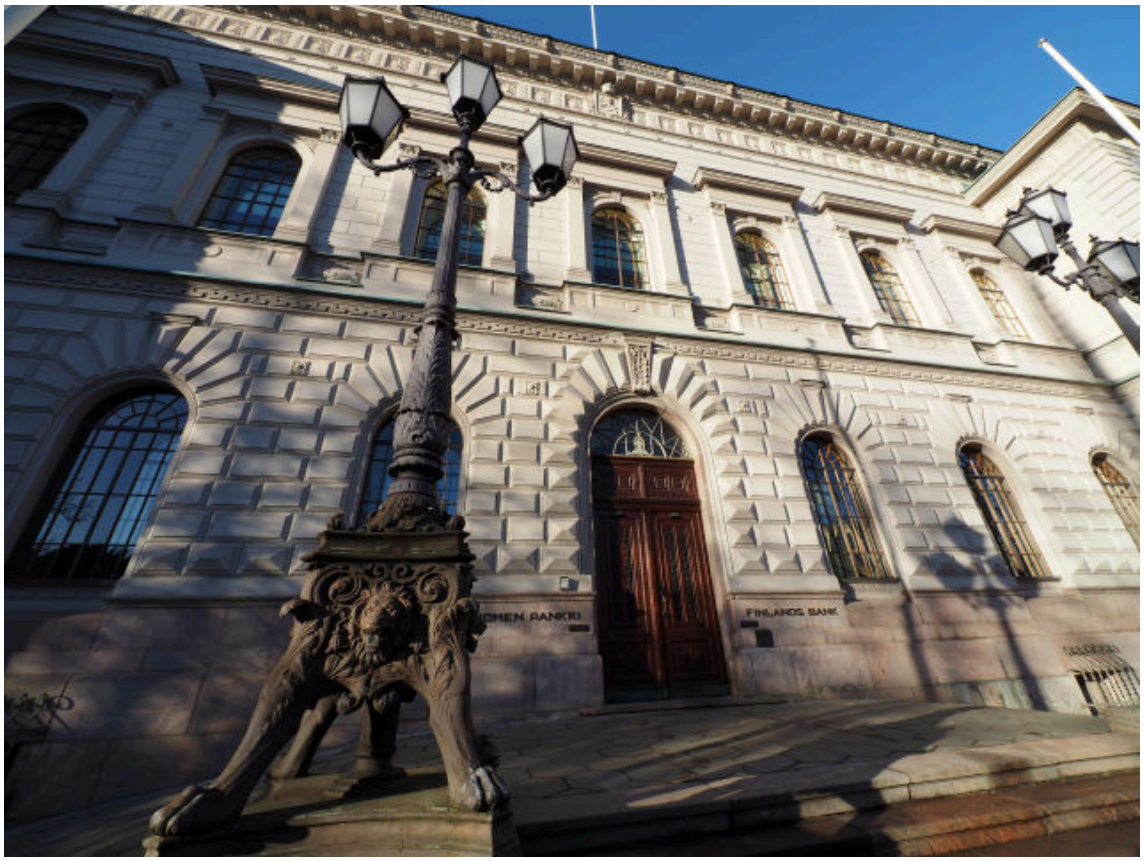
Editorial

Editorial: Shortcomings in the macroprudential toolkit and changes in the banking sector increase financial system risks

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There is no indication of growth in cyclical risks to the financial system in Finland. Finnish banks and insurance companies are financially sound. The financial system is, however, structurally vulnerable against the backdrop of households' high and unevenly distributed indebtedness. To ensure households' debt-servicing capacity, a more diverse macroprudential toolkit is needed than the one currently in place. Structural changes in the banking sector may have an impact on risk spillovers between the Nordic countries.



Finland appears to be gradually leaving behind the protracted period of weak economic growth. Accelerating growth may increase financial system vulnerabilities and risks in an environment of

low interest rates, as monetary policy is guided by the euro area-wide inflation target. In Finland there is currently no indication of excessive cyclical increases in house prices or credit growth. The financial system is, however, structurally vulnerable against the backdrop of a high degree of household indebtedness. It is important that the authorities have adequate macroprudential tools at their disposal to prevent imbalances from growing too large in a period of low interest rates.

