Finland alerted to household debt

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The European Systemic Risk Board (ESRB), which is responsible for macroprudential oversight of the EU's financial system, has issued a warning to Finland concerning the medium-term vulnerabilities related to household indebtedness and lending for house purchase. For purposes of risk mitigation, more efficient instruments should be made available to the Finnish authorities to limit the maximum size of new housing loans relative to the loan applicant's debt-servicing capacity. There are, however, no threats to the stability of the Finnish financial system in the short term.

The European Systemic Risk Board (ESRB)[1], which is responsible for macroprudential oversight of the EU's financial system, has drawn attention to the vulnerabilities related to the Finnish housing market and to the inadequacy of the powers available to the Finnish authorities to address such risks. According to the ESRB warning to Finland, published at the end of November 2016, the vulnerabilities arising from high household indebtedness in particular may, in the medium term, jeopardise financial and macroeconomic stability in Finland.[2]

The Bank of Finland has in recent years repeatedly drawn attention to the structural vulnerabilities inherent in household indebtedness and lending for house purchase.[3]

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1. See appendix: What is the European Systemic Risk Board and how does it operate?
2. The ESRB conducted an assessment of the housing market risks of all EU Member States and issued a warning to seven other Member States in addition to Finland. See the ESRB's press releases.
3. Bank of Finland Bulletin 2/2015, 5/2015 and 2/2016.

The Bank has also underscored the need to expand the macroprudential toolkit available, in order to contain an increase in such risks and vulnerabilities.

The Bank of Finland concurs with the ESRB's assessment of the risks involved in the high and increasing level of household indebtedness, which is unevenly distributed among households. Sustainable economic recovery in Finland cannot permanently rest on growing household debt, which erodes the ability of both households and the overall economy to adjust to future disruptions. For example in the face of rising unemployment or falling house prices, there may be a sudden contraction in the consumption of highly-indebted households, in particular, which would put the stability of the financial system and the economy at peril.

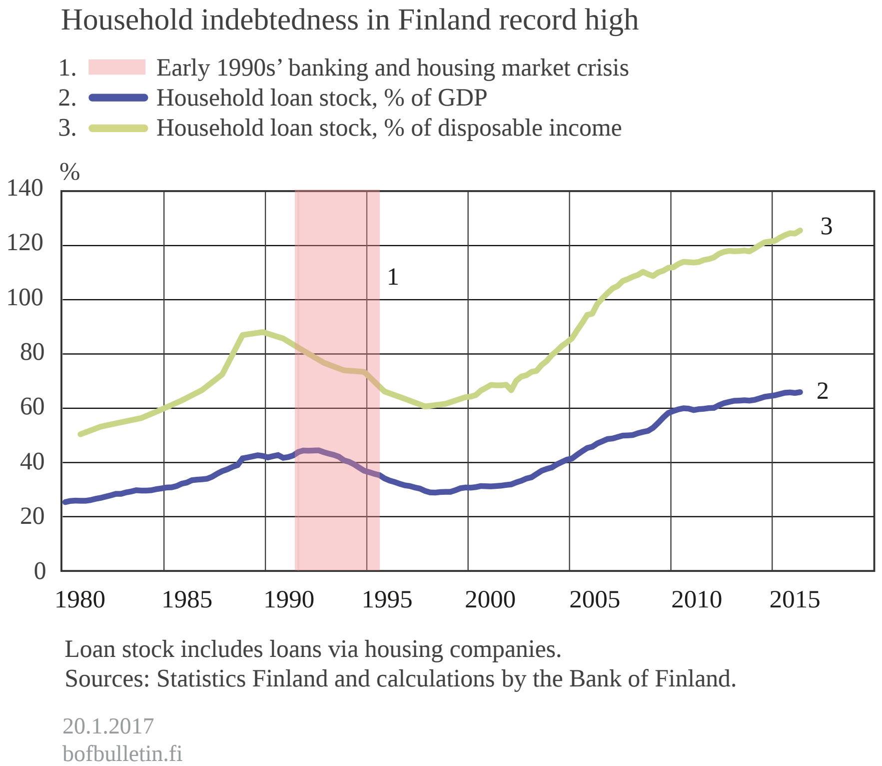
The vulnerability of the Finnish financial system is further increased by the special structural features of the banking sector, such as a high level of concentration and close interlinkages with the banking systems of the Nordic countries. Notwithstanding this, the Finnish banking sector has remained well capitalised and profitable amidst a difficult operating environment.

