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Financial Stability Committee
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Minutes from the meeting of the Financial Stability Council held on 17 December 2021

Summary

The Stability Council[1] held its second meeting of the year and discussed the stability situation.

The pandemic has made a considerable dent in Swedish and global economic growth. However, the economic recovery has been strong, which has brought the Swedish economy back onto the same growth path as before the pandemic. Since the Stability Council meeting last summer, inflation has risen sharply, largely due to temporary factors. The current increased spread of infection and the measures taken to combat it have so far not had any significant impact on economic growth, but a temporary cyclical slowdown cannot be ruled out.

The Swedish financial system currently works well, but risks are building up. The strong recovery has been followed by a greater risk propensity and the risks for financial instability are heightened. Housing prices and equity prices have risen sharply. In particular commercial property companies and households show risk appetite; they are prepared to take on higher debt in the light of expectations of continued low interest rates and financing costs.

The authorities discussed the support measures and development of the pandemic.

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

In addition, the authorities discussed the 2021 UN Climate Change Conference and risks related to cyber security and cyber attacks, as well as the crisis exercise of a cyber attack that they conducted in the autumn.

§ 1 Stability assessment

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

The pandemic has made a considerable dent in Swedish and global economic growth. However, the economic recovery has been strong, and in Sweden the economy is back on the same growth path as before the pandemic. The recovery is partly explained by massive support measures, mainly via fiscal policy but also through monetary policy and other policy areas. Reduced restrictions that have increased mobility and thus favoured contact-intensive industries have also contributed to the recent recovery. The economic recovery has enabled most support measures to be discontinued or reduced. Since the Stability Council's meeting in June, inflation has risen sharply in Sweden and in the rest of the world, but with limited effects on long-term interest rates. At present there are concerns not least due to rising energy prices and increased spread of infection and lockdowns, which pose downside risks to the economy, but their impact is limited so far.

Overall, the strong recovery has been accompanied by a greater willingness to take risk. Risk premiums were historically low before the pandemic, rising sharply during the start of the pandemic in 2020, but support measures pushed them down rapidly. The higher risk appetite is likely affected by the asset purchases programmes and other support measures taken during the crisis.

Asset prices such as housing and equities have risen sharply, in particular several property shares. There was a brief fall in asset prices at the start of the pandemic, but since 1 April 2020 housing prices have risen by more than 20 per cent and the stock market by more than 60 per cent.

The high appetite for risk also means that companies and households are prepared to take on higher debt in relation to income. Public indebtedness in the rest of the world has also increased during the pandemic. The increased interest-rate sensitivity gives cause for concern.

Housing prices have continued to grow faster than incomes and higher housing prices are driving household indebtedness, and debt is expected to continue to accelerate. The proportion of mortgage holders who assume high debt levels in relation to both income and value of the housing is increasing. However, there has been some slowdown in prices in the autumn. The drivers of the rise in housing prices are part of the unusual economic impact of the pandemic, such as increasing demand for housing space as a result of working from home, and households' reduced consumption and increased savings, which has provided room for housing purchases. Somewhat lower interest rates and rising incomes have also contributed to the price increase.

There is an increased risk of falling prices in several asset classes, such as housing and equities, especially if interest rates rise. This means that, combined with high housing and share prices, an economic disruption affecting both asset classes would have a significant negative impact on households' balance sheets. For example, Finansinspektionen's analyses show that about 30 per cent of all new mortgage holders would have negative net worth in the event of a negative disruption of approximately the same magnitude as the rise in asset prices we have seen during the pandemic. The consequences of such large falls in wealth would affect households' willingness to consume. Those with negative net worth would in practice find it very difficult to move.

For businesses, the recovery has been somewhat uneven, with, for example, manufacturing industry recovering rapidly from the downturn at the start of the pandemic. Hotel and restaurant businesses have experienced some recovery, while passenger transport businesses, such as airlines, continue to find it difficult. Overall, bankruptcies have been low in Sweden and the rest of the world. This is partly a consequence of the support measures targeting businesses. However, it is not possible to rule out some increase in bankruptcies in the future, albeit from low levels. At present there are good opportunities for businesses to borrow from banks and on the capital market. The increase in borrowing on the capital market over the past year has primarily been driven by property companies.

