



Financial Stability Committee
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Minutes from the meeting of the Financial Stability Council held on 1 June 2022

Summary

The Stability Council¹ held its first ordinary meeting of the year.

There has been rapid recovery in economic growth after the pandemic. However, since the last ordinary meeting of the Stability Council in December, inflation and interest rates have risen sharply, and now weaker growth is expected both in Sweden and globally. Russia's invasion of Ukraine has had a negative impact on the real economy, not least in the euro area. Sweden's direct exposures to Russia and Ukraine are small but we are indirectly affected by such things as rising oil and commodity prices, which also contribute to higher inflation. Rising interest rates are putting pressure on asset prices and debt-heavy sectors such as the property sector and the household sector. At the same time, low interest rates have been a significant driver of the risks that have been built up. A shift to an environment with higher interest rates and reduced risk-taking can therefore mean reduced risks in the longer term. However, there may be turbulence during a transitional period.

The Swedish financial system is currently functioning well. However, rising interest rates mean that threats to financial stability have increased, partly as a result of highly indebted actors such as households and property

¹Present: *Ministry of Finance*: Max Elger, Chair of the meeting, Therese Pelow, Anna Jegnell; *Finansinspektionen*: Erik Thedéen, Karin Lundberg, Henrik Braconier; *National Debt Office*: Karolina Ekholm, Karolina Holmberg, Mårten Bjellerup; *Riksbank*: Stefan Ingves, Cecilia Skingsley, Olof Sandstedt; and *Financial Stability Council Secretariat*: Niclas Alsén.

companies being interest-rate sensitive. The probability has thus increased that the risks built up over a long period of time may materialise.

The Stability Council also discussed the functioning of the government bond market and crypto-assets. In addition, the Stability Council discussed cyber security and operational risks as a result of the invasion of Ukraine

§ 1 Stability assessment and measures

Stability assessment

The Chair opened by noting that much had happened since the extraordinary meeting of the Stability Council in January. The security policy situation has changed after Russia's invasion of Ukraine. The Government has prioritised sanctions against Russia, supporting Ukraine and strengthening Sweden. Several sanctions packages have been introduced and the European Council has now reached agreement on a sixth sanctions package. Sweden has also applied for membership of NATO. The Government believes that Swedish NATO membership is the best way to protect Sweden's security in light of the fundamentally changed security policy situation after Russia's invasion of Ukraine. Since the last meeting of the Stability Council, uncertainty about developments in the world economy has increased, partly as a result of the geopolitical situation. Inflation has risen in Sweden and the rest of the world and interest rates have risen. We know that the household sector is sensitive to changes in housing prices. This affects the costs for both households and the property sector and leads to an increase in the risks that we have identified for a long time.

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

Strong growth has led to the recovery of large GDP falls during the pandemic. However, growth prospects have now deteriorated, and growth is expected to enter a calmer phase.

Russia's invasion of Ukraine has had a negative impact on the real economy. Inflation began to pick up before the invasion but has increased further as a result of the economic effects of the invasion. Sweden's direct links with Russia and Ukraine are small, but the invasion has a major impact on

development in many countries, not least in the euro area, which indirectly affects the Swedish economy negatively.

Inflation has risen sharply since the December meeting of the Stability Council. Russia's invasion and sanctions have contributed to a further rise in inflation, including through rising energy and commodity prices. Inflation has risen rapidly in many countries. Many central banks have started to conduct a less expansive monetary policy. At the same time, credit spreads have also risen, further increasing interest rates faced by many businesses. Given the low initial interest rates, the increase has meant a significant rise.

The rise in inflation and interest rates is the largest for a very long time and means a transition to a new phase of development in the economy and in financial markets. An important question is how long-lasting the rise in inflation will be and how much and for how long interest rates will rise.

The global low-interest environment has helped households and businesses to borrow more, which has led to high indebtedness and sensitivity of these actors to rising interest rates.

Household debt has been increasing faster than incomes for a long time. Mortgage rates are now rising, both fixed mortgage rates and mortgage rates with short interest rate fixation periods. Finansinspektionen exemplified the consequences of the Riksbank raising the policy rate according to market expectations in that the effect will be a tripling of the interest cost by 2024. There will be a significant impact on indebted households when interest costs in relation to borrowers' disposable income increase to a level not seen since the 1990s. This would mean that many indebted households need to reduce other expenses.

Higher interest rates can also lead to problems for property companies and thus for their lenders. Property companies account for a large part of the banks' lending and for a large part of the bond loans issued by non-financial companies in Sweden. Debts have increased faster than their operating profit and the interest rates the property companies face in the bond market have now risen sharply. If financing costs remain at that level for a longer period of time, many property companies may face problems in the form of lower earnings, which can lead to falling property values. Finansinspektionen's stress tests show that the banks could then suffer higher credit losses.

The authorities noted that for several years there has been a steady deterioration in liquidity in the secondary government bond market and that there are probably several explanations for this. The recent deterioration, in the wake of the rise in interest rates, can be said to be an amplification of past problems. However, the primary market for government bonds continues to function well.

