew by 2.5%, as did total revenue by 4.1%. The total tax ratio, i.e. the ratio of tax or tax-like payments to the GDP, fell to 42.1%, down by 0.3% from 2018.

As a result of growing uncertainty in the global economy, market rates sank to a historically low level in 2019. This benefited the price development of shares and corporate bonds in the euro area. The European Central Bank (ECB) relaxed its monetary policy and relaunched its bond purchasing programme on 1 November 2019. The rates of inflation have long been much slower than the rates ECB aims at.

Finnish households' loan debts totalled €157 billion at the end of 2019, which is €5 billion more than in 2018. Housing loans comprised the majority of this debt with €100 billion. Households were liable for approximately €18 billion in limited-liability housing company loans, and for €23 billion in consumer credits. In recent years, unsecured consumer credits (so-called payday loans) have grown at a fast rate. This has given reason for concern, as a big part of registered payment defaults are related to outstanding consumer credits. In 2018, the Ministry of Finance appointed a working group to examine ways in which the excessive indebtedness of individuals and households could better be controlled and macroprudential risks thus reduced. The working group published its report in October 2019.

1.2 Housing market

Construction slowed down in terms of growth in 2019. According to Statistics Finland, construction was started on about 39,000 new dwelling units, which is 13.7% less than in 2018. This decrease was most prominent in detached houses, but the number of new blocks of flats and terraced houses was also smaller than the year before. The number of new building permits also shrank. Slightly over 37,400 new building permits were granted in 2019, which is 14.3% less than the previous year. The highest number of new building permits was granted in 2017 with close to 49,100 permits. Despite this direction of development, the number of completed dwelling units was nevertheless only 0.8% smaller in 2019 than in 2018 due to the large number of new building permits granted in 2018.

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. Although Finland's housing corporation loans are included in the corporate loan portfolio in international statistics, in national statistics the corporate loans and housing company loans are separate categories, which means increased construction does not have the same effect on the corporate loan portfolio.

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.

The housing corporation loan portfolio was almost €35 billion at the end of 2019, growing 8.7% from 2018. 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 €18 billion. Statistics Finland revised its calculation model in late 2019 and updated the whole statistical time series. As a result of the revision, which introduced more data sources for accuracy, households' share of housing corporation loans decreased. Despite the revision, households proportion of housing corporation loans has evidently continued to grow in recent years. This is also one of the main factors for households' increasing indebtedness. We take a closer look into households' debts in Section 3.

Overall housing prices went up by 0.9% in 2019. As a result of urbanisation, the housing market continued to diverge: in the capital region, housing prices went up by 2.4%, 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 capital region, relative prices have in fact fallen by roughly 10% in the past decade.

