REPORT

Stability in the Financial System

27 May 2024

FI Ref. 24–14801

Content

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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 policy 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, 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 A1 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 (ICR) and a high loan-to-value (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 cyber attacks, could spread quickly and have a large impact 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 expectations that interest rates will be lower. 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 cost levels, 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.

Macrofinancial situation

The past six months have been influenced by increased expectations that central banks will start lowering policy rates. Global economic growth has been dampened, but it is expected to improve in the coming year. Lower uncertainty about inflation and interest rate prospects have led to increased risk-taking on the financial markets. Liquidity on the bond market has improved according to both the market actors and FI's liquidity indicator.

	Level	Development
Risk-taking financial markets	Yellow	↗
Lack of market liquidity	Orange	↘

The colors indicate the current level of vulnerability. Green represents low vulnerability. Yellow, orange and red indicate differing degrees of elevated vulnerability. The arrows show how FI assesses that the vulnerability develops. An upward-pointing arrow means that the vulnerability is increasing and a downward-pointing arrow that it is shrinking. The assessment of vulnerabilities are based on a combination of quantitative measurements and expert assessments.

Increased expectations that interest rates will come down

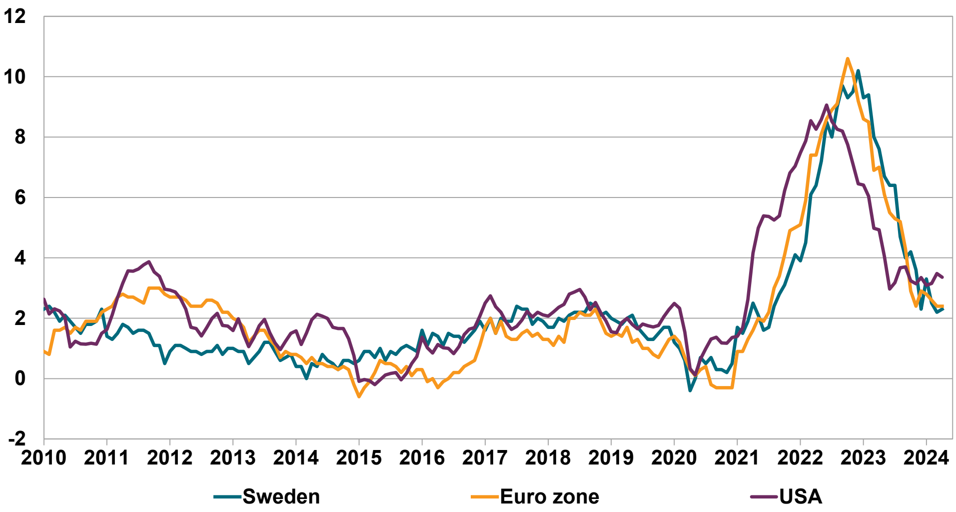
Inflation in Sweden and large economies has continued to decrease during the start of 2024 and is now close to 2 per cent (Diagram 1) As inflation and inflation expectations have fallen, expectations among households, firms and market participants have increased that central banks will begin to lower their policy rates. Central banks have communicated that they may start to lower their policy rates in 2024 but with the reservation that the rates may need to be kept at a high level for a longer period of time to ensure that inflation is anchored at the target level. In Sweden, a first policy rate cut occurred already in May. In the USA, inflation has not contracted to the same extent. As a result, there continues to be uncertainty about when interest rates there will begin to be lowered.

Uncertainty about inflation, high interest rates, and geopolitical uncertainty burdened the global economy in 2023, but development was mixed. For example, the USA economy grew substantially more than the European economy. In 2024, growth in Europe is expected to improve but at a rate that is still low from a historical perspective. The interest rate increases that were made have still not had a full impact on the global economy. Even if interest rates were to start to come down, firms and households would still feel the pressure of the higher interest rates for some time. This dampens the strength of the recovery in the global economy.

Geopolitical uncertainty has further increased due to the increasing tension in the Middle East. This contributes to increased economic uncertainty, in part through increased costs for international trade. The presidential election in the USA in the autumn could also contribute to both security and economy uncertainty given the country's strong position on the global market. This could spill over into the global financial markets and lead to increased turbulence there.

Households, firms and market participants have previously adapted to the new conditions created by higher interest rates by, among other things, reducing their risk-taking. In recent months, however, we have seen that risk-taking has reversed course and begun to increase. This is explained largely by the rising expectations that interest rates will come down. If inflation is not dampened and interest rates do not fall as expected, there is a risk that uncertainty and turbulence will increase once again, which could dampen economic development.

1. Lower inflation in Sweden and large economies
Per cent



Source: Refinitiv.
Note: Refers to CPIF (Sweden), HICP (euro zone) and CPI (USA), annual change.

Economic downturn in Swedish economy in 2024

According to current forecasts, Swedish GDP is expected to grow at a moderate rate in 2024.[2] Household demand is low since household buying power contracted following price increases and higher interest rate expenses. According to survey data, households have become more positive in the past six months about their future finances, but their expectations are still at historically low levels.[3] At the same time, labour demand has remained at relatively high levels so far. If

[2] According to National Institute of Economic Research (March 2024), GDP in Sweden is expected to increase by 0.8 per cent in 2024.
[3] National Institute of Economic Research, Household Confidence Indicator

unemployment were to increase significantly as a result of limited demand in the economy, this would place an additional burden on households.

Households under pressure, high interest rates and construction costs, and cautious development in housing prices have contributed to a significant decrease in construction investments, which also slows economic growth. The rate of construction of housing in particular is expected to continue to be low for both units that are sold to households and those managed as rentals.

Investments in the industry are also falling this year as capacity utilisation decreases. The sector is compensated to some extent by increased competitiveness since the Swedish krona depreciated against larger currencies. At the same time, a weak and volatile currency can have a negative impact on firms' opportunities to manage currency risk and make foreign financing more expensive.

The public finances in Sweden continue to be very strong. Lower inflation means that a more expansive financial policy is possible, and the rate at which public consumption will increase is expected to be higher than normal this year.

Lower financial uncertainty leads to higher risk appetite

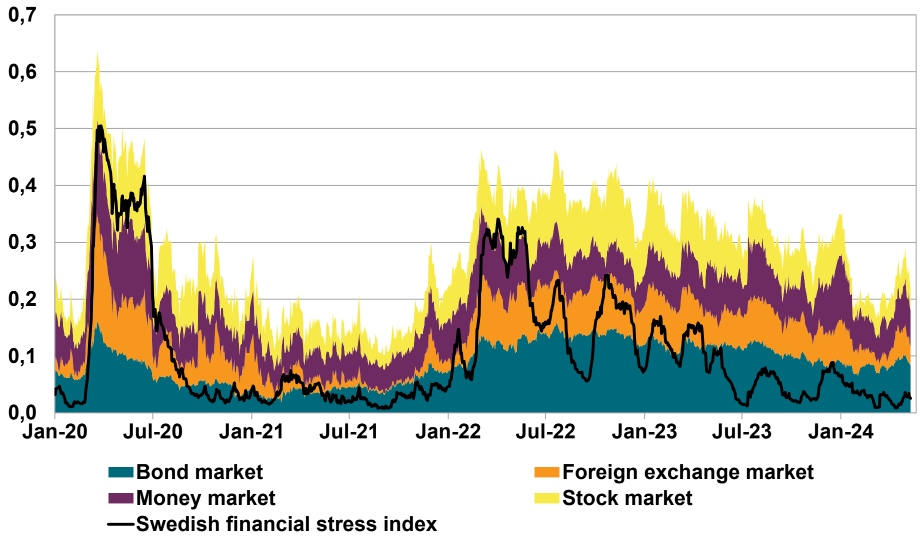
The development on the financial markets continues to be influenced by market participants' expectations about future monetary policy and economic development. The expectations that central banks would lower their policy rates earlier than expected and that the rate cuts would be more numerous led to a drop in interest rates, increased optimism, and higher risk-taking in the financial markets at the end of 2023 and the start of 2024. During the spring, expectations were dampened somewhat when central banks communicated that they would be cautious about easing monetary policy and inflation did not fall as quickly as expected, particularly in the USA.

Monetary policy has been highly synchronised globally over a period of several years, but more recently the communication from central banks has diverged. The reason for this is that economic development is more clearly following different paths. While the US economy has shown significant resilience and continued to grow with support from fiscal stimuli, the economic recovery in Europe is delayed. As a result, the monetary policy that different countries choose may become more out of sync than before. This could lead to market participants needing to adapt to a new environment on the financial markets.

The stress on the Swedish financial markets has gradually decreased since the spring of 2022, and it fell sharply at the end of 2023 as a result of decreased uncertainty about inflation and interest rate outlooks (Diagram 2). As a result, risk appetite and asset prices have risen while risk premiums have fallen since the last stability report. Stock market volatility has been trending downward for a long period of time, but it increased in the past month as global financial markets reacted to surprisingly strong inflation data in the USA. This contributed to an increase in the financial stress even in Sweden, although risk appetite in terms of risk premiums has not been notably impacted. This shows clearly how strong of an impact interest rate expectations have on pricing and reactions on financial markets right now.

2. Financial stress is decreasing

Index



Source: Sveriges Riksbank.

Note: Swedish stress index. Ranking: 0=low stress, 1=high stress.

The higher interest rates have led investors to distinguish more between firms with different risk profiles. This, in turn, has increased the differences in firms' financing costs and opportunities to raise capital. Higher risk awareness is positive at a fundamental level, but it has meant that weak actors have found it difficult at times to raise financing at a sustainable cost. Despite the recovery in risk appetite the past six months, there continue to be clear differences in the firms' opportunities to obtain financing. However, there are signs that the access to financing is beginning to improve in general; for example, initial public offerings, which were conspicuously absent last year, have begun to rebound both in Sweden and internationally. In addition, the interest rates on commercial real estate (CRE) firms' capital market financing have fallen significantly (Diagram A6 in the appendix). CRE firms with good creditworthiness are once again able to borrow at market rates that correspond to the rate on a bank loan.

However, the improved financing conditions are largely dependent on the general development in market sentiment. A scenario where inflation proves to be more persistent than expected, the economic downturn is significantly worse than expected, or geopolitical conflicts are scaled up could lead to a rapid increase in uncertainty on the market, a repricing of assets, and elevated financing costs.

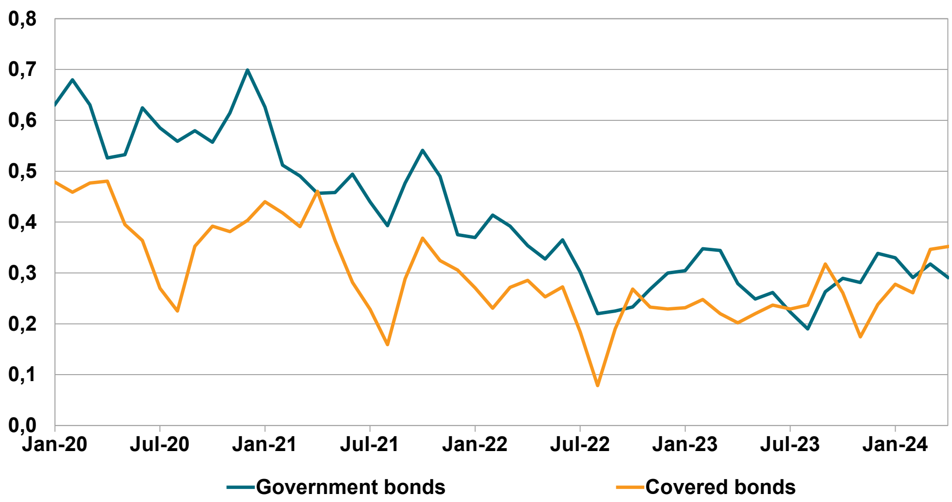
Market liquidity improved from low levels

Liquidity continues to be low for trading on the secondary bond markets. During periods of financial stress, low market liquidity can have a negative impact on the market's functionality and lead to large market fluctuations and volatility.

Recently, market liquidity for government bonds on the secondary market seems to have improved. According to a survey by the Swedish National Debt Office and the financial market survey by the Riksbank, market participants are reporting improved liquidity on the government bond market.[4] They say that the improvement is because the Riksbank has decreased its holding of government bonds, which increased the volume of government bonds available for trade on the secondary market.

FI's liquidity indicator[5] shows that liquidity has improved from low levels for both Swedish covered bonds and nominal government bonds (Diagram 3). The driving factors are lower transaction costs, lower volatility and higher volumes per transaction. Turnover, as well, appears to have increased slightly.

3. Market liquidity improved on fixed-income markets from low levels
Index



Source: FI's transaction reporting system, Refinitiv, Swedish National Debt Office and Svenska Handelsbanken Bond Indices.

[4] For more information, see the report "Statsupplåning - Prognos och analys 2024:1", Swedish National Debt Office.
[5] For a more detailed description of Finansinspektionen's liquidity indicator, see Crosta and Zhang (2020), "Nya likviditetsindikatorer för räntemarknaden", FI Analysis 21, FI Ref. 20-15313. An English translation is available at www.fi.se.

