STATENS OFFENTLIGA UTREDNINGAR

2022-12-15

Financial Stability Committee
Fi 2013:09

Minutes from the meeting of the Financial Stability Council held on 6 December 2022

Summary

The Stability Council[1] held its second ordinary meeting of the year.

Inflation is high in many countries, which is an effect of the pandemic and the invasion of Ukraine, but also of expansionary economic policies in several countries. Several central banks have raised their interest rates to bring down inflation and prevent it from becoming entrenched. At the same time the economic outlook has deteriorated. The combination of high inflation, high interest rates and prospects of slower growth means that the risks of financial instability have increased, both in Sweden and globally.

In Sweden, vulnerabilities linked to high asset prices and high indebtedness have been built up over a number of years, which can lead to problems for financial stability. This is primarily to do with the banks' large exposure to the highly indebted commercial property companies but also the high level of household indebtedness. Households are under pressure from rising expenditure and falling housing prices, which have a negative impact on consumption. However, credit losses from household loans are expected to be low.

In recent years, commercial property companies have particularly increased their capital market financing. However, market financing is now shrinking due to a sharp increase in financing costs at the same time as bank lending is

[1]Present: *Ministry of Finance:* Niklas Wykman, Chair of meeting, Johan Almenberg, Anna Jegnell; *Finansinspektionen*: Susanna Grufman, Karin Lundberg, Henrik Braconier; *National Debt Office*: Karolina Ekholm, Karolina Holmberg, Erika Färnstrand Damsgaard; *Riksbank*: Stefan Ingves, Per Jansson, Olof Sandstedt; and *Financial Stability Council Secretariat*: Niclas Alsén.

increasing. A large proportion of property companies' bonds will mature in the coming years, while interest rates in the bond market are significantly higher than when the bonds were issued. The risks in the sector can affect lenders such as bond investors and banks in the form of credit losses.

The financial markets generally function satisfactorily, although some property companies find it difficult to raise funding through the bond market. Finansinspektionen also pointed out that the liquidity risks in corporate bond funds that were apparent at the beginning of the pandemic remain. In the secondary market for government bonds there has been a deterioration in market liquidity in recent years. A deterioration can be seen over the last ten years as a whole, although developments have fluctuated. The recent high uncertainty and volatility, as a result of global interest rates rising over the same period, contribute to further impairing market liquidity. However, the primary market for government bonds continues to function well.

The Stability Council also discussed the cyber security action plan, as well as a follow-up of the handling of the problems in the electricity derivatives market.

§ 1 Stability assessment and measures

Stability assessment

The authorities (National Debt Office, Riksbank and Finansinspektionen) presented their stability assessments.

The financial stability situation is characterised by high inflation, including high energy prices and high interest rates, but also by a deteriorating economic outlook. The risks to stability have increased since the last ordinary meeting of the Stability Council in June.

Inflation is high in many countries, which is an effect of the pandemic and the invasion of Ukraine, but also of expansionary economic policies in several countries. Several central banks have raised their interest rates to bring down inflation and prevent it from becoming entrenched. As in other countries, there has been a tightening of monetary policy in Sweden. It is uncertain how economic actors can cope with the rapid upturn in inflation and interest rates. In particular, there are structural vulnerabilities in the form of large debt and interest rate sensitivity for households and the commercial property sector.

The financial markets generally function satisfactorily, although some property companies find it difficult to raise funding through the bond markets. In the secondary market for government bonds there has been a deterioration in market liquidity in recent years. A deterioration can be seen over the last ten years as a whole, although developments have fluctuated. The recent high uncertainty and volatility, as a result of global interest rates rising over the same period, contribute to further impairing market liquidity. However, the primary market for government bonds continues to function well.

Electricity prices have periodically been high and volatility has increased. There is a great deal of uncertainty about price developments in the future. The National Debt Office has so far not issued any credit guarantees for loans to electricity producers under the guarantee programme developed in September, but the guarantee programme is deemed to have contributed to reducing the risks of major liquidity problems in the electricity derivatives market.

Many years of high construction costs, low interest rates and high risk-taking have contributed to building up vulnerabilities in terms of large debt and high asset prices. The authorities have warned of these developments in the past. During the pandemic, housing price rises accelerated, but now the housing market is subsiding and the fall in prices may continue into the future. Falling housing prices can also be seen in several other countries.

