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Bank of Finland Bulletin 2/2013: Financial stability

Deputy Governor,
Pentti Hakkarainen
23/05/2013

Themes of the Financial Stability publication

- ◆ International operating environment
- ◆ Domestic operating environment and the financial sector
- ◆ Infrastructure
- ◆ Measures to ensure financial stability

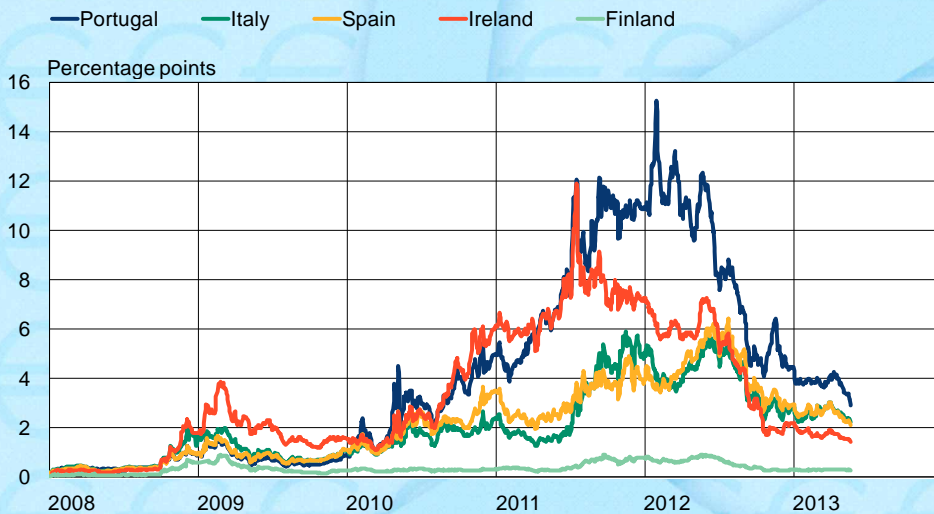


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International operating environment

Twofold situation: financial markets picked up, real economy deteriorating

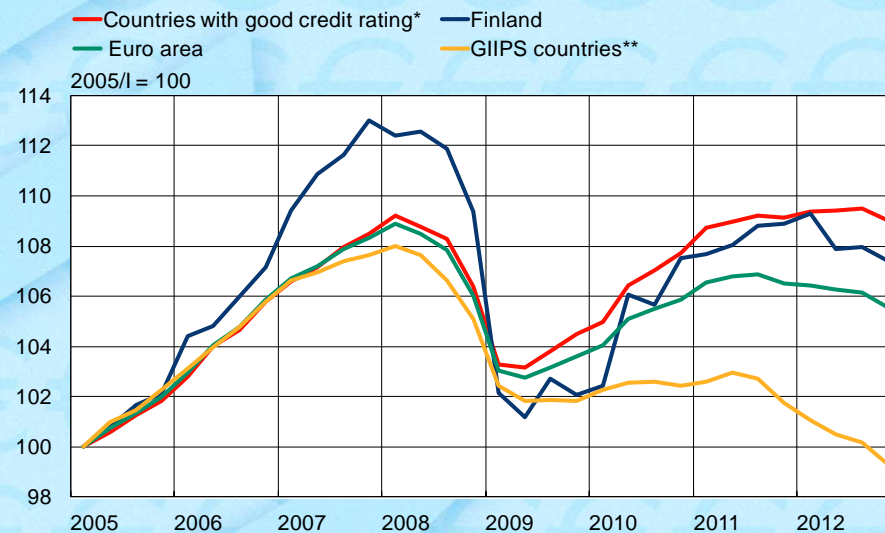
CDS spreads on European government bonds have declined



Source: Bloomberg.

GDP developments have deteriorated also in countries with high credit ratings

GDP



* Austria, Belgium, Finland, France, Germany and the Netherlands.

** Greece (2011-2012, est.), Ireland, Italy, Portugal and Spain.

Sources: Eurostat and Bank of Finland calculations.

Factors outside Finland causing uncertainty

- ◆ Weaker-than-expected economic development
 - Negative influence on domestic corporations and households
 - Financial sector profitability pressures and disturbed transmission of financing
 - Threat from growing problems in public sector
- ◆ Re-emergence of European financial crisis
 - Weakening confidence, renewed escalation of debt crisis
 - Potential negative impact on Finnish government and banking sector funding, as highly dependent on foreign sources
- ◆ Negative side effects of low interest rates

