

ARTICLE – The market for Swedish covered bonds during the coronavirus pandemic

This article examines how the market for covered bonds has developed during the pandemic and describes how the Riksbank's measures linked to the market have functioned. The Riksbank has purchased covered bonds and eased the requirements for the banks to use these as collateral for loans in the Riksbank. The purpose has been to alleviate the effects of the pandemic on the Swedish economy. The measures have helped keep the general level of interest rates low, at the same time as the Riksbank's presence as purchaser had a stabilising effect on the market in the initial phase of the pandemic. The Riksbank has begun to taper its purchases during 2021 and decided to revert to the previously applicable collateral requirements at the turn of the year.

During the pandemic, the investor structure in the market has changed. More flighty investors have sold off their holdings, including many foreign investors, in step with the Riksbank's purchases. Activity in the secondary market has also decreased slightly during the pandemic, to which the changed investor structure and the Riksbank's purchases may have contributed. However, the banks' funding opportunities via covered bonds remain good and they have issued covered bonds throughout the pandemic.

Even if the support measures are motivated, in the longer run they may lead to excessive risk-taking and the accumulation of vulnerabilities if financial actors expect to always receive help in a crisis. Similarly, companies and households need to consider that their interest expenses may rise going forward.

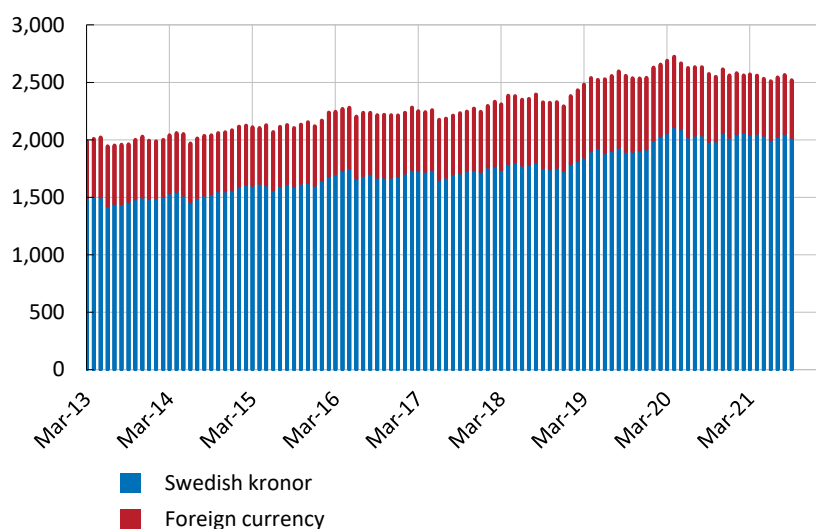
The market is important for financial stability and the monetary policy transmission mechanism

A bank can fund its lending to households and companies in various ways, with mortgages primarily being funded by the bank issuing covered bonds. The Swedish market

for covered bonds is very large and has grown over time. The total outstanding volume currently amounts to around SEK 2,500 billion (see Chart 31).¹³⁴ This is more than twice the outstanding volume of government bonds and corresponds to approximately half of Sweden's annual GDP. Given the size of the market and its significance for the banks' funding, it is important for both financial stability and the monetary policy transmission mechanism that it functions satisfactorily.¹³⁵ Insurance companies and pension funds are major domestic investors in these bonds, as are funds and the banks themselves. Foreign investors also have a significant market share. In addition the Riksbank has become a significant participant during the pandemic.

Chart 31. Outstanding volume of Swedish covered bonds

SEK billion



Source: Statistics Sweden.

The Riksbank's measures linked to covered bonds

The restrictions that the authorities introduced during the pandemic to reduce the spread of infection had major consequences for the real economy and completely changed the economic prospects. Uncertainty with regard to how the real economy would cope with the crisis initially led to a substantial deterioration in the financial markets. Investors in general sought safer and more liquid assets. This increased the yield differentials between government bonds and riskier assets and there were signs of a deterioration in the functioning of the markets. This also applied to the market for covered bonds, where yields rose and liquidity deteriorated.¹³⁶ The turbulence

¹³⁴ Covered bonds are sometimes also called mortgage bonds. The holder of a covered bond has a special priority right in a so-called collateral volume, which consists primarily of mortgage loans, if the bank fails.

