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The stability of the Swedish financial sector- a summary

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- The Swedish life-insurers, previously severely hit by declining equity prices, have clearly improved their financial performance during 2004. However, some of the companies are still vulnerable, due to low solvency. This requires a continued close monitoring by Finansinspektionen

- The large banking groups are financially strong with very low credit losses and with a modest growth when it comes to risk exposures. This, coupled with a likely further improvement of general economic growth, and an ongoing improvement of risk management, means that risks to systemic stability are small for the foreseeable future. In a longer perspective, however, the expansion of their business abroad, including the Baltic states and Russia may imply increasing risks. Mortgage lending is also one area where risk exposures are growing. Finansinspektionen will monitor these developments.

- In the near future, two important regulatory complexes will be implemented in Sweden as well as in many other countries – the new Basle accord on capital requirements (“Basel II”) and the IFRS/IAS on the accounting side. Both will have important implications for financial firms, especially for the banks. At the same time it is difficult to foresee all the effects and implications these changes may have, and even more so, the possible effects they may give rise to in combination. Therefore, the implementation has to be monitored closely by Finansinspektionen.

Over the last year, macroeconomic conditions have improved globally and in Sweden as well. Financial markets have been characterised by stability, with modestly rising equity prices and without any dramatic shifts in interest rates. This has meant improved possibilities for financial firms to strengthen profitability and to manage risks.

Banks

The four big banking groups – which heavily dominate the Swedish banking market – have lived through the macroeconomic downturn 2000-2002 without any financial strain. They have managed to keep their good profitability and capitalization. Some important reasons behind this are increased cost-efficiency, a growing market for mortgage lending and a very low level of credit losses.

Considering this, together with the likely prospect of a further improvement in the macroeconomic situation, and with no obvious indications of increasing risk levels in lending etc, it is hard to foresee any risks to systemic stability. The strong growth in mortgage lending over the last years, the effect of low interest rates and rising prices on real estate, may lead to losses when interest rates turn higher and collateral values asa aconsequence may diminish. Still, this is a threat for certain customers to the banks rather than the banks themselves.

High capitalization together with improving market conditions may lead to banks getting overoptimistic, making heavy investments in new products and new markets, engaging in expensive acquisitions etc. and thereby becoming more financially vulnerable. So far, however, no such tendencies are evident. Instead, good profitability and high capitalization have mainly been expressed in dividends and equity buy-backs.

Therefore, the possible risks to the banks are mainly to be seen in a longer perspective. All four large banking groups are nowadays Nordic-Baltic groups rather than Swedish banks. In a sense, this means a lowering of risk by geographical diversification. It also provides good opportunities for profitable banking business, due to the strong underlying growth in the Baltic markets. The high growth in lending is to some degree reasonable, since these economies are fast-growing, on their ways to diminish the gaps to more developed economies. But the general positive development may make it more difficult to distinguish between low and high risk customers and projects, since the prospects may look good for everybody. The increased risk-exposure that the banks take on in these markets is something that is worth close monitoring by Finansinspektionen.

Swedish banks are also about to establish themselves in Russia and Ukraine. Even though the business is very limited, these markets may give rise to higher operational, legal and political risks than other establishments, which is important from a supervisory perspective.

Improved financial situation in life insurance companies

The life insurance companies have further recovered from the problem that appeared in connection with the declining interest rates and stock market downturn in the first years of the decade. The problems appeared in three different areas. The companies' solvency had fallen and some companies faced problems in complying with the legal minimum solvency ratio. The preliminary calculated bonuses to the clients were too high in relation to accumulated profits. Finally, questions were raised about whether the companies had in some transactions seen to the interests of the shareholders rather than the interests of the policy holders, which is not allowed according to Swedish law.

