Financial Stability Assessment

Lowering the loan cap will reduce the risks associated with debt

Financial stability | 23 May 2018

A macroprudential decision taken by the Financial Supervisory Authority's Board in early spring to tighten the maximum loan-to-collateral (LTC) ratio for housing loans will bolster the stability of the Finnish financial system. The policy adjustment will help curtail growing household indebtedness by restricting the provision of large housing loans relative to collateral and by increasing awareness of the risks inherent in such loans. It will not, however, remove the risks associated with outstanding household debt and its protracted growth. New macroprudential tools are still required to contain growing indebtedness.



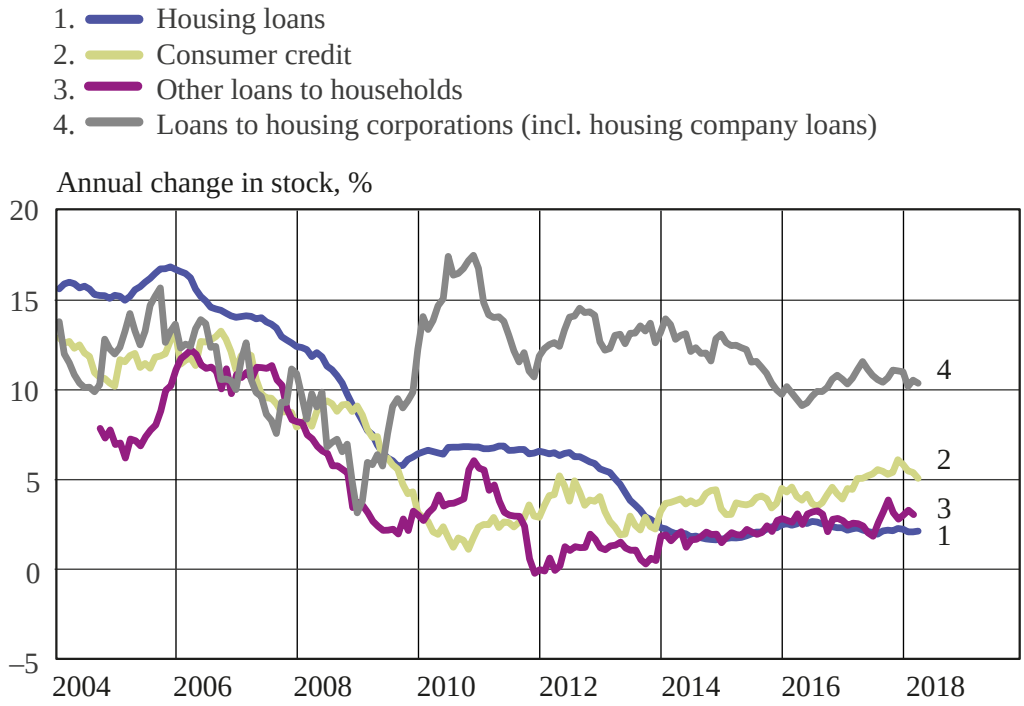
Household indebtedness poses risk to financial stability

In March 2018, the Board of the Financial Supervisory Authority (FIN-FSA) decided to lower the maximum loan-to-collateral (LTC) ratio, i.e. the loan cap, for housing loans other than first-home loans from 90% to 85%. The decision will enter into force in July, and will mitigate household indebtedness and strengthen mortgage borrowers' risk resilience. Household indebtedness is at a record high in Finland (Chart 1). Debt has been accumulating for many years, and is concentrated on a proportion of households. Households that are heavily indebted relative to their income and

assets are vulnerable to higher interest rates, income losses and falling house prices.

Chart 1.

Household indebtedness from a variety of sources and purposes



Loans granted by Finnish credit institutions to households and housing corporations.
Source: Bank of Finland.

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Household indebtedness is estimated to increase further, fuelled by favourable borrowing conditions. The interest rates on new housing loans have declined to record low levels, loan margins have narrowed and repayment periods have lengthened. The upswing in the Finnish economy strengthened in 2017, and economic growth is expected to continue. Strong consumer confidence in the economy, exceptionally low interest rates and improved employment will boost household consumption, but also household indebtedness. In the immediate years ahead, household consumption expenditure is forecast to remain higher than disposable income, thereby keeping the household sector savings ratio in negative territory.[1]

Economic recessions that follow debt-driven upswings are typically deeper and longer than other downturns.[2] Indebted households are prone to cut their spending during an economic downturn, which leads to even weaker economic developments (see Household indebtedness contributing to corporate loan losses). History has shown that growth in mortgage lending predicts financial crises more strongly than growth in other lending.

