REPORT

Stability in the Financial System

23 November 2021

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Stability assessment

The global economic recovery in 2021 has been stronger than expected, in part as a result of powerful support measures. This has meant that bankruptcies and credit losses were limited, which reduced the immediate risks for the financial system. Strong demand also contributed to an increase in inflation globally, but most forecasters and market participants consider the rise in inflation to be temporary. Long-term market rates have not increased significantly, either. However, if the inflation persists, interest rates may rise, which would have an impact on both households and companies since they are noticeably more indebted today than they were before the pandemic. Rising interest rates could also lead to a rise in risk premiums, which are very low today. This could result in, for example, a drop in asset prices and an increase in financing costs. One sector that is vulnerable in such an environment is commercial real estate. Due to rising risks in this sector, banks need to continue to have large capital buffers as well as a need to reduce the vulnerabilities on the corporate bond market and the fund market.

The support measures have been necessary for maintaining economic activity during the crisis and supporting the recovery. In particular, the measures helped stabilise the financial markets, which ensured access to financing during the crisis. Central banks continued their support measures in the form of asset purchases even after the acute period of the crisis. Long-term asset purchases contribute to stability risks by applying pressure to interest rates and risk premiums, which leads to increased risk-taking and higher debt. These types of measures can also have a negative impact on the functionality of the Swedish fixed-income markets. The longer the purchases are made, the greater the risk that such effects become permanent. Since Sweden’s economy has largely recovered and there is good access to financing in the financial system, the phase-out of asset purchasing should begin.

It is now important to once again build up resilience in the financial system. Finansinspektionen (FI) has therefore made the decisions to, for example, withdraw the general possibility of exemption from the amortisation requirement since the end of August and reactivate the countercyclical capital buffer. FI has set the buffer at 1 per cent, and it goes into effect as of September next year. The increase is the first step in a gradual increase towards what FI considers a normal level. FI is also continuing its efforts to strengthen the functionality of the corporate bond market and fund market.

Risk-taking is high

FI takes the position that risk-taking on the financial markets continues to be high Low interest rates have for a long time meant that investors are taking on more risk to gain a return. Despite signs of higher inflation the past year, the low interest rates have largely persisted. During the economic recovery, risk-taking continued to increase. Risk-taking has been diluted by the extensive support purchases of, for example, housing bonds and corporate bonds. Risk premiums are as low, or lower, than they were before the pandemic.

Support measures have driven up asset prices by lowering the price of both capital and risk. Prices of both financial assets and real estate (residential and commercial) have also increased significantly. Rising share prices played a role in households' savings becoming more concentrated in shares and equity funds. The percentage of investments that life insurance undertakings and institutions for occupational retirement provision are placing in shares also continued to increase. High asset prices have resulted in the build-up of vulnerabilities. A drawn-out period of continued support measures could therefore lead to continued risk build-up and incorrect capital allocation. This could result in a stronger correction in asset prices in the future if conditions were to change or a shock were to occur. Triggering factors could be, for example, an increase in interest rates or events that increase uncertainty on the financial markets.

Increase in vulnerability linked to debt

The debt of non-financial corporations and households has been high for a long time. In 2021, household mortgages continued to increase from an already high rate. It is clear that the sharp increase in housing prices has meant that households need to take increasingly larger mortgages. Within the commercial real estate (CRE) sector, demand for both bank- and market-based financing continued to be high. Debt is increasing in relation to the CRE companies' income, more firms are vulnerable, and they are more sensitive to interest rates. FI makes the assessment that the high debt levels are making households and firms more vulnerable and sensitive to disruptions than before the pandemic.

The uncertainty in several industries decreased during the year. The banks' credit loss reserves also fell to pre-pandemic levels, and realised credit losses were limited. Risks continue to build up at the same time in the CRE sector, where the banks have large exposures. Increased vulnerabilities in the CRE sector indicate that the banks continue to need to hold large capital buffers, and FI has already raised the countercyclical capital buffer.

As of Q3 2021, FI will be applying the EU's so-called Banking Package in full. This means, for example, that FI will inform the banks what level of own funds is appropriate in addition to the capital requirements (the so-called Pillar 2 guidance). This guidance is intended to cover risks, or aspects of risks, and stressed situations that are not already covered by the capital requirements. The capital requirements also increased slightly under the Banking Package.

