Resilience of borrowers and the financial system must be strengthened

Bank of Finland’s financial stability assessment

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Bank of Finland’s financial stability assessment

- Editorial: Resilience of borrowers, banks and payment systems must be strengthened
- Financial stability assessment: The weakening economy and tightening financing conditions pose a challenge to financial stability
- Experts’ articles on topical issues
  - From crisis to crisis – companies are once again faced with a challenging operating environment
  - New housing loans increasingly larger – a significantly larger share also with longer maturities
  - Nordic housing market risks can affect Finland’s economy
  - Large structural risks require banks to have buffers for a rainy day
  - Macroprudential toolkit should be replenished in Finland and Europe
  - Financial sector also facing new kinds of threats

Key messages

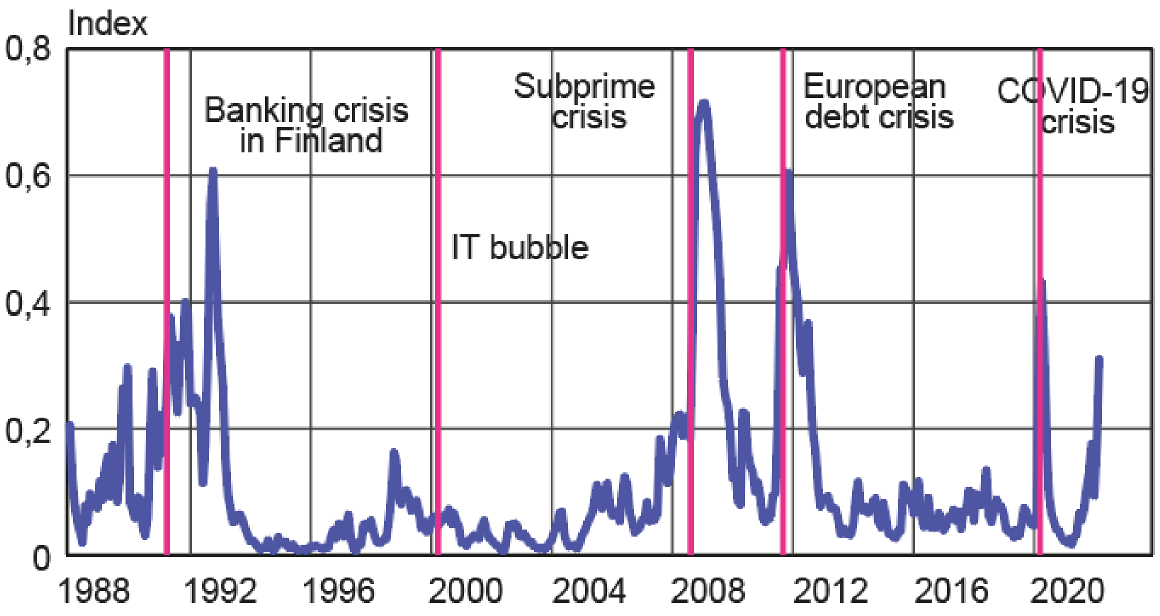
- The Finnish financial system is stable despite Russia’s invasion of Ukraine, but risks to financial stability have increased.
- Due to the difficult operating environment and the vulnerabilities in the Finnish financial system, it is important to strengthen the resilience of banks.
- Households have an increasing amount of debt relative to income – the planned new macroprudential instruments are not sufficient for curbing excessive growth in indebtedness.
- More decisive action must be taken to prepare for cyber threats and vulnerabilities in payment and settlement systems.

Risks to financial stability have increased

Financial markets have operated without disruptions, but risks to financial stability have increased

- The financial markets reacted strongly to the start of the war, but there has been no need for new measures to support financial stability.
- The financial system’s direct exposures to Russia are manageable, but the war increases the indirect risks via several channels.
- A weakening economy and tightening financing conditions are a problematic combination in terms of financial stability.