¹³⁵ For a more detailed review of covered bonds and their link to financial stability, see J. Fager Wettergren, D. Forsman, M. Sandström and J. Stenkula von Rosen, "The market for Swedish covered bonds and links to financial stability" *Economic Review* 2013:2, Sveriges Riksbank.

¹³⁶ See *Financial Stability Report 2020:1*, Sveriges Riksbank.

continued, which put credit supply in the Swedish economy under considerable pressure. There was a risk that this would aggravate the downturn in the economy and lead to prolonged negative consequences for output and employment.

The Riksbank's purchases of covered bonds

To mitigate the effects of the crisis, the Riksbank has implemented a number of measures. One of them has been to extend purchases of Swedish securities to cover more asset types than government bonds, including covered bonds.¹³⁷ The purpose of the purchases was to keep down the general level of interest rates and contribute to a functioning credit supply. The fact that the Riksbank also began to buy covered bonds was important for maintaining the pass-through of monetary policy. The purchases of other asset types have also given the Riksbank the capacity and operational preparedness to act quickly, and have made it possible to implement such purchases if this were to become necessary in future stressed situations.

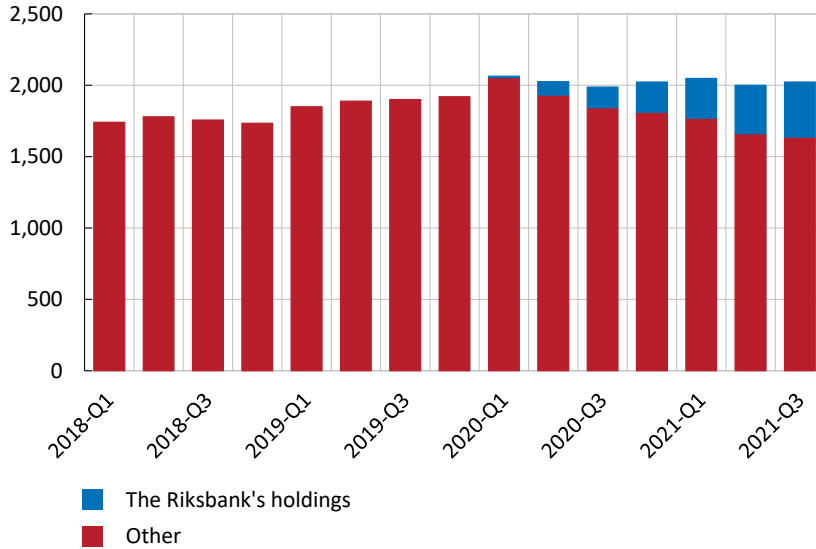
Up to 29 October 2021, the total purchases of covered bonds amounted to SEK 410 billion and the Riksbank's holdings amount at present to about 20 per cent of the total outstanding volume issued in Swedish kronor (see Chart 32). Since the purchases started, they have corresponded to just over 40 per cent of the covered bonds issued in the market (see Chart 33). By 31 December 2021, the Riksbank shall have purchased covered bonds for SEK 435 billion. The Riksbank has forecast that its total asset holdings will be more or less unchanged in 2022.¹³⁸

¹³⁷ Other central banks, such as the European Central Bank and the Federal Reserve, also expanded their asset purchases. See J. Birging and D. Hansson (2021), "the Riksbank's asset purchases during the coronavirus pandemic", *Economic Commentaries* No 12, Sveriges Riksbank for more information.

¹³⁸ See *Monetary Policy Report*, September 2021, Sveriges Riksbank.

Chart 32. Outstanding volume of Swedish covered bonds and the Riksbank's holdings

