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Bank of Finland Financial Stability Report

One of the Bank of Finland's core tasks is to contribute to the reliable, efficient and stable functioning of the financial markets. The Bank conducts regular analyses of the vulnerabilities and risks related to the financial system that could trigger or exacerbate economic disruptions. These are not forecasts, but analyses of potential financial market developments.

The financial stability analysis published on the Bank of Finland website is intended for financial market participants, other authorities and the general public to provide information and promote discussion on financial stability. The objective is to ensure that these parties take the current condition of and future outlook for the financial system into consideration in their operations. In addition to the stability analysis, the publication features articles of topical interest.

The contents of the Bulletin may be freely quoted, but due acknowledgement is requested.

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EDITORIAL

Regulation has strengthened the financial system's resilience

5 MAY 2020 11:00 AM • BANK OF FINLAND BULLETIN 2/2020 • EDITORIAL

The resilience of banks, firms, and households is being put to the test as the Finnish economy and the economies of its important trading partners experience a sharp contraction. However, financial institutions' solvency and liquidity positions have been strengthened significantly since the global financial crisis, and borrowers are in many respects on sounder footing than they were before the financial crisis or during the Finnish banking and economic crisis of the early 1990s. Strong capital adequacy ensures that banks are better equipped to lend to households and firms. A well-functioning banking sector together with government relief measures will bolster the economy's outset for growth after the crisis.



The economic news from around the world has proven exceptionally bleak recently, as the effects of the uncertainty and containment measures prompted by the coronavirus pandemic reverberate through the economy. The Finnish economy will contract this year because of the containment measures put in place domestically but also because of lower demand for Finnish exports. The crisis confronting the Finnish economy is global and broadly based. It is not enough that only Finland should survive the coronavirus pandemic. For our economy to recover, it is important that our trading partners get back on their feet as quickly as possible.

Economic conditions in other countries have a bearing on the Finnish financial system and its stability. The deterioration of the economic outlook has been reflected in financial

markets as heightened volatility and as occasional strains in access to market funding. The Nordic banking sector is strongly interlinked, and a number of Finnish banks have significant receivables from abroad—especially from the rest of the Nordics. This exposes our financial system to disturbances stemming from outside Finland.

The crisis has disrupted the operations of many firms and reduced their revenues. The hardship of businesses has already translated into a significant number of lay-offs. To prevent these lay-offs from turning into redundancies and the difficulties of profitable firms from leading into bankruptcies, it is of primary importance that the business sector is helped through the worst of the crisis. Banks must be able to provide liquidity to sound businesses and channel monetary policy stimulus from the central bank to the non-financial corporate sector.

The European Central Bank (ECB) and European supervisory authorities have lowered their capital requirements, made use of flexibility in the interpretation of regulation and eased banks' reporting requirements. The Finnish Financial Supervisory Authority Board and other Nordic macroprudential authorities have lowered their capital requirements for banks. These measures have strengthened the ability of banks to offer their customers flexibility in loan repayment schedules in light of the coronavirus pandemic. They have also increased banks' lending capacity and improved the availability of finance to non-financial corporations. Some firms lack the collateral necessary for a loan withdrawal or are ill-positioned to borrow during a time of heightened economic uncertainty. Government-backed loans and direct subsidies are thus also needed to help firms overcome their financial distress.

Bank solvency is much stronger today than it was in the 1990s, and interest rates are at a significantly lower level. Foreign currency-denominated loans are rare, and the Finnish housing market has not experienced a similar overheating as in the late 1980s. During the banking and economic crisis of the early 1990s, the solvency of the Finnish banking sector was so weak that it could not even channel funding to profitable firms.

The crisis resilience of the banking system has been reinforced systemically over the past decade since the global financial crisis. These efforts are now supporting banks' ability to lend and are strengthening their ability to absorb potential credit losses. The economic recession caused by the coronavirus pandemic is in many respects different from the global financial crisis or the Finnish banking crisis of the 1990s. The loan losses that banks potentially face have been modelled based on historical data.

The Bank of Finland has drawn attention to household debt and emphasised the importance of strong bank capitalisation. When compared with levels during the banking and economic crisis of the early 1990s or the global financial crisis, Finnish household debt is now historically high. For households to be able to service their debts in the future, it is important that the financial distress suffered by firms does not lead to permanent job losses and increased long-term unemployment.

The acute and broad-based economic crisis precipitated by the coronavirus containment measures demonstrates the importance of a well-functioning financial sector. It is important that banks, firms and households prepare for adversity by building buffers and strengthening their finances during the good times. It is also important that the

macroprudential toolkit is developed further. The report left by the Ministry of Finance's working group offers a good starting point for this development. This will strengthen the ability of the financial system to withstand future crises, beyond the coronavirus pandemic.

Helsinki 28 April 2020

Marja Nykänen
Deputy Governor

Tags

regulation, loan losses, coronavirus pandemic, corporate finance, crisis resilience, corona

Pandemic demonstrates necessity of risk buffers

TODAY 4:00 PM • BANK OF FINLAND BULLETIN 2/2020 • FINANCIAL STABILITY

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.



The Finnish version of Financial Stability Assessment was published on 5 May 2020.

Extensive restrictions on the movement and assembly of people and the conduct of business have been introduced, aimed at bringing the coronavirus pandemic under control. The collapse of economic activity caused by the restrictions has led to serious liquidity problems in a large number of companies. The fall in income has forced companies to reduce or temporarily lay off their staff, which has increased households' financial difficulties.

It will take time until the restrictions aimed at slowing down the pandemic can be fully lifted, for health and economic uncertainty to dissipate and for the economic conditions to be restored even in part. In spite of the relief measures put in place, the human and economic toll of the pandemic will prove significant.

The global financial system is stronger now than it was before the global financial crisis just over ten years ago. After the financial crisis, credit institutions were required to

accumulate capital and liquidity buffers to protect against future banking crises. In many countries, the risk of a housing market crisis was reduced by introducing macroprudential instruments to curb excessive household borrowing. The risk buffers accumulated in response to banking regulation must now be deployed to mitigate the shock caused by the pandemic crisis.

Despite the severe shock caused by the pandemic, Finland's financial system has remained operational. Finnish banks have increased their lending to businesses and granted grace periods (amortisation holidays), thereby improving their customers' ability to meet their payments. The government has eased companies' liquidity crisis through direct subsidies, by increasing Finnvera's guarantees and through other measures.

The contraction of the economy will weaken the solvency of households and businesses. Banks' loan losses from corporate and household loans will inevitably increase. The Bank of Finland has calculated scenarios on the development of the Finnish economy over the next few years and, based on these, estimated the amount of loan losses arising from Finnish bank loans. Based on the calculations, the pandemic crisis may result in significant loan losses for the banks. The amount of loan losses will increase if the restrictions need to be extended and the economy is pushed into a prolonged recession.

Banks operating in Finland acquire a large part of their funding on the international financial markets. Due to the pandemic, it has occasionally become more difficult to obtain funding. The European Central Bank has increased its policy measures to ensure liquidity on the financial markets and access to funding for businesses.

The resilience of the Finnish financial system is supported by the fact that house prices have not risen exceptionally rapidly in recent years. However, some Finnish households are heavily indebted relative to their income due to large mortgages and other loans, which weakens their ability to adapt to disturbances in their own finances.

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.

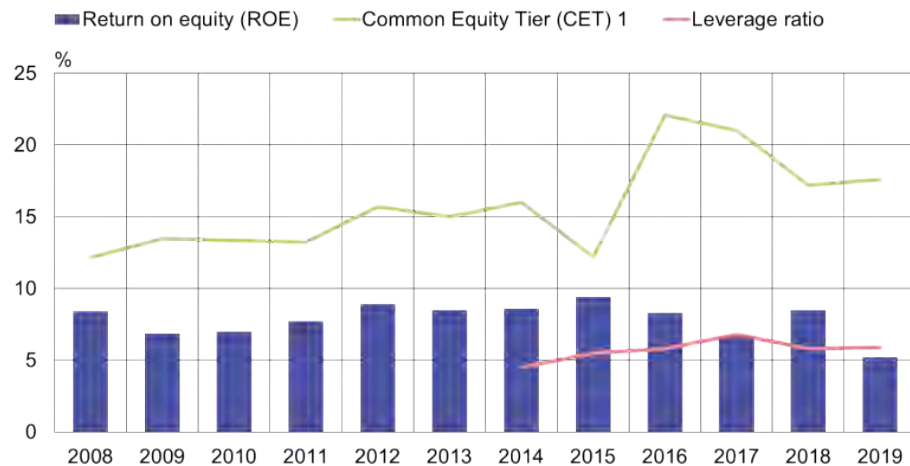
Financial market valuations of risky assets were close to all-time record levels just before the crisis hit. Since then, the sharp deterioration in the economy has erased previous expectations of companies' earnings performance and dividends, caused a worldwide collapse in stock prices and raised the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

Key figures for Finnish banks



Source: Financial Supervisory Authority.

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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.

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

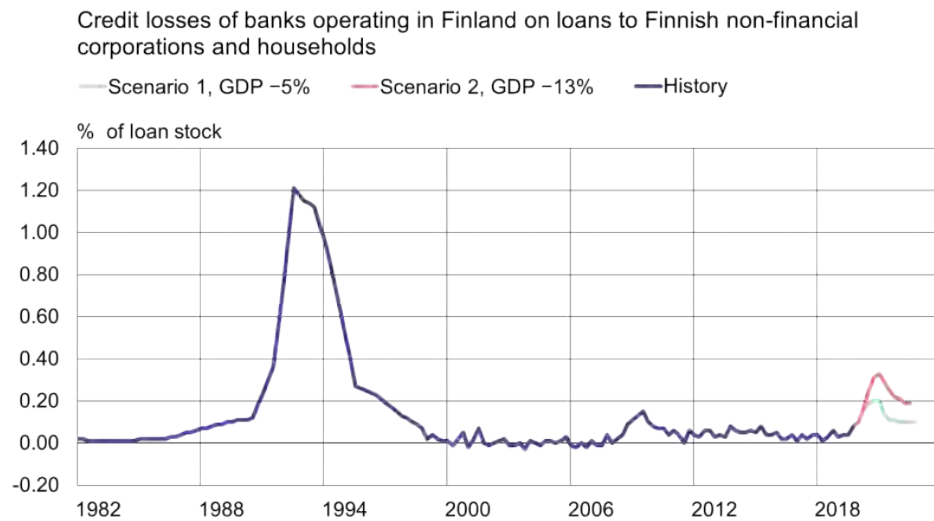
2. Jokivuolle, E. – Pesola, J. – Virén, M. (2015) 'Why is credit-to-GDP a good measure for setting countercyclical capital buffers?' *Journal of Financial Stability*, Volume 18, June 2015, pages 117–126.