Financial market stress indicator for Finland

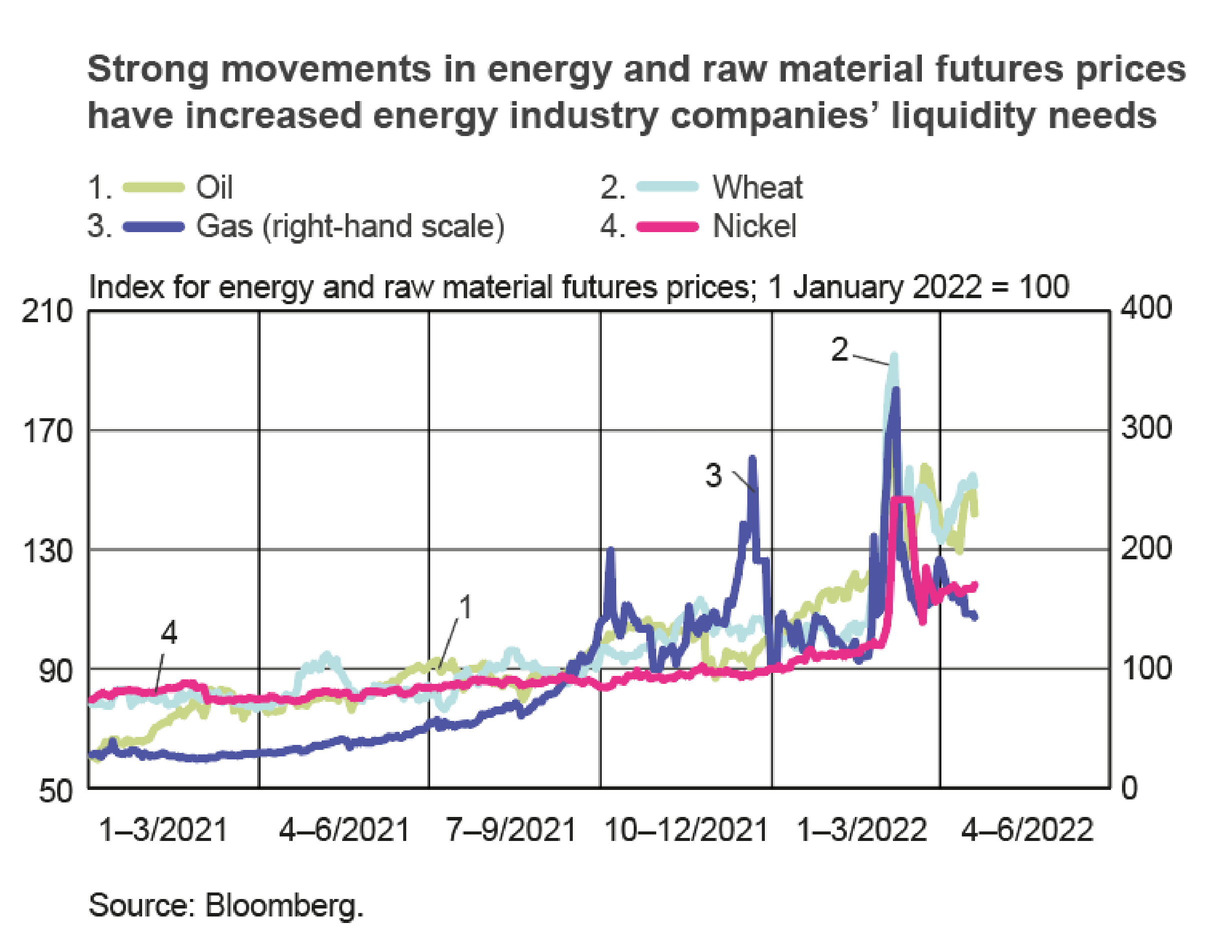


Sources: Bloomberg, Datastream and calculations by the Bank of Finland.

The impacts of the war are particularly evident on the energy and raw material markets

- Cutting the ties to Russian energy pushes up inflation and puts a strain on the companies and industries with the highest energy-dependency.

- Energy industry companies´ larger liquidity needs have led to an increase in Finnish banks´ lending to businesses.



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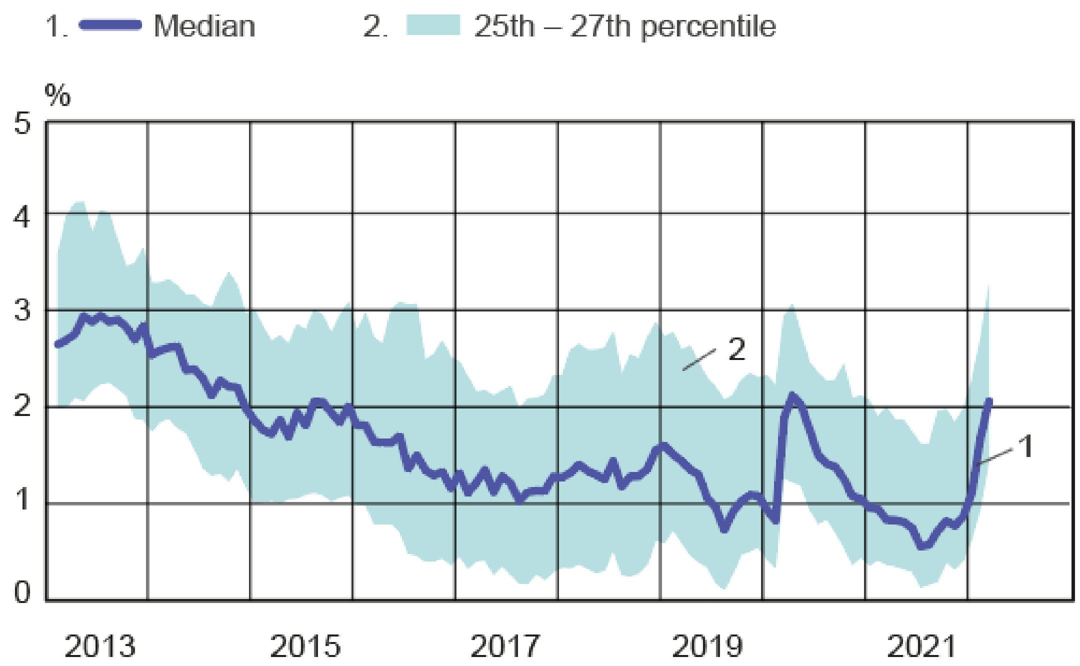
Companies are facing a more difficult operating environment

- The second-round effects of the war will have an extensive impact on Finnish companies.
- The increasingly difficult operating environment may raise credit risks on companies and push up the price of financing.
- Companies' starting point is mainly good, but the impacts of the pandemic are still felt in some industries.