The banking sector has managed the pandemic relatively well and has been able to sustain credit supply. Credit losses increased slightly in 2020, but in 2021 credit losses decreased and profitability increased. However, high asset prices and the banks' customers' debt present risks ahead. Finansinspektionen has therefore started to increase the counter-cyclical capital buffer and envisages continued increases to maintain banks' resilience ahead of the next crisis. As regards the requirements for eligible liabilities (MREL requirements), the banks' margins are good.

Central government finances have developed surprisingly strongly, and public indebtedness continues to decline. In the government bond market, there is a high level of activity in the primary market with issues that are oversubscribed several times over. On the secondary market, the tradeable volume is decreasing. The effect of the reduced volume is a deterioration in liquidity. This has been going on for a few years, but the situation is now worse than before. The National Debt Office mentioned that both market participants and research indicate that there seems to be a threshold effect affecting liquidity more negatively when central bank purchases of a government bond pass a certain proportion of its outstanding stock. The consequences of a deterioration in liquidity are that borrowing becomes more expensive in both the shorter and longer term and that the risk of increased volatility increases. The government bond market is a central part of the financial markets and functionality is very important, especially in a crisis.

<u>Finansinspektionen</u> estimates that many businesses and households have come out of the pandemic more vulnerable due to their increased indebtedness. This makes them more vulnerable to future shocks, for example in terms of rising interest rates. Developments over the last two years also show that the world is uncertain. No one could predict the pandemic or the remarkable rise in inflation two years ago. The longer the rise in inflation, the higher the risk of consequent rising interest rates, which could affect financial stability. It will be particularly difficult if interest rates rise while growth slows down.

<u>The National Debt Office</u> shares the view that it is difficult to predict inflation. There must be preparedness for it not falling back as expected. Wage growth is not driving inflation this time, but other factors and it may be more difficult to cope with a supply-driven inflation price shock compared to one that is demand-driven.

The Riksbank notes that the rise in inflation in Sweden is largely driven by rapidly rising energy prices. They also note that Sweden has slightly lower inflation than many other countries and clearly lower underlying inflation than, for example, the United States, but it is difficult to know what it will be like in the long term. According to the Riksbank's forecast, energy prices are not expected to rise as rapidly next year and then inflation will fall back. The Riksbank also states that the financial sector in Sweden is mainly exposed to the property market, i.e. housing and commercial properties. The Riksbank notes that the high level of indebtedness among households and some businesses implies a high interest rate sensitivity. This means that financial stability could be affected if interest rates were to rise sharply.

The Chair thanked the authorities for their stability assessments and noted that the situation is stable but that there are uncertainties, such as the evolution of inflation, development of debt levels and the impact of external developments.

§ 2 The pandemic: Update on crisis management

The authorities discussed the support measures and evolution of the pandemic.

The National Debt Office noted that the spread of infection has gathered pace again and that it will probably affect both the supply and demand sides of the economy. In the short term, there is no concern for financial stability in the light of low interest rates and ample liquidity. On the other hand, fiscal policy is too tight and central government finances are very strong. There is an underlying scope for reform that should be exploited. The National Debt Office is ready to increase borrowing if necessary and is prepared for fallback procedures such as guarantee programmes for businesses and airlines if the need arises.

The National Debt Office raised two factors to consider. The first is to prepare for the pandemic continuing, possibly for several years. It is therefore important to avoid sudden changes and instead help as far as possible to mitigate uncertainty, not least in vulnerable sectors. It is necessary to find a way to respond to an undulating pandemic, for households and businesses as well as for policy makers.

The second is that an exit strategy is needed to ensure stability even in the long term. The key economic policy frameworks must be safeguarded, as well as the defences that have been built. There are other benefits, as for example capital requirements not only benefit stability, but also banks themselves through lower financing costs.

Developments thus far — with debt and prices rising rapidly and risk premiums falling from already very low levels — are not sustainable. An important future component is that indebtedness must be made less attractive, for example by reducing or abolishing interest rate deductions, which, unlike higher interest rates, has a positive effect on public finances. Granting credit for property, including commercial property, should be moderated. Not least because instability is likely to come primarily from the commercial sector, rather than from households.

The Riksbank's measures to deal with the effects of the pandemic have started to be phased out. By the end of the year, the Riksbank will have completed the asset purchase programme triggered by the COVID-19 pandemic. The forecast is that the holdings will then be kept roughly unchanged in 2022, and then reduced, but the exact pace will depend on economic developments. In order to keep inflation close to the target in a sustainable manner, a continued expansionary monetary policy is required, although it is important to take into account vulnerabilities arising from it.

