Banking Industry Country Risk Assessment: Finland

February 9, 2021

Banking Industry Country Risk Assessment Group		2
2	**Economic Risk**	
Economic resilience	Very Low Risk	
Economic imbalances	Low Risk	
Credit risk in the economy	Low Risk	
3	**Industry Risk**	
Institutional framework	Intermediate Risk	
Competitive dynamics	Low Risk	
System wide funding	Intermediate Risk	

Government Support:

Support Uncertain

Major Factors

Strengths:	Weaknesses:
- Wealthy economy with an innovative and highly educated labor force. - Resilient, digitally advanced, and well-capitalized banking sector characterized by cooperative banking and pan-Nordic groups. - Banking sector's prudent risk-management approach. - Sound household and corporate balance sheets.	- Structural funding gap and reliance on international wholesale funding. - Rising household indebtedness, driven by mortgage loan growth over the past decade. - High interconnectedness with Nordic banking systems, exposing the banking sector to potential external risks.

Rationale

S&P Global Ratings classifies the banking sector of Finland (AA+/Stable/A-1+) in group '2' under its banking industry country risk assessment (BICRA). This is among the best scores of the 86 banking systems we assess globally. Other countries in group '2' are Sweden, Norway, Switzerland, Belgium, Germany, and Canada (see chart 1).

Our bank criteria use our BICRA economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for banks operating only in Finland is 'a-'.

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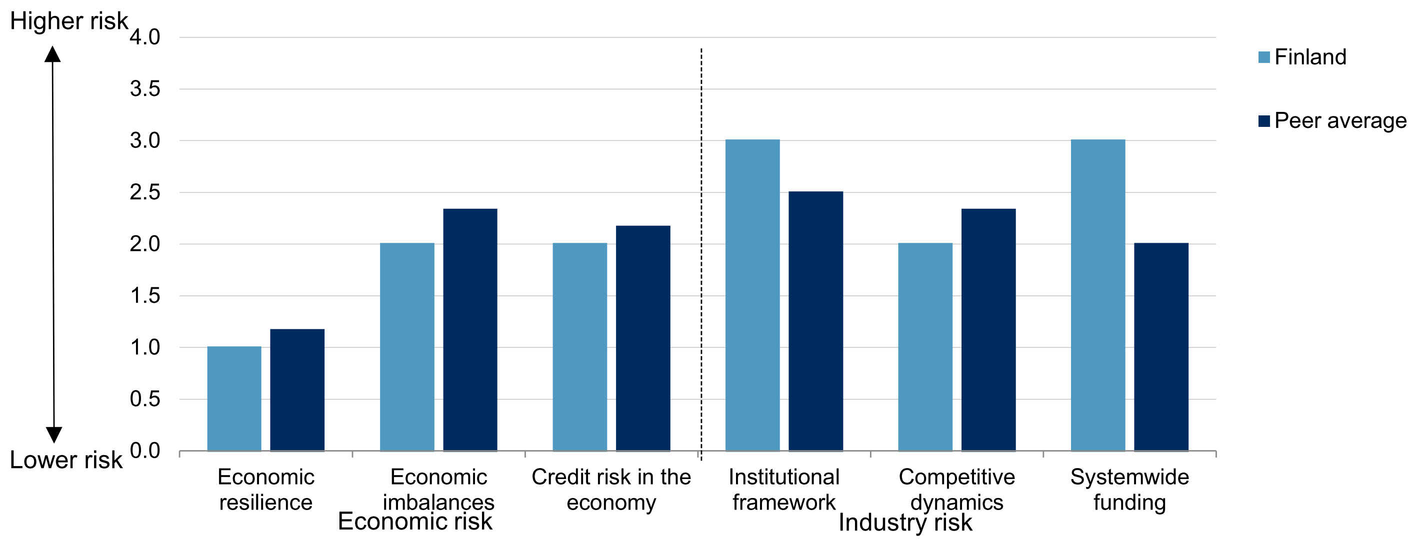
Chart 1

BICRA Comparison: Finland Versus Peers



Source: S&P Global Ratings.

Economic risk for Finland's banks is low in a global comparison. In our view, Finland is an innovative, wealthy, small, and open economy, with mature political and institutional structures. We believe Finland has an elaborate social welfare and well-functioning health system, which has been beneficial in mitigating the impact of the COVID-19 pandemic. We expect the Finnish GDP will contract moderately in 2020 due to COVID-19 impact and related containment measures, but will rebound in 2021. We believe recovery will be driven by private consumption and expansionary fiscal policy, with exports recovering to pre-pandemic levels only toward 2022. We expect this will help the banking sector withstand the economic stress. Although Finnish private sector credit has gradually increased on the back of mortgage and consumer lending growth over the last decade, it remains moderate in a peer comparison, and households' wealth and a strong social safety net will support the private sector's repayment capacity. We expect Finnish banks' asset quality will weaken through 2021, but believe the banking sector's core profitability and superior capitalization will absorb this burden. We do not expect the banking sector will depart from its moderately conservative underwriting standards in the persisting low-interest-rate environment.

We think industry risk for banks in Finland remains intermediate in global terms. Despite the banking sector's concentration, intense competition, low lending margins, and high market share of cooperative and mutual banking groups, we believe the sector's overall profitability and capitalization will remain resilient during this pandemic. We do not expect banks will compromise their restrained risk appetite. Therefore, we anticipate the Finnish banking sector is well prepared to weather the current shock, although business prospects will weaken through 2021. We believe that the risk of tech disruption remains moderate, given the banks' advanced digital agenda, digital customer offerings, and ongoing investments in a core banking overhaul and innovation. Finnish banks' dependence on external funding makes them vulnerable to changes in confidence sensitivity, which we consider a key risk. But despite the stressed environment in 2020, they continue to demonstrate good access to capital markets.

Economic And Industry Risk Trends

We believe risks to the Finnish economy and the banking sector are abating, and now view economic risk trend for the Finnish banking system as stable. We expect the country will be able to recover from the economic shock caused by the pandemic, benefitting from domestic demand recovery and a rebound in investments and net exports. We now project GDP contraction will be contained at 3.8% in 2020, followed by a rebound of 2.3% in 2021 and settling at about 1.5% thereafter. We believe the government will continue to support the Finnish economy in recovering from the pandemic, and will remain committed to making incremental progress toward addressing structural reform needs, especially in terms of the labor market. Despite the temporary economic downturn, we believe nationwide house prices will remain stable and market activity in the major cities will be intact, owing to the households' sound financial position and the prevailing low-interest-rate environment, supporting our view that there are currently no meaningful economic imbalances and that the risk of house price correction remains remote.

We expect industry risk in the Finnish banking sector will remain stable. In line with that of European peers, Finland's banking system is characterized by adequate regulatory standards and bank supervision, while the resources at Financial Supervisory Authority (FIN-FSA) have been strengthened following Nordea's redomicile to Finland in late 2018. Despite the high concentration and intensive competition, we do not consider the banking sector's competitive landscape as distorted by the presence of large pan-Nordic banks such as Nordea Bank, the domestic cooperative banking group OP Financial Group, which dominates the competitive landscape. We expect the sector will restore its overall profitability and maintain superior capitalization, demonstrating resilience against the current stress. We expect banks will remain dependent on external funding, given the structural funding gap, and, although this could increase confidence sensitivity, will also continue to demonstrate good access to capital markets. The Nordic banking system remains highly interconnected, resulting in potential spillover risks for the Finnish economy from external events.