Figure 3. Housing supply in Finland

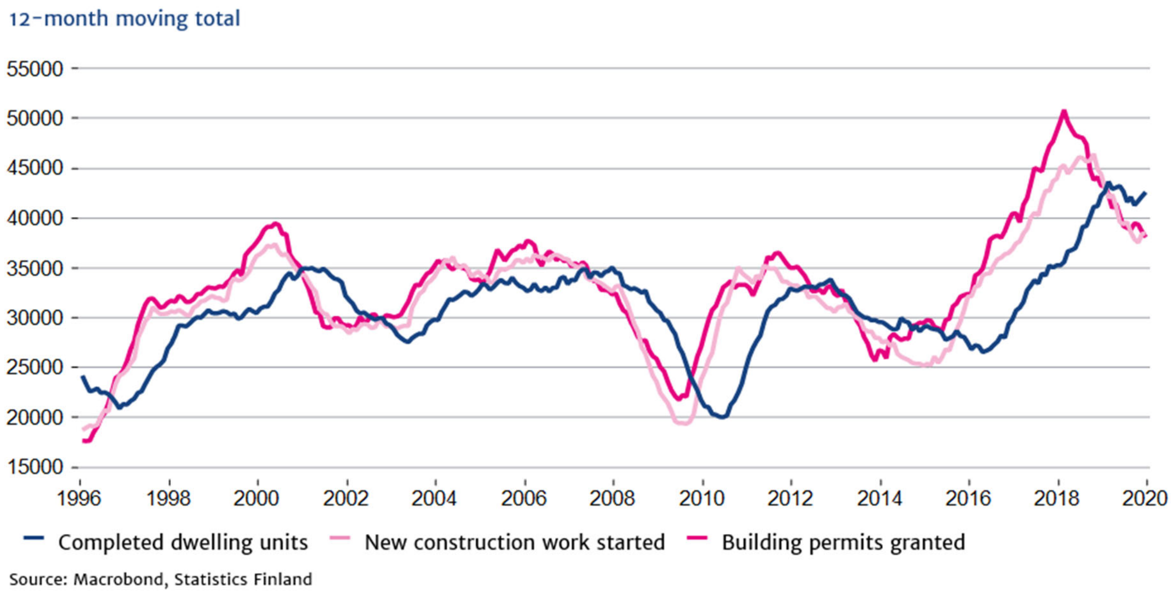
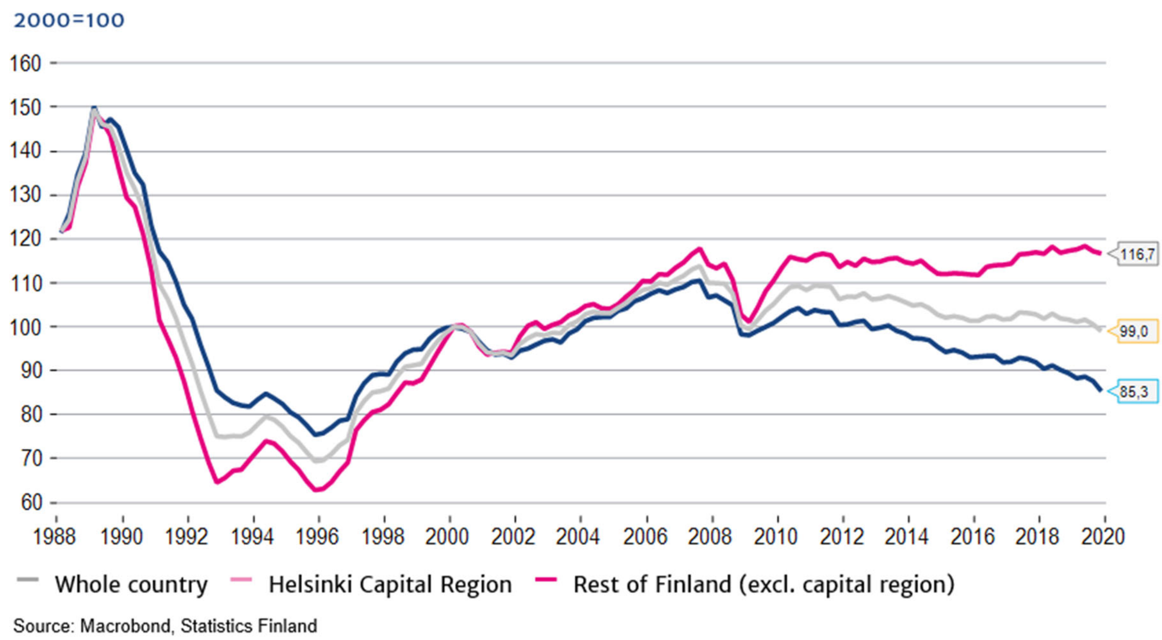


Figure 4. Housing prices in relation to income level



1.3 Regulatory environment

The regulatory environment was eventful both nationally and internationally, as it has for many years now. In Finland, the Ministry of Finance set up a working group on the national implementation of the EU “banking package”. The new International Financial Reporting Standard, IFRS 16 Leases, also entered into force at the start of the year, after being prepared for a long time. The standard changed the accounting and reporting treatment of leases.

