

# CENTRAL GOVERNMENT GUARANTEES AND LENDING

A Risk Analysis



## The Debt Office's mandate

The Swedish state provides guarantees and loans for purposes established by the Riksdag (Swedish Parliament) and the Government. A guarantee entails that the central government stands surety for the payment obligations of another party. This involves a credit risk for the state. A credit risk also arises when the state lends money to parties, such as a company or private individual.

At year-end 2020/2021, central government guarantees and lending with credit risk, excluding the deposit insurance scheme, amounted to SEK 698 billion.<sup>1</sup> The portfolio includes student loans, export guarantees, housing guarantees and guarantees to benefit international financial institutions of which Sweden is a member. These commitments are collectively referred to in this report as the regular portfolio. The deposit insurance scheme, which amounted to SEK 1,734 billion as at 31 December 2019, is analysed separately in the report.<sup>2</sup>

The Swedish National Debt Office has submitted the report *Central Government Guarantees and Lending – A Risk Analysis* to the Government every year since 2012. The report is prepared in collaboration with EKN (the Swedish Export Credit Agency), Boverket (the Swedish National Board of Housing, Building and Planning), Sida (the Swedish International Development Cooperation Agency) and CSN (the Swedish Board of Student Finance), as well as other relevant government agencies.<sup>3</sup>

### Increased awareness for better risk management

This risk analysis report is a supplement to the financial reporting of the guarantee and lending operations provided in the central government's annual report. That report includes outstanding amounts, provisions for losses, and the fees charged by the central government as part of these activities. The purpose of the risk analysis is to provide further information on the credit and liquidity risks involved in the commitments. This report therefore focuses primarily on:

- the risk of major credit losses in the portfolio, i.e. losses that exceed expectations and normal deviations (credit risk analysis)
- events or circumstances that could give rise to large credit losses
- the central government's ability to handle large unforeseen payments and the risk of payments connected to guarantees and loan commitments leading to higher borrowing costs in the central government's liquidity management operations (liquidity risk analysis).

These in-depth analyses facilitate the ability of political-decision makers to both communicate that there is good control over the operations as well as to determine whether further risk-limiting measures need to be taken.

<sup>1</sup> Excluding the commitments exempted from the risk analysis (see Appendix 2).

<sup>2</sup> The size of the deposit insurance scheme for 2020 was not available at the time of this report.

<sup>3</sup> A report containing a comprehensive risk analysis of central government guarantees and lending is to be presented on 15 March in accordance with the Ordinance containing instructions for the National Debt Office (2007:1447).



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## Summary

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The Debt Office's assessment is that the risk of large losses in the regular portfolio – which amounts to SEK 698 billion and includes student loans, export credit guarantees and guarantees to benefit international financial institutions – has remained at the same low level as in the previous year's risk analysis report. The risk of large losses in the deposit insurance scheme is assessed to remain at the same moderate level as in the previous year. The ongoing pandemic, with the ensuing economic downturn, is considered to have only adversely affected the risk level to a limited extent in both these portfolios. The term “large losses” refers to SEK 20 billion over a five-year time horizon.

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### Low risk of large losses in the regular portfolio

The Debt Office assesses the risk of large losses in the regular portfolio to be low. Large parts of the portfolio have good creditworthiness, and the share of commitments with very poor creditworthiness is low. The portfolio is assessed to have limited sensitivity to economic downturns, which is largely due to the generally good creditworthiness. There are a number of significant concentrations in the portfolio, but the risk of large losses occurring among them is deemed low. Other parts of the portfolio are well-diversified across many geographic areas and sectors.

The concentrations mainly regard individual large commitments, a geographical concentration to Sweden (45.2 per cent) of which a very large part is student loans (70.5 per cent) and a sector concentration to telecom operators (10.2 per cent). The main reason the Debt Office assesses the risk of these concentrations leading to large losses to be low is that the creditworthiness is relatively high in the commitments that account for the concentrations.

The share of guarantees and lending with close connections is small in terms of amount and therefore entails a low risk of large losses owing to covariance in the portfolio.

If large losses were to arise, despite a low risk level, they would most likely be caused by a deep and lengthy recession that – in addition to generally increasing the overall level of losses in the portfolio – particularly affected one or more of its concentrations. The currently good creditworthiness of the portfolio contributes to it being relatively resilient to normal economic downturns. Unless the ongoing crisis becomes worse, its effects will likely have a limited adverse impact on the portfolio.

The relatively low level of risk in the portfolio is largely attributable to the principles and regulatory frameworks governing the central government's guarantee and lending operations. The central government's risk-taking is moderated by the limits placed on guarantees and loans in terms of amount and time, the fact that the expected cost is reported and financed at the time of decision, and that risk-limiting conditions are applied. This is described in further detail in Appendix 1.

**Table 1. Credit risks in the regular portfolio**

<b>Risk factor</b>	<b>Risk of large credit losses (previous year)</b>
<b>Risk from changes in the general economic environment</b>	Low (Low)
<b>Name concentration (individual large commitments)</b>	Low (Low)
<b>Close connections between guarantee holders or borrowers</b>	Low (Low)
<b>Sector concentration</b>	Low (Low)
<b>Geographic concentration</b>	Low (Low)

The risk level is assessed according to a four-degree scale: low, moderate, significant or high.

## Moderate risk of large losses in the deposit insurance scheme

The Debt Office assesses the risk of large losses in connection with deposit insurance to be moderate.

For the major banks and other institutions deemed systemically important, the deposit insurance scheme may need to be utilised to provide consumer protection in resolution. However, those institutions would have to suffer significant losses for such a measure to be required. The Debt Office assesses the risk of that occurring to be low.

If a non-systemically important institution were to fail, the deposit insurance commitment would instead be fulfilled by the central government paying compensation directly to the depositors and then acquiring a claim on the institution. It would take the failure of at least two to three non-systemically important institutions in order for large losses to occur. The Debt Office assesses the risk of that occurring to be moderate. However, the risk of significantly greater losses than SEK 20 billion is deemed low, due to the limited volumes for each institution and because, consequently, a large number of them would have to fail.

**Table 2. Risk by type of fulfilment**

<b>Type of fulfilment</b>	<b>Risk of large losses (previous year)</b>
<b>Direct fulfilment</b>	Moderate (Moderate)
<b>Fulfilment in resolution</b>	Low (Low)

The risk level is assessed according to a four-degree scale: low, moderate, significant or high.

## Flexible cash management provides low liquidity risk

The Debt Office's assessment is that the liquidity risks in the guarantee and lending portfolio remain low, despite the ongoing pandemic. These liquidity risks arise because it is not known if or when potential amounts would have to be paid out. The Debt Office's assessment is that such less likely amounts can be borrowed on short notice. Although the borrowing cost would certainly be higher in some cases, it would only be in the short term and connected to individual payments.

## Analytical framework

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The Debt Office's risk analysis of central government guarantees and lending with credit risk is based on an analytical framework establishing basic assumptions, definitions and methodology.

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### Scope of the risk analysis

The risk analysis contains both a credit risk analysis and a liquidity risk analysis. The credit risk analysis comprises the central government's portfolio of guarantees and loans with credit risk that, at year-end 2020, had been issued to parties outside central government. In addition to these guarantees and loans, the liquidity risk analysis comprises loan commitments in which a party has the right to borrow under certain terms and conditions from the central government but has not utilised this right.

The fact that the analysis is based on the commitments in the portfolio at the most recent turn of the year is indeed a simplification, as the contents of the portfolio are continually subject to change; for example, certain commitments are settled as others arise. A more dynamic approach, however, would increase both the complexity and uncertainty in the analysis, partly because this would require making assumptions about decisions not yet taken.

Lending financed by appropriations, public enterprises' guarantees, the investor compensation scheme, and capital adequacy guarantees are excluded from the risk analysis. In this context, that type of lending entails such small amounts or negligible risks as to be excluded for practical reasons. The exceptions do not affect the Debt Office's conclusions. See Appendix 2 for more information on these exceptions.

### Credit risk analysis

The credit risk analysis covers the risk of losses of at least approximately SEK 20 billion in the regular portfolio or for the deposit insurance scheme over the next five years.

The deposit insurance scheme, in terms of reported amount, accounts for more than half of the central government's aggregate portfolio. In light of the large amount and complex regulatory frameworks that directly affect the risk in the deposit insurance scheme, the analysis is presented in a separate section. If there are large losses in one portfolio, there is an increased likelihood that the losses in the other portfolio are also higher than normal, even if the latter do not necessarily exceed SEK 20 billion. This is because large losses usually occur during a deep recession, which adversely affects both portfolios. However, the analysis is based on the same analytical framework as for the regular portfolio.

The risk of large losses is assessed according to a four-degree scale: low, moderate, significant and high. The scale should primarily be viewed in terms of the need for a more in-depth analysis of the portfolio risks and covariance of losses. At a low risk level there is probably no such need, whereas moderate risks call for closer monitoring. A significant or high level of risk increases the need for



analysis. At the same time, it may be relevant to analyse whether it is possible to limit the level of risk, and whether this would be appropriate is, in turn, a political decision.

## Losses

The term losses is used in the credit risk analysis as a collective name for the fulfilment of guarantee commitments and the write-off of loans, in the event of an established loss on lending.

Fulfilment of guarantee commitments affects both central government net lending and central government debt. The write-off of loans only affects central government net lending because they do not involve any cash flows. In the analysis, the Debt Office also comments on the effects that reductions and cessations of payment of student loans have on the central government's cash flow, even though these are not classified as losses in the analysis. The fact box in Appendix 1 describes in detail how central government finances are affected by the guarantee and lending operations.

Even if the fulfilments involve a loss, in the sense that they have an immediate effect on central government finances, they do not necessarily have to ultimately lead to a loss if the state retroactively recovers, (gets back) the guarantee amount being fulfilled. In the credit risk analysis, the Debt Office therefore comments on the opportunities for recovery in the event of fulfilment. A large part of the recoveries will, however, be made beyond the five-year time frame of the analysis because the recovery process can often take many years to complete. The focus is thus mainly on the risk of fulfilments.

For the deposit insurance scheme, the central government also has the right to retroactively raise the fee charged if the losses become large enough to erode the fund used to cover them – that is, a retroactive right to cover losses in the long term.

## Focus on large losses over five-year period

In the report, large losses refer to those that amount to at least approximately SEK 20 billion in the regular portfolio or for the deposit insurance over the next five years.<sup>4</sup>

From a risk perspective, it is not apparent which size of losses to should receive the most focus. The size relevant for analysis can vary depending on the situation – specifically the financial position of the central government when the losses occur.

The Debt Office's assessment is that the risk analysis should focus on losses that significantly exceed expected losses and average historical losses, because such outcomes clearly limit the possibility of achieving fiscal and budgetary policy objectives, compared with an expected or historically "normal" outcome. On this basis, the Debt Office has chosen to focus on the risk of losses of at least SEK 20 billion over a five-year period. It should be emphasised that this represents a gross loss. The net effect of the losses is lower from the central government making recoveries and taking out fees in the same period. The average annual fee charged has, for example, amounted to SEK 1.7 billion for the regular portfolio and SEK 1.5 billion for the deposit insurance over the last ten years.<sup>5</sup>

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<sup>4</sup> If the losses amount to a total of at least SEK 20 billion, the majority of them are assumed to occur in most cases during one, or a few, more critical years, while losses during the remainder of the five-year period are assumed to be at more normal levels.

<sup>5</sup> Not cleared for transfer of part of the fee to Finland and Denmark

A five-year period is intended to reflect a medium-term time horizon, or approximately one business cycle, in keeping with other economic forecasts and evaluation periods within central government. A limited time period is required for making a sufficiently relevant assessment of the risk of large losses. In the long term, fees and recoveries from the guarantee and lending operations are to correspond to the losses, which is why the net effect on central government finances is intended to ultimately be balanced to zero (see Appendix 1). However, seen in terms of a limited time period, large losses have a negative effect on central government finances. Choosing a short period of time (such as one year) instead would also compromise the relevance of the analysis. This is because credit risks often tend to be small in the short term.

With the designated timescale, the risk analysis is based on the size of the amounts that can be fulfilled by outstanding guarantee commitments over the next five years. This can, in some cases, differ significantly from the amounts in the central government's annual report, depending among other things on the fact that many guarantee commitments are not immediately fulfilled in their entirety but rather continually in pace with the guaranteed loans reaching maturity. However, when nothing else is stated, the size of the commitments is presented in the report based on the amounts in the central government's annual report, among other things to clarify the risk analysis' connection with the portfolio presented in that annual report.

## Liquidity risk analysis

Guarantees and loan commitments entail a liquidity risk because it is not known beforehand whether or when payments connected to the undertakings will need to occur. On the other hand, with direct lending, no such risk arises because the state cannot be affected by further payments after that point.

The section on liquidity risk addresses the central government's ability to handle large unforeseen payments, including the risk that payments connected to guarantees and loan commitments lead to higher lending costs in the liquidity management operations. The liquidity risk analysis is based on the potential need for large amounts to be paid out as non-recurring payments or as several payments within a few days. In this sense, that analysis has a much shorter timescale than the credit risk analysis.

## Risk factors

There are essentially two types of events that can result in large losses:

- a small number of losses for individual large guarantees or loans that form a significant proportion of the portfolio
- a group (cluster) of losses that collectively constitutes a large amount and is, as a rule, attributable to covariance.<sup>6</sup>

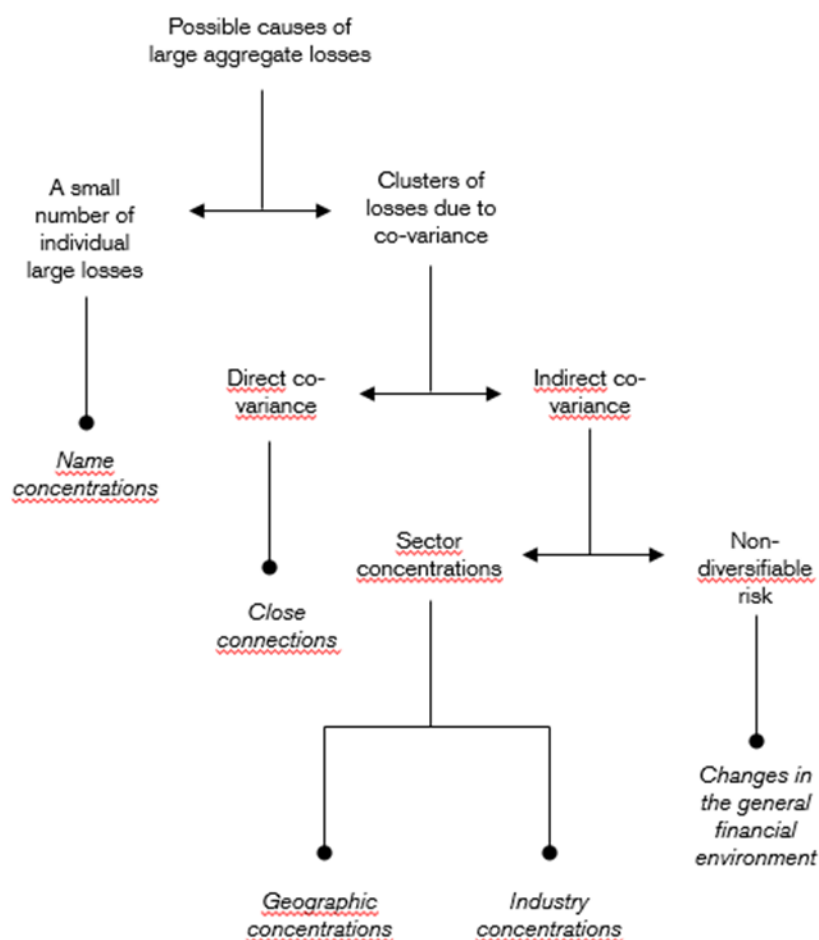
The risk analysis identifies and discusses circumstances – risk factors – that can give rise to these two events. The risk factors identified are: changes in the general economic environment, name

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<sup>6</sup> Depending on, for example, the business cycle or altered conditions within a particular sector (either in an industry or geographic area), credit losses tend to coincide in time in so-called clusters. This can be interpreted to mean that the possibility for guarantee holders and borrowers to fulfil their commitments covaries. There are two types of covariance. "Direct covariance" means, in this context, that the credit risk in one guarantee or loan directly affects the credit risk in another. "Indirect covariance" means that one background factor affects the credit risk in several commitments.

concentrations, close connections between guarantee holders and borrowers, sector concentrations, and geographic concentrations. Chart 1 summarises the interrelationships between the identified risk factors.

**Chart 1. Risk factors and their interrelationships**



### Changes in the general economic environment

Other risk factors described below pertain to the presence of concentrations in a portfolio. However, even in a perfectly diversified portfolio (without major concentrations) there is a risk of loss clustering due to indirect covariance. A financial shock such as an economic downturn affecting several sectors and geographic regions can give rise to indirect covariance between different sectors, despite a lack of distinctly direct economic connections.

**Name concentrations (individual large guarantees and loans)**

The analysis of name concentrations is connected to the size of the proportion of the portfolio that a particular commitment represents. If there are individual commitments representing a significant share of the portfolio, a small number of defaults can induce large losses. This can occur without the presence of covariance, as a small number of defaults should be able to occur randomly at the same time from entirely unrelated causes. Accordingly, the analysis of name concentrations differs from the analysis of other risk factors that are all due to covariance.

**Close connections**

If guarantee holders or borrowers have close financial or legal connections with one another, a default by one of these may lead to the others also defaulting on their commitments. Examples of such connections are when a number of companies belong to the same corporate group or are part of the same supplier chain. In this way, close connections give rise to direct covariance that can lead to clusters of losses.

**Concentrations in a particular sector or geographic region**

Indirect covariance can arise in different sectors – for example, industries or geographic regions. This occurs because the creditworthiness of guarantee holders and borrowers in one sector is often affected by the same underlying factors, such as demand for a product that is manufactured by another company in the same sector. A negative shock, such as a drop in demand, can give rise to indirect covariance between companies within a sector and create clusters of losses.

“Sector concentration” refers to low diversification regarding guarantee holders’ and borrowers’ affiliation to a particular industry. This can occur because either the portfolio is exposed to only a few industries or because some individual ones represent a significant share of the portfolio.

Geographic concentrations entail that guarantee holders and borrowers in the same geographic region are affected simultaneously by negative economic changes, such as a downturn or major changes in currencies or interest rates. Negative shocks can then lead to indirect covariance that gives rise to clusters of losses.

## Credit risks in the regular portfolio

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The Debt Office assesses the risk of large losses in the regular portfolio to be low. To some extent, the ongoing pandemic has had a negative impact, mainly by new lending having somewhat lower creditworthiness than the average commitments, which is a natural effect of turbulent periods. Large parts of the portfolio continue to have relatively good creditworthiness, and the exposure to commitments with very high credit risk is small. There are a number of significant concentrations in the portfolio, but the risk of large losses occurring among them is deemed low. Other parts of the portfolio are well-diversified across many geographic areas and sectors.

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### The regular portfolio

This section analyses the risk of major credit losses in the regular portfolio. In accordance with the delimitations presented in Appendix 2, the portfolio amounted to SEK 698 billion on 31 December 2020, compared with SEK 609 billion at the end of the preceding year.<sup>7</sup> The increase in size is mainly due to COVID-related measures, which are presented in the section: *Impact of the coronavirus pandemic on central government guarantees and lending – and measures taken*. The portfolio is divided into around 1,900 guarantees and close to SEK 1.6 million loans and contains:

- guarantees and loans managed in accordance with the central government guarantee and lending model (see Appendix 1)
- student loans issued under the student aid system
- callable capital subscribed to various international financial institutions of which Sweden is a member

In addition to this risk analysis, the Debt Office has made quantitative calculations for the guarantees in the regular portfolio, using a portfolio model described in detail in Appendix 4. The results, which indicate that the risk in absolute terms is higher than in the previous year, are still considered to be in line with the conclusions presented in the report. A contributing factor is that the exposure to *speculative grade* has increased by around SEK 40 billion at the same time as the number of guarantees has decreased, which means that large commitments have a greater effect in the simulation.

The structure of the section follows the analytical framework. Based on the identified risk factors, an analysis is first made of the portfolio's sensitivity to the general economic development (systemic risk). Thereafter, the risk of large losses occurring from concentrations in the portfolio is analysed.

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<sup>7</sup> An in-depth account of the amounts dealt with in the risk analysis is provided in Appendix 3.

## Commitments in the regular portfolio

Tables 3 to 7 show the total size of the central government's guarantees and loans in the regular portfolio on 31 December in 2019 and 2020, respectively. At the turn of the year 2020/2021, the regular portfolio amounted to SEK 698 billion, compared with SEK 609 billion the preceding year.

**Table 3. Housing guarantees**

SEK million	31/12/2019	31/12/2020
Housing credit guarantees	3,028	2,731
Acquisition guarantees	0	0
<b>Total</b>	<b>3,028</b>	<b>2,731</b>

Boverket (the National Board of Housing, Building and Planning) issues, administrates and reports on central government housing guarantees.

**Table 4. Export credit guarantees**

SEK million	31/12/2019	31/12/2020
Export credit guarantees	195,862	238,556

EKN (the Swedish Export Credit Agency), provides government export guarantees to promote Swedish export and the internationalisation of Swedish companies.

**Table 5. Guarantees and credits within foreign aid and development**

SEK million	31/12/2019	31/12/2020
Development credit guarantees	683	488
Independent guarantees	5,814	5,834
<b>Total</b>	<b>6,497</b>	<b>6,322</b>

Within the framework of Swedish foreign aid and development cooperation, there are several guarantees and loans managed by Sida (the Swedish International Development Cooperation Agency).

**Table 6. Student loans**

SEK million	31/12/2019	31/12/2020
Student loans <sup>1</sup>	227,982	237,736

A large part of the regular portfolio consists of student loans that are granted and managed by CSN (the Swedish Board of Student Finance).

<sup>1</sup> The amount refers to student loans that are financed by loans from the Debt Office.

## Other

The central government also issues guarantees and loans for, among other things, infrastructure projects, commitments linked to the state's role as owners in various companies, membership in international financial institutions, and research and technological development (RTD) investments (see Table 7).

**Table 7. Other commitments managed by the Debt Office and the Government Offices that are included in the regular portfolio.**

SEK million	31/12/2019	31/12/2020
Credit guarantees within infrastructure	15,716	13,607
International commitments	2,910	1,081
Base fund commitments	405	405
Callable capital	148,179	169,402
Provision of capital	0	7,694
Pension guarantees	7,674	7,322
Other credit guarantees	6	1802
Lending to other governments		
Lending within infrastructure	865	819
Lending to RTD	83	70
Other lending	156	10,174
<b>Total</b>	<b>175,994</b>	<b>213,196</b>

## Impact of the coronavirus pandemic on central government guarantees and lending – and measures taken

### The Swedish National Debt Office

Due to the significant impact of the coronavirus pandemic on the Swedish economy, the Riksdag (Swedish Parliament) and the Government decided on a number of support measures within the area of guarantees and lending in order to mitigate the adverse effects. For the Debt Office, this has entailed putting into place a guarantee scheme for small and medium-sized enterprises, called the Government guarantee programme for companies (Företagsakuten). This programme originally amounted to SEK 100 billion, under which the Debt Office guarantees up to 70 per cent of a loan. The loans are granted by banks and other credit institutions in accordance with their regular credit processes. The guarantee programme has been extended in stages and now runs until 30 June 2021, although it may be extended further. So far, 71 banks and other credit institutions have entered into agreements with the Debt Office to be able to participate in guarantees at a total value of SEK 39 billion. Outstanding guarantee amounts at year-end totalled SEK 1.8 billion.

