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Financial market crisis expected to have indirect implications for Finnish banks, too

- Finnish banks’ financial position is good
- Direct impacts of the financial crisis so far reasonably limited, but indirect implications are to be expected
- Banks’ financial results are decisively affected by future economic developments and the financial market situation
- According to stress tests, the banking sector is set to withstand even a significant weakening of the macroeconomy

Prospects for the economic operational environment weaken amid continued financial market uncertainty

- Economic growth is anticipated to slow down by more than expected.
- Financial market turbulence is strongly reflected in market interest rates.
- Financial market uncertainty is still high, with no clear signs of an improvement in the situation in light of risk premia developments.
- The United States is undergoing very important events, the implications of which for the duration of the financial market crisis are difficult to estimate as yet.

Banks’ stress test calculations from August 2008

- Banks’ capital adequacy was assessed in a stress scenario calculation completed in August 2008
- The scenario assumes that the turbulence started from the US housing market will continue, with its ramifications also spreading to the Finnish macroeconomy
- No bank or banking group will see its capital adequacy jeopardised in a situation envisaged by the scenario
- In assessing the results, one must bear in mind the dependency on the chosen scenario and the fact that the results also take account of factors improving capital adequacy

Falling income from investment and lower fee income caused a downturn in bank profitability

- Other income than net interest income declined clearly in the face of the international financial crisis.
- Positive developments in banks’ net interest income owing to higher reference rates and increased lending volumes dampened the effects of the financial market crisis on banks in Finland.
- Weaker economic prospects make maintenance of profitability more difficult. Cost control will again be needed.

Capital adequacy of Finnish banks weakened

- Despite recent decline of capital ratios, Finnish banks are still financially sound in international comparison.
- Quality of Finnish banks’ own funds of remains solid.

Demand for credit is still strong; signs of a weakening in the quality of the lending stock

- Growth of the stock of corporate credit has accelerated, growth in household credit has decelerated
- Number of nonperforming loans is growing, signs of a weakening in the quality of the lending stock
- Banks’ loan impairments have increased
- Economic downturn a threat to debtors

Finnish banks have enough liquidity to withstand the market turbulence

- Ongoing general uncertainty on the market and the major restructuring of the US financial markets in September further deepened the financial market crisis.
- Finnish deposit banks' liquidity has remained good and banks have not encountered problems in acquiring funding.
- Deposit growth has remained strong throughout the year as investors seek secure investment products.

Low interest rate risks in the banking sector

- Interest rate risks do not pose a threat to capital adequacy of the banking sector
- Swelling of banks' balance sheets has not increased interest rate risks of core banking activities

Challenging operating environment for investment firms

- Number of agents to grow
- Corporate restructuring to make comparison of profits more difficult
- Unfavourable market conditions to reduce expected returns

The long-standing growth of management companies took a downturn

- The decline in management company fees continued in the wake of a fall in fund assets and the profitability of management companies weakened
- Management companies' level of own funds fulfilled legal requirements

Impact of financial market turmoil on mutual funds registered in Finland

- Fund assets totalled approximately EUR 55 bn, as of 31 August 2008
- The so-called 'Lehman effect' on mutual funds amounts to EUR 34.3 million, accounting for 0.05–5.9% of the total value of the funds
- As a result of market disturbances in Russia, four management companies interrupted redemptions of and subscriptions to their Russia funds
- FIN-FSA investigated the valuation of corporate loans in mutual funds as a result of the challenging market situation

Can you stay in the saddle?

The FIN-FSA has produced a set of tasks on saving, conventional loans and instant loans for pupils in the last grade of comprehensive school. Titled 'Can you stay in the saddle?', the task package is available on the Bank of Finland Euro.fi online study site.

Financial market crisis expected to have indirect implications for Finnish banks, too

Finnish banks on a sound footing

Despite weaker financial results, the profitability of Finnish banks continues to be good. Banks also have firm buffers to encounter unexpected losses, ie their capital adequacy is strong. The capital adequacy of all Finnish banks exceeds the required level (8%): the band as at 30 June 2008 ranging between 10%–22%. As Finnish banks did not invest much in subprime loans, they were able to retain a high degree of credibility and therefore reasonably-priced funding has also been sufficiently available during the financial market turmoil. Accordingly, the liquidity situation at Finnish banks has remained good.

Direct impacts of the financial market crisis likely to remain limited

The financial market crisis has manifested itself as great uncertainty, falling prices in capital markets and loss of confidence in the wholesale market for funding. The crisis has led to immediate problems at financial-sector corporations holding exposures in declining property markets (particularly in the United States) and seeking financing mainly through the wholesale market. The immediate implications of the crisis for Finnish banks and a large number of European banks have been limited, as their business concepts have not included these operations in which risks have substantially materialised.

According to information collected by the Financial Supervision Authority (FIN-FSA), Finnish banks – considering their capital adequacy and size – do not have important exposures in the Lehman Brothers group or the insurance company AIG, or the investment banks taken over by the US federal government (Fannie Mae, Freddie Mac). Finnish banks' exposures in Lehman amounted to EUR 166 million in terms of market value in mid-September and from AIG to EUR 36.5 million. The exposures were made up of bonds, derivatives positions (positive market values) and other exposures. The FIN-FSA will closely follow the developments and the risks arising from them, in cooperation with Nordic and other European supervisors.

As regards mutual funds, the financial market crisis has been seen in those funds that have invested in securities issued by the Lehman Brothers group. The market value of such investments amounted to a total of EUR 34.3 million at the end of August. Given that the maximum proportion of securities issued by Lehman Brothers in the holdings of individual mutual funds registered in Finland amounted to 6% of net asset value, the impact can be considered as reasonably limited. The spillover of the crisis to the Russian market was also reflected in the Finnish market, as four (4) fund management companies suspended redemptions and subscriptions in respect of their Russia-related funds. In doing so, they made use of the measures permitted by laws and regulations under exceptional circumstances.

Indirect implications from the financial market crisis to be expected for the banking sector

While the direct impacts of the financial market crisis on Finland have remained limited, indirect implications are to be expected. First, the crisis may lead to weaker-than-forecast overall economic performance and, as a consequence, to a wider realisation of credit risk than anticipated. In addition, the price for hedging against risk will continue to rise, as the serious market dislocation persists. During a slump, banks' other income, notably fee income, will also decline. Second, ongoing uncertainty and loss of confidence in the markets will cause banks' funding costs to rise, thereby imposing a further strain on banks' results. Third, an increase in risk premia on bonds as a result of market uncertainty may add to the already realised valuation losses. At this stage of the crisis, it is however too early to assess the seriousness of such indirect implications.

Economic activity plays a key role

The effects of the financial market crisis will pass on to the Finnish banking sector largely through overall economic developments. In early autumn, the number of worrying news releases has increased and economic growth is expected to decline next year. The financial crisis may deteriorate the economic outlook further still. If the economy performs as forecast, the banking sector will not face any major problems.

However, if the weak economic cycle is to continue for a long time, it will necessarily be reflected in the banking sector's results. Even so, according to stress tests, the capital adequacy of individual banks or banking groups will not be jeopardised in the case of even a significant weakening of the economy.

A turn in economic activity is starting to take tangible form as a weakening of the bank lending stock quality. Despite loan stock growth, banks have for years had an exceptionally low level of problem assets. Households and corporations alike have been able to service their debts. During the current year, the situation has taken a turn for the worse and the number of non-performing loans has started to increase from an exceptionally low level.

Real housing prices have started to fall, activity in housing sales and purchases has calmed down and the number of new unsold housing units is rising. The situation is challenging for the construction sector. Owing to higher interest rates, an increasing number of households with large loans have had to realign their debt-servicing programmes. Weaker economic prospects cause companies to revise their profit forecasts downwards, which in turn may lead to deterioration in employment. This would at worst mean an increase in households' debt-servicing problems.

As poor economic developments are reflected in banks' profit performance with a fairly long time lag, the near future will give no cause for any major concern. Nevertheless, we are now experiencing a turning point and a period of uncertainty in the macroeconomy. As future economic trends are currently difficult to foresee, any household planning for borrowing should calculate more accurately the size of a loan it is able to service. Owing to the rapid change in the housing market, those changing homes should take care that they are not caught in a financial trap with two homes. In an uncertain situation, it is usually wise to sell first the old home and then buy a new one.

The financial market crisis has raised banks' funding costs and households' debt-servicing expenses

The financial market turbulence has made banks' liquidity management more difficult, but Finnish banks have coped well with the situation because of their ongoing high creditworthiness. As a result, banks' liquidity situation is good. Strong deposit growth has facilitated banks' financial situation, and banks have not had much need to acquire long-term funding at higher prices. The share of deposit funding at Finnish banks is high, which has again helped to afford some protection from funding risk. Deposits, though, are no longer as advantageous funding as they used to be, as competition has clearly raised the rates paid on deposits. Moreover, pressures to diversify the funding structure force banks to also acquire more expensive long-term market funding to cover gradually maturing long-term debt. More expensive funding will strain banks' income from financial operations in the future, also depending on how customer margins evolve.

Ongoing problems in the United States and protracted financial market uncertainty will also be felt in Finland as higher financing costs for banks and elevated interest rates for mortgage borrowers. For one year already, households have been paying a risk premium related to the financial market crisis of about one percentage point in the rates charged on their housing loans.

Risk of valuation changes again increased

Finnish banks' capital adequacy is strong and the quality of own funds good. Where a number of European banks have had to acquire new equity funding for billions, Finnish banks' requirements have been very limited. There has been no need, as the banking sector's financial results have been good and writedowns due to the financial crisis have mainly remained reasonably low. Even so, the risk of valuation changes has again increased, as bond risk premia have resumed an uptrend in the face of market uncertainty. Valuation losses may also put a strain on bank results. No credit crunch, ie a situation where banks are compelled to restrict lending on account of inadequate own funds, can however be seen in Finnish financial markets.

Banks have invested in risk management

The banking sector is currently well-positioned to respond to the challenge posed by a weak cyclical situation. In addition to strong capital adequacy, banks have for years been allocating resources to the development of risk management, which makes their situation clearly far better than at the time of the banking crisis in the 1990s.

In the current financial market turmoil, the FIN-FSA has intensified its supervision with respect to the adequacy of banks' risk management. Nothing that could jeopardize the banking sector's short-term capital adequacy has turned up. Nevertheless, development of risk management is an ongoing process. Criteria for good risk management are continuously being updated in concert with supervisors of various countries and representatives of the financial community.

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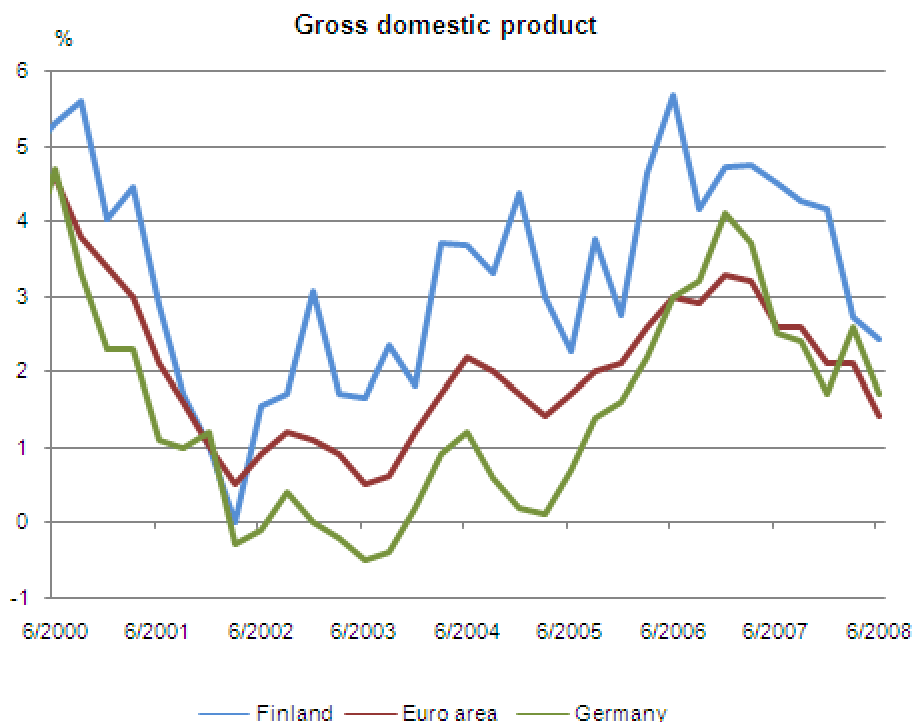
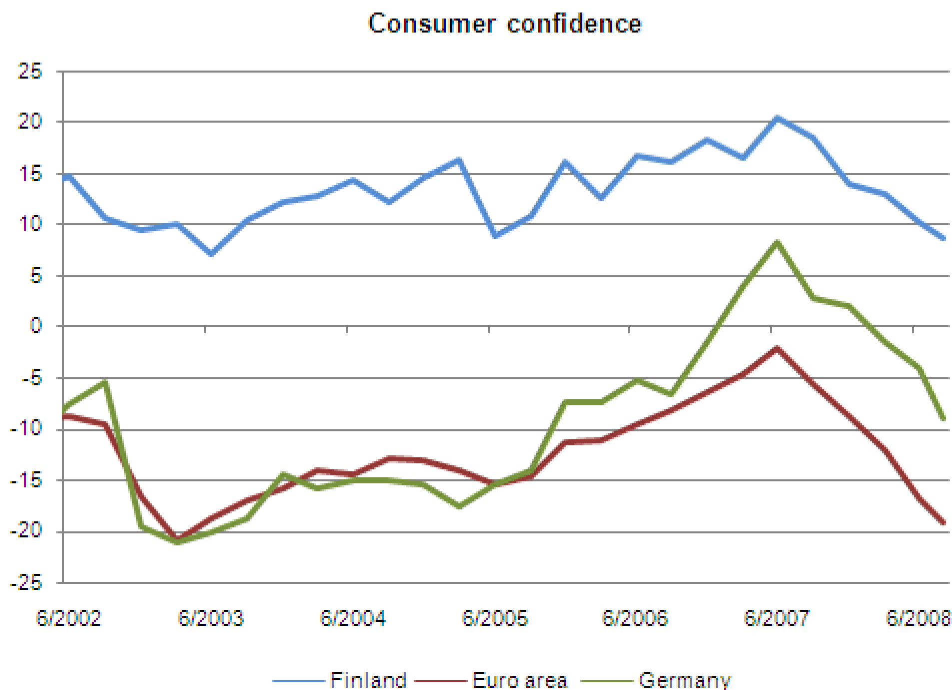
Prospects for the economic operational environment weaken amid continued financial market uncertainty