Negative effects of long-term low interest rates

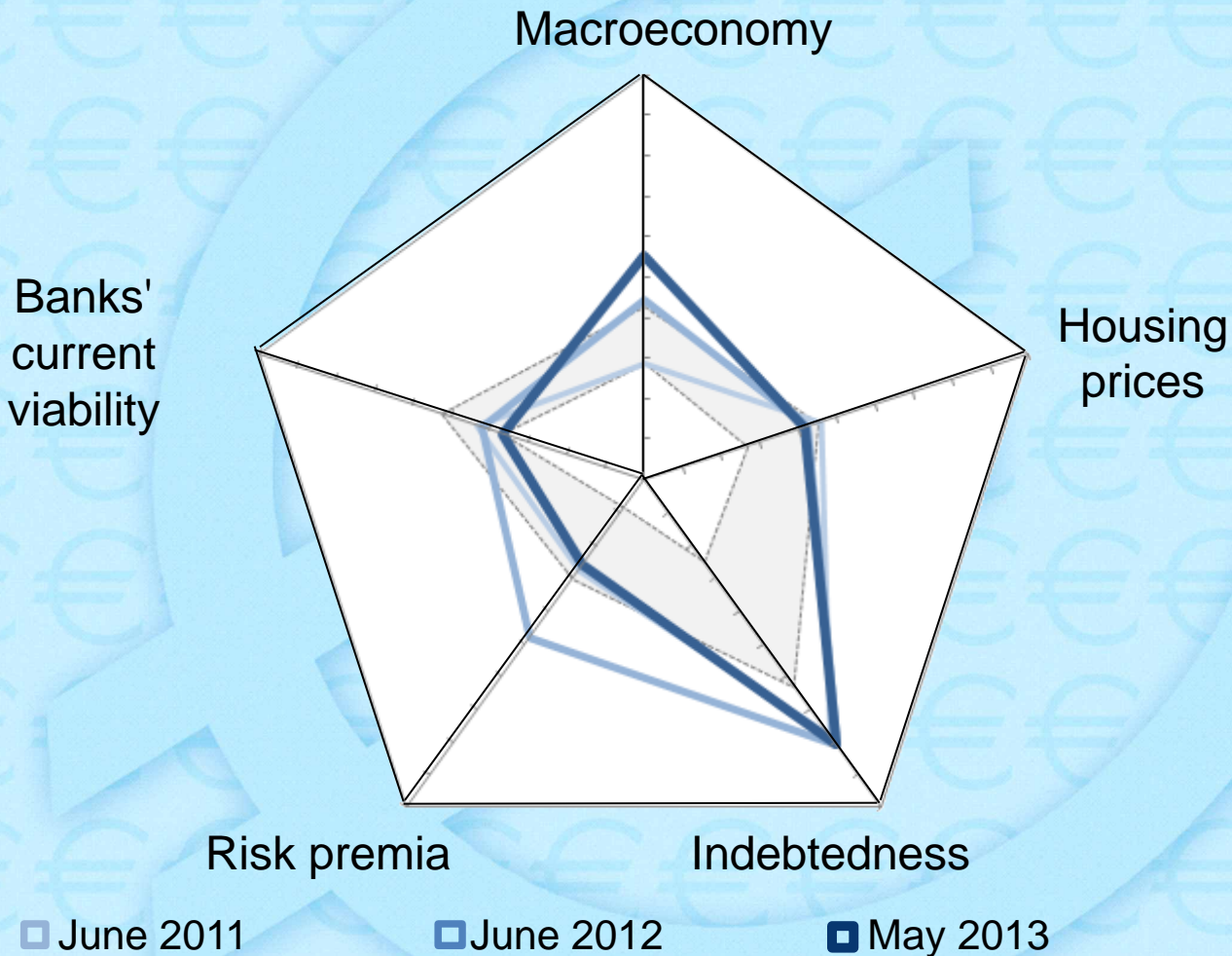
- ◆ Rates kept low for protracted period reduce banks' net interest income and insurance companies' investment income and put pressure on their profitability
- ◆ Debt service burden eased, increases loan forbearance, delays deleveraging
- ◆ Search for yield affects allocation of investment, can distort pricing of risk and overheat prices



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Domestic operating environment and the financial sector

Indebtedness and macroeconomic development pose greatest risks to Finnish financial system

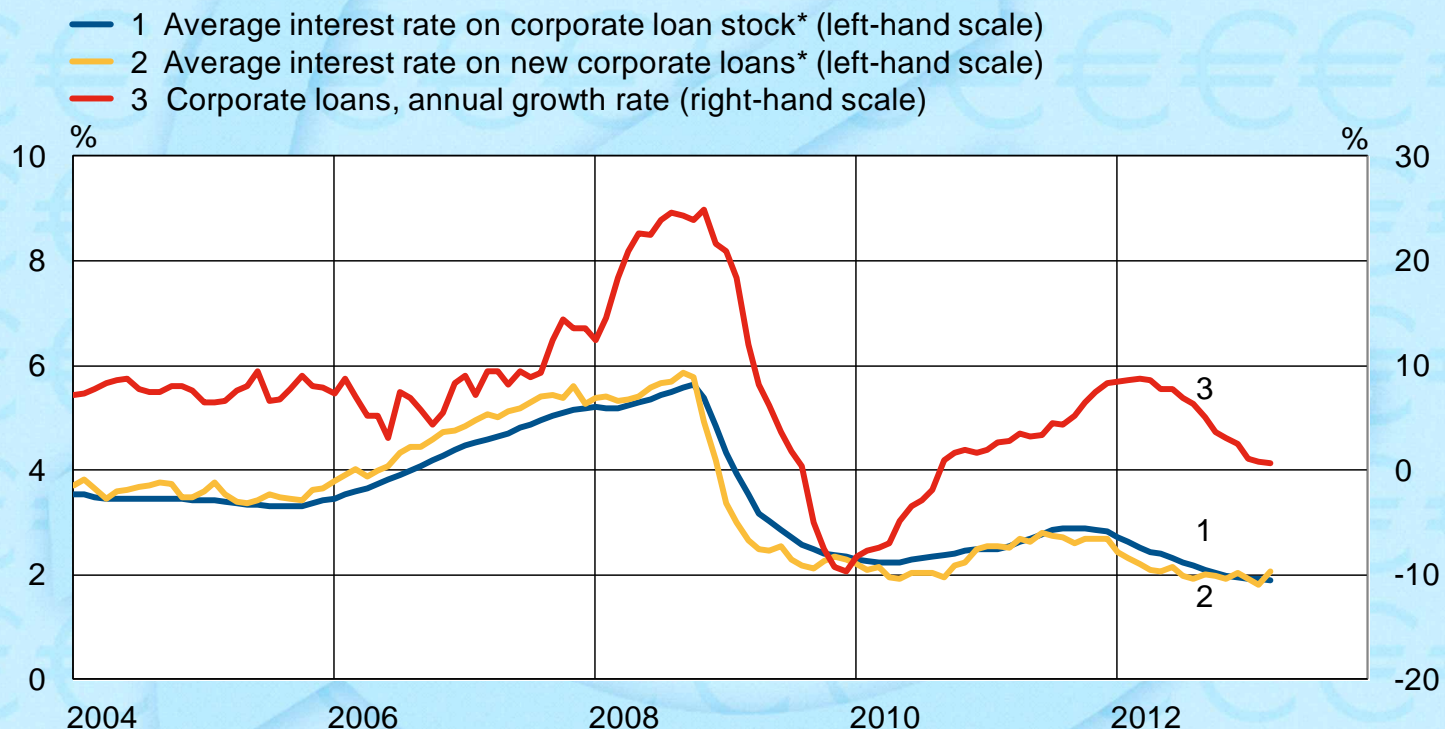


The outer values reflect higher systemic risks.

Sources: NASDAQ OMX Helsinki, banks, Statistics Finland and Bank of Finland.

