FINANCIAL STABILITY ASSESSMENT

Household debt and banking sector concentration pose risks for Finland

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Finland's domestic financial system has continued to function well despite the prolonged recession. Short-term risks to the stability of the domestic financial system relate particularly to weaker-than-forecast developments in the Finnish economy and risks developing on the international financial markets.

Macroprudential measures need to be tailored in line with the foreseeable risks to stability. There is no call to tighten cyclical requirements, as the economic situation is difficult and lending is moderate.

Households have continued to accumulate debt despite lacklustre mortgage lending in recent years. There no signs of significant overvaluation in housing prices in Finland, but the high level of debt makes households more vulnerable than before in the event of a fall in house prices, a rise in interest rates or negative shocks to the economy.

In conditions of prolonged low interest rates, Finland must be prepared for possible overheating on the housing market or excessive growth in mortgage lending. Looking ahead, it is important to put together a package of measures to ensure housing market stability. As part of this, we should consider what would be an appropriate maximum size of housing loan relative to the borrower's debt-servicing capacity, the maximum length of such loans and loan amortisation requirements.

The structure of the Finnish banking sector makes it particularly vulnerable, and the consequences of banking crises could therefore be exceptionally severe. Finland's banking system is among the most concentrated in the euro area and dependent on foreign finance; it is also strongly interlinked with the other Nordic countries, but not so heavily regulated.

The potential impact of these structural vulnerabilities should be reduced by ensuring banks' capacity to bear risk. They must maintain strong capital adequacy in order to ensure their ability to lend in all circumstances. The authorities should be equipped with internationally harmonised tools to ensure this.

The operational reliability of the financial market infrastructure supports financial stability by enabling the smooth operation of payment systems and efficient collateral management. National preparedness and attention to cyber security are fundamental to ensuring operational reliability. Banks must ensure their electronic services can work without disruption in all situations.

The financing options for non-financial corporations need to be diversified. The European Commission initiative for a Capital Markets Union will improve corporate funding options and create a foundation for economic growth. As sources of funding outside the banks increase, it will be necessary to forestall any related new risks to stability.

Risk-taking on financial markets has increased

The prolonged period of low interest rates, investors' increased search for yield and abundant market liquidity are causing a build-up of risks on international financial markets that may also spill over to the Finnish financial system.

The need to generate adequate returns on investment in an operating environment of low interest rates and easily available finance may induce investors to underestimate risks inherent in some investments. Underestimation of risks and strong demand for assets can lead to prices overheating, triggering, in a worst-case scenario, major asset price bubbles. Price bubbles, particularly in assets largely used as collateral, would be a matter of concern for financial stability. In addition, asset price bubbles are always linked with an inefficient allocation of economic resources.

The greatest risks from growth in financial intermediation outside the banking sector relate to the ability of (possibly new) providers of finance to assess and price the risks correctly, and to financial innovations. Higher prices of assets and their use as collateral increase the risk of strong procyclical growth in the provision of credit outside the banking sector, which is an opaque area subject to less stringent regulation and supervision than bank lending.

Economic developments and greater-than-foreseen fluctuations in lending pose domestic risks

The stability of the domestic financial system is exposed to both downside risks in the economy and risks associated with stronger-than-foreseen fluctuations in lending. In addition, the domestic banking system is structurally vulnerable: the consequences of banking crises could be particularly serious in the concentrated Finnish banking system.

Many financial crises have been preceded by excessive credit growth. A commonly applied indicator for measuring perilously rapid credit growth is the large trend deviation of the ratio of private sector credit to GDP: if credit grows faster than GDP for a long time, the risks from unsustainable debt accumulation and rising asset prices will increase.

Finland witnessed brisk credit growth in the first post-millennium decade, which caused the credit-to-GDP gap to widen considerably (Chart 1). The value of the indicator has diminished since 2010 amid a slower pace of credit growth. Estimates also point to moderate credit growth in the immediate years ahead.

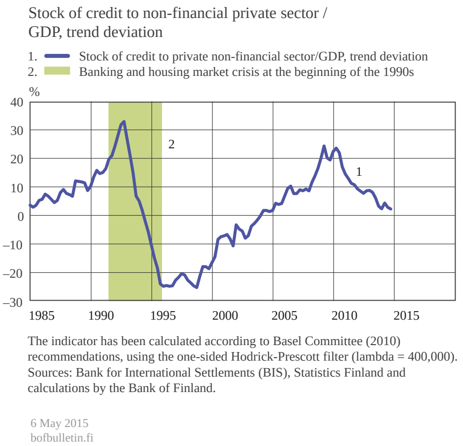

Chart 1

Macroprudential policy,[1] designed to strengthen banks' risk resilience and to contain the credit cycle, needs to be formulated so as to support effective financial intermediation in the economy. Given Finland's strained economic situation, it is vital to ensure that macroprudential measures will not prevent sound bank lending, thus putting a drag on economic recovery. With no signs pointing to excessive credit growth, it is justified for the present to avoid imposing higher countercyclical requirements on banks through the activation of macroprudential instruments.

