Analysis

Household debt – how much is too much?

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The trends of the early post-millennium years – a larger average loan size and longer loan repayment periods – have permanently increased household vulnerability to debt-related risks in Finland. Household indebtedness embraces another four features that amplify the risks to the economy: the debt level is high relative to GDP, risks are unevenly distributed, loans are tied to variable interest rates and, in part, loans are large relative to the collateral provided. The stabilisation of debt developments in the 2010s has been positive for financial stability.



Many factors have served to fuel debt

It is hard to provide a watertight assessment of the amount of debt households as a whole are able to carry over the long term. On one hand, borrowing is a way of smoothing the mismatch between income and expenses at different stages of life. This brings flexibility to the economy. On the other hand, excessive credit growth and leverage weaken the capacity of households, and hence of the economy as a whole, to adapt to negative economic shocks. This may amplify cyclical fluctuations in the economy.

Heavily indebted households are vulnerable to higher interest rates, rising unemployment and falling asset prices. Consequently, the threats related to debt accumulation are linked with the same macroeconomic factors that, under favourable circumstances, feed growth in debt. Low interest rates, higher income, rising housing prices and easy access to finance have bolstered household borrowing in Finland for most of the period since the turn of the millennium.

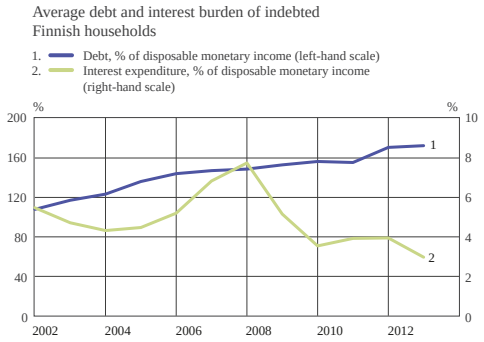
The fastest phase of growth in household debt accumulation has subsided in recent years as the recession has weighed on the Finnish economy. Receding credit demand has been reflected in a smaller amount of new drawdowns of housing loans and a slowdown in credit growth. This development has been consistent with the weakness of overall economic activity, the moderation in house price trends and increased economic uncertainty.

Household vulnerability has increased

Growth in household debt relative to annual disposable income has already continued without interruption since the end of the 1990s. This evolution includes features that increase risks and vulnerabilities for households and the economy as a whole from the perspective of financial stability.

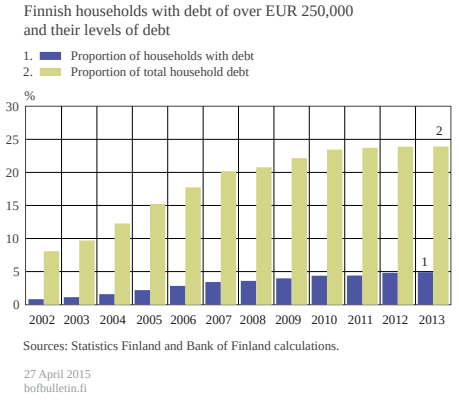
In the first place, total household debt relative to GDP is historically large, at 65% at the end of 2014. There is no single commonly applied benchmark available for assessing the sustainability of the ratio of household debt to GDP, and differences across countries are considerable.[1] However, the rapid widening of the debt ratio in Finland in the period since the turn of the millennium points to increased vulnerabilities. Growth in indebtedness has slowed since 2010 relative to its long-term trend (Chart 1). This is a positive development for curbing growth in risks to financial stability.

Chart 1.



Secondly, household debt and the related risks are very unevenly distributed among households. For example, although there are still very few households (about 5% of households with debt) holding the largest debts of over EUR 250,000, these account for nearly a quarter of total household debt (Chart 2). Two structural changes have contributed to the increasing importance of large debts: the increase in the average size of new loans and the lengthening of average repayment periods, compared with the situation at the turn of the millennium. The situation has remained unchanged since 2010.

Chart 2.



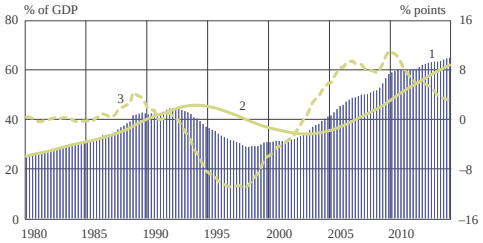
Thirdly, household loans are mainly tied to variable interest rates. This means that there may be considerable annual variation in household interest expenditure according to the level of interest rates (Chart 3). Thus, long-term debt sustainability not only depends on the amount of debt, but also on the rate of interest payable thereon. Lower interest rates and longer repayment periods throughout the years since the turn of the millennium have kept households' annual debt-servicing burden in check, although the amount of debt has at the same time substantially increased. However, debt-servicing expenditure over the loan period as a whole is higher, the

larger the loans are, and the longer the maturities.

Chart 3.

Household indebtedness in Finland

1. Household loan stock, % of GDP (left-hand scale)
2. Loan stock-to-GDP ratio, long-term trend* (left-hand scale)
3. Loan stock-to-GDP ratio, deviation from long-term trend (right-hand scale)



Loan stock incl. household share of housing company loans.
*Calculated using a one-sided Hodrick–Prescott filter (lambda 400,000).
Sources: BIS, Statistics Finland and Bank of Finland calculations.

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Fourthly, a substantial proportion of housing loans taken out in recent years are large not only in absolute terms and relative to the borrower's income but also with regard to the value of the housing property serving as collateral for the loan. On the basis of a sample survey conducted by the Financial Supervisory Authority (FIN-FSA), the self-financing share has been below 10% for a significant proportion of new housing loans granted in recent years.[2] This increases the risks related to a decline in house prices.

What if?

The risks related to household debt are not limited to direct credit risks from loans granted to households. Over the long term, accumulated vulnerabilities may also unravel as losses for the financial system and the real economy through lower household consumption demand, falling asset prices and corporate losses.

Global financial crises have shown that the overall losses they cause for society at large may be huge. The highest costs have stemmed from crises in which the real economy and the financial system become ensnared in a crisis at the same time.[3] In most cases, the severest crises have been marked by strong overheating of credit and housing markets in an economic upturn and their collapse in the wake of the crisis.

Consequently, in assessing debt sustainability, 'what if' questions regarding unlikely but plausible developments also need to be addressed. Alternative scenarios that are more adverse than expected are reviewed regularly in bank stress tests conducted by the authorities and in financial margin calculations carried out by banks in respect of individual loan applicants, as recommended

by the authorities. The Finnish banking sector's resilience to risks has been assessed as strong in both national and international stress tests.

Notes

1. According to European Commission reference values, general government consolidated gross debt should remain below 60% of GDP (excessive deficit procedure) and private sector consolidated debt below 133% (macroeconomic imbalance procedure). These ratios for Finland in 2013 were, according to the European Commission, 56.0% and 146.6% respectively. ↑
2. Financial Supervisory Authority (2012) Sample survey of housing loans 2012. ↑
3. Reinhart, C. M. and Rogoff, K. (2009) This time is different: Eight centuries of financial folly. Princeton University Press, Princeton. ↑

Keywords

financial stability, households, indebtedness