Credit institutions have become more vulnerable to systemic risks from the housing market as mortgage lending and lending for housing construction has taken an increasing proportion of bank lending to the public. Measures have been taken to strengthen credit institutions' resilience against these risks. As of the beginning of 2018, a floor of 15% was set for the average risk weight on housing loans, which is applicable to credit institutions that have adopted the Internal Ratings Based (IRB) approach for calculating regulatory capital requirements. The risk weight floor strengthens banks' capacity to withstand credit losses from mortgage lending even in severe crisis situations.

In addition to reasonable LTC ratios for housing loans and adequate regulatory capital levels of credit institutions, it is also important to ensure that mortgage borrowers' debt-servicing capacity remains sufficient. The Finnish macroprudential toolkit should be supplemented with instruments that have proven effective in other countries in limiting housing loan size or the maximum debt-servicing costs relative to borrower income (see Instruments designed to mitigate indebtedness). The current loan cap, which is proportionate to the value of all real collateral, should in turn be replaced by a cap set in relation to the value of the property purchased, as is the prevailing practice in many other countries.[3]

Household indebtedness has many sources

New drawdowns of housing loans were slightly higher in early 2018 than in previous years. However, growth in the stock of housing loans has partly been slowed by the fact that low interest rates have boosted repayment of fixed-instalment loans, which in turn has shortened the remaining maturity of these loans. The decline in reference rates has also reduced the service costs of annuity and other fixed period loans.[4] The effects are opposite when interest rates rise – a fact debtors and creditors should be prepared for.

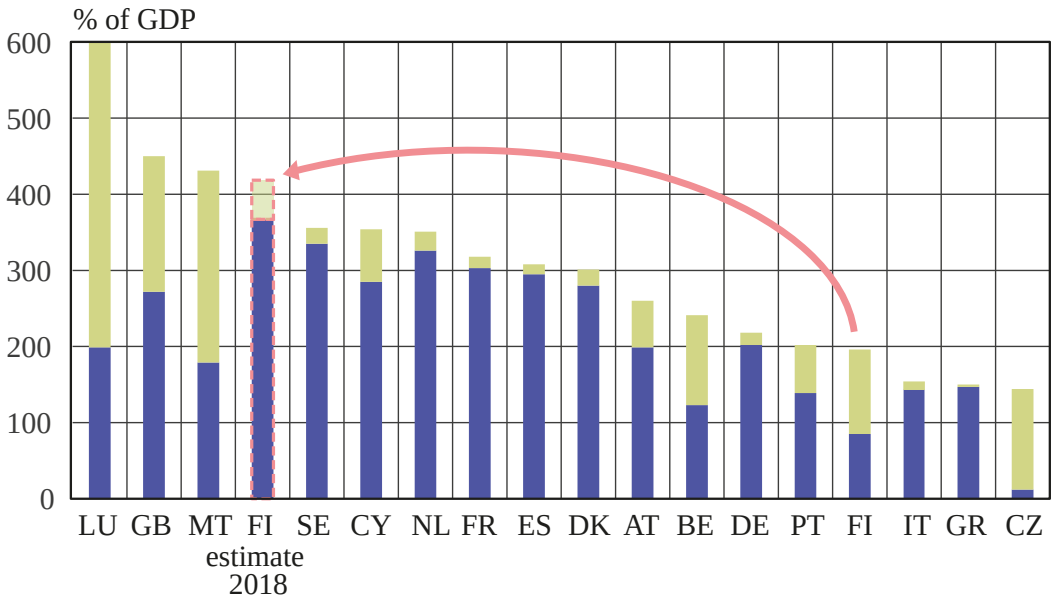
The structure of housing finance has undergone a change in Finland. The aggregate stock of loans to housing corporations, such as housing companies and rental housing companies, has grown at a rapid pace due to both new construction and renovation work (Chart 2). The vast majority of these loans is taken out by private housing companies owned by residents and investors.

Shareholders of housing companies repay housing company loans in the form of charges for capital costs, which increases their debt-service burden. The indirect nature of housing company loans may tempt households to take out excessively large loans if they do not assess their capacity to service housing companies' high capital charges. Households should be aware of how interest rate hikes and the expiration of possible interest-only periods for housing company loans might impact the costs of servicing these loans and housing company charges. Lenders, in turn, should be able to identify the risks and responsibilities associated with housing company loans and take these into account in estimating households' and housing companies' debt-servicing capacity.

Chart 2.

