



Financial Market Report

2 • 2011

- Finnish companies prepared for worsening financial situation
- Financial crisis raises concern for EU banks' ability to withstand growing credit losses
- Tighter capital requirements to apply to systemically important banks
- Worsening debt crisis hinders financial intermediation
- Changes in payment infrastructure disturb payment flows in Finland



Bank of Finland

Financial Stability and Statistics

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Contents

1	Financial intermediation	4
1.1	Finnish companies prepared for a weakening financial situation	4
1.2	IMF's Financial Soundness Indicators – a rich databank	7
1.3	Uncertainty hampers financial intermediation	9
2	Banks and insurance corporations	12
2.1	Recapitalisation of banks – one of the key measures for restoring confidence	12
2.2	Limited investments by Finnish investors in debt securities of euro area periphery countries	14
3	Securities markets	17
3.1	Narrower definition of European money market funds	17
3.2	Expanding market for exchange traded investments funds	20
4	Infrastructure	22
4.1	Payment systems – the economy's circulatory system	22
4.2	More delays in payment flows	23
4.3	Retail payment services not profitable for banks	24
5	Key regulatory and supervisory initiatives	26
5.1	Systemically important banks to face tighter requirements	26
5.2	Efforts at maximum harmonisation hamper preparation of EU capital adequacy regulation	29
5.3	European Systemic Risk Board's first recommendation deals with foreign currency loans	31

List of charts

Chart 1.	Annual growth of corporate loans by sector	5
Chart 2.	Average interest rates on corporate loans	5
Chart 3.	Commercial paper intermediated by credit institutions	5
Chart 4.	Interest-carrying debt of 30 largest listed companies in terms of turnover	6
Chart 5.	Earnings before taxes of 30 largest companies listed on the Helsinki stock exchange	6
Chart 6.	Return on equity in the banking sector	8
Chart 7.	Interest rate margin in the banking sector	8
Chart 8.	Banks' refinancing needs in the coming years	10
Chart 9.	Interest rate spread between euro area corporate and government bonds, by sector	10
Chart 10.	Net issuance of international money market instruments and bonds	

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(issuance – repayments)	11
Chart 11. Estimated need for recapitalisation, by country	13
Chart 12. Claims* of Finnish credit institutions, insurance corporations and employment pension funds on selected European countries, end-August 2011	15
Chart 13. Investments of Finnish credit institutions in debt securities* of selected euro area governments and MFIs*	15
Chart 14. Investments of Finnish insurance corporations in debt securities* of selected euro area governments and MFIs	16
Chart 15. Investments of Finnish employment pension funds in debt securities* of selected euro area governments and MFIs	16
Chart 16. Finnish money market funds: net asset value and net subscriptions	17
Chart 17. Assets of international ETFs	20
Chart 18. Additional loss absorbency requirements on systemically important banks	27
Chart 19. Foreign currency lending relative to total lending, June 2011	31

List of tables

Table 1. IMF's Financial Soundness Indicators	7
Table 2. Indicators used for assessing systemic importance and their weights	27

1 Financial intermediation

1.1 Finnish companies prepared for a weakening financial situation

Pertti Pylkkönen and Jukka Vauhkonen

Escalation of the sovereign debt crisis is reflected in various ways in key indicators for the use and availability of corporate finance in Finland. The latest data indicate that banks' corporate lending has picked up, whereas corporate bond issuance has virtually dried up.

Most financial crises severely hamper corporate finance. This was also the case for Finnish businesses with the culmination of the international financial crisis in autumn 2008.¹

The recent escalation of the European sovereign debt crisis has raised fears of renewed financial difficulties for companies. This section assesses the availability of external financing for Finnish businesses, large companies in particular, on the basis of several key indicators.

The weakening of companies' financing possibilities was reflected in autumn 2008, for

¹ The Bank of Finland Governor Erkki Liikanen's speech on the international financial crisis and Finland (conference of Finnish venture capital investors 'Pääomasijoituspäivä', Helsinki, 3 February 2009) gives a detailed presentation of the increase in Finnish companies' difficulties in obtaining financing in autumn 2008 and early 2009.

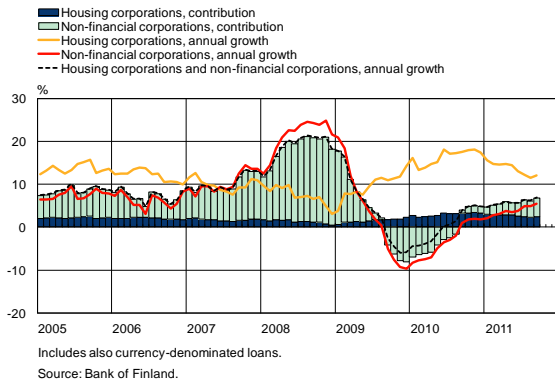
example in the brisk growth of corporate loans granted by domestic banks and employee pension companies, as reduced availability and higher costs of market-based financing induced large customers to turn again to domestic banks and to draw on credit subject to previously-agreed credit limits. The growth rate for corporate lending by domestic banks picked up to almost 25% at the end of 2008. Premium loans granted by employee pension companies, which were already nearly nonexistent, increased almost tenfold from over half a billion euro to almost tenfold after the financial crisis of autumn 2008. Also corporate credit by Finnvera increased briskly.

Corporate loans by banks modestly increasing

Based on statistical data and other observations, businesses are currently better prepared for weakening finances than they were prior to the culmination of the financial crisis in autumn 2008.

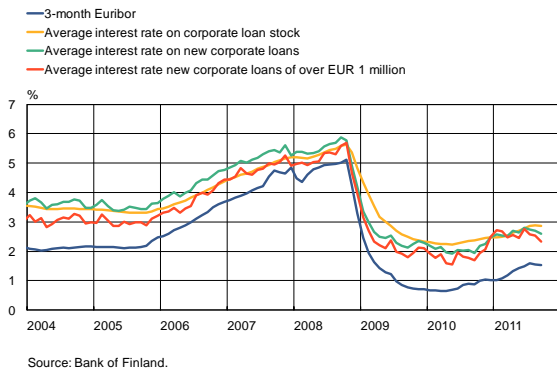
A similar growth in corporate lending by banks as in autumn 2008 has not been witnessed this autumn (Chart 1). The growth rate for corporate loans (excl. loans to housing corporations) granted by domestic banks has picked up moderately to about 5%. The moderate growth rate indicates that large companies have not been forced to increase their borrowing from Finnish banks. The stable growth of corporate loans is also positive from the financial stability perspective: at least so far, there has been no sign of a decline in lending volumes as observed in 2009.

Chart 1. Annual growth of corporate loans by sector



Interest rates on new corporate loans from banks have moved in line with changes in Euribor rates (Chart 2). Interest rate margins on new loans have therefore not widened notably.

Chart 2. Average interest rates on corporate loans



Based on data from various sources, large companies have also prepared for possible problems in the availability of financing by lengthening their credit lines and increasing cash reserves. The recent growth in companies' bank deposits also likely reflects businesses' increased cash reserves. Companies' preparedness is also reflected in the fact that Finnish businesses have concluded new syndicated credit agreements by over EUR 11 billion in 2011.

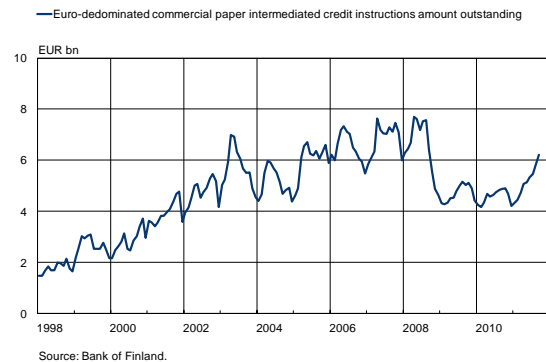
Preparedness is necessary, since corporate bond markets have almost dried up due to the debt crisis.

The amount of bonds issued by Finnish companies in the Finnish and international markets has contracted from EUR 18.9 billion at the end of 2010 to EUR 18.6 at the end of September 2011.

Commercial paper issuance has recovered

A positive sign for the availability of short-term corporate finance is that the Finnish commercial paper market would seem to be functioning without problems. Commercial-paper financing is typically used to cover short-term funding needs, such as for working capital. The stock of commercial paper outstanding contracted markedly in 2008. In 2011 it has increased by almost EUR 2 billion, to about EUR 6 billion (Chart 3).

