FINANCIAL STABILITY ASSESSMENT

Debt-to-income cap and maturity limits necessary to curb financial stability risks

4 May 2021 – Financial Stability Assessment – Financial stability

The vulnerabilities related to housing finance have increased in Finland during the COVID-19 pandemic. Long housing loans are being taken out more than ever and a larger proportion of new mortgages are being granted to borrowers whose total debts will then be very high relative to income. The persistent upward trend in household indebtedness will undermine the economy's ability to withstand future economic crises. A debt-to-income cap and a limit on the maturity of housing loans should be introduced without delay to stop the loosening of credit standards.

For now the Finnish economy has survived the shocks of the COVID-19 pandemic and suffered less damage than was feared. Furthermore, the Finnish financial system has remained stable despite the pandemic. Households and businesses have benefited from a strong fiscal and monetary policy stimulus, banks' forbearance towards their customers, direct business grants, and the easing of macroprudential requirements and other banking regulation.

However, household indebtedness, which has been on the increase for some time now, threatens to make the Finnish economy less able to overcome future economic crises. Mortgage lending has risen sharply since the summer of 2020 and increased the indebtedness of households. A larger number of new mortgages are with households that carry a significant amount of debt relative to their income.

Housing loans with very long maturities have increased rapidly and the average size of new housing loans has increased further during the pandemic. From the perspective of financial stability, the increasing popularity of housing loans with long maturities is alarming. A significant lengthening of housing loan maturities from the current level could increase the average size of loans and household indebtedness even further and fuel the rise in house prices in growth centres.

A Ministry of Finance working group has proposed that the risks related to high household indebtedness should be reduced by, for example, introducing a debt-to-income cap and by limiting the maximum maturity of new housing loans. In contrast to views that have been expressed in the public arena, the proposed debt-to-income cap would not target particularly first-home buyers.

The ongoing increase in household indebtedness and the loosening of the terms of new mortgages underline the urgency of the legislative changes proposed by the working group. The purpose of the proposed tools is to complement the current maximum loan-to-collateral ratio for residential mortgages. Another advantage of the proposals is that the instruments would apply not only to credit institutions but broadly also to other creditors.

The share of household debt attributable to housing company loans that households must service has continued to grow. In purchasing a new dwelling, the buyer often assumes responsibility for the dwelling's share of any loan the housing company has taken out, which can represent a significant share of the dwelling's total value. This practice can blur house purchasers' grasp of their overall housing costs and lure households and investors into buying dwellings that are expensive relative to their ability to cover their debts and the housing company's maintenance charges. Imposing a loan-to-value limit and a maximum maturity limit on housing company loans would reduce the granting of the largest housing company loans. The various forms of housing finance should be afforded as equal regulatory treatment as possible.

Banks operating in Finland are exposed to the risks on the domestic and Nordic residential property markets. The Nordic housing market was only temporarily dampened by the COVID-19 pandemic. House prices are rising swiftly again in Sweden and Norway, threatening to fuel housing market imbalances in these countries in particular.

Banks have a considerable amount of receivables from the property investment sector. The majority of these are related to residential investment. The pandemic has depressed professional property investors' returns, most notably from investment in office and commercial real estate.

Despite the pandemic, the profitability of Finnish banks improved in 2020. The banking regulatory reforms implemented after the global financial crisis have significantly strengthened the solvency of banks around the world. The lending and loss-bearing capacity of Finnish banks has remained good.

So far, credit losses from corporate loans have increased less than feared. However, there is reason to prepare for increased credit losses, as they typically materialise with a delay after the worst phase of a crisis is over.

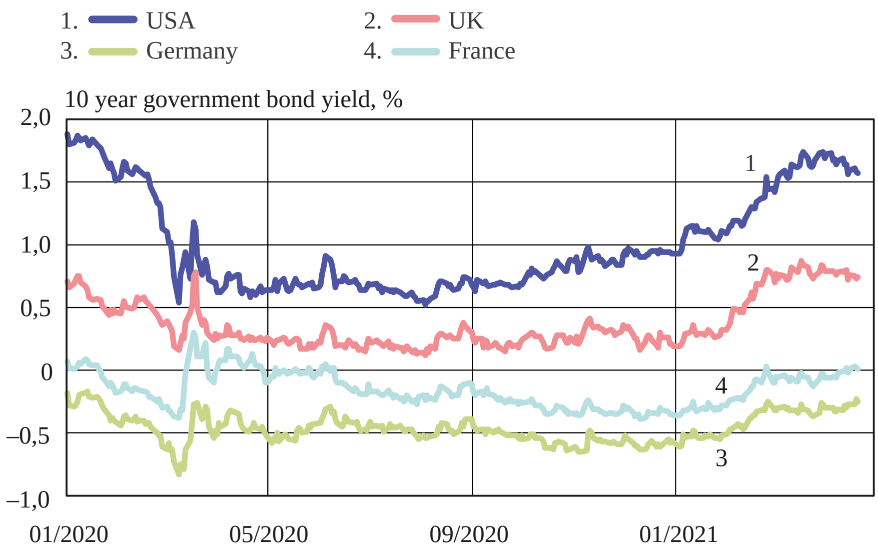
The stability of the international financial system relies on support measures

The COVID-19 pandemic continues to dominate the outlook for both the domestic and the global economy and for financial stability worldwide. The global economy is expected to continue to recover with the roll-out of the vaccination programmes in 2021, but the pandemic remains serious and the economic outlook is still uncertain, especially in the short term. The stability of the international financial system still relies on expansionary monetary and fiscal policy and other support measures.