Note: The liquidity indicator is an aggregate of various individual indicators for covered bonds and nominal government bonds with benchmark status. Higher values signify higher liquidity. The series show a two-month moving average of the index. The calculation method has been revised, which means that historical values differ slightly from the values presented in previous stability reports.

Households

The higher interest rates have now had a larger impact on households with large loans. Household debt has stopped increasing, and households are spending a larger portion of their income on interest rate payments. If interest rates continue to fall as expected, this will strengthen households' cash flows. Housing prices have not fallen compared to the last stability report, and households that save in shares and funds have seen their assets increase in value.

	Level	Development
Debt growth	Green	↘
Cash flow	Orange	→
Financial position	Yellow	→

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Households borrow less but are more optimistic

Households continue to borrow less, and their total loans have now almost stopped increasing. The debt level, however, continues to be higher than before the pandemic and high from a historical and an international perspective. The aggregate loan-to-income (LTI) ratio has fallen since the second quarter of 2022 (Diagram 4). This makes households less vulnerable to disruptions in the longer term. As mentioned in earlier sections, households are still cautious, but they are more optimistic about future economic development than they were six months ago.

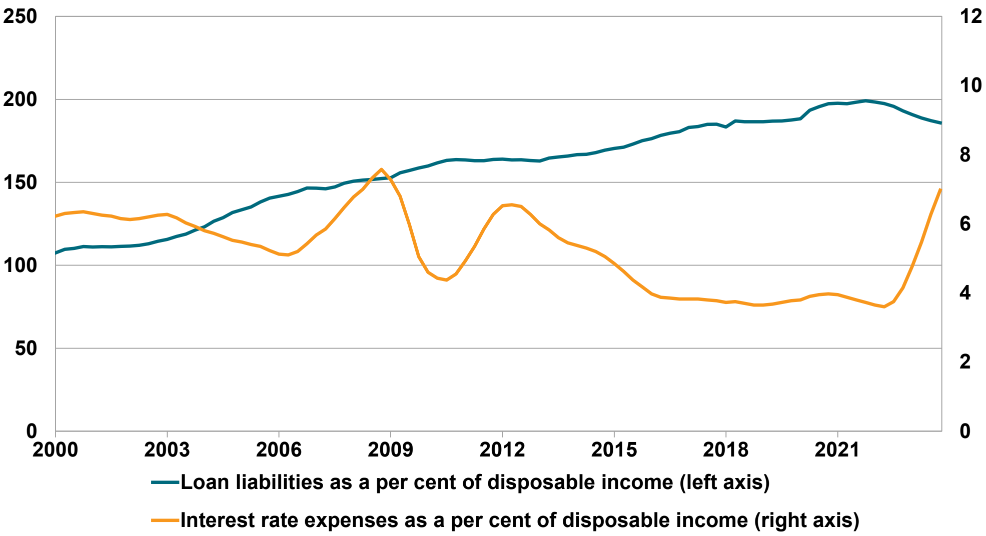
Households continue to be cautious with their daily finances. Their real consumption decreased slightly last year due to rapid price increases and higher interest rates. In March, consumption increased compared to last year, but it is still weak. Consumers are still purchasing fewer durable goods than they did during the pandemic. Households' cautious behaviour is leading to lower profitability for household-related businesses, such as the retail sector.

Even though household consumption is weak, households are continuing to consume more than what many forecasters expected. Two possible explanations are that, to date, employment has withstood the economic downturn better than expected and households built up a buffer during the pandemic that they can now use. Forecasters predict that unemployment will continue to rise until it starts to fall in 2025. If more people lose their jobs and are pressured financially, consumption will most likely weaken again.

Cautiousness among households is also evident on the housing market, where activity is still low. After a clear price drop at the beginning of 2022, housing prices have stabilised.[6] However, unlike last autumn, an increasing number of homeowners, around 40 per cent, believe that housing prices will rise.[7] Even if many households and some market analysts believe that housing prices will be higher in the future, it cannot be ruled out that high housing costs and other subsistence costs continue to apply downward pressure to housing prices. This applies in particular if inflation rises again or if mortgage rates do not fall as much as expected. Compared to in 2023, turnover on the housing market has increased. If turnover continues to increase going forward, household debt will probably also begin to increase again.

4. Households spend a larger portion of their income on interest payments

Per cent



Source: Statistics Sweden.

Note: Loan liabilities as a percentage of disposable income are total current debt divided by the past four quarters' aggregate disposable income. Interest expenses as a percentage of disposable income are interest expenses (pre-tax) divided by disposable income.

Households' financial scope has decreased

Households' real disposable income decreased by more than 6 per cent between 2021 and 2023.[8] The decrease in households' real salaries has been offset by

[6] At the start of 2024 and up to and including April, housing prices increased by approximately 1 per cent in seasonally adjusted terms according to Valueguard's index.

[7] Nordea, Boendebarometern nr. 25.

[8] Real disposable income is defined as household income minus taxes and fees adjusted for inflation.

upward inflation adjustments to the state's transfers to households, for example sickness benefits, parental benefits, and guarantee pension.[9]

The average interest rate on new mortgages has increased by over three percentage points since 2021. Around 64 per cent of household mortgages are at a variable rate. The share of loans at a variable rate has increased sharply since 2022. In a European context, Sweden stands out with its short fixed-interest periods; therefore, the higher interest rates have more quickly impacted households in Sweden than in many other European countries. Swedish households currently have an average mortgage rate that is almost 2 percentage points higher than the average in the euro zone. Roughly half of Swedish households expect lower interest rates within one year, and they are probably waiting until this expectation is met before they fix their rate.[10]

Even if households expect lower interest rates going forward, the high interest rates are continuing to burden households' expenditures. Households now spend an even larger share of their disposable income on interest payments than they did in the autumn of 2023 (Diagram 4).

The median surplus for new mortgagors (discretionary income) decreased over the past two years (Diagram 5). [11] Inflation has also led many borrowers to spend a larger portion of their income on covering necessary housing and subsistence costs. This, combined with the dilution of households' buying power due to inflation, means that homebuyers' buffers have decreased by around SEK 1,000 between 2021 and 2023 in inflation-adjusted terms. This is a decrease of almost 20 per cent.

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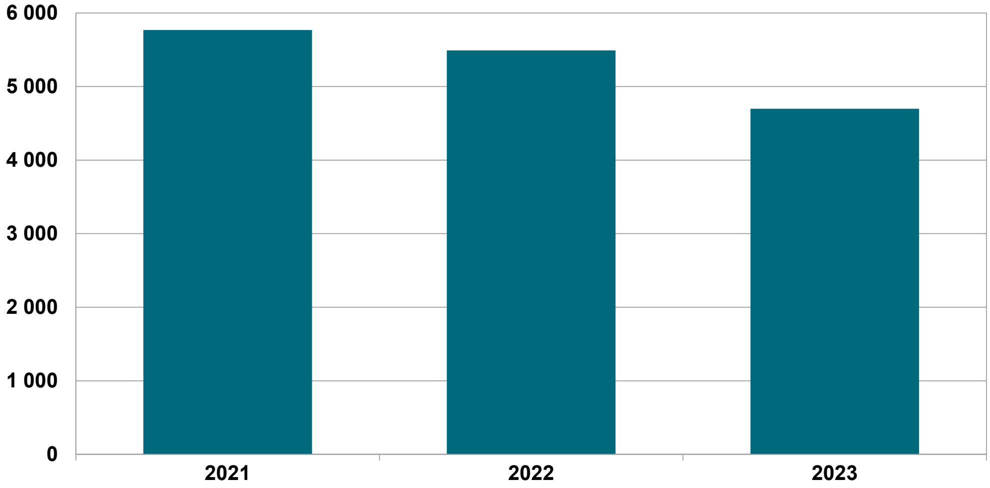
[9] For more information, see NIER's in-depth review "Inflationens påverkan på den offentliga sektorns inkomster och utgifter" [Impact of inflation on public sector revenue and expenditure] in Konjunkturläget (The Swedish Economy), December 2022. https://www.konj.se/download/18.1d35c93d1852997ae32124a3/1671545397806/Inflationens%20p%C3%A5verkan%20.pdf
[10] Nordea, Boendebarometern nr. 25.
[11] When banks conduct so-called discretionary income calculations during the credit check of new mortgagors, they deduct expected housing costs and subsistence costs from the potential mortgagor's income. The surplus between income and costs after the necessary costs have been paid is the household's estimated financial scope. Interest rate developments have a limited impact on the discretionary income calculation since the stressed interest rate is used is kept rather constant.

5. New borrowers now have a smaller surplus every month

SEK



Source: FI.

Note: The median surplus in the discretionary income calculation is estimated according to the banks' calculations for new mortgagors. The base year for the calculation is 2021. For 2022 and 2023, the surplus has decreased with the rate of inflation (CPIF) since 2021. The effect of the higher stressed interest rate in 2022 and 2023 in relation to 2021 has been added back to the surplus. Between 2021 and 2023, the average stressed interest rate has increased from 6 per cent to 6.6 per cent. It had decreased from 7 per cent to 6 per cent between 2019 and 2020.

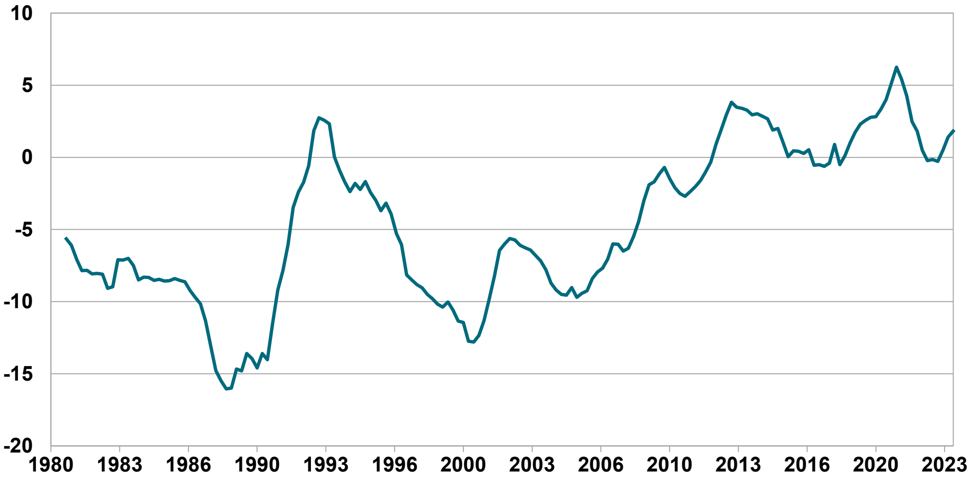
Furthermore, tenant-owner associations increased their fees by 8 per cent on average between 2022 and 2023 in response to the higher interest rates and inflation. For newly produced tenant-owned apartments, which typically have larger loans, the increase in the fee was particularly large, almost 30 per cent. This naturally further burdens households that live in a tenant-owned unit.

Even though the margins of many households have become substantially smaller in recent years, FI makes the assessment that most households are able to make their loan service payments. If the weak state of the economy leads to higher unemployment, those who lose their jobs could be significantly impacted. Mortgage providers may grant temporary exemptions from the amortisation requirement to households with mortgages that are facing significantly altered financial conditions.

Households are saving more

During the pandemic, household savings were at record-high levels (Diagram 6). Even if savings have decreased slightly since then, they are still high from a historical perspective despite households experiencing higher costs.

6. Households place a larger portion of their income in savings
Per cent



Source: Statistics Sweden.
Note: The diagram shows the share of disposable income that goes to savings, excluding savings in occupational and premium pensions and amortisation payments.

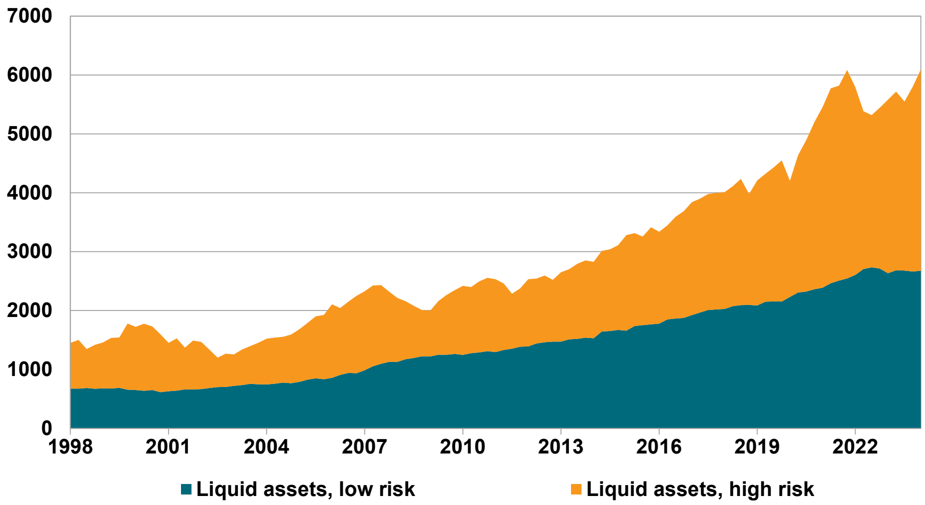
Household liquid wealth has increased and is high from a historical perspective (Diagram 7). However, bank deposits have decreased slightly despite higher deposit rates. This is likely both because the most pressured households need to spend their buffers and because households with higher financial margins are moving their assets to riskier assets such as shares and funds.

