REPORT

Stability in the Financial System

20 November 2024

Stability assessment

Sweden is experiencing a mild economic downturn, and unemployment is relatively high. However, the lower inflation and the Riksbank's interest rate cuts are contributing to increased optimism about the future, primarily for households. The economy has begun a slow recovery that is expected to continue into next year. How the economy will develop is dependent on households' and companies' expectations about the future as well as global growth. While the US economy has shown resilience, growth has been weaker in the euro zone.

The economy is also sensitive to a potential escalation in ongoing conflicts. There is an elevated risk that a deterioration in the geopolitical situation will impact global trade and energy prices adversely. This also means that the risk of cyber attacks on the financial sector could increase further. This places higher demands on digital operational resilience, and work is ongoing in the financial sector to strengthen this. Finansinspektionen (FI) also coordinates measures in the civil contingency sector for financial services to prepare for a heightened state of alert.

In this environment, investors' risk-taking has increased during the year. The risk appetite has benefited from the central banks cutting their policy rates and also communicating their intentions to make further cuts. As a result, the stock market has risen during the year while credit risk premiums have declined.

In the real economy, households and non-financial corporations are continuing to be cautious and restrictive in their consumption and investments. Household savings are high from a historical perspective, and household debt is decreasing in relation to disposable income. Non-financial corporations' bank loans are decreasing, while commercial real estate firms' total debt is relatively stable. Lower interest rates mean that the pressure on commercial real estate firms is starting to lessen somewhat, but the firms that are more vulnerable should continue to work to strengthen their financial position.

The banks have experienced a period of historically high profitability, but their net interest income has plateaued. The uncertain state of the economy continues to contribute to higher credit risk for Swedish banks, which have low credit losses, though, compared to their European counterparts. Swedish banks also have good liquidity coverage and are assessed to be able to manage stressed scenarios. The vulnerabilities for both the insurance sector and the fund sector are largely unchanged. The fund managers affected by the procurement of the new fund marketplace need to prepare for the coming transfers of premium pension capital to avoid the occurrence of any potential problem.

Taken together, the financial stability outlook has improved somewhat since the last stability report. The economy is weak, but interest rates are coming down and low credit growth is helping to reduce the build-up of cyclical systemic risks. FI makes the assessment 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. FI therefore intends to leave the countercyclical buffer rate unchanged in Q4 2024.

Increase in risk-taking in the financial markets

Expectations of additional interest rate cuts and an economic recovery are impacting the development on the financial markets. Investors' risk appetite has increased, and market volatility is rather low.

The stock market rose clearly during the year, and the OMX 30 index is close to its historical peak in nominal terms. The number of initial public offerings also increased compared to last year, which indicates a more positive atmosphere. Some segments on the market, for example the technology sector in the USA, are highly valued in relation to expected future profit growth. This could make them particularly sensitive to unexpected and unfavourable events. Because the sector also has a large market share on the stock exchange, a negative development could have an impact on broader equity indices.

Credit risk premiums have decreased gradually and are currently at their lowest level since mid-2022. Firms have been able to issue bonds in SEK to a greater extent than before, which broadens their financing options. In contrast, however, the conditions for foreign currency have not yet improved sufficiently for commercial real estate firms to issue bonds in other currencies to a greater extent. This could indicate that foreign investors are currently being cautious about increasing their holdings of bonds of Swedish commercial real estate firms.

Risk-taking on the financial markets is increasing despite elevated uncertainty related to both the weak economy and the serious security situation, which means that the financial markets could be sensitive to adverse developments. The sudden increase in volatility at the beginning of August is an example of this. If global risk premiums are suddenly revalued, this could lead to strong price corrections on the financial markets, particularly for risky assets.

Dampened debt development

The low credit growth in the economy is helping to reduce the build-up of cyclical systemic risks and also signalling that the financial conditions in the economy remain tight.

Households are continuing to be cautious due to the dampened economic growth and are choosing to save more. The interest rate for new mortgages has begun to turn downward, but households' interest expenses in relation to disposable income are still high. Growth in lending to households is increasing slowly but is still low due to the higher interest rates and the weak economy. Household debt in relation to disposable income is decreasing, however, which in the long term makes households less vulnerable to unforeseen events. With lower interest rate expenses and greater optimism about the future, it is likely that household consumption will pick up again well into next year.

The annual growth rate in lending to non-financial corporations is negative and continuing to decrease. This is break in the trend come after a long period of steady increases in lending to non-financial corporations. Commercial real estate firms' total debt has remained relatively unchanged since mid-2022. Debt in relation to operating profit is still decreasing moderately, while the loan-to-value ratio has turned downwards following a stabilisation in real estate values. Given the uncertain state of the economy, vulnerable commercial real estate firms should continue to focus on strengthening their balance sheets and reducing their debt.

