FINNISH BANKING 2021

This report by Finance Finland is an overview of the Finnish banking sector and the key changes in its operating environment in 2021.

Written by Finance Finland's adviser
Jussi Kettunen

FINANCE FINLAND

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Introduction

The *Finnish banking 2021* report is an overview of the Finnish banking sector and the key changes in its operating environment in 2021. Finance Finland publishes the banking report annually, with a focus on current topics affecting the sector that year. The report covers two main themes: 1) developments in the operating environment and 2) developments in the banking sector.

The purpose of the report is to increase knowledge of the factors that affect the banking sector and to present a summary of the state of the banking sector. To offer a fuller picture of developments in the operating environment, this year's report discusses monetary policy measures and the regulatory and supervisory environment in more detail than previous reports.

1 General operating environment

Like its predecessor, the year 2021 was coloured by the COVID-19 pandemic. It was characterised not only by uncertainty caused by the pandemic, but also by optimism and a strong upswing in the global economy thanks to extensive stimulus measures and the release of pent-up demand. Inflation was also a permanent topic of discussion in 2021. Towards the end of the year, inflation in the euro area reached about 5%, a level unprecedented in the European single currency era.

In 2021, the pandemic began to subside as vaccination coverage increased and restrictions proved effective in curbing the pandemic. Many EU countries lifted their travel restrictions to and from countries with a good epidemiological situation, while simultaneously also preparing a variety of measures to ward off new virus variants. Globally, countries recovered from the pandemic at very different paces. One of the winners was China, which bounced back from the financial shock caused by the pandemic quite quickly.[1] Finland also managed to keep the pandemic in check fairly well, benefiting from the high degree of digitalisation that has enabled many people to work remotely and avoid physical contact.

The potential deterioration of the pandemic continued to pose the greatest immediate risk to the economy in 2021, even though new pandemic waves affected the economy less and less as vaccinations progressed. In the spring, the number of COVID-19 infections dropped in many countries and global economic recovery picked up speed, with the effects spreading increasingly also to the service sector. Decision-makers seemed to be less inclined to introduce new restrictions, and people seemed to better tolerate higher infection numbers without feeling the need to barricade at home again, perhaps because the groups of people who might otherwise have been the most cautious had the best vaccination coverage. New virus variants caused concern over the year, but people had already learned to live with the pandemic.

Economic activity remained at a high level, which also helped maintain strong overall vitality in the stock market. In general, central banks' monetary policy remained highly accommodative. Towards the end of the year, inflation and rising interest rates resurfaced on the central banks' agenda after a long break. During the year, inflation increased significantly in many countries, partly because of the low comparison level of the year before, but partly also because of the bottlenecks caused by economic recovery and the rising price of raw materials. Monetary accommodation also caused inflation to pick up speed. Inflation concerns were a frequent topic already in early 2021 – rapidly rising inflation was considered

[1] https://www.bofit.fi/en/monitoring/weekly/2022/vw202204_1/

a threat. In late 2021, the tightening relations between Ukraine and Russia increased uncertainty in Europe, adding tension in superpower relations and pushing the price of energy even higher.

In addition to the coronavirus pandemic and the rising tensions between Russia and Ukraine, other topics that featured heavily during the year included climate change and its effects and mitigation. From a climate perspective, 2021 was indeed one of the hottest years on record. The EU's aim to make Europe the world's first climate-neutral continent by 2050 sets certain expectations both for new regulation and the financial market's role in achieving this. The banking sector will play a significant role in climate transition as finance will be increasingly redirected towards green investments. One of the EU's central actions in promoting sustainable finance is the EU Taxonomy, a classification system for sustainable economic activities that establishes common, science-based criteria for sustainable investments.[2] The purpose of the Taxonomy is to help banks and other financiers identify investments that are truly sustainable. It is important to note that even if a company's operations fall outside the classification, it does not mean that they are automatically unsustainable or environmentally harmful.

The Taxonomy is a living tool that will evolve over the years. Finance Finland considers it important that the Taxonomy is tailored for the EU's financial market and that its definitions are harmonised. For the banking sector, this will mean a great deal of new, evolving regulation in the coming years.

1.1 Finnish economy

The Finnish economy developed favourably in 2021. As the world economy recovered, industrial production increased and the export outlook improved. In addition to vaccination progress, trust in economic development was bolstered by the added growth boost from new stimulus measures and by the easy financing conditions.

The Finnish economy took a strong upturn in early 2021. Both companies and households were in a good financial position and optimistic about the future. Bankruptcies were on a par with the previous years. Unemployment decreased, and the improved employment situation boosted home sales. The housing market was busy, and loans were taken out for both homes and holiday homes at a rapid pace in the summer.

In late 2021, however, the growth outlook become more subdued as the economy suffered increasingly from bottlenecks and the accelerating rise of prices.

Looking back to 2020 and the early days of the coronavirus crisis, it is safe to say that the pandemic caused less economic damage in Finland than feared. According to Statistics Finland, the volume of Finland's gross domestic product (GDP) fell by 2.3% in 2020.[3] The decline in the euro area was more pronounced. Because Finland's GDP fell less sharply than that of the euro area on average, the recovery was also less radical.

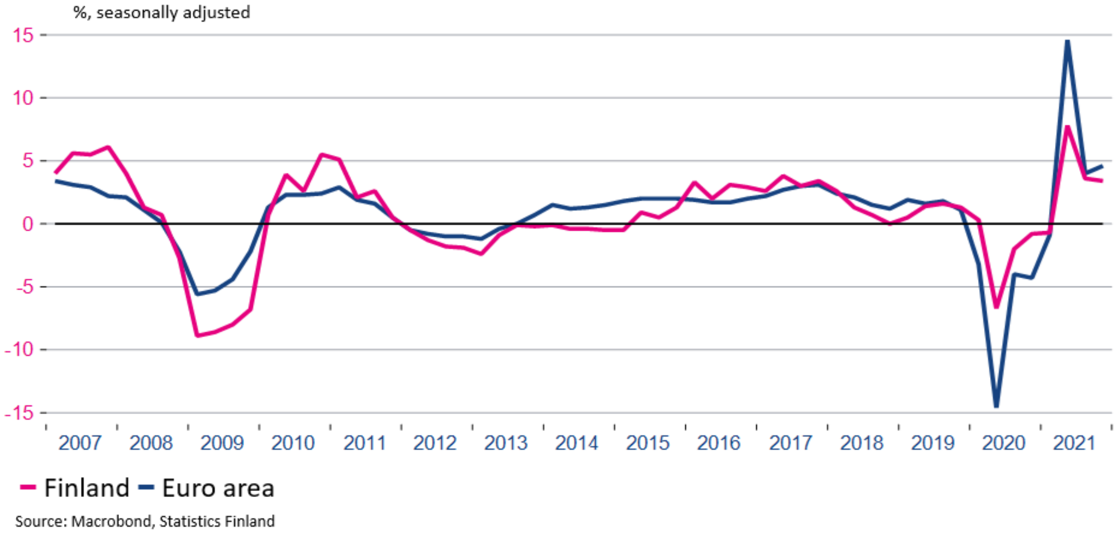
The year 2021 was a time for repairing the damage caused to the economy by the pandemic, and the prevailing mood was that of uncertainty mixed with optimism. Several forecasters improved their economic forecasts on Finland's economic growth throughout the year.