The risk assessment is, however, surrounded by uncertainties, whose impact and development are subject to close monitoring (see the article 'Alarming signs of a banking crisis'). The main uncertainties relate to the prevailing exceptionally low level of interest rates and the ample liquidity on international financial markets. Low interest rates add to the attraction of debt: liquidity abundance makes it easier for banks and the largest non-financial corporations to raise funds on financial markets, among other factors.

Low interest rates and abundant liquidity underpin a pick-up in lending in Finland, too. Even so, the provision of credit is being held back, in part, by the predicted weak performance of the real economy: although the growth outlook for the economy is better

1. Macroprudential policy refers to the exercise of public power with a view to impacting the financial system and preventing and mitigating systemic risks, safeguarding the stability of the financial system. In Finland, the powers for making macroprudential decisions have been conferred on the Board of the Financial Supervisory Authority. The need to take policy actions is assessed in cooperation between the key authorities.

than envisaged earlier, it is still rather subdued.

Household debt up, house prices down

The biggest domestic threats to stability relate mainly to the significant level of household debt. The level of debt continues to grow, albeit at a decelerating pace. The bulk of household debt is housing debt.

Relative housing prices have continued to decline slowly (Chart 2), in line with the economy's muted growth prospects. Housing prices do not currently signal significant overvaluation, but vulnerabilities stemming from considerable household indebtedness and potential declines in house prices constitute major sources of uncertainty and risks to the stability of the financial system.

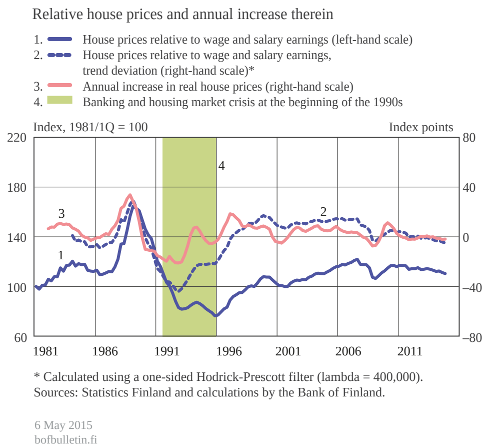

Chart 2

However, particularly over the longer term, overheating on international financial markets and demand pressures on housing property or other assets may also cause domestic asset prices to rise strongly (see the article 'Low interest rates stimulate but also create risks'). Sharp simultaneous increases in asset prices and debt levels would provide a significant element of vulnerability for domestic financial stability.

Finland must be prepared for housing market risks

Potential overheating on the housing market or excessive growth in lending for house purchase need to be addressed promptly and forcefully. If housing market risks are seen to increase, banks' resilience must be improved in order to safeguard their lending capacity and, if necessary, to rein in credit growth. Going forward, consideration must also be given to adoption of a package of measures to secure stability on the housing market.

Of the macroprudential instruments currently in place in Finland, the setting of a higher countercyclical capital buffer requirement would probably have a very limited impact on the housing loan market (see the article 'Tightening regulation has only a limited impact on loan margins'). Targeted measures that increase bank capital requirements for housing loans are more suitable for preventing stability threats related to lending for house purchase. Such measures would improve banks' ability to cope with the effects of a housing price collapse that could result from an overheating of the housing market.

The application of higher capital requirements for housing loans would also tend to raise interest rates on new housing loans, thereby curbing lending and housing market overheating. If higher requirements were targeted at housing loans, this would avoid any direct increase in lending rates on corporate loans.

However, with a view to safeguarding stable developments in housing prices and lending for house purchase and mitigating the adverse effects of housing market crises in the future, a broad package of macroprudential measures would merit consideration. Such a package should enable normal housing market activity but prevent excessive fluctuations in house prices and lending; it should also contain household debt accumulation and ensure that banks have adequate capital buffers in place to secure their lending capacity and cover potential loan losses on housing loans. Looking ahead, the details, design and impact of the measures should be examined in cooperation between the various authorities, but it could include the following elements.

Higher capital requirements for housing loans could act as one pillar of the package. Another could be the maximum loan-to-value (LTV) ratio (loan cap) due to enter into force in Finland in July 2016, which will restrict the amount of a housing loan relative to available collateral. However, the stabilising impact of the loan cap on the housing market will be eroded by, among other things, the tendency of higher housing prices to also boost collateral values and, by extension, the housing loan size permitted by the loan cap.

The ongoing process of reducing the tax deductibility of interest payments on housing loans is contributing to housing market stability. This process should be continued, as a part of the whole, at least at the scheduled pace.