To ward off the risks identified by the ESRB it is vital that the Finnish authorities be provided with more powerful macroprudential instruments to address household indebtedness and related systemic risks. Although there are no imminent threats to financial stability at present, the capacity to deploy macroprudential instruments should be built in good time.

Short-term housing market risks have stabilised

Household indebtedness has continued to grow in Finland. The aggregate debt of the household sector relative to disposable annual income has climbed to over 125% (Chart 1).

Chart 1.



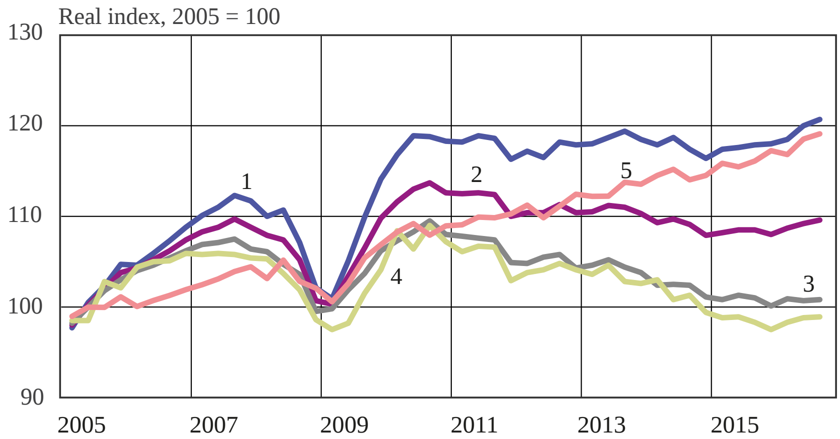
By contrast, the short-term risks to financial stability stemming from the Finnish housing market have stabilised against the background of moderate developments in the growth rate of the housing loan stock and house prices.

There are no signs of any widespread overvaluation of house prices in Finland. House prices are close to their long-term average nationwide, relative both to rents and to the level of wage and salary earnings. There are, however, large regional differences in house prices between growth centres and the rest of the country (Chart 2). The protracted period of slow growth has left the Finnish economy increasingly exposed to a major slowdown in global growth. The realisation of such a negative risk could also cause a drop in house prices.

Chart 2.

House prices are diverging

1. Helsinki Metropolitan Area*
2. Whole country
3. Finland excl. Helsinki Metropolitan Area
4. Satellite municipalities**
5. Helsinki Metropolitan Area relative to the rest of Finland



*Helsinki, Espoo, Vantaa, Kauniainen.
**Hyvinkää, Järvenpää, Kerava, Riihimäki, Kirkkonummi, Nurmijärvi, Sipoo, Tuusula, Vihti.
Sources: Statistics Finland and calculations by the Bank of Finland.

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Finnish banks demonstrate good resilience to direct risk exposures from lending for house purchase, against the backdrop of strong capital adequacy ratios and own funds of high quality. In addition, regular amortisation of housing loans reduces the risk that the market value of the house of a mortgage-holding household would fall below the outstanding loan value in the event of a crisis.