Household liquid wealth is unevenly distributed, and it is primarily high-income earners who benefit from upswings in the stock market.[12] Households with a small or no buffer are still sensitive to a loss of income and higher costs.

[12] Statistic Sweden's shareholder statistics show that the 5 per cent with the largest shareholdings own 85 per cent of the total share wealth.

7. Households' liquid assets continue to be at high level

SEK billion



Source: NIER and Statistics Sweden.

Note: Bills, coins and deposits are classified as low risk. Swedish listed shares, foreign shares and fund units (excl. fixed-income funds) are classified as high risk.

Non-financial corporations

Lending to non-financial corporations is decreasing broadly across all industries. At the same time, interest rates are expected to start going down. Together with lower credit premia, this reduces the pressure on, for example, commercial real estate (CRE) firms. However, lower inflation and an increased share of vacant premises will probably decrease growth in CRE firms' rental income going forward.

	Level	Development
Debt growth		↘
Indebtedness		→
Financing		↘

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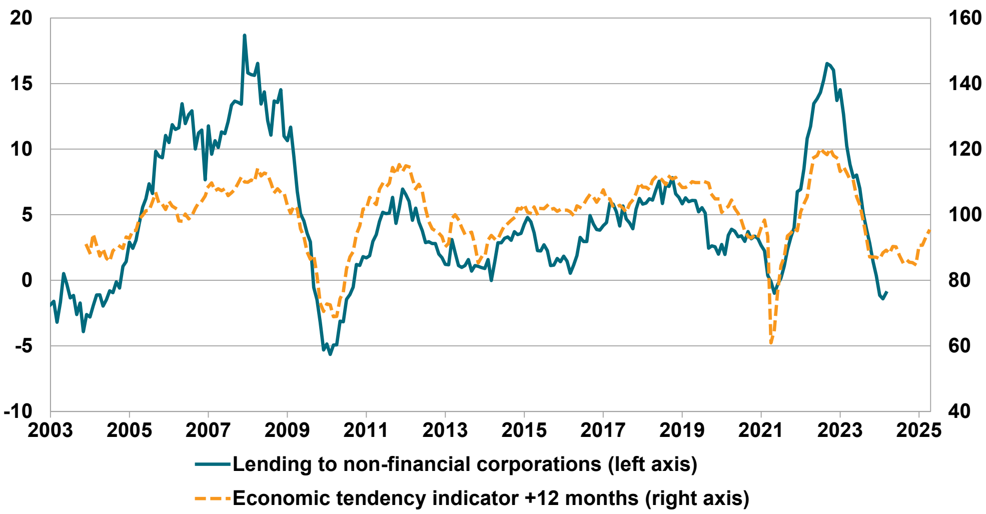
Firms are borrowing less, and bankruptcies are increasing

Firms are continuing to borrow less during the economic downturn, and lending is decreasing broadly across all industries, particularly in retail and manufacturing (Diagram 8). The number of bankruptcies in the commercial sector is high and continues to increase, and more employees are affected now than before.

8. Firms are borrowing less

Annual change in per cent (left axis) and index, average = 100 (right axis)



Source: FI, NIER, and Statistics Sweden.

Note: Lending to non-financial corporations includes lending from monetary financial institutions (MFI), mortgage institutions, and alternative investment funds (AIF), but not market financing. The barometer indicator from NIER has been shifted forward 12 months.

Just like last year, the construction and retail industries were the hardest hit, but since firms in these industries do not have large bank loans, banks' credit losses have not yet been impacted (see the section Stability in the banking sector). The weak economy is reflected in lower demand for premises, which leads to the CRE firms having a higher share of vacant premises. If this development continues, the CRE firms' rental income will be subject to downward pressure (see the section CRE firms' earnings can be challenged going forward").

The economic downturn is also visible through reduced production. In total, production in the commercial sector decreased by around 2 per cent in January this year compared to the same period last year. In the construction industry, production decreased by around 6 per cent compared to last year. Housing construction is showing greater sensitivity than the construction industry as a whole. Housing investments decreased by approximately 25 per cent in a year.

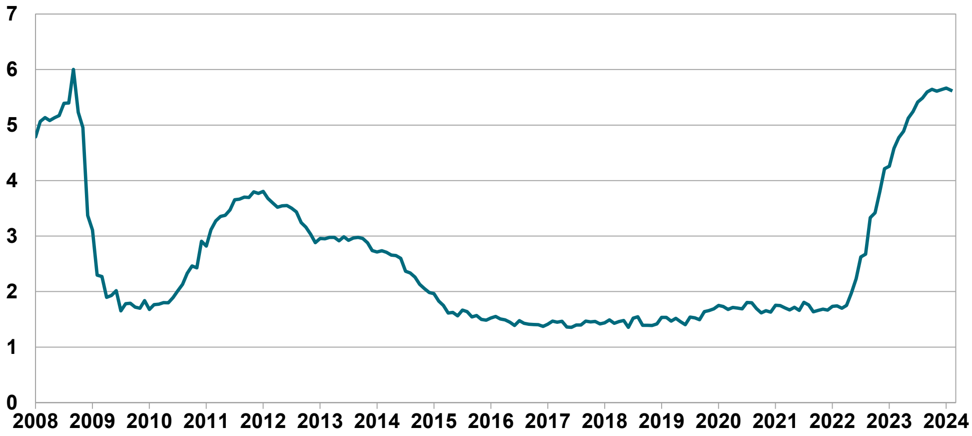
Increasing impact of higher interest rates on firms

The interest rate on new bank loans to non-financial corporations has levelled off but is at its highest level since 2009 (Diagram 9). Implied market pricing indicates that interest rates will drop further in the future, although probably not back to pre-2022 levels. Because many firms have short fixed-interest rate periods, changes in interest rates can quickly impact firms' financial expenses.[13]

[13] In March 2024, 77 per cent of the outstanding loans from MFIs to non-financial corporations had a fixed interest rate period of less than three months, and an additional 6 per cent had a fixed interest rate period of less than one year.

9. Lending rates to non-financial corporations is levelling off

Per cent

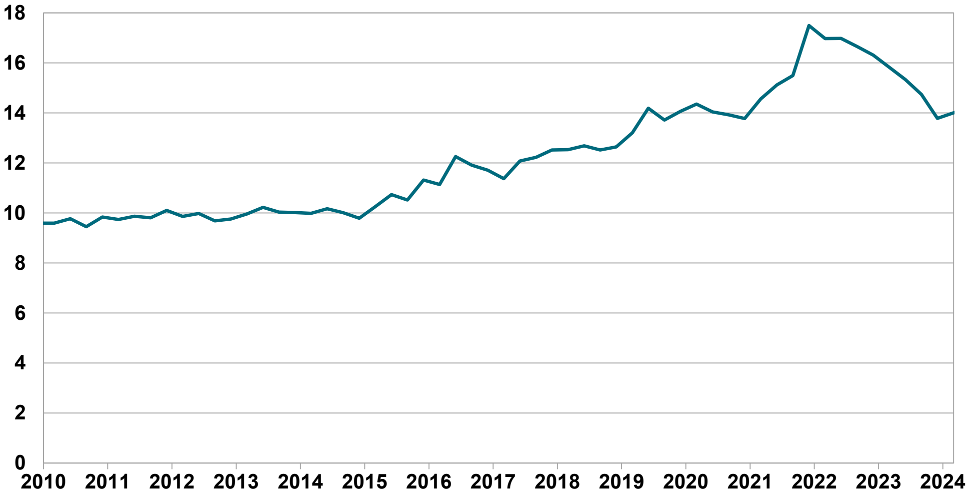


Source: Statistics Sweden.
Note: Refers to the average interest rate on new loans from monetary financial institutions to non-financial corporations.

CRE firms represent approximately 40 per cent of the total debt in the Swedish non-financial corporation sector. Uncertainty surrounding the CRE sector has decreased with expectations that interest rates will go down. This has also led to lower credit premia for the sector, but it is not certain that CRE firms' borrowing costs will decrease correspondingly. This could lead to a more drawn-out stressed situation than expected for many firms. There is no guarantee that the expectations on lower interest rates will be met, and renewed uncertainty for the sector due to persistent high interest rates or lower earnings could entail that credit premia will increase once again.

Since the beginning of 2022, CRE firms' net debt in relation to operating profit has decreased (Diagram 10). The main reason was an increase in operating profit as firms could increase their rents with the higher inflation. In the third quarter of 2023, CRE firms' net debt also began to decrease. This shows that firms have taken measures to adapt to the higher interest rates.

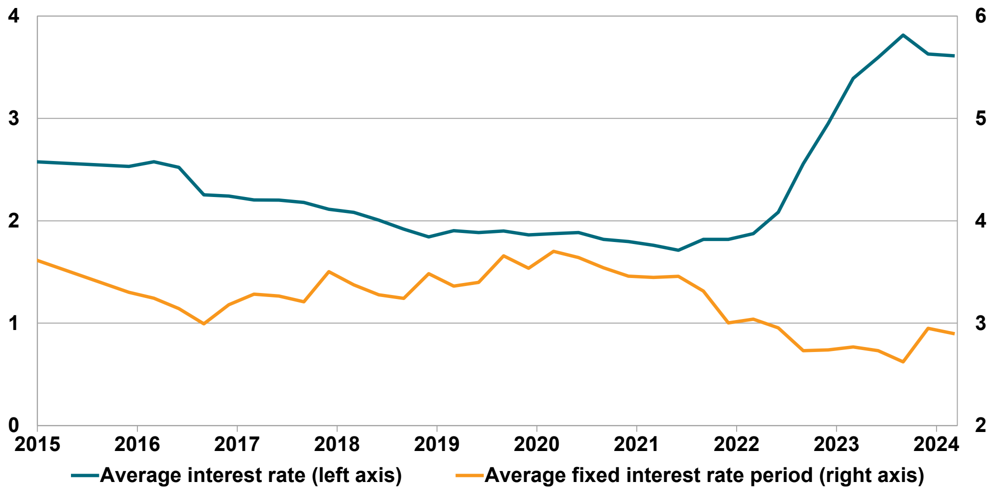
10. CRE firms have decreased their loans in relation to their operating profit
Ratio



Source: Sedis.
Note: The diagram shows net debt in relation to EBITDA. Net debt is a firm's interest-bearing liabilities less cash and cash equivalents. EBITDA is a firm's earnings before financial items, taxes, depreciation and amortisation (goodwill).

Even through CRE firms are regularly refinancing their debt in a setting with higher interest rates, some firms successfully lowered their interest rate expenses slightly (Diagram 11). Many firms have focused on reducing their loans, particularly those with high interest rates. Furthermore, firms have extended their fixed interest rate period by hedging their interest rates for part of their loans (Diagram 11). This has been beneficial since the market rate has been lower for long maturities. Firms that have worked actively to decrease their loans and extended their fixed interest rate period have decreased their average interest rate the most. However, the firms' interest rate expenses may still increase going forward since large loans that were financed during the low interest-rate environment will regularly need refinancing at a higher rate, even if market rates have decreased slightly since the autumn of 2023. The firms that have tied large parts of their loans to a fixed interest rate via interest rate derivatives, however, will not benefit from lower interest rates as other firms do if the Riksbank continues to lower the interest rate.

11. CRE firms have decreased their average interest rate and slightly extended their average fixed-rate period
Percentage (left axis) and year (right axis)



Source: Sedis.

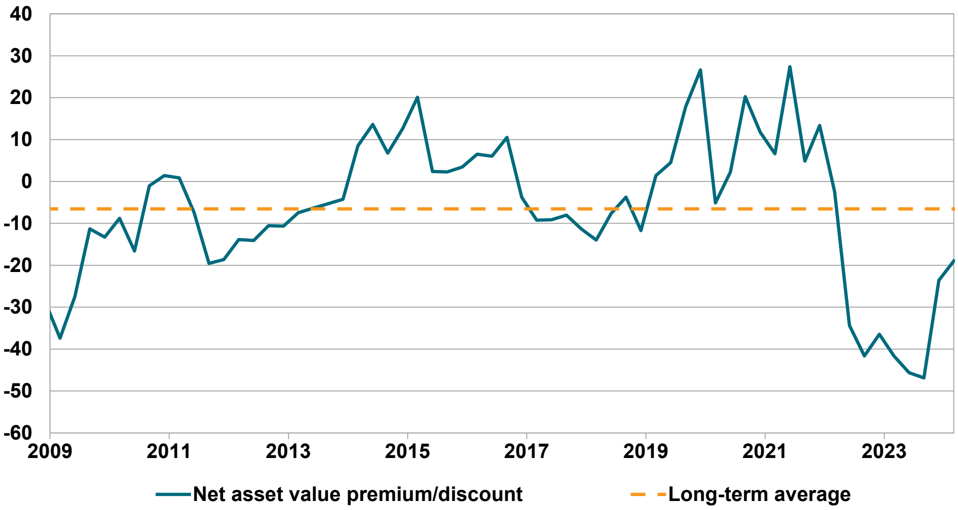
The higher interest rates have increased the yield requirements on the firms' property assets, which in turn has resulted in lower property values. There is still a risk that property values will continue to decrease. On the stock market, CRE firms are valued at a significant discount in relation to their long-term net asset value (NAV).[14] But the NAV discount has decreased somewhat during the second half of 2023, which indicates a more positive view of the sector (Diagram 12).