The latest economic forecasts anticipate a slowdown in world economic growth in the face of the financial market turmoil, higher inflation and a lower level of confidence. The euro area growth outlook is subdued, as growth is expected to moderate to about 1.5% in the current year. In 2009, growth is likely to remain at only 1%, but is believed to recover gradually again. However, given the exceptional and significant nature of recent financial market events, it is still too early to assess their overall implications for the financial markets

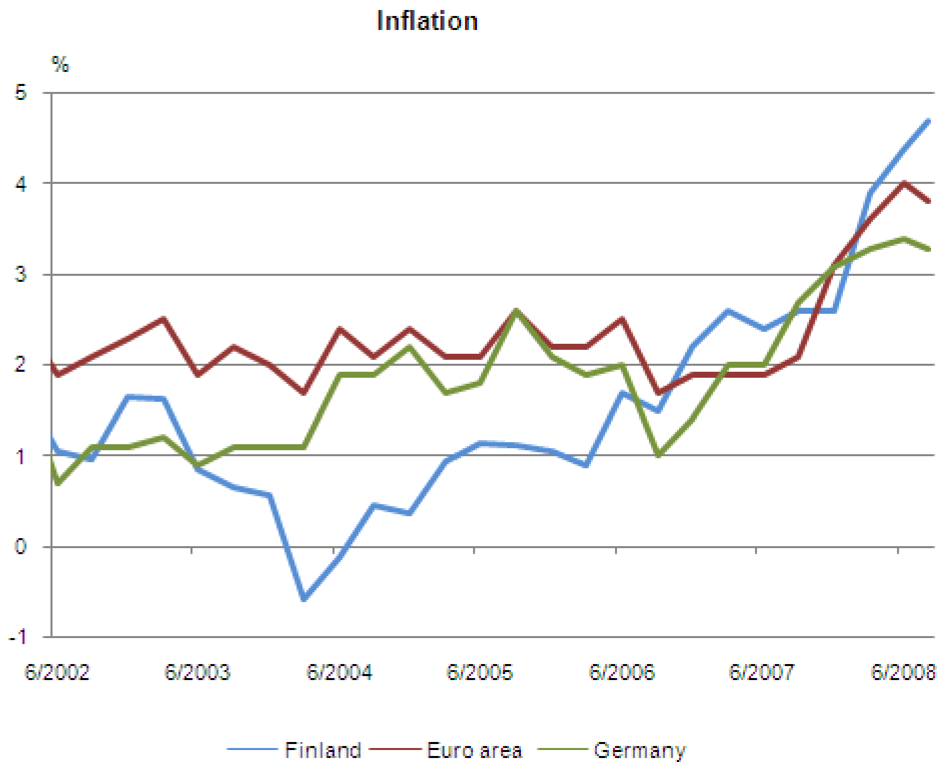
and their spillover effects on world economic growth. The risks to economic growth are widely seen as being skewed to the downside.

Economic developments in Finland have been fairly similar to those in the euro area on average. Even so, Finnish economic growth continues to be stronger than in the euro area as a whole, with Finland's GDP growing at a rate of about 2½ in the first part of 2008. The euro area economic outlook has deteriorated, as household and corporate confidence has weakened amid accelerating inflation, higher interest rates and negative economic news releases. In light of country-specific consumer confidence indicators published by the European commission, falling confidence has been highly broad-based across euro area countries. In Finland, too, households' confidence in their own finances has declined substantially, being currently at its lowest level for more than 10 years. However, Finnish household confidence continues to be within fairly reasonable limits, compared with a number of other euro area countries. By contrast, industrial confidence has weakened more clearly to the average euro area level.

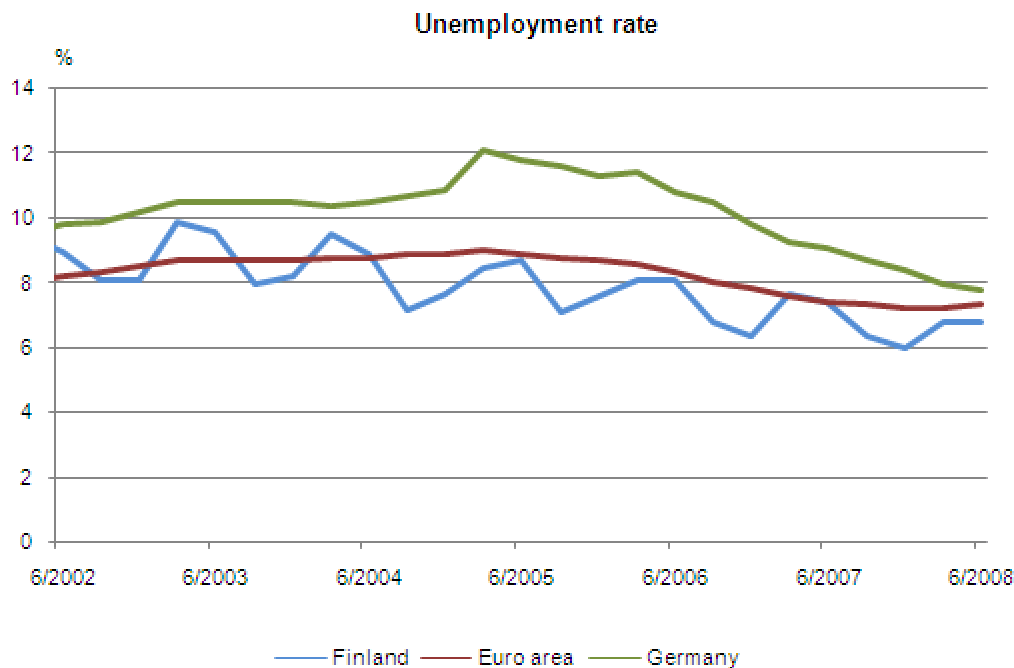


Source: Bloomberg.

Inflation developments in Finland in recent months have been stronger than in other euro area countries. On the other hand, as Finland has enjoyed very moderate inflation in recent years, the inflationary shock has been more severe here than in the euro area on average.

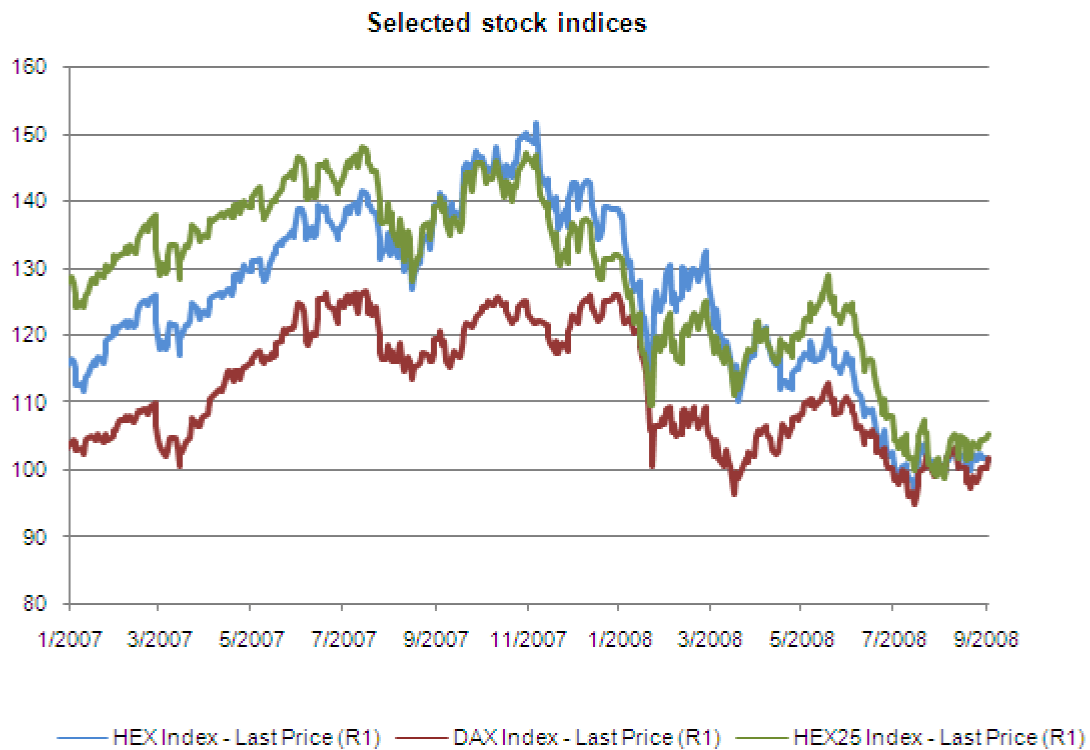


Despite weaker economic prospects, Finland's economic fundamentals continue to be fairly good. Corporate profitability has already for a longer period of time been good and public finances have been showing clear surplus. The position of banks is also solid. Irrespective of slower economic growth, unemployment has continued to fall to a good 6%, which is about 1 percentage point lower than the average figure for the euro area. Good employment has been an obvious positive factor. Employment developments will also play a key role in the operational environment facing the financial sector in the future, as employment largely determines, for instance, households' debt-servicing ability.



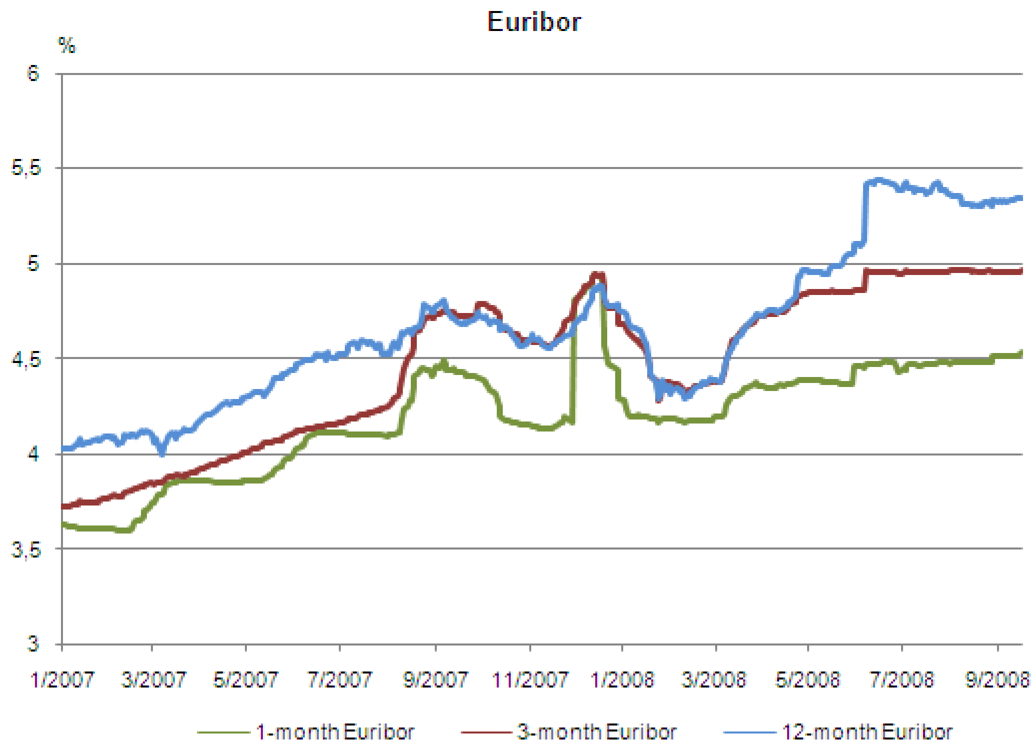
Consumers' increased caution and higher interest rates act as a constraint on credit demand

There may be a number of factors underlying the lower level of confidence in Finland. As well as moderating economic growth, the strong stock market slide, increased inflation and higher interest rates have made consumers more prudent. This is likely to curtail economic activity, thereby barring future economic growth. According to the banking survey published by the Federation of Finnish Financial Services in June, however, consumers' willingness to take on credit is expected to fall moderately. Corporate borrowing is still assumed to be brisk, which may not only reflect ongoing investment but also a tightening in the availability of, and higher prices for, market-based funding amid continued global financial market turmoil.