Growth of non-financial corporations' stock of loans decelerated

Average interest rates on MFI corporate loans and annual growth rate in Finland



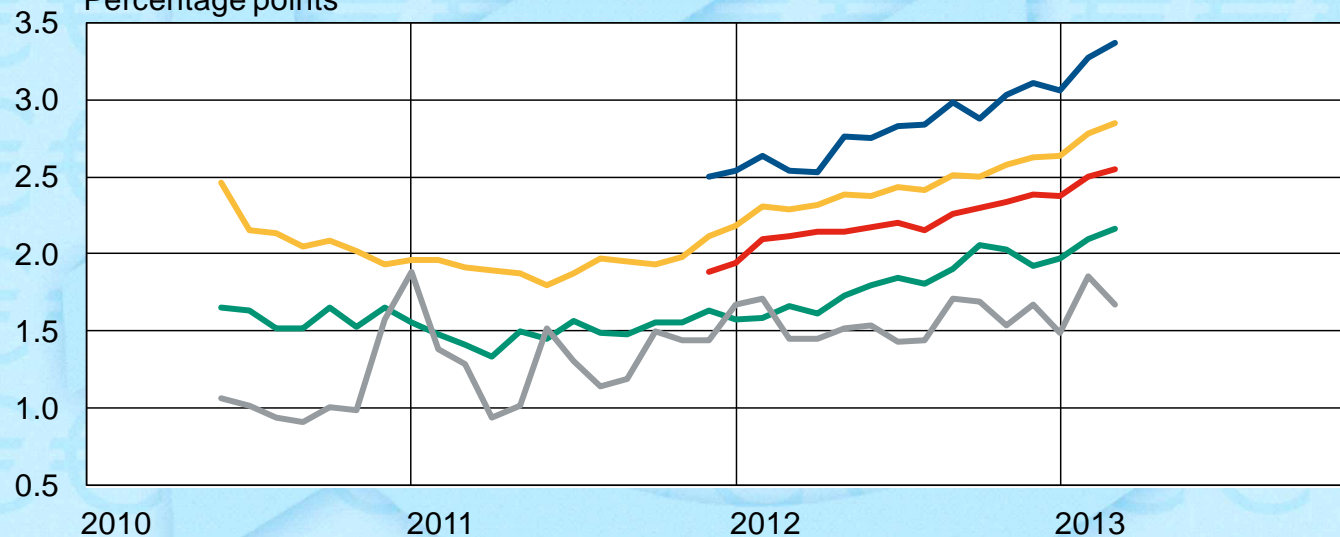
* Also includes housing corporations.
Source: Bank of Finland.

Interest rate margins widened most for small corporate loans

Average margins on new corporate loans granted by Finnish MFIs, by loan size

- New drawdowns of up to EUR 50.000
- New drawdowns of up to EUR 250.000
- New drawdowns of over EUR 50.000 and up to EUR 250.000
- New drawdowns of over EUR 250.000 and up to EUR 1 million
- New drawdowns of over EUR 1 million

Percentage points

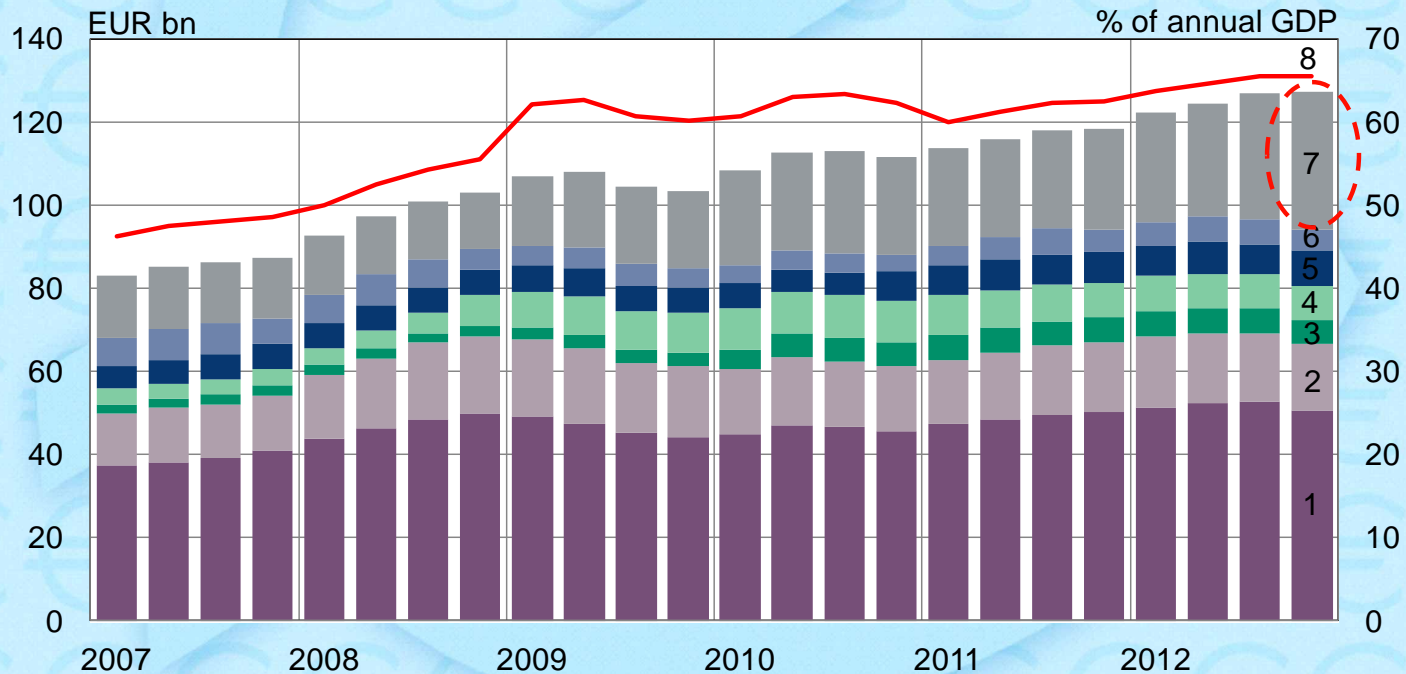


Excluding account and repo agreements.
Source: Bank of Finland calculations.

