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Minutes from the meeting of the Financial Stability Council held on 6 December 2019

Summary

The Stability Council[1] discussed the stability situation.

The financial system operates satisfactorily at present. Among the risks and vulnerabilities that could threaten financial stability, the low interest rate has increased in importance. Globally and in Sweden, interest rates have been low for a long period, and for some time market actors have expected sustained low interest rates in both the rest of the world and in Sweden. Swedish households' high level of indebtedness continues to pose a major risk in the Swedish economy, and it is important that the macroprudential measures in place are maintained. Against the background of continued low interest rates, the development of increased indebtedness in the commercial property sector is also a significant risk, and banks need to hold additional capital in lending to this sector in order to increase their resilience. The low interest rate environment may also threaten the resilience of pension companies in the long term.

The Stability Council also discussed money laundering and cyber risks. Money laundering is an important area and extensive measures have been taken. The legislation has been strengthened and further steps are underway in the near future. The Government has decided to set up an inquiry to propose further reforms and there will be further international evaluations

[1] Present: *Ministry of Finance:* Per Bolund, Chair, Ulf Holm, Anna Jegnell; *Finansinspektionen*: Erik Thedéen, Karin Lundberg, Henrik Braconier; *The National Debt Office*: Hans Lindblad, Karolina Holmberg, Mattias Persson; *The Riksbank*: Stefan Ingves, Per Jansson, Olof Sandstedt; and *Financial Stability Council Secretariat*: Niclas Alsén.

going forward. Cyber security is an issue that the Stability Council works with and that cooperation will continue.

§ 1 Stability assessment

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

The financial system operates satisfactorily at present, but there are risks. The slowdown in the world economy has contributed to expectations of low interest rates for a long time to come. Also, the trade dispute between the US and China as well as the uncertainty about the United Kingdom's exit from the EU could increase unease in the financial markets. The authorities agree that household indebtedness remains a major risk to the Swedish economy. This assessment is shared by international expert agencies. The growth rate of household debt remains high, but since 2016 it has decreased from around eight per cent to less than five per cent per year, which is positive. Finansinspektionen deems that the macroprudential measures taken are sufficient and sees no need for further tightening. The Riksbank deems that it is important that implemented macroprudential measures remain in place, but at the same time it is important that Finansinspektionen is prepared to act if risks increase. At the same time, the authorities see a need for structural reforms, for example of the tax system and housing policy, to address housing market challenges.

The authorities also agree that persistently low interest rates pose several risks to financial stability. Market actors' expectations of continuing low interest rates in the coming years may contribute to an increase in indebtedness and lead to investors chasing yield, i.e. taking higher risk. Before the financial crisis, many analysts were concerned that risk premiums were depressed. At present there is also cause for concern, as risk premiums are even more depressed and have been so over a longer period today than in the period before the financial crisis. The interest rates on government bonds in many countries are negative far along the yield curve, and this may have several potential spill-over effects.

The National Debt Office highlighted in particular the risk of liquidity deterioration in government securities, which in turn may lead to higher borrowing costs in the long term and also to misallocation when prices do not reflect the underlying risk.

The authorities also discussed the risks linked to commercial property companies. These have large debts that have grown faster than the companies' income. Even a relatively small increase in interest rates can have a major impact on this sector and lead to losses for the banks. Finansinspektionen pointed out that Swedish banks have a large exposure to commercial property companies and that the banks set aside too little capital given the risks.

The authorities further discussed the fact that the pension companies are under pressure from low interest rates, due to their difficulty in obtaining a return on assets matching the guarantees they have given to policy holders. This difference will become troublesome to deal with if interest rates remain low. The cost of future pension liabilities is also underestimated due to the administrative discount rate, which is high compared to market rates. If market rates continue to be low, the financial strength of the companies will continue to deteriorate. It is therefore of great importance that the pension companies maintain significant capital buffers to deal with the risks associated with low interest rates.

Finansinspektionen deems that Swedish banks in general have sufficient resilience, with good profitability, significant capital buffers and high market confidence. The 3 per cent leverage ratio requirement that will be in place is a valuable complement to other capital requirements. At the same time, the Riksbank notes that Swedish banks on average have a lower leverage ratio than many European banks, and the Riksbank's assessment is that a requirement of five per cent should apply to all banks operating in Sweden.

The authorities also discussed risks related to money laundering and cyber threats (see under point two below). The authorities noted that cyber risks have increased in recent years and require in-depth analysis. Cyber risks may pose a risk to financial stability. The National Debt Office also considers that cyber risks may affect the conditions for effective resolution.

The National Debt Office reported that the banks' alignment with the resolution framework is progressing well, that more banks issue "MREL instruments" and that they are issuing larger volumes. The market is established and efficient. This is necessary to make banks resolvable. The National Debt Office pointed out in this context, and in relation to implementing the revised Bank Recovery and Resolution Directive, the importance of being able to continue to impose appropriate MREL requirements on systemically important banks, with regard to both level and composition. The Debt Office believes that this can be achieved within the framework of the new legislation, but it requires Sweden to make use of the flexibility provided by the EU regulatory framework. The National Debt Office assumes this will be the case. Otherwise, the resilience will be weakened, increasing vulnerability.