In spring 2021 financial conditions tightened somewhat globally. The launch of the vaccine programmes and the US stimulus package heightened optimism about economic recovery. This pushed up long-term government bond yields, especially in the USA, and was also reflected in government bonds in the euro area (Chart 1). Furthermore, the interest rates on long-term corporate bonds rose and stock market volatility increased worldwide.

Chart 1.

Long-term government bond yields increased in the spring of 2021, especially in the USA



Source: Macrobond.

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The main threats to the stability of the Finnish financial system are linked to the long-term impact of the pandemic. Support measures have been used to build a bridge over the immediate problems, but, as a result of these measures, the pandemic's adverse effects on the debt sustainability of companies and households are somewhat unclear. What is crucial is how the most indebted companies and households, and those which have suffered most due to the pandemic, will be able to manage their obligations after the moratoria and other support measures are over.

European banks have been able to provide financing for companies and households, with the support of monetary accommodation, a temporary easing of regulation and other measures. The credit risks that banks face have, however, grown and may even continue to grow if the pandemic drags on (see Pandemic continues to cast a shadow over the outlook for European banks' credit risks). The amortization holidays and other repayment flexibilities offered to bank customers have for now curbed the growth in problem loans, and some of the loans to businesses and households are still benefiting from the amortization holidays that began during the pandemic.

Nordic housing market livelier despite weak economic developments

The majority of lending by Nordic banks consists of residential mortgages and commercial property loans. Indebted households and real estate investors have so far been able to service their debts quite well despite the financial difficulties caused by the pandemic. There are, however, concerns regarding lending growth and the housing market, which has recently seen very strong activity in relation to the economic situation (see Nordic housing market showing strength, but not without risks).

Sales activity on the Nordic housing market has been brisk following the first phase of the pandemic. House prices have risen rapidly, especially in Sweden and Norway, where they were already high. These developments have partly been driven by the low level of interest rates and other measures to stimulate the economy. Housing market risks will increase if borrowing is based on expectations that interest rates will long remain exceptionally low and property values will continue to rise in urban centres.[1]

The first wave of the pandemic in spring 2020 led only to a temporary drop in house sales and new mortgage lending in Finland, and the prices of homes sold at that time did not differ much from the previous year. The housing market bounced back quickly in the summer. In late 2020 and early 2021, house sales were brisker than a year earlier. House prices rose in large cities, further adding to the divergence in the prices between growth centres and the rest of the country.

Growth in the stock of housing loans has accelerated on the back of new housing loan drawdowns and fixed-term payment holidays negotiated in spring 2020 (Chart 2). Growth in the stock of housing company loans and other housing corporation loans, in turn, has decelerated due to a decline in residential construction. The pace of growth is still quite swift, however, and residential construction activity is stronger than, for example, over the past decade on average.

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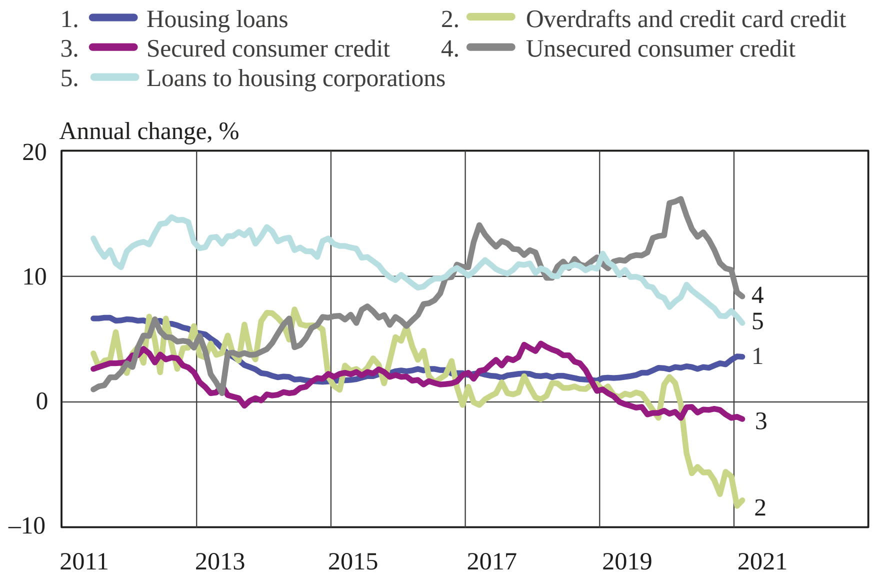
1. Over the past decades, rapid debt accumulation and growth in housing market risks have preceded the most severe banking and financial crises in advanced economies. See e.g. Tölö, E. – Laakkonen, H. – Kalatie, S. (2018) Evaluating Indicators for Use in Setting the Countercyclical Capital Buffer. Journal of Central Banking 14: 51–111. The article provides a comprehensive overview of empirical research on factors signalling financial crises.

Chart 2.

Faster growth for housing loan stock, slower for consumer credit stock



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

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The pandemic depressed professional real estate investors' returns and sales on the Finnish and Nordic real estate investment markets. The greater shift towards remote working and online shopping has meant that office and business premises have become less attractive to investors. The share of residential property in professional real estate investors' portfolios has grown. Despite the pandemic, foreign investors increased their share of the stock of Finland's real estate investments in 2020.