The resilience of households is now being tested with the rapid rise in interest rates. Swedish households have relatively short fixed interest periods on their mortgages, which increases interest rate sensitivity. The vast majority are expected to make loan repayments, but consumption will be negatively affected. Interest expenditure as a proportion of disposable income may in future be at the 1990s level. Some mortgage holders will be greatly affected, especially those who bought their homes at high prices in recent years. Finansinspektionen estimates that if mortgage interest rates rise to a level of more than 5 per cent, nearly 15 per cent of those who bought a house in 2021 may have aggregate expenses that are greater than their income. The existing safety valve in the amortisation requirements is available to help households with such problems. In total, around 70,000 mortgage holders could end up in deficit, which banks are expected to be able to manage.

Banks have large exposures to commercial property companies, which account for almost half of their exposure to businesses. Many of these companies are highly indebted and interest rate sensitive. The property sector has become increasingly interconnected with other parts of the financial system, partly because market financing has increased rapidly. However, market financing is now shrinking due to a sharp increase in financing costs, at the same time as bank lending is increasing. Real property companies will have large amounts of bonds maturing in the coming years. The authorities estimate that the situation will deteriorate in the sector as rising financing costs gradually have a greater impact on the companies' interest expenditure. Many of these companies now face high bond yields, some companies up to 10 per cent. Many companies have started to take various measures to deal with these problems, such as property sales, suspended dividends and taking in new owners.

The focus is often on the large property companies listed on the stock exchange, but there are thousands of property companies that have loans with the banks, and it is the small and medium-sized companies that account for most of the credit losses when Finansinspektionen is stress testing the sector and the banks. Therefore, these small and medium-sized companies, taken together, have a higher credit risk than the large companies. How much interest rates rise and how long they remain high is crucial for the outcome. At the same time, Finansinspektionen estimates that the banks have considerable resilience as profitability has recovered since the pandemic and capital buffers have been rebuilt.

Government bond yields have risen in many countries. Support packages to compensate households and businesses for high energy prices have also been launched in many countries. Overall, pressure on central government finances has increased in highly indebted countries and poses a risk. However, Swedish public finances are strong and central government debt is expected to continue to decline.

The market liquidity of several asset classes, including the government bond market, in the largest economies has deteriorated recently, according to the latest Stability Report from the International Monetary Fund (IMF). The IMF considers that deteriorating market liquidity could lead to stability risks. There are recent signs of a deterioration in liquidity in the government bond market in Sweden. Structural factors have probably contributed to the deterioration of market liquidity in the secondary market for government bonds since the financial crisis.

Finansinspektionen also pointed out that the liquidity risks in corporate bond funds that were apparent at the beginning of the pandemic remain. There are funds with too little liquidity that may be forced to sell bonds in a stressed situation, which can amplify a negative spiral in the market. Further work is therefore needed to improve liquidity risk management in the fund area.

The Chair summarised the stability situation and noted that the authorities appear to agree on the assessment. The risks to stability have increased since the last ordinary meeting of the Stability Council in June. High inflation and rising interest rates are putting businesses and households under pressure and the markets are characterised by the uncertainty surrounding future economic developments. There is increased uncertainty regarding commercial property companies, which entails increased risks of credit losses in the banking system in the long term, although banks are in a favourable starting position. The high volatility of many asset markets can create new risks. In addition, there is an international situation that adds further uncertainty.

Discussion by the authorities

The authorities discussed developments in which non-financial companies in recent years have increasingly opted to raise funding through bond markets rather than banks. Property companies account for a significant part of the increase, but now their market financing is shrinking due to sharply increased financing costs and a simultaneous increase in their bank loans. In general, it is a good thing to have several financing markets because any losses are spread in the financial system.

There has been work in the EU to promote market financing in Europe because the market has been very bank-dominated and there are benefits to balancing different sources of funding. At the same time, when there is more uncertainty, there is a risk that the supply of credit via market financing will not work as well as bank financing. However, market financing worked better than bank financing in the USA during the 2008-09 financial crisis.

