EDITORIAL

Regulation has strengthened the financial system's resilience

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The resilience of banks, firms, and households is being put to the test as the Finnish economy and the economies of its important trading partners experience a sharp contraction. However, financial institutions' solvency and liquidity positions have been strengthened significantly since the global financial crisis, and borrowers are in many respects on sounder footing than they were before the financial crisis or during the Finnish banking and economic crisis of the early 1990s. Strong capital adequacy ensures that banks are better equipped to lend to households and firms. A well-functioning banking sector together with government relief measures will bolster the economy's outset for growth after the crisis.

The economic news from around the world has proven exceptionally bleak recently, as the effects of the uncertainty and containment measures prompted by the coronavirus pandemic reverberate through the economy. The Finnish economy will contract this year because of the containment measures put in place domestically but also because of lower demand for Finnish exports. The crisis confronting the Finnish economy is global and broadly based. It is not enough that only Finland should survive the coronavirus pandemic. For our economy to recover, it is important that our trading partners get back on their feet as quickly as possible.

Economic conditions in other countries have a bearing on the Finnish financial system and its stability. The deterioration of the economic outlook has been reflected in financial markets as heightened volatility and as occasional strains in access to market funding. The Nordic banking sector is strongly interlinked, and a number of Finnish banks have significant receivables from abroad—especially from the rest of the Nordics. This exposes our financial system to disturbances stemming from outside Finland.

The crisis has disrupted the operations of many firms and reduced their revenues. The hardship of businesses has already translated into a significant number of lay-offs. To prevent these lay-offs from turning into redundancies and the difficulties of profitable firms from leading into bankruptcies, it is of primary importance that the business sector is helped through the worst of the crisis. Banks must be able to provide liquidity to sound businesses and channel monetary policy stimulus from the central bank to the non-financial corporate sector.

The European Central Bank (ECB) and European supervisory authorities have lowered their capital requirements, made use of flexibility in the interpretation of regulation and eased banks'reporting requirements. The Finnish Financial Supervisory Authority Board and other Nordic macroprudential authorities have lowered their capital requirements for banks. These measures have strengthened the ability of banks to offer their customers flexibility in loan repayment schedules in light of the coronavirus pandemic. They have also increased banks' lending capacity and improved the availability of finance to non-financial corporations. Some firms lack the collateral necessary for a loan withdrawal or are ill-positioned to borrow during a time of heightened economic uncertainty. Government-backed loans and direct subsidies are thus also needed to help firms overcome their financial distress.

Bank solvency is much stronger today than it was in the 1990s, and interest rates are at a significantly lower level. Foreign currency-denominated loans are rare, and the Finnish housing market has not experienced a similar overheating as in the late 1980s. During the banking and economic crisis of the early 1990s, the solvency of the Finnish banking sector was so weak that it could not even channel funding to profitable firms.

The crisis resilience of the banking system has been reinforced systemically over the past decade since the global financial crisis. These efforts are now supporting banks' ability to lend and are strengthening their ability to absorb potential credit losses. The economic recession caused by the coronavirus pandemic is in many respects different from the global financial crisis or the Finnish banking crisis of the 1990s. The loan losses that banks potentially face have been modelled based on historical data.

The Bank of Finland has drawn attention to household debt and emphasised the importance of strong bank capitalisation. When compared with levels during the banking and economic crisis of the early 1990s or the global financial crisis, Finnish household debt is now historically high. For households to be able to service their debts in the future, it is important that the financial distress suffered by firms does not lead to permanent job losses and increased long-term unemployment.

The acute and broad-based economic crisis precipitated by the coronavirus containment measures demonstrates the importance of a well-functioning financial sector. It is important that banks, firms and households prepare for adversity by building buffers and strengthening their finances during the good times. It is also important that the macroprudential toolkit is developed further. The report left by the Ministry of Finance's working group offers a good starting point for this development. This will strengthen the ability of the financial system to withstand future crises, beyond the coronavirus pandemic.

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Key words

corporate finance, COVID-19, COVID-19 virus pandemic, credit losses, crisis resilience, regulation