Chart 3. Commercial paper intermediated by credit institutions

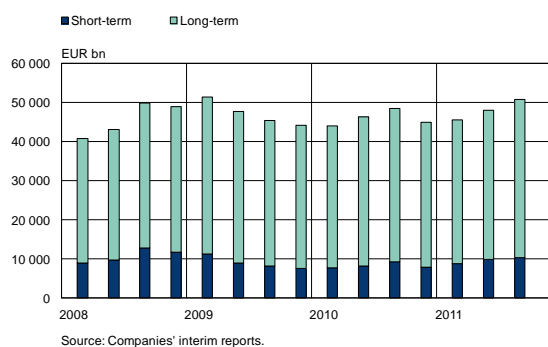


Finnish businesses have reduced their indebtedness, which makes them less vulnerable to financial market disruptions. Finnish corporate sector debt has remained almost unchanged since the early part of 2009, and indebtedness relative to the corporate sector's aggregate balance sheet has decreased.

In recent months, however, the total debt has edged up again. As for large businesses, the growth has been witnessed in outstanding short-term debt, such as commercial paper, and in long-term borrowing (Chart 4). However, corporate-specific differences are

considerable. For some large businesses, debt has increased rapidly even though eg investments have remained small. This implies a weakening of profitability.

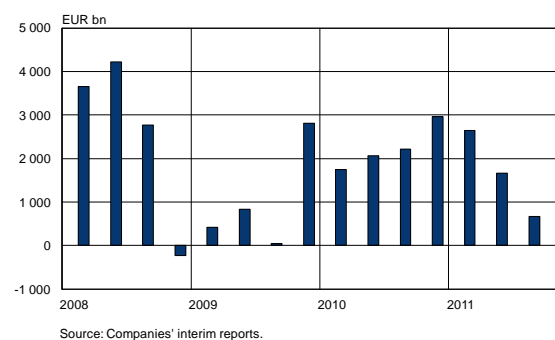
Chart 4. Interest-carrying debt of 30 largest listed companies in terms of turnover



Confidence in Finnish companies' debt-servicing ability has been supported by profitability, which has remained strong until recently (Chart 5). The financial crisis of 2008 brought a sharp fall in the financial results of the largest listed companies.

However, the results rebounded to sound levels after a few weak quarters. In the third quarter of 2011, business results seem to be repeating the developments of 2008 to some extent. On the other hand, the latest data indicate that the decline in results is not as severe as three years ago.

Chart 5. Earnings before taxes of 30 largest companies listed on the Helsinki stock exchange



1.2 IMF's Financial Soundness Indicators – a rich databank

Eero Savolainen

The International Monetary Fund (IMF) publishes on its website **Financial Soundness Indicators for over 60 of its member countries.**² These indicators give a comprehensive summary of the health of financial systems in those countries and enable international comparison. Data for Finland have been available since spring 2011.

The need for Financial Soundness Indicators (FSIs) was first highlighted in the IMF already in connection with the financial crisis of 1997. Developmental work on FSIs began around the turn of the millennium.

Among other measures, the IMF published a guide on FSIs³ and coordinated an international pilot exercise in the construction of FSIs. Regular publication of FSIs commenced in summer 2009.

There are now 40 Financial Stability Indicators in all, including both core and encouraged FSIs. All 12 core FSIs are based on data on deposit takers. These are metrics for the sector's capital adequacy, asset quality, profitability, liquidity and sensitivity to market risk. Most of the encouraged FSIs are also calculated on the basis of deposit-taker data, but some relate to other financial corporations, non-financial corporations, households, and financial and real-estate markets. The number, frequency and timeliness of the

² See Financial Soundness Indicator website, <http://fsi.imf.org/>

³ Compilation Guide on Financial Soundness Indicators (2004); <http://www.imf.org/external/np/sta/fsi/eng/2004/guide/index.htm>

reported FSIs vary across countries, which may in some cases reduce their usefulness.

Table 1. IMF's Financial Soundness Indicators

Core FSIs	
Capital adequacy	Regulatory capital to risk-weighted assets Tier 1 capital ratio to risk-weighted assets Non-performing loans net of provisions to capital
Asset quality	Non-performing loans to total gross loans Sectoral distribution of loans to total loans
Earnings and profitability	Return on assets (ROA) Return on equity (ROE) Interest margin to gross income (Non-interest) expenses to gross income
Liquidity	Liquid assets to total assets Liquid assets to short-term liabilities
Market risk	Net open position in foreign exchange to capital

Source: IMF.

Definition of deposit-takers plays a central role

FSIs mainly concern deposit takers, which means that the specific extent of the sector plays a central role. The IMF definition of the deposit-taking sector differs in some respects from those of monetary and banking statistics. According to the IMF definition, deposit takers are all institutional units that take deposits and whose liabilities are included in the national measure of broad money.⁴ Conceptually the group is very close to banks, and the latter term is used hereinafter.

Compilation of indicators based on bank data requires that the level at which sector data are consolidated must also be defined. The IMF's view is flexible, and the FSI compilation guide presents alternative consolidation approaches. The chosen method depends primarily on the available source data. If source data allow several consolidation approaches, selection should take account of the structure of the country's banking sector and the importance of possible foreign ownership.

⁴ The deposit taking sector also includes all institutions that are legally defined as banks. Holding companies are excluded, as are money market funds, even if their liabilities are included in broad money.

The main rule is that intra-unit (eg intra-group) data must always be removed. This differs from the approach applied in monetary and banking statistics, where not only resident intra-group items but also items between the head office and a foreign branch are recorded on a gross basis.

In calculating the FSIs, Finland applies the approach recommended by the IMF, which is based on data on established resident banks and their foreign branches and financial-sector subsidiaries. Data on insurance companies within banking groups are not included. Consequently, Finnish FSIs are calculated on the basis of group-level data for banks resident in Finland, excluding insurance business. Finnish subsidiaries of foreign banks are included, whereas branches are not.

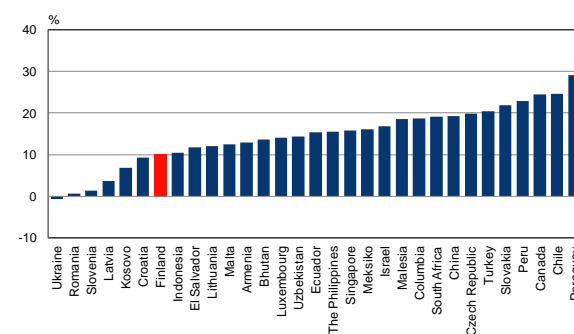
However, calculation of some FSIs is based on monetary and banking statistics where the coverage differs from the above. The relevant definitions are given in the FSI compilation guide, and country-specific methodologies are shown in metadata available on the IMF website.

Bank interest margins and return on equity vary widely by country

The following sections present Charts derived from FSIs. The Charts are based on the most recent data for the second quarter of 2011 or later months. Not all of the countries are included. The number of countries increases considerably if older data are included.

The profitability of the banking sector varies markedly as measured by return on equity (ROE) (Chart 6). In Finland, ROE was 10.2% in the first half of 2011.

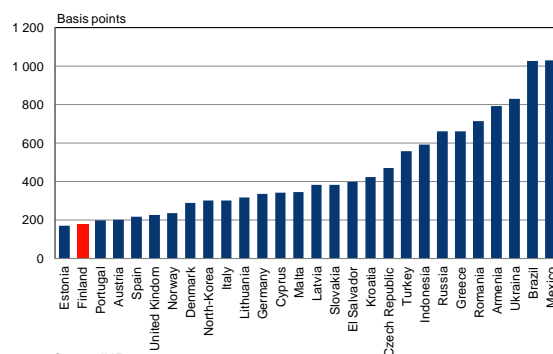
Chart 6. Return on equity in the banking sector



Source: IMF.

Net interest income has traditionally been a key income source for banks. Net interest income depends largely on the amount of deposits and loans as well as the interest margin between deposit and loan rates. The variation in interest rate margins is remarkably wide (Chart 7). The margin for the Finnish banking sector has been very narrow by international standards: only 178 basis points in June 2011.

Chart 7. Interest rate margin in the banking sector



Source: IMF.

1.3 Uncertainty hampers financial intermediation

Jarmo Pesola and Katja Taipalus

Risks in the economy have increased, as uncertainty about the euro area debt-problem countries' ability to meet their debt-servicing targets has increased and the group of countries next in the line has expanded. The metamorphosis of the sovereign debt crisis into a systemic risk has had a significant impact on the financial markets and financial intermediation in the area's economies.

Restoring market confidence in countries' ability to service their debts requires signs of economic growth. However, sustainable economic growth does not come without preconditions: stability is needed in the financial system and in the supply of funding. The banking sector plays an important role in financial intermediation. However, sovereign risks in banks' balance sheets (see section 2.1) have hampered the flow of finance in the European banking sector.

Euro area banks tightened their credit standards on households and corporations in the third quarter of 2011.⁵ This is due mainly to banks' own funding constraints and liquidity management problems. The escalation of the situation is evidenced by the fact that not only long-term funding but also short-term funding has been hard to obtain. Confidence among banks has clearly weakened. This is reflected in interbank

⁵ See the EU Bank lending survey (BLS):

<http://www.ecb.int/stats/money/surveys/lend/html/index.en.html>

lending and in the fact that banks have preferred to hold excess liquidity in central banks rather than invest it in interbank markets. The bulk of banks' long-term debt financing is obtained via covered bonds.