The airline industry is one of the industries most severely affected by the pandemic, and the Debt Office therefore received a mandate to issue credit guarantees in 2020 to certain airlines. The credit guarantees could reach a total of SEK 5 billion. The Debt Office has issued two guarantees: one to SAS for SEK 1.5 billion and one to Braathens Regional Aviation for SEK 180 million. SAS repaid the guaranteed loan in the autumn, and that credit guarantee was thereby settled prematurely.

Since 2009, the Debt Office has provided a lending framework to AB Svensk Exportkredit (the Swedish Export Credit Corporation, abbreviated to SEK). The credit limit amounted to SEK 200 billion on 31 December 2020. Last year, a need to borrow arose at the same time as the prospects for borrowing in the market decreased. The Swedish Export Credit Corporation therefore utilised the credit for the first time and borrowed SEK 10 billion from the Debt Office. The loan runs until 2022 March.

The Debt Office also received a mandate to manage the Swedish state's guarantee commitments regarding two European guarantee schemes. These two programmes are managed outside the central government guarantee model, which among other things means that the resources for potential fulfilments are financed through appropriations.

One of them is the European Investment Bank's (EIB) guarantee fund to support companies. The Swedish share of the guarantee commitment amounts to around EUR 863 million. The purpose of the fund is to counteract the economic impact of the pandemic by ensuring liquidity and funding for small and medium-sized enterprises in the member states participating in the fund. Initially, the fund will be able to approve aid until 31 December 2021, with the possibility of extension by decision.

The other guarantee is for the EU's employment fund SURE (Support to mitigate Unemployment Risks in an Emergency). This is a support instrument catering to member states in need of economic resources. The Swedish share amounts to around EUR 849 million and consists of a guarantee commitment concerning potential losses for loans under SURE. The guarantee is limited to loans taken prior to 31 December 2022.

The Debt Office's assessment is that its portfolio at present has not been adversely affected significantly by the prevailing crisis. Respite has nevertheless been granted for a few loans during the year, and the risk level has to some extent been raised in a few commitments.

### **EKN (the Swedish Export Credit Agency)**

EKN has analysed and inventoried the extraordinary measures deemed necessary by export companies during an accelerating crisis. In the initial stages of the crisis, financial market participants responded by tightening the provision of credit, and risk margins rose and the costs of available funding thereby went up. For EKN, this meant adapting the regular supply of export credit guarantees if necessary. At the same time, a need arose for offering new products that could mitigate the adverse effects of the pandemic. Thanks to the experience gained from the financial crisis of 2008/2009 during which a similar turbulent situation arose in the financial markets, EKN was able to launch new products and modify existing ones. To ensure the capacity necessary for issuing guarantees, the Riksdag and the Government decided to increase EKN's guarantee framework from SEK 450 billion to SEK 500 billion.

In March and April, new fixed-term products were introduced while adjustments to the existing portfolio and the terms and conditions were made. One temporary product is guarantees for working capital financing for major corporations (individual credit guarantees) with undertakings of SEK 146.5 billion. The guaranteed amount reached SEK 54.4 billion at year-end. Export credit institutions within the EU are not normally allowed to provide short-term guarantees for export to "market-countries" (the EU countries plus an additional nine high-income countries) as defined by the EU. In March, the European Commission decided to temporarily remove these countries from the list in order to enable the provision of guarantees. The latest decision concerns the issuance of



guarantees up to and including 31 December 2021. The undertakings for this type of short-term guarantee amounted to around SEK 1 billion during 2020, whereby the guaranteed amount reached SEK 366 million.

In addition to the temporary products, changes were made to the existing guarantees for working capital loans for small and medium-sized enterprises. Aside from the earlier risk distribution of 50 per cent between EKN and the loan-providing bank, the EKN's coverage was raised to 80 per cent as a possible option for the guarantee holder. This was introduced to facilitate the banks' provision of credit for small and medium-sized enterprises.

In the early stages of the pandemic, EKN received signals from exporters that were the holders of existing guarantees indicating that some debtors had insufficient liquidity. To make it easier for otherwise stable companies to weather the difficulties brought about by the pandemic, the opportunity of a payment respite was introduced. In 2020, a total of 225 debtors were granted a respite.

The international community, under the leadership of the International Monetary Fund (IMF), the World Bank, the G20 countries and members of the Paris Club proposed at the outset of the pandemic a mechanism that would contribute to easing the repayment burden for the poorest and most indebted countries. The initiative was named the Debt Service Suspension Initiative (DSSI). The debt easing applies to maturities up to and including June 2021. As far as Sweden and EKN are concerned, this pertains to claims on Pakistan – renegotiated within the Paris Club.

### **CSN (the Swedish Board of Student Finance)**

The actions taken within education to mitigate the economic impact of the pandemic have led to increased disbursements of student aid. In 2020, the aid paid out increased by SEK 2.2 billion and the loans paid out increased by SEK 2.9 billion compared with the previous year. The increase in loans paid out is mainly due to an additional 42,000 people taking out loans but also to the loan amount being raised in line with the customary adjustment.

The increased volume has various explanations: many people who have immigrated to Sweden in recent years have used financial aid to begin their studies, there are more locations within the majority of types of schools, and the worsened economy has led to increased unemployment and the temporary discontinuation of the fee-waiver amount.

The Government has decided that student loans received during extraordinary peacetime events shall under certain circumstances be written off entirely or partially. The pandemic is an extraordinary event of this kind, which students themselves are not able to dictate and which has affected their educational opportunities. If the organiser of an educational programme consisting of at least 50 per cent over at least one calendar week has cancelled it, the borrower is to receive a write-off of the student loan for that period. Provisions for loan losses have been made, with SEK 70 million for write-offs, in accordance with Section 7 of Ordinance (2020:201) on financial aid to students in the event of the spread of a specific disease. These write-offs are expected to occur in 2021. As of the turn of the year, it is unknown how many and which borrowers have had their studies cancelled and for how long. Calculating the provision amount is therefore uncertain.

Instalment repayments (amortisations) of student loans amount to SEK 12,724, which after being adjusted for delayed direct debit in 2019 is a reduction of SEK 12 million. The reduced annual

amount for student loans has increased for the payment year 2020, which affects the size of the instalment payments. The reductions have increased by SEK 182 million compared with 2019, likely as a result of the economic consequences of the ongoing crisis.

### **Sida (the Swedish International Development Cooperation Agency)**

The pandemic's impact on Sida's existing guarantees materialised during 2020 in the form of a number of problem loans, a damages case directly linked to the pandemic, and requests for contract revisions. The assessment is that the development has not been exceptionally negative, which was a major concern when the pandemic brought the global economy to a halt and forced entire countries into lockdown. In its approach to minimising damages cases that are due to the pandemic, Sida has been very intent on efforts to adapt in order to assist guarantee holders and debtors. With the aim of preventing losses, the restructuring of loans under three guarantees was approved. The majority of collaborative partners were highly successful with their lending despite the circumstances. Some, however, experienced difficulties in finding relevant investment objects in the wake of the turbulence and therefore showed unsatisfactory results in terms of utilisation. During the year, Sida approved a contract revision regarding increased guarantee coverage, in hopes of facilitating opportunities for new lending. In order to reduce the impact of the prevailing lending difficulties, Sida also decided to allow the extension of two guarantees.

The pandemic also had some impact on the preparation of new guarantees, both in the idea phase and in the administration of ongoing preparations. Sida prioritised the preparation of several pandemic-related items during the year, but none of these guarantees had been issued by year-end.

In Sida's assessment, it is highly likely that demand for guarantee instruments will increase in the coming years. This is due in part to the consequences of the pandemic on the economy in general and the solvency of companies, but also to the fact that the pandemic is expected to force more people into poverty.

### **Boverkett (the Swedish National Board of Housing, Building and Planning)**

Boverkett has not yet experienced any significant adverse impact from the pandemic to its credit guarantee operations. Housing production and financing via lenders is considered to have proceeded as usual. There was, however, a lull in the market for a while during the spring, but it has since normalised and the number of credit guarantees during the construction period continues to increase.

In the spring, Boverkett presented a proposal for a fee reduction for the guarantees that potentially needed to be extended because of delayed construction due to the pandemic. One preliminary proposal has also been presented for a new guarantee form for tenant-owners' housing associations intended to enable financing if there is a lower rate of sale. The guarantee is meant to allow associations to be protected from financial detriment due to unsold apartments if at the time of access there are not apartments available, which the developer does not have the means to acquire. Both proposals have been submitted to the Government Offices, but because the major adverse impact on residential housing construction that was previously anticipated did not materialise, accordingly there have not been any changes or new guarantee arrangements.

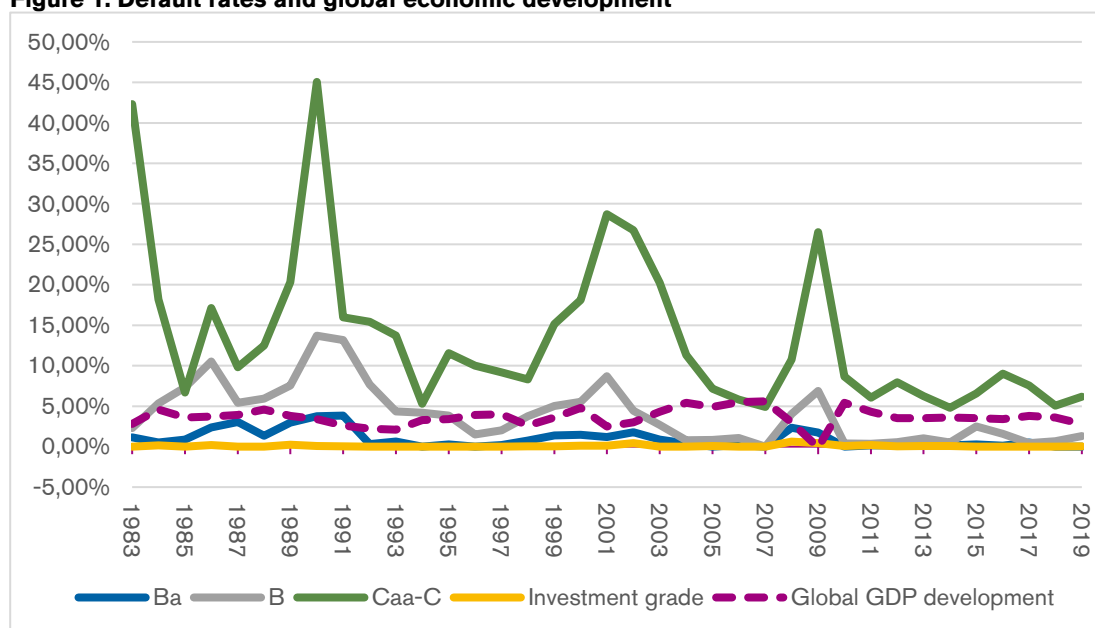
## Limited sensitivity to economic downturns

Changes in the general economic environment (business cycle) constitute a risk factor to which few guarantee holders or borrowers are immune. Therefore, diversification cannot remove this risk. The degree to which creditworthiness can be affected by an economic downturn varies for different categories of commitments. However, it can generally be said that a guarantee holder's degree of sensitivity to cyclical variations is reflected in the creditworthiness (rating). Whether the effect is significant enough to lead to a default also largely depends on the commitment's creditworthiness before the economic downturn occurs, beyond the magnitude of that downturn. The following section contains a review of historical relationships between economic downturns and defaults, as well as a description of the creditworthiness of the commitments in the regular portfolio.

### Guarantee sensitivity to the general economic development

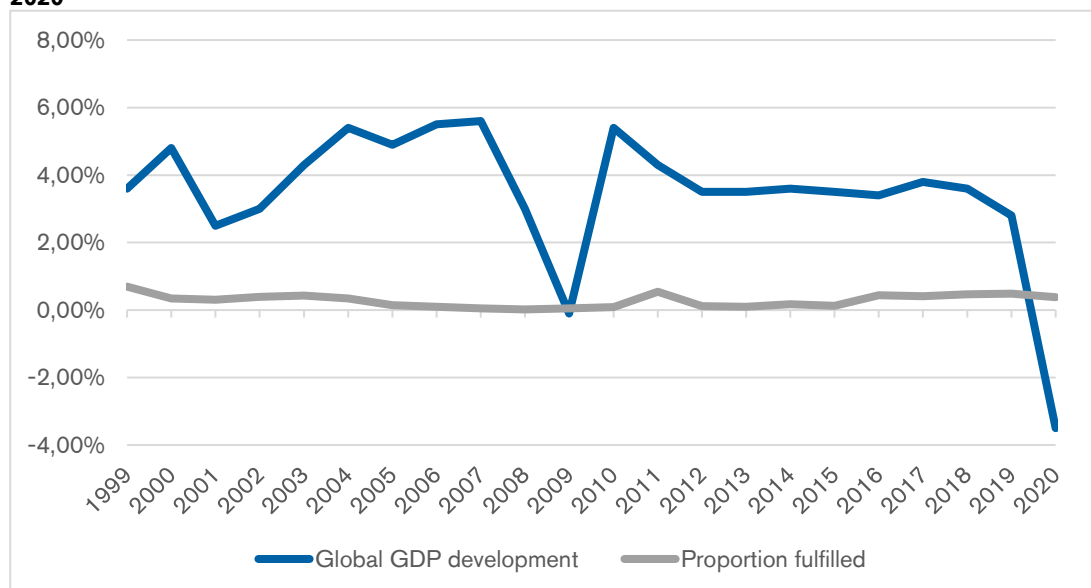
Figure 1 shows variations in global GDP development and default rates among companies who have had a rating from Moody's. The default rate among the two lowest rating categories in the figure (B and Caa-C) is significantly higher during the three economic crises that arose during the period 1983–2020, the crisis of the early 1990s, the IT crash around 2001, and the financial crisis of 2007–2009. The default rate is considerably lower in the periods between these crises.

**Figure 1. Default rates and global economic development**



Moody's Annual Default Study Corporate Default and Recovery Rates 1920–2019, Exhibit 40–41 - Annual Issuer-Weighted Corporate Default Rates by Letter Rating, 1920–2019. IMF, 2020.

Figure 2 describes the proportion of the central government's guarantee undertakings in the regular portfolio fulfilled during the period 1999–2020. Rather, the proportion shows a uniformity over these years. The largest annual fulfilment during the 20-year period consisted mainly of the guarantee for Saab Automobile, which in 2011 amounted to SEK 2.1 billion.

**Figure 2. Proportion of guarantee portfolio fulfilled and global economic development, 1999–2020**

Data from EKN, Sida, Boverket and the Debt Office. GDP development from the IMF, 2021 (GDP for 2020 is an estimate by the IMF)

The Debt Office lacks data for aggregate fulfilments during the period before the end of the 1990s. The period before this includes, for example, the financial crisis in the beginning of the 1990s and the oil crisis of the 1970s. In the wake of the oil crisis, mainly countries in Latin America and Africa were affected by the economic consequences, which led to the debt rescheduling that took place in what was known as the Paris Club. For EKN (the Swedish Export Credit Agency), this entailed a large amount of guarantee commitments being fulfilled in the 1980s, peaking at SEK 1.7 billion in 1987.<sup>8</sup> The Swedish shipbuilding crisis also resulted in guarantee losses that mostly occurred in the 1980s. This sector experienced a deep recession in Sweden during the 1970s and 1980s, and the state issued a large amount of guarantees in an attempt to promote the sector. The Debt Office's guarantees to the sector amounted to at most SEK 64 billion in 1983, and the amounts fulfilled were over SEK 4.5 billion in the most critical period of 1983–1987.

Recalculated to current monetary value, EKN's and the Debt Office's fulfilments do in fact amount to around SEK 20 billion over a number of years in the 1980s. However, these losses are mainly due to both a geographic and a sector concentration rather than a decline in the general economy.

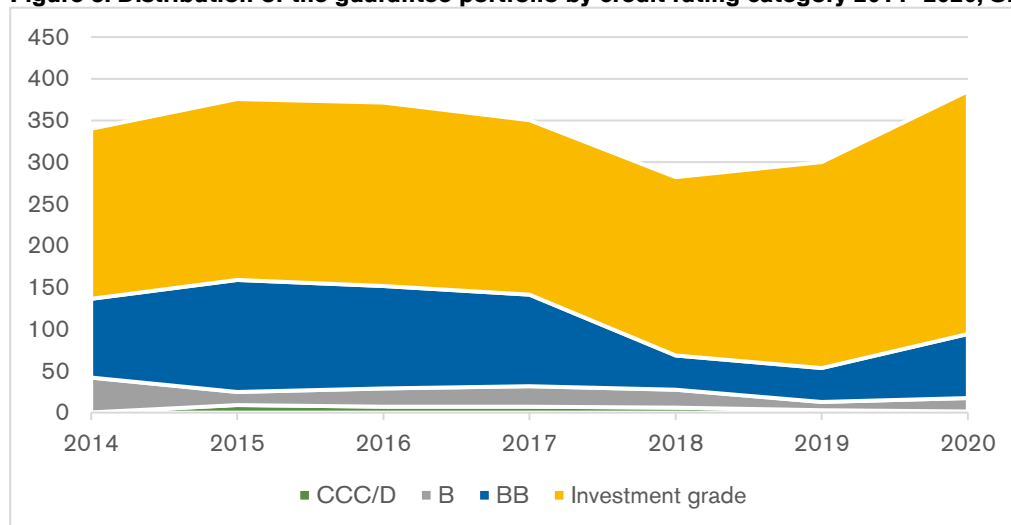
This historical data indicates that there has been limited sensitivity to business cycles in the guarantee portfolio. A likely partial explanation is that the proportion of guarantees with high credit risk has been relatively small.

The speculative grade rating (BB+ or lower) exposure has markedly declined from around 40 per cent in 2014 to under 24 per cent. This is however an increase from the previous year when the speculative grade rating amounted to 18 per cent. The increase is mainly due to the majority of the

<sup>8</sup> Large parts of these amounts paid out from EKN were recovered in the long term.

new guarantees in the analysis being assigned a credit rating of between BB+ and BB- (corresponding to Moody's Ba1–Ba3). Normally, the increase in the share of *speculative grade* during a crisis is due in part to certain existing commitments receiving a lower rating, yet mostly because new guarantees are often issued to industries in distress that generally have poorer creditworthiness. Of this 24 per cent, the exposure to the two lowest credit rating categories has only consisted of a smaller portion, which can be seen in Figure 3.

**Figure 3. Distribution of the guarantee portfolio by credit rating category 2014–2020, SEK billion**



Exposure during 2018 to 2020 refers to the amount that can be fulfilled during the time horizon of the analysis. Exposure based on the total guarantee amount would otherwise have increased to approximately SEK 456 billion. For a smaller portion of the exposure, no assessment of creditworthiness is made.

The creditworthiness of the portfolio's commitments varies from year to year. The value of analysing historical defaults is less for a portfolio with creditworthiness that differs significantly from previous periods. However, given that the guarantee portfolio would have a greater exposure to guarantee holders with poor creditworthiness, the risk of large losses would likely increase and vice versa.

There is a lack of detailed information on the development of the exposures' creditworthiness over longer periods, but the Debt Office's assessment is that it has likely not deteriorated over time. Rather, the inception of the central government guarantee model at the end of the 1990s is an indication that the issuance of new guarantees, and the risk management of existing ones, has become more restrictive from a risk perspective.<sup>9</sup> In recent years, this guarantee model has been augmented to also include central government lending. The majority of the model's requirements contribute to decision makers' awareness of risks and to central government subsequently taking these risks into account. Other requirements are intended to ensure that the state avoids taking on certain types of undesirable risks and that the level of risk-taking is, to a reasonable extent, reduced.

<sup>9</sup> Appendix 1 includes a description of the central government guarantee and lending model.

### **Lending sensitivity to the general economic environment**

Central government lending with credit risk consists mainly of SEK 1.6 million in student loans corresponding to SEK 238 billion. In addition there are a few loans at the Debt Office amounting to around SEK 11 billion.

For student loans, no assessment of individual borrowers' creditworthiness is made because the conditions for lending are governed by study-related criteria as opposed to the borrower's economic situation. The Debt Office is therefore not able to assess the sensitivity of student loans in relation to economic downturns based on the credit rating of the various borrowers. At an aggregated level, however, there is reason to presume that student loan holders have relatively good creditworthiness, mainly in light of the comparatively high level of education.

There is also much to indicate that the size of annual write-offs of student loans does not, to any significant degree, depend on prevailing economic conditions. The student loans mostly subject to write-offs are those held by borrowers who have reached the age at which this is done as a matter of course. The size of these depends mainly on demographic factors and the financial situation of these borrowers up until the age at which the loans can be written off automatically. In the next five years, this entails a maximum of SEK 2.2 billion in loans written off due to the borrower's age. The write-offs can also be due to the event of death, so-called qualifying studies or other exceptional reasons. It is the Debt Office's assessment that such write-offs also do not vary significantly in relation to prevailing economic conditions.

What could vary more in relation to economic conditions, however, is the proportion of the annual amount CSN charges student loan holders that is paid in. A reduction in this proportion does not have to lead to increased write-offs, but it has a direct effect on the central government's cash flows and thereby the central government debt. These variations will be addressed in the following sections.

### **Concentration risks are likely the most relevant to analyse**

The Debt Office's assessment is that the regular portfolio has limited sensitivity to the general economic development. This assessment is primarily due to the portion of commitments with the lowest creditworthiness (B-CCC/D) being small. The historical outcome regarding losses also indicates a limited sensitivity to business cycles. The inception of the central government guarantee model in the 1990s has also resulted in a reduced risk of many, and large, commitments being added to the portfolio. This indicates that the credit quality of the portfolio has been strengthened, from a longer-term perspective, which has contributed to limited sensitivity to the general economic development.

Owing to the above, the Debt Office assesses that there is a low risk of large losses occurring solely as a result of systemic risk. The occurrence of such a scenario would require a very deep recession or lengthy economic crisis.

It is important to emphasise that the conclusion is not that the general economic development lacks relevance for the risk analysis. If large losses arise, it is likely in connection with a financial crisis of some kind. However, possible causes and backgrounds for such a crisis are not analysed in this context, although previous crises may serve as plausible examples. Other more pressing examples of such a situation are the ongoing pandemic and the unease and uncertainty in the surrounding world in regard to conflicts and refugee situations. During events of this kind, it is likely that losses

can derive from one or some of the portfolio's concentration risks. This refers to a financial crisis scenario in which the portfolio's largest guarantee commitments are fulfilled or a sector concentration is for some reason hit particularly hard at the same time as there is an overall increase in fulfilments and also in cessations of payment in the rest of the portfolio. To understand and assess the risk of large losses, these particular concentrations need to be analysed in detail.