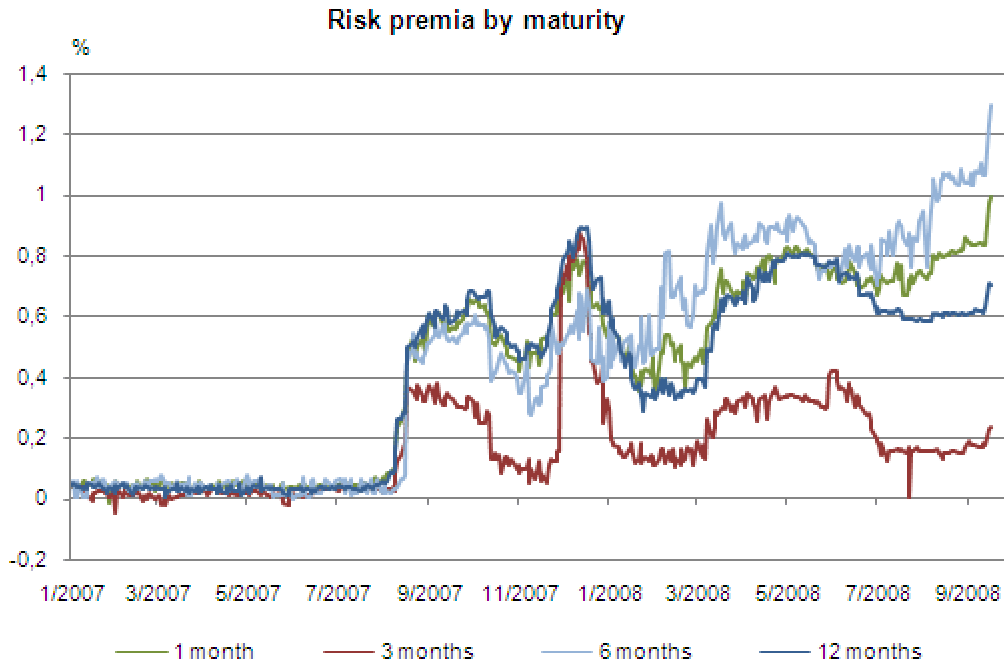
Consumers' heightened caution has also been reflected in savings behaviour. The popularity of deposits has grown, as fund savings have contracted along with the fall in stock prices. On the other hand, rising interest rates have already had a downward impact on consumption. Higher deposit rates have made deposits more competitive in relation to other savings products.

The financial market turbulence is strongly reflected in Euribor rates



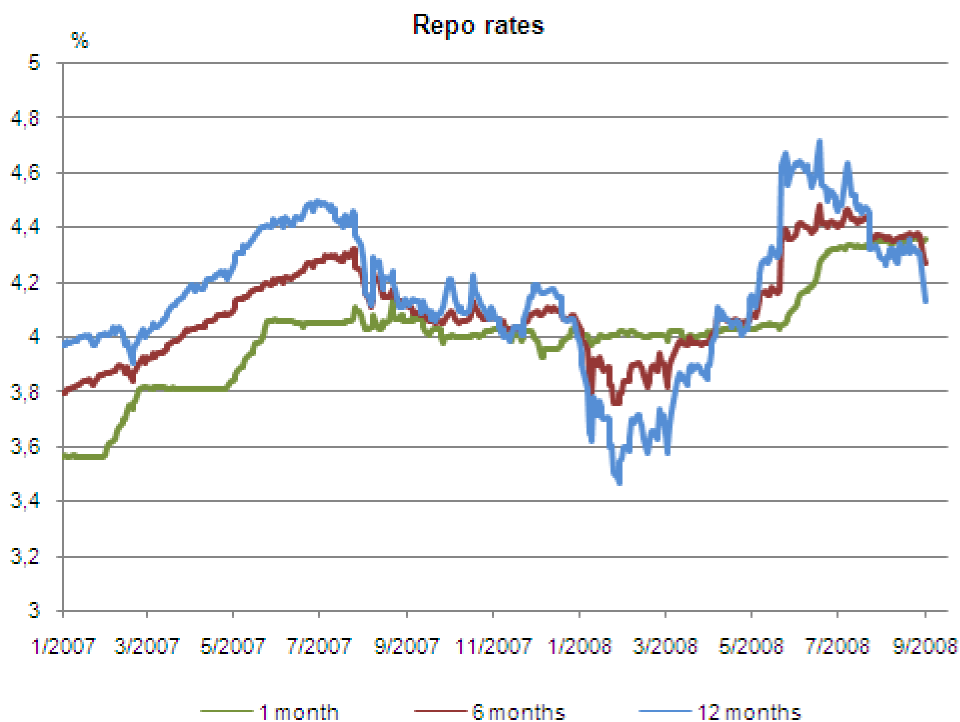
The debt-servicing costs of banks' loan customers have generally grown in response to a pick-up in interest rates. The key reference rates ie interbank Euribor rates and banks' own prime rates have already risen from their historically low levels of a good 2% to as high as over 5%. According to the lending stock statistics compiled by the Bank of Finland, the average interest rate on housing loans in July was 5.49%, as opposed to 4.90% a year earlier.

Behind such rate increases have been higher risk premia for interbank funding in particular. In late spring and early summer, a change in the market's interest rate expectations was also reflected in interest rate developments. The spread between interbank secured and unsecured lending (risk premium) has remained at a historically high level, especially in longer (more than 1 month) maturities.



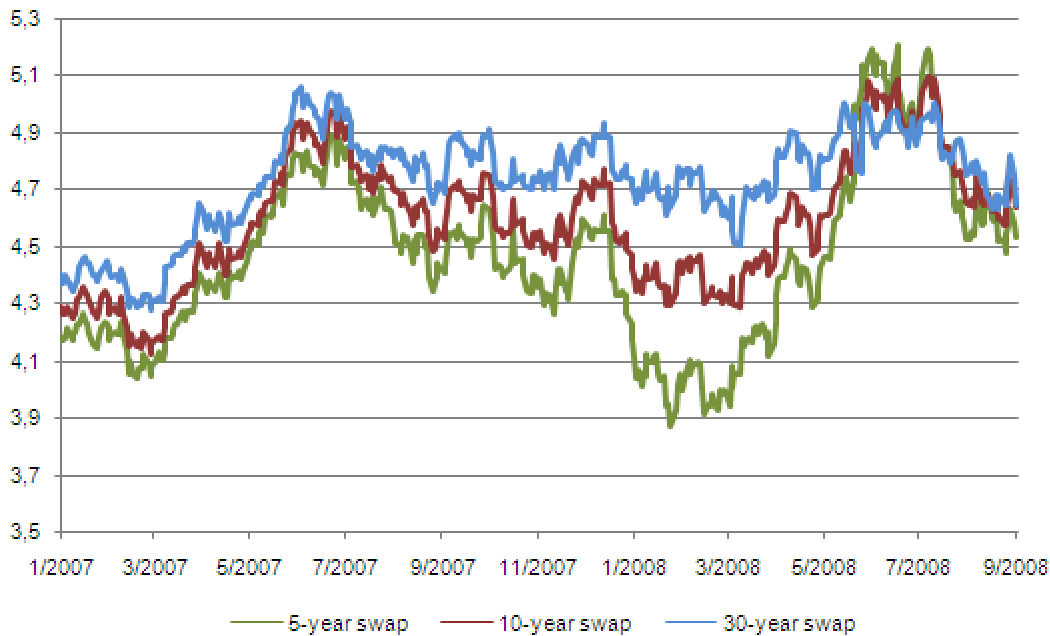
Source: Bloomberg.

By contrast, interest rates on interbank secured lending have been reflecting changed interest rate expectations better than have Euribor rates. Prior to the current financial market crisis when risk premia were still very low, secured and unsecured interest rates moved almost in tandem. Along with the crisis, secured rates actually declined to a level 1 percentage point lower than unsecured market rates. Without an increase in risk premia as a consequence of the crisis, Euribor rates could now be markedly, even a good percentage point, lower than they are at present.



Source: Bloomberg.

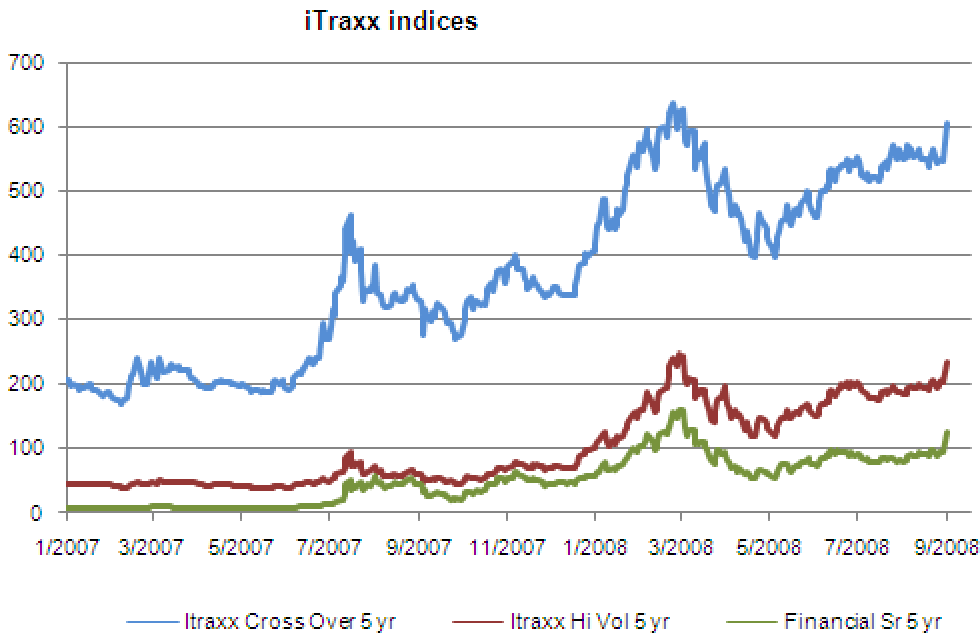
In early autumn - with a deepening of the financial market turbulence and a weakening of the outlook for the real economy - expectations of a rate cut have started to revive in the euro area. This becomes evident, inter alia, from long-term interest rate swaps in which interest rates have come down slightly. It may be worthwhile to monitor developments in long-term interest rate swaps, when one is, for example, planning for tying one's housing loan to a fixed interest rate for a longer period. The bank will add a customer-specific margin to the interest rate quoted in the market for interest rate swaps, as in connection with other reference rates.



Source: Bloomberg.

Credit spreads still high

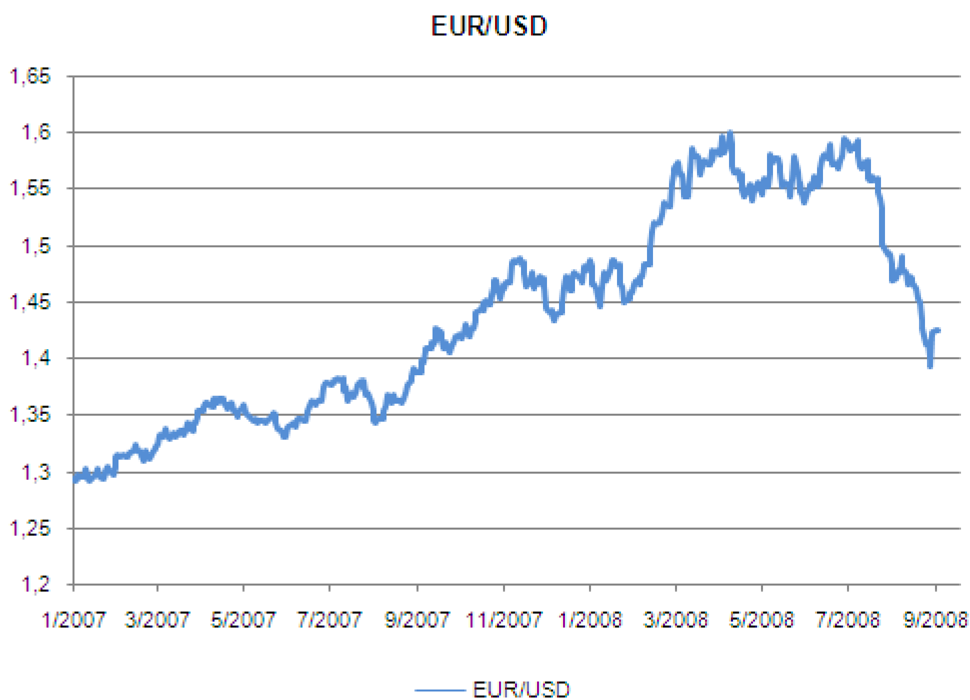
The growth in credit spreads caused by the financial crisis manifests itself in the corporate bond market (eg in ITraxx CDS indices). Especially credit spreads for corporations with lower ratings are still high, but also those for higher-rated and financial-sector corporations continue to be at historically high levels. In the corporate bond market, the liquidity situation is also clearly tighter than before the crisis. Increased credit spreads in the corporate bond market may also lead to further writedowns of market values of invested assets in the financial sector. Other sectors, too, are witnessing an uptrend in credit spreads because of recent events and the prospect of reduced liquidity in the credit risk market.



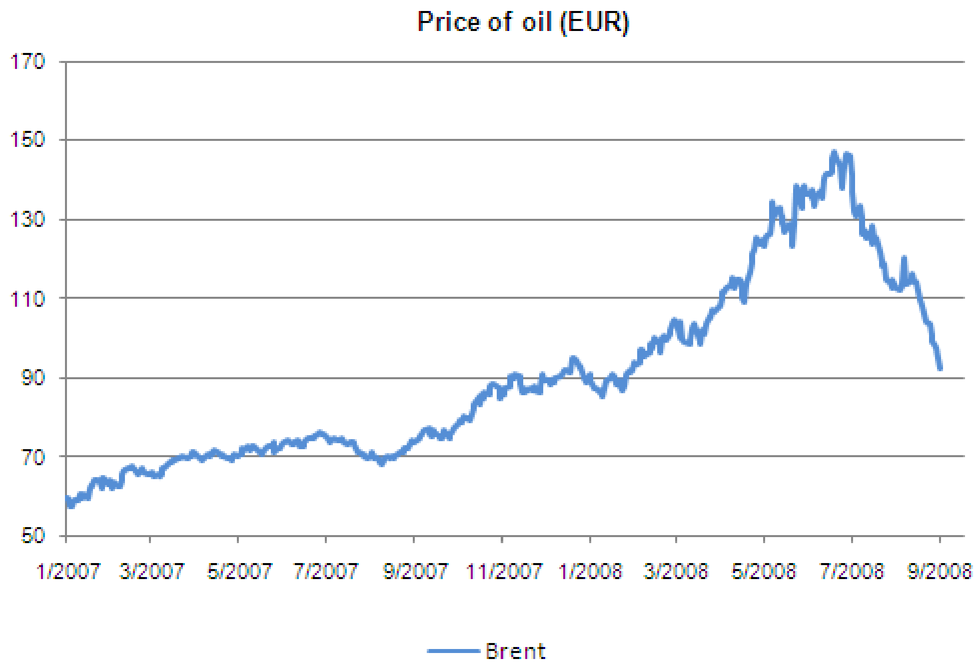
Source: Bloomberg.