Finnish macroprudential toolkit needs beefing up

Several measures designed to mitigate the risks highlighted by the ESRB are either in place or in the pipeline in Finland: tax deductibility of mortgage interest is gradually being curtailed, the maximum size of new housing loans relative to loan collateral was restricted by the loan cap (loan-to-value or LTV ratio) introduced on 1 July 2016, and the Financial Supervisory Authority (FIN-FSA) has announced that it will impose a minimum requirement on banks' average risk weights for housing loans by July 2017. In addition, the capital conservation buffer requirement for credit institutions and the additional capital requirements for systemically important credit institutions (O-SIIs) provided for under EU regulations were put in place in Finland without application of the transitional periods allowed under EU legislation.

In its warning focused on medium-term vulnerabilities, the ESRB deems the measures adopted appropriate, but possibly insufficient. The ESRB draws special attention to the

Finnish authorities' lack of powers to restrict the maximum size of new housing loans, for example in recognition of the household's loan-servicing burden. In its assessment of the risks to the Finnish financial system, the International Monetary Fund (IMF) arrived at a similar conclusion.[4]

In order to complement Finland's current macroprudential toolkit (Table), the Ministry of Finance is in the process of drafting legislation allowing the authorities to impose on credit institutions a discretionary additional capital requirement – a systemic risk buffer (SRB) – based on the vulnerable structure of the banking system.

Table.

Finland's macroprudential toolkit *

Macroprudential instrument	Deployment
Countercyclical capital buffer requirement for credit institutions.	Set at 0% for QI2015–QIV2016 , reviewed on a quarterly basis.
Additional capital requirement for systemically important credit institutions (O-SIIs).	Additional capital requirements of 0.5–2.0% were set for 4 credit institutions, effective as of 7 January 2016, to be reviewed annually.
LTV ratio for housing loans.	90% of collateral value (95% for first-time buyers) as of 1 July 2016, may be tightened, to be reviewed on a quarterly basis.
Articles 124 and 164 of the CRR: increase in risk weights for real-estate mortgaged credit.	Not deployed.
Article 458 of the CRR: adoption of stricter national measures to address macroprudential risks.	Preparations are underway to set a 10% floor for average housing loan risk weights, to become effective by 1 July 2017.

* In addition to deploying formal macroprudential instruments, the financial supervisor may also impose discretionary additional requirements (Pillar 2 requirements) on credit institutions, based on the institution's financial position as revealed by supervision.

Sources: FIN-FSA and Bank of Finland.

There is no visible imminent threat to the stability of the Finnish financial system. The Bank of Finland finds the macroprudential measures adopted to be sufficient in the short term. It is nevertheless important that the authorities be ready to intervene promptly in

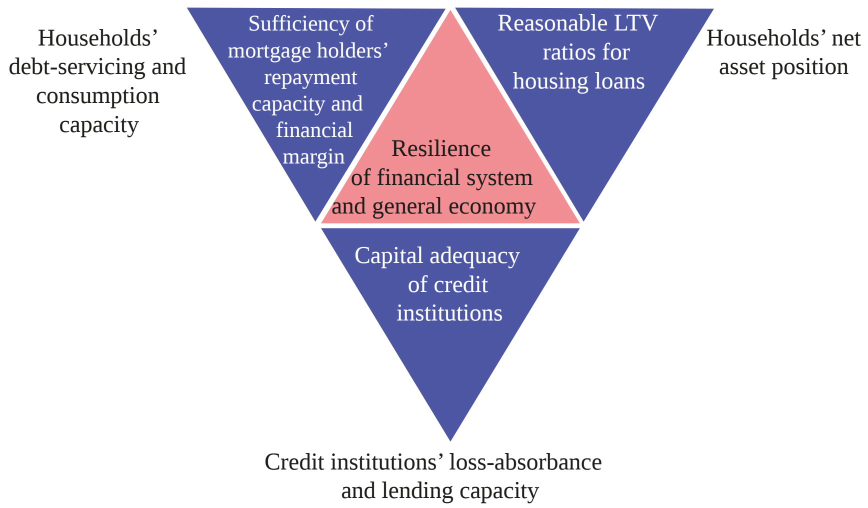
4. See the IMF's assessment of the vulnerabilities inherent in the Finnish financial system, https://www.imf.org/external/pubs/cat/longres.aspx?sk=44437.0 s.]

the event of an excessive reinforcement of the credit cycle. The tools necessary for countering threats must be readily available in good time.