Higher debt has made households increasingly vulnerable to cyclical changes and disruptions in their private finances. Although households currently have a good debt-servicing capacity, they may need to spend a significant part of their income on interest payments if interest rates rise. This applies in particular to highly indebted households.

Finansinspektionen stressed that the Swedish system for building resilience has served us well, and that the crisis management during the pandemic has worked well. At the same time, the challenges ahead are significant. Finansinspektionen has therefore ended the temporary exemption from amortisation requirements and increased the countercyclical capital buffer to build resilience. However, the strong build-up of corporate and household debt requires the use of other tools, such as changes in interest rate deductions and real estate taxes. It is an important discussion to have in the Stability Council.

Developments during the pandemic showed that the Swedish corporate bond market functions poorly under stress. Finansinspektionen is therefore working to make bond issuance more standardised so that the market can function better in a stressed situation. According to Finansinspektionen there may be a need to limit, for example, funds' ownership of bonds. The Riksbank should also taper off its bond purchases more quickly.

The increased spread of infection poses a certain increased risk to the economic recovery. At the same time, the threshold should be very high before general support measures taken in spring 2020 are reintroduced, although targeted support measures may need to remain in place for a while.

The Chair mentioned that on that day the Government had communicated the reintroduction of certain support measures aimed at businesses. The Government is following developments closely and is ready if new measures are required.

§ 3 Discussion of analyses and potential measures

Crisis exercise

The Stability Council Secretariat presented information on the crisis exercise carried out with the Stability Council authorities during the autumn concerning the effects of a cyber attack on the financial sector. The exercise was instructive and resulted in a number of lessons that the authorities on the Stability Council should work on in the future to strengthen resilience.

The authorities underlined the importance of conducting crisis exercises. Exercises contribute to knowledge building and are an opportunity to test tools, collaboration and information sharing.

The Chair appreciated that the exercise had taken place in view of the threat posed by cyber attacks.

Cybersecurity, risk picture, collaboration and strategy

Finansinspektionen presented the risk picture, the work on a cyber strategy for the financial sector, and Finansinspektionen's work in this area.

In general, the risk picture is worrying and Finansinspektionen agrees with the Chair that there are reasons for concern. This assessment is also shared by supervisory authorities internationally. The DORA regulation being negotiated in the EU will be important in the future.

Finansinspektionen's assessment is that the current external threat image in the cyber area remains at a high level. Supply chain attacks, i.e. attacks targeting vulnerable parts of a supply chain, are increasing. As financial companies increasingly choose to use external suppliers, exposure to such attacks is increasing. Advanced actors have the capacity to quickly exploit vulnerabilities in products and services used in the company or by providers for fraudulent purposes, such as ransomware, where malware is used for blackmail purposes. DDOS attacks (a type of denial-of-service attack) continue to be widespread. These have become more sophisticated and often last for a longer period than before. Finansinspektionen has also received reports of an increase in the number of so-called phising attacks, where it is not uncommon for the COVID-19 situation to be used as a component of the method of committing fraud.

Finansinspektionen and the Riksbank are working together on a strategy for the financial sector that will provide a platform for further work in the authorities and in the sector regarding cyber security. An important part of this work is cooperation with the national cyber security centre. The strategy is to be in place by summer 2022 and will be discussed in the Stability Council.

Finansinspektionen is also working to strengthen the supervision of IT risks, including cyber security, in the financial sector and has received more funding from the Government for this. The IT risk supervision for the entire financial sector is placed in the same group at the authority. Finansinspektionen is now also the supervisory authority under the new Protective Security Act, which in practice will largely concern IT protection. By combining IT risk supervision and protective security supervision into one group, it is possible to build a critical mass of competence in the field.

The authorities agree that cyber security should be a priority. The national cyber security centre is expected to play an important role and the financial sector should also be represented in the centre. The National Debt Office underlined the importance of quickly putting in place the strategy for the financial sector that Finansinspektionen and the Riksbank are working on.

The Chair shared the view of the authorities that cyber security is a priority and supported the focus of the work. Looked forward to a report at the next meeting of the Council.

