REPORT

Stability in the Financial System

31 May 2022

Stability assessment

In 2021 and the start of 2022, global inflation increased sharply. Russia's invasion of Ukraine is causing widespread human suffering. From a financial perspective, the invasion is further exacerbating inflation and contributes to the slow-down in global economic growth this year. The uncertainty resulting from the pandemic has declined significantly. Many countries no longer consider the pandemic to be a threat to society and have therefore lifted restrictions. However, the new and continued lockdowns in China are affecting logistics chains and thus also inflationary pressure. The high inflation has meant higher interest rates and rapidly rising interest rate expectations. How inflation and interest rates develop will have a major impact on financial stability.

In the short term, the transition to higher interest rates will lead to elevated uncertainty and greater risks. An extended period of very low interest rates has resulted in high risk-taking, which is evident from rapidly rising debt and high prices for housing, real estate and financial assets. Greater uncertainty in the valuation of assets has already resulted in sharp downturns on equity markets. Large and rapid falls in asset prices can have a negative impact on financial stability, but, in the long term, rising interest rates that lead to more normalised interest rates can also contribute to a decrease in risk-taking among households, firms and in the financial system. Higher interest rates mean higher financing costs and higher risk premiums, which normally results in a more restrictive valuation of assets and lower asset prices. Borrowing also becomes more expensive, which can slow debt growth. Therefore, the current developments could lead to a decrease in the risks posed to financial stability in the long term.

One sector that is particularly vulnerable to higher interest rates is the commercial real estate sector. In this sector, higher interest rates mean both impaired profitability from higher financing costs and potentially weaker balance sheets due to lower real estate prices. The large debts in the commercial real estate sector mean that both the banking system and other parts of the financial system are highly exposed to the sector. Finansinspektionen (FI) has previously highlighted the risks the commercial real estate sector poses to financial stability. These risks have further increased through the combination of continued growth in debt, rapidly rising interest rates and higher credit risk premiums on the bond market.

Even households have taken large loans that make them sensitive to higher interest rates. For households with large debt and small margins, the effect of higher interest rates can be significant. FI still makes the assessment that household debt is a macroeconomic risk rather than a risk to financial stability.

Central banks around the world are about to face difficult trade-offs in their monetary policy over the next few years. Inflation is high at the same time as growth is slowing. Monetary policy can be tightened through both interest rate increases and reduced quantitative easing. FI has previously emphasised that long-term quantitative easing and holdings of securities can lead to stability risks by applying downward pressure on risk premiums, which leads to increased risk-taking and higher debt. Quantitative easing can also contribute to impaired liquidity on the bond market. FI therefore welcomes the start of the Riksbank's reduction in its securities holdings during the second half of the year.

Overall, the financial stability risks in the immediate future have increased. This demonstrates the importance of resilience among households and firms and within the financial system. FI aims to raise the countercyclical buffer rate in June to a neutral level of 2 per cent in order to further strengthen the banks’ capital buffers. We are also continuing to work to improve how the corporate bond and fund markets function in order to mitigate risks and vulnerabilities in the presence of stressed market conditions. FI has also been given a more active role in strengthening the resilience of the financial sector to cyber attacks.

Risk-taking is high

The willingness to take on risk decreased in 2022, which is evident in part by higher risk premiums. Despite this, FI continues to make the assessment that risk-taking on the financial markets is high. An extended period of low interest rates has meant that investors have taken greater risks to get a return. Drawn-out support measures related to the pandemic have driven up asset prices by lowering interest rates further and reducing risk premiums. Prices on both financial assets and real estate are high, even if share prices fell during the beginning of 2022.

Rising share prices have played a role in households’ savings becoming more concentrated to shares and equity funds in recent years. The percentage of investments that life insurance undertakings and occupational pension undertakings are placing in shares also continued to rise. FI makes the assessment here that the investment risk has increased. Higher asset prices have led to the build-up of vulnerabilities. Rising interest rates and interest rate expectations can thus lead to substantial price corrections and large fluctuations in prices, particularly for assets associated with high risk and sensitivity to changes in the interest rate.

Rising debt leads to greater vulnerabilities

Non-financial corporations and households hold considerable debt. At the start of 2022, households’ mortgages were growing at an increasing 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 sector, demand for both bank- and market-based financing continued to be high. Debt has increased in relation to real estate firms’ revenue. These firms have thus become more sensitive to interest rate changes. FI makes the assessment that the high level of debt has meant that households and firms are more vulnerable and sensitive to shocks.