To supplement the package of macroprudential policy measures geared to stabilising the housing market, other instruments would also be needed as safeguards to prevent excessive credit growth from feeding an upward spiral in housing prices. These measures could include restrictions on the maximum size of a housing loan relative to the borrower's debt-servicing ability and requirements regarding housing loan maturity and loan repayment (see also the article 'A broader set of tools needed to prevent financial crises').

Making the maximum size of a housing loan conditional on the borrower's disposable income would stabilise the housing market, particularly in those regions where house price increases and housing debt have been identified as being more substantial than elsewhere in Finland (see the article 'One country, many housing markets'). Moreover, there could be a case for setting restrictions on housing loan maturity and requirements on loan amortisation. In Finland, housing loans with very long maturities and unamortised loans have so far been rare. Experience from other Nordic countries shows that, if these types of loans were to become widespread, they could significantly fuel overheating on the housing market.

Finnish banking system structurally vulnerable

In Finland, the banking system plays a major role in financial intermediation. The operational capacity and strength of the banking system are therefore of the utmost importance for domestic financial stability. Finnish authorities must have access to internationally comparable tools for ensuring the banking sector's capital adequacy and other operational capacity.

Finnish banks' risk resilience has remained strong and has actually improved slightly. An indication of this is the banking sector's stronger capital adequacy and larger loss buffers. Even so, the domestic banking and financial sector includes structural vulnerabilities that expose the system to long-term risks.

The structural vulnerabilities of the domestic financial system relate to the large size of the credit institutions sector relative to the economy, the sector's high degree of concentration (Chart 3) and its strong links with the equally strongly concentrated Nordic credit institutions sector.

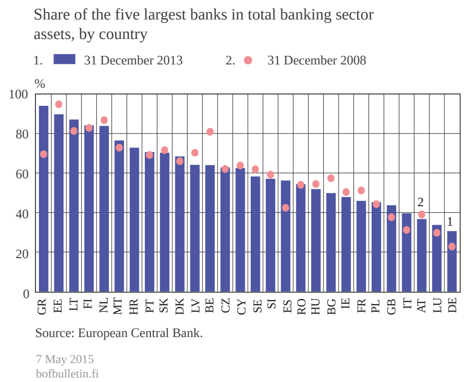

Chart 3

The Finnish banking sector's structural vulnerabilities cannot be removed quickly by simple measures, but their impact can be reduced by improving banks' risk resilience.

Owing to the vulnerability of the banking sector, it is important for banks to maintain their current strong levels of capital with a view to preserving their lending capacity under all circumstances. In order for macroprudential policy to ensure the adequacy of bank capital, the commonly applied tools enabled by EU legislation must be available in Finland.

Under the Act on credit institutions, additional capital requirements for systemically important credit institutions will enter into force at the beginning of 2016. The Financial Supervisory Authority is responsible for identifying the relevant institutions and defining the additional capital requirements for them. Even if these capital surcharges are taken into account, bank capital requirements in Finland are lower than in e.g. Sweden and Denmark. Consequently, in accordance with the generally applied practice in both the Nordic countries and EU Member States, Finnish legislation should enable the imposing of a systemic risk buffer requirement (see also the article 'A broader set of tools needed to prevent financial crises').

Via its funding, the Finnish banking sector is exposed to disruptions on the international financial markets, as the funding gap between bank loans granted and bank deposits received – which the banks cover by raising funds mainly on the international financial markets – is still large (see the article 'Concentrated banking system reinforces crises'). On the other hand, the use of covered bonds as a source of bank funding has increased. This has contributed to the strengthening of Finnish banks' funding structure, as the share of long-term debt instruments in funding has increased.

Because of Finnish banks' relatively strong reliance on market funding, particular care must be devoted to the banking sector's liquidity.[2] In recent years, Finnish banks have succeeded in reducing their dependency on market funding, while being able to increase the amount of their liquid assets. It is important for this development to continue so that banks can better withstand potential disruptions in financial market liquidity. If the favourable trend were to halt in the future, this would force an assessment as to whether the stability of bank funding, in particular, could be supported by macroprudential policy.

Operationally reliable infrastructure provides base for financial stability

The great importance of the financial market infrastructure[3] means that its operational reliability needs to be secured under all circumstances. The infrastructure must cope with different problem situations that could hamper operation of the financial markets, for example, by hindering financial intermediation. National emergency preparedness and contingency arrangements constitute an essential element of technical reliability (see the article 'Better preparations for disruptions in basic banking services required'). Even in the face of serious stress, the financial infrastructure should continue to operate according to pre-scheduled timeframes.