The authorities noted that the banks' liquidity coverage ratio (LCR) in Swedish kronor has increased significantly recently. Some of the major banks have previously had very low levels, but now the banks' levels are above 100 per cent. The LCR in all material currencies has also increased, which is positive. However, the LCR levels do not provide a good measure of resilience in a time horizon of more than 30 days. The Riksbank has therefore stress tested the liquidity of four banks and measured liquidity needs up to six months. The results of the stress tests show that liquidity needs of banks will increase rapidly if financial stress continues for more than a month, and that the banks will have material liquidity needs after six months.

§ 2 Discussion of analyses and potential measures

Cyber security

The Stability Council discussed work on cyber security and cyber threats in relation to financial stability.

The National Debt Office pointed out that cyber security is important for financial stability. In order to safeguard stability, the authorities need to intensify their efforts to address these risks and to further strengthen the resilience of the financial system. It is important to continue working together on these issues and it is positive that the Government is creating a national cyber security centre. The National Debt Office also welcomes the Riksbank's work with TIBER.

The Riksbank mentioned that there is extensive dialogue on cyber security both within Sweden and internationally. For example, the Riksbank participates in various working groups of the BIS, the ECB and the ESRB and also recently hosted the Nordic Annual Cyber in Finance Conference held in Stockholm in November. The Riksbank is currently working on introducing and adapting the ECB's TIBER-EU framework to Swedish conditions (TIBER-SE). TIBER aims at testing an organisation's cyber security by simulating a cyber attack. The main objectives of the framework are to reinforce resilience to cyber threats in the financial sector, to standardise and harmonise the execution of red team tests across the EU, and to provide support for cross-border testing. Furthermore, efficient coordination is important for sound cyber defence and therefore it is important to find good future forms of cooperation, both between public authorities and with the private sector. The planned national cyber security centre is a good initiative. At the same time, many of the systems in the financial sector transcend borders and therefore international cooperation is also important.

Finansinspektionen gave an account of its supervisory responsibilities in relation to financial companies from a cyber security perspective. Finansinspektionen sees a continuing need to work on these issues going forward.

The Chair of the Stability Council welcomes the ongoing work to explore the possibility of a cyber security centre in Sweden, but also stressed that the work must continue within the Stability Council and that it is important for all parties concerned to follow this issue.

Money laundering

Finansinspektionen thinks that money laundering is a challenge to the Swedish banking system. Finansinspektionen has therefore intensified its supervision and will triple its capacity in the area in the coming years. At the same time, cooperation with the Baltic authorities has increased. Further steps will be taken next year, in which the IMF is expected to review anti-money laundering efforts in the region. Finansinspektionen will also extend cooperation with the Swedish Police Authority and the Swedish Economic Crime Authority.

The National Debt Office noted that money laundering may reduce confidence in banks, affect their profitability and reduce their access to funding markets. Thus, the management of money laundering is fundamentally also a matter of stability.

The Riksbank raised the point that anti-money laundering work is important to ensure financial stability and maintain confidence in the Swedish banking system. The expected cross-border evaluation of anti-money laundering activities by the IMF in the Nordic-Baltic region would be an important complement to other ongoing evaluations.

The Chair of the Stability Council underlined the importance of continuing work in this area. Over the course of the year, the Government has taken extensive measures and submitted three bills to the Riksdag with substantive amendments to the Anti-Money Laundering Act. Further proposals are being developed. In addition, the Government has set up an inquiry on *Stricter measures against money laundering and terrorist financing*. The report is to be presented by 31 December 2020. There is also extensive work at international level and the expected review by the IMF is part of this. It is also important that all parties devote sufficient resources to ensure the success of the fight against money laundering.

Low interest rate environment

The Riksbank raised the point that global real interest rates have fallen over several decades, which is explained by structural forces. Thus, the neutral real interest rate, which is the real interest rate level that neither stimulates nor slows down the economy, has fallen. This means that the Riksbank must reduce the interest rate to a lower level than in the past in order to have an expansionary effect on the economy. Market actors now expect long-term low policy rates, both in Sweden and the rest of the world. Such a situation entails new issues to work on. One example is that when nominal interest rates are low, it is more difficult for banks to obtain revenue, which means that they have to lower their costs. However, the good profitability of Swedish banks has been maintained, largely due to banks benefitting from recent years' steep rise in house prices and thus a high demand for mortgages. The long-term functioning of the European banking sector requires structural measures. Many European banks need to cut costs and reduce the proportion of bad loans.

The National Debt Office pointed out that in an environment of continued low interest rates it is important to maintain the macroprudential measures implemented.

Finansinspektionen pointed out that an additional consequence of low interest rates is the challenge in a downturn. With limited possibilities to reduce interest rates, measures other than monetary policy are required. In such a situation, fiscal policy is the natural tool, but there is a risk that the pressure to ease structurally correct macroprudential measures will increase in a downturn. This would be unfortunate, as it would increase the risks of a future financial crisis.

