FINANCIAL STABILITY ASSESSMENT

Pandemic demonstrates necessity of risk buffers

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The coronavirus pandemic is rapidly pushing the global economy into a deep recession. Due to the effects of the pandemic, Finnish businesses are facing the most serious difficulties since the Finnish banking and economic crisis of the early 1990s. In order to minimise the economic costs of the crisis, the national government, authorities and financial institutions must continue their efforts to help households and sound businesses through the crisis.

Dramatic contraction of the Finnish economy

The massive economic shocks caused by the global financial crisis just over ten years ago and the coronavirus pandemic today demonstrate just how quickly and unpredictably disturbances to general economic developments and the financial markets can develop. While financial crises and other major economic shocks cannot be completely prevented, it is necessary to prepare for crises. In good times, it is vital to ensure that financial institutions, non-financial corporations and households have sufficient financial buffers for crisis situations.

The coronavirus pandemic will strongly reduce supply and demand worldwide. In April 2020, the

Bank of Finland published two different scenarios regarding developments in the Finnish economy over the next two years (see Scenarios of the Finnish economy for the years ahead). In these scenarios, the economy contracts by around 5–13% in 2020 as a result of the direct and indirect effects of the pandemic. In the scenarios, the economy is expected to recover in 2021 once the spread of the pandemic is under control and containment measures are eased.

It is difficult to predict the duration of the current exceptional economic situation, and forecasting economic developments is particularly challenging. Current macroeconomic models, based on economic developments in recent decades, are not suited for a crisis like the one we are currently experiencing, as a devastating pandemic was last experienced in developed countries over a hundred years ago.[1]

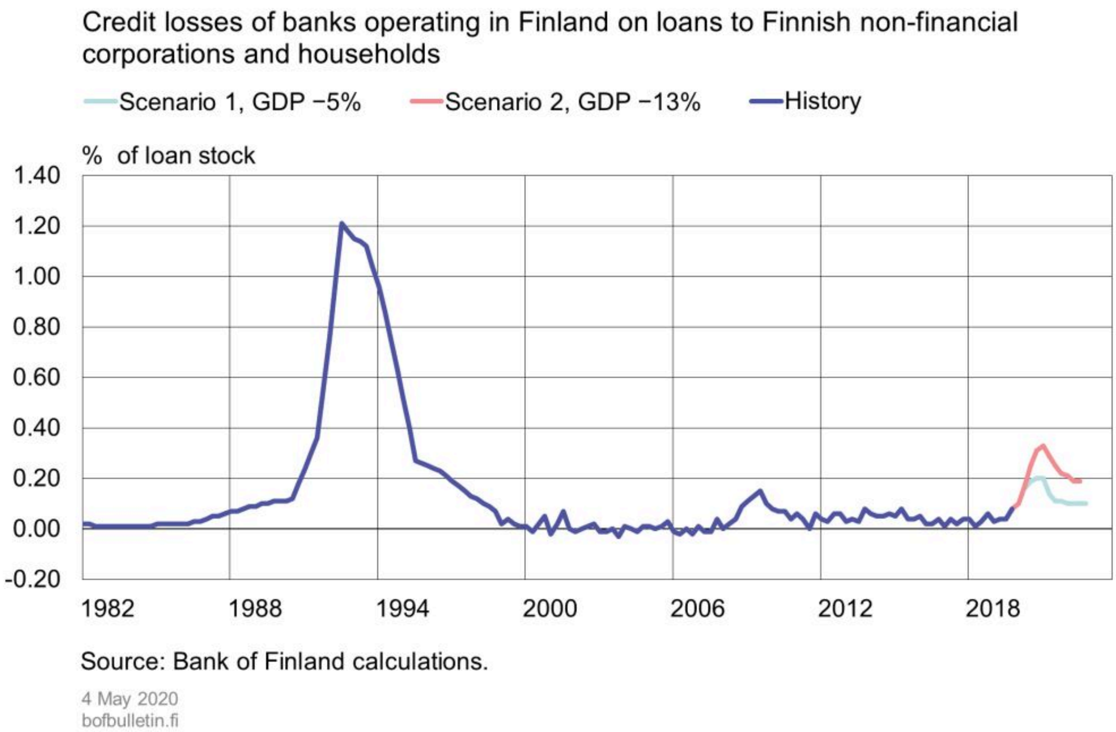
The global economy has had to face the crisis caused by the coronavirus in a situation where growth had already slowed down and world trade had contracted. Finland's exports and investments were already projected to suffer from the slowdown in world trade in 2020.