Activity on the transaction market for properties fell sharply in 2023 and is now at the lowest level since the 2009 financial crisis. This is probably due to the tight financial situation for CRE firms and because buyers and sellers are having difficulties agreeing on the price in real estate transactions. This indicates that there is still significant uncertainty about the property values and that prices could decrease further.

[14] Net asset value is the firm's net assets. It is a measure of the company's equity, which is calculated by subtracting the recognised value of the debt from the recognized value of the assets. The most important asset type is properties, and these have been measured at fair value according to the consolidated financial statements.

12. Reduced net asset value discount indicates a more positive market view

Per cent



Source: Sedis.

Note: The diagram shows the median of the listed commercial real estate firms' NAV discount and premium in per cent. A negative value indicates a NAV premium.

Earnings of CRE firms can be challenged going forward

So far, some CRE firms have been able to offset the sharp increase in interest expenses by raising their rents as inflation has increased. As inflation decreases, earnings will probably increase at a slower pace. In addition, vacancy rates have risen in almost all segments, which indicates that the economic downturn has led to lower demand for premises. The office segment exhibits the highest vacancy rate and is showing a sharp increase in 2023. Historically, rental income tends to decrease when unemployment increases, and vice versa (Diagram 13). If unemployment continues to increase and the economic downturn deepens, growth in rental income could continue to be under downward pressure.

Furthermore, more people are working from home and farther away from their workplace. This is a structural change that has been progressing since the corona-virus pandemic. In the USA, this development has progressed further, and analysts are saying that the so-called work-from-home trend will have a major impact on the office market there. It is possible that the clear upswing we are currently seeing in vacant office premises is an indication that this trend has also reached Sweden. FI makes the overall assessment that a drop in earnings is a large risk for CRE firms right now together with additional pressure from high interest rate expenses.

13. Higher unemployment indicates lower rental growth going forward

Rental growth (left axis) and change in unemployment in percentage points (right axis)

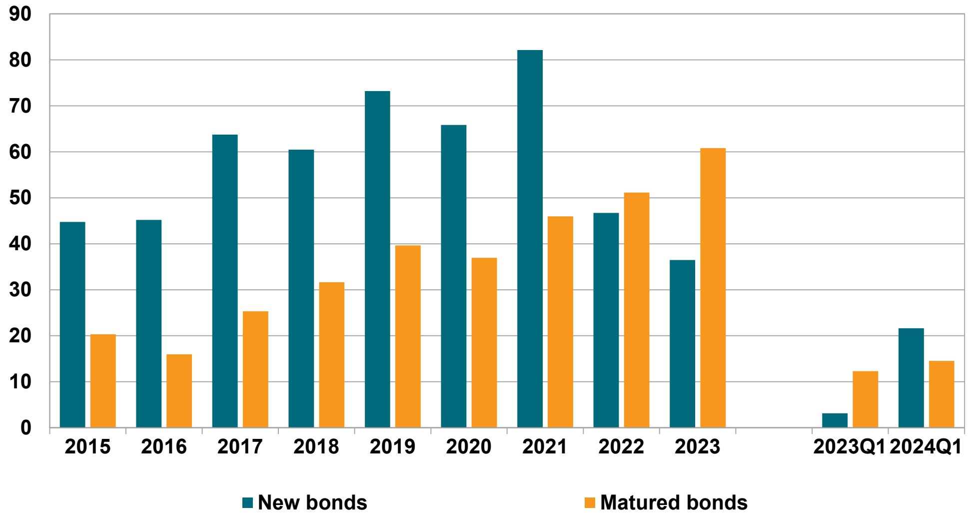
Source: JLL, Pangea and Statistics Sweden.
Note: Rental growth is shown as an annual change in per cent and is displayed on the left axis. The change in unemployment is displayed on the right axis, which is inverted.

After a period of sharply increasing bond yields and challenging conditions on the primary market, the conditions on the bond market have now improved for CRE firms. Since the bond yields for CRE firms with higher credit ratings began to decrease mid-year last year, yields also turned downward for CRE firms with lower credit ratings (Diagram A6 in the appendix). As a result, more CRE firms have issued bonds. In the first quarter of the year, CRE firms issued larger amounts in Swedish bonds than what has matured thus far (Diagram 14). This shows that the activity on the bond market has improved compared to the first quarter last year since the amounts that matured then were larger than what the firms issued.

CRE firms[15] have around SEK 18 billion in outstanding bonds[16] that will mature before the end of the year and an additional SEK 73 billion will mature in the coming year. CRE firms in general have successfully managed their loan maturities, partly with help from the banks. It is likely that they will be able to manage future maturities as well, particularly if the maturity structure does not change significantly and the conditions on the bond market continue to improve.

[15] Firms with A rating or higher are not included.
[16] Refers to bond volumes in all currencies.

14. CRE firms are currently issuing larger amounts than what are maturing
SEK billion



Source: Statistics Sweden.
Note: Refers only to bond volumes in SEK (excluding money market instruments). *New bonds* refers to issued amounts in SEK billion at each point in time. *Bond maturities* refers to amounts in SEK billion that have matured at each point in time.

Stability in the banking sector

The Swedish banks still have very high profitability, even if it is probable that this will decrease somewhat as the policy rate is lowered. However, there are already significant risks associated with the banks' lending portfolios, in part related to CRE firms. The banks therefore still need to hold significant capital and liquidity buffers that can be drawn upon if economic situation worsens.

	Level	Development
Concentration and interconnectivity		→
Solvency and profitability		↘
Asset quality and credit risk		→
Financing and liquidity		→

The colors indicate the current level of vulnerability. Green represents low vulnerability. Yellow, orange and red indicate differing degrees of elevated vulnerability. The arrows show how FI assesses that the vulnerability develops. An upward-pointing arrow means that the vulnerability is increasing and a downward-pointing arrow that it is shrinking. The assessment of vulnerabilities are based on a combination of quantitative measurements and expert assessments.

Banking sector is concentrated and interconnected

The Swedish banking sector is largely concentrated to five major banks: the three major Swedish banks – Svenska Handelsbanken (SHB), SEB and Swedbank – and the two systemically important branches – Nordea's and Danske Bank's Swedish branches and mortgage companies.[17] These major banks are closely interconnected, both to one another and to other parts of the financial sector. Problems arising in any of the major banks could potentially spread quickly to other financial actors. In recent years, competition on the banking market has increased. The major banks have lost market shares in some submarkets, but despite this they still hold a central role in Sweden.

High buffers and good profitability contribute to resilience

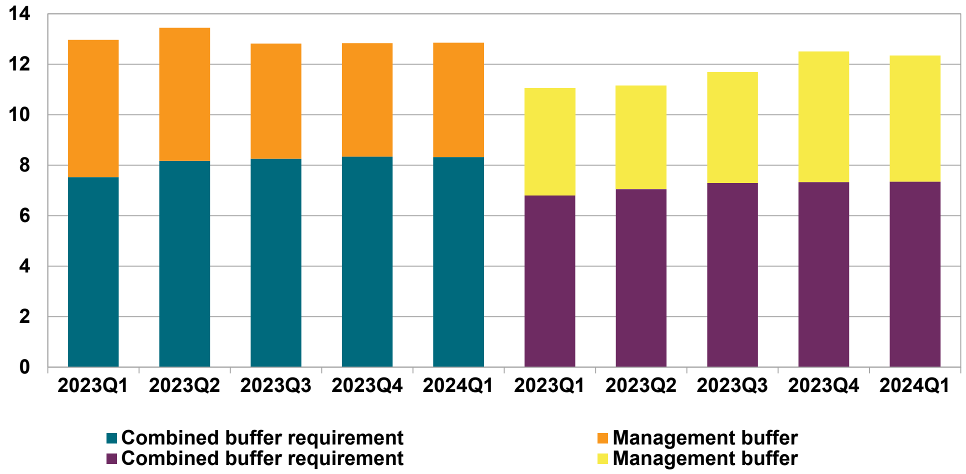
The major banks have substantial capital buffers, which makes them well-prepared for potential future difficulties (Diagram 15). Thanks to their high profitability, the major banks still have large management buffers[18] despite significant dividends

[17] For these five major banks, the figures refer to the consolidated situation unless otherwise specified. Together they represent around 75 per cent of deposits and lending to Swedish households and corporates and just under 70 per cent of domestic payments. Danske Bank and Nordea are referred to going forward as *systemically important branches*.
[18] *Management buffer* refers here to the margin between the banks' capital levels and the regulatory buffer requirements.

and higher buffer requirements[19]. FI intends to leave the countercyclical buffer rate unchanged at 2 per cent (see In-depth Review).

15. Capital buffers continue to be high for the major banks

Percentage of risk-weighted assets



Source: FI and the banks' public reports.

Note: Capital requirements as a share of risk-weighted assets. Refers to buffers at the consolidated level. The management buffer includes the so-called Pillar 2 guidance, which for the major Swedish banks is 0.5 per cent.

In-depth Review – FI intends to leave the countercyclical buffer rate unchanged in Q2

The countercyclical buffer rate has been at 2 per cent since June 2022. This corresponds to the positive neutral level that FI applies to the countercyclical buffer rate during periods in which we assess that cyclical systemic risks are not building up. FI intends to leave the countercyclical buffer rate unchanged in Q2 2024.

Sweden is in the middle of a recession. The general price level and interest rates continue to be higher than before. Therefore, many non-financial corporations and households continue to be under pressure. Over the past year, the number of bankruptcies has increased to historically high levels. Unemployment has also increased slightly.[20] The growth rate for banks' lending to households and non-financial corporations is at historically low levels (Diagrams F3 and A4 in the appendix). In Q4 2023, GDP grew more than lending to households and corporates. Therefore, the credit-to-GDP gap shrunk slightly, and the buffer guide remains at 0 per cent (Diagrams F1 and F2). The systemic risk indicator (d-SRI)

[19] Nya kapitalkrav för svenska banker, FI Ref. 20-20990, November 2020, https://www.fi.se/globalassets/media/dokument/diverse/2020/nya-kapitalkrav-svenska-banker-20-20990.pdf

[20] In seasonally adjusted terms.

describes the overall risk build-up.[21] Low credit growth and weak asset price development indicate that the build-up of cyclical systemic risks according to d-SRI has decreased in recent quarters (Diagram A1 of the appendix).

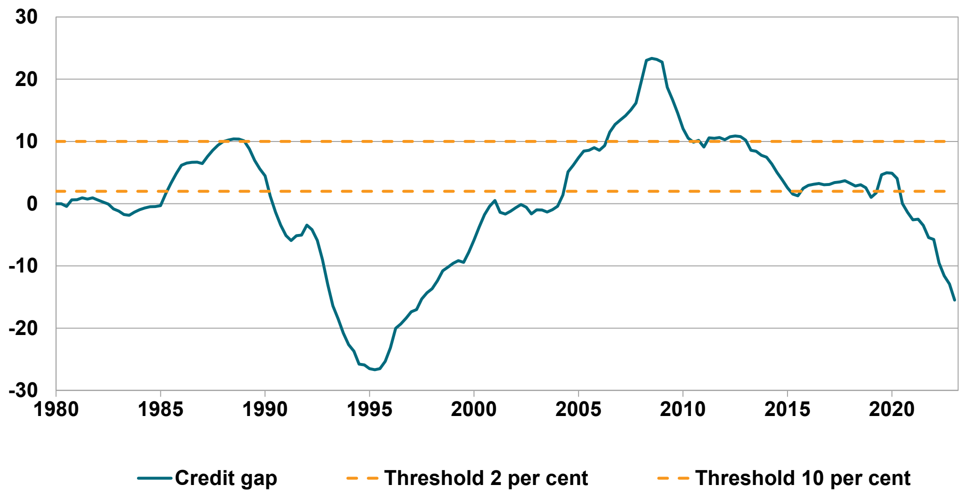
Inflation in Sweden and globally is close to the inflation targets, and several central banks have begun to communicate that they can soon start to lower their key policy rates. This, in turn, has contributed to slightly improved outlooks. The optimism of households and non-financial corporations continues to be weak, but it has improved in recent months.[22] This is reflected in part in the housing market, where the turnover has increased compared to the previous year. The difference in credit premiums between CRE firms with different ratings has also decreased significantly. It has also become easier for CRE firms to issue new bonds. From a forward-looking perspective, it is likely that lower interest rates and a stronger economy could lead to an increase in the lending rate, risk-taking and asset prices. But we are not there today.