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.

scenario.^[5]

Chart 2.



Source: Bank of Finland calculations.

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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.

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.

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

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%.

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.

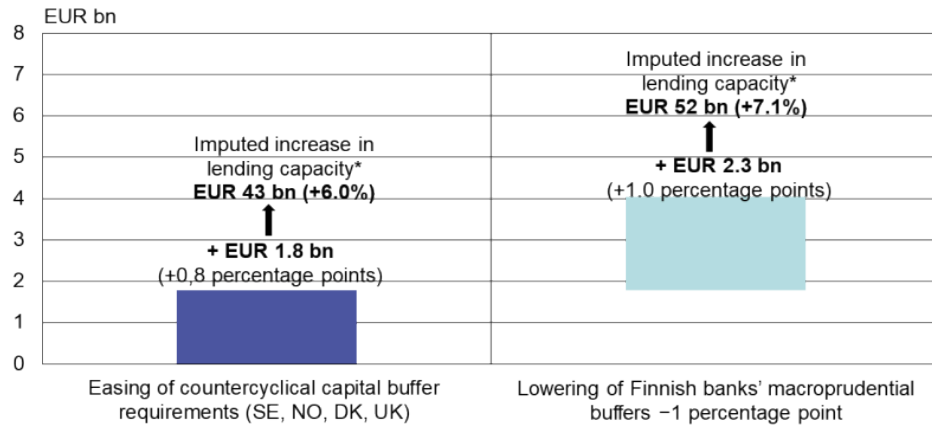
Government and authorities have taken a number of measures to help businesses overcome their economic difficulties. The Finnish government increased Finnvera's provision of collateral from EUR 4 to EUR 12 billion to facilitate access to funding for businesses. Private entrepreneurs may apply for a discretionary 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.

7. The macroprudential decisions were estimated to increase Finnish banks' capacity for lending within Finland by EUR 30 billion.

Chart 3.

Estimated impact of the macroprudential decisions taken by other countries and the FIN-FSA on Finnish banks' additional capital buffers and lending capacity



*Expansion of balance sheet that would keep total capital requirements unchanged at current risk-weight levels.

Source: Financial Supervisory Authority.

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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

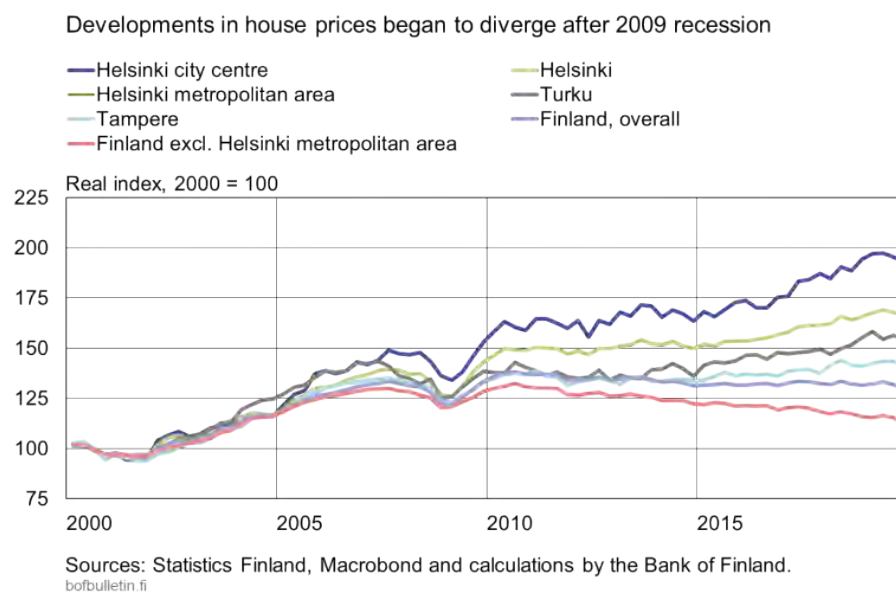
In January and February 2020, the Finnish housing market was still more buoyant than a year earlier. The containment measures adopted in response to the coronavirus pandemic, together with heightened economic uncertainty, began to depress housing sales and demand for new housing loans in the latter half 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.

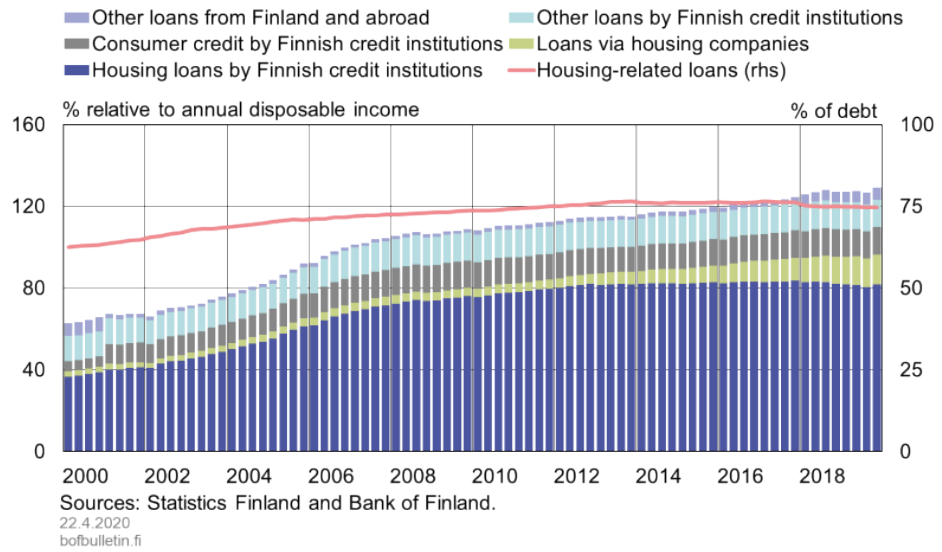


Risks of excessive household debt could materialise

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.

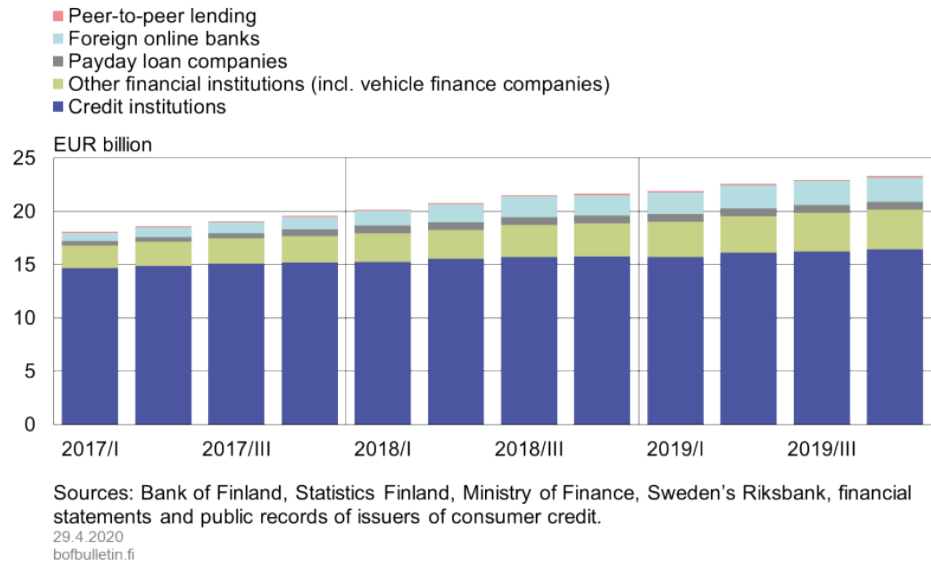
Household indebtedness historically high in Finland



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.

Consumer credit stock has grown in recent years



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

8. See <https://www.asiakastieto.fi/web/fi/asiakastieto-media/blogit/389-500-suomalaisella-on-maksuhairiomerkittoja.html> (in Finnish).

9. See the Bank of Finland's statement to the Ministry of Finance [lausuntopalvelu](#) website (in Finnish).

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.

Tags

housing markets, financial stability, coronavirus pandemic, corona, corporate finance, banks

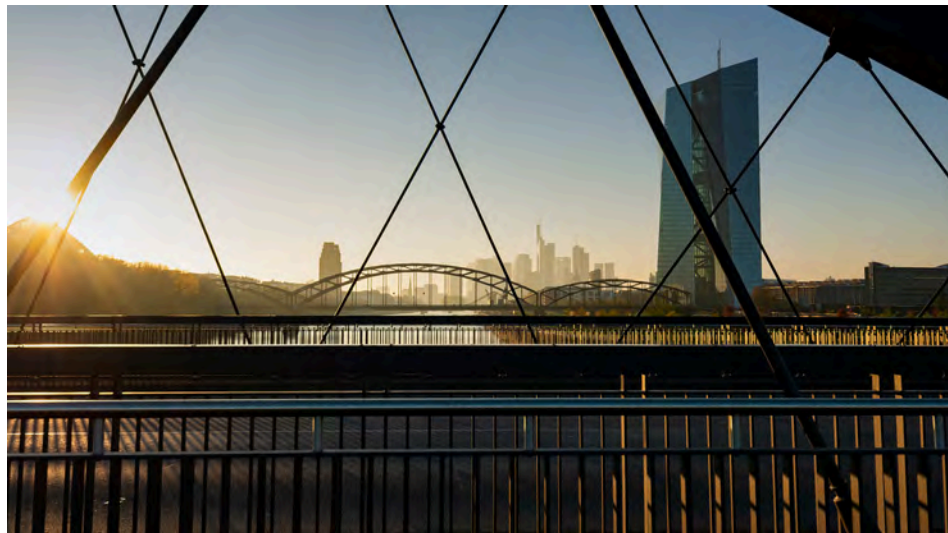
Coronavirus shock will further weaken bank profitability in the euro area

TODAY 4:00 PM • BANK OF FINLAND BULLETIN 2/2020 • FINANCIAL STABILITY



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Expectations of a deteriorating economic outlook increased the risks to banks' operating environment even before the coronavirus pandemic spread to Europe. At the end of 2019, banks' return on equity was 5.2%, compared with 6.2% a year earlier. While some banks were experiencing profitability challenges already prior to the outbreak of the pandemic, profitability also differs greatly between countries, bank business models and individual banks. Due to the coronavirus pandemic, banks' income development will further deteriorate, and it is likely to fall well below banks' imputed cost of equity. The effects of the pandemic are widely reflected in the stock prices of European banks (Euro Stoxx Banks Index), which have fallen by 40% since the beginning of 2020.