[2] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R2139

[3] https://www.stat.fi/til/vtp/2020/vtp_2020_2022-02-28_tie_001_en.html

According to Statistics Finland, the volume of Finland's GDP rose by 3.5% in 2021, and Finland managed to reach the pre-pandemic level of production during the year.[4]

Figure 1: Annual change of GDP in Finland and the euro area (%)



As the economy picked up, employment also moved up a gear: Finland's average employment rate was 72.3% in 2021, up from 70.7% in 2020. The average unemployment rate was 7.7% in 2021, which is the same as in 2020. In 2021, the number of unemployed persons averaged 212,000.[5]

Households increased their financial assets, which reflected on the growing popularity of investments. At the end of 2021, almost one third of Finns had savings in investment funds or shares.[6] By the end of September, more than 200,000 people had opened an equity savings account, which were only recently introduced in Finland.[7]
The pandemic period is characterised by an increase in deposits: households' net acquisitions of deposits reached a record high at the end of 2021, totalling €109bn.[8] In total, retail deposits increased by €5.8bn during the year.

The pandemic years are also characterised by the growth of the student loan stock. According to the Bank of Finland statistics, the student loan stock also broke records,

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[4] https://www.tilastokeskus.fi/tup/suoluk/suoluk_kansantalous_en.html#Annual%20change%20in%20the%20volume%20of%20gross%20domestic%20product

[5] https://www.stat.fi/til/tyti/2021/12/tyti_2021_12_2022-01-25_tie_001_en.html

[6] https://www.finanssiala.fi/uutiset/tilastokeskus-lahes-kolmannes-suomalaisista-on-rahasto-tai-osakesaastajia/ (in Finnish)

[7] https://www.euroclear.com/finland/fi/news-and-insights/news/Osakesaastotileilla-yli-miljardin-euron-arvoiset-sijoitukset-suomalaisiin-osakkeisiin.html (in Finnish)

[8] https://www.suomenpankki.fi/en/Statistics/mfi-balance-sheet/older-news/2022/december-2021-sees-an-exceptionally-large-amount-of-corporate-loan-drawdowns/

exceeding €5bn for the first time in August 2021.[9] The pandemic has cut the number of jobs in many sectors that typically employ students, thus increasing the need for financial aid for students. The volume of student loans has been increased by the larger loan tranches that flowed from the student financial aid reform of 2017[10] and by an increased number of borrowers. The low interest rates have also increased the popularity of student loans. According to the statistics[11] of the Social Insurance Institution of Finland (Kela), the amount paid in student loan compensation for students who have graduated in target time has grown in recent years, which for its part has served to slightly slow down growth in the stock of student loans.

1.2 Housing market

The Finnish housing market has boomed during the pandemic. Despite the active market situation, housing prices have developed moderately overall, with no sign of general overheating or a price bubble. Regional differences in housing prices remain large, and in parts, the market has continued to diverge even further. In many municipalities, housing prices have either remained level or continued to fall.

In an international ranking of the world's bubbliest housing markets by Bloomberg Economics, Finland does not rank on top, but of the Nordic countries, Sweden and Norway feature high on the list.

The banking sector has continued to grant credits to households as usual during the pandemic, which has been extremely important in terms of labour mobility and the increasing popularity of remote work, for example. The pandemic has changed housing needs as people have increasingly worked from home. Thanks to the easy monetary policy, pandemic savings and the increased value of investments, many households have been able to purchase a new home.

At the end of December 2021, the stock of housing loans stood at €107.6bn, and the annual growth rate of the stock was 4.1%.[12] [13] Buy-to-let mortgages accounted for 8.1% of the housing loan stock. Out of all loans of Finnish households at the end of December, consumer credit totalled €16.8bn and other loans €17.9bn.

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[9] https://www.suomenpankki.fi/en/Statistics/mfi-balance-sheet/older-news/2021/average-interest-on-new-student-loans-close-to-zero--stock-of-student-loans-exceeds-eur-5-billion/

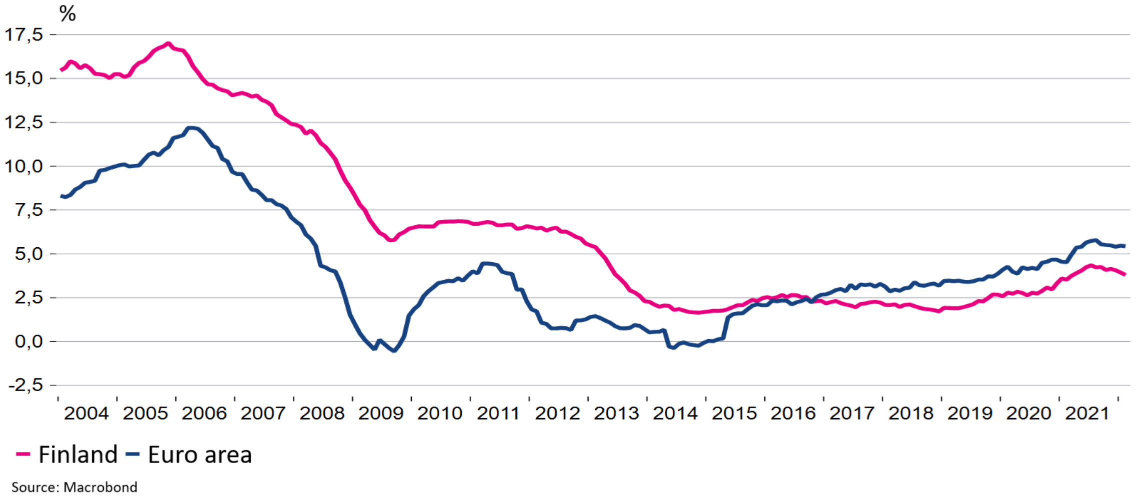
[10] https://www.eurojatalous.fi/fi/blogit/2017/opintolainat-kasvavat-ennatysvauhtia-suurin-syy-opintotuen-uudistukset/ (in Finnish)

[11] https://www.kela.fi/web/en/statistics-by-topic-financial-aid-for-students

[12] https://www.suomenpankki.fi/fi/Tilastot/rahalaitosten-tase-lainat-ja-talletukset-ja-korot/taulukot/rati-taulukot-fi/markkinaosuudet_luottolaitokset_fi/ (in Finnish)

