FINANSINSPEKTIONEN

Risks in the financial system 2012

8 NOVEMBER 2012

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CONTENTS

Foreword

The ”Risks in the Financial System” report highlights the risks that Finansinspektionen (FI) considers to be the most serious in the coming year. This includes risks affecting financial stability and consumer protection on financial markets, as well as risks that in the long run could jeopardise confidence in financial markets and how they function.

Since last year’s report, uncertainty about the European debt crisis has persisted, and it is still the biggest risk to Swedish financial institutions. FI also highlights the risks of life insurance undertakings’ market risk management, including changed terms for consumers, and the risks of unsuitable investments.

In the risk report, we describe the risk analysis we make in order to prioritise our supervisory work. Going forward, we see these risks being met by measures from the firms and their management.

Stockholm 8 November 2012

Martin Andersson

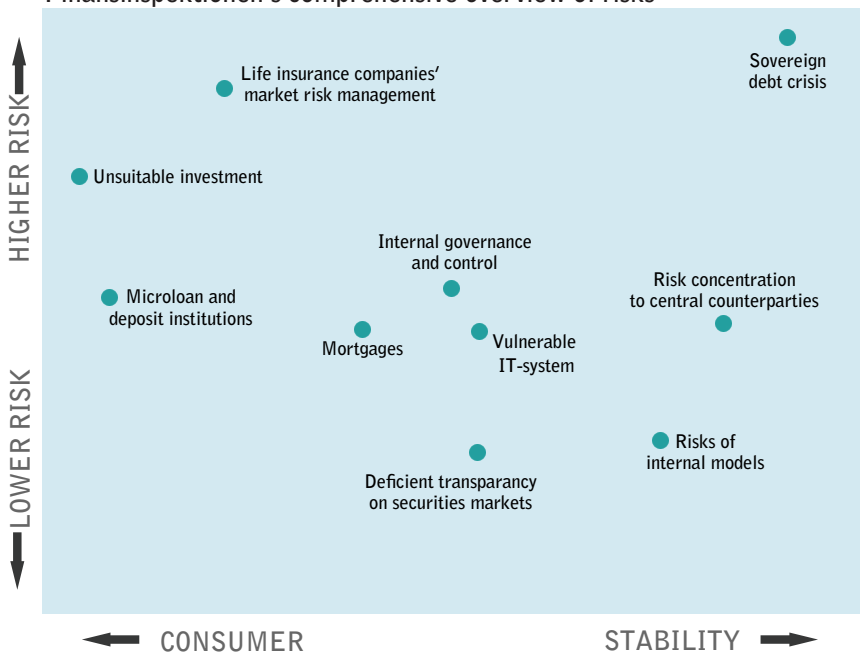
Director General

Summary

In the past year, the measures taken mainly by central banks have reduced the uncertainty on financial markets. However, the underlying structural problems in the debt-burdened countries and in the European banking system still persist to a great extent. A turn for the worse in the sovereign debt crisis still constitutes the greatest risk to Swedish financial institutions. Swedish banks are relatively strong, but are vulnerable to changes for the worse abroad. Some Swedish life insurance undertakings remain under pressure from the low interest rate environment, but have received a certain amount of support from Finansinspektionen's (FI's) temporary rate floor. For consumers, the risks remain high, particularly in terms of complex products and unsuitable advice.

FI compiles a comprehensive overview of risks in its work of analysing the risks on financial markets and in order to prioritise the focus of its supervisory activities. This overview contains the most prominent risks facing financial stability and consumers as well as risks that, in a longer perspective, may affect the way financial markets function. At the centre of the overview are the risks that can affect both consumer protection and financial stability.

Finansinspektionen's comprehensive overview of risks



Risks	Development in the year	Chapter
Sovereign debt crisis	→	Bank/insurance
Life insurance companies' market risk management	→	Insurance
Unsuitable investments	→	Consumer
Micro loans and deposit institutions	↗	Consumer
Internal governance and control	→	Bank/insurance
Deficient transparency on securities markets	↘	Securities
Mortgages	↘	Bank
Vulnerable IT systems (NEW)	↗	Bank/securities
Risk concentration to central counterparties (NEW)	↗	Securities
Risks of internal models (NEW)	↗	Bank

RISKS TO FINANCIAL STABILITY

In connection with the 2011 risk report, unease on financial markets had once more increased. While this unease is still high this year, it has subsided slightly as a result of measures taken by central banks and, to a certain extent, also by parliaments, governments and supervisory authorities. However, the underlying structural problems in the debt-burdened countries still persist.

A deepened sovereign debt crisis still constitutes the greatest risk to Swedish financial stability. A deeper, more drawn-out recession in the eurozone would probably also give rise to a poorer economic climate in Sweden. This could have a negative effect on Swedish banks in the form of poorer access to liquidity and greater credit losses. However, Swedish banks are relatively strong with high capital ratios and liquidity buffers, and they currently have low funding costs. However, Swedish banks are heavily reliant on market funding, and if confidence in the banks were to quickly decline, this could involve major risks to the Swedish financial system.

Swedish household indebtedness largely consists of mortgages. Although the loan-to-value ratio for new mortgages has dropped slightly since the introduction of the mortgage cap in 2010, high indebtedness poses a potential risk to consumers and financial stability alike. FI is therefore closely monitoring developments on the Swedish mortgage market.

This year, FI also draws attention to increased risk concentration to central counterparties with the new EU regulations regarding clearing obligations for standardised derivative transactions. Counterparty risks on the derivatives market will be concentrated to just a few central counterparties, and some of these are or may become systemically important players. While the increased use of central counterparties is desirable because it reduces counterparty risks, it poses new challenges for supervisory authorities and central counterparties. It is therefore important that regulations are in place to manage the reconstruction and winding-up of these players.

RISKS TO CONSUMERS

The solvency of a number of life insurance undertakings remains under pressure due to the low interest rate environment, and there is a risk that, over time, consumers will not obtain the return they were promised. There is also a risk that weaker life insurance undertakings will, in order to avoid a further deterioration in their solvency, be forced to carry out

unfavourable transactions. This would lock in low return in the long term for the firms and hence also for policyholders. In order to counteract these changes driven by short-term factors, in June 2012 FI introduced a temporary floor for the discount rate in calculating technical provisions. The rate floor means that the size of the insurance undertakings' commitments can be temporarily limited in pure calculation terms. At the same time, it is important that the firms work on improving their market risk management and on addressing a situation that is difficult in the long term. The sole purpose of FI's decision to introduce a discount rate floor is to provide insurance undertakings with a little more time to adapt their operation to future changes in market circumstances.

The measures taken by the insurance undertakings directed at consumers must also be designed such that they do not mislead the individual consumer. Firms may not take advantage of consumers' disadvantage in terms of information. Those wishing to exit entered agreements must be able to do so on market terms. If a consumer has been given a commitment regarding future pension amounts, it is primarily the firm that should cover any deficit in the existing agreement in the event of a change in terms, at least if the firm is owned by parties other than the policyholders.

In the consumer area, FI also sees that the risks in complex products and unsuitable advice remain high. In complex products, high fees are concealed and it is very difficult to understand the actual risk involved in the investment. The firms that sell these products often receive their remuneration in the form of commissions, which creates a conflict of interest between the interests of the advisor and of the consumer. The information provided by the firms to customers regarding their incentives and remuneration is often deficient. FI believes that the firms must review their routines in order to provide customers with correct information, conduct correct suitability assessments and ensure that their staff have the training required to provide sound advice. FI is still of the opinion that a commission ban should be introduced on insurance mediation focused on investment advice.

Last year, FI held the opinion that the risks associated with micro loans had decreased. However, in the past year the problems have resurfaced with the debts of more consumers ending up at the Swedish Enforcement Authority. FI believes that micro loan firms focusing on consumers and deposit institutions should come under FI's supervision because this would bring about authorisation assessment requirements and provide stronger possibilities of intervening against these operations.

Finansinspektionen's expert panel

This year too, the panel highlights the sovereign debt crisis in Europe as the most important risk going forward. They also mention that the European banking system has still not implemented necessary measures, such as sufficient recapitalisation. This year's panel includes Markus K. Brunnermeier (Princeton University), Douglas W. Diamond (University of Chicago), Albert S. Kyle (University of Maryland) and Marco Pagano (University of Naples Federico II).

In each risk report, Finansinspektionen (FI) turns to a group of prominent economic researchers. They provide their assessment of the macro economy and the trend seen in the international financial system. They also highlight the greatest risks they see ahead to the economic trend in Europe and the rest of the world.

MAJOR ECONOMIC TRENDS AND RISKS

- What do you see as the major macroeconomic risks in the next twelve months in terms of impact on the financial system?
- What are the risks that you see if a country were to leave the euro? How high is the probability of this occurring?
- Do you believe that budgetary discipline and not stimulus in the crisis-stricken countries is still recommendable? How do you view the risk of the economic trend spreading globally from the situation in Europe?
- What do you believe that central banks have left in their toolbox to support the economic trend?

All panellists this year too were in agreement that the greatest macroeconomic risk is linked to the sovereign debt crisis in Europe. They emphasise several aspects regarding the crisis, but all mention the vulnerability of the European banking system. They believe that the European banks still have weak balance sheets and that further capital is required. For the time being, the European banking system is being buoyed with the help of liquidity chiefly from the European Central Bank (ECB). However, they do not believe that the ECB has much left in its toolbox based on the regulations currently applicable within the euro.

Several panellists mention the underlying structural problems which the debt-burdened countries face, and that politicians have not yet understood the severity of the situation. They also indicate that the forthcoming elections in the USA and Germany may be contributing reasons for the politicians' hesitancy in the autumn in terms of potential measures. In the future, the danger of the problems spreading to more and larger countries are greater than Greece leaving the euro or once more writing down its debts. They see a sustained high probability of a country leaving the euro (somebody even mentions Germany), and that more countries will be forced to write down their debts. The obvious risk, irrespective of which country leaves, is of capital leaving the weak countries, of the banking system hence weakening further and of more countries potentially going the same way. This could lead to a steeper downturn in the economy, both in Europe and for its trade partners. They therefore believe that in this event it is important to have a plan in place for mana-

ging a country's euro exit or debt writedown in order to minimise the consequences for the economy. However, one of the panellists believes that the risk for Europe is greater in the long term if the crisis-stricken countries actually remain in the euro.

All panellists expressed that the crisis-stricken countries need both stimulus and budgetary discipline. However, one problem is that the countries do not have sufficient means to stimulate the economy. What is required, in their view, are structural reforms that improve competitiveness in the longer term, such as pension reforms, rather than short-term budgetary cutbacks that risk aggravating the economic downturn.

Several panellists also mention that they anticipate a weaker global economic trend ahead. China is slowing down and constitutes an important export market, not least for Germany. Europe looks to be heading back towards a recession, and it looks set to be a prolonged one. This also affects the USA, which nevertheless looks to be managing to achieve moderate growth.

Another risk highlighted by a panellist is about US money market funds. Before the Dodd-Frank Act[1] the American central bank could guarantee the commitments of these funds, but may no longer do so following the introduction of the Dodd-Frank Act. The risk of investors in money market funds quickly withdrawing their investments thus increases. American money market funds keep European, including Swedish, certificates, and problems for these funds involves poorer access to market funding for European banks.

RISKS FOR SPECIFIC SECTORS AND INSTITUTIONS (BANKS, INSURANCE COMPANIES, FUND MANAGEMENT COMPANIES, HOUSEHOLDS)

- In your opinion, how far have banks and other financial institutions come in their recovery since the last risk report?
- What risks do you see from a prolonged period of very low interest rates? How do you view the trend in the insurance sector due to the low rate environment?
- Which sectors do you believe will be the most vulnerable in the next twelve months?

The panel was in agreement that the European banks need to take further measures to reduce their vulnerability. They are of the opinion that the strain is in the entire European banking system, including French and German banks. Although a certain amount of capitalising of the banks has occurred, they believe that major capital injections into the European banking system are required. They have so far, according to the panel, partly recapitalised by selling off assets (particularly foreign assets) and reducing their balance sheets, but it is fundamentally new capital that they need. Reduced balance sheets bring about reduced lending, which subdues the economic trend. They mention that stopping bank dividends would be desirable, and that the banks actually need to take in more capital, rather than just liquidity from the ECB, which is currently the case. One of the panellists also highlights that the risk in liquidity from the ECB is that the banks buy government securities,[2]

1 See http://www.sec.gov/spotlight/dodd-frank.shtml.

2 The ECB provides loans to banks using e.g. government bonds as collateral.

often from the debt-burdened countries, which then end up on their balance sheets, hence making them even more vulnerable.