Owners of commercial real estate in Finland have had to renegotiate leases, and real estate vacancy rates have partly increased. Rental income from hotel properties, offices and business premises contracted in 2020. Residential, social and logistics properties, in turn, have yielded comparatively strong investment returns during the pandemic.

The prolongation of the pandemic has been reflected in slightly tighter lending standards for the real estate sector in Finland, and growth in loans granted to the sector has slowed. Domestic banks have considerable exposures to the real estate sector, but the majority of these are related to the housing market. Banks' exposures to domestic property market operators most affected by the pandemic, such as owners of hotels, shopping centres and office buildings, are relatively low.

Housing loans with very long maturities increase indebtedness

The terms of new mortgages have been relaxed further in Finland. Mortgage rates are at historically low levels, reflecting the slight narrowing in average margins and the fact that the reference rates of Euribor-linked housing loans have remained practically at zero.

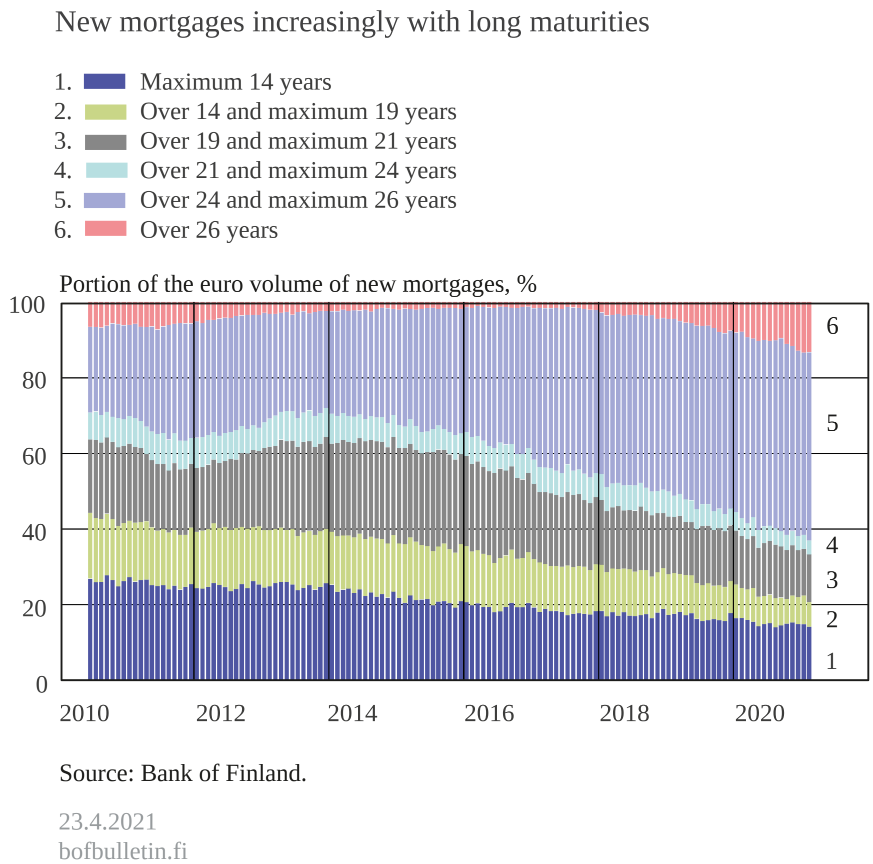
The Board of the FIN-FSA restored in late June 2020 the maximum loan-to-collateral ratio, i.e. the loan cap, for residential mortgage loans other than first-home loans to the standard level of 90%. The decision enabled banks to grant larger loans relative to the amount of collateral. The measure supported the functioning of the housing market in a weak economic situation caused by the COVID-19 pandemic.

New mortgages in Finland typically have an initial maturity of about 25 years, but longer maturities of some 30 or 35 years have become increasingly popular during the past two years (Chart 3). Furthermore, the average size of mortgages has grown. Of the households that have taken out a new mortgage, many are highly indebted relative to income (see New mortgage-borrowers have an increasing amount of debt relative to income).

The increasing popularity of housing loans with very long maturities and growth in borrowing by households with high debt-to-income ratios are worrying phenomena from the perspective of financial stability. Also, the Board of the FIN-FSA has repeatedly underlined the importance that banks carefully assess borrowers' ability to pay and has urged lenders to exercise restraint in granting loans that are very large in relation to the applicant's income and have a longer-than-usual maturity.[2]

2. See Macroprudential decision: FIN-FSA will not tighten macroprudential requirements but will closely monitor mortgage lending.

Chart 3.