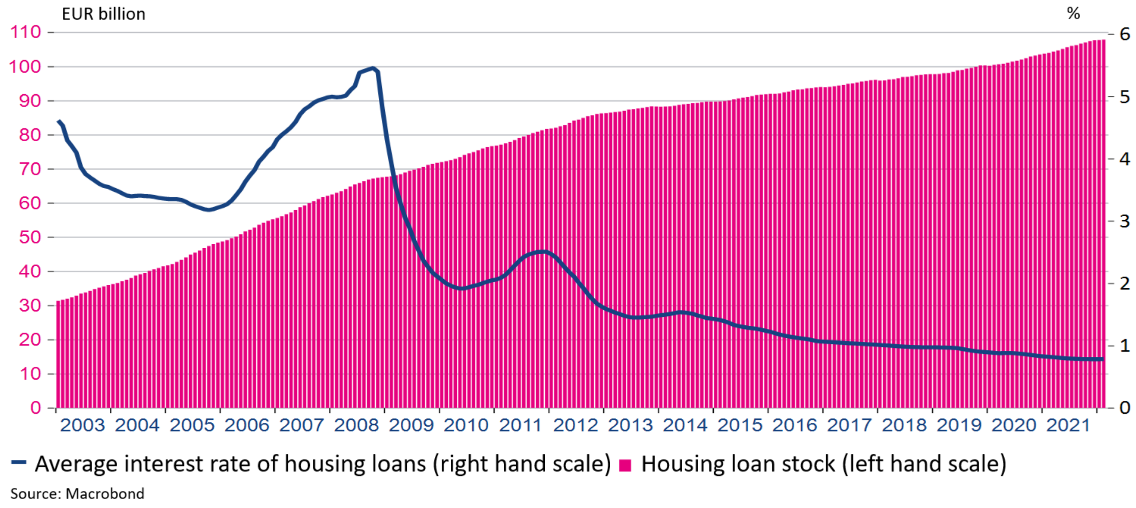
[13] https://www.suomenpankki.fi/en/Statistics/mfi-balance-sheet/older-news/2022/december-2021-sees-an-exceptionally-large-amount-of-corporate-loan-drawdowns/#:~:text=At%20the%20end%20of%20December%202021%2C%20the%20stock%20of%20housing,totalled%20EUR%2016.8%20bn%20and%20other%20loans%20EUR%2017.9%20bn

Figure 2: Annual growth rate of the housing loan stock in Finland and the euro area



The interest expenses of housing loans continued to remain moderate. At the end of 2021, the average interest rate was 0.78% in housing loans and 0.91% in buy-to-let mortgages.[14]

Figure 3: Households' housing loan stock and average interest rate



At the end of December, the stock of loans to housing corporations stood at €39.5bn. Finnish limited liability housing companies have certain unique characteristics that are also reflected in the credit statistics. In other countries, increased housing 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, corporate loans and housing company loans are separate categories, which means that increased construction does not have the same effect on the corporate loan portfolio.

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[14] https://www.suomenpankki.fi/en/Statistics/mfi-balance-sheet/older-news/2022/december-2021-sees-an-exceptionally-large-amount-of-corporate-loan-drawdowns/

In general, loans taken out to construct a residential building in Finland are recorded on the establishing 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 limited-liability housing companies. Some of the housing corporation loan volume is held by households, some by housing investment funds and other housing investors, and some by companies.

In 2021, the number of building permits granted and building starts grew significantly from the previous year. During the year, construction of around 48,000 new dwellings was started, and the number of completed dwellings was just over 37,400.[15]

2 Supervisory measures

2.1 The ECB's monetary policy

The European Central Bank (ECB) published its new monetary policy strategy in 2021. The revised strategy has both direct and indirect effects on the operating environment of banks. The ECB's new target is an inflation rate of 2% over the medium term. The ECB has kept its key interest rates at a very low level for a long time, while the inflation rate has fallen short of the target level.

In 2021, the big picture in monetary policy was characterised by the continuation of an accommodative monetary policy stance and various exceptional measures. The ECB committed to maintaining favourable financing conditions to see households and companies over the coronavirus crisis, which in part kept long-term interest rates and interest rate expectations at a low level. The ECB stated that with a subdued inflation outlook, a highly accommodative monetary policy was still required. As inflation accelerated towards the end of the year, the discussion on ECB measures acquired new tones. Some also criticised the ECB's monetary accommodation.

The ECB continued to conduct net asset purchases under the pandemic emergency purchase programme (PEPP) according to market conditions in 2021. The ECB's Governing Council also kept in force other measures to support the achievement of the price stability objective and to boost economic growth: it kept the key ECB interest rates unchanged, continued to conduct net asset purchases under the asset purchase programme (APP) and reinvest the principal payments from maturing securities purchased under the APP, and stayed on track with the targeted longer-term refinancing operations. The ECB's interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility remained unchanged at 0.00%, 0.25% and -0.50% respectively.

In June 2021, the ECB announced that it would continue the exceptional circumstance measures until March 2022. Among other things, this meant allowing for the extension of the temporary exclusion of certain central bank exposures from the leverage ratio. Such assets include coins and banknotes as well as deposits accumulated during the pandemic that banks hold at the central bank.

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[15] https://www.tilastokeskus.fi/til/ras/2021/12/ras_2021_12_2022-02-22_tie_001_en.html

The ECB's targeted longer-term refinancing operations (TLTROs) continued in 2021. Through TLTROs, the ECB offers banks collateral-backed long-term central bank funding at a low interest rate, thus supplementing their funding and available financing. The objective of the TLTROs is to incentivise banks to increase lending to the private sector and to solidify the liquidity position of banks.[16] At the end of 2021, the Finnish banking sector had acquired some €36bn through the programme.[17] Affordable central bank loans have decreased the need for banks to rely on bonds.

In addition to the monetary policy measures, fiscal stimulus has also played an important role in the coronavirus crisis. Monetary and fiscal policy supported each other when the euro area economy took a sudden halt. The adopted policy measures have allowed banks to continue to grant loans and companies and households to have access to enough financing.

The ECB has stated that the banking sector will be subject to more climate actions in the future. In its new strategy, the ECB's Governing Council commits to implementing a climate action plan. This action plan comprises a variety of measures for 2021–2024, many of which deal with monetary policy collateral and thus also affect asset purchase programmes.[18]

2.2 Regulatory environment

The regulatory environment was busy in 2021. The widely discussed Basel III reform on banks' capital requirement regulations was active throughout the year. Most of the binding obligations included in the previous phase of the reform took force in late June.

The financial crisis that broke out in 2008 revealed significant shortcomings not only in the regulation of the financial market, but also in its supervision. Since the financial crisis, the prudential framework applied to banks has undergone significant global changes to improve the resilience of banks. This work has continued to date. The EU has carried its weight by implementing reforms of its Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD).

The reforms implemented so far have focused on improving the quality and quantity of the regulatory capital that banks must have to cover potential losses. They also aim to curb banks' over-indebtedness, improve their short-term resilience to liquidity shocks, reduce their dependence on short-term funding, limit their concentration risk, improve their capital buffers and tackle 'too big to fail' problems. Thanks to these reforms, the resilience of the EU banking sector has improved considerably from the financial crisis, allowing the sector to face the COVID-19 crisis in much better shape.

