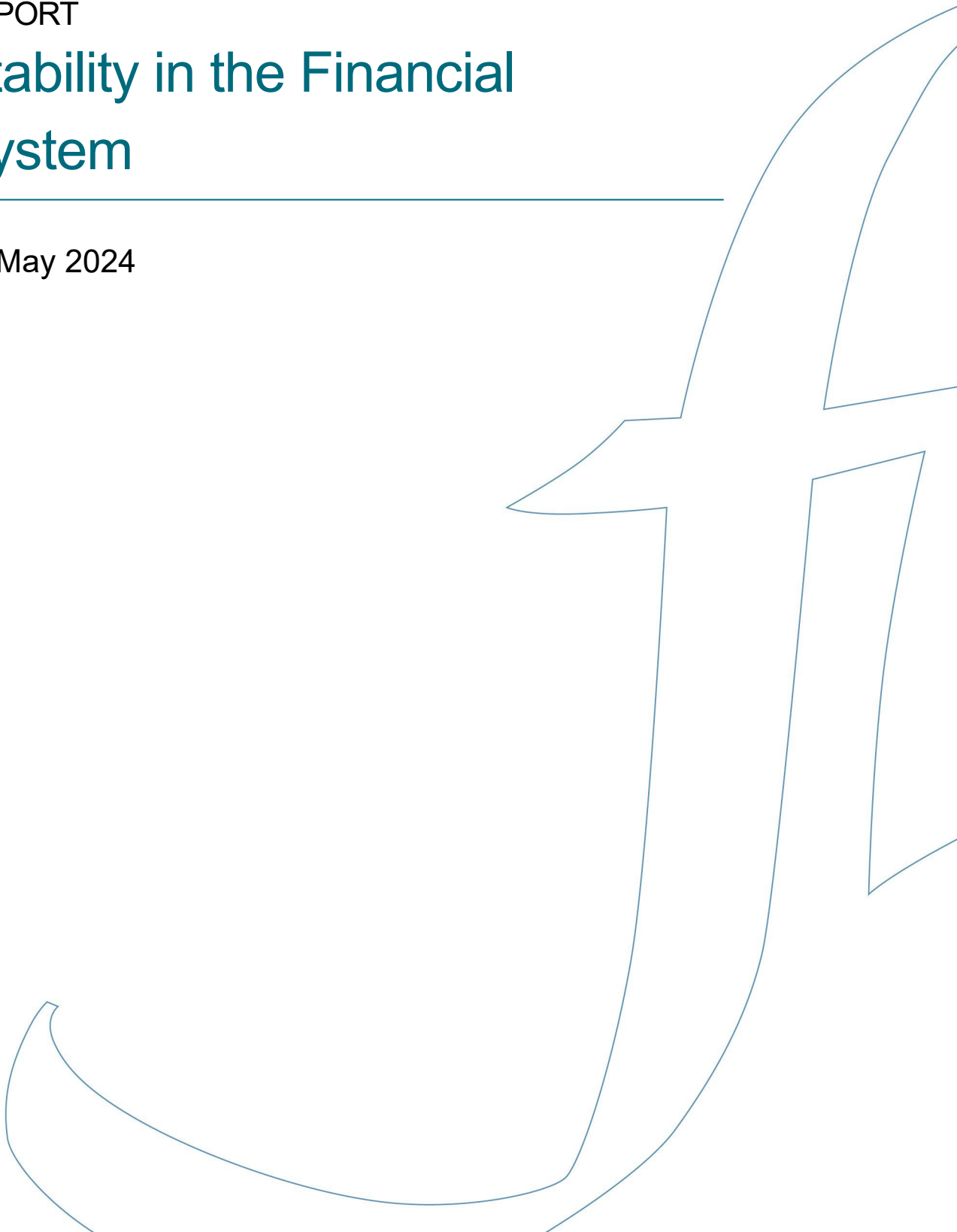




REPORT

Stability in the Financial System

27 May 2024



Stability assessment

Inflation in Sweden has continued to decrease during the start of 2024 and is now close to the Riksbank's target. At the same time, the economy is still in a recession, and GDP has contracted for four consecutive quarters. The Riksbank has lowered the main policy rate to 3.75 per cent, and market actors are expecting more cuts to the policy rate in the coming year. This has contributed to a recovery in risk appetite among investors. However, if inflation does not slow or the key rate is not lowered in the manner expected, there is a risk of negative reactions and increased uncertainty on the financial markets.