Companies increasing bond financing

Finnish corporate sector's interest-bearing debt structure

- 1 Loans from MFIs
- 2 Overseas loans (excl. direct investments)
- 3 Loans from other OFIs
- 4 Loans from employee pension companies
- 5 Loans from other public-sector entities
- 6 Short-term debt securities
- 7 Long-term debt securities
- 8 Debt relative to GDP (right-hand scale)

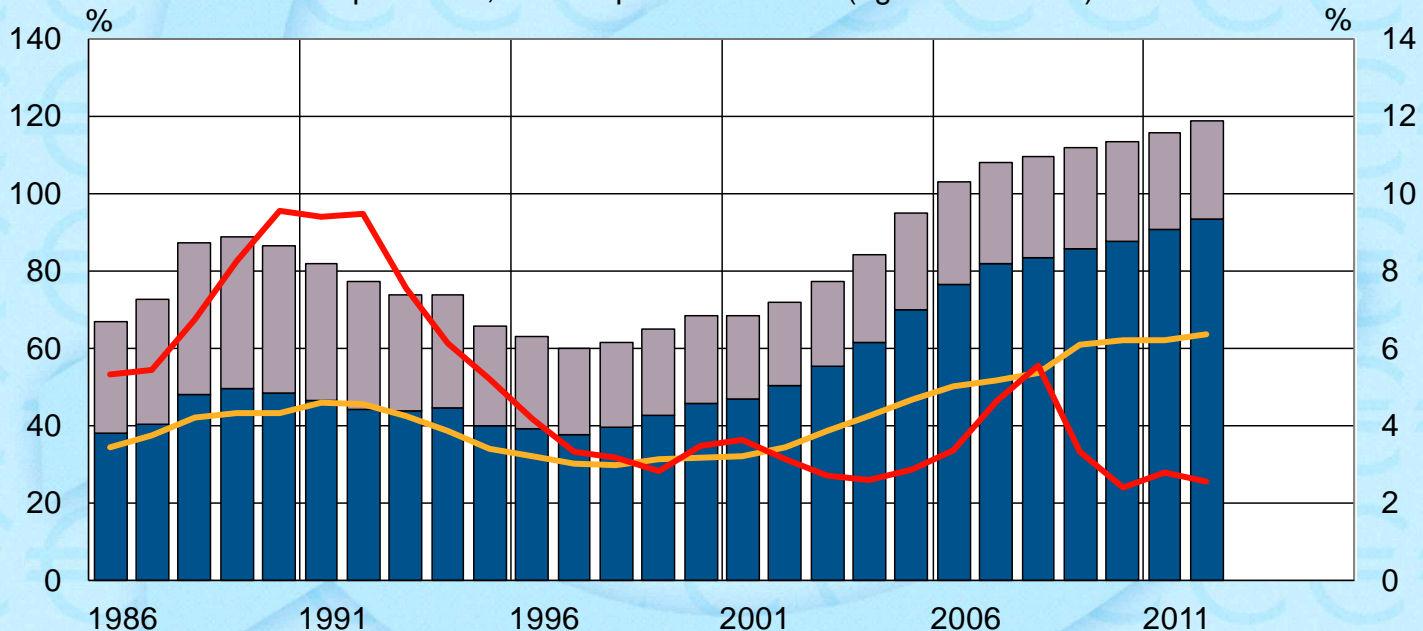


Sources: Statistics Finland and Bank of Finland

Household debt accumulation continues – the bulk of which for housing or renovation

Household indebtedness and interest burden in Finland

- Housing-related loans*, % of disposable income (left-hand scale)
- Other loans, % of disposable income (left-hand scale)
- Total loans*, % of GDP (left-hand scale)
- Total interest expenditure, % of disposable income (right-hand scale)

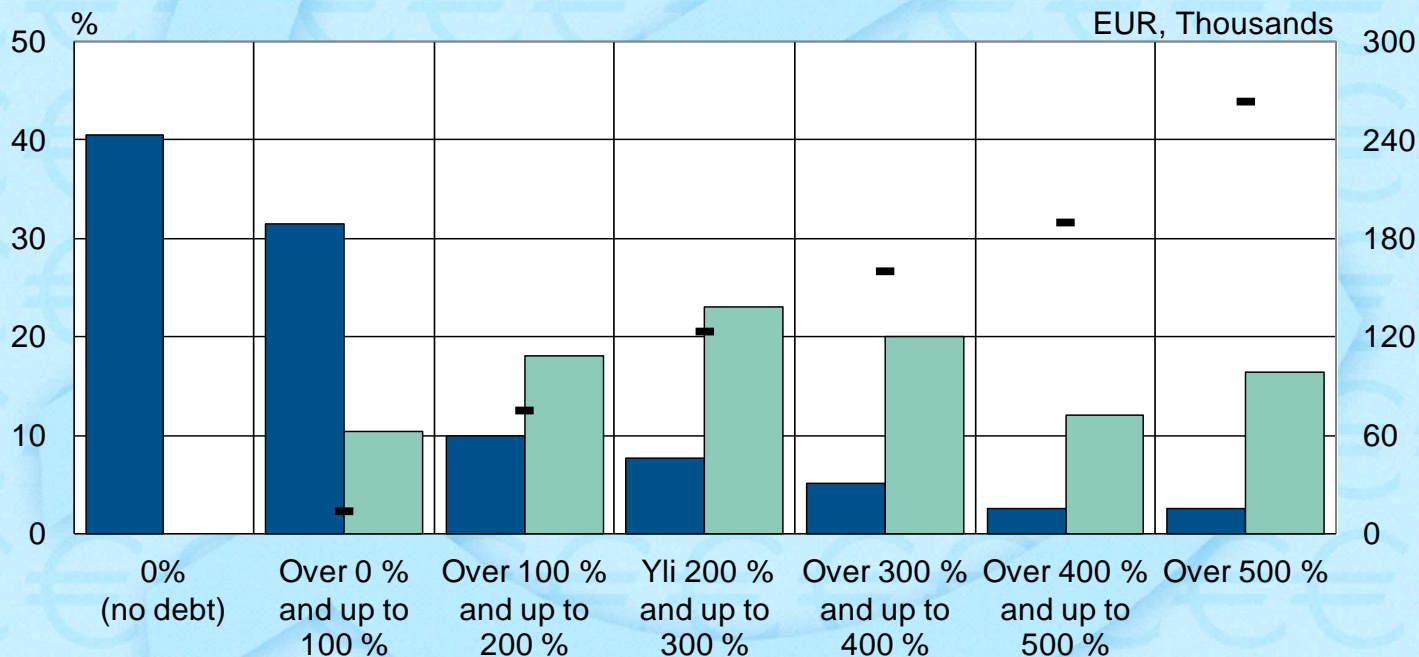


* Housing loans and households' estimated share of housing corporation loans.
Sources: Statistics Finland and Bank of Finland calculations.