Competition in deposit funding has also tightened. This has been the case especially for the banking sectors in debt-problem countries, due to constraints in obtaining market-based funding. Attempts to restrain aggressive competition have led to a search for a bypass. For example in Spain, attempts to restrain interest rates on certain deposit types have led to a greater emphasis on other savings products. In Europe, slightly over 40% of bank funding is in interbank loans and market-based finance. Deterioration of bank funding is alarming, since the drying-up of market-based funding was one of the key factors in the tightening of banks' credit standards in 2008. Banks expect credit standards to tighten further in the last quarter of 2011.

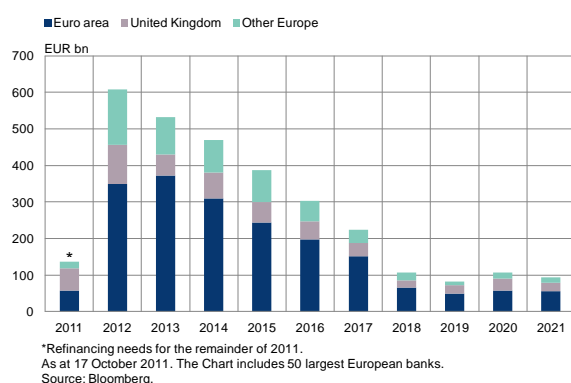
At the same time, banks are under pressure to strengthen their capital adequacy (see section 2.1). Although banks primarily seek to bolster their capital position via capital increases, stronger capital adequacy can, at worst, lead to asset sales and contraction of lending. In France, the United Kingdom, Ireland, Germany and Spain, banks have announced balance sheet reductions totalling EUR 775 billion over the next two years. The reductions are effected via asset sales, scale-downs in activities and by cutting credit and lending. Banks in Ireland and the United Kingdom have contracted their balance sheets already since 2008. Even though balance-sheet reductions are necessary in some cases, the challenge is to do so without endangering monetary transmission and the functioning of the economy.

Besides credit supply, the demand for credit has also decreased because the expected decline in

economic growth has reduced credit demands of households and corporations. Macroeconomic developments are monitored closely, and big purchases are readily postponed.

Ensuring smooth transmission of long-term market funding is one of the key challenges for the functioning of financial markets. In the coming years, availability of market-based funding will not only be a major risk for banks but also for businesses and governments. In 2012 refinancing needs of European Banks alone amount to about EUR 600 billion (Chart 8).

Chart 8. Banks' refinancing needs in the coming years



Of bank finance guaranteed by EU governments in 2008 and 2009 alone, almost EUR 200 billion will mature in the first half of 2012.

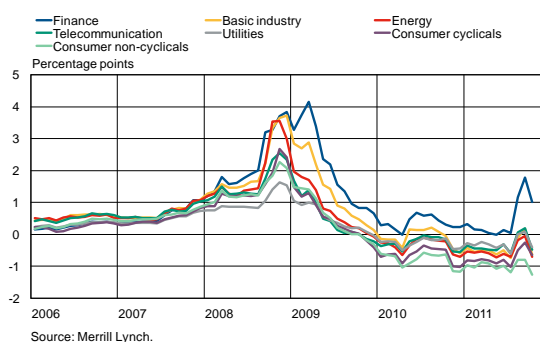
Increased uncertainty has markedly reduced risk-bearing capacity in the markets. The stock market volatility index, which is a metric of uncertainty, has risen⁶ as share prices have declined⁷. Pricing of risks in the bond markets has boosted risk premia, especially for lower-rated corporate loans. Nevertheless, the

⁶ See the Bank of Finland chart gallery, Chart *Volatility of stock indices, euro area, USA and Japan*, at: <http://www.suomenpankki.fi/en/tilastot/kuviopankki/Pages/default.aspx>

⁷ See chart gallery, Charts *Stock indices: Europe, USA and Japan* and *Stock indices: Nordic countries*.

interest rate spread has been narrower than in 2008 and 2009.⁸ Risk premia for corporate and government bonds tend to move in the same direction when government risk premia are relatively high. Even though corporate bond emissions have been rare in indebted countries, in recent weeks highly-rated businesses have made successful bond issuances in these countries, some corporations even at lower interest rate than their own national governments pay. The interest rate spread for the monetary sector in particular has widened notably compared to other corporate sectors (Chart 9).

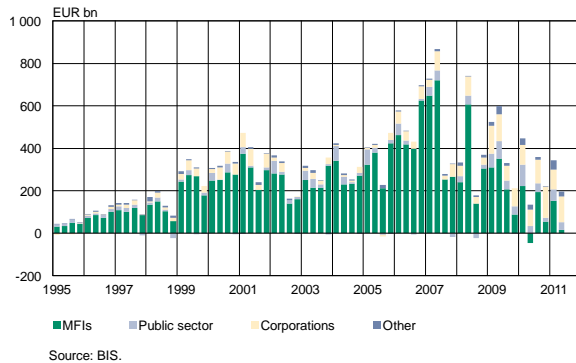
Chart 9. Interest rate spread between euro area corporate and government bonds, by sector



The uncertain outlook is also reflected in the issuance of money and financial market instruments: net emissions have not returned to the level of peak year 2007 (Chart 10).

⁸ See chart gallery, Chart *Interest rate spread between corporate and government bonds, euro-denominated and US dollar-denominated*.

Chart 10. Net issuance of international money market instruments and bonds (issuance – repayments)



In the pricing of sovereign risks, we see a definite divergence: highly-rated (safe-haven) governments have benefited from lower interest rates, whereas low-rated countries have suffered from more cautious risk-pricing, as reflected in their interest costs.

Tightening of financial regulation may also have an effect on financial transmission. Examples of this are trade and documentary credits granted by banks. The rapid deterioration of global trade in 2008 was partly attributable to a marked contraction of trade credits. Consequently, banks' increased cautiousness concerning product-related credits has raised new concerns of a possible slowdown in trade.

It is estimated that tighter regulations for insurance companies could lead to shorter maturities in their investments. This would change the overall financial market structure towards an increased portion of short-term finance. In addition, the value of investments on insurance companies' balance sheets has recently fallen markedly, as an uncertain outlook weighs on their willingness to commit to long-term investments.

2 Banks and insurance corporations

2.1 Recapitalisation of banks – one of the key measures for restoring confidence

Mervi Toivanen

Recapitalisation of banks is expected to contribute to reducing the growing loss of confidence in the European banking sector, triggered by the protracted political solution to the debt crisis and the weakening of the economy. Banks already meet the statutory capital adequacy requirements, but strengthening their capital positions will protect them against unexpected shocks.

The time spent in finding a solution to the sovereign debt crisis has eroded market confidence in European political decision making. At the same time, pessimistic estimates of the economic outlook have increased the uncertainty surrounding governments' debt-servicing capacity.

The results of stress tests published in spring 2011 show that the European banking sector has significant holdings of government bonds that in the event of government default could result in losses. The recession would also increase banks' losses on household and corporate loans. As a result, investors' lack of confidence has focused not only on governments but also on the European banking sector and its capital adequacy. Governments' ability to support their banking sectors, if necessary, via capital injections and/or guarantees has weakened as a result

of the prolonged crisis. Thus the linkage between the situation regarding the governments and the banks creates a self-propagating downward spiral.

The general lack of confidence is reflected in a decline in banks' share prices and has hampered their funding. In practice, the availability of funding has deteriorated and banks' funding costs have risen.

Another sign of increased stress in the financial market is that European banks have acquired a significant amount of refinancing from the European Central Bank (ECB) and have deposited their excess liquidity with the ECB.

Recapitalisation helps to restore confidence

The lack of confidence in banks has resulted in a situation in which first the markets and now the supervisory authorities require banks to hold larger capital buffers to cover risks. Based on statutory requirements, banks' capital positions are sufficiently strong, but the growth in wholesale funding has increased banks' vulnerability to disruptions in funding. Investors dislike uncertainty and are reluctant to lend to banks when there is a severe loss of confidence in banks' capital adequacy. Funding can easily dry up. For example, the Franco-Belgian bank Dexia was unable to acquire new market funding to replace short-term funding that was expiring and had to be rescued by the French and Belgian governments.

