The Riksbank's operational framework for the implementation of monetary policy – overall description

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SVERIGES RIKSBANK

List of contents

1	Objectives and tasks	4
2	Counterparties	4
2.1	Different categories of counterparty	5
2.2	Requirements for counterparties	6
3	Instrument	7
3.1	Standing facilities	7
3.2	Market operations	9
4	Collateral	10

The Riksbank's monetary policy operational framework

This document describes Sveriges Riksbank's monetary policy operational framework.

The aim of this document is to describe and explain the actual application of the Riksbank's monetary policy operational framework.

More detailed rules for the RIX payment system and the monetary policy operational framework are given in the Terms and Conditions for RIX and Monetary Policy Instruments (the Terms and Conditions), which can be found on the Riksbank's website www.riksbank.se.

1 Objectives and tasks

Pursuant to the Sveriges Riksbank Act (SFS 2022:1568), the overriding objective of the Riksbank is to **maintain low and stable inflation (the price stability objective)**. The Riksbank has specified an inflation target, according to which the annual change in the consumer price index with a fixed interest rate (CPIF) is to be 2 per cent.

According to the Sveriges Riksbank Act, the Riksbank shall also, without neglecting the price stability objective, **contribute to the stability and efficiency of the financial system**, including the ability of the public to make payments. This assignment includes the exclusive right to issue banknotes and coins in Sweden and the responsibility for the country's provision of cash. In addition, for eligible institutions, the Riksbank provides a payment system for central bank money in accounts – deposits in accounts in the Riksbank – which is known as RIX. The Riksbank's work on the payment system primarily aims to reduce systemic risk, which is to say the risk that a party's financial or technical problems will spread and threaten the financial system.

The Riksbank has also interpreted the assignment of promoting a safe and efficient payment system as meaning that the bank shall act to preserve the stability of the financial system as a whole through preventive work and crisis management. In a crisis, there may arise a shortage of liquidity because the financial markets that offer funding are then working less efficiently than normal. In such a situation, the Riksbank has several ways of quickly adding liquidity. This could entail providing liquidity assistance to single institutions or general measures to strengthen liquidity. The reason that the Riksbank has this task is due to its unique capacity to provide unlimited liquidity in Swedish kronor, which makes it possible to conduct monetary policy.

The aim of the Riksbank's transactions within the monetary policy operational framework is to steer short market rates, which in turn influence other interest rates in the economy and thereby ultimately economic activity and inflation. The overnight interest rate functions as an anchor for interest rates with longer maturities and is the interest rate that is easiest for the Riksbank to control. One operational objective for the Riksbank's Markets Department is therefore that the overnight rate should be close to the Riksbank's policy rate, which is set by the Executive Board.

2 Counterparties

To manage its tasks, the Riksbank needs to interact with a number of market participants. These can apply to become counterparties to the Riksbank in various kinds of transaction. The Riksbank uses different categories of counterparty depending on the type of transaction in question:

- settlement of payments in Swedish kronor
- monetary policy transactions
- transactions in foreign currency.

2.1 Different categories of counterparty

The Riksbank thus has three different categories of counterparty, one category for each type of transaction.

RIX participants

Participants in RIX have the advantage of being able to execute payments without being exposed to any greater credit or liquidity risk. This is desirable from the point of view of the Riksbank and of society, as it limits the systemic risks in the financial system. Credit institutions, investment firms, central counterparties, clearing organisations, central securities depositories, central banks and state authorities conducting operations comparable to those of the Swedish National Debt Office may become participants in RIX. Which institutions may become participants in RIX is restricted by the Act on Systems for Settlement of Obligations on the Financial Market (1999:1309). In addition to making requirements for which types of institution may become participants, the act stipulates that all participants shall be subject to adequate supervision by an authority or other competent body in their home country. Institutions that can be participants under the Act on Systems for Settlement of Obligations on the Financial Market have the right to become RIX participants if they comply with the Riksbank's requirements according to the *Terms and Conditions for RIX and Monetary Policy Instruments* (the Terms and Conditions).

Monetary policy counterparties

To be able to steer market rates, the Riksbank needs to be able to execute transactions in Swedish kronor with a number of financial companies that are domiciled or have a branch in Sweden, and which are active on the Swedish financial market. These financial companies make up the Riksbank's monetary policy counterparties. A monetary policy counterparty has access to the Riksbank's monetary policy instruments, the standing facilities and market operations described in section 4 below. Only RIX participants that are credit institutions in accordance with EU law can apply to become monetary policy counterparties. The reason for this is that, if a monetary policy counterparty was not a RIX participant, it would have to act via a correspondent bank that is a RIX participant and this would create unnecessary uncertainty in the monetary policy transactions.