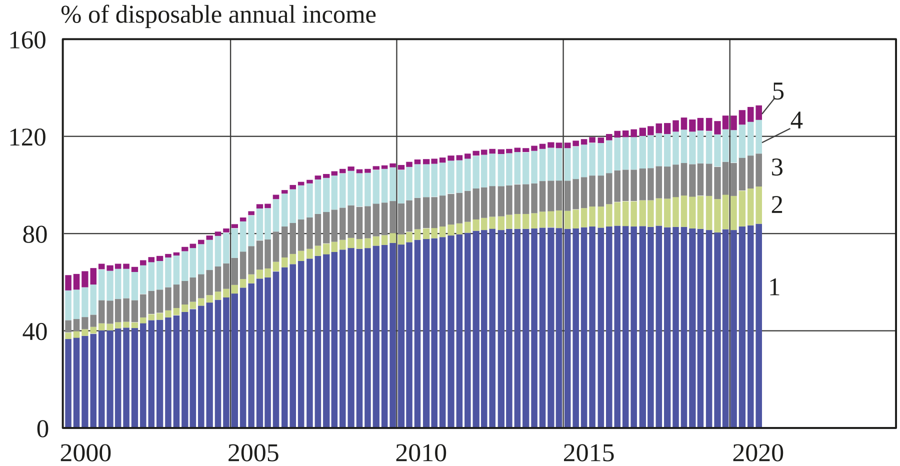


Finnish households' indebtedness has continued to increase during the pandemic, as debts have grown faster than incomes. The majority of debt and its long-term growth is housing-related debt, i.e. households' mortgages and loans for dwellings for investment purposes, as well as housing company loans related to owner-occupied housing and dwellings for investment purposes (Chart 4). The relative importance in housing finance of loans for dwellings for investment purposes and housing company loans has grown in recent years, which has contributed to the increase in risks caused by housing finance and indebtedness (See Separating buy-to-let mortgages from other housing loans provides a clearer look into household debt and Imposing a loan-to-value limit on housing company loans would only affect a share of construction finance).

Chart 4.

Household debt levels have risen for a long time

1. Housing loans from credit institutions operating in Finland
2. Loans via housing companies
3. Consumer credit from credit institutions operating in Finland
4. Other loans from credit institutions operating in Finland
5. Other loans from Finland and abroad



Sources: Statistics Finland and Bank of Finland.

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Growth in consumer credit by credit institutions operating in Finland has slowed notably since the outbreak of the pandemic (Chart 2). Consumer spending declined in 2020 in response to the containment measures, furloughs and decrease in consumer confidence caused by the pandemic. This was accompanied by an increase in household savings. The Consumer Protection Act was amended by introducing a 10% interest rate cap and a direct marketing restriction on consumer credit, which are in force until the end of September 2021.

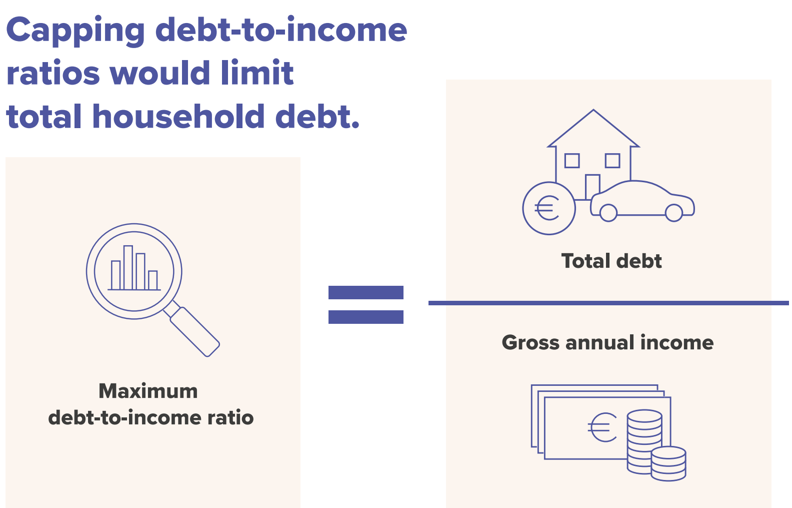
Proposed measures to prevent excessive household indebtedness

A working group of the Ministry of Finance, led by Leena Mörttinen and representing several authorities and the financial sector, published its report in October 2019.[3] In this report, the working group proposed, among other things, the limitations presented below to be incorporated into Finnish law to prevent excessive household indebtedness. The limits would apply to both banks and other creditors.

Maximum debt-to-income ratio

The maximum debt-to-income (DTI) ratio, or debt-to-income cap would curb indebtedness in relation to income. The total debts of the loan applicant or household would include housing loans, housing company loans and consumer credits. This total would be divided by the loan applicant's gross annual income, i.e. wage earnings, capital income and benefits before taxes and deductions. The DTI cap would be applied when granting new housing loans or large amounts of consumer credit.

Chart 5



Source: Bank of Finland.

The working group proposed that the DTI cap would be calibrated so that the total amount of the new loan and any existing loans would not exceed 450% of the gross annual income of the loan applicant or applicants. In addition, creditors would be allowed discretion and flexibility in the case of individual borrowers, i.e. up to 15% of the euro volume of loans could be granted with a ratio higher than the maximum DTI ratio.

Maximum maturity of housing loans and housing company loans

The maximum maturity of housing loans, and housing company loans for new housing construction, would be limited to 25 years. However, creditors could deviate from these limits in the amount of 10% of the euro volume of the loans granted, meaning that some of the loans could have a maturity in excess of 25 years.

The proposal on the maximum housing loan maturity does not exclude the possibility of interest-only amortization holidays during the loan term. In the case of housing company loans for new housing construction, no interest-only periods would be allowed for five years following the completion of the dwelling.

Loan-to-value limit on housing company loans

A loan-to-value (LTV) limit, or a maximum credit share of 60% would be set for housing company loans for new housing construction. This would mean that, at the construction stage, the maximum amount of credit issued to a housing company could be 60% of the unencumbered price of the flats to be sold.

Other proposals

The working group proposed that the Financial Supervisory Authority also supervise creditors other than banks in the future. In addition, creditors would not be permitted to grant loans to applicants who are likely to be unable to repay the loan.