It is important that the banking sector can provide households and corporates with loans. A deterioration in real economic development or impaired access to market financing could mean that households and firms will turn to an even larger extent to the banking sector for financing. 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. If FI were to make the assessment that there is a limited supply of credit from the banking sector, we can lower the buffer rate to free up room for the banks to loan more. However, the banks have good profitability and large management buffers (Diagrams 15 and 16). This suggests that the banks have good capacity to maintain the supply of credit. FI thus intends to leave the countercyclical buffer rate unchanged in Q2 2024.

[21] For more information, see Sandström, C. (2023), "En systemriskindikator för Sverige", FI Analysis 43, FI Ref. 23-34670. An English translation is available at www.fi.se.
[22] According to the Economic Tendency Survey, March 2024, National Institute of Economic Research.

F1. Credit-to-GDP gap dropped in Q4

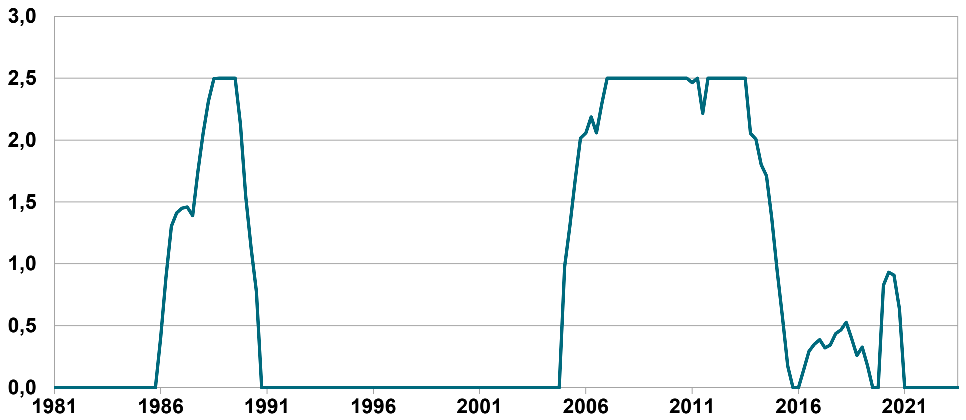
Deviation from trend, ppts



Source: FI and Statistics Sweden.
Note: Credit-to-GDP gap according to the standardised approach. The dashed lines show the thresholds (2 and 10 per cent, respectively) that according to the standardised approach are to be used to transform the credit-to-GDP gap into a buffer guide.

F2. Buffer guide remains at 0 per cent

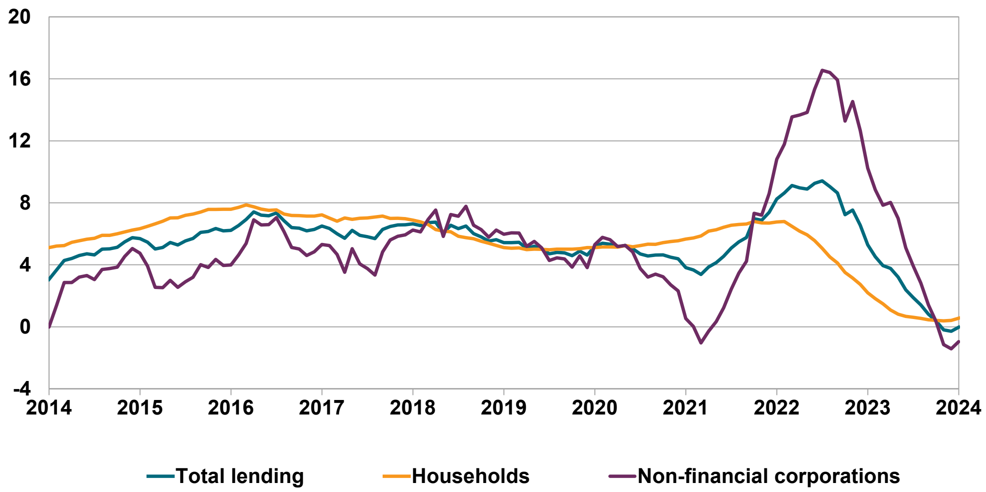
Per cent



Source: FI and Statistics Sweden.
Note: Buffer guide according to the standardised approach.

F3. Negative growth in total lending

Per cent



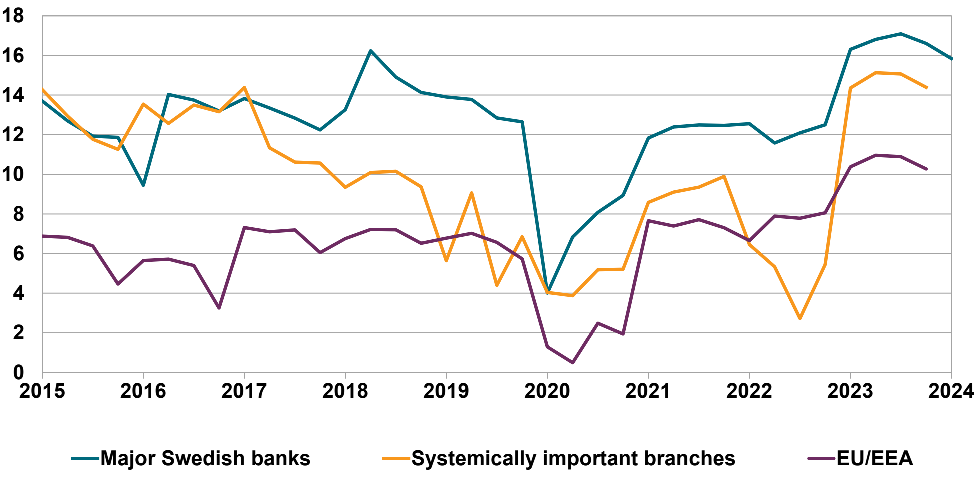
Source: Statistics Sweden.

Note: Monthly data. Annual change in growth in per cent. MFI stands for monetary financial institution.

During the past three years, the profitability of the major banks has been unusually high from a historical perspective, and it has also been high in comparison to European banks (Diagram 16 and Diagram A3 in the appendix). This has primarily been due to interest income from the banks' lending having increased more rapidly than interest expenses. The banks' high profitability means that it is easier for the banks to absorb any credit losses in a deteriorated economic scenario. The beneficial conditions for the major banks are also reflected in the valuations of their shares, which are at record-high levels.

16. Profitability no longer increasing but at historically high levels

Per cent

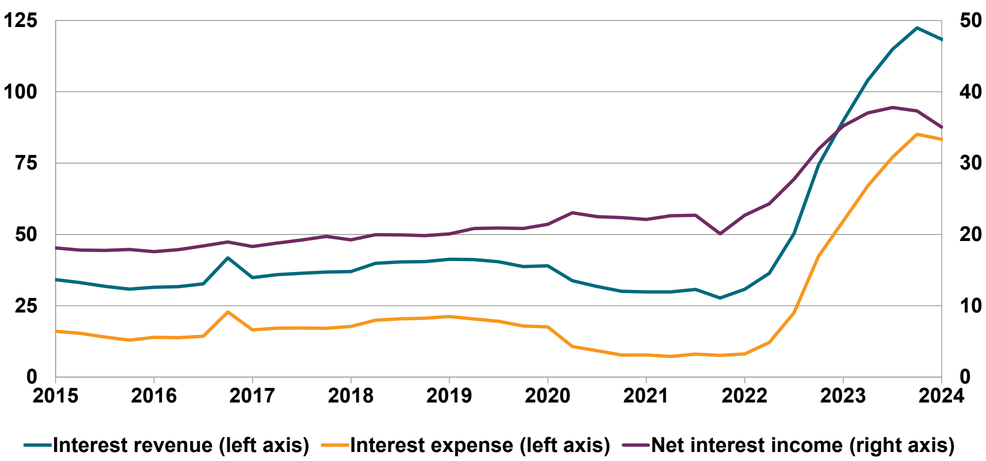


Source: FI, EBA Risk Dashboard and Refinitiv Eikon.
Note: Return on equity. *Systemically important branches* refers to Danske Bank and Nordea. *EU/EES* refers to approximately 160 large European banks.

The banks' net interest income increased, mainly due to an increase in their loan volumes, until mid-2022 when the Riksbank started to increase the policy rate. The margin on lending to the general public, in contrast, was relatively constant. However, since interest rates began to rise, the banks' net interest income margin has increased while their lending volumes instead have fallen slightly (Diagram A4 in the appendix). The major Swedish banks' net interest income levelled off in Q4 2023, but it is still at a very high level from a historical perspective (Diagram 17).

17. Net interest income levels off

SEK billion



Source: FI.

Note: Only major Swedish banks. *Profit/loss items* refers to the profit/loss in the quarter, i.e., not adjusted to an annual rate. The series are not adjusted for seasonal effects.

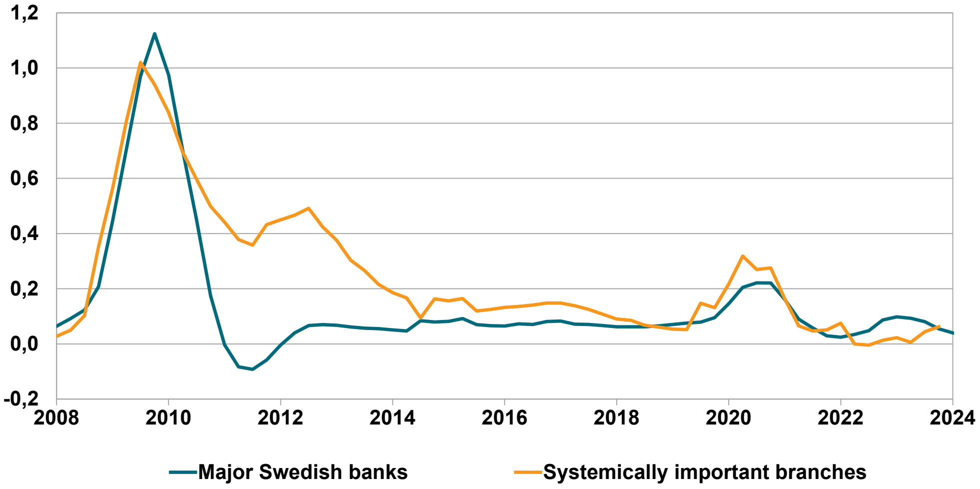
Continuously elevated credit risks

The macroeconomic situation is still a challenge for both Swedish households and some commercial sectors despite waning inflation and expectations of future interest rate decreases. Lower credit demand has contributed to the major banks' lending volumes no longer increasing. Total lending to the public even decreased in Q4 2023. Lending to non-financial corporations contracted the most and decreased for full-year 2023. This is a clear contrast to 2022, when lending to non-financial corporations increased by around 15 per cent (Diagram F2 and Diagram A4 in the appendix).

The macroeconomic uncertainty is also reflected in the banks' asset quality. Since 2022, the credit risk has increased (Diagram A5 in the appendix). During the same period, the credit loss level has also gone up, but it is still at low levels (Diagram 18). At the end of 2023, the major banks' provisions were on average 0.36 per cent of total lending, but the provision rate is still significantly lower than during the pandemic. Aside from a temporary increase during the pandemic, the major banks have had low credit losses for a long time. One reason for this is that many bank customers have fared better than expected despite the high levels of corporate bankruptcies. This is because the banks have relatively low exposures to the industries that have suffered the most bankruptcies. The sectors that have the highest share of bankruptcies, within construction and retail, represent in total 6.7 per cent of the total lending to non-financial corporations. Instead, the largest share of the major banks' exposures is to the CRE industry, 53.3 per cent. This means that the development in the CRE industry continues to be of crucial importance for the major Swedish banks, which are more exposed to this sector than other Swedish banks. To date, the CRE sector only represents 3 per cent of commercial bankruptcies, but the sector is still facing uncertain conditions. If the expectations that interest rates will come down are met, however, the risks are expected to decrease. The major banks' credit spreads have also fallen over the past year, which is an indication that the market no longer considers credit risk to be on an upward trajectory (Diagram 19).

18. Credit losses continue to be at low levels

Per cent

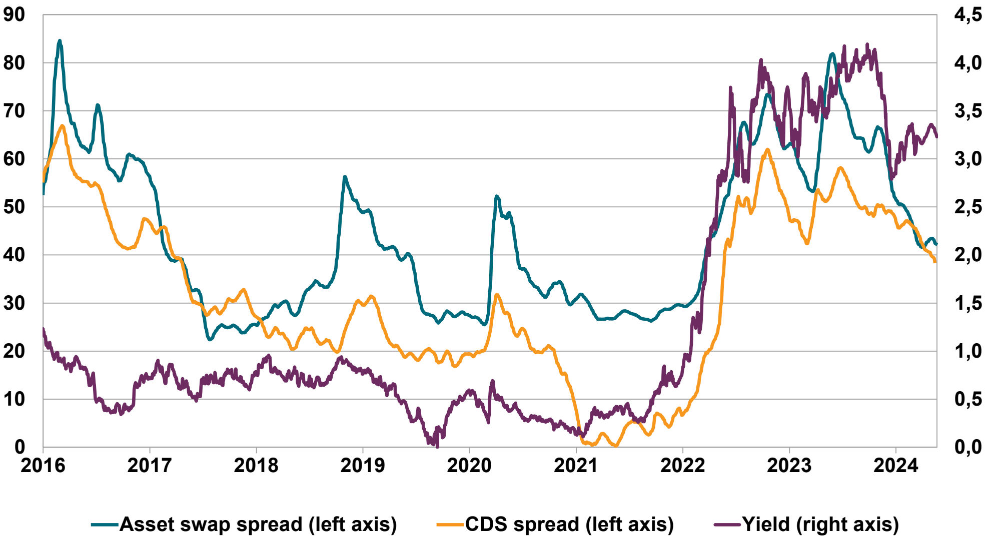


Source: FI.