Financial market valuations of risky assets were close to all-time record levels just before the crisis hit. Since then, the sharp deterioration in the economy has erased previous expectations of companies' earnings performance and dividends, caused a worldwide collapse in stock prices and raised the price of debt financing.

Finnish banking sector in a good position to face the crisis

The capital ratios of Finnish banks improved slightly at the end of 2019 and were higher than the average for EU banks. The Common Equity Tier 1 (CET1) capital ratio of the Finnish banking sector was 17.6%, and the leverage ratio 5.9% at the end of 2019 (Chart 1).

Chart 1.



The financial sector faces the economic crisis in a stronger condition than, for example, going into the global financial crisis just over ten years ago. The financial sector has become subject to more regulation and credit institutions' capital requirements have been raised since the financial crisis in order to enhance their ability to bear risk. Liquidity buffers have also been strengthened to ensure the liquidity of credit institutions in the event of financial market disturbances. These buffers accumulated in the upturn following the global financial crisis are now available to strengthen and sustain banks' lending capacity.

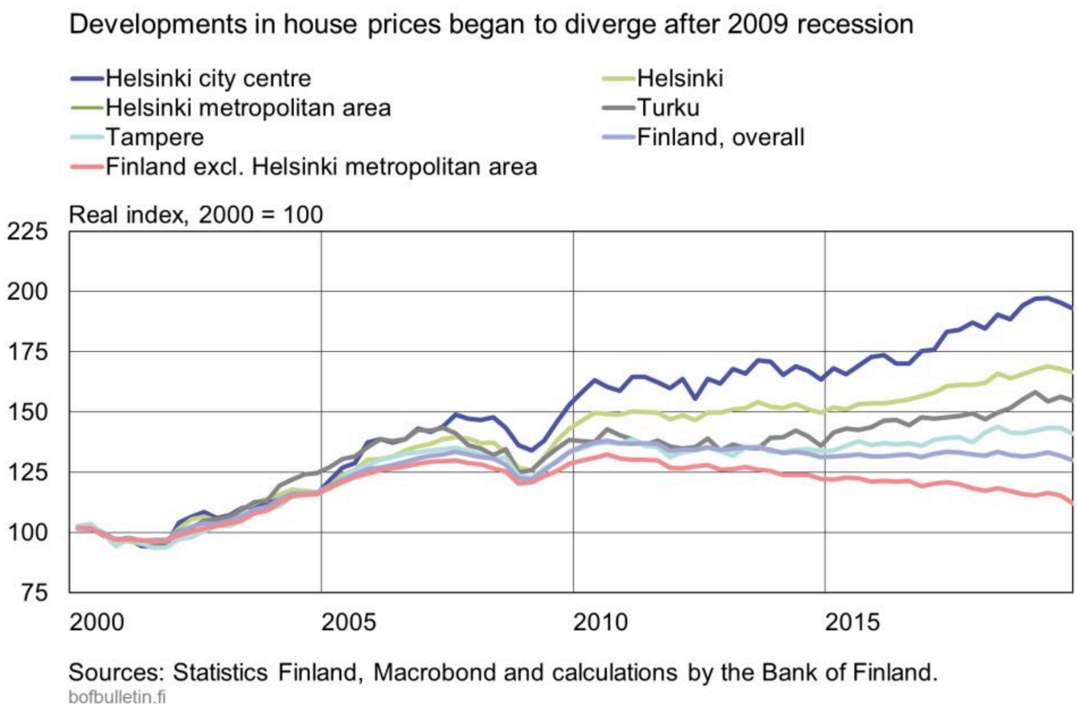
Authorities have eased the capital requirements on credit institutions following the escalation of the pandemic in Finland and elsewhere in Europe. Furthermore, banks have been urged to strengthen their capacity to withstand losses by refraining from dividend payments. Through the decisions of European and national authorities, Finnish banks' ability to grant loans to businesses and households in an exceptional economic situation has also improved markedly.

The dramatic deterioration of the economic situation is expected to increase banks' loan losses. The duration of the containment measures relating to the pandemic and the success of measures aimed at supporting the financial position of businesses will have a significant impact on the amount of loan losses. The loan losses will manifest with a delay, as payment difficulties will first increase the amount of banks' past due loans.

The Bank of Finland has calculated scenarios on the loan losses of banks operating in Finland on loans granted to Finnish businesses and households. The calculations make use of the model presented by Jokivuolle, Pesola and Virén (2015)[2] and are based on the typical development of loan losses in recent history and during the financial crises of the past few decades. The calculations do not take into account the impact that exceptional government measures to support businesses may have on bank loan losses. (See Banks must be able to finance companies and withstand loan losses amid the coronavirus pandemic.).