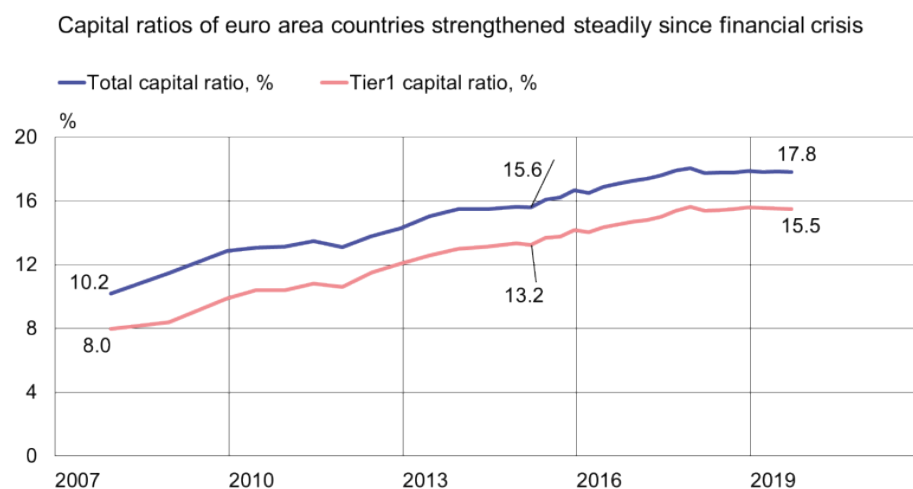


Banks' capital adequacy position better than in previous crises

The regulatory reforms implemented since the global financial crisis have enhanced banks' ability to bear risk. The capital adequacy of euro area banks has strengthened and their dependency on short-term market funding has diminished. The credit stock of European banks has not grown sharply, and the banking sector has also worked

determinedly to reduce the volume of problem loans.

Chart 1.



Source: European Central Bank.

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Government measures significantly increased lending capacity of banks

The decisions taken by supervisory and macroprudential authorities following the escalation of the coronavirus pandemic have eased the capital requirements of euro area banks. These relief measures have markedly increased banks' lending capacity to non-financial corporations and households.^[1] Banks have also been urged to refrain from making distributions. In order to support banks' operational capacity, the European supervisory authorities have increased flexibility in reporting and regulatory interpretations.

Functioning of markets important – ECB operations support transmission of funding to non-financial corporations and households

The smooth functioning of the market is important for banks as it affects their own funding. Uncertainty and distrust have a rapid impact on the functioning of the market and on the price and availability of market funding. The coronavirus pandemic has raised the price of market funding for banks and non-financial corporations in the euro area and has occasionally weakened access to funding. Financing problems have been reflected in both short-term unsecured commercial papers and loans and long-term bonds. Following the escalation of the coronavirus pandemic, access to funding deteriorated in the dollar money market as well, but monetary policy measures taken by

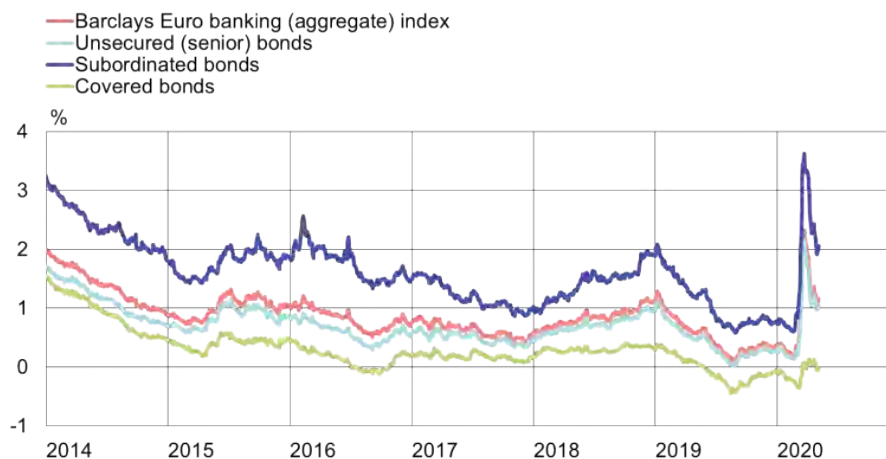
1. The measures taken by supervisory authorities are estimated to free EUR 120 billion of core capital, which will enable up to EUR 1,800 billion of new lending to euro area households and corporations.

the FED and the ECB stabilised the situation at the end of March.

Central banking operations, such as new credit operations, collateral easing measures and purchase programmes, have facilitated banks' access to funding and reduced the price of market funding. Especially markets for low-risk instruments, such as covered bonds, have reopened.

Chart 2.

Central bank measures lowered banks' funding costs



Source: Bloomberg/Barclays.

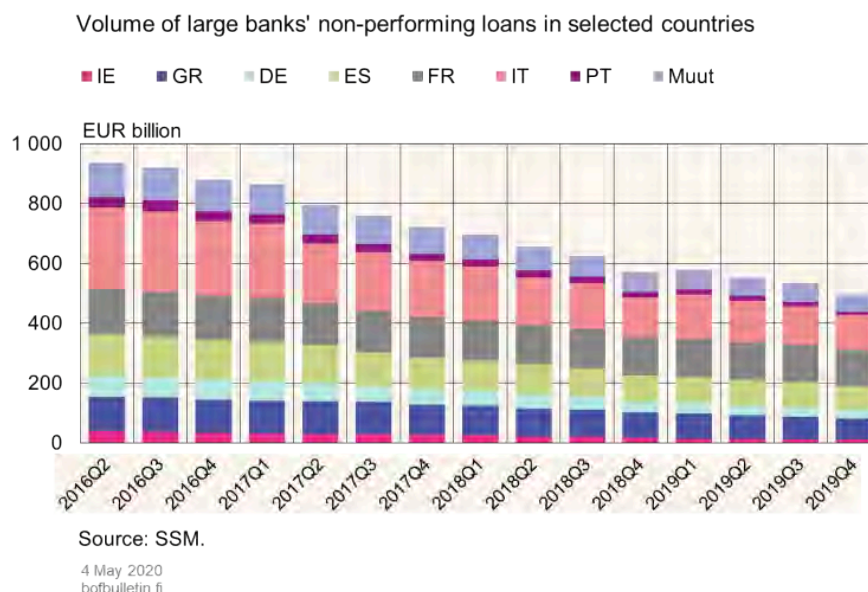
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Financial crisis cast a long shadow over problem loans – coronavirus pandemic will once more increase banks' credit risks

The number of non-performing loans of euro area banks continued to decline in 2019. According to the European Central Bank, euro area banks had EUR 506 billion of non-performing loans on their balance sheets at the end of 2019, which is about 13% less than a year earlier.^[2]

2. On average, around 3.2% of the credit claims of euro area banks are non-performing loans. At the beginning of 2016, the corresponding figure was 6.9%.

Chart 3.



Despite the reduced volume of bad loans in several countries, loan losses and provisions continue to weigh substantially on the performance of some banks. These banks have an insufficient ability to strengthen their capital adequacy position through income financing, and they also face challenges in raising new capital.

The coronavirus pandemic increases the credit risk of banks. Both the containment measures to curb the pandemic and the exceptional uncertainty have significant effects on the real economy, and the slowdown in economic activity will increase banks' loan losses. The weakening outlook for economic activity and the prolongation of the exceptional measures are affecting the corporate sector, especially companies with small cash reserves. The prolongation of the crisis may also be reflected on the housing and real estate markets. The exposure of the banking sector to different sectors varies from country to country, and the different exposures will be reflected in each country's loan loss development.

Many countries have launched guarantee schemes to help profitable companies, where the state guarantees banks loans to corporations. Loans with a guarantee may account for a large proportion of new loans, as in many countries the size of these programmes is significant.^[3] Guarantee schemes stimulate the funding of companies, but also transfer part of the credit risk from banks to the public sector.

Some euro area banks own significant amounts of public sector bonds in their own country. In many countries, measures to combat the coronavirus pandemic are expected to significantly increase government debt. This is reflected in the risk of bank-owned government bonds and reinforces the harmful link between banks and their sovereigns. Efforts to weaken this link must be actively continued in the future by offering banks safe

3. The size of the guarantee programmes is discussed in the April 2020 edition of the IMF Fiscal Monitor, <https://www.imf.org/en/Publications/FM/Issues/2020/04/06/fiscal-monitor-april-2020>.

and low-risk investment options alongside sovereign bonds. It is also important to finalise the EU Banking Union with a common European Deposit Insurance Scheme and to strengthen the Single Resolution Mechanism and the Single Resolution Fund. The development of the Capital Markets Union is also important in order to diversify financial intermediation in Europe, where the financial system has traditionally been very bank-centric. Due to the interconnections between intra-euro area trade and financial markets, favourable economic developments and stable financial conditions are important for all Member States.

Tags

[financial stability](#), [euro area](#), [coronavirus pandemic](#), [corona](#), [banks](#)

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Banks must be able to finance firms and withstand loan losses amid the coronavirus pandemic

TODAY 4:00 PM • BANK OF FINLAND BULLETIN 2/2020 • FINANCIAL STABILITY



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Stricter capital requirements since the global financial crisis have improved the ability of banks to lend and absorb losses in a crisis situation like the coronavirus pandemic. A robust lending capacity is now needed to finance fundamentally sound Finnish companies with liquidity needs. It must be ensured that banks are well-capitalised to withstand future loan losses.



