

**WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD**  
**of 22 September 2016**  
**on medium-term vulnerabilities in the residential real estate sector of Finland**  
**(ESRB/2016/08)**  
(2017/C 31/05)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board <sup>(1)</sup>, and in particular Articles 3 and 16 thereof,

Whereas:

- (1) Past experience in many countries shows that the manifestation of residential real estate vulnerabilities may lead to significant risks to domestic financial stability and serious negative consequences for the real economy, as well as potentially leading to negative spill-overs to other countries.
- (2) The European Systemic Risk Board (ESRB) has recently concluded a systematic and forward-looking Union-wide assessment of vulnerabilities relating to residential real estate. In this context, the ESRB has identified in eight countries certain medium-term vulnerabilities as a source of systemic risk to financial stability, which may have the potential for serious negative consequences for the real economy.
- (3) The ESRB's vulnerability assessment highlights the following for Finland:
  - a. An already high and increasing level of household indebtedness has been identified as the main vulnerability related to residential real estate in Finland. Currently, Finnish household debt-to-income levels are at a historical peak and above the Union average. This is due to the fact that the growth in households' income has been muted, while, at the same time, households have continued to accumulate debt. Furthermore, the debt is concentrated in a relatively small group of highly indebted households. These households would be particularly vulnerable to adverse economic conditions or developments in the residential real estate market. In addition, variable interest rate loans are the ones most commonly provided in the Finnish mortgage market, thus exposing households to interest rate risk.
  - b. In recent years, the moderation in household borrowing and house price trends has been significant, and represents a development that mitigates to some extent the identified risks to financial stability. Furthermore, it is common for Finnish households to amortise their mortgage debt, thus the average loan-to-value on outstanding mortgages is considerably lower than that for new loans.
  - c. Currently, residential real estate price indicators, such as price-to-income and price-to-rent ratios, are close to their long-run averages, suggesting that there is no clear evidence of overvaluation in residential real estate prices. Nevertheless, given the current weak economic outlook for the Finnish economy, there could be a risk of decreasing residential real estate prices in the event of a negative economic shock. In July 2016, a limit on the loan-to-value ratio for new housing loans was introduced into Finnish legislation to ensure a minimum collateral coverage for new mortgage loans, which will be useful should prices decrease.
  - d. Finnish banks have large mortgage portfolios with lower risk weights compared to their European peers. Moreover, Finnish banks rely heavily on market-based funding, which has proved to be a less stable source of funding during episodes of financial instability. These vulnerabilities are compounded by the high concentration in the Finnish banking system, and its size in relation to the economy. Further, the interconnectedness between banks across the Nordic-Baltic region means that there could be significant cross-border spill-overs between banking systems as a result of difficulties related to residential real estate stresses in any of the countries of the region. However, Finnish banks are among those in the Union with the highest capitalisation level and have a high quality of capital. In the light of the overall high solvency ratios of Finnish banks as well as the capital buffers introduced by the Finnish authorities, the banking system appears to be resilient to a direct residential real estate shock.

<sup>(1)</sup> OJ L 331, 15.12.2010, p. 1.

- e. An economic or financial shock could lead to the crystallisation of some of the abovementioned risks — for example, if unemployment increases and/or income growth decreases then some highly indebted households may find it more difficult to service their debts and the number of mortgage defaults may increase leading to direct credit losses to banks, especially if accompanied by a decrease in residential real estate prices. Moreover, if an adverse scenario for the economy does materialise, the associated negative household income and wealth effects may reinforce the initial shock, further enhancing the negative direct and indirect effects on financial stability (e.g. if households need to reduce consumption in order to service their mortgage loans).
- f. The ESRB notes the policy measures implemented in Finland with regard to the residential real estate market, including the gradual phasing-out of the possibility of deducting the tax on mortgage interest payments, the limit on the loan-to-value ratio of new mortgages, planned initiatives to strengthen capital adequacy requirements for mortgage exposures, and the early introduction of capital buffers (including specific requirements for systemically important banks). While these policy measures are appropriate given the nature of residential real estate vulnerabilities in Finland, they may not be sufficient to fully address them. However, it should be noted that the Finnish authorities do not have the legal powers to implement other relevant macroprudential measures such as limits on loan-to-income, debt-to-income or debt service-to-income ratios, which could be used to curb further increases in household indebtedness,

HAS ADOPTED THIS WARNING:

The ESRB has identified medium-term vulnerabilities in the residential real estate sector of Finland as a source of systemic risk to financial stability, which may have the potential for serious negative consequences for the real economy. From a macroprudential perspective, the ESRB considers the main vulnerabilities to be the high and increasing household indebtedness, especially among some groups of households. In addition, if risks were to materialise, there could be potential spill-over effects to other countries in the Nordic-Baltic region.

Done at Frankfurt am Main, 22 September 2016.

Francesco MAZZAFERRO

*Head of the ESRB Secretariat*

*On behalf of the General Board of the ESRB*

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