The calculations are based on two economic scenarios by the Bank of Finland, where Finland's real GDP will contract by 5–13% in 2020, depending on the virus management strategy and the scale and duration of the restrictive measures.[3] Under both scenarios, the economy begins to recover in 2020. In the first scenario, the economy resumes a growth trajectory in June 2020, whereas in the second scenario the containment measures remain in place until the end of September and economic growth does not start until the end of the year. Market interest rates are expected to remain roughly unchanged, at close to zero.[4] Interest rate premiums on loans to non-financial corporations and households affect the amount of loan losses envisaged under each scenario.[5]

Chart 2.



Economic models are simplifications of reality and cannot take into account all transmission channels. As government measures reduce companies' difficulties, the calculations may overestimate the magnitude of domestic loan losses. On the other hand, the foreign lending of banks will cause loan losses that have not been taken into account in the calculations. Some of the banks operating in Finland operate in several countries, and loans granted abroad constitute a substantial part of these banks' lending stock.

The calculations do not examine items in the income statement other than loan losses. A large part of the loan stock of Finnish banks is sound and generates interest income even in a bad economic climate. In addition, banks have fee and commission income and other income that are not taken into account in the calculations.

In the economic and banking crisis of the 1990s, loan losses were high for a number of reasons. Firstly, the recession in the 1990s was very long. Interest rates were remarkably high in the 1990s, making the situation more difficult for debtors. As the external value of the Finnish markka devalued, the debt of those with foreign currency loans increased, making the situation of many debtors unsustainable. Nowadays, as most loans are denominated in euro, exchange rate fluctuations do not have a significant impact on the loans. The balance sheets of banks and non-financial corporations were weaker in the 1990s, and regulation concerning banks' solvency and risk management was undeveloped. In many respects, the balance sheet positions of companies are now stronger, and the increased banking regulation since the global financial crisis has required banks to build stronger capital and liquidity buffers. On the other hand, household indebtedness is now considerably higher than before the crisis in the 1990s.

Access to financial markets has been periodically impaired

Like other Nordic banks, Finnish banks have a strong reliance on market-based funding.[6] Due to the exceptional financial market conditions, access to funding for both banks and non-financial corporations has been constrained, reflecting the very cautious approach to risk-taking now adopted by investors and a deterioration in market liquidity.

The strong reliance on market-based funding exposes the Nordic banks to a decline in investor confidence. The Nordic banks have long enjoyed popularity among investors, but the suspicions of shortcomings in their anti-money-laundering practices that have been voiced publicly during the past few years have been reflected in their share prices. In response to the severity and global character of the coronavirus crisis, the share prices of Nordic and euro area banks plunged in early 2020. The occurrence of widespread problems in euro area banks could weaken general investor confidence in the banking sector and, by extension, constrain access to market funding for Nordic banks.

Despite the global nature of the coronavirus pandemic, the national economic effects of the crisis vary across countries. The cross-border operations of the Nordic banking sector serve to increase the interconnectedness of the Nordic financial systems. Disruptions on e.g. the housing and property markets in other Nordic countries may deepen the economic downturn in Finland, increase the loan losses incurred by Nordic banks and constrain access to funding for banks operating in Finland, thereby weakening their lending ability. Housing market developments are particularly important for Nordic banks' access to funding, considering that covered bonds collateralised by mortgage loans are a key source of funding for banks. (See Nordic countries are vulnerable to housing market risks aggravated by the coronavirus pandemic.)

Access to the monetary policy operations of the European Central Bank (ECB) supports the financial position of Finnish banks. In March 2020, the ECB increased support to the financial system by conducting additional longer-term refinancing operations and easing the terms of longer-term refinancing operations in general (see EKP:n rahapolitiikan toimet koronapandemian aikana (The ECB's monetary policy measures in response to the coronavirus pandemic), in Finnish only). The ECB also adopted a package of temporary collateral easing measures and initiated purchases of public and private sector securities to relax financing conditions in all sectors of the economy. In addition, the Eurosystem will undertake pandemic-related and other asset purchases on a large scale in 2020.

The stability of the US financial system is important for Nordic banks, as a portion of their funding is denominated in US dollars. As a measure to ensure the availability of dollar funding, the Nordic central banks and the ECB have agreed on a swap line with the Federal Reserve.