Reasonable loan maturities and the tradition of loan amortisation have moderated Finnish households' accumulation of debt. Low interest rates have facilitated loan-servicing in recent years. During the last twenty years, mortgage maturities have become longer in Finland, although they are still shorter than in, for example, Sweden. Household indebtedness is at a high level in Finland, and the debt burden is unevenly distributed among households. The Bank of Finland takes a cautious attitude towards banks' offers for mortgages with increasingly long maturities. In future, the established practice of regular amortisation of mortgages should continue and maturities should not increase from their current level.

High household indebtedness poses a risk to economic growth and stability. This risk is managed by macroprudential instruments. The Bank of Finland has on several occasions drawn attention to the fact that there is a need to develop the current macroprudential toolkit. Authorities should continue their cooperation in developing these tools. In this preparatory work, different options for ensuring households' loan-servicing ability are being reviewed, with a broad-based assessment undertaken of the impact of the tools envisaged. The aim is to create a sufficiently comprehensive macroprudential toolkit to safeguard the stability of the Finnish financial markets, prevent over-indebtedness and ensure households' debt-servicing capacity. At the same time, it is important to secure the functioning of the housing market in Finland.

Financial market regulation has recently surfaced in discussions at international level, particularly in the United States. In this context, it has been suggested that financial sector regulation should be rolled back. Regulatory deficiencies and inadequate supervision were key contributors to the build-up of the financial crisis. Regulatory shortcomings have subsequently been remedied and supervision intensified. Adequate regulation helps ensure that financial crises like the one recently experienced and their negative macroeconomic implications could be avoided going forward. Against this background, large-scale financial sector deregulation would not be a step in the right direction, and postponement of the completion of international regulatory reforms is disquieting. Significant rollback of regulation, in combination with strengthening economic growth and low interest rates, would open the door for new imbalances to emerge on the financial markets. Even so, regulation needs to take account of the scope and riskiness of the activities involved. There is a case for considering, for example, the setting of more relaxed reporting requirements on smaller credit institutions with no systemic importance.

With the financial sector undergoing transformation, it is worth evaluating and identifying any development and improvement needs caused by such shifts. The financial sector is at present under strong pressure for renewal, as digital applications and new market players are gaining ground. The challenge is to cater for effective regulation, while ensuring a level playing field between new players and market incumbents. Scope for more nimble regulation and a higher degree of competition will be offered by e.g. the Commission's proposal for enabling recently entered market players to operate within less stringent regulatory constraints, provided their activity is conducted on a small scale. A diversified field of market participants will open up new financing channels for firms and support their access to finance, thereby promoting the objectives of the EU's Capital Markets Union. New market players and operating procedures will also bring risks. This highlights the importance of sufficient investor protection and consumers' financial literacy.

In Finland, as in the other Nordic countries, banking and insurance are concentrated on a few large companies. The structure of the Finnish banking sector is changing significantly, as some of the largest banks in terms of market share have begun to convert their group structures from subsidiaries into branch-based frameworks. Changes in the structures of banking groups operating in Finland may have an impact on the spillover of stability risks and the availability of finance in Finland. This scenario may materialise if, for example, a bank, upon encountering problems, were to restrict its lending in the host country of its branch in an effort to safeguard the continuity of operations in the home country.

Key to ensuring financial stability, continued confidence and a level playing field for market players is the application of consistent supervisory practices based on the single EU rulebook to all banks operating within the EU. In the longer term, financial stability and confidence could be strengthened by migration to common deposit protection. For the single deposit guarantee scheme to become a reality, it is, however, essential that participating banks' balance sheet items be of good quality and their capital positions at adequate levels.

Changes in the banking system highlight the importance of smooth cooperation between the authorities. To foster cooperation, the Nordic central banks, supervisory authorities and finance ministries have issued memoranda of understanding, including principles relating to exchange of information. Although the capital adequacy of Finnish banks and insurance companies and their Nordic equivalents operating in Finland is currently in order, the prospect of exceptional situations emerging in the future cannot be ruled out entirely. This is why we must ensure that cooperation between the authorities functions well in the event of potential emergency conditions.

Preparation for problem situations and disruptions, also in respect of the financial infrastructure, is warranted. Payment and settlement systems serving the Finnish financial markets are

international, largely operating beyond Finland's borders. This needs to be taken into account when planning contingency measures. Finland's national preparedness for disruptions is currently not adequate. The situation must be improved significantly in cooperation between those operating in the financial sector and the relevant authorities. Financial stability is based on the presence of financially sound and profitable financial-sector players, while also requiring payment and settlement systems that function reliably.

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Keywords

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