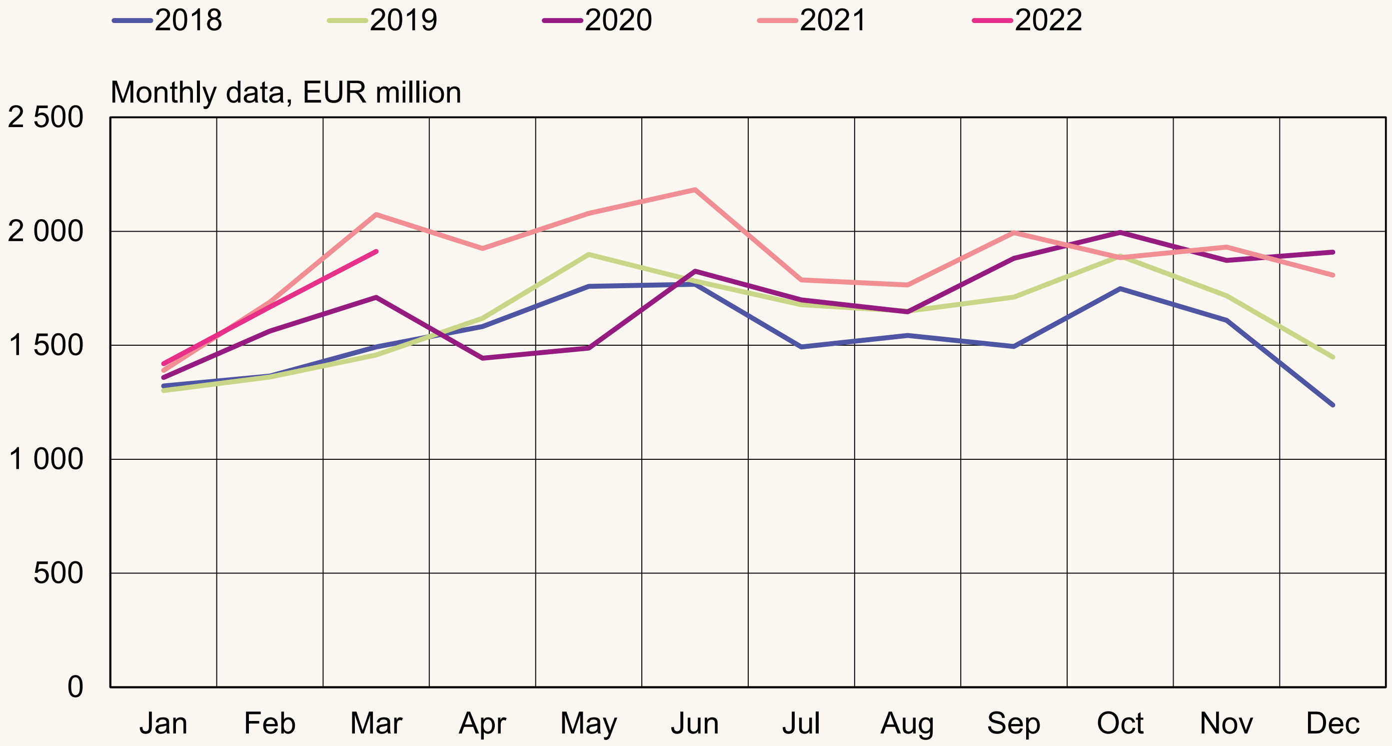
The price of domestic companies' market-based funding has increased in 2022



The chart shows the average return requirement (median) for domestic companies' euro-denominated bonds and the quartile range of the return requirement (range of the 25th and the 27th percentile).
Sources: European Central Bank and Bank of Finland.

Housing sales and housing credit dampened in March compared with a year earlier, but still remained brisk

New housing loan drawdowns from credit institutions in Finland



Source: Bank of Finland.