With a view to safeguarding the stability of the Finnish financial system, the macroprudential decision-making body in Finland – the FIN-FSA board – should have access to appropriate instruments for ensuring 1) the sufficiency of the repayment capacity and financial margin of mortgage holders, 2) reasonable LTV ratios for housing loans and 3) the sound capital adequacy of credit institutions (Chart 3).

Chart 3.

Resilience of financial system to mortgage risks rests on a number of pillars



Source: Bank of Finland.

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The Finnish authorities do not currently have sufficient powers to ensure the adequacy of debt-servicing capacity in the household sector (Chart 3, left-hand side upper triangle). In fact, ever since 2010 the FIN-FSA has recommended that banks, in their credit granting process, test the repayment capacity of a customer in a scenario of an interest rate of 6% and a repayment period of 25 years. Expansion of the macroprudential toolkit with the instruments mentioned by the ESRB and IMF would give the authorities more robust powers to ensure the loan-servicing capacity of mortgage holders.

Vulnerable structure of the banking sector

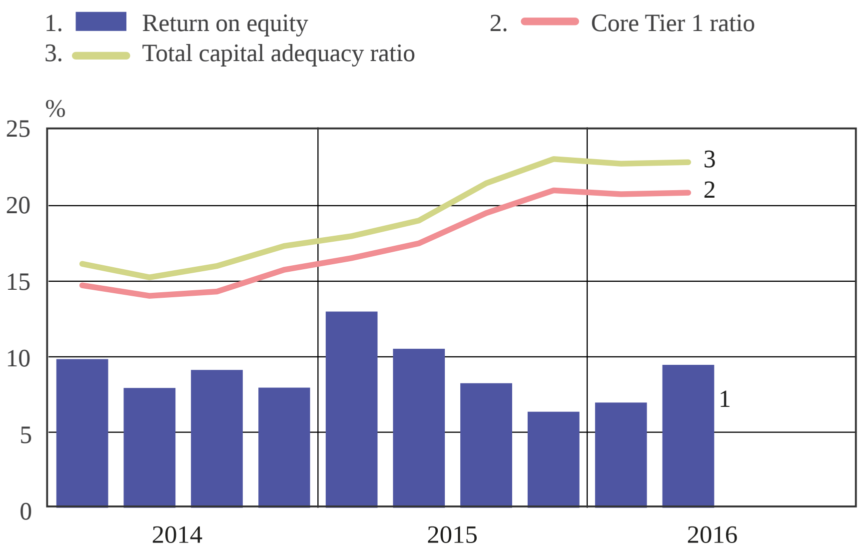
The Finnish banking sector has remained stable regardless of the challenging operating environment. Finnish banks are profitable and well capitalised, on average. However, the vulnerability of the Finnish financial system is accentuated by the high level of concentration in the banking sector: at the end of 2015 the two largest players together held a market share of nearly two-thirds of MFI loans and deposits.

Other structural vulnerabilities of the banking system include a high share of housing loans in the banks' credit portfolio, the low average risk weights on housing loans employed in banks' capital adequacy calculations, banks' high dependence on external market funding and the close interlinkages of the Finnish banking sector with the Nordic and Baltic banking systems.

The profitability of the domestic banking sector has remained relatively good despite the low interest rate environment and sluggish economic growth (Chart 4). Capital ratios remained high in the early part of 2016, with banks' own funds and risk-weighted assets practically unchanged. Capital adequacy in the banking sector continues to be characterised by a high share of Core Tier 1 capital in own funds. The credit stock is of good quality and stable, while non-performing assets are low.[5]

Chart 4.

Finnish banking sector remains well capitalised



Source: Financial Supervisory Authority.