2 Economic Risk

We believe the Finnish economy demonstrates strong resilience owing to its digitally advanced, competitive and diversified economy, skilled workforce, and high social welfare. Urbanization trend continues to affect the Finnish housing market, but we do not observe a build-up of economic imbalances. Although private sector leverage remains moderate compared with that of Nordic peers, we still see increasing household debt as a risk for the banking sector.

Economic resilience: Very low risk but structural challenges remain

Economic structure and stability. Finland is a wealthy economy supported by transparent governance and political institutions, a skilled workforce, and elevated labour participation rates. Due to the pandemic-induced downturn, we expect Finnish GDP will contract by 3.8% in 2020, resulting in estimated GDP per capita of about $48,200 in 2020 (see table 1). Although Finland declared a state of emergency in spring, a full lockdown was not implemented and industrial production and construction continued through the pandemic, supporting economic output. We also foresee a healthy rebound in 2021 and 2022, with GDP increasing by 2.3% and 1.5% respectively, but weaker that of Nordic peers. We believe the rebound in 2021 will mostly stem from private consumption, given households' accumulated savings over 2020 and the gradual delayed recovery of the export sector. Yet, prior to COVID-19, the dynamics of Finland's growth cycle were weakening due to structural challenges, which started to affect activity levels during fourth-quarter 2019. We believe these underlying factors could weigh on the speed of the recovery.

Macroeconomic policy flexibility. The Finnish government has introduced significant support measures to mitigate the COVID-19 outbreak. These, together with the spending items allocated in the 2020 budget, add up to 3.5% of GDP. The additional costs, coupled with a reduction in revenue of about 4% of GDP, will lead to a deficit of about 8% of GDP in 2020. Finland's contingent liabilities are predominantly composed by guarantees and amount to almost 25% of GDP. These have increased due to the introduction of the government's COVID-19 support schemes for corporates and businesses, but the uptake has been contained so far. According to our estimates, Finland's net general government debt will stand at about 30% of GDP at the end of 2020 and will likely continue increasing, before stabilizing in 2023. We expect Finland's gross general government debt will stabilize at below 75% in 2023.

Political risk. We view Finland's policymaking as prudent, transparent, and consensus-based, and we observe widespread consensus in favour of fiscal prudence within the established political parties. Finland has successfully managed both the health pandemic and economic stress, provided high social welfare support to households and corporates, and has a digitally savvy society, which allowed the population to swiftly adapt to social distancing measures. Furthermore, the Finnish government aims to increase public investments, research and development spending, digitalization, and improving the transportation infrastructure. We expect Finland will opt for the eligible resources that will be available under the EU Recovery Fund.

Table 1

Finland--Economic Resilience

	2017	2018	2019	2020e	2021f	2022f
Nominal GDP (bil. $)	255.24	275.96	269.30	266.33	290.64	299.74
Per capita GDP ($)	46,379	50,055	48,805	48,219	52,525	54,071
Real GDP growth (%)	3.3	1.5	1.1	(3.8)	2.3	1.5
Inflation (CPI) rate (%)	0.8	1.2	1.1	0.4	1.2	1.4
Monetary policy steering rate (%)	0.0	0.0	0.0	N/A	N/A	N/A
One-year government borrowing rate (%)	(0.2)	0.0	0.0	N/A	N/A	N/A
Net general government debt as % of GDP	22.0	20.8	19.4	28.0	32.5	34.7

f--Forecast. E--Estimate. CPI--Consumer price index. N/A--Not applicable.

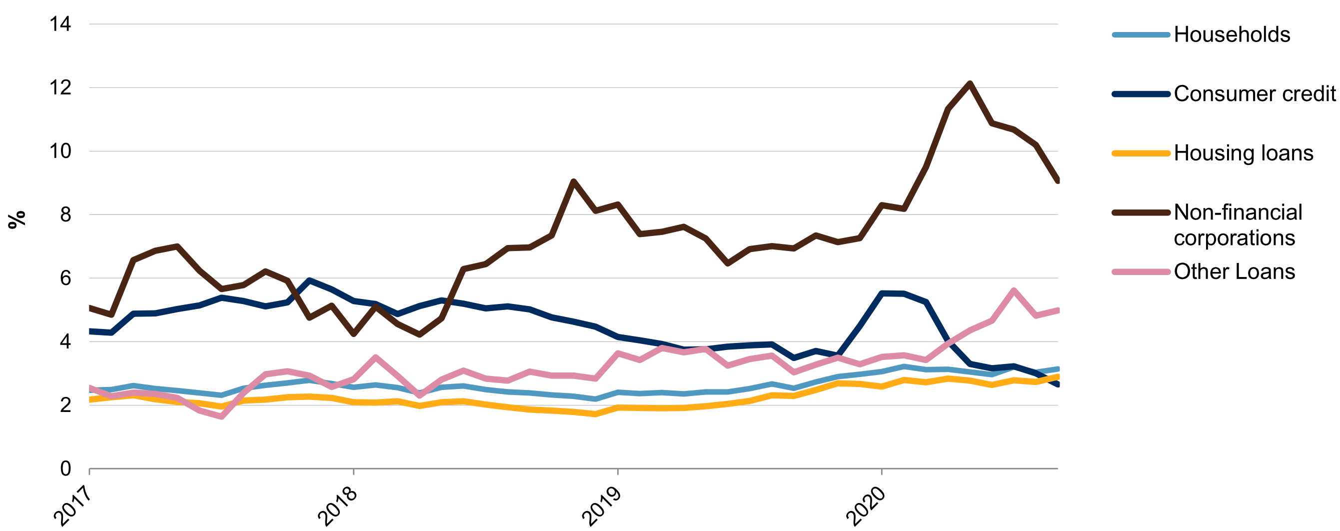
Economic imbalances: Nationwide house process remain stable, but development continues on two tracks.

We continue to view the Finnish economy as being in an expansionary phase, but believe economic growth following the 2021 economic rebound will be modest.

Private sector credit growth. We expect the demand for investment and credit will remain moderate through 2022 due to the economic downturn. We forecast private sector credit will increase by 4.0% annually compared with 4.7% in 2020, thanks to households' increased savings and continued demand for mortgage loans.