Counterparties in foreign exchange transactions

The Riksbank sometimes needs to conduct exchanges between foreign exchange and Swedish kronor and must also be able to intervene in the foreign exchange market. When making transactions in foreign currency, the Riksbank needs counterparties with sufficient capacity to trade in the relevant currencies. A credit institution that has a share of the foreign exchange market that the Riksbank considers to be sufficiently large can apply to become a counterparty in foreign exchange transactions. Such a counterparty does not need to be a RIX participant as it is of minor significance how settlement is effected as regards the part of the transaction that involves Swedish kronor.

2.2 Requirements for counterparties

For the Riksbank, it is important to ensure that the aim of the operations the counterparty participates in are fulfilled well. In the Terms and Conditions, the Riksbank therefore places requirements that must be fulfilled by potential counterparties at the time of application, as well as ongoing requirements for counterparties that have already been accepted. These include both general requirements for all counterparties and special requirements for each counterparty category.

The requirements are of two different types:

- *qualification* requirements, which are evaluated upon application and regularly followed up
- *commitments*, which the counterparty must fulfil in connection with participation and which are regularly followed up.

If the requirements are not fulfilled, this can ultimately lead to suspension (temporary) or exclusion (permanent).

The general qualification requirements include the requirement that the counterparty shall be subject to adequate supervision and shall comply with the regulations applicable in the country where the counterparty is domiciled. If the institution is domiciled outside the EEA, the regulations shall be comparable to those which apply within the EU.

For an institution to be accepted as a *RIX participant*, it must have the operational capacity to participate in RIX and efficiently execute transactions so that the Riksbank's risks as operator of RIX are limited. An institution cannot be accepted as participant if its participation would jeopardise the security of RIX or seriously impair the Riksbank's ability to carry out its tasks. The Riksbank expects each RIX participant to have secure technical systems and to comply with all its obligations related to legislation covering the prevention of money laundering and funding of terrorism.

A *monetary policy counterparty* shall have the operational capacity to act as such. Among other things, this means that the counterparty shall have the capacity to act on relevant markets, to execute transactions and to conclude business with the Riksbank and other parties. This also means that it has access to the systems support required and is able to manage the risks entailed by its operations. An institution cannot be accepted as a monetary policy counterparty if this would seriously impair the Riksbank's ability to carry out its tasks.

The monetary policy counterparties must act in a manner that promotes the Riksbank's ability to steer market rates. Monetary policy counterparties are also expected to participate actively in the daily balancing of liquidity on the overnight market and to contribute towards increasing the Riksbank's knowledge of how the financial markets function.

In addition, monetary policy counterparties shall, in accordance with the Riksbank's detailed instructions, report to the Riksbank both the size of the turnover the monetary policy counterparty and its group companies have had in the money and bond markets, and information on transactions in the money market.

3 Instrument

The Riksbank can implement monetary policy by both steering the so-called overnight rate, so that it lies close to the Riksbank's policy rate, and by buying and selling securities.

To steer the overnight rate, the Riksbank uses standing facilities and market operations with its monetary policy counterparties.

3.1 Standing facilities

By using standing facilities for deposits and loans overnight, the Riksbank can set limits – an interest rate corridor – for the overnight rate, in which the deposit rate forms the floor and the lending rate the ceiling in the corridor. The overnight interest rate should lie inside the interest rate corridor because a bank in need of liquidity can always borrow from the Riksbank against collateral at the lending rate and a bank with surplus liquidity can deposit the surplus in the Riksbank at the deposit rate. As there is a difference between the deposit and lending rates, the banks have an incentive with regard to overnight loans to agree on an interest rate that lies between the rates they would pay to or receive from the Riksbank. The Riksbank can therefore ensure that the overnight rate lands within the interest rate corridor, while the banks can borrow from each other at a cost that is lower than it would be if they were to conduct equivalent transactions with the Riksbank.

The standing facilities thus form an instrument for steering the overnight rate and managing the monetary policy counterparties' liquidity. In the event of temporary imbalances on the market for balancing liquidity overnight, the standing facilities may be utilised by the monetary policy counterparties.