Nordea's relocation will increase size of Finnish banking sector

1. Total assets of foreign branches and subsidiaries
2. Total consolidated assets of domestic banking groups



LU = 1520%, chart cut for presentational reasons.
Sources: European Central Bank and calculations by the Bank of Finland, 2017/III.

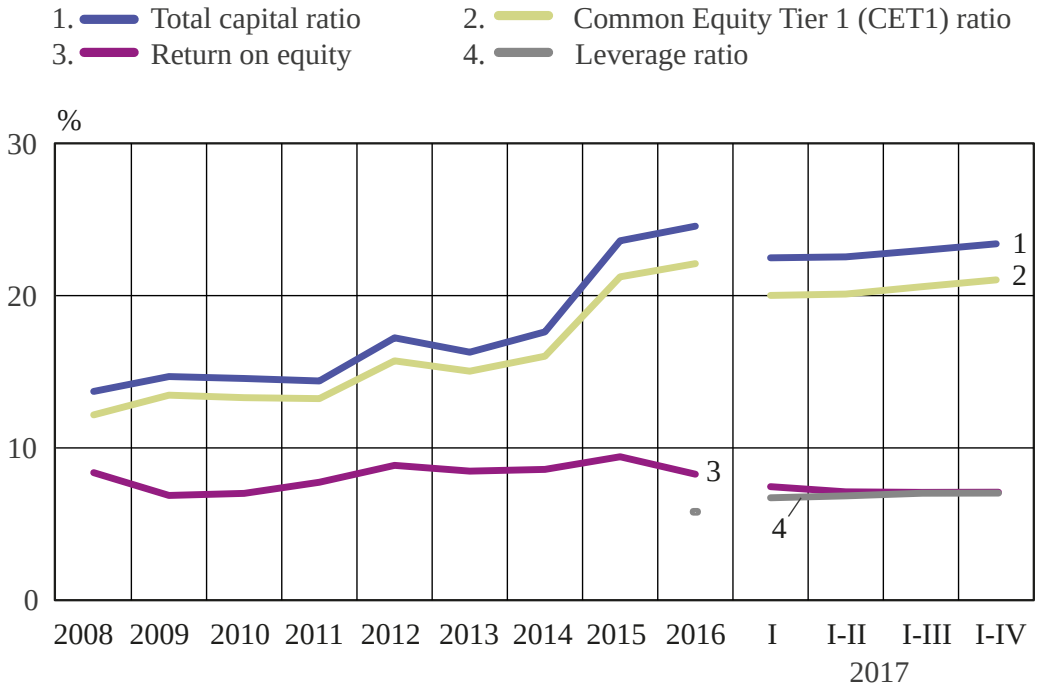
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Housing price developments have been moderate on average over the country as a whole, but

price differentials between particularly the Helsinki metropolitan area and the rest of the country have increased throughout the current decade (Chart 3) (see also Wide regional disparities in Finnish house prices and household indebtedness). Growth in housing construction and accumulation of mortgage debt has concentrated on growth centres. Curbing excessive indebtedness and maintaining healthy lending and debt-servicing practices also support the stability of the housing market. In addition, stable housing market dynamics are important for geographical labour mobility.

Chart 3.

Finnish credit institutions sector financially solid and profitable



Source: Financial Supervisory Authority.

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The stock of consumer credit has grown at a rapid pace in recent years (Chart 2 above). According to a study[5] conducted by the FIN-FSA, credit institutions have promoted consumer credit growth in many ways, and in some cases customers' creditworthiness has been assessed based on too little information. Growth has been pursued by, for example, loosening credit criteria, granting larger loans and extending loan repayment periods. While consumer credit has been growing, the

number of individuals with payment defaults has simultaneously increased to a new record high.[6]