The panellists also mention that they see the European banks as the most vulnerable going forward. This is particularly the case if they fail to take in new capital. One of the panellists mentions the problems that can arise for the US money market funds, and highlights that sector as a risk.

Most panellists believe that the current low-rate environment could be a problem. It could lead to an inefficient allocation of capital and to asset bubbles which can affect risk groups such as households. Neither is there any guarantee that the central banks will manage to retract all liquidity once demand and inflationary pressure actually rise.

DESIRED AND EXPECTED REGULATORY CHANGES AND AUTHORITY ACTIONS

- What is your view on the timing of the introduction of higher capital and liquidity requirements? Do you believe that a rapid implementation is important, or should it be possible to phase it in over a longer period of time?
- Do you see a risk that requirements will be watered down during national implementation?
- What is your opinion about the introduction of a banking union in Europe?

All panellists agree that more capital is required in European banks. The majority believes that the regulations should be introduced as soon as possible, and emphasises that dividends should be kept down until a satisfactory capital level is achieved. They also believe that the banks should be nationalised if they cannot reach the capital requirements. They believe that the banks should subsequently focus on lending to stimulate the economy. One panellist believes that it is important firstly to ensure that the balance sheets of banks are diversified and not full of government securities from the debt-burdened countries, which has tended to be the case. Higher capital and liquidity requirements should subsequently be introduced gradually. However, a gradual introduction may not be an excuse to delay the necessary recapitalisation of banks.

The panellists unanimously express that they see a clear risk of the requirements being watered down when they are actually to be introduced. One panellist mentioned that, even if the definitions of the liquidity measurements were fundamentally imperfect, they are nevertheless better than not doing anything at all.

The majority of the panellists are generally positive on the introduction of a banking union in Europe. They see advantages in breaking off supervision of the banks from the individual countries, because the connection between politicians and the banks is strong in certain countries. However, all believe that there are great risks in a joint banking union. For instance, they mention joint deposit insurance and the fact that the ECB has neither the mandate nor tools necessary to conduct supervision. Building up a good supervisory system takes several years and now they do not have that amount of time.

This provides banks with the incentive to purchase government bonds, even in countries with sovereign debt problems.

The economic situation

As emphasised by Finansinspektionen's (FI's) expert panel, the European sovereign debt crisis and macroeconomic risks have continued to coin the trend on financial markets in the past year. Uncertainty about the situation in the debt-burdened countries and in the European banking system persists. Stimulus measures from the ECB and other central banks have meanwhile once again curbed the unease on financial markets. However, the underlying structural problems remain in the crisis-stricken countries and in their banking systems. Despite the uncertainty abroad, the Swedish economy has shown resilience.

The greatest risk to the Swedish economy is an intensified sovereign debt crisis or deepened, drawn-out recession in the eurozone. In such a scenario, the stable situation could change in a short space of time. A weaker Swedish economy would, in turn, affect Swedish financial institutions through lower asset prices, increased credit losses and poorer access to market funding.

HEIGHTENED MACRO RISKS ABROAD

The market trend during the year has continued to feature the sovereign debt crisis and the situation in the eurozone's banking sector. However, the most acute stress has subsided and unease is slightly lower now compared to a year ago. This is largely due to the extensive stimulus measures of central banks, but also partly to the initiatives of parliaments, governments and supervisory authorities. However, there remains a need to implement a series of necessary reforms.

Many debt-burdened countries have underlying structural problems, such as weak competitiveness and weak banking systems. Major cost-cutting packages and a weak economic trend also make it very hard for them to implement the reforms needed. This is confirmed by FI's expert panel, which also emphasises the importance of politicians in Europe fully realising the severity of the situation.

Problems in the eurozone persist

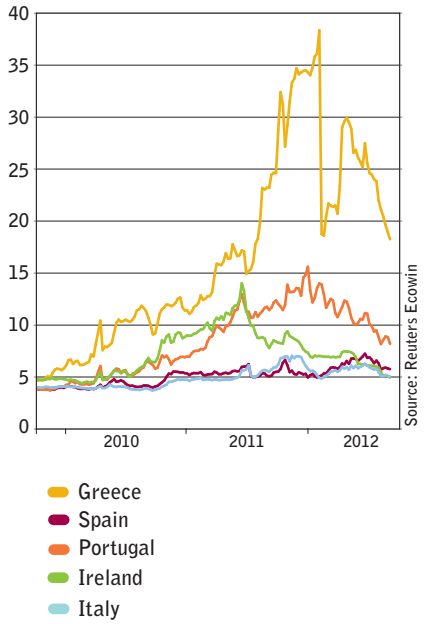
The situation in the GIIPS countries[3] remains problematic. Recently, focus has largely been on Spain. The country's major budget deficit, weak banking sector and low growth as well as the weak finances of the Spanish regions have increased the probability of the Spanish government being forced to seek some sort of support. Market observers believe that Spain will submit a formal application for support before the turn of the year, probably in the form of credit from ESM – the European Stability Mechanism. In the summer, Spanish government bonds reached record-high levels, but have since recoiled.

Italy has also had major problems and the country's economy has been weak for a long time. On the other hand, the situation in Ireland and Portugal has improved during the year.

Greece still has significant sovereign debt and political problems. Low political confidence and major difficulties in implementing many of the measures required by the EU, ECB and IMF have once again raised the

3 Greece, Ireland, Italy, Portugal and Spain.

INTEREST RATES
ten-year government bond (per cent)

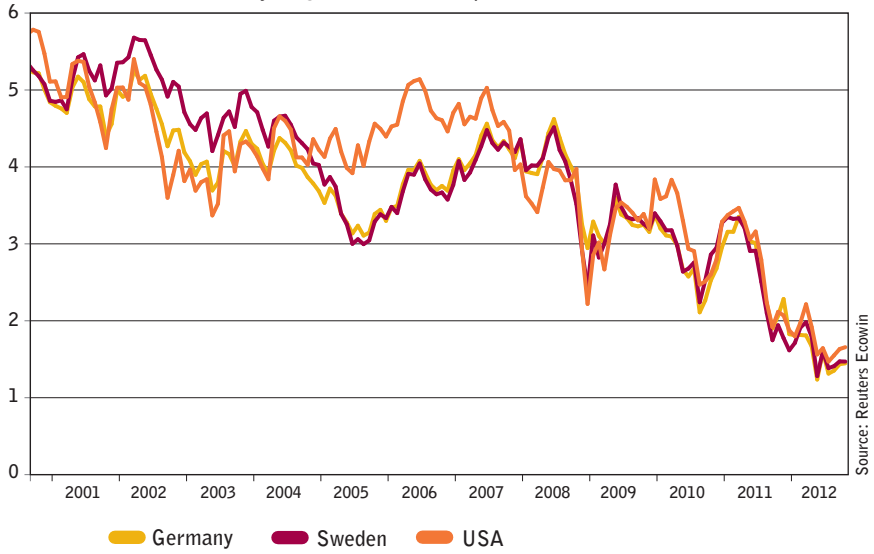


question about a potential Greek exit from the euro. The risk remains of Greece being forced to default on its payments or write down debt again. If Greece, or any other of the euro countries, is forced to leave the euro, there could be ripple effects. FI's expert panel believes that an exit would probably create a capital exodus from weaker countries, further weakening their banking systems, which could force more countries to leave the euro.

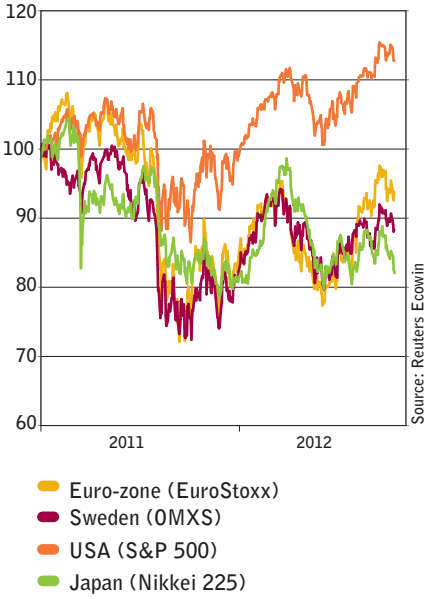
Investors seek safe investments

Large amounts of capital have already flowed out from the eurozone's debt-burdened countries to those with more stable public finances. This is due to increased demand for low-risk assets. It has meant that rates on government securities from the debt-burdened countries have been sharply driven upwards. At the same time, rates on the government securities of more stable countries have been pushed down to record-low levels. Swedish government security rates have also continued to fall during the year. The low rate level has a negative effect on the solvency of life insurance undertakings. The Insurance and Fund chapter provides more information on this.

INTEREST RATES ten-year government bond (per cent)



STOCK EXCHANGES
(index 100 = 4 jan 2011)



The fact that the acute stress has waned on financial markets is also evident on stock markets, where volatility is lower now than it was a year ago. Stock markets have also risen slightly in the past year.

Strong link between governments and banks

The debt crisis has highlighted the link between a country's public finances and its banking sector. Banks in a country with public finance problems may have difficulties in obtaining funding via capital markets, and if the state has to support the banking sector with capital, its public finances deteriorate further. This relationship can also work in the opposite direction. The perception of market participants of a country can deteriorate if the banking sector has severe problems, because there is a risk of the state having to support the banks with capital or guarantees.

FI's expert panel highlights the vulnerability in the European banking system and the weak balance sheets of the banks. During the sovereign debt crisis, it has become harder for many European banks to obtain funding through capital markets. At the end of last year, fears about the situ-

ation in the banking sector were high, and in order to secure access for the banks to liquidity, the ECB announced in December that it was prepared to provide unlimited liquidity to the banking sector. This was then done on two occasions through the ECB offering three-year loans on favourable terms.[4] The measure relieved the banks' funding and reduced the risk of a serious banking crisis. In order to prevent the borrowing costs of the debt-burdened countries from escalating to unreasonable levels, in September the ECB launched a program for the purchase of government bonds with maturities of one to three years on the secondary market.[5]

EU's plan to strengthen the capitalisation of large European banks

The EBA (European Banking Authority) has recommended that major banks in Europe strengthen their capital buffers to ensure that the banks can handle both increased risk in government finances and higher losses resulting from a potential downturn in the European economy.[6] So far, the capital reinforcement amounts to just over EUR 200 billion, and the majority comes from direct capital injections. According to the EBA, the temporary capital buffers created by European banks should remain in place until the banks show that they meet the forthcoming higher capital requirements from the new European capital adequacy regulations (CRR/CRD 4).

The EBA's latest analysis of the capital situation of European banks, converted to the Basel 3 regulation, shows a deficit of EUR 199 billion just for the 44 largest European banks to reach a common equity Tier 1 capital ratio of 7 per cent.

The strong link between governments and banks has not least become apparent in Spain. As a result of high unemployment, many borrowers are finding it hard to pay current borrowing costs. Because of the burst property bubble, the Spanish banking sector is also suffering from loan amounts exceeding collateral values in many cases. At the beginning of June, the situation became unsustainable and the Spanish government reached an agreement with other euro countries involving a loan commitment of up to EUR 100 billion to recapitalise the banks.[7]

Banking union

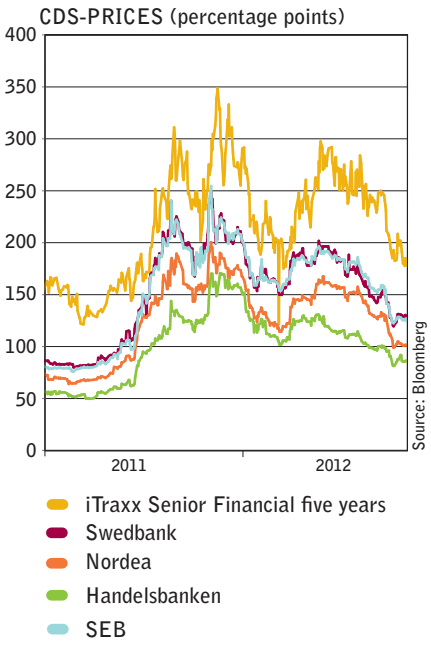
In order to stabilise and reinforce European cooperation, and to break down the bad link between weak states and weak banks, in September the EU Commission presented a proposal for a banking union. The proposal con-

4 The Long Term Refinancing Operation – LTRO, was implemented in December 2011 and February 2012.

5 The transaction is called Outright Monetary Transactions (OMT). In order to carry out the supporting purchases, it is required that the country in question has submitted a formal application for support from the ESM or EFSF support funds. The purchases are linked to obligations from these countries and if they do not meet the commitments the purchases are suspended.