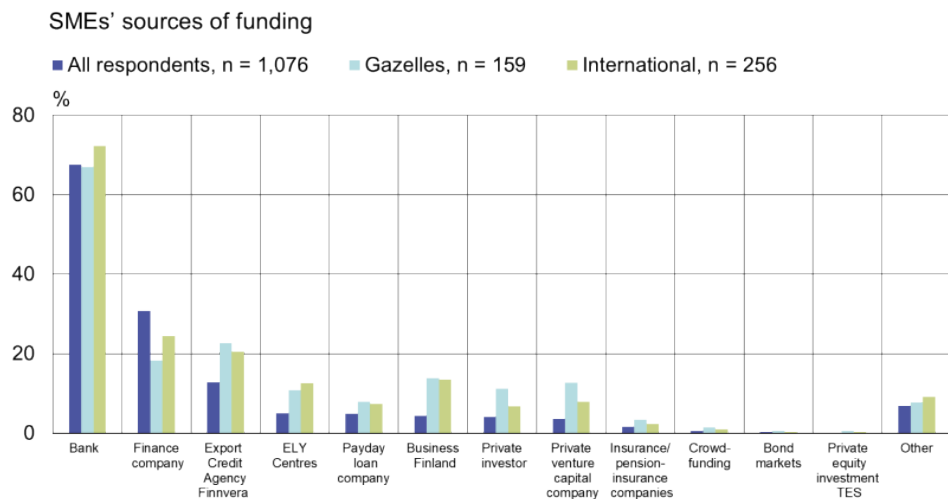
A large number of Finnish companies are seeing sharply falling revenues as a result of the coronavirus containment measures and declining consumer confidence. The abrupt contraction in income has been mirrored by a strong increase in the demand for funding. With collapsing sales, many companies will see their cash reserves quickly run dry without significant operational adjustments, additional financing or other support measures (see [Yritysten maksuvaikeudet koronapandemiassa – laskelmia yritysaineistolla](#), 'Companies' liquidity problems during the coronavirus pandemic – calculations based on company data', in Finnish only).

Businesses are in need of funding or direct financial support to survive the transitory external shock to the economy. The purpose of such is to prevent companies' liquidity problems from turning into bankruptcies and extensive lay-offs from leading into mass

unemployment. These measures are aimed at preventing a long-lasting recession similar to that of the 1990s, when banks were incapable of financing sound companies, resulting in a dramatic rise in unemployment.

Domestic banks are by far the most important source of external funding for Finnish firms. Banks are especially important for the financing of micro- and small and medium-sized enterprises (Chart 1). To mitigate the recession, as well as for the recovery of the economy, it is essential that Finnish banks are able meet companies' at least temporarily higher need for loans.

Chart 1.



Source: Federation of Finnish Enterprises, SME Barometer Spring 2020.

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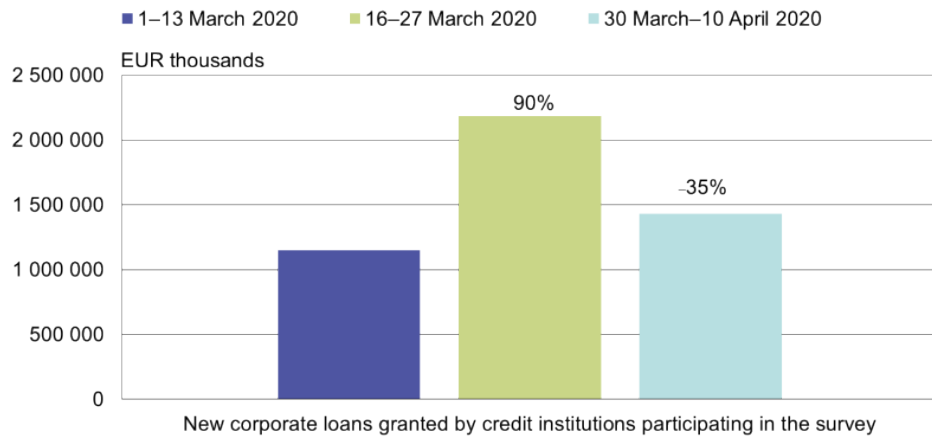
Coronavirus pandemic testing the lending capacity of Finnish banks

The financing needs of Finnish companies began to spike in mid-March 2020, when most of the restrictions and recommendations on public gatherings and personal movement were introduced. In anticipation of a potential rise in companies' borrowing needs, authorities have introduced several measures aimed at strengthening the lending capacity of banks.

A survey on bank lending to non-financial corporations conducted by the Financial Supervisory Authority (FIN-FSA), Bank of Finland and Ministry of Finance shows that the provision of new corporate loans by banks in the second half of March (16–27 March) was over 90% larger than in the first half of the month (1–13 March) (Chart 2). However, during the first two weeks of April banks' new corporate loans had declined on the preceding two weeks. This decline in companies' need to borrow might in part be explained by direct corporate subsidies launched by the government in the second half of March.

Chart 2.

What was the volume of new corporate loans granted by your bank during the survey period, percentage change on the previous period



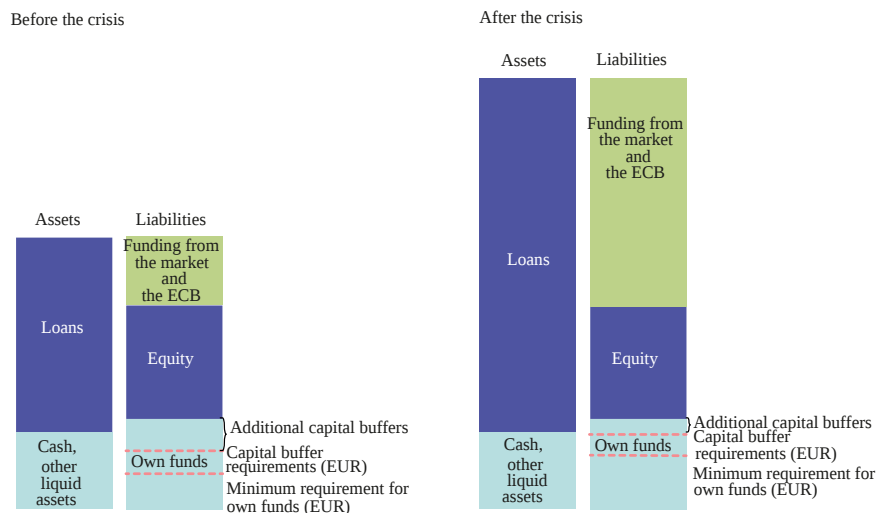
Source: Survey by FIN-FSA, Bank of Finland and Ministry of Finance.

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When evaluating the banking system's capacity to increase its lending, a simplified balance sheet example can help illustrate which factors determine a bank's ability to lend. Chart 3 shows the balance sheet composition of a hypothetical bank before the pandemic crisis ('before the crisis') and after escalation of the pandemic ('after the crisis'). For the purpose of illustration, changes in the balance sheet are portrayed as very large and do not represent actual volume changes in the size or composition of the balance sheet.

Chart 3.

A bank's balance sheet before the crisis and after the escalation of the crisis



Source: Bank of Finland.

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The majority of a bank's assets (left-hand side of the balance sheet) are loans granted by the bank. In addition to this, banks hold cash or capital instruments that can quickly be converted into cash to safeguard their liquidity. In Chart 3 these liquidity items are presumed to remain unchanged.^[1]

The majority of a bank's liabilities (right-hand side of the balance sheet) are deposits held by households and firms. The loan-to-deposit ratio of the Finnish banking sector is above 100 percent, i.e. the volume of loans granted is larger than the volume of deposits received.

Banks finance their lending not only with deposits but also by issuing bonds.^[2] In addition, euro area banks receive funding from the European Central Bank (ECB) against collateral. Chart 3 assumes that banks will finance their higher lending entirely by drawing on wholesale funding and by receiving funding from the central bank.

Own funds are the third item on a bank's balance sheet that it can use to finance lending. After the global financial crisis banks have been required to hold a significantly higher volume of own funds, to protect depositors and taxpayers from bank defaults and banking crises.^[3]

Banks' capital adequacy requirements can roughly be divided into two types or requirements: a minimum capital requirement and buffer-type additional capital requirements. Non-compliance of the former may lead to a bank having its authorisation withdrawn, and non-compliance of the latter will result in restrictions on profit distribution, among other penalties.^[4]

Own funds held by Finnish banks exceeded the volume demanded by the minimum capital requirement and buffer requirements at the end of 2019. Because a higher volume of lending increases a bank's capital requirements in euro terms (right-hand side), it is the size of the additional buffers that in the short term dictates how much a bank is able to increase its lending.

Bank lending capacity has been strengthened by monetary, fiscal and macroprudential policy

1. A bank's minimum liquid assets are determined on the basis of the liquidity coverage ratio (LCR) requirement, which was introduced worldwide following the global financial crisis, to prevent systemic liquidity risks in the banking sector.

2. The fund raising of banks will be regulated globally by the Net Stable Funding Ratio (NSFR). The purpose of the NSFR requirement is to prevent the excessive funding of banks' activities with very short-term funding that may dry up very rapidly in a crisis situation. The regulation will enter into force in the EU on 28 June 2021.

3. Banks are today required to hold a significantly larger volume of own funds with the highest ability to absorb losses, for example share capital and cooperative share capital. Moreover, systemically important banks must hold debt instruments that can be written down in a crisis situation or be converted into Common Equity Tier 1 capital to finance crisis resolution. Bank supervision has been harmonised and improved since the crisis.

4. These buffer requirements are either statutory requirements or additional requirements by supervisory or macroprudential authorities that can be imposed for reasons such as the systemic importance of a bank or structural vulnerabilities in the banking system. A more detailed description of bank capital regulation is available on the FIN-FSA's website at: <https://www.finanssivalvonta.fi/en/regulation/regulatory-framework/crrcrd/>

measures

The stylised balance sheet shows that if a bank increases its lending (left-hand side), it must increase its funding (right-hand side) accordingly. When evaluating the Finnish banking systems' capacity to meet a potential rise in the funding needs of Finnish companies, three points deserve particular focus, namely (i) how much and for how long will companies' funding needs increase; (ii) how willing are banks to increase their corporate lending; and (iii) how will the banking sector finance its increased lending.