In late 2016, the European Commission published a legislative proposal, the banking package (also known as 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). The EU reached a consensus on the package in early 2019, and the new rules entered into force in mid-2019. In Finland, the Ministry of Finance set up a working group on the national implementation of the EU banking package. FFI participated in the working group, which was mandated to run from September 2019 to June 2020. The regulation related to the banking package will enter into force at the beginning of 2021.

At the end of 2017, the Basel Committee published the finalised standards of the Basel III reform (also referred to as “Basel IV” due to its significance). The EBA received a request for advice from the EU Commission on the impact and implementation of the finalised standards. EBA published its impact assessment and advice in August 2019, after which the Commission launched a public consultation. In March 2020, the Basel Committee postponed the implementation of Basel IV with one year to 2023, which also meant that the full-scale implementation of the output floor (setting a minimum ratio to banks’ risk weighted assets generated by internal models) was correspondingly postponed to the beginning of 2028.

At the beginning of 2019, the new IFRS 16 Leases entered into force. The objective of the revised financial reporting standards was to improve the transparency of lease transactions in financial statements, for example by preventing a lessee from recording leases as off-balance sheet arrangements. The lessee is also required to recognise all assets and liabilities for all leases. The accounting treatment of lessors, on the other hand, was more or less unaffected by the new standards. The new IFRS 16 Leases also affects national accounting rules, because the amended Finnish Accounting Act enables the voluntary application of IFRS 16 also in the financial sector’s separate financial statements.

Payment Services Directive 2 (PSD2), adopted by the European Parliament, came fully into effect on 14 September 2019. The new statutes require banks to allow third-party service providers access to customers’ payment accounts. The third-party service providers can now provide payment initiation services, account information services, and card-based payment instruments. The new legislation was also aimed at improving the security of payments. Strong customer authentication became obligatory whenever the customer accesses their payment account online, makes electronic transactions, or takes any other action that involves a risk of fraud or abuse. The customer’s personal liability was reduced in cases of unauthorised payment transactions.

The Financial Action Task Force (FATF) assessed Finland’s anti-money laundering and counter terrorist financing (AML/CFT) system and published its mutual evaluation report in

April 2019. Finland was commended for its international cooperation, national risk assessment, and data acquisition. Areas to improve on were the same as in other Nordic countries, for example supervisors' limited understanding of the risks in the supervised areas.

2 Banks operating in Finland

2.1 Banking group employees and offices

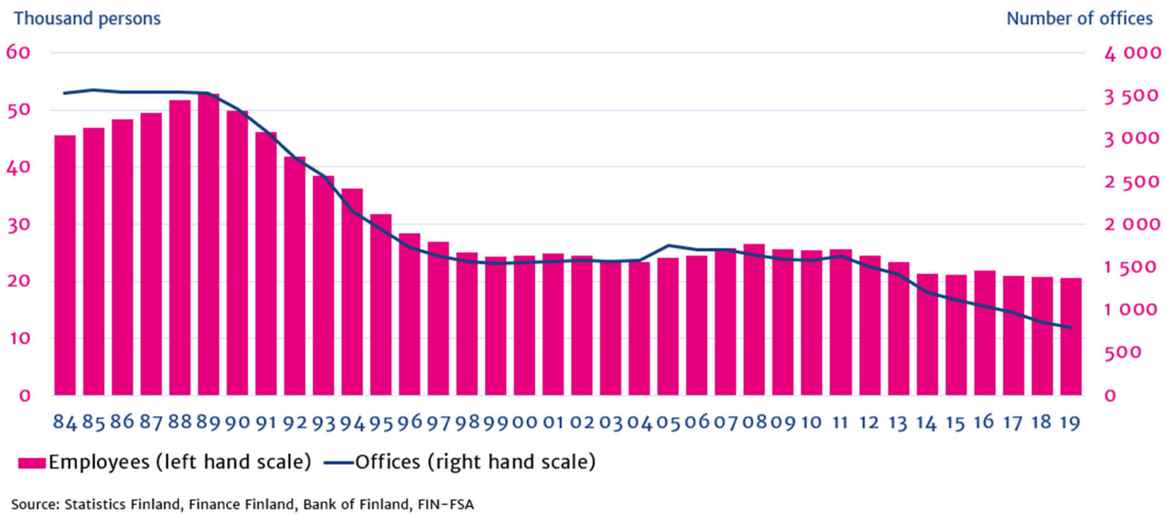
At the end of 2019, there were 246 credit institutions operating in Finland if group structures are ignored. This is 9 fewer than at the end of 2018, mainly due to mergers within banking groups. Credit institutions include deposit banks and other credit institutions that do not take deposits, such as finance houses, credit card companies, mortgage credit banks, and Municipality Finance plc.