Chart 2

Finnish MFI Loans To Eurozone Residents
12-month rate of change

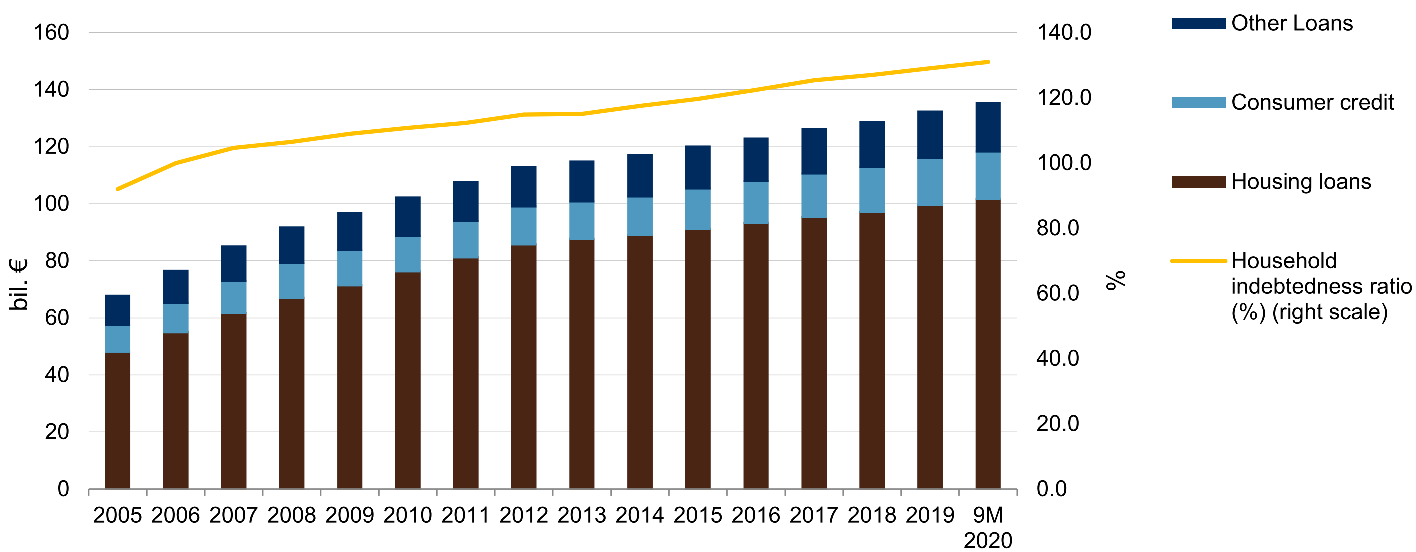


Source: Bank of Finland.

Domestic financial leverage has increased markedly as a result of the expansion of household debt; the ratio of debt to disposable income reached historical high of 131% in September 2020, increasing significantly from about 100% in 2006. Over the past few years, we have observed accelerated growth in housing company loans and consumer lending, which are estimated at € 21 billion (13.5% of household debt) and €21.7 billion (14% of household debt) respectively. We acknowledge that indebtedness is unequally distributed between households; the highly indebted households are typically among the highest income brackets and slightly more than half of Finnish households hold no debt at all. Overall, Finnish household debt remains lower than that of other Nordic countries and Switzerland (Sweden: 188% of net disposable income in 2019; Norway: 239%, Denmark: 257%, and Switzerland 223% according to data from the Organisation for Economic Co-operation and Development). That said, private sector debt accumulation requires continued attention and the use of macroprudential tools in order to slow down the increase in household indebtedness, in our view.

Chart 3

Finnish Households' Indebtedness And Loans Development

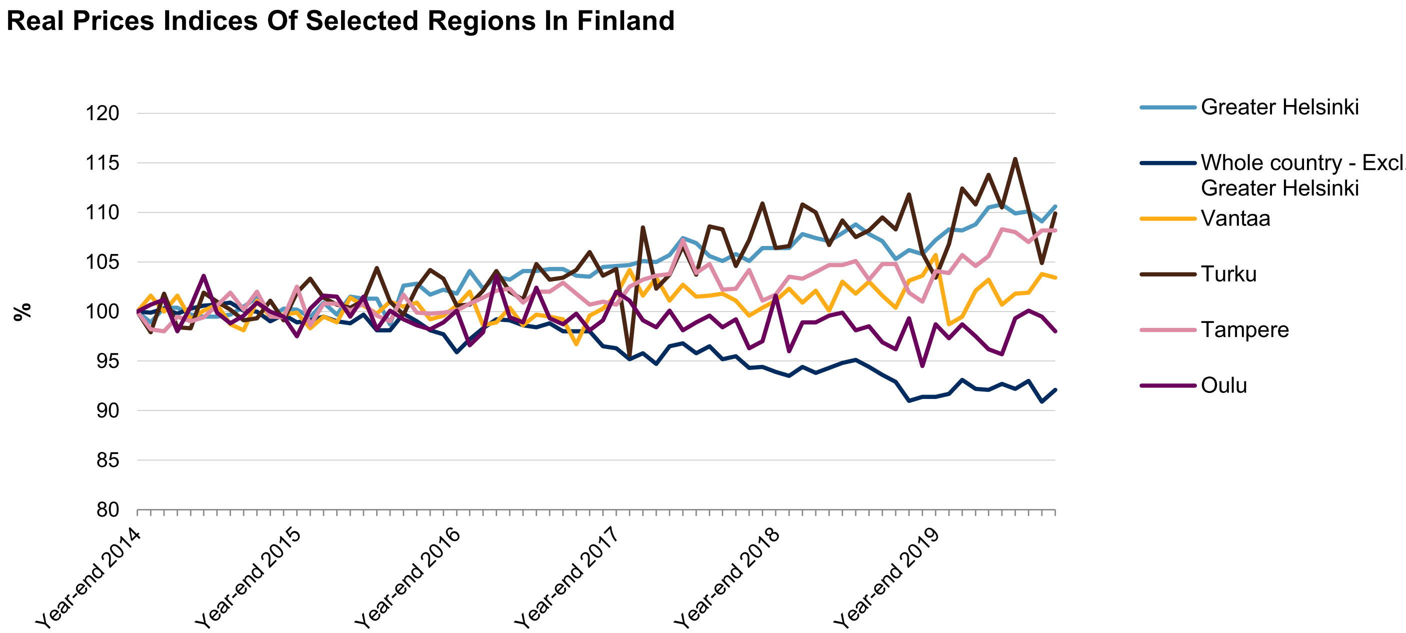


Source:S&P Global Ratings, Bank of Finland, Statistics Finland.

Real estate prices. We see no major domestic economic imbalances in the Finnish economy. Nationwide house prices were stable over 2020, while the Helsinki showed a 4.6% year-on-year increase in December 2020. Activity in the housing market normalized quickly after the first lockdowns, and households' financial positions remain sound, so we do not foresee much risk of price correction in the real estate market. As such, we forecast the four-year annual average will show a marginal decrease in national house prices in real terms through 2020.

We observe continuous house prices development on two fronts—growth in the capital region, and growth in cities versus more rural areas. The Helsinki capital region posted annual price increases of 3.5% in December 2020, whereas in the rest of the country housing prices were fairly stable relative to the previous year. Due to the strong urbanization trend in Finland, we forecast that increasing price development in Helsinki and the main growth centers (such as Tampere--3.7% as of December 2020, Turku--2.5%, but also Oulu, will continue throughout 2022, while prices in the rest of the country are still likely to stay flat or decrease over the next few years.

Chart 4



Source: S&P Global Ratings.

The Finnish banking sector remains exposed to property market, which includes housing corporations and commercial real estate. As of Sept. 30, 2020, loans to property markets and construction amounted to €55.1 billion, or 57% of loans to nonfinancial and housing corporations. In particular, loans to housing corporations have increased rapidly over the past 10 years due to renovations and new construction. The commercial property market hasn't shown performance problems, and vacancy rates are relatively stable in the Helsinki metropolitan area and larger cities, although they are likely to increase due to the pandemic. Deals are underwritten in a prudent way, and the vast majority of lending is to cash-flow-generating property. However, external investors represent more than 50% of transaction volumes, linking the Finnish commercial real estate market to international markets, which could make it more vulnerable in a downturn.

Equity prices. Given the equity holdings of the Finnish banking sector make up less than 1% of the total sector's balance sheet, we consider the inflation-adjusted developments in equity prices a neutral factor in our assessment of economic imbalances.

Current account and external debt position. We expect Finland's current account will have closed 2020 with a modest deficit due to reduced demand for goods imports, with exports facing a similar decline. At the same time, we expect a reduced deficit on the services balance from lower spending by Finns on overseas vacations, together with a tightening income balance will contribute to the overall balanced position. For 2021, we expect the current account will have widened, but will report moderate deficits given increasing domestic consumption will generate imports and drive the initial economic rebound. We expect exports will be slow to catch up.

