



Financial Stability Committee
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Minutes from the meeting of the Financial Stability Council held on 4 December 2018

Summary

The Stability Council¹ discussed the stability situation.

The Stability Council sees higher stability risks in the rest of the world, for example linked to trade conflicts, uncertainty concerning the economic and financial effects of the United Kingdom's withdrawal from the EU and developments in the eurozone, for example relating to Italy.

At present, the financial markets in Sweden are operating well. At the same time, there are vulnerabilities and risks in the Swedish financial system that are influenced by the long period of low interest rates in Sweden and the world at large. High levels of household debt continue to be one of the major risks.

The Stability Council discussed the measures taken to increase households' resilience, and the effects they have had. The Stability Council also spoke about the need for anonymised microdata on households' debts and assets in order to better assess the position of households.

The authorities also discussed the resilience of the Swedish banking system, in the form of capital buffers and liquidity requirements. As regards risks to banks, the Stability Council in particular raised developments in the commercial property sector. Indebtedness among commercial property companies has increased, and a clear trend in recent years is that to an

¹ Present: *Ministry of Finance*: Per Bolund, Chair, Ulf Holm, Aino Bunge; *Finansinspektionen*: Erik Thedéen, Martin Noréus, Henrik Braconier; *National Debt Office*: Hans Lindblad, Johanna Fager Wettergren, Mattias Persson; *Riksbank*: Stefan Ingves, Kerstin af Jochnick, Olof Sandstedt; and *Financial Stability Council Secretariat*: Niclas Alsén.

increasing extent they finance themselves directly via financial markets. As the sector is sensitive to interest-rates and the business cycle, as well as closely linked to the financial system, the Council sees a need to continue monitoring developments.

Furthermore, the Stability Council discussed cyber security and its significance for the financial system. The authorities agreed to keep each other informed about their respective activities in the area and highlight issues that require close coordination.

Ahead of the next meeting of the Stability Council on 10 June 2019, the Council's members will continue to work together on the stability issues discussed at the meeting. This applies to work related to scenario exercises, the resilience of the banking system, household indebtedness, stability issues linked to current EU matters, Brexit and cyber security.

§ 1 Stability assessment

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

There are several risks associated with international developments that may impact financial stability in Sweden. Examples are trade conflicts and the uncertainty concerning economic and financial effects of the United Kingdom's withdrawal from the EU. Apart from these risks, the structural problems in the euro area, such as in the banking sector, and problems of weak public finances, not least in Italy, remain.

The interconnection between banks and countries' sovereign financial situation in Europe constitutes a vulnerability. Spreads have increased somewhat in the market for European corporate bonds. But in general spreads are depressed, due to the pursuit of yields.

Sweden has had unusually low interest rates for a period of time and the interest rate level is expected to increase in the future. About 70 per cent of households' mortgages are taken out at a variable interest rate, which means that changes in interest rates quickly impact household interest expenditure. Household interest expenditure, both in absolute terms and as a percentage of disposable income, is therefore expected to increase in the coming years.

High levels of household debt is one of the major risks in the Swedish economy. The aggregate debt ratio is now more than 185 per cent. After last year's fall, housing prices have stabilised recently, and indebtedness is now increasing at a slower pace, though still faster than households' disposable incomes. In the last quarter, businesses increased their debt levels to a greater extent than households, predominantly via market funding rather than bank funding.

The financial system operates well at present. However, the Swedish banking system is large, interconnected and dependent on market funding, which entails structural vulnerabilities. The financial infrastructure has functioned well, in the sense that basic functions have been maintained, but the participant failure at Nasdaq Clearing in the autumn raises a number of questions. Consequently, the authorities see a need to monitor events closely.

The considerable money laundering that has taken place in Danske Bank's Estonian branch has led to extensive discussion, for example as regards allocation of responsibility for money laundering supervision in the EU and cooperation between various authorities. Money laundering damages confidence in the banking sector.

The Chair expressed thanks for the presentations and noted that there seemed to be agreement on the risks; a less peaceful world, uncertainty in the eurozone, Brexit, household indebtedness and the housing market are all factors viewed as risks to financial stability. The analysis of money laundering issues will continue, and the work has high priority; for example, the Fifth Anti-Money Laundering Directive will be implemented and supervision has been given more resources.