Most Finnish credit institutions belong in a banking group or amalgamation. Calculated by group (foreign branches excluded), there were 12 Finnish banking groups or amalgamations at the end of 2019.

Nordea, OP Financial Group and Municipality Finance are under direct supervision of the ECB, while other credit institutions in Finland are supervised by the Finnish Financial Supervisory Authority (FIN-FSA).

Finnish banking groups and foreign deposit-taking banks' Finnish branches employed a total of 20,644 people at the end of 2019 (20,588 in 2018). Finnish banking groups had 790 offices in Finland, which is 64 fewer than the year before. Compared to 2018, the number of employees and offices both reduced at a slower rate. The reductions are the result of customer service moving to digital channels, increased automation, improved efficiency of functions, and mergers.

Figure 6. Bank employees and offices

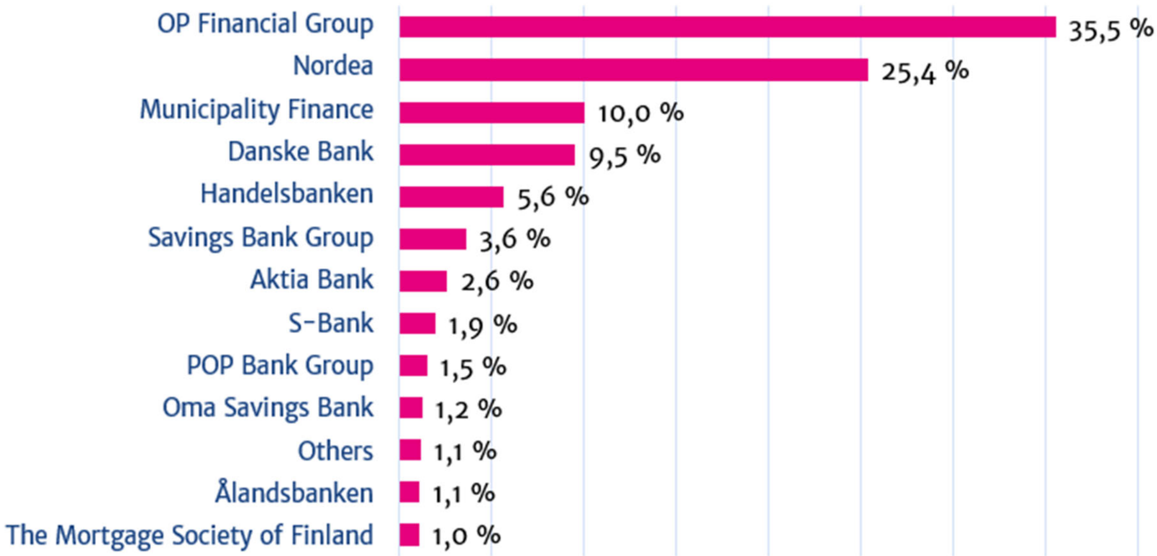


2.2 Credit institutions' market shares

The largest Finnish banking group in terms of market share is OP Financial Group, which is under ECB's direct supervision. OP Financial Group commands a market share of 36–40% in deposits, housing loans and corporate loans alike. The second largest banking group at year-end 2019 was Nordea Group with market shares of 25–30%.