Even if the policy rate is expected to come down somewhat in the future, implied markets pricing is indicating that the interest rate will not come down to the same low level that it had been at for a long time before global inflation rose. The tightening of financial conditions due to the higher interest rate levels is putting pressure on highly indebted households and firms, which means that some vulnerabilities in the financial system continue to be elevated. In addition, the cost and price levels are significantly higher than they were several years ago, which has decreased households' financial scope. Because interest rates are higher, the growth rate for banks' lending to households and non-financial corporations is at historically low levels. The low credit growth and a more cautious development in housing and property prices indicate that the build-up of cyclical systemic risks is decreasing (see Diagram B1 in the appendix).

In the commercial segment, some sectors are facing significantly weaker demand. The number of bankruptcies has risen to high levels, but the banks' exposures to the industries that have been hit the hardest are relatively low. The outlook for the commercial real estate (CRE) sector has improved, however. A number of firms have lowered their debt, but some are still vulnerable with a low interest coverage ratio and a high LTV ratio.

The current economic downturn – which has put pressure on many households and firms – entails an elevated risk of credit losses within the banking sector. In general, thanks to their large buffers and good profitability, banks are resilient enough to be able to also handle a considerable worsening of the economy.

The increased tensions around the world have further weakened the global security policy situation. Ongoing conflicts may impact the real economy, for example through supply shocks. The interconnectedness of the financial sector also means that operational stability risks, such as cyberattacks, could spread quickly and have large consequences on the financial system.

Overall, the outlooks for financial stability have improved somewhat, and uncertainty has decreased compared to last year. However, there is still uncertainty

about both the full economic effects of the previous upswing in inflation and interest rates and the speed at which interest rates will come down.

Risk appetite is recovering

Financial market development continues to be influenced by market participants' interest rate expectations. Due to expectations of lower interest rates and brighter economic outlooks in 2024, risk appetite among institutional investors has recovered. This is reflected in higher share prices in relation to future expected profits and lower risk premia on the credit market since the fall. The stress on the Swedish financial markets has also clearly decreased since last year.

Sectors that are sensitive to interest rate changes – in particular the commercial real estate sector – have benefited from the lower interest rate expectations. The commercial real estate sector has outperformed the general stock market index since interest rates began to come down last year. However, the performance of smaller listed firms has been significantly weaker than that of the largest Swedish corporations. The higher interest rates in the past year appear to have contributed to an increased risk awareness among investors, who appear to place greater importance on company-specific risk than they did previously. Risky assets can also be sensitive to sudden price fluctuations in an environment with increasing risk appetite, particularly when the economy is weak and geopolitical uncertainty has increased.

Dampened debt development

The debt of non-financial corporations increased over a long period of time. However, the higher interest rates in the past year have resulted in a sharp decline in the annual lending growth rate, and loans are now decreasing. A number of CRE firms have taken action to reduce their vulnerability by amortising loans that have high interest rates and extending fixed interest rate periods on parts of their loans. Despite this, some real estate firms are vulnerable due to low ICRs and high LTV ratios. Even if the situation in the sector has improved somewhat, risks remain. One particular risk for the sector is that earnings come under pressure due to higher vacancy rates, which would impair the ability of the CRE firms to pay back their debts.