Problems with maturity imbalances and market liquidity

Banks fund themselves to a large extent with debt that has a shorter maturity than their assets. This is a natural part of banks' business models, but the imbalance should not grow too wide. The liquidity requirements on the banks were tightened after the financial crisis, and they therefore entered the pandemic with significantly higher resilience than they had before. A sharp increase in deposits during the pandemic decreased the banks' dependence on market funding, but the inflow of deposits will probably taper off as the economy normalizes and monetary policy support purchases decrease. Therefore, overall the banks' funding is considered to be unchanged and stable.

CRE companies also have a need to regularly refinance parts of their debt portfolio. They have become more dependent on the bond market for both short-term and long-term financing. Disruptions to this market can therefore quickly have an impact on the financing of CRE companies. If risk-taking among investors decreases, it can become more expensive and more difficult for CRE companies to finance themselves on the bond market, particularly for companies with lower credit ratings.

The corporate bond market demonstrated sharply reduced functionality in the spring of 2020, for example in the form of poor liquidity and highly uncertain pricing. Even though it normalized after the crisis phase, the Swedish corporate bond market continues to feature low market liquidity. In the presence of renewed stress on the financial markets, it may become difficult once again to trade securities and issue new financing. This creates a vulnerability for the participants dependent on the market, both issuers and investors. There is therefore a need for additional measures to create a more functional corporate bond market with higher resilience.

A large portion of the participants on the corporate bond market are funds that offer daily redemption. They are therefore dependent on being able to turn assets into cash on short notice. If many funds are selling off similar assets at the same time, this can amplify price fluctuations and thus cause contagion effects. This is particularly relevant on markets with low liquidity. FI takes the position, therefore, that Swedish management companies need to be better at considering the assets' liquidity and managing liquidity risks. This management should be adapted so redemption can occur both in normal times and given the rapid emergence of a financial stress. FI will also follow up on these liquidity tests by conducting its own stress test.

Concentration and interconnectivity increase vulnerability in the financial system

The financial system is characterised by not only concentration but also interconnectivity. Concentration means that systemically important financial services are provided by only a few banks, life insurance undertakings, institutions for occupational retirement provision and infrastructure companies. The financial firms also share an interconnectivity in, for example, financing, investments, and the exchange of systemically important services. This means that problems at one participant can quickly spread to others, which can have a major impact on the functionality of the financial system. This interconnectivity in the Swedish financial system therefore contribute to the vulnerability of the system.

Concentration risks can also arise through large exposures to individual sectors and counterparty risks. The CRE market represents both a majority of the banks' lending to corporates in Sweden and a large share of the total lending on the Swedish corporate bond market. If the sector were to experience problems, this could impact both banks and other lenders in their role as investors in the CRE companies' shares and bonds. FI therefore makes the assessment that the financial system's concentration to the CRE sector is a clear vulnerability. This concentration risk continued to increase during the pandemic. Potential structural changes as a result of new work and consumption patterns after the pandemic are also contributing to elevated uncertainty about the outlook for the CRE market.

Another concentration that is increasing is the exposure of both households and insurance undertakings to the equity market. FI makes the assessment that life insurance undertakings and institutions for occupational retirement provision have satisfactory buffers for being able to handle even large falls in equity prices without enhancing market fluctuations through large sell-offs. Household wealth could drop significantly if equity prices fall, which could result in households increasing their saving and thus reducing their consumption.

Risks and vulnerabilities linked to cyber attacks are increasing. The number of attacks is rising, as is their scope. The interconnectivity of the financial system increases vulnerability to cyber attacks. An incident at a systemically important market participant could rapidly result in consequences for the rest of the financial system. It is therefore important to continue to strengthen the preventive measures combating cyber attacks. Together with Sveriges Riksbank, FI has started a project to develop a cyber strategy for the financial sector. The strategy, which will be developed under the auspices of the Financial Stability Board, will also involve the national cyber security centre.

Concentration and interconnectivity are phenomena that are difficult to avoid and can change slowly over time. FI is therefore focusing primarily on ensuring that systemically important actors and markets are sufficiently resilient to be able to manage disruptions without too much of an impact.