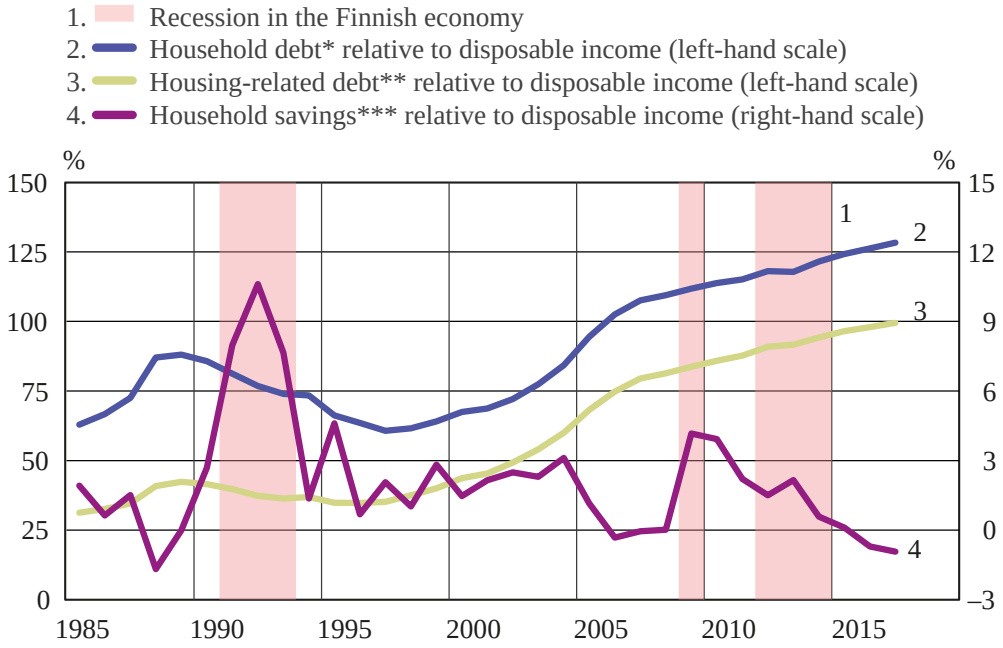
In December 2017, the Ministry of Justice launched an assessment of the possibility of establishing a positive credit register in Finland.[7] Such a register would provide a more comprehensive and up-to-date picture of household debts and their distribution across credit types and households. Utilisation of the register data would help authorities tailor and target measures for mitigating indebtedness and thus promote financial stability and stable economic developments.

Finnish banks' lending capacity must be ensured with adequate capital requirements

Nordea's Annual General Meeting approved in March 2018 the relocation of the Nordic banking group's parent company to Helsinki. The relocation of the corporate headquarters is scheduled to take place at the beginning of October. As a result, the Finnish banking sector will grow many fold in size and become one of the largest in Europe relative to the size of the economy (Chart 4).

Chart 4.

Households accumulating debt and spending a lot relative to income



*Incl. estimated housing company loans. ** Housing loans and housing company loans.
***Income minus consumption expenditure.
Sources: Statistics Finland and calculations by the Bank of Finland.

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Nordea's relocation signals trust in the Banking Union and will strengthen the future prospects for the Finnish financial sector. The relocation of the head office of a large international bank such as Nordea will also improve the possibilities for new Finnish financial sector companies (FinTech companies) to cooperate with the banking sector, expand their customer base and strengthen their expertise.

However, the expansion of the banking sector will increase the already high structural vulnerabilities of the Finnish banking system: in addition to its large size, the Finnish banking sector will be highly concentrated and exposed to housing market disruptions and disruptions in other Nordic economies and their financial systems. These disruptions may spread rapidly and become intensified especially in structurally vulnerable banking systems, as is the case in Finland. In the worst case, they can cause significant macroeconomic costs.

Finland's participation in the EU's Banking Union serves to mitigate the systemic risks associated with the change in the banking sector: single supervision and single resolution will reduce the risks to macroeconomic and financial stability stemming from banks' severe problems (see the Bank of Finland's autumn 2017 financial stability assessment: Finland's banking sector expands – Banking Union mitigates risks). A common deposit insurance scheme, which is yet to be implemented within the framework of Banking Union, would mitigate the risks further (see Progress in work to complete Banking Union).

At the beginning of 2018, a new macroprudential tool – the systemic risk buffer – became available to the Board of the FIN-FSA. The systemic risk buffer is an additional capital requirement that can be imposed on credit institutions, whenever necessary, to ensure sufficient loss absorption and lending capacity of the systemically vulnerable banking sector under all circumstances (see Systemic risk buffer protecting the banking sector under difficult conditions). Imposition of the systemic risk buffer would help to maintain the banking sector operational even under severe disruptions to the financial system.