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The interest rate on financial and non-financial corporations' deposits payable on demand has fallen very close to zero. A few banks have begun to apply negative rates to the deposits of their largest institutional customers. Households' current account deposits have expanded, although interest rates on them have also fallen in the latter part of 2016. This probably reflects households' appreciation of the liquidity of these

5. Valvottavien taloudellinen tila ja riskit 2/2016 ('Financial position and risks of supervised entities 2/2016', in Finnish only).

deposits, although deposit rates are exceptionally low.[6]

The phased-in introduction of the Liquidity Coverage Ratio (LCR) for banks began in October 2015. Banks' balance sheets must show a sufficient amount of high-quality assets that can be easily converted into cash at low cost, as a measure against an estimated net outflow of funding in stressed adverse circumstances lasting for 30 days. The Finnish banking sector easily fulfils the LCR requirement for 2016.

Digitalisation, non-bank competition and the prolonged period of low interest rates has been reflected in banks' business models, especially in development of tools for mobile payment. In addition, some banks are diversifying into multiple services, expanding their business beyond traditional banking, e.g. into the health and welfare business.

With the establishment of Banking Union and the Single Supervisory Mechanism (SSM), direct supervision of the four largest Finnish credit institutions was taken over by the ECB. The largest of these, the Nordea Bank Finland group (NBF), will be converted from a subsidiary into a branch of its Swedish parent company at the beginning of 2017. This is likely to reduce the aggregate balance sheet of the domestic banking sector substantially, considering that NBF accounted for 62% of the aggregate balance sheet of Finnish banks in June 2016.[7] All the assets and liabilities related to the NBF's financial business in secured bonds have already been transferred to the balance sheet of Nordea Mortgage Bank.[8]

Insurance and employee pension institutions play a major role as investors

Insurance and employee pension institutions rank among the major institutional investors in Finland. The significance of such large-scale investors for financial stability is mainly demonstrated by their investment behaviour, as any forced sales of securities undertaken by them in a crisis may give rise to serious problems on the capital markets. Consequently, the macroprudential authorities need to assess the investments of insurance companies, as well as their solvency.

Insurance companies do no operate in an easy environment. In a low-interest-rate environment, insurance companies' exposures increase, as technical provisions are to be valued at market price in the solvency analysis according to the international Solvency II Regulatory Framework for insurance companies introduced at the beginning of 2016. Furthermore, fixed income investments of the highest investment grade yield weak returns, especially in the case of new investments. Notwithstanding this, the share accounted for by fixed income investments in insurance companies' asset portfolios has remained unchanged, and the companies' risk appetite has not been extended, on

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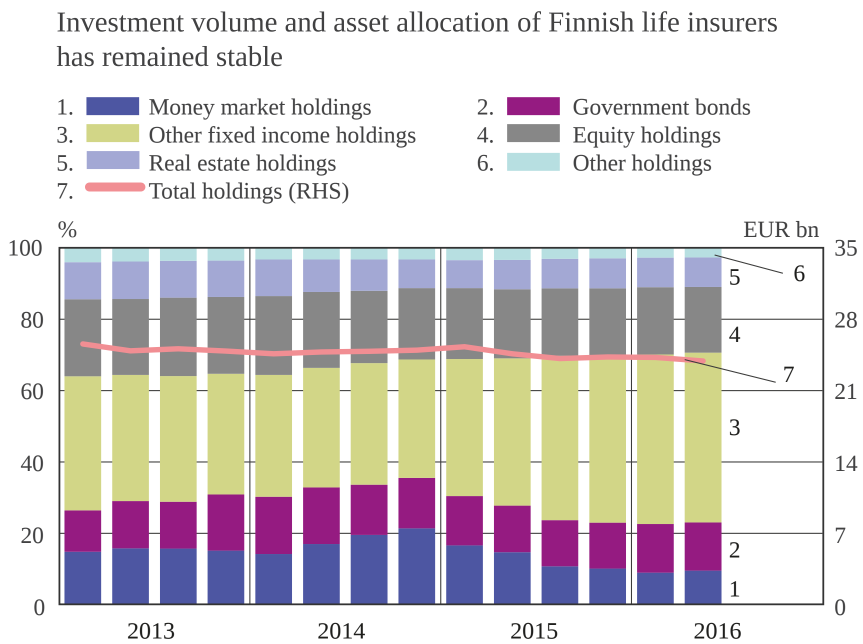
6. The position taken by the Ministry of Finance to negative reference rates helps safeguard banks' net interest income. In spring 2016, the Ministry proposed that lenders have the right to charge the whole amount of the housing loan margin also in the context of negative reference rates, if so provided in the credit agreement.
7. The domestic banking sector does not include Finnish branches of foreign credit institutions.
8. The restructuring of Nordea scarcely registers in the Bank of Finland's MFI statistics, which also includes the Finnish branches of foreign credit institutions.