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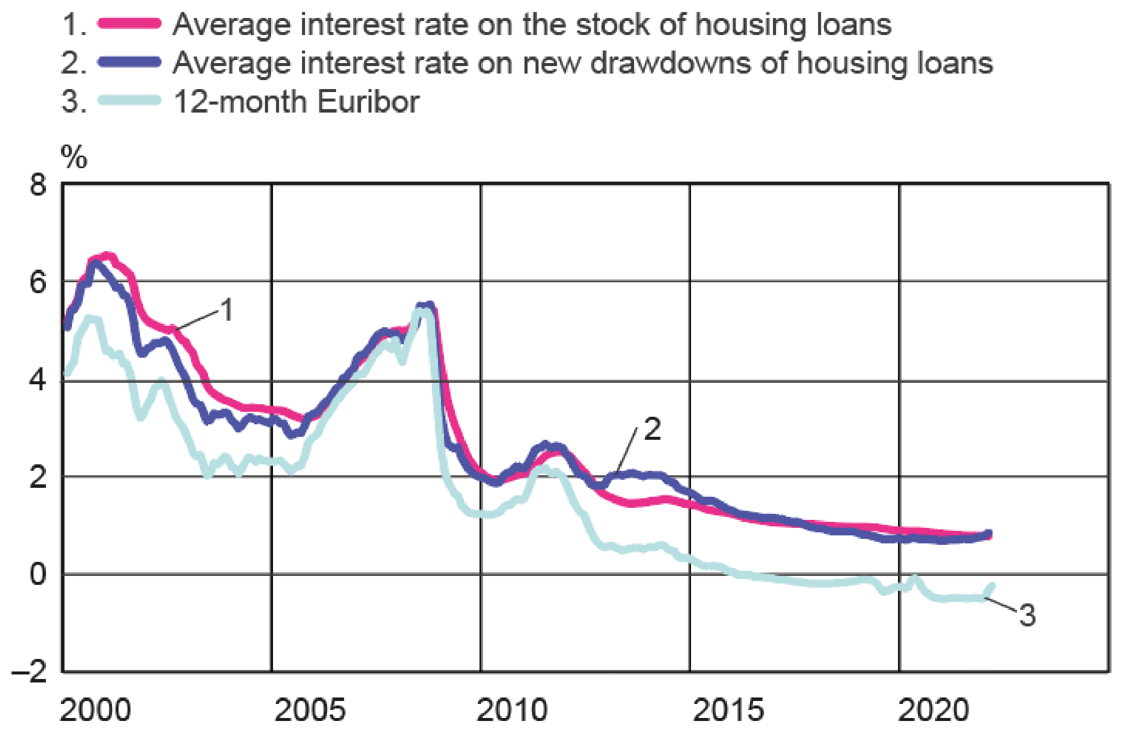
The interest rates on housing loans have long been low, but a rise in interest rates will pass rapidly through to lending rates

- In Finland, interest rates on housing loans typically rise and fall in parallel with reference rates.
- A rise in interest rates increases the monthly payment or lengthens the loan period.
- Interest rate hedging decreases the risk associated with rising interest rates.

Interest rates on housing loans historically low in Finland



Sources: Bank of Finland and Thomson Reuters.

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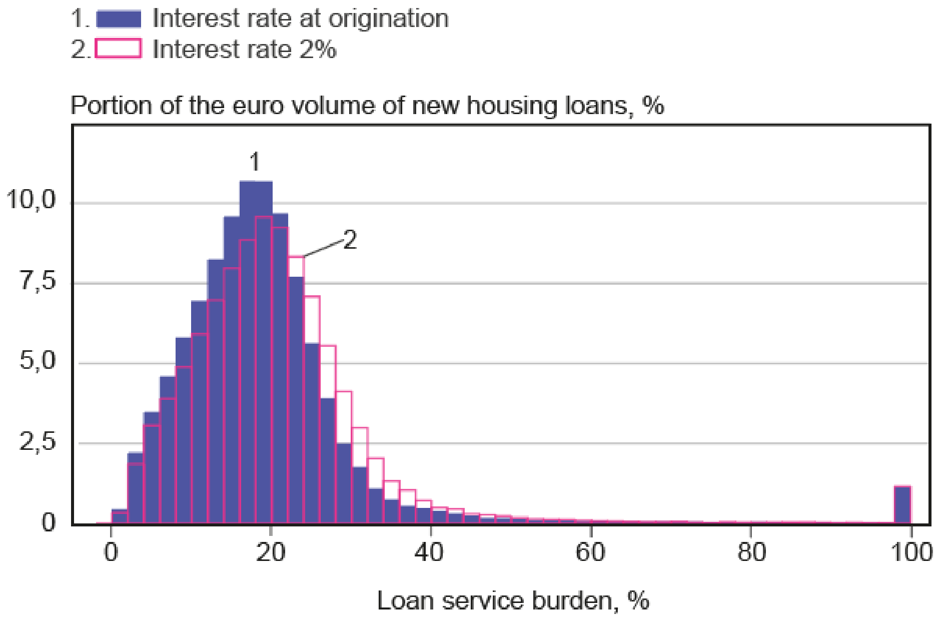
Higher cost of living and the rise in loan reference rates will increase household expenditure

New housing loans according to borrower's loan-servicing burden at various interest rates



The loan-servicing burden has been calculated from loan-specific data, and it describes the monthly loan-servicing expenses relative to the borrower's net income. The servicing burden of fixed-rate, interest rate-hedged, and fixed-instalment loans is assumed to remain the same as at origination. Outliers of the right-hand tail of the distribution have been added to 100%.

