FINANCIAL STABILITY ASSESSMENT

Debt risks amplified by housing company loans

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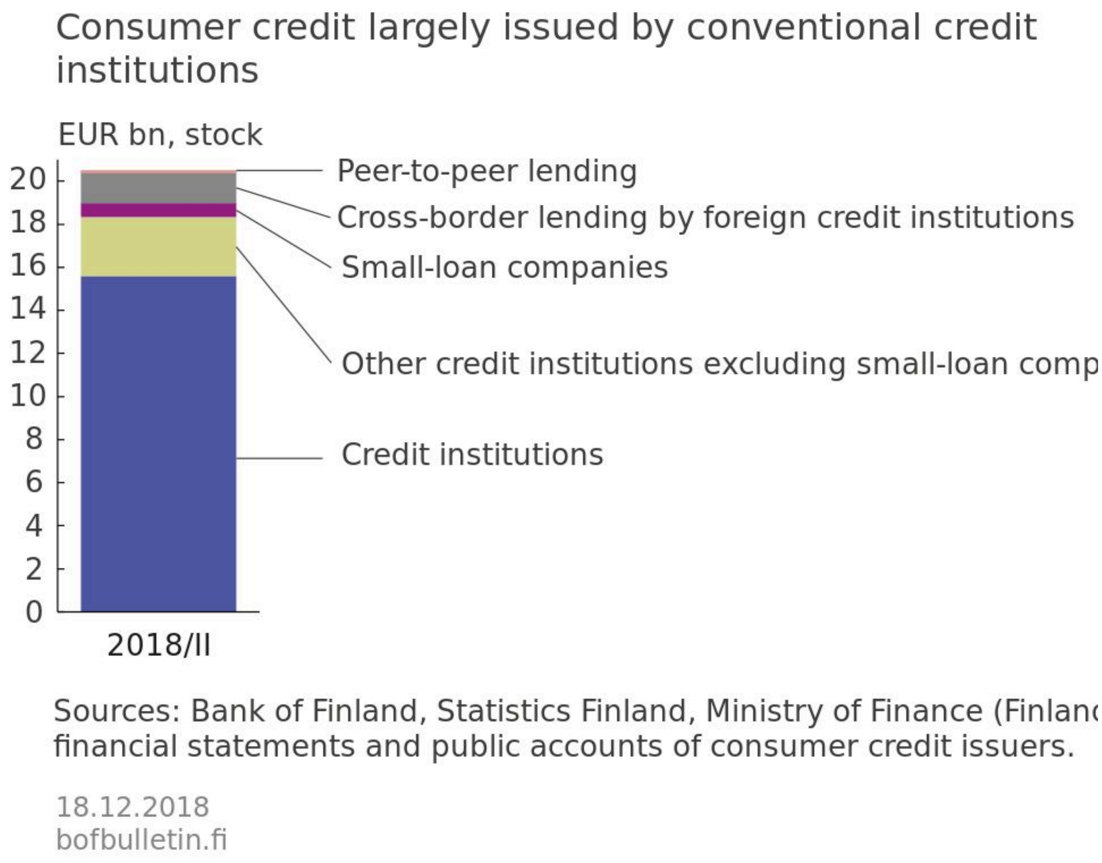
Housing company loans and consumer credit add to high and rising levels of household indebtedness. The macroprudential toolkit needs to be replenished with borrower-based instruments that take into account loan applicants’ repayment ability and are able to address the rise of household indebtedness as a whole. Nordea's redomiciliation has increased the size and structural vulnerability of the Finnish banking sector. Italy's budget crisis and Brexit proceedings have contributed to uncertainty in Europe. Cyber risks and climate change pose yet further challenges for financial stability.

Housing company loans a growing proportion of total household debt

Household indebtedness in Finland has continued to rise for a long time. It remains one of the most important structural vulnerabilities for the financial system, and its potency to amplify the economic cycle is widely recognised. Finnish household debt stood at about 128% of annual disposable income in mid-2018 — a twofold increase from the early 2000s (Chart 1). Indebtedness has especially been fuelled by housing-related loans, which at present account for slightly over

75% of aggregate household debt.[1]

Chart 1.



A growing proportion of households' housing-related debt is formally held by housing companies, where repayment liability is assumed by the company's shareholders. The stock of housing company loans has grown significantly over the past decade.[2] Briefly put, housing companies may use these loans to fund both renovation work and new-build construction, by placing the property they own as collateral.

In recent years, housing company loans have increasingly been used towards purchase of newly constructed residential dwellings, complementing — or even superseding — a function traditionally served by personal mortgage and buy-to-let mortgage loans. In housing company loans, a repayment share of the loan principal is determined for each residential unit. Owners then amortise their respective loan shares with a monthly financial charge to the housing company. This effectively allows homebuyers to take on smaller personal mortgage loans; in fact, a housing company loan might be used to fund a significant proportion (e.g. up to 70%) of a dwelling's debt-free price. In addition to homebuyers, housing company loans have become an increasingly important source of funding for professional investors, and this has had a material effect on the nature of these loans. When housing companies take loans from banks, the concentration risk of these loans is much greater if housing companies have a high degree of investor-ownership, as compared with ownership being diversified among residents.

