ACCESSIBLE SUMMARY

Household debt burden worryingly large – we must take a variety of measures to guard against the risks

29 May 2019 – Simply Short – Financial stability

Finnish households are carrying a worryingly large amount of debt. Housing loans and housing company loans have become more common and larger, and their repayment periods have become longer. In addition, the supply of consumer credit has become broader and more varied. High levels of household debt can make a downwards spiral in the economy worse, if economic growth slows substantially or interest rates rise. We need to take steps in advance to prevent excessive household debt. A debt-to-income cap would complement the protection provided by the current loan-to-collateral cap on housing loans.

That the debt burden on Finnish households has become worrying large is clearly shown in the Bank of Finland's latest financial stability assessment. The level of household debt relative to income has doubled in 20 years (from 62% to 127% over the years

1998–2018). Thus, over a long period, debts have grown much faster than the disposable income available to cover living costs and other consumption and savings.

The biggest cause of the increase in Finns' debt burden has been housing loans and housing company loans, which have become both more common and larger in size. Admittedly, people's monthly debt-servicing expenditure has remained moderate due to the low level of interest rates, but paying off the debt is taking longer than before. While at the end of the 1990s housing loans were repaid in around 15 years, nowadays the repayment period is normally around 25 years and the interest rate changes annually.

The repayment period also often contains periods of paying only the interest on the loan. Large housing company loans and long amortisation-free intervals immediately at the start of the repayment period have become common especially in new apartments in multistorey blocks, large numbers of which have been built in recent years. This may in itself be an encouragement to take on debt.

The volume of consumer credit has also greatly increased in recent years, and the supply is rather heterogeneous. Most of this credit has been granted by credit institutions operating in Finland, but households are increasingly taking out loans from online banks operating outside Finland. Consumer credit is also provided by companies specialising in car loans and payday loans. New types of lenders often advertise loans fairly aggressively. The borrower receives money quickly and without collateral, and a single individual can have several high-interest loans at the same time. There has, in fact, been an increase in payment defaults, and they tend to pile up on the same people.

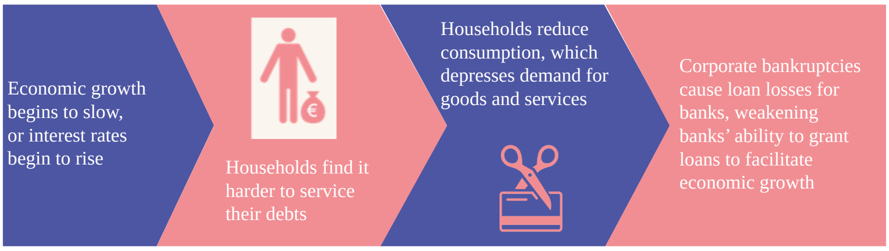
The Bank of Finland has long drawn attention to the risks of growing debt. The concern is that the most heavily indebted households have very little financial room for manoeuvre. For example, a rise in interest rates or increased unemployment could bring about a situation in which many households find themselves simultaneously in payment difficulties. A decline in house prices would also increase the financial pressures on households with housing debt. Finns' assets are, after all, primarily tied up in their homes.

When economic uncertainty increases, people generally first cut their consumption, to enable them to continue servicing their debts and to accumulate savings for a rainy day. For example, when the global financial crisis broke out around 10 years ago, many countries experienced a pronounced contraction in household consumption. Consumption fell all the more markedly, the greater the debt burden households had taken on prior to the crisis.

A contraction in consumption has far-reaching consequences for the entire economy. It reduces demand for the goods and services companies sell. This, in turn, increases their payment difficulties and bankruptcies. If companies cannot pay their debts, banks and other credit institutions can face considerable losses. Loan losses reduce banks' own funds and hence their ability to grant new loans to households and businesses. This further reinforces and prolongs the downward spiral in the economy (Chart 1). In this way, households' heavy debt burden weakens the ability of the entire economy to adjust to serious disruptions.

Chart 1.

Households' heavy debt burden poses a risk to the entire economy



Source: Bank of Finland.

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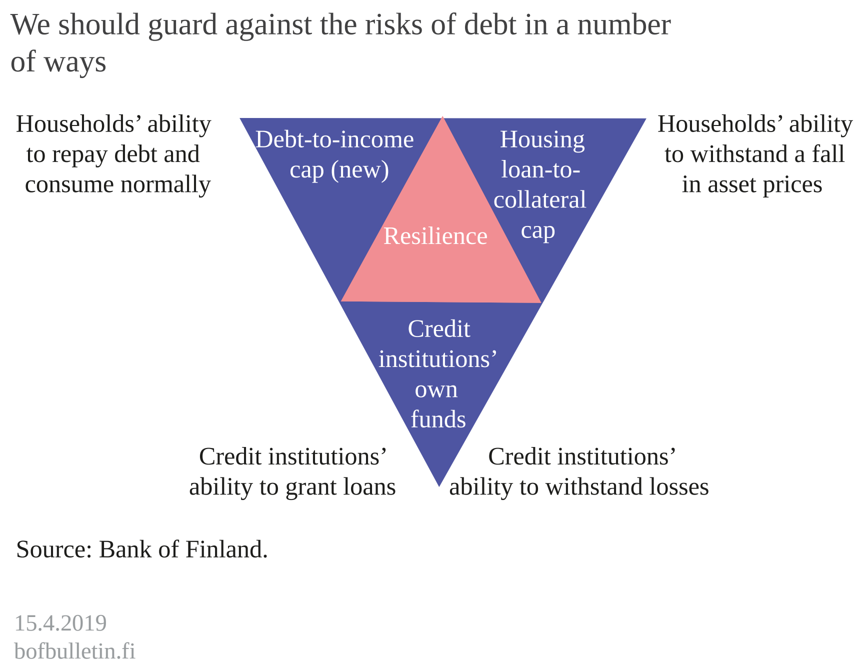
We need to take steps in advance to prevent excessive levels of household debt. According to the Bank of Finland, new legislation is necessary to give the authorities responsible for ensuring the stability of the financial system a broader arsenal of measures with which to combat the excessive accumulation of debt by households and the consequent risks to the economy.

Currently only housing loans have a loan cap (which ensures that new housing loans are not unreasonably large relative to the property being purchased and the borrower's other assets). Alongside this there is a pressing need for a new, more comprehensive debt cap that would also take into account all the borrower's debts relative to his/her income. Such a debt-to-income cap would prevent over-extension particularly in situations where collateral values are rising rapidly and lending threatens to become overheated. This would improve households' financial room for manoeuvre, and hence the economy's ability to cope with disruptions.

In the future, control of excessive accumulation of debt would also benefit from the sort of 'positive credit register' currently being planned, on which the Ministry of Justice published a report in September 2018. This would give the authorities and lenders better information on the debts of individual loan applicants. The negative credit register currently in use only records information on payment defaults. The new national register would show all a household's debts, even in the absence of payment defaults. It would help lenders to abide by good lending practices, and also the supervision of said practices. The data in the register would also give borrowers an opportunity to better manage their finances in situations where they have a number of loans from several different lenders.

Any single measure by the authorities cannot resolve all the observed problems. The proposed new debt-to-income cap, a positive credit register and steps already taken would, however, together moderate the accumulation of debt and the associated risks. From the point of view of the big picture, it is also important to ensure that banks and other credit institutions are more resilient. Credit institutions now have more own funds relative to their risks. This will strengthen their capacity to withstand losses and intermediate finance in all circumstances. In the long run this will enhance the stability of the financial system and the economy as a whole (Chart 2).

Chart 2.



Tags

financial stability, consumer credit, housing loans, debt accumulation, banks