The instability of the markets and the fall in share prices have weakened the solvency of Finnish pension companies. The law requires that a pension institution prepare a reorganisation plan for its economic position if the institution's solvency capital falls below the statutory solvency limit. The plan must identify the measures to be adopted in order to restore the solvency of the institution to above the solvency limit by the deadline set. At the end of March 2020, the Finnish Government issued a decree granting the Financial Supervisory Authority (FIN-FSA) the powers to extend the deadline for submission of the reorganisation plan. The decree is designed to ensure that the financial market crisis caused by the outbreak of the coronavirus pandemic will not force pension institutions to realise their equity holdings in an unfavourable market situation.

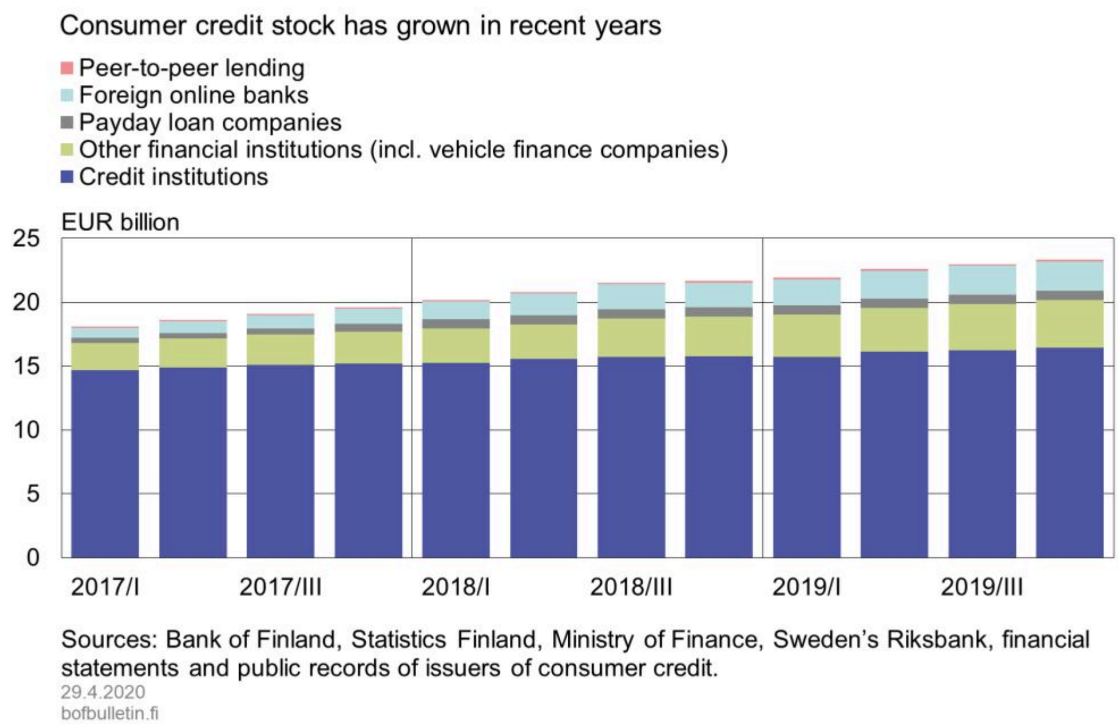
Extensive measures to support businesses and employment

In severe economic recessions, the majority of banks' loan losses are typically related to lending to non-financial corporations. During the Finnish economic depression of the 1990s, even some profitable businesses were driven into bankruptcy due to liquidity problems, as the banking sector was unable to provide enough credit to businesses. As a consequence of the bankruptcies, unemployment surged and remained high for a long time, as the recovery of the economy was very slow, partly reflecting the structural problems on the labour market.

Government and authorities have taken a number of measures to help businesses overcome their economic difficulties. The Finnish government increased Finnvera's provision of collateral from EUR 4 to EUR 12 billion to facilitate access to funding for businesses. Private entrepreneurs may apply for a discretionary allowance from the municipalities, while Business Finland has made two new funding services available for small and medium-sized enterprises. The Ministry of Justice have started preparations on a proposal that will restrict creditors' right to file for bankruptcy against a debtor company (See Banks must be able to finance firms and withstand loan losses amid the coronavirus pandemic.).

