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The stability of the Swedish financial sector – a summary

The stability of the Swedish financial sector

- The large banking groups have grown even stronger financially during 2005 and the first half of 2006. Credit losses are virtually zero. With general economic growth likely to continue to improve, risks to systemic stability are low for the foreseeable future. In a longer perspective, however, expansion of business abroad and in countries such as the Baltic states and Russia may suggest increased risk. Finansinspektionen (FI) will follow these developments closely and in collaboration with the supervisors in these countries.

- Swedish life insurers, severely hit by declining equity prices and interest rates a couple of years ago, have improved their financial performance considerably during 2006, largely thanks to rising equity prices and long-term interest rates.

- A number of new regulatory complexes have been implemented over the past couple of years, with more to come. The majority of regulatory changes involve portions of the EU's Financial Services Action plan, aimed at an integrated financial market within the EU. The new regulation on capital adequacy, known as "Basel 2", will be implemented by 2007. For banks and credit institutions this will have a number of important implications, not all of which will be foreseeable. Based on preliminary calculations, a reduction in the capital required by Swedish banks seems likely, mainly due to the large share of low-risk lending, such as mortgages, which constitute their loan portfolios.

- During 2006, a small non-bank deposit-taking credit institution, Custodia, had its license withdrawn by FI, and went bankrupt a few months later. This event has raised a number of issues concerning the ways and methods for supervising small deposit-taking institutions, the legal framework for handling defaulting institutions and the requirements for activating the deposit guarantee scheme, as well as concerning ways to improve consumer awareness of financial risk. FI has identified a number of regulatory measures that need to be taken and has also communicated this to the Government. At the same time it has begun to develop supervisory methods and indicators to achieve better monitoring of this type of institution.

Banks

Economic growth has been strong in 2006. Inflation has increased slightly due to growth picking up and to the surge in oil prices. One consequence of this trend is an increase in both short- and long term interest rates. According to recent forecasts, economic growth is likely to continue in 2007 and 2008, albeit at a successively slower rate. The gradual tightening of monetary policy already under way is also expected to continue, resulting in repo rates increasing from 2.5 per cent today to 3.5–4 per cent by the end of 2007. By and large, this forms a healthy environment for the financial sector. The basic and most likely scenario is one of continued growth and stability. As always, events may produce a less positive scenario, such as another hike in oil prices or financial strains related to the growing deficit in the US current account. Moreover, completely unforeseeable disasters may occur, such as earthquakes, terrorist attacks, computer systems collapsing, etc. But looking at factors that can be monitored and assessed with reasonable accuracy, the prospects for financial sector developments and for financial stability are indeed very good.

The four big banking groups that heavily dominate the Swedish banking market survived the macroeconomic downturn 2000–2002 without any financial strains. Since then, they have managed to increase their healthy profitability and capitalization. Important underlying reasons include increased cost-efficiency, a growing market for mortgage lending, growing non-interest income and virtually zero credit losses.

Considering this, and the prospects of a healthy macroeconomic environment even in 2007 and 2008, it is hard to foresee any risks to systemic stability. However, the strong growth in mortgage lending over a number of years, due to low interest rates and rising real estate prices, is likely to produce losses when interest rates or unemployment figures turn higher. Nevertheless, this is a threat to bank customers rather than to the banks themselves. Corporate lending has also increased over the past one to two years, reflecting growing real investments after several years of very low demand for bank credit. Another significant development has been the rather intense activity on the private equity market, where banks have been involved as credit providers, financing buy-out activities. We have also witnessed a trend toward a higher concentration of lending to the largest counterparties of the four big banks, which, in principle, should imply higher risk. Generally, lending to the corporate sector involves more risk than financing mortgages; in this respect bank lending can be said to have become riskier over the last year. Still, it is hard to see any obvious risks to stability in a short term perspective, provided the macroeconomic situation develops as expected.

Potential risks to banks are instead mainly found in a longer perspective. All four large banking groups are currently Nordic-Baltic groups rather than Swedish banks. In a sense, this means a lowering of risk by geographical diversification, but it also means increasing operative risks working in different markets and within different jurisdictions. In countries such as the Baltic states, where two of the banks have dominating market positions, and in Russia and Ukraine, where some banks are establishing, financial risks may also be greater and more difficult to analyze and manage.

Life-insurance sector

The financial strength of the life insurance sector is good and has improved considerably during 2006, mainly due to healthy – though sometimes volatile – developments on the equity market and to rising long-term interest rates; over the past twelve months long-term rates have climbed from 3.0 per cent to 3.6 per cent and additional, albeit modest, increases are foreseen.