The Riksbank mentioned that there has been imbalance in the housing market for a long time. In order to improve the functioning of the housing market and to manage the risks associated with household indebtedness, broad reforms are needed in housing and tax policy, such as a review of tax relief on interest, real estate tax and the regulatory framework for new housing production. The measures taken by Finansinspektionen, such as the amortisation requirements and the mortgage loan-to-value ceiling, have contributed to households amortising more and taking out smaller mortgages than would otherwise have been the case. This is positive, not least in the current situation, and the measures should be continued. Furthermore, it is positive that there is now an inquiry proposal on how we can access better microdata about households, and that a central register for tenant-owned properties has been investigated. Since the risks in the Swedish financial system are high, banks should be restrained regarding large dividends and share buy-backs to enable greater financial room for manoeuvre. In addition, the Riksbank considers it important for Finansinspektionen to continue to raise the countercyclical capital buffer rate from 2 to 2.5 per cent.

The events surrounding the FTX crypto exchange are an example of poor management and lack of regulation. Although these events have not caused problems from a stability perspective, they show the need for international regulation and the importance of our ensuring that such an event does not occur in Sweden.

The National Debt Office agrees that access to microdata is important.

Regarding market liquidity in the secondary market for government bonds, the National Debt Office considers that structural factors probably contributed to deteriorating liquidity since the financial crisis, and that they are now reinforced by temporary factors, such as high uncertainty and volatility, which further contribute to deteriorating liquidity.

Recent developments in the form of problems with exchanges trading crypto-assets, electricity derivatives and the bond market in the UK are examples of problems that can arise in a wide range of areas. There are grounds for the Stability Council to strengthen its monitoring of various potential hotspots.

Finansinspektionen supports the finding of a solution for the collection of microdata.

Property companies are now considered to be the greatest stability risk. It is important that banks support long-term viable companies in their efforts to adapt to a new interest rate environment, but a balance between this and banks' credit risk should be made. A sound and credible valuation of real property is important for the property market.

At present, Finansinspektionen sees no need for a general suspension of the amortisation requirements. The safety valve included in the amortisation regulation can be used to help those most affected and is therefore relevant.

As far as banks are concerned, it is good that they have large capital buffers in light of the risks that exist. Finansinspektionen also considers that the banks have satisfactory resilience at present, as profitability is good, and the buffers are significant. Therefore, Finansinspektionen sees no need at present to increase buffer requirements beyond the increases announced this summer, especially as banks already hold large buffers in addition to Finansinspektionen's buffer requirements.

As the Swedish corporate bond market is still relatively undeveloped, Finansinspektionen would prefer that the authorities continue their cooperation to improve transparency and increase standardisation via benchmark bonds in the market. Finansinspektionen also sees that improved self-regulation can contribute to better functioning markets and has therefore initiated further discussions with industry representatives.

Finansinspektionen has for a long time pointed out that the Riksbank's asset purchases have become too large and have been going on for too long. It is therefore positive that the Riksbank is now gradually reducing its holdings and the direction should be to liquidate them.

The situation with sharply rising interest rates and a deterioration in the economic outlook means that things can happen in the financial system that are difficult to predict. It is therefore good to have a high level of preparedness.

§ 2 Reporting of projects within the Stability Council

The cyber security action plan

Finansinspektionen described the work on the joint cyber security action plan, which was completed in the autumn. Finansinspektionen was responsible for the work, but it was done in cooperation with the Riksbank and the National Debt Office. The work has resulted in a description of responsibilities and cooperation as well as various measures and proposals for measures. One example of a measure is that the financial sector is now a pilot in the work of the National Cyber Security Centre for cooperation between the private sector and public authorities. Another example is the increasing participation of Swedish companies in the Nordic Financial CERT, which is particularly important for small and medium-sized banks.

Finansinspektionen continues to see a strong need for continued work on cyber risks. For example, there are further proposals for measures in the report Finansinspektionen submitted to the Government in May this year, including the establishment of a crisis management body. One activity proposed in the action plan is to carry out a broad cyber crisis exercise in 2023, which also includes key private actors. Finansinspektionen would like this work to be done in cooperation with the Stability Council.

The Digital Operational Resilience Act, DORA, has recently been adopted by the EU. This will lead to a lot of work on implementing the rules, but it will provide a major boost to the work across the EU to strengthen resilience to cyber attacks in the financial sector.

The Riksbank thinks it is positive that FRA (the National Defence Radio Establishment) can now support private actors and that there will be more members within the framework of the Nordic Financial CERT. The Riksbank's work with TIBER-SE is also an important contribution to the financial actors' efforts to strengthen their resilience to cyber threats. At European level, not least, the European Systemic Risk Board (ESRB) stresses the need to progressively increase resilience to cyber threats in the financial system as a whole. This requires increased cooperation between different areas of operation.