Imbalances on the Swedish housing market also pose a risk for Finland

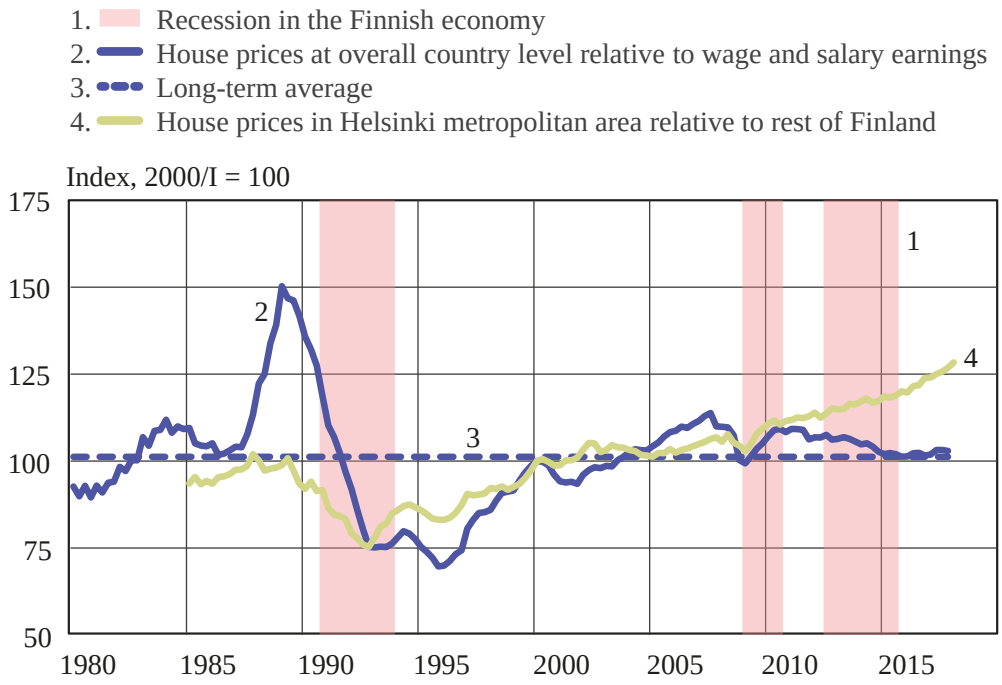
The relocation of Nordea's corporate headquarters to Helsinki makes the Finnish banking sector increasingly interconnected with the Nordic banking system and more exposed to the risks of the Nordic economies. In terms of the stability of the Finnish financial system, the major external risks are currently related to the imbalances in the Swedish housing market and their possible second-round effects.

International analyses show that the level of house prices in Sweden is high relative to the long-term average trend. The increase in house prices has been bolstered among other things by the country's favourable economic developments, a low level of interest rates, long average loan repayment periods, urbanisation and the scarce supply and regulation of rented housing.

In autumn 2017, house prices declined across the board in Sweden.[8] For example, prices of flats dropped in real terms by more than 10% over a short period. According to an assessment by the Riksbank, the recent surge in housing construction and, by extension, the supply of housing may have contributed to the drop in prices.[9] During the first few months of 2018, price developments have become more stabilised (Chart 5).

Chart 5.

House price developments moderate, but regional differences on the increase



Sources: Statistics Finland and calculations by the Bank of Finland.

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In the worst-case scenario, a plunge in house prices could trigger a negative spiral if a large number of households were to postpone their house purchase in anticipation of further price declines. In such a spiral, a strong contraction in housing demand would bring house sales to a standstill and fuel the price decline further. Dwindling prices could also discourage investment in residential construction and make indebted households cut their consumption. Occurring together, these reactions could have a large negative effect on GDP and employment.

Controlled stabilisation of Swedish house price developments would be welcome for both the country itself and for its neighbours. A steep and abrupt correction in prices in Sweden would also have adverse consequences for the Finnish economy. Slowing economic growth in Sweden would impair Finnish exports, while growing credit risks and loan losses in Sweden could hamper Nordic banks' ability to access funding on the international financial markets, undermining their lending capacity both in Sweden and in other countries.

In addition to the risks on the housing market, many euro area countries have voiced concerns about the increase in commercial real estate prices and the growth in commercial real estate construction. Also in Finland, the professional real estate investment market has expanded in recent years, with a stronger presence of foreign investors (see The Finnish real estate investment market).

Low risk premia and high valuation levels that expose the securities markets to abrupt corrections in asset prices and risk premia present major threats to the stability of the global financial markets, in addition to the risks related to the real estate market. Share prices dipped worldwide in early 2018, and major fluctuations in share prices have also been witnessed since then. The vulnerabilities of euro area banks, together with concerns about public sector debt sustainability, also pose a risk to financial stability.