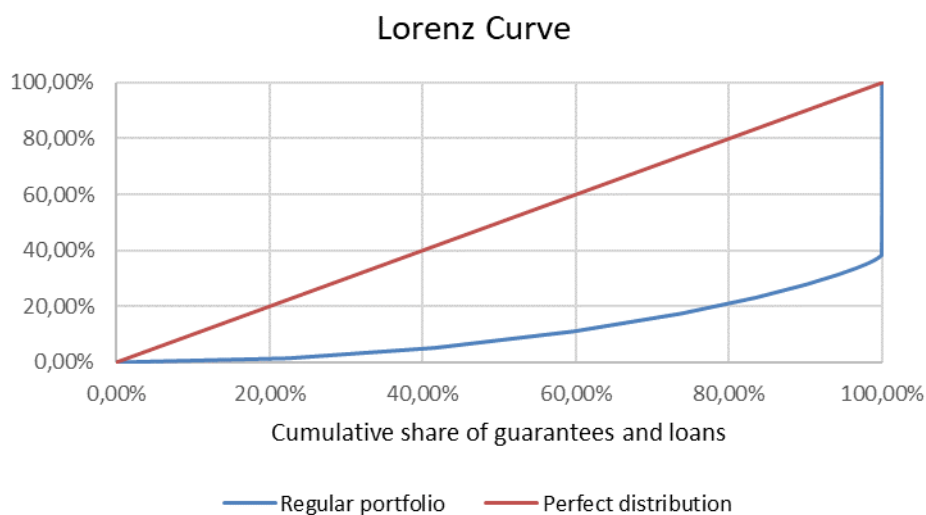
## Low risk of large losses despite concentrations

The regular portfolio contains a number of large name concentrations, a sector concentration to the telecom sector and a geographic concentration to Sweden mainly consisting of student loans. The Debt Office assesses there to be a low risk of large losses occurring among the identified concentrations. Other parts of the portfolio are considered to be relatively well-diversified.

## Name concentrations – good creditworthiness in individual large commitments

The regular portfolio consists of a large number of commitments, most of which are student loans. The latter comprises 99.9 per cent of the total number of commitments but only 34 per cent of the total amount. In addition, there are a few commitments that individually account for a significant proportion of the portfolio in terms of their amount. These are called name concentrations. For a portfolio with a large amount of commitments, the presence of name concentrations can be shown with a Lorenz curve (see Figure 4).

**Figure 4. Lorenz curve demonstrating the distribution of amount in the regular portfolio**



Data from EKN, Sida, CSN, Boverket, and the Debt Office, as at 31 December 2020.

The share of the portfolio's total amount is shown along a y-axis and the share of the commitments in the portfolio is shown along an x-axis. The straight line in the figure represents a portfolio in which all commitments are of the same size. The more a portfolio deviates from the straight line, the more uneven the distribution of amounts of the various commitments is. Figure 4 shows that the distribution of the regular portfolio is considerably uneven.

### Individual large commitments

The 15 largest commitments are shown in Table 8. These constitute 46 per cent of the total portfolio, compared to 45 per cent in the previous year. The right-hand column presents the maximum fulfilment over the time horizon of the analysis. For the second-largest guarantee, there is a significant difference between the size of the commitment and how much can be fulfilled in the next five years. This is because only a small portion of the guaranteed loans have been paid out.

In order to provide a more accurate picture, the amounts for guarantees or loans issued to the same counterparty have been consolidated. This is because a guarantee holder or borrower that is unable to honour its commitments will usually default on several or all its commitments simultaneously.

**Table 8. Size of the 15 largest commitments in the regular portfolio as at 31 Dec 2020, SEK billion**

	Total guarantee undertakings	Number of guarantees	Fulfilment amount <sup>1</sup>
Callable capital EIB	78.5	1	78.5
Credit guarantee <sup>3</sup>	51.7	1	5.7
Callable capital NIB	26.1	1	26.1
Callable capital AfDB	25.6	1	25.6
Credit guarantee <sup>3</sup>	22.4	1	16.7
Credit guarantee <sup>3</sup>	22.1	1	18.0
Callable capital IBRD	19.5	1	19.5
Credit guarantee <sup>2</sup> ÖSK	13.6	1	13.6
Credit guarantee <sup>3</sup>	10.0	1	10.0
Lending	10.0	1	10.0
Credit guarantee <sup>3</sup>	9.8	1	9.8
Credit guarantee <sup>3</sup>	9.0	1	9.0
Credit guarantee <sup>3</sup>	8.0	1	8.0
Other guarantee SURE	7.7	1	7.7
Callable capital EBRD	5.4	1	5.4
<b>Total</b>	<b>319.5</b>		<b>263.6</b>

<sup>1</sup> fulfilment amount is the maximum amount that can be fulfilled within the five-year time horizon of the analysis.

<sup>2</sup> The Swedish state and the Danish state jointly stand surety for all Öresundsbro Konsortiet (Öresund Bridge Consortium) loans. Therefore, the extent to which the Swedish state's undertaking is to be utilised in its entirety, or up to 50 per cent of outstanding amounts, is not given. In the table, a strict formal assessment has been made with the entire amount reported. This also corresponds with how the undertaking is reported in the central government's annual report.

<sup>3</sup> Refers to credit guarantees issued by EKN for which a counterparty cannot be named.

Data From EKN, Sida, CSN, Boverket, the Debt Office and the Government Offices.

### Low credit risk in individual large commitments

In most cases, the Debt Office obtains assessments of creditworthiness and recovery given default from the agency that has issued the guarantee or loan, or from the three major international credit rating institutions: Standard & Poor's (S&P), Moody's Investors Service (Moody's) and Fitch Ratings (Fitch) in cases where there is an externally published credit rating.



Table 9 shows the aggregate creditworthiness of the name concentrations shown in Table 8 with the exception of the callable capital that is analysed separately in the next section as well as the credit guarantee for which only SEK 5.7 billion of SEK 51.7 billion can be fulfilled within a five-year period. The majority of the commitments are considered to have good creditworthiness, *investment grade*, while the minority are considered weaker.

**Table 9. Creditworthiness assessments for individual large credit guarantees and loans (excluding callable capital) as at 31 Dec 2020, SEK billion**

	High expected recovery ( $\geq 60$ %)	Normal expected recovery (25 - 60 %)	Low expected recovery ( $\leq 25$ %)
Minimal to limited credit risk (AAA/Aaa – BBB-/Baa3) <sup>1</sup>	23.6	27.8	16.7
Significant to very high credit risk - (BB+/Ba1 – C/C) <sup>2</sup>	-	27.0	-

<sup>1</sup> Investment grade rating

<sup>2</sup> Speculative grade rating

The amount that can be fulfilled within the five-year time horizon of the analysis. Data from EKN and the Debt Office.

Most of the exposure is to commitments with minimal to limited credit risk. That indicates that there is a low risk of large losses occurring from one or more large fulfilments occurring independently of one another.

### Credit risk in the callable capital individually represented by large commitments

Sweden is a member of a number of international financial institutions (multilateral development banks), which through their lending activities contribute to the objectives agreed upon by the member countries. Membership can be equated with partnership, since each member country contributes a portion of the institutions' equity. This consists of both paid-in capital and callable capital. The callable capital entitles the institutions to additional capital contributions from the member countries, up to the guaranteed amount. The size of Sweden's callable capital commitments to international financial institutions is shown in Table 10.

**Table 10. Sweden's callable capital in international financial institutions as at 31 Dec 2020, SEK billion**

	Callable capital
European Investment Bank	78.5
Nordic Investment Bank	26.1
African Development Bank	25.6
World Bank Group	19.5
European Development Bank	5.4
Inter-American Development Bank	4.4
Asian Infrastructure Investment Bank	4.1
Asian Development Bank	4.1
Council of Europe Development Bank	1.2
Eurofima	0.4
<b>Total</b>	<b>169.4</b>

Data as at 31 December 2020 from the Government Offices of Sweden and Trafikverket (the National Transport Administration).

To date, capital has never been called in the formal sense. The international financial institutions' capital has instead been gradually increased as the member countries have paid in small amounts and adjusted the size of the callable capital amounts. The Debt Office's assessment is that the callable capital commitments would only need be fulfilled if an institution were to find itself in an extraordinary situation involving an acute need of capital infusion due to financial difficulties. In such a situation, the member countries could also opt to make capital contributions that don't involve fulfilling callable capital commitments. No member country, however, has committed to any such capital contributions. Instead, this would be done through new agreements between the member countries and the institutions. The risk analysis only focuses on the capital contribution commitments to which the state has committed explicitly and which could potentially entail fulfilment.

The Debt Office assesses there to be a low probability of callable capital commitments being fulfilled. This is mainly because the institutions have a high underlying creditworthiness, attributable in part to their role as preferential creditors.<sup>10</sup> The underlying creditworthiness, as opposed to a rating, takes into account the institutions' creditworthiness, providing that they did not have access to extraordinary support from the member countries. Table 11 shows that S&P's assessments of the various institutions' underlying creditworthiness lie within the range of aa to aaa. This high underlying creditworthiness is also based on the fact that the member countries have a history of contributing capital, when required, for example when an institution's lending is to be increased.<sup>11</sup> The good creditworthiness of the institutions therefore entails a low likelihood of them encountering an

<sup>10</sup> The good underlying creditworthiness can also be explained by the fact that dividends are generally not distributed. NIB (Nordic Investment Bank), however, normally distributes an annual dividend of 25 per cent of profit to the member countries. In most of the other institutions, however, distributions have never occurred and they are not expected to occur in the future.

<sup>11</sup> The member countries are, however, not obligated to make such capital contributions and they also involve small amounts that are paid in under normal circumstances.

extraordinary situation in which member countries would need to contribute capital, for instance by fulfilling callable capital commitments.

**Table 11. Creditworthiness of international financial institutions of which Sweden was a member as at 31 Dec 2020**

	Underlying creditworthiness	Rating
European Investment Bank	aaa	AAA
Nordic Investment Bank	aaa	AAA
World Bank Group	aaa	AAA
African Development Bank	aa+	AAA
Inter-American Development Bank	aaa	AAA
European Development Bank	aaa	AAA
Council of Europe Development Bank	aaa	AAA
Asian Development Bank	aaa	AAA
Asian Infrastructure Investment Bank	aaa	AAA
Eurofima	aa-	AA

## Close connections limited – low risk of problems spreading

The guarantee holders and borrowers in the regular portfolio have a few connections to one another that could give rise to what is known as default contagion. However, these financial relationships, which occur for example through participating interests and group affiliation, are small in terms of amounts. They therefore entail a low risk of large losses.

## Sector concentrations – exposure to telecom operators

The regular portfolio consists of commitments in a number of various sectors, presented in Table 12. The most prominent sector concentration is on the telecom sector. It amounts to SEK 70.9 billion, or 10.2 per cent of the portfolio. This consists mainly of export credit guarantees linked to the sale of telecommunications equipment, for which the state's credit risk lies with the purchasers (telecom operators).

The exposure to telecom operators increased in absolute terms to SEK 70.9 billion, from SEK 68.1 billion the previous year. The share of industry concentrations in the regular portfolio decreased, however, to 10.2 per cent compared with 11.2 per cent the previous year. As in the previous year, a number of guarantees within the telecom sector are large enough to also constitute individual name concentrations (see section on individual large commitments).

Table 12 shows that only a small share of the portfolio, 23.7 per cent, can be categorised by sector affiliation. The remainder of the portfolio consists primarily of student loans (SEK 238 billion) and callable capital (SEK 169 billion).

**Table 12. The regular portfolio's exposure to companies, by industry, as at 31 December 2020**

	SEK billion <sup>1</sup>	Share in per cent
Telecommunications	70.9 (58.3)	10.2
Transport	41.8 (40.7)	6.0
Industrial goods and metals	20.1 (18.9)	2.9
Power supply	17.7 (12.5)	2.5
Finance	10.7 (10.7)	1.5
Properties	2.8 (2.8)	0.4
Energy and natural resources	1.4 (1.4)	0.2
<b>Total</b>	<b>165,4 (145,3)</b>	<b>23.7</b>

<sup>1</sup> The maximum amount that can be fulfilled within the five-year time horizon of the analysis is shown in parentheses. Sectoral distribution based on the Global Industry Classification Standard (GICS) developed by Morgan Stanley Capital International (MSCI) and S&P. Data From EKN, Sida, CSN, Boverket, the Debt Office and the Government Offices.

### Concentration to telecom operators

The Debt Office assesses there to be a low risk of the sector concentration to telecom operators giving rise to large losses. The industry remains relatively stable with a low probability of negative shocks that can cause clusters of losses, even though the industry's prospects are assessed to be less positive than previously.

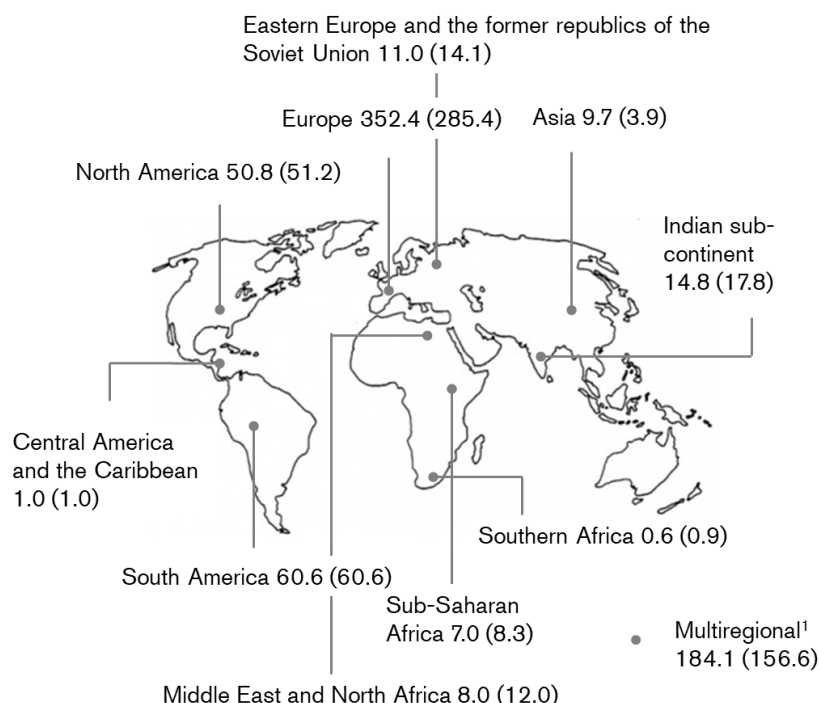
The central government's exposure to telecom operators consists of export credit guarantees. Historically, these have mainly been issued for export transactions to more risk-laden countries, while a transition towards countries associated with less risk has occurred. The creditworthiness in the telecom portfolio has improved from previous years, and the portfolio's distribution has shifted to countries with low country risk.

Further, the Debt Office assesses there to be a lower likelihood of issued guarantees being fulfilled than what the guarantee holders' creditworthiness indicates. This is mainly due to the conditions of the guarantees, such as risk distribution, providing incentives for the lenders to avoid fulfilment of a guarantee commitment in the event of default.

The Debt Office assesses the central government's opportunities for recovery after fulfilment to be normal in most cases, corresponding to a recovery rate of about 50 per cent of the fulfilled amount. EKN, however, expects the recovery rate for some of the telecom-industry guarantee commitments that have large sums to be lower than usual.

## Geographic concentrations – large proportion in Sweden

Commitments in the regular portfolio have a distinct geographic concentration to Sweden. The commitments in the regular portfolio are distributed across a large number of countries, which is mainly attributable to the export credit guarantees issued by EKN and the central government's commitments with international financial institutions. Chart 2 shows the portfolio's composition in terms of geographic regions, with 2019 figures in parentheses.

**Chart 2. Regular portfolio distribution by geographic region as at 31 Dec 2020, SEK billion**

<sup>1</sup>The multi-regional category includes callable capital commitments to international financial institutions. The common denominator of the commitments in this category is that they contribute to the geographic distribution of the portfolio.

The categories correspond to those used by Moody's to analyse geographic concentrations in the structured products. Moody's Approach to Rating Corporate Synthetic Collateralised Debt Obligations. Exhibit 9: Classification of Countries by Contagion Region (2015). Figures in parentheses refer to 2019. Data From EKN, Sida, CSN, Boverket, the Debt Office and the Government Offices.

### High geographic concentration to Sweden

The geographic distribution of the portfolio in Chart 2 is supplemented in Table 13 with data on the ten largest exposures to individual countries. The latter also describes how external assessors view the country risk in these countries. The country risk takes the degree of economic and political stability into account and can be considered an indicator of the risk of negative financial shocks.<sup>12</sup>

<sup>12</sup> The country risk of a particular country is not to be confused with a state's creditworthiness. Even though these two risk assessments largely take into account the same risk factors, there are also key differences between them.

Table 13 shows that there is a clear geographic concentration to Sweden, where around 45 per cent of the guarantees and lending portfolio are.

**Table 13. The ten largest country exposures in the regular portfolio as at 31 Dec 2020, SEK billion**

	Country Credit Rating <sup>1</sup>	Country Risk Rating <sup>2</sup>	Amount	Share
Sweden	0	Aaa/Aaa	315.5	45.2
Brazil	4	Baa1/Baa2	55.7	8.0
USA	0	Aaa/Aaa	49.0	7.0
UK	0	Aaa/Aaa	8.8	1.3
Denmark	0	Aaa/Aaa	7.8	1.1
Spain	0	Aa1/Aa1	5.5	0.8
India	3	A2/A3	5.1	0.7
Turkey	5	Ba3/B2	4.7	0.7
Japan	0	Aaa/Aaa	4.7	0.7
Pakistan	7	Ba3/B2	4.3	0.6
<b>Total</b>			<b>461.1</b>	<b>66.1</b>

<sup>1</sup> Refers to EKN's country risk classification, in which category 0 represents the lowest risk and category 7 the highest risk.

<sup>2</sup> Refers to Moody's "country ceiling" for debt instruments in local and foreign currencies, respectively. Moody's (2021) Sovereign and Supranational Rating List.

### Low risk of large losses for Swedish student loans

The Debt Office assesses there to be a low risk of large losses for student loans resulting from the concentration to Sweden. The largest part of the concentration, 70.5 per cent, corresponding to SEK 222 billion, consists of student loans to borrowers residing in Sweden.

The student loans have been issued under two distinct systems – student loans and annuity loans. Both types of loans have similar characteristics, such as long maturities (on average 25 years or more) and in part “soft” conditions involving the option to reduce the borrower's annual payments during periods of lower income. The student loans can therefore be compared with conditional loans, for which the extent and rate of repayment to the central government depends on the borrower's future income growth. As stated in the above section The Analytical Framework, a reduction is, however, not classified as a loss in this analysis. Rather, a loss does not occur until the actual write-off of a loan.

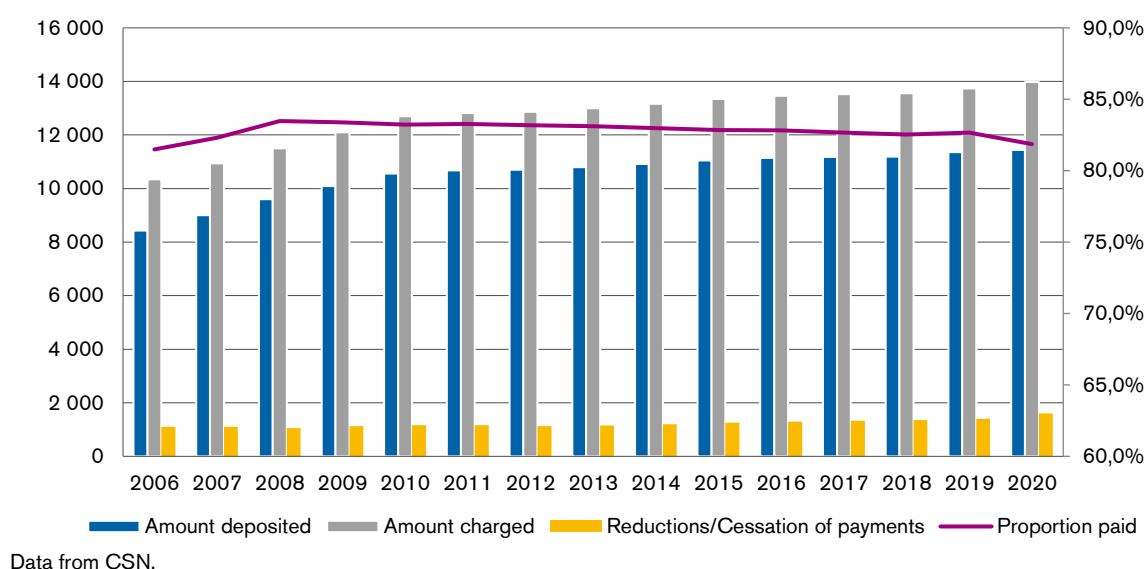
The Debt Office's assessment is that the risk of large write-offs is low. Write-offs due to age cannot exceed SEK 2.2 billion over the coming five years given the state of the loan portfolio. Other significant reasons for write-offs, such as deaths and qualifying studies, are not deemed to have a significant effect on the economic development in the country. Therefore, there is a low likelihood of these reaching significant amounts during the analysis' horizon.

### Significant deterioration in cash flow from student loans is less likely

The analysis of large write-offs is mainly relevant because they have a negative effect on central government net lending. However, only analysing the risk of write-offs provides a limited picture of how student loans can affect state finances – because it does not address the effect that reduced payments on loans during certain periods has on the central government's cash flow. Given the size

of the annual deposits, a drastic reduction of payments on student loans would have distinctly adverse effects on the central government's cash flow. Therefore, although reduced payments are not classified as losses, the risk is relevant to analyse. Figure 5 shows both the size of the amounts deposited and charged for student loans annually as well as the relationship between them.

**Figure 5. Amounts deposited and charged annually, SEK million**



The difference between charged and deposited annual amounts is mainly in the form of reductions of the annual amount and the amounts that the borrowers were obligated to pay but still failed to pay (cessation of payments). A reduction means that borrowers will postpone repayment, and it is still implicit that they are to pay back the loan in full. If a reduction is made for annuity loans, corresponding amounts are therefore added to future payments. Decisions on reduction can be made several years in a row. If a debt remains due to a reduction, it is written off when the borrower becomes eligible for a write-off based on age. The write-off does not necessarily have to correspond to the sum of all reductions and cessations of payments. A reduction of the "same lent krona" can be made several years in a row but can only be written off once. An increase in reductions and cessations of payment, however, entails a corresponding increase in the central government debt and budget balance, all else being equal.