Debt levels are rising – the debt-to-income cap is a matter of urgency

As the heightened uncertainty related to the COVID-19 pandemic recedes, it is justified to extend Finland's macroprudential toolkit by introducing into legislation measures proposed by the Ministry of Finance working group (see Proposed measures to prevent excessive household indebtedness]).[4] The Bank of Finland supports the working group's proposals.[5]

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3. See the Ministry of Finance working group's Report on means to prevent excessive household indebtedness (in Finnish).
4. More detailed information on the progress of the initiative is available on the Ministry of Finance website (in Finnish only).

Borrowing helps households to even out their expenditure in the different phases of their life, but very high debt levels relative to income weaken the ability of both households and the economy to adjust to possible negative shocks. The proposed maximum debt-to-income ratio, i.e. the debt cap, would prevent households' total debt from rising to very high levels relative to income, which is a measure of a household's repayment capacity.

The purpose of the debt-to-income cap is to strengthen the resilience of the household sector and the economy and to curb excessive growth in household indebtedness. The continued upward trend in indebtedness underlines the fact that regulation on the debt-to-income cap should be introduced rapidly. It is also important to ensure that the scope of the debt-to-income cap is as extensive as possible, i.e. that it will apply to not only credit institutions but also other entities granting credit to households.

Based on available data[6], the calibration of the debt-to-income cap proposed by the working group would more or less, have allowed the current credit practices. It is justified to calibrate the debt-to-income cap so that its entry into force does not cause abrupt and significant changes in credit-granting practices. As banks can more or less continue their lending practices, the possible negative impacts of regulation on households, housing markets and the economy can be avoided.[7]

Calculations by the Bank of Finland using the most recent data show that new-mortgage borrowers' total debt relative to income has increased in the past two years. Therefore, the debt-to-income cap should now be calibrated to as high as 500% if the objective is to minimise its direct impacts on the provision of credit (see New mortgage-borrowers have an increasing amount of debt relative to income).

High debt-to-income ratios are more common in growth centres than elsewhere in Finland. High debt-to-income ratios are less common in the case of first-home loans than in other new housing loans. This is due to the fact that first-home buyers' total debts are smaller than those of other home buyers. Therefore, the debt-to-income cap does not seem to target particularly the financing of first-home loans. Based on analysis by the Bank of Finland, the debt-to-income cap would have a moderate impact on long-term economic growth, and it seems to be more effective in dampening economic fluctuations than the maximum loan-to-collateral ratio on housing loans currently applied in Finland (See A debt-to-income cap would dampen economic fluctuations).

In public debate, the view has been expressed that the introduction of a debt-to-income cap would hamper the purchase of housing, particularly in growth centres, and thus decrease the regional mobility of labour. A barrier higher than the possible debt-to-income cap to the internal migration of workers is, however, the regional diversification of house prices, which is a global phenomenon related to urbanisation. Refraining from or undermining reforms that are important for safeguarding financial stability would be both the wrong and an ineffective way of maintaining labour mobility. The internal

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5. See Bank of Finland's opinion (in Finnish only).
6. The data covered the total volume of mortgages granted by banks and mortgage-applicants' other debt. The calculations were based on observations on which there was sufficient information available.
7. See also Velkakatto ja enimmäislaina-aika hillitsisivät liiallista velkaantumista joustavasti ('A debt-to-income cap and maximum maturity would curb excessive indebtedness flexibly', in Finnish only).

migration of workers and the balanced regional development of house prices will be supported better by ensuring an adequate supply of housing in growth regions.

Essential to ensure equal regulatory treatment of different forms of housing finance

In order to reduce the vulnerabilities related to excessive household indebtedness, which are high to begin with, it is necessary to take measures to limit the maximum maturity of housing loans. As well as the debt-to-income (DTI) cap, the maximum limit on housing loan maturities proposed by the Ministry of Finance working group should be introduced without delay (see Proposed measures to prevent excessive household indebtedness).

Imposing a maximum limit on housing loan maturities would reduce the number of loans that are very high in relation to the borrower's debt-servicing capacity, as borrowers should, as a rule, be able to repay their loans within the prescribed time. Some lenders have offered loans with maturities over 25 years, and the proposed regulations will not necessarily allow them to extend the same amount of long-term credit as they recently have (see New mortgage-borrowers have an increasing amount of debt relative to income).

Large unit shares of housing company loans and interest-only periods at the beginning of the loan period impair the ability of buyers to assess the debt-servicing costs associated with housing company loans. As a result, a subset of buyers may purchase dwellings that are too expensive in terms of their debt-servicing costs and housing company maintenance charges. Large unit shares of housing company loans expose households and the economy to the risks of overindebtedness.

Imposing a loan-to-value limit on housing company loans would mitigate the risks associated with very large housing company loans. The proposed limit would still allow for the substantial use of housing company loans to finance new owner-occupied construction. The impact of the loan-to-value limit on new-build construction and its financing will depend on the ability of construction companies to supplement housing company loans with other sources of funding (see Imposing a loan-to-value limit on housing company loans would only affect a portion of construction funding).

The financial literacy of Finnish citizens plays an important role in curbing excessive indebtedness. In January 2021, the Bank of Finland submitted to the Ministry of Justice its proposal for a national strategy for financial literacy.[8] The aim is to help people make sound financial decisions and avoid over-indebtedness.[9] The management of household finances will also be fostered by the positive credit register to be introduced in 2024. This will include data on the total debt held by borrowers.[10]

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8. See Finns will have the world's best financial literacy by 2030 (suomenpankki.fi).
9. The idea here is, among other things, that by developing easily accessible proactive advisory services we can give people the means for planning their everyday spending, the funding of major purchases, as well as their borrowing, savings and investment behaviour.
10. See working group report on legislation on the positive credit register (Positiivista luottotietorekisteriä koskeva lainsäädäntö: Työryhmän mietintö - Valto (valtioneuvosto.fi), in Finnish only).