Note: The credit loss level refers to total net provisions on an annual basis for loans and interest-bearing securities that are reported at accrued cost divided by total loans and interest-bearing securities at accrued cost. Provisions for off-balance sheet items, assets held for sale, and discontinued operations are not included.

19. Credit spreads have contracted somewhat

Basis points (left axis) and per cent (right axis)



Source: Refinitiv Eikon.

Note: Asset swap spread: credit spread for Swedish covered bonds with estimated fixed duration, five-year effective maturity, refers to one-month rolling average for the three major Swedish banks and Nordea. CDS spread: credit spread for senior unsecured bonds; refers to one-month rolling average for the five major Swedish banks. Yield: interpolated market yield for Swedish covered bonds with estimated fixed duration, five-year effective maturity.

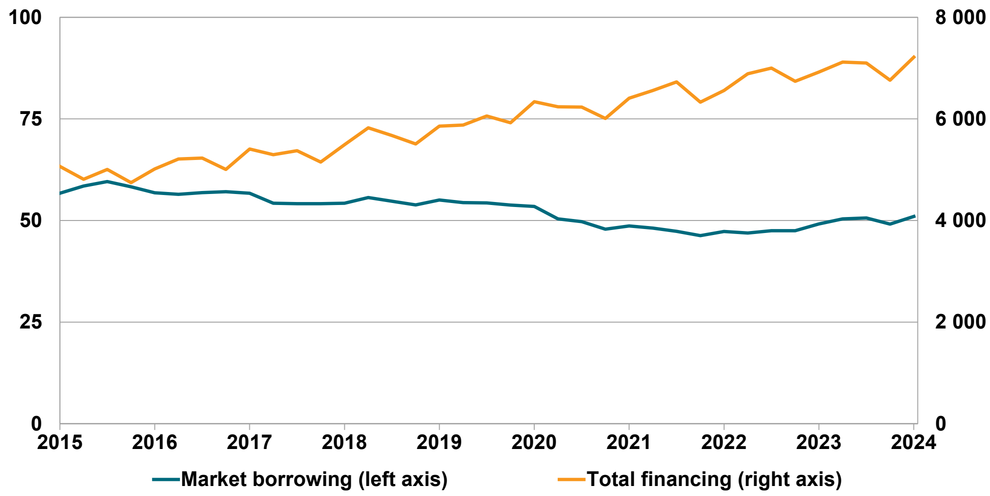
Overall, there continues to be significant uncertainty, regarding both macroeconomic development and the risk that sectors that are more important for the banks could experience problems. FI therefore makes the assessment that the banks' credit risk remains elevated.

Banks continue to have good access to funding

Swedish banks raise funding through deposits and market financing, where the latter consists of certificates, covered bonds, and unsecured bonds. The banks have continued to have good, stable access to market financing, and the interest rates on covered bonds have gone down since the autumn of 2023, even if the market has been volatile at times.

Deposits are also an important source of funding for Swedish banks. Since mid-2022, deposits from households and non-financial corporations have gone down slightly, in part as households' expenses increased due to higher subsistence costs, the continued high level of amortisations, and rising interest rates (Diagram 20). The decrease in central banks' holdings of interest-bearing securities has caused the liquidity surplus on the market to start decreasing, which has had an impact on deposit volumes as well. This trend will probably continue. This means that the share of market financing – all else equal – will increase, which could put pressure on banks' profitability since market funding typically is more expensive than deposits.[23] FI's overall assessment is that the banks continue to have good access to funding through both deposits and market financing.

20. The major Swedish banks largely fund themselves via the market
Per cent (left axis) and SEK billion (right axis)



Source: FI.

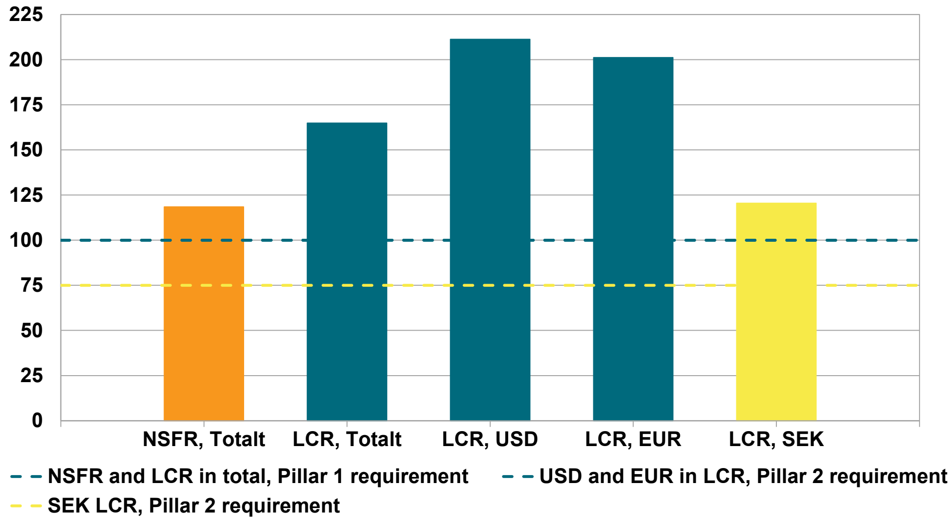
[23] During the period of very low interest rates, however, the relationship was the opposite since covered bonds could be issued at negative rates.

Note: Market financing includes issued securities and subordinated debt. Only major Swedish banks.

Banks have sufficient liquidity buffers

In order to reduce risks concerning liquidity and refinancing, FI imposes requirements on the banks to ensure they hold liquidity buffers. These buffers can be drawn upon to handle short- or long-term liquidity stress. The major Swedish banks currently have good liquidity and meet the margin requirements for the liquidity coverage ratio (LCR) for total currency and individual currencies, as well as the requirement for the net stable funding ratio (NSFR) (Diagram 21).[24] FI also makes the overall assessment that the resilience of the Swedish banks to liquidity shocks is satisfactory. The Swedish financial system is also well-equipped for the type of liquidity problems that affected some American banks in the spring of 2023 (see In-depth Review – Limited risk of bank runs in Sweden).

21. Major Swedish banks meet liquidity margin with strong margin
Per cent



Source: FI.
Note: Only major Swedish banks. Unweighted average. Data for March 2024.

In-depth Review – Limited risk of bank runs in Sweden

FI has previously described the bank runs on four American banks and one Swiss bank in the spring of 2023.[25] In conjunction with this, we made the assessment that

[24] LCR – Ratio between high-quality assets held by the bank and the total outflow during a 30-day stress test scenario.
NSFR – Ratio between available stable financing and the need for stable financing during a one-year period.
[25] Stabiliteten i det finansiella systemet (2023:1). An English translation is available at www.fi.se.

Swedish banks are better equipped for these problems. During the autumn of 2023, FI looked more closely at the causes underlying the banking turmoil in the spring of 2023 and analysed to what extent Swedish banks are exhibiting similar vulnerabilities. One general conclusion is that several factors contributed to the bank runs that occurred in the USA and Switzerland. The banking turmoil had three root causes: weak internal governance and control at the affected banks and deficiencies in both supervision and regulation, which led to the build-up of vulnerabilities in the banks such as concentration risks (for both deposits and lending), interest rate risks, assets in the liquidity reserve that were reported at accrued cost, low share of guaranteed deposits, and poor profitability. The course of events was then accelerated by a digital environment where runs can occur significantly faster than what has historically been the case.

FI's assessment is that Swedish banks do not exhibit the same combination of vulnerabilities that drove the events last spring. Regulations, for example capital requirements for interest rate risks, contribute to the prevention of the build-up of large risks. The difference between the market value and the carrying amount is also low in general for the assets held by Swedish banks. The major Swedish banks have good profitability and lower risk-taking than the American banks that were affected in 2023. And among the smaller banks that demonstrate poorer profitability, the share of guaranteed deposits is high, which decreases the risk of bank runs.

That said, the digital development creates new challenges for supervision. Swedish consumer credit banks and securities banks in particular to an increasing extent fund their lending via so-called deposit platforms, a type of lending that is potentially more volatile than traditional deposits. However, this type of deposit is currently not particularly widespread and is only present at a few smaller institutions. For several of these institution, though, this type of deposit represents a high share of their total funding. FI is currently mapping deposits from digital banking services and comparison and deposit intermediaries to gain a clearer overview of potential vulnerabilities linked to this type of deposit financing.

Stability in the insurance and fund sector

Life insurance undertakings and occupational pension undertakings have a large share of risky assets and concentrations to other sectors – primarily the banking sector. Solvency has decreased slightly, but firms still have buffers that can withstand shocks to the financial markets. There are segments with elevated liquidity risk on the Swedish fund market, but FI currently makes the assessment that the fund managers are able to manage this risk.

	Level	Development
Investment risk in the insurance sector	(orange)	→
Financial position in the insurance sector	(green)	↗
Concentration of assets in the insurance sector	(yellow)	→
Liquidity risk on the fund market	(yellow)	→

The colors indicate the current level of vulnerability. Green represents low vulnerability. Yellow, orange and red indicate differing degrees of elevated vulnerability. The arrows show how FI assesses that the vulnerability develops. An upward-pointing arrow means that the vulnerability is increasing and a downward-pointing arrow that it is shrinking. The assessment of vulnerabilities are based on a combination of quantitative measurements and expert assessments.

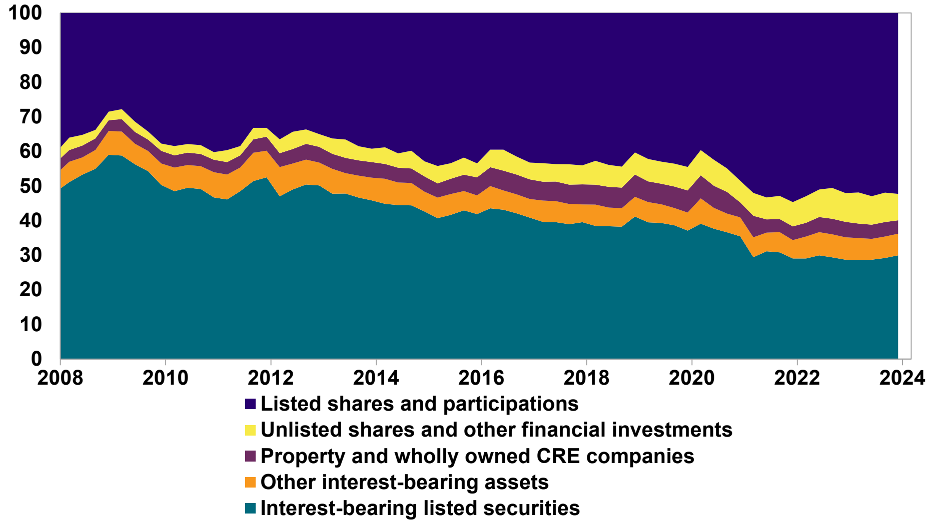
Continued high share of risky investments

During the long period with low interest rates, life insurance undertakings and occupational pension undertakings increased their investments in risky assets. They did this to cover their long-term financial guarantees but also to deliver higher returns. Given that interest rates are higher today, it appears that these undertakings' investments in risky assets have decreased (Diagram 22). It is too early to determine if this is a temporary or long-term change, and the answer most likely depends on how the interest rates develop going forward.

Risky asset portfolios have benefited life insurance undertakings and occupational pension undertakings, primarily in periods when share prices have been increasing (Diagram A2 in the appendix). Today's high interest rate levels increase the incentive to return to a larger share of interest-bearing securities, which could be advantageous since they generate known cash flows that can be matched against the pension liability. Interest-bearing securities with good creditworthiness also lead to lower capital requirements than more risky asset types, which has a positive effect on solvency. But if interest rates fall to significantly lower levels, this could result in a need for continued high or increased risk-taking.

22. Share of risky assets still high

Per cent



Source: Statistics Sweden.

Note: The diagram refers to the distribution of life insurance undertakings and occupational pension undertakings between interest-bearing and risky assets (excluding unit-linked and deposit insurance). *Other interest-bearing* is cash, accrued interest income and loans. *Risky assets* refers to listed shares, property, wholly owned commercial real estate firms, and other financial investments.