The 2021 UN Climate Change Conference (COP 26)

Finansinspektionen presented information about the meeting, which it attended as the Director General of Finansinspektionen chairs an IOSCO Task Force dealing with securities regulation. Finansinspektionen initiated the creation of this group in 2018 and the mission is to participate in work to develop a global accounting standard for climate risks. The work is based on the merging of different standards that will eventually be added to IFRS, which was communicated at the Glasgow Climate Summit. The standard will be developed and then supported by supervisory authorities to form the basis of legislation in the next step. Ultimately, it is about pricing climate risks so that capital can be allocated properly.

The Chair expressed thanks for the report and underlined that work on sustainable finance is an important issue.

Update on the situation in the commercial property sector

Finansinspektionen presented the risks in the commercial property sector. There is a strong link to financial stability due to the sector being cyclical, highly indebted and thus sensitive to interest rates. Furthermore, it has a strong link with the banking sector, as financing for the real estate sector accounts for 40 per cent of the banks' corporate lending. Companies in the sector have also increasingly financed themselves on the corporate bond market and have therefore also played an important role for the funds. The increasing share of market funding is positive in the sense that it reduces the risk for large credit losses in banks, which could threaten the entire financial system. At the same time, a growing and unstable bond ownership base entails a risk of panic sales, illiquidity and reflows to the banks in a crisis.

The post-pandemic outlook for the sector is uncertain. The sector is very sensitive to interest rates and there is uncertainty about future interest rates. Demand, especially for offices and retail outlets, is uncertain and vacancies have now risen significantly. There is also a rapidly rising supply of new rental apartments with high rents and in more peripheral locations.

Despite these vulnerabilities, the indebtedness of the sector has continued to grow more than 10 per cent per year during the pandemic. When the pandemic hit, bond lending temporarily disappeared, and bank lending became more important. Market funding in particular is growing rapidly again.

The rapidly increasing debt levels has resulted in debt growing faster than revenues, despite the fact that revenues have shown strong growth for several years. Liabilities in relation to operating profit are now at record levels in the sector. Due to the increase in debt and the stagnation of revenues, the vulnerability of property companies is increasing. To avoid instability, it is therefore important to suppress panic sales through more stable bond financing and less pro-cyclicality in fund markets. However, it is a difficult area to regulate through funding channels as market-based, and often international, funding constitute such important components. An alternative could be to set key figures that, if passed, would entail restrictions on businesses, i.e. think and communicate as in the household sector. One reason for the risks in the sector is that interest rates have been at low levels for a long time, and this makes it possible to bear more debt. However, this makes the financial system extremely sensitive. Property bonds are growing substantially and now account for about 50 per cent of the Swedish bond market and are expected to increase to 70 percent in the long term. In addition to managing risks related to market funding, Finansinspektionen considers that announced increases in the countercyclical capital buffer are needed to maintain sufficient resilience in the banks.

<u>The Riksbank and the National Debt Office</u> agree with the view of the risks. The Riksbank mentioned the experiences of the 1990s crisis in Sweden, which was largely a property crisis. They noted that the cash flow of property companies is crucial for how they can cope with changing economic conditions such as higher interest rates, and when a rapid cash flow cessation is suspected, the companies face problems. Problems in the commercial property sector may in turn spread to the financial sector.

<u>The authorities</u> discussed potential measures such as taxes. There are now strong incentives for companies to take on too much debt.

The Chair summarised that this is an issue that will occur again on the agenda and that it is a good thing that Finansinspektionen is following developments.

§ 4 International questions

The Ministry of Finance provided a brief update on some of the ongoing negotiations in the EU in the area of financial markets. These included the new banking package, changes to Solvency 2 in the field of insurance, the money laundering package, the Markets in Financial Instruments Regulation, and the Alternative Investment Fund Managers Directive.

The Riksbank noted that it is in Sweden's interest that Basel III is fully implemented, on time and in a consistent manner. The Riksbank noted in relation to this that it is disquieting that the European Commission's proposal for the implementation of Basel III, i.e. the new banking package, represents a significant dilution. Sweden should not contribute to watering down the implementation.

Finansinspektionen shares the Riksbank's view that it is important that the Basel Accord is not watered down in the legislative process currently under way within the EU.

§ 5 Future work

Ahead of the next meeting of the Stability Council on 3 June 2022, the Council's members will work together on the stability issues discussed at the meeting. This includes issues related to stability risks in the long term as a result of the pandemic and strengthening resilience to cyber threats. The Stability Council will also continue to work on issues relating to the commercial property sector, household indebtedness and new risk pictures.