The rise of housing company loans has important implications for the composition of households' housing-related debt. It is important to keep a broad view of household borrowing and total debt-servicing costs. To this end, the FIN-FSA updated its recommendations to credit institutions in May 2018 for assessing the repayment capacity of housing loan applicants.[3] Accordingly, financial charges associated with housing company loans, as well as the estimated impact of an interest rate rise on such, must be fully taken into consideration, irrespective of repayment-free periods. It is especially important that households assess their own repayment ability in situations where the transaction is financed with a large housing company loan as opposed to a regular mortgage loan.

The FIN-FSA Board took the decision to lower the maximum loan-to-collateral (LTC) ratio, i.e. the loan cap, for non-first time buyers from 90% to 85%, effective from July 2018. Housing company loans are to be factored into the LTC ratio. This effectively means that the combined value of a mortgage loan and the unit share of a housing company loan may amount to, but not exceed, 85% of a dwelling's debt-free price and additional collateral. The maximum LTC ratio for first-time mortgage borrowers remained unchanged, at 95%.

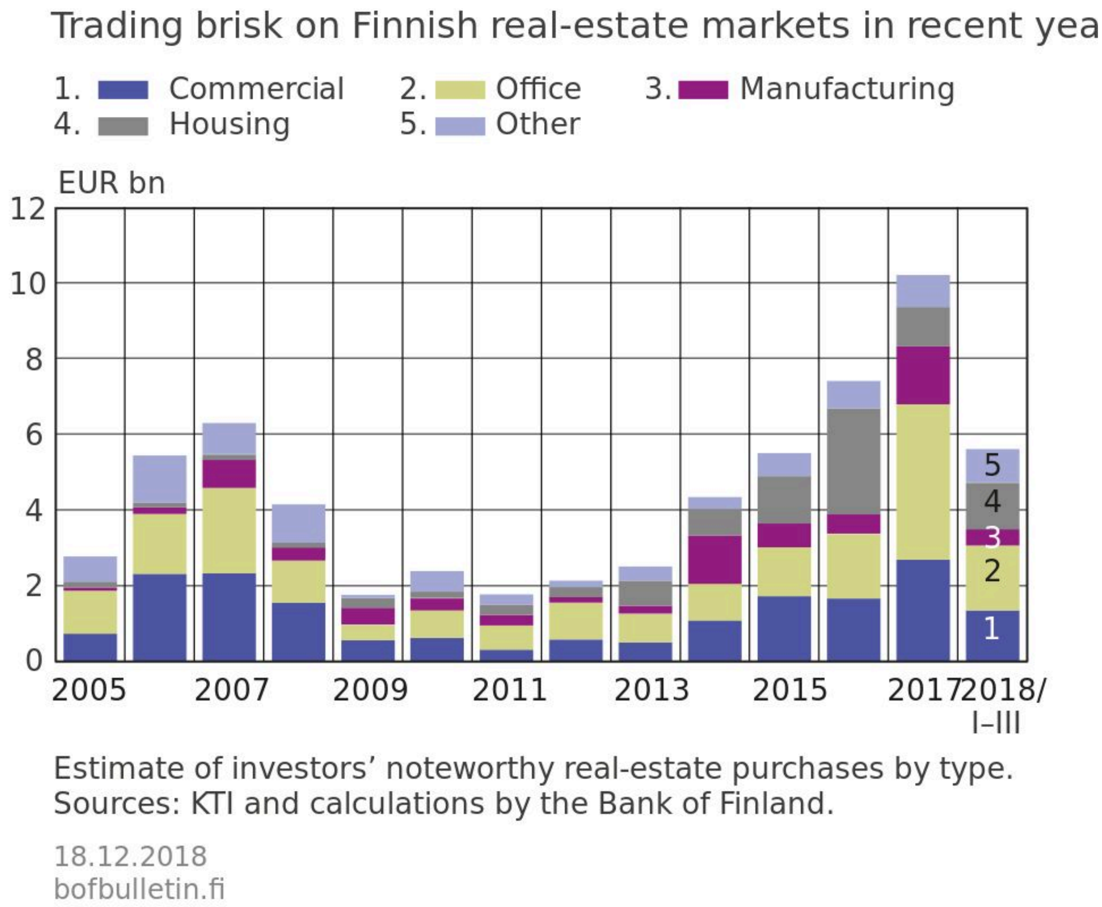
Consumer credit growth continues — data gaps in statistical reporting

Consumer credit is often advertised, for example, in connection with sales of consumer durables. The total stock of consumer credit has grown, but data coverage is incomplete, as information is only collected from a subset of lenders.

The vast majority of households' consumer credit is issued by credit institutions (Chart 2). According to data gathered by the Bank of Finland, consumer credit growth has continued at an annualised rate of about 5%, i.e. at a pace quicker than average in the 2010s. In September 2018, such credit comprised some EUR 15.8 billion. This figure only includes credit and overdrafts issued by credit institutions, and not, for example, peer-to-peer lending.

Consumer credit is not only issued by banks but also by other financial institutions. High-cost short-term credit has been the subject of much scrutiny in the public debate on debt. More colloquially known as 'payday loans', they are estimated to only comprise a small proportion of total consumer credit, but their growth has nevertheless been rapid. Further still, payday loans are often taken out by individuals who have problems with their personal finances.