The solvency in the sector as a whole is now satisfactory. Some companies have, however, uncomfortably low solvency ratios. The prospects for these companies to restore the solvency ratio to more appropriate levels are hampered by their reduced possibility to invest in the stock market, which also limits the possibilities of a high future bonus rate for the policy holders. The preliminary calculated client bonuses are also at satisfactory levels in the sector as a whole. Three companies have however still a to high preliminary bonus in comparison to their assets.

Several measures have been taken by regulators and supervisors to restore policyholders' faith in the traditional life insurance product. A governmental inquiry presented a proposal on how to modernize the solvency rules for insurance companies. Even though it is not yet clear in which way the proposal will be implemented, the proposed method for measuring risk that applies to the entire balance sheet, can be used for improving the transparency regarding the financial risk and to improve the supervision. The government has also initiated an inquiry about the legal form of business activity for insurance companies. The inquiry is to propose new regulation that reduces the conflicts of interest in insurance companies and that makes a clear distinction between shareholders' and policyholders' interests.

Pending the inquiry's proposal, several regulatory changes and guidelines have been implemented to safeguard that owners do not by deceptive transactions extract profits from the non-dividend insurance companies. Examples of such changes are that a majority of the board members have to be independent from other companies in the same group, transactions with related companies should be accounted for openly and that all life insurance companies have to have a compliance function. Finansinspektionen has also received increased means of sanctions against companies that do not follow the rules.

As a consequence of this, the companies have taken meassures to better handle conflicts of interest, for example by management guidelines and by improved information to policy holders. The companies' own initiatives for improving their image and also the public's faith in the traditional life insurance product have, however, been relatively limited in comparison to the financial and trust related problems the sector has experienced.

Improved situation in non-life insurance companies

The none-life insurance companies withstood the stock market fall better than the life insurance companies, even though the fall coincided with an increased indemnification ratio. This was mainly because the non-life insurance companies in several aspects have a different structure than the life insurance companies. The non-life insurance companies have a lower proportion of their assets in equities, mainly because their liabilities have shorter duration than life insurance contracts and because of less of a preassure to generate high investment returns to make their product attractive. The balance sheet is also considerably smaller in non-life insurance business and premium income is bigger in relation to the balance sheet. As a consequence, it is easier for the none-life insurance companies to absorb losses in the investment portfolio. In addition, the companies have increased premiums considerably. The ability to handle the combination of a large stock market fall and an increased indemnification ratio indicates that the stability risk in the sector is limited. The premium increase has, however, resulted in considerably higher costs for retaining insurance cover.

Risks from several simultaneous rule changes

One of the big changes that the financial companies are facing is the introduction of the international accounting standards (IAS), that all listed companies have to apply from next year. The IAS rules introduces important changes to accounting in Sweden. For instance, the new rules will allow for greater flexibility in the way financial statements are presented and the accounting shall mainly reflect the fair value of assets, in comparison to the prudent valuation that is the main principle in Swedish accounting today. However, the EU has decided that the most important rules for financial companies – those regarding financial instruments and insurance liabilities – will not be fully applicable from the start next year. The main reason for this is that both banks and financial supervisors in Europe have been critizising the rules quite strongly. Even though parts of the rules will be applicable from next year, it is still not yet clear how the rules regarding financial instruments will be applied. This will of course cause considerable problems for banks when it comes to adjusting their accounting systems. For insurance liabilities it is clear that it will only be a first step towards implementation next year, while the more complex rules will have to be elaborated further and implemented at a later stage.

Another rule change is the introduction of new capital adequacy rules (Basel II) that have been proposed during the year with a target date for implementation at year end 2006. Both Basel II and IAS imply far-reaching changes for the financial sector. These changes taken separately are large enough to make it difficult to assess all possible consequences. Seen from that perspective, it is a cause for concern that these two changes come more or less at the same time. Not least in the combination of and in the interaction between these two legislative frameworks, unforeseen risks may occur. Finansinspektionen will however, have to pay close attention on the implementation of these legislative changes and how the companies adjust to them.