STATENS OFFENTLIGA UTREDNINGAR

16 June 2023

Financial Stability Committee
Fi 2013:09

Minutes from the meeting of the Financial Stability Council[1] held on 9 June 2023

§ 1 Stability assessment and measures

The authorities presented their stability assessments and discussed possible measures.[2]

The Riksbank pointed out that the Swedish financial system on the whole has worked well, but there are vulnerabilities that pose challenges. This applies not least to the highly indebted commercial real estate companies and banks large exposure to the sector. Although many commercial real estate companies have taken steps to improve their financial position, these are not sufficient. The banks play an important role here, partly by maintaining the supply of credit to viable companies, and partly, within the framework of their lending, by requiring commercial real estate companies to take measures to reduce their financial risks.

Another vulnerability is household indebtedness. Higher living costs as a result of broad price increases and higher interest rates are forcing many households to make significant adjustments. The vast majority of mortgage holders, on the other hand, are expected to be able to meet their debt repayments. The amortisation requirements and mortgage loan-to-value cap have contributed to households amortising more and taking out smaller mortgages than would otherwise have been the case. It is therefore important to retain them. However, it is a good thing that the amortisation

[1]Present: *Ministry of Finance:* Niklas Wykman, Chair of meeting, Johan Almenberg, Anna Jegnell; *Finansinspektionen*: Daniel Barr, Henrik Braconier, Per Nordkvist; *National Debt Office*: Karolina Ekholm, Karolina Holmberg, Erika Färnstrand Damsgaard; *Riksbank*: Erik Thedéen, Anna Breman, Olof Sandstedt; and *Financial Stability Council Secretariat*: Niclas Alsén.

[2] Finansinspektionen presented its report Stability in the Financial System (2023:1) on 30 May and the Riksbank presented its Financial Stability Report 2023:1 on 1 June.

requirements are designed with a certain flexibility, where mortgage holders can get exemptions for special reasons.

There were several events during the bank turbulence in the spring that could be of significance for how global regulatory standards for banks will be designed in the future. It is important to draw lessons from the problems that arose in order to make regulatory frameworks more robust in the future. Many of these issues will therefore be discussed intensively going forward.

Finansinspektionen (FI) noted that high inflation, higher interest rates and a reduced risk appetite continue to entail elevated risks in the financial system in Sweden and globally. The banking turbulence in the USA and Switzerland in the spring shows that risks continue to materialise in the global financial system. At the same time, the impact on Swedish banks has been limited. One explanation is that the interest rate risk and the risks of volatile deposits that existed in the US Silicon Valley Bank are significantly smaller in Swedish banks. At the same time, the rapid and large outflows of deposits from the US banks raise questions about how to improve the management of this type of risk in the future.

In Sweden, households and commercial real estate companies are particularly affected by higher interest rates as they have large debts. An adjustment to a higher interest rate level and a lower willingness to take risk is now being made in that households and businesses are reducing their debts, which should in the long term reduce risks in the financial system. Household debt is now falling in real terms. Based on existing fixed interest periods and the market's expectations of further interest rate increases, households' interest costs will increase further in the coming year. However, mortgage holders as a whole are resilient, among other things as a result of robust credit assessments and the loan-to-value cap and amortisation requirements imposed by FI. FI therefore sees limited risks of significant credit losses from mortgages.

Higher funding costs also put pressure on some commercial real estate companies and especially those with low credit ratings. It will take a year or two before the effect of the higher interest rates is fully felt by the commercial real estate companies, due to the profile of bond maturity, fixed interest periods and interest rate hedges. The most vulnerable companies need to withhold dividends, raise new capital, sell assets and go to banks to secure their finances. It is important that the vulnerable companies act vigorously to avoid losing their room for manoeuvre.

All in all, banks' credit losses are likely to increase in light of the higher interest rates. FI's stress test shows that credit losses in banks as a result of lending to the commercial real estate sector may be significant in a really severe scenario, especially if interest rates are elevated over a long period. FI therefore previously raised the capital requirements for this type of exposure and, in addition, the countercyclical capital buffer is now raised to two per cent as a result of FI's decision in June 2022. The banks' good profitability and significant buffers mean that resilience is satisfactory. In a stressed scenario, banks' credit losses are expected primarily to come from many small commercial real estate companies, i.e. those that borrow only from banks.