At the heart of the latest reform were changes to the risk calculations of banks. The European Commission published its much-debated proposed changes on 27 October 2021. The reforms agreed by the Basel Committee on Banking Supervision are meant to improve

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16 https://www.ecb.europa.eu/mopo/implement/omo/pdf/TLTRO3-calendar-2021.en.pdf

17 https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=123.ILM.M.FI.N.A050200.U2.EUR

18 https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210708_1_annex~f84ab35968.en.pdf

comparability between banks and fix a number of shortcomings in current regulation. The proposed reforms (CRR III and CRD VI) are supposed to take effect at the beginning of 2025.

The Finnish banking sector is concerned about how the EU implementation of the Basel standards will increase Finnish banks' capital requirements and about how little attention the standards give to promoting sustainable economic growth. The regulation entails significant changes to banks' capital requirement regulation and especially to the risk assessment of banks' assets. When the Basel III reform began, one of the preconditions laid down was to avoid significantly raising capital requirements for banks. Impact assessments by supervisory bodies and research institutes nevertheless indicate that the reform is in fact about to increase the capital requirements, particularly for EU banks. According to the Finnish Financial Supervisory Authority (FIN-FSA), the increase in capital requirements in Finland would average 15%. The reform would also change the calculation of capital requirements to reflect risks less accurately than before. The regulation would affect especially housing and corporate loans, which Nordic banks hold to a great degree.

The key parts of the previous phase of the Basel reform took force in June 2021. Key changes included the binding leverage ratio requirement, aiming to curb the excessive indebtedness of banks, and a binding net stable funding ratio (NSFR) requirement, aiming to reduce banks' dependency on short-term funding. Finnish banks have been preparing for these new binding requirements for years and already fulfil them by a wide margin. The topic is discussed in more detail in Finance Finland's Finnish-language reports.[19] [20]

The Pillar III disclosure required of banks underwent changes when the updated Capital Requirements Regulation (CRR) came into effect on 28 June 2021. Disclosures are published quarterly, semi-annually and annually. The updated disclosure requirements take into consideration the amendments to the CRR and entail changes to counterparty credit risk, NSFR and balance sheet reporting.

One of the most significant Finnish regulatory projects in 2021 was the national implementation of the EU Risk Reduction Package, whose legislative proposals involved diverse stakeholder groups, including Finance Finland, in a working group led by the Ministry of Finance. The package implemented the revised rules on EU capital requirements (CRR II/CRD IV) and resolution (BRRD II/SRMR II). The Finnish Parliament passed the legislative changes in the spring, and they largely entered into force on 1 April 2021.

The Ministry of Finance also worked on a decree on the implementation of the systemic risk buffer requirement. The Ministry of Finance decree on the systemic risk buffer capital add-on for credit institutions and investment firms (523/2021) was published on 19 May, and the requirement took effect on 20 May. In the future, supervisory authorities must justify their decisions on banks' systemic risk buffer requirements in more detail.

The Finnish Act on Mortgage Credit Banks was updated in 2021, when the EU Covered Bonds Directive enacted in November 2019 was adopted into national legislation. Covered bonds are an important funding instrument for banks and also serve as eligible assets for collateral for central bank credit. When drafting the regulation, the objective was to maintain equal opportunities for both large and small banks to participate in the covered bonds market, without adding too many costs arising from regulation.

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[19] https://www.finanssiala.fi/wp-content/uploads/2021/07/FA_0207_Suomen_pankkisektorin_omavaraisuus.pdf (in Finnish)

[20] https://www.finanssiala.fi/wp-content/uploads/2021/06/FA_14062021-Raportti_Vakaat_rahoituslahteet.pdf (in Finnish)

The effectiveness of macroprudential regulation was also assessed in 2021. In November, the European Commission published a targeted consultation on improving the EU's macroprudential framework for the banking sector.[21] The objective of the consultation was to assess the effectiveness of the macroprudential framework and the need to make improvements. In its response to the consultation, Finance Finland argued that macroprudential requirements must be kept predictable, symmetric and transparent. The guiding principle should be that of only one capital requirement or other measurement stemming from a certain risk. The amendments should not increase the overall level of capital requirements from their current level. Moreover, the principles of the use of macroprudential instruments should be harmonised at the EU level.

2.3 Supervisory environment

On the supervisory front, 2021 was another eventful year.

The Finnish Financial Supervisory Authority (FIN-FSA) enhanced its monitoring of the effects the pandemic-induced financial shock had on banks' capital adequacy, liquidity and operative risks. One of the FIN-FSA's concrete measures involved changes to the reporting obligations of its supervised entities. The ad hoc reporting practices adopted soon after the pandemic broke out were kept in force until early 2021. Although some of the banks' reporting obligations were relaxed with the pandemic, a number of new obligations were created, causing a significant burden on banks. The FIN-FSA's reporting practices will be reformed as the FIN-FSA adopts a new reporting system in 2022.

In auditing, the FIN-FSA enhanced its monitoring of credit risk development, analysing particularly the development of banks' corporate financing.

Following the outbreak of the pandemic, supervisory authorities adopted several exceptional measures, which they began to gradually abandon in 2021. The FIN-FSA decided not to extend its recommendation on the distribution of credit institutions' profits beyond 30 September 2021. The recommendation expired as to both profit distribution and variable remuneration. The FIN-FSA's decision takes into account the ECB's corresponding decision, which was based on the rebound in economic activity and hence reduced uncertainty.

Through a decision published by the ECB on 12 March 2020, banks under the direct supervision of the ECB were permitted flexibility in meeting the requirement for the liquidity coverage ratio (LCR). The FIN-FSA adopted the same approach in banks under direct FIN-FSA supervision. The relief supported the banks' ability to finance the economy in the face of COVID-related market uncertainty.

On 17 December 2021, the ECB announced that it would not extend the liquidity relief measure beyond 31 December 2021. The ECB considered that there was no longer any need for the relief as banks had ample liquidity buffers. In Finland, too, banks' liquidity was at a high level. There was accordingly no need to maintain the option for flexibility in meeting the LCR requirement with banks under direct FIN-FSA supervision either. As of 1 January 2022, all banks have therefore been expected to maintain a liquidity coverage ratio of above

[21] https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/2021-banking-macroprudential-framework-consultation-document_en.pdf

100%.[22] The average LCR of Finnish banks stood at 177% at the end of 2021 (171% at the end of 2020).[23]

At the end of July, the European Banking Authority (EBA) published the results of its EU-wide stress test exercise assessing how resilient significant banks are to possible changes in the operating environment. Of Finnish credit institutions under the ECB's supervision, OP Financial Group and Nordea participated in the EBA stress test and Municipality Finance in the parallel ECB stress test. At the same time, the FIN-FSA conducted a stress test in Finland, covering the following smaller banks and groups that are under direct FIN-FSA supervision: Aktia Bank, Oma Savings Bank, POP Bank Group, S-Bank, Mortgage Society of Finland Group, the Savings Banks Group and Bank of Åland. The FIN-FSA's stress test exercise was based on the guidelines and scenarios of the EBA's EU-wide stress tests. The results showed that the Finnish banking sector's solvency would withstand a strong weakening in the operating environment.