The higher interest rate environment has now had more of an impact on households, which are directing a larger portion of their income to paying interest expenses. Together with the high level of costs, this is resulting in poor sentiment among households, even if they have become more positive about the future. Growth in household loans is low, which means that their debt in relation to disposable income is continuing to decrease. Housing prices have remained largely unchanged in the past year, but there are now signs that activity on the housing market is picking up. As interest rates come down, financial margins go up and

consumption opportunities improve. However, higher unemployment can dampen such a development.

Banks' provisions for expected credit losses have increased since the autumn of 2022 but are still at low levels. The challenging economic conditions facing firms and households may entail that banks' provisions and credit losses might increase. At the same time, the banks have good profitability and significant buffers which enable them to continue to grant loans even if the economy were to decline considerably. Finansinspektionen (FI) therefore intends to leave the countercyclical buffer rate unchanged at 2 per cent. FI's assessment is that the low growth rate in lending is primarily driven by lower demand from borrowers rather than a limited supply of credit from the banking sector.

Somewhat improved liquidity on the bond markets

Liquidity on the government bond and covered bond markets has been low for a long time. As a result, these systemically important markets can be vulnerable to shocks at a time of heightened stress. The higher interest rates have contributed to interest-bearing securities becoming more attractive than before. At the same time, the volume of available bonds is increasing since the Riksbank is decreasing its holdings.

FI's liquidity indicators are showing that liquidity has improved for both government bonds and covered bonds compared to last year. This improvement is confirmed by the Riksbank's and the Swedish National Debt Office's surveys, where market actors report improved market liquidity.

The recovery in risk appetite has also led to lower risk premia on corporate bonds. This has presented firms with better conditions for raising financing via the capital market, which reduces their refinancing risks. Despite this, liquidity is limited. It therefore continues to be important for fund managers to be able to manage their liquidity risks in a satisfactory way so they can meet redemption requirements even in stressed situations, particularly in funds that invest in corporate bonds.

Deposits are a key component in banks' financing. Over the past year, deposits from households and non-financial corporations decreased slightly, but banks have good and stable access to market funding. The weak economy could lead to both households and firms needing to further reduce their deposits with the banks. Given Swedish banks' good profitability, proven business models, and significant liquidity margins, FI still makes the assessment that there is a low risk of bank runs or a lack of confidence in the market that could introduce funding problems for these banks.

Concentration and interconnectedness introduce vulnerabilities into the financial system

The financial system is concentrated and closely interlinked. The clearest example is the banking sector, which is largely concentrated to the major banks despite increased competition on the banking market in recent years. Banks' large exposures to the CRE sector, and life insurance and occupational pension insurance undertakings' significant exposures to the banking sector are other examples of concentrations and interconnectedness in the financial system.

Interconnectedness and concentration are also key vulnerabilities in the operational function of the financial system. The increased tensions around the world have worsened the global security situation. The risk of conflict spreading in one form or another has increased. This raises the risk that the financial system will be exposed to cyber attacks. The high degree of interconnectedness in the financial sector means that such attacks can quickly spread and lead to extensive disruptions that could have a major impact on financial stability. FI makes the assessment that the resilience to various shocks has not been built up quickly enough even if awareness among firms has increased in general. One important step for reducing vulnerabilities is the preparations that are made to enable compliance with the EU's Digital Operational Resilience Act (DORA)¹.

Outsourcing can contribute to operational vulnerability if many financial firms become dependent on a few suppliers of critical services. It can be more effective, safer and cheaper for a firm to outsource critical services, but there is also a risk that shocks will spread in such a way as to impact the entire function of the financial sector. Therefore, the DORA regulation, which contains specific rules for management of the risks associated with outsourcing linked to digital resilience, will soon enter into force and is a welcome addition.

¹ Regulation (EU) 2022/2554 of the European Parliament and of the Council of 14 December 2022 on digital operational resilience for the financial sector and amending Regulations (EC) No 1060/2009, (EU) No 648/2012, (EU) No 600/2014, (EU) No 909/2014 and (EU) 2016/1011.