The full impact of COVID-19 on businesses is yet to be seen

So far, businesses and the Finnish economy in general have come through the crisis with less damage than most other European countries (see Moderate growth in the number of Finnish companies' non-performing loans). This has been facilitated by, for example, direct support measures, interest-only periods on corporate loans and companies' own adjustment measures. However, the impact of the crisis has been particularly severe in the services sector.

In 2020, the share of non-performing loans and forborne exposures in the corporate loan stock of Finnish banks grew only marginally from the end of 2019. Banks' loan losses from corporate and household loans have so far also increased only moderately compared with the worst case scenarios presented in the early stages of the pandemic. If the Finnish economy recovers from the pandemic as predicted, bank loan losses will not increase as much as estimated in the loan loss scenarios published by the Bank of Finland in spring 2020.[11]

However, there is still considerable uncertainty regarding the survival of companies through the pandemic and the magnitude of long-term risks to the financial system rooted in the corporate sector. Temporary reliefs for companies – such as the easing of the bankruptcy legislation until January 2021, and the interest-only periods on corporate loans granted in spring 2020 – may only have postponed the insurmountable problems of some companies. However, the number of bankruptcies initiated in February–March 2021 was only slightly higher than in the corresponding months in 2017–2020. (Chart 6).

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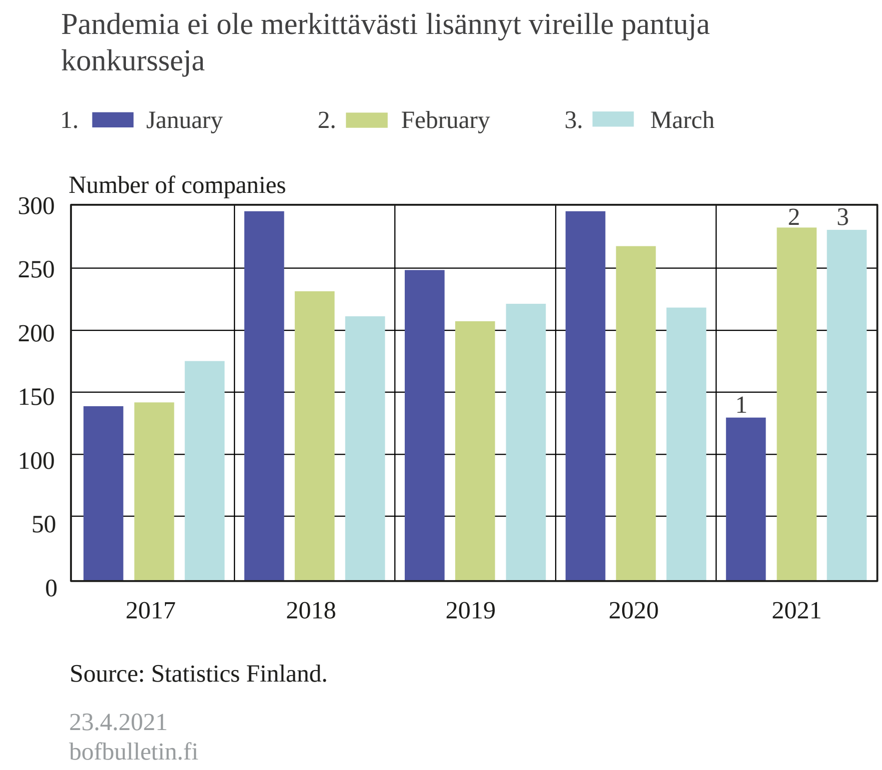
11. See the Bank of Finland's assessment of the stability of the Finnish financial system, spring 2020.

Chart 6.



Crises such as the COVID-19 pandemic weaken the creditworthiness of companies affected by the crisis and increase the credit risk of loans granted to them. The pandemic appears to have had only a minor impact on the average margins on new corporate loans granted by Finnish banks. Moreover, according to surveys conducted with companies and banks, the pandemic does not seem to have significantly tightened the credit policies of corporate financiers.[12]

Uncertainty related to the operating environment causes companies to postpone fixed investments until the outlook for the economy becomes clearer. It is important that the banking sector has sufficient capacity to support companies' investments and the recovery of the Finnish economy when investment and the related demand for funding pick up again.