average (Chart 5).[9]

Chart 5.



Excludes derivatives.
Source: Financial Supervisory Authority.

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The insurance portfolio of Finnish life insurance companies is mainly composed of unit-linked policies, where the investment risk is borne by the policyholders. The volume of guaranteed-return investment policies is lower in Finland than in many other countries. This facilitates the functioning of Finnish life insurers in a low interest rate environment.

As a measure against market disruptions, the FIN-FSA has granted several life insurance companies permission to apply the long-term transitional provisions under the Solvency II Regulatory Framework for insurance companies. At the end of June 2016, all Finnish insurance companies fulfilled both the solvency and minimum capital requirements.[10]

The average investment return of employee pension institutions was nil in the early part of 2016. The low level of interest rates notwithstanding, the share of fixed income investment in the asset allocation increased. Total investment risk declined in step with the fall in the portfolio share of equities. This strengthened the risk-based solvency

9. See article 'Korkotason laskusta huolimatta henkivakuutusyhtiöiden vakavaraisuus hyvällä tasolla' ('Life insurance companies demonstrate good solvency despite the fall in interest rates' in Finnish only).
10. The widespread application of the transitional provisions under the Solvency II Regulatory Framework impairs comparison of the solvency of insurance companies. Some companies have volunteered to release solvency data without application of the transitional provisions, but comparable data for all insurers will at the latest be available in spring 2017, when the companies publish annual reports on their solvency and financial position.

position of the institutions. According to the FIN-FSA's assessment, the resilience of the employee pension institutions remains good.[11]

Room for improvement in financing growth companies

Efficient financial intermediation is vitally important for economic growth. Finland's financial system is dominated by the banking sector, and small and medium-sized enterprises (SMEs) are particularly dependent on bank-based finance. High-growth SMEs generate new jobs, thereby supporting employment and, more generally, the economy as a whole.

Although access to corporate finance has remained relatively unconstrained according to recent survey data, growth-oriented SMEs have been frustrated by the availability and terms of financing making it harder to finance their projects.[12] Such companies' funding needs are also greater than for SMEs on average.

According to a survey by the ECB,[13] excluding interest payments on loans, Finnish SMEs have seen a rise in their costs. Collateral requirements and other loan conditions, such as covenants and guarantees, have tightened. Nevertheless, the availability of bank funding for SMEs in Finland remains one of the best in Europe: 80% of applicants were granted loans either equal or close to the full amount requested. This ratio has remained broadly constant since 2014.

Collateral requirements are particularly frustrating for SMEs who require financing but whose primary assets are intangible. Newly established and rapidly growing SMEs often have short credit histories, which can prove detrimental to the availability and terms of finance.

The corporate sector's consolidated interest-bearing debt reached around 78% of GDP in June 2016 (Chart 6). Of this debt, 37% consisted of overseas loans, which were primarily used by business concerns to finance internal direct investments. Omitting this relatively fluctuant component from our analysis reveals that the 2014–2015 trend of shrinking corporate debt-to-GDP ratios came to an end in 2016. The stock of domestic corporate loans issued by Finnish monetary financial institutions (MFIs) increased by slightly over 2% in 2016.

