EDITORIAL

Stability is paramount – Resilience will remain essential going forward

14 May 2024 – Editorial – Financial stability

The resilience of Finland's financial system has remained robust. This is no coincidence, but instead largely a result of the improvements made in financial regulation and supervision and the macroprudential policy measures taken. Resilience to risks must be ensured in the future too, and calls for reducing financial regulation must be treated with caution. The geopolitical situation, digitalisation and climate change are all exposing the financial system to new threats. Changes in financial regulation should take account of anticipated developments in the operating environment and in risks so that we are not simply fighting old crises.

The increases in interest rates and costs have tested the resilience of borrowers, investors and the financial system. Most households and businesses have found ways of adjusting to the rise in costs, and their debt servicing capacity has remained largely good. At the same time, household consumption has slowly risen and corporate investment has fallen. Higher interest rates have improved the profitability of banks operating in Finland, but in the economic downturn their credit risks have risen and are continuing to grow.

The rise in interest rates has been a strain on the housing and real estate markets in particular. Residential property sales have dwindled, and housing prices have fallen significantly. The standstill in the property market has a broad impact across the economy. There has been an increase in bankruptcies in the construction sector in particular, and credit risks have grown.

Brighter times ahead for the economy are already anticipated, however. Inflationary pressures have diminished, and markets are expecting the Governing Council of the European Central Bank (ECB) to begin cutting interest rates in the summer. Lower inflation and a cut in interest rates are expected to be a significant boost to the economy, helping it return to growth in the latter part of this year. An improvement in the operating environment would also support financial stability.

It is too early though to breathe a sigh of relief. In the forecasts for the economy, there is a risk that growth will be lower and inflation higher than projected. The recession in the housing and real estate markets could continue if interest rates stay high for longer than expected and if the recession in Finland's economy is prolonged and deepens. Structural changes affecting the property market, such as an increase in remote working and e-commerce, could also contribute to slowing the recovery in investor demand for commercial real estate.

In Finland, most of the financing granted by banks is variable rate financing. The banks' customers have therefore largely borne the interest rate risk, which materialises when interest rates rise. The interest paid by banks on deposits has not risen at the same pace. The net interest income of the banks has been strong, which has been reflected in their robust profits. It is important that these are used for strengthening the capital adequacy of the banks and not solely for satisfying the dividend needs of shareholders.

The long-term structural vulnerabilities of Finland's financial system and economy are, for the most part, unchanged. Finland's banking sector is large and concentrated and is closely interconnected with the Nordic financial system. Common to Nordic banks is a significant exposure to the housing and real estate markets. A recovery in these markets is therefore also essential for financial stability.

The banks that operate in Finland are financially sound and profitable, which is important in our bank-centric financial system. They are therefore able to engage in financial intermediation in all circumstances. In recessionary conditions, the demand for loans has been low, although the availability of finance has been good – but at a higher price. Finland's financial system is still sound, and the current recession is not threatening the risk-bearing capacity of the Finnish banking sector. Stress tests indicate that the banks could withstand even a much deeper recession.

Many of the financial vulnerabilities and risks in Finland's financial system are familiar from previous crises. They are relatively well known and can be assessed and managed, both through measures taken by the sector itself and regulatory and macroprudential policy measures. Finland's financial system and that of Europe as a whole have survived relatively unscathed the major unanticipated social and economic shocks of recent years.

The financial system's strong resilience is no coincidence or stroke of luck. It has largely been due to the significant improvements made to financial regulation and supervision during the 15 years since the global financial crisis.

There are also a lot of new and uncharted threats associated with the deterioration in the international security environment and with digitalisation and climate change, and these could undermine financial stability in both the short and the long term. Digitalisation in the financial sector increases risks regarding the transmission of disinformation and information influencing. Climate change and biodiversity loss are adding to the risks and vulnerabilities in the financial system and are still difficult to assess. The sector and the relevant authorities should also prepare for the newer risks.

The resilience of financial system participants must be maintained using macroprudential policy tools. The toolkit must be sufficient and appropriate. Opportunities for the flexible use of macroprudential tools should also be expanded so that the capacity of macroprudential policy to respond in the event of disruptive situations affecting the economy can be improved. Trust in the resilience and reliability of the financial system should be firmly strengthened against threats from outside the financial system. It is important that the banks and the authorities ensure that continuity planning is appropriately carried out and that preparations are made for operational disruptions and an increase in cyber risks. Management of liquidity and funding risks by the banks must be a priority in supervision.

Financial stability is closely linked to the soundness of the public finances and to the outlook for them. Robust public finances will ensure access to reasonably priced finance from international financial markets and will improve Finland's ability to respond in any disruptive situation. Consolidating the public finances will also promote financial stability.

The European Union would benefit in many different ways from a single capital market. A single capital market would make the financial system less bank-centric and would further the EU's competitiveness and risk sharing. A well-functioning capital market would create diverse opportunities for financing growth – and for higher risk investments. The advancement of a capital markets union has gained new impetus in recent months due to discussion of the objectives of the next European Commission. Both the ECB Governing Council and the euro area finance ministers have been in favour of advancing the capital markets union more rapidly. A capital markets union would occupy a central place in financing the EU's increased investment needs and in reinforcing its strategic autonomy.

The long-term outlook for Finland's economy is uncertain and in many respects weak. The growth prospects for the economy are subdued, the consolidation of the public finances has just begun, and no immediate easing of the geopolitical risks is yet in view. Climate change risks are already with us. Households, businesses, banks, other financial corporations and the financial system's key infrastructure must all be able to withstand different kinds of disruptions in an uncertain environment.

The operating environment has become more challenging, and change has brought new risks and vulnerabilities. The recent calls for reducing financial regulation must therefore be treated with caution. Regulation is not cast in tablets of stone, nor is it an end in itself. Regulation should be examined closely and reshaped where necessary, on the basis of careful planning. Similarly, reducing regulation or preventing further regulation cannot in itself be the objective. Changes in financial regulation should take account of anticipated developments in the operating environment and in risks so that we are not simply fighting old crises. Resilience in the financial system is needed now and will continue to be required in future years.

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Tags

digitalisation, risks, financial stability, geopolitics, financial system, climate change