



REPORT TO THE SWEDISH GOVERNMENT, NOVEMBER 1, 2001
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# The stability of the Swedish financial sector - a summary

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## **Financial stability**

Financial operations and financial companies have distinct features that make them the objects of special legislation and of supervision. This applies in part to aspects of consumer protection and in part to the risk that problems can spread in a way that threatens the stability of the entire financial system. The task of surveillance, and thus of Finansinspektionen (Swedish Financial Supervisory Authority), is to promote both good consumer protection and financial stability – objectives that largely coincide but which also involve balancing problems. In a phase characterized by comprehensive and rapid changes in financial markets, heavy demands are being imposed on the development of tools and methods for achieving these objectives. Analysis of the conditions for, and risks to, financial stability – based in part on different world conditions and in part on the situation in financial firms – constitutes an important element in the arsenal of supervisory tools.

It is in this perspective that Finansinspektionen's work with stability analysis and with this report should be viewed. In addition to being a report to the Government, it offers a starting point for the direction and planning of Finansinspektionen's supervisory programs, as well as for information to companies, the media and the public on the manner in which the Finansinspektionen views and deals with various issues and problems.

## **The economic downturn and growing strains**

The financial sector is now facing the "stress test" that each recession involves. The downturn in the world economy that has been apparent since last winter has gradually become increasingly striking, not least in the shadow of the acts of terrorism in the United States in September.

Finansinspektionen does not consider that it is its task to develop forecasts for macroeconomic trends. Finansinspektionen notes, however, that the degree of uncertainty is unusually large and that the likelihood of a deeper and extended recession has increased and that the risk-picture has been complicated by the security-policy dimension that has been added.

Increased uncertainty and weaker economic growth normally mean that the trend of income declines, that the value of property decreases, that it becomes more difficult to obtain risk capital, and that the risks of various types of market disturbances increase. Greater vigilance is required, and resistance to the strains that can arise must be built up.

In the stability report that was published last year, Finansinspektionen declared that stability in the financial system was good and that it would probably continue during the coming year. At the same time, certain areas that could create problems in the future were noted. The general evaluation that was made has proved to be correct and various types of programs have been implemented in the areas that were pointed out, for example, with respect to preparatory matters and documentation of credit exposure in the telecom sector.

### **Effects of the decline in the stock market**

On the other hand, what the report did not fully reflect were the effects of the continuing decline in the stock market, which has set its mark on the trend of the financial markets since the spring of 2000. The effects of the decline in the stock market can now be discerned in the problems that have affected life insurance companies and securities institutions. Banks have also been affected by lower commission revenue, but the impact on earnings has been less dramatic. But the more indirect effects of the decline of the stock market on, for example, the supply of risk capital and the quality of bank credit, are now also beginning to become visible.

In a longer-term perspective, it may be said that the securities markets generally, and the stock markets in particular, are growing in importance for the financial system and for an ever-broader group of customers. This is imposing partially new demands on supervision, matters with which Finansinspektionen worked actively during the year.

### **Granting of credit**

As a result of a good economy with declining unemployment, rising incomes and increased confidence in the future, combined with the fulfilment of investment and reinvestment needs that had been neglected earlier, there has been a rapid expansion of credit in recent years. This has been a natural element in the economic cycle and, as such, nothing to be concerned about. When financial stability is involved, the important questions are whether the expansion of credit has been and is reasonable relative to the economic growth in general – expressed, for example, in terms of growth in GDP – and whether the quality of risk management is not such that credit exposure currently being built up will be difficult to manage in a more austere general economic climate.

The table below shows more precisely how credit has expanded. In this context it should be noted that lending by the credit institutions today does not pertain exclusively or almost exclusively to the Swedish market. As a result of the Swedish bank sector's rapid internationalization in general, and its "Nordicizing" in particular, a growing percentage of the lending is to the so-called foreign public.

### Lending to the public. Distribution by borrowers

	June 2001 (SEK bn)	Change June 1999-2000	Change June 2000-2001
Nonfinancial companies	1,119	1.8%	9.7%
Households (including family businesses)	995	8.1%	8.8%
Other	135	4.5%	-12.6%
<b>Swedish public, total</b>	<b>2,249</b>	<b>4.7%</b>	<b>7.6%</b>
Comparison with GDP (nom)	2,083	4.7%	4.4%
Foreign public	391	13.7%	34.0%
Total	2,640	5.7%	10.9%

Lending to the Swedish public thus amounted to slightly less than SEK 2,300 billion in June 2001. Of this amount, the four large bank groups accounted for SEK 1,863 billion, or 83 percent. It may be noted that the growth in lending, after having developed at the same rate as the nominal GDP between June 1999 and June 2000, thereafter was clearly higher than the growth in nominal GDP.