Chart 2.



The volume of unsecured consumer credit has in particular seen brisk growth. Unsecured lending carries a higher credit risk than secured loans and is thus more frequently associated with higher interest rates and higher shares of non-performing loans.[4]

Overindebtedness and its prevention

To minimise the risk of repayment issues and default, borrowers' repayment ability must be realistically assessed. Consumers need good financial literacy, and lenders must assess consumers' credit worthiness. Yet even with these precautions in place, unexpected and misfortunate turns of events can give rise to repayment difficulties. In the worst case, a borrower may not possess the financial literacy needed to understand or compare the true costs of different credit options, or be able to compare these against his or her repayment ability over the long term. According to Suomen Asiakastieto, a data services company which provides consumer credit information, over 380,000 individuals in Finland have payment defaults on their credit records.[5] First entries are generally associated with consumer credit.[6]

Establishment of a positive credit register would help clarify the debt situation and prevent additional credit being issued to individuals with unsustainable amounts of old debt. This is particularly topical, as the Ministry of Justice published a report in September 2018 outlining the requirements for such a system. The report is in favour of establishing the register.

Indebtedness has been fuelled by a number of trends in the economy in recent years; low interest rate levels, extended mortgage maturities, amortisation-free periods, large residential shares of housing company debt, increased leverage in real-estate investment, and a proliferation of new consumer credit options have all contributed to an increasingly hazy overall picture of the risks posed by indebtedness.

High levels of debt make housing markets and the entire economy more sensitive to shocks. The more debt that a household possesses, the more likely it is to respond to changes in the economy by altering its consumption habits. When consumption is reduced, this has a detrimental effect on domestic businesses and employment levels. Banks may face credit losses as businesses struggle to adapt to a deteriorating operating environment, weakening banks' lending capacity in the midst of an economic downturn. Together, these factors can exacerbate an already ailing economy.

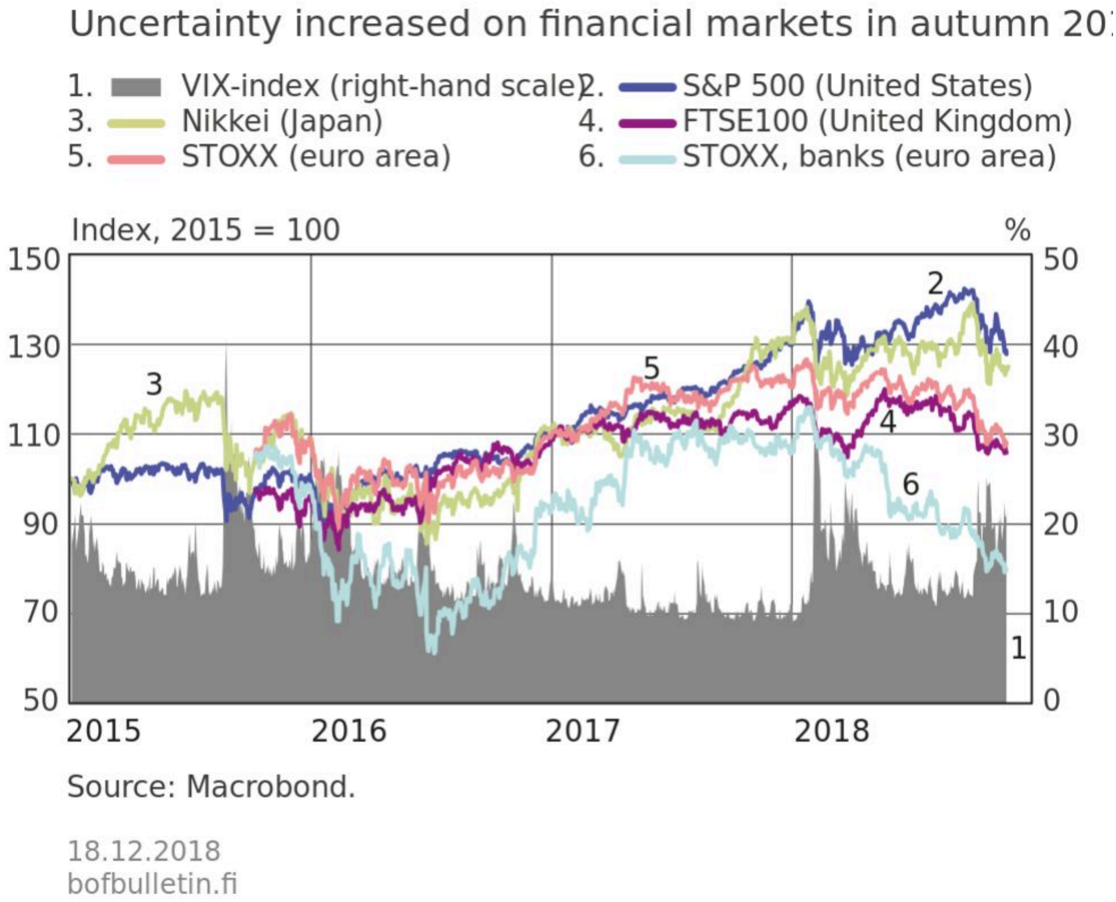
In the autumn of 2018 the Ministry of Finance established a working group tasked with exploring measures for curbing the rise of household debt, including that of housing companies, and its potential negative effects on the real economy. The working group is to draw upon both domestic and international experiences and will prepare the necessary proposals for changes to the national legislation. The Bank of Finland is keenly involved with the working group's efforts and contributes its own assessments of the various options considered.[7]

