EDITORIAL

Confidence in the financial system is created through persistent action

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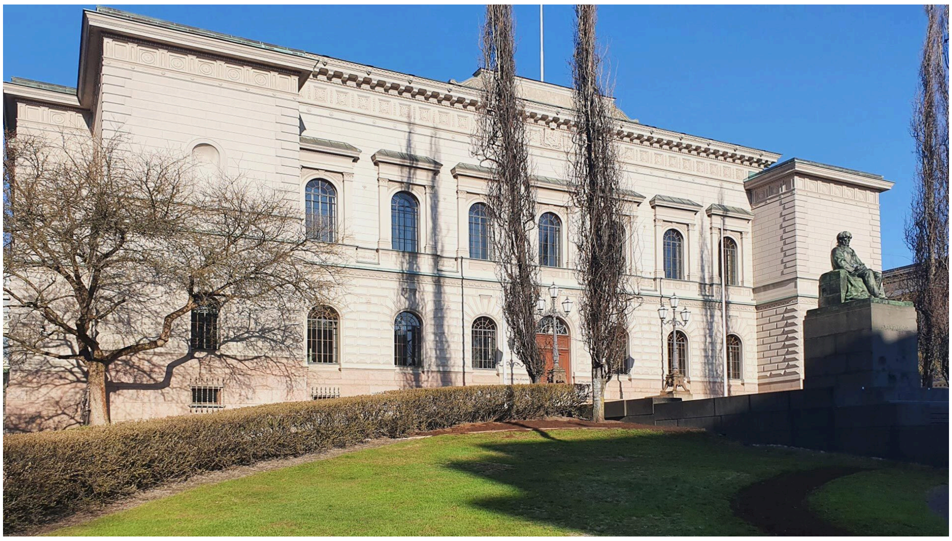
The tightening of financing conditions can expose the vulnerabilities and risks that were built up during the period of low interest rates, both in Finland and elsewhere. Although Finland's banking sector is well placed to withstand any real-life stress test that it may face, there is good reason to be properly prepared for an increase in credit and liquidity risks. Financial stability is founded on confidence, and the basis for this is created through persistent action. Occasional crises should not be allowed to delay the work being done to strengthen the resilience of the financial system.



Interest rates were low for a long period, but this came to an end last year. Central banks in the world's main economic regions, including the European Central Bank (ECB), began to raise their key interest rates at a brisk pace. The aim of this was to curb the soaring rate of inflation. Although interest rates have risen exceptionally fast, the current level is not especially high by historical standards. However, even a moderate rise in interest rates matters as, in many countries, debt accumulation by households, businesses and central government grew considerably during the time of low interest rates.

Finnish households have more debt than ever before, amid fast rising interest rates. The effects of the rapid and steep rise in interest rates have been a cause of anxiety to many in recent months. The impact of higher interest rates is felt particularly in the most indebted households, unless their loans are hedged against rising interest rates. According to a survey by the Bank of Finland, about a quarter of the total housing loan stock is hedged against interest rate rises. However, the proportion of the most indebted households that have taken out interest rate hedging is less than for other households, and this is a cause of concern.

A loan taken when interest rates were low can turn out to be too large for some borrowers, even where the household's financial standing ought to be sufficient for managing repayments. Households need to be able to meet other expenses, too. The alternative scenario examined in the Bank of Finland's economic forecast made in December 2022 demonstrated that the recession could be deeper than projected if households have to cut back on their spending by more than expected because of high levels of debt. This would have an adverse impact especially on businesses providing consumer services and consumer products, and there have already been signs of an increase in these companies' credit risks. The impact of higher interest rates on households, businesses and the real economy may become evident to an even greater extent as the current year wears on.

The rise in interest rates and the tighter financing conditions have weakened the financial cycle. Prices in securities markets have fallen across a broad front, and price volatility has grown. The housing and real estate markets have dampened significantly, and the rate of credit growth has slowed.

The decline in residential property prices has led many to ponder how long this might continue. Nobody has a crystal ball, but the decline in securities and property prices during a downturn is typically sharper when preceded by a rapid, debt-driven rise in prices. This appears to be the case now as well: prices have dropped the most in the largest urban centres, where residential property prices were climbing the fastest and property sales were financed by larger than average loans.

In Finland, the financial cycle has, in recent years, been fairly calm and no major overheating of the housing or credit markets has been detected. It is possible that the downward correction in house prices will remain moderate in Finland. On the other hand, large shares of housing company loans with long interest-only periods show that borrowers have also taken risks. In Sweden, the vulnerabilities of the housing and real estate markets have been considerable for a long time already. Due to the interconnectedness of the Nordic banking sector, the risks are in many respects shared. Developments in the Swedish real estate market should be monitored very closely in Finland.

Higher interest rates and tighter financing conditions can expose the risks that were taken and the vulnerabilities that were built up when financing conditions were looser. These risks became a reality during the spring in the United States, where Silicon Valley

Bank's sudden collapse raised questions about the risk management and supervision of mid-sized banks in the US. The wave of distrust expanded to Europe, where it affected the fate of Swiss bank Credit Suisse, which had long been in difficulty.