Debt burden and risks distributed unevenly

Households and their debt by debt ratio* in Finland

- Share of households (left-hand scale)
- Share of household debt (left-hand scale)
- Average debt per household (right-hand scale)



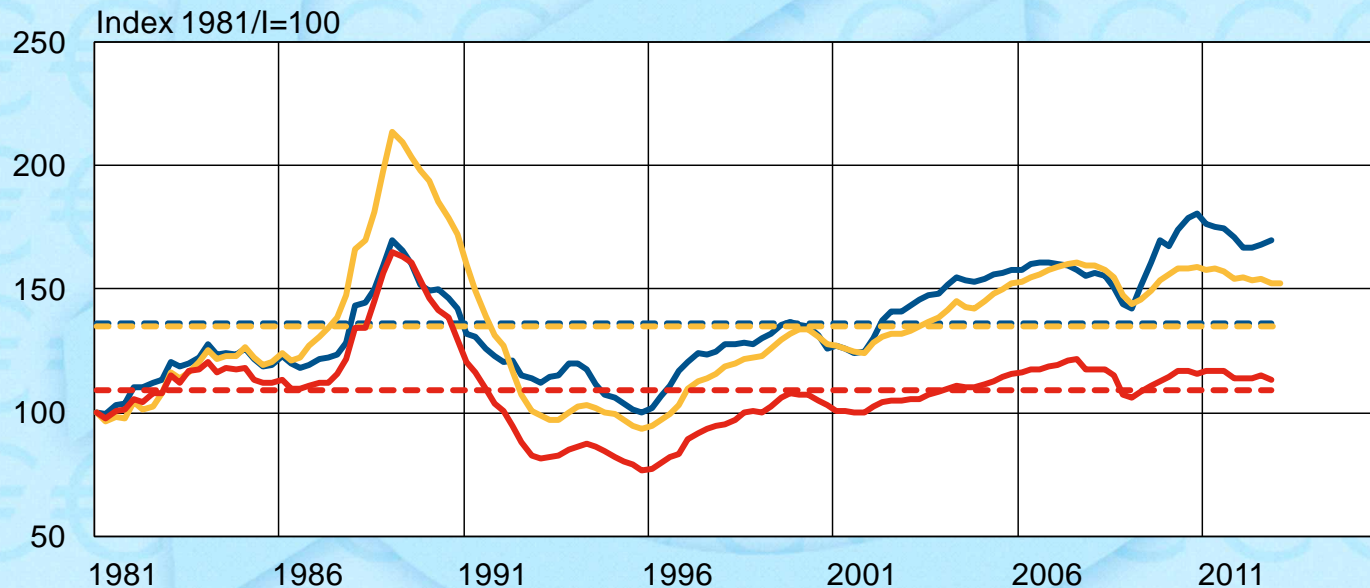
* Horizontal axis: household debt, % of disposable monetary income 2011.

Sources: Statistics Finland and Bank of Finland calculations.

Relative housing prices higher than long-term averages

Relative housing prices in Finland

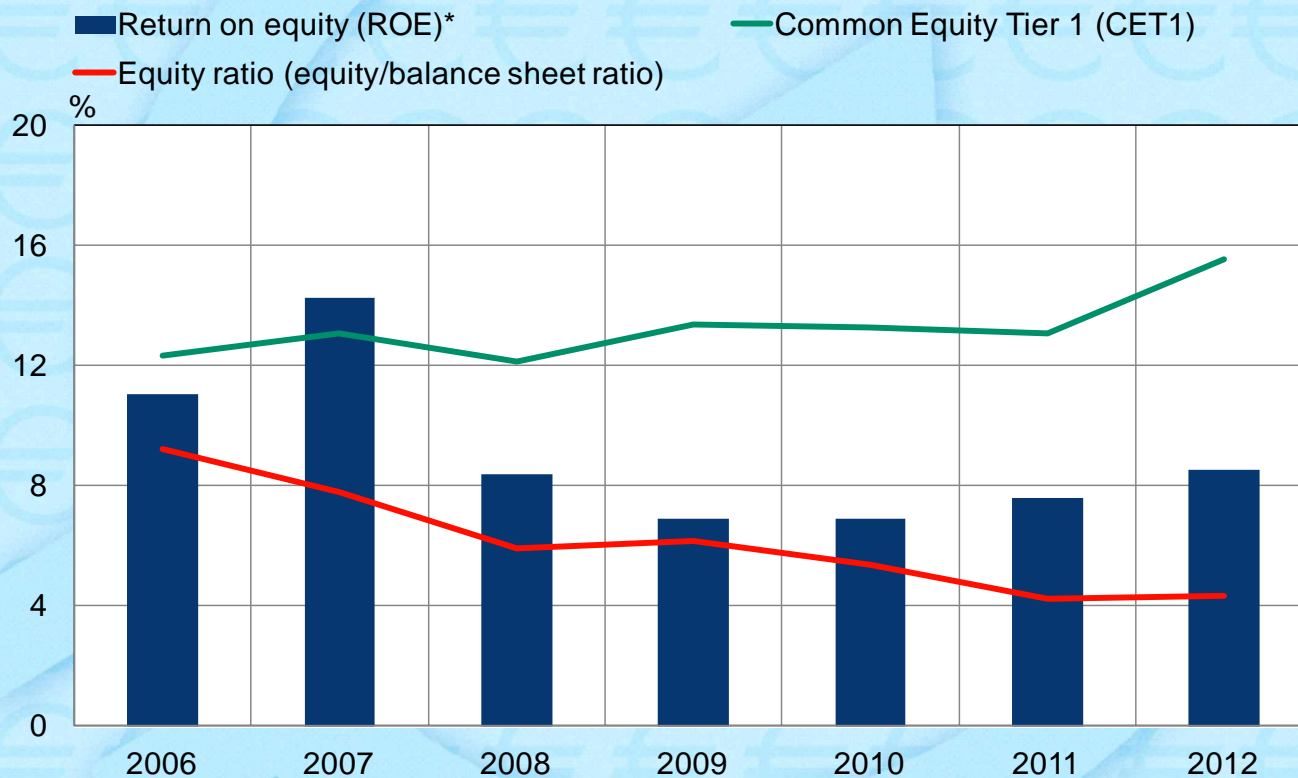
- In relation to cost of housing construction
- - - Average*
- In relation to housing rents
- - - Average*
- In relation to wage and salary earnings
- - - Average*



* Average of the review period.

Sources: Statistics Finland and Bank of Finland calculations.