Finland's range of macroprudential tools should be complemented with instruments found useful in other countries.[8] Currently the tools available to Finnish authorities do not consider the loan servicing capacity of households, often measured in terms of debt to income or debt-servicing costs to income. In Finland, the cap on mortgage loans is now based on the value of all real collateral; this ought to be restricted so that the loan cap is limited solely to the value of the property for purchase, as is standard practice in many countries. New macroprudential tools need to be as broad as possible so that they are applicable to all sources of household debt, irrespective of lender or loan type.

Construction and real-estate investment brisk

Construction of new apartment buildings has continued at an unusually brisk pace since 2015 (Chart 3). The number of building permits granted is, however, beginning to flatten out, suggesting that the pace of construction is approaching an inflection point. Nevertheless, a large number of apartment buildings are expected to be finished in the years 2018–2019. Brisk construction, especially in growth centres, is likely to have contributed the rather moderate development of prices of existing residential properties. There are currently no signs of an overheating of the housing market at large. The market is, however, exhibiting significant price divergence, both with respect to a dwelling's size and location. Prices of one-room apartments throughout the Helsinki metropolitan area have risen the most.

Chart 3.

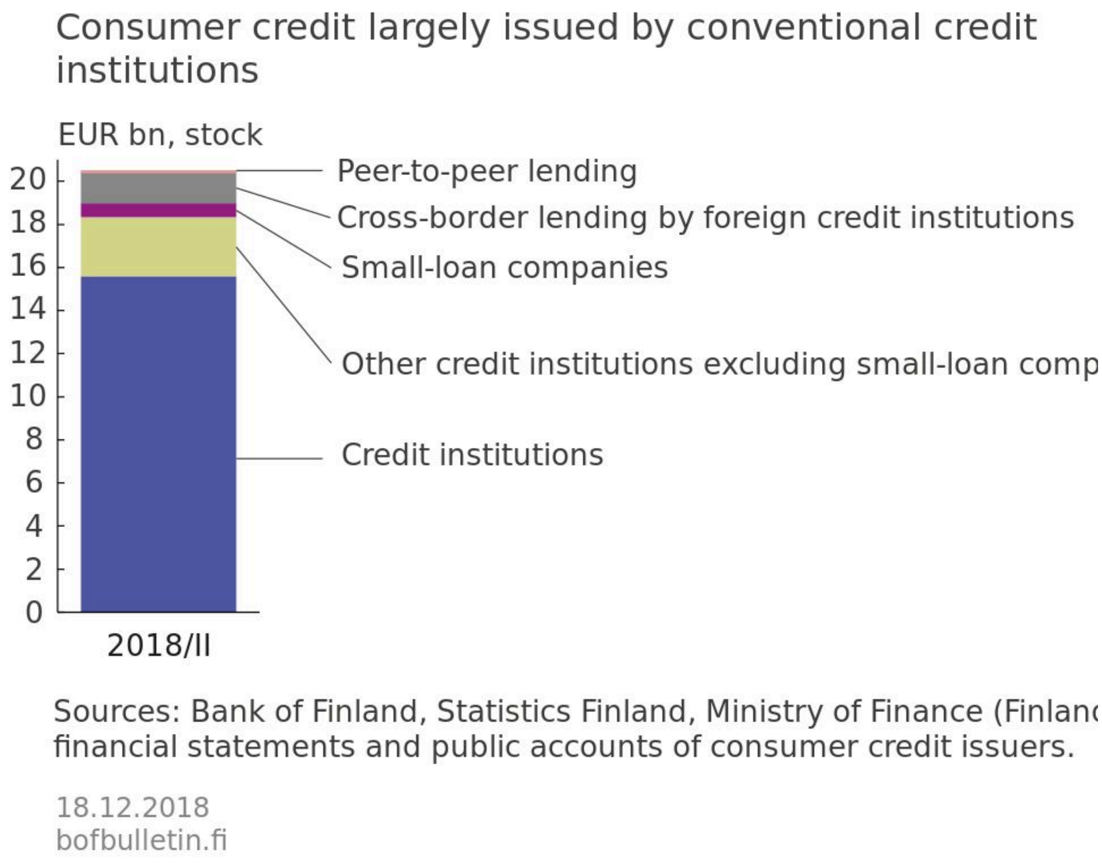


New-build construction on rented plots has increased in recent years. Under such an arrangement, investors own the plot that a property is built on and collect rent from the housing company who occupies it.[9] This can benefit construction companies in that it lowers the amount of capital needed for a building project, as capital usually earmarked for land purchase is freed. Housing built on rented plots is often advertised as having a lower purchase price; however, housing companies that pay rent on land need to make up for this by charging their residents higher management fees, compared with a situation where the housing company owns the plot itself. A dwelling's debt-free price does not include the per-unit share of the value of the plot, nor do monthly management charges paid to the housing company lower the plot's redemption price, should the owner of the apartment eventually decide to redeem its share of the plot from the investor. Furthermore, rents are typically subject to increases at regular intervals, and a plot's redemption price will rise with the general price level.[10] There is a risk that not only large housing company loans, but also the separation of plot ownership in housing purchase, will frustrate a homebuyer's ability to assess the total price and running costs associated with a property.