It is difficult to estimate how the funding needs of firms will develop. During the global financial crisis, Finnish banks strongly increased their lending to non-financial corporations as soon as the crisis escalated. Afterwards, lending began to quickly decline as companies started to postpone investments.

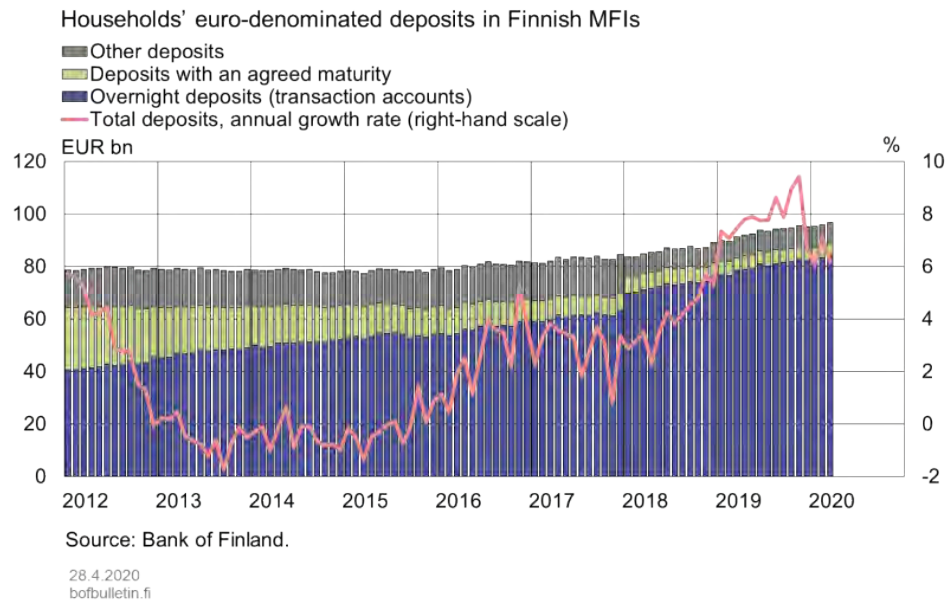
The coronavirus pandemic weakens the economic outlook for Finland and Finland's trading partners and raises credit risk on corporate loans. The Government's decision to increase several times over the loan guarantees offered by Export Credit Agency Finnvera distributes credit risk between banks and the government, and encourages banks to increase their lending to small and medium-sized enterprises (SMEs). The purchases in the commercial paper market launched by the Bank of Finland, which have a maximum envelope of EUR 1 billion, in turn, decrease the need for large businesses to acquire bank loans and thus strengthen the ability of banks to lend to smaller businesses ([Suomen Pankki käynnisti toimintansa yritystodistusmarkkinoilla](#), 'The Bank of Finland re-entered the commercial paper market', in Finnish only).

As shown in the balance sheet illustration above, Finnish banks can finance a potential rise in corporate loans by (i) attracting more deposits; (ii) increasing their volume of own funds or (iii) obtaining additional funding from the wholesale market or central bank.^[5]

Deposit volumes usually grow in crisis situations, as households and firms wish to keep their assets in a form that is as liquid as possible. Finnish MFIs' stock of deposits has increased rapidly since 2018. The annualised growth rate in the stock of household deposits was slightly higher than 6% in March 2020. This strong growth in deposits contributes to the lending capacity of Finnish banks. Weaker profitability and higher loan losses, in turn, are detrimental to the accumulation of own funds in a crisis situation, as they reduce retained earnings. In addition, the demand for share issuances is virtually nil during crisis situations.

5. If a bank were to hold a considerable volume of cash, it could in principle increase its lending by converting part of its cash holdings into credit. In practice, however, it is not profitable for banks with a high loan-to-deposit ratio to hold large volumes of assets as cash or equivalents.

Chart 4.



The FIN-FSA Board's decision to lower banks' capital buffer requirements by one percentage point, as well as the decisions taken by other Nordic supervisors to ease countercyclical capital buffer requirements, has increased the lending capacity of Finnish banks by an estimated EUR 95 billion.^[6]

European supervisory authorities have also granted quantitative and qualitative allowances in capital and liquidity requirements and have urged banks to use their accumulated buffers to maintain their lending to the real economy. Banks have also been recommended to refrain from dividend distribution at least until 1 October 2020. In addition, banks are allowed to make use of flexibility in the accounting and regulatory framework, as they determine how the modified loan repayment arrangements they have offered their customers in response to the coronavirus pandemic should be taken into account in loan loss provisions and the assessment of customer credit risk. Supervisory authorities have also alleviated banks' regulatory burden for instance by granting leeway in reporting requirements and by postponing bank stress tests to 2021.

For Finnish banks to increase their lending, banks themselves must be able to borrow from the financial markets and the ECB. In this respect, it is fortunate that the yields on covered bonds issued by large Nordic banks remain historically low, even if they have risen slightly. ([Nordic countries are vulnerable to housing market risks aggravated by the coronavirus pandemic](#)). Since the escalation of the pandemic, the ECB has increased its refinancing at very favourable terms in order to support bank lending to businesses (EKP:n rahapolitiikan toimet koronapandemian aikana, 'ECB's monetary policy measures during the coronavirus pandemic', in Finnish only).

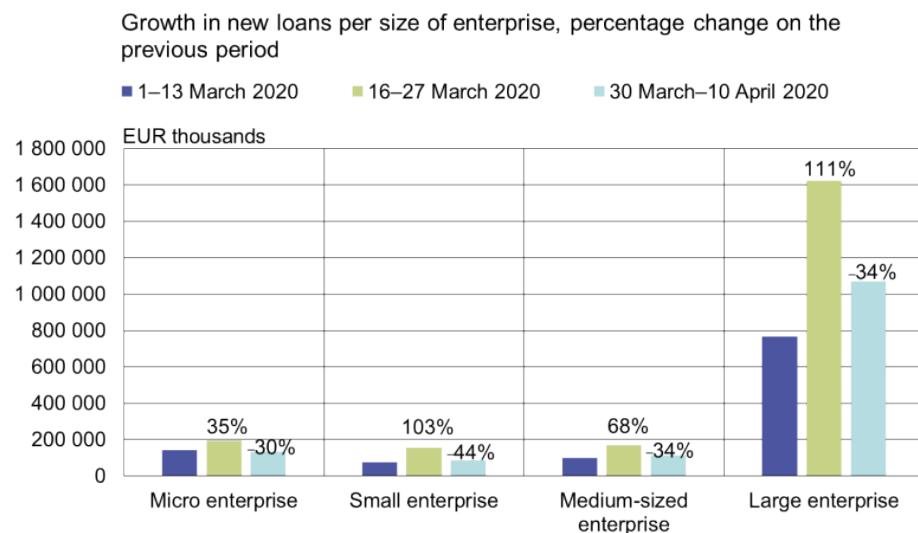
6. The decisions increased the domestic lending capacity of Finnish banks by an estimated EUR 30 billion. See <https://www.finanssivalvonta.fi/en/publications-and-press-releases/Press-release/2020/macprudential-decision-fin-fsa-board-lowers-credit-institutions-capital-requirements/>

Not all companies are keen to borrow amid economic uncertainty

Making bank loans more readily available does not help companies that do not consider it prudent to borrow in exceptional economic circumstances or that have little collateral available. Companies may avoid borrowing if they are uncertain about improving their profitability after the crisis and being able to service a larger debt burden.

The survey conducted by the FIN-FSA, Bank of Finland and Ministry of Finance suggests that banks increased their lending to companies of all sizes during the second half of March. However, loans to micro enterprises increased by far the least in relative terms (Chart 5). This may suggest that micro enterprises are particularly hesitant to take on new loans. For many firms especially in the service industry, profitability is modest even during normal times, which is likely to increase their reluctance to borrow.

Chart 5.



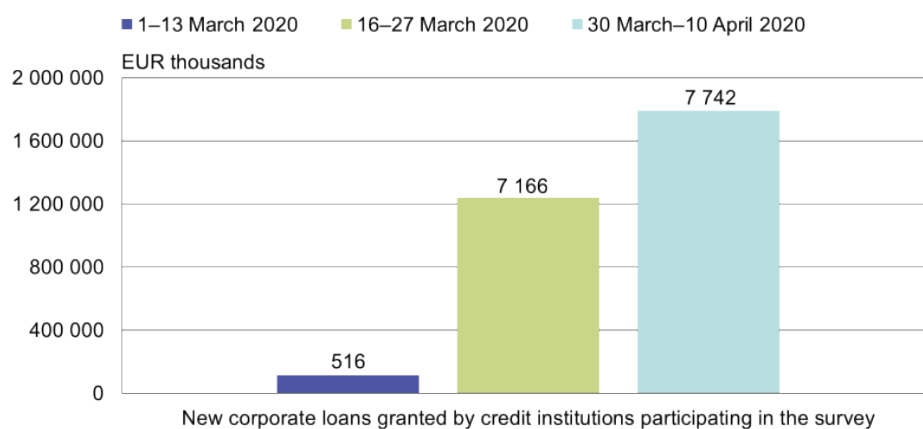
Source: Survey by the FIN-FSA, Bank of Finland and Ministry of Finance.

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The extensive fiscal measures currently in place to prevent bankruptcies ought to be continued, so that fundamentally sound but distressed companies might continue their operations (see [Pandemic demonstrates necessity of risk buffers](#)). Banks have helped ease the liquidity crisis of firms by granting interest-only periods and other changes to loan repayment programmes. The aforementioned survey conducted by authorities shows that the amount of interest-only periods granted by banks during the second half of March was nearly 15-fold compared with the first half of the month (Chart 6).

Chart 6.

Regarding corporate loans, how many interest-only periods or other allowances in repayment arrangements did your bank grant during the survey period, number of exemptions on bars



Source: Survey by the FIN-FSA, Bank of Finland and Ministry of Finance.