Finnish banking sector: capital adequacy improved despite slight decline in own funds

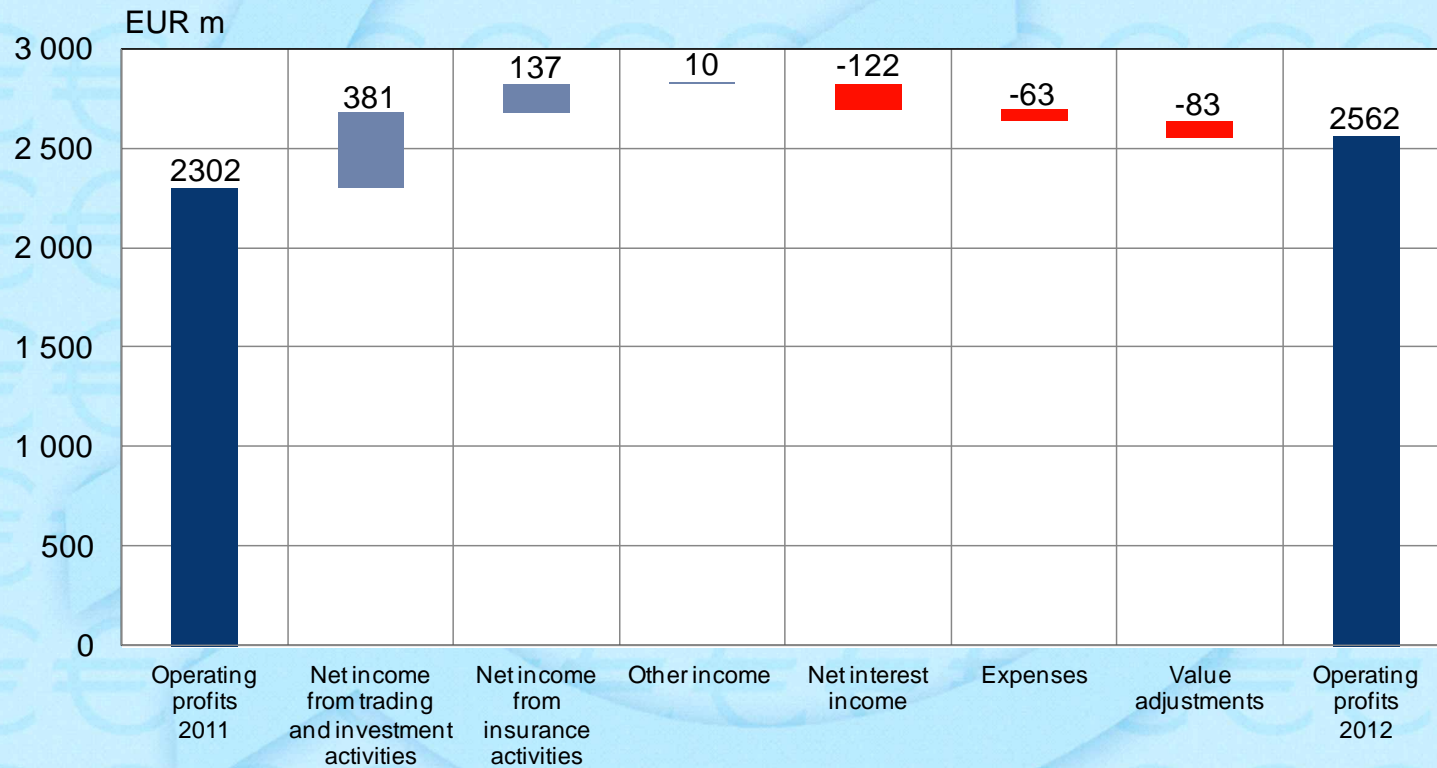


* Returns in 2006–2007 are affected by certain reorganisation measures in the banking sector.

Source: Financial Supervisory Authority.

Low level of interest rates weakens banking profitability

Factors underlying changes in Finnish banking performance

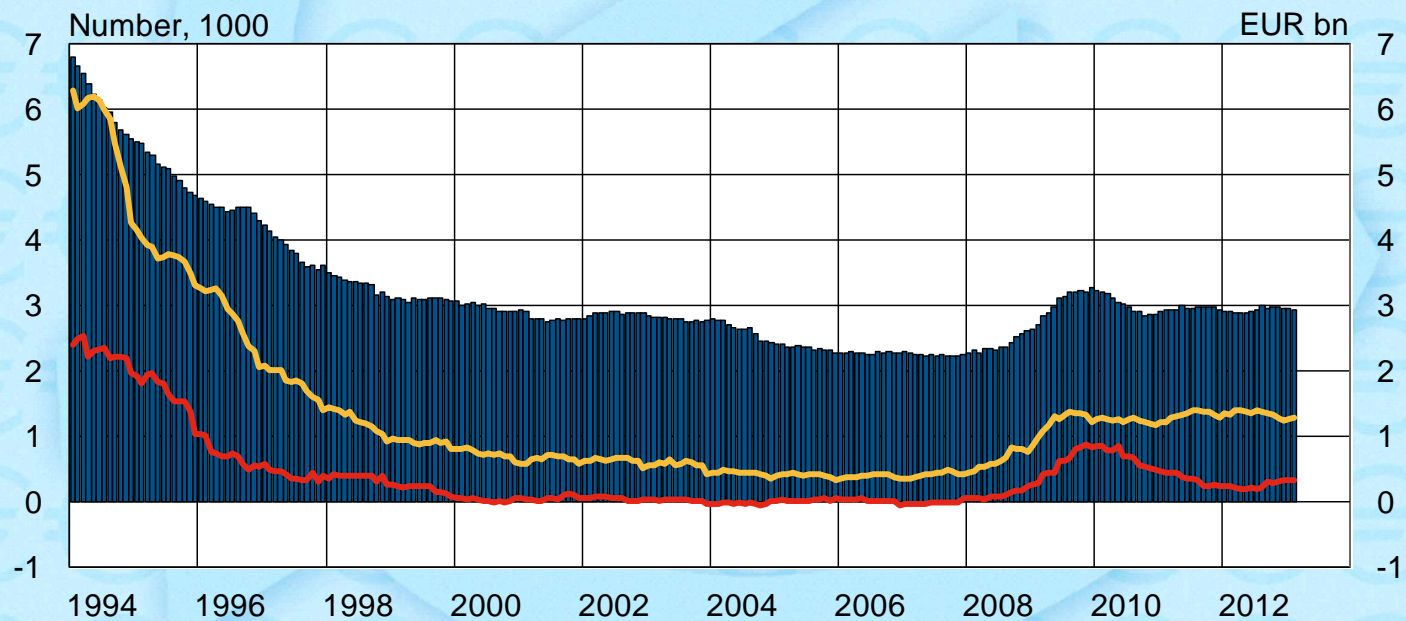


Source: Financial Supervisory Authority.