The National Debt Office emphasised that, in addition to cooperation fora, capability improvement must be ensured. The National Debt Office emphasised the benefits of conducting a crisis exercise with broad participation.

The Chair expressed thanks for the reports and underlined that these are important issues.

Functioning of the bond market

The National Debt Office presented information on the work of a project on the bond market initiated by the Stability Council at its last ordinary meeting in June. The background was the deterioration in market liquidity in the secondary market for government bonds, and what was seen as a risk was how a deterioration in the market's functioning could have a negative impact on financial stability. The authorities are working jointly to map the Swedish bond market in order to assess the problems. The issue concerns all the stability authorities in different ways and the authorities' respective resources complement each other well in this work. This is an interim report, and the ambition is to continue the work and complete the analysis. Policy proposals or recommendations will be presented later on.

The Riksbank sees benefits from the work being done, but noted that it is important to get it right when it comes to trade-offs in these contexts, since lower liquidity cannot be equated with low financial stability. It is therefore important that the mapping of the functioning of the bond market discusses structural factors and their changes as well as describing and measuring financial stability in a relevant way. The fact that the market is functioning worse at the moment is seen as natural, given that interest rates are rising sharply for the first time in a very long time.

Finansinspektionen agrees that it is good that this work is being done, that the subject needs to be analysed further and that policy issues also need to be addressed.

The Chair agreed on the need to continue the work. Final reporting can take place at the Stability Council meeting in June 2023, but after that further issues may remain to be addressed in the future.

Follow-up of problems in the electricity derivatives market

Finansinspektionen has carried out a preliminary evaluation of the problems that arose in the electricity derivatives market during the summer. The aim has been to describe the problems, the process, whether the measures taken had the intended effect, and what to work on in the future.

Overall, Finansinspektionen considers that the introduction of liquidity support was adequate in the situation prevailing in August and September. Prices and margin calls increased, which various actors contacted Finansinspektionen to report. The probability that liquidity risks would have materialised is difficult to assess, but if they had, it would have had a significant negative impact on the electricity derivatives market with contagion risk to the financial markets.

An interesting question is whether this problem and its scope could have been identified earlier than was the case. The situation was mentioned in Finansinspektionen's Stability Report in May 2022, but was not then seen as an acute problem. The assessment is that it would have been difficult to predict the scope earlier.

Lessons to be learned are to be more aware of counterparty risk, to do more stress tests, and to increase knowledge and understanding of the energy market in a financial stability perspective.

Conceivable measures are to work with the regulatory framework that will be introduced in the EU in future regarding such things as which collateral can be provided, monitoring of developments from central clearing to bilateral clearing, as well as issues related to risk management and supervision of Nasdaq.

The National Debt Office sees great value in this follow-up and the lessons learned. A further lesson is that there are reasons to strengthen preparedness to enable early identification of possible future problems. The Stability Council is a good forum for this.

The Riksbank agrees that a deeper understanding of the energy market from a stability perspective would be of benefit.

The Ministry of Finance presented information on the work in the EU. Proposals may be made on the basis of the lessons learned from the European Commission proposal expected on 7 December.

The Chair expressed thanks for the good reporting.

§ 3 International questions

The Ministry of Finance presented brief information on the planned work on financial market issues during the Swedish Presidency of the Council of the European Union in the first half of 2023. The Presidency's work programme will be presented on 14 December. Certain priorities between negotiations will be necessary given the large number of legislative acts.

The Riksbank mentioned a report coming this spring from the IMF dealing with money laundering with a focus on the Nordic-Baltic region. The Riksbank is in favour of the proposal for instant payments in euro recently presented by the Commission.

§ 4 Completed and future work within the Stability Council

The Ministry of Finance briefly presented the work carried out within the framework of the Stability Council since the last ordinary meeting in June, in addition to the reports already made at the meeting. The Stability Council is to continue to work on how to identify unexpected risks.

The Stability Council Secretariat presented the outcome of a crisis exercise to test the new regulatory framework for recovery and resolution of central counterparties.

The National Debt Office presented information on a project carried out to strengthen information sharing between the authorities in the Stability Council.

The Stability Council agreed that ahead of the next meeting in June 2023 its members will work together on issues related to cyber security, risks related to the evolution of inflation and interest rates in relation to interest rate sensitivity among borrowers such as the commercial property sector, and on a crisis exercise.