Finnish banks have avoided the worst

In Finland, the pandemic's direct impact on banking operations has been less drastic than the impact on many other sectors. The profitability of the Finnish credit institution sector improved in 2020. According to the Financial Supervisory Authority, net interest income increased by around 4% compared with 2019, mainly as a result of lower interest expenses.[13] Costs decreased, although in the year of comparison a good number of non-

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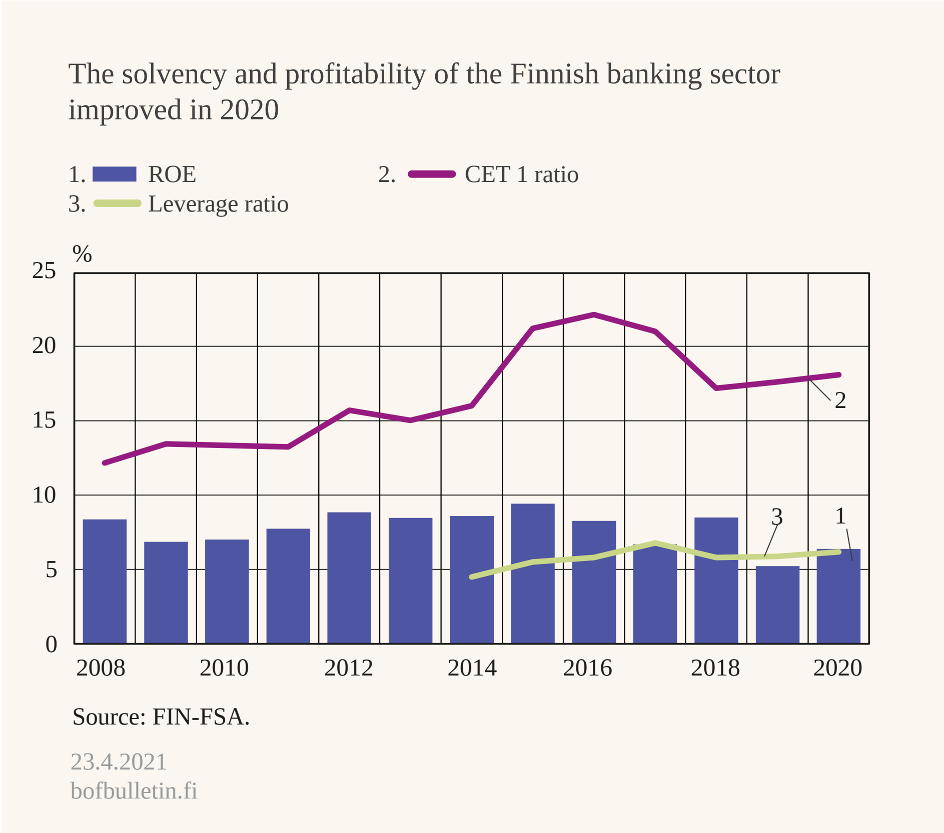
12. For more information on the bank survey, see the results for Finland in the ECB's Bank Lending Survey. For more information on the corporate survey, see Finnish Enterprises' SME Barometer, spring 2021 (in Finnish only).

recurring expenses were recorded. Not one banking group made a loss.

At the end of 2020 the overall capital ratio of the Finnish credit institution sector was over 21% and the capital adequacy ratio (CET 1) over 18% (Chart 7).[14] The restrictions on profit distribution helped strengthen the banks' loss-absorbing capacity. The credit ratings of Finnish banks have remained stable.

Chart 7.



The Central Bank's share of bank financing grew with the longer-term refinancing operations in June 2020. Moreover, the deposits made by households and companies have also increased during the pandemic. The number of debt securities issued by Finnish credit institutions remained almost unchanged from January 2020 to January 2021. A larger proportion of this financing is long-term, which reduces liquidity risks.

The interest on covered bonds issued by Finnish banks is still negative. The interest on covered bonds over a term of around three to five years was virtually unchanged at the start of 2021.

Many banks recorded far more in bad debt provisions in 2020 than in 2019, particularly in the first half of the year. The pandemic may weaken customers' ability to pay long-

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13. Consolidated data for all Finnish banks, including their branches and subsidiaries abroad.
14. See the FIN-FSA report Pankkisektorin vakavaraisuus säilyi vahvana ja liikevoitto parani ('Capital adequacy of the banking sector remains strong and operating profit improves') (in Finnish only); the data is available in English: https://www.finanssivalvonta.fi/en/statistics/banks/key-financial-figures/.

term, and its effects may not yet have been fully reflected in banks' lending portfolios. The banks therefore need to continue to prepare for possible problems ahead.

Finnish non-life insurance companies have remained solvent. Their sound financial position was strengthened even further in 2020 by favourable returns on investment and improved profitability in the insurance business. The position of the life insurance sector remained sound, although it was less so than a year before.[15]

Improved financial regulation in the wake of the financial crisis has helped during the pandemic

The adverse effects of the COVID-19 pandemic on the economy have been dampened in diverse ways as a result of measures taken by the ECB and the macroprudential authorities as well as the supervisory and regulatory authorities.[16] For many countries the pandemic was the first test to show how macroprudential policy can strengthen the ability of banks to lend. For example, in Finland, the Board of the Financial Supervisory Authority eased the capital buffer requirements of Finnish credit institutions in April 2020. The aim was to maintain the stability of the financial system and promote lending to businesses and households.[17]

The capital buffer requirements set for credit institutions are legislated under the EU's Solvency Directive, which was amended with the banking package in 2019. The amendments to the Finnish Act on Credit Institutions required by the banking package entered into force in April 2021.[18]

The amendments to the law obviate any overlap in the use of capital buffer requirements and permit use of a more targeted systemic risk buffer.[19] The banking package in the EU also implements some of the reforms in banking and financial regulation agreed worldwide following the global financial crisis.[20]

A set of tools more flexible than previously is available to the authorities responsible for