Financial institutions continue to dominate Finland's external ratios. In particular, Nordea's relocation to the country has affected Finland's international investment position, with both assets and liabilities increasing significantly, but largely in tandem, leaving the net position largely unaffected. Even though the economy's external short-term debt remains well above 100% of current account receipts (CARs), and narrow net external debt will stay high at about 225% of CARs on average over 2020-2023, if we consider Finland's net international investment position, the country looks much stronger, with external assets largely equal to external liabilities. Overall, we do not believe Finland's external debt position exacerbates economic imbalances.

Table 2

Finland--Economic Imbalances

	2017	2018	2019	2020e	2021f	2022f
Annual change in claims of resident depository institutions in the resident nongovernment sector in % points of GDP	(1.0)	1.1	1.4	4.3	0.7	1.5
Annual change in key index for national residential house prices (real) (%)	0.3	(0.6)	(0.3)	1.4	0.7	0.6
Annual change in inflation-adjusted equity prices (%)	5.6	(7.1)	18.9	(100.4)	N.M.	N.M.
Current account balance/GDP	(0.8)	(1.6)	(0.5)	(1.4)	(1.2)	(1.1)
Net external debt / GDP (%)	39.6	44.1	44.7	43.7	42.5	41.8

e--Estimate. f--Forecast. N.M.--Not meaningful. GDP--Gross domestic profit.

Credit risk in the economy: Low risk, but private sector debt has increased substantially over the past decade

Private-sector debt capacity and leverage. Private-sector debt (household and non-financial corporation debt) is projected at 140% of GDP in 2020. Therefore, the credit risk in the Finnish economy should remain low in peer comparison, despite being characterized by an increasing level of household debt.

The household debt has accumulated because of low interest rates, households' strong credit demand over the past decade, and that of housing corporations in the past couple of years. Despite the rise in housing and housing corporation loans, affordability remains sound. Furthermore, Finnish households have accumulated financial assets of €342.4 billion as of September 2020, and the COVID-19 pandemic has led savings to increase through 2020. Given the persisting low interest rate environment, private sector debt capacity remains good for now. However, an unexpected increase in debt service costs could reduce household consumption and weaken the economic cycle.

We note corporate borrowing, including nonbank funds and bank lending, has also continuously increased over recent years, and stood at about 79% of GDP at December 2019. We project corporate credit as a percentage of GDP (excluding loans to housing corporations) will increase in 2020 because corporates have drawn down on the bank lines, and slightly diminish thereafter.

Lending and underwriting standards. Due to the pandemic, we expect Finnish banks' nonperforming assets (NPAs) will increase to about 1.8% of systemwide loans over 2020-2021, up from 1.4% in 2019. Considering purely domestic lending, NPAs are projected to increase to 1.5% in 2020-20201 (see table 3) However, in our view, Finnish banks continue to have sound underwriting standards and prudent practices.

Household mortgage lending in Finland is more conservative than in other Nordic countries, with the maximum term for these mainly amortizing loans set at 20-25 years. While this limits borrowers' capacity to assume sizable debt and explains Finland's lower household debt levels than Nordic peers, maximum loan terms and average repayment terms have lengthened over the past few years. We estimate the average loan-to-value ratio in mortgage lending at 55%-60%.

Mortgages are generally linked to floating rates in Finland, so the low interest rate environment has helped households service debt. Conversely, the variable rates expose the Finnish household sector to an increasing debt-service burden, should the interest rate start to rise again. While the banks continue to use a 6% stressed interest rate in line with FSA recommendation when extending a new loan, the regulator is considering new tools such as a maximum debt service-to-income ratio to limit the size of loans.

We see no significant sector concentration among the system's corporate loans. The property sector including housing corporations remains an important part of most banks' lending portfolios, representing about 20% of banks' total lending, although most of this relates to cash-flow-generating properties. We estimate the level of foreign currency-denominated loans to be marginal in the Finnish market.

Payment culture and rule of law. We view the legal framework for creditor protection as effective and predictable. Moreover, we believe the Finnish payment culture benefits loan repayment, and is deeply rooted in a cultural approach to debt following the 1990s housing crisis. Corruption in Finland is very low. The country ranked No. 3 globally in Transparency International's corruption index for 2019.

Table 3

Finland--Credit risk in the economy

	2017	2018	2019	2020e	2021f	2022f
Claims of resident depository institutions in the resident nongovernment sector as a % of GDP	93.9	95.0	96.4	100.7	101.4	102.9
Household debt as % of GDP	55.8	55.0	55.0	58.4	58.3	58.6
Household net debt as % of GDP	(77.9)	(74.9)	(83.8)	(88.1)	(86.8)	(89.3)
Corporate debt as % of GDP	78.1	74.7	79.3	84.7	80.4	76.1
Real estate construction and development loans as a % of total loans	1.1	1.8	2.0	1.9	2.0	2.0
Foreign currency lending as a % of total domestic loans	0.5	0.7	0.8	0.3	0.7	0.7
Nonperforming assets as a % of systemwide domestic loans (year-end)	1.3	1.1	1.0	1.5	1.5	1.3

e--Estimate. f-Forecast. N/A--Not applicable. GDP--Gross domestic profit.

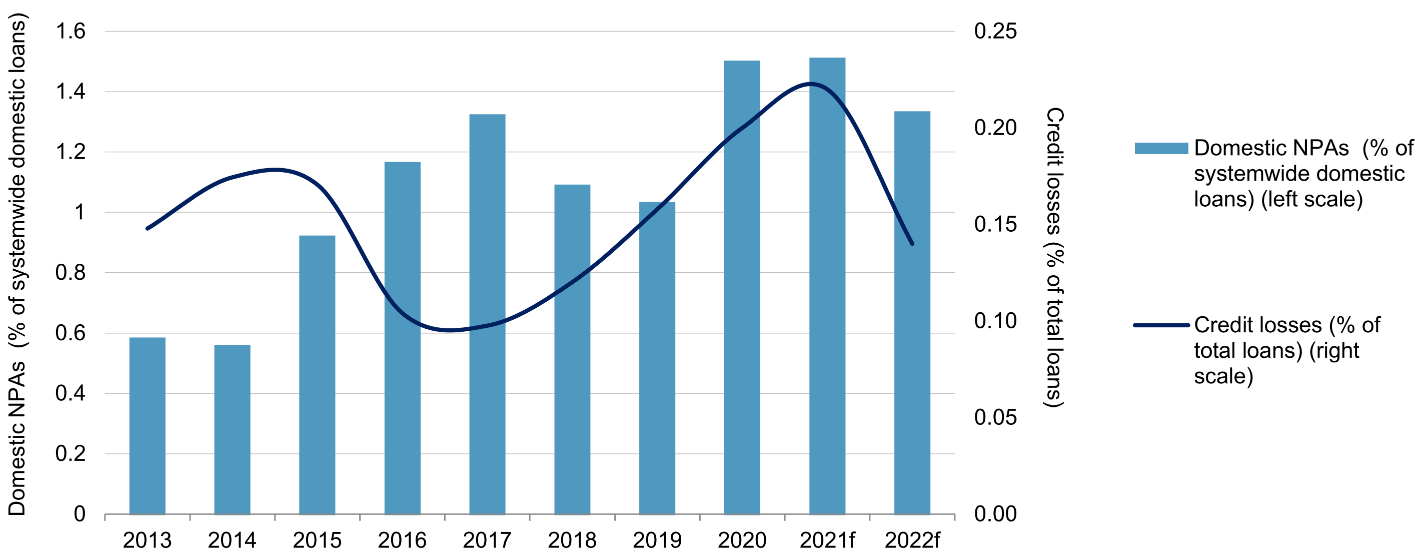
Base-Case Credit Losses

We do not expect the Finnish banking sector will remain immune to the pandemic-induced stress, even though the picture now looks less gloomy than in April 2020 when we assessed the economic risk trend as negative. We forecast banks' credit losses will moderate at about 30 basis points (bps) in 2020-2021 (doubling from 15 bps in 2019), despite a likely increase in corporate bankruptcies, active use of instalment-free periods, and more muted credit demand. NPLs should return to pre-pandemic levels in 2022. We do not exclude even higher loan losses once