SEK billion

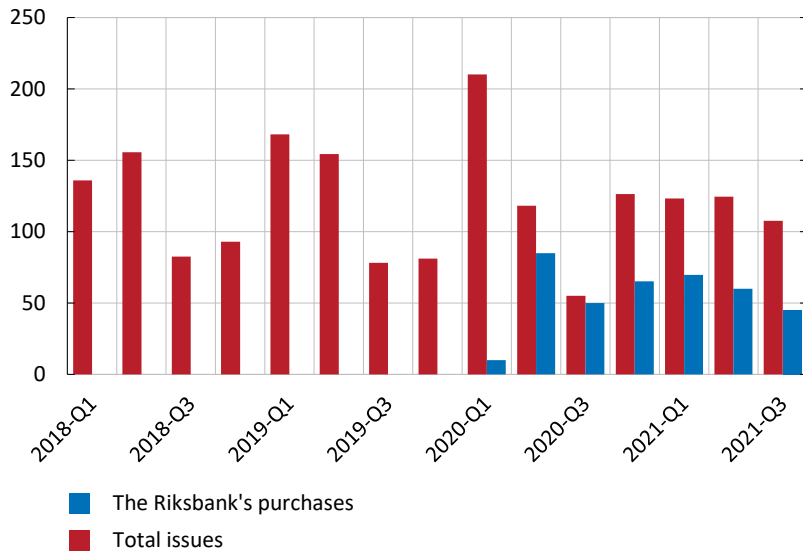


Note: Refers to Swedish covered bonds issued in Swedish kronor.

Sources: Statistics Sweden and the Riksbank.

Chart 33. Total issues of Swedish covered bonds and the Riksbank's purchases

SEK billion



Note: Refers to Swedish covered bonds issued in Swedish kronor.

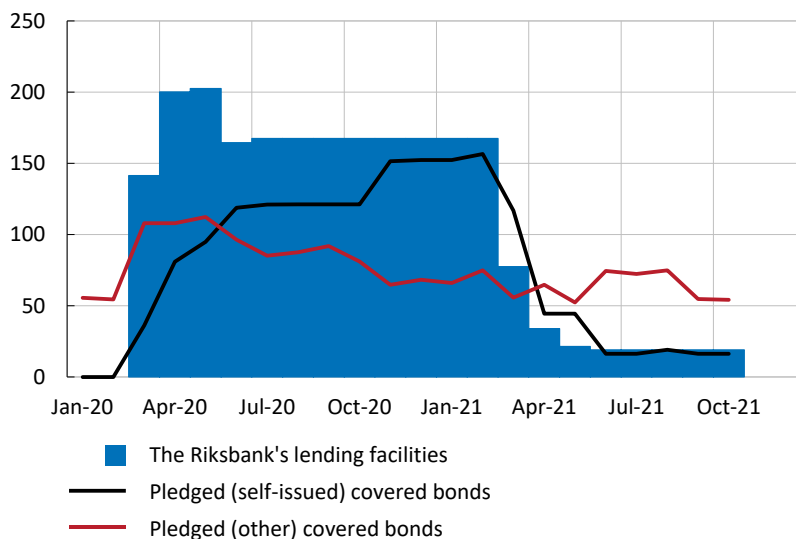
Sources: Statistics Sweden and the Riksbank.

The Riksbank temporarily eased the collateral requirements in its loan terms

When the Riksbank provides credits to its counterparties, they are required to provide adequate collateral in exchange. The Riksbank eased the collateral requirements during the pandemic to strengthen banks' access to liquidity in Swedish kronor and to promote the impact of the lending programme to banks, which was aimed at supporting corporate lending. This easing meant that the special limit rules applying to covered bonds were abolished and that self-issued covered bonds, that is covered bonds issued by the counterparty itself, could start to be used as collateral.¹³⁹ In this way, the banks could use significantly more covered bonds for credit at the Riksbank. As the banks borrowed from the lending facilities launched by the Riksbank during the pandemic, the amount of covered bonds pledged as collateral in the Riksbank increased, and the increase consisted almost exclusively of the banks' self-issued bonds (see Chart 34). As the volume borrowed by the banks decreased in the spring of 2021, the amount of self-issued covered bonds pledged at the Riksbank also decreased. On 21 September 2021, the Riksbank closed the lending facilities that were launched during the pandemic. At the turn of the year, the collateral requirements will also revert to those that applied before the pandemic.¹⁴⁰

Chart 34. Volume borrowed in the Riksbank's lending facilities and pledged covered bonds

SEK billion



Source: The Riksbank.

¹³⁹ This easing meant that the highest permitted share of covered bonds in a counterparty's total collateral for credit at the Riksbank was raised from 60 per cent to 100 per cent and that the highest permitted collateral value for covered bonds issued by an individual issuer, or group of individual issuers, was raised from 50 per cent to 100 per cent.

¹⁴⁰ The stricter collateral requirements and limits will be reinstated on 3 January 2022. With regard to outstanding loans in the programme for funding to banks to support corporate lending, the existing collateral requirements will apply until the loan has been paid. See *Monetary Policy Report, September 2021*, Sveriges Riksbank.