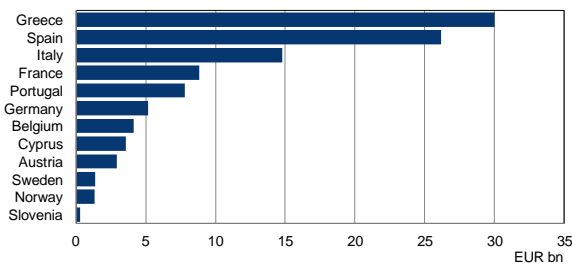
There is a danger that the lessening availability of market funding will slowly erode banks' ability to lend to the private sector. At worst, this could lead to a credit crunch if banks have to drastically cut their lending or sell some of their assets.

A bank's capital adequacy ratio should be higher than the statutory minimum requirement, particularly in times of uncertainty. A bank with a strong capital buffer is better protected from market disruptions. The purpose of large capital buffers is to restore confidence in the European banking system.

EU-level decisions

The euro area countries reached an agreement on 27 October 2011 on the recapitalisation of European banks. The European Banking Authority's (EBA) preliminary estimate shows that banks' aggregate capital target is ca EUR 106 bn (Chart 11).

Chart 11. Estimated need for recapitalisation, by country



Other European banks do not need recapitalization, or the capital needs are minor. The recapitalization needs of Belgian and Austrian banks are mainly due to Dexia and Volksbank, which are being restructured. The figures may change significantly.

Source: European Banking Authority.

Banks' final capital shortfalls will be calculated on the banks' figures as at 30 September 2011. Banks are required to raise their common equity (Core Tier 1) capital adequacy ratio⁹ to 9% by the end of June 2012. To reach the target, banks should primarily resort to market funding, build up their capital base by retaining earnings and withholding dividends and bonuses. If banks are unable to acquire the additional capital, the government may provide support to its national banking sector. The recapitalization must however entail strong conditionality. If governments are unable to provide sufficient funding, euro area banks can, as a

⁹ Core Tier 1 ratio = common equity / risk-weighted assets.

Common equity has the highest loss-absorption capacity but does not include hybrid instruments.

last resort, be funded via loans from the European Financial Stability Facility (EFSF).

Banks can fulfil the capital adequacy requirement by either bolstering their capital position or reducing their risk-weighted assets. To avoid excessive deleveraging and adverse impacts on the real economy, banks are required, by 31 December 2011, to submit, to their national authorities their plans detailing the actions they intend to take to reach the set targets. The plans will be subject to a coordinated review on the European level.

2.2 Limited investments by Finnish investors in debt securities of euro area periphery countries

Harri Kuussaari and Hanna Putkuri

Investments by Finnish credit institutions, insurance corporations and employment pension funds in debt securities of euro area governments and MFIs are very modest compared with their other foreign claims. Investments in the highest-rated government bonds have increased in 2011 while investments in debt securities of periphery countries have declined.

Investments in government debt securities are part of the traditional trading and longer-term investment strategy for banks and other key investor sectors. The euro area debt crisis has increased the risks of investment in debt securities of euro area governments and MFIs. Market confidence in the debt-servicing capacity of the so-called periphery countries¹⁰ of the euro area has diminished, which has raised interest rates on debt securities issued by these countries, relative to interest rates on investments that are considered safe, eg German government bonds. A substantial portion of the debt securities of the periphery countries are held by their domestic banks and other European banks, which has also eroded confidence between banks, in fear of possible contagion effects.

¹⁰ Greece, Ireland, Italy, Portugal, and Spain (GIIPS countries).

Key investor sectors' foreign claims mainly on Europe

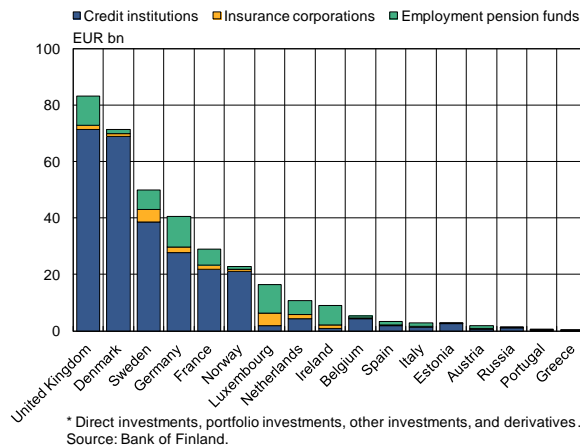
Foreign claims of Finnish credit institutions, insurance corporations and employment pension funds totalled ca EUR 410 bn at the end of August 2011. About half of the total was on the United Kingdom, Denmark and Sweden; slightly less than a third was on the euro area, 10% on other European countries and 10% on other countries.¹¹

More than half (59%) of Finnish credit institutions' claims on Europe were on non-euro area countries (Chart 12). Of credit institutions' claims on the United Kingdom, the majority are derivatives for which the counterparties operate in the United Kingdom or which have been traded on the London Securities and Derivatives Exchange. Credit institutions' claims on other Nordic countries are mainly interbank loans and deposits. The Finnish banking sector is highly integrated with Sweden and Denmark, so that a significant portion of these claims are intra-group items of multinational banking groups.

¹¹ See

http://www.suomenpankki.fi/fi/tilastot/maksutase/Documents/-Table13_2011M08.xls. The figures include direct investment, portfolio investment (shares, bonds and notes and money market paper), other investment (eg loans and deposits) and derivatives.

Chart 12. Claims* of Finnish credit institutions, insurance corporations and employment pension funds on selected European countries, end-August 2011



Insurance corporations' and employment pension funds' claims on Europe are mainly portfolio investments diversified among several countries. Country-specific risks are also reduced by the fact that a portion of these claims are investments in investment funds that are registered in eg Ireland and Luxembourg but that invest their assets internationally.

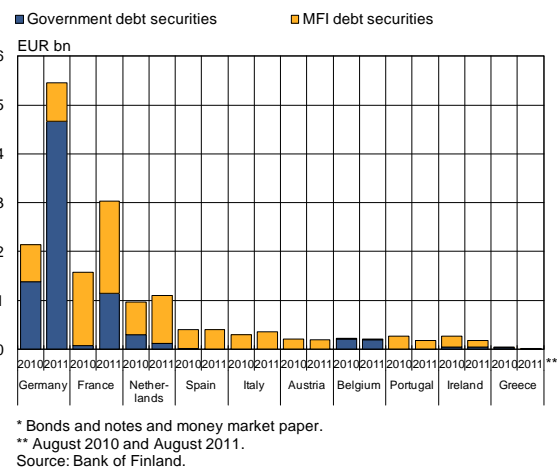
Investments in euro area government debt securities concentrated in lower-risk countries

Finnish credit institutions have increased their investments in government bonds that are considered safe, eg bonds issued by Germany and France, the large euro area countries with the highest credit rating (Chart 2).¹² In contrast, their investments in debt securities of other euro area countries have remained modest or have decreased since August 2010. Credit institutions' investments in government debt securities of GIIPS countries are very limited, totalling only ca EUR 54 million at end-August 2011.

¹² Credit institutions have also increased their investments in Finnish government bonds that are also among the highest-rated bonds.

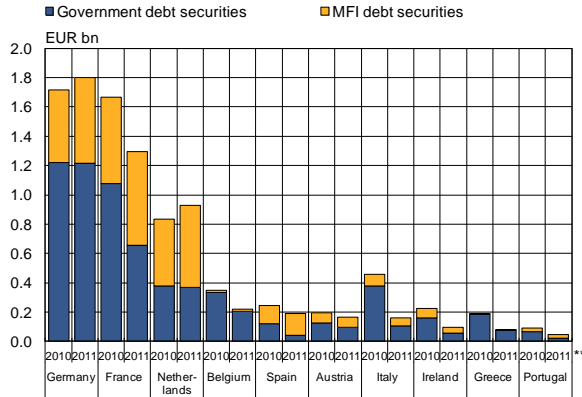
There is a shared fate between the euro area countries with debt problems and the banks, and thus investors are increasingly reluctant to invest in MFIs operating in these countries. The majority of investments of Finnish credit institutions in euro area MFIs are in the large countries of central Europe, ie France, Netherlands and Germany (Chart 13).

Chart 13. Investments of Finnish credit institutions in debt securities* of selected euro area governments and MFIs*



Investments by Finnish insurance corporations in euro area government debt securities have decreased significantly in the past year, with the exception of those in German and Dutch debt securities (Chart 14). The largest decrease was in investments in government debt securities of GIIPS countries; at end-August 2011 they totalled only ca EUR 304 million.

Chart 14. Investments of Finnish insurance corporations in debt securities* of selected euro area governments and MFIs

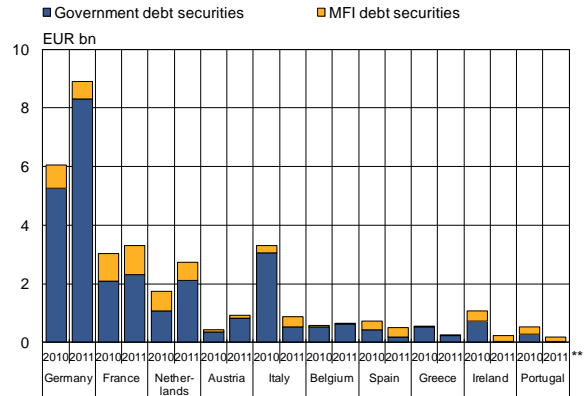


* Bonds and notes and money market paper.
 ** August 2010 and August 2011.
 Source: Bank of Finland.