Office and commercial real-estate construction has continued briskly throughout 2018, although remaining at a moderate level by historical standards. The attention of building companies is largely focused on residential real estate instead of office and commercial spaces.

Finnish real-estate markets have remained humming. According to KTI, a data services company for the Finnish real-estate sector, the volume of noteworthy real-estate transactions reached EUR 5.6 billion during the first three quarters of 2018 (Chart 4), which is nevertheless about 25% less than a year earlier.[11]

Chart 4.



Interest from international investors in Finland's real-estate markets has remained high. Accordingly, foreign investment accounted for 58% of the volume of real-estate sales during the first three quarters of 2018. The growing presence of foreign investors bespeaks their search for yield and desire to diversify real-estate holdings. Commercial properties have seen their valuations rise in many central hubs in Europe. Returns are now being sought elsewhere – such as in Finland, with its reliable infrastructure and efficient rental markets. The Helsinki metropolitan area in particular is seeing an abundance of new commercial property and offices, which will spur competition between shopping centres and office spaces. However, with digitalisation and online commerce transforming the nature of retail and work, there is a risk of supply exceeding demand.

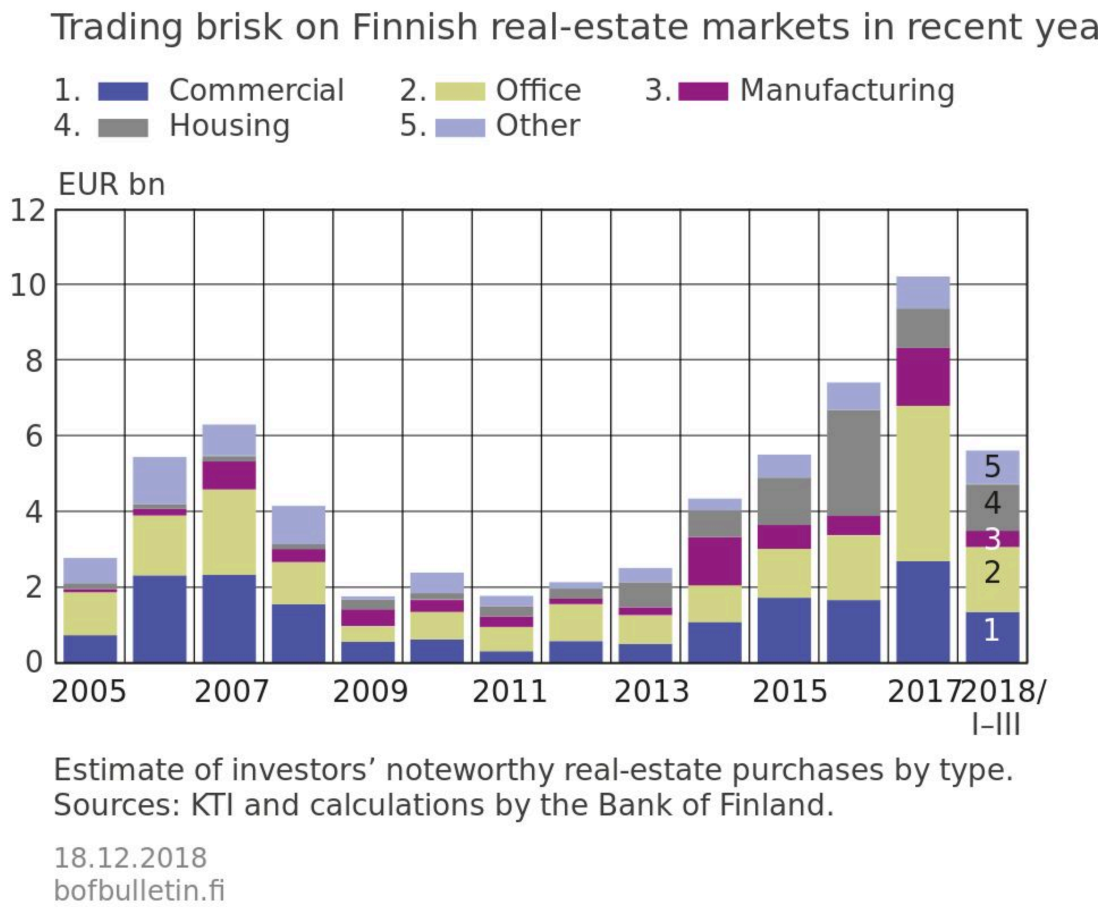
Capital adequacy of Finnish banks still among best in class in Europe

Credit institutions in Finland experienced slightly weakened profitability during the first half of 2018. Return on equity reached almost 8% in 2017, but this remained just shy of 7% as of mid-2018. The decline in profitability is explained especially by the rising costs of banks. Nevertheless, both the profitability and liquidity of Finnish credit institutions remain somewhat above the EU average.