Euro weakened against the dollar

The extended period of euro appreciation in the foreign exchange markets has come to end for the time being, and the value of the euro vis-à-vis the dollar has started to weaken, although the events in the US financial sector in the last few days have again lowered the dollar. On the one hand, euro depreciation supports the competitiveness of the export industry but, on the other hand, impairs the profitability of those companies that acquire their raw materials in dollars. Currency movements also have an important effect on oil price developments, a key factor from the viewpoint of inflation.



Source: Bloomberg



Should we get worried about the weakening operational environment?

Protracted good economic performance in Finland has taken a turn for the worse and uncertainty has increased. This makes consumers and corporations more cautious, which may be reflected in economic growth more strongly than anticipated. Markets have widely started to expect a cut in the ECB's policy rate, but there is still reason to prepare for other types of developments. A high degree of financial market uncertainty in particular continues to persist, and the evolution of risk premia gives no signs of an improvement in the situation; in fact, risk premia have grown following recent news releases concerning the US financial sector. Lehman Brothers' insolvency, the federal takeover of the key mortgage lenders Fannie Mae and Freddie Mac and the insurance company AIG, the sale of the investment bank Merrill Lynch to Bank of America and the establishment of a financial rescue fund have been highly significant events and still too recent to permit an assessment of their implications for the duration of the crisis. In Finland, however, banks are in a better position than in many other countries, and an economic slowdown foreseen in newly published forecasts and the latest events do not yet pose a threat to the operational ability of the domestic financial sector.

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Banks' stress test calculations from August 2008

The assumption underlying the stress calculation is for Finland's economic performance to undergo substantial deterioration and the financial market turbulence to continue and to get worse

The capital adequacy in a weak macroeconomic and financial market situation of the largest banks and banking groups operating in Finland was assessed by means of a scenario calculation conducted in summer 2008. The calculation was undertaken as a joint effort between the relevant authorities.[1] The calculation assumes that the economy will be hit by a shock in which the turbulence started from the US housing market continues and becomes aggravated, with its effects spreading to the Finnish macroeconomy, too.

The aim was to have a consistent scenario that would put banks' profit performance and capital adequacy to the test.[2] There is reason to underline that a scenario true to the shock is possible, but not expected or a probable path. It was equally clear that developments assessed in the scenario would be adverse to banks and pose a threat to capital adequacy.

1 The fictitious scenario of weak economic performance presented in the calculation is based on simulations made by the Bank of Finland's macroeconomic model.
2 The point of departure was not to assess the worst possible case. A 'worst case' scenario would not bring significantly better insights into banks' risk sensitivity. In addition, the calculation could not capture measures by bank management to foster capital adequacy in a highly serious situation.

Stress scenario for three years, commencement at the beginning of 2008

The scenario includes a rise in Euribor rates amid increasing loss of confidence between banks, lower demand for Finnish products, higher unemployment, and a decline in investment and consumption. The scenario foresees a sharp fall in property and stock prices.

Table 1 on the following page presents an estimated development of key variables in the scenario. According to the stress scenario, annual GDP change would be at its lowest –1.8% and only 0.3% in positive region in the two other scenario years. However, assumed economic performance would not be the gloomiest conceivable possibility, but milder in terms of duration and effects than, for example, in the recession of the 1990s.

The forecasts were drawn up for a large number of economic and banking indicators and variables.

The table presents part of the variables that are important from the perspective of banking.

		STARTING LEVEL t	YEAR t+1	YEAR t+2	YEAR t+3
MACROECONOMY MONEY MARKETS AND SHARES	Gross domestic product, % change	-	0,3	-1,8	0,3
	Unemployment rate, %	6,9	7,3	9,7	10,7
	3-month EURIBOR	4,3	5,7	5,8	5,7
	10-year bond yield	4,3	4,5	4,7	4,7
	Property prices, % change	-	-6,4	-9,1	-10,4
	Lending rates for companies with low ratings	5,5	7,2	7,4	7,3
	Share prices, % change	-	-32	0	14,7
BANKING	Overall interest rate margin	2,7	3,2	3,3	3,5
	Loan stock, % change	-	5	0	-5
	Deposit stock, % change	-	11,1	2,6	0,2
	Impairment losses on loans, % of the loan stock	0,05	0,3	0,82	1,23

The scenario also includes factors softening the effects of the macroeconomic shock

Credit, equity and interest rate risks are by nature different from each other, and this was also reflected in their different treatment in the calculation. Credit risk is realised through impairment losses on loans in the long term extending over several years, whereas market risk often reflects unexpected realisation of effects. From the viewpoint of banks, an important turn caused by the shock is that impairment losses start to rise sharply, with the rise continuing throughout the scenario period. Accordingly, the effects of impairment losses put a strain on banks in each year of the scenario. The effects are felt quickly in respect of shares and risk-sensitive instruments, but no further shocks are assumed to occur after changes experienced at the beginning of the scenario. Extending the period under review up to 3 years ahead is of greatest importance for impairment losses. Other factors exerting influence throughout the period are psychological effects on the behaviour of consumers and firms in connection with drawdowns of loans and placing of deposits. The calculation makes the largest assumptions in respect of such psychological factors.

From the banks' point of view, the rise in the general interest rate level acts as a factor softening the effects of the shock and has an upward impact on net interest income during the entire review period. The scenario calculation excludes some potentially important risk factors, such as analysis of counterparty risks, risk concentrations and strategic risks. A general macroeconomic scenario is not the best possible tool of approach to assessing all risks, as some risks, such as counterparty risk, are highly bank-specific.

Results

To summarise the results, it can be noted that no bank or banking group sees its capital adequacy jeopardised in the scenario explored. Impairment losses on loans and writedowns on shares, real property or bonds impose a strain on banks, and their profits fall clearly behind the levels achieved in 2007. However, their profits are boosted by growing net interest income as a result of higher interest rates. The final outcome is that banks' financial results enable maintenance of capital adequacy without recourse to loss buffers.[3]

3 A loss buffer means here a notional loss buffer between a bank's own funds and the 8% capital requirement.

Table 2 summaries some effects of the stress test on the profits of banks and banking groups.

CHANGES IN PROFITS COMPARED TO 2007	YEAR t+1	YEAR t+2	YEAR t+3
Banking, total, EURm	-1439	-872	-882
Banking, on average, %	-40	-41	-33
Strongest decline, %	-57	-94	-88

In assessing the results, one must bear in mind the dependency on the chosen scenario and the fact that the results also take account of factors improving capital adequacy.

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Falling income from investment and lower fee income caused a downturn in bank profitability

The Finnish banking sector's combined profit for January-June 2008, excluding the effects of one-off items, was about 5% lower than in the same period a year earlier. Financial performance displayed considerable volatility among individual actors compared with the early part of the preceding year. The profit of Nordea Bank Finland, for example, rose by about a fifth, the profit of the Sampo Bank Group, excluding one-off items, remained unchanged and the profit of the OP-Pohjola group fell by almost a third. Most Finnish banks' financial results weakened in the first half of this year compared with the early part of 2007, but the business operations of the largest domestic banks continued to be clearly profitable. Higher risk premia and lower share prices worldwide were reflected in Finnish banks mainly as losses from investment and declining income from savings and investment services.

Rising reference rates and increasing corporate lending boosted net interest income

Owing to higher reference rates and the ongoing strength of credit demand, robust growth in net interest income continued in the early part of the year, thus compensating the effects of more expensive bank funding. The rise in reference rates is reflected in banks' net interest income as an increase in income from assets tied to variable interest rates. However, the financial crisis has clearly eroded banks' other income. Higher interest rates and lower share prices have in particular led to redemptions of households' investments in mutual funds and shares, thereby decreasing the value of managed assets. As the public's interest in portfolio investments waned, banks' fees from asset management, securities intermediation and securities issuance declined.

Banks' own investments and income from investment services suffered most

In addition to investment services, banks' own investments also suffered. Aktia and the OP-Pohjola group, which have fairly large insurance-related portfolios, have made the largest writedowns on the fair values of their portfolios. As both groups classify such securities as available-for-sale financial assets, negative changes in asset values are reflected as reductions in groups' own equity.

Profits of local banks and Bank of Åland on the decrease

Local cooperative banks' combined operating profit for January-June 2008 was 6% lower than in the first half of 2007. As regards savings banks, their combined operating profit weakened by 9% compared with the same period of last year if a one-off income item that increased last year's profit by EUR 12 million is excluded. The deterioration of the profits of both local bank groups was primarily due to a drop in income from investment in relation to the benchmark period, whereas net interest income and net fee income continued to evolve positively.

The operating profit of the Bank of Åland for January-June 2008 was down 24% compared with the first half of 2007. Profitability was most impaired by a decline in income from investment to about a third and an increase in expenses by 15% in relation to the corresponding period a year ago. In the first half, there was also a fall of 5% in fee income on the previous year.

Nordea Markets boosted profit from Finnish operations

Nordea Bank Finland's half-year profit grew by almost a fifth from the previous year's January-June period. Developments in Nordea's Finnish retail banking operations were in line with those elsewhere in the banking sector, but net income from instruments measured at fair value expanded by about 50%. Nordea Markets operating from Finland has benefitted from the recent extremely rapid rise in demand for various hedging products.

Lower profits from investment dragged down OP-Pohjola

The operating profit of the OP-Pohjola group for the first half of 2008 was down 31% from the corresponding period of the previous year. Developments in lending and net interest income were positive as elsewhere in the banking sector, but the group's operating profit was weighed down by lower income from investment because of financial market problems. Net fee income in January-June remained broadly at the level of the corresponding period of the previous year.

Sampo Bank's difficulties continue

Sampo Bank Group's operating profit for January-June 2008 remained roughly at the level of the same period in 2007 if the one-off impact of proceeds from the sale of Baltic subsidiaries on the 2007 results is excluded. In the second quarter of 2008, however, the group's fee income dropped sharply and also developments in lending volumes were weaker than elsewhere in the sector. The integration of Finnish operations into Danske Bank was known to involve high costs, but extra outlays caused by technical problems have burdened Sampo Bank's profits with an exceptional vigour during the spring. A decline in income caused by lost customer relationships has also eroded group profitability.

Weakening of profits may continue further still

The growth outlook for the economy has deteriorated at the same time as inflation expectations are high. Moreover, the crisis involving the largest companies in the US financial markets has rapidly deepened and uncertainty surrounding international financial markets has increasingly heightened. So far, with the stock market and overall economic activity cooling down, banks' income from investment and fee income have been the first to decline. If negative economic performance and serious financial market problems are to persist, Finnish banks' core business that generates net interest income may also suffer in the long run. Impairment losses on loans may also increase. A particular challenge for banks consists of adjusting their level of expenses to lower income prospects. Especially staff and information-technology expenses have increased rapidly on account of enlargements and pay rises.

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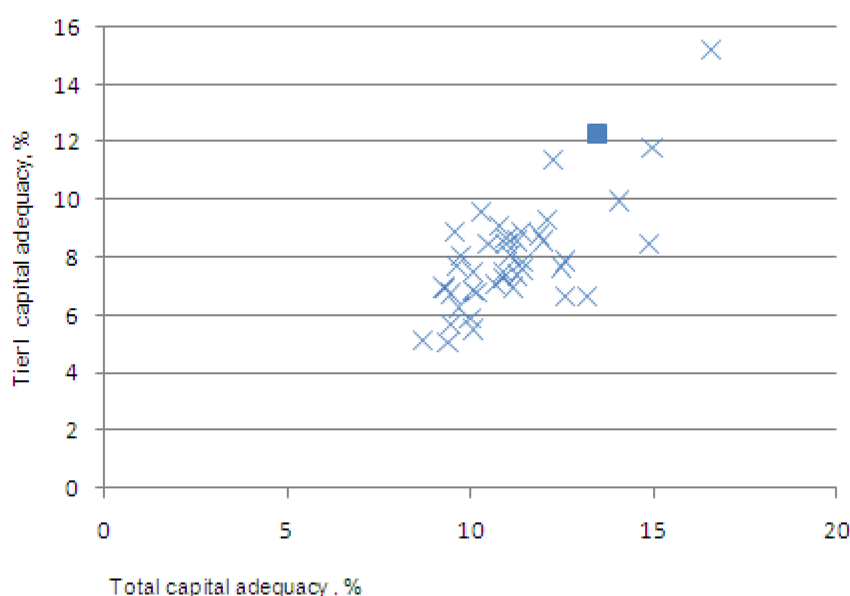
Capital adequacy of Finnish banks1 weakened