COVID-19-related policy measures end, but we believe the banking sector holds sufficient earnings and capital buffers to absorb potential further stress. The Finnish banking sector demonstrated strong capitalization, underpinned by a weighted average risk-adjusted capital ratio of 12.8% for rated entities at mid-2020. We will closely monitor banks' forbearance measures and stage transfers under International Financial Reporting Standards (as the instalment-free periods terminate and the relaxation of insolvency law ends. At the peak of the economic stress, these measures amounted to about 10% of mortgage loans and 6% of corporate loans, although individual banks' offerings were different.

Chart 5

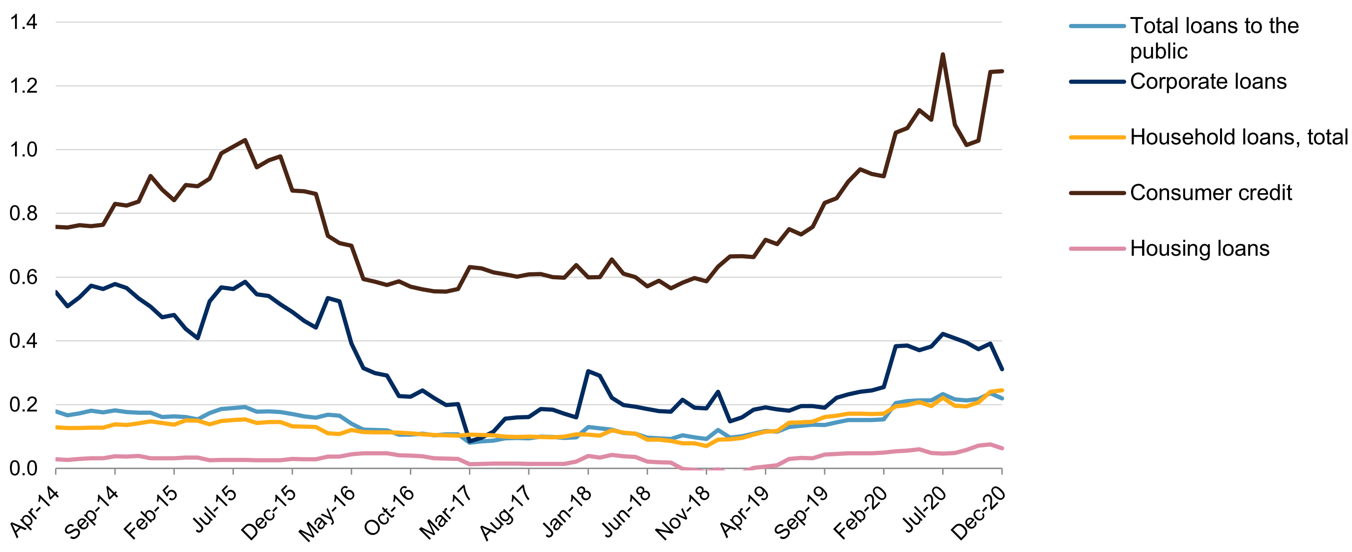
Credit Losses Are Expected To Rise Significantly In 2020-2021



f--Forecast. NPA--Nonperforming assets. Source: S&P Global Ratings.

Chart 6

Impairment Losses Registered In The Past 12 Months Relative To Loan Stock



Source: Bank of Finland

Table 4

Finland - Base-case Credit Losses (% Of Domestic Loans)

Actual and projected losses

	2017	2018	2019	2020	2021f	2022f
Households	0.11	0.09	0.17	0.24	N/A	N/A
of wich residential mortgages	0.02	0.00	0.05	0.06	N/A	N/A
of which consumer loans	0.64	0.63	0.94	1.25	N/A	N/A
Non-financial corporations	0.16	0.24	0.24	0.31	N/A	N/A
Total	0.10	0.12	0.15	0.22	0.30	0.14

e--Estimate. GDP--Gross domestic profit. Source: Bank of Finland and S&P Global Ratings.

3 Industry Risk

We base our industry risk score for Finland on our assessment of its institutional framework, which is in line with European standards, as well as competitive dynamics, underpinned by a concentrated and well-capitalized banking sector with a high presence of cooperative and mutual groups, and strong focus on digitalization. We see the dependence on external funding as the main risk to the banking sector.

Institutional framework:Intermediate risk, in line with international standards

Banking regulation and supervision. In our view, the Finnish banking regulation and supervision is in line with European standards. As a eurozone country, Finland is a member of the European Banking Union. The Finnish Supervisory Authority (FIN-FSA) cooperates closely with the European Central Bank (ECB), which has supervised the largest credit institutions under the single supervisory mechanism since 2014. The FIN-FSA has identified OP Cooperative, Nordea, and Municipality Finance PLC as other systemically important institutions (O-SII).

We believe the FIN-FSA continues to face regulatory challenges posed by pan-Nordic banks, and that the banking sector's strong interconnectedness requires close coordination between the Nordic regulators. The Nordic regulatory colleges continue to coordinate supervision closely, given Nordea's Nordic branch operations and the presence of the pan-Nordic banks operating as systemically important branches in Finland.

With the outbreak of COVID-19, the Finnish regulator has temporarily loosened its regulatory requirements, but we expect they will be restored once the economic stress will abate. The regulator has abolished the systemic risk buffer, addressing long-term noncyclical risks to the financial system; the risk buffers ranged from 1%-3% (Nordea Group, 3%; OP Financial Group, 2%; Municipality Finance, 1.5%; and other institutions, 1%) and lowered the O-SII buffer on OP Financial Group to 1% (from 2%). Moreover, the FIN-FSA has not yet activated the countercyclical buffer. In general, we consider the Finnish banking sector well capitalized, with an average common equity tier 1 ratio of 17.5% (12/2019: 17.6%), and a capital adequacy ratio of 20.6% (12/2019: 21.3%) as of Sept. 30, 2020.

The FIN-FSA continues to focus strongly on ensuring strict underwriting criteria for household lending, but has restored the 90% cap on maximum loan-to-value ratios on new mortgage loans (95% for first-time buyers), with the aim of supporting banks' resilience and lending capacity during the pandemic. Still, the proposed macroprudential tools to curb households' increasing indebtedness have been put on hold. That said, the maximum interest rate on unsecured consumer loans has been temporarily capped at 10% to prevent increases in household leverage amid the current economic crisis.