Sources: Financial Supervisory Authority and calculations by the Bank of Finland.

- Housing loan-servicing expenses at loan origination typically account for some one-fifth of the borrower's net income.
- An expected rise in interest rates would increase the loan-servicing burden moderately in the main.
- A rise in loan interest rates burdens most the borrowers that have the highest debt ratios.
- Increases in essential consumption expenditures and loan-servicing expenses as well as uncertainty on the labour market may amplify the financial distress of households.

Banks’ resilience must be strengthened

Large vulnerabilities require strong resilience from banks under all circumstances

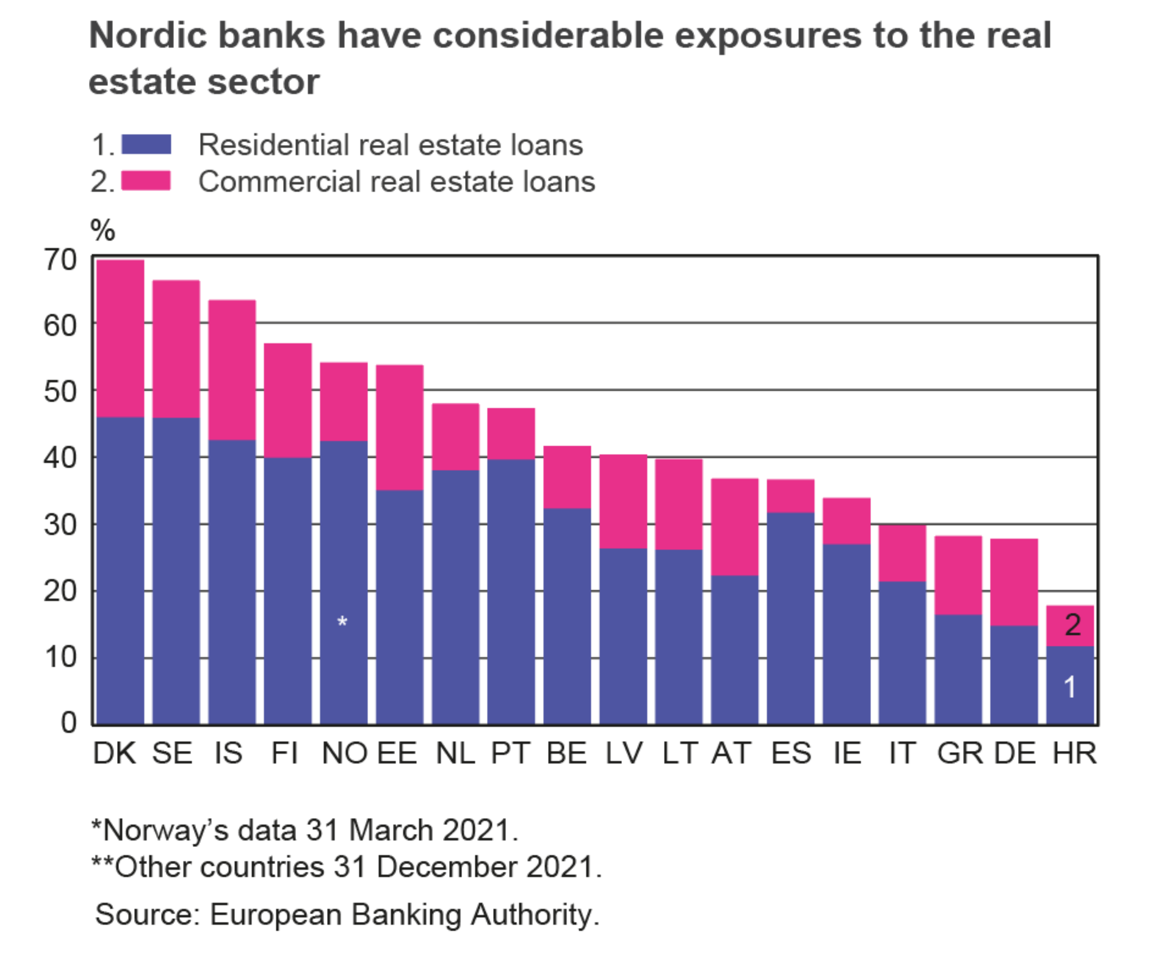
- In Finland, the banking sector plays an important role in the intermediation of finance to companies and households.

- In an economic downturn and in the event of disruptions, smooth and efficient transmission of finance is even more important.

- The banking sector's key vulnerabilities are structural
  - Household indebtedness is high and has been on an upward trend for a long time.
  - The banking sector is large, concentrated and tightly interconnected with the Nordic countries.

Finland and the other Nordic countries are exposed to risks related to household indebtedness and the housing markets

- Households have a large amount of debt relative to income.
- Banks have a large volume of housing loans and loans to the real estate sector.
- Due to these vulnerabilities, Finland and the other Nordic countries are particularly exposed to risks in the residential and commercial real estate markets.