The Riksbank offers a deposit facility, the standing deposit facility, and two lending facilities: the standing lending facility and the supplementary liquidity facility. In the standing lending facility, the Riksbank offers lending against high-quality collateral (primary collateral volume) at a low interest rate, and in the supplementary liquidity facility the Riksbank offers lending against lower-quality collateral (secondary collateral volume) at a somewhat higher lending rate. The facilities are priced in a way that creates incentives for counterparties to first seek market solutions to manage their liquidity and, second, to use the Riksbank's facilities.

3.1.1 The standing deposit and lending facilities

The overnight rate is mainly controlled by the standing deposit and lending facilities. The pricing of the standing facilities is such that the deposit rate equals the Riksbank's policy rate minus 0.10 percentage points and the lending rate equals the policy rate

plus 0.10 percentage points. In addition, credit in the standing lending facility is only granted against collateral from the primary collateral volume. Assuming that the other applicable conditions have been met, this consists of:

1. securities issued by governments
2. securities issued by central banks
3. other receivables at central banks.

If the balance of a bank's account shows a surplus when the payment system closes, the bank earns the deposit rate on the sum overnight. There is no limit on how much a bank may deposit in the deposit facility. If the balance of a bank's account with RIX shows a deficit when the payment system closes for the day, the bank has to pay the lending rate on the balance borrowed in the facility overnight (that is until the next bank day). The sum that can be borrowed from the lending facility is limited by the adjusted value of the primary collateral provided by the bank. If the negative balance exceeds the value of primary collateral pledged by the counterparty, this will be interpreted as a request from the counterparty to utilise the supplementary liquidity facility for the remaining deficit.

3.1.2 The supplementary liquidity facility

The supplementary liquidity facility is a higher-interest lending facility with lighter security requirements than the standing lending facility. The pricing of the supplementary liquidity facility is such that the liquidity facility rate is equal to the Riksbank's policy rate plus 0.30 percentage points. In addition, credit in the supplementary liquidity facility is only granted against collateral from the secondary collateral volume. Assuming that the other applicable conditions have been met, the secondary collateral volume is made up of:

1. securities issued by international organisations
2. securities guaranteed by governments
3. covered securities, taking restriction rules into account
4. securities issued by agencies
5. other eligible securities.

The banks receive credit in the supplementary liquidity facility only if the deficit in their RIX account when the payment system closes for the day, exceeds the counterparty's adjusted value of primary collateral. The bank must then pay the higher liquidity facility rate overnight (i.e. until the next bank day) on the part of the amount borrowed in the facility. The sum that can be borrowed from the supplementary liquidity facility is limited by the adjusted value of the secondary collateral provided by the bank.

The interest rate on the supplementary liquidity facility is higher than the interest rate on the standing lending facility. This reflects the yield spread between securities in the primary and secondary collateral volumes respectively.

3.2 Market operations

It is important for the Riksbank's ability to steer the overnight rate that the liquidity of the banking system towards the Riksbank is well balanced. To ensure that this is the case, the Riksbank conducts regular market operations in the form of weekly issues of Riksbank Certificates to absorb liquidity from the bank system, or, alternatively, offers monetary policy repos or credit against collateral to provide the banking system with liquidity.

3.2.1 Riksbank Certificates

Every week, the Riksbank offers Riksbank Certificates with one week maturities at the policy rate. The Riksbank's monetary policy counterparties are thus given the opportunity to invest in securities with a short maturity issued by the Riksbank. The issue volume corresponds to the banking system's liquidity surplus with regard to the Riksbank. However, the Riksbank may choose to reduce the issue volume by a smaller amount if it is deemed appropriate, due to the prevailing market situation. This amount is intended to reduce the risk that some banks will have a significant liquidity deficit at the end of any day during the term of validity of the Riksbank Certificate. In addition, to facilitate liquidity management by the banks, Riksbank Certificates can be resold. If demand for the Certificates are greater than the amount on offer, allocation will take place pro rata, based on the ratio between the amount offered and total demand. If the banking system were to have a liquidity deficit towards the Riksbank, the Riksbank would offer to supply liquidity via weekly repos or credit against collateral, instead of withdrawing liquidity via Riksbank Certificates.

3.2.2 Credit with varying maturities

If it is deemed justifiable, the Riksbank can offer credit against collateral for shorter or longer maturities. During the financial crisis in 2008-2009, the Riksbank offered loans with maturities of up to 12 months. To alleviate the economic consequences of the coronavirus pandemic, the Riksbank also offered extraordinary loans with three and six months' maturity to monetary policy counterparties (with effect from March 2020 to September 2021) and loans with up to four years' maturity to companies via monetary policy counterparties with effect from 20 March 2020 to 20 September 2021).