Finnish employment pension funds have increased their foreign investments in government bonds with the highest rating (Chart 15). In contrast, investments

in debt securities issued by periphery countries have decreased significantly; and end-August 2011, they totalled ca EUR 1 billion.

Chart 15. Investments of Finnish employment pension funds in debt securities* of selected euro area governments and MFIs



* Bonds and notes and money market paper.
 ** August 2010 and August 2011.
 Source: Bank of Finland.

3 Securities markets

3.1 Narrower definition of European money market funds

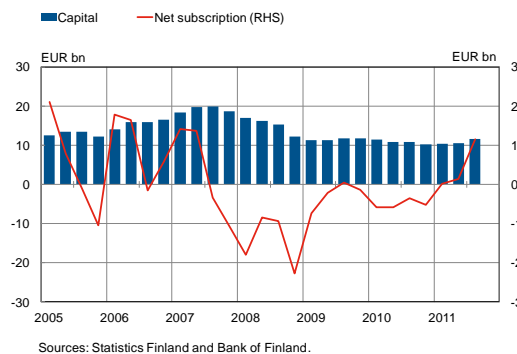
Hermann Teräväinen

The legal definition of money market fund will change. The broad criteria will be replaced by tighter identification criteria. As a result, the number of domestic money market funds will decrease considerably. The main purpose of the change in definition is to improve investor protection.

In 2008, some of the global money market funds ran into difficulties because of the depreciation of their portfolio investments. Liquid money market fund shares had been considered a safe investment instrument, and a substitute for deposits, where the invested principal is preserved. The value of some fund shares however plummeted. The exceptional fall in value during the market turmoil was possible because the rules of the funds permitted larger-than-expected risk-taking and reaching for extra yield. Concerns about losses and the risks of the investments resulted in a rapid increase in redemptions of fund shares, and portfolio managers had to sell some investments in order to make the redemptions. The assets of funds registered in Finland and classified as money market funds declined in 2008 as much as EUR 6.5 bn, from EUR 18.7 bn to EUR 12.2 bn. Of this decline, EUR 5.9 bn was due to negative net

subscriptions and EUR 0.7 bn was due to valuation changes (Chart 16).

Chart 16. Finnish money market funds: net asset value and net subscriptions



This development led to a reassessment of the definition of a money market fund. The Committee of European Securities Regulators (CESR)¹³ in May 2010 issued a guideline on a common definition of European money market funds.¹⁴ The main purpose of the recommendation is to improve investor protection by setting specific requirements regarding investment activities and marketing for funds that label or market themselves as money market funds. In order to obtain a harmonised definition, the European Central Bank also amended accordingly its regulation on the balance sheet of the monetary financial institutions sector, which includes the identification criteria for money market funds¹⁵. With this measure, the population of money market funds is aligned with the identification

¹³ Predecessor of the European Securities and Markets Authority.

¹⁴ CESR's Guidelines on a common definition of European money market funds (CESR/10-049). In the guidelines, money market funds are divided into two internal classes: Short Term Money Market Funds and Money Market Funds.

¹⁵ ECB/2008/32 (amended by ECB/2011/12).

criteria applied for supervisory purposes.¹⁶ These changes will lead to the harmonization and possible shrinking of the group of money market funds in Europe.

Main new requirements

According to the new definition, the primary investment objective of a money market fund must be to maintain the principal of the fund and aim to provide a return in line with money market rates. Investments are focused on high-quality liquid money market instruments¹⁷ and deposits with credit institutions. Money market instruments must have been awarded one of the two highest available short-term credit ratings by each recognised credit rating agency¹⁸. If an instrument is not rated, it must be of equivalent quality as determined by the management company. A money market fund may also hold sovereign issues of at least investment grade quality¹⁹. Such ratings limits were not previously defined for European funds. The definition also permits investments in floating rate securities with residual maturity to the legal redemption date of 2 years or less, provided the time remaining to the next interest rate reset date is 397 days or less.

The focus of a money market fund's claims must be on very short-term investments. This is ensured by restricting the portfolio's weighted average maturity (WAM) to no more than 6 months and its weighted average life (WAL) to no more than 12 months. The

¹⁶ In the statistics, money market funds are not divided into short-term money market funds and money market funds, but are lumped together.

¹⁷ Section 4 of the Ministry of Finance Decree (9 June 2008/391) on financial instruments as referred to chapter 11 of the Mutual Funds Act. The residual maturity of the money market instrument or time before adjustment of interest income is maximum 397 days.

¹⁸ Minimum A-2 (S&P), P-2 (Moody's) and F2 (Fitch).

¹⁹ Minimum A-3 (S&P), P-3 (Moody's) and F3 (Fitch).

purpose of the ratios is to limit the fund's interest rate and credit risk.²⁰ The calculation of WAM and WAL take into account the impact of financial derivative instruments, deposits and efficient portfolio management techniques.

In addition to floating rate securities, money market instruments and deposits, money market funds are permitted to invest in shares of other money market funds. Investment in shares of other types of investment funds is no longer permitted, as it is prohibited to take on direct or indirect exposure to equity or commodities. This must be taken into account also in investment in derivatives; derivatives may be used only in line with the money market investment strategy of the fund. Investment in non-base currency securities is allowed provided the currency exposure is fully hedged.²¹

Impact of the amended definition

The guideline of the Committee of European Securities Regulators (CESR) entered into force on 1 July 2011. Funds in existence prior to 1 July were allowed a transitional period until 31 December 2011 to comply with requirements on investment strategy and rules of the funds, as defined in the guidelines. Funds may not market themselves as money market funds unless they comply with the guideline. The Bank of Finland will make the required changes to the classifications in its statistics at the end of January 2012. In the statistics, money market funds are

²⁰ WAM is a measure of the average length of time to maturity of all of the underlying securities in the fund weighted to reflect the relative holdings in each instrument. The calculation takes into account the final maturity of fixed-rate instruments and the next interest rate reset date of floating rate instruments. WAL is calculated correspondingly, except that calculation of WAL for floating rate securities uses a security's stated final maturity.

²¹ For fund investors, currency exposure remains if the invested assets are of a non-base currency.

included in the MFI sector, so the change in definition will reduce eg the aggregate balance sheet of MFIs and the monetary aggregate M3²². Correspondingly, the balance sheets items of other financial institutions will increase as a result of the sectoral change due to the reclassification of investment funds.

At the end of September 2011, the number of money market funds registered in Finland was 29, and their net assets totalled EUR 11.6 bn. Management companies still have time to adjust the investment strategy of their money market funds to the new definition. The group of domestic money market funds will however most likely shrink to less than a third, measured in both numbers and net asset value.

²² M3 is a key measure of monetary reserves which describes the amount of currency in circulation. Money market funds are comparable to deposits due to eg their liquidity, and in statistics they are included in the MFI sector. Other investment funds are included in the sector other financial institutions.

3.2 Expanding market for exchange traded investments funds

Pertti Pyykkönen

The markets for exchange traded investment funds in the international investment market is growing rapidly. In Finland, the start-up has been sluggish.

The first exchange traded index fund (ETF) was launched in the United States in 1993 when the American Stock Exchange started to quote an index fund tracking the S&P-500 stock index. In Finland, the first index share fund (OMXH 25), launched in 2002, tracks the 25 most-traded shares on the Helsinki Stock Exchange.

Trading in fund shares

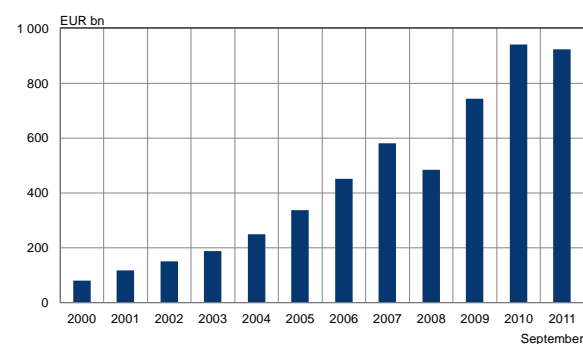
The shares of ETFs are traded during the continuous trading session, and the subscription and redemption prices are based on the price of the underlying basket of shares. ETFs have a market maker, as a result of which the fund shares are liquid and are continuously quoted. ETFs do not usually charge a fee for subscriptions or redemptions. Brokers charge a fee that is the spread between the subscription and the redemption price. For the smaller and less liquid ETFs, the spread between buying and selling price can be fairly large. The ETF management charges are smaller than those of traditional investment funds. Investors in foreign ETFs often also have to pay charges related to foreign exchange transactions.