§ 2 Discussion of analyses and potential measures

Resilience in the banking sector

The Riksbank considers that, given the structural vulnerabilities of the Swedish banking system, Swedish banks need to strengthen their resilience in the form of both capital and liquidity. The Riksbank notes that the Swedish banking sector has a low leverage ratio compared with other European countries. It is also important for banks to reduce their liquidity risks. The Riksbank has recently decided to change the composition of its currency reserve to better reflect the liquidity risks taken by banks in

different currencies. However, it remains very important that the banks primarily themselves have sufficient liquidity reserves in all important currencies so that they can manage the risks they incur in their operations.

Finansinspektionen estimates that the major banks have sufficient liquidity buffers. It is particularly important that the banks have large buffers of EUR and USD that can easily be used in a future crisis by being converted to the currencies needed. In the opinion of Finansinspektionen, buffers are also needed in other important currencies such as SEK, but these buffers should not be built up at the expense of buffers in EUR and USD.

Finansinspektionen also judges Swedish banks to have satisfactory resilience in terms of significant capital buffers. Stress tests carried out by the European Banking Authority (EBA) show that the banks seem able to manage greater economic hardship than many European banks. This reflects high profitability, but also that credit risks are more limited in Swedish banks. Swedish banks also have low borrowing costs relative to European competitors, which shows that market actors see Swedish banks as less risky. Finansinspektionen does not consider the leverage ratio to be a good measure of resilience, as it ignores the risks that exist in banks. A comparison between European banking systems rather shows the opposite correlation; that the leverage ratio is high in banking systems with major problems and low in systems with stable banks.

The National Debt Office shares Finansinspektionen's view regarding liquidity and capital buffers.

Household indebtedness: effect of measures taken and the need for potential further measures, as well as the need for microdata

Finansinspektionen presented its view of the risks associated with household debt. Household debt is now growing at a slower pace, but still rising faster than disposable incomes. Evaluations show that Finansinspektionen's cumulative efforts to counteract household debt have had a clear effect on indebtedness, while the effect on prices has been limited. It is important not to focus only on total debt, as the greatest risks can be linked to the most indebted households. The percentage of new mortgage holders with debts exceeding 450 per cent of their gross income increased up to last year, but is expected to decrease as a consequence of the stricter amortisation requirement. At the same time, Finansinspektionen and the Riksbank see a

need to analyse microdata on household debts and assets in order to better follow the risks in the household sector. Statistics Sweden should therefore be instructed accordingly.

As regards the fall in housing prices in 2017, Finansinspektionen's analyses show that this was mainly driven by an increased supply of newly built housing, but that the stricter amortisation requirements also contributed to some extent. Turnover in the housing market in 2018 is approximately the same as in 2017, which also does not indicate any major consequences of the stricter amortisation requirement. The slowdown and stabilisation of housing prices that has taken place is fundamentally a good thing, though it entails challenges for some housing developers and their financing model.

The National Debt Office pointed out that there are major uncertainties concerning the size of the supply problem. This is important to take into account in order to ensure that conclusions on building and financial stability are correct. The general debate on price developments is in some sense exaggerated.

The Riksbank brought up that there have been problems in the Swedish housing market for a long time. It would therefore be unfortunate if only measures that exclusively impact new mortgages were taken. Structural reforms are needed, which address such issues as the rent-setting system, taxation of capital gains on housing sales, property tax and tax relief on interest payments.

The National Debt Office agrees with the Riksbank on the need for structural reforms in the housing market.

Finansinspektionen shares the assessment of the Riksbank and the National Debt Office on the need for structural reforms to improve the functioning of the housing market and that this can mitigate the risks linked to household indebtedness. At the same time, some countries that do not share the same structural problems in the housing market as Sweden, nevertheless struggle with a high level of indebtedness. Structural reforms that improve the functioning of the housing market will therefore not in themselves solve all problems linked to the high level of household debt.

The Riksbank mentioned that housing investments are expected to decline in the future. The slowdown in housing prices has created uncertainty in the

housing market. For example, weaknesses have been exposed in the financing models of housing developers for new housing production. The model entails assigning a large share of the risks in construction projects to the households. In the longer term it is likely that the actors will need to use other financing models and share the risks more to enable the production of more tenant-owned housing.