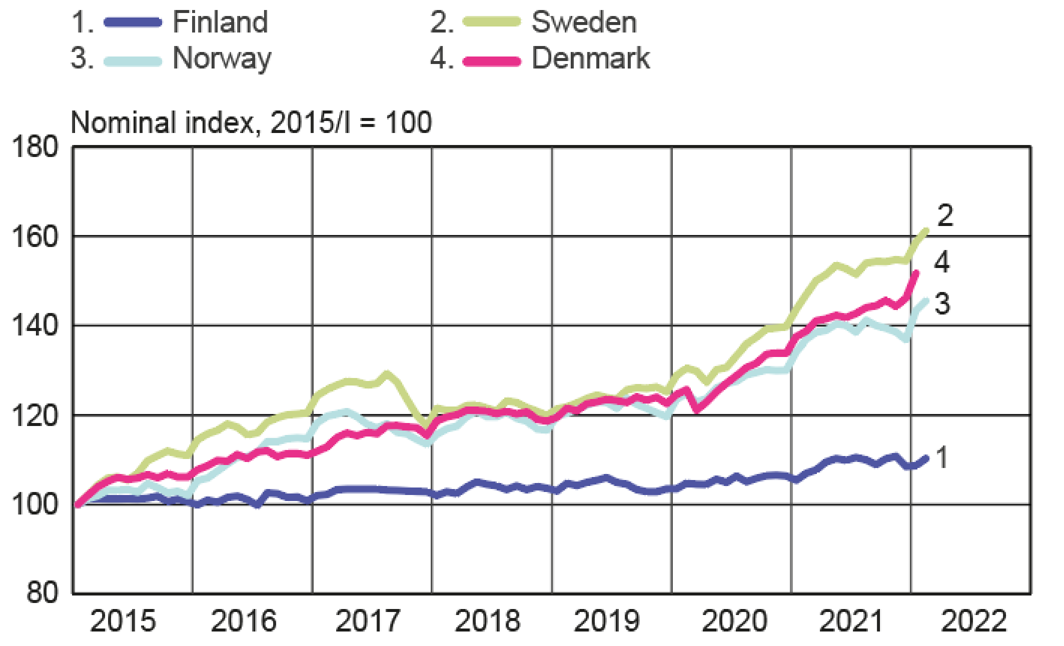


Nordic housing market risks can affect the Finnish economy, too

- The rapid rise in housing prices has increased risks on the housing markets of the other Nordic countries.

- Housing market shocks in these countries would spill over to Finland via economic and banking sector interconnectedness in the Nordic countries.

Residential property prices have risen during the pandemic – especially in Sweden

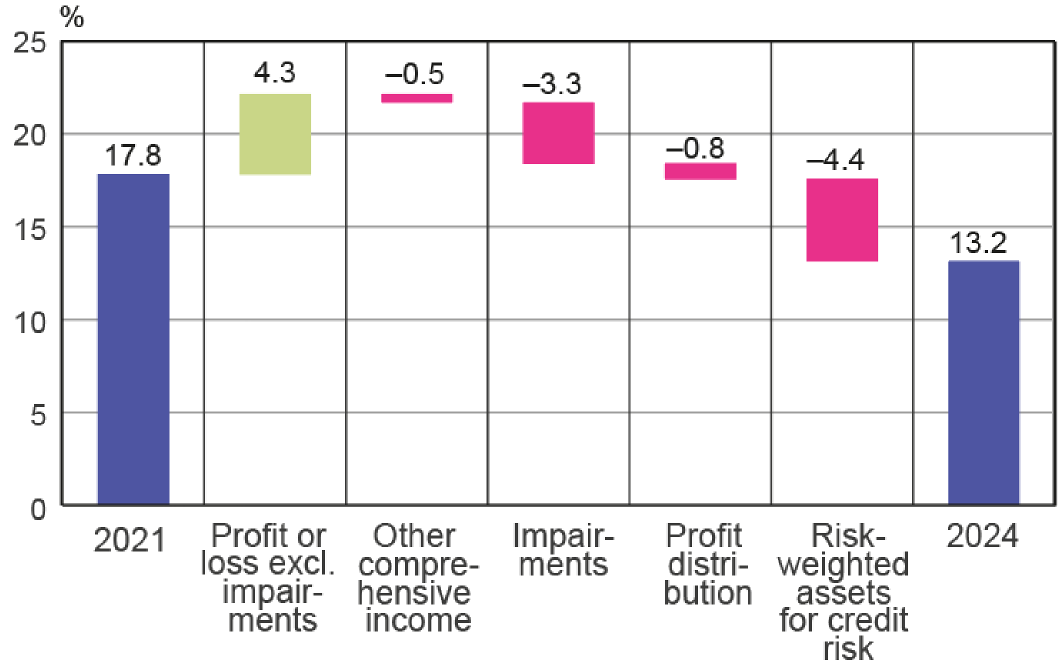


Finland: old dwellings in housing companies. Sweden, Denmark and Norway: all dwellings.
Sources: Statistics Finland, Valueguard, Statistics Denmark, Eiendom Norge, Macrobond and calculations by the Bank of Finland.