The buying and selling prices of shares in investment funds (eg UCITSs) are quoted once each

day, and the subscription and redemption prices are identical so that either constitutes the EFT management fee.

The markets for ETFs have grown rapidly. At the end of September 2011, ETF assets totalled over EUR 900 bn.

Chart 17. Assets of international ETFs



Despite the rapid growth, ETF assets amount to only 5% of the assets in traditional investment funds.²³

At the end of September, ca two-thirds of ETF assets were in US funds. The assets of European ETFs amounted to one-fifth of the assets of global ETFs. In Europe, the majority of investors in ETFs are institutional investors. In the US, the portion of private investors is considerably higher.

Cash-based and synthetic ETFs

The basic idea of an ETF index fund is to offer a share of a specific stock index. These ETFs invest their assets in accord with the weights of the index in question, and the goal is to achieve the average return on the index, at a lower cost than for traditional investment funds.

A large number of funds investing in instruments other than stocks have entered the market, eg those investing in commodities (Exchange Traded Commodities, ETCs) or in exchange-traded notes (ETNs). The market share of stock-index ETF funds

²³ ETF Landscape Industry Highlights, BlackRock, End Q3 2011.

has shrunk due to the increasing popularity of synthetic ETFs. The share of synthetic ETFs has increased particularly in Europe, due to the more lenient regulation of the derivatives they use, compared to eg US regulation. In Europe, the UCITS directive on collective investment undertakings allows for synthetic ETFs based on index derivatives.

ETFs investing in derivatives are mainly synthetic funds. Their portfolios are based on index derivatives.

The issuer of a synthetic ETF owns a basket of collateral consisting of the securities included in an index. The collateral basket can also be independent of the ETF's investment instrument. Against the collateral, the ETF enters into a derivatives contract, ie a cash flow swap, with a third party. In the cash flow swap, the ETF exchanges, with the counterparty of the swap, the returns on the collateral basket for the returns on the index²⁴.

Counterparty risk in synthetic ETFs

In a swap agreement, investors in synthetic ETFs are exposed to counterparty risk, ie the risk of the counterparty to the swap being unable to meet its obligations. For ETF funds that fall within the scope of EU legislation²⁵, the limit for counterparty risk is 10% of the value of the fund.

For investors, traditional ETF share index funds are transparent and simple investment instruments, and their risks are easier to identify. The identification of risks may be somewhat more difficult if the fund engages in share lending and the counterparty of the lending is not known.

Synthetic ETFs have reduced the transparency of the ETF markets and the products have become

increasingly complex, as a result of which eg small investors may meet with insurmountable difficulties in assessing the risks, eg counterparty risk, related to synthetic ETFs. It is difficult to obtain information on the counterparties of a derivatives contract. Moreover, the counterparties can be part of the same financial group as the management company providing the services, which may also expose the investor to a conflict of interest.

²⁴

http://www.finanssivalvonta.fi/en/Financial_customer/Financial_products/Investments/ETF/Pages/Default.aspx

²⁵ UCITS Directive.

4 Infrastructure

4.1 Payment systems – the economy’s circulatory system

Heli Snellman

The former governor of the US Federal Reserve has noted²⁶ that the effective way of paralysing the US economy would be to take out the payment systems. This is true for both Europe and Finland.

It is important for a smoothly functioning economy that its payment systems operate in a reliable fashion. Payment systems enable money to flow into the economy, which keeps the wheels of society turning.

If one bank’s disposable funds in the system run out, it cannot settle its payments to the other participants. These will then also face a shortage of disposable funds, and the circulation of money in the economy may be impaired. In other words, the problems of a single bank can spread to other banks within the same payment system. Problems can also spill over from one system to another as, for example, the settlement of many other payment systems takes place in the Eurosystem central banks’ TARGET2 system. In addition, the same banks may participate in several systems – also in the systems of many different countries – and expose those systems to their own problems.

²⁶ Greenspan, A (2007): “We’d always thought that if you wanted to cripple the US economy, you’d take out the payment systems. *The Age of Turbulence, Adventures in a New World*, Penguin Press, New York.

In order to get an idea of the magnitude of money flows in payment systems, one can compare the amount of money flowing in large-value payment systems, for example, with the value of GDP. The average daily turnover of payments executed via TARGET2-Suomen Pankki²⁷ in 2010 was about EUR 40 billion. This includes both domestic and cross-border payments to and from Finland. From the perspective of inflows of money via the system to the Finnish economy, the value of incoming cross-border payments, in addition to domestic payments, is of material importance. This almost reached a daily average of EUR 29 billion, while Finland’s total GDP in 2010 amounted to well over EUR 180 billion. A comparison between these figures shows that there was an inflow of money as high as Finland’s GDP via TARGET2-Suomen Pankki in the form of domestic and cross-border incoming payments over a period of slightly more than six days. The flows of money are indeed significant. If their movements were to be disturbed, the repercussions would be swiftly felt in the everyday lives of firms and consumers.

TARGET2-Suomen Pankki is also used for the settlements of retail payment systems, meaning that payment of electricity bills or receipt of wages or pensions by Finnish customers, from one bank to another, will not be visible in beneficiary accounts until the banks have settled the transactions in central bank money.

When payment systems operate smoothly, they remain unnoticed by ordinary end-customers. Their key importance is not noticed until problems occur and

²⁷ TARGET2-Suomen Pankki is a component of the TARGET2 system.

payments are delayed. A more detailed analysis of delays is provided in section 4.2.

4.2 More delays in payment flows

Timo Iivari

Delays in Finnish payment flows have increased significantly in the last twelve months. Payment transmission is undergoing major changes, and this is also reflected in an increasing number of disturbances. They have mainly shown up as delayed entries in customer accounts.

Finnish payment transmission is undergoing major changes. The underlying reason is the pan-European integration, which is reflected in the introduction of common payment standards, in the harmonisation of legislation governing payments and in the application of new processes. This substantial transformation has not taken place without problems, however. Delays in payment systems have occurred regularly in the last twelve months, as migration into new payment standards has been underway.

Delays are never the concern of just one bank. Disturbances in interbank payment transmission or in a single bank's processes have a domino effect, causing problems to other banks and their customers. In a worst case scenario, the payer must take on complaints about payments that have not arrived – without knowing the reason for the delay. Some firms that have considerable payment volumes to settle use one bank as a distributor, entrusted with the transmission of all payment orders to other banks. If this distributor

bank should encounter problems, this is reflected in the accounts of other banks' customers.

Domino effects may take various forms and may impact other banks' asset management as well as bank customers.

Delays cannot be blamed on a single component of the payment value chain; rather the reasons are very diverse. Most often the fault lies with malfunctions in information systems. These malfunctions occur especially in banks' own systems rather than in the operation of the clearing centre that transmits payments. Accordingly, banks' internal processes need to be well defined and banks must be prepared for contingencies involving other systems. In addition, banks need to ensure timely communication, even if the delay does not concern the bank's own customers.

The general public has become aware of the disturbances mainly in connection with time-critical payments. These typically include wages and pensions, which citizens expect to have in their accounts early on payday morning. If a delay occurs in interbank payment systems for one reason or another, payments of wages and pensions are not credited to beneficiary accounts on time.

The Bank of Finland and the Financial Supervisory Authority (FIN-FSA) have discussed payment disruptions with the banks involved. FIN-FSA is responsible for clearing up the disturbances of individual banks. The Bank of Finland, in turn, in its capacity as payment system overseer, is engaged in discussions with the Federation of Finnish Financial Services for finding system-level solutions to the problems concerned.

4.3 Retail payment services not profitable for banks

Päivi Heikkinen

In Finland, we are used to making payments through our bank accounts, either as credit transfers via online facilities or by using payment cards at shops. We seldom use cash, except for very small payments. Payment services related to bank accounts constitute an essential element of our everyday life. Production of payment services requires that banks have in place large systems and the necessary resources for their maintenance and development. According to a cost study, the results of which will be published shortly, production of payment services is in general unprofitable for banks and these services are financed out of revenues from other banking operations.

The Bank of Finland has participated in a European-wide cost study aimed at a clarification of the social costs of repayment payment transactions. As part of this project, banks have been asked to provide information on the production costs for their retail payment services and on the fees charged. Not only direct but also indirect costs were studied. As there are some differences between banks in how they assess these costs, it is not advisable to draw straightforward conclusions from the results. However, on the basis of uniform responses, the results are in the right direction.

The highest costs are incurred by the banks for the maintenance of the credit transfer system, the payment card system and cash. The production of payment

services is typically associated with high direct system-related costs and indirect personnel expenses. As the costs are reviewed relative to the frequency of use of these means of payment, cash and credit cards entail the highest costs. The production costs of debit card transactions, in turn, are the lowest.