Capital adequacy in the Finnish credit institutions sector weakened slightly on year-end 2017 to the end of June 2018, but remains well above the EU average. Credit institutions' CET1 ratio stood at 20.4% by end-June 2018, while total capital adequacy was 22.8% (Chart 5). In the EU, the average CET1 ratio was 14.9%. The slight decline in capital adequacy is primarily explained by a rising corporate loan stock in the first half of 2018.

The leverage ratio of the credit institutions sector has remained broadly unchanged: by end-June 2018 the ratio stood at 6.7%, compared with 6.8% at the end of 2017. The minimum leverage ratio requirement suggested by the Basel Committee on Banking Supervision is 3%, which means Finnish banks held more than twice the amount of required equity as of end-June 2018.

Chart 5.



Finnish deposit banks finance their lending not only with deposits but also by market-based wholesale funding. Market-based funding accounted for just over half (54%) of banks’ total funding. This exposes banks to volatility in the pricing and availability of finance.[12]

The credit institutions sector in Finland is large, concentrated and strongly interlinked with the Nordic financial system. Finland's and the other Nordic financial systems are vulnerable to housing market shocks as their households are indebted and their banks’ housing loan stocks large. Housing market shocks pose a threat to bank funding in the Nordics, as banks seek their market-based funding by issuing covered bonds.

Because of such structural vulnerabilities in the financial sector, Finland is to implement a structural capital buffer requirement, i.e. a systemic risk buffer. The buffer serves to solidify the capital positions of credit institutions, and thus improve the sector's resilience against systemic vulnerabilities. In June 2018 the FIN-FSA Board took the decision to set the systemic risk buffer at

3% for Nordea, 2% for OP Group, 1.5% for Municipality Finance, and at 1% for other credit institutions, respectively. The new requirement will become effective as of July 2019.

Nordea's relocation underscores the importance of the banking union

As a result of Nordea's redomiciliation, Finland's banking sector is now one of the largest in Europe relative to the size of the national economy. Similarly, Nordea is the single largest credit institution under the European banking union, when compared with the economy of its domicile.[13]

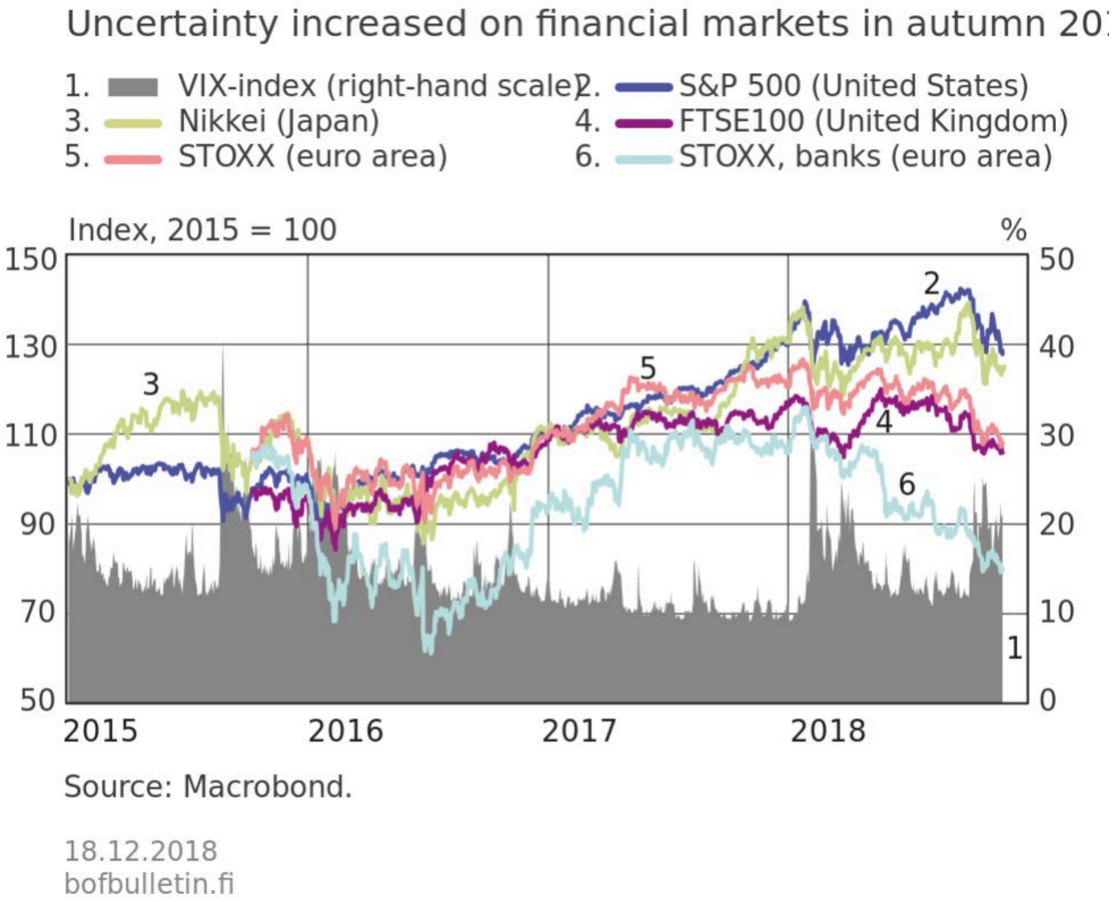
Following the bank's redomiciliation, Nordea is now under the prudential supervision of the Single Supervisory Mechanism. In practice, supervision duties are carried out in close collaboration between the ECB and the FIN-FSA. In addition, the supervisory authorities from the rest of the Nordics also contribute via supervisory colleges. Nordea operates subsidiaries such as mortgage banks throughout the Nordics; subsidiaries who pursue credit institution activities are subject to the supervisory framework of their respective domiciles.