6 See http://www.eba.europa.eu/capitalexercise2012/PressReleaseRecapitalisationExercise.pdf and http://www.eba.europa.eu/News--Communications/Year/2012/EBA-publishes-results-of-the-Basel-III-monitoring-.aspx.

7 At the end of September, a stress test was published by the Spanish banking sector. According to the test, a capital injection of just under EUR 60 billion would suffice in a crisis scenario. See Asset quality review and bottom-up stress test exercise, Oliver Wyman, 28/09/2012.

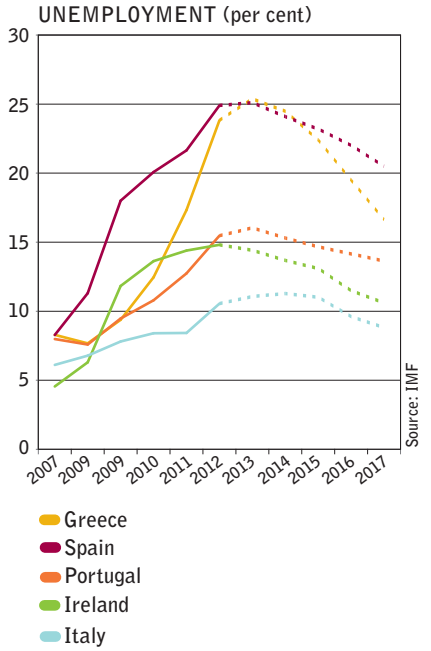


sists of several parts: joint deposit insurance, a joint system for managing winding up banks in crisis and joint bank supervision in the eurozone. When joint banking supervision is in place, the ESM should be able to recapitalise banks directly, instead of having to go through the government. In so doing, no burden is placed on the country's public debt. Meanwhile, there is disunity between European leaders regarding when direct recapitalisation should start to apply, and about whether the ESM should bear responsibility for all debts, or only those debts arising after the joint supervisory authority has been installed. The content of the proposal for a banking union is still subject to discussion. According to the current plan, joint banking supervision will take over supervising systemically important European banks as early as in mid-2013.

Despite the uncertainty on financial markets, Swedish banks have good access to funding, as shown in for instance the lower premiums for CDS contracts issued to Swedish banks. However, there is a risk of the situation changing if the economic downturn in the eurozone deepens. Read about FI's assessment of the risks for Swedish banks in the Banks and investment firms chapter.

RISK OF A PROLONGED ECONOMIC DOWNTURN

During the year, the global economy has weakened despite massive central bank measures to stimulate the economy. The debt-burdened countries in the eurozone have shown the weakest trend, but there are a growing number of signs to suggest that the economic trend in countries that were strong before, like Germany and Sweden, are also starting to become subdued.



Dotted lines are IMF's forecast.

The eurozone is approaching a recession[8] for the second time in three years. Unemployment has increased in the past year, chiefly in the debt-burdened countries. For example, Spain and Greece have unemployment around 25% and almost one young person out of two doesn't have a job.

Signs of the economy cooling off are also increasingly apparent in countries that have been the engine of the global economy in the past few years, such as China. The Chinese economy has slowed down in the past year. This is due to, for instance, weakened demand from Europe and the US. Other growth economies that have been important in buoying global growth, including Brazil, Russia and India, are also sustaining a weaker economic trend.

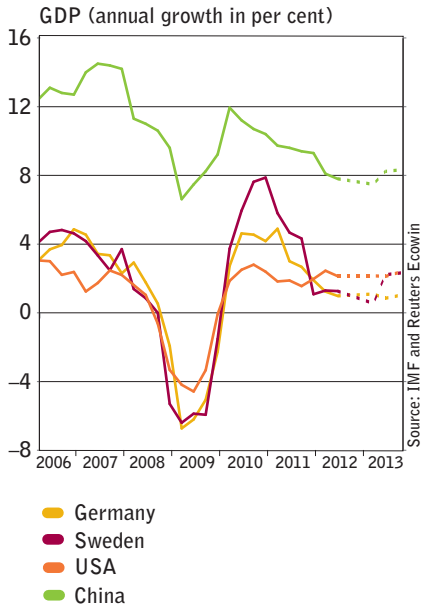
US growth has still not yet really gained momentum after the 2008 financial crisis, and there are now signs that the recovery will take time. Unemployment remains historically high and has been at around 8 per cent in the past three years. There is also great uncertainty about what will happen if they do not reach an agreement about the budget, and automatic fiscal policy austerity measures[9] kick in at the beginning of next year. This would slow down the recovery of US growth and probably also affect global growth negatively.

Slowdown in the Swedish economy too

Despite the weak economic trend abroad, Sweden has continued to show resilience throughout the year. In the first two quarters, Swedish growth was healthy and slightly above the expectations of market observers.

8 Two consecutive quarters of negative economic growth.

9 The so-called "fiscal cliff".



Dotted lines are IMF's forecast.

However, unemployment has risen during the year, and in the past few months signs have emerged of the economy heading for a weakening.[10] It is also probable that the Swedish economy would deteriorate if the recession in the eurozone is deep and drawn out.

Both Denmark and the Baltic countries are important markets for the Swedish banks. The situation in the Danish banking sector remains problematic, with several banks defaulting in the last few years. The tough austerity measures of the Baltic countries following the 2008 crisis have produced results and their economies are now recovering. However, there are downside risks for these economies in the event of a global economic slowdown or a rise in unemployment.

Since the autumn of 2011, the Riksbank has cut the repo rate three times. The rate is now at 1.25 per cent, which is the same level as at the beginning of 2011. According to the Riksbank's forecast, the repo rate is expected to remain low ahead, and there is a probability of the rate being further cut slightly.

10 Weaker labour market data, but also indicators such as the purchasing managers' index, the Riksbank's company interviews and the National Institute of Economic Research's confidence indicator have come out weaker.

Banks and investment firms

Swedish banks are currently well-capitalised and have, despite the uncertain situation on financial markets, had good access to market funding during the year. The greatest risk for the Swedish banks is linked to their major reliance on market funding, and the risk of the sovereign debt crisis in the eurozone escalating. Finansinspektionen (FI) is of the opinion that the mortgage cap has produced effects, which has slightly reduced consumer risks on the housing market. However, in the longer term, increased household indebtedness still constitutes a potential risk.

DEVELOPMENT DURING THE YEAR

The total assets of the Swedish banking sector[11] amount to just over four times Sweden's GDP, and the sector is dominated by the four major banks. In the past year, Swedish banks have benefited from the stable trend of the Swedish economy. The major banks have a high earnings level and are currently well-capitalised. To a great extent, they have already adapted to forthcoming higher capital adequacy requirements and demonstrate good resilience in the stress test's scenarios of a poorer economic climate. The economic trend on the major banks' domestic markets in the rest of the Nordic region and the Baltic countries has been relatively stable during the year. On the whole, this has meant that the Swedish banks have had access to market funding on good terms, despite the uncertainty that has prevailed on financial markets.

Earnings, credit losses and profitability

In the past year, the four major banks' combined earnings before credit losses increased by 3 per cent, while equity grew by 5 per cent.[12] The increase in earnings before credit losses is explained by an increase in the banks' net interest income. Net interest income, which constitutes almost 60 per cent of the major banks' income, has been strengthened thanks to higher interest rate margins.

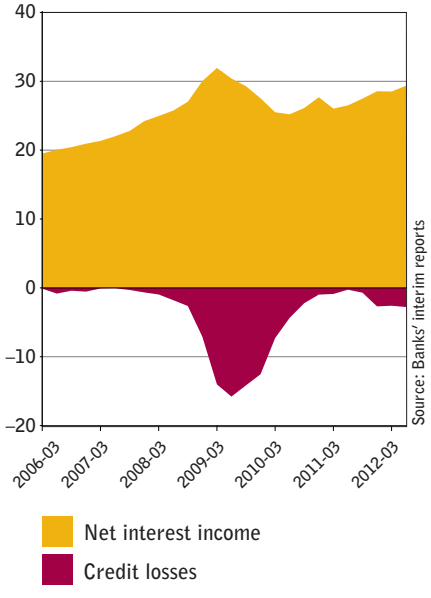
Total net earnings fell 3 per cent, however, partly explained by the fact that the reversal of previous provisions for credit losses no longer make a positive contribution to net earnings.The major banks' average return on equity has, however, decreased slightly, to just over 11 per cent in the past year. However, the underlying credit loss level remains low in most segments.

The other Swedish banks have also had a healthy earnings trend, although the credit loss level has increased slightly. Profitability of the investment firms remains poorer, however, and operating profit has generally declined compared to the preceding year. This is chiefly due to poorer earnings and the fact that their costs in relation to revenues have remained high.

Lending

Although the banks have largely already adapted to the forthcoming capital and liquidity requirements, lending to households and corpora-

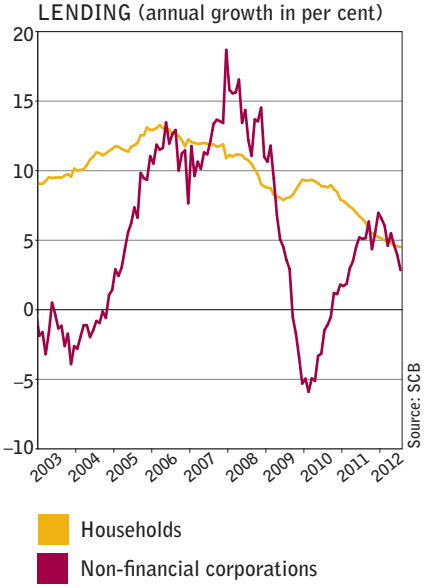
EARNINGS AND LOSSES
(billions SEK)



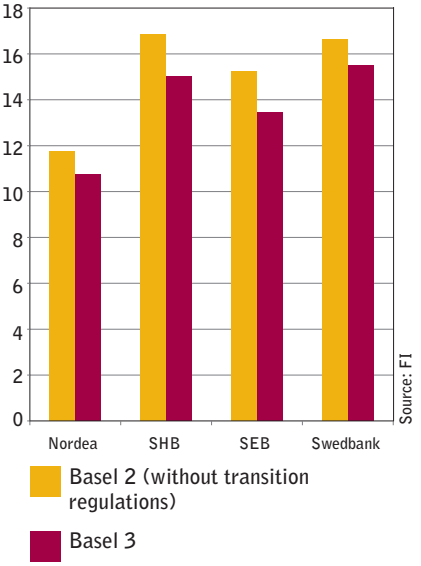
11 The banking sector in this report refers to: the major bank groups, other banks, investment firms and credit market companies.

12 Unless otherwise specified, the information refers to the period until the second quarter of 2012 inclusive. The period 1 July 2011 – 30 June 2012, compared to the preceding twelve-month period.

LENDING (annual growth in per cent)



COMMON EQUITY CORE TIER 1 CAPITAL RATIO (per cent)



Note. The part of Swedbank's share capital consisting of preference shares (corresponding to around SEK 8.7 billion) has been included as Common Equity Tier 1 capital. Swedbank's preference shares will be converted to ordinary shares in the first half of 2013.

tions is on the rise. However, growth in lending to households has been subdued from the high level a few years ago, and is now at the lowest level since 1997. One reason for this is the introduction of the mortgage cap in October 2010. Lending to non-financial companies has increased at a lower rate during the year, but remains positive, unlike the situation in the eurozone.[13]

Capital

The common equity Tier 1 capital ratios[14],[15] of the major Swedish banks have increased in the past year, and stood at an average of 14 per cent for the four major banks at the end of June. Converted to the Basel 3 regulation, the level would be cut by an average of 1.4 percentage points. Other regulatory changes will also affect the banks' capital levels going forward, such as accounting change IAS 19[16] and a potential change in risk weights for Swedish mortgages.