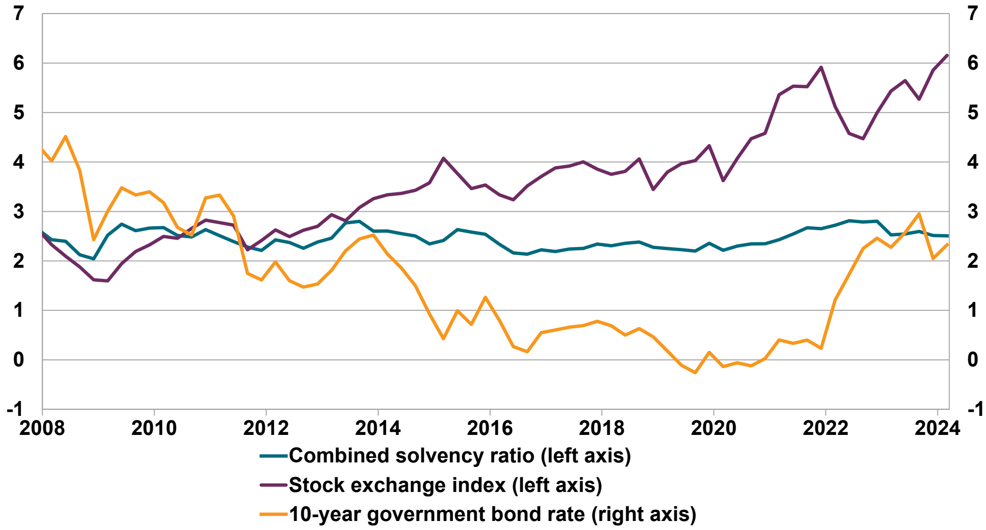
Solvency somewhat impaired

Firms' solvency is calculated by setting own funds in relation to a risk-based capital requirement. Life insurance undertakings and occupational pension undertakings have large equity portfolios in general. When equity prices go up, the asset pool and own funds increase. At the same time, significant stress is applied to these holdings in the capital requirements calculation, which means that the capital requirements increase when the stock markets are rising sharply. When market rates go down, this leads to an increase in the estimated pension liability, and own funds are affected negatively. Lower own funds are set against higher capital requirements, which overall impairs solvency (Diagram 23).

Even if solvency has decreased slightly in recent quarters, it is still at a good level, and FI makes the assessment that firms' buffers are large enough to withstand major shocks to the financial markets.

23. Solvency contracts slightly

Ratio (left axis) and per cent (right axis)



Source: FI, Nasdaq OMX and the Riksbank.

Note: Up through 31 December 2021, the diagram shows the traffic-light ratio for life insurance undertakings that applied the Solvency I regulations before they were converted to occupational pension undertakings. Since 31 March 2022, solvency is shown in accordance with the new occupational pension regulation. The series is a mix of two measurements that FI has chosen to call a solvency ratio.

Concentrations in investments

Approximately one-third of life insurance undertakings' and occupational pension undertakings' investments consist of exposures to the banking sector, excluding unit-linked and deposit insurance. Investments consist primarily of shares and securities in Swedish banks, of which approximately one-third of the securities are covered bonds. In a scenario where banks experience clearly higher credit losses, these assets could drop in value. In addition to investments in the banking sector, concentration risks arise through owner structures, where insurance undertakings own banks or banks own insurance undertakings.

Another exposure in the portfolios of life insurance undertakings and occupational pension undertakings consists of properties and holdings in CRE firms. These undertakings have a number of different exposures to the sector, both directly – through property ownership – and indirectly – through real estate funds, corporate bonds, and shares in CRE companies – that in total amount to approximately 13 per cent of the investments. Swedish banks have large exposures to the CRE sector. As a result, the insurance sector also has an indirect exposures to the CRE sector via exposures to the banking sector. FI makes the assessment that, despite these concentration risks, the buffers that life insurance undertakings and occupational pension undertakings have are sufficient for handling a scenario with lower values on CRE-related holdings in addition to the impairments recorded in 2023.

Risks on the Swedish fund market

The risks on the Swedish fund market are basically the same as they have been before.

Higher interest rates mean a higher risk level in funds, especially fixed-income funds and funds with high exposure to the CRE sector. If interest rates or inflation remains high for a longer period of time, fund savers may need to reduce their savings to handle increased housing costs and other subsistence costs. If savings drop and savers redeem their fund units, this could lead to a greater selection of bonds. The situation could be further reinforced by many central banks discontinuing their bond purchases (quantitative easing).

Being able to value the funds' holdings is fundamental. In addition to increased flows, market turbulence can also make it difficult to value assets. Valuation uncertainty combined with large outflows from investors could lead to fund managers having to delay the sale and redemption of certain funds. It is therefore important that fund managers ensure an adequate matching of the funds' assets and liabilities. Even if there are some fund segments that are judged to have an elevated liquidity risk, such as high-yield funds, FI makes the assessment that fund managers are currently able to manage these risks.

Swedes' fund savings generally have not changed. In Q1 2024, equity funds and long-term fixed-income funds had inflows while hedge funds and short-term fixed-income funds had outflows.

In 2023, the restructuring of the premium pension system began, and the Swedish Fund Selection Agency (Fondtorgsnämnden) will procure over the next few years all categories in the premium pension system to create the future fund selection. The purpose of the procurement is to raise the quality while lowering the fees on funds in the premium pension. The only funds that are not procured are the two pre-selected funds at Seventh AP Fund (Sjunde AP-fonden). Once the changes are implemented, it is estimated that there will be approximately 150–200 funds in the premium pension system instead of today's roughly 450 funds.

Five procurements have been started so far, of which one has been completed. Additional procurements are expected to start later in the year. Once a procurement is completed, there is a period during which savers and capital are moved from the terminated funds to the procured funds.

FI has identified a number of risks pertaining to the transfer of premium pension funds, primarily liquidity risks in the funds and the risk of market impact on individual instruments. Liquidity risks at the fund level arise since the Swedish Pension Agency often has significant ownership and holdings. The risk of market impact on individual instruments can arise in conjunction with the fund managers managing the flows, particularly if several funds in the same category sell or buy the same underlying security. There can be additional reinforcing negative effects if other market actors speculate on the large flows through derivative positions. Both large institutions and small savers can be negatively impacted if unmotivated movements in individual securities arise on the market or if the funds are forced to postpone their trading due to the change in the premium pension system.

Operational stability risks and financial infrastructure

The serious state of global affairs is leading to an increasing need for systems and procedures that are stable enough to manage cyber risks. The financial sector is highly digitalised, and its actors are interlinked, which entail risks. It is therefore important that firms in the financial sector continuously analyse and evaluate vulnerabilities to ensure sufficient resilience.

Serious state of global affairs entails increased operational risks in the financial system

According to the Swedish Security Service, several nations are conducting systematic, extensive intelligence and security-threatening actions against Sweden and Swedish interests. The serious state of global affairs increases the risk of cyber attacks, misinformation, infiltration and sabotage to the financial system.

A widespread disruption to the financial system can threaten financial stability, which in turn could have an impact on Sweden's security. Financial corporations conducting business crucial for Sweden's security are subject to FI's security protection supervision. These firms need to, among other things, identify which components of their own operations are worthy of protection and assess their dependency on other firms and their processes or on society in general. This type of analysis is complex, can take a long time to carry out, and needs to be followed up regularly. These firms must also implement relevant protection measures, which requires that the firm has identified the threats for which the firm needs protection. Deficiencies in this respect can have consequences from a stability perspective. As part of our supervision, we monitor how firms work with this.

Digitalisation requires more resilience to technical disruptions

Resilience to technical disruptions, in other words the operational capacity to manage security in the business network and information management system, is central for reducing the risks of disruptions to critical financial services. Firms in the financial sector need to have good capacity for protecting their operations to reduce the risk of disruptions. FI has seen in its supervision that financial corporations have not built up their resilience to various disruptions at the same rate as the operations have been digitalised. The interconnectedness of systems and interdependencies that exist between different actors in the financial sector are examples of vulnerabilities that entail operational stability risks. As resilience is bolstered, financial corporations can prevent, or in any case reduce, the risk that such risks will accrue.

DORA, the EU's digital operational resilience regulation, will go into effect in January 2025. The regulation targets most firms that today fall under FI's supervision. It places stricter requirements on firms to manage risks in information and communication technology (ICT), report ICT-related incidents, test digital operational resilience, and manage ICT-related third-party risks (also see below). The regulation both tightens and unifies the requirement on financial corporations' management of cyber risks, which in turn strengthens resilience to disruptions. FI makes the assessment that when firms have adapted their operations to the new rules, the operational stability risks should decrease compared to today. We will follow as part of our supervision how this adaptation is carried out.

Outsourcing entails concentration risks

Outsourcing contributes to another type of operational vulnerability that potentially could threaten stability. Financial corporations are increasingly outsourcing critical operations to third-party suppliers.[26] This provides the firm with access to specialists, for example IT competence, without needing to build up corresponding competence internally. This can be more efficient, safer and cheaper. However, it also contributes to an increased concentration of critical services to a small number of suppliers. This – combined with the interconnectedness inherent to the financial sector – poses a risk that shocks could quickly impact large areas of the financial system or potentially spread in a way that has a serious impact on the entire financial sector and thus could be a threat to financial stability.

Outsourcing also places new demands on the firms' governance and control of how they are managing their risks. Where third-party suppliers in turn outsource parts of their operations, this can introduce a risk of insufficient transparency and lead to impaired control of the supply chain.

As previously mentioned, DORA will also introduce special rules that apply to the management of ICT-related third-party risks that could arise during outsourcing. In the new rules, financial corporations are required to prepare a register of all outsourcing, and the contents of the register must be shared with concerned supervisory authorities. FI will thus gain a better overview of the risks related to outsourcing and thereby be able to impose clearer demands in our supervision.

[26] *Third-party suppliers* refers here to another firm that provides services to the financial corporation, i.e., the financial corporation outsources parts of its operations to another firm.

Continued elevated vulnerabilities in financial infrastructure

The financial infrastructure consists of market participants providing systems for payments, settlement of securities transactions, and management of counterparty risks. FI makes the overall assessment that the vulnerability in the financial infrastructure is elevated but unchanged since its last stability report. This is due, in part, to the residual uncertainty related to the forming of a new payment infrastructure and, in part, to the uncertainty caused by Nasdaq Clearing's planned divestment of the electricity derivative clearing to European Commodity Clearing (ECC). ECC does not accept non-financial members, and there is therefore a risk that moving the electricity derivative clearing will lead to more bilateral trade. This could result in increased credit risks and decreased efficiency and transparency on the market.

	Level	Development
Financial infrastructure		→

The colors indicate the current level of vulnerability. Green represents low vulnerability. Yellow, orange and red indicate differing degrees of elevated vulnerability. The arrows show how FI assesses that the vulnerability develops. An upward-pointing arrow means that the vulnerability is increasing and a downward-pointing arrow that it is shrinking. The assessment of vulnerabilities are based on a combination of quantitative measurements and expert assessments.

Important modernisation of payment infrastructure

The capacity to make payments is central for a functional society, financial stability, and thus society's resilience. Efforts are currently underway to modernise Bankgirot's existing IT platform and develop a new system for so-called batch payments. Real-time payments, which have previously gone from Swish via Bankgirot now instead go directly to the Riksbank for settlement. High resilience and a good ability to manage risks are particularly important when new systems are developed. It is also important that banks, in their role as owners, take responsibility for ensuring the stability of the Swedish payment infrastructure. FI will regularly follow up on this work as part of its supervision.

Increased activity on the cleared derivative market

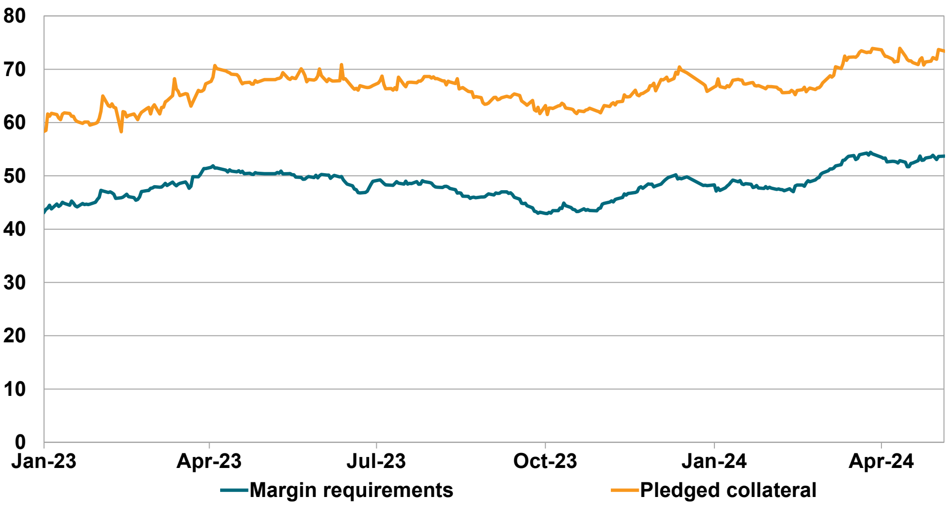
Europe appears to be leaving the heating season with high gas storage levels, which is positive for next winter. This is reflected in the prices of Nordic electricity derivatives that fall due next autumn and winter. They have demonstrated a downward trend since last autumn. Price development on the electricity market also led to a decrease in the margin calls[27] for members of Nasdaq Clearing's commodity market by 12 per cent during the period.