At the European level, the ECB prepared its climate stress tests, whose participants will in the early stages include the largest euro-area credit institutions. Climate stress tests differ from traditional stress tests in that they cover a horizon of 30 years. In the summer, the EBA and the FIN-FSA issued guidelines instructing banks to better consider ESG risks in their credit granting.

The ECB climate stress test examines the resilience of companies and banks to a range of climate scenarios. These scenarios set out plausible representations of future climatic conditions while also accounting for how businesses are impacted by the measures taken to limit the extent of climate change, such as carbon taxes. The ECB scenarios are based on those provided by the Network for Greening the Financial System (NGFS), but they have been adjusted to better capture the relationship between transition risk and physical risk.[24]

The FIN-FSA has various national-level macroprudential instruments that it decides on quarterly. In 2021, these instruments primarily targeted the housing market.[25] Finance Finland issues its comment on the macroprudential situation to the FIN-FSA before each decision. The comments are available in Finnish on the Finance Finland website.

The FIN-FSA eased its macroprudential policy in 2020 and kept the policy light in early 2021. It also maintained the countercyclical capital buffer requirement at 0.0% and kept the loan cap at the statutory level of 90% for new residential mortgage loans other than first-home loans and of 95% for first-home loans.

The FIN-FSA decided to discontinue the risk weight floor set for residential mortgage loans applicable to credit institutions that have adopted the Internal Ratings Based (IRB) Approach for the calculation of capital requirements. The requirement expired on 1 January 2021. In its justifications for the decision, the FIN-FSA stated that the macroprudential significance of the risk weight floor has declined as a result of microprudential measures and regulatory

[22] https://www.finanssivalvonta.fi/en/publications-and-press-releases/supervision-releases/2021/european-central-bank-will-not-extend-liquidity-relief-into-next-year/

[23] https://www.finanssiala.fi/wp-content/uploads/2021/08/FA_16082021_Suomen_pankkisektorin_maksuvalmius_sailynyt_vahvana.pdf (in Finnish)

[24] https://www.ecb.europa.eu/press/blog/date/2021/html/ecb.blog210318~3bbc68ffc5.en.html

[25] https://www.finanssivalvonta.fi/en/financial-market-stability/macroprudential/macroprudential-decisions-and-appendices/makrovakauspaatokset-2021/

changes. At the time of the decision, Finnish banks' average risk weights on residential mortgage loans exceeded the 15% limit. The FIN-FSA Board therefore did not consider it necessary to extend the validity of the risk weight floor.

In February, the FIN-FSA Board decided that the average minimum risk weight of 25% for residential mortgage loans awarded by credit institutions applying the IRB Approach, adopted by the Swedish Financial Supervisory Authority (Finansinspektionen), will also be applied to credit institutions registered in Finland. The minimum risk weight applies to individual credit institutions with a residential mortgage loan stock in Sweden exceeding SEK 5bn.[26]

In late June, the FIN-FSA Board decided to tighten its macroprudential policy by lowering the loan cap for residential mortgage loans other than first-home loans by five percentage points, to the pre-pandemic level of 85%. The decision on the tighter loan cap entered into force on 1 October 2021.[27]

In addition to the decisions concerning the systemic risk buffer and the housing market, the FIN-FSA also decided in summer 2021 on the additional capital requirements set for other systemically important credit institutions (O-SIIs). The O-SII buffer rate for Nordea was set at 2.0%, for OP Financial Group at 1% and for Municipality Finance at 0.5%. The FIN-FSA emphasised that lenders should exercise restraint in granting loans that have a particularly long repayment period and are large with regard to the borrowers' income.

2.4 The Financial Intelligence Unit and suspicious transaction reports

The Finnish Financial Intelligence Unit receives reports regarding suspicious transactions and suspected terrorist financing from parties subject to the reporting obligation under the Act on Preventing Money Laundering and Terrorist Financing. Some of the reports are transaction-based mass deliveries that are based on the automatic reporting practices of certain obliged entities. Mass reports are typically based on a certain maximum threshold, meaning that all transactions that exceed the maximum threshold are reported to the Financial Intelligence Unit.

According to the Financial Intelligence Unit's half-year report, banks submitted about 7,200 suspicious transaction reports in the first half of 2021.[28] The number of suspicious transaction reports has some annual variation. By way of comparison, banks submitted about 12,900

[26] https://www.finanssivalvonta.fi/en/financial-market-stability/macroprudential/macroprudential-decisions-and-appendices/makrovakauspaatokset-2021/macroprudential-decision-18-february-2021/

[27] https://www.finanssivalvonta.fi/en/publications-and-press-releases/Press-release/2021/macroprudential-decision-housing-loan-cap-for-residential-mortgage-loans-other-than-first-home-loans-to-be-set-at-85/

[28] https://poliisi.fi/documents/25235045/67733116/2021-Rahanpesun-selvittelykeskus-puolivuosikatsaus.pdf/e7c27211-792a-a06c-04cc-4cfd834bf1f1/2021-Rahanpesun-selvittelykeskus-puolivuosikatsaus.pdf?t=1626780902217 (in Finnish)

reports in 2020.[29] Financial sector companies spend over €100 million every year to prevent money laundering. Only a fraction of the reports lead to preliminary investigation or charges.

3 Banks operating in Finland

3.1.1 Overview of the Finnish banking sector and key figures in 2021

The Finnish banking sector had a good year in 2021. Boosted by the easy monetary policy and various government stimulus measures, economic recovery increased loan demand and improved the financial situation of both companies and households. At the end of 2021, loans to households stood at €141.7bn and loans to housing corporations at €39.5bn. At the end of December 2021, the stock of loans to non-financial corporations (excluding housing corporations) granted by banks operating in Finland totalled €59.8bn. The corporate loan stock was about €1.5bn larger than at the beginning of the COVID pandemic in March 2020. It grew rapidly at the beginning of the pandemic as companies prepared for financial difficulties by withdrawing pre-agreed credits and making use of their credit limits, but contracted when the economic situation stabilised and the need for preparedness decreased.[30]

In addition to the increased loan demand, the optimistic note of the investment market and the low cost of funding was reflected in the business results of banks through growing net interest income and commission income.

The Finnish banking sector's profitability remained above the European average. The strong result brought the return on equity (ROE) up to 9.9% at the end of 2021 (6.4% in 2020). The strong development of Finnish banks' profit also improved the sector's cost/income ratio (CIR). At the end of 2021, the Finnish banking sector's CIR was approximately 51%, when the average CIR for EU countries in January–September was 60.4%.

Net interest income continues to be a major source of income in the banking sector: its share of profits was 49.2% in 2021 (51.9% in 2020). The Finnish banking sector's net interest income increased by 9%, totalling €7.3bn.[31] The growth of net interest income was boosted by the growth in loans granted by banks and by the low cost of financing, which improved net interest income by approximately €270bn. Commissions have increased their share for several years in a row, reaching just over 32% of banks' income in 2021 (30.8% in 2020). The share of net income from trade and investments was 7.8% (7.7% in 2020) and the share of other income was 10.6% (9.6% in 2020).[32]

The impairment losses recorded by Finnish banks reached about €365 million (€1.1bn in 2020), which is about 0.07% of the loan stock. For the most part, the allowances for loan losses made in 2020 have not been cancelled, so potential future credit losses can be covered by cancelling the allowances without it having an effect on the result.