The fact that reductions and cessations of payments increase over time in terms of volume is, as described, a result of increased lending by CSN. However, if the increases are particularly high during certain periods, the possibility of payment is lower than usual during these periods. All else being equal, this leads to poorer cash flow for the central government.

As a proportion of the total amount paid in, even the most significant increases during the years in focus have been relatively limited. A likely explanation for the fact that the reductions and cessations of payments did not increase more during the financial crises that have occurred in Sweden since the 1990s is that, generally, student borrowers had good creditworthiness and thereby the capacity

to pay despite the crises. However, we can see in the above figure that the rate of payment sunk somewhat during 2020 but that the decline is so far relatively low and corresponds to approximately SEK 200 million<sup>13</sup>. The borrowers' relatively high level of education reduces the risk of unemployment, and the presence of unemployment insurance and other insurance systems mitigates the impact of unemployment on borrowers' incomes. Student loans are well-diversified because the borrowers are employed across a variety of sectors. This reduces the risk of a sharp decrease in payments on student loans if only individual sectors were to be affected by economic shocks.

The proportion of the population registered for national unemployment insurance has decreased somewhat in the 2000s but went up significantly last year. Despite this, the share is lower than it was in beginning of the 2000s. A continued decline in this proportion could lead to sharper increases in reductions and cessations of payments than previously in a scenario in which many student borrowers lose their jobs.<sup>14</sup> Another factor that could involve sharper increases, primarily in cessations of payments, than in previous financial crises is if many borrowers were to be at a significantly higher level of indebtedness.

## Consolidated assessment of risk factors

Based on the analysis of identified risk factors, the Debt Office estimates that the risk of large losses occurring in the regular portfolio is low.

The portfolio's sensitivity to economic downturns is judged to be limited, although a very deep and lengthy recession could cause large losses. A more extensive economic crisis than what has so far been caused by the pandemic could thereby affect the overall assessment. This is especially true if such a recession were to strike one or more of the concentrations in the portfolio particularly hard at the same time as the losses in the rest of the portfolio were higher than normal. Large parts of the portfolio have relatively good creditworthiness, and the share of commitments with very low creditworthiness is small. The relatively good creditworthiness in itself indicates that there is good resilience to economic downturns. Existing portfolio concentrations are currently only considered to give rise to a low level of risk.

What would primarily lead to a higher risk of large losses, however, is if the creditworthiness in the portfolio would diminish and there would be a significant increase in commitments with very high credit risk (credit rating B to C). This is especially true if the commitments with low creditworthiness were to be particularly sensitive to economic fluctuations and/or active in a sector or geographic area undergoing significant transition.<sup>15</sup>

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<sup>13</sup> CSN, in its annual report, defines the rate of repayment as the annual amount charged after reductions. In this report, the Debt Office uses the annual amount charged including reductions, which accounts for the deviation in the rate of repayment.

<sup>14</sup> <https://iaf.se/statistikdatabasen/statistikdatabas/arbetsloshetskassornas-medlemsantal/> 3 mars 2021

<sup>15</sup> Examples of losses occurring in the wake of major transitional periods include guarantees to the Swedish shipbuilding industry in the 1980s, export credit guarantees to, among others, Latin America during the same period and the guarantee to Saab Automobile after the most recent financial crisis.



## Credit risks in the deposit insurance scheme

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The Debt Office assesses the risk of large losses in the deposit insurance scheme to remain at the same moderate level as in the previous year. For the major banks and other institutions deemed systemically important, the deposit insurance scheme may need to be utilised to provide consumer protection in resolution. These institutions often have a debt structure with an extensive amount of liabilities with lower priority rights than those of guaranteed deposits, which means that very significant losses would have to occur before the deposit insurance scheme would need to be activated. If a non-systemically important institution were to fail, the deposit insurance commitment would be fulfilled by the state paying compensation directly to the depositors and receiving a claim on the institution. Due to their smaller size, at least two to three non-systemically important institutions would have to fail before such fulfilments would lead to large losses. The Debt Office assesses the risk of that occurring to be moderate.

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### Commitment to consumer protection and financial stability

Deposit insurance is a form of consumer protection for money in accounts at banks, credit market companies and securities companies, collectively referred to here as institutions.<sup>16</sup> The maximum compensation amount is SEK 1,050,000 per person and institution. On 25 March 2020, the Debt Office decided that the maximum compensatory amount shall continue to be expressed in Swedish kronor but that it is to be regulated in rules set out by the Debt Office, as opposed to legislation as previously. The decision means that the Debt Office is able to adapt the maximum compensatory amount to the equivalent amount in the EU directive (EUR 100,000) in connection with the recalculation to Swedish kronor using the current exchange rate that is done every five years.

According to the EU directive, a recalculation occurred for the first time at the exchange rate that applied on 3 July 2020. Therefore, the Debt Office decided to, starting 1 January 2021, raise the maximum compensatory amount to SEK 1,050,000. The previous amount was SEK 950 000.<sup>17</sup> Deposit insurance is a form of consumer protection, but it also reduces the risk of many depositors withdrawing their funds at the same time, and thereby so-called bank runs, which could threaten financial stability.

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<sup>16</sup> Most institutions authorised to accept deposits from the public are covered by deposit insurance, in accordance with the Deposit Insurance Act (1995:1571). There are exceptions, however, such as so-called deposit-taking companies.

<sup>17</sup> Information regarding the change of compensation amount is found in the Debt Office's regulations RGKFS 2020:2

Deposit insurance is the single-largest central government guarantee in terms of reported amount. On 31 December 2019, the total guaranteed deposits amounted to SEK 1,734 billion distributed among 104 institutions.<sup>18</sup>

## Different function depending on type of crisis management

The purpose of the deposit insurance scheme is the same in all situations – but it functions differently depending on whether a failing institution is placed in bankruptcy or managed through resolution.

If an institution with guaranteed deposits encounters problems that lead to bankruptcy or if Finansinspektionen (the Swedish Financial Supervisory Authority) decides that the deposit insurance scheme should be activated, there is a so-called direct fulfilment of the deposit insurance commitment.<sup>19</sup> This means that the central government pays out compensation to the institutions' depositors and acquires the depositors' claims on the institution in bankruptcy.

If a failing institution is deemed systemically important<sup>20</sup> and therefore to be managed through resolution, the central government assumes control (but not ownership) of the institution in order to restructure it or wind it up in orderly manner.<sup>21</sup> The main principle of resolution is that shareholders and lenders have their claims written down and/or converted into equity on the basis of a predetermined order of priority, as part of process called a "bail-in".

Guaranteed deposits, however, are exempt from the write-down of liabilities. Any losses or recapitalisation requirements for which the depositors would have been responsible, had they not been exempted, are covered instead by the deposit insurance fund. The fund can contribute a maximum of SEK 27.7 billion per institution (see the fact box Payments from the deposit insurance fund). This is done through an injection on the asset side of the institution's balance sheet.

Based on these different modes of functioning, the risk analysis is divided into two parts:

- Direct fulfilment

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<sup>18</sup> Guaranteed deposits are reported once a year, and the volumes as at 31 December 2020 had not yet been received at the time of this report. The amount is therefore not adjusted for changes in 2020.

<sup>19</sup> Section 8 of the Deposit Insurance Act (1995:1571) states that decisions by Finansinspektionen are based on the circumstance that a deposit fallen due for payment has not been repaid by the institution and that the inability to pay is attributable to the institution's financial situation and not merely temporary.

<sup>20</sup> "Systemically important" refers in this report to the Debt Office's classification of an institution as having operations that, were they to cease, would likely lead to a serious disruption of the financial system.

<sup>21</sup> Resolution is a restructuring procedure for institutions that cannot be wound up through bankruptcy, as this would create serious disturbances in the financial system. The purpose of resolution is to give the state an opportunity to maintain the institution's critical functions (accounts, payment processing, access to capital, etc.) without taxpayers having to bear the costs. As with bankruptcy, the intention is for shareholders and lenders to bear the costs of an institution's failure. The Debt Office is the Resolution Authority responsible for both the preparatory work and management of institutions in crisis. Resolution is regulated under the Resolution Act (2015:1016) and the Resolution Ordinance (2015:1034). These are based on EU Directive 2014/59 and the Commission Delegated Regulation (EU) 2016/778.

- Deposit insurance contributions in resolution

In accordance with this division, the institutions have been separated into different categories.

## Different categories of institutions

The relevant institutions in the analysis of the deposit insurance scheme have been divided into four categories on the basis of the different modes of functioning for the deposit insurance scheme (see Table 14). The institutions assessed to be subject to resolution are placed in categories 1 and 2. The risk analysis is based on the assumption that these institutions fully comply with the requirements stipulated by the Debt Office in its resolution planning, including MREL. The Debt Office's method of setting MREL entails that the minimum requirement must be met exclusively with subordinated instruments (own funds and subordinated liabilities). The stipulation that the liabilities used to meet the minimum requirement must be subordinated applies as of 2024<sup>22</sup>. Institutions that are instead considered to be subject to direct fulfilment in the event of their failure are included in categories 3 and 4. The division is based on the Debt Office's resolution planning decision from December 2020, entailing that eight deposit-taking institutions conduct activities deemed critical to the financial system.<sup>23</sup> The decisions are based on an assessment of whether the individual institution could be managed through bankruptcy/winding up or whether resolution measures would be required. If the conditions change, the decision may be reconsidered. For example, at default, an institution in category 1 or 2 could be deemed non-systemically important and thus subject to direct fulfilment instead of resolution. Conversely, it could be judged necessary to employ resolution for institutions in categories 3 and 4 – for example, in a situation involving a more widespread and general threat to financial stability. This circumstance does not appreciably affect the conclusions of the analysis.

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<sup>22</sup> See the fact box for a more detailed explanation of MREL.

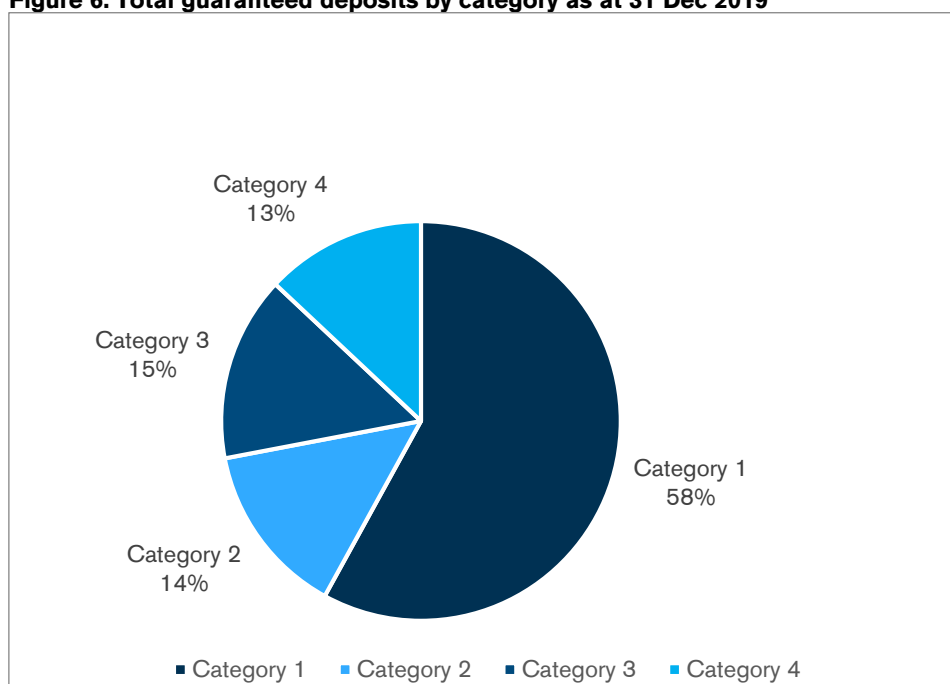
<sup>23</sup> SEK (the Swedish Export Credit Corporation) is also subject to the same decision by the Debt Office, but this institution has no guaranteed deposits.

**Table 14. Categories of institutions according to the analysis in this report**

Institution categories	Resolution	Bankruptcy/liquidation (direct fulfilment)
Category 1: Major banks that, in the event of a crisis, cannot be managed by means of bankruptcy proceedings.	- Skandinaviska Enskilda Banken - Svenska Handelsbanken - Swedbank	
Category 2: Other institutions that, like the major banks, are not deemed suitable for bankruptcy.	- Landshypotek Bank - Länsförsäkringar Bank - SBAB - Skandiabanken - Sparbanken Skåne	
Category 3: Institutions considered subject to direct fulfilment of the deposit insurance scheme and that have guaranteed deposits of more than SEK 10 billion.		14 institutions.
Category 4: Institutions considered subject to direct fulfilment of the deposit insurance scheme and that have guaranteed deposits amounting to less than SEK 10 billion.		Approx. 80 institutions.

As shown in Figure 6, the guaranteed deposits are unevenly distributed among the various institutions. The three major banks (category 1) account for 58 per cent while the smallest institutions, in category 4 – approximately 80 institutions – account for only 13 per cent combined.

**Figure 6. Total guaranteed deposits by category as at 31 Dec 2019**



## Distinguishing risk factors for the deposit insurance scheme

The initial analytical framework describes different risk factors and that there are essentially two types of events that could cause large losses.

The first such event is if individual, or a small number of, sufficiently large institutions fail independently of one another and thus, by their size alone, generate large losses. There are significant name concentrations within the first two categories of institutions. There are also smaller name concentrations in category 3 that include the fourteen institutions deemed subject to direct fulfilment and that have guaranteed deposits in excess of SEK 10 billion.

The other such event is if the majority of the institutions were to fail, together causing large losses. A high degree of default could almost exclusively be attributed to them having been in some way dependent on one other, i.e. covariance. Covariance can be direct or indirect (see Chart 1).

The fact that different groups of institutions have similar business models can also generate covariance of default risk. If institutions have similar lending portfolios, there is for example an increased probability of large credit losses within a specific area of lending affecting several institutions. An example of a business model shared by the majority of institutions is the issuance of loans to parties with lower creditworthiness. In the event of a persistent recession, for example, this customer group is more likely to have payment problems. When they are unable to pay interest and amortisation payments, several institutions thereby suffer higher credit losses. In the worst case, this could lead to several defaults.

Another risk factor for the financial system is that the institutions are, to varying degrees, interconnected. One such connection is the occurrence of financial connections between certain institutions. The institutions have varying degrees of credit exposures to one another in the form of both secured and unsecured lending. This means that financial problems affecting an institution will spread to other institutions through their ownership of securities in, and lending to, the first institution. If the institutions affected by these spillover effects fail to manage the losses that occur, there may in turn be additional spillover effects.<sup>24</sup>

The fact that these institutions are interconnected also entails the risk that one institution's credibility problems will spread to another. The spread of credibility problems mostly concerns institutions with a similar risk profile or that are active in the same markets. An example of this was when money laundering accusations in 2018 and 2019 towards a couple of banks operating in the Baltic market also led to suspicions of other institutions with activities in the Baltic region. The fact that credibility issues can spread in this way could exacerbate problems for an institution that is already in a difficult situation for other reasons.

As with mainly student loans in the regular portfolio, the deposit insurance also has a geographic concentration to Sweden, even if many major institutions have significant operations in other

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<sup>24</sup> Riksbank (2020). Financial Stability 2020:2. p. 3

countries. An overall deterioration of the state of the Swedish economy would thereby increase the risk of direct fulfilments of the deposit insurance commitment.

## **Moderate risk of direct fulfilments causing large losses**

As previously explained, direct fulfilment only applies to institutions in categories 3 and 4, because institutions in categories 1 and 2 are expected to be managed through resolution. The risk that arises as the result of direct fulfilments of the deposit insurance commitment would most likely be due to covariance leading to the failure of several institutions. It is more likely that large losses would arise as a result of independent defaults of individual large institutions.

### **Low risk of large losses resulting from name concentrations alone**

The risk that the name concentrations in category 3 would lead to large losses depends mainly on the likelihood of default among these individual large institutions and the size of their guaranteed deposits. As the institutions in category 4 each have a smaller amount of guaranteed deposits, the risk of large losses, due to defaults independent of one another, in this category is considerably lower. Accordingly, this section focuses on category 3.

Altogether, the fourteen institutions in category 3 have around SEK 261 billion in guaranteed deposits and the distribution among them is relatively even. Consequently, several institutions would have to fail for large losses to occur in the deposit insurance scheme. The likelihood of several mutually independent defaults occurring over a limited period of time is significantly lower than the likelihood of an individual default.

It should be noted that the likelihood of a direct fulfilment of the deposit insurance commitment is lower than the likelihood of an institution failing. This is mainly because some of the problems that could lead to a default would not necessarily result in a direct fulfilment. An example of this is if Finansinspektionen were to revoke an institution's authorisation (which would be classified as a default) and the institution were subsequently wound up through another actor acquiring all or parts of the institution (including its stock of deposits).<sup>25</sup>

The likelihood of default can be estimated by assessing an institution's creditworthiness, for example, by means of a credit rating. This has been used in the analysis of those institutions with a public rating. For the most relevant institutions, among those lacking such a rating, the Debt Office has made its own creditworthiness assessment based on the methodology of the international credit rating institutions.<sup>26</sup>

Some of the institutions in category 3 have relatively weak creditworthiness. The probability of such institutions failing is not insignificant. The Debt Office's assessment is that there is a low risk of large losses occurring, which would result from a number of mutually independent defaults among these institutions. Even if the institutions generally have a lower rating than the institutions in categories 1 and 2, there is a limited number with relatively weak creditworthiness.

The assessment is based on the prevailing conditions and therefore takes into account the impact of the pandemic.

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<sup>25</sup> An example of such a case is when HQ Bank lost its authorisation in 2010 and was acquired by Carnegie Investment Bank.

<sup>26</sup> Moody's (2018) Rating Methodology: Banks. S&P (2011). Banks. Rating Methodology and Assumptions.

### **Moderate risk of large losses due to covariance of defaults**

The analysis of covariance of defaults includes both categories 3 and 4. Category 4 consists of approximately 80 smaller institutions that together have guaranteed deposits totalling approximately SEK 230 billion. Altogether, both categories amount to about a hundred institutions with a total volume of almost SEK 491 billion.

As previously mentioned, the financial sector is characterised by a number of risk factors that can contribute to covariance of defaults, which also applies to the institutions in categories 3 and 4. The vast majority have either all or parts of their operations in Sweden, i.e., a geographic concentration. Many are savings banks with similar business models in the form of deposits and lending at the local level, even if these have a large geographic distribution across the county.

A risk factor is that certain institutions have a significant part of their lending to the customer segment with relatively low creditworthiness. This business model entails an enhanced risk of credit losses in the institutions because the creditworthiness of borrowers in similar sectors also tends to be affected by the same background factors, such as the general economic development.

A shock to the economy, for example a downturn that leads to a sharp increase in credit losses in the financial sector, could cause large losses for this group. However, in regard to the aggregate limited volumes involved, fulfilments would need to be made for at least two to three of these institutions in order for large losses to occur. The Debt Office assesses this risk to be moderate. The risk of significantly greater losses than SEK 20 billion occurring is deemed low. This is due to the limited volumes for each institution and the fact that an even larger number would thereby have to fail.

### **Lower recovery with direct fulfilment than in resolution**

The Debt Office's assessment is that recovery of paid-out funds in most cases is lower with direct fulfilment of the deposit insurance commitment than when deposit insurance is utilised in resolution. The degree of recovery can, however, vary widely between compensation cases.

The degree of recovery is based on these institutions largely being funded by deposits, which leads to a capital structure usually involving a limited volume of liabilities that are written down before guaranteed deposits. The positive effect of the right to a higher order of priority for guaranteed deposits is thus limited for the institutions deemed subject to direct fulfilment.

At the same time, it should be pointed out that larger fulfilments, which erode available funds in the deposit insurance fund, lead to an increase in future fees paid by the institutions that are affiliated to the deposit insurance scheme (see the box Payments from the deposit insurance fund). This retroactive fee is distinct from the regular portfolio fee and contributes to the entire loss being borne by the institutions. However, depending on the situation that arises, this long-term cost coverage may be beyond the time perspective in this risk analysis.

The deposit insurance fee is calculated on the basis of the institutions' risk level and is intended to reduce the incentive for excessive risk-taking. In 2020, the Debt Office made a couple of changes to

the fee model, which entail that additional risk parameters are taken into consideration and that the fee better reflects the institutions' level of risk. The revised model applies from 1 January 2021.<sup>27</sup>

### **Large share of deposits affect recovery rate**

In conjunction with the crisis management directive being transposed into Swedish law in 2016, guaranteed deposits were assigned a general right of priority<sup>28</sup>. This entails a preferential claim on any distributions from a bankruptcy in relation to claims having no priority right (so-called non-preferential claims). The preferential arrangement must also be respected in resolution.

The prioritised position of guaranteed deposits entails a lower risk of losses for the deposit insurance scheme both in the case of direct fulfilment and resolution. However, this positive effect is judged to be limited for institutions that finance their operations extensively via deposits from the general public (with the majority of those deposits protected by deposit insurance). This is because these institutions lack a large quantity of claims with lower priority rights than those of guaranteed deposits.

While the capital structure of the institutions presumed to be the subject of direct fulfilments (categories 3 and 4) does in fact show differences, the share of deposits is significantly higher overall than in the institutions in categories 1 and 2. Some institutions fund their activities almost exclusively with deposits; others employ more diversified financing that also includes non-preferential capital market borrowing. The share of deposits covered by the deposit insurance is, on average, 83 per cent for institutions in category 3<sup>29</sup>. For a number of institutions, however, that share is over 90 per cent.<sup>30</sup>

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<sup>27</sup> The Swedish National Debt Office's regulations (RGKFS 2020:3).

<sup>28</sup> The change entered into force on 1 Februari 2016. Section 13 a of the Rights of Priority Act (1970:979).

<sup>29</sup> As a result of the large number of institutions in category 4, only an average has been calculated for category 3.

<sup>30</sup> Certain types of debt have the same priority rights. These include non-preferential debt such as short-term capital market borrowing, interbank borrowing, bond loans and derivatives.



**Figure 7. Balance sheet for two types of institutions considered subject to direct fulfilment as at 31 Dec 2019**

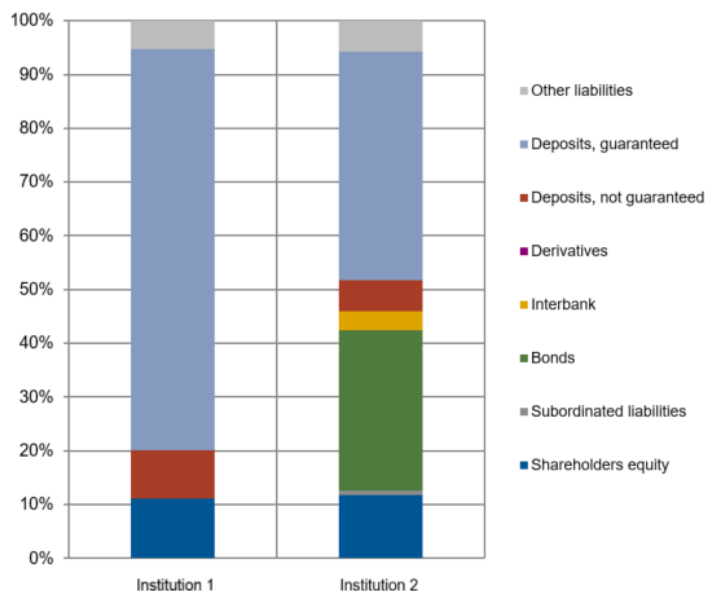


Figure 7 illustrates the two institutions in category 3 that are the extremes in regard to capital structure. Institution 1 is the one that finances its activities to the largest extent through deposits, and institution 2 is the one with the largest share of non-preferential capital market borrowing. The capital structure is shown on the basis of the order of priority that applies in bankruptcy.