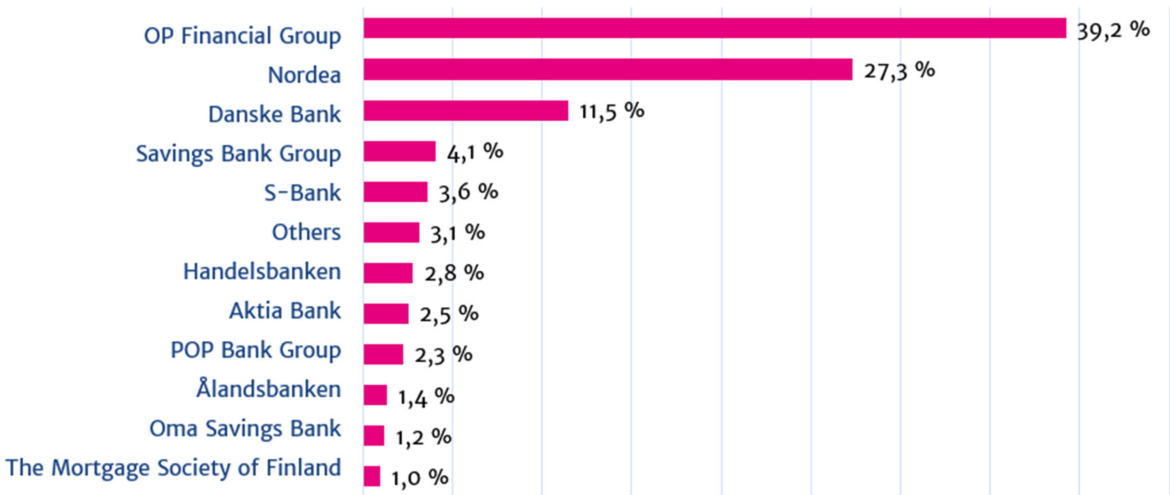
Credit institutions' market shares have not changed much in recent years. In granted loans, changes were very small, at most 0.5% in 2019. In deposits, OP Financial Group gained 0.8% in market share while Danske Bank lost 0.7%.

Figure 7. Credit institutions' non-MFI loans in Finland, market shares on 31 Dec 2019



Source: Bank of Finland

Figure 8. Credit institutions' non-MFI deposits in Finland, market shares on 31 Dec 2019



Source: Bank of Finland

2.3 Capital adequacy and profitability

The capital ratios of the Finnish banking sector strengthened in 2019. At the end of 2019, the overall capital adequacy ratio of the sector stood at 21.3%, up by 0.4 percentage points from 2018. The sector's Common Equity Tier 1 (CET1) ratio strengthened 0.4 percentage points to 17.6%. The leverage ratio increased 0.1 percentage points to 5.9%. The capital adequacy of the Finnish banking sector remains well above the EU average.

The aggregate operating profits of the Finnish banking sector totalled €3.4 billion in 2019. Non-recurring costs weakened banks' operating profits by roughly a third. Net interest income, the banking sector's most substantial source of income, improved with the volume growth of lending and the low cost of funding. Other sources of income, i.e. commissions and net income from trade and investments, also improved from the previous year. The favourable development of net interest from trading and investment activities was largely the result of changes in market values. Investment activities include banks' dealing on own account.

Net interest income is the difference between interest income and interest expenses. It currently contributes more than 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. Commissions include, for example, the fees collected from customers' use of payments and asset management services.

The banking sector's weaker operating profits in 2019 are largely due to the one-off write-downs entered by Nordea in Q3 2019. The sector's operating profits were especially burdened by an IT-system related write-down, restructuring-cost reserves, and loan impairments. Banks have made large investments into IT projects and digitalisation. The implementation phase of the new systems means the old systems need to be entered as one-off write-downs. Although personnel costs grew, the inter-group transfer of a statutory pension liability resulted in a slight decrease in comparable personnel costs. Non-recurring costs raised banks' operating expenses somewhat compared to 2018.