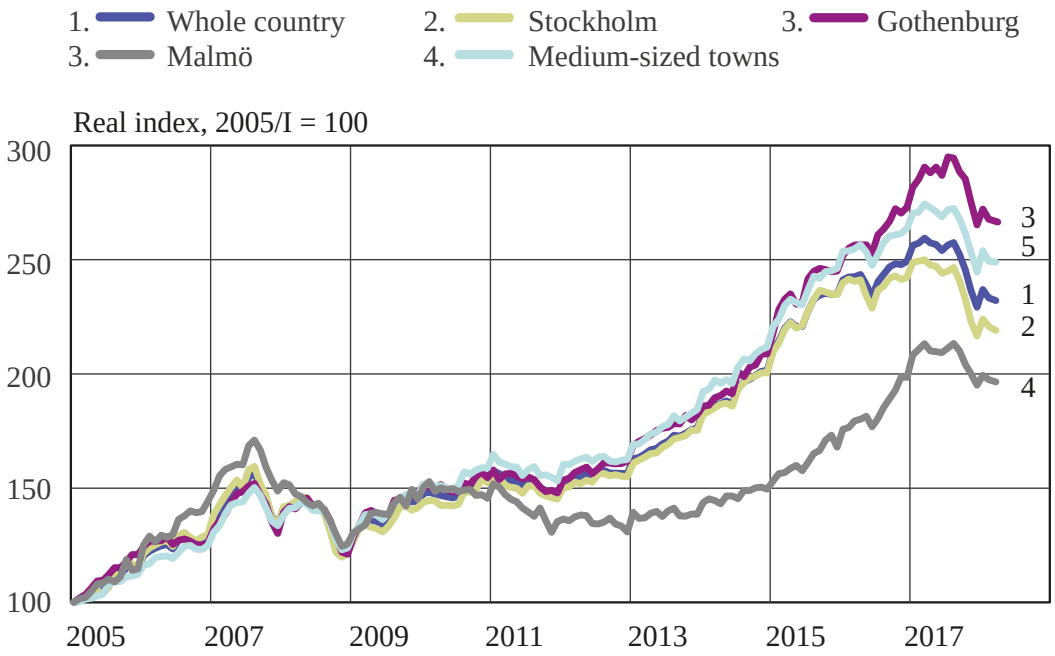
Risk resilience of Finnish financial system remains good

The risk resilience of the Finnish credit institutions sector has remained strong overall relative to the credit and other risks addressed in the capital adequacy analysis.[10] Common Equity Tier 1 (CET1) ratio[11] for the credit institutions sector stood at 21.0% at the end of 2017, while the total capital ratio stood at 23.4% (Chart 6). Capital ratios had declined slightly from the year before. By contrast, the leverage ratio for the sector improved to 6.8%. The ratios were higher than in the EU on average, with capital ratios exceeding minimum requirements by a clear margin.[12]

Capital adequacy ratios declined at the beginning of 2017, in response to the restructuring of the Finnish subsidiary of Nordea into a branch of the Swedish parent company and the decision of the European Central Bank (ECB) to apply a lower risk weight to the retail exposures of OP Group, on a temporary basis. The restructuring of Nordea also contributed to the improvement in the leverage ratio. At the end of 2017, Danske Bank also carried out a restructuring, transferring most of its Finnish business operations to a branch.

Chart 6.

Prices of flats in Sweden began to fall in autumn 2017



Sources: Valueguard, European Central Bank, Macrobond and calculations by the Bank of Finland.

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Measured by return on equity and cost-to-income ratios, Finnish credit institutions are more profitable and efficient than EU credit institutions on average. The quality of the loan stock has been good for a long time: nonperforming assets relative to the credit stock have remained low and net impairment losses small.[13]

Covered bonds have continued to play a major role for credit institutions in terms of both liquidity and funding. Considering the role played by these secured debt instruments in extending funding maturities, the large proportion accounted for by them in the banks' funding is positive in itself. That said, they also increase asset encumbrance, the interconnectedness of credit institutions and their exposure to disruptions on the Nordic housing markets. The short-term liquidity and liquidity buffer composition of credit institutions have remained good, overall. Access to market-based funding continues to be good and the price favourable, but credit institutions' exposure to changes

in investor risk sentiment presents one of the permanent structural vulnerabilities of the sector.

The Finnish insurance sector has also remained stable. The solvency of employee pension institutions and life and non-life insurance companies has remained sound, on average.[14] In 2017, most of their investment income was derived from equity investments. In response to the low level of interest rates and the search for yield, real estate investment gained in importance for total yield, especially at the expense of debt securities. However, like the credit institutions sector, the Finnish earnings-related pension sector and life and non-life insurance sectors are highly concentrated in structure.

Euro area financial system must be reinforced with common deposit insurance

Since the financial crisis, the global financial system has been strengthened in a number of ways. Insufficient regulation, supervision and resolution have been improved. In addition, macroprudential policy tools have been introduced to prevent systemic risks to the financial system.

