S U M M A R Y

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Stability of the Swedish financial sector

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Summary

Real economic growth is strong, and is expected to remain strong, with high GNP growth and decreased unemployment, but the uneasiness on financial markets has increased risks.

The risk that there will be a rapid downturn in the business cycles in Estonia, Latvia and Lithuania – where two Swedish banks have significant operations – has increased over the last year. The Latvian economy in particular is judged by many to be overheated and has considerable imbalances that must somehow be evened out.

There has been turbulence on the financial markets, and from an international perspective the changes have been more dramatic than in many years. Increased payment difficulties for American mortgage holders, primarily among the weakest borrowers, are the root of the problem and large losses now need to be absorbed by the financial system. This problem, combined with the uncertainty about where these losses are located, has squeezed financing markets. In the long run, this can mean that lending for the real economy will slow and financing costs will increase.

All of the above creates a cloud of uncertainty over the financial system. There is also a risk that other negative events not directly influenced by the business cycle may occur – financial institutions may make poor business decisions, employees may make mistakes or defraud their employers, technical systems may fail or catastrophes and terrorist attacks may occur. The stronger companies are both operationally and financially, the lower the risk that individual or simultaneous negative events will harm them, and it can be stated that financial institutions today are stronger financially than they have been for many years.

Banks

The turbulence on financial markets over the past few months has also affected Swedish banks. Swedish banks have not had more than marginal exposure to the epicentre of the turbulence – American subprime loans – and have only had a limited number of direct and indirect exposures to other assets that were affected by the shake-up, for example different types of structured credit derivatives. However, Swedish banks have still been affected, primarily now that financing has become more complicated as a result of higher lending costs and shorter maturities. With all probability, the banks' earnings will be negatively affected not only by rising financing costs, but also by lower activity levels on securities markets and the reduction in the value of bond portfolios. In the longer term, business cycle effects resulting from the recent turbulence will also have an effect.

Uncertainty on the international financial markets naturally increases vulnerability for other disturbances. One sector where