A substantial portion of Finnish banks' funding comes from non-MFI deposits, whose average interest was close to zero in 2019. However, the numbers vary greatly between credit institutions: some fund their operations almost entirely with deposits, while others[1] do not take deposits at all.

Most deposits come from households. The average interest rate for household deposits fell minutely to 0.10% in 2019. 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 rate fell below zero at the end of 2019. 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 (i.e. certificates of deposit) has been shrinking since 2008. Banks' risk reduction package

[1] Finance houses, mortgage credit banks and Municipality Finance plc.

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 4.9% at the end of 2019, slightly below the average ROE for all EU banking sectors (5.4%). 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.

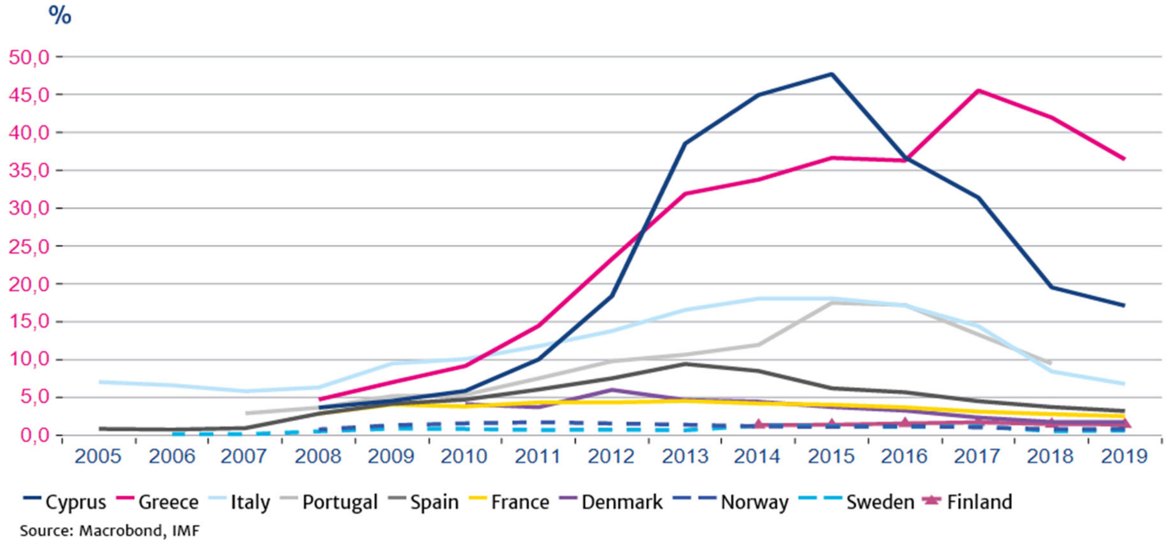
As noted, non-performing assets and problem loans have burdened the European banking sector after the financial crisis, some areas like Southern Europe more than the others. European authorities have initiated several measures to clean up the balance sheets of banks. One of them is the regulation regarding minimum loss coverage for non-performing exposures that entered into force in spring 2019.

In Finland, non-performing assets have not been a problem. At the end of 2019, they remained at the same low level as in 2018, comprising about 1.7% of the loan portfolio.

The Finnish banking sector's short-term liquidity remained strong in 2019, although the sector's Liquidity Coverage Ratio (LCR) fell 9 percentage points to 166%. The LCR is calculated by comparing a bank's liquidity buffer with its net cash outflows over a 30-day stress period. The minimum LCR requirement is 100%. The average LCR in the EU is 148%.

The liquidity buffer of Finnish banks totalled €130 billion and consisted mainly of central bank deposits (35%) and high-quality covered bonds (27%). As much as 96% of the liquidity reserves consist of level 1 assets, which are the most liquid assets. The main difference between the 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 2019, the rate was negative at -0.50%.

Figure 9. Non-performing exposures in relation to the loan portfolio



3 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 2019, the ratio of household debt to income was 129%. 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 when regulation grew more strict. The Danish also have the most living space in Europe, which ties in with sizeable housing loans.