The Finnish banking sector's capital adequacy remained strong in 2021, and banks have supported their customers in various ways during the coronavirus pandemic. The banking

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[29] https://www.finanssiala.fi/uutiset/pankeilta-viime-vuonna-12-900-rahanpesuilmoitusta-vain-pieni-osa-tutkintaan/ (in Finnish)

[30] https://www.suomenpankki.fi/en/Statistics/mfi-balance-sheet/older-news/2022/december-2021-sees-an-exceptionally-large-amount-of-corporate-loan-drawdowns/

[32] https://helda.helsinki.fi/bof/bitstream/handle/123456789/18322/Pankkisektori-Q4-2022.pdf?sequence=1&isAllowed=y (in Finnish)

sector's common equity tier 1 (CET1) capital ratio was 17.8% (18.1% in 2020) and total capital ratio was 21.4% (21.2%). The slight dip in the CET1 ratio is explained by changes in the internal ratings-based models used for calculating capital adequacy by some Finnish banks, by supervisory limitations and distribution of profits. The banking sector's continued strong performance increased the level of retained earnings and supported its capital position.

The Finnish banking sector's own funds exceeded the capital requirements by a wide margin. The sector's surplus of own funds exceeded the total capital requirement by €17.6bn at year-end 2021 (€17.0bn in 2020), which is about 7.3% of risk-weighted assets. At the end of 2021, the majority of Finnish banks had a higher level of own funds surplus than they did before the pandemic. The stronger capital buffers are explained by stronger capital ratios, and especially by the lighter macroprudential buffer requirements adopted in spring 2020.

The Finnish banking sector's capital ratios are above the European average. The strong capital position puts Finnish banks in a good position to withstand losses potentially brought on by the negative economic effects of Russia's war in Ukraine or by major changes in the financial market pricing, for example.[33]

By European comparison, the quality of Finnish banks' credit portfolio remained higher than the European average. In household loans, the ratio of non-performing loans (NPL) was 1.4%, which is slightly higher than before the pandemic, but in corporate loans, the NPL ratio was 2.1%, which is lower than the pre-pandemic level.

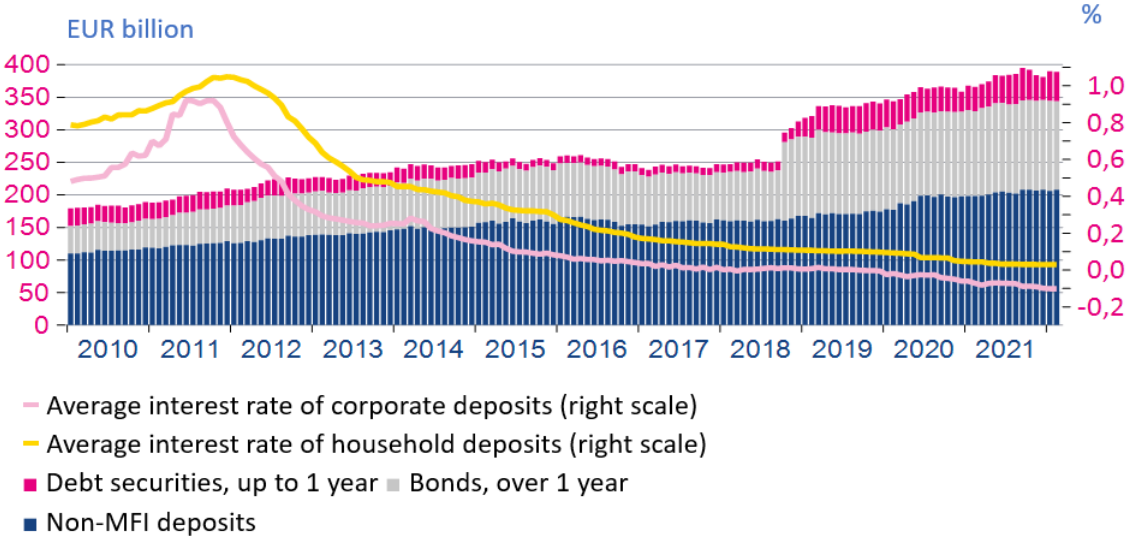
The banking sector's leverage ratio fell to 6.0% (6.2% in 2020) as liabilities grew faster than CET1 capital. The leverage ratio of Finnish banks is on a par with the European average.

The liquidity and financial position of banks in Finland, and elsewhere in Europe, remained good in 2021, supported particularly by central bank deposits and funding.

Current accounts and other accounts with low rates of interest held a large amount of deposits, which was reflected in banks' funding costs. At the end of December 2021, Finnish households' deposit stock totalled €109bn, with the average interest rate of household deposits being 0.03%. Overnight deposits made up for €100.1bn and deposits with an agreed maturity for €2.2bn of households' deposit stock.

[33] https://www.finanssivalvonta.fi/en/publications-and-press-releases/Press-release/2022/finnish-financial-sectors-capital-position-provides-buffer-against-weaker-economic-outlook---important-to-prepare-for-higher-risk-levels/

Figure 4: Credit institutions' funding and the average interest rates of corporate and household deposits



Source: Macrobond/Bank of Finland

The Finnish banking sector's liquidity improved in 2021. The average liquidity coverage ratio (LCR) stood at 177% at the end of 2021 (171% in 2020).

When the pandemic spread, LCR ratios and reserves grew rapidly throughout Europe as banks prepared for an increase in the demand of corporate loans and other potential liquidity needs. At the end of 2021, Finnish banks' liquid assets for meeting the LCR requirement totalled €154bn, more than half of which consisted of central bank reserves. The liquid assets were almost entirely of the highest quality, i.e. level 1 assets.

The Finnish banking sector's net stable funding ratio (NSFR) stood at 117% at the end of 2021, which is well above the 100% requirement but below the EU average. Banks' available stable funding (€506bn) surpassed the requirement by €74bn.

The substantial increase in central bank funding has raised the asset encumbrance (AE) ratio of European banks. In Finland, the AE ratio has been at a fairly high level for a long time due to banks' reliance on covered bonds, but it has remained stable. At the end of 2021, the AE ratio stood at 29.3% (29.8% in 2020), which is roughly the same as the EU average.

In planning for their funding activities, Finnish banks have prepared for the potential release of the pandemic build-up of household and corporate deposits when household consumption returns to normal and the investment demand of companies is revived. Strong liquidity buffers, relatively diverse and decentralised funding channels as well as low market funding costs made possible by a solid capital position protect Finnish banks from risks related to a potential decline in deposit funding. A relatively small share of Finnish banks' funding consists of central bank funding, which also reduces the refinancing risk related to the maturity of central bank funding.[34]

[34] https://helda.helsinki.fi/bof/bitstream/handle/123456789/18130/Pankkisektori-Q2-2021.pdf?sequence=1 (in Finnish)

Thanks to its solid financial standing and sufficient liquidity reserves, the banking sector has been able to offer its customers flexibility in loan servicing during the pandemic, which in turn has helped promote Finland's recovery from the crisis. Banks have also continued to offer new loans to their customers. Regulation has not supported these measures in all respects, but the banking sector and the authorities have reached a good enough mutual understanding of the necessity of the measures. All in all, the mutual efforts of various different parties have allowed the Finnish economy to come out well from the coronavirus crisis.