Banking Union, which became operational in 2014, has strengthened the European financial system by supporting financial integration and the cross-border provision of financial services and by harmonising banking supervision and enhancing the effectiveness of the resolution of distressed banks. The third element of Banking Union, the element that completes the Single Supervisory Mechanism and the Single Resolution Mechanism – a single European Deposit Insurance Scheme – is however still lacking (see Progress in work to complete Banking Union).

The resources of a single European Deposit Insurance Scheme would be stronger than individual national deposit guarantee schemes. It would increase the stability of the euro area banking system significantly compared with the current situation in which national funds are responsible for deposit guarantee. The objective is that depositors throughout the euro area trust that they have uninterrupted access to their covered deposits. The stronger and more credible the deposit insurance scheme, the smaller the likelihood of deposit runs.

As a result of the financial and debt crises, some euro area banks still have on their balance sheets legacy non-performing loans of customers that have repayment difficulties. These loans burden banks' balance sheets, weaken their lending capacity and thereby undermine the transmission of finance to the real economy. Realisation of a European Deposit Insurance Scheme can be promoted and Banking Union reinforced by reducing the amount of non-performing loans and thereby strengthening banks' balance sheets.

Breaking the bank-sovereign nexus was one key reason for creating Banking Union (Chart 7). Banks' considerable exposures to domestic sovereign debt should therefore be decreased with arrangements that encourage banks to reduce their large holdings of individual countries' sovereign debt.

Chart 7.

Links between banks and their national sovereigns must be weakened



Source: Bank of Finland.

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Risks in the European banking sector should be decreased further, but the conditions for moving to a common deposit insurance should, however, be set realistically. It is justifiable to tackle the problem of non-performing loans created during the financial crisis with national funds and in line with guidelines adopted by the European Commission. To ensure healthy incentives for risk-taking, banks' deposit insurance contributions should be calibrated based on the risks caused to the deposit insurance scheme by the activities of the individual banks as proposed by the European Commission (see Construction of a risk-based European Deposit Insurance Scheme).

In May 2018, the European Commission will publish the final legislative initiatives related to the framework for a Capital Markets Union. The Council of the European Union and the European Parliament have, however, been unable to keep up with the pace of the Commission in the finalisation and adoption of the legislative proposals, and it is therefore uncertain whether all the initiatives will be adopted before the elections to the European Parliament in 2019. Progress on the Capital Markets Union is, however, important to help the capital markets provide more support for the banking sector in the distribution of risk and funding the real economy.

Post-financial crisis Basel III regulation still being finalised

The global financial crisis showed that the quality and quantity of bank capital were too low relative to the risks. Already during the financial crisis, measures were taken to address the shortcomings in the global regulatory framework for bank capital and liquidity. In 2010, the Basel Committee on Banking Supervision introduced a set of reform measures, the Basel III standards. The new rules were phased in gradually in the European Union, starting on 1 January 2014.

In December 2017, the Basel Committee introduced standards that complement the capital framework for banks. The revised standards aim to constrain the use of internal ratings-based approaches in the calculation of capital requirements. The key objective of the revisions is to improve the credibility and comparability of banks' capital ratios by reducing excessive variability of risk-weighted assets[15] in capital adequacy calculations. Finalisation of the Basel III framework is an important step, despite the considerable effort already made to improve financial stability.

Estimates by the FIN-FSA show that as a result of the planned reform, the Finnish banking sector's euro-denominated capital requirements will increase and capital ratios will decline more than in the EU on average. The FIN-FSA assessment shows that even after the reform, the Finnish banking sector's capital adequacy would remain strong and clearly higher than the EU average.

During the financial crisis, the stability of the financial system was threatened, but some may have already forgotten the critical moments. The United States is dismantling some of the post-financial crisis lines of defence of financial stability. Economic history shows that deregulation during good times sows the seeds of a new crisis. Deregulation should therefore be treated with caution.

Digitalisation of financial services creates new services and risks

Rapid advances in and increasingly widespread introduction of information and communication technology – digitalisation – are thoroughly reshaping the economy, working life and society. Finland has been a forerunner in financial sector digitalisation (see Nordic banks go digital). Digitalisation creates not only new products, services, competition and economic growth, but also new risks.

The digitalisation of financial services has become evident to Finnish consumers particularly in retail payments. Banks and new entities have started to provide consumers with, for example, new easy-to-use mobile payment services. Some global technology majors have also joined the competition.