We consider the Finnish regulatory framework a neutral factor in promoting innovation or disrupting retail banking. Digitalization has been a driving force in the banking sector's investments in technology and innovation in the customer offer for years, and we expect the Finnish regulator will closely monitor the trends, analyse their impacts on the banking sector, and develop supervisory practices. The DIAS digital mortgage lending platform using is a testimony of the joint efforts of a Fintech, the banking sector, real estate agencies, and with the public records and tax authorities in creating a fully digital property transaction process by using blockchain technology.

We observe that the environmental, social and governance factors are gaining importance on domestic banks' agendas, but also regards FIN-FSA supervision. FIN-FSA has identified climate change as one of the key areas of supervision in its strategy, alongside digitalization and anti-money laundering. We note that Nordea Bank is a founding member of UNEP FI and a banking sector sustainability initiative, which further domestic banks including OP Financial Group and Bank of Aland have also joined. FIN-FSA aims to ensure that the domestic banks will adequately analyse the impact of climate change and policy on their operations.

Regulatory track record. We consider that the Finnish regulator has a good track record of dealing with crises, seen through its response in 2008-2009 and during the current COVID-19 induced stress. In the 2008-2009 financial crisis, the government prepared a support package for the banking sector, including guarantees for issuance and the possibility for government investment in banks. However, no Finnish banks required these mechanisms. In our view, the regulator reacted rapidly in the current crises by relaxing capital requirements in order to support the banks' lending capacity during 2020.

The FIN-FSA and the resolution authority have proactively strengthened its staffing and skills to supervise and monitor the group in cooperation with the ECB's Single Supervisory Mechanism (SSM) and Single Resolution Board (SRB) to accommodate the supervision of Nordea Group.

Governance and transparency. We consider governance and transparency strong in Finland, relative to that of peers. In our view, there are no meaningful conflicts of interest among the different stakeholders, and banks follow transparent and timely reporting in line with international standards and sound compensation practices.

Competitive dynamics: Low risk, in view of high stability and the concentrated banking market's advanced level of digitalization.

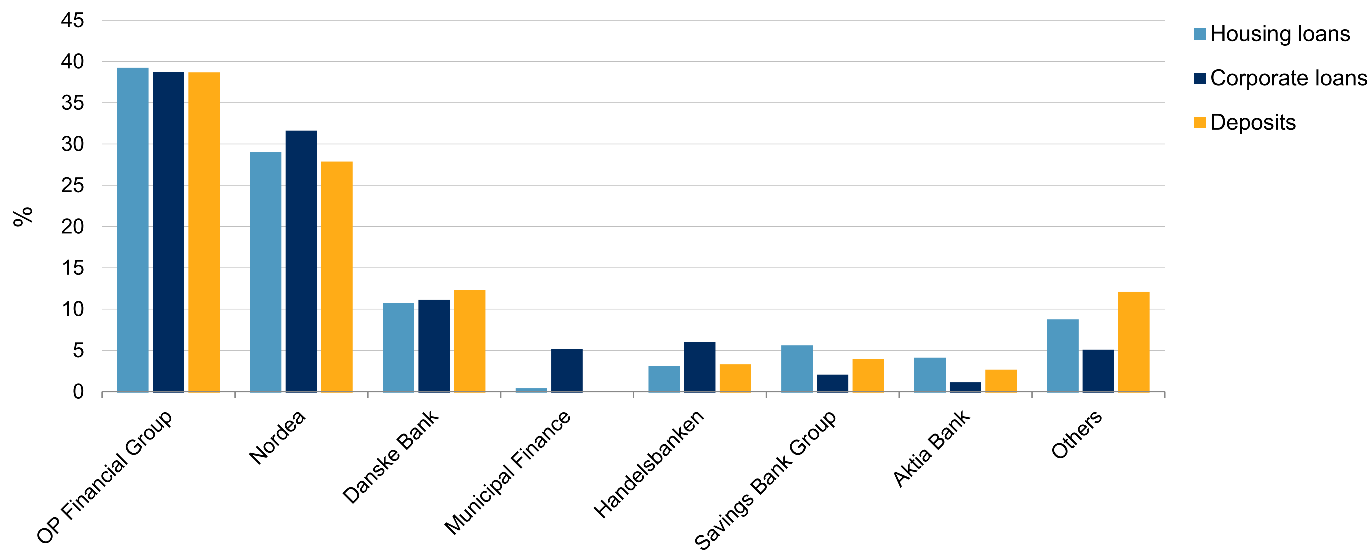
Risk appetite. In our view, banks' risk appetite in Finland is restrained and we see no excessively risky banking products in the market or signs of the risk appetite increasing in the low-interest-rate environment. The banking sector generates about 53% of its earnings from net interest income, mainly from mortgage lending (funded by retail deposits and covered bond funding) and corporate lending. These stable earnings sources are complemented by fee income (31% as of June 2020) from an expanding asset management business and payments and lending business. These income source make up to 84% of the banking sector's total income.

We expect the banking sector's profitability will be under pressure in 2020-2021 owing to lower operating income, valuation effects, and higher cost of risk. Yet, we believe domestic banks' return on equity (ROE) will return to stable high-single-digit levels in the next years. The profit levels, which are below those of Nordic peers, reflect the high share of cooperative and savings banks in Finland (about 45% of domestic deposits and 47% of loans to Finnish households), which generally focus on stable returns, high capitalization, standard lending, deposits, and asset management products for member or owner customers. While lending margins are some of the lowest in Europe, the projected sound asset quality, combined with moderate cost of risk and sound operating efficiency (cost-income ratio of 58.5% in 2019), supports the banks' healthy and stable core profitability.

Industry stability. The Finnish banking sector is characterized by two large domestic banks, OP Financial Group and Nordea, as well as pan-Nordic players operating through branch operations and cooperative and savings banks amalgamations, leading to total 12 banking groups in Finland. Overall, the market is highly concentrated, but we believe dynamics will remain stable and risk of tech disruption remains limited. The three largest banking groups dominate about 80% of the market (see chart 7). The high interconnectedness between the Nordic banking sectors means the capacity of the Finnish entities to extend credit could be affected by financial difficulties of the large pan-Nordic parent groups in their other, non-Finnish operations.