The European banking union currently lacks a single deposit insurance scheme. Implementation of such a framework would prove especially important for a country like Finland, whose banking sector is large and concentrated. A credible single deposit insurance scheme would reduce the likelihood of bank runs in crisis situations and bolster confidence in the banking system. Bank's statutory contributions to the deposit scheme could be determined on a risk basis. Under this framework, banks who choose to pursue riskier activities, thus placing a greater burden on financial stability, would contribute more to the deposit scheme than low-risk banks. In addition to enhancing structural measures, more work is needed to ensure that banks are better equipped to withstand the idiosyncratic risks of their domiciles.

International financial stability threats have increased

Uncertainty increased on international financial markets in the autumn of 2018. This was most readily felt on stock markets, where volatility has increased and valuations have retreated (Chart 6). Weakening performance of several emerging market currencies against the US dollar, and the resulting pressure this puts on the sustainability of private sector debt, has raised concerns for global financial stability. In the euro area, uncertainty remains centred around Italy, whose sovereign bond yields have risen since May 2018. Political uncertainty has also depressed Italian bank shares in recent months and has increased their insurance premium against credit risk on derivatives markets, resulting in higher CDS pricing.

Chart 6.



The three most significant international threats to financial stability in Finland are related to the global securities markets, the sustainability of sovereign debt and problems related to the banking sector in the euro area as well as risks associated with the Swedish housing market.[14] The likelihood of a realisation of these risks has, in part, risen since spring 2018. Historically high valuation levels and low risk premia have increased global securities markets' exposure to price corrections, i.e. the sudden repricing of assets and risk premia. Still, recent market volatility has neither led to widespread nor long-lasting disruption in the transmission of finance. The large indebtedness of Italy's general government, together with political uncertainty and the banking sector's vulnerabilities, now constitutes a considerably greater threat to the euro area's financial stability than before. Sweden's housing market remains exposed to various risks. Uncertainty on the housing market has persisted at an unusually high level, even though the development of house prices has remained balanced after a decline in late 2017.

London is the financial hub of Europe, but this may be subject to change as the United Kingdom withdraws from the EU. In particular, a no-deal Brexit would especially prove testing for financial stability, as relocating operations from London to mainland Europe is no simple undertaking. In spite of positive news concerning negotiations, considerable risks remain on the path of the EU and United Kingdom forging a new partnership.[15]

Brexit's risks to financial stability could be realised through several channels. These include a weakening of the real economy, heighted volatility on markets as uncertainty increases, and statutory restrictions on financial market entities and functions. The most significant risks are related to the requirements for UK financial market entities to operate within the European Union and vice versa (e.g. licences), derivatives contracts, eligibility of collateral, and the handling of securities that are traded in London. Supervisors and authorities have urged market participants to commence with preparations in good time.

Digitalisation casts spotlight on cyber security matters

Digital technology, with its potential to disrupt established industries and bring about new business models, is continuing its transformation of the financial sector. In addition to new opportunities, the future of banking will need to contend with a host of new challenges, such as those related to cyber security and climate change.

Digitalisation of the financial sector has already sparked robust debate over the past few years.[16] From a regulatory perspective, one key challenge is to implement a framework that strikes a suitable balance between innovation and stability. Customers and businesses should benefit from innovation while the financial system remains stable, secure and inclusive at the same time. Digitalisation holds vast promise for new operating models in the financial sector, and clear examples of this can already be seen in the field of payments.

The Payment Services Directive will help bring to market new and easy-to-use ways of making retail payments, while instant payment infrastructures will make sure these transactions happen in real time. These new technologies, combined with contactless payment systems, promise to make electronic payment as quick and easy as cash.[17]

Cyber risks are the downside of digitalisation, however, and will become increasingly at the forefront as financial services continue to digitalise. It is therefore with good reason that the cyber risks faced by Finnish banks are treated as operational risks. Recent attention has focused on the threat posed by potential systems-level cyber risks, if risks consolidate around a single and critical market entity or if there is underlying risk of contagion.[18] The threat of a financial crisis being sparked by cyber risks outside the financial system or by disruptions in clearing and settlement systems should be given due consideration.

Climate change a concern for the financial sector

Climate change poses a major challenge for the years and decades ahead. Although many predictions suggest that the full brunt of climate change will only begin to manifest after the 2050s, its effects are already evident in the occurrences of extreme weather events.