The Riksbank further argued that if a household wishes to retain its scope for consumption without adjusting its savings when interest rates rise, the household's debt needs to decrease considerably. If mortgage rates are doubled from two to four per cent, the household's debt would have to be halved from current levels to enable the household to keep interest expenditure unchanged, and thus retain its scope for consumption and saving unchanged. The Riksbank agrees with Finansinspektionen concerning the need for micro data on households' assets and liabilities. The best option would be for Statistics Sweden to collect such data, but they probably do not have the right to request it. As regards collecting such micro data, it is a complex matter that primarily the Government needs to properly investigate.

The Chair emphasised that the Government continues to closely follow developments in household indebtedness and in the housing market.

Households generally seem to take longer to decide on buying a new home, but this may also be positive. The transition government has taken a decision on adjustment of the amortisation requirement to include the new actors in the mortgage market. The Chair further argued that as regards the matter of micro data, it is important that the matter be properly investigated, but it is not a matter for a transition government to decide.

The Chair asked Finansinspektionen how the high debt ratios have been affected by the stricter amortisation requirement.

Finansinspektionen estimates that the stricter amortisation requirement will mean that new mortgage holders will borrow less and buy slightly cheaper homes, but that the mortgage survey to be conducted in the spring will give a more complete picture. At the same time the full effect of Finansinspektionen's macroprudential supervision measures on the entire stock of borrowers will only be felt in 15-20 years, as the measures mainly affect new borrowers. There should therefore not be any unrealistic expectations on what macroprudential supervision can achieve.

Commercial property risks

Finansinspektionen presented the risks in the commercial property sector. The sector accounts for 28 per cent of non-financial companies' debts and 21.5 per cent of banks' total lending, even though its value added only accounts for 4.4 per cent of the total. The high level of debt, combined with close links with the banks and high sensitivity to the business cycle, means that the sector is important for financial stability. Prices have increased rapidly since 2012, driven by low interest rates, high growth and a strong labour market. At the same time, indebtedness has increased, from SEK 150 to 350 billion since 2013, and the companies are interest-rate sensitive. Market funding has increased from 2 to about 25 per cent, which reduces the banks' direct exposure. But the increasing bond funding may pose problems in a future crisis, with increasing demand for bank funding as a consequence. Stress tests indicate that a significant share of property companies may have profitability problems if interest rates rise and rent levels fall. Finansinspektionen continues to analyse the sector and will expand on its view in the spring financial stability report.

The Chair expressed thanks for the analysis, and asked questions about banks' exposure to the sector now, as compared to previous crises.

The Riksbank referred to the Swedish crisis of the 1990s, when problems in the commercial property sector contributed to major price falls, large credit losses and difficulties for the Swedish banking system. It is essentially a good thing that commercial property companies use several different sources of funding, since this reduces dependence on the banking sector. But at the same time, increased market funding entails indirect risks to the banking system, since the loans ultimately risk ending up with the banks. Given that the banking system already has a large exposure to the sector, it is important to monitor future developments.

Finansinspektionen mentioned that there is a link to household debt in that rising interest rates can be expected to contribute to lower consumption, which may affect the commercial property sector through lower cash flows. The National Debt Office addressed the fact that property companies' market funding consists of a large proportion of loans with short maturities, and that this contributes to refinancing risk. The low interest rates affect the market for commercial properties and contribute to increasing prices and rents.

Cyber security: The work of the authorities

Finansinspektionen presented its work on cyber security. This is a large and complex area. Cyberattacks have increased in recent years and cyber risks are now one of the most important risks in the financial system. Many actors can damage the financial system and sensitivity increases with digitalisation. The IT environment in banks is complex, which creates risks and vulnerabilities. Finansinspektionen will increase monitoring and supervision in this area. It is important that the banks have systems to deal with these risks; both protection against the threats and back-up systems to maintain the infrastructure in the event of an incident. One issue is outsourcing of IT services, and the requirements that should be made of suppliers, which are not normally regulated. Finansinspektionen cooperates with several other authorities, such as the police, the Swedish Economic Crime Authority, the National Debt Office and the Riksbank. The intention is to further strengthen this cooperation in future.

The Riksbank noted that cyber risks are a priority area for the Riksbank but that it is also a matter of civil defence. The authorities will need to devote more resources to cyber security in future. The Riksbank cooperates with the ECB and Finansinspektionen, among others. Cooperation and practice are important. For a long period, the Riksbank has led the private-public partnership in FSPOS (the Swedish financial sector's private-public partnership group) whose vision is that essential financial services should function at all times. This work is on a voluntary basis, but is becoming increasingly important and therefore responsibility for emergency preparedness in the central payment system should be clarified in legislation as soon as possible.