Calculating the revenues of payment services is also a challenging task, not least because of different pricing practices. For all means of payment, the above study reveals that banks are able to cover only about half their retail payment costs from the direct fees charged for these services. The costs can best be covered in the case of debit cards, credit cards and credit transfers. Again, the results disclose major differences between banks. Cash is consistently unprofitable for banks. This becomes apparent as free services for consumers, while fees for the processing of cash are usually collected from shopkeepers only.

Payment services, including cash withdrawals from ATMs, are typically related to bank accounts. The current study did not cover interest paid or not paid on bank accounts or banks' potential marginal income earned on funds in bank accounts. Also, interest income on card credit was not taken into consideration. It is, however, obvious that these revenues serve to cover the production costs of payment services.

Clarification of the social costs of retail payment transactions also includes the assessment of payment-related costs for end-customers, particularly for shopkeepers. This part of the study has been delayed because of firms' inadequate ability and limited possibilities to provide the necessary detailed cost data. A typical feature of a payment transaction is, however, that the income of one member of the service chain is the cost of the other. For obtaining an overview of the situation, it would be important that

data from other service chain parties be obtained for analysis. The study now due for publication only covers bank costs and revenues.

A publication concerning banks' retail payment costs in Finland will be released online on the Bank of Finland's website in mid-November.

5 Key regulatory and supervisory initiatives

5.1 Systemically important banks to face tighter requirements

Hanna Westman

Work on additional regulation and tighter supervision of systemically important financial institutions has made headway in international fora.

The problems of systemically important banks and other financial institutions are often reflected in problems elsewhere in the financial system and the real economy. The operations of large financial institutions generate externalities, for which other parties may become liable to pay the costs. The authorities seek to remedy this drawback by imposing stricter provisions on systemically important banks than on others. These reforms are mainly aimed at attaining two objectives. First, no financial institution can be too big to fail. Second, a bailout of a financial institution must be possible if it is the best solution for society. However, the costs of such a recovery operation should not be borne by taxpayers.

The Basel Committee on Banking Supervision has developed a methodology for assessing banks' systemic importance.²⁸ Banks are evaluated on five

²⁸ Basel Committee on Banking Supervision (November 2011), *Global systemic important banks: Assessment methodology and the additional loss absorbency requirement*.

criteria: cross-jurisdictional activity, size, interconnectedness, substitutability and complexity. Each criterion is assigned one to three indicators as base for defining a bank's systemic importance (**Error! Reference source not found.**).

Using this methodology, the Basel Committee on Banking Supervision has classified 29 banks as global systemically important. A bank-specific list was published at the G20 summit in Cannes, France, in early November.²⁹ Of the Nordic banks, Nordea is listed.

Going forward, global systematically important banks will be subject to the following specific requirements. First, banks' crisis resilience will be enhanced by tightening the relevant capital adequacy requirements. Second, the authorities will be provided with the necessary tools for an orderly resolution or, if necessary, a recovery operation. Third, efforts will be made to intensify bank supervision through international cooperation between the concerned authorities.³⁰

²⁹ FSB (November 2011), *Policy Measures to Address Systemically Important Financial Institutions*.

³⁰ Proposals for developing supervision are not dealt with here. For more details, see the FSB publication, *Intensity and Effectiveness of SIFI Supervision*, November 2011.

FINANCIAL MARKET REPORT

Table 2. Indicators used for assessing systemic importance and their weights

Category	Indicator	Indicator weighting, %	Category weighting, %
Cross-jurisdictional activity	Cross-jurisdictional claims	10.00	20.00
	Cross-jurisdictional liabilities	10.00	
Size	Total exposures as defined for use in the Basel III leverage ratio	20.00	20.00
Interconnectedness	Intra-financial system assets	6.67	20.00
	Intra-financial system liabilities	6.67	
	Wholesale funding ratio	6.67	
Substitutability	Assets under custody	6.67	20.00
	Payments cleared and settled through payment systems	6.67	
	Values of underwritten transactions in debt and equity markets	6.67	
Complexity	OTC derivatives notional value	6.67	20.00
	Level 3 assets	6.67	
	Trading book value and value of assets available for sale	6.67	

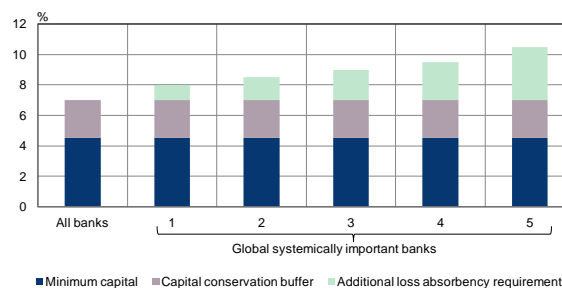
Source: Basel Committee on Banking Supervision.

Tighter capital requirement

The Basel Committee on Banking Supervision has proposed imposition of an additional loss absorbency requirement of 1.0–2.5 percentage points on global systemically important banks³¹ (Chart 18). This additional capital requirement is believed to encourage banks to shrink their operations so as to reduce their systemic importance. If a bank increases its systemic importance, for example, via a merger or acquisition, its additional loss absorbency requirement will be 3.5 percentage points. The Basel Committee on Banking Supervision takes a reserved attitude towards the use of contingent capital, and will require fulfilment of the additional loss absorbency requirement by core Tier 1 capital.

³¹ Banks are classified according to their systemic importance into five categories, on the basis of which the size of the additional loss absorbency requirement is determined.

Chart 18. Additional loss absorbency requirements on systemically important banks



Note: The chart illustrates the Basel III regulatory requirements that banks are required to fulfil by core Tier 1 capital.

Source: Basel Committee on Banking Supervision.

Banks have a variety of options for strengthening their capital positions. In choosing a more moderate dividend strategy, the bank can reduce profit distribution to shareholders and thereby strengthen its capital structure. The bank can also tap the markets for more capital or shrink its balance sheet by restricting lending and selling assets. The restriction of lending is unfavourable for the economy, as it acts as a constraint on firms' funding possibilities, thus impairing economic growth.

In order to minimise these adverse effects, banks have been afforded plenty of time to fulfil their additional capital requirements.

³² Consequently, the implications of the additional capital requirements for the economy are expected to be very modest. According to calculations, a 1% additional loss absorbency requirement would lead to a 0.06% fall in GDP during the eight-year transitional period.³³ Nevertheless, the long-term benefits from the lower frequency of financial crises are considerably larger (0.5% of GDP).

Crisis management to be intensified

The Financial Stability Board (FSB), operating under the aegis of the G20 Group, has submitted a preliminary proposal for the necessary tools and procedures for orderly resolution or recovery of global systemically important financial institutions.^{34, 35} The FSB proposal is wider in scope than the Basel Committee recommendation, as besides banks it also applies to holding companies of financial institutions, including non-regulated shadow banking, insurance companies and financial market infrastructures.

Each financial institution must have a designated administrative authority with the necessary powers for implementing recovery and resolution measures in all those countries in which the financial institution operates. The designated administrative authority must ensure that the impact of official measures is assessed at consolidated group level and that the implications for financial stability across countries are taken into

account. Cross-country cooperation and readiness to respond in crisis situations will be enhanced by setting up crisis management groups. In addition to supervisors, central banks, ministries of finance, and deposit insurance and guarantee funds must be represented in these groups.

The authorities should have sufficiently extensive mandates for early intervention, in order to solve financial institution problems before they develop into a crisis. If preventive measures and recovery efforts fail, resolution is necessary. Important resolution tools include the authorities' powers to transfer to a bridge bank such operations as are important for the functioning of the financial system and to write down the values of debt instruments or convert them into equity (bail-in).

In support of recovery and resolution measures, each global systemically important financial institution is required to have a recovery and resolution plan in place by the end of 2012. The supervisory authority is mandated to require that a financial institution's operational models or organisational structures be changed in order to facilitate potential resolution.

It is proposed that supervisory measures aimed at financial institutions be funded via national deposit insurance schemes and bailout funds.

³² The timetable is the same as for the Basel III regulatory package in respect of the capital conservation buffer and countercyclical buffer, ie the requirements will be introduced gradually from the start of 2016.

³³ Macroeconomic Analysis Group (MAG) (October 2011), *Assessment of the macroeconomic impact of higher loss absorbency for global systemically important banks*.

³⁴ FSB (October 2011), *Key Attributes of Effective Resolution Regimes for Financial Institutions*.

³⁵ The European Commission's proposal for EU banks' crisis management regime is similar in content. Release of a final version of the Commission's proposal is expected in November 2011.

5.2 Efforts at maximum harmonisation hamper preparation of EU capital adequacy regulation

Jukka Vauhkonen

The European Commission's proposal for a Capital Requirements Directive and Regulation may restrict authorities' ability to ward off risks to financial stability.