The Chair of the Stability Council noted that the current low interest rate situation still needed to be discussed within the Stability Council, not least because of the multifaceted nature of the risk and its potential impact on various parts of the financial sector.

§ 3 International questions

The Ministry of Finance presented current EU negotiations. In the negotiation on crisis management of central counterparties, a general approach was adopted in November and trilogue negotiations are expected to start in early 2020. The proposal for a taxonomy for the classification of green investments has reached a political agreement. Work on the implementation of Basel III in the EU has started and a legislative proposal from the European Commission is expected in 2020. In December ECOFIN adopted Council conclusions, i.e. the direction for future policies, on anti-money laundering and the development of the capital markets union. The same ECOFIN meeting also decided on a joint statement by the Council of the European Union and the European Commission on "stablecoins".

The Ministry of Finance presented information on two inquiries that will submit their reports in December; the banking package inquiry, proposing how capital requirement and crisis management provisions are to be incorporated into Swedish law, and the banking union inquiry.

The United Kingdom will go to the polls on 12 December and we are now awaiting the outcome. The Government Offices are ready to start the process of preparing negotiations on the future relationship between the EU and the United Kingdom. In addition, the Ministry of Finance provided the information that the temporary permit allowing EU companies to use UK-based clearing houses will be extended.

With reference to the capital markets union, the Riksbank raised the need to remove technical and legal barriers that make it more difficult for common capital markets in the EU. A willingness to build trust needs to permeate all work on the capital markets union, for example by basing the way financial products are sold on incentives to look at the best interests of the customer. With regard to stablecoins, it is unclear at this stage how appropriate regulation can be achieved. Further analysis of potential risks and discussions at international level are needed, in particular in the regulatory area. Global stablecoins must be regulated in a way that effectively reduces the risks associated with them. It is important that central banks work further on these issues and, where necessary, can offer safe, attractive and stable alternatives to such initiatives.

Finansinspektionen pointed out that regarding the capital markets union there may be reasons for initiatives at the Nordic level.

The National Debt Office welcomed the progress made in the negotiations on a framework for crisis management of central counterparties, which play an important role in the financial system and may suffer losses which, in the worst case, are not covered by the current loss management system. The National Debt Office also welcomed the fact that the Ministry of Finance has created the conditions for the establishment of a crisis management group (CMG) for the Swedish central counterparty Nasdaq Clearing.

The Chair of the Stability Council noted that the capital markets union can both offer opportunities for Swedish actors but also that risks can build up. The Chair also informed that the Riksbank Committee has submitted a proposal for a new Riksbank Act. The proposal has been circulated for comment, including to the European Central Bank, which is expected to submit an opinion in April.

§ 4 Other stability issues

Measure for lending to commercial property companies

Finansinspektionen set out the background to the risks in the market for commercial properties in the stability assessment under item one. The fact that banks underestimate the risks is because their internal models do not fully identify them. There is also a difference between these risks and the risks linked to mortgages, as the latter involve limited direct credit risk. More capital is therefore needed to allow fully for the risks. Finansinspektionen has therefore proposed higher capital requirements for the major banks and is now awaiting comments on this proposal.

Climate risks and possible measures

The Chair of the Stability Council began by noting that the impact of climate risks on the financial market has several dimensions and that existing tools and models are not always adapted to accommodate them. It is therefore important that the authorities follow these issues.

Finansinspektionen works on climate risks in its ongoing supervision, including in the dialogue with financial companies. At the same time, it is a challenging area and Finansinspektionen sees a need to better integrate climate risk into its supervision. Finansinspektionen is working on the development of quantitative risk assessment methods in this area, including via international cooperation on climate stress tests and its own model use. The EU taxonomy is an important instrument for dealing with green investments, but there is also a need for tools to classify brown investments. In addition, it is central to create drivers for the 80-90 per cent of investments that lie between green and brown. Here, measures that drive up the global carbon price are central, but also reporting on carbon price assumptions used by investors could help to identify climate risks in investments.

The National Debt Office welcomed the fact that climate risks and the link to the financial system was on the agenda and presented information about its remit to issue a green government bond in 2020. An evaluation of the issue will take place next autumn and a report will be made in 2021.

The Riksbank mentioned that it is important that the climate related risks can be better measured, priced and managed. Climate risks need to be understood from both a stability perspective and a balance sheet perspective, as central banks themselves invest in different assets. With regard to the management of gold and foreign reserves, good preparedness to fulfil the policy remit of the Riksbank is always the main focus. However, to the extent possible the Riksbank would like to contribute to more sustainable development, which it did recently when the Riksbank sold semi-government bonds in Australia and Canada. Climate risks in the context of financial stability will be part of the IMF's Article IV and the FSAP reviews in the future.

§ 5 Future work

Ahead of the next meeting of the Stability Council on 5 June 2020, the Council's members will continue to work together on the stability issues discussed at the meeting. These include banks' resilience, household indebtedness, risks linked to the low interest rate situation and cyber security.