Climate change will increase the financial sector's exposure to both material and transitional risks. Material risks refer to the economic losses caused by storms, floods, and other extreme weather events. Insurance companies will have to settle covered losses, while sufferers of uninsured damages will be left to contend with the financial burden themselves. Banks will also face growing credit risks, should borrowers suffer material losses that effect their repayment ability and/or which impact the material value of loan collateral. Moreover, if a region becomes effectively uninsurable because of climate change, this will have a direct bearing on the geographical distribution of manufacturing hubs and new-build construction. Older properties might see their values decline and lose eligibility as collateral.

Transitional risks refer to the issues that arise when a firm shifts away from a carbon-intensive business model to one that is low emission. Businesses will not only have to contend with climate policy and regulation, but also with shifting consumer preference and technological change. Companies may become less valuable during this transitionary period, particularly if a company's revenue is largely dependent on carbon-intensive industry.

Central banks and supervisory authorities the world over have embarked on a common effort to raise their thoughts on climate change and its implications for financial stability. The Bank of Finland is currently partnered with other authorities in a cooperation network, whose mission is to further understanding on the risks of climate change, and to create a framework for best practices that account for such risks. These principles are eventually to be introduced to the financial industry at large, in close cooperation with regulators and financial companies.

Footnotes

1. This figures does not include online lending by foreign credit institutions. For more detail, see following section, ‘Consumer credit growth continues — data gaps in statistical reporting.’ ↑
2. Comprehensive statistical data on households’ housing company loans are so far unavailable, but estimates have been made with regard to their volume. One such

estimate by Statistics Finland put the total loan stock of residentially-owned housing companies at some EUR 19.3 billion as of June 2018. According to an estimate by the FIN-FSA, privately and domestically owned housing corporations held an outstanding loan stock of EUR 12.5 billion — excluding construction-stage financing — during the same period. Similarly, a survey conducted by the Bank of Finland put the same loan stock, but including construction-stage financing, at EUR 15.9 billion the year previous (See Vilkas rakentaminen kasvattaa asuntoyhteisöjen lainakantaa (Finnish only)). ↑

3. See "Risks increasing in construction stage financing and housing corporation loans". ↑
4. According to the FIN-FSA, 1.5% of mortgage loans issued by credit institutions were non-performing at the end of June 2018, whereas the share of non-performing loans in consumer credit was 3.7%. "Valvottavien taloudellinen tila ja riskit 30.6.2018 Suomen finanssisektori on vakavarainen – äkillisiin korjausliikkeisiin kuitenkin varauduttava" (Finnish only). ↑
5. According to the National Administrative Office for Enforcement, private receivables under enforcement, excluding alimonies, reached EUR 2.3 billion at year-end 2017. This represents an increase of about EUR 200 million on the year previous. ↑
6. Suomen Asiakastieto press release 2 March 2017 (Finnish only): "Valmiiksi ylivelkaantuneet hakevat lisää luottoja". ↑
7. The report is due for completion by March 2019. See further (Finnish only) "Työryhmä selvittämään kotitalouksien velkaantumisen rajoittamista". ↑
8. In addition to the Bank of Finland's Financial Stability Assessment (Financial Stability Assessment 23.5.2018), authorities including the European Systemic Risk Board (warning on the vulnerabilities in the residential real estate sector of Finland 22.9.2016) and IMF (Concluding Statement on the Finnish economy 6.11.2018) have suggested that macroprudential instruments tied to borrowers' incomes would prove effective in curbing household debt growth. ↑
9. Rented plots are typically owned by real-estate funds with primarily domestic institutions as investors. ↑
10. A plot's redemption price may, for example, be tied to a cost-of-living index. ↑
11. Several individual transactions however, such as Sponda's sale to Blackstone, account for a large share of 2017's sales volume. ↑
12. The banking sector's loan-to-deposit ratio increased from 122% at the end of 2017 to 131% at the end of June 2018. In the EU, the average loan-to-deposit ratio stood at about 119% at the end of March 2018. Finland also has credit institutions who do not accept deposits at all and instead finance all of their lending through market-based funding. Accordingly, the entire credit institutions sector's loan-to-deposit ratio stood at 189% at the end of June 2018. ↑

13. In its fiscal year-end statement in 2017, Nordea's consolidated balance sheet was reported at EUR 582 billion, which is approximately 2.6 times the volume of Finland's GDP in the same year. See also (Finnish only): Nordean kotipaikka siirtyi Suomeen – Pankkisektori kasvoi yhdeksi Euroopan suurimmista. ↑
14. See Koskinen and Laakkonen (2018) Repricing of securities markets' risk premia still most significant threat to global financial stability. Bank of Finland Bulletin analysis article. ↑
15. As of the time of writing, it remained unclear whether or not the UK Parliament would accept the proposed withdrawal agreement on 11 December. ↑
16. Nordic banks go digital. ↑
17. Contactless payments replace both chip and pin along with cash. ↑
18. (Finnish only) Kyberriskit huomioitava, jotta rahoitusvakaus säilyy. ↑

Key words

banking sector, climate change, consumer credit, digitalisation, financial stability, indebtedness, mortgage credit granting