The measures helped to stabilise the market and keep interest rates low

The Riksbank's purchases improved the functioning of the covered bond market at the beginning of the pandemic, partly by reducing market participants' concerns that they would not be able to find buyers for their holdings if they wanted to sell. The risk premiums on covered bonds rose sharply at the start of the pandemic, but then fell up until autumn 2020 (see Chart 22 in Chapter 2), a development the purchases probably contributed to. However it is difficult to determine the degree to which the Riksbank's purchases affected interest rates, given the turbulence that prevailed and given that many measures were implemented at the same time, both in Sweden and abroad.

At present, both yields and risk premiums are on a historically low level. Yields have also fallen for bonds issued by institutions from which the Riksbank has not purchased and for types of bond the Riksbank has not purchased, which may indicate that the purchases have had a broad impact on the market.¹⁴¹ The low interest rates have contributed to the banks' lending rates to households and companies not having risen and helped to maintain lending.

The investor structure has changed and activity has declined

The investor structure in the market has changed during the pandemic. Above all, it is foreign investors who have gradually sold off their holdings of covered bonds (see Chart 35). This has happened as the Riksbank has made purchases and as risk premiums have fallen. For other investor categories, the changes have generally been small. This could be because other participants, such as insurance companies and pension funds, have a more long-term investment horizon. However, the funds sold a certain amount of their holdings at the start of the pandemic when redemptions from unit-holders increased as a result of the unease. The banks' holdings increased somewhat in the initial stage of the pandemic, but are at present back at roughly the same level as before the pandemic.

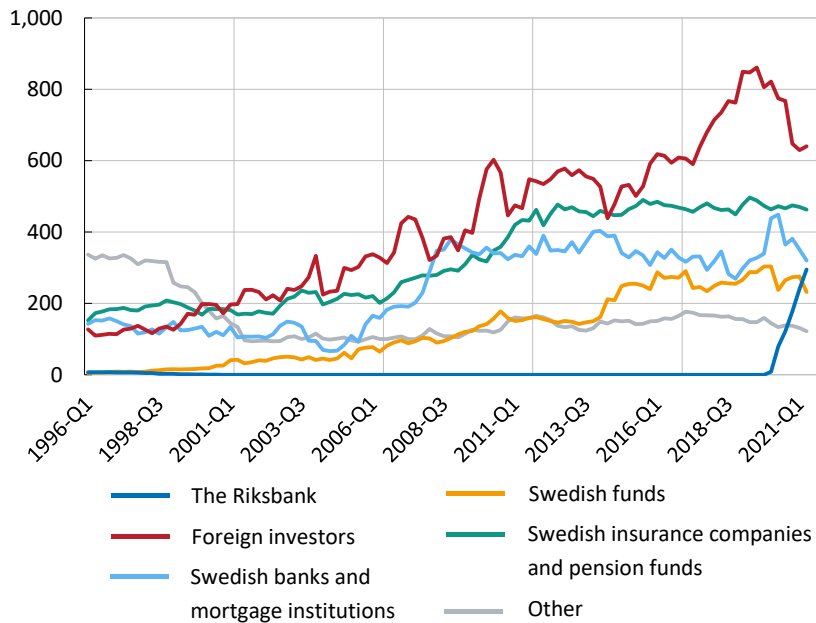
Some market investors are generally more flighty and more sensitive to changing market conditions, including some foreign investors. In addition, foreign investors do not often have a need for assets in a specific currency, like Swedish kronor, but can change currency on the basis of what suits their risk profile in different situations. They may therefore be more likely to sell off their holdings of covered bonds in a stressful situation, as happened during the global financial crisis of 2008-2009. When a large proportion of investors wish to sell their holdings at the same time, there may be several negative consequences, not least given the size and importance of the Swedish market for covered bonds. If there are not sufficient buyers, it may aggravate

¹⁴¹ The Riksbank purchases so-called benchmark bonds issued in Swedish kronor by Swedish institutions with resale agreements. See J. Alsterlind (2021), "The development of risk premiums on covered bonds during the coronavirus pandemic", *Economic Commentaries* no. 13, Sveriges Riksbank for a more in-depth review.

an already stressed situation. Ultimately, it may make it more difficult for banks to fund themselves through covered bonds.

