STATENS OFFENTLIGA UTREDNINGAR

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Financial Stability Committee
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Minutes from the meeting of the Financial Stability Council held on 4 June 2021

Summary

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

Extensive support measures around the world have helped to mitigate the economic consequences of the pandemic. With the help of the support measures, the Swedish financial system has managed relatively well and a financial crisis has been avoided. The major banks in Sweden remain profitable and their credit losses have so far been small. Credit supply to households and businesses has been maintained and important funding markets are now functioning satisfactorily. Bankruptcies have so far remained at relatively low levels.

However, there are several risks to financial stability in Sweden in the long term. The development in the housing market is worrying and household debt is growing, which means that there is reason to evaluate measures that reduce the risks. In addition, risks in the commercial property sector were discussed, how it has been affected by the pandemic, and what this means for risks in the banking system. It was also noted that asset prices have risen at a rapid pace with high equity valuations and low risk premiums, which can create turbulence if prices fall. In Europe there are additional risks, including weak public finances and a weak banking sector in the euro area.

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

The Stability Council discussed the support measures and the appropriate time for discontinuing them, as well as the stability risks to be taken into account.

The Stability Council also discussed cyber security and the need for the authorities to strengthen cooperation to increase resilience to cyber threats to financial stability.

§ 1 Stability assessment

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

The cyclical effects of the pandemic on the world economy and the Swedish economy have been smaller than many initially feared, which can be explained, among other things, by the historically extensive support measures put in place around the world. In Sweden, the economy has been less affected by the pandemic than in many other countries. Both in Sweden and globally, economic recovery is now under way. Within the industry sector global growth has been the strongest in 20 years.

High risk-taking and low risk premiums have resulted in high asset prices globally, which can create turbulence if prices go down. Also in Sweden, asset prices have risen at a rapid pace and are at historically high levels. Financial conditions continue to be expansionary and the risk appetite among investors is high. Market borrowing for financial institutions functions efficiently and risk premiums on covered bonds and certain corporate bonds are lower than before the outbreak of the crisis. Household saving has increased during the pandemic. This is not considered to be due primarily to increased precautionary saving, as in more normal downturns, but to households not having had the possibility to consume certain services.

At the beginning of the crisis, Swedish companies in many different industries were affected. Interest rates on corporate loans rose slightly in March 2020, but subsequently fell back, partly as a result of the support measures taken. Despite the recovery that can now be seen, some companies describe their financing situation as more strained than normal. The number of bankruptcies during the pandemic has been in line with previous years, but there is a risk that they will increase when the support measures are removed.

The major banks in Sweden remain profitable and their credit losses have so far been small. Among banks in Europe, there was an increase in provisions for expected credit losses at the beginning of the pandemic, but since then they have decreased in many countries. However, as support measures are phased out, new challenges may arise, especially for the banks in the euro area, related to non-performing loans for example. Furthermore, many countries in the euro area have weak public finances. It is thus not certain that all banks have sufficient resilience – or that all countries have sufficient capacity to implement the measures needed – if bankruptcies increase and the crisis becomes deeper or more protracted.

The extensive outflow from Swedish mutual funds that took place in March 2020 has now been recovered as a result of households choosing to make new deposits. In the short term it looks better than six months ago, but structural weaknesses remain in the fund and bond markets. It is important that fund management companies manage their liquidity risks and regulatory changes may also be needed to create greater resilience.

In Sweden, central government finances have developed surprisingly well, especially tax revenues. Sweden's public indebtedness was low even before the pandemic in an international comparison, and that picture has been strengthened during the pandemic. There is strong demand for secure investments such as government securities, and liquidity in Swedish government bonds on the secondary market continues to be low.

Housing prices in Sweden have risen sharply during the pandemic, probably driven by a combination of increased demand as a result of working more from home, high levels of saving in the household sector and continued low interest rates. As a proportion of disposable income, household debt is now 200 per cent, which is the highest level to date. The authorities noted that debt growth needs to be monitored closely. Housing prices were high even before the crisis and household debt is expected to continue to grow as a result of the rise in prices we have now seen.

Corporate indebtedness has also continued to rise during the pandemic.

The Chair shared the view of the authorities. One source of concern is the continued rising household and corporate indebtedness together with high housing prices. Another question is how long the price increases can continue on the stock and housing markets and how bankruptcies will develop.

§ 2 Long-term macroeconomic and financial stability in relation to the pandemic

The authorities discussed the support measures, the time for discontinuing them, and the stability risks to be considered.

The Riksbank noted that last year it was clear that the economy would be hit hard as a result of the pandemic and that extensive support measures were needed to stimulate the economy, for example in the form of keeping interest rates low and facilitating credit supply. The Riksbank also emphasised that the support measures taken have mitigated the effects of the pandemic on the real economy, alleviated the turmoil on the financial markets and prevented a financial crisis.