On January 1, 2006, the Directive on Institutions for Occupational Retirement Provisions (IORP Directive) came into force in Sweden. A central feature of the IORP Directive is that detailed regulations have been replaced by general principles, with companies assuming greater responsibility for prudently handling risks and operations. The IORP directive has also resulted in a realistic valuation of liabilities. Moreover, FI monitors insurance company risks using new supervisory methods that provide early warning signals of any problems.

A key aspect of the new surveillance is the traffic light model, which measures companies' exposure to financial risk and is part of the supervision aimed at ensuring that companies can meet their obligations. This tool has been in regular use in 2006, after sometimes fierce discussions among industry representatives and financial market actors related to the model's likely effects on interest rates, equity prices, risk-management, etc. So far, companies have shown no sign of converging in risk profiles, thereby creating risks of destabilizing herd behavior in times of stress, which was one of the fears that some players expressed. When applying the model to monitor the present risk outlook for companies, only one small company received the "red light" warning. All other players can withstand considerable negative movements in asset prices without any suggested threat to their undertakings.

Regulatory changes

Risks to the financial system and to the consumer are not static, but constantly changing and therefore the supervisory response must change as well. We see this today – major changes in regulatory frameworks surrounding all financial sub-sectors such as banks, insurance companies, and investment firms. Moreover, and equally important, most changes are part of a European – and sometimes even global – process.

The reshaping of regulatory frameworks has several drivers. One is to increase financial stability, another is to improve consumer protection, still another is to foster financial market integration by harmonizing regulatory and supervisory standards within Europe.

For banks and investment firms the introduction of Basel 2, effective from 2007, should result in both improved transparency as well as better and more efficient risk management. It will also provide incentive for a more risk-based pricing of credit. Ultimately, it aims to reduce systemic risks and to increase stability.

Preliminary calculations suggest that Swedish banks will need considerably less capital than today, although additional needs that will surface within the "pillar 2"-framework are likely to be a countervailing force. Also, transitional rules will prevent any immediate reduction. Nevertheless, FI believes that if capital decreases, the net effect on banking stability will still be positive, due to improved risk management, pricing of risk, and allocation of capital both between and within banks.

One possible drawback of the new regulatory framework is the risk that capital requirements will behave pro-cyclically. Here, banks have to assess their sensitivity to cyclical factors and, based on this insight, take measures to ensure capital will be sufficient even during an economic downturn. Finansinspektionen, together with the Riksbank (the Swedish central bank) have studied stress testing procedures in the larger banks. Methodological standards were found to be satisfactory, though there is room for further improvement. The actual test results indicate that the banks seem able to withstand negative scenarios on the macroeconomic scene and it should also be possible to handle cyclical variation in capital adequacy.

In the insurance field, a similar process is underway in the EU initiative "Solvency 2", with new legislation expected in 2010. Before that, however, new national legislation on solvency will be implemented based on the same principles as in the upcoming EU-wide legislation: founded on realistic values and intended to reflect financial risks in assets and liabilities more accurately than is currently the case.

The regulatory changes mentioned here are by far not the only ones coming in the near future that will affect financial firms. It is usually easy to find good reasons for changing specific regulations and for harmonizing them internationally. But regulatory change is not a free lunch; the process often involves huge costs – the implementation of Basel 2 is a clear example here. Moreover, simultaneous changes in a large number of regulatory fields, as is the case at this time, can also produce inconsistencies, unforeseen cross-effects and uncertainty in markets. It is difficult to predict the interaction and full cross-effects of, for example, the new accounting rules (IFRS) and "Basel 2". What we do know is that supervisors must watch this closely.

The Custodia case

During 2006, the supervisory responsibilities to protect consumers have been widely discussed, due to the failure of a small non-bank credit institution, Custodia, which also accepted deposits.

Following an on-site inspection in late 2005, Finansinspektionen decided to revoke Custodia's license at the end of January 2006 due to poor governance in certain respects, including bad management of credits. This triggered a lengthy process of efforts to rescue the company by obtaining new capital, as well as legal suits, since the company questioned FI's action. Finally, at the end of August, the company was declared bankrupt.

Although FI, in our view, has handled this case appropriately, these events have raised a number of issues concerning the ways and methods for supervising small deposit-taking institutions, the legal framework for handling defaulting institutions and the requirements for activating the deposit guarantee scheme. Ways to improve consumer awareness of financial risk, and of clarifying the assignments and responsibilities that remain with governmental authorities are other important issues here. FI has identified a number of regulatory measures that need to be taken and has also communicated this to the Government. At the same time it has begun developing supervisory methods and indicators to achieve better monitoring of this type of institution.