From a stability perspective, deteriorating secondary market functionality is worrying, given the central function of the government bond market for the overall financial system. This applies not least in relation to its importance for related markets, such as that for covered bonds.

The authorities also discussed crypto-assets. Development is fast and the financial regulatory work needs to be accelerated to create a common view on how issuers of crypto-assets should be classified and how the risks they give rise to should be managed and regulated

Overall, the Swedish financial system is currently functioning well, but at the same time developments since the December meeting of the Stability Council mean that the threats to financial stability have increased. Rising interest rates are putting pressure on the debt-heavy property sector, households and asset prices. At the same time, low interest rates have been a significant driver of the risks that have been built up. A shift to an environment with higher interest rates and reduced risk-taking can therefore mean reduced risks in the longer term. However, there may be turbulence during a transitional period.

Discussion by the authorities

The Riksbank referred to the April monetary policy decision and noted that, even disregarding energy prices, inflation has also been significantly higher than in the Riksbank's previous forecast. The outcomes indicate that the rise in inflation is now widespread. In view of this, the policy rate was raised from 0 to 0.25 per cent and the forecast means that it is expected to be slightly below 2 per cent at the end of the forecast period.

A higher policy rate means a rise in the interest cost of mortgages that have been taken at variable interest rates. Mortgages at longer term fixed rates have also increased recently. An unfavourable scenario where, for example, mortgage rates and living costs are higher than expected, while housing

prices also fall sharply, could have a very severe impact on many highly indebted households and lead to a substantial adjustment of their consumption or savings.

Finansinspektionen described the risks associated with the commercial property sector. The analysis of these risks is challenging, partly because the corporate structures are often complex and the number of property companies is large. Different companies are also exposed to different types of risk. Therefore, the average values for the sector are of less interest. There is a significant group of more sensitive property companies that would have problems at an interest rate that remains above 4.5 per cent for a long period. A major difference compared to the 1990s is the large-scale borrowing in the bond market. One concern and risk is that that market will cease to serve as a source of financing for property companies. The question is whether banks will be there to back up the companies in such a situation.

The Riksbank pointed out that a major cause of problems in the commercial property sector during the 1990s was the high degree of complexity, which made it difficult for banks and other financial actors to determine what the property companies had done. One factor that makes the current situation in the commercial property sector complex is the significant cross-ownership that exists between different property companies. This, together with the sector's high indebtedness, highlights the importance of closely monitoring developments.

The National Debt Office highlighted the lack of liquidity in the government bond market, where the situation has gone from worrying to serious, which is also pointed out by various financial actors, such as central banks, major investors and retailers. The National Debt Office emphasised that a functioning bond market in kronor is important. Poor functioning of the government bond market, including the effects it has on related markets such as mortgage bonds, entails risks for both the government as a borrower and the financial system as a whole, where the government bond market plays an important role, not least in a crisis.

There are several factors that have contributed to the steady deterioration we have seen in recent years. The main issue is that the volume of government securities that is available to trade on the secondary market has decreased over the last few years. This is partly because the Riksbank has purchased

government securities for monetary policy purposes and partly because at the same time the National Debt Office's supply has decreased as a result of strong public finances. In addition, market participants point out that certain regulatory requirements have meant that banks do not hold stocks of government securities in the same way as before.

The National Debt Office supports the functioning of the market, both by being predictable and transparent in borrowing and by offering market support facilities that allow retailers to always obtain government securities. However, both of these have a limited effect and other issues need to be discussed. The National Debt Office emphasised that a well-functioning fixed income market is a common interest of the Stability Council authorities and proposed joint promotion of such work.

The Riksbank noted that investigative work should look at why banks hold such small trading books and what structural changes are taking place in the market. In connection with such work, it may also be useful to analyse what the market should look like.

Finansinspektionen is concerned about a situation with increased credit risk combined with a poorly functioning bond market. Repricing may then lead to problems from a stability perspective. One important actor is the pension funds that can now shift from bonds to shares.

Finansinspektionen announced on 31 May that it intends to raise the countercyclical capital buffer from 1 to 2 per cent. The Board will take the decision in June. Before the pandemic, Finansinspektionen had raised the countercyclical buffer to 2.5 per cent, which allowed Finansinspektionen to lower the buffer when the pandemic struck. Based on the positive experiences during the pandemic, Finansinspektionen has developed a conceptual framework where the buffer is 2 per cent in a normal situation, and Finansinspektionen now sees that an increase to this level is good for stability.

Finansinspektionen is sometimes asked about how to deal with amortisation requirements when households' finances are now under pressure from rising interest rates and high inflation. However, Finansinspektionen's mandate is not about short-term economic policy, but about safeguarding financial stability. The suspension of the amortisation requirement during the pandemic was an exceptional measure taken in an exceptionally uncertain

situation. There is no such uncertainty today. In addition, it would be problematic for Finansinspektionen to take measures that counteract the Riksbank's interest rate increases. Moreover, in normal cases, there is also scope for banks to temporarily suspend the amortisation requirement for individual households, for example in the event of unemployment. Overall, Finansinspektionen therefore sees no reason to change the amortisation requirements.