The increase in the capital ratios during the year is partly explained by retained profits, resulting from healthy profitability. Another factor is that the capital requirement, calculated without transition regulations[17], has decreased because the average risk weights on the banks' assets have declined. The lower risk weights are partly due to changes in models, and partly to changes in lending portfolios.

The goal of higher capital adequacy levels for the major Swedish banks presented in November 2011 means that the common equity Tier 1 capital ratio needs to amount to 10 per cent in 2013 and 12 per cent in 2015[18]. In relation to the minimum regulations of Basel 3, this involves a 5-percentage-point higher level for the common equity Tier 1 capital ratio in 2015. This can be compared with the phasing-in period of the Basel Committee to a 7 per cent common equity Tier 1 capital ratio until 2019. The sound capitalisation of the major Swedish banks at the outset, combined with a high profitability level, means that they have good possibilities of reaching the higher Swedish requirements.

Stress test of the major banks.

FI's internal stress test[19] carried out during the third quarter of 2012 confirms that the major banks, through their high underlying earnings levels,

13 According to the ECB's financial market statistics, lending to non-financial companies in the eurozone decreased by 1.4 per cent in September 2012 compared to a year ago.

14 Common equity Tier 1 capital refers to Tier 1 capital (chiefly comprising equity and profit in the company) less capital contributions and reserves which may be included in the capital base and as Tier 1 capital according to Chapter 3 Section 4 of the Capital Adequacy and Large Exposures Act (2006:1371) in relation to risk-weighted assets.

15 Calculated for the financial groups without transition regulations.

16 IAS 19 involves a changed accounting principle for employee remuneration (pension liabilities) as of 1 January 2013. A deficit in the difference between assumptions and provisions affects equity.

17 The transition regulations involve that at least 80 per cent of risk-weighted assets according to the Basel 1 regulations are to be used in calculating capital requirements during the transition period.

18 See http://www.fi.se/Regler/Kapitaltackning/Listan/FI-vill-se-hogre-kapitalkrav-for-svenska-storbanker/.

19 See www.fi for a more detailed description of the stress test model and outcome.

are well equipped to face high credit losses even in a scenario of a sharp economic downturn. In order to secure solid capital preparedness, it is required that the banks are able to implement tangible activities which improve capital adequacy when needed. FI believes that the major Swedish banks currently have such preparedness.

Stress tests are one of the tools used by FI in its supervision of banks. The tests are conducted on a regular basis to assess the banks' ability to withstand various negative scenarios. The stress tests are also used in the annual supervisory review and evaluation process conducted for each bank.

The stress test is based on publicly available information and the method is standardised, partly because it does not use a specific macro scenario based on the current status of the market, and partly because it does not take account of differences in the quality of each bank's exposures within various lending segments.

The banks' resilience is calculated based on a three-year scenario containing a sharp economic downturn. The scenario assumes that the banks experience lower earnings and higher credit losses. In the scenario, the credit losses are high in all industries and regions.

Results

In the stress test scenario, it is calculated that the combined total of credit losses of the four major banks is at around the same level as total combined profit before credit losses for the three-year period. At the same time, risk-weighted assets are assumed to grow, so the overall effect would equal a deterioration in common equity Tier 1 capital ratios of between 1.1 and 2.8 percentage points per bank, during the scenario period.

Simplified income statement for 2013–2015 (SEK million)

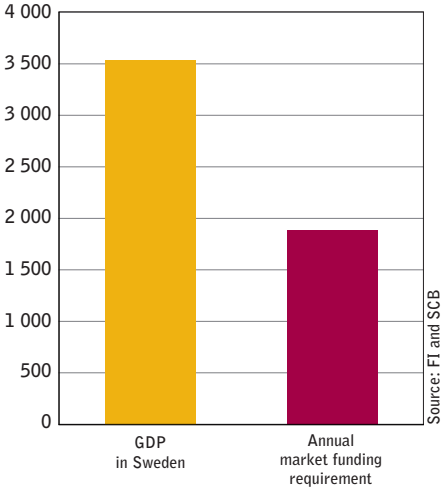
	Nordea	Handelsbanken	Swedbank	SEB
Profit/Loss before credit losses	119,665	52,032	50,093	44,285
Credit losses	124,669	50,128	45,104	48,490
Tax	663	567	1,155	83
Profit/Loss after tax	–5,668	1,337	3,834	–4,288
Dividend	766	686	1,533	102
Change in equity	–6,434	650	2,300	–4,390

During the period covered by the scenario (2013–2015), a number of regulatory changes will be implemented that will affect the banks' capital adequacy, chiefly the introduction and implementation of CRR/CRD 4 and IAS 19. The effect of the new regulations is estimated based on how they would affect the banks if they were introduced already today, and in this case a decline of a further 1.2 to 2.9 percentage points per bank is assessed on top of the effect of the stress test. The actual size of the effects when the new regulations are introduced depends on several factors, such as balance sheet compilation and the interest rates prevailing at the time.

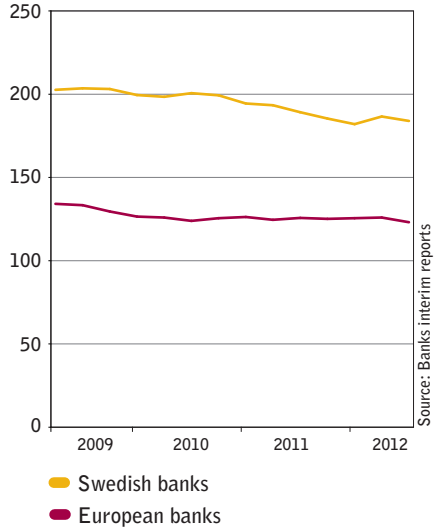
The stress test shows that the major banks have sound resilience in a scenario of a sharp economic downturn resulting in falling earnings and high credit losses in all areas. After deducting the assessed effects of forthcoming regulatory changes, not all banks would, however, have capital levels that fully cover the buffer requirements planned for introduction[20]. This involves, according to the forthcoming regulations, restrictions on, for instance, share dividends and bonus payments. FI believes however that all the banks have good possibilities of achieving sufficiently high capital levels thanks to high underlying profitability and sound capital preparedness. The major banks are

20 The capital conservation buffer and supplementary capital for systemically important banks.

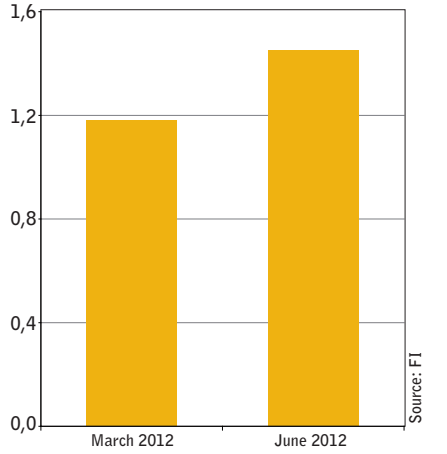
MARKET FUNDING
(billions SEK)



LENDING TO DEPOSIT RATIO
(per cent)

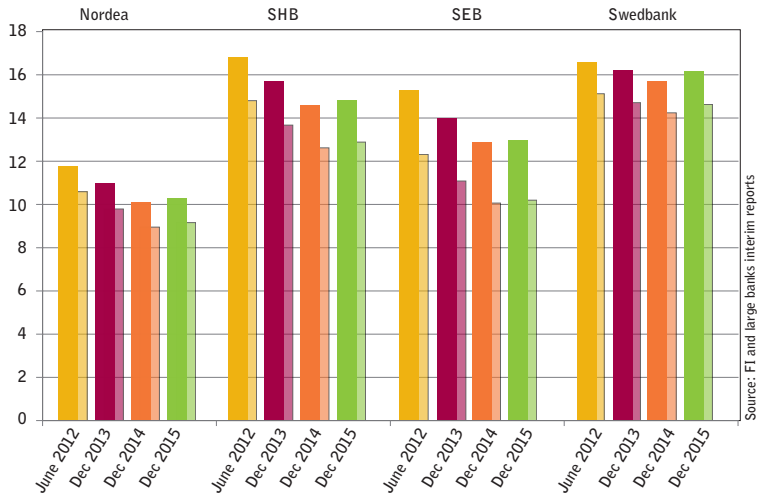


LIQUIDITY COVERAGE RATIO
IN LARGE BANKS



thus already working today with forward-looking capital planning in order to ensure that all capital buffers in the new regulations will be fully covered when the new regulations come into effect. FI is monitoring these efforts though an ongoing dialogue with the banks.

THE COMMON EQUITY TIER 1 CAPITAL RATIOS OF THE STRESS TEST SCENARIO
(per cent)



Note. The bars at the front show the result of the stress test with the current regulations. The bars at the back show the effects of the stress text when the forthcoming requirements are also included.

RISKS FOR BANKS AND INVESTMENT FIRMS

Sovereign debt crisis

The sovereign debt crisis in several European countries and poorer global economic outlook still represent the greatest risks to Swedish banks. The direct effects resulting from exposures to the debt-burdened countries have been small so far, but the indirect ripple effects could, in a negative scenario, have significant consequences and are also hard to predict.

Vulnerability in the Swedish banking system is linked to the major reliance on market funding. The financial savings of Swedish households consist to a lesser extent of bank deposits, compared to households in the rest of Europe. Instead, a large proportion of savings in Sweden consists of funds, shares and different types of insurance. An effect of the low deposit volumes in Sweden is that there is a significant difference between the banks' lending and deposits. The banks must primarily cover this difference with market funding, such as covered bonds. For the major Swedish banks, the annual market funding requirement equals over half of Swedish GDP.

The ratio between the major Swedish banks' lending and deposits, and hence the share of the balance sheet that needs to be funded on the capital market, has decreased slightly in recent years. The difference between Swedish and other European banks has also decreased slightly.

Almost two thirds of the banks' market funding occurs in foreign currency, largely in euro and dollars. This means that the banks rely on a smoothly functioning international capital market. The high proportion of foreign currency in borrowing is partly explained by the fact that the major banks have a large part of their operations abroad, and borrowing therefore occurs in a currency other than Swedish kronor. Another reason is the generally more beneficial terms in foreign currency compared to funding in Swedish kronor, where supply is limited. The latter part

can be replaced by funding in Swedish kronor, while the former cannot be replaced because it involves an actual need of foreign currency.

A sustained weak and uncertain trend in the eurozone and its banks could also involve a risk to the borrowing possibilities of Swedish banks. The major Swedish banks have, however, been increasing their liquidity reserves for a long time. They have higher buffers than a year ago, which reduces the risk in the event of disruptions on the short-term funding market. Although the Swedish banks currently have the possibility of managing moderately heightened market unease, the banks should, in a longer perspective, continue to strive for a higher share of stable funding sources, such as deposits, and longer funding durations.

Internal governance and control

Deficiencies in internal governance and control can manifest themselves in different ways, but often lead to weak risk control and compliance. It is also at times of market unrest that internal governance and control are most important. FI holds regular dialogues with the firms about internal governance and control in order to call attention to the fact that capital or liquidity reserves must be accompanied by sound risk control. On several occasions, FI has been forced to intervene against firms due to such very deficiencies in internal governance and control.

In terms of internal governance and control, FI has noticed several times that board members, particularly of small firms, do not allot sufficient attention or resources to governance and control. Heightened requirements in management assessments have, during the year, resulted in a number of new board member proposals being withdrawn.

These requirements have gradually evolved from focusing on strict checks to expecting companies under FI's supervision to largely demonstrate a holistic approach to their operations, including in particular the board of directors' work on targets, risk management and follow-up.