The macroprudential decision-maker in Finland, the Board of the FIN-FSA reduced the structural macroprudential capital buffer requirements for credit institutions in order to increase the banking sector's lending capacity. Macroprudential decisions taken in the other Nordic countries have helped increase the lending ability of the Finnish banking sector (Chart 3).[7] The European Central Bank and the FIN-FSA recommended that banks refrain from dividend payments until October 2020 and use their profits to strengthen their balance sheets. In addition, the ECB and national banking supervisors have provided banks greater flexibility in fulfilling their additional capital and liquidity requirements.

Chart 3.



The Eurosystem and euro area national governments have adopted a number of measures to ease the economic effects of the coronavirus pandemic. The Eurosystem launched a Pandemic Emergency Purchase Programme (PEPP) with a volume of 7% of euro area GDP. National purchases will, in principle, be made relative to the capital key. In addition, the ECB's additional longer-term refinancing operations have been targeted to provide credit to the real economy.

The Bank of Finland started to invest in the domestic corporate paper market immediately upon the escalation of the Covid-19 crisis (see Bank of Finland launched activities on the domestic corporate paper market, in Finnish). The commercial paper purchases are part of the Bank of Finland's investment operations. The purchases have bolstered the functioning of the corporate paper market and eased domestic businesses' access to funding, while freeing up banks' lending capacity for the funding of small businesses.

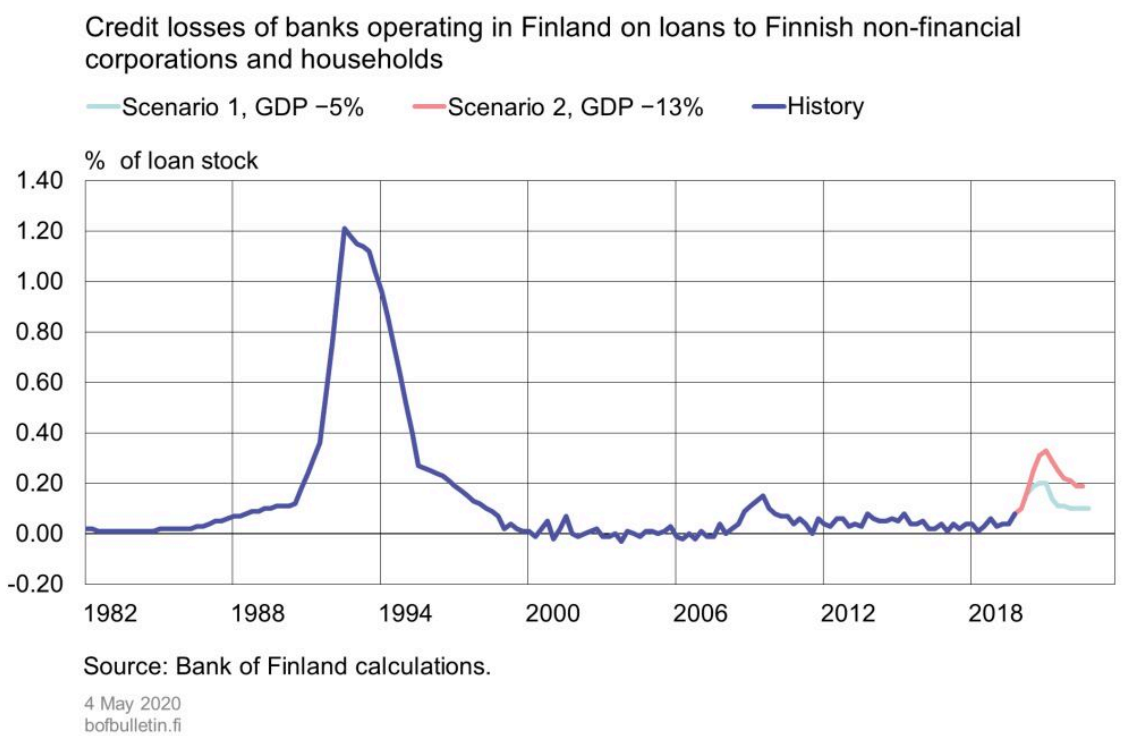
Coronavirus crisis depresses the housing market

In January and February 2020, the Finnish housing market was still more buoyant than a year earlier. The containment measures adopted in response to the coronavirus pandemic, together with heightened economic uncertainty, began to depress housing sales and demand for new housing loans in the latter half of March. Banks and real estate agents have endeavoured to promote e-business within the housing market to sustain sales. Still, housing sales are expected to remain notably slower than usual and sales periods to extend until the exceptional conditions come to an end and the economic outlook improves.