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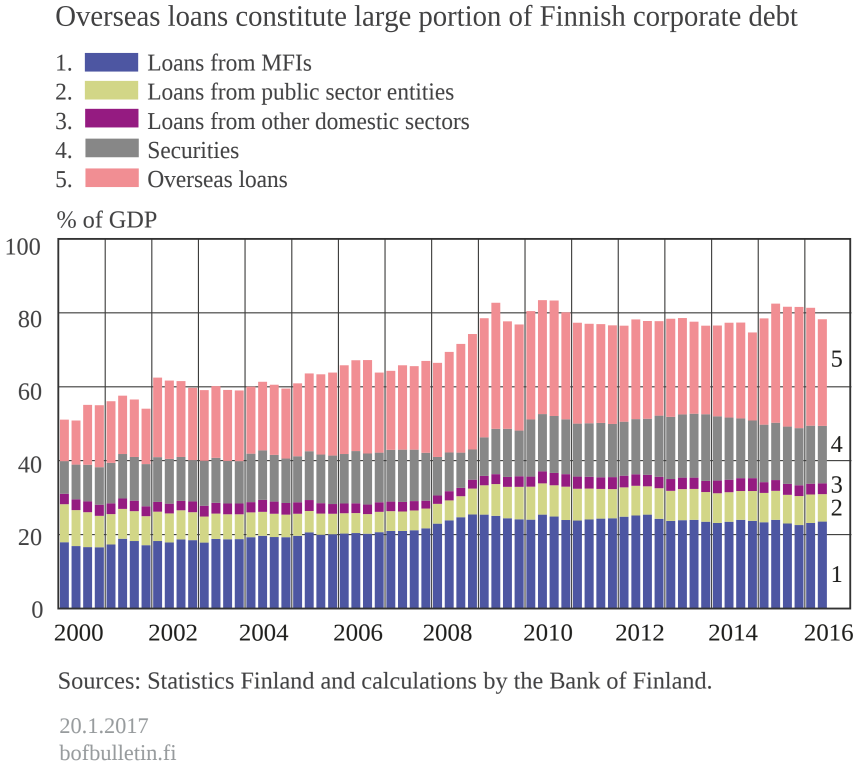
11. See article 'Työeläkesektorin alkuvuoden alavireinen vakavaraisuuskehitys pysähtyi, mutta haasteet jatkuvat tulevina vuosina' ('The sluggish development in solvency in the employee pension sector witnessed in the early part of the year was reversed, but there are further challenges in the years ahead', in Finnish only).
12. Survey by the Federation of Finnish Enterprises. PK-yritysbarometri 2/2016. Finnish only.
13. Survey on the access to finance of enterprises (SAFE).

Chart 6.



Increased competition within the banking sector as well as greater diversification in funding sources would facilitate better access to corporate finance. The reduction of banks' local branch networks remains a continuing trend in Finland. As banking operations become increasingly centralised and local branches' tacit knowledge on corporate clients lessens, this could change the availability and conditions of corporate loans.

Swedish housing markets risks are a cause for concern in Finland, too

Cross-border financial interlinkages increase the Finnish financial system's vulnerability to serious disruptions in the international and European financial systems.

The risk resilience of Europe's financial system has been systematically strengthened in the years following the global financial crisis. Regulatory reforms already implemented or currently being prepared place considerably greater capital, leverage and liquidity requirements on banks and incentivise the use of stable sources of funding. These regulatory reforms as well as the introduction of the Single Supervision and Crisis Resolution Mechanism under Banking Union will act to contain the occurrences and effects of financial crises.

The low interest rate environment is weakening the profitability of euro area banks. Additionally, a number of banks are burdened by large quantities of nonperforming loans. Many euro area countries are vulnerable to the cyclical and structural risks of the housing markets.