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15. See the FIN-FSA report Valvottavien taloudellinen tila ja riskit ('Financial condition of, and the risks associated with, supervised entities', in Finnish only).
16. The banks were allowed some flexibility with respect to their liquidity and capital requirements. They were also afforded the opportunity to show flexibility in the way they recorded reserves against bad debts, for example. The European banks complied broadly with the recommendations of the supervisory authorities, temporarily refraining from paying dividends. Many national macroprudential authorities in Europe eased their banks' capital buffer requirements or reversed earlier tightening. Moreover, the implementation of Basel III, the final instalment of accords to strengthen banks' capital adequacy and liquidity was delayed by a year.
17. See Marja Nykänen's blog Koronakriisi toi esiin makrovakauspolitiikan hyödyt ('COVID-19 crisis shows the benefits of macroprudential policy', in Finnish only).
18. See the Act on Credit Institutions (in Finnish only).
19. The Board of the Financial Supervisory Authority can set a capital risk requirement known as a systemic risk buffer for a credit institution if it believes that the credit institution sector is structurally vulnerable to financial crises and their wide spread within the financial system. The Board can also prevent systemic risks associated with large exposures to credit institutions generally by means of a new sector-specific systemic risk buffer.
20. These include the requirement for a minimum amount of a credit institution's own funds in relation to the size of its balance sheet (leverage ratio) and the net stable funding ratio requirement, which curbs any over-reliance on the part of the organisation on short-term market funding.

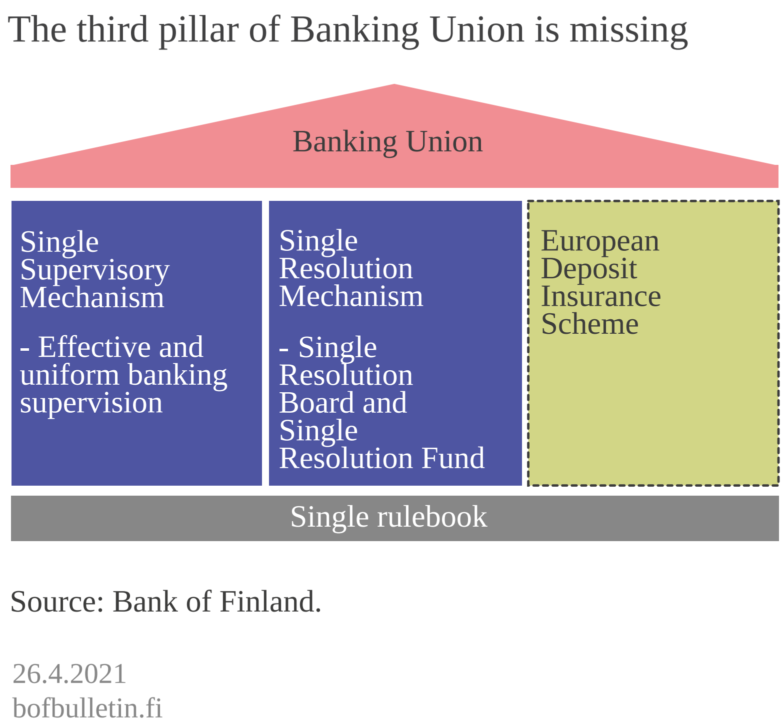
the stability of the Finnish financial system when they assess the capital adequacy of Finnish credit institutions in the operational environment after the pandemic. The assessment may make use of stress tests customised to reflect the situation in Finland and which evaluate the ability of the Finnish banking sector to withstand major financial crises and the losses they cause (see New stress testing framework to assess the capital adequacy of Finnish banks).

By the end of June 2022, the European Commission is to examine the adequacy of the regulation on macroprudential instruments and evaluate areas that need improvement. As regulation evolves there are good arguments for focusing special attention on the systemic risks that arise outside the credit institution sector and propose ways to mitigate them.

It is vital to complete the Banking Union and diversify the capital markets

Completion of the European Banking Union is vital, as it would support financial stability and financial intermediation. The common European Deposit Insurance Scheme is the most important missing part of the Banking Union. A common deposit insurance would increase confidence in the banking system, prevent deposit runs and reduce harmful links between banks and their home countries. In the longer term, it would be particularly important for countries such as Finland with a proportionally large and concentrated banking sector.

Chart 8



The finalisation of the Banking Union and the single European Deposit Insurance Scheme has been delayed by the large number of non-performing loans of European banks. Banks have significantly reduced their non-performing loans since the financial crisis, but the pandemic is threatening to increase them again. Measures proposed by the European Commission in December 2020, such as the development of a secondary market for non-performing loans, are to be highly commended.

In order to reduce bank NPLs and support market-based solutions, the possibility to grant state aid provided by the EU's resolution and state aid legislation should not be abandoned in the short term.[21] This mechanism should be dropped at a later date, but with a sufficiently long transitional period.

In order to diversify Europe's banking-centred financial system, it is important to continue the development of the capital markets. A more determined dismantling of barriers to capital market integration in the EU would promote access to business finance, sustainable economic growth and cross-border diversification of investment risks. The new Capital Markets Union action plan, published by the European Commission in autumn 2020, proposes actions to improve small and medium-sized enterprises' access to market financing, among other things.

The objective of sustainable economic growth is also supported by the European Green Deal, which drives the European economy towards climate neutrality while simultaneously reducing potential short-term risks to the financial sector in the transition to a carbon-neutral economy. Developing the market for green finance would support the EU's climate objectives.

Tags

financial stability, debt-to-income cap, mortgage lending, COVID-19, indebtedness, banks

21. As a rule, state aid to banks is prohibited, but EU legislation on bank resolution allows for state aid under certain conditions provided by the legislation.