REPORT

Stability in the Financial System

28 November 2023

Stability assessment

In 2023, not only did inflation fall globally, but it is also expected to drop further in 2024. At the same time, there is continued insecurity regarding what measures central banks will take and how the interest rate will develop. There continues to be a weak outlook on global economic development due to the high interest rates.

As a result of the higher interest rates, actors on the financial markets and borrowers have needed to make adjustments, and Finansinspektionen (FI) is now seeing a drop in risk-taking. These adjustments have created an environment in which stability risks can be quickly exposed. For example, at the beginning of 2023, a number of large international banks experienced significant problems, which led to defaults and fire sales. Even if Swedish institutions have not been directly impacted, the events show that uncertainty is present. Multiple vulnerabilities may be exposed in the near future, in both the global financial system and the Swedish financial system.

Commercial real estate firms in Sweden are particularly vulnerable as they have high debt, are very sensitive to changes in the interest rate and have a substantial need to repeatedly refinance their debt. It is therefore important for highly indebted commercial real estate firms to reduce their debt and strengthen their equity so the sector is not forced to implement more uncontrolled adjustments in the future. Households have also been impacted, and their economic margins have declined.

Swedish banks are currently very profitable but there is an increased risk of greater future credit losses in the bank system due to deteriorated conditions for companies and households. However, FI believes that Swedish banks are resilient to the challenges that may arise thanks to their liquidity and capital buffers.

Uncertainty in the geopolitical sphere continued to rise in the past six months and security, particularly for Sweden, has deteriorated. Being that the financial system is digitalised, the risk of cyber attacks or other forms of sabotage has risen. Attacks on sensitive parts of the system can have an impact on critical functions and, in the long run, can throw financial stability into disorder. It is FI's assessment that financial actors will need to strengthen their digital resilience.

Though insecurity regarding how much interest rates will rise has declined, there is greater insecurity regarding how long the interest rates will remain high. Higher interest rates result in smaller margins for many households and companies. If interest rates remain high for a long period of time, the burden will increase for more people and institutions. Such a development would entail a greater risk of problems in the financial sector as well. Simultaneously, the current environment entails that risk taking and debt build-up have slowed, resulting in less vulnerability in the longer term.

Less willing to take on risk

With the interest rate increases and a weaker economic outlook, more actors are striving to decrease their risk-taking. These adjustments have resulted in higher risk premiums in both the stock and fixed-income markets, for example.

Risk premiums have primarily increased for sectors with business models that are sensitive to interest rate fluctuations or whose returns come at a far later date. Examples of these are the commercial real estate sector and growth firms. For these sectors, the result has been substantial drops in share prices and significantly higher interest rate increments on bonds. More than for larger undertakings, the risk premiums for smaller undertakings has risen significantly as investors are increasing their focus on company-specific risk. This development will be strengthened and potentially lead to additional price corrections and market turbulence if interest rates continue to rise or remain on the same high levels.

The fact that undertakings are less willing to take on risk is having an impact on their possibilities for financing via the equity and bond markets. There have been very few issues on the stock market in 2023 and costs have been high on the bond market, especially for commercial real estate firms and firms with lower creditworthiness. The firms can therefore not fully replace maturing market financing, which will be problematic if the situation persists for a longer period of time.

Large debts growing at a slower rate

In 2023, there has been a slowing of the rate at which corporate debt has been increasing, and the build-up of household debt halted entirely. However, the level of corporate and household debt remains high.

Commercial real estate firm debt has been increasing sharply for a long time, making them vulnerable to higher interest rates and creating a need to refinance large sums for loans that are maturing. The higher interest rates have decreased their profitability and resulted in the beginning of downward adjustments to real estate valuations. The current valuation of listed real estate firms indicates that the market is attributing a significantly lower value to real estate assets than those the firms themselves report. FI anticipates that reported values will continue to experience downward adjustments, especially in the case that interest rates remain high. Impaired profitability and lower property values in relation to the size of debt entails that the risk of exposures for real estate firms will increase for banks and other financiers in the sector.

Households are also sensitive to interest rate increases due to high debt with short interest rate adjustment periods. In 2023, household margins decreased as a result of higher interest rates combined with high inflation. Vulnerabilities related to

households' cash flows have therefore begun to be tested, even if most mortgagors continue to have satisfactory margins. High interest rates for a prolonged period would put further strain on households with limited margins. Weak price development on the equity and housing markets can also have a negative impact on households' assets. FI assesses that the primary risk associated with high household debt is a decrease in consumption, which can amplify a macroeconomic downturn.

