BANK OF FINLAND BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

Table of Contents

Macroprudential toolkit should be replenished in Finland and Europe 3

Macroprudential toolkit should be replenished in Finland and Europe

13 May 2022 – Bank of Finland Bulletin 1/2022 – Financial stability


Tuulia Asplund
Senior Economist

Jukka Topi
Principal Adviser

Finland and the EU have now gained almost a decade of experience in macroprudential policy. Banks' risk resilience has been increased, and the supply of credit has been relatively stable even in crisis situations. Disruptions threatening stability may emerge both within and outside the financial system. The macroprudential toolkit should include a higher amount of releasable capital buffers to be used by banks in the event of disruptions. Macroprudential authorities should have more effective and uniform instruments at their disposal to address housing market risks and excessive growth in household indebtedness. The macroprudential toolkit should be further improved both at EU level and in Finland.

Large-scale banking crises and other financial disruptions have repeatedly affected financial systems in different countries and on different continents. The substantial negative economic consequences of these crises have demonstrated the need for forceful measures to prevent crises that threaten financial stability and to mitigate their ramifications. This is why authorities have begun to deploy macroprudential policies to strengthen banks' risk resilience and to contain excessive growth in credit and household indebtedness.

The first common macroprudential instruments were introduced in the EU early in the last decade.[1] These included, in particular, additional capital requirements for credit institutions, some of which were based on global standards of the Basel Committee on Banking Supervision (BCBS).[2] Several EU countries also adopted instruments to contain excessive household borrowing on the mortgage credit market.[3] An example of these is the maximum upper limit on the loan-to-collateral ratio (loan cap) adopted in Finland, which limits the size of housing loans in relation to collateral.

The benefits of macroprudential policy have so far been reflected in the EU specifically in that macroprudential instruments have successfully raised the banking sector's capital requirements for crisis situations. Banks' risk resilience has been strengthened, on one hand, for cyclical risks and, on the other hand, for situations where the banking system's concentration, risk concentrations and other factors increase the risk of individual problems spilling over and leading to a widespread banking crisis. In addition, more capital is required from banks that are particularly important for the financial system.

The COVID-19 pandemic and Russia's war against Ukraine are unfortunate examples of disruptions that arise unexpectedly outside the economy and the financial system and which countries should be better prepared for with macroprudential policy. Macroprudential requirements should ensure that banks are well capitalised against shocks, while on the other hand enabling capital buffers to be released for use by banks to sustain the provision of credit to the economy in severe crisis situations.

Risks in the residential real estate market and the rising level of household indebtedness have long been considered as key risks to financial stability. However, EU countries lack harmonised macroprudential instruments to tackle these risks more effectively. As in many other countries, household indebtedness has been growing for a long time in Finland, too, but the tools to effectively mitigate the related risks are inadequate.

Work underway to improve the EU macroprudential regulatory framework

The EU macroprudential regulatory framework is reviewed every five years. In autumn 2021, the European Commission launched a consultation on the macroprudential framework. Based on consultation responses and advice from the European Systemic Risk Board (ESRB)[4], the European Central Bank (ECB)[5] and the European Banking Authority (EBA)[6], the Commission is required to review the framework and to submit, by the end of 2022, possible legislative proposals for the modification of the macroprudential regulatory framework applicable to the banking sector.[7]

---

1. The EU Credit Institutions Directive and the Capital Requirements Regulation, which entered into force at the beginning of 2014, laid the foundation for macroprudential policy in Europe.
2. See Basel III standards of the BCBS.
3. For a list of macroprudential measures directed at the residential real estate sector and mortgage lending in the EU, see A Review of Macroprudential Policy in the EU in 2020, Annex 2.
4. See ESRB Review of the EU Macroprudential Framework for the Banking Sector.
5. See ECB response to the European Commission's call for advice on the review of the EU macroprudential framework.
6. See EBA advice on the review of the macroprudential framework.
7. The EU macroprudential regulatory framework is largely based on the Capital Requirements Regulation (CRR)

At the onset of the COVID-19 pandemic, macroprudential authorities and instruments were tested for the first time in a crisis situation. In addition to other extensive measures, macroprudential authorities also supported financial stability and the continuation of credit supply by, for example, relaxing banks' capital requirements. The pandemic revealed in Europe that, in order to prepare for unexpected shocks, to smoothen cyclical fluctuations in credit supply and to improve banking sector resilience against shocks, macroprudential authorities should have the powers to strengthen banks' countercyclical capital buffers in normal times, i.e. well before overheating of the credit market and realisation of external shocks such as the pandemic. This would allow the authorities to relax buffer requirements when credit conditions deteriorate, supporting bank lending in bad times, too.