During the past year lending by banks and other credit institutions to households and family businesses increased much more sharply than lending to corporations, thereby elevating household lending to nearly the same level as corporate lending. The picture has changed in 2001, and lending to corporations has now grown more rapidly. This may reflect a number of trend factors. One is that the investment activity of companies generally occurs relatively late in an economic cycle, with a consequent effect on the time profile of their borrowing.

Another factor that probably played a certain role, is that the decline in the stock market made it more difficult to mobilize risk capital in general, and via initial public offerings in particular. If, and to the degree that demand shifts from the market for risk capital to the market for credit, this should mean a higher risk-content in lending – directly because the banks will be "taking over" risks for which shareholders would normally be responsible, and indirectly because the companies' equity/asset ratios would weaken, everything else being equal.

In brief, it may be said that despite the declining economy, at least until September the growth in lending was still substantial.

## Credit institutions

### *Earnings and profitability*

Earnings and profitability generally declined between June 30, 2000 and the corresponding date this year. During the first half this year revenue increased by 4 percent and expenses by 5 percent. As far as revenue is concerned – for growth in 2000 amounted to a full 14 percent – the trend has involved, in addition to a decline in growth, a change in composition; net interest income has improved at the same time that commission revenue has decreased sharply, by 10 percent. Here, the decline in the stock market is leaving clear traces.

#### **Operating income and return on equity in the four large bank groups**

	Jan.-June 2000		Jan.-June 2001	
	Operating income, SEK billions	Return on equity, %	Operating income, SEK billions	Return on equity, %
SEB	5.4	21.3	3.7	15
Handelsbanken	6.1	23.3	6.0	20.4
FöreningsSparbanken	5.3	20.8	4.4	14
Nordea	11.3	14.8	11.2	15.5

Source: Interim reports

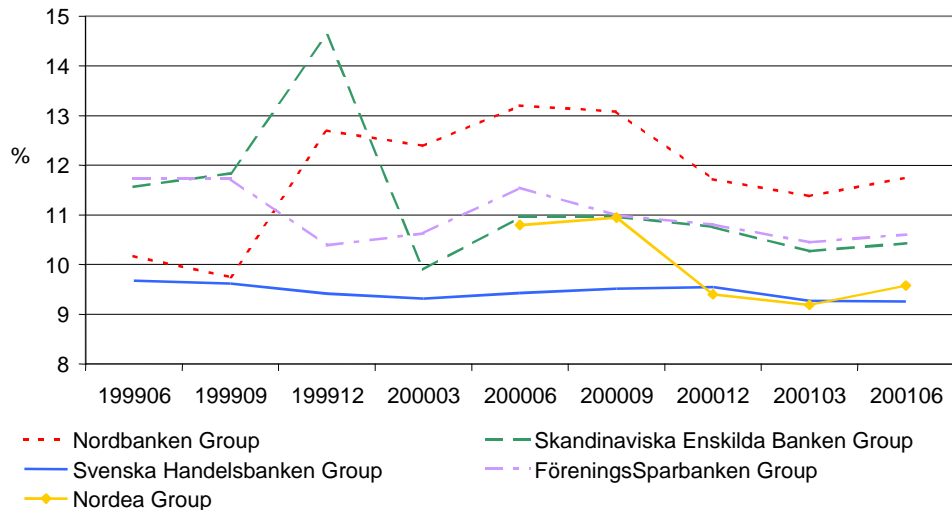
The banks' credit losses have been at record-low levels for a number of years, with the result that an upturn is not unexpected, particularly against the background of a declining economy. A certain amount of credit losses that vary over an economic cycle are not, in themselves, disturbing; on the contrary, it may be said that the socio-economic role of banks and other credit providers includes taking calculated risks and being paid for them. But problems arise if the credit losses are far above the calculated levels. Statistics now show the beginning of a tendency toward growing credit losses. The growing portfolios of problem loans and doubtful receivables are a leading indicator for this trend.

Based on a survey of the large banks that Finansinspektionen conducted in May and June, there is also a clear expectation of growing credit losses on the part of the banks. The banks also expected that lending would continue to increase. But, at the same time, it was also apparent that the banks generally were tightening their demands for collateral, and on customers' ability to repay loans. The banks were thus actively engaged in improving their management of credit risks.

### **Capital adequacy**

The capital ratios of the large Swedish banks increased slightly during the most recent quarter, except in the case of Handelsbanken, where it was unchanged. However, if one examines the trend over a year, capital adequacy has declined in all banks.