Large structural vulnerabilities require banks to hold buffers for a rainy day

- The Finnish banking sector's Common Equity Tier 1 (CET1) capital ratio would weaken by 1.4–4.7 percentage points in a Nordic stress test scenario.
- Capital adequacy would be weakened particularly by an increase in credit risks.
- Capital adequacy would exceed the minimum level also during stress test conditions.

The CET1 ratio would be weakened mostly by growth in impairments and risk-weighted assets for credit risk



Sources: Calculations by the Financial Supervisory Authority and the Bank of Finland.

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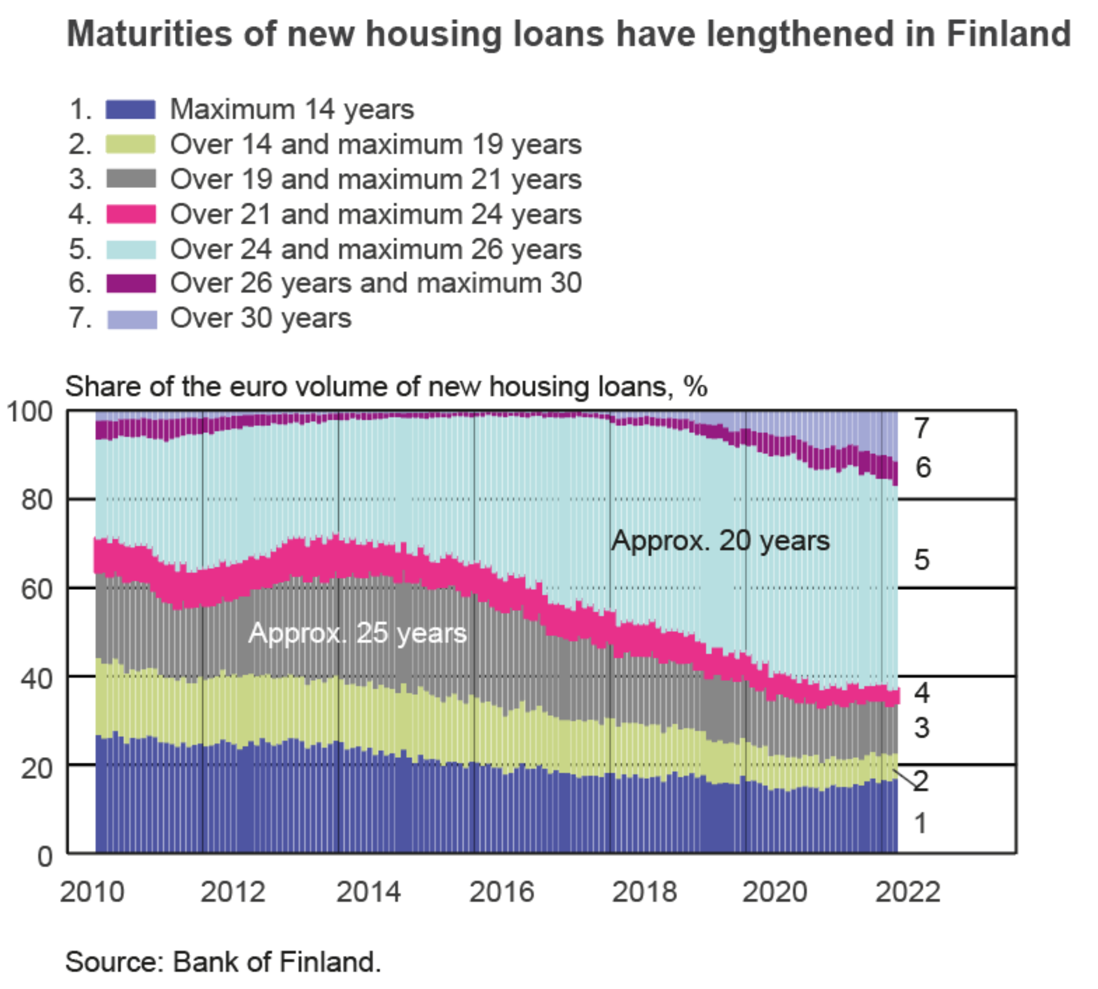
The new macroprudential instruments planned in Finland are inadequate for mitigating excessive growth in indebtedness

The proposed macroprudential instruments for mitigating indebtedness are inadequate

- The draft Government proposal includes a maximum maturity for housing and housing company loans as well as a loan cap and an amortisation requirement for housing company loans.
  - The proposed new instruments are necessary and welcome.
- The proposed instruments do not include a maximum debt-to-income ratio (debt cap) or similar instrument.
- Macroprudential instruments limiting the debt-to-income (DTI) ratio or debt service-to-income (DSTI) ratio have become more common in Europe.
  - The European Systemic Risk Board (ESRB) and the International Monetary Fund (IMF) have recommended that these instruments be introduced also in Finland.