Risks of internal models

Since the introduction of Basel 2, the banks have had the possibility of applying for authorisation from FI to use internal models to calculate the

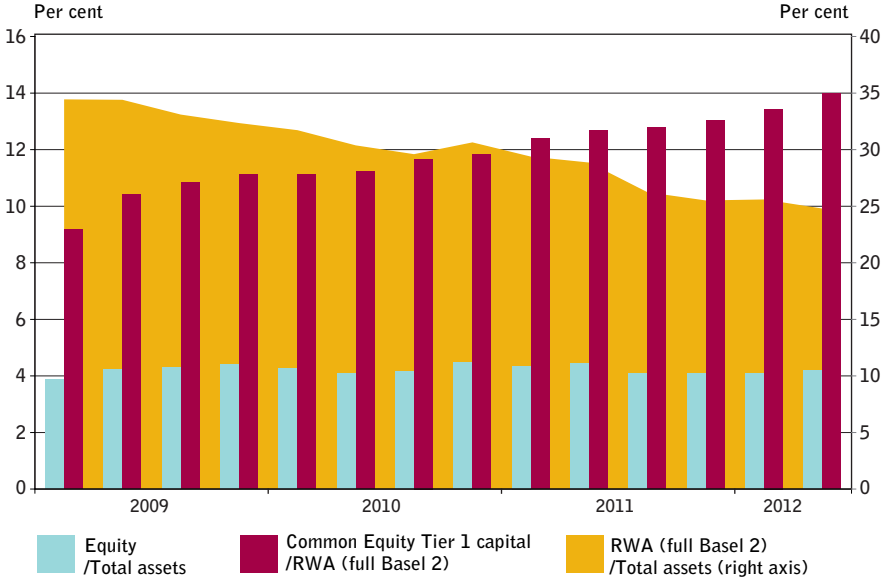
■ Forthcoming regulation of liquidity risk

FOn 28 June 2012, FI published a proposal for a quantitative liquidity coverage ratio (LCR) requirement and reporting liquid assets and cash flows. The proposal is based on the guidelines of the Basel Committee on Banking Supervision regarding calculating LCR, established in the autumn of 2010 and planned for introduction in the EU from 2015.

It is proposed that the requirement should apply to such credit institutions and investment firms that are highly dependent on market funding and can thus have a significant bearing on the stability of the financial system. It is proposed that the requirement be applied at aggregate currency level, but also in the individual currencies EUR and USD. This is to ensure good liquidity management also in the foreign currencies in which Swedish firms chiefly obtain funding, and where possibilities of liquidity support from the Riksbank are more limited.

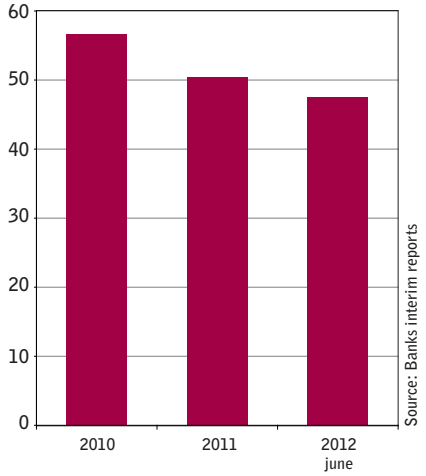
The new regulations are proposed to apply from 1 January 2013.

COMMON EQUITY TIER 1 CAPITAL, EQUITY AND RISK-WEIGHTED ASSETS (large banks)

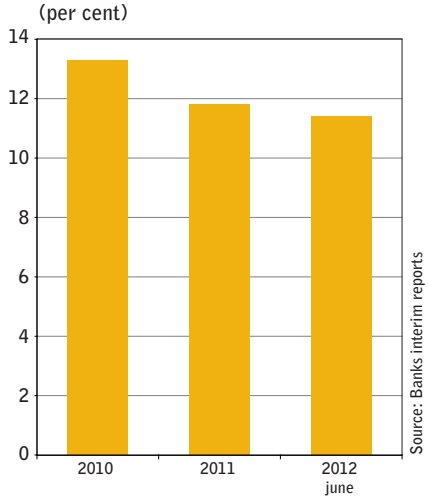


Source: Large banks interim reports

RISK WEIGHTS FOR NON-FINANCIAL CORPORATIONS (per cent)



RISK WEIGHTS FOR HOUSEHOLDS (per cent)



Note. Average risk weights for large banks' IRB-portfolios.

capital requirement for credit risk. The desired effect is partly for the capital requirement of the bank's various operations to be fairer, and partly for the bank to get better at measuring and understanding its risks. The models are based on historical data, e.g. by identifying explanatory links between incurred losses and various indicators. A shortcoming in this principle may, however, be an overestimation of the forecast value in historical relationships. If high loss levels only occur on very rare occasions, the historical data series perhaps do not reflect such unusual events. This can lead to the risk weights according to internal models being too low.

The effect on the capital requirement from the models is currently limited by still applying the Basel 1 transition regulations. The Basel Committee, EBA and Nordic supervisory authorities are investigating methods to reduce the risk of internal models underestimating the capital requirement. FI has already communicated that it deems that, in certain cases, the internal models lead to capital requirements for Swedish mortgages that are far too low. In order to reinforce the banks' resilience to future financial crises, FI is investigating how risk weights for mortgages can be raised.

Vulnerable IT systems

Nowadays, a growing number of consumers conduct their banking business online. The systems are also becoming more important, larger and interlinked within financial institutions. Cost cuts, flexibility and expertise requirements are common reasons for the banks contracting external suppliers to take care of their IT operations. Cost cuts sometimes lead to lower priority for system development, which can make the systems more vulnerable.

Swedish online banking services regularly come under attack from harmful code[21]. Such attacks are an international phenomenon and often come in waves. Because Swedish consumers conduct payment services online to a great extent nowadays and the development of online services has risen, access to payment services is crucial for individual consumers.

Operational disruptions that affect stability are unusual, but the consequences could potentially be very hard indeed to manage. However, several firms have suffered various incidents due to deficient change management routines. Changes ensuing from company mergers, cost reduction programs, product development and new technology place stringent demands on firms' change management routines. By this is meant that the changes increase the operational risks and it is important for firms to have sound routines to manage changes in a controlled manner.

Mortgages

FI is of the opinion that household mortgages do not currently constitute a threat to financial stability, and that the risks for consumers have decreased slightly. However, the risks on the mortgage market are interlinked and affect each other. Consumer risk pertains primarily to individual households borrowing more than they can manage in the event of e.g. unemployment or interest rate hikes. This risk usually accumulates when interest rates are low, like they are today. The stability risk chiefly comprises the high indebtedness among Swedish households, consisting largely of mortgages. High indebtedness involves a potentially height-

21 **Harmful code denotes harmful software often developed to wilfully harm a** computer. Examples of harmful software are viruses, worms or trojan horses.

ened risk to the national economy, involving direct and indirect risks to financial stability.

Last year, the trend of a steady increase in loan-to-value ratios for new mortgages witnessed almost throughout the entire 2000s was broken. A reason for this is the mortgage cap introduced in the autumn of 2010. The share of households with very high loan-to-value ratios, i.e. over 85%, has also decreased. The stress tests carried out on households in the mortgage survey's random sample showed that households that take out a new mortgage generally have good repayment capacity and resilience to loss of income, rate hikes and price depreciation on homes. Although resilience is generally good, the consequences can nevertheless be great for the individual households affected.

In the autumn of 2012, FI is once more conducting a mortgage survey, taking a random sample for the third time of new loans in order to evaluate the effects of the mortgage cap, gain more in-depth information about the mortgage repayment behaviour of households, and to perform stress tests to assess household resilience. The results from the survey will be presented in a report in the spring of 2013.

Encumbered assets

Encumbered assets[22] are assets used as collateral or that are otherwise pledged as security in the market funding of financial institutions. The purpose is to reduce the risk for investors and hence reduce the borrowing cost. Swedish firms pledge collateral mainly when they issue covered bonds[23], which is a result of how the Swedish banking system's mortgage funding is constructed. Purchasers of the bonds have right of priority in the event of bankruptcy or distraint. In certain other countries, institutions use securitisation[24] to a great extent instead, which often leads to higher borrowing costs and poorer credit quality.

Because of the large proportion of covered bonds, the level of encumbered assets is relatively high for several Swedish financial institutions. The matter of encumbered assets, and whether a high level poses a risk to financial stability, has recently attracted increasing attention internationally. Covered bonds have been a stable source of funding for Swedish banks, but a proportion of collateral that is too high may involve problems in the event of liquidity disruptions. At times of major unrest on financial markets, investors are most often interested in safe assets. They often require access to collateral, which firms that have already pledged their entire balance sheet lack. The risk of funding problems can also arise in the event of sharp price drops on assets, because in this event the firm can be forced to contribute further collateral, for instance to avoid a downgraded credit rating on its bonds.

Where Swedish banks are concerned, it is primarily illiquid assets that are pledged as collateral, such as mortgages. However, if a large proportion of more liquid assets (with major variations in market value) is pledged as collateral, e.g. government securities, the bank's sensitivity even to minor disruptions on the capital market increases.

22 **Asset encumbrance – assets with priority rights.**

23 **The covered bond market consists of both domestic and foreign investors.** Covered bonds are regulated in Finansinspektionen's regulations FFFS 2004:11 and in the Covered Bonds (Issuance) Act 2003:1223 in the Swedish Code of Statutes.

24 **In securitisation, institutions package various assets (loans) and then sell** them on to investors. The balance sheet of the institution therefore shrinks.

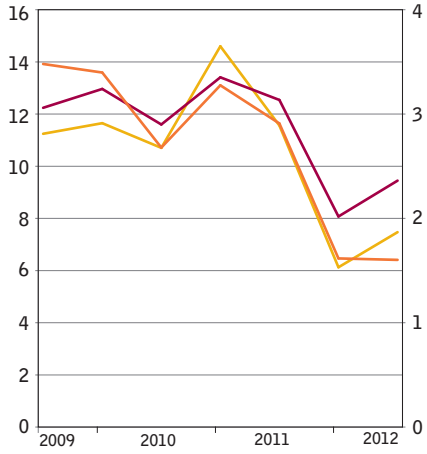
FI believes that, to a greater extent, financial institutions should, in connection with e.g. quarterly publication of financial information, publish the extent of the share of various assets in the balance sheet that are encumbered, and for which purposes. Better transparency would make it easier for external observers and reduce the uncertainty about the financing structure of firms, and its risks.

If too large a share of a firm's assets are encumbered, the risk could increase at the taxpayer's expense. This is because, in this event, the company would have fewer assets remaining to pay unsecured exposures, such as the government deposit guarantee. This is something that should primarily be addressed through the framework of crisis management of banks and the deposit guarantee being prepared in Europe.

Insurance and funds

The sovereign debt crisis has also continued to put pressure on the solvency of life insurance undertakings. The firms are affected by the fact that government bond rates in Sweden have dropped to record-low levels, and that stock markets have shown only a mildly positive trend. At the start of the summer of 2012, Finansinspektionen (FI) introduced a temporary floor for the discount rate. The measure aims to prevent regulation-driven portfolio changes which could harm consumers over time. The underlying problems of deficient market risk management persist at many firms, however, and will remain in the focus of FI's supervision.

SOLVENCY RATIO FOR LIFE INSURANCE UNDERTAKINGS



DEVELOPMENT DURING THE YEAR

Life insurance undertakings

The solvency of life insurance undertakings has, during the year, primarily been affected by the performance of financial markets, and the rate trend in particular. The firms have long-term commitments in the form of promises of future payments of pensions and insurance. These commitments extend far into the future, often more than 40 years. The valuation of the commitments is based on present value calculations based on a discount rate determined based on market rates.

When in the second quarter this year and as a result of the sovereign debt crisis, investors sought out countries perceived to be safe, including Sweden, there was a sharp drop in Swedish market rates. A result of this was that the solvency of Swedish life insurance undertakings and occupational pension funds deteriorated quickly, because the discount rate for the financial commitments (liabilities) of the insurance undertakings dropped sharply.

In such a situation, a firm with weak solvency can attempt to reduce the market risk. The firm achieves lower risk by, for example, selling shares and buying bonds. Because the supply of bonds with long maturities in Swedish kronor is limited, the actions of the individual firm can push rates even lower, hence worsening solvency further, both for the firm itself and for others. However, such short-term action mainly affects policyholders and other parties entitled to payment. Major financial values are destroyed if the firm is forced to sell risky and illiquid assets in a stressed market, and low returns are locked in for a long time.

At the end of May, FI held the opinion that market rates had reached such low levels that they could trigger further and extensive portfolio changes. It could also be questioned as to whether the rate levels gave a reasonable portrayal of the return that insurance undertakings could expect in the long term. In order to prevent the risk of short-term market changes forcing portfolio changes with harmful long-term consequences for policyholders, FI decided in June to introduce a time-limited floor for the discount rate. Between 30 June 2012 and 15 June 2013, insurance undertakings and mutual benefit societies have the possibility of calculating technical provisions[25] in an alternative way. This provides the firms with the possibility of calculating the discount rate based on prices

■ Present value calculation of insurance liabilities

The present value of the firms' commitments to policyholders is calculated using applicable regulations with a discount rate established based on current market rates. If market rates decline, the value of the firm's assets and liabilities to policyholders increases. However, the level of the liabilities rises much more if the rate falls because the maturity of the liabilities is much longer than for the assets, which means that rate differences sharply affect the liability.