The Riksbank pointed out that there are vulnerabilities that may accumulate under an expansionary monetary policy, but that there are also risks associated with reducing support too early. In addition, it was noted that the overall economic policy still needs to support economic recovery, while taking vulnerabilities into account in the longer term.

The Riksbank expressed concern about household debt and what it could lead to in the future. If private debt grows faster than the economy, it will be increasingly difficult to manage. In addition, there have been fundamental problems on the Swedish housing market for many decades that exacerbate the situation.

Finansinspektionen noted that it is very positive that the economy is growing. However, things are moving rapidly upwards and Finansinspektionen therefore sees a need for Sweden to start building resilience for the next crisis already now. The extensive support measures implemented by the authorities and the Government during the crisis were good and, together with a relatively resilient economy, contributed to dampening the economic downturn, but now one needs to think ahead.

The rise in housing prices is influenced by low interest rates, changed preferences and a high level of savings, but also by expectations. This means that the longer the rise continues, the more people will start thinking that they want to buy, which can lead to expectancy-driven price rises. There are significant risks associated with that. Consequently, there is reason to be vigilant.

Crisis management during the pandemic was resolved with good decisions that were partly coordinated. Finansinspektionen made it clear to the financial system that they should use the buffers they had. That worked. All in all, the stimulation measures and crisis management helped us to avoid a sharp economic downturn. High digitalisation in the Swedish economy also contributed to the relatively high adaptability of the economy during the pandemic.

The countercyclical capital buffer will be restored. The buffer is needed because systemic risks that existed before the pandemic remain and have even been strengthened through extremely low risk premiums and increased indebtedness.

In an international perspective, Finansinspektionen has measures in place that are similar to those of many other European countries, such as the restriction of mortgages. If necessary, these tools can be sharpened, even if Finansinspektionen is not currently working on any specific proposals. An alternative to tightening current regulatory requirements could be to steer borrowers towards mortgage rates fixed for five years or more, which would make households more resilient to an increase in interest rates. One obstacle, however, is the current design of the interest differential compensation that disadvantages the consumer relative to the bank if the loan is redeemed prematurely.

With regard to other crisis measures, Finansinspektionen argued that the Riksbank should gradually begin to phase out its asset purchases now that the economy is recovering rapidly and the short-term risks have been dampened. The support purchases of covered bonds and corporate bonds risk contributing to increased risk-taking, resulting in higher indebtedness in the long term, not least if they continue even though the economy is otherwise strong. It is also important to avoid providing support to companies that are not viable in the long term. At the same time, certain support measures need to remain in place, but the focus should be on measures that do not contribute to future risks. In this perspective, the focus should be that fiscal policy should play a greater role than monetary policy now that financial markets have calmed down and the recovery is clear.

The crisis has shown vulnerabilities in the bond and fund markets that need to be managed. Part of this is greater market transparency, which is now on its way. Finansinspektionen has also sent a report to the Government on new liquidity tools for funds. Such tools are one of several ways to reduce the liquidity risks in the funds and make them more stable.

The Swedish National Debt Office noted that through several different measures, such as credit guarantees for airlines, corporate loan guarantees, easing of MREL requirements and an expanded credit guarantee framework for the Swedish Export Credit Agency, the authority had helped to mitigate the effects of the pandemic and to maintain efficient credit supply during the crisis.

The Swedish National Debt Office also noted that the very expansive policy, alongside higher employment, resulted in record low risk premiums, rising asset prices and increased stability risks. The temporary support measures therefore need to be phased out and the aim should be set on a long-term stimulating policy that benefits the labour market while taking account of the distributional effects. The risk is not that the policy will be too expansive, but rather that the redirection of policy will be too slow. Compared to many other countries, Sweden has fared well during the crisis, which was made possible, among other things, by the sound public finances. The Swedish National Debt Office believes that the state of public finances and the underlying strength of the Swedish economy indicate that there is scope for structural reform. This, combined with the risk of rising long-term unemployment, means that there is now reason to switch to an expansive fiscal policy focused on promoting growth. Continued expansionary fiscal policy would also more clearly relieve monetary policy.

From a stability perspective, measures should be taken to make it more expensive for households to take on debt. Clearly reduced tax relief on interest should be considered. The Swedish National Debt Office emphasised that households should be compensated in other ways for reduced tax relief on interest as it is not a matter of tightening the economy, but the aim is to make it relatively more expensive to borrow. Measures that provide incentives for households to extend the interest-rate fixation period for mortgages are also urgent. The Swedish National Debt Office agreed with Finansinspektionen that the interest differential compensation is important in this context and should be reviewed.

The Chair reported that the Government has implemented measures during the pandemic for more than SEK 400 billion. The packages of measures have contributed to sustaining economic activity, including limiting the rise of unemployment. Many of the measures are dependent on companies' development and will phase themselves out as fewer and fewer apply for compensation. However, this does not apply to all measures, so fiscal policy must remain vigilant so that the measures are phased out at the right time. There was an important signal value in indicating preparedness and that the measures exist. There are concerns about the European risks, for example in the banking sector, and whether they can affect Sweden. As far as Sweden is concerned there are questions about the housing and property sector and the labour market.

