The article contains a summary of the analysis "Valvottavien taloudellinen tila ja riskit" (Financial position and risks of supervised entities) published in Finnish on 1 April 2009.

Profitability of Finnish financial sector to weaken; loss-bearing capacity remains fairly solid

Financial crisis affects supervised entities' investment returns the most

The financial crisis that emerged from the US housing loan markets in 2007 led to large reductions in asset values over the past year. Operational disruptions in the markets were also reflected in banks' refinancing. Uncertainty in the markets continues. Raising long-term market based funding is difficult for both banks and companies outside the financial sector.

In the Finnish financial sector, the largest impacts of the crisis so far have been felt by companies whose investment assets have been exposed to the decline of market prices. In particular, the solvency margins of employment pension and life insurance companies have been reduced. The decline of investment values has also been reflected clearly in banking groups with significant life insurance activities. From the banks' perspective, the crisis has also been seen as higher costs of funding and decreasing fees and commissions.

Since late last year, the financial crisis has caused a rapid weakening of the real economy at a global level. Future economic developments remain surrounded by a high level of uncertainty. The depth and duration of the recession will continue to have a major impact on the development of the financial sector. Weak development of the real economy causes the largest risks for banks in the form of credit risks, and for other financial sector companies in the form of reduced income and asset values. In turn, it is the functioning of the financial sector that enables the growth of the real economy.

The Finnish financial sector will be able to cope with the economic recession if the economy performs in line with the baseline forecasts and the worst crisis scenarios do not materialise. However, negative financial results may also be seen in the context of the baseline scenario. Profitability of the banking sector weakens materially but is likely to remain positive on the whole in 2009. Credit losses will clearly increase, but the present estimates of two- or three-fold credit losses would only amount to about half a percent of the loan stock. Hence, we are still a long way from the level of the banking crisis of the 1990s when credit losses amounted to 3.7% of the loan stock. Fortunately, Finnish financial sector companies faced the crisis in good shape. The buffers accumulated over a period of many years come in handy now.

Maintaining profitability will be challenging

The financial crisis has already weakened the profitability of supervised entities. Banks' operating profit contracted materially from the previous year. The impact was seen particularly from last years' final quarter onward. Developments remained similar during the two first months of this year. Both net interest income and net fee income contracted and credit losses increased. Nor did loan stock grow from the turn of the year. In contrast, income from investment operations recovered somewhat.

Last year, the income of investment firms fell and 16 companies made a negative result. The capital of fund management companies decreased materially, particularly due to the reduction of share prices.

The slowdown of economic growth adds to the challenges of financial market participants. A threat to banks' results is posed by continued weak income developments. Banks' profitability is put to the test by the decline of market rates, which reduces the net interest income of the banking sector. The increased cost of funding also undermines profitability. Furthermore, in the present market situation it is difficult to find sources of fee and investment income. Decreasing income and increasing credit losses may lead to a significant reduction in the operating profit of the banking sector from the previous year.

The prospects are also challenging for others – investment firms, management companies and the entire insurance sector. The results of life insurance companies are weakened by the low level of interest rates, since a significant part of the technical provisions of life insurance companies consists of insurance policies with a high guaranteed return relative to the present level of interest rates. The premiums of non-life insurance operations are likely to dampen apace with economic activity.

Finansinspektionen, PB 103, 00100 Helsingfors
telefon 010-831 51
www.finansinspektionen.fi

Manifold increase in credit losses

The quality of banks' loan stock is expected to deteriorate across the board – in private customers as well as corporate loans. So far, the amount of non-performing loans is fairly small but it is increasing at a rapid pace. Relative to the previous years, the amount of credit losses is expected to grow two- or three-fold. Economic recessions are usually shown in credit losses with a lag of one or two years, and therefore credit losses are likely to increase further in 2010.

Credit losses are mainly expected from the corporate sector, but the payment capacity of households also weakens in an economic recession. As sectors, construction, land transportation and accommodation and hospitality services are already emerging as the weakest ones. Households' debt-servicing situation is alleviated by variable-interest-rate loans. In Finland, the majority of housing loans is variable-rate so when market rates decrease, debt-servicing costs are reduced, with a short lag.

Capital adequacy of supervised entities has weakened but buffers continue to exist

The capital adequacy of Finnish banks weakened last year but still continues to be at least moderate. The combined loss buffer of the banking sector amounts to about EUR 8.5 billion. This buffer will have to be tapped if the operative result of the banking sector before credit losses is lower than the credit losses to be booked. The situation of Finnish banks is clearly better than that of many other European banks. While many European countries have been forced to support their banks heavily, Finnish banks have not needed any government support.

At the beginning of 2009, in order to improve their capital adequacy, banks have cut their dividends and announced share issues. Banks try to maintain capital adequacy at a solid level in order to be able to keep funding costs in check.

The liquidity of Finnish banks has remained solid despite the difficult market situation. However, structural funding risk has increased because obtaining long-term funding continues to be difficult and the tenor of funding has been shortened.

The capital adequacy of non-life insurance companies continues to be at a good level although it has weakened from last year. The capital adequacy of employment pension and life insurance companies weakened materially, mainly as a consequence of a reduction in the value of equity investments. Life and employment pension companies in particular are sensitive to developments in the investment markets. The solvency of life insurance companies is only at a satisfactory level although many life insurance companies were recapitalised during the year. The solvency calculation rules for employment pension companies in contrast were revised by emergency legislation. The purpose of the law was to avoid the forced disposal of equities in a difficult market situation. Due to the calculation method, the solvency margin of employment pension companies increased by about EUR 5.1 billion and their average solvency improved to a good level.

Preparations have been made in Finland for banks' sustained lending capacity

Finnish banks' solid basic profitability and capital adequacy buffers enable continuing banking and lending operations as usual, thereby supporting Finnish economic developments. However, increasing risks and increased costs of banks' funding have lead to increasing customer margins and increased caution by banks in lending. Sound credit risk management is indeed very important to prevent the risks from threatening banks' capital adequacy. Preparations for a weakening situation have been made by providing banks with the opportunity to have government guarantees for long-term market funding, and reinforcement of banks' capital by a subordinated capital loan is also being prepared. It is important that also in Finland banks with sound capital base have the opportunity to apply for these support forms until financial markets resume their normal operation.

For further information, please contact:
Jukka Vesala, Head of Department,
tel +358 10 831 5374.