New construction permits and new residential building projects have been declining in number ever since early 2018. Consequently, new drawdowns of loans by housing companies and other housing corporations have decreased. However, there are still many construction projects under way and new flats are being completed in large numbers. The containment measures in response to the coronavirus pandemic may cause project delays, if there is a shortage of foreign labour due to the movement restrictions, or if material supplies from abroad are delayed.

While developments in the prices of old dwellings have been mainly moderate in recent years, price differences between different regions have grown. In recent years, house prices have increased mostly in big cities, like Helsinki, Tampere and Turku, and notably in their centres. A deep and prolonged economic recession could cause house prices to decline all over the country, as happened during the recession in 2009. At the time, the correction was relatively mild and short-lived, but divergence within the housing market began to strengthen thereafter (Chart 4).

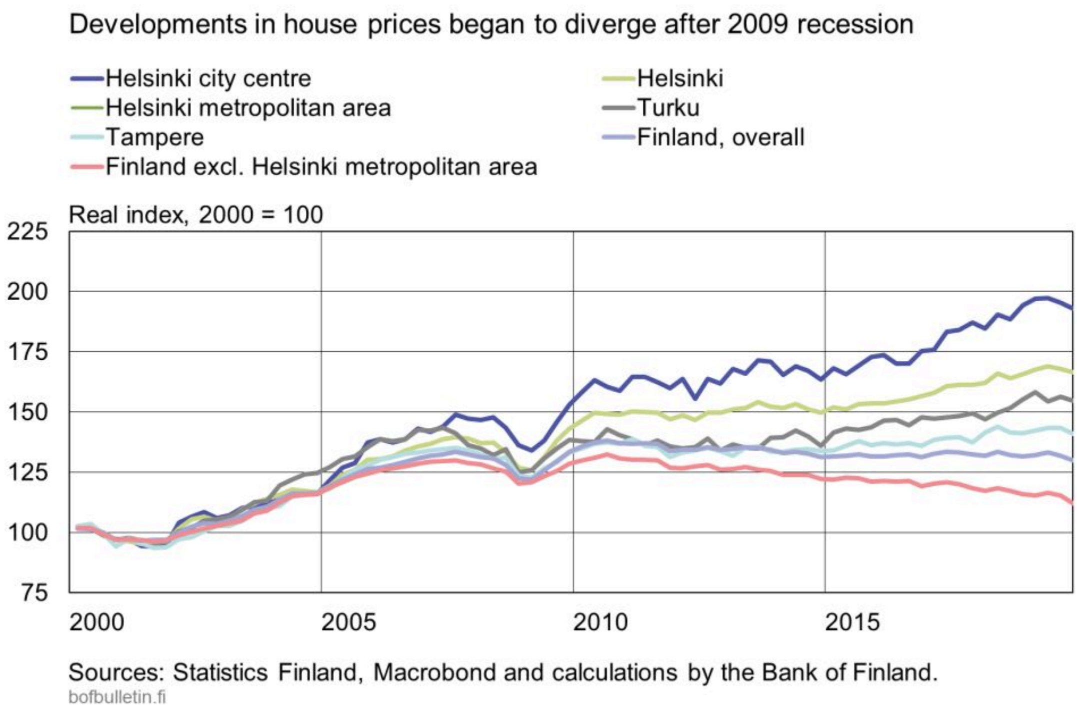
Chart 4.