Although households will be under pressure from rising interest rates, Finansinspektionen sees only limited credit risks linked to mortgages. Finansinspektionen's analyses show that at an interest rate of 5 per cent, more than 95 per cent of new mortgage borrowers are able to pay interest and necessary expenses, and at an interest rate of 7 per cent, the corresponding figure is just under 90 per cent of households. This shows the importance of credit assessments being sound and the cost of capital not being too low. Households have increased their savings ratio over the years with low interest rates. However, saving is not evenly distributed and much of it is in shares, which showed weak growth in 2022.

The Riksbank was positive towards Finansinspektionen raising the countercyclical capital buffer. It would also be a good thing to have a larger proportion of fixed-rate mortgages. The Riksbank supports Finansinspektionen's request to amend the rules on interest differential compensation for early redemption of mortgages.

The authorities discussed crypto-assets and the risks related to developments. The proposed EU regulation is a good step towards regulation. However, there is a risk that this will not be sufficient, partly because activities linked to crypto-assets are to a large extent cross-border. This underlines the importance of international cooperation.

The Chair summarised the stability assessment and the discussion. The Swedish financial system is currently functioning well but risks have increased. This is an uncertain environment and high inflation and high interest rates lead to risks for highly indebted sectors such as the commercial real estate sector and households. It calls for vigilance. The respective authorities in the Stability Council are closely monitoring developments.

Although the overall situation is stable in the bond market, risks have been observed that require vigilance. A functioning bond market in kronor is

important. The Stability Council will take the initiative to review the functioning of the government bond market and work towards identifying possible measures.

§ 2 Completed and future work within the Stability Council

The Chair concluded that there has been intensive work in the Stability Council over the past six months.

The Ministry of Finance reported on the work of the Stability Council. Cyber security issues have been particularly important during the six months given the security policy situation. Work has been done to strengthen preparedness in various ways, not least through improved communication and information sharing. In addition, other issues of importance to financial stability were also discussed.

Ahead of the next meeting of the Stability Council, the Council members will work together on issues related to cyber security, climate, risk pictures related to the evolution of inflation and interest rates in relation to interest rate sensitivity among borrowers such as the commercial property sector, work on a crisis exercise and the functioning of the bond market.

§ 3 Cyber security

Finansinspektionen described how the work carried out during the spring has strengthened the exchange of information on cyber risks between the authorities in the Stability Council and the financial sector, which is positive. The risk of cyber attacks remains high. In the report submitted to the Government in May by Finansinspektionen, it is proposed that a structure be created to deal with actual cyber incidents.

Finansinspektionen is planning two new investigations in the area of IT risk. After the Government has provided additional funds, the agency will recruit more IT and security experts. In the long term, the investigations can be expanded.

During the year, Finansinspektionen has worked on the joint cyber security action plan together with the Riksbank and the National Debt Office. The work had three different objectives. One objective is to build up cooperation on the financial sector with the National Cyber Security Centre. The Cyber Security Centre will now start with the financial sector as a pilot to

strengthen cooperation between the sector and the authorities. This work will start in the autumn and will eventually be transferred to completely different sectors. A second objective is to strengthen the sharing of information between the authorities and the financial sector, and a model exists for it in the form of Nordic Financial CERT. Part of the second objective is also that FRA (the National Defence Radio Establishment) is expected to be able to support the private sector with technical systems. The third objective is to describe the division of roles between authorities and financial companies and to create a description of cooperation structures.

The Riksbank noted that there have been no significant changes in attack attempts against the Riksbank. Continued work on the Cyber Security Action Plan is positive.

The National Debt Office is in favour of the work currently being done to strengthen cyber security efforts and supports the proposed pilot for the exchange of information on cyber risks between the private and public sectors. For the pilot to be successful, it will be important to listen to the needs of the private sector. Given the risks of attack, the proposal for a structure to deal with operational incidents in the financial sector is also sound.

In the further work, it will be important to clarify the mandates, roles and responsibilities of the various groupings that are now being created.

The Stability Council discussed what Nordic and other international cooperation on cyber security looks like and how it works. There is extensive exchange, especially with Nordic colleagues.

The Chair noted that a final report on cyber security work could be presented at the autumn Stability Council meeting.

§ 4 International questions

The Ministry of Finance provided a brief update on ongoing negotiations in the EU in the area of financial markets, and on proposals that may be presented in the autumn. Many negotiations are expected to be in the trilogue phase during the Swedish Presidency, which is in the first half of 2023.

Finansinspektionen mentioned ongoing work within the International Organization of Securities Commissions, IOSCO, on climate reporting. The working group is chaired by Finansinspektionen. There is great interest in the work on how companies are to report climate risks in the future.

The Riksbank noted that it is important for Sweden to push for the EU to implement all parts of Basel III fully, on time and in a consistent manner, without watering it down. If the EU waters down the standards, the likelihood of other global jurisdictions also diverging from those standards increases. This may lead to a decline in the resilience of the international financial system, which in turn negatively affects Swedish financial stability. Furthermore, the Riksbank noted that the use of CCPs from third countries does not need to be reduced if supervision and legislation in their home jurisdictions are deemed to be equivalent to those of the EU.