Chart 7

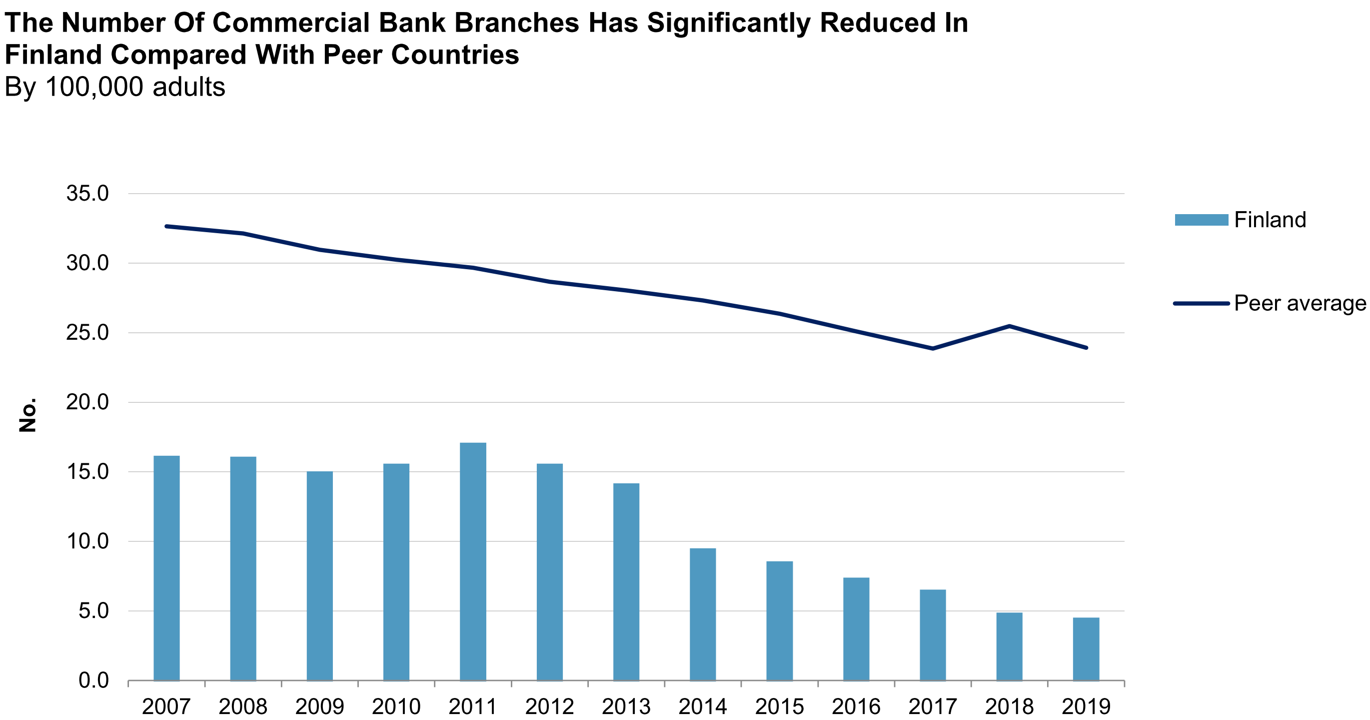
The Finnish Banking Sector Remains Highly Concentrated
As of June 30, 2020



Source: Bank of Finland and S&P Global Ratings.

We believe the Finnish banking sector will continue to invest heavily in digitalization and a core banking overhaul over the next two years. The country is one of the most digitized economies in the world, along with those of Nordic peers, reflected in a highly digitalized banking sector. Online banking was introduced in Finland in the 1990s and today, 93% of the population uses digital banking services. We have further observed a rapid decline in banks' branch networks over the past 10 years (see chart 8). The mobile channel overtook online banking in terms of monthly logins a few years ago. We believe that national champions are well advanced in the digitalization efforts and digital customer offer, but we project increased information technology spending at smaller domestic banking groups, weighing on profitability in the next two years.

Chart 8



Peer group includes: Belgium, Canada, Germany, Norway, Switzerland and Sweden. Source: IMF's Financial Access Survey.

Nonbanks have increased offerings rapidly, especially in the area of consumer finance, while the traditional players have managed to maintain a dominating market position in the traditional lending areas and payments. However, market shares of non-bank operators remain marginal and are not expected to change the competitive landscape. Banks and authorities continue to cooperate to ensure thriving digital development, such as by using blockchain technology to develop digital end-to-end mortgage products, but the payment market is not as unified as in neighboring Nordic countries, where banks cooperate closely.

Market distortions. The government is not involved in the banking sector as owner and, in our view, there are no particular government policies affecting the market meaningfully. We do not see any other significant market distortions.

Table 5

Finland--Competitive Dynamics

	2017	2018	2019	2020e	2021f	2022f
Return on equity (ROE) of domestic banks	8.3	8.5	5.2	5.3	6.9	8.9
Systemwide return on average assets (%)	0.6	0.6	0.3	0.4	0.5	0.6
Net operating income before loan loss provisions to systemwide loans (%)	1.0	2.4	1.6	1.9	2.3	2.4
Market share of largest three banks (%)	71.6	77.0	78.0	78.0	80.0	80.0

Table 5

Finland--Competitive Dynamics (cont.)

	2017	2018	2019	2020e	2021f	2022f
Market share of government-owned and not-for-profit banks (%)	N/A	N/A	N/A	N/A	N/A	N/A
Annual growth rate of domestic assets of resident financial institutions (%)	(12.4)	19.6	6.9	10.0	2.3	2.0

f--Forecast, N/A--Not applicable.e--Estimate. Source: S&P Global Ratings.

Systemwide funding: Intermediate risk, structural funding gap countered by stable covered bond funding

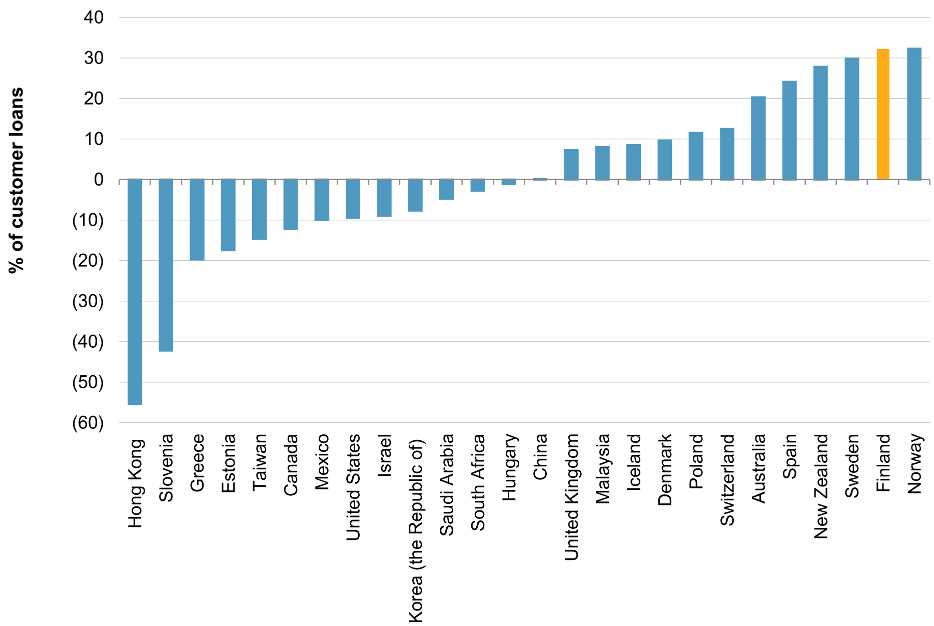
Core customer deposits. Like for peer countries, we observed a strong deposit inflow in the Finnish banking sector, with corporate deposits showing a 20.9% increase and household deposits 7.4% as of November 2020 compared with the previous year. We believe this is a temporary impact of the COVID-19 pandemic and lower corporate investments and household consumption. We project the Finnish core customer deposit base to total domestic loans will remain at 50%-55% through 2022. This is slightly below that of European peers, but higher than in other Nordic peers, and reflects the tendency of Finnish households to channel savings into deposits instead of mutual funds and other forms of savings as in other Nordic countries. However, rapid loan growth has resulted in a need to fund substantial loans in capital markets through covered bond issuance, as indicated by the loan-to-deposit ratio of close to 154% at November 2020. Adjusted for covered bond funding the loan-to-stable funding ratio is estimated at 135%.

External funding. We see the Finnish banking system's structural dependence on external wholesale funding as a key weakness. The funding gap is filled with issuance of covered bonds but also unsecured debt and commercial paper. Finnish banks have issued over €165 billion of long-term and short-term debt as of year-end 2019, constituting 69% of GDP (increasing from 62% as per year-end 2018, driven by the re-domiciliation of Nordea to Finland). External funding is estimated at about two-thirds of wholesale funding, a figure we expect will remain fairly stable. Also, the three largest financial institutions account for almost all of the system's external funding, although smaller banks and banking groups have also started issuing covered bonds.