Improved market liquidity, but maturity imbalances a vulnerability

Liquidity on the government bond and covered bond markets has started to improve from low levels. FI's liquidity indicators indicate that liquidity on the bond markets has improved compared to last year, particularly for government bonds. The driving factors are primarily lower transaction costs, lower volatility, more securities that are traded regularly, and larger transaction volumes compared to the past year. The proportion of market actors that consider liquidity in both government bonds and covered bonds to be good right now has increased this year compared to last year. A similar trend is also evident for corporate bonds with an investment grade rating, according to the Riksbank's financial markets survey.[1]

Despite this, the bond markets are vulnerable to disruptions in the event of increased stress. Market makers'[2] risk mandate and incentives to hold large bond trading books have decreased in recent years.[3] This can be expected to impact market liquidity in stressed periods. There is a similar uncertainty about liquidity in stressed situations on the equity and foreign exchange markets since trading in recent years has become more automated and fragmented. When market uncertainty spiked and the stock markets fell at the beginning of August, trading on the international stock exchanges for the most part still continued in an orderly manner. The markets recovered quickly, with limited contagion effects. However, this event could be an example of underlying vulnerabilities on financial markets

[1] For more information: Financial Markets Survey, Sveriges Riksbank, Autumn 2024.
[2] Market makers undertake to provide bid and ask prices on the secondary market.
[3] To read more: ”Obligationsmarknaderna – en kartläggning”, Kommittén för finansiell stabilitet: FI 2013:09 (Committee for Financial Stability), Swedish Government Official Reports.

that could be revealed following sudden changes in circumstances. If the markets' functionality is suddenly impaired, this could lead to large price fluctuations, thereby potentially limiting financing options. In the long term, this could also pose risks to financial stability.

On the fund market, it is important for fund managers, particularly in less liquid assets such as corporate bonds, to be able to manage liquidity risks and meet the redemption requirements that could arise even in stressed situations. Market actors impacted by the procurement of the new fund marketplace need to be prepared and work actively to plan for the coming transfers of premium pension capital. In this way, they can reduce potential risks that could arise, for example problems handling redemptions or an unjustified large impact on market prices as a result of necessary sales.

Some of the banks' core operations are to transform financing with short maturities into loans with long maturities, which generates significant maturity imbalances. It is therefore important that banks have good and stable access to financing, which the major Swedish banks have. They also meet the liquidity requirements by a good margin, even in foreign currencies. The risk of major banks experiencing problems with their financing overall is currently low. One growing source of deposits in recent years at smaller credit institution is deposit platforms. If a larger share of the banking sector's deposits would end up on this type of platform, it could lead in the long run to elevated risks to financial stability, since lending via these platforms can be particularly volatile. FI has therefore stated that this should be reflected in how the institutions calculate their liquidity requirements.

Higher demands on digital operational resilience due to global security

The financial system is both concentrated and closely interlinked. The clearest example is the banking sector, which is largely concentrated to the major banks in terms of deposits and lending. Banks' large exposures to the commercial real estate sector and life insurance undertakings' and occupational pension insurance undertakings' significant exposures to the banking sector are other examples of concentrations and interconnectedness. A high degree of interconnectedness in the financial system is to some extent unavoidable and could contribute to efficiency gains, but it simultaneously places high demands on risk management in firms as well as regulation and supervision to limit related systemic risks.

The high degree of interconnectedness and concentration are also key vulnerabilities in the operational functioning of the financial system. For the past two years, FI has been the authority responsible for the civil preparedness sector Financial Services. This assignment entails, among other things, that FI is leading the work to coordinate measures to ensure that nationally essential activities in the sector can be maintained during heightened states of alert and in the event of war.

The tense state of geopolitical security is increasing the risk of cyber attacks to the financial system. Many actors in the financial sector are also dependent on one another, and an attack on one actor could rapidly impact others, which in a worst-case scenario could lead to extensive disruptions that could have a major impact on financial stability. FI makes the assessment that there is more to do to build up sufficient resilience to various types of disruptions. An important step is the EU's Digital Operational Resilience Act (DORA)[4], which goes into effect next year. Companies are now preparing to comply with the new requirements. The regulation is expected to also strengthen FI's supervision work since reported data will make it easier to measure and analyse vulnerabilities among financial firms.

A few third-party providers are also being used for many critical services since it can be more effective, safer and cheaper for a firm to outsource these services. However, this also means there is a risk that disruptions at critical third-party providers will impact many financial actors simultaneously. Outsourcing therefore places higher demands on the firms' governance and control of how they are managing risks.

Finally, a major development project is under way in the Swedish payment infrastructure. It is important that actors who are affected take responsibility for ensuring the stability of the Swedish payment infrastructure. High resilience and a good ability to manage risks are particularly important aspects when new systems are developed.

[4] 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.