The banks' credit loss provisions and realised credit losses are still low, but the deterioration in the conditions for firms and households means that the banks' provisions and credit losses will probably increase. However, banks also have significant buffers and thus the resilience to take on even a sharp economic downturn. FI therefore makes the assessment that the banks can handle significant credit losses and continue to issue loans even if the market conditions were to decline significantly. To ensure this, it is crucial that the banks also continue to hold large capital buffers. FI previously decided that the countercyclical buffer rate will be raised to 2 per cent, and intends to leave this level unchanged. Though an additional raise would increase resilience, FI assesses that it is not justified considering the slowing of both debt build-up and risk-taking (also see in-depth review "FI aims to leave the countercyclical buffer rate unchanged in the fourth quarter.").

Maturity imbalances and poorly functioning bond markets can create problems

Liquidity on the government bond and covered bond markets has been low for a long period of time. FI makes the assessment that so far this has not impacted the state's or the banks' ability to raise funding, but these central and systemically important markets can be vulnerable to disruptions given the current market conditions.

Liquidity has also been weak on the market for corporate bonds. Poor liquidity on the secondary market leads to uncertainty in pricing and can make financing on the primary market more difficult. A lack of market liquidity also increases the liquidity risk in the funds that are investing in corporate bonds. Currently, FI sees the greatest liquidity risks in funds with exposures to corporate bonds with lower credit ratings.

Reduced risk-taking has impacted the primary market for corporate bonds where issue volumes are still limited. This has particularly impacted commercial real estate firms and firms with lower credit ratings. Due to unsatisfactory financing on the corporate bond market, FI assesses that the commercial real estate firms' refinancing risk is currently very high.

Deposits are a key component for the banks' financing. During the pandemic, bank deposits increased sharply, and they are still at a high level. This has reduced banks' dependence on market funding. Access to market financing continues to be good, but the cost of it has continued to increase at pace with rising interest rates. The economic development may result in both households and firms needing to reduce their deposits in the banks. Individual banks may also become subject to runs if confidence in the bank decreases, as we have seen in US and Swiss banks during the year. At the same time, Swedish banks have high profitability, proven business models and significant liquidity margins and are thus able to handle large withdrawals for a short period of time. To manage different types of events, it is crucial to safeguard these liquidity buffers (see also in-depth review "Deposit volatility"). Overall, FI makes the assessment that banks continue to have a good funding situation.

Concentration and interconnectivity increase vulnerability in the financial system

The financial system is concentrated and closely interlinked. The banks' large exposures to the commercial real estate sector are one type of such concentration. Other parts of the financial sector also finance the commercial real estate sector through equity shares and corporate bonds. Problems in the real estate sector could therefore quickly spread through large parts of the financial system. More restricted access to market financing increases the pressure on the banking sector to provide financing. When banks need to increase their lending to corporate real estate firms, their concentration toward the sector further increases.

Concentration also occurs when financial instruments are cleared with a central counterparty to reduce counterparty risks. Risk management is concentrated to the central counterparties which become a very important part of the financial infrastructure. In 2022, margin calls increased sharply for members of central counterparties that cleared electricity market instruments. The situation has now improved, primarily due to lower electricity prices. The 2022 development resulted in more actors going over to clearing contracts bilaterally outside central counterparties. An increase in the share of bilateral clearing can lead to deterioration of price-setting, reduced transparency and negative stability effects as bilaterally cleared contracts are not covered by the risk-mitigating tools and measures that trading with central counterparties entails.

The payment system is clearly interlinked in the banking sector. The tapering off of P27 development marks the end of a key modernisation of the payment system in Sweden. It is therefore important that the initiative that Bankgirot is now taking to modernise the Swedish payment infrastructure is completed and adapted to existing needs and set requirements. FI will be monitoring this development closely.

The concentration risk is further exacerbated by the fact that financial corporations are increasingly purchasing critical operations from external suppliers. Some services are only provided by one or a few suppliers. This means that functions and expertise are concentrated to individual actors who end up playing a crucial role, especially in terms of operational resilience. For the financial system in general, the concentration to a limited number of actors combined with existing interlinkage poses a risk of disruptions spreading in a way that can have serious consequences for the functioning of the financial system.

The financial sector's interlinkage and increased digitalisation has resulted in greater vulnerabilities to cyber-related attacks and incidents. The financial sector is a conceivable target for attacks as it manages large volumes of capital, is critical to society and is largely digitalised. Cyber security matters are thus very important for financial stability and the entire economy. The risks of different types of attacks have increased after Russia's full-scale invasion of Ukraine and the resulting deterioration in the security situation brought on by the war. FI's overview of cyber security in the Swedish financial sector is that many firms are working actively to build up resilience, but it is clear that some actors have come further in their work than others and that there is a considerable need for cooperation to increase resilience.