The Riksbank agreed that measures that extend the fixed rate term on mortgages are a good way forward. As the debt stock look today, it is reasonable that more mortgage holders borrow at longer fixed-rate periods, but in this context the system of interest differential compensation also needs to be reviewed. At the same time, measures in housing and tax policy are needed to solve the basic problems related to the housing market and household indebtedness.

If central government debt decreases even more, mortgage bonds will become increasingly dominant in the Swedish bond market. The Riksbank's asset purchases have meant that the investor base for Swedish mortgage bonds has changed, where for instance foreign investors, who have been relatively fickle even in previous years, have reduced their holdings.

The Riksbank responded to Finansinspektionen's comment on the asset purchases and said that they were designed to decrease over time. Thus, the purchases are not as extensive now as when they were launched. The Riksbank also pointed out that monetary policy stimulus measures contribute to the recovery in the economy and to achieving the inflation target of two per cent.

Finansinspektionen agreed with the Swedish National Debt Office that it is reasonable to sort out the tax relief on interest, and that it is a good time now. The housing market requires new production at reasonable prices. In retrospect, too many tenant-owner apartments and too few single-family houses have been built. Turnover in the existing stock also needs to be improved.

§ 3 Discussion of analyses and potential measures

Cyber security

The Stability Council discussed its work on cyber security and the link to financial stability.

Finansinspektionen reported that cyber risks are steadily increasing as internet exposure increases. Threat environments are increasingly well-resourced. The outsourcing of critical activities to third-party suppliers is also increasing, and they in turn have subcontractors.

The authorities in the Stability Council need to strengthen cooperation with regard to cyber security. Finansinspektionen has therefore carried out work on the different roles and tasks that need to be filled in a well-functioning system. Finansinspektionen therefore proposed that the authorities, based on FI's work, jointly draw up a sector-specific strategy for cyber threats affecting financial stability. This work can then be reported to the Stability Council.

The National Debt Office agreed with Finansinspektionen. The effect of an attack on a bank or financial infrastructure can spread rapidly and threaten financial stability, which could affect the whole of society. The Swedish National Debt Office also has operational functions in the financial sector and can thus be exposed directly to cyber threats as well.

The Swedish National Debt Office stated that a clearer structure is needed to create resilience to cyber threats.

Like the Swedish National Debt Office, the Riksbank operates its own systems and, just like many others, is subjected to numerous attempted cyber attacks. For example, the Riksbank is subjected to thousands of attacks from all over the world every day. Furthermore, the Riksbank noted that coordination of the work on cyber risks could be improved with a sector-wide strategy to strengthen resilience and a clarification of the authorities' roles and responsibilities, both in preventive work and in the event of a cyber incident.

The Chair appreciated the cooperation between the authorities and could see the need for a sector-specific strategy.

Update on the situation in the commercial property sector

Finansinspektionen presented the risks in the commercial property sector. It is a sector that is central to financial stability and has caused many financial crises, for example in Sweden in the 1990s. The sector is cyclically and interest rate sensitive, highly indebted, and closely linked to the banks and the bond market. The sector in Sweden is among the largest in the world in relation to GDP. Both in the period before and during the pandemic, debts in the companies increased faster than profits. As a result of the risks in the banks' large exposure to the real property sector, Finansinspektionen raised the capital requirements of the banks just before the pandemic.

During the crisis, the sector has received a lot of indirect support. Some parts of the sector have been hit hard during the crisis, such as commerce and hotels, while other parts such as housing and industrial properties have gone well. It is too early to assess the long-term structural effects of the pandemic on demand in different sub-sectors. However, as an example, demand for offices could decrease by 10 percent if more people work at home two days a week. A more stable bond market is required to avoid excessive contagion effects if something occurs in the commercial property sector.

§ 4 International questions

The Ministry of Finance gave an update on ongoing negotiations in the EU. There are currently two ongoing negotiations that are expected to be completed in the Council in June. They also briefly outlined some EU proposals expected in 2021.

The authorities discussed the issue of British central counterparties in view of the European Commission's decision on whether to allow them to continue offering their services to EU actors despite their systemic importance or whether they should be relocated to the EU. This is an important issue for Sweden as a significant proportion of Swedish interest rate derivatives is cleared in London.

§ 5 Other stability issues

Preparations for a cyber crisis exercise

The Stability Council Secretariat outlined the work on a crisis exercise to practice cyber threats to financial stability. The exercise will be carried out in autumn 2021. The purpose of the exercise is to practice the joint capacity to manage the effects of a cyber incident.

§ 6 Future work

Ahead of the next meeting of the Stability Council on 8 December 2021, 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 household indebtedness and new risk pictures.