Mitigating the risks related to housing finance and the residential real estate market was one of the key objectives of macroprudential authorities in many EU countries even before the COVID-19 pandemic. These vulnerabilities have continued to increase in several countries during the pandemic. Many countries have deployed macroprudential instruments affecting the demand-side of credit, known as borrower-based measures, using them to influence the terms of housing and real estate loans. In addition to the maximum loan-to-collateral ratio in use in Finland, borrower-based instruments include limits on the loan applicant's debt-to-income (DTI) ratio or debt-service to income (DSTI) ratio, an amortisation requirement and a maximum maturity for housing loans (see Instruments preventing the risk of indebtedness are becoming more common in Europe).

The use of borrower-based measures has become more widespread in recent years. However, since these instruments are governed by national legislation, their range and design differ substantially across EU countries. If national macroprudential authorities have limited possibilities to tackle domestic risks because of lacking or complex macroprudential tools, risks and crises originating from the residential real estate market may spread from one country to another through the real economy or the financial markets.

The review of the EU macroprudential regulatory framework provides an opportunity to improve and harmonise the range and usability of macroprudential instruments by ensuring that the national macroprudential authorities of all EU countries have at least some borrower-based tools at their disposal. To take into account country-specific risks and market specificities, the activation and calibration of these tools should be governed by national authorities, as has been the case so far.

In the same vein, the review of the macroprudential regulatory framework provides an opportunity to harmonise, simplify and streamline the use of macroprudential instruments already provided for in EU legislation. Ensuring that the instruments are applied on the basis of sufficiently uniform risk criteria is also important from the

---

and the Capital Requirements Directive (CRD). These entered into force in 2014 and, besides macroprudential provisions, also contain a wide range of other provisions directed at banks. Since then, the regulatory framework has been specified, and some relaxations were stipulated in summer 2020 on account of the COVID-19 pandemic. The ongoing consultation and possible legislative amendments concern only macroprudential regulation. The CRR and the CRD are also in process of being updated to transpose the Basel III reforms into EU legislation.

perspective of a level playing field (see Banks' macroprudential buffer requirements are lighter in Finland than in its peers).

Financial sector transformation and digitalisation can increase the importance of new and cross-border lenders operating outside the traditional banking sector. As the provision of financial services is becoming more diversified, we should ensure that economic actors providing similar financial services are regulated in the same way, irrespective of whether the lender is a bank or some other service provider. New global phenomena from climate and other sustainability risks to cyber risks also require serious attention from macroprudential policy.

Need for development of macroprudential policy in Finland

Development of the EU macroprudential regulation also affects the set of macroprudential instruments available in Finland. However, macroprudential tools should also be developed at the national level to the extent that there are shortcomings in EU regulation and risks and vulnerabilities are emerging which could pose a serious threat to the stability of the domestic financial system.

Finland has long paid special attention to the problems caused by excessive household indebtedness and has taken steps to improve the tools for its mitigation. For example, as early as ten years ago, the key conclusion made in the Bank of Finland's financial stability report was that the indebtedness of Finnish households should be held in check by various means.[8]

The maximum loan-to-collateral ratio introduced in spring 2016 is so far the only binding macroprudential instrument in Finland included in national regulation. It restricts lenders from granting housing loans that are very large in relation to the underlying collateral. Prior to its enforcement, the Financial Supervisory Authority (FIN-FSA) had already issued recommendations on loan-to-value limits and on the assessment of housing-loan applicants' financial margin.

In recent years, the Bank of Finland has analysed and proposed methods to prevent excessive household indebtedness. The Bank participated actively in the work of the Ministry of Finance working group set up to examine means to limit household indebtedness. In its report published in autumn 2019, the working group proposed, among other things, the introduction of a maximum upper limit on the debt-to-income (DTI) ratio (a DTI cap), a maximum maturity for housing loans and a limit on loans granted to housing companies for new-build construction.[9]

In spring 2020, the Board of the FIN-FSA – the body deciding on macroprudential policy in Finland – took steps to mitigate the economic effects of the COVID-19 pandemic by ensuring banks' sufficient capacity to continue lending under strained conditions. Prior

---

8. See Bank of Finland Bulletin 2/2012: Financial stability.
9. See the Ministry of Finance working group's Report on means to prevent excessive household indebtedness (in Finnish with an English abstract).

to the pandemic, no such strengthening of the credit cycle had been observed in Finland as would have required the imposition of a countercyclical capital buffer (CCyB) requirement for cyclical risks. To counter the serious disruption, the FIN-FSA Board had to resort to relaxing structural macroprudential buffer requirements that are primarily designed for preventing the materialisation of long-term systemic risks in the financial system.

One of the lessons learnt from the pandemic in Finland was that the macroprudential authority should, already in good times, be able to set such additional capital requirements for banks that can be eased or removed in full, if necessary, in the event of an unforeseen external shock to the financial system, the effects of which could jeopardise national financial stability or the stability of financial intermediation. It is precisely for this reason that many EU countries have set the CCyB rate above 0% even in situations where the credit cycle has not overheated. This has created macroprudential policy space for unexpected disruptions.