An institution's capital structure could change if financial problems arise, which would lead to an increased risk of losses under the deposit insurance scheme. Such dynamic capital structure changes are explained in more detail in the next section on the deposit insurance scheme's contribution in resolution.

## Low risk of large losses for deposit insurance in resolution

The Debt Office's assessment is that there is a low risk of large losses resulting from potential deposit insurance contributions in resolution. If resolution intervention were nevertheless required, there would have to be significant losses in the institutions to merit activating the deposit insurance scheme. In most cases, there would be good potential for recovering funds paid out under the scheme.

The analysis covers the institutions that would presumably be subject to resolution if they were to fail. These include the major banks (category 1) and five other deposit-taking institutions (category 2).

### Probability of resolution intervention

The probability of resolution intervention depends on the likelihood of an institution failing.

All institutions in categories 1 or 2 have a rating that is A3 or higher according to the Moody's scale, so all institutions have an *investment grade rating*, as shown in Table 15. This implies a low probability of default and resolution intervention.

**Table 15. Rating and probability of default**

	No. of institutions	Probability of default for individual institutions <sup>1</sup> per cent
Minimal to limited credit risk (AAA/Aaa – BBB-/Baa3) <sup>2</sup>	8	0.1-2.1
Significant to high credit risk (BB+/Ba1 – C/C) <sup>3</sup>	-	-

<sup>1</sup>For a five-year time horizon.

<sup>2</sup> Investment grade rating.

<sup>3</sup> Speculative grade rating

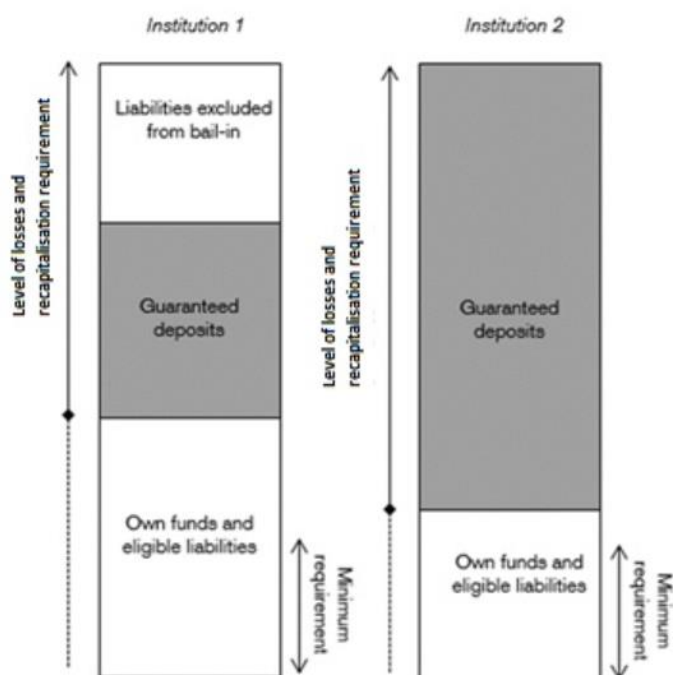
Moody's Annual Default Study 2020, Exhibit 46 – Average Cumulative Issuer-Weighted Global Default Rates by Alphanumeric Rating, 1983-2019.

## Likelihood of deposit insurance being utilised in resolution

It is the Debt Office's assessment that the institutions would have to experience significant losses in order for it to become necessary to activate the deposit insurance scheme in resolution. This is because guaranteed deposits have a high rank in the capital structure given the general priority right.

There are two primary factors that affect the risk of the deposit insurance being utilised in resolution. The first is the size of the losses in an institution and thus the need for loss absorption and recapitalisation. The other is the institution's capital structure, i.e. the amount of own funds and eligible liabilities with lower priority rights than those of guaranteed deposits.

Chart 3 describes the schematic level of the losses that would have to occur before the deposit insurance scheme would need to contribute in resolution, depending on the capital structure of the institution. The likelihood of such a contribution is particularly low for institutions with own funds and eligible liabilities that exceed the minimum requirements (MREL). If we compare the institutions in Chart 3 below, the level of losses required to activate the deposit insurance scheme in resolution is lower in institution 2 than in institution 1.

**Chart 3. Illustration of loss level required to activate deposit insurance scheme in resolution**

## Minimum Requirement for Own Funds and Eligible Liabilities (MREL)

To ensure that resolution can be carried out without requiring the use of state funds, the Debt Office imposes specific demands on the capital structure of financial institutions, called the Minimum Requirement for Own Funds and Eligible Liabilities (MREL). The requirement is to ensure that the institutions always have a certain amount of own funds and liabilities with lower priority rights than those of guaranteed deposits.

MREL shall reflect the assessed loss absorption and recapitalisation requirements for every individual institution in the event of default. MREL therefore consists of two subcomponents: a loss-absorption amount that is to essentially correspond to the firm's capital requirements, and a recapitalisation amount that is to correspond to the amount needed to restore capital to the requirement levels that will apply for the institution after resolution.<sup>31</sup>

<sup>31</sup> For certain institutions deemed subject to resolution, there is a recapitalisation requirement only for the parts of the operations assessed to contain critical functions, whereas it is judged that the remaining parts can be extracted and wound up through normal bankruptcy proceedings.

In December 2020, the Debt Office decided on the MREL requirements that would apply for the institutions. The Debt Office's method of setting MREL entails that the minimum requirement must be met exclusively with subordinated instruments (own funds and subordinated liabilities). The stipulation that the liabilities used to meet the minimum requirement must be subordinated applies as of 2024<sup>32</sup>

### **Analysis of the major banks' capital structure**

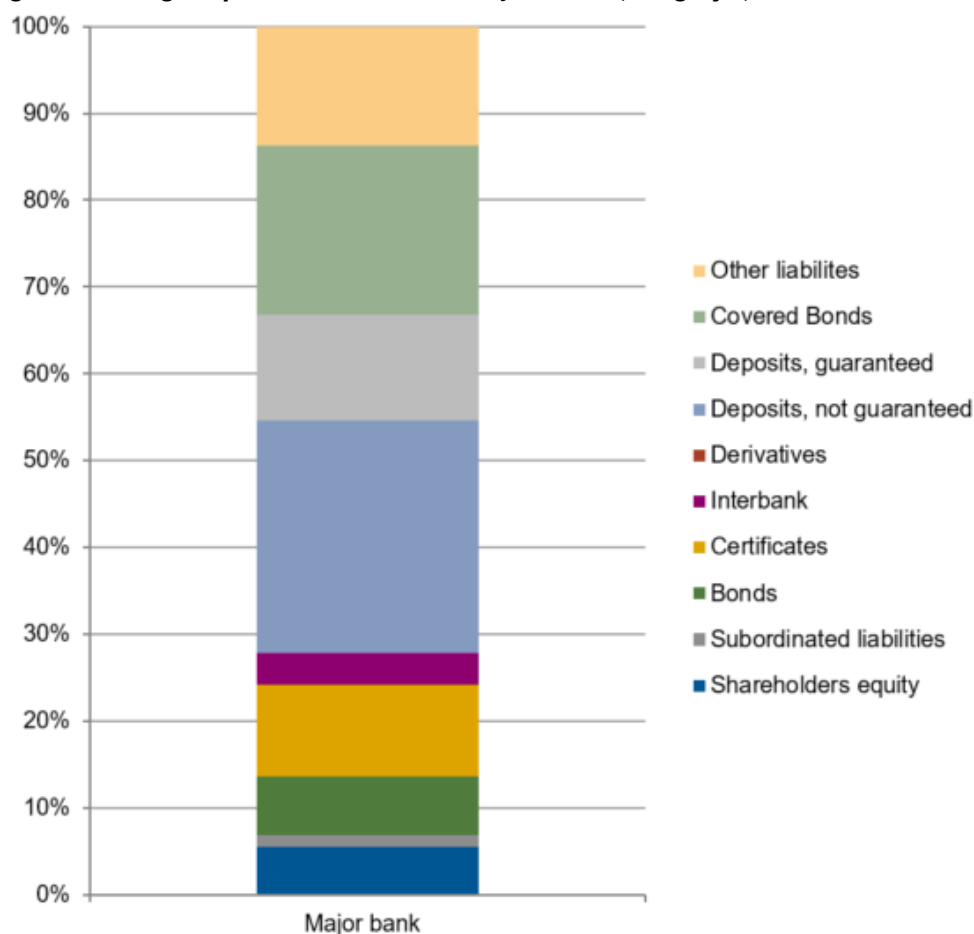
Figure 9 shows the average capital structure of the major banks at year-end 2019. For major banks, the share of liabilities with lower priority rights than those of guaranteed deposits amounts to an average of almost 55 per cent of total liabilities and own funds.<sup>33</sup>

Excluding certificates, interbank borrowing and derivatives (see the section Dynamic capital structure changes), the proportion of liabilities with lower priority rights than those of guaranteed deposits was around 40 per cent. Even taking into consideration the risk that the extent of non-preferential deposits may decrease, the proportion of liabilities with priority rights lower than those of guaranteed deposits is therefore significant and exceeds MREL by an average of approximately 33 percentage points.

<sup>32</sup> See the Debt Office report (in Swedish), Tillämpning av minimikravet på nedskrivningsbara skulder ("Application of the minimum requirement for own funds and eligible liabilities"), Ref. No. 2016/425.

<sup>33</sup> There is currently no data on the proportion of major banks' deposits that consist of non-preferential deposits from large companies and institutions.

**Figure 8. Average capital structure of the major banks (category 1) as at 31 Dec 2019**



The major banks' capital structure will be gradually adapted because of MREL. A significant proportion of their existing loan financing will need to be replaced with subordinated debt instruments.<sup>34</sup>

### Capital structure of other systemically important institutions

The average capital structure for category 2 institutions is illustrated in Figure 9.<sup>35</sup>

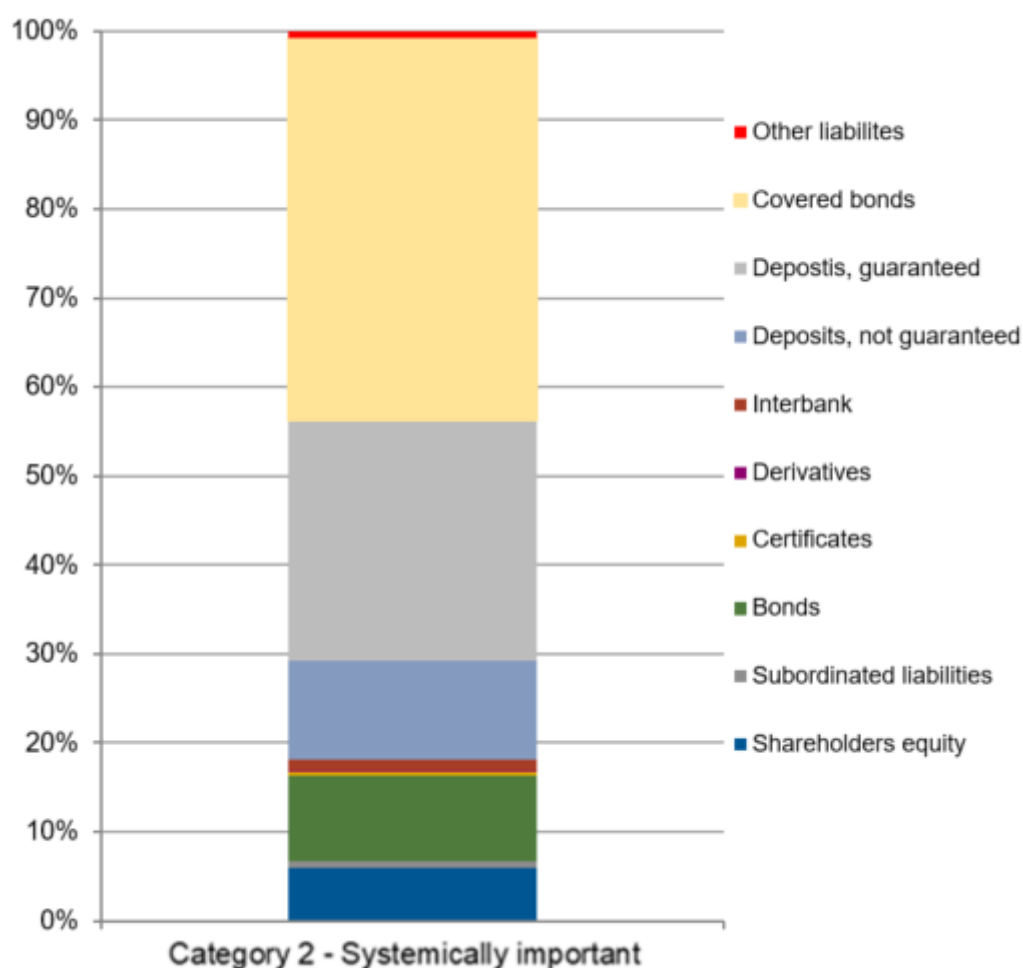
For this category, the proportion of liabilities with a lower priority right is less than 29 per cent.<sup>36</sup> Excluding certificates, interbank borrowing and derivatives, the share is 27 percent.

<sup>34</sup> In December, the Debt Office calculated that the major banks must issue subordinated bond loans totalling approximately SEK 300 billion up until 2024.

<sup>35</sup> There are other systemically important institutions included in category 2 that do not conduct deposit-taking operations and are therefore excluded here.

<sup>36</sup> None of the institutions in category 2 have deposit-taking operations in markets other than Sweden, so the proportion of guaranteed deposits is known.

**Figure 9. Average capital structure of other systemically important institutions (category 2) as at 31 Dec 2019**



One conclusion is that the capital structure of these medium-sized institutions does not differ significantly from that of the major banks in terms of own funds and liabilities with lower priority rights than those of guaranteed deposits. This applies particularly if short-term borrowing and interbank borrowing are excluded, as these account for a comparatively larger proportion of the major banks' capital structure.<sup>37</sup>

However, the categories differ regarding their proportions of deposits versus secured financing. The proportion of deposits covered by the deposit insurance also varies: the average for the major banks

<sup>37</sup> The medium-sized institutions obtain a significantly smaller proportion of their funding from short-term borrowing. The medium-sized institution with the highest proportions is Sparbanken Skåne, at 1.2 per cent each in funding from certificates compared with Handelsbanken at 16.3 per cent.

was 31 per cent guaranteed deposits, whereas the average proportion for category 2 was 71 per cent. Both of these proportions are lower than the average of 83 per cent for the institutions deemed subject to direct fulfilment. For institutions in category 2, the likelihood that the deposit insurance will be needed to be utilised in resolution is therefore deemed low.

### **Dynamic capital structure changes**

It is also necessary to clarify potential changes in the volume of liabilities that must bear losses before guaranteed deposits in resolution. Types of debt with lower priority rights than those of guaranteed deposits can, for example, decline in scope when the creditworthiness of an institution worsens.<sup>38</sup> The risk of this happening increases the shorter the maturity of the debt is and the lower its priority rights are.<sup>39</sup>

There is a risk that maturing short-term borrowing in the form of borrowing in certificates and unsecured interbank borrowing will not be renewed or replaced with secured borrowing – and thus receive a higher priority than that of guaranteed deposits. There is also a risk that the part of the wholesale deposit not covered by deposit insurance will decrease because it constitutes a non-preferential claim that is largely immediately callable.

Altogether, this increases the likelihood that the deposit insurance scheme will be required to contribute in resolution. In this context, it is worth noting that MREL is a cap on the size of the capital structure changes that can occur.

### **Discretionary exceptions**

Under certain circumstances, a need can arise in resolution to exempt liabilities from being written down (discretionary exceptions).<sup>40</sup> As a departure from the regular priority right is permitted in such cases, these exceptions may entail an increased risk of the need for contribution from deposit insurance. However, due to the Debt Office's requirement that MREL must be met entirely with subordinated liabilities, the need for such exceptions is assessed to be small.

### **Historical losses in banks**

The overall likelihood of the deposit insurance scheme being activated in resolution is deemed low, given the significant losses required and the specific requirements placed on the institutions. This level of losses can be compared with historical loss levels in bank defaults.

A review of a number of studies on the size of losses at default indicates that a loss absorption and recapitalisation capacity corresponding to the MREL requirement would have been sufficient to cover losses arising in most cases.<sup>41</sup> Supposing that, in a resolution intervention, the institutions studied would have had own funds and eligible liabilities exceeding MREL, as in the capital structure

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<sup>38</sup> Adjustments of priority rights that pose a disadvantage to a certain type of debt at the expense of other types of debt can also lead to such changes, without an institution's creditworthiness having declined.

<sup>39</sup> Experience from the US, among others, suggests that such changes occur before an institution fails. See Marino, James A. and Bennett, Rosalind L. (1999): The Consequences of National Depositor Preference. FDIC Banking Review, Volume 12, No. 2, pp. 19–38.

<sup>40</sup> Chapter 21, Section 27 of the Resolution Act (2015:1016).

<sup>41</sup> See, for example, the Financial Stability Board, 2015: Historical losses and recapitalisation needs, and BCBS, 2010a: Calibrating regulatory minimum capital adequacy requirements and capital buffers: a top-down approach.

analysis above, the studies show no loss levels that would lead to a deposit insurance contribution in resolution

## **Relatively good potential for recovery in resolution**

The contribution from the deposit insurance scheme in resolution corresponds to the amount the scheme needs to contribute to cover losses or recapitalise an institution.<sup>42</sup> To the extent that the contribution from deposit insurance is used to recapitalise an institution, the deposit insurance fund receives an asset in the form of shares in that institution. This constitutes compensation for the deposit insurance contribution to recapitalisation and entails a good potential for recovery for central government.

If, instead, the deposit insurance contribution is used to absorb losses, there is no chance for recovery. This is because, in the case of loss absorption, there is no claim that could generate a recovery, which is equivalent to what happens to a lender's claim when liabilities are written down in a bail-in.

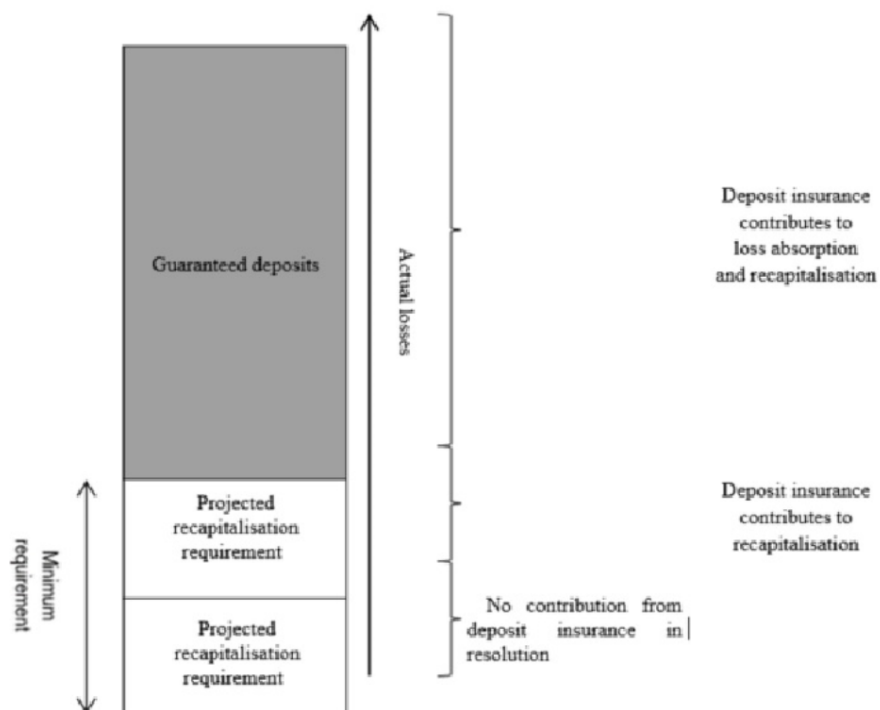
However, it is more likely that activating the deposit insurance scheme for an institution undergoing resolution would entail recapitalisation rather than loss absorption. This is because the level of losses required to activate the scheme in order to absorb losses would be higher than that required for recapitalisation (see Chart 4). This aspect works in favour of the central government's long-term potential for recovery.

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<sup>42</sup> As previously described in regard to direct fulfilments, the state shall take out retroactive fees if losses occur that are large in relation to the funds in the deposit insurance fund. This is also described in further detail in a fact box in the next section on liquidity risks.



**Chart 4. Illustration of loss levels required for a deposit insurance contribution to recapitalisation and loss absorption in resolution**



## Liquidity risks linked to central government guarantees and lending

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In spite of the outbreak of the pandemic in 2020, outgoing payments in connection with guarantees and loan commitments have not decreased significantly compared with the previous year. Guarantees and loan commitments entail a liquidity risk because it is not known beforehand whether or when payments connected to the undertakings will need to occur. These liquidity risks are assessed to be low, and the amounts can be borrowed on short notice. Although the borrowing cost would certainly be higher in some cases, it would only be in the short term and connected to individual payments.

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### Basic premises for the liquidity risk analysis

Central government borrowing is primarily based on how state finances develop. The virus outbreak in the beginning of 2020 had an impact on state finances, which led to the government implementing several fiscal support measures to mitigate the adverse effects on the economy. Altogether, the measures contributed to a rapidly growing debt and increased borrowing requirement. The borrowing strategy became to increase short-term borrowing first and subsequently adjust the supply of bonds gradually.

The same strategy is used if a central government guarantee is fulfilled, or when a loan commitment is utilised. In both cases, money is paid out and the central government borrowing requirement increases. The borrowing requirement is managed in the short term as part of the liquidity management operations and in the long term through planned issuance of government securities. These guarantees and loan commitments entail a liquidity risk because it is not known beforehand whether or when payments connected to the undertakings will need to occur. Despite the pandemic, the liquidity risks remained low and the outgoing payments linked to guarantees and loan commitments did not deviate significantly since the year before.

Central government borrowing is planned on the basis of the total borrowing requirement. An important strategy for minimising long-term borrowing costs is to keep the supply of regularly issued government securities stable and predictable. Short-term fluctuations in the borrowing requirement are handled within liquidity management. This applies to both anticipated fluctuations and unforeseen payments such as when a guarantee commitment is fulfilled or a loan commitment utilised. If the payment entails a permanent increase in the borrowing requirement, it is then gradually phased into the long-term borrowing.