[27] *Margin calls* refers to the estimated cost of closing a position.

Since last autumn, the number of transactions and volumes in cleared equity, interest and commodity derivatives has increased at Nasdaq Clearing. This is probably because risk appetite has begun to recover and market liquidity has improved. This – combined with market fluctuations on the equity and fixed-income markets – has meant that the margin requirements for derivatives linked to these instruments have increased by around 25 per cent.

The margin requirements have gradually increased over time. This has thus not entailed liquidity stress for members. In total, Nasdaq Clearing's members have pledged assets for large amounts that significantly exceed the requirements (Diagram 24). Thus, there is some room for increased margin requirements without needing more pledged assets.

24. Margin requirements and pledged collateral for equity and interest derivatives
SEK billion



Source: FI and Nasdaq Clearing.
Note: Refers to total margin requirements and pledged collateral for equity and interest derivatives at Nasdaq Clearing.

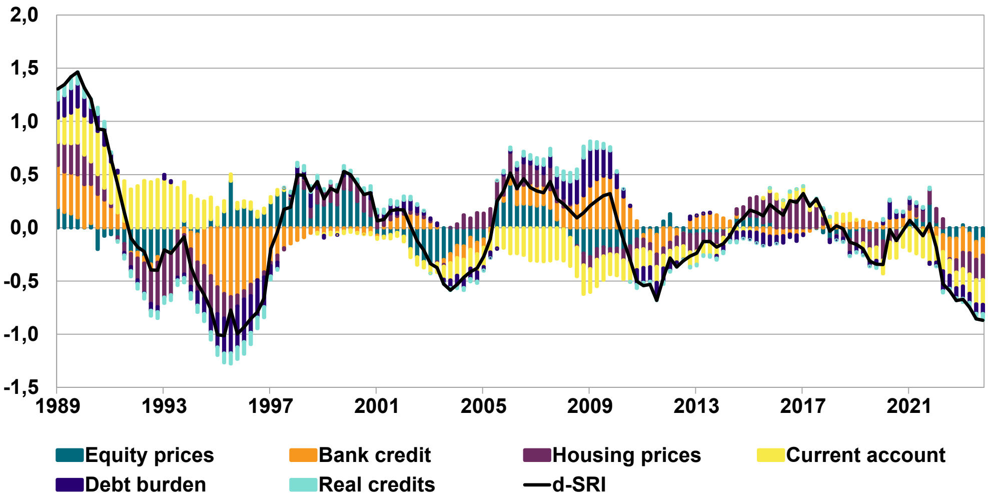
The divestment of commodity clearing to European Energy Exchange and its corresponding clearing commission, ECC, that Nasdaq Clearing announced is now under assessment and awaiting a decision by the European Commission. A decision is expected imminently. To date, Nasdaq Clearing has not noted any change in behaviour from its members as a result of the announced plans to divest the commodity clearing. However, FI still sees a risk that a move to ECC could lead to more bilateral trading on the Nordic market, which would negatively impact pricing and transparency and could lead to increased credit risks on the market.[28]

[28] Stabiliteten i det finansiella systemet (2023:2). An English translation is available at www.fi.se.

Appendix of diagrams

A1. The systemic risk indicator d-SRI captures historical periods of risk accrual

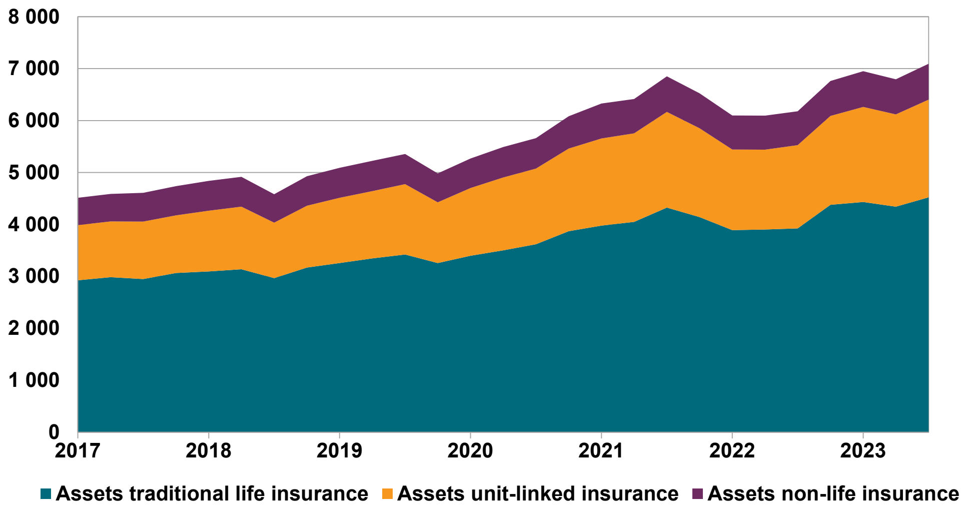
Normalised value



Source: FI.
Note: Normalised value means subtracting the median from the observation and dividing by the standard deviation.

A2. Insurance undertakings manage large amounts

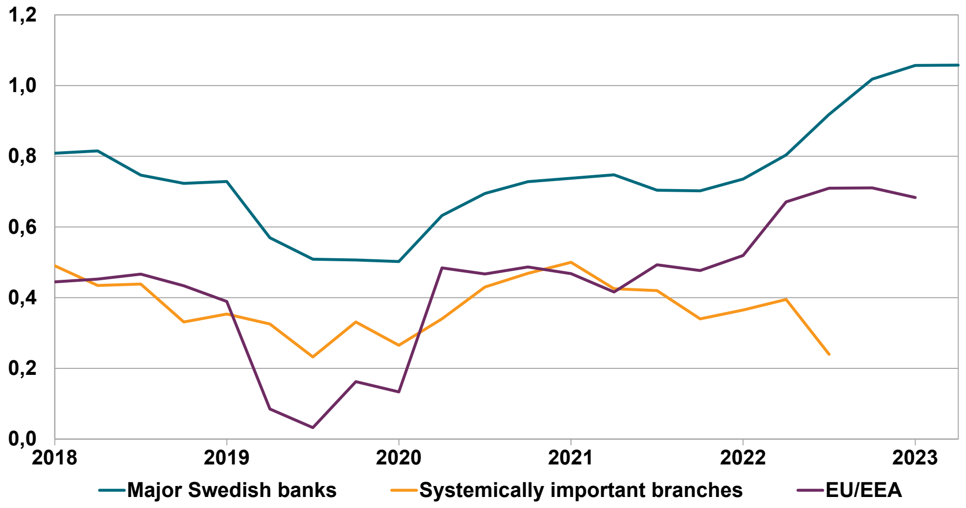
SEK billion



Source: Statistics Sweden.
Note: Insurance undertakings' investment assets broken down into traditional life insurance, unit-linked insurance and non-life insurance.

A3. Profitability no longer increasing but at historically high levels

Per cent

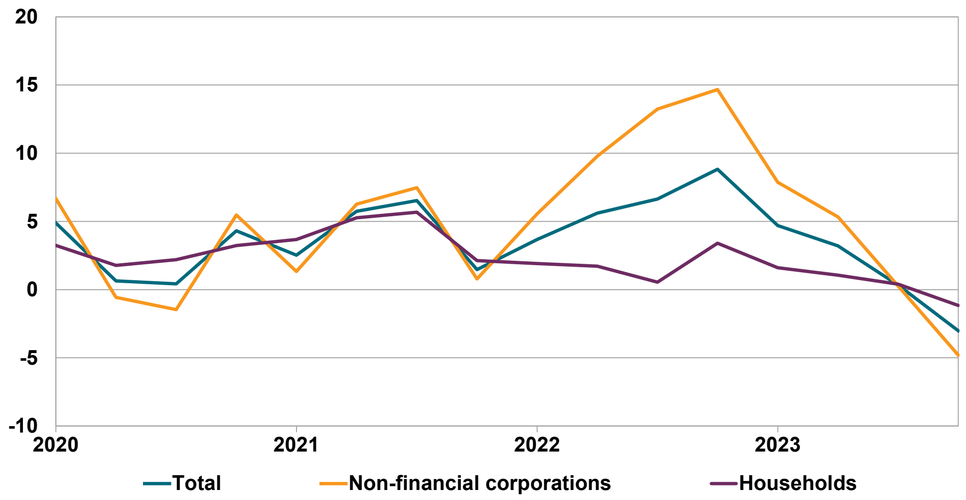


Source: FI.

Note: Annualised return on total assets with four-quarter rolling mean. *Systemically important branches* refers to the branches of Danske Bank and Nordea. *EU/EES* refers to approximately 160 large European banks.

A4. Less lending from major banks

Per cent

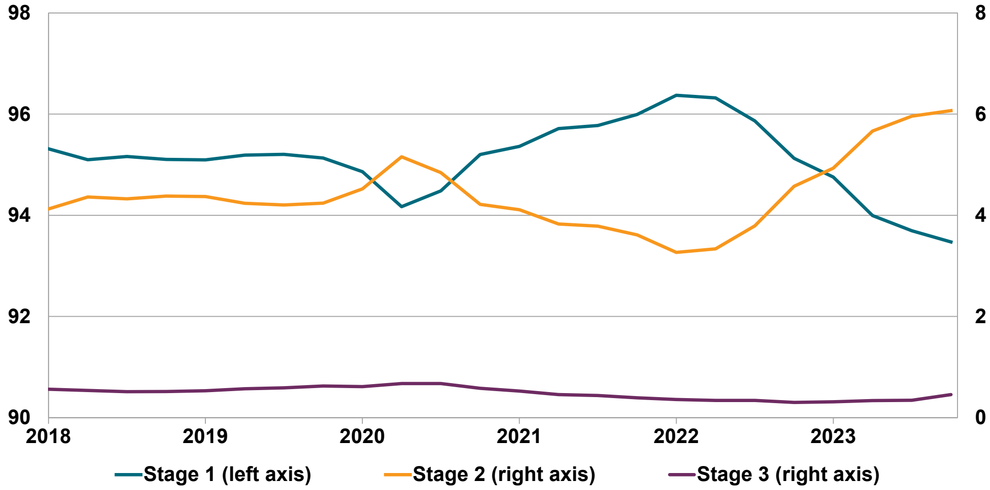


Source: FI.

Note: Refers to the major Swedish banks' exposures at the consolidated level and the Swedish branches of Nordea and Danske Bank.

A5. Increase in loans in stages 2 and 3.

Per cent

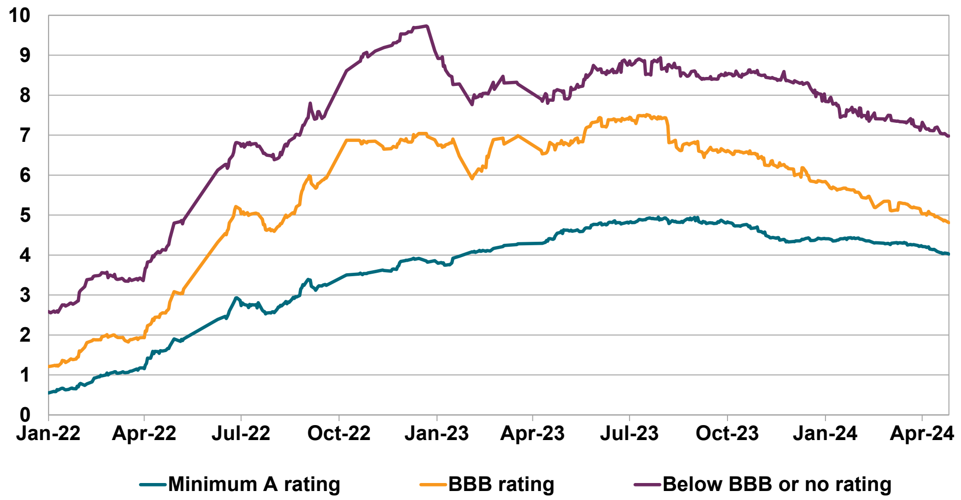


Source: FI.

Note: Refers to the major Swedish banks' exposures at the consolidated level and the Swedish branches of Nordea and Danske Bank. The breakdown into stages is based on the accounting standard IFRS 9, where Stage 2 entails a significant increase in the credit risk since the loan was issued and Stage 3 is that a loss event has occurred and the loan is written off.

A6. Bond rates also fallen for commercial real estate firms with lower credit ratings

Per cent



Source: Refinitiv Eikon.

Note: The data refers to a sample of commercial real estate firms' bonds where the issuer falls in one of the credit rating categories and the bonds have coupon payments in SEK at a variable rate.