The capital position and liquidity of the Finnish banking sector are strong. The sector has participated not only in the stress tests conducted by supervisors, but also in the Finnish financial sector's FATO joint preparedness exercise in autumn 2021, testing how financial sector organisations and authorities are able to function and cooperate during extensive disruptions. Participants to the exercise included all the members of the National Emergency Supply Organisation's Finance Pool: the Ministry of Finance, the Bank of Finland, the Finnish Financial Supervisory Authority, the Financial Stability Authority and the financial institutions crucial for emergency supply, which in practice include all Finnish banks. The total number of participants was 22.

The results of the FATO exercise show that the banks and authorities participating in the exercise have improved their preparedness for diverse threats. Overall, Finnish banks and authorities performed well in the exercise.

3.1.2 Particular features of the Finnish banking sector

One of the particular features of the Finnish banking sector is its concentration. The share of loans granted to non-financial institutions by the three largest banks (OP Financial Group, Nordea and Danske Bank) totalled 68.9% (69.3% in 2020) and their share of all deposits totalled 76.9% (78.1% in 2020).

In addition to its concentrated nature, the Finnish banking sector is closely interconnected with the other Nordic countries through ownership and investments. Its dependence on market-based funding is also relatively large. Other typical features include the significant share that housing loans have of all lending and the small amount of non-performing assets. The share of mortgage-backed loans of all loans granted by banks has risen in recent years, reaching 54% at the end of 2021.

In European comparisons, Finnish banks' profitability has remained at a good level over the past ten years. Finnish banks also have strong capital adequacy and their financial position and liquidity have remained stable during the pandemic, as has already been discussed.

Overall, international credit rating agencies consider banks' operating environment to be stable, partially thanks to their good capital levels and profitability. Finnish banks' assets consist mainly of low-risk mortgage-backed claims and corporate loans. The sector has a strong loss-absorbing capacity, as is also proved by the supervisory stress tests.[35]

Being part of the euro area and the ECB's banking supervision increases the predictability of the Finnish banking sector's operating environment and promotes fair competitive conditions

[35] https://www.finanssivalvonta.fi/en/publications-and-press-releases/Press-release/2021/results-of-the-eu-wide-stress-tests-finnish-banking-sectors-solvency-would-withstand-a-strong-weakening-in-the-operating-environment/

with our European counterparties. This ensures that banks have good preconditions to grow and develop their services, which in turn increases stability in the financial market.

In Finland, national debt is not as common a topic as it is in southern Europe, for example. The Finnish government diversifies the investor base of its funding in terms of geography.[36] A broad investor base strengthens the government's funding capacity, supports credit pricing in the secondary market and forms a part of refinancing risk management. Despite the ECB's monetary policy purchase programmes, Finland's public debt is still largely owned by international investors. The growing share of central bank holdings has reduced the share of Finnish investors' holdings, and Finnish banks now own a relatively small share of Finland's public debt.[37] During the pandemic, the Bank of Finland has significantly increased the amount of government bonds that it purchases from the financial market. At the end of 2021, the Finnish government bonds and government-related bonds acquired by the Bank of Finland through different asset purchase programmes totalled €34.5bn (€29.8bn in 2020).

By international comparison, the Finnish banking sector has below-average exposures to the sectors most badly damaged by the pandemic (tourism, hospitality). In fact, the Finnish banking sector has survived the shock brought on by the pandemic well, and the changes in non-performing assets or IFRS 9 assets do not speak of significantly increased risks. In the Nordic countries, banks' credit losses from the pandemic crisis seem to be proving smaller than feared.

3.1.3 Banking group employees and offices

At the end of 2021, there were 208 credit institutions operating in Finland if group structures are ignored.[38] This is 20 fewer than at the end of 2020, 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 2021.

Nordea, OP Financial Group and Municipality Finance are under the direct supervision of the ECB. Other credit institutions in Finland are supervised by the FIN-FSA.

The Finnish banking sector continues to have an important role as an employer. Finnish banking groups and foreign deposit-taking banks' Finnish branches employed a total of 19,695 people at the end of 2021. This is 622 employees fewer than in the previous year. Compared to 2020, the number of employees reduced at a slightly faster rate. The reductions are the result of customer service moving to digital channels, increased automation, improved efficiency of functions, and mergers.
The number of bank offices grew in 2021. Finnish banking groups had 810 offices in Finland, which is 41 more than the year before. This increase results partially from classification

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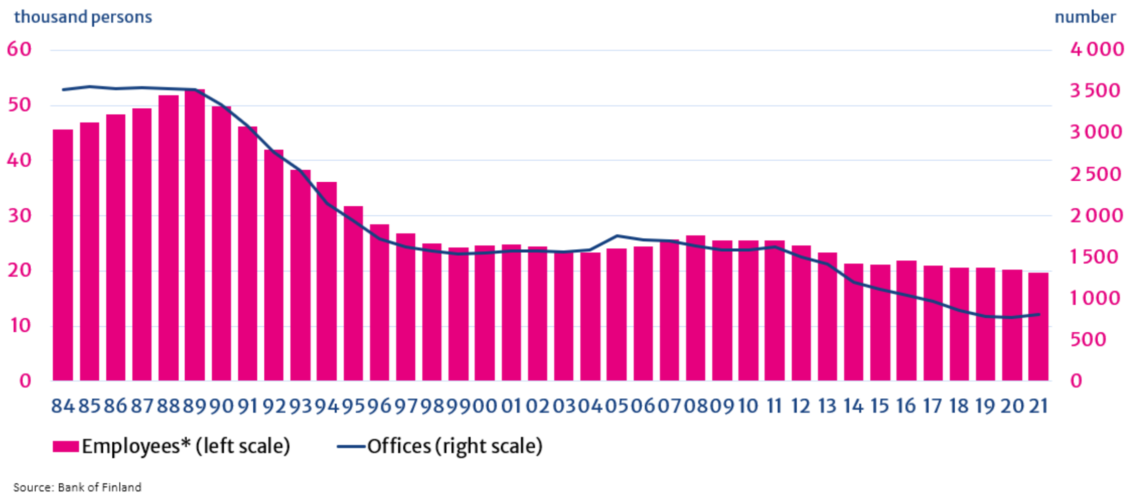
[36] https://www.treasuryfinland.fi/risk-management/financing-risk/

[37] https://www.valtionvelka.fi/blogi/suomen-valtionvelka-on-pitkalti-kansainvalisten-sijoittajien-salkuissa/ (in Finnish)

[38] https://www.suomenpankki.fi/en/Statistics/mfi-balance-sheet/list-of-mfis/

changes, but also from some of the banking groups seeking to increase their market share by offering face-to-face customer service.