**Chart 6. Capital ratios for the large bank groups**



A declining capital adequacy means that the banks become more vulnerable to unexpected losses that may occur – and which are increasingly likely to occur in view of the general trend of the economy. It may be noted here that, although the capital ratios are well above the prescribed minimum level of 8 percent, the buffer for nearly all banks has slightly decreased in the past two years.

It should be said, however, that the capital ration figure, in particular based on the calculation methods that are still being used, is not a precise measurement of the true level of risk and the ability to deal with unwelcome occurrences. One aspect of this is that a bank with – let us say – 10-percent capital ration does not necessarily have to be in a worse situation when it comes to meeting problems than a bank with 12 percent; the ability of the bank to "replenish" capital as needed is an important factor. If its possibility of doing this is good, a relatively low figure for the capital ratio does not have to be considered disturbing.

Another, somewhat contrasting, aspect of this is that increased assumption of risk in lending does not in practice always have an impact on risk-weighted amounts and measured capital ratio. The trend now under way in the form of declining credit quality and increased risk in lending, primarily, to corporations, should thus in principle involve an increase in the risk-weighted amounts and thereby a larger capital base, if the capital ratio is not to decline. But, with the method of calculating the requirement for capital that is still being used, this trend is not picked up. It may be added that, based on the Swedish rules governing reserves compared with the rules applied in many other countries, the capital requirement in Sweden should be set higher in order to reflect the same actual risk.

## **Life insurance companies**

In the case of life insurance companies, the connection with the trend in the stock market is very strong and earnings are dependent to a very high degree on the return on investments in Sweden and other countries. Shares account for roughly 50 percent of the total value of investment assets. The share portfolios are currently evenly divided between Swedish and foreign companies. Foreign assets account for approximately 30 percent of the total.

Dependence on the stock market naturally represents a problem when the market has developed as it has done during the year. The traditional life insurance companies recorded a notably high total return – approximately 20 percent on an annual basis – in 1999. Last year the return was lower, 5 percent. The return in the first half of this year was negative, minus 1.5 percent. As recently as last year the companies' bonus rates were at levels below the total return, which drove up the collective reserve to a level that was not consistent with the policy the companies themselves had stated – and which led Finansinspektionen to recommend measures to reduce the level. One year later the picture is the reverse; primarily as a result of the trend of the stock market, the collective reserve has decreased dramatically and has necessitated a reduction in bonus rates.

## **Finansinspektionen's work with Group-wide risk assessment**

One of Finansinspektionen's most important tasks is to organize the diversified information on the financial situation, on various types of risk exposure, and on risk-management capacity. The tool that is known as Group-wide risk assessment and which is now being developed within Finansinspektionen is one way of doing this that is both easy-to-grasp and usable operationally. The program is also a way of applying the "supervisory review" that constitutes an important part of the future new Basle Accord.

A key part of this program involves creating a more general model for analyzing and evaluating the firms under Finansinspektionen's supervision, a model in which the same methodology and the same bases for evaluation are used, regardless of the type of business being considered. Greater uniformity should also reduce the risk of arbitrariness in an evaluation. The purpose of the assessment is to assess financial companies' assumption of risk and risk-management ability relative to their risk capital. The ultimate objective of the risk assessment is that it should serve as a basis for discussions with the managements of the companies involved, and be a tool in Finansinspektionen's setting of priorities for supervisory measures in the coming year.

Finansinspektionen's method of risk assessment conforms in all essential respects with the international trend in the supervisory field. Among other factors, the methodology is adapted to the requirement to evaluate the level of risk and need for capital. In the process of developing its method, FI has also drawn inspiration from a number of foreign supervisory authorities that in recent years have been driving forces in the development of principles for risk evaluation. A large part of today's methodology for total risk evaluation originated in the United States, where the so-called CAMEL model is used by the federal supervisory authorities. In the CAMEL model, a qualitative

evaluation is made in the form of in-house studies of the key areas that have been identified.

Finansinspektionen has sought to combine qualitative supervisory evaluations with quantitative evaluations of key data. A number of countries today – the Netherlands and the United Kingdom, for example – have developed their supervisory models along these lines. The methodology chosen by Finansinspektionen is close to that which has been developed and is being used in those countries.

The methodology for group-wide risk assessment developed within Finansinspektionen is based on underlying material that consists of three different blocks of data. The three parts have somewhat different functions and different internal users. The common characteristic, however, is that each should constitute a basis for the total risk evaluations of large financial companies that Finansinspektionen conducts each year for the purpose of documenting risks and risk-management ability, estimated capital requirements, and the like.