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Coronavirus pandemic to increase banks' credit risks and loan losses

The weakening of the economic outlook will be similarly reflected in the quality of banks' credit portfolios after a delay. Scenarios for estimating bank loan losses can be constructed based on the alternative economic scenarios published by the Bank of Finland in April.^[7]

In the following, loan losses on credit institutions' domestic lending are estimated based on a model introduced by Jokivuolle, Pesola and Viren (2015).^[8] The model explains the banking sector's ratio of loan losses (as a percentage of outstanding loans) by regressing the loan loss ratio on GDP, inflation, the real interest rate, house and stock (share) prices, and the credit-to-GDP gap.^{[9],[10]}

House and stock price changes are simulated using a simple econometric model. Price movements are based on a mechanical specification and depend on changes in GDP and interest rates.^[11] In the scenarios, both prices decline by about 20% compared with levels

7. In April the Bank of Finland published two alternative scenarios looking at the impact the coronavirus containment measures might have on the Finnish economy. In the first scenario, the Finnish economy contracts by 5% in 2020. The containment measures are gradually lifted, and the economy expands by nearly 7% in 2021. In the second scenario, the Finnish economy contracts by about 13% in 2020. As the containment measures are held longer in place than in the first scenario, economic growth remains at about 3.5% in 2021.

8. Esa Jokivuolle, Jarmo Pesola and Matti Viren: Why is credit-to-GDP a good measure for setting countercyclical capital buffers? *Journal of Financial Stability*, 2015, vol. 18, issue C, 117-126.

9. The credit-to-GDP gap is the statutory primary indicator for setting a countercyclical capital buffer (CCyB) requirement.

10. Calculations of the size of the credit-to-GDP gap are based on the assumption that the credit stock remains unchanged and GDP contracts as estimated in the alternative scenarios.

11. Prices are explained also by past changes in prices.

at the end of 2019.

The model calculates the loan loss ratio for the domestic loan stock given the assumed development of the underlying variables. The loan loss ratio can be presented in euro terms by multiplying the estimate with the aggregated stock of household and corporate loans, which stood at about EUR 225 billion at the end of 2019.^[12] In addition, the model assumes that the interest rates on household and corporate loans are 1.5 percentage points higher than the Euribor.

The results of the model are presented as quarterly loan losses in Chart 7. The cumulative loan losses from the first quarter of 2020 onwards are shown in the tables below.

Chart 7.



Table 1.

Loan losses on corporate and household loans in scenario 1

12. The applied model does not directly estimate the distribution of loan losses between corporate and household loans. These relative shares have instead been estimated separately under the different scenarios.

	Non-financial corporations, cumulative loan loss		Households, cumulative loan loss		Cumulative loan losses total EUR bn
	% of loan stock	EUR bn	% of loan stock	EUR bn	
2020	1.1	1.0	0.4	0.5	1.5
2021	2.2	2.0	0.5	0.7	2.7
2022	3.0	2.7	0.7	0.9	3.6

Source: Bank of Finland.

Table 2.

Loan losses on corporate and household loans in scenario 2

	Non-financial corporations, cumulative loan loss		Households, cumulative loan loss		Cumulative loan losses total EUR bn
	% of loan stock	EUR bn	% of loan stock	EUR bn	
2020	1.4	1.3	0.4	0.6	1.9
2021	3.6	3.2	0.8	1.1	4.3
2022	5.2	4.7	1.0	1.4	6.1

Source: Bank of Finland.

Foreign lending accounts for a significant share of the loan stock for some Finnish banks. Because of the global nature of the coronavirus pandemic, it is reasonable to assume that banks will take loan losses on foreign lending as well. However, the volume of these losses is not estimated in our calculations, as the alternative scenarios focus on developments in the Finnish economy. Furthermore, the calculations look at the banking sector in aggregate, so loan losses have not been estimated for individual banks.

The loan losses on domestic lending are first estimated based on the scenarios and then compared to Finnish GDP and the banking sector's volume of own funds. In scenario 1, loan losses amount to some 1.5% of GDP in 2019, and to approximately 8% of banks' own funds at the end of 2019. In scenario 2, loan losses come to about 2.5% of GDP in 2019, and to about 13% of banks' own funds at the end of 2019. These results are sensitive to the assumed interest rate margin. If the interest rate margin were one percentage point higher than the baseline assumption, the estimated loan losses for scenario 2 would increase about 20%.^[13]

During the Finnish banking and economic crisis of the 1990s, the banking sector's aggregate loan losses totalled EUR 11 billion during the period 1991-1996, which corresponds to about 12% of GDP in 1990 and some 14% of the stock of loans to households and non-financial corporations at the end of 1990. The cumulative loan losses realised during 1991-1996 were larger than the total value of bank capital at the end of 1990.^[14]

The alternative scenarios and derived loan loss estimates are subject to exceptionally high uncertainty, particularly in relation to the length of the crisis. Nevertheless, these indicative calculations demonstrate the importance of ensuring that banks are well-capitalised to withstand future loan losses.

Tags

[loan losses](#), [corporate loans](#), [coronavirus pandemic](#), [corona](#), [banks](#)

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13. Changing the interest rate premium allows for an assessment of the impact of tighter credit policies on the situation. Stricter lending terms would be reflected as higher interest margins and lending income, but probably also as higher loan losses in the economy as a whole.

14. The banking sector was recapitalised during the 1990s crisis.

Nordic countries are vulnerable to housing market risks aggravated by the coronavirus pandemic

TODAY 4:00 PM • BANK OF FINLAND BULLETIN 2/2020 • FINANCIAL STABILITY



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The coronavirus (COVID-19) pandemic is dampening the Nordic housing market in many ways. The economic outlook and consumer confidence in the economy have deteriorated precipitously. The restrictions imposed under the state of emergency are affecting the activities and financial position of banks, real estate agents and customers. Home sales have decreased and sales times are lengthening. The dependence of banks on wholesale funding renders them vulnerable to tensions in the international financial markets.



The coronavirus pandemic threw the international financial markets into unprecedented turmoil in March 2020 and brought the world economy to an abrupt halt. Estimates of the duration of the pandemic and its impacts on health and on the economy are continuously being updated. While the pandemic hit the economy as an external shock, it may – if protracted – trigger vulnerabilities that have long been building up in the financial system and in the housing market.

Economic growth in the Nordic countries was slowing down already before the outbreak of the coronavirus pandemic. The coronavirus crisis has demanded rapid updates to estimates of economic developments for the immediate years ahead. The economy is

expected to contract significantly in 2020 in all the Nordic countries. Employee cooperation negotiations have increased and the number of layoffs and unemployed jobseekers has risen abruptly. The risk of a protracted recession has increased, but a moderately swift recovery is still possible after the most acute phase of the crisis.^[1]

The resilience of the Nordic banking system has been strengthened in various ways since the global financial crisis. The solvency and liquidity positions of banks have been improved and new macroprudential instruments have been introduced to curb lending for house purchases and excessive household indebtedness. These requirements were eased when the pandemic broke out, and banks and households are utilising buffers to mitigate the economic impacts of the recession.

In response to the coronavirus crisis, Swedish banks have been given the permission to grant mortgagors an exemption from the financial supervisory authority's existing amortisation requirements.^[2] In Norway, banks are allowed greater flexibility in, for example, the application of the maximum loan-to-value (LTV) ratio, i.e. the loan cap.^[3] Banks operating in Finland, in turn, have granted temporary interest-only periods for housing loan customers.

While housing markets have often been at the centre of economic and financial crises^[4], vulnerability to the risks in the market varies by country. Recessions have been particularly deep and protracted when they have been preceded by excessive household indebtedness and debt-driven overheating of the housing market.^[5] For example, the global financial crisis in 2007–2008 had its origins in the US housing market, and the global economic downturn that followed triggered a recession in all the Nordic countries. Among the Nordics, problems in the housing market were severe and protracted only in Denmark, where house prices had risen rapidly prior to the crisis and declined for many years thereafter.

History has also known epidemic-driven recessions and housing market disruptions. These crises have remained short-lived, however, with only limited effects on financial stability. The SARS epidemic, for example, spread to dozens of countries in 2003 and hit Hong Kong particularly hard. House sales in Hong Kong temporarily declined dramatically, but the recovery was swift and the impact on house prices remained modest.^[6]

1. See e.g. [https://www.eurojatalous.fi/fi/2020/artikkelit/Scenarios fo the Finnish economy for the years ahead/](https://www.eurojatalous.fi/fi/2020/artikkelit/Scenarios%20fo%20the%20Finnish%20economy%20for%20the%20years%20ahead/).

2. See <https://www.fi.se/en/published/news/2020/banks-may-now-grant-amortisation-exemption/>.

3. See <https://www.regjeringen.no/en/aktuelt/temporary-changes-in-the-mortgage-regulation/id2694589/>.

4. Reinhart, C. M. – Rogoff, K. S. (2009) *The aftermath of financial crises*. The American Economic Review, Volume 99, Number 2, 466–472.

5. See e.g. <https://voxeu.org/article/great-mortgaging>.

6. House prices in Hong Kong were declining already before the epidemic and fell only marginally relative to the previous trend during the epidemic. For further details, see Wong, G. (2008) *Has SARS infected the property market? Evidence from Hong Kong*. Journal of Urban Economics, Volume 63, Issue 1, 74–95. See also <https://www.zillow.com/research/pandemic-literature-review-26643/>.

Nordic financial system vulnerable to housing market risks

The Nordic financial system is vulnerable to many risks intensified and triggered by the coronavirus pandemic. These risks may materialise and spread across international financial markets, the real economy and the residential and commercial real estate markets. The Nordic countries share many common structural vulnerabilities in their financial systems, and banks are therefore exposed to similar credit, investment and funding risks. The current recession increases the risk that long-accumulated vulnerabilities will begin to translate into losses.

The major role of housing finance and the housing market in the Nordic financial system has long been recognised as one potential source of risks. Significant common vulnerabilities associated with the housing market are high household indebtedness, the notable share of housing loans in bank lending to the public, the large share of covered bonds in banks' market-based funding and liquid assets, and the importance of wholesale funding in bank funding in general.^[7] Housing loans account for more than 40% of total bank lending in all the Nordic countries.