Weak economic development adds to credit risk

Bankruptcies, nonperforming assets and net impairment losses in Finland

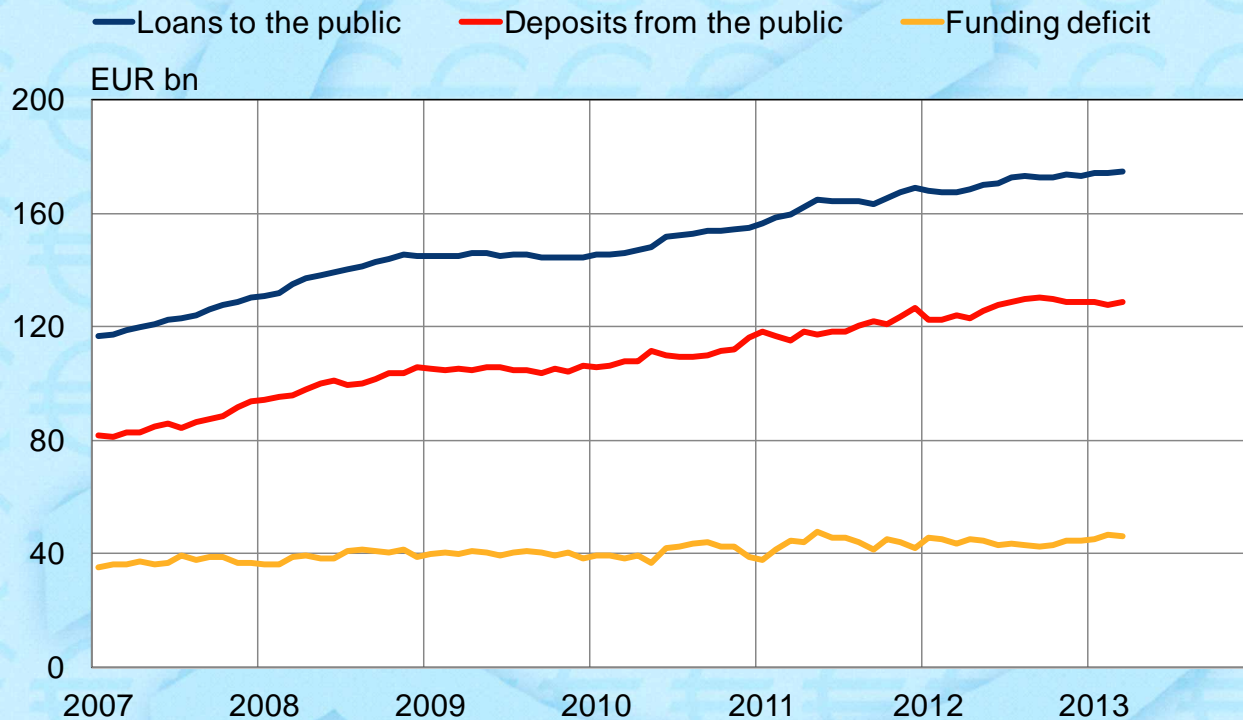
- Corporate bankruptcies filed, 12-month moving total (left-hand scale)
- Banks' non-performing assets (right-hand scale)
- Banks' net impairment losses, 12-month moving total (right-hand scale)



Sources: Statistics Finland, Financial Supervisory Authority and Bank of Finland calculations.

High dependency on international market funding

Funding deficit of Finnish banking sector

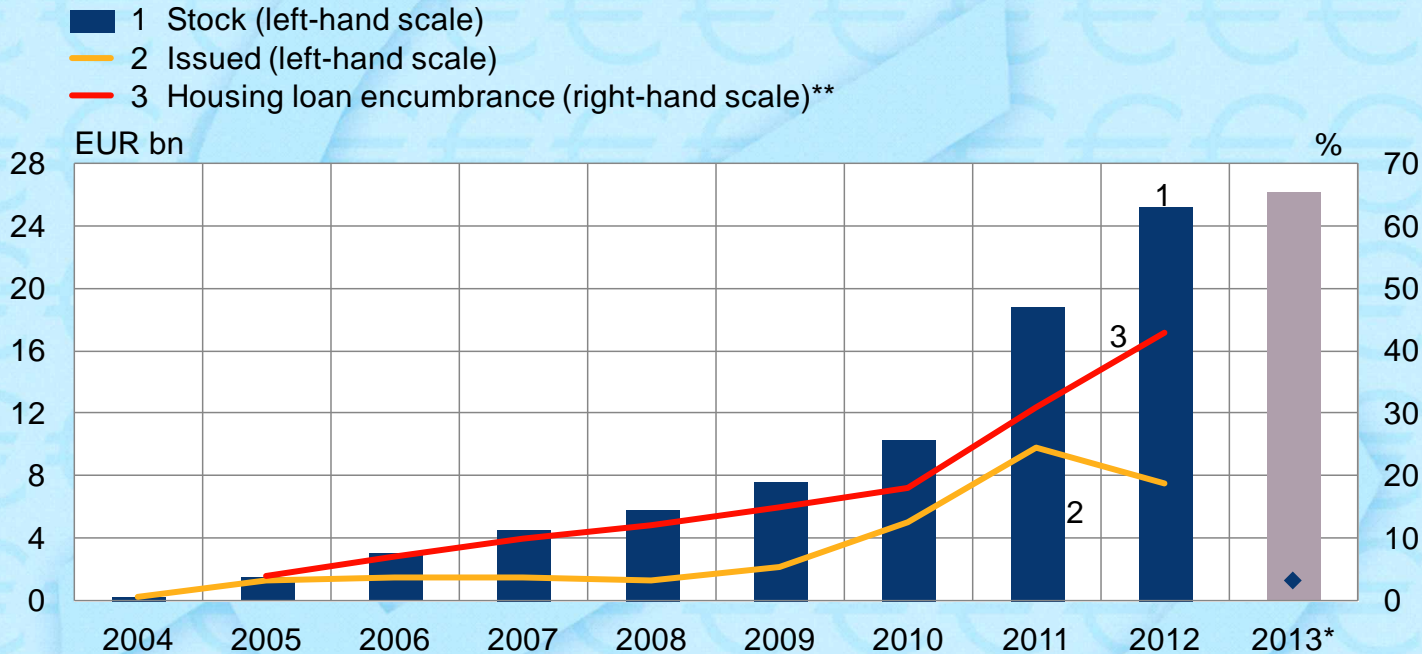


The counterparties of loans to the public and deposits from the public are others than financial institutions.

