SIMPLY SHORT

Higher interest rates are beginning to bite

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Banks and the rest of the financial system in Finland have remained stable despite the many disruptions in the global economy and financial markets this spring and in recent years. Households with high debts in relation to their income may come under particular strain in the near future, as both loan servicing and other daily costs are rising at the same time. There is still work to be done to improve resilience to crises. Key steps would include a stronger cap on household borrowing in Finland, and a common system of protection for bank deposits across Europe.

Rapid rise in interest rates is a strain on borrowers and investors Banks in Finland are well equipped to meet growing risks
Work still to be done to improve resilience to crises

The rapid rise in interest rates is now a strain on many borrowers and investors, both in Finland and around the world. Interest rates have risen sharply from their previous exceptionally low level. In Finland, for instance, the 12-month Euribor, which is the commonly used reference rate for loans, is now (April average) at around 3.7%, whereas a year ago it was still at zero and had been a negative rate for a number of years before that.

Central banks began raising the interest rates which they set for monetary policy purposes, because inflation – a rise in the general level of prices for goods and services – had climbed far too high. Energy prices were rising in Europe following the start of Russia's war in Ukraine more than a year ago, and even before that, inflation had been rising due to the higher prices of many raw materials in response to the disruptions in the international economy brought by the COVID-19 pandemic.

The steep rise in costs is exposing risks that were taken by households, businesses, investors and banks during the period of low interest rates. As reference rates rise, the interest rates on most loans in Finland have also been increasing substantially. Share prices and the prices of fixed-rate debt securities have, in turn, fallen, which has caused considerable losses to investors. Bank funding raised on financial markets has also become more expensive.

In March, international financial markets experienced a sudden spring storm when investors lost confidence in specific banks. First in the eye of the storm was the US Silicon Valley Bank, which failed due to a run on deposits – when large numbers of customers withdrew their deposits urgently from the bank. In Europe, the Swiss bank Credit Suisse, which had long been in difficulty, was sold to a competitor. The authorities acted quickly to resolve these crises, which prevented the problems from spreading far and wide.

Chart 1.

Finland's financial system has remained stable and banks are well placed to meet growing risks. Banking regulation and supervision was tightened widely following the global financial crisis of 2008. The banks now have more assets for covering losses and for improving their liquidity positions. Finland also has a new backup system for ensuring that customers can access their bank accounts under all circumstances.

The turmoil seen in international financial markets in March has subsided for the time being. However, turbulent conditions could still return and their impact could also reach

Finland. Finnish banks acquire considerable funding from international investors to enable them to grant loans to households and businesses, and if instability were to intensify in the markets, this could elevate bank funding risks in Finland, too.

The risks carried by Finnish banks could also grow when it comes to lending. Among the banks' customers, households that are heavily indebted, in particular, may come under exceptional strain in the near future, as both loan servicing and other daily costs are rising at the same time. If such financial difficulties reduce sales of products and services by businesses, then not only will spending be down but investment will fall as well. Losses could then increase, also via secondary effects in the economy.

The housing market in Finland has slowed due to the sharp rise in interest rates and living costs. Purchases of residential property by households and investors have been below their normal level, and property prices have fallen throughout the country. A lot of new homes are under construction at the same time as an increasing amount of existing dwellings are on sale, especially in the Helsinki metropolitan area. This is increasing risks in the construction sector and in housing finance from the banks.

Sustained efforts are still needed in Finland and jointly in Europe to improve resilience in the financial system. There is also still a need for improved tools to safeguard financial stability.

The Bank of Finland has long been in favour of a debt-to-income cap that would curb household borrowing and therefore strengthen the ability of households to repay debts. The Bank is currently supporting a new proposal from a Ministry of Finance working group. The proposal is that the cap would set an upper limit on how much of a borrower's income could be used for debt servicing. The calculation would be based on a higher interest rate than the rate prevailing at the time the loan is taken out.

It is important that in Europe a common deposit insurance scheme be introduced in place of separate national systems. Such a scheme would protect customers' deposits if a bank were to become insolvent or go bankrupt. The common scheme proposed for the EU banking union would strengthen customers' confidence in the banks and prevent bank runs on deposits. In a crisis situation, it would also reduce detrimental linkages between banks and their home countries.

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