In addition to housing loans, Nordic banks have granted a high volume of loans to the commercial real estate sector. The share of these loans in total bank lending to the corporate sector varies among the Nordics from around 40% to some 60%. In previous crises, banks have suffered significant credit losses on loans to the commercial real estate sector, as the sector is highly cyclical. Risks in the commercial real estate market may spread across borders both through banks and through investors.

The banking sectors of the Nordic countries are large in relation to the size of the economy, concentrated and interconnected. The largest banks operate in several countries in the region. The Nordics are also important trading partners to each other, and international trade as a whole plays a significant role in the economy. For these reasons, financial and economic crises could have particularly severe repercussions for the Nordics and spread from one country to another.^[8]

The Nordic financial system has many strengths. The banking sectors of the Nordic countries are financially sound and enjoy good credit ratings. This improves their resilience against losses and their ability to ensure financial intermediation under different circumstances. The risk resilience of the Nordic banking sectors is supported by their good profitability in a European comparison. This is partly due to the low level of non-performing assets and credit losses. The Nordic financial systems and housing finance have functioned without major issue in the difficult economic situation during and after the global financial crisis.

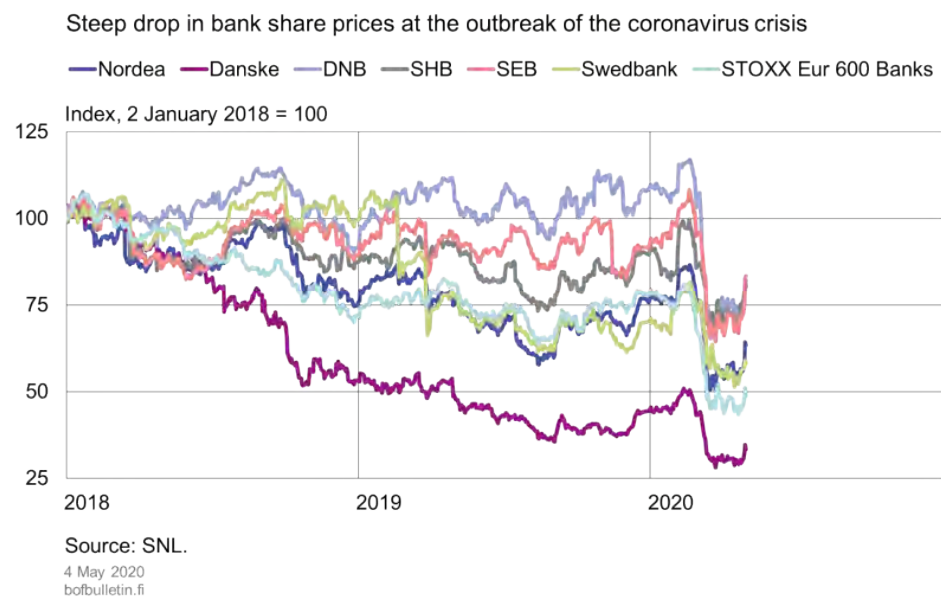
7. In 2019, the European Systemic Risk Board (ESRB) warned the Nordic countries of medium-term vulnerabilities in the residential real estate sector and issued recommendations for action to prevent in particular the risks stemming from the high level of household indebtedness.

8. See also <https://www.bofbulletin.fi/en/2018/articles/risks-on-the-swedish-housing-market-also-a-cause-for-concern-in-other-nordic-countries/>.

The coronavirus pandemic was quickly reflected in the stock and bond prices of mortgage lenders

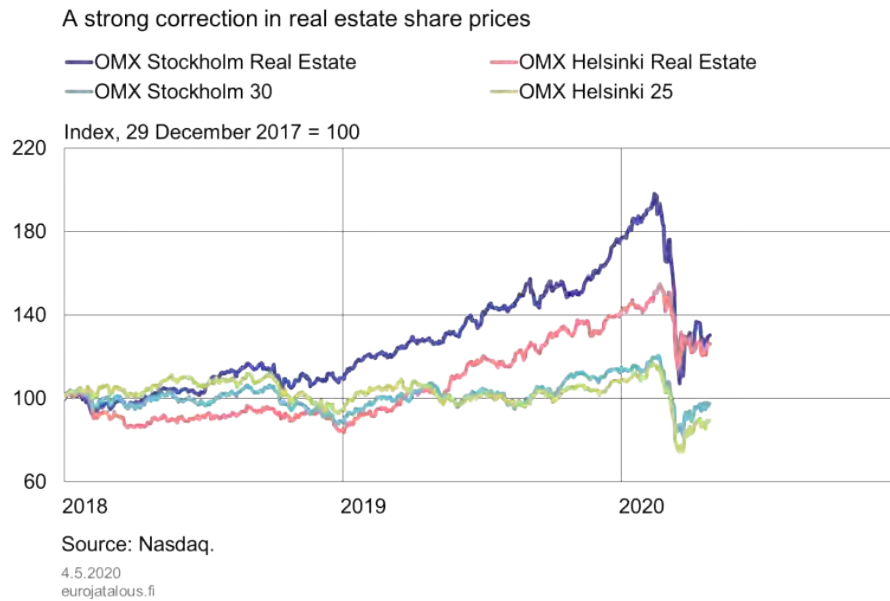
The stock prices of banks fell worldwide as soon as the coronavirus crisis intensified (Chart 1). Although Nordic banks have long enjoyed investor confidence, their stock prices have also been affected by suspicions that have emerged over the past few years about shortcomings in banks' anti-money laundering efforts. With the steep drop in stock prices, it is important for banks that the cost of their bond market funding has not risen notably.

Chart 1.



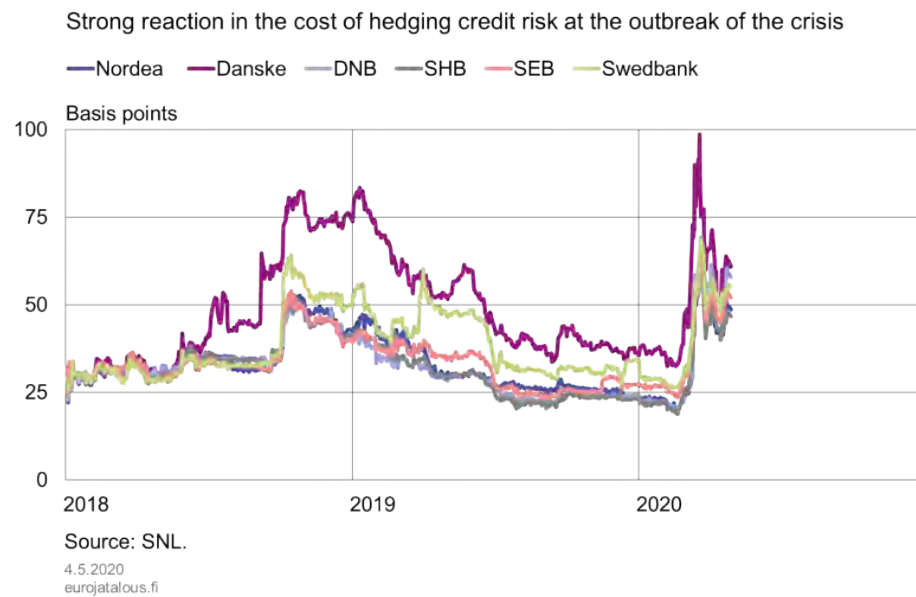
Nordic banks have granted a high volume of loans to companies in the real estate sector. The stock prices of listed companies in the sector rose steeply, especially in 2019, as relatively stable house prices and the popularity of residential property as an investment asset sustained the positive sentiment in the real estate market (Chart 2). In Sweden, the real estate equity index had doubled its value since the beginning of 2018, but after the coronavirus outbreak the index plummeted along with other shares.

Chart 2.



The cost of hedging credit risk increased notably for Nordic banks following the intensification of the coronavirus crisis. The situation has calmed down thereafter (Chart 3).

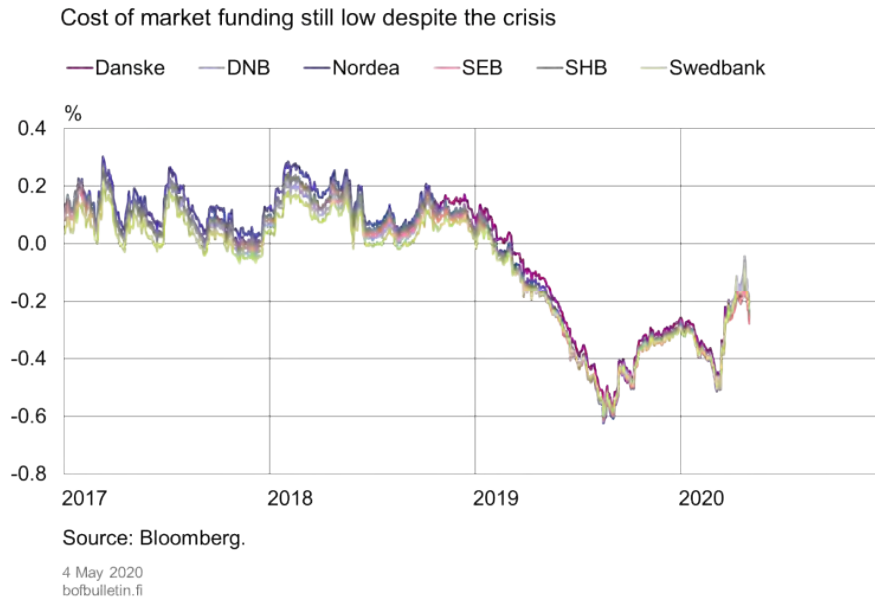
Chart 3.



Covered bonds are an important source of funding for Nordic banks. While funding collateralised by housing loans has been relatively cheap for Nordic banks in recent years, its pricing depends on investor confidence in banks and in the housing market. The prices of covered bonds of large Nordic banks declined at the outbreak of the coronavirus crisis, and thus required yields increased. The yields on these loans are historically still very low, however (Chart 4). The yields have even been negative in recent

years, as investors have considered covered bonds to be very safe investment assets. A significant increase in the cost of funding would affect banks' lending capacity and tighten the terms of new loans.