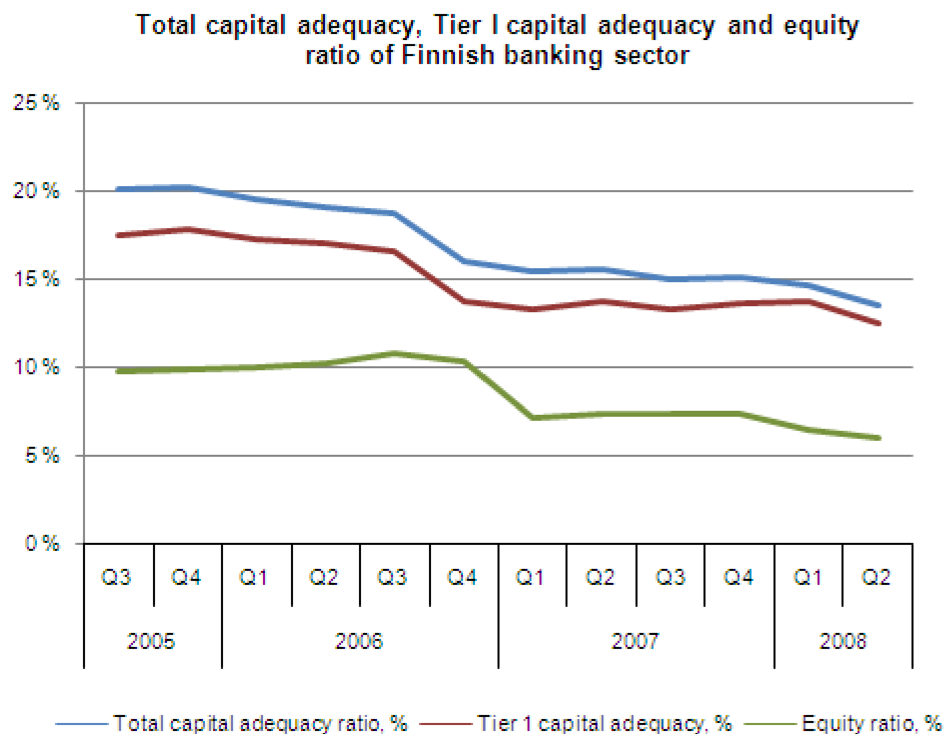
The total capital adequacy of the banking sector has continued to decline, standing on average at 13.5% (14.6% in 2008Q1 and 15.1% in 2007Q4), which is nevertheless a high level in international comparison. The Tier I capital adequacy was high at 12.3%. The weakening of capital adequacy this year was partly attributable to a EUR 500 million reduction in the own funds of Sampo Bank and an increase of about EUR 500 million in the regulatory capital charge for Nordea Bank Finland Plc.

1 The tern “bank” is used in this article also for the banking groups OP-Pohjola, Local Cooperative Banks, and Savings Banks. The Finnish aggregate figures are dominated by a few banks, for example the Nordea Bank Finland’s proportion of the own funds and capital charge of Finland’s banking sector is over 50%.



Aktia and the OP-Pohjola Group engaging in insurance activities have this year made a total of over EUR 300 million of impairments to the fair values of their available-for-sale financial assets. The impairments of Finnish banks have, however, remained fairly low in comparison to many other European banks. The subprime-crisis-related losses and impairments of European banks have this year totalled a good EUR 90 billion.

As of the first quarter of 2008, all banks are now applying the Basel II regulations. The adoption of Basel II has not caused large changes in the capital adequacy figures as a consequence of the so-called floors eliminating large impairments for three years. On the other hand, in comparison with the Basel I figures, the capital charge for operational risk has been introduced as a new element. To facilitate comparison, equity ratio has been added to Chart 2 (Equity/Balance sheet total) x 100), the calculation of which has not been changed as a result of the Basel II reform.

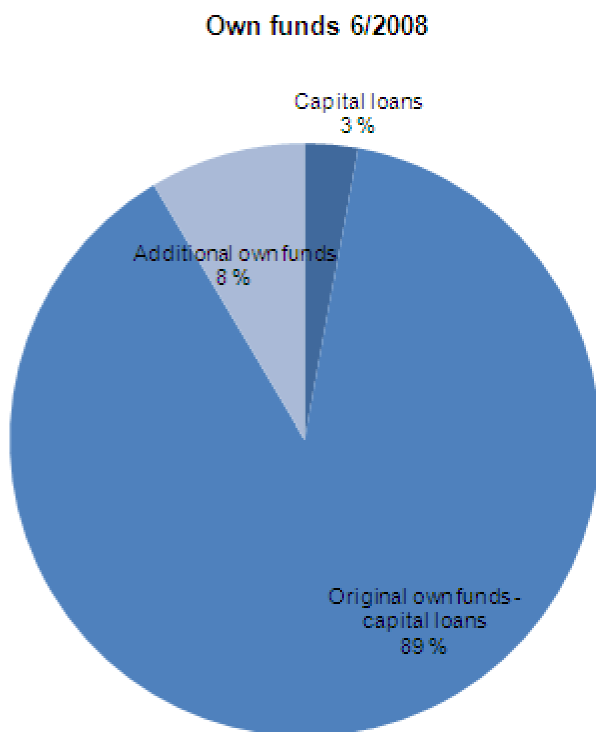


Source: Financial Supervision Authority.

There are significant differences in the capital adequacy of Finnish banks, with total capital adequacy ranging from 10.3% to 22.2%. However, the capital adequacy of all banks appears reasonable, since it exceeds the conservative levels of 10% (total capital adequacy) and 6% (Tier I capital adequacy). The minimum requirements are 8% and 4%.

Quality of own funds remained solid

A good 90% of own funds are original own funds, and their share increased slightly from the beginning of the year. The proportion of capital loans of original own funds was less than 3% and the amount has remained stable this year. Additional own funds consist mainly of subordinated loans, the amount of which has also remained broadly stable. One reason contributing to the stability of capital and subordinated loans may be the market situation, which does not particularly favour their issuance. Finnish banks have not raised any significant amounts of new equity capital this year. Generally speaking, European banks have been quite active in raising own capital. In total, they have obtained a good EUR 90 billion of new Tier I and II capital. The passivity of Finnish banks is explained by relatively small impairments, reasonable profits and solid capital adequacy.



Source: Financial Supervision Authority.

Capital charges for credit risks to diminish

The Basel II minimum requirement for banks is dominated by the credit risk charge with a share of almost 90%. In the first half of 2008, banks did not yet benefit from the reduced credit risk capital charges due to Basel II to any significant degree. Only Nordea Bank Finland Plc has so far been permitted to apply the Internal Ratings-Based Approach (IRBA) to some of its exposures. Small banks that mainly adopted the Basel II based standard approach at the beginning of 2007 benefitted mainly from the reduced capital charges for property-backed assets (housing loans).

Also banks that calculated the capital adequacy requirement for credit risk during the transitional period in accordance with Basel I adopted the standard approach to credit risk in the calculation of the capital adequacy requirement at the beginning of the year. Going forward, the use of internal credit ratings will reduce capital requirements significantly, as new banks and groups of exposures will be introduced in the scope of the calculation.

Market risk charges remain small

The amount of own funds required to cover market risk has increased for most supervised entities during spring 2008. Market risk charges remain small relative to the own funds required to cover credit risks.

The own capital requirements for banks engaging actively in trading are primarily under two per cent of own funds. The market risk capital charges for banks concentrating on investment services are higher in relative terms than for other deposit banks since they have less lending. The division of charges to credit and market risks also depends somewhat on whether the relatively large liquidity buffers of debt securities are recorded in the banking book or trading book.

Capital charge for operational risk applies to all supervised entities

The capital charge for operational risk is calculated by multiplying the average of the income statement items included in accordance with the so-called income indicator from the last three financial statements by the coefficient 0.15. At Nordea Bank Finland and Sampo Bank as well as certain other foreign-owned entities supervised by FIN-FSA, the charge is calculated in accordance with the standardised or advanced measurement approach applied by the parent company.

From the beginning of 2008, the capital charge for operational risk applies to all supervised entities referred to in the directive. The aggregate capital charge for operational risk in the banks that had applied the capital adequacy requirement for the risk area in June 2007 increased by June 2008 by EUR 43 million. The relative share of operational risk of the total charge varies markedly depending on the nature of the bank's business. In a large banking group, the proportion of operational risk is about 10% of the total charge, where as the ratio is about 50% in a smaller bank engaging in more limited operations in terms of scope.

Capital adequacy figures vary across banking and insurance conglomerates

There are three Finnish financial and insurance conglomerates operating in Finland, two of them focusing on finance and one on insurance. The finance-focused groups are Aktia and the OP-Pohjola Group. The insurance-focused group is Tapiola.

A financial and insurance conglomerate is a group with both banking and insurance operations. Banks, investment firms and insurance companies belonging to financial and insurance conglomerates calculate their company-specific capital adequacy figures normally in accordance with the sector-specific regulations applying to each company. Additional supervision of financial and insurance conglomerates also includes the calculation of a conglomerate-specific capital ratio. The purpose of this is to ensure that the conglomerate is financially sound also as a whole.

The capital ratios for financial and insurance conglomerates are calculated by comparing the own funds of the conglomerate to the minimum capital requirement based on the risks of the conglomerate. The capital ratio must be at least 1. In general, it can be said that the capital ratios of insurance-focused conglomerates tend to be higher than those of banking-focused conglomerates. This is due to the different capital adequacy requirements for banking and insurance, although the calculation is harmonised at the conglomerate level.

Indeed, the insurance-focused Tapiola has the highest capital ratio in accordance with the Act on the Supervision of Financial and Insurance Conglomerates, 3.37. This means that Tapiola's own funds are 3.37 times the minimum amount required by the law. The ratios for banking-focused conglomerates are lower. The ratio in accordance with the Act on the Supervision of Financial and Insurance Conglomerates is 1.48 for OP-Pohjola and 1.15 for Aktia.

The proportion of banking activities of the capital charge for all conglomerates was about 85%. The remaining 15% is divided in half between life and non-life insurance. At the aggregate level, the capital adequacy of the conglomerates at the end of June was sufficient, the capital ratio for the whole sector standing at 1.58.

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Demand for credit is still strong; signs of a weakening in the quality of the lending stock

Stock of lending continued to grow fairly strongly

According to Bank of Finland statistics, the stock of MFI lending totalled EUR 152.1 billion in July, ie 13.2% more than a year earlier. Demand for housing loans and consumer credit continued to grow briskly, albeit at a slower rate than in 2007. The annual growth rate of household credit was at the end of July still 10.2%. The annual growth rate of corporate credit remained robust, in July it was as high as 19.9%. The exceptionally rapid rate of growth is partly due to the fact that banks have replaced direct market funding with bank loans that during the financial market disruption proved to be less expensive than market funding.

Households' propensity to borrow is forecast to decline

Non-financial corporations regarded their business outlook normal in August, but near-term expectations have weakened. General economic conditions are forecast to deteriorate considerably towards the end of the year and at the turn of the year.1 Corporate borrowing is however expected to increase slightly over the next 12 months. In contrast, households' propensity to borrow is expected to decline.[2]

According to the consumer confidence indicator,[3] consumers' expectations on the development of the Finnish economy and employment remain bleak. Moreover, consumers' confidence in their own finances is at its weakest level in over a decade, even though consumers consider their own financial situation and savings possibilities good. Borrowing is now considered uneconomic. The results indicate that the growth in demand for household credit may have reached its peak.

1 Confederation of Finnish Industries, Business outlook indicator, August 2008.
2 Federation of Finnish Financial Services, Banks' economic outlook indicator 2/2008.
3 Statistics Finland, Consumer confidence indicator, August 2008.

Uncertainty in the housing market and rising interest rates dampen the demand for household credit

The fairly low level of interest rates in recent years has rapidly boosted the demand for housing loans and contributed to a rise in housing prices. This has been accompanied by a significant increase in the average size of a housing loan and the length of the repayment period.

According to Statistics Finland, the nominal prices of housing continued to rise slightly in April–June in the country as a whole, compared to the second quarter of 2007. Real prices have already started to fall, and the rise in nominal prices is also likely to have come to a halt in some regions. The uncertainty in the housing market is also reflected in the longer selling periods of old housing. The selling of first-time housing and new housing has slowed particularly in the Greater Helsinki Area. The number of finished unsold housing by construction companies has already increased. With signs of a slowdown in the economy and rising interest rates, consumers have become increasingly cautious about taking up a housing or consumer loan. Growing servicing costs of housing loans will initially dampen the demand for consumer credit.

Due to the changes in the market situation, the demand for housing loans has slowed by 2.5 percentage points in the past year. The growth rate of the stock of housing loans was nevertheless 11.1% in July. For example in Sweden, the stock of housing loans has in 2008 decreased by 6% on the previous year. At the end of July, housing loans accounted for EUR 65.9 billion of the total stock of household credit (EUR 91.6 billion). The stock of consumer credit also continued to grow briskly, with the annual rate of change standing at 9.2% and the stock of consumer credit at EUR 11.9 billion at the end of July.

Continued growth in banks' past due items and nonperforming assets

The amount of banks' past due items (loans overdue for 30–90 days) was at the end of July 61% higher than a year earlier. Their share of the lending stock also increased and was in July 0.93% (0.65% in 7/2007), which anticipates the weakening of the quality of banks' credit portfolios. Nonperforming assets[4] (loans

overdue for more than 90 days) grew by 43% in euro terms.[5] Their share of the lending stock is nevertheless still low, ie 0.42% (0.33 % in 7/2007), and hence the overall quality of the lending stock can still be considered quite good. There are however signs of a weakening in the quality of the lending stock. The household sector accounted for approximately 55% of banks' total nonperforming assets.

4 Nonperforming assets = nonperforming assets (overdue for more than 90 days) + guarantee claims + zero-interest assets outside the group.
5 Figure for Sampo Bank refers to April 2008.

Impairment losses continue to grow

Banks' net impairment losses weakened banks' results by 34 million at the end of July, whereas a year earlier, impairment losses totalled approximately EUR 3 million. Gross impairment losses (EUR 118 million) represented only 0.08% (same as a year earlier) of the stock of lending. The ratio still remains substantially lower than the long-term average.