The liquidity risk analysis begins by comparing the size of the payments that central government guarantees and loans can give rise to and the flexibility in the liquidity management operations. The purpose of the comparison is to address the issue of whether potential payments can be managed within these operations. The analysis then describes the risk of the payments leading to higher liquidity management costs. This risk is determined in part by the size of the payments as well as how quickly and in which currency they are made.

## Potential payments are not too large to manage

The larger the guarantees and loan commitments, the larger the payments can be. Table 16 shows the largest undertakings in the regular portfolio together with the deposit insurance scheme's largest commitments within each category of institution.<sup>43</sup> The amounts may seem large, but daily deficits (borrowing requirements) of sometimes more than SEK 100 billion are funded within the central government's liquidity management operations.

Granted, if several sizeable guarantees or loan commitments had to be fulfilled in the same short period of time, even larger deficits could arise. However, these flows are also deemed manageable within the framework of the continual liquidity management. At the same, the likelihood of such an outcome is very low and the need for quick payments is, in practice, lower than the amounts shown in the table below. This is because the entire amount is rarely to be paid out at the same time.

**Table 16. Undertakings over SEK 10 billion as at 31 Dec 2020**

	SEK billion
Lending framework For SEK (the Swedish Export Credit Corporation) <sup>1</sup>	200
Callable capital EIB	78.5
Credit guarantee <sup>2</sup>	51,7
Deposit insurance – categories 1 & 2 <sup>3</sup>	27.7
Deposit insurance – category 3 <sup>4</sup>	26,8
Callable capital NIB	26.1
Callable capital AfDB	25,6
Credit guarantee	22.4
Credit guarantee	22.1
Callable capital IBRD	19.5
Credit guarantee for ÖSK <sup>5</sup>	13,6
Credit guarantee	10
Deposit insurance – category 4 <sup>6</sup>	10

<sup>1</sup> SEK, max. SEK 50 billion can be paid out at once

<sup>2</sup> The maximum fulfilment amount over 5 years is SEK 5.7 billion

<sup>3</sup> The deposit insurance scheme's contribution in resolution may never exceed 200 per cent of the target level of the deposit guarantee (see the box Payments from deposit insurance fund). If additional funds are required in resolution, they are primarily contributed by the resolution reserve.

<sup>4</sup> A direct fulfilment of the deposit insurance commitment for an institution in category 3 can amount to a maximum or approximately SEK 26.8 billion.

<sup>5</sup> The Swedish state and the Danish state jointly stand surety for all Öresundsbro Konsortiet (Öresund Bridge Consortium) loans. Therefore, the extent to which the Swedish state's undertaking is to be utilised in its entirety, or up to 50 per cent of outstanding amounts, is not given. In the table, a strict formal assessment has been made with the entire amount reported.

<sup>6</sup> A direct fulfilment of the deposit insurance commitment for an institution in category 4 can amount to a maximum or almost SEK 10 billion.

<sup>43</sup> The financial institutions that have guaranteed deposits are divided into four categories in the section Credit risks in the deposit insurance scheme, Different categories of institutions.

**Usually a time period between fulfilment and payment**

A review of the contractual terms that apply to the undertakings presented in the table shows that the potential liquidity strain is often significantly lower than what the amounts imply. Either circumstances dictate that the central government need not fulfil the entire commitment at one time, or there is in practice a time frame enabling systematic planning of the payments. In certain cases, it may still be necessary to rapidly fulfil the commitment in its entirety. This mainly applies to subscribed callable capital and deposit insurance.

There is no contractual payment period for the callable capital. In a few cases, however, it has been communicated that, if necessary, the state must pay out a capital contribution within one week but that the time allowed will be adapted according to the size of the payment. A larger amount provides an opportunity for a longer period and vice versa.

For the deposit insurance scheme, the law states that compensation to affected depositors must be available within seven working days. Deposit insurance shall also be able to contribute funds in resolution. There are no stated time frames for payments from the scheme made to an institution in conjunction with resolution, but the Debt Office's assessment is that such a payment may be required on short notice. The time depends on how long it takes to carry out the resolution transaction. Payments connected to the deposit insurance scheme shall primarily be made from the deposit insurance fund. If the fund amounts are insufficient, the central government can borrow what is required (see the box in the last chapter).

**Considerable flexibility in the liquidity management operations**

The liquidity management operations are designed to ensure that central government payments are always carried out on time. All payments to and from central government agencies are collected in a central account, meaning that only the net of these payments is handled by the liquidity management operations. On days when outgoing payments exceed incoming payments, the Debt Office borrows to finance the deficit in the account. Conversely, when incoming payments exceed outgoing payments, the surplus is invested. The result is that the balance of the central account is zero at the close of the day.

In order to ensure effective liquidity management, the Debt Office plans according to daily borrowing and investment needs. At the same time, the management must be flexible in order to appropriately handle unexpected payment flows. For example, the Debt Office is able to choose instruments, maturities and counterparties (within the framework of applicable regulations and guiding principles).

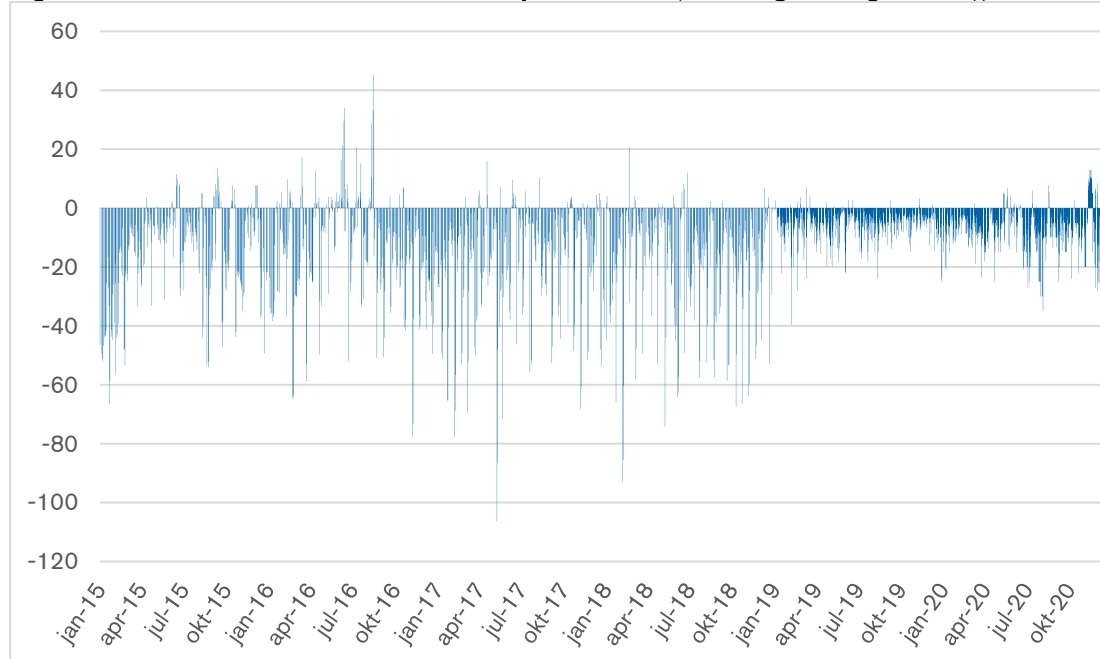
**Access to several different instruments**

The Debt Office can employ several instruments in its liquidity management operations. If large unexpected payments arise with a few days' notice, borrowing can begin in advance in the money market. This is mainly done through deposits, that is, standardised agreements on depositing and lending between market participants. If the unforeseen payment must be made on the same day, the deficit is funded with an overnight loan – the most short-term type of deposit.

In the overnight market (deposit market), the liquidity requirement in kronor is balanced to zero each day between the market participants and the Swedish payment system. If the central government has a deficit to finance overnight, there is always one or several market participants with a

corresponding surplus to invest. This is because the money paid out by the Debt Office has gone elsewhere in the payment system. The system is thus set up so that it is always possible to fund deficits (and invest surpluses) in kronor overnight. Figure 10 illustrates the variation in the daily flows that the Debt Office handles with deposits.

**Figure 10. Debt Office transactions in the deposit market (including overnight loans), SEK million**



A minus sign refers to loans, a plus sign to investments.

If the increased borrowing requirement from the payment is expected to persist for some time, the Debt Office can instead issue commercial paper in foreign currency. This borrowing instrument works much like a bond but with a shorter maturity. Commercial paper provides access to the international money market, which is considerably larger than the Swedish market. Combining this borrowing with currency derivatives makes the procedure comparable to borrowing in Swedish kronor.

### Potential additional cost is short term and isolated

When a large payment is funded short term with commercial paper instead of by utilising deposits, the borrowing cost can be slightly higher (or lower) depending on the price of the included currency derivative. An additional cost would, however, be isolated to the specific payment and disappear within a short time as the initial short-term borrowing is phased into the continual issuance.

In the event of payment connected to a guarantee or loan in foreign currency, the Debt Office borrows in the same way as for a payment in kronor and makes an exchange simultaneously. If there is a need to exchange large amounts on small foreign exchange markets, where liquidity is limited, there is a risk that the transaction will be more costly than usual. Currently, however, there is no exposure to smaller currencies among the portfolio's major undertakings.

## Payments from the deposit insurance fund

Disbursements under the deposit insurance scheme are financed by the deposit insurance fund. As opposed to the regular portfolio's guarantee reserves, which are accounts at the Debt Office, this fund consists of securities in the form of Swedish government bonds. This means that the fund must sell government bonds when the compensation is to be paid out. If there are not sufficient assets in the fund, the Debt Office has unlimited credit in order to raise new debt to cover the amounts required (see Deposit Insurance Act (1995:1571) for more detailed information).

### Deposit insurance is financed by fees

The deposit insurance fund is built up by a statutory and risk-differentiated fee that the institutions covered by the deposit insurance scheme pay. The fees shall amount annually to a sum corresponding to 0.1 per cent of the institutions' aggregate guaranteed deposits at the end of each year. The fund, which is administered by Kammarkollegiet (the Swedish Legal, Financial and Administrative Services Agency) by commission of the Debt Office, amounted as at year-end 2020 to SEK 46.4 billion. This corresponds to approximately 2.68 per cent of the guaranteed deposits.

By law, the fund must amount to at least 0.8 per cent of the guaranteed deposits. If the fund falls below two-thirds of this level, the amount must be restored within six years. Therefore, when necessary, the fees can become higher than the 0.1 per cent normally charged.

### Limited contribution from deposit insurance in resolution

According to resolution regulations, the deposit insurance fund may also be utilised to protect depositors in resolution. The contribution for a single institution, however, may never exceed 200 per cent of the minimum level of the fund. The fund can thus contribute a maximum of 1.6 per cent of guaranteed deposits, which corresponds to SEK 27.7 billion based on guaranteed deposits as at year-end 2019.

However, the fact that the deposit insurance contribution in resolution is limited in its amount does not mean that the protection for depositors is limited. Any additional funds (over and above SEK 27.7 billion per institution) required for resolution must initially come from the resolution reserve.<sup>44</sup>

### Sales of government bonds may entail additional costs

From a liquidity risk perspective, it is worth noting that assets in the deposit insurance fund must be realised at the time of disbursement. A large volume of government bonds may then need to be sold in a short time, which may adversely affect the sales price. Although this has no direct effect on central government borrowing costs, it entails additional costs for the deposit insurance scheme.

<sup>44</sup> The resolution reserve is a special financing arrangement, separate from the deposit insurance fund, established to finance resolution measures taken by the Debt Office that are permitted under the Resolution Act (2015:1016). A payment from the reserve, which is an account at the Debt Office, affects the central government's borrowing requirement and the central government debt.

## Appendix 1: Central government guarantee and lending operations

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The management of central government guarantees and lending is based on distinct principles and regulations designed to clarify the associated financial risks and costs (the guarantee and lending model). This ensures that central government avoids undesirable risks. These principles and regulations are described below because they have an inherently favourable effect on the risk level of the central government guarantee and lending portfolio. There are also commitments regulated separately from the collective model – for example, student loans and the deposit insurance scheme.

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### The central government guarantee and lending model

In the mid-1990s, a model for managing central government guarantees was adopted by the Riksdag for the first time, in the Central Government Budget Act (1996:1059). In the period up to and including 2001, risk assessments of previously issued guarantees were conducted in accordance with the new model. As of 2002, the principles of the guarantee model have therefore also been applied to guarantees issued before the model was introduced.

The revised Budget Act (2011:203) further clarified the principles for issuing central government guarantees. At the same time, it was decided that corresponding principles should also be applied to central government lending with credit risk. More detailed provisions can be found in Regulation (2011:211) on lending and guarantees. The result is uniform and distinct rules for both guarantees and lending with credit risk.

Overall, the central government guarantee and lending model is based on a number of regulations intended to foster both responsible and cost-effective management of financial risks. Most of the regulations help ensure that decision makers are aware of the risks and that the central government makes provisions for those risks. Others are intended to ensure that the central government avoids undesirable risks and minimises risk-taking in general.

The primary rule is to ensure the following: that guarantees and loans are to be limited in amounts and maturity, that the expected cost is booked and financed in conjunction with the issuance decision, that the financial position of the guarantee and loan recipients is analysed, and that the contracts include adequate conditions for limiting risk. In addition, the authorities that issue guarantees and loans will regularly analyse, limit and report the credit risk of commitments issued. This approach serves to reduce the likelihood that the portfolio will become too large or contain risks that are inappropriately high or difficult to assess. Altogether, the principles and regulations on which this lending model is based are significant in forming the assessment that there is a low overall risk of large losses in the regular portfolio.

### Long-term cost recovery principle

One of the fundamental principles for central government is to charge a fee that corresponds to the expected cost of the guarantee or loan. The expected cost consists both of the expected credit loss (usually shortened to expected loss) and the administrative costs associated with the commitment.

The expected loss arises from the probability that the recipient of a guarantee or loan will not be able to fulfil its commitment, which usually results in a credit loss for the central government. For loans, the central government's interest expense for financing the loan is added to this.

**Expected loss** = Exposure at Default x Probability of Default x (1 – Expected Recovery given Default)

The central government charges a fee to cover this expected cost. The expected cost for the state is thus matched by a predetermined income. Accordingly, the state's financial position is, in theory, unaffected at the time of decision to issue a central government guarantee or loan.

If the guarantee or loan recipient is allowed to pay a fee lower than the expected cost, a state subsidy arises. To create transparency around this subsidy, the Budget Act requires that it be financed, unless the Riksdag makes a decision to the contrary. This often entails that a sum corresponding to the subsidy is charged to an appropriation. This, in turn, means that the expenditure for the subsidy must be weighed against other expenditure in the central government budget and therefore competes for inclusion under the expenditure ceiling. Consequently, any subsidy of a government guarantee or loan is treated in the same way as any other central government expenditure.

A model in which fees – including any subsidy financed via appropriations – are allocated equal to the state's expected costs involves an actuarial cost-reimbursement principle. In the long term, the accumulated fees are expected to correspond to the costs of credit losses and administration. In practice, however, the outcome in the operations will vary over time and deviate from the expected outcome – in both a positive and a negative direction. Accordingly, in many ways the model has parallels to conventional insurance operations, in which fees from a large number of claim-free commitments are expected to cover the costs related to a small number of claims (credit losses).

### Central government is risk-neutral at the margin

In accordance with the fundamental principle in the Budget Act, central government does not charge a risk premium – unlike the situation in insurance operations. In theoretical terms, this can be seen as central government being risk-neutral at the margin and therefore not requiring a return to cover the risk that follows from guarantees and lending, i.e. deviations from the long-term expected outcome. One significant reason for this is that the state has an extensive and strong balance sheet underpinned by its right of taxation. As a result, the central government does not maintain an earmarked risk buffer and does not tie up any capital that requires a return. It should be stressed that the central government is only risk-neutral at the margin, that is, for risks that are not excessive in relation to the entire central government balance sheet.

### Outcomes are recorded in notional reserve accounts

The design of the guarantee and lending model entails that fees and costs are handled outside the income headings and appropriations in the central government budget. Fee income – including



appropriated funds to cover any subsidies – is not entered in the income heading but are instead reported against notional reserve accounts. Accordingly, even credit losses and any recoveries are recorded in these reserve accounts as well.

Unlimited borrowing is authorised for each reserve account. This addresses the budget-technical issue of how to finance and report credit losses that exceed the accumulated funds in the reserves, allowing for a negative balance from time to time.

It is important to note that the reserves at the Debt Office are only notional accounts. There are exceptions, however, in the form of actual funds, for example the deposit insurance fund.

One reason for mainly having notional reserve accounts instead of special asset and liquidity portfolios is that such portfolios could add risks rather than reduce them. Therefore, it is normally not a question of either earmarking or accumulating money in an actual fund. Instead, fee income recorded in the notional reserve accounts is included in the central government's continual cash flow. A paid-in fee thus improves the budget balance and reduces central government debt.

The total assets in the guarantee and lending operations do not consist solely of the balance in the notional reserve accounts that the responsible agencies have at the Debt Office. Other significant assets are the recourse claim that arises when a guarantee commitment is fulfilled as well as the remaining value of outstanding claims following realised defaults on loans issued. The present value of agreed but not paid fees is also an asset. The total value of all these assets should be compared with the expected losses when assessing the actuarial deficit or surplus in the central government guarantee and lending operations.

## Guarantees and lending regulated separately

Some guarantees and loans are regulated separately, in separate acts or through individual decisions by the Riksdag or the Government.

### **The student aid system**

The Student Aid Act (1999:1395) regulates the management of student loans. The Act contains stipulations regarding who can receive student loans and grants, interest, repayment, and recovery. These differ in several respects from how lending is handled under the guarantee and lending model. However, new student loans granted after 2013 are managed in accordance with the guarantee and lending model in the sense that appropriated funds corresponding to expected losses are transferred to a notional reserve account. For the remainder of the loans, realised credit losses are financed as they arise by appropriations.

### **Deposit insurance scheme and investor compensation scheme**

The deposit insurance scheme is intended to provide consumer protection for deposits by private individuals and to promote the stability of the financial system. Deposit insurance is regulated under the Deposit Insurance Act (1995:1571).

The investor compensation scheme provides loss protection for investors' financial instruments and funds held with a securities company, fund manager, or an asset management company. Any costs for central government following activation of the scheme are paid retroactively by the remaining institutions covered.

**Lending funded by appropriations**

According to Chapter 7, Section 3 of the Budget Act, lending with high expected loss must be financed by appropriations. Since such lending is already fully funded by appropriations, there is no reserve account to manage losses on these loans. Amortisation and interest payments are reported under an income heading.

**Callable capital to international financial institutions**

The central government has issued guarantees to provide, when required, additional capital – known as callable capital – for a number of international financial institutions of which Sweden is a member.

Callable capital has been exempted by the Riksdag from the central government guarantee and lending model. However, to clarify that these guarantees and the risks associated with them exist, a specialised notional account with credit has been set up at the Debt Office. Any charge to this account has to be cleared with appropriated funds from the central government budget.

**Public enterprise commitments**

Following decisions by the Riksdag and the Government, public enterprises can also issue guarantees and provide loans linked to their activities. At present, Luftfartsverket (the Swedish Civil Aviation Administration) has commitments of this kind.

## How guarantees and loans affect central government finances

The following two simplified examples illustrate the effects of guarantees and loans on central government finances.

**The state issues a guarantee for SEK 100**

When the guarantee is issued, the state charges a fee corresponding to its estimate of the expected loss on the guarantee. Suppose the fee is set at SEK 5. The balance in the state's guarantee reserve increases by SEK 5 while its reserve requirement increases by the same amount. Central government net wealth is thus unaffected. The state's cash flow increases by SEK 5, decreasing central government debt by the same amount. Central government net lending is also strengthened by the corresponding amount.

*A change in the expected loss*

If the expected loss of the guarantee increases/decreases, the state must increase/decrease provisioning for the guarantee by the corresponding amount. As a result, central government net wealth decreases/increases. A change in the expected loss, however, has no effect on central government net lending or central government debt.

*The state fulfils the guarantee commitment*

The state makes a payment corresponding to all or part of the guarantee. This is funded, like all other cash flows, within the framework of the Debt Office's debt management. Suppose the commitment to the whole amount under the guarantee, SEK 100, is fulfilled. Central government debt increases by SEK 100 and the balance in the guarantee reserve

decreases by the same amount. Central government net lending is also reduced by the corresponding amount.

When a guarantee commitment is fulfilled, the state also receives a recourse claim (an asset). Suppose the claim is initially expected to be worth 50 per cent of the fulfilment amount. In this situation, central government net wealth has decreased by SEK 45.

*The state recovers 60 per cent of the fulfilment amount*

The balance in the guarantee reserve increases by SEK 60. At the same time, the state receives a deposit that improves cash flow, as well as strengthening central government net lending, by SEK 60 and reduces central government debt by the same amount.

In terms of all events, the total change in central government net wealth ended up at SEK 35. The net charge to the guarantee reserve is also SEK 35, as is the increase in central government debt and the decrease in central government net lending.

**The state issues a loan for SEK 100 with credit risk**

To finance the loan, the state must borrow, increasing central government debt by SEK 100. At the same time, the state receives an asset in the form of a loan receivable. Central government net lending is unchanged, as lending corresponds to a financial asset in the form of this claim. However, because of the credit risk in the loan, this asset is worth less than SEK 100. The expected loss is estimated at SEK 5. Thus, the carrying amount of the state's loan receivable is written down by SEK 5 to SEK 95. The expected loss, however, has no effect on central government net lending.

The state charges an interest margin on the loan corresponding to the expected loss. The balance in its credit reserve increases by SEK 5. At the same time, central government debt decreases accordingly and central government net lending improves by the corresponding amount. The value of the state's loan receivable of SEK 95 is equivalent to an increase in the debt by SEK 95. Central government net wealth is thus unaffected.

*A change in the expected loss*

The value of the state's loan receivable decreases/increases. As a result, central government net wealth decreases/increases. A change in the expected loss, however, has no effect on central government net lending or central government debt.

*A default occurs*

The state's cash flow is reduced by the amount of contracted payments not received from lenders. For the sake of simplicity, it is presumed that none of the loan amount is repaid. After confirmed default, the expected recovery is 50 per cent of the loan receivable. The value of the loan receivable is therefore written down to SEK 50. Central government net wealth has decreased by SEK 45.

*The state recovers 60 per cent of the amount lent*

The central government's cash flow is improved by SEK 60, reducing central government debt by the same amount. In total, central government net wealth is reduced by SEK 35, central government debt increases and central government net lending decreases. The point in time when this effect on net lending arises may vary depending on when the credit loss is finally reported and established.

## Similarities and differences between credit guarantees and lending

Credit guarantees and lending is regulated in a similar way because the credit risk, and thus the expected cost, is the same for the two types of commitments. Both guarantees and lending require approval by the Riksdag and are treated similarly in the central government budget process. However, the state must consider the differences when it decides whether to issue a guarantee or loan for funding purposes.

