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Russia's invasion reminds us that the financial system needs to be well prepared to bear risks

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Finland's financial system has remained stable, but uncertainty has increased. The general level of prices is rising rapidly at the same time as economic growth is expected to fade. Growth in unavoidable costs and in debt-servicing expenditure is squeezing the finances of many individuals and businesses. The banks are in good shape, but their credit risks could grow. Limits should be placed on household indebtedness, and banks' ability to withstand crises should be further improved.



Russia's invasion of Ukraine has increased uncertainty in the Finnish economy and financial system. The international financial markets reacted rather strongly to the outbreak of war, and, for example, stock prices fell rapidly. The reaction focused particularly on companies, banks and countries with links to Russia, such as Finland.

The rise in the general level of prices (inflation) was already accelerating during the pandemic, but, as a result of the war, prices of energy and food have risen in such a way that nobody could fail to notice the change in their daily lives. The traditional remedy for rapid inflation is for the central

bank to raise interest rates. Since the start of 2022, central bank rates have been raised in the United States, among others, and financial conditions are expected to tighten in the immediate years ahead also in Europe, in the wake of a possible rise in interest rates. If there is an interest rate hike, debt-servicing expenditure will also increase, which will have an impact on the finances of both businesses and private individuals alike.

The situation is not made any better by the fact that economic growth is at the same time expected to suffer, particularly in Europe and in Finland. The economy will be hampered by e.g. rising costs for raw materials and difficulties in sourcing them. Moreover, the COVID-19 pandemic is not yet over, which further depresses the economic outlook.

The war will affect Finnish companies particularly via indirect channels. The rise in energy prices will increase costs particularly for those companies that use a lot of energy in their production. Examples of such industries are manufacturing, agriculture and transport. Moreover, before the war, some companies had significant trading links with Russia.

All in all, Finnish companies were in rather good shape before the outbreak of the war. However, a prolonged war could weaken their profitability. Companies could also find it harder to manage their debts if energy continues to be very expensive and some products and services are not in such great demand as before. This will increase banks' credit risks, as most of the debt financing of Finnish companies is provided by the banks. The debt-servicing capacity of the companies that have suffered most from the pandemic is already weakened, which will not make the overall situation any easier.

The rapid rise in prices will also be seen as a bigger dent in people's wallets and bank accounts. Many daily consumer goods – such as fuels, electricity and foodstuffs – have become more expensive recently, and particularly since the outbreak of the war. Thus, essential consumer spending is taking an ever larger share of people's income.

The debt-servicing expenditure of many Finns is also on the rise. In Finland, the interest rates on housing loans generally rise and fall with the reference rates. The most common reference rate is the 12-month Euribor, which rose above zero in April for the first time since 2016. This will push up interest expenditure on loans and hence either inflate monthly instalments or lengthen the repayment period for the loans.

Chart 1.



RUSSIA'S INVASION
of Ukraine increases risks

- Economic growth will fade, prices rise and loans become more expensive
- Rising costs will tighten borrowers' finances
- Banks may experience increased loan losses



THE RISKS necessitate
buffers for a rainy day

- Excessive household debt must be reined in
- Banks' capacity to withstand crises must be improved
- Banks must prepare carefully for cyber risks

The debt burden on households has long been growing. The Bank of Finland and the Financial Supervisory Authority oversee the stability of Finland's financial system and have long been expressing concern over the increasing level of indebtedness. This concern is increased by the fact that new housing loans are larger than in the past, and it is increasingly common that the durations of the loans are longer than the previous standard of 25 years.

Household indebtedness and the consequent risks should be mitigated more effectively than heretofore. A government proposal drafted by the Ministry of Finance proposes an upper limit on the duration of housing loans and limitations on the size and duration of loans to housing companies. In order to better bring indebtedness under control, the setting of a debt ceiling should also be considered. When a borrower seeks a new housing loan, all their significant debts would be taken into account and the maximum amount of any loan granted would be linked to the borrower's income. This would prevent uncontrolled growth in debt.

Although there are many causes for concern, the banking sector in Finland is nevertheless profitable and solvent. Stress tests conducted on the banks indicate they would withstand even a very severe economic and financial market crisis. This shows that Finnish banks are well positioned to adapt to a deterioration in their operating environment.

Even if the financial system itself is bearing up well, external factors could also threaten Finland's financial stability. The war and the pandemic provide fresh examples of such factors. Thus, the authorities should be equipped to ensure the banks can survive even in stormy conditions. It

should be possible to strengthen banks' capital buffers in a greater variety of ways than is the case today. Capital buffers refer to funds the banks can deploy to cover their losses. Where necessary, the authorities can also release buffers for the banks to use, so that in a difficult economic situation they can maintain lending to companies and households. Moreover, banks should have sufficient preparedness for serious operational disruptions, such as heightened risks of cyber attack.

Keywords

banks, companies/firms, financial stability, household indebtedness, macroprudential policy, Russia, Ukraine, war