Proportion of corporate sector's problem loans still small

Banks' claims on non-financial corporations increased by approximately 75% on the previous year. At the end of June, they accounted for 0.51% (0.37% in 6/2007) of the stock of corporate credit. Nonperforming assets increased by 18%, year-on-year, and their proportion of the stock of corporate credit remained at the level of June 2007 (0.28%). Despite the strong growth in lending to non-financial corporations, the proportion of the corporate sector's problem loans has thus far remained fairly small.

Slight increase in number of bankruptcies

In January–July 2008, the number of bankruptcy proceedings initiated increased by 7% on the year earlier period (Statistics Finland). The biggest increase, 28%, was witnessed in manufacturing, mining and energy supply.

Payment defaults due to consumer credit becoming more widespread

The number of new payment defaults by private individuals decreased in January–June by 2.9% on the previous year. The number of defaulting private individuals however remains higher than in the year-earlier period, due to the fact that payment defaults are concentrated on persons that have previous payment defaults. The number of demand for-payment rulings on new payment defaults grew by approximately 15%, which was mainly as result of overdue consumer credit. Payment defaults due to small consumer credit, ie instant loans, are becoming increasingly widespread among the 18 to 24-year-olds.[6]

6 Suomen Asiakastieto Oy, 8 July 2008.

Household sector's problem loans increasing

The amount of households' past due items has increased by 39%, year-on-year, and at the end of June, the proportion of past due items in the sector's stock of credit was 0.73% (0.58% in 6/2007). One way of measuring loan repayment capacity is to look at households' nonperforming assets, which have increased by 22% per annum. Their proportion of the stock of household credit increased slightly, to 0.39% (0.35% in 6/2007). Banks' nonperforming assets in relation to total exposures are still low compared to the level of nonperforming assets during the recession, when households' nonperforming assets' relation to household lending was several percentage points.

The recent rise in market interest rates has lengthened the repayment period of loans with equal principal repayments and significantly increased the debt-servicing expenses of annuity loans. According to calculations by Suomen Rahatieto, the rise in interest rates may have lengthened the repayment period of a 20-year loan to as much as 30 years. In a long-term housing loan, the interest payment often becomes bigger than the monthly instalment, in which case the repayment schedule has to be renegotiated.

Households' housing debt problems increasingly accumulate to young families with children, part of whom have to rearrange their loans, or in the worst case, find a new form of accommodation. Banks increasingly grant amortization-free periods, and mortgage holders have protected themselves against rising interest rates by eg negotiating an interest rate ceiling on their loan. Mortgage holders however have less leeway than before because not only loan-servicing costs but also the cost of living has risen rapidly in the past year.

Households' indebtedness continues to increase

Households' debt ratio, which is an indicator of the average development of debt, has risen substantially in the past four years. The debt ratio, ie the proportion of debt of annual disposable income, is estimated to reach 107.5% in 2008 and 113% in 2009.[7] The debt ratio of Finnish households is however lower than in other countries on average. The indebtedness of households with a mortgage has risen particularly fast in Denmark, the Netherlands, Ireland, the United Kingdom, and France.

7 Federation of Finnish Financial Services, Households' assets and liabilities, 4 June 2008.

Economic downturn a threat to mortgage holders

Growing uncertainty about the economic outlook and rising interest rates have slowed the demand for household credit. The stock of credit has nevertheless continued to grow rapidly, particularly in the corporate sector. On the whole, households' payment problems have not increased significantly in the past year, owing to the continued favourable developments in employment and income. The declining solvency of mortgage holders is mainly due to a fall in income caused by several reasons. The largest debt-servicing problems are concentrated only on a proportion of households with a housing loan and consumer credit. A significant downturn in the economy and employment would however increase the number of problem loans and households encountering repayment difficulties. The situation is exacerbated by the fact that the rise in interest rates triggered by the financial market crisis has already increased mortgage holders' debt-servicing costs over the past year.

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Finnish banks have enough liquidity to withstand the market turbulence

International financial markets

A little over a year ago, an abundance of liquidity was still available on the financial markets and was inexpensively priced. At the same time, investors sought income from new complex investment products that had a complex risk profile and were less liquid and transparent than traditional investments. As loan losses on subprime mortgages grew, the risks started to emerge, but their size and exact location remained obscured. This caused a major loss in confidence between banks and the other market participants.

The international financial markets are still riddled with rumours and market participants still lack confidence in the financial sector. In September, the financial market crisis deepened when big financial and insurance corporations had to face major restructuring, the direct and indirect impact of which on market participants was unclear. The situation thus remains highly uncertain and market liquidity is exceptionally weak. Moreover, market conditions are not expected to normalise rapidly.

Banks' funding costs rise as a result of the financial market crisis

The price of a bank's funding consists of a risk-free interest rate and the bank's risk premia. The loss in confidence increased banks' risk premia on funding, particularly those that were due to credit risk. These risk premia have remained high because weak market liquidity and the ongoing uncertainty have resulted in further losses and write-downs and it remains impossible to assess the total impact of the financial market crisis.

The growth of risk premia increases the price of market funding for banks. The costs for renewing funding are higher. The credit risk premia is particularly high for long-term funding (with a maturity of over a year), which has a direct impact on the price of funding. Heightened competition for deposits has also squeezed banks' margins. Deposit funding nevertheless remains the most inexpensive form of funding for banks.

Banks are prepared for a prolonged period of market uncertainty

Finnish banks' liquidity remains good. The risk premia on funding, particularly the price of long-term funding, have remained high for already over a year. Thanks to their good reputation, Finnish banks have thus far suffered less from the market disruption than many European and US banks. The banks affected by the turbulence have made major write-downs on their subprime investments, and their liquidity and capital have become tighter. The rise in funding costs weakens banks' profitability even though banks in the Finnish market have gradually transferred the higher funding costs also to interest rates on loans. Finnish banks have managed to finance the demand for loans without difficulties.

Finnish banks have managed to maintain confidence and a relatively good position in the market. Finnish banks have not encountered problems in acquiring funding in the past year. Banks have large reserves of liquid funds which enable them to withstand temporary disruptions, even large ones, such as the shock reactions of the markets in September 2008. Excluding the extreme days of disruption, Finnish deposit banks have been successful in acquiring long-term funding. Banks have obtained shorter-term funding also in the form of deposits. Banks have not had problems in obtaining longer-term market-based funding, but the price of funding has remained exceptionally high. As the market turbulence continues, it becomes increasingly important for banks to monitor their liquidity risk closely.

Banks are prepared for a protracted period of market turbulence, and market uncertainty is taken into account in liquidity risk management. Banks use their reserves of liquid funds to prepare for unexpected large market disruptions, like the ones experienced in the early autumn. In addition to holding large liquid reserves, banks are minimizing their dependency on short-term funding, and covering their refunding needs in advance, which makes them less exposed to shock reactions in the markets.

Deposit funding continued to grow robustly throughout the spring

Deposit growth already picked up in autumn 2007, clearly exceeding the level in previous years, as investors sought secure investment products. Growth in deposits accelerated further in spring and summer 2008. Deposits stood at EUR 102 billion in June 2008 (up 16.7% year-on-year).[1] The increase was particularly pronounced in fixed-term deposits, which grew by over 50% on June 2007. Competition over fixed-term deposits tightened in the spring, which has squeezed banks' interest rate margins. Funding via deposits is still less expensive than market-based funding. Two-thirds of total deposits are in transactions accounts, whose low interest rates contribute to curbing the costs of deposit funding.

On average, deposits covered 74% of banks' lending to the public and public sector entities. For several banks, such as local banks, the importance of deposit funding is even higher. The ratio started to edge up slightly in 2007, following a declining trend over a number of years. Deposits can be considered a more stable source of funding than market funding, which reduces banks' vulnerability to market disruptions.

1 Source: Bank of Finland, Financial Markets – Statistical Review 8/2008.

Long-term market funding remains expensive

The availability of long-term funding has remained high over the past year; the price of funding nevertheless remains elevated. Consequently, there have been only little issuance of bonds by banks. As a result of favourable developments in deposits, banks do not have any acute need for long-term funding. Banks have however launched smaller issues in order to ensure a diverse structure of funding. Banks are prepared for a protracted period of tight liquidity.

The credit crisis has highlighted the importance of funding acquired via mortgage banks. The price of funding acquired via mortgage-backed covered bonds has also risen, but considerably less than unsecured bonds. In autumn 2007, mortgage banks did not have any need for funding, but in the spring and summer, they again issued mortgage-backed bonds. Mortgage-backed covered bonds have traditionally been used to acquire funding with and extremely long maturity. The maturity of issues launched in the past twelve months has however shortened to two years. The proportion of mortgage-backed funding in the funding of housing loans is likely to continue to grow. Mortgage banks already play an important role in the funding of housing loans, as approximately 10% of the stock of housing loans is in the balance sheets of mortgage banks.

The bulk of market funding is short-term money market funding

The robust growth in deposits since autumn 2007 has decreased the need to obtain market funding. Long-term funding is still considerably more expensive than prior to the credit crisis. Banks have issued only a small number of new long-term bonds and replaced only a proportion of the matured issues with long-term funding. The stock of bonds issued by deposit banks amounted to EUR 15.5 billion in June (up 9% year-on-year). Banks acquired short-term funding mainly via issuance of certificates of deposit. The stock of certificates of deposit stood at EUR 38 billion in June (up 10.5% year on year).

Bonds falling due further shortened the average maturity of market-based funding in the spring. The maturities of bonds issued were shorter than before, which also affected the average maturity of funding. Of the stock of bonds and certificates of deposit issued by deposits banks to the public, almost 80% matured within one year. A total of 39% of bonds matured within three months. The corresponding figures in June 2007 were 66% and 33%, respectively.

The shortening maturity of market funding increases structural funding risk because the risks of renewing funding increase. Banks have to ensure that a sufficient proportion of funding is long-term funding, despite the challenging market situation. Diversification of market funding as regards instruments and markets also reduces availability and price risks involved in renewing funding.

Liquid assets have increased

Regular reports to the authorities show that the one-month funding deficit, ie the difference between cash flows falling due within a month has grown in the past year. This is due to shorter maturities for market funding and the growing amount of short-term deposits. Banks' aggregate one-month funding deficit exceeded EUR 14 billion in June. Banks liquidity has remained good, despite the growing funding deficit. Robust growth of deposits has boosted liquidity. Banks have also built up their liquidity buffers since summer 2007. The amount of liquid assets and various debt securities eligible for use as collateral for central bank financing increased in June to over EUR 13 billion. When market liquidity remains weak, it is important that banks have buffers of liquid, low-risk securities, which can rapidly be converted into cash or used as collateral for funding.

Deposit growth has reduced banks' dependency on market funding. As a result of favourable developments in deposits, banks have been able to maintain a diverse funding structure, despite the shorter maturities on market funding.

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Deposits and claims on public sector entities
EUR bn
150
140
130
120
110
100
90
80
70
60
2003
2004
2005
2006
2007
2008
Deposits
Claims on public and public sector entities
Source: Financial Supervision Authority.

Deposits as a percentage of claims on public and public sector
92 %
90 %
88 %
86 %
84 %
82 %
80 %
78 %
76 %
74 %
72 %
70 %
2003
2004
2005
2006
2007
2008
Total deposit banks
Source: Financial Supervision Authority.

Low interest rate risks in the banking sector

The increase of euro area interest rates that has continued non-stop already for almost three years and the lending growth that has remained rapid for years have not increased banks' interest rate risks. Turbulence in the fixed-income markets has not increased the interest rate risks of core banking activities, since at least for the time being, the increased uncertainty has not had a significant impact on the balance sheet structure of the banking sector. Finnish deposit banks' absolute income risk and relative income risk compared to net interest income have remained almost unchanged from the end of 2007. The income risk resulting from a one-percentage point increase in interest rates at the end of June 2008 was EUR 435 million (EUR 436 at the end of 2007), and 13% (13%) relative to net interest income around the turn of the year. In other words, if market rates rose by one percentage points, the net income from financial operations of the banking sector would increase by over EUR 400 million. In contrast, the investment risk of interest-rate sensitive instruments held solely for trading purposes increased somewhat during the year, to EUR -467 million (EUR 418 million).

The markets are expecting short-term euro area money market rates to decrease over next year by about 0.5 percentage points. If realised, an interest rate drop of this magnitude would reduce the net income from financial operations of the banking sector by about 7% but would not endanger banks' capital adequacy.

Indicators used in monitoring banks' interest rate risks

The Financial Supervision Authority monitors, by way of regular reporting, the interest rate risks related to banks' financial activities (banking book) and price risks in their trading books (investment risk). Interest rate risk in the banking book covers all interest rate related risks faced by a bank except those resulting from trading activities. Changes in the level of interest rates cause both income-based and present-value-based risk to banks.

Income risk refers to the impact of the maturity imbalances between the bank's assets and liabilities on the net interest income accrued during the year when market rates rise, assuming that the balance sheet structure remains unchanged. The Financial Supervision Authority has monitored the income risk of the banking sector already for years.

The present-value-based risk refers to a reduction of the economic value (present value) of interest-rate-sensitive items in the banking book resulting from a change in the level of interest rates. Economic value refers to the discounted expected value of the net cash flows of items in the banking book. Directive 2006/48/EC on banks' capital adequacy requirements requires that the Financial Supervision Authority monitor banks' economic-value-based interest rate risks. Therefore, risk reporting by banks based on the economic value approach to the Financial Supervision Authority began from the situation in the end of June 2008.

The interest rate risk of the trading book is covered in pillar 1 of the Basel II capital adequacy framework. In contrast, interest rate risk of the banking book is one of the most significant Pillar 2 market risks, which the banks must themselves recognise and analyse and allocate sufficient capital to cover them.

