Editorial

Editorial: New instruments are needed to rein in household debt

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Household behaviour and business activity continue to be very much influenced by the COVID-19 pandemic. The prospects for the economic environment returning to a state of normalcy are improving, however, as vaccine rollouts gather pace in Finland and abroad. The Finnish economy has held up better than feared in the worst-case scenarios envisaged one year ago, and the financial system has continued to function well. The economy's better-than-expected performance can be attributed especially to the policy measures put in place domestically and in the euro area, and to the ability of households and businesses to adjust to the emergency conditions.



Activity on the housing market has remained largely brisk in spite of the weak performance of the economy overall. The low cost of finance and relaxed lending terms have contributed to an acceleration in the growth of household debt in Finland. A clear upward trend can be identified in the debt-to-income ratios of new mortgage borrowers. Developments in the level of household debt and the housing market are being closely monitored, and assessments are being drawn as to whether the rise in indebtedness warrants further measures by the authorities.

In the short term, the growth of households' housing-related debt can be curbed by restricting loan-to-value ratios on housing loans. But a maximum loan-to-value ratio for housing loans should be supplemented with instruments that are able to curb total indebtedness. The prevailing favourable financing conditions that have been calibrated for the euro area as a whole hold the potential to accelerate the growth of household debt in Finland. The measures proposed by a Ministry of Finance working group in October 2019 can help prevent the threat of a debt-driven boom and bust cycle.

The maximum debt-to-income ratio proposed by the ministerial working group can be implemented in such a way that lending could broadly continue as it has recently been. The proposal's framework grants lenders a margin of discretion in exempting loans from the proposed debt-to-income cap. The debt-to-income cap would not have a significant impact on first-time homebuyers, as first-time buyers typically hold less debt than households changing homes.

The proposed maturity limit on housing loans and housing company loans would curtail the growth of indebtedness. The maturities on Finnish housing loans began to lengthen in the early 2000s, at which point the debt burden of households also began rapidly expanding. Banks' lending practices are diverse, so the impact of a maturity limit would affect banks differently.

Imposing a maximum loan-to-value ratio for housing company loans would limit the risks of large housing company loans currently associated with new builds. When a large share of the unencumbered price of a dwelling is financed by a housing company loan and the loan begins with an amortisation-free period, buyers are incentivised to purchase a dwelling that is expensive relative to their debt-servicing ability. It should be stressed that the loan-to-value limit for housing company loans would not affect loans for building refurbishment.

The Finnish banking sector was well-capitalised at the time the pandemic hit, and it has been able to provide finance to households and firms during the crisis. The benefits of the stronger regulation put in place after the global financial crisis can be seen in that the financial system has, by and large, operated without disruption during the pandemic. The banking sector's ability to sustain its lending to the real economy might have been disrupted if the capital adequacy of banks had been weaker. The importance of financial market regulation for the functioning of the economy cannot be overstated.

Businesses that are otherwise sound are still in need of economic support to cushion the effects of the restrictions put in place to combat the lingering pandemic. The protracted pandemic will inevitably raise the credit risk of banks. Hence it is still prudent for banks to prepare for a rise in loan losses, even if they have already increased their loan loss provisions and have, for the time being at least, experienced fewer losses than anticipated. The economy remains clouded by

uncertainty, nor have all of the ramifications of the lockdown measures yet been felt.

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Marja Nykänen
Deputy Governor

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