In Finland, 71.1% of households owned their own home at the end of 2019. 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 more than half of German households living in owner-occupied homes. In Eastern Europe, the majority of the population own their homes and have no debt. On average, 69.3% of all EU households own their home.

At the end of 2019, the loan debts of Finnish households totalled €157 billion. Housing loans comprised the majority of this debt with €100bn. Consumer credit totalled €23 billion. It should be noted, however, that the statistical data on consumer credit is not complete. In recent years, unsecured consumer credits, such as payday loans, have grown at a fast rate. This has given reason for concern because most cases of registered payment defaults are related to outstanding consumer credits.

Other loans totalled €16 billion. These include €5 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.

The loans of limited-liability housing companies, or housing company loans, are the hardest to compile statistics on. As described in Section 1.2, the loans are recorded on the housing company's balance sheet, not directly on the household or company that is the owner. Households' share of the housing company loans has therefore been based on a calculated estimate. According to an estimate by Statistics Finland, households held €18 billion in housing company loans at the end of the year. In total, the housing corporation loan portfolio amounted to €33 billion, leaving €15 billion for companies and other parties. Statistics Finland updated its evaluation of households' share in autumn 2019, revising it downwards. However, the estimate should still 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 been attributed to households, but in recent years, the number of investors in new acquisitions has grown exceptionally large. This means that housing funds and housing investment companies probably have a greater role in the growing loan amounts than before.

In 2018, the Ministry of Finance appointed a working group to examine ways in which the excessive indebtedness of individuals and households could better be controlled and macroprudential risks thus reduced. The working group published its report in October 2019.

The report proposes a number of additional tools to the macroprudential stability toolkit currently in use in Finland. These include a debt-to-income (DTI) loan cap, maximum loan term of 25 years on mortgage lending, and limitations to housing company loans in new housing construction. The latter also involve a loan cap, 25-year maximum maturity, and a rule that no interest-only periods could be used for the first five years.

The report also includes proposals which are primarily related to customer protection, but which can indirectly be considered macroprudential policy tools. These include an authority for the FIN-FSA to issue regulations on maximum values for the assessment of the default risk, and tightening of the default risks and assumptions used in the assessment of creditworthiness. The working group also proposed the transfer of the responsibility for the supervision of payday loan companies to FIN-FSA.

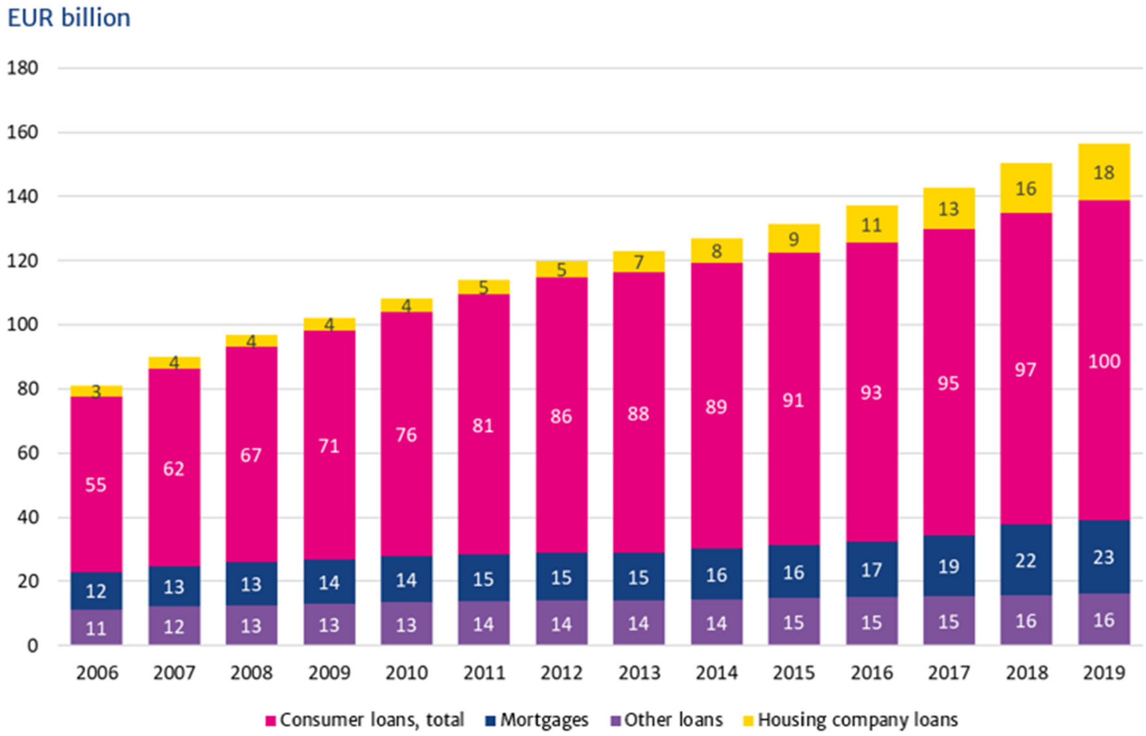
The government's draft legislation process has been delayed. The new legislation will probably be handed over to the Finnish Parliament in early 2021.