25 **Must equal the amount required for the insurance undertaking to meet its** commitments towards policyholders and parties entitled to payment, i.e. life insurance provisions and provisions for outstanding claims.

prevailing on 31 May 2012 instead of current ma rket prices.

Any valuation gains arising due to the regulations should not leave the firm. The regulations are therefore supplemented with general advice stating that firms which use alternative calculations should be restrictive with dividends and other value transfers. The temporary rate floor provides the insurance undertakings with more time to adapt their operations to future changes in market circumstances. The temporary rate floor is thus no permanent solution to the underlying problem at certain firms, with guaranteed benefits that are unsustainable in the long term.

Non-life insurance undertakings

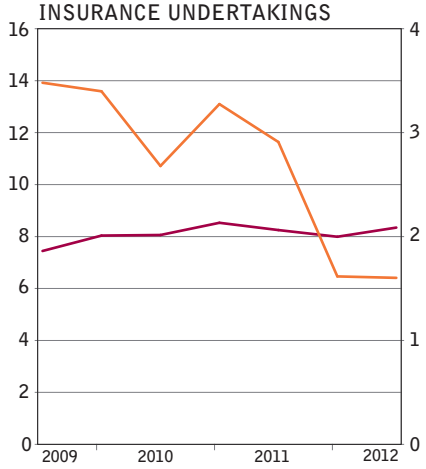
The non-life insurance undertakings generally have good solvency. A number of small local insurance undertakings have merged during the year. These mergers are not deemed to affect consumer protection or financial stability.

RISKS TO INSURANCE AND FUNDS

Market risk management of life insurance undertakings

Many life insurance undertakings and occupational pension funds have obligations nowadays which extend far into the future and give rise to a major rate-sensitive debt that is hard to match[26]. The situation last spring is an example of how solvency weakens when market rates decline, and how the problem can be acute for certain firms. In that situation, flexibility is limited. Reducing the rate risk in the market in a stressed situation is expensive, or can be impossible. The firms have limited possibilities of changing entered agreements, especially in the short term. It is easier for life insurance companies to obtain external contributions from shareholders than mutual companies, which are owned by the policyholders themselves. Because firms with weak solvency have limited flexibility, it is important that the firms work on preventing imbalances. Excessive risk-taking, unsuitable valuation models and short-term product design are factors that can cause problems in both the short and long term.

SOLVENCY RATIO NON-LIFE INSURANCE UNDERTAKINGS



Since 2006, the valuation of life insurance companies' commitments have been based on market rates. This involves market risks, and in order to absorb these, a greater buffer than previously is required. If the firm has a balanced market risk level on its balance sheet, the probability of the firm being forced to buy and sell in unfavourable market conditions is low.

Accurate, regular valuation of the firm's commitments is fundamental to its ability to manage market risk. Many insurance agreements with guarantees can resemble structured products, and for these commitments, the choice of valuation model must be made with care so that the model captures all substantial risks. The choice of valuation model does not only affect the value of the commitment and the company's provisions, but also how market risk is measured. If the valuation and provisions are too low, the probability of the firm failing to meet its commitments increases. With poorer risk measurement, it is harder for the firm to control investments and achieve the desired risk profile.

It is possible to prevent imbalances when designing new products. Even if the firm wants to bring an attractive product to the market quickly, in

26 See the report Risks in the financial system 2011, http://www.fi.se/Press/Pressmeddelanden/Listan/Risker-i-det-finansiella-systemet-2011/.

the long term it may be worth drawing up the insurance terms in such a way that the firm can manage the risks in the commitments. The terms for customers in long-term insurance agreements can be drawn up based on the possibilities of hedging the risks in financial markets. Products sold today can give rise to commitments that last for decades. The regular valuation of the commitments and the investments made should, however, provide an up-to-date and accurate presentation. If pricing is fully or partly locked throughout the entire term of the agreement, this leads to a risk for the firm. However, if it is possible for the firm to adjust pricing during the term of the agreement, the risk of major imbalances accumulating decreases.

Unclear information for consumers

FI has placed requirements on firms reviewing their commitments so that they are sustainable in the long term. Several firms have already commenced such efforts by reducing guarantees on new policy subscriptions and adapting the design of the products. Although the firms' measures are necessary in the long term, they can be associated with risks for certain consumers. Risks for consumers lie in firms' offers of changed terms, transfers or switches. There are particular problems in terms of private pension insurance. Consumers are generally at a disadvantage in terms of information, and there is a risk that firms present information that leads consumers, based primarily on the firms' own interests.

FI wishes to issue a reminder that normal game rules apply to offers of changed terms. Firms may not take advantage of consumers' lack of knowledge. Those wishing to exit entered agreements should be able to do so on market terms. If a consumer was given a commitment regarding future pension amounts, it is primarily the firm that should cover any deficit in the existing agreement in the event of a change in terms, at least if the firm is owned by parties other than the policyholders.

The pension reform has meant consumers having to make an increasing amount of decisions themselves. Many think it is hard to make the choices required. Many consumers have learned to be vigilant in terms of fees on their savings. Recently, FI has seen how firms use changes in fees to get customers to move their savings to better suit the firm. In FI's view, there are examples here than can be misleading.

When consumers take a position on an offer of changed terms, they should naturally take into consideration the fees in both the existing solution and the offer. However, consumers should also think about their overall financial situation and view of risk. The choice of a savings product may depend on age and other savings. Individuals also have varying risk tolerance. It is important to know the values and benefits taken on and turned down, respectively, when transferring savings. The firm will present the benefits of the solution to which the consumer is switching, but it is also important that consumers understand the benefits they relinquish in a switch.

Normally, the offers of changed terms in question involve a higher expected return, but also a higher risk because the guaranteed benefits diminish or are removed completely. The individual consumer is thus given the possibility of a higher return than in the existing guarantee product, but the outcome can also be much worse. It is important that consumers understand how the risk in the savings changes.

FI monitors the offerings of changed terms or transfer of the life insur-

■ Valuation and internal pricing

How a firm prices a product internally shows if the firm has actually understood the risk. If the firm underestimates the risk and sets a price that is too low, this can have long-term and serious consequences for the solvency of the firm. Internal pricing of products starts with the valuation of the obligation that arises. A product valued and priced too low can become a commercial success. It can take a long time for the firm to discover what it will cost to fulfil the commitments, but by that time a large stock can already have been built up.

A profit-distributing firm can choose to use internal pricing as a control measure. If the cost of the subsidy is appropriately allocated in the organisation, the incentives are healthy. Subsidising is more difficult for mutual firms because the scope for action is limited by the contribution principle, which involves bonuses being distributed according to how policyholders contributed to the surplus.

ance companies in the interests of consumer protection, and is currently investigating the conditions for taking measures.

Deficient internal governance and control at management companies

A few years ago, FI called attention to the deficiencies in the control functions of management companies, and how they were designed and organised. FI also saw certain inactivity among the boards, whereby several management companies had not implemented the changes in compliance regulations that started to apply as early as in 2008.[27] In light of this, the focus of supervision of management companies has been on internal governance and control in recent years, and on the work of boards with these matters.

A prerequisite for a board and management to have sound control of the operations is that the control functions are appropriately designed and staffed, and that there is a sound control environment, that independent controls are carried out and that the board receives regular reports. This is ultimately the responsibility of the board. In order to demonstrate that the board is active, documentation is required that demonstrates the activity and measures of the board. It is therefore important that the board documents its own work and any measures taken.

It is important for the companies to work with this continually because regulatory changes occur frequently while the market evolves quickly. In recent years, FI has intervened against several management companies due to deficient internal governance and control, but can now see examples of measures having been taken.

27 See Chapter 6 of FFFS 2008:11.

Securities markets

Central counterparties will play a greater role on derivatives markets following a European regulation. Finansinspektionen (FI) believes that the increased use of central counterparties is positive, but that it also brings about fresh challenges, both for supervision and for the central counterparties. Securities trading is otherwise more fragmented than before. This has led to reduced transparency and hence to more difficult supervision, both for trading venues and supervisory authorities. The Markets in Financial Instruments Directive (Mifid) is currently being updated, which may to a certain extent reduce the new risks and problems brought about by the fragmentation.

The structure of securities markets has undergone major changes in recent years, primarily due to new legislation but also to technological developments.

In the financial crisis of 2008, acute fears emerged on financial markets. One reason for this was the situation on derivatives markets, where great uncertainty prevailed about which exposures various financial institutions had, and to whom. International efforts are thus under way, in the EU through the European Market Infrastructure Regulation[28] (EMIR), with the aim of more derivatives being cleared through central counterparties and information being recorded in transaction registers.

Mifid, which came into force in 2007, involved deregulation of trading in financial instruments aimed at, for instance, increasing competition on securities markets. However, the deregulation resulted in more fragmented trading, giving poorer possibilities of monitoring trading. At the same time, trading has also changed due to technological developments and globalisation. For instance, high frequency and algorithmic trading has increased, but the investigation into high frequency trading in Sweden presented by FI at the beginning of the year showed that the negative impact on trading of high frequency trading is less than feared.[29]

RISKS ON SECURITIES MARKETS

Increased concentration to central counterparties

The 2008 financial crisis shed light on the difficulties in gaining an overview of counterparty risks on the derivatives market in the global financial system. Regulatory efforts aimed at enhancing the transparency of the derivatives market and increasing the use of central counterparties have been under way in recent years. In Europe, the regulations have just been decided. EMIR aims to reduce risks related to trading in OTC derivatives and increase safety in the central counterparty. The regulations bring about a series of positive effects, chiefly in the form of reduced counterparty risks. While FI takes a positive view of the extended obligation to use central counterparties in derivative transac-

28 The EMIR is an EU regulation, meaning that it will be directly applicable in Sweden. The regulation will be supplemented with detailed provisions in the form of technical standards drawn up by ESMA – the European Securities and Markets Authority. In addition, EMIR must be supplemented with Swedish regulations regarding supervision powers for FI and sanctions.

29 See http://www.fi.se/Utredningar/Rapporter/Listan/Kartlaggning-av-hog-frekvens--och-algoritmhandel/.

tions, it also means that the importance of these firms to financial stability increases. It is therefore crucial that sound risk control is maintained among the central counterparties.

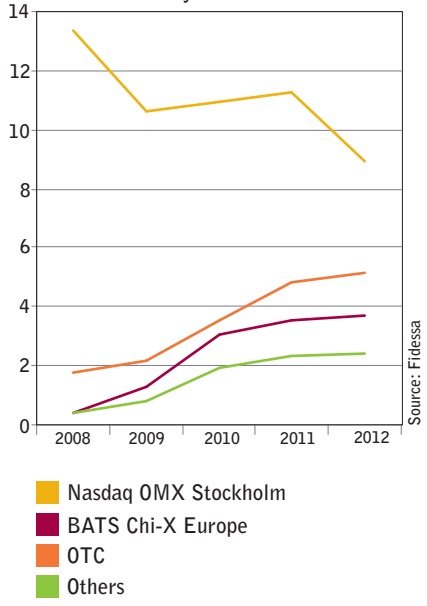
Central counterparties and clearing

For a party closing a securities contract, it is important to be able to rely on the counterparty's ability to fulfil its commitment. This is secured on most trading venues through a central counterparty. A central counterparty is an institution that enters as the seller for all buyers and the buyer for all sellers for the financial instruments being traded. This means that the central counterparty is responsible for the agreements being fulfilled vis-à-vis buyers and sellers, which constitutes clearing. Counterparty risks are thus concentrated to the central counterparty, which assumes responsibility itself for verifying the creditworthiness of each counterparty, and requesting collateral.

There may be initial difficulties for the central counterparty to obtain reliable price benchmarks in terms of certain OTC derivatives, which in turn makes it harder for the central counterparty to establish the collateral level that should be required. Insufficient collateral in relation to risks involves an increased risk of the central counterparty defaulting. However, EMIR contains detailed rules about how central counterparties should protect themselves and their members against losses. For instance, the members must contribute to a joint losses fund. If in the future a central counterparty nevertheless experiences major problems, this may have tremendous consequences for financial stability and market functioning. It is therefore important that regulations are in place to manage the reconstruction and winding-up of these players.