The three parts of the assessment system are developed in parallel and are technically independent of each other. However, this does not mean that they are applied independently of each other. The results obtained from each block are, in themselves, part of the total risk evaluation. Part 1 is a quantitative analysis that results in a rating of the company being evaluated; it may also be used for scenario and sensitivity evaluations. Part 1 can and should be used for all companies. Part 2 is a compilation of external data that is available only for certain companies. Part 3 is a tool for evaluating the risk in a company based on the studies conducted by Finansinspektionen; it is a qualitatively oriented evaluation. Part 3 should be used only for the, now 13, financial firms that are defined as systemically important.

During the autumn Finansinspektionen has conducted risk assessments in which the emphasis was on documenting the structures of the large bank groups and analyzing the most critical areas within the banks. The evaluations were also focused on documenting the current risks in the various business areas. Decisions were made with respect to how well the banks are evaluating and managing various types of risk.

Finansinspektionen has conducted four such group-wide risk assessments for the bank groups during 2001. This work was conducted parallel with the system development that has been described. The assessments that have been produced to date thus do not correspond to the those that are to be produced when the system is fully developed. On the other hand, the organization and focus of the 2001 assessments are well in line with the system that is being built up.

## **An agenda for supervision**

### ***Credit risks and capital position***

Greater vigilance is required with respect to the consequences that a declining economy and increased uncertainty will bring. In this area, the repercussions of profit expectations and operating income in a real economy



are important, and this will have an impact on the credit risks in banks, as well as in the asset markets.

Against this background, the importance of good risk management and capital strength in the banks is increasing.

In connection with the year's risk evaluations, Finansinspektionen has focused in particular on the banks' capital positions. The objectives set by the institutions for both Tier-1 capital and total capital are important starting points in the supervisory program. These objectives may be at different levels, depending on the composition of the lending portfolio and the focus of operations in the different banks. It is important that firms evaluate and adjust these guidelines on a continuing basis, against the background of the changes in risk profile that have taken place during the past year.

In the opinion of Finansinspektionen, the trend of credit risks makes it necessary to have a greater margin of safety in order to be able to resist the increased strains that may be expected in the future. According to Finansinspektionen, there is reason to maintain the Tier-1 capital levels at, or above, the guidelines that the banks have set as targets.

Within the framework of the Group-wide risk assessment, Finansinspektionen will develop an analysis and follow-up of the capital situation in the large bank groups; this will be done in a dialogue with the banks and in close co-operation with the other Nordic supervisory authorities.

### ***Continuing development of the international supervisory activity***

Internationalization of the financial markets is imposing increased demands for continuing development of international supervisory programs, and this is becoming even more important in a world economy characterized by increasing weakness and growing uncertainty. There is a trend within the European Union toward greater convergence where supervision is concerned. This is positive and is supported actively by the Finansinspektionen. Specific issues that require co-operation within the Nordic Region pertain to the supervision of Nordea, If and the so-called Norex co-operation.

### ***Operating risks and preparedness***

Issues related to physical security, security against IT attacks and the possibility of "back-up" operations to ensure the strength of the Swedish financial system are becoming increasingly important. The events in the United States in September were a dramatic example of what happens when an extremely unlikely event becomes a brutal reality. Where the financial sector is concerned there are primarily two consequences of this; it illustrates on a general level the importance of implementing various forms of stress tests to determine the freedom of action and the alternatives that are available even in extreme situations; and, more specifically, it illustrates the importance of having a high degree of preparedness for events and developments related to the new security/political situation that has begun, and the consequences that this can have for markets and firms.

During the past year Finansinspektionen has devoted substantial work to preparedness matters and stress tests together with companies and in cooperation with ÖCB (Swedish Agency for Civil Emergency Planning). A continuing high rate of activity in this area is required. The special stress tests that have been introduced during 2001 will be further developed in coming years.

### ***Life insurance companies and collective reserves***

Life insurance companies have been affected by declining market values in their investment portfolios combined with an excessively slow adjustment of bonuses to customers. These factors, combined with the elimination of certain transition rules in legislation dealing with the strengthening of life-insurance companies' technical provisions, have exposed the sector to financial strain. It has become necessary to ensure that customers are informed that conditions for bonus participation have changed.

Finansinspektionen has requested current monthly reporting of the financial positions of life insurance companies for the remainder of this year. This increased monitoring should be maintained until further notice.

### ***The trend in securities companies***

The negative trend of earnings in securities companies may involve the liquidation of some companies and other changes in the structure of the market. These factors do not in themselves constitute a serious problem in terms of systemic stability but, to maintain confidence in the securities market, it is important that this process will be effected in an orderly manner. During the autumn Finansinspektionen conducted a special follow-up of the capital adequacy situation and trend of earnings in a large number of securities companies. This expanded monitoring will continue in order to permit active follow-up of developments in these companies.