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To banks operating in Finland

SAFEGUARDING BANKS' LONG-TERM PROFITABILITY AND CUSTOMER PROTECTION

According to the view of the Financial Supervisory Authority (FIN-FSA), price competition for housing loans and particularly fixed-term deposits has tightened to such an extent that maintaining bank profitability over the long term may be jeopardised. FIN-FSA finds that, in the current economic environment, banks also need to specifically ensure personal customers' adequate debt repayment capacity and provide customers with sufficient information on loan insurance products.

Deposit and loan pricing must safeguard maintenance of bank profitability

The strong decline in market interest rates that started at the end of 2008 and the resultant tightening of bank competition have clearly narrowed banks' overall interest rate margins. In FIN-FSA's view, deposits and loans must be priced so as to ensure that the overall interest rate margin covers the costs and risks arising from the bank's operations and that an adequate level of net interest income remains in place.

Tight price competition for fixed-term deposits in particular may significantly impair bank profitability. Customer-specific margins in housing loans should cover the credit risk related to the customer, the bank's funding costs and risks involved, as well as the bank's return-on-equity requirements and other expenses, throughout the entire validity of the loan agreement.

Safeguarding customers' debt repayment capacity is of key importance in the context of low interest rates

Exceptionally low market interest rates have increased the risk of customers having too big loans with regard to their repayment capacity. In this operating environment, banks need to carefully assess customers' ability to service their loans out of their own income sources.

FIN-FSA encourages the banks to undertake systematic calculations of housing affordability in respect of all new housing loan applicants and to take these calculations into account in their lending decisions. The interest rate level used in affordability calculations for assessing the impact of a rise in interest rates should be set at least at the maximum interest rate level prevailing since the introduction of the euro (Oct. 2008: 12-month Euribor of 5.5%). Consequently, the banks' calculations should use at least a 6% notional interest rate (market interest rate plus customer-specific margin).

A housing affordability calculation must always be presented to the customer. The customer must also be clearly informed of the impact of a rise in market interest rates on the housing loan repayment schedule. This applies particularly to annuity loans, where the loan period may be extended considerably because of a rise in interest rates.

The risk of a rise in interest rates will also be reflected in the risk included in housing prices. FIN-FSA considers it important for banks to require an adequate self-financing share from customers in order to mitigate customer risk. In capital adequacy calculations, residential mortgage lending with a less than 70% loan-to-value (LTV) ratio is considered lower-risk. FIN-FSA invites the banks to abstain from financing home purchases for own use involving a higher than 90% LTV ratio relative to the market value of the property to be financed, with the exception of certain rare cases.

Customers must be better informed of agreements on interest-rate caps and loan insurance policies

Information provided to customers on the prices and costs involved in interest-rate cap agreements and loan insurance policies, including the coverage of such agreement and insurance (agreement content, terms and conditions) must be transparent and comprehensive.

FIN-FSA recommends that, in concluding interest-rate cap agreements, customers should be particularly informed of:

- the total euro price of the interest-rate cap and the price as an interest expense *per annum*, as well as information on whether the customer-specific margin is included in the interest-rate cap
- the impact of the interest-rate cap on the customer’s loan service costs in different situations
- the consequences of an early termination of the interest-rate cap agreement.

As regards loan insurance policies, customers need to be informed particularly of:

- the type of protection the loan insurance policy provides and the limitations of the insurance coverage
- the costs of the policy (insurance premium)
- the consequences of an early termination of the insurance policy
- the situations where insurance expires or the insurer has the right to terminate insurance.

FIN-FSA considers that customers must be able to freely choose the means with which they wish to hedge themselves against personal payment defaults. The bank should assess with the customer the protection needed and the suitable way of doing so. Other options for hedging against risks (for example, a fixed-rate loan and the customer’s own savings) should be discussed. FIN-FSA underlines that, as a condition for granting a loan, the bank must not require that the borrower should sign an interest-rate cap agreement or loan insurance policy with the bank or a company belonging to the same group or group of companies as the bank.

FINANCIAL SUPERVISORY AUTHORITY

Anneli Tuominen
Director General

Jukka Vesala
Deputy Director General