The banks’ credit loss reserves and realised credit losses are still limited. FI makes the assessment that the banks’ resilience is satisfactory, as is their ability to issue credit even if market conditions were to deteriorate. In the long run, weaker growth and higher interest rates could lead to impaired profitability and larger credit losses for the banks. The banks’ large exposures to the commercial real estate sector mean growing vulnerability. This indicates that the banks will continue to need to have large capital buffers. FI is therefore planning to raise the countercyclical buffer rate in June to a neutral level of 2 per cent (see the fact box *FI intends to raise the countercyclical buffer rate to 2 per cent*).

Impaired liquidity on the bond markets

During the pandemic, bank deposits increased sharply, and deposit volumes are still higher than they were before the pandemic. This has reduced banks' dependence on market funding. At the same time, the banks’ costs for market lending have increased since the end of the year as inflation and interest rate expectations have risen. Overall, FI makes the assessment that the banks’ financing situation is somewhat more stressed than it was in the autumn, but that it continues to be stable.

Commercial real estate firms need to refinance parts of their debt on an ongoing basis. They have become increasingly dependent on the corporate bond market for both short-term and long-term financing. If risk-taking among investors decreases, it can become both more expensive and more difficult for these firms to finance themselves on the securities market, particularly for firms with lower credit ratings. This in turn can impact profitability in the sector and create problems for some firms.

The Swedish corporate bond market has functioned poorly during periods of elevated uncertainty and financial turbulence. During the spring of 2022, turnover on the secondary market decreased once again, and issued volumes have also fallen. FI therefore considers the refinancing risk for commercial real estate firms in particular to have increased.

At the end of 2021 and the beginning of 2022, liquidity on the markets for government bonds and covered bonds also declined, a development that can be attributed to several potential factors. One contributing factor is that there is less volume available for trading. This is in part due to the fact that the Riksbank now holds large parts of the outstanding volume. Poor market liquidity means greater vulnerability during stressed market conditions. The banks’ financing terms can also worsen as a result of poorly functioning markets.

Concentration and interconnectivity increase vulnerability in the financial system

The financial system is characterised by not only concentration but also interconnectivity. *Concentration* refers to the provision of systemically important financial services by a few banks, infrastructure companies, and life insurance and occupational pension undertakings. Financial firms also share an *interconnectivity* in, for example, financing, investments, and the exchange of systemically important services. Through potential spillover effects, this interconnectivity in the Swedish financial system makes it vulnerable.

Concentration risks can also arise through large exposures to individual sectors and counterparty risks. The commercial real estate sector represents a large share of the banks' lending to corporates in Sweden as well as a large share of the total lending on the Swedish corporate bond market. A higher share of market financing by the commercial real estate firms has decreased the concentration risks in the banking sector to the real estate sector. At the same time, concentration risks to the real estate sector have increased in other parts of the financial sector that invest in the commercial real estate firms' shares and bonds. FI therefore makes the assessment that the financial system's concentration to the commercial real estate sector is a clear vulnerability.

Another concentration that is increasing is the exposure of both households and insurance undertakings to the stock market. FI makes the assessment that life insurance undertakings and occupational pension undertakings have satisfactory buffers to handle even large falls in share prices without enhancing market fluctuations through large sell-offs. Household wealth can decrease sharply if share prices fall. This, in turn, could result in households wanting to increase their savings, thus reducing their consumption.

Risks and vulnerabilities associated with cyber attacks have increased over a long period of time. The number of attacks is rising, as is their scope. The risks have further escalated given the current security policy climate. The financial system provides fundamental infrastructure for society that needs to continuously be available, and it is therefore an attractive target for cyber attacks. The high degree of digitalisation of and the interconnectivity within the financial system further increase the vulnerability to cyber attacks. It is therefore important to continue to strengthen the measures to prevent cyber attacks. In March, the Government assigned FI the task of submitting a proposal for how to strengthen the financial sector's resilience to cyber attacks. FI has proposed, among other things, a substantial increase in the ambition level of its supervision of financial firms' cyber risks, allowing the Swedish National Defence Radio Establishment to assist financial firms, and accelerating the establishment of a national cyber security centre.