3.2.3 Purchases and sales of securities

Pursuant to Chapter 2, Section 4 of the Sveriges Riksbank Act, the Riksbank may in relation to financial companies purchase and sell Swedish government securities to implement its monetary policy. If there are exceptional reasons, the Riksbank may also buy and sell financial instruments other than Swedish government securities to implement monetary policy.

During the period March 2020 to the end of December 2022, the Riksbank made monetary policy more expansionary by purchasing government bonds. The purpose of these purchases was to push down the general level of interest rates in the economy. However, according to the ban on monetary funding in Chapter 1, Section 6 of the Sveriges Riksbank Act, the Riksbank may not acquire debt instruments directly from

the state. Consequently, the Riksbank cannot purchase government bonds when the Swedish National Debt Office carries out issues on the primary market. The Riksbank's purchases of government bonds must, where appropriate, be motivated by monetary policy and be made on the secondary market.

The Riksbank's purchases took place by means of reverse auctions in which the Riksbank's monetary policy counterparties and the Swedish National Debt Office's primary dealers had the opportunity to participate. A reverse auction is a lowest-bid auction in which the bidder offering the highest interest rate (lowest price) receives the first allocation. After that, the bidder offering the second-highest interest rate receives allocation and so on until all the volume on offer has been allocated. In this way, the pricing and allocation of the Riksbank's transactions are made clear to the market.

To mitigate the financial consequences of the coronavirus pandemic, the Riksbank decided in spring 2020 to purchase mortgage and municipal bonds and to offer to purchase both commercial paper and corporate bonds.

The purchases of mortgage bonds and municipal bonds were concluded at the same time as the purchases of government bonds were concluded in December 2022. By contrast, the purchases of corporate bonds were concluded in June 2022 and purchases of commercial papers were concluded in December 2021.

The Riksbank can also dispose of securities to strengthen the tightening effect of the monetary policy conducted, if necessary. In February 2023, for example, the Riksbank decided that with effect from April 2023 it would begin selling government bonds to make monetary policy tighter, and in this way safeguard the inflation target. The decision means that the Riksbank's holdings of government bonds will decline faster than solely through maturities.

3.2.4 Operations in the foreign exchange market

The Riksbank can use repurchase agreements in foreign currency against Swedish kronor (FX swaps) to stabilise the overnight rate on the market by controlling the liquidity position of the banking system in Swedish kronor towards the Riksbank. If the overnight market is surprised by liquidity shocks, the Riksbank can stabilise the overnight rate quickly and efficiently by using FX swaps to supply or drain liquidity to fend off demand or supply surplus in Swedish kronor on the overnight market.

4 Collateral

One of the Riksbank's tasks is to supply liquidity to the financial system. However, this is expected to be conducted in a way that does not involve the Riksbank risking its capital. The Riksbank therefore has to accept collateral that is sufficiently adequate to prevent this happening. The Riksbank places certain demands for something to be approved as collateral and decides how this collateral is to be valued. For collateral to be adequate, it is required that its value does not risk decreasing if the borrower providing the collateral encounters financial problems.

So that the Riksbank shall not risk its capital, the probability that collateral will significantly lose value needs to be very small. Assets provided as collateral must therefore have a very high credit rating. Collateral is mainly comprised of various types of Swedish or foreign securities with high credit ratings. In the Riksbank's assessment, those countries whose debt instruments are accepted as adequate collateral shall be considered to be comparable with Sweden as regards protection for investors, among other things. The kind of securities that can be accepted is specified in the Terms and Conditions. To a certain extent, foreign currency can also be used as collateral. For such currency to be considered adequate, it is required to be in an account in a central bank approved by the Riksbank.

Another precondition for collateral to be considered adequate is that there exists a secure arrangement through which the Riksbank receives collateral in the asset in question. The Riksbank must determine how its connection to the securities depository in which the collateral is stored shall be arranged for this to be considered secure. The requirements for this are described in the Terms and Conditions.

The Riksbank's collateral is valued at market value. But for the collateral to be adequate, the Riksbank must take account, during valuation, of the possibility that the value may decrease due to price changes or changes in exchange rates. The Riksbank therefore makes deductions from the market price when valuing collateral to cover for potential price risk and foreign exchange risk (haircut). In addition, the haircuts are calculated conservatively.

If the collateral pledged at the Riksbank consists to a large degree of a single asset type, the Riksbank faces a concentration risk. To reduce this concentration and thereby improve diversification, limit rules can be applied. For example, structural risks and vulnerabilities linked to securities of a certain kind can justify the application of additional limit rules.

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