New housing loans ever larger and with longer maturities

- In March, banks granted a record share of new housing loans with maturities of over 26 years.
- The majority of these loans have a maturity of approximately 30 or 35 years.
- Loans with longer-than-usual maturities are notably larger than loans with a maturity of approximately 25 years or less.



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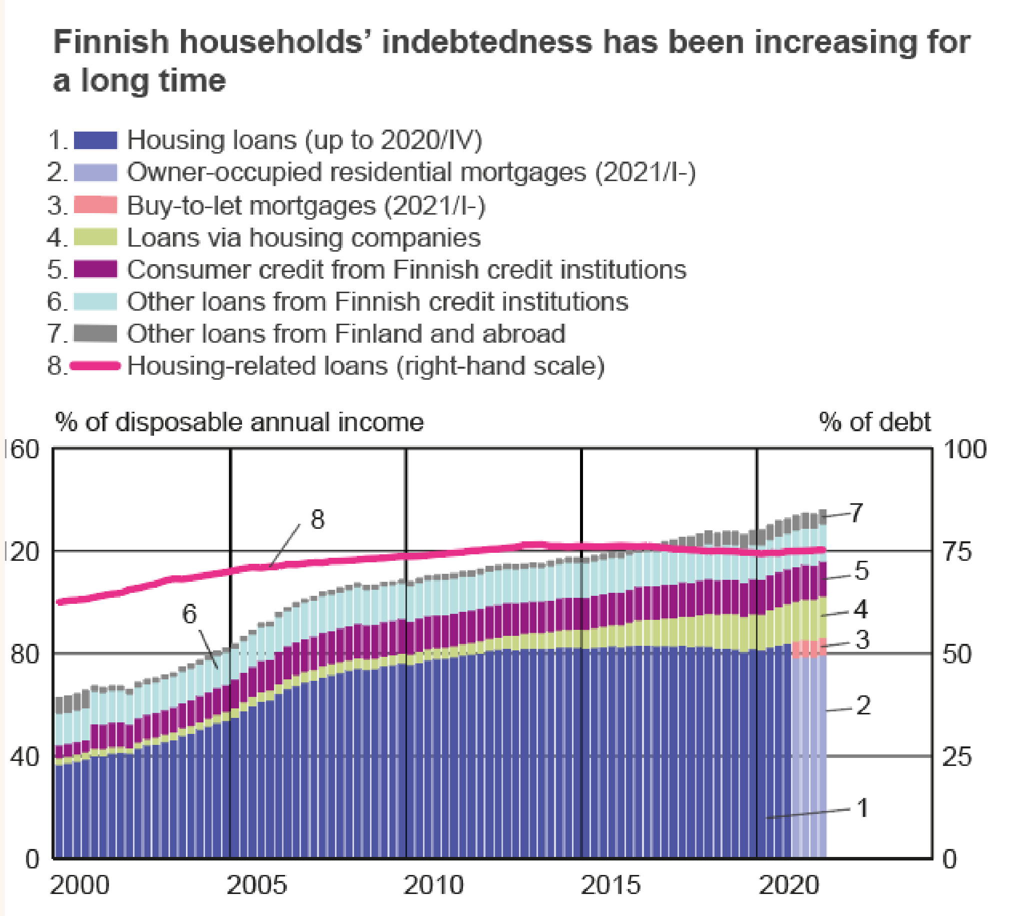
Households have an increasing amount of debt relative to income



Sources: Statistics Finland and Bank of Finland.

- An increasingly large share of new housing loans are granted to borrowers that are highly indebted relative to income.
- A debt-to-income or debt service-to-income cap would curb growth in indebtedness and strengthen the resilience of the household sector.

Macroprudential toolkit in Europe must be harmonised

- The EU regulatory framework is currently under review, with the purpose of improving and harmonising the macroprudential instruments.

- All EU countries should have in place strong instruments for mitigating the risks related to housing markets and indebtedness.

- EU regulation should allow the introduction of a countercyclical capital buffer requirement that is above zero even during the neutral phase of the credit cycle.

More decisive action must be taken to prepare for cyber threats and vulnerabilities in payment and settlement systems

Vulnerabilities in the financial sector infrastructure require decisive action

- The financial industry is an important part of the critical infrastructure which must function in all circumstances.

- The heightened geopolitical uncertainty increases the likelihood of cyber risks and other forms of influencing.
  - There is a risk of a wider lack of confidence in the operational reliability of the financial system.

- Vulnerabilities related to location of payment and settlement systems identified in preparedness exercises
  - Preparedness work requires more decisive cooperation between the industry and the authorities.

Summary of key messages

- Risks to financial stability have increased
- Banks’ resilience must be strengthened
- A household debt-to-income cap is necessary
- Key banking and payment services must be ensured under all circumstances

Thank you!

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