Chart 35. Owners of Swedish mortgage institutions' bonds

SEK billion



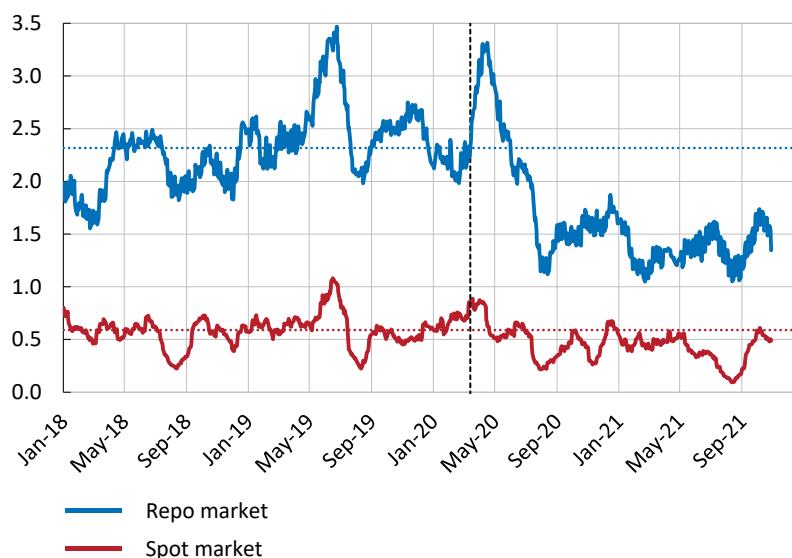
Note: Refers to Swedish mortgage bonds issued in all currencies.

Source: Statistics Sweden.

Activity in the secondary market, i.e. the trading between different investors, has also decreased slightly during the pandemic (see Chart 36). This applies both to the spot market and to the repo market, where a repo means that a bond is borrowed or lent out for a certain period of time. However, the fall is most substantial in the repo market. The Riksbank's purchases may have contributed to a reduction in turnover as they have decreased the supply of bonds freely available for trade in the market. The reduced presence of foreign participants has also contributed to the decrease, above all in the repo market, where foreign hedge funds, for instance, are usually active.

Chart 36. Daily turnover in the secondary market

Per cent of total outstanding volume



Note: Rolling average 30 days. Horizontal broken lines refer to the average prior to the coronavirus pandemic. Refers to covered bonds issued in Swedish kronor.

Sources: SELMA and Statistics Sweden.

The Riksbank's pandemic measures are motivated but agents cannot always expect support

Despite the change in the market for covered bonds during the pandemic, the banks' funding possibilities via covered bonds remain good. The banks have issued covered bonds throughout the pandemic to sustain the market and maintain their relationships with investors. If some of the deposits that increased during the pandemic decrease going forward, the banks may need to issue more bonds, which they are deemed able to do.

It is important that the banks reflect over the composition of their investor structure and are aware that some investors, often foreign ones, historically have turned out to be more flighty in turbulent situations, which creates stress unless there are other participants who wish to purchase. The larger the proportion of the covered bonds that are owned by such flighty investors, the greater the stress may be in such situations. Therefore, to maintain stability in the market, it is important that the banks have an investor structure with a long-term investment horizon so that individual groups of investors do not risk exacerbating a development that is already stressed. To support this, it is important that there is satisfactory data on the ownership of the bonds, and that the banks work to become more transparent regarding the structure.

During the pandemic, the banks have used the Riksbank's lending facilities and have pledged their own covered bonds as collateral for these to a high degree. At present, almost everything borrowed from the Riksbank has been repaid, at the same time as

the Riksbank has communicated that the collateral requirements will be restored. The Riksbank has also begun to taper its purchases of covered bonds during 2021.

The support measures implemented have helped the financial system to function satisfactorily during the pandemic. The measures are motivated but, at the same time, may add to the vulnerabilities in the financial system over the longer term.

Another concern is the financial sector relying on government measures to always protect banks and other financial agents from losses in a crisis. Going forward, this may also lead to excessive risk-taking, so-called “moral hazard”, and to vulnerabilities accumulating in the financial system. It is important for financial agents to realise that they cannot always count on support measures. The measures implemented during the pandemic were aimed at improving the situation for the market as a whole and the entire economy, rather than supporting individual institutions. In addition, both companies and households should make allowances for the possibility that their interest expenses may rise going forward, not least because current interest rate levels are low from a historical perspective.