The financial market authorities and central banks took steps to stabilise the situation in the United States and Switzerland, including the provision of liquidity to banks in order to safeguard financial stability. The situation in international financial markets is now stable, but investors are still rather sensitive to any bad news. If market uncertainty increases and is prolonged, this could, through the banks' market funding, be reflected in the price and availability of credit – in Finland as well.

Banking is a business based on confidence. The spring turbulence in the US banking sector was a reminder of how quickly the situation can escalate if confidence in banks is shaken. The most vulnerable operators will quickly be the subject of close scrutiny if customer confidence and the risk appetite of the market dry up. Digitalisation in banking, rapid communications, and the sharing of information and disinformation on social media have brought new dimensions to financial stability, the significance of which is not yet fully understood.

Confidence in the stability of the banking system is based on a number of factors: the transparency of banks' operations and risks, well-functioning micro- and macro-level regulation and supervision, the sufficiency of capital and liquidity buffers, and an effective bank resolution mechanism. These are all areas in which regulatory reforms have been made since the global financial crisis, and these reforms have stabilised Europe's banking system.

Confidence in Finnish and Nordic banks has remained strong. Nordic banks' funding costs have risen by less than those of other European banks during this period of market uncertainty. The structural vulnerabilities of the Finnish banking sector are significant and relate to the high level of household indebtedness and linkages in the real estate market. Counterbalancing the structural vulnerabilities of the sector, the capital position and profitability of banks are above average. Based on earlier stress tests, it is estimated the banks could withstand even large financial losses originating from the housing market. A fresh assessment of the crisis resilience of banks will be available in July, when the results of the European banking supervisors' current round of stress tests are published.

Finland's banking sector is also well placed to withstand any real-life stress test that it may face if the economy slows further. The crisis resilience of banks has been strengthened by setting them additional capital requirements based on macroprudential regulation, for the purpose of covering systemic risks. The resilience of the financial system has been improved with the new backup system for daily payments. This will ensure the usability of bank accounts under all circumstances.

Significant progress has been made in curbing excessive household indebtedness during the current year. A respecified recommendation issued to banks by the Board of the Financial Supervisory Authority concerning an upper limit on the debt servicing burden of residential mortgage borrowers came into effect at the start of 2023. New legislation is to enter into force at the start of July 2023 on containing the risks related to housing loans and especially housing company loans, through measures such as limiting the maximum maturity of such loans. A Ministry of Finance working group issued its recommendations in April concerning measures for promoting the debt sustainability of households. The cap on debt service-to-income (DSTI) proposed by the working group merits support and is particularly important both in terms of financial stability and for ensuring the debt sustainability of individual households.

There has been considerable discussion in recent times about the need to rebalance Finland's general government finances. The increase in Finland's debt level and its differentiation from the debt trend of the other Nordic countries also give cause for concern in regard to financial stability. A robust level of debt sustainability for the country is an essential condition for financial stability, especially for a country like Finland whose banking sector is concentrated, internationally connected and comparatively large in relation to the national economy. The price a country pays for its debt imposes in practice a floor on the price of market funding for its banks and businesses. The risk premia demanded by investors from the government and from banks have traditionally been low, which reflects the confidence of investors. This confidence should be nurtured by maintaining a strong banking sector and through responsible management of the public finances.

The foundations for financial stability are created through persistent action. Although a lot has been done already, the work to promote resilience needs to continue. In recent years, attention has been given especially to unforeseen shocks from outside the financial system, and to ensuring preparedness for such shocks. The latest crises have shown that not all the vulnerabilities and risks threatening financial stability originate from within the system. The current macroprudential policy toolkit should include a countercyclical capital buffer (CCyB) requirement that can be flexibly set. Reducing the requirement would support the lending capacity of banks during downturns in the economy, even where these are unexpected. This would help curb the downward spiral that can emerge between a slowing economy and diminished lending from banks.

The existence of factors such as the pandemic, Russia's war in Ukraine, geopolitical instability and climate change, which are external to the financial system, emphasises the importance of reforms and regulatory projects for promoting stability. It would be short-sighted to postpone such projects in Finland or in Europe due to the occasional crisis. We will in any case have to deal with the reform challenges sooner or later – and their severity might have increased by that time.

It is particularly important that the EU banking union be completed. Currently it covers common banking supervision and the banks' resolution mechanism, but not a common deposit insurance scheme. The standing of European banks has improved in recent years despite the pandemic and other uncertainties in the operating environment. The non-performing loans inherited from the sovereign debt crisis that have been an obstacle to the completion of the banking union have largely been eliminated from banks' balance sheets. Completion of the EU banking union would be an important step for unity across Europe and would further strengthen confidence in Europe's banking system. Both are necessary in the prevailing conditions of geopolitical and economic uncertainty.

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Tags

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