The Riksbank, in its supervision of financial infrastructure companies, has conducted cyber resilience surveys. Preparatory work is also in progress at the Riksbank with regard to the use of the ECB's TIBER-EU framework. This framework makes it possible for authorities to test resilience to cyber risks in a standardised way at infrastructure companies and banks. Next year the Riksbank will also host a Nordic cyber conference.

The National Debt Office noted that the authorities have different roles, both operative and supervisory. The National Debt Office works very actively on cyber risks, not least in view of its role as the State's internal bank, as debt office and in cash management. In addition, a major

investigation project is under way on the state payment model. There is currently a lack of knowledge about how to deal with cyber threats and cooperation on these issues, as well as on how they link to financial stability, is important. A first step is to analyse the impact on stability, the current framework and how the authorities manage cyber risks.

The Chair noted that it is important to work together when threats are rising. It is central to financial stability that efforts to protect the Swedish market from serious breaches continue to develop. The Stability Council needs to revisit this question at its next meeting.

§ 3 International questions

The Ministry of Finance presented current EU negotiations.

The Ministry of Finance gave an account of the Brexit negotiations. After approval of the withdrawal agreement at the extraordinary meeting of the European Council last Sunday, it is now up to Theresa May to convince the UK Parliament that this agreement is better than a situation in which the United Kingdom leaves the EU with no agreement at all, i.e. a hard Brexit. The Government is prepared, regardless of the outcome, and there is ongoing contact with the relevant authorities. The Commission has announced that, in order not to jeopardise financial stability, in the event of a hard Brexit, there will be a transitional assessment of the London Clearing House as an approved CCP in order to gain time to deal with the large volumes of derivatives.

The Ministry of Finance has worked with 18 EU negotiations in the financial market area this year. The *'banking package'* has involved intensive negotiations, and an agreement is being discussed by the ECOFIN Council today. The Government takes the view that the authorities can retain requirements on Swedish banks which correspond to their risks, even after the implementation of the new rules. The focus of negotiations on *the Banking Union* has been the joint deposit guarantee scheme and the common backstop mechanism in the resolution fund, but further work remains to be done on the proposals. The review of the European Supervisory Authorities, *the ESA review*, continues to be negotiated. Direct supervision has been a sensitive issue there. In the negotiations on *central counterparties*, or *CCPs*, the Council has now agreed on a proposal covering the supervision of central counterparties, both in the EU and in third countries, such as the United Kingdom after Brexit. An agreement has also been reached on a framework

for *covered bonds*. The European Commission has published three legislative proposals to promote a *sustainable financial market* that are currently under negotiation in the Council. There is relatively broad consensus on the proposals on disclosure requirements and a carbon dioxide index. The discussion on the definition of green activities is more complicated.

§ 4 Other stability issues

Scenario exercises

The Riksbank and the Stability Council Secretariat presented information on ongoing work on scenario exercises and other crisis planning measures that focus on such things as the intersections of various responsibilities of the authorities.

The E-krona project

The Riksbank presented its ongoing e-krona project. For 350 years the Riksbank has provided the public with money, but technical developments and the digitalisation of payments have brought to a head the question of the future role of the State. If marginalisation of cash continues, a digital krona, an e-krona, could ensure that the public continues to have access to a state-guaranteed means of payment. Like the Riksbank, many other central banks are also analysing central bank digital currency and have projects to test and build different technical solutions.

Under the Sveriges Riksbank Act, Swedish kronor, in the form of cash, are legal tender. But at the same time, it is possible to contract away the possibility of paying in cash. It may therefore be appropriate to review whether the concept of legal tender should be changed and whether cash, and a potential e-krona, should be given a stronger position.

Finansinspektionen and the National Debt Office consider that an e-krona may have a significant impact on the functioning of the financial system and the role of the State in this. The matter should therefore be investigated by a government inquiry.

§ 5 Future work

Ahead of the next meeting of the Stability Council on 10 June 2019, the Council's members will continue to work together on the stability issues discussed at the meeting. This applies to work related to scenario exercises,

the resilience of banks, household indebtedness, stability questions linked to current EU matters, Brexit and cyber security.