Both banking-book interest rate risk measures are material and complement each other. The income risk measure can be used to quantify and control the uncertainties related to the bank's net interest income resulting from changes in interest rates. Since net interest income constitutes a significant proportion of the income of traditional banking, controlling the income risk has an important role in managing the uncertainty related to banks' cash flows.

In the present-value-based approach, interest rate risks are assessed from the viewpoint of economic value to the bank. Risk management is used to mitigate reductions in economic value resulting from sudden movements in interest rates. In other words, in the economic value approach, the objective is comprehensive management of the bank's balance sheet risks, while the objective of management of income risk is to ensure sufficient accrual of cash flows to the bank in all possible operating conditions.

The most simple and most frequently used approach of managing banking book interest rate risks is to ensure that the maturity imbalances of assets and liabilities remain small. Indeed, the majority of hedging of income and present-value-based interest rate risk is conducted by matching balance sheet items.

Swelling of balance sheets is not reflected in banks' income risks

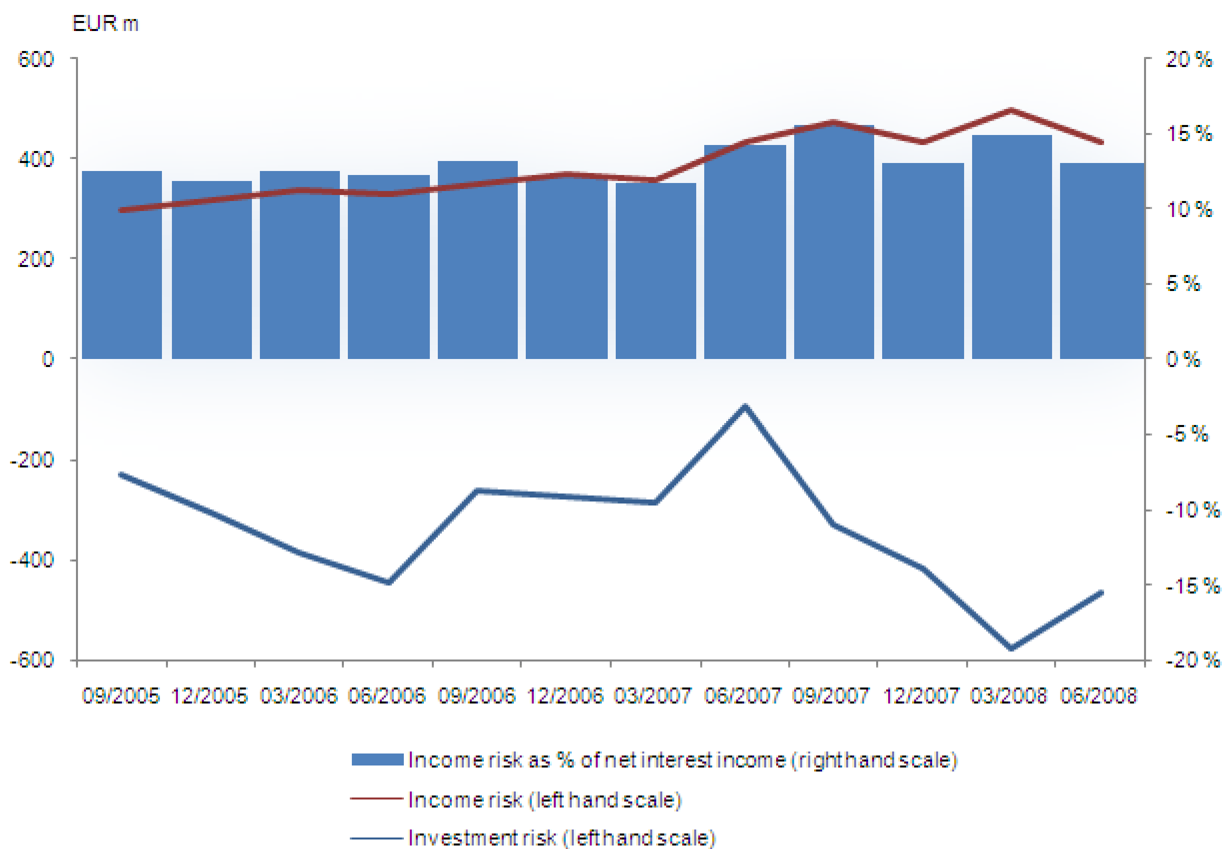
Banks' balance sheets have expanded forcefully over the past year, which is reflected in increased balance sheet items in the calculation of income risk. However, the expansion of balance sheet items has not increased the aggregate income risk of the banking sector, which is why the income risk relative to net interest income has remained at a moderate level.

Among the liability items in the balance sheet, strongest growth has occurred in short-term debt from credit institutions and term deposits from the public, while in the asset side, receivables from the public (housing loans) and credit institutions have grown the most. The faster growth of assets particularly in the short maturities contributed to an increase in the income risk in the balance sheet, but hedges made with derivatives eliminated this impact. The most traded type of derivatives instruments were interest rate swaps.

The proportion of foreign currency items in the income risk has again increased slightly from the turn of the year. While the proportion of foreign currencies at the end of 2007 stood at 29%, by the end of June the proportion had increased to 44%. Besides the euro, the most significant currencies were the Swedish and Danish krona and the US dollar.

Investment risk in the trading book has increased slightly

The investment risk in the trading book increased over the year to EUR -467 million (EUR -418 million). The most important reason was an increase in the investment risk of euro-denominated items. Negative interest-rate sensitivity means that the value of contracts decreases as the yield curve rises in all maturities by one percentage point. The increased investment risk is almost entirely explained by the growth of market value.



Source: Financial Supervision Authority.

Risks of the banking sector based on economic value are low

The interest rate risk of the banking sector as measured by the economic value method can be considered fairly low. If interest rates suddenly rose by two percentage points, the present value of the balance sheet of the banking sector would decrease by about EUR 200 million, which corresponds to about one percent of banks' own funds. At the aggregate level, the risk is much smaller than the risk limit provided in the directive on capital adequacy requirements, according to which a reduction in economic value resulting from a ±2 % change in interest rates may not exceed 20% of the bank's own capital. The low level of risk is mainly explained by the fact that the maturities of the interest rate sensitive items in the banking book of the banking sector are fairly short, since a majority of the loans granted have been linked to floating market rates and banks' own prime rates, and correspondingly the maturities of the liability items used to fund the loans are equally short. The low level of the present-value-based risk figure is due to the fact that the sensitivity of the economic value of an asset/liability item to interest rate changes is the lower the shorter the maturity of that item is.

Interest rate changes expected by the market do not threaten the capital adequacy of the banking sector

Interest rate expectations calculated on the basis of the prices of actively traded interest rate options indicate that the three-month Euribor is expected to decrease by about half a percentage point over the following year. The interest rate change expected by the markets is considerably smaller than the 100 and 200 basis point shocks used in the analyses above. If realised, this interest rate scenario would reduce banks' net interest income on average by about 7% but would not pose a threat to the capital adequacy of the banking sector by any measure.

Aggregate interest rate risk of the banking sector including derivatives activities: euro and other currencies combined

(EUR million if interest rates rise by one percentage point)

	30 Jun 2008	31 Dec 2007	Change
Interest rate risk of banking book			
Income risk	435	436	-0.2 %
Net income from financial operations (31 Dec 2007)	3,334	3,334	
Relative income risk, % of net income from financial operations	13 %	13 %	
Stress test 1: sight deposits < 1 month	-87	-114	-23.9 %
Stress test 2; currencies at intrinsic value	719	932	-22.9 %
Risk based on present value	100		
Own funds	20,867		
Relative present value risk, % of own funds	0.5 %		
Interest rate risk in trading book			
Investment risk	-467	-419	11.5 %
Stress test 3; currencies at intrinsic value	531	533	-0.3 %

Source: Financial Supervision Authority.

Definitions of interest rate risk and further information on evaluation methods

In FIN-FSA analyses, interest rate risk has been divided into income risk, economic-value-based interest rate risk and investment risk.

Income risk refers to the impact of the imbalance of the maturities of the bank's assets and liabilities on the net interest income accrued during the year when market rates rise, assuming that the balance sheet structure remains unchanged. The Financial Supervision Authority has already monitored the income risk of the banking sector for years.

The economic-value-based interest rate risk refers to a reduction of the economic value (present value) of interest-rate-sensitive items in the banking book resulting from a change in the level of interest rates, where economic value means the discounted expected value of net cash flows generated by banking book items.

Investment risk refers to the immediate change of the market values of bonds and derivatives in the trading book when interest rates rise.

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Challenging operating environment for investment firms

New investment firms entering the market

The number of investment firms will increase over the coming months as companies that have applied for authorisation to launch their operation or continue their present activities as investment firms. These new agents will increase competition and diversity in the field, as the provision of investment advice and operation in the commodities derivatives market begin to require authorisation.

Investment services may be provided by domestic credit institutions, investment firms or management companies engaging in asset management. Furthermore, foreign credit institutions and investment firms may offer investment services either on a cross-border basis or through a branch based in Finland. At the end of June 2008, there were a total of 45 domestic investment firms (47 on 30 June 2007). In addition, investment services were provided by three branches of foreign investment firms operating in Finland.

Corporate restructuring reduced the assets under management of investment firms

The total amount of assets in asset management (investment firms, banks and management companies) was reduced by about 12%, standing at about EUR 130 billion at the end of June. The share of investment firms as an asset manager has been reduced substantially following corporate restructuring at the end of 2007. This is also reflected in the income received from asset management. While the assets in asset management by investment firms were reduced by 44%, the income from asset management was correspondingly reduced by about 49%.

Profitability at a relatively solid level

Income from investment service operations[1] at the end of June 2008 amounted to about EUR 130 million (EUR 225 million as at 30 June 2007). A majority of the reduction in income was due to the shift of major agents as part of the parent bank, after which the income of these companies are shown in the income statement of these credit institutions. If companies exiting and correspondingly entering the market during the year are eliminated from the figure, the income from investment services at the end of June 2008 amounted to about EUR 114 million (EUR 131 million as at 30 June 2007). In this respect, the reduction of income only amounts to about 13%.

1 Includes only the income of investment firms (not including income of credit institutions from investment service operations or income of management companies engaging in asset management).

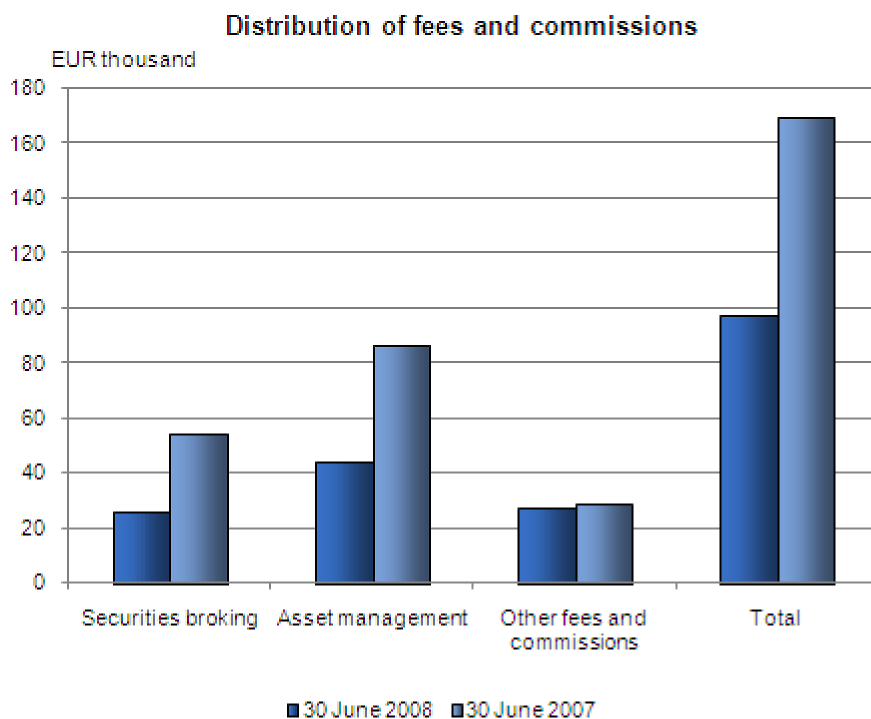
In a cumulative review, the profitability of investment firms remained at a relatively solid level despite the market situation, although operating margins were reduced from the level of previous years. At the end of June, the cumulative operating margin (operating profit/income from investment services) stood at about 29%, as opposed to about 45% a year earlier. The proportion of administrative expensive of income was higher than in the comparative year, which is shown as reduced margin and lower operating margin.

Profit performance shows large variation across the different agents. Income from investment services had decreased from the comparative period at 24 companies and increased at 13 companies. Eight agents lacked comparative figures. Companies showing the highest reductions of income in terms of percentages were investment firms engaging in asset management.

There were 13 investment firms showing a loss. Among them, six had a positive result in the comparative period. As a rule, the surplus of own funds and loss buffer of the companies showing a loss were sufficient to cover also potential losses over the following quarters.

Securities broking and asset management continue to be the main sources of income in asset management, although the share of other fees and commissions of total fees and commissions has increased.

In euro terms, the income from securities broking and asset management has decreased by about 50%, while other fees and commissions have remained almost unchanged from the previous year. The large reduction in income is explained by the corporate restructuring referred to above and the unfavourable market situation, which is reflected most heavily exactly in broking and asset management.



Source: Financial Supervision Authority.

Capital adequacy and sufficiency of own funds

Investment firms have followed new capital adequacy requirements from the beginning of 2008. The minimum requirement of own funds consists of shares allocated to credit, market and operational risk. In relative terms, investment companies had to reserve the highest amount of own funds for operational risk (the proportion being over 75% of the minimum own capital as at 30 June 2008).