In recent years, cyber security has rapidly emerged as a key component of operational reliability (see the article 'Could a cyber attack lead to financial crises?'). Digital financial markets are vulnerable to cyber attacks if preparations for cyber threats are inadequate. An operationally reliable infrastructure enables frictionless payments and smooth functioning of the securities markets, maintaining public confidence in the financial system as a whole.

Market developments following the financial crisis and post-crisis regulatory reforms

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2. Banks will be bound by the upcoming EU liquidity rules, whose first step consists of phasing in a liquidity coverage ratio (LCR) for banks, starting in October 2015. This is a requirement for banks to hold sufficient levels of high-quality liquid assets to cover their payment obligations over a stressed period of one month. The net stable funding ratio (NSFR) requirement, which will have an impact on bank funding, is still under preparation within the EU.

3. Financial market infrastructure refers to different payment and settlement systems that ensure transfers of assets in due form. This infrastructure is invisible for ordinary users, as they are only in contact with their own service providers (e.g. banks), who handle business transactions via the infrastructure. See the summary of the Bank of Finland oversight assessment of key systems, http://www.suomenpankki.fi/en/rahoitusjarjestelman_vakaus/infrastruktuuri_valvonta/Documents/Infrastructure_critical_to_the_Finnish_financial_market.pdf.

have substantially boosted demand for collateral.[4] This growth in demand has given rise to discussions on the possibility of collateral drying up in crisis situations. As the amount of collateral available has not increased, the use of existing collateral assets must be intensified by facilitating their transfer across borders and between different markets.

A more uniform infrastructure and links between securities settlement systems promote the transferability of collateral, improving efficiency and lowering costs in collateral management. The forthcoming pan-European Target2-Securities (T2S) platform[5] will foster uniform settlement processes for central securities depositories (see the article 'A new era in securities settlement and custody markets'). The purpose of the settlement platform is to enable cross-border settlement on the same conditions as applied domestically. The platform will improve liquidity management by offering an opportunity to benefit from collateral that is available on one market so that it can be used on other markets.

In the coming years, financial market regulation will change and in conjunction with different initiatives, such as the Capital Markets Union, the operational models of the sector as a whole may undergo revision. But at the same time as the large patterns change, the banking sector will also need to improve the operational reliability of the systems that are visible to customers.

Capital Markets Union will bring diversity to corporate finance

Although surveys of finance suggest that the provision of finance to small and medium-sized enterprises (SMEs) has also functioned reasonably well in Finland (see the article 'Banks' share in corporate finance has increased'), it is important to improve the operation of the financial system by removing barriers to new alternative forms of corporate finance and by eliminating bottlenecks therein.

In summer 2014, the European Commission submitted an initiative concerning all EU Member States for building a Capital Markets Union, scheduled to be established by 2019. The Commission published a Green Paper on the objectives and overall content of the Capital Markets Union in February 2015, requesting different parties to deliver their opinions on the project during the course of the spring. The aim is to diversify the current EU financial system and remove barriers to the development of SME finance, in particular, in the single market. The details of the Capital Markets Union are only at the specification stage, and in autumn 2015 the Commission is expected to provide a more precise action plan for the project.

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4. Collateral is used to manage counterparty risks in different types of transactions, such as central bank market operations, derivatives trading and trades between market participants. If one party to a transaction were to encounter difficulties prior to the conclusion of the transaction, the underlying collateral assets could be used for covering potential losses incurred by the other party, in part or in full.
5. T2S is a settlement platform offered by the Eurosystem to European central securities depositories. It harmonises securities settlement and post-trade practices. T2S will go live in June 2015, with various central securities depositories migrating to the system in four waves. Finland will join the system in the last wave in February 2017.

The Capital Markets Union is a project that merits support and may foster the supplementing of Europe's bank-centred financial system with market funding, thereby creating opportunities for economic growth. Capital markets integration is an important way of improving conditions for corporate finance both in Finland and throughout the EU. Integration also means a more effective sharing of risk across national borders, while also bolstering the stability of the financial system and the operation of Economic and Monetary Union.

Despite the significant benefits of the Capital Markets Union, it should be noted that, with increased funding taking place outside the banking sector, the related risks will also grow (see the article 'Structural changes in banking have paved the way for shadow banks'). The Capital Markets Union must be accompanied by increased attention to the prevention of stability threats from increasing risks. Market regulation and supervision need to be harmonised and, if necessary, centralised in a manner that is appropriate for the evolving structure of the capital markets.

Particular attention must be focused on the prevention of stability threats building up outside the banking system and affecting the financial system as a whole. It is therefore necessary to evaluate and develop macroprudential instruments that are capable of addressing the build-up of systemic risks on the capital markets. For example, excessive cyclical fluctuation related to securities financing transactions could be reduced by setting either counter cyclical or fixed haircut requirements for the underlying collateral assets.

Tags

threats to financial stability, systemic risks, macroprudential policy