As counterbalance to their debts, Finnish households also have a great deal of wealth. At the end of 2019, households held €329.3 billion in financial assets[2] and €184.1 billion in financial liabilities[3]. Their net assets thus totalled €145.2 billion. Households' net assets have grown by more than €100 billion over the past two decades. In addition to financial assets, households also have real assets, such as housing wealth, which in fact comprises the majority of household assets.

[2] Deposits, shares, fund units, insurance savings and other receivables.

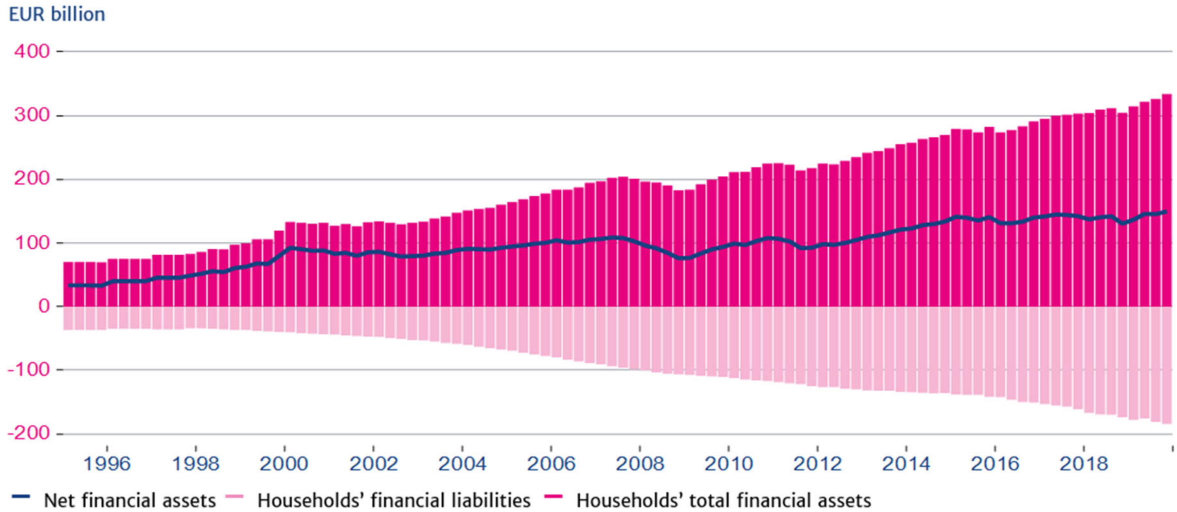
[3] Loans and other debts.

Figure 10. Households' total loan debt



Source: Bank of Finland, Statistics Finland

Figure 11. Households' net financial assets



Source: Macrobond, Statistics Finland

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