In Sweden, Nasdaq OMX Stockholm (NOMX) conducts central counterparty clearing which is in turn supervised by FI. FI will lead a supervisory college for Nasdaq OMX Stockholm in accordance with the regulations of EMIR. Swedish financial institutions will use foreign central counterparties and will hence be exposed to them. FI may participate in supervisory colleges for foreign central counterparties.

TRADING VOLUME
(billions SEK/day)



Deficient transparency on securities markets

In previous risk reports, FI has mainly discussed the problems with stock market transparency, and the effects of this on confidence and market functioning.

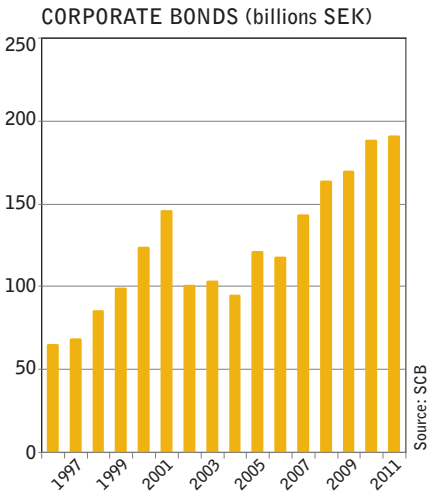
Transparency requirements in terms of the publication of share price information, irrespective of whether the shares were traded on or outside of a trading venue, were introduced through Mifid. Nonetheless, it is deemed more difficult today for investors to gain a holistic view of trading in a share. Trading today is dispersed over many different trading venues, and often over national borders, while at the same time gaining access to consolidated share price information is costly. A current update of Mifid should reduce the problems.

In OTC trading in particular, the transparency and quality of the information published by market players is unsatisfactory. On the stock market, parts of trading take place on trading venues in which order information is concealed because large order volumes can be closed without appreciably affecting the market price, unlike a trading venue with an open order book. However, this occurs at the expense of transparency.

Following the financial crisis, it has become increasingly apparent that there is a need for better transparency also on other securities markets, not just the stock market. The sovereign debt crisis and the Libor scandal[30] have brought to light the importance of confidence in the market, not least in terms of bank and state funding.

Deficiencies in reference rate transparency

In June, the FSA in the UK decided on a fee for Barclays Bank because they had manipulated the Libor reference rate. Reference rates and how they are calculated have come under scrutiny after the financial crisis, because there were suspicions that banks had manipulated the setting of interest rates. Investigations have shown deficient frameworks and routines at individual banks and, in certain cases, manipulation. The rates are important because they are used as reference rates for a large proportion of loans for consumers and companies, but also for large volumes of derivative contracts. A review of reference rates is currently under way both at the national level in several countries and also within the EU and Iosco[31]. Increased regulation of reference rates is in store. There are proposals today for clearer wording in the proposal for revised market abuse regulations. In Sweden, the Riksbank carefully follows work regarding Stibor, and the participating banks are conducting an investigation. FI wants to see increased transparency for the general public as to how Stibor is set, as well as a clearer framework.



In the past few years, activity on the Swedish corporate bond market has gained momentum. Since the turn of the year, corporate bonds to a net value of around SEK 20 billion have been issued on the Swedish market. A growing number of companies state that they seek market funding as an alternative to bank loans and other funding. This is visible in the fact that the number of issuers has increased, and a greater spread in creditworthiness has come about. However, market funding continues to constitute around as large a share of the total funding of non-financial companies. Previously, the market consisted primarily of large companies or municipalities with good creditworthiness, which issued relatively large volumes now and then. There are now more, smaller issuers, often lacking a credit rating, with lower issue volumes and with pricing largely determined by analysing the company's credit risk.

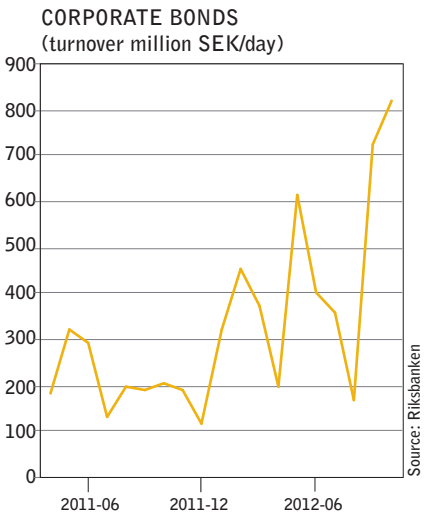
Buyers of corporate bonds have traditionally been large credit institutions such as insurance companies. These investors have, to a great extent, kept corporate bonds to maturity, which has meant lower trading volumes on the secondary market than for government and housing bonds. However, corporate bonds have grown in popularity as an asset class in funds, and are today a product offered to private individuals. There is increased demand among these investors for better transparency of pricing and volumes for analysis and valuation.

The corporate bond market

The corporate bond market is only partly a market maker market. This means that the bank(s) and investment firm(s) which act as the issuing institution

30 For more information about Libor, see http://www.bbalibor.com.

31 The International Organization of Securities Commissions, which is the international organisation for securities supervision.



Note. This diagram includes, besides bonds issued by non-financial companies, municipal bonds and non-covered bonds issued by financial institutions.

for a company can also guarantee part of the liquidity. This is voluntary, however. This means that, if the bank acting as the issuing institution cannot sell on the volumes undertaken, it might be forced to put the corporate bonds in its own stock. The bonds then remain in the bank's stock until the bank finds a buyer at a later date. In cases where such volumes equal large amounts, this involves a greater risk for the bank during the period it carries the bond on its own balance sheet.

Swedish regulations include a transparency requirement for the bond market that goes beyond Mifid. There is satisfactory information today about pricing and traded volumes on the market for both government and covered bonds. The corporate bond market has the same rules, but the corresponding information is missing. In order for a market to function properly and efficiently, several factors must be weighed up. Sound transparency is however important for efficient and smooth markets.

According to FI, improved transparency on the Swedish corporate bond market is crucial. The current review of Mifid will probably involve greater transparency requirements than currently. FI is of the opinion however that the increased interest in corporate bonds justifies the change towards better transparency starting already now.

Insufficient stock market supervision

In Sweden, the trading venues[32] have long had a responsibility for monitoring trading and supervising the listed companies' provision of information. Trading venues that exercise solid supervision boost confidence both in the market as a whole and in their own trading venue, which adds to the efficiency of trading. There is however an inherent conflict of interest in trading venues having to exercise supervision of their customers. While the emergence of conflicts of interest on the financial market is not in itself unusual, it is important that they are correctly addressed. Increased competition between trading venues risks undermining supervision, whereby statutory requirements are met with the smallest possible margin.

The regulations about market abuse form an important part of stock exchange supervision. Market abuse involves investors inappropriately using insider information or influencing the price of a security for their own gain. This damages confidence in securities markets. Just like investors, those responsible for market monitoring on a trading venue do not always have a holistic view of trading in an individual financial instrument, because this often occurs on several different trading venues. A system for efficient cooperation and exchange of information between the supervisory functions of different trading venues is currently lacking. Harmonised legislation at the EU level is an initial step in the right direction in terms of establishing a solution to the issue.

The trading volumes are statutorily responsible for real-time monitoring of trading, and in turn FI is responsible for supervising the trading venues. It is crucial that the trading venues' monitoring keeps up with market developments, because the possibility of detecting market abuse depends on the monitoring resources of the market places. In this context, high frequency trading poses an important challenge. The trading venues must also actively work to achieve better coordination between

32 **Market for trading in financial instruments, for example stock exchanges,** MTFs (multilateral trading facilities) or investment firms which organise trading.

trading venues in order to detect market abuse. Securities institutions also have a responsibility to report suspicious behaviour.

Vulnerable IT systems

The operational risks in the technical environments of financial institutions has risen considerably. Technological developments have enabled increasingly complex system environments, and also the links between different markets and participants are growing in number and scope in real time, which also increases the risk of problems spreading in the event of disruptions. In the last few years, a large increase in the amount of messages in order-routing[33] and trading systems has been observed. The increasing degree of automated trading, such as algorithmic and high frequency trading, occurring at increasing speed, contributes to the large amount of data. This places great demands on firms' routines to control the systems and having functioning processes for this. It is very important that the firms have satisfactory system support in order to be able to detect and rectify any problems at an early stage. An example of a serious incident is Knight Capital of the US, which in a short time lost a very large amount of money due to software errors.

Knight Capital

On 1 August 2012, the computer-assisted system of trading firm Knight Capital issued millions of erroneous orders to the market for 45 minutes before the error was discovered. This caused major abnormalities in the prices of 148 companies listed on the New York Stock Exchange. One of the companies was Wizzard Software Corporation, whose share price appreciated by 322%. Knight Capital lost USD 440 million and was on the brink of ruin. The reason was errors in the software following a system upgrade.

Intrusion attempts have increased and become more advanced than before, which involves risks of interruptions in securities trading. In the past year, there have been reports of intrusion or intrusion attempts among a number of stock exchanges around the world. So-called overload attacks against financial institutions have also increased. This risks creating disruptions in terms of access to financial information and online services. For example, at the beginning of 2012, overload attacks were launched simultaneously against several major stock exchanges in the US. The overload attacks caused temporary trading stops.

Incidents at firms under FI's supervision have also been observed. The events were minor in nature but were able to occur due to unsatisfactory risk control. Although the events have been relatively few and comparatively minor in scope, it is crucial that financial institutions maintain satisfactory risk control as regards their technical systems. If an incident, due to deficient risk control or IT attacks, affects a systemically important institution, this could have consequences for the stability of the financial system.

33 System for forwarding orders using algorithms. For example, an order, in whole or in parts, sent from an end customer via a bank or brokerage to one or several market places.

Risks for Swedish consumers

Finansinspektionen (FI) highlights this year too the risks of unsuitable investments. This is because the products offered are complex, but also because they are linked to complicated remuneration and fee structures that entail conflicts of interest. Advisors do not perform sufficient suitability assessments of customers, and often lack relevant knowledge themselves. The risks of micro loans and deposit institutions which are only registered but not under FI's supervision are also still a problem.

CONSUMER RISKS ON SECURITIES MARKETS

Complex savings products with hidden fees, unclear and often very high risks and return potential that is hard to understand exist on the Swedish private market. In the last few years, return potential on the stock market has diminished and interest on savings is low. This has led private individuals to seek complex products which often come with promises of high returns.

Complex products

The complex products contain a complicated structure in terms of fees, risk and expected return. Overall fees and remuneration are generally high in complex products. There can be hidden fees and remuneration for the intermediary or distributor. The information about the costs of the products given to customers upon investment, often presented as an initial fee and in many cases recalculated per year over the product's duration, is directly inaccurate if the customer does not keep the product for the entire duration. In its regular supervision work, FI has noticed cases of complex products maturing prematurely. The fees can also be charged directly to the invested amount, which means that a good return is required just for consumers to get their investment back.

It is hard to understand both the risk level and expected return in complex products. The risk level in these products is usually unclear because they contain several underlying financial instruments which can affect the ultimate risk and return. It can also occur that peak levels in the underlying financial instruments or certain periods of time in the duration of the products are omitted.

FI concludes that there are products that are not suitable for anybody in light of the built-in fees, the product's unclear and often high risk, and the conditions that have to be fulfilled for the product to generate return. It is hard for customers to understand and obtain sufficient information about complex products.

Unsuitable advice

A private customer often has insufficient knowledge to understand complex products. Deficiencies in the suitability assessment of the advisor, such as identifying the consumer's risk profile, prior to recommending a product to the consumer thus creates major risks of consumers being given improper investments that do not suit their needs. It is the responsibility of advisors to both clearly inform the consumer about the risks of an investment, and document their suitability assessment.

The advisor possessing sufficient financial knowledge is fundamental for both an accurate suitability assessment and appropriate information for

consumers. FI sees a significant risk for consumers in advisors with insufficient financial knowledge providing advice about complex products. FI also sees a risk in firms underestimating the need for quality control of the training programs attended by their employed advisors. Employed advisors possessing sufficient training that is appropriate for the operations is ultimately the responsibility of the firm.

The complexity and high built-in charges of the products have contributed to possibilities of paying out high commissions. The conflict of interest created by high remuneration for the advisor while the advice should be adapted to the customer's needs creates major consumer risks, which are intensified further by deficient information for customers.

