A broader set of tools needed to prevent financial crises

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Financial crises and other serious financial disruptions may be caused by several different types of risks. Macroprudential policy, designed to prevent such crises, needs a more diversified set of tools than are available in Finland at present. Although the Board of the Financial Supervisory Authority already has access to a number of macroprudential instruments, there is reason for the toolkit to be supplemented. There is a need for instruments to ensure capital adequacy in the Finnish banking sector and, if necessary, prevent the housing market overheating.

New tools for preserving financial stability

Macroprudential policy is a new segment of economic policy designed to prevent banking crises and other financial disruptions. The aim is to reduce the huge macroeconomic costs of crises and ensure sound financial intermediation for non-financial corporations and households. Crises may build up if, for instance, lending grows too fast and banks or other financial institutions are not sufficiently prepared for the risks stemming from excessive credit growth.

Such systemic risks can be mitigated by macroprudential instruments, e.g. by requiring banks to hold more capital as a safeguard for sound business, or by imposing restrictions to curb lending. As a new macroprudential instrument, Finland should enable the use of an additional capital requirement protecting banks' operating capacity against structural systemic risks (systemic risk buffer), such as is already in place in many EU and Nordic countries. In addition, the Board of the Financial Supervisory Authority (FIN-FSA) should be empowered to restrict the maximum size of new housing loans relative to the borrower's debt-servicing ability, to limit loan maturities and to set requirements for loan repayment.

Prompt action may be needed to address risks

In Finland, macroprudential competence has been conferred on the FIN-FSA Board. In order to meet its responsibilities, it must have access to a sufficiently wide range of macroprudential instruments. Consequently, since the beginning of 2015, the new Act on credit institutions has provided FIN-FSA with a variety of instruments based on the relevant EU legislation, such as a countercyclical capital buffer requirement for all domestic bank risks, to be activated as necessary.

In its first macroprudential decision of March 2015, the FIN-FSA Board noted that there were no grounds for adopting a countercyclical capital buffer requirement or other macroprudential tools at that time, as e.g. developments in housing prices, lending and the external balance of the economy did not signal growth in systemic risks.

The conduct of macroprudential policy is complicated by the fact that several, highly different risks can lead to financial crises and thus need to be averted by a broad set of diverse tools. As risks have the potential of expanding rapidly, the preventive instruments should be promptly available. However, even if legislation permits access to the instruments, this does not necessarily mean their immediate, active use, as their adoption should be decided separately, taking into account current and foreseeable threats to stability.

Despite FIN-FSA already having a number of macroprudential tools at its disposal, incorporation of new instruments into domestic legislation is worth considering. Two new instruments in particular will be required.

A systemic risk buffer in line with the common approach

To date, Finnish legislation has mainly provided for macroprudential instruments capable of preventing cyclical systemic risks, such as setting higher capital requirements on the banking sector if lending accelerates. Moreover, capital surcharges of a permanent nature may be assigned to the systemically important institutions.

However, Finland will need specific tools to improve the structural resilience of the entire banking sector, as the sector is highly concentrated and important for the provision of finance to the economy as a whole (for structural risks in the banking sector, see the article 'Concentrated banking system amplifies banking crises'). It is precisely for these types of structural factors that the EU Capital Requirements Directive enables the activation of an additional capital requirement for banks, known as the systemic risk buffer.

The application of a systemic risk buffer requirement is possible in most EU and Nordic countries, but not in Finland for the time being. As the requirement is already in place in Sweden and Denmark, it will need to be implemented in Finland to prevent regulatory cross-border differences from triggering transfers of own funds from one country to another within Nordic banking groups, which would be an undesirable development for the functioning of the financial system.

It must be possible to rein in housing market overheating

Imbalances on the housing market have traditionally played an important role in the genesis of serious financial crises. As banking business in Finland is strongly focused on housing loans, macroprudential policy must also be poised to influence lending for house purchase with a diversified array of tools.

To mitigate systemic risks on the housing loan market, the FIN-FSA is already empowered to take measures so as to increase capital requirements for housing loans. Additionally, in July 2016, a maximum loan-to-value (LTV) ratio, the 'loan cap', will become effective, restricting the size of a new housing loan to a maximum of 90%[1] of the current value of the collateral provided for the loan. The FIN-FSA may lower the loan cap by ten percentage points, where necessary.

Higher bank capital requirements for addressing credit risks in housing loans and the loan cap are useful tools for safeguarding banks' risk resilience, as they support the adequacy of bank capital and ensure the presence of strong collateral for housing loans. Even so, these tools may turn out to be insufficient for containing the mutually reinforcing spiral of housing debt and higher house prices. The impact of a loan cap is eroded by the tendency of rising house prices to boost collateral values and, by extension, the permitted size of housing loans (for the observed link between house prices and housing debt, see the article 'One country, many housing markets').

As a new macroprudential instrument for curbing excessive increases in house prices and households' housing debt, the FIN-FSA Board could be empowered to restrict, whenever required, the maximum size of new housing loans relative to the borrower's debt-servicing capacity. Making the maximum size conditional on e.g. disposable income would prevent growth in housing loan size in an economic upswing and indirectly prevent excessive fluctuation in housing prices. To avoid overheating on the housing market, it would also be justified to allow the restriction of loan maturities and the setting of requirements for loan repayment.

The current condition of the Finnish housing market does not require tightening of the requirements. However, a responsible decision-maker will prepare in good time for any

1. The restriction will be 95% in the case of loans taken out by first home buyers.

changes that may be required.

Tags

maximum loan-to-value ratio, housing markets, systemic risk buffer, macroprudential instruments, macroprudential policy