The revised EU Directive on Payment Services (PSD2) will contribute to improving the conditions for competition in payment services (see Effects of the revised Payment Services Directive: first assessment). For example, the Directive requires that banks provide, with the consent of the customer, third party service providers limited free-of-charge access to the customer's account.

Ease of payment and seamless integration of payments with purchase transactions make spending and debt accumulation increasingly easy. Households' good level of financial literacy and management of personal finances will become increasingly important civic skills.

Digitalisation will facilitate the entry onto the market of new entities not only in payments but also in other financial services. It will also facilitate the provision of financial services outside the stringent regulation applied on credit institutions. Authorities must try to ensure that they apply similar regulation on similar financial services, irrespective of which entity is providing the service.

Possibly the largest risks to financial sector digitalisation are systemic cyber risks. Digitalisation increases financial sector fragmentation, complexity and interconnectedness, which makes the complex systems even more vulnerable to cyber risks. In recent years, authorities have significantly enhanced global cooperation in preparing against cyber risks (see Digitalisation poses new security challenges for payment systems). Preventing cyber risks will, however, require continuous vigilance by both authorities and market participants in a rapidly changing operating environment.

Notes

1. https://www.bofbulletin.fi/en/2017/5/forecast-upswing-more-broadly-based-improved-chances-for-balanced-growth-in-finland/ ↑
2. Jordà, Ò. – Schularick, M. – Taylor, A. M. (2016) 'The great mortgaging: housing finance, crises and business cycles', Economic Policy, Volume 31, Issue 85, 107–152. ↑
3. It would also be easier to implement the loan cap if credit institutions were allowed to deviate from it for a separately determined proportion of new mortgage lending. ↑
4. According to a Bank of Finland survey on credit institutions, fixed instalment loans accounted for about 40% of the housing loan stock in 2016. According to data collected by the FIN-FSA, fixed instalment loans constituted 27% of the euro volume of new housing loans granted between 1 July 2016 and 31 March 2017. ↑
5. http://www.finanssivalvonta.fi/en/Publications/supervision_releases/Pages/18_2018.aspx. ↑
6. Suomen Asiakastieto Oy, press release of 6 April 2018. ↑
7. The assessment is scheduled to be finalised by June 2018, see the Ministry of Justice press release of 5 December 2017 (in Finnish): http://oikeusministerio.fi/artikkeli/-/asset_publisher/positiivisia-luottotietoja-koskevasta-jarjestelmasta-selvitys. ↑
8. Valueguard HOX price index (https://valueguard.se/indexes). ↑

9. Stability Report 2017:2 of the Swedish Riksbank (https://www.riksbank.se/globalassets/media/rapporter/fsr/engelska/2017/fsr-171122/rap_fsr2_171122_eng.pdf). ↑
10. This section is largely based on FIN-FSA information; see the report on the financial position and risks of supervised entities released on 19 March 2018 (in Finnish) (http://www.finanssivalvonta.fi/fi/Tiedotteet/valtari/Pages/Default.aspx). ↑
11. The CET1 ratio refers to the amount of common equity tier 1 capital, i.e. capital of highest quality, relative to total risk-weighted assets. ↑
12. These requirements include a total minimum capital requirement of 8% (relative to total risk-weighted assets), a capital conservation buffer of 2.5%, and additional capital requirements for systemically important credit institutions (O-SIIs). In addition, the ECB and FIN-FSA have imposed institution-specific discretionary additional capital requirements (Pillar 2 requirements) in connection with the supervisory reviews. The capital adequacy requirements are also dependent on the geographical distribution of exposures and the counter-cyclical capital requirements set in the country of location, although the role played by these at the end of 2017 was negligible. ↑
13. The proportion of non-performing assets relative to the credit stock is higher for consumer credit (3.5% at the end of 2017) than for housing loans (1.5%) and loans to non-financial corporations (2.2%). ↑
14. The solvency ratio for employee pension institutions (the ratio of pension assets to technical provisions) stood at 130.7% at the end of 2017. The Solvency Capital Requirement (SCR) reflecting the solvency of the non-life insurance sector was 225%, while that for the life insurance sector was 193%. ↑
15. Banks' capital requirements are expressed as a percentage of a bank's total risk exposure, i.e. risk-weighted assets. The total amount of risk-weighted assets is calculated by multiplying the exposures, for example loans, by their risk weights before summing up the exposures. The smaller the risk weight of an item, the smaller the amount of capital the bank has to set aside for that asset. ↑

Keywords

banking union, banks, financial regulation, financial stability, indebtedness