Figure 5. Bank employees and offices



3.1.4 Credit institutions' market shares

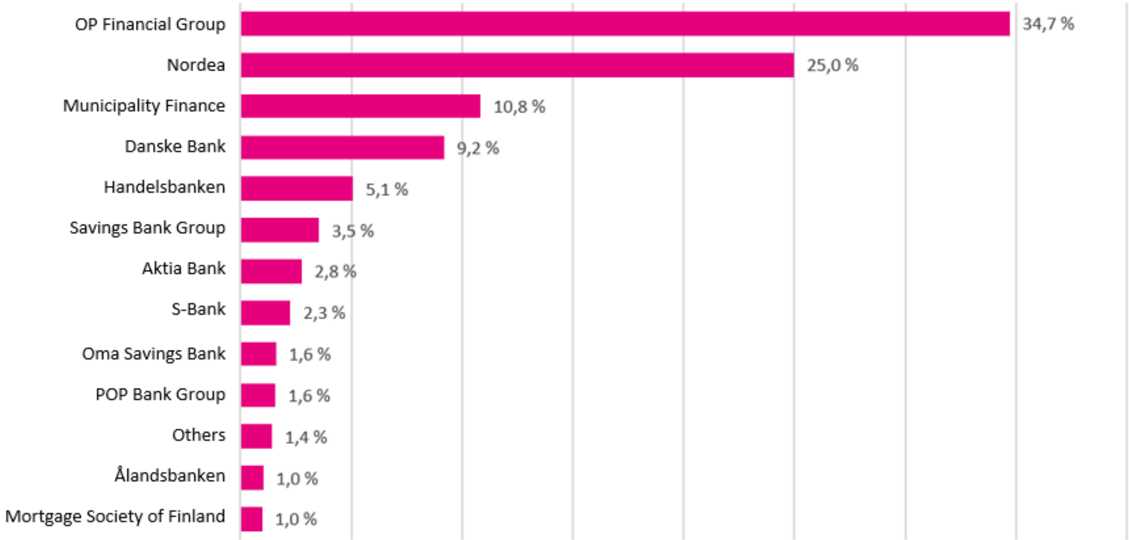
In 2021, the largest Finnish banking group in terms of market share was OP Financial Group, which commanded a market share of 34–39% in deposits, housing loans and corporate loans alike. The second largest banking group was Nordea Group with market shares of 25–32%.[39]

Credit institutions' market shares have not changed much in recent years. In granted loans, changes were very small, about half a percentage point at most in 2021. In deposits, Nordea gained 1.1 percentage points in market share while Danske Bank lost 2.7 percentage points.

In October 2021, the Swedish bank Handelsbanken announced that it will divest its business in Finland. It held a market share of 5% in loans and 3% in deposits.

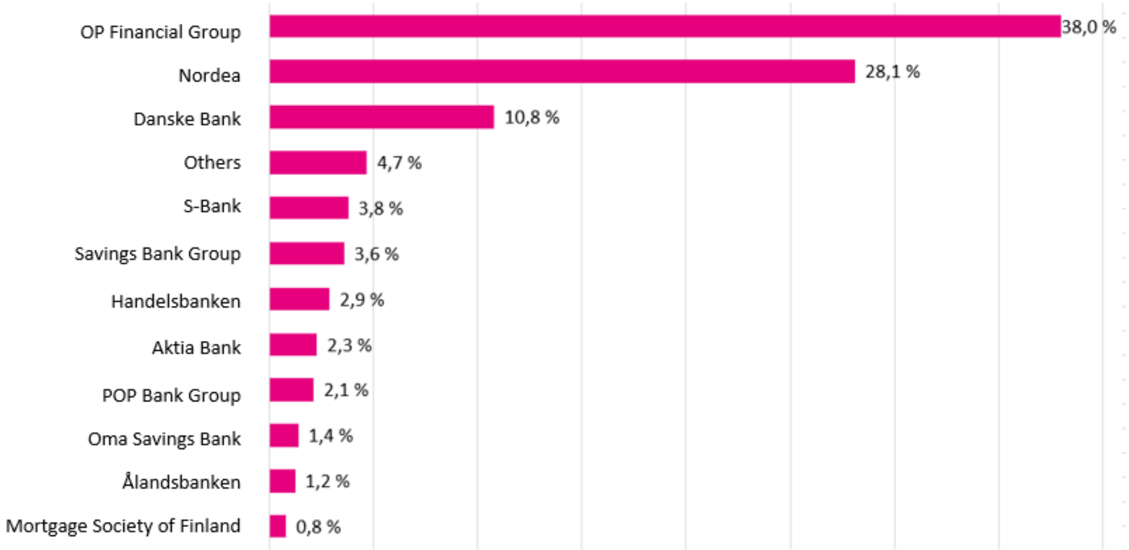
[39] https://www.suomenpankki.fi/fi/Tilastot/rahalaitosten-tase-lainat-ja-talletukset-ja-korot/taulukot/rati-taulukot-fi/markkinaosuudet_luottolaitokset_fi/ (in Finnish)

Figure 6. Credit institutions' non-MFI loans in Finland, market shares on 31 Dec 2021



Source: Bank of Finland

Figure 7. Credit institutions' non-MFI deposits in Finland, market shares on 31 Dec 2021



Source: Bank of Finland

3.1.5 In conclusion

Banks have played a central role in economic development and stability during the coronavirus pandemic. In terms of their capital position, Finnish banks' performance has been first-rate, as proved by the banks' stress tests results published in 2021. Additional capital buffers and a good liquidity position improve the risk tolerance of Finnish banks. Thanks to its sound basis, the sector can offer customers flexibility in loan payments and provide other forms of support in the face of a crisis, thus directly benefiting the real economy. An efficient and flexible allocation of financing and a stable financial system promote economic growth and welfare. The importance of this cannot be overstated.

Although banks' financial development and performance have remained strong during the pandemic, banks are not short of challenges. Their operating environments and business requirements are in constant change. Over a longer term, banks' profitability has decreased because of increased financial regulation, low interest rate levels, higher own funds requirements, more intense competition, new supervisory measures and the costs resulting from these measures. Banking sector regulation has increased significantly after the financial crisis, both globally and in the EU.

The Finnish banking sector's profitability and return on equity is on a good level by European comparison. The cost/income ratio that measures cost-effectiveness is better than the European average. It is worth noting that banks have a relatively low return on equity compared to many other sectors.[40]

In the future, it is particularly important that new fees, new regulation and other measures that put a strain on banks' profitability are justified. It is vital to guarantee such conditions for banks that allow them to conduct profitable business and encourage them to develop new services and functions. As a funder of investments, the Finnish banking sector has an important role in the economic transition towards a carbon-neutral future. This role must not be underrated.

[40] https://www.finanssiala.fi/julkaisut/suomalaispankkien-oman-paaoman-tuotto-kansainvalisesti-verrattuna-hyva-mutta-historiaan-verrattuna-matala/ (in Finnish)

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

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