In December 2010, the Basel Committee on Banking Supervision published a comprehensive overhaul of banking regulation, known as Basel III. The aim is to remedy the serious defects in banking regulation brought to light by the global financial crisis. The reform tightens banks' minimum capital requirements. In addition, new liquidity, leverage and capital buffer requirements are imposed on banks.³⁶

The Basel regulatory regime is by nature a recommendation, but authorities almost worldwide are committed to its implementation in their respective national legislations. At EU-level, the Basel Committee recommendations are included in the current Capital Requirements Directive for banks. The European Commission published its proposal for an EU Capital Requirements Directive and Regulation in July 2011.

To date, the EU Capital Requirements Directive has largely corresponded to Basel Committee recommendations. The Commission's July proposal,

³⁶ The content of the reform is discussed in detail, for example, in the article: Vauhkonen (2010) Basel III -uudistus parantaa pankkien riskinkantokykyä (Basel III reform will strengthen banks' risk-bearing capacity). Euro & talous 3/2010.

however, deviates significantly from Basel Committee recommendations.

Since 1988, the Basel capital adequacy framework has defined the international *minimum level* for banks' capital requirements. The original aim of the Basel regime was to curb competition between countries for more relaxed banking regulation. The competition was deemed to have adverse effects, and looser approaches were feared to lead to an overall erosion of banking regulation.

In legal technical terms, Basel Committee recommendations have been based on the *minimum harmonisation* of the capital requirements regime: countries complying with the recommendations have been allowed to have, in their national banking legislation, stricter but not looser requirements than the Basel Committee recommendations.

The European Commission, however, considers that, at EU level, minimum harmonisation has led and may continue to lead to a more fragmented regulatory environment, which enables regulatory arbitrage and competitive distortions and puts costs on banks operating in many countries. In order to prevent such problems, the Commission decided in its July proposal for a Capital Requirements Directive and Regulation to partly abandon the minimum harmonisation principle.

If the Commission's proposal materialises, the bulk of the quantitative requirements in the Basel III recommendation will be implemented as *maximum harmonisation*: the EU member states could not deviate downwards or upwards from the requirements agreed at EU level. In legal technical terms, the reform would be implemented so that requirements that are directly binding on all member states are included in the regulation and other provisions in the directive.

The Commission's proposal for maximum harmonisation has met with a mixed response. The banking sector generally appears to support the proposal. By contrast, several central banks and international organisations, such as the European Systemic Risk Board (ESRB), have strongly criticised the proposal because it could excessively restrict the authorities' potential to respond to risks that threaten the stability of national financial systems.

According to the ESRB, national credit and leverage cycles differ significantly. In order to level these cycles, the authorities need macroprudential tools, such as capital, liquidity or leverage ratio requirements that can be tightened on a discretionary basis. The Commission's proposal would however peg these requirements at a single European level, thereby preventing discretionary national application.

5.3 European Systemic Risk Board's first recommendation deals with foreign currency loans

Hanna Westman

The European Systemic Risk Board (ESRB) has published its first recommendation for the EU member states. The aim of the recommendation is to ensure that the risks of foreign currency lending do not increase so as to threaten financial stability.

The ESRB commenced operations at the start of this year.³⁷ The ESRB's most important task is to identify risks threatening the whole financial system and prevent their build-up by means of warnings and recommendations.

So far, the ESRB has convened three times to discuss systemic risks threatening the EU countries and to decide on necessary measures for safeguarding financial stability. Although the ESRB's primary objective is to mitigate longer-term systemic risks, it has also had to take stands on critical financial market problems.

The ESRB issued its first recommendation in mid-October 2011.³⁸ The recommendation concerns the risks of lending in foreign currencies. Foreign currency lending may lead to the build-up of systemic risk within the financial system in a variety of ways. First, lending in foreign currencies increases financial institutions' exchange rate risk unless it is duly

³⁷ For a description of the ESRB's structure, see Financial Market Report 1/2011

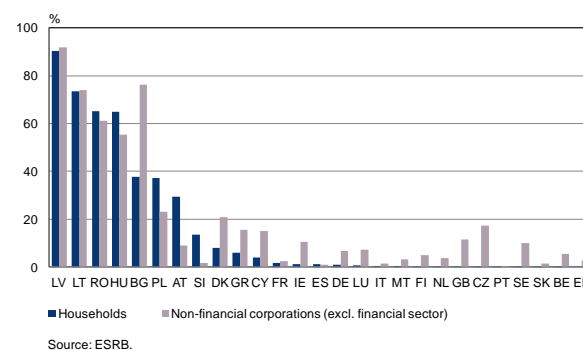
³⁸ Recommendation of the European Systemic Risk Board of 21 September on lending in foreign currencies (ESRB/2011/1).

covered. In addition, a financial institution's credit risk may well be assessed as too low if there is a significant mismatch between foreign currency assets and liabilities in its customers' balance sheets. Foreign currency lending also increases financial institutions' funding and liquidity risk and intensifies the risk of contagion between parent companies and subsidiaries. Moreover, the often lower interest rates on foreign currency loans may lead to excessive credit growth, thereby promoting asset price bubbles in the real estate market, for example.

Foreign currency loans popular despite their risks

Foreign currency loans have been popular particularly in Central and Eastern European countries, but also in non-euro area countries such as Denmark and Sweden (Chart 19).

Chart 19. Foreign currency lending relative to total lending, June 2011



In Finland, households and small and medium-sized enterprises have not used foreign currency loans to any significant extent since the negative experiences of the 1990s; thus, the ESRB recommendation will not cause any specific action in Finland.

Swedish banks' aggressive lending in the Baltic countries in the first years of the 2000s is one example of the risks related to foreign currency lending. The financial crisis has had a large negative impact on the Baltic economies, while increasing Swedish banks'

loan losses.³⁹ In some cases, the losses have been so large that the bank's capital adequacy has been jeopardised.

Hungary provides another example of the risks of foreign currency lending. In Hungary, 50% of housing loans have been granted in foreign currencies (largely in Swiss francs). The strong appreciation of the Swiss franc relative to other currencies has increased the Hungarians' debt burden, as household incomes are in Hungarian forints. The debt burden of many households was already oversized before the onset of the financial crisis, and recent events, such as rapid growth in unemployment and collapsing housing prices, have further exacerbated the situation. In September, the Hungarian government submitted a radical bill that would allow debtors to amortise their foreign currency loans as a one-time payment at a fixed exchange rate. The proposed Swiss franc to Hungarian forint exchange rate was significantly lower than the current rate, which would in practice mean losses for lenders.⁴⁰ Since foreign currency loans are mainly granted by foreign (in particular Austrian) banks, the problem of foreign currency lending would be transferred from Hungarian households on to the neighbouring country's banking sector.

Measures to mitigate the risks of foreign currency lending have also been undertaken in Latvia, Poland, Romania and Austria. The Austrian central bank and national supervisory authority, for example, have long been warning banks about excessive levels of foreign currency lending in Eastern European countries. Even so, the measures have failed to produce the desired outcome.

³⁹ In 2009 GDP contracted by 14%, 18% and 15% in Estonia, Latvia, and Lithuania respectively. At the same time, housing prices collapsed by 50–70% and unemployment jumped.

⁴⁰ The proposed fixed exchange rate was 180, and when the bill was submitted, the exchange rate was 240. The bulk of the housing loans had been granted when the exchange rate was between 150 and 160.

The recommendation calls for special measures regarding foreign currency lending

The ESRB's first public recommendation includes seven items dealing with consumer protection and customers' creditworthiness, risk management and risk pricing, and financial institutions' capital adequacy. The recommendation also encourages monitoring of the impact of increasing foreign currency lending (over-indebtedness and build-up of asset price bubbles). One of the most important parts of the recommendation is the requirement of reciprocity. This means that, if the authorities in EU country A introduce measures to mitigate risks related to foreign currency lending, the authorities of all other EU countries should ensure that their supervised entities comply with the rules set by the authorities of country A when they grant foreign currency loans in country A. Reciprocity is intended to limit the possibilities of circumventing regulation via organisational change.

The recommendation is addressed to the EU member states, national supervisory authorities and the European Banking Authority (EBA), and is applicable to authorities in all EU countries. All EU member states are required to act in compliance with the recommendation as from December 2012.⁴¹ However, since the importance of foreign currency lending in terms of financial stability varies from one country to another, the implementation of the recommendation is subject to the principle of proportionality. In practice, this means that country-specific differences are taken into account in complying with the recommendation. If an EU member state decides not to comply with the recommendation, it must present its justification to the ESRB no later than the end of 2012.

⁴¹ Part of the recommendation must be implemented as early as June 2012, while the deadline for some sub-areas is the end of 2013.