Source: Bank of Finland.

Banks increased use of covered bonds

Finnish banks' covered bonds



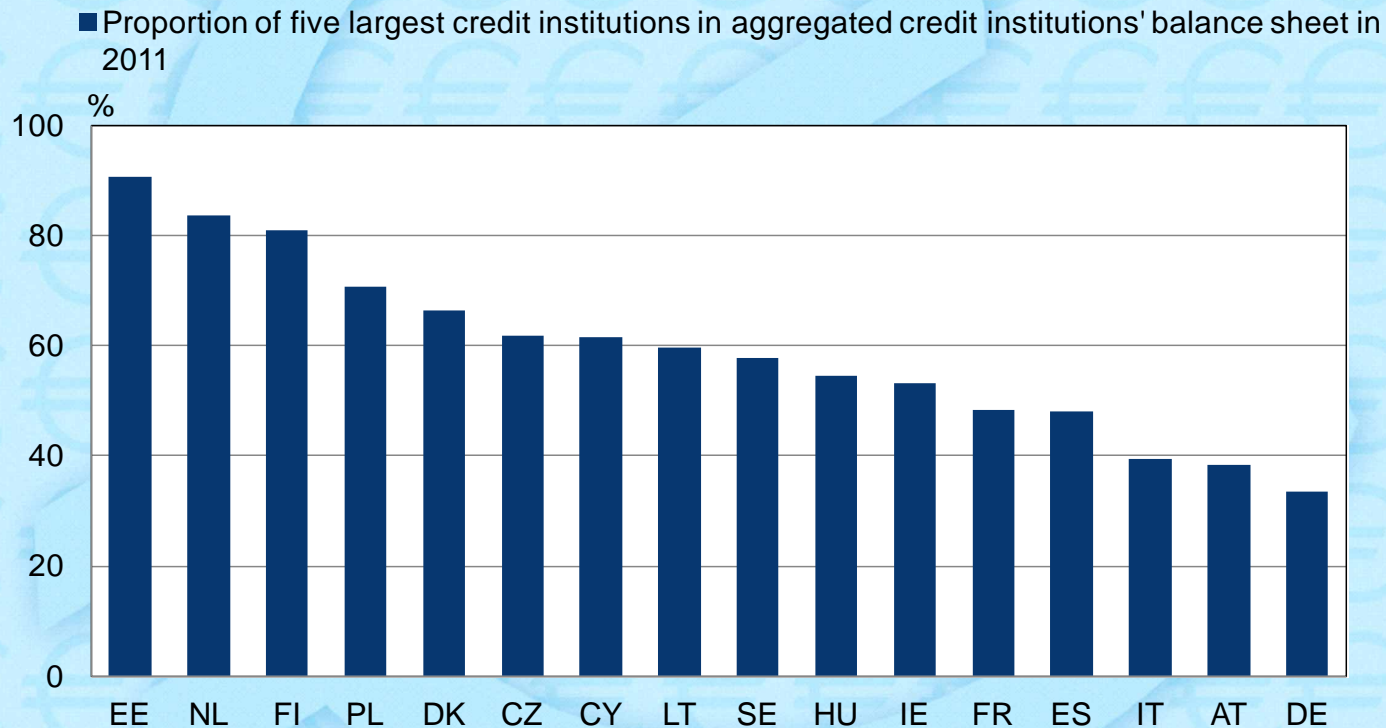
* 2013 to end-April and January-April issue.

** Covered bonds as collateral for housing loans as share of entire stock of housing loans. Calculation presumes 4.4% of housing loan stock does not qualify for use of bond as collateral.

Sources: Bank of Finland, European Covered Bonds Council, Bloomberg and Financial Supervisory Authority.

Finland's banking sector is concentrated

Concentration of banking system in different EU countries



The figures for the EU countries also include subsidiaries and branches of foreign banks operating in the country.

Source: European Central Bank.



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Infrastructure

Payment and settlement systems being reformed

- ◆ Challenges posed by internationalisation of infrastructure
 - Increased competition between infrastructure services
 - Strive for economies of scale
 - TARGET2-Securities and European harmonisation
- ◆ Changes and improvement in efficiency in cost of systems' reliability and service levels?
 - Importance of market consultation
 - Continuity and contingency arrangements
 - Vulnerable groups' requirements: unhindered payments



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Measures to ensure financial stability

1) Finland to consider additional requirements for systemically important banks

- ◆ Consequences of bank crisis serious in concentrated banking system, such as in Finland
- ◆ Other Nordic countries significantly tightening regulations concerning systemically important banks
- ◆ Regulations need to be as harmonised as possible internationally and in Nordic countries in particular

2) Finland needs to establish ways of reducing housing loan-related risks

- ◆ No country is safe from the housing and property crises
 - In the 2000s: Denmark, Ireland, the Netherlands, Spain, the United States...
 - Finland suffered crises in the 1930s and 1990s
- ◆ International experience: A maximum loan-to-value ratio is a way of dampening excessive growth in housing loans and housing prices
- ◆ Studies show that FIN-FSA's current loan-to-value ratio recommendations are not adequate
 - A binding LTV ratio is needed as a macroprudential tool

3) Bank liabilities should be used in banks' crisis resolution

- ◆ Banks' effective recovery and crisis resolution requires the possibility to write down the liabilities in the balance sheets of troubled banks or convert into equity (bail-in)
- ◆ Bail-in should be the general rule; bail-out should be considered an exceptional solution and only applied after separate political consideration
- ◆ Write-downs should first be directed at those debtors with the best ability to evaluate and price risks (market discipline)
- ◆ Effectiveness of crisis resolution improved by bail-in instruments

4) Functioning of business financing must be ensured

- ◆ Smooth functioning of corporate financing is vital to economic growth
- ◆ In EU comparison the availability of corporate financing in Finland is good, however lending terms are getting tighter
- ◆ Small and medium-sized companies dependent on bank financing
- ◆ Promoting diverse sources of financing, in particular for small and medium-sized companies
 - Enhancing the domestic bond market
 - European level measures