We observe that the Finnish banking sector occasionally experiences large inflows of foreign deposits that are channelled through commercial banks to the Bank of Finland, the only Nordic central bank that is part of the euro area. In our view, this is because of market observers perceiving Finnish banks as having safe-haven status and, given their issuance in euros, is a testament to the banks also having access to a wide external investor base, both through secured and unsecured issuance.

Chart 9

Global Comparison Of Finnish Banking Sector's Material Dependence On Net External Borrowings
As of Dec. 31, 2019



Source: S&P Global Ratings.

Domestic debt-capital markets. Finland's private sector debt market continues to expand, and by our estimate represented about 89% of GDP in 2019 (nonfinancial corporations 20% and monetary financial institutions 69%). The banking sector's debt outstanding consists chiefly of senior unsecured bonds, but the covered bond issuance is gaining importance, with new issuers entering the market alongside established covered bond issuers. Finnish nonfinancial corporates and banks have proven access to euro-denominated issues, as demonstrated in the market volatility during spring 2020, underpinned by the frequent issuance of unsecured and secured debt instruments with medium-term maturities of three-to-six years.

Government role. As a eurozone member, the Finnish Central Bank operates under the ECB. We believe the ECB has considerable capacity to support domestic banks' funding and liquidity, which provides uplift to our overall systemwide funding assessment.

Table 6

Finland--Systemwide Funding

	2017	2018	2019	2020e	2021f	2022f
Systemwide domestic core customer deposits by formula as a % of systemwide domestic loans	49.0	50.7	50.9	53.7	53.7	53.3

Table 6

Finland--Systemwide Funding (cont.)

	2017	2018	2019	2020e	2021f	2022f
Net banking sector external debt as a % of systemwide domestic loans	33.9	32.8	32.1	26.0	25.2	24.1
Systemwide domestic loans as a % of systemwide domestic assets	56.5	49.6	49.1	46.6	46.5	49.1
Outstanding of bonds and CP issued domestically by the resident private sector as a % of GDP	19.2	19.6	19.5	22.2	21.0	20.4
Total consolidated assets of FIs as a % of GDP	200.0	269.0	271.1	299.0	296.9	296.8
Total domestic assets of FIs as a % of GDP	175.5	202.9	210.6	238.5	235.3	232.9

f--Forecast. CP--Commercial paper. FI--Financial institutions. GDP--Gross domestic profit.

Peer BICRA Scores

Finland's economic risks is in line with the peer group average, reflecting the strong economic resilience of the country's small open economy, demonstrated during the COVID-19 pandemic. We assess credit risk in Finland as among the lowest in the peer group. Risks from economic imbalances are lower than the peer average, reflecting house price and loan growth rates that are moderate in a global context. However, we observe a continuous increase in household debt on the back of increasing mortgage and housing corporation loans, although the level is still lower than that of Nordic peers. This trend is mitigated by the high social welfare, and households' increasing financial savings. Overall, we now consider our assessment of Finland's economic risk as stable, in line with other Nordic peers, despite increasing global economic stresses due to COVID-19.

Our assessment of Finland's industry risk combines our views of banking regulation and funding prospects in line with the Nordic peers, and the low risk of competitive dynamics, despite the concentrated and highly competitive banking market. The Finnish banking sector demonstrates superior capitalization and sound and stable profitability, although below those of the peer countries. This reflects the dominant share of cooperative and savings banks group that are focused on long-term stability over short-term returns, and high capital levels. Similar to those of Nordic peers, the Finnish banking sector is well advanced in terms of digitalization and the risk of tech disruption remains moderate. We believe regulatory oversight has been strengthened following redomiciliation of Nordea to Finland in 2018, but the regulatory framework remains in line with EU standards.

Table 7

BICRA Finland--Peer Scores

	Finland	Sweden	Norway	Belgium	Germany	Switzerland	Canada
BICRA Group	2	2	2	2	2	2	2
Economic risk score	2	2	2	2	1	2	3
Economic risk trend	Stable	Stable	Stable	Negative	Negative	Stable	Stable
Industry risk score	3	3	3	3	3	2	2

Table 7

BICRA Finland--Peer Scores (cont.)

	Finland	Sweden	Norway	Belgium	Germany	Switzerland	Canada
Industry risk trend	Stable	Stable	Stable	Stable	Negative	Stable	Stable
Government propensity to support	Uncertain	Uncertain	Uncertain	Uncertain	Uncertain	Uncertain	Supportive
Sovereign rating	AA+/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+
BICRA Subscores							
Economic resilience	Very low	Very low	Very low	Low	Very low	Very low	Very low
Economic imbalances	Low	Intermediate	Intermediate	Low	Very low	Low	Intermediate
Credit risk in the economy	Low	Low	Low	Low	Low	Low	Intermediate
Institutional framework	Intermediate	Intermediate	Intermediate	Intermediate	Intermediate	Low	Very low
Competitive dynamics	Low	Low	Low	Intermediate	Intermediate	Low	Low
Systemwide funding	Intermediate	Intermediate	Intermediate	Very low	Very low	Low	Low

All assessment as of Jan. 26, 2021. Source: S&P Global Ratings Financial Institutions.

Government Support

We believe that the prospect of the Finnish government providing extraordinary support for the banking sector is uncertain following the full implementation in 2015 of the EU's Bank Recovery and Resolution Directive, including bail-in powers, in concert with other EU countries. The national Financial Stability Authority (FFSA; Rahoitusvakausvirasto) started operations in 2015. The resolution act vests the authority with resolution powers and bail-in tools, and we understand that FFSA has concluded resolution plans on all institutions in its remit.

Table 8

Finland--Largest Financial Institution By Assets

Financial institutions by assets (mil. €)

Bank	Parent Name	Parent Country	Total assets	Systemic Importance
Nordea Bank Abp	-	-	554,848.2	High
OP Financial Group	-	-	147,023.7	High
Municipal Finance	-	-	38,933.4	N/A
Danske Bank, Finland branch	Dankse Bank A/S	Denmark	N/A	N/A
Handelsbanken, Finland branch	Svenska Handelsbanken AB	Sweden	N/A	N/A

Table 8

Finland--Largest Financial Institution By Assets (cont.)

Financial institutions by assets (mil. €)

Bank	Parent Name	Parent Country	Total assets	Systemic Importance
Savings Bank Group	-	-	12,009.1	Moderate
Aktia Bank PLC	-	-	9,697.1	Moderate

N/A - Not Applicable. Financial Data as of December 2019. Source: Company information, Financial Supervisory Authority, S&P Global Ratings Financial Institutions.

Related Criteria

- Sovereign Rating Methodology, Dec. 18, 2017
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011

Related Research

- Banking Industry Country Risk Assessment Update: January, Jan. 28, 2021
- Outlooks On Seven Finnish Banks Revised Due To Their Resilience In The COVID-19-Induced Downturn, Jan. 22, 2021
- Nordic spotlight: COVID-19 Weighs on Creditworthiness, Nov. 18, 2020
- COVID-19: Resilient Fundamentals And Assertive Policy Measures Will Buoy Nordic Banking Systems, June 16, 2020
- Tech Disruption In Retail Banking: Nordic Techies Make Mobile Banking Easy, Feb. 4, 2020

This report does not constitute a rating action.

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