Risks of excessive household debt could materialise

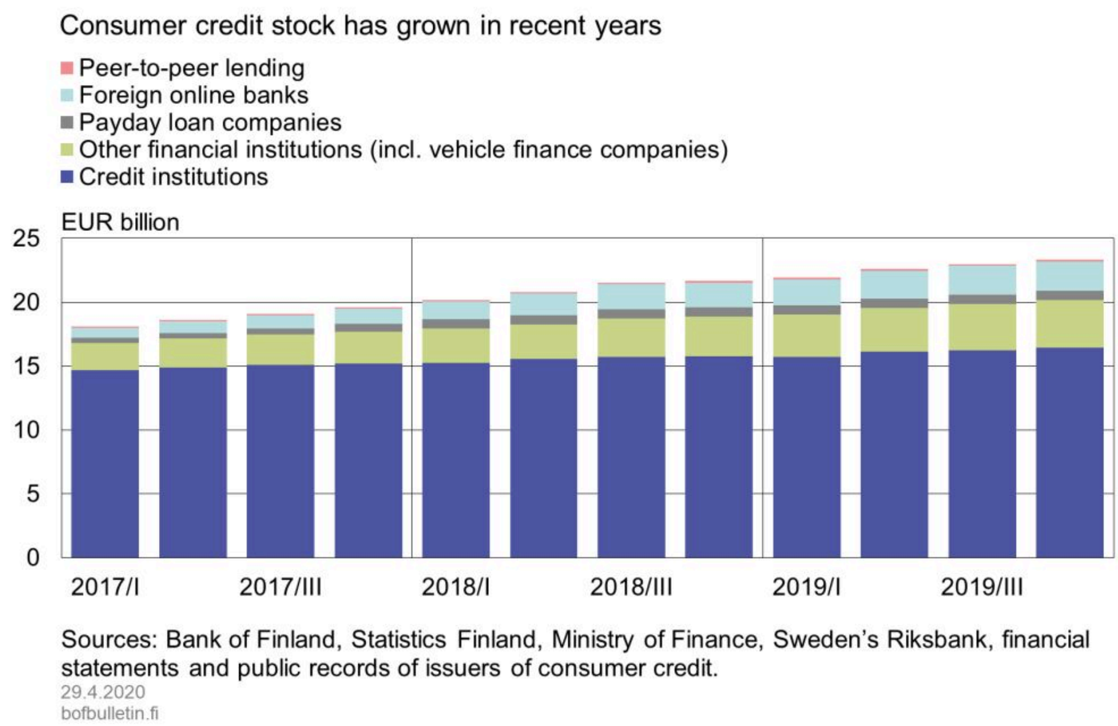
Household debt relative to annual disposable income is currently historically high (Chart 5). About half of this debt is held by households whose debts are over three times greater than their annual disposable income. These highly indebted households comprise about one-tenth of all households and one-fifth of all borrowers. Rising lay-offs and redundancies or problems with one's own business can quickly weaken the solvency of many households. The low level of interest rates and changes granted in loan repayment schedules are, for their part, providing households with debt-servicing relief in the short term.

Chart 5.



Housing loans and housing company loans borne by households comprise about three quarters of the total loan stock of the household sector. The composition of household debt has become riskier over time, due to the rapid rise of housing company loans and unsecured consumer credit. The majority of consumer loans are issued by credit institutions operating in Finland, but households are increasingly taking out loans from other domestic financial institutions and foreign online banks (Chart 6).

Chart 6.



At the end of March 2020 Finland had a record number of private individuals with payment defaults. Payment issues caused by the coronavirus crisis are reflected in newly registered payment defaults only months later.[8] In April 2020 the Finnish Government presented a legislative proposal for the provision of relief to borrowers left in financial disarray by the coronavirus pandemic. The proposal calls for the interest rate cap on consumer loans to be halved temporarily, from the current 20% to 10%. According to the bill, the temporary lower interest rate cap will not be applied to consumer durable loans, such as credit card loans, for example. In addition, the direct marketing of consumer credit will be suspended on a temporary basis.

Additional borrowing and allowances in households' loan repayment programmes can be prudent measures if they allow households to overcome their temporary payment issues and escape the ongoing economic crisis as quickly and with as little damage as possible. There are risks to taking on significantly more debt, however, if a household is unable to recover its debt-servicing capacity or if this remains permanently diminished.

In its report published in October 2019, the working group on household debt appointed by the Ministry of Finance proposed new measures to curb excessive growth in household debt and debt-related risks. Among other measures, the working group proposed limiting the total amount of debt available to households based on their income, i.e. introducing a debt-to-income (DTI) cap. In addition, the working group would restrict the use of housing company loans to finance new-build construction and house purchase by imposing a maximum credit share for these loans and by setting maximum maturities for housing loans and housing company loans.

The Bank of Finland has backed the working group's proposals.[9] Household indebtedness, although record high, does not pose an immediate threat to the stability of the Finnish financial system. But it does increase the vulnerability of households and the economy to crises like the current one. Excessive levels of debt can amplify fluctuations in the economic cycle and increase the likelihood, severity and length of financial crises and other serious disruptions to the financial system.

Lastly, the Financial Supervisory Authority's supervisory responsibilities ought to be expanded to lenders and intermediaries other than credit institutions, as proposed by the Ministry of Finance's working group. This would clarify the jurisdiction of authorities in supervising consumer lending.

Moves to reinforce the EU's financial system should continue after the crisis

The global banking system is in a better position to confront the financial and economic crisis caused by the coronavirus pandemic than it was before the global financial crisis that originated in the financial system more than a decade ago. Because of the regulatory reforms put in place since the financial crisis, banks hold not only more but higher-quality equity to cover losses and support their lending ability. In addition, bank liquidity has been improved and supervision enhanced. The buffers that have been accrued are now proving their worth as the economy and the banking system contend with an unforeseen global shock.