The National Debt Office also pointed to the gradual impact of higher interest rates on the financial system. The National Debt Office also emphasised the effects of high geopolitical risks and the increasing number of cyber attacks. In the Swedish government bond market, volatility is now lower, while the decline in liquidity in the market has slowed down recently. It is positive that the Riksbank has started selling its holdings of government bonds, which is expected to improve liquidity. However, the National Debt Office estimates that the government bond market's resilience to shocks is lower compared to ten years ago.

The National Debt Office mentioned that the turbulence during the spring in the American and Swiss banking sectors has raised questions about the frameworks for crisis management. The National Debt Office argued that it is important to conduct this kind of discussion but also that it is important to stick to the principle that it is those who take risk who should also bear the cost of default, not the taxpayers.

The authorities discussed retail payments and Bankgirot. P27 Nordic Payments, the project that was to build a common payment infrastructure in the Nordic region, withdrew its clearing licence application from Finansinspektionen during the spring. Bankgirot will therefore continue to handle retail payments and Finansinspektionen will follow Bankgirot closely from a supervisory perspective. The Riksbank stressed that banks must assume their responsibility for Bankgirot and ensure a well-functioning payment infrastructure. The Riksbank has enhanced its monitoring and is closely following how Bankgirot is managed by the banks.

The Chair summed up the discussion. The financial markets are subject to increased risks when higher interest rates reveal vulnerabilities and adjustment is made in different parts of the financial system. At present, resilience is judged to be good in the system as a whole. The areas that need special attention are the commercial real estate sector, and the risks associated with household indebtedness. Banks need to prepare for increased credit losses, notwithstanding their current strong position. Additional areas that need to be monitored are the liquidity of bond markets, developments in the payment infrastructure and increased cyber attacks in light of the changed security situation. The Chair also noted that stability and security issues are now increasingly linked, but that there is no conflict of objectives between them.

§ 2 Reporting of projects within the Stability Council

Functioning of the bond market

The National Debt Office presented information on the authorities' joint survey of the functioning of the Swedish bond market. The survey is a starting point for further analysis and action.

Liquidity in the bond markets affects market participants' funding and risk management opportunities. In recent years, market liquidity has declined. So far, this has not affected the conditions for the central government or banks to obtain funding. However, in the first instance it has become somewhat more expensive to manage interest rate risk. In a stressed financial scenario, there may be a risk of further deterioration in market liquidity. Participants' ability to raise funding and manage risk may then be reduced.

Overall, the analysis points to a deterioration in the functioning of the bond markets. Market liquidity over the past decade has probably been affected by a combination of regulatory, monetary and fiscal factors, as well as falling and long-term low market interest rates. Strengthened capital and liquidity rules (Basel III) and stricter requirements for central clearing in securities trading have had the effect the regulators intended and have increased banks' resilience and reduced risk-taking. At the same time, the regulations have also changed the conditions for the Swedish bond market, where trading is organised with market makers. In particular, market makers' incentives and financial capacity to take market risk and to hold large trading books of bonds have been reduced. The supply of government bonds has been affected by the Swedish central government's low borrowing needs, which has resulted in limited issuance volumes and a broadly unchanged stock of government bonds. At the same time, the Riksbank's purchases of bonds have led to a reduction in the tradeable volume of bonds. Finally, the development of interest rates up to 2022 has led, among other things, to ever lower returns and a trend among investors to reduce exposure to low-yield assets such as government securities in favour of riskier assets. This has meant lower demand and probably lower liquidity in Swedish government securities.

§ 3 International questions

The Ministry of Finance presented brief information on the work on financial market issues during the Swedish Presidency of the Council of the European Union and presented the status of some of the acts related to financial stability.

§ 4 Completed work within the Stability Council

The Ministry of Finance briefly presented the work carried out within the framework of the Stability Council since the last ordinary meeting in December, in addition to the reports already made at the meeting.

The next ordinary meeting of the Stability Council will be held in December 2023.