The International Monetary Fund (IMF) assesses the stability of the Finnish financial system and the stance and development needs of macroprudential policy as part of its annual Article IV consultations and the periodic Financial Sector Assessment Programmes (FSAP).

In the most recent assessment published in January 2022, the IMF recommended that Finland restore the structural macroprudential buffer requirements eased at the onset of the pandemic to pre-pandemic levels.[10] In practice, the IMF staff team recommended the re-introduction of the systemic risk buffer (SyRB) requirement of 1% for the entire credit institutions sector. The IMF staff team also considered that, in order to cover systemic risks arising from mortgage lending, it would be advisable to consider supplementing the requirements with a sectoral SyRB for mortgage lending.

In its country report, the IMF sent a strong message for Finland on the development of macroprudential instruments. It considered that the Finnish macroprudential toolkit should be enhanced with borrower-based measures. As a first-stage measure, the IMF staff team recommended that Finland introduce a debt-to-income (DTI) ratio (DTI cap) limiting the level of household debt in relation to income. Once the positive credit register is operational, Finland should also introduce a stressed debt-service-to-income (DSTI) cap, calculated based on the borrower's monthly income and a higher, 'stressed' interest rate.

In addition, in the medium term, the IMF considered it necessary that Finland build macroprudential policy space by introducing a positive neutral countercyclical buffer requirement, i.e. a CCyB rate that is above zero even during the neutral phase of the credit cycle. The IMF's estimates indicated a positive neutral CCyB rate of 0.5%.

The European Systemic Risk Board (ESRB), which is responsible for macroprudential oversight in the EU, has on several occasions drawn attention to the vulnerabilities related to the Finnish housing loan market and household indebtedness. In November 2016, The ESRB issued a warning to Finland and five other countries on medium-term

---

10. The IMF's press release, report and statement for Finland can be downloaded here.

vulnerabilities in the residential real estate sector, highlighting in particular the high and increasing level of household indebtedness.

As a follow-up to the warning, in September 2019 the ESRB issued recommendations on measures to address these vulnerabilities.[11] The key recommendation was that Finland include in its national legal framework, as legally-binding macroprudential instruments, a limit that applies either to the DTI ratio or to the DSTI ratio, and a maturity limit for mortgage loans. The ESRB also recommended that the maximum loan-to-collateral ratio in use in Finland be defined in such a way that only the real estate collateral underlying the mortgage loan could be accepted as eligible collateral when calculating the loan applicant's loan-to-collateral ratio.

Furthermore, the ESRB urged that, even prior to the potential use of the recommended legally binding instruments, Finnish authorities issue recommendations to credit institutions or take other non-legally binding measures to restrain lenders from excessively granting mortgage loans that are too large in relation to borrowers' income or debt servicing capacity.

In February 2022, the ESRB published an assessment of compliance with its recommendations. The ESRB concluded that Finland was 'materially non-compliant' with the recommendation to include the new macroprudential tools in Finnish legislation. It also stated that the recommendations of Finnish authorities should be more precise in order to better curb growth in household indebtedness.

Measures to improve macroprudential policy in Finland

The authorities have moved forward with projects to develop macroprudential instruments in Finland. As discussed above, a Ministry of Finance working group published a report in autumn 2019 proposing a maximum DTI ratio and other instruments to prevent excessive household indebtedness.

In late January 2022, based on the working group's work, the Ministry of Finance published a draft government proposal to be circulated for comment. The main difference compared with the working group's proposal was that the draft government proposal did not include a maximum DTI ratio. In its statement, the Bank of Finland considered that the draft proposal contains a number of justified measures to prevent growth in excessive household indebtedness, but that it is nevertheless deficient in some respects. In particular, the Bank considered the lack of a maximum DTI ratio to be problematic and saw that this specific instrument or some other limit based on the ratio between debt and income would be pivotal in reducing the number of households that are heavily indebted relative to their income and in improving the ability of households to repay their loans with interest.

Since autumn 2020, the body deciding on the use of macroprudential instruments in

---

11. See Recommendation of the ESRB on medium-term vulnerabilities in the residential real estate sector in Finland.

Finland – the Board of the FIN-FSA – has repeatedly recommended that lenders exercise restraint in granting loans that are large with regard to the loan applicant's income and have a longer maximum repayment period than usual. With these recommendations, the Board has sought to contain growth in household indebtedness and also to act in line with the ESRB's recommendation. However, despite the FIN-FSA Board recommendations, the level of indebtedness has continued to increase.

The FIN-FSA Board announced in late 2021 that it would specify its recommendation in the first half of 2022. In its detailed recommendation, the Board will elaborate on, for example, the types of loans lenders should exercise restraint in granting. In the second quarter of 2022, the FIN-FSA Board is also scheduled to decide on the level of structural macroprudential buffers, taking into account the economic and stability situation. In addition, the Board is in the process of updating its macroprudential stability strategy.

Tags

regulation, financial stability, macroprudential instruments, macroprudential policy, banks