Risks to the Finnish economy in the event of global economic and financial crises and other serious disruptions include weakened exports, constraints on banks' access to market funding, and restrictions on credit issued by Nordic financial institutions. Finland's banking sector is becoming increasingly interconnected with the Nordic financial system, a trend reinforced by the restructuring of Nordea.

Household indebtedness and the stock of mortgages held by financial institutions have increased in Sweden. Consequently, the rise of house prices has rapidly overtaken that of households' disposable income. Moreover, the banking sector is large, concentrated, interconnected and dependent on market funding, partially denominated in euro and US dollars.

Both the Swedish authorities and international organisations have expressed concern over the growing risks associated with Sweden's housing market.[14] The realisation of systemic risks stemming from the Swedish housing market would probably also affect Finland, particularly via the Nordic banking groups and intra-Nordic trade. The magnitude of cross-border contagion would depend on the extent of Swedish banks' exposure to the housing market and the effects this would have on their liquidity, credit lines and ability to raise capital.

The growing interconnectedness of the Nordic and Baltic banking systems requires deeper cooperation and information-sharing between authorities to ensure the stability of the financial system. To this effect, the central banks of these countries signed a revised Memorandum of Understanding to outline mutual policy in the event of crises or other contingencies.

The cross-border interlinkage of the banking system increases the importance of EU Member States having a uniform range of macroprudential tools at their disposal as well as the prerogative to target systemic risks. It is essential that the effects of macroprudential policy also extend to foreign banks operating within a country, particularly when these banks play a significant role in the financial system. This will require authorities to coordinate and reciprocate their macroprudential policies as comprehensively as possible.

Appendix. What is the European Systemic Risk Board and how does it operate?

The legislation establishing the European Systemic Risk Board (ESRB) was passed in December 2010. The ESRB largely consists of the central banks and financial supervisory authorities of EU Member States.[15] Its General Board, chaired by ECB president Mario

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14. The European Systemic Risk Board issued a warning to Sweden over its housing market at the same time as the warning to Finland over its own housing market. See the latest Riksbank financial stability report.
15. In addition to the central banks and financial supervisory authorities of the 28 EU Member States, the ESRB's membership includes 6 European institutions (the ECB, the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority

Draghi, serves as the executive body.[16] The Governor of the Bank of Finland serves as a voting member on the General Board, while the Director General of the Financial Supervisory Authority serves as a non-voting member. Bank of Finland experts participate in the preparation of meeting agendas. The ESRB operates from within the ECB in Frankfurt.[17]

The ESRB is responsible for the macroprudential oversight of the EU's financial system. Its mission is to identify, prevent and mitigate the effects of systemic risk within the financial system.

When the ESRB identifies systemic risk, it responds by issuing warnings or making policy recommendations. Recommendations can address specific vulnerabilities or broad threats to financial stability. Moreover, the ESRB can issue warnings and recommendations to the entire EU, or any combination of Member States and their respective financial supervisory authorities. The ESRB General Board holds the right to publicise its warnings and recommendations.

The ESRB may issue a warning when it has identified one or several risks that threaten financial stability. Warnings do not contain explicit policy instructions, nor is the recipient expected to issue reports on their policy response. Recommendations issued by the ESRB do, however, lay out macroprudential policy guidelines and a deadline for implementing these measures. The ESRB monitors implementation of its recommendations, and the recipient is obliged to report on their progress to the ESRB and the European Council.

Tags

financial stability, households, housing loans, indebtedness, macroprudential policy, mortgage credit granting

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(EIOPA), and the EU's Economic and Financial Committee (EFC) plus the central banks of Norway and Iceland as observers.

16. Other organs are the Steering Committee, the Secretariat and two advisory committees (the Advisory Technical Committee and the Advisory Scientific Committee) supported by a number of expert working groups.

17. For more information on the structure and mission of the ESRB, please visit its website.