### **Lending is more transparent than guarantees**

When the state grants a loan, it is financed by the central government. In the case of a credit guarantee, the financing of the underlying loan is done by a private party.

Consequently, unlike guarantee issuance, lending affects both the central government borrowing requirement and debt at the time the loan is granted. In the case of a guarantee, the borrowing requirement increases only if a guarantee commitment is fulfilled. Guarantees can thus be seen as contingent government debt.

This difference is also reflected in the financial reporting. Increased borrowing affects gross debt, and the loan receivable is recorded as an asset in the balance sheet.

### **Losses can have different effects on central government net lending**

Normally, a fulfilled guarantee commitment entails a corresponding immediate effect on central government net lending. The effect of a corresponding default on a loan will normally have no immediate effect on central government net lending. In the case of loans, the effect on central government net lending normally arises when the loss is realised in conjunction with write-off.

### **Lending is normally less expensive than guarantees**

The state's cost for expected loss and administration is normally about as high when funding is provided through direct loans from the central government as it is when provided through a state guaranteed loan from a private actor. The total cost of funding through direct lending includes the central government borrowing cost. The cost of funding through a central government guarantee, on the other hand, includes the private lender's cost for borrowing and administration.

As, under normal circumstances, the private actor's borrowing costs are higher than those of the central government, the cost for the borrower via direct lending by the state is lower than that of a guarantee. This applies despite the risk to the state being the same in both cases.

### **Loans involve more restrictive management**

A difference in the regulation of guarantees in relation to loans is that only loans with low expected losses can be funded with borrowing at the Debt Office. In practice, this means that loans with high expected losses are funded through appropriations. There is no corresponding regulation for guarantees. Consequently, the Budget Act stipulates a more prudential treatment of lending with high credit risk.

### **Lending sometimes involves less complicated management**

A credit guarantee often involves a tri-party relationship between the central government, the lender and the borrower. Loan issuance entails only a relationship between two parties. This tri-party arrangement may give rise to more complex management in order to avoid risks that arise from, for example, moral hazard.

**Advantages of guarantees may outweigh the disadvantages**

Although in most cases lending is preferred over issuing guarantees, there are several examples of situations in which the advantages of a guarantee outweigh the disadvantages. One argument in favour of guarantees is that they can facilitate risk distribution, which is usually preferred, by the central government guarantee covering less than the whole amount of the underlying loan. In addition, guarantees can be more effective than loans. In situations in which there are a large number of potential beneficiaries, the banks' existing networks, systems and administrative routines might, for example, lead to greater efficiency than if the central government were to engage in direct lending. Guarantees can also entail a lower degree of intervention in the retail market compared with loans, as central government lending in some cases risks crowding out private lenders.

## Appendix 2: Commitments excluded from the risk analysis

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The Debt Office has chosen to exclude the following from the risk analysis: lending financed by appropriations, guarantees and loans issued by public enterprises, capital adequacy guarantees and the investor compensation scheme. This is primarily for practical reasons but also because they involve either small amounts or limited risks. These exclusions only marginally limit transparency and do not affect the Debt Office's conclusions in the risk analysis.

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### Lending funded by appropriations

Unlike lending funded by central government borrowing, lending funded by appropriations is included under the expenditure ceiling. Such funding thus falls outside the guarantee and lending model (not pursuant to Chapter 6, Section 3 of the Budget Act). Lending funded by appropriations can be viewed as a transfer with repayment conditions. Potential credit losses can therefore be assumed to have been subject to the customary political discussion of expenditure prioritisation in the central government budget, which is why this lending is excluded from the risk analysis.

Lending funded by appropriations amounted to SEK 2.8 billion as at 31 December 2020. Most of the amount consists of older student loans and home improvement loans.

### Public enterprises

The few loans and guarantees issued by public enterprises are excluded from the risk analysis. Any losses related to such guarantees are borne, primarily, by the assets in the respective agencies' operations. Should these assets prove insufficient, losses will be borne by appropriations, as the public enterprises and the central government are one and the same legal entity.

As at 31 December 2020, Svenska Kraftnät's (Swedish National Grid) loans issued totalled SEK 127 million.

### Capital adequacy guarantees

Trafikverket has issued one capital adequacy guarantee to Arlandabanan Infrastructure AB (Arlandabanan) and one to Svensk-Danska Broförbindelsen AB (Svedab). The scope of the capital adequacy guarantees is not explicitly limited, making it difficult to assess the credit risk.

Trafikverket's capital adequacy guarantee to Arlandabanan is also designed in such a way that the risk of fulfilment is not linked to credit risk. The capital adequacy guarantees are therefore excluded from the analysis.

Capital adequacy guarantees from Trafikverket to Arlandabanan and to Svedab amounted to SEK 1,780 million and SEK 4,169 million, respectively, at year-end 2020.

## Investor protection

The investor compensation scheme protects securities holders whose securities are held on deposit by a securities firm. The guarantee is activated if such a firm goes bankrupt and has not held customers' assets separate from its own assets, for example as a result of negligence or criminal activity. The probability of the investor compensation scheme being utilised is therefore significantly lower than that of an institution going bankrupt.

The size of the central government's undertaking under the investor compensation scheme is not known. As fees are only charged retroactively to recover compensation paid out under the scheme, the scope of the assets protected has only been established on one occasion, in connection with one case of compensation. At that time, the securities firms' aggregate assets protected by the scheme were estimated at around SEK 93 billion. However, this figure referred to 31 December 2004, the year of the bankruptcy that led to the compensation case.

There are many indications that the central government's cost for the investor compensation scheme is small. Since the scheme was introduced, there has only been one small case in which it was utilised. In addition, as the central government retroactively charges fees to the remaining institutions – recovering the full cost of any compensation paid out – it essentially does not bear any credit risk for the investor compensation scheme. This presumes that the amount paid out will be restored within a short amount of time by the fees paid in from the other institutions, which the Debt Office deems likely. Therefore, the investor compensation scheme is excluded from the risk analysis.

For the deposit insurance scheme, the central government is also entitled to charge fees retroactively to cover losses if retained fees prove insufficient. The potential amounts are, however, larger for the deposit insurance scheme, and the retroactive fees would likely come in at a slower pace than they would for the investor compensation scheme.<sup>45</sup>

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<sup>45</sup> This applies as long as the losses exceed the extra fee of 0.5 per cent of the institutions' total deposits that the guarantee authority is entitled to take out. Section 13 a of the Deposit Insurance Act (1995:1571).

## Appendix 3: In-depth presentation of the central government guarantee and lending portfolio

The in-depth disclosure in this appendix is intended to further increase transparency in regard to central government guarantees and loans with credit risk. The appendix is a supplement to both the risk analysis in the report and to the central government's annual report. The amounts presented in the appendix pertain to the commitments included in the risk analysis.

### Size of the guarantee and lending portfolio

Table 17 presents the size of the central government portfolio of guarantees and lending at year-end 2020, in both absolute and relative terms with certain major central government financial events. This shows the development since 1999.

**Table 17. Size of the guarantee and lending portfolio as at 31 Dec 2020**

	SEK billion <sup>1</sup>
Guarantees and loans to companies and private individuals	698 (609)
Deposit insurance <sup>2</sup>	1,734 (1,631)
<b>Total</b>	<b>2,432 (2,240)</b>
Share of GDP	49% (45%)
Percentage of central government debt	200% (213%)
Share of central government total assets	119% (115%)

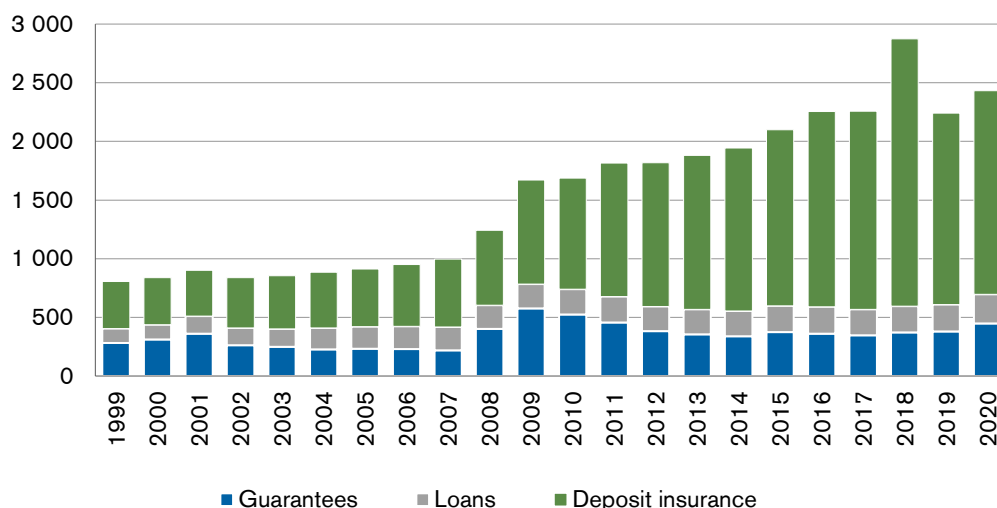
<sup>1</sup> Previous year's amount in parentheses

<sup>2</sup> The amount referring to the deposit insurance is from year-end 2019, as the 2020 figure was not available when the report was written.

Data From EKN, Sida, CSN, the Debt Office, the Government Offices, the ESV (Swedish National Financial Management Authority) and own computations.



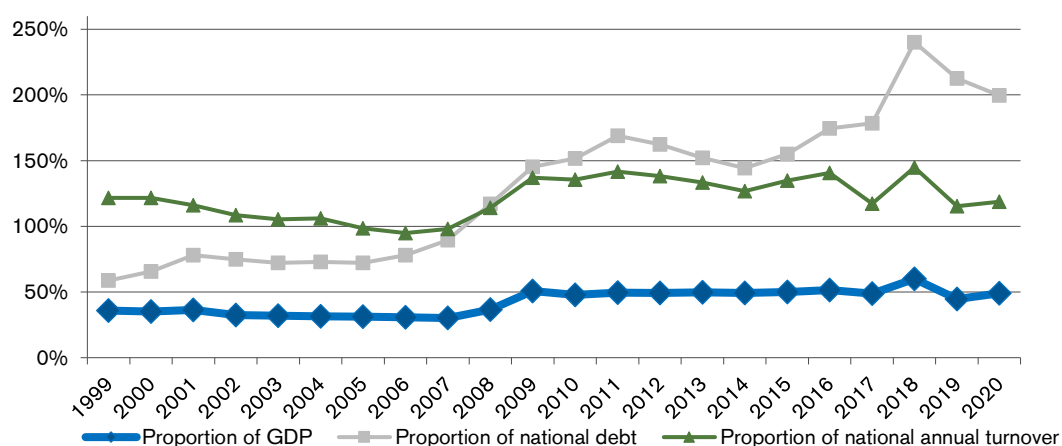
**Figure 11. Historical data on the size of the portfolio 1999–2020, SEK billion**



The central government's annual report, information for that annual report compiled by the Debt Office, and own computations. Note that the 2019 deposit insurance figure is used as an approximation of the 2020 figure, as the 2020 information was not available when the report was written.

In Figure 12, similar historical data are presented in relation to Sweden's GDP, the central government debt and the central government's balance sheet total.

**Figure 12. Historical data on the relative size of the guarantee and lending portfolio 1999–2020**

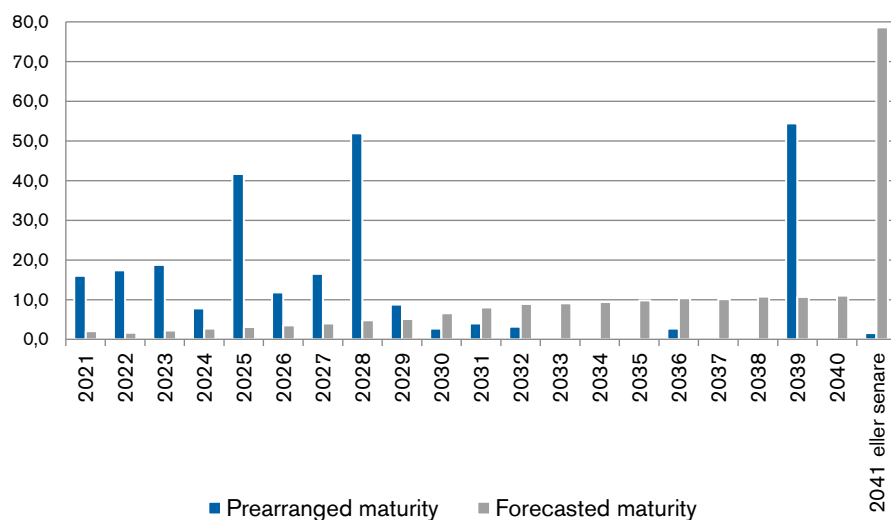


The central government's annual report, information from ESV and SCB, and own computations.

## Maturities

A large part of the central government's portfolio (80 per cent) contains guarantees with no time limit, for example the deposit insurance scheme and the callable capital provided to international financial institutions. In the remaining cases, the maturity is predetermined in an agreement or as the result of the development of underlying factors (for example, earnings development for loans with conditional repayment). For the latter, there is instead a forecast for the maturity. The maturity structure for the guarantees and loans with an agreed or forecast maturity is shown in Figure 13.

**Figure 13. The guarantee and lending portfolio's maturity structure as at 31 Dec 2020, SEK billion.**



Excluding guarantees that are without a time limit (SEK 1,923 billion). Data From EKN, Sida, CSN, Boverket and the Debt Office.

## Currencies

The loans issued by the central government and the undertakings guaranteed are in different currencies. Table 18 shows the corresponding value in kronor for the ten largest currency exposures in the central government's guarantee and lending portfolio.

**Table 18. The ten largest currency exposures in the guarantee and lending portfolio as at 31 Dec 2020, SEK billion**

	Amount	Share
SEK	2129.1	87.55
EUR	140.4	5.77
USD	124.1	5.10
JPY	4.6	0.19
DKK	2.4	0.10
CHF	1.0	0.04
GBP	0.6	0.02
Special drawing rights <sup>1</sup>	29.7	1.22

<sup>1</sup> Special drawing rights correspond to a group of currencies used in international trade and finance (EUR, GBP, JPY and USD).

Data from EKN, Sida, CSN, Boverket, the Debt Office and the Government Offices

### Approaches to financing the credit risk of commitments

The commitments in the portfolio are managed differently in terms of cost recovery. Table 19 illustrates these differences.

Many of the commitments are managed on the basis of the central government guarantee and lending model. A key part of this model is that the expected loss of the guarantee or loan is financed at the time of issuance, generally with fees charged to guarantee holders and borrowers and in exceptional cases by appropriations. The fees are booked against a notional reserve account, for which there is an unlimited mandate to raise new debt in order to deal with losses that temporarily exceed the size of the reserve. The management of student loans is regulated separately.

For loans issued as of 2014, the expected loss is funded by appropriations when the loan is granted, which is in line with the guarantee and lending model. For student loans issued prior to that date, actual losses are funded when they occur by appropriations. The management of the deposit insurance scheme is also regulated separately.

All institutions covered by the scheme pay an annual statutory fee to the central government, which is risk-differentiated for individual institutions. The level of the aggregate annual fees charged, however, is regulated by law. The fees are placed in a fund with its own assets. Deposit insurance payouts are financed primarily with money from this fund. If the fund's assets are insufficient, there is unlimited authorisation to borrow.

In addition, there are outstanding guarantees and loans with credit risk that are managed separately on the basis of individual decisions. Among these are the central government's callable capital commitments to international financial institutions of which Sweden is a member. Payments under these guarantees are funded as they arise by appropriations.

There are also a small number of loans financed by borrowing that were issued before the central government lending model was introduced. In some cases, fees covering at least the expected loss were set at the time the loans were granted. In other cases, no fee has been charged at all.

However, the common denominator of these loans is that the method of financing realised credit losses has not been established in advance.

**Table 19. The portfolio divided by approach to financing credit risk of commitments, as at 31 Dec 2020, SEK billion**

Order	Expected loss	Actual loss	Amount	Share
Guarantee and lending model	Fees/appropriations	Reserve	289.7	11.9
Deposit insurance scheme	Fees <sup>1</sup>	Reserve	1734.2	71.3
Student aid system:				
New student loans	Appropriations	Reserve	119.4	4.9
Old student loans <sup>2</sup>	-	Appropriations	118.4	4.9
Other management:				
Callable capital	-	Appropriations	169.4	7.0
Individual loans	Fees/-	Unknown	0.9	0.0
<b>Total</b>			<b>2,432.0</b>	<b>100</b>

1 Fees for the deposit insurance are not set on the basis of expected loss. The statutory fee is taken out at 0.1 per cent of the institution's aggregate guaranteed deposits at the end of the most recent year.

2 Student loans granted prior to 2014

Data from EKN, Sida, CSN, Boverket, the Debt Office and the Government Offices

### Problem commitments

For problem guarantees and loans, a credit loss is deemed likely. These are commitments for which a negative credit event – such as delayed payment or non-payment of interest or amortisation – has already occurred (see Table 20). Alternatively, there are other good reasons to doubt whether a loan issued or guaranteed will be repaid in time.<sup>46</sup>

**Table 20. Problem guarantees and loans as at 31 Dec 2020, SEK billion**

	Amount	Share
Problem commitments	7.5	0.3
Performing commitments	2431.9	99.7

Data From EKN, Sida, CSN, Boverket and the Debt Office.

## Difficulties in determining expected loss

Disclosing and financing the expected loss that relates to the credit risk in a guarantee or loan is an important part of the central government's guarantee and lending model. There are, however,

<sup>46</sup> Problem commitments do not include the following two of CSN's criteria for losses on lending: reservation based on security rules in respect of repayment, and reservation with respect to future losses due to death.

circumstances that make it more challenging to reliably estimate the expected loss for a guarantee or loan. That being said, it is important to stress that such guarantees and loans are not necessarily unjustified or ill-advised. In essence, the issuance of central government guarantees and loans is a political decision. The objectives that form the basis for the decisions often contain other positive effects that outweigh the difficulties in managing the commitments. Transparency regarding these commitments may nevertheless result in greater awareness of the problems they bring.

The data in Table 21 shows that there are guarantees and loans with characteristics that make estimating the expected loss more challenging (for parts of the portfolio where estimation of expected loss is required according to regulations). This mainly relates to guarantees and loans with very long maturities or for which the maturity is not regulated at all.

### **Unlimited undertakings**

A typical example of challenging characteristics for determining expected loss is guarantees or loan commitments without time and/or amount restrictions. Such commitments involve a certain arbitrariness in the risk assessment, which often applies primarily where there is no limit on the amount involved. In those cases, it is not possible to unequivocally determine the scope of the central government's undertaking.

### **Guarantees or loans with long maturities**

For guarantees or loans with very long maturities – more than 20 years – it is also difficult to estimate the expected loss for the whole of the term in a non-arbitrary way.

### **Guarantees or loans to parties that are not economically viable**

Another aggravating circumstance concerns guarantees or loans to counterparties that are not financially viable. One such example is companies that have financial difficulties due to a prolonged decline in sales or a weak capital structure.

Issuing a guarantee or loan in these circumstances increases the asymmetry between risk and reward that already exists between a company's owners and its creditors. In turn, this makes it difficult for the state as the issuer of guarantees or loans to assess and limit its credit risk. Determining the expected loss in a reliable way becomes difficult as well.

### **Guarantees for which the role of central government is unclear**

A final example of challenging characteristics is when guarantees are issued to companies in which the state is also a major shareholder. Such dual roles make it challenging to assess the probability of the guarantee commitment being fulfilled because, in practice, this partly depends on an assessment of how the state in its role as an owner is expected to proceed if the company encounters difficulties. This problem arises mainly with guarantees that entail a pledge to inject new capital.

**Table 21. Commitments with challenging characteristics, as at 31 Dec 2020, SEK billion**

Challenging characteristics	Amount
Guarantees or loans with unlimited maturity <sup>1</sup>	7.7
Guarantees or loans with unlimited maturity and amount <sup>2</sup>	13.6
Guarantees or loans with an original maturity exceeding 20 years	58.9
Guarantees or loans granted to counterparties not economically viable	-
Guarantees for which the role of central government is unclear	0.4
<b>Total</b>	<b>80.6</b>

Excluding the deposit insurance scheme (SEK 1,734 billion), callable capital (SEK 169 billion), student loans granted prior to 2014 (SEK 118 billion) and royalty- and conditional loans (SEK 1 billion) for which expected loss is not calculated.

<sup>1</sup> Outstanding amounts for guarantee undertakings with unlimited maturities. This mostly refers to guarantees managed by the Debt Office as well as guarantees with Boverket.

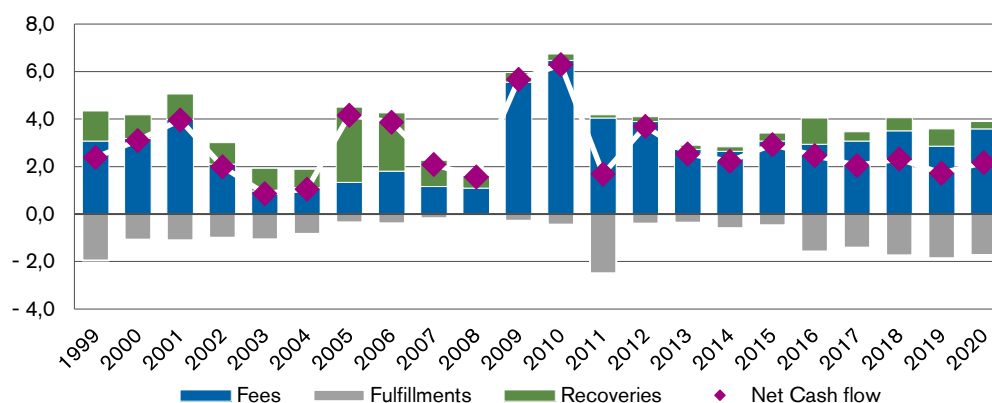
<sup>2</sup> Outstanding amounts for guarantee undertakings with unlimited maturities and amount. Refers to guarantees managed by the Debt Office.

## Historical flows

### Guarantees

For guarantees, there are mainly three types of flows: incoming payments of fees, outgoing payments due to guarantee commitments being fulfilled, and recoveries from previous fulfilments. These inflows and outflows vary over time, for example because the fulfilments tend to be higher in recessions and several years can elapse between fulfilment and recovery. Consequently, it is natural for the size of inflows and outflows to differ during individual years.

**Figure 14. Historical inflows and outflows in the guarantee portfolio 1999–2020, SEK billion**



The central government's annual report, information for the 2020 annual report compiled by the Debt Office, and own computations.