The Basel Committee on Banking Supervision deferred introduction of its revised standards for bank capital requirements, often referred to as the finalisation of Basel III, by one year, so that banks and supervisors may concentrate on mitigating the coronavirus pandemic's economic and financial stability effects. This allows more time to transpose the Basel III framework into EU legislation.

The EU-approved regulatory changes known as the Banking Package is due to enter into force at the end of 2020. Amendments contained in the Banking Package give national macroprudential authorities stronger means to prevent financial crises and strengthen the resilience of the banking system using macroprudential instruments. These instruments have already proven necessary in many countries to mitigate the economic effects of the current crisis. It is therefore important that the preparatory work for incorporating the Banking Package into national legislation be continued.

The coronavirus crisis has highlighted the need for further developing and strengthening the European banking system. The bank-sovereign feedback loop needs to be reduced by completing the EU Banking Union with its third pillar, a single European deposit insurance scheme, and by augmenting the second pillar – the Single Resolution Mechanism and Single Resolution Fund – with a common backstop.

To diversify and strengthen the bank-centred European financial system, it is important to continue developing the Capital Markets Union. Strengthening the EU capital markets is also important for tackling climate change, as reaching emissions reduction targets will require copious funding.

The financial infrastructure must function under all conditions

Reliable payment and settlement systems are central for maintaining financial stability and the smooth functioning of society. Payment is an integral part of economic activity, which is why we must guarantee that payment systems function under all conditions.

The reliable and uninterrupted functioning of these systems is especially important during times of crisis, when economic uncertainty is heightened. Disruptions in, for example, card payment systems or interbank payments, which are also used to transfer wages and benefits, would bring further inconvenience to consumers and merchants. During the coronavirus pandemic, trading volumes on securities markets have increased from their usual levels, which is why a systems failure would also have an unusually large impact.

National authorities, for their part, work closely together towards safeguarding the reliability of payment systems. The Finnish Financial Supervisory Authority is responsible for supervising individual entities, and the Bank of Finland carries out supervision on a systemic level. Safeguarding the smooth functioning of payment systems during severe shocks and emergency situations also demands good cooperation between authorities and the industry. Designing, building and testing back-up systems is a key part of this work.

Footnotes

1. The negative effects of the coronavirus pandemic on the economy will be on a completely different scale to those of other epidemics in the industrial era. Epidemics have often

caused economic recessions, but they have been short-lived. In the early years of Finland's independence, the Spanish flu is likely to have killed more than 20,000 people in Finland, but the epidemic appears to have had only a very limited impact on the banks, the financial markets and the national economy. Similarly, neither the Asian influenza in the 1950s nor the Hong Kong flu in the 1960s caused economic crises. ↑

2. Jokivuolle, E. – Pesola, J. – Virén, M. (2015) 'Why is credit-to-GDP a good measure for setting countercyclical capital buffers?' Journal of Financial Stability, Volume 18, June 2015, pages 117–126. ↑
3. See Scenarios of the Finnish economy for the years ahead. ↑
4. The calculations do not take into account banks' potential loan losses from foreign loans. Under scenario 1, loan losses amount to approximately EUR 3.6 billion in 2020–2022, equalling 1.6% of the stock of corporate and household loans granted by banks in Finland at the end of 2019. Corporate loans account for about EUR 2.7 billion of these losses. Under scenario 2, the total loan losses amount to around EUR 6.1 billion, i.e. about 2.7% of the loan stock. Under this scenario, the share of corporate loan losses amounts to approximately EUR 4.7 billion. ↑
5. Under scenario 2, loan losses increase by around 20% if the interest rate premiums on corporate and household loans is 1 percentage point higher than the baseline assumption over the period considered. ↑
6. The ratio between the stock of loans and deposits in Finland stood at 158% at the end of 2019, against an EU average of under 120%. ↑
7. The macroprudential decisions were estimated to increase Finnish banks' capacity for lending within Finland by EUR 30 billion. ↑
8. See https://www.asiakastieto.fi/web/fi/asiakastieto-media/blogit/389-500-suomalaisella-on-maksuhairiomerkintoja.html (in Finnish). ↑
9. See the Bank of Finland's statement to the Ministry of Finance lausuntopalvelu website (in Finnish). ↑

Key words

banks, corporate finance, COVID-19, COVID-19 virus pandemic, financial stability, housing markets