Editorial

Rising household debt poses risk to the economy

Financial stability | 16 May 2018

The primary purpose of the macroprudential measures that restrict lending for house purchase is to reduce the economy's exposure to risks stemming from high household indebtedness. These risks are realised when indebted households respond to disturbances in the economy by sharply reducing consumption. Macroprudential policies that impose capital buffer requirements for banks, on the other hand, are designed to ensure that the banking system's lending capacity and ability to function remain satisfactory under all economic conditions.



The Bank of Finland as well as many other authorities and international organisations have repeatedly drawn attention to the risks associated with Finland's household debt and its growth. To mitigate these risks, the Board of the Financial Supervisory Authority (FIN-FSA) recently took a macroprudential decision to tighten the maximum loan-to-collateral ratio for housing loans. It had previously issued banks with a minimum level for the average risk weight on housing loans.

Why do authorities warn against household indebtedness and impose restrictions on bank lending for house purchase, even though housing loans did not result in significant loan losses even during Finland's economic and banking crisis in the 1990s? Why is rising household debt seen as a threat

to the economy, despite evidence that the majority of households remain diligent in their repayments and are able to repay their loans within a reasonable timeframe?

The issue lies in the detrimental impact that indebtedness can have on households' and, subsequently, the economy's ability to respond to negative economic shocks. Indebted households and businesses typically react to economic disturbances by sharply reducing consumption and postponing investments. Households will increase their savings and continue to service their debts but will readily cut back on all non-compulsory consumption.

Businesses will respond to the resulting shortfall in demand by reducing output, resulting in layoffs and redundancies. If prolonged, recessions especially increase the risk of bankruptcy in industries that are sensitive to the business cycle, such as construction. Bankruptcies lead to loan losses for creditors, weakening the capital adequacy and lending capacity of banks. Reduced lending can diminish economic activity even further, ultimately deepening the recession.

Crises that are exacerbated by household indebtedness do not necessarily result in large housing loan losses for banks. Instead, indebtedness may have second-round effects and increase loan losses in other sectors, should, for example, the effects of weakening aggregate demand reduce the sustainability of corporate debt.

The lion's share of household debt consists of housing loans, so it is well-grounded to address indebtedness by targeting macroprudential policy on lending for house purchase; however, consumer credit and housing company loans have also added to the debt burden of households in recent years. Moreover, while digitisation may provide households with better access to financial products and services, it also risks creating new avenues for debt accumulation.

The Ministry of Justice's investigation into establishing a positive credit register in Finland is a welcome development. The register would provide more comprehensive and up-to-date data on the components and overall distribution of household debt. The macroprudential toolkit should be further supplemented with discretionary measures that could limit the maximum maturity of new housing loans or their maximum size relative to household income.

The existing macroprudential toolkit was complemented last year by a discretionary additional capital requirement, i.e. the systemic risk buffer. This provides authorities with better means to safeguard the lending capacity and solvency of Finland's systemically vulnerable banking system. The expansion of the macroprudential toolkit coincides with the relocation of Nordea´s corporate headquarters to Finland, turning the country's banking sector into one of Europe's largest relative to GDP.

Helsinki, 15 May 2018

Marja Nykänen

Member of the Board

Keywords

indebtedness, macroprudential toolkit, positive credit register, systemic risks