The fees of the products place high demands on information.

The fees for complex products visible to the customer often include a commission of e.g. 2 per cent. Many customers do not understand that, besides the commission, charges can be made directly to the customer's investment, which often comprise commissions for the advisor amounting on average to around 4 per cent. On top of this, the distributor's overheads are often built into the product's structure as fees. It is not made clear to customers that the entire fee can be charged upon investment. This results in the customer's initial investment being immediately undermined when the product is launched.

Information for consumers regarding how the advice is affected by the firm's incentive to sell certain products is rarely sufficient, despite detailed regulatory requirements. There is a clear risk that the products discussed when advice is provided are those that generate the highest commissions for the advisor, and not those that are most suitable for the individual consumer.

FI recommends a commission ban

The fact that many advisors on the market get paid through commissions gives rise to conflicts of interest. In 2012, FI has collected information about commission income for insurance intermediaries. FI sent out a request to 323 companies authorised to mediate life insurance and 99 per cent of the firms stated that they have remuneration through commissions. About half of the companies stated that they also receive commissions for financial instruments other than fund units within insurance. Since January 2011, FI has recommended a commission ban in insurance mediation, because it is very hard to combine such commissions with advice in the customer's interest. FI views this need to be particularly high with regard to investment advice within insurance mediation. In the new intermediary directive (IMD 2), a commission ban is proposed for independent intermediaries. FI believes that this does not suffice because there is a great risk that customers will still be given advice from advisors who get paid through commissions, and it is hard for customers to understand that the advisor is not independent.

Depository insurances[34] have enabled the sale of complex products within the insurance mediation authorisation. However, for the customer there is an increased risk of unsuitable advice if depository insurances are primarily used to enable the intermediary to sell a complex product. The insurance might turn out to be an unnecessarily expensive storage area for the consumer's financial instruments compared with an ordinary securities depository, especially if commissions govern the advisor's insurance solution recommendation.

Complex products in a depository insurance policy can involve additional costs

The fees a customer must pay for an investment solution consisting of one or several complex products within an insurance policy includes the fees for the depository insurance on top of the cost of the products. The insurance itself can be associated with an annual fee based on a percentage of the value of the assets, or premiums paid. FI has also observed insurance solutions on the market in which an annual service fee has been added calculated on the value of the assets, as well as other administrative fees. If a customer wants to make a premature withdrawal from the insurance, this is often associated with high redemption fees. Certain fees and taxes are charged irrespective of whether the value has increased or not. It is therefore required that the products contained in the insurance generate a much higher return than otherwise in order to offset the fees and tax charged to the insurance.

The relatively low entry barriers to the insurance mediation market, and the risk of intermediaries revoking their authorisations ahead of sanctions and hence of there being no possibility of preventing them from applying for a new authorisation, have made it hard to keep dubious players away from the market. FI is therefore working with an extended authorisation procedure for insurance intermediaries, monitoring of intermediary companies within regular supervision and clarifications regarding the regulations regarding order management among insurance intermediaries and investment firms.

Micro loans and deposit institutions

For several years, FI has been raising the problems associated with certain firms only being registered with FI, while others have received authorisation and hence come under FI's supervision.[35] There is a significant risk that consumers believe that registered firms come under the same supervision as those with authorisations. In the past year, the cases of a growing number of consumers have ended up at the Swedish Enforcement Agency due to micro loans and the increasingly aggressive marketing of deposit institutions. This involves heightened risk for consumers.

Micro loans

The positive developments for consumer protection on the micro loan

34 Depository insurance is life insurance with a savings structure, in which policyholders themselves choose how the savings should be invested, and hence assume the risk of the policy's value performance. The assets are placed in a depository at a bank, investment firm or insurance company. The content of depository insurance is subject to standard tax instead of the investor paying tax on gains and dividends.

35 See http://www.fi.se/Utredningar/Skrivelser/Listan/FI-vill-ha-tillsyn-over-snabblaneforetagen/.

market predicted in the last risk report have failed to emerge. Despite stricter rules and the supervisory efforts of the Swedish Consumer Agency, the Swedish Enforcement Agency has reported a great increase, of about 70 per cent, in the number of cases in the first half of 2012.

FI is currently in discussions with the government and the concerned authorities regarding how to address the problem. The increased powers of the Swedish Consumer Agency were a step along the way, but FI believes as it did before that firms offering credits to consumers should seek authorisation from FI and be subject to regular supervision with the possibility of sanctions.

Deposit institutions

There are around 30 firms and associations authorised by FI to receive deposits from the general public. The funds received by a deposit institution from its customers are not protected by the government deposit guarantee. If a deposit institution encounters difficulties, there is a risk of the firm's customers not getting their money back. There is also a risk that, following problems at one deposit institution, the customers of other deposit institutions also want to withdraw their money, giving rise to dissemination risks.

In the past year, FI has noticed increasingly aggressive marketing from some of the deposit institutions, which practically compete to have the highest deposit rate and hence expand the quickest. Interest rate levels of up to 10 per cent are currently being offered. In order to live up to such commitments, the firms must take significant risks in their business operations.

Deposit institutions are obliged to have a capital buffer of SEK 10 million in restricted equity. For economic associations, the requirement is SEK 5 million. The size of the capital buffer is not reliant on the risks taken by the firm with the loaned money, but is determined at a fixed amount. FI can conclude that in most cases, the capital buffer requirements do not suffice in the event of the firms encountering financial problems.

FI primarily believes that, for the sake of consumer protection, receiving deposits should only be permitted for firms with authorisations, such as banks or credit market companies, and which are covered by the deposit guarantee.

Glossary

Algorithmic trading Trading where orders are generated by an electronic system based on pre-determined instructions and parameters. An example of this is high frequency trading, in which investment decisions are made very quickly by a computer that has been programmed to read market movements and the behaviour of various players.

Basel Committee/Basel regulations The Committee that negotiates the regulations for banks and credit institutions that will apply on a global level. Examples of accords include capital requirements for credit institutions, liquidity reserve requirements and requirements on credit institutions to publish information. The first regulatory framework was created in 1988 and was called Basel 1. Basel 3 is currently being discussed and designed and its introduction will commence in 2013.

Bond Interest-bearing security which can be issued by governments, municipalities, credit market companies, mortgage institutions and large corporations. Bonds have a duration of at least a year and the nominal amount is repaid upon maturity. Until then, bondholders receive payments mainly in the form of interest. Bonds issued by corporations are called corporate bonds and are an alternative to funding through e.g. bank loans.

Capital adequacy A measurement of the buffer capital that banks have to manage future losses.

Capital requirement According to the rules governing capital adequacy, the capital requirement is linked to the bank's current and future risk profile, a self-conducted measurement of risk and an assessment of risk capital needs. For insurance undertakings, the capital requirement is called the solvency margin.

CDS (Credit default swap) Contract between credit market participants market aimed at transferring the credit risk in an underlying asset from one player to another. The buyer of the contract pays a premium to the seller, thus insuring him/herself against a credit event. If a credit event occurs, the seller takes over the insured asset and pays the nominal value of the asset to the buyer. The annual cost in basis points to buy such a contract is called the CDS premium.

Central counterparty (CCP) A player who acts as an intermediary between a buyer and seller in the management of a securities transaction. In central counterparty clearing, the original contract between buyer and seller is replaced by two contracts with the central counterparty. Therefore, the original counterparties in the transaction no longer have any risk vis-à-vis each other, but instead vis-à-vis the central counterparty.

Common equity Tier 1 capital Tier 1 capital (chiefly comprising equity and profit in the company) less capital contributions and reserves which may be included in the capital base and as Tier 1 capital according to Chapter 3 Section 4 of the Capital Adequacy and Large Exposures Act (2006:1371).

Common equity Tier 1 capital ratio Relationship between common equity Tier 1 capital and risk-weighted assets

Covered bonds Bonds issued by credit institutions, the issuance of which requires special authorisation. In the event of the institution entering bankruptcy, the bond holders have a special right of priority to the cover pool consisting primarily of mortgages.

Depository insurance Life insurance that features savings, in which policyholders themselves choose how the savings should be invested, and hence assume the risk of the policy's value performance. The assets are placed in

a depository at a bank, investment firm or insurance undertaking. The content of depository insurance is subject to standard tax instead of the investor paying tax on gains and dividends.

Derivative instruments Financial contracts that are linked to events or conditions at a specific future point in time or period of time. The value of a derivative instrument is linked to the value of the underlying asset. Derivatives redistribute risk and can thus be used both to increase and reduce investors' risk exposure. Examples of derivative instruments are options, futures and swaps.

Eba (European Banking Authority) The EU supervisory authority which regulates banks.

Emir (European Market Infrastructure Regulation) The EU regulation which came into effect in August and which requires OTC derivatives to be cleared by a central counterparty to a greater extent, and places new requirements on central counterparties.

ESM (European Stability Mechanism) The EU's permanent stability mechanism which is to provide financial support to euro countries in order to secure financial stability in the eurozone. The ESM was started up in October 2012 and will take over after the two provisional crisis funds the EFSM (European Financial Stabilisation Mechanism) and the EFSF (European Financial Stability Facility).

Finansinspektionen's general guidelines and regulations (FFFS) Regulations which supplement the laws and regulations that fundamentally govern financial operations. Regulations are binding while general guidelines act as guidance.

IMD (Insurance Mediation Directive) EU directive regarding insurance mediation.

Iosco (International Organization of Securities Commissions) An international organisation for securities supervision comprising a collaboration between over 100 national supervisory authorities regarding common regulations for players in the securities market.

LCR (Liquidity Coverage Ratio) A short-term liquidity measurement which measures a bank's ability to manage a stressed net liquidity outflow for thirty days.

Libor (London Interbank Offered Rate) The interbank rate, i.e. the rate banks pay to borrow from each other, used as a standard in Europe.

Market funding When a country, a bank or a corporation borrows money by issuing different types of securities on capital markets.

Maturity The amount of time remaining until the payment of a liability or until a bond falls due.

Mifid (Markets in Financial Instruments Directive) EU Directive regarding markets in financial instruments. Contains regulations about the operations of trading venues and transparency requirements for securities transactions.

Money market fund A fund which only invests in interest-bearing securities with a duration of less than a year. Also known as a short fixed income fund.

Mutual insurance undertakings Insurance undertakings owned by the customers. This means that the customers must bear any deficit in the operations, but also receive any surplus in the form of bonuses.

Net interest income The difference between income from lending and costs of deposits and borrowing.

OTC (Over the Counter) Trade that occurs directly between a buyer and seller, but outside a market place. OTC derivatives are derivatives that are traded between two parties without using a market place and with fully or partly concealed order information.

Risks:

Counterparty risk The risk of a counterparty to an agreement not being able to meet his/her commitments and obligations.

Credit risk The risk of a borrower failing to meet his or her obligations.

Interest rate risk The risk of the value of financial assets and liabilities changing when market rates rise or fall. Interest rate risk is a type of market risk.

Liquidity risk The risk of not being able to meet payment obligations due to deficient liquidity.

Market risk The risk of losses due to an unfavourable trend on financial markets, mainly for rates, equities and currencies.

Operational risk The risk of suffering losses resulting from inappropriate or failed processes, human error, erroneous systems or external events.

Risk-weighted assets By combining the value of all of the assets of a bank and risk-weighting these assets using certain percentages, a value for the risk-weighted assets of the bank is obtained. The percentages used in the calculation are called risk weights.

Securitisation When institutions package various assets (loans) and then sell them on to investors.

Solvency Financial measurement of a firm's ability to fulfil its payment obligations towards policyholders. One way to strengthen a firm's solvency is to create sufficiently large equity to cover any future losses.

Stibor (Stockholm Interbank Offered Rates) Swedish interbank rate, i.e. the rate banks pay to borrow from each other.

Stress test Analysis of various scenarios to assess the resilience of banks, households or other players to unanticipated negative effects.

Supervisory review and evaluation process (SREP) An internal, annual capital assessment that FI conducts on each individual credit institution. The scope of the SREP varies depending on the complexity and size of each institution.

Technical provisions The liability of insurance undertakings calculated based on entered insurance agreements. The provisions are to correspond to the amount required for the insurance undertaking to fulfil its obligations towards policyholders and other parties entitled to payment.

Trading venue Market for trading in financial instruments, for example investment firms which organise trading, stock exchanges or MTFs. Also called market place.

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