All agents exceeded the minimum requirement of own funds at the end of June 2008. The own funds of investment firms stood at about EUR 123 million at the end of June. Correspondingly, the cumulative minimum requirement was about EUR 29 million. Hence, the surplus of own funds was roughly threefold in comparison with the minimum requirement.

The amount of surplus own funds and capital adequacy ratios showed large variation across the different agents. There were two companies in the group with a capital adequacy ratio below 10%. Both were part of a consolidation group, where the parent company is able to provide additional capital when necessary.

Investment firms may assess their capital needs primarily on the basis of Pillar 1 calculation. However, an overall assessment of the sufficiency of own capital must account for the risk profile of the company and review all material risks with an influence on the operation of the company. Typical risks affecting investment firms and remaining outside Pillar 1 calculation include large exposure risk and reputation risk.

In particular, investment firms with a low or materially reduced loss buffer must critically assess the sufficiency of own capital in their operations. The requirement of operational risk reduced the surplus of own funds in all investment firms. Often the need for additional buffer also results from changes in the company’s risk profile or operating environment.

Unfavourable market conditions will reduce expected returns

The profitability of investment firms depends on the development of fees and commissions. Income from securities broking and asset management depends on both activity of the securities market and the market value of assets under management.

The volume of share trading has been reduced materially, amounting to about EUR 15 billion at the end of August. The volume has not been as low since 2005. At the same time, the market value of listed shares has decreased, standing at about EUR 182 billion at the end of August. On a constant basis, the market value has been at a similar level in 2005.

Income from investment advice may even rise temporarily in a weak market situation. Nevertheless, if the unfavourable market situation persists, the earnings expectations of investment firms for the rest of the year will weaken and fees and commissions will likely remain below last year's level.

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The long-standing growth of management companies took a downturn

Fund assets continually on the decrease

The number of Finnish management companies as at the end of June 2008 totalled 29, of which eight offered asset management services.

Persistent uncertainty on the interest rate and share markets continues to affect the funds market. In January–June 2008, fund assets have shrunk by some EUR 10 billion. The fall was due to redemptions (58%) and changes in share prices (42%). In equity funds the impact of changes in share prices was substantial, accounting for more than 70% of the fall in capital. Correspondingly, looking at interest rate funds as a whole, the decline in capital in interest rate funds was practically wholly due to redemptions of fund units. In terms of fund categories, net subscriptions notwithstanding, the joint value of corporate interest rate funds has decreased in the review period. This is explained by the growth in credit risk add-ons on the corporate credit market. The widening of spreads lowers the value of corporate loans and of funds investing in them.

The breakdown of capital into interest rate funds and equity funds has not changed dramatically January–June 2008. More than half of the capital invested in funds continues to lie in equity funds. In euro terms, interest rate funds have been much more severely affected by redemptions than equity and interest rate funds. The transfer of capital to deposits has been particularly reflected in short-term interest rate funds, from which fund units have been redeemed to the total value of EUR 2.7 billion during the first half of 2008. At the end of June, fund assets amounted to EUR 55.9 billion.

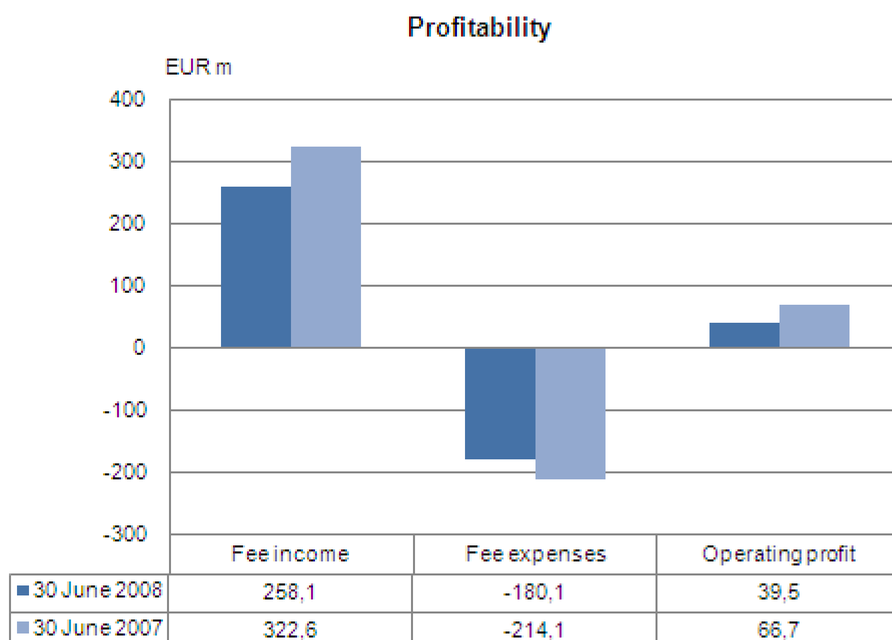
Decline in fund assets reflected in management companies' fee income

In June 2008, management companies' fee income was 20% lower than a year earlier. Developments in fee income are in line with developments in fund assets in the corresponding period.

Although the average profitability development of management companies was poorer than a year earlier, there are management companies whose fee income and asset development was positive. The best profit performance was produced by small management companies.

Seven management companies reported losses in June. In relative terms, the performances of management companies engaged in asset management declined the most.

The decline in management companies' cumulative profit has exceeded income in the first six months. The slow adaptation of expenses to lower income resulted in weaker profitability. Measured in term of the operating profit percentage, profitability fell from 20.7% to 15.3 %.



	Fee income	Fee expenses	Operating profit
30 June 2008	258,1	-180,1	39,5
30 June 2007	322,6	-214,1	66,7

Sourde: Financial Supervision Authority.

Capital requirements met

Management companies engaged in asset management must meet the requirements of the Mutual Funds Act as well as the capital requirements of Basel II. The minimum requirement on own funds for these management companies consists of capital allocated to credit, market and operational risk.

All management companies fulfilled the capital requirements set on them. Own funds were adequate in terms of both the Mutual Funds Act and Basel II requirements, and no material changes have been observed in the quantity or quality of own funds. If companies reporting losses continue to perform poorly, some management companies' own funds will fall close to the absolute minimum.

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Impact of financial market turmoil on mutual funds registered in Finland

Finnish mutual funds' direct investment in the Lehman Brothers group

Total assets in Finnish mutual funds amounted to approximately EUR 55 bn as of 31 August 2008. Of this, direct investment in the Lehman Brothers group (shares and bonds) totalled some EUR 34.3 million ie 0.06% of total fund assets. The investment was distributed over 16 mutual funds managed by seven management companies. At the end of August, investment in Lehman accounted for 0.05–5.9% of the capital of a single mutual fund.

According to the Mutual Funds Act and the regulations on mutual funds, investment in the securities and money market instruments of a single issuer may account for 10% of the total assets of the fund, at the most. Less extensive decentralisation is accepted for special mutual funds, with the limit on the latter set at 20%. The obligation to disperse investment lowers the risk associated with mutual funds and weakens the impact of a single issuer on the value of the fund.

The value of fund assets is determined on the basis of developments in the market value of the underlying instruments. Thus, the bankruptcy application of Lehman Brothers (Chapter 11), which was almost immediately reflected in the prices of shares and bonds issued by group, has already been accounted for in the development of the value of funds possessing these instruments. The market value of direct investment in the Lehman Brothers group as at the beginning of week 38, following the announcement by Lehman, was only some EUR 12.4 million. In fact, some management companies had been selling their Lehman investment since the end of August, prior to Lehman's announcement. The value of Lehman investment continues to vary according to developments in the market value of these investments and will thus be reflected in the value of mutual funds.

Some Russia funds put redemptions and subscriptions on hold

Last week, the financial market turbulence spread to the Russian market and trading on Russian stock exchanges was suspended. Trading was interrupted for nearly all of Wednesday and all day on Thursday, which had a direct impact on Finnish funds investing in Russia.

The Mutual Funds Act makes it possible for management companies to temporarily suspend the redemption of units in a fund under its management in situations specifically described in the rules of the mutual fund. One such reason in the regulations of many mutual funds is that if the market place, which can be considered as the primary market place with a view to the investment policy of the fund, has been closed for an unforeseeable reason or trading on the market place has been restricted. Redemption of fund units can be suspended only when it is specifically in the interests of fund unit holders to do so. Management companies may temporarily suspend the redemption of fund units upon the FIN-FSA's permission if in the interest of unit holders to do so.

For some management companies, the suspension of trading on Russian stock exchanges lead to a situation where it was impossible to perform reliable valuation of the underlying instruments for the purposes of calculating the value of assets of the fund. Management companies came to the conclusion that the objective criteria normally used in exceptional circumstances are also not adequate in the current situation for the reliable valuation of these funds. Therefore the issue and redemption of units by certain funds that mainly invest in Russia was temporarily suspended in order to safeguard the interest and ensure equal treatment of unit holders.

The suspension affected four management companies that manage funds investing in Russia.

Inspection concerning the valuation of corporate bonds in mutual funds

In spring and summer 2008, FIN-FSA inspected the valuation of corporate bonds owned by mutual funds managed by 24 management companies as well as the process of valuation of management companies.

The purpose of these inspections was to establish the accuracy of valuation of corporate bonds owned by mutual funds, ie their compliance with rules and regulations as of 31 January 2008. An additional objective was to verify the effectiveness and independence of the valuation process and the related controls and to evaluate the internal guidelines issued by management companies.

Most notable observations

In the rules of certain mutual funds, the clause concerning the valuation of interest-bearing instruments does not provide adequate details on the measurement method and the rules do not necessarily reveal to which instruments the measurement method is intended to relate.

With the rules enabling a variety of objective applications of the measurement principles has led to the situation where there are considerable discrepancies in the prices applied to the funds administered by various management companies.

In many fund management companies, the internal guidelines on the measurement approach are based on self-regulation. The Finnish Association of Mutual Funds (SRY) has prepared a recommendation on objective principles for the companies operating in the sector. However, some of the fund management companies had not tailored the recommendation to their own needs but adopted the recommendation as such. This cannot be found to be sufficient.

According to the rules of some fund management companies, decisions on certain aspects of the measurement process are to be taken by the company’s board. This may not always be the case in practice.

Some fund management companies could not afterwards provide documentation to support their measurement approach. In these cases it was not possible to verify, in retrospect, that the measurement approach had been applied appropriately. Similarly, available material did not in all cases indicate how the value had been arrived at.

In their internal guidelines, fund management companies often indicate the frequency at which the prices or pricing parameters for illiquid instruments are reviewed. Usually a control frequency of one month is applied, but longer intervals may also occur.

The FIN-FSA's view

In a joint inspection letter addressed to all fund management companies, FIN-FSA required that companies take up the letter for review at a board meeting and introduce corrective measures to redress any shortcomings or irregularities.

In the letter, FIN-FSA urged fund management companies to review the sections on measurement in the rules of their mutual funds and specify them to remove any ambiguities. The companies should also review their internal guidelines and revise the guidelines based on the recommendation on objective principles to reflect the nature, investment policy and instruments of the mutual funds managed, together with any other factors specific to the mutual fund or management company. Fund management companies must take the decisions required in the rules and guidelines of the mutual funds. The companies must have in place an internal guideline on the measurement approaches for bonds and their order of application, clearly indicating what bodies the fund management company considers to be relevant market participants or price sources for the purposes of bond measurement.

Companies must, in the future, upgrade their documentation on value calculation and measurement to ensure that it meets the standards set by FIN-FSA and the recommendation issued by the Finnish Association of Mutual Funds. In this way, it will be possible to afterwards verify that the measurement principles are appropriate and correctly applied and infer how the values were generated from source data. The documentation must be stored at least for the time required by FIN-FSA and the recommendation.

FIN-FSA takes the view that companies may determine the measurement approach and the measurement processes so that the values or measurement parameters for illiquid instruments are reviewed at certain

selected intervals. However, the aim should be as accurate and correct values as possible. The control frequency must be shortened when so required by market conditions. For example, for the securities inspected in the past spring and summer review on a monthly, or less frequent, basis cannot be held appropriate in light of the prevailing market situation. The companies must put in place routines for ensuring that control frequencies, if applied, will reflect changes in market conditions more closely in the future.

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Can you stay in the saddle?

The FIN-FSA has produced a set of tasks on saving, conventional loans and instant loans for pupils in the last grade of comprehensive school. Titled ‘Can you stay in the saddle?’, the task package is available on the Bank of Finland Euro.fi online study site. The tasks focus on the various financing alternatives available for the purchase of a moped. The package includes a loan calculator, which can be used to see how large monthly installments would be needed to pay back a loan.

The online study package for upper secondary schools and vocational colleges includes the Finanssihai (Financial Wizard) quiz published by the FIN-FSA in November 2007 (currently available only in Finnish and Swedish). Participants can test their skills on matters related to saving, investment and borrowing. Points will be given for correct answers and for speed in answering the questions. If the answer is incorrect, the quiz will be over, but a subsequent link takes the player to the page where the correct information can be found. Of course you can always restart the quiz! So far, more than 35 000 attempts have been made at the quiz in Finnish and Swedish.

The online study package seeks to address the objectives set out in the economics curriculum for upper secondary schools and vocational colleges. The Finnish association of history and social studies teachers has provided valuable support in designing the tasks to the appropriate level of difficulty.

The tasks in the interactive section ‘Can you stay in the saddle?’ and in the Financial Wizard quiz are part of the FIN-FSA's customer education programme. The FIN-FSA considers it important that young people learn at school how to take on the responsibility and care for their financial affairs.
Link to the tasks: http://www.euro.fi/e/lukioammkarkaakomopo.html.

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