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The stability of the Swedish financial sector

- a summary

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- Looking at the official reports, the Swedish life-insurers, previously severely hit by declining equity prices and interest rates, have improved their financial performance during the last two years. However, if one looks at the figures that emerge if realistic interest rates are applied, the outcome is clearly more negative - in fact, solvency har decreased for six years. Still, the sector as a whole remains financially strong, although some companies do have problems with their solvency ratios. But the sector is vulnerable; should interest rates go down further or if equity prices should fall, a growing number of insurers will get into problems. Finansinspektionen (FI) is closely monitoring this and also developing new supervisory tools, such as the so called Traffic-light model

- The large banking groups are financially strong with virtually no credit losses and with a modest growth when it comes to risk exposures. This, coupled with a likely further improvement of general economic growth, means that risks to systemic stability are low for the foreseeable future. In a longer perspective, however, the expansion of their business abroad and in countries like the Baltic states and Russia may imply increasing risks. FI will follow these developments, and in collaboration with the supervisors in these countries.

- A number of new regulatory complexes has been implemented during the last years, and there are a lot more to follow. The major part of the regulatory changes are parts of EU's Financial Services Action plan, aiming at an integrated financial market within the EU. Although there are goods reasons for regulatory reforms, it also raises problems. It is difficult to foresee all the effects and implications these changes may lead to, and even more so the possible effects they may give rise to in combination. Therefore the implementation and the possible adverse effects that may come out of these changes has to be monitored closely by Finansinspektionen.

Banks

After slowing down the first half of this year, growth is picking up, and is expected to do so also during next year. The National Institute of Economic Research (Konjunkturinstitutet), foresee a GDP- growth this year around 2,5 percent, increasing to 3,2 percent next year. Inflation is expected to increase slightly as growth picks up, and so will both short-term and long term interest rates. Of course, there are some factors that may produce a less positive scenario, e.g. even higher oil prices and financial strains related to growing deficits in the US current account. Moreover, disasters that are completely impossible to foresee can always occur – like earthquakes, terrorist attacks, computer systems collapsing etc. But looking at the factors that can be monitored and assessed with reasonable accuracy, the prospects for financial sector developments and for financial stability are indeed very good.

The four big banking groups – which heavily dominate the Swedish banking market – lived through the macroeconomic downturn 2000-2002 without any financial strains. Since then, they have managed to increase their good profitability and capitalization. Some important reasons behind this are increased cost-efficiency, a growing market for mortgage lending and a very low level of credit losses – in fact, in mid-2005 the Swedish banking sector, taken as an aggregate, had no credit losses at all.

Considering this, the prospects of a likely further improvement in the macroeconomic situation, and no obvious indications of increasing risk levels in lending etc , it is hard to foresee any risks to systemic stability. The strong growth in mortgage lending over the last years, thanks to low interest rates and rising prices on real estate, may lead to losses when interest rates turn higher. Still, this is a threat for certain customers to the banks rather than the banks themselves. Of course, high capitalization together with improving market conditions may lead to banks getting overoptimistic, making heavy investments in new products, new markets, engaging in expensive acquisitions etc. and thereby getting more financially vulnerable. So far, however, no such tendencies are evident.

Therefore the possible risks to the banks are mainly to be seen in a longer perspective. All four large banking groups are nowadays Nordic-Baltic groups rather than Swedish banks. In a sense, this means a lowering of risk by geographical diversification, but it also means increasing operative risks working in different markets and within different jurisdictions. In countries such in the Baltic states, where some of the banks have strong market positions, and in Russia and Ukraine, where some banks are establishing, also financial risks may be higher and more difficult to analyse and manage.

The life-insurance sector

The financial strength of the life insurance companies sector is good. However, if the liabilities are valued with realistic assumptions - that is with the realistic market interest rate - financial strength has declined sharply the last six years. The falling market rates are the main reason for this development. Several companies are now vulnerable for further falls in the market rates or falls in other asset prices. The development as described by the official solvency ratio based on so called sufficiently prudent assumptions, which is used today by the insurance companies, is on the other hand showing a positive development. In reality, this is however not a relevant description of the actual development.

FI will order companies that are so weak that the interest of the policyholders can be considered in danger, to prepare a financial reconstruction plan. The plan shall describe how the company will make sure that the financial obligations towards the policyholders are fulfilled. If the company is violating the formal solvency requirement FI has in the end the right to take over the entire operation of the company, or parts of it.

The prolonged decline in solvency measured by realistic assumptions, is a sign of problems in the companies portfolio management. These have the

origin in tradition, market circumstances and the regulatory framework. This is not at unique Swedish problem. Similar problems are found in other countries as well.

On January 1, 2006, the Directive on Institutions for Occupational Retirement Provisions (IORP's Directive) will come into force in Sweden. A central feature of the IORP's Directive is that detailed regulations will be replaced by general principles and that a larger responsibility is placed with the companies to handle risks and the operations of the company in a prudent way. The IORP's directive will also result in a realistic valuation of the liabilities. This will increase the transparency of the companies. FI's monitoring of insurance company risks will be conducted by means of new supervisory methods that offer early warning signals of any problems. A key aspect of the new surveillance is the traffic light model, which measures the companies' exposure to financial risk. This is part of the supervision aimed to ensure that companies can meet their undertakings. Also other tools that provide early warning signals of problems in the insurance companies will be used.

Regulatory changes and risk

Risks to the financial system and to the consumer are not something static, but constantly changing. Consequently, the supervisory response must change as well. And this is what we see today – big changes in the regulatory frameworks surrounding all financial sub sectors such as banks, insurance companies, investment firms etc. Moreover, and equally important, most changes is part of a European, and sometimes also global, process.

The reshaping of the regulatory frameworks has several drivers. One is to increase financial stability, another is to improve consumer protection, still another is to foster financial market integration by harmonising regulatory and supervisory standards within Europe. On the Swedish national level a number of regulatory changes have been made recently, for example the new banking legislation that was implemented last year. On the insurance side a number of regulatory measures have been taken, partly as a response to the problems in that sector that surfaced a few years ago, and there is more to come.

For banks and investment firms the introduction of the so called Basel II, effective from 2007 on, will hopefully imply both better transparency and a better and more efficient management of risks. It will also provide incentive for a more riskbased pricing of credit. Ultimately, it aims to reduce systemic risks and increase stability. In the insurance field a similar process is under way within the EU through the work on the so-called "Solvency II"-directive, which will later on materialize in new legislation. For the securities market, a number of directives have been issued and implemented – for example the directive on prospectuses and on market abuse. Another important regulatory complex is the new directive on investment services, the so called MiFID, will come on stream next year, with numerous implications for all firms active in this area.

And on top of that, new accounting standards, the IFRS, have been implemented from this year on, with direct implications for all public companies, both financial and non-financial.

But regulation and changes in regulation also poses problems and risks. There are a number of issues here to deal with.

- The huge volume of new or revised regulations coming on stream within a few years time may create problems in handling it practically and conceptually.
- Within the EU-framework, regulations are produced within a complex process of negotiating and compromising, where different national interests, industry interests etc have to reach agreements. This process contains obvious risks with respect to creating a regulation that is "optimal" in some sense. Instead, the risk of overregulation is definitely there.
- Simultaneous changes in a large number of regulatory fields - which is clearly the case right now - can also produce inconsistencies, unforeseen cross-effects and uncertainty in markets.

It is very hard to know what the interaction would look like and what the full cross-effects will be of, for example, the new accounting rules and Basle II. What we do know is that it is necessary to keep a close eye on this.

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