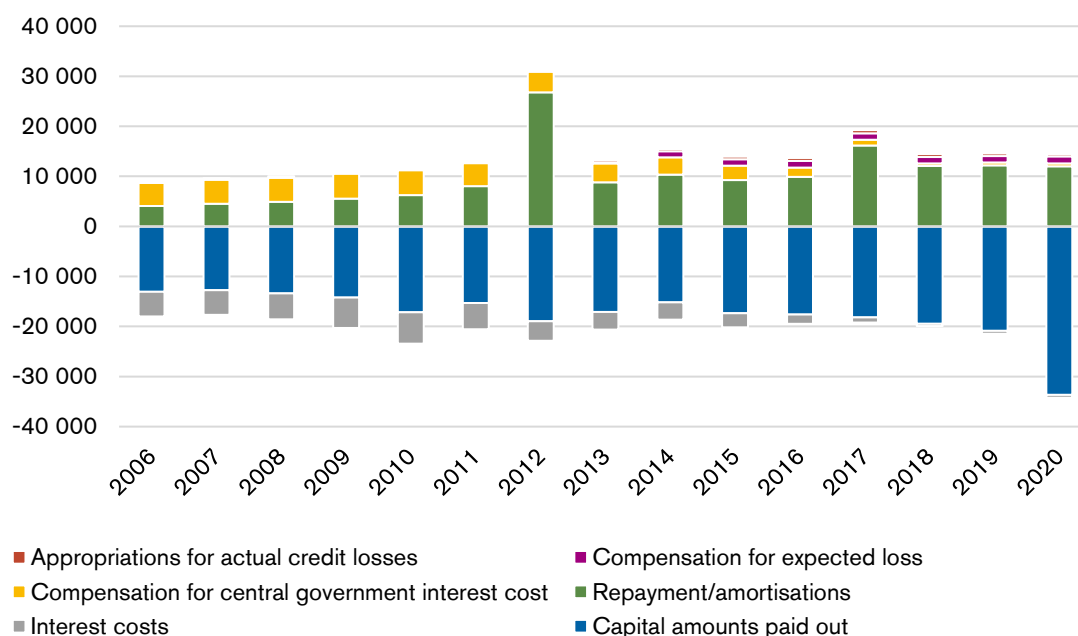
### Lending with credit risk

Central government lending with credit risk is dominated by the CSN's student loans but also includes lending by the Debt Office. SEK (The Swedish Export Credit Corporation) lent SEK 10 billion in 2020, which explains the increased lending compared with previous years. The large amortisation for 2012 refers to a loan to the Bothnia Line issued by the Debt Office.

The compilation of historical flows concerning central government lending in Figure 15 consists of capital amounts paid out, interest costs, repayment/amortisation, compensation for central government interest cost, compensation for expected loss, and appropriations for actual credit losses for the 2006–2020 period.

Flows relating to royalty loans are excluded from the figure.

**Figure 15. Historical flows in the central government lending portfolio 2006–2020, SEK billion**



Data from CSN and the Debt Office.

## Appendix 4: Calculation of the risk of large losses

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In a calculation example, expected and unexpected losses occurring over a three-year time horizon with less than 1 per cent probability have been estimated at 8 per cent of the portfolio's size, without taking into account any recoveries. When the calculations are stressed, the corresponding result is marginally higher. Note that there are several important limitations regarding the calculations, which is why the figures must be interpreted more as an indication of the risk level in the portfolio.

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### Quantitative portfolio model

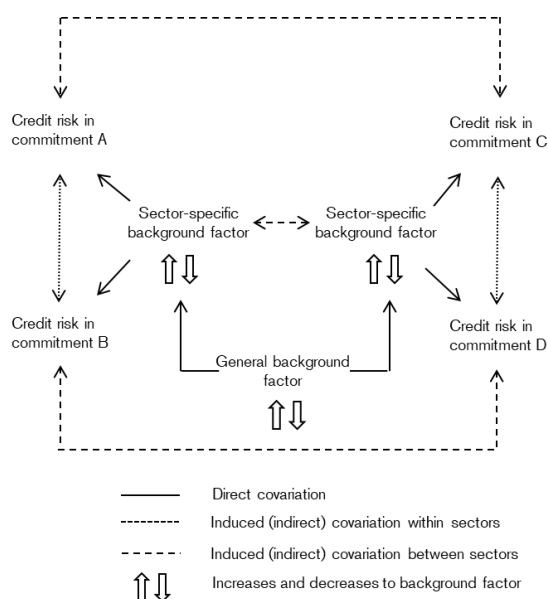
Using a portfolio model, the qualitative risk analysis of the central government guarantee and lending portfolio can be supplemented with a quantitative analysis. The model developed by the Debt Office has been developed on the basis of established methodology – from the perspective of both academic studies and experience from professional practitioners. It has also been important that the model is rigorous, easy to use and can be explained in an understandable way.

The chosen model is, in simplified terms, based on variation of default rate for the commitments in the portfolio. The modelling is done with reference to individual guarantee holders' and borrowers' joint dependence on various background factors. This includes both specific background factors in regard to sector concentrations that occur as well as a general background factor that reflects general economic development (see Chart 5).

Thus, other levels are modelled than is normally the case. For example, if the modelled default frequencies are higher than normal, this reflects an increased likelihood of credit losses that coincide in clusters, i.e. an expression of (indirect) covariance that can lead to large losses.



**Chart 5. Induced (indirect) covariance between individual commitments**



The box Modelling of covariance with a factor model provides an overview of the model. A technical and more detailed description is available on the Debt Office's website in the focus report Calculations of the risk of large losses in the central government's guarantee and lending portfolio, from 15 March 2017.

### Usability and limitations of the model

A calculation model is only as good as the preconditions used in its design and implementation. Without knowledge and understanding of this, exact figures from a model can be interpreted as providing more information than they actually do. In the worst case, this can lead to the calculations being misinterpreted.

The model developed by the Debt Office provides a description of the factors and relationships that constitute important explanations for large losses in the portfolio. This means that there is a good chance of distinguishing a high-risk portfolio from a low-risk portfolio. The calculations thus contribute to increased transparency in regard to the portfolio's risk profile (not least by comparing the calculations over time). It is also the Debt Office's assessment that the results from the model provide an indication of the size of less probable losses.

At the same time, it should be noted that calculations with a portfolio model entail a reduced format for credit risk analysis. This is in part because, for a comprehensive portfolio, a large number of combinations of possible outcomes are to be explained using the model. Also, for credit losses in

general – and clusters of credit losses in particular – there is limited access to data.<sup>47</sup> Overall, this means that minor changes in assumptions and or data can have a significant impact on the calculation results. In addition, there is no opportunity to investigate how reliable the estimates generated by the portfolio model are.<sup>48</sup> A figure from a model that cannot be evaluated in a statistical test is, in practice terms, a qualified guess.

Thus, it can be concluded that there is analytical added value in implementing the calculations, but that they should be interpreted with caution.

### Unexpected loss

Unexpected loss is illustrated by the spread around the expected loss in the portfolio for a given time horizon. However, there is no unambiguous definition of unexpected loss. The Debt Office has chosen to express the spread as the difference between the mean of the losses exceeding Value-at-Risk (VaR) for a specific confidence level, called conditional value-at-risk (CVaR) or expected shortfall, and expected loss. VaR, in simplified terms, refers to an amount that is not lost more than with a certain probability.

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$$\text{Unexpected loss} = \text{Expected shortfall} - \text{Expected loss}$$


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#### *Expected shortfall (CVaR)*

Unlike VaR, expected shortfall takes into account all losses above a specified level, instead of a single outcome. Expected shortfall is determined by calculating the expected loss *provided that* the actual loss is greater than VaR for a chosen confidence level.

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$$CVaR_{\theta} = E[L \mid L > VaR_{\theta}(L)]$$


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### Delimitations

The calculations are made from a subset of the regular portfolio, in which student loans and Boverket's guarantees are not included. In previous years, delimitations have also been made for all guarantees and loans that are less than SEK 5 million – but after optimisation of the calculation model, which reduces the time spent per simulation, these have been included in the calculations. Finally, the calculations are delimited as to maximum amount of fulfilments within the upcoming five-year period.

#### *Student loans*

At present, it is not possible to include student loans (which account for just over 34 per cent of the regular portfolio) in the model in a way that is conceptually and methodologically consistent with the remaining parts of the portfolio. This is because concepts such as probability of default and recovery rate given default are not applied in CSN's operations and the necessary data is therefore missing.

---

<sup>47</sup> Credit losses rarely occur and only once for the same commitment. Consequently, a completely different situation applies compared with many other types of financial models – such as changes in market prices or macroeconomic quantities that can be observed more or less continuously.

<sup>48</sup> In practice, the evaluation of the portfolio model is limited to validation of the logic and reasonableness of the model's design.

*Boverket's guarantees*

Boverket's fee model is developed solely for the purposes of determining expected loss in the guarantees it has issued. Therefore, Boverket does not have a method for estimating the probability of default and the expected recovery rate separately. The portfolio calculations require that these two components be distinguished from each other. However, there is no need for Boverket to produce these two components in any other context than for the portfolio calculations. Boverket's guarantees are therefore not included in the calculations. These comprise only a very small part -- less than 0.5 per cent of the regular portfolio, and their exclusion has no significant effect on the calculation results.

**Simplifications***A static portfolio*

Amounts and credit rating assessments are based on the information compiled by the agencies in their annual accounts. The portfolio for which the calculations are made is kept unaltered for the respective period of time to which the calculations pertain (irrespective of the actual remaining maturities of the guarantees and the loans).

*The risk of default contagion is handled outside the model*

Modelling direct covariance due to business or legal obligations between different guarantee holders and borrowers is a complicated process. A simple, though conservative, solution is to merge the guarantees or loans in cases in which such connections are deemed to exist.

*Focus on name and sector concentrations*

The analysis of concentrations in the calculations is limited to name and sector concentrations. Geographic concentrations are excluded due to a lack of data.

*Fundamental approach*

As empirical evidence is lacking, the assumptions are made in part because the guarantee holders or borrowers are uniquely linked to only one sector, and in part because the variation in the guarantee holder's or borrower's default rate is entirely explained by changes in the background factors in the modelling.

**Specific basic assumptions**

A quantitative analysis contains a number of necessary basic assumptions. The Debt Office has made the following choices:

- The calculations are made for a time horizon of one and three years, respectively.<sup>49</sup>
- It may take several years before the final net loss (actual loss after any recoveries) can be determined following a default. At the same time, recoveries – partial or full – can even be made in the short term. Therefore, both gross losses (losses irrespective of potential recoveries) and net losses are calculated.

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<sup>49</sup> With the length of the time horizon, both the individual guarantee holders' and the borrowers' (cumulative) likelihood of default and the degree of covariance between them increases. Thus, the longer the time horizon, the greater the risk of unexpected loss.

## Implementation

In accordance with the delimitations made, calculations are made for a portfolio totalling SEK 385 (300) billion and distributed among 1932 (2762) commitments.

### Data

Data for the model has been taken from the international credit rating agencies' databases and methodology documentation:

- For each sector category in Table 12, the report has a time series compiled with the aggregate default rate for respective sector.<sup>50</sup>
- For individual guarantees and loans, the default rate for various rating categories (for each time horizon) is matched with assessments of creditworthiness that each responsible agency makes in connection with expected losses recorded in the annual accounts.<sup>51</sup>
- The recovery rates given default assessed by the responsible authority for the individual guarantees and loans in the portfolio have been divided into the categories high, normal and low recovery.<sup>52</sup>
- For the connection between default rate and recovery rate given default, the correlation between the aggregate default rate and the recovery rate given default has been studied.<sup>53</sup>

### Monte Carlo simulation

The calculations have been performed using the Monte Carlo simulation method for making digital calculations with the model. The advantage of this method is that it is flexible. The disadvantage is the difficulty in obtaining a high level of precision in the calculations of less probable outcomes (which entails a risk of underestimating the so-called tail in the loss distribution). For each run of the model, 250,000 portfolio outcomes have been simulated.

## Model uncertainty

Forward-looking calculations based on historical data add to the assumption that the course of events that forms the basis for the estimates of the parameters will recur in the future, which is always associated with uncertainty. In addition, historical data is often limited to variations, and thereby risk, under normal circumstances.

One way to account for this is to perform supplementary calculations in which different parameters in the model are stressed. This entails adjustments in regard to situations that occur less frequently, but which are particularly unfavourable, and lead to more and larger credit losses.

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<sup>50</sup> Standard & Poor's. CreditPro® - Corporate Ratings. "Comparative Marginal Default Rate (percent, NR Included) Conditional on Survival, Number of Issuers (All), All Rated" (14/02/2019).

<sup>51</sup> Moody's Investors Service (2020). Moody's Annual Default Study Corporate Default and Recovery Rates 1920-2019, Exhibit 35 – Average Cumulative Issuer-Weighted Global Default Rates by Alphanumeric Rating, 1983-2019. The default rates have then been adjusted with a smoothing algorithm developed by the Debt Office to produce "ideal default rates", i.e. default rates that are strictly increasing (decreasing) for lower (higher) ratings.

<sup>52</sup> Moody's Investors Service (2015). Moody's Approach to Rating Corporate Synthetic Collateralised Debt Obligations. Exhibit 3: Mean and Standard Deviation Assumptions by Asset Type, Seniority and Security.

<sup>53</sup> Moody's Investors Service (20). Moody's Annual Default Study Corporate Default and Recovery Rates 1920-2019. Annual Issuer-Weighted Corporate Default Rates by Alphanumeric Rating, 1983-2019 (All rated) and Exhibit 20 - Annual Defaulted Corporate Bond and Loan Recoveries (All Bonds).

The Debt Office has stressed the parameters by doubling the standard deviation for background factors included in the model. Also, the spread has increased around the expected recovery rate given default. At the same time, the Debt Office has assumed a high correlation between the default rate and rate of recovery given default in regard to changes in the general economic development.

## Results

Table 22 below summarises the results of the various calculations. The calculations when accounting for recoveries are shown in parentheses.

**Table 22. Estimates of expected losses as of 31 December 2020, SEK billion**

<i>Confidence level<sup>1</sup></i>	<i>Expected Loss</i>	<i>Unexpected loss</i>		
	-	90 %	95 %	99 %
<i>Base calculations</i>				
1-year time horizon	1.59 (1.12)	7.41 (5.89)	9.41 (6.89)	16.41 (13.89)
3-year time horizon	5.80 (4.05)	12.20 (10.95)	15.20 (13.95)	24.20 (21.95)
<i>Stressed calculations</i>				
1-year time horizon	1.59 (1.17)	7.41 (5.83)	9.41 (8.83)	16.41 (15.83)
3-year time horizon	5.77 (4.14)	12.23 (10.86)	16.23 (14.86)	25.23 (23.86)

<sup>1</sup> The higher the confidence level, the lower the probability of losses greater than those calculated for the selected confidence level.

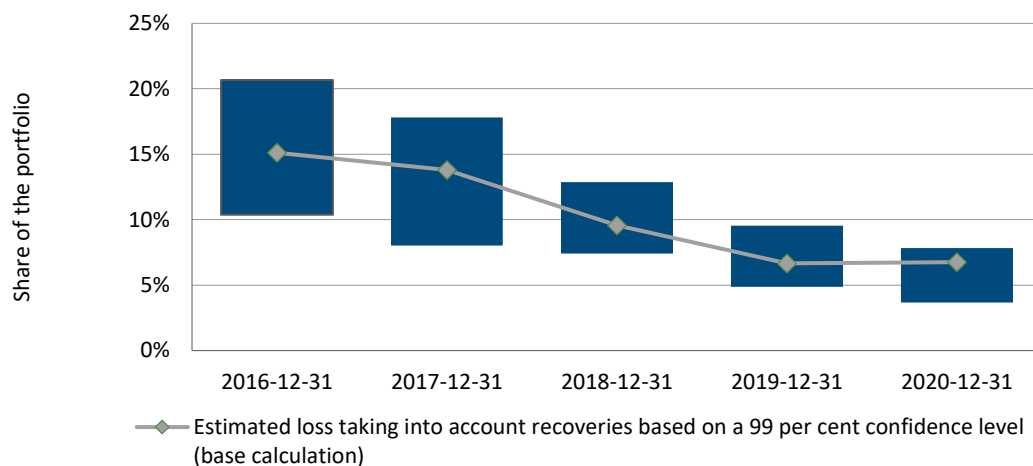
The losses simulated irrespective of recoveries are in, order of size, SEK 9–30 billion when expected and unexpected losses are compiled, which corresponds to 2–8 per cent of the portfolio in the calculation example. The wide range reflects the fact that the longer the time horizon and the higher the degree of confidence chosen is, the larger the simulated losses are – and vice versa.

When accounting for recoveries, the corresponding losses are naturally lower. The losses calculated are in the range of SEK 7–26 billion, which corresponds to 2–7 per cent of the portfolio.

When the model's parameters are stressed, the simulated losses increase but still are accommodated within a range of 2–8 per cent of the portfolio irrespective of recoveries, and 2–7 per cent when accounting for recoveries.

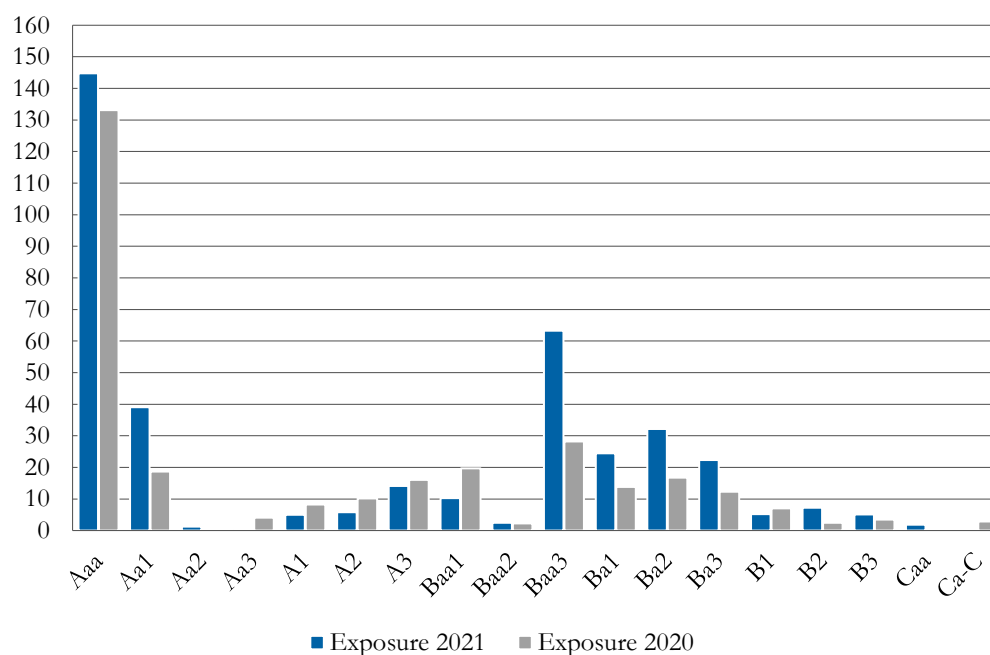
Figure 16 compares the year's calculations for a three-year time horizon with comparable calculations from previous years.

**Figure 16. Comparison over time of estimated losses for a three-year time horizon**



As shown in the Figure 16, the size and trend of the losses calculated have decreased over time. The decrease from the previous year-end is partly because the underlying data shows a lower frequency of default for almost all credit ratings. On the other hand, the exposure to credit ratings between Baa3 and B3 has increased, mainly because of new guarantees and not because existing ones have been given a lower credit rating. (see Figure 17).

**Figure 17. Exposure per rating 31/12/2020 compared with 31/12/2019 SEK billion**



Data from EKN, Sida, CSN, Boverket, and the Debt Office, as at 31 December 2020.

However, there was a special method change for the calculations performed as of 31 December 2018; the exposure amounts since then correspond to the amounts that can be fulfilled within a five-year period.<sup>54</sup> In previous years, the exposure corresponded mainly to the total guarantee commitments, with only a few adjusted for what could be fulfilled within a five-year period. This largely explains the vast difference between 2017 and 2018. Even without this method change, exposure to borrowers and guarantee holders with a speculative grade rating has decreased over time.

## Modelling of covariance with a factor model

The Debt Office has chosen to develop a multifactor model that is based on the established portfolio model CreditRisk +.<sup>55</sup> In technical terms, the specific model chosen is a Compound Gamma Model).<sup>56</sup>

### Background factors to explain indirect covariance

An established approach to modelling the risk for clusters of losses in a guarantee and lending portfolio is to use a factor model. This is a model in which covariance between different guarantee holders and borrowers are explained by a smaller number of background factors. To the extent that the creditworthiness of individual guarantee holders and borrowers depends on changes in the same underlying background factor(s), it can be assumed that their default rates indirectly covary.

Once it has been taken into account what different guarantee holders and borrowers have in common in terms of dependence on one or more background factors, it is possible to treat them as if they were independent.<sup>57</sup> This is a key element in the design of most portfolio models. This is because it is much easier to make calculations of the risk of several losses at the same time.

### Average default rates as background factors

The background factors explaining covariance between individual guarantee holders and borrowers vary between different factor models. On the other hand, they are based on the same mathematical framework and basic elements.<sup>58</sup> The choice of a specific factor model is less about accuracy and more about what is practically feasible. Here, the Debt Office has chosen a factor model in which the background factors consist of the aggregate default rate for different sectors.

### Covariance within and between sectors

In the portfolio model, the degree of covariance between different guarantee holders and borrowers depends on whether they belong to the same or different sectors.

<sup>54</sup> The Debt Office did not have access to information about maximum fulfilment of one or three years when the calculations were made.

<sup>55</sup> CreditRisk+ was developed by Credit Suisse First Boston International, CreditRisk+ A Credit Risk Management (1997). The model was never commercialised. Instead, the idea has been from the beginning that the model could be modified after the user's requirements and preferences.

<sup>56</sup> Gundlach, Matthias and Lehbass, Frank (2004): CreditRisk+ in the Banking Industry. Springer-Verlag. Berlin Heidelberg New York. pp. 153-165. ISBN 3-540-20738-4.

<sup>57</sup> This implies a basic assumption of what is called conditional independence.

<sup>58</sup> Hickman, Andrew and Koyluoglu H. Ugur (1998): Reconcilable Differences. Risk, Volume 11, Issue 10. pp. 56-62.

For guarantee holders and borrowers in the same sector, it is assumed that the more the aggregate default rate for the sector varies over time, the stronger the covariance is between the guarantee holders and the borrowers in the sector. A concentration to a sector with large fluctuations in the aggregate default rate is assumed to entail a higher risk of loss clustering than the corresponding concentration to a sector with minor fluctuations.

Covariance between guarantee holders and borrowers in different sectors are modelled by taking into account the average correlation between the aggregate default rate in different sectors. In simplified terms, this means that the more correlated different sectors are altogether, the greater the impact of changes in the general economic environment is on the risk of loss clustering.

By taking into account covariance both within sectors and between sectors, the model provides differing results for portfolios with different compositions – and thus different risk profiles.



**The Swedish National Debt Office is the central government financial manager and the national resolution and deposit insurance authority. The Debt Office thus plays an important role in the Swedish economy and the financial market.**



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