Chart 4.



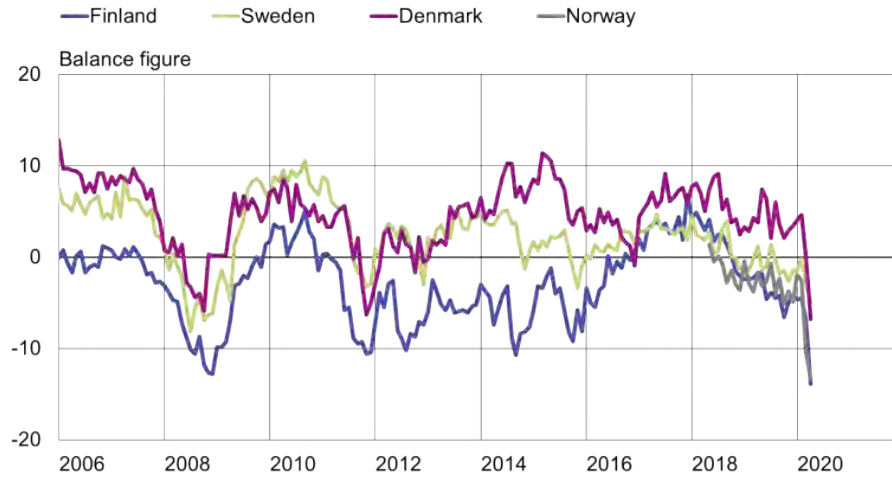
Survey data indicates a decline in residential property sales and prices

The effects of the coronavirus pandemic have been apparent in the Nordic housing market since March 2020, as house sales have decreased for both economic and practical reasons. Due to the rapid deterioration of the economic outlook and the rise in unemployment, households and investors have become more cautious in making major economic decisions. Consumer confidence in the economy has deteriorated precipitously (Chart 5) and consumer intentions to take out a loan or buy a home have abated.

The restrictions prompted by the pandemic are affecting the activities of banks, real estate agents and customers. Digital services have become more important. Real estate agents have made an effort to promote house sales by organising private and virtual home tours. Bank customers have been able to apply for new housing loans via mobile and online banking already before the pandemic. It is also possible to sign the purchase and sale agreement and loan documents electronically.

Chart 5.

Consumer confidence in the economy deteriorated amid the coronavirus crisis

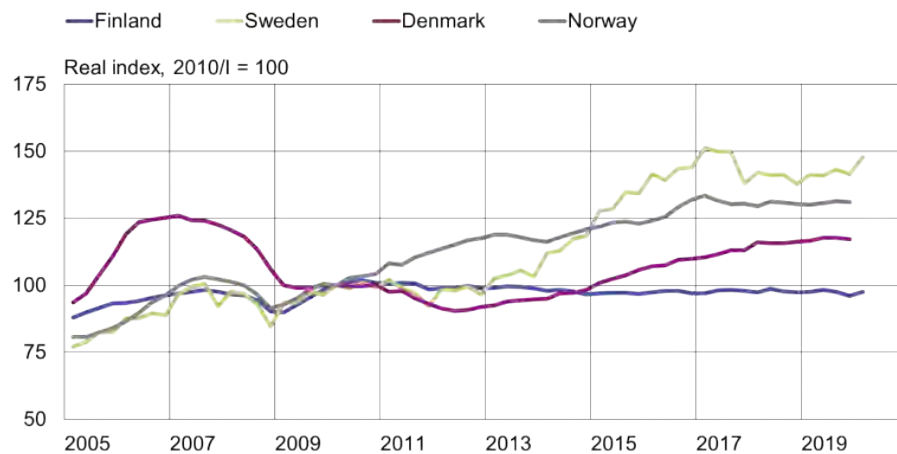


Sources: Statistics Finland, Opinion AS, Eurostat and Macrobond.
29.4.2020
bofbulletin.fi

The Nordic housing market was still as lively as usual in February, and house sales were increasing as the market was heading towards spring. There were, however, no specific signs of overheating in the housing market. In Sweden and Norway, house prices increased in real terms until 2017, after which there was a correction and prices stabilised (Chart 6). In Denmark, real house prices began to rise in 2012 and were approaching the level preceding the global financial crisis. Compared with the other Nordics, Finnish house prices followed a more stable trend throughout the 2010s, although price differences within Finland increased.

Chart 6.

Stable trend in house prices before the coronavirus crisis



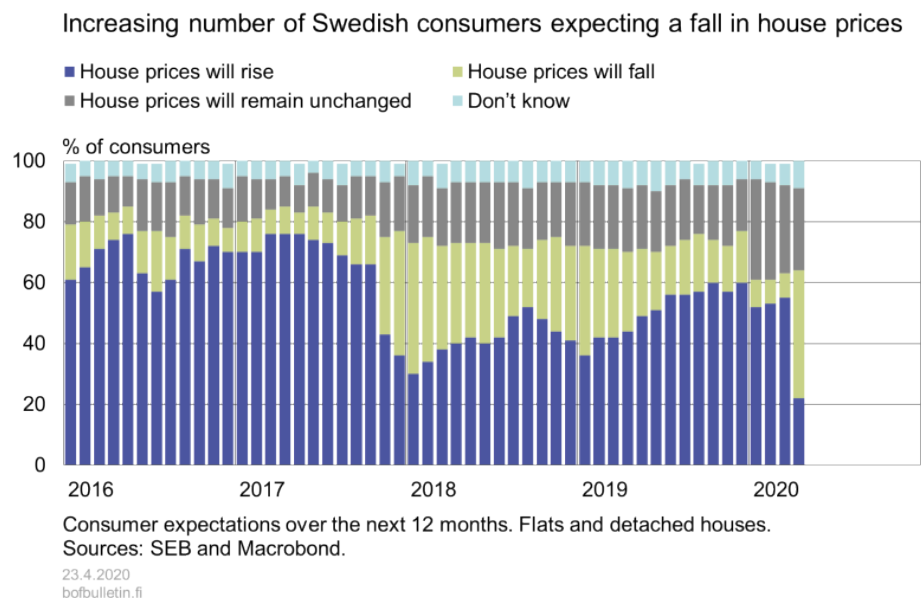
Sources: Statistics Finland, Valueguard, OECD, Macrobond and calculations by the Bank of Finland.
5.5.2020
bofbulletin.fi

In the long term, house price developments have diverged significantly among the Nordic

countries, which is why assessments of the state of housing markets also differ.^[9] In Sweden, house prices are at a historically high level, and so is household indebtedness. The rental market is also strictly regulated, which has contributed to rising house prices. On the other hand, the Swedish financial supervisory authority has assessed that the macroprudential instruments introduced in recent years to curb indebtedness have improved household finances to such an extent that, in the current crisis, banks will not suffer major credit losses on housing loans.^[10]

Survey data^[11] suggests that an increasing number of Swedes expect house prices to fall in the next 12 months (Chart 7). The share of consumers expecting lower house prices increased from 8% to 42% between the surveys of March and April. At the same time, the share of those expecting higher house prices fell from 55% to 22%. Expectations of this kind tend to become self-fulfilling if households postpone purchase decisions and sellers have to lower their asking prices. However, price fluctuations in the housing market are usually smaller and slower than in the stock market, where trading is rapid.

Chart 7.



According to the Swedish real estate portal Hemnet, the number of new listings of homes for sale submitted in March and early April was higher than usual.^[12] This may indicate that, due to increasing uncertainty, households considering the sale of their home have thought it best to place their house on the market quickly. If expectations of a fall in house prices increase further, the number of homes for sale may decrease. In Finland, the real estate portal Etuovi.com has received fewer new listings since mid-March than a

9. See e.g. the European Central Bank's indicators measuring potential overvaluation of residential property prices https://www.esrb.europa.eu/pub/pdf/dashboard/esrb.risk_dashboard200107-5ebd02b8b3.en.pdf.

10. See <https://www.fi.se/en/published/reports/swedish-mortgage-reports/the-swedish-mortgage-market-2020/>.

11. Survey by the Swedish SEB bank.

12. See <https://www.hemnet.se/artiklar/bostadsmarknaden/2020/04/15/utbudet-fortsatter-att-oka> (in Swedish).

year earlier, and fewer homes were for sale in March than in the previous year.^[13]

Real estate agents have reported that residential property sales in Finland and Sweden were almost at the same level in March as in 2019.^{[14],[15]} Sales of new and existing homes increased by about 2% in Finland and decreased by 1% in Sweden. In the latter part of March, however, house sales were clearly lower than a year earlier. Based on house sales concluded and the number of homes for sale, house prices showed a slight decrease in March, but the change was not very significant. In Stockholm there were signs of a decrease in house prices especially in the latter part of March.^[16]

Housing is a significant investment, and the residential and commercial property markets are interconnected through domestic and international investors. In Finland, for example, a significant proportion of international real estate investors are from the other Nordic countries.^[17] Residential investment accounted for around 32% of the Finnish real estate investment market in 2019, which makes residential property the largest individual item before offices and business premises. The coronavirus crisis is having a negative impact especially on hotel and retail property, from which real estate investors are likely to miss out on rental income. Income flows from residential property are likely to remain more stable compared with other real estate investments.

Tags

[Nordic countries](#), [housing markets](#), [financial stability](#), [coronavirus pandemic](#), [banks](#), [corona](#)

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13. See <https://www.etuovi.com/koti/blogi/asuntomarkkinoiden-kysynta-vireaa-poikkeustilassakin/> and <https://www.etuovi.com/asuntojen-hinnat-ja-asuntomarkkinat> (both in Finnish).

14. See <https://kvkl.fi/keskusliiton-asuntomarkkinakatsaus-q1-2020/> (in Finnish).

15. See <https://www.maklarstatistik.se/pressmeddelanden/sma-prisrorelser-men-vikande-antal-forsaljningar-i-mars/> (in Swedish).

16. See <https://valueguard.se/article/53> (in Swedish).

17. See also <https://www.bofbulletin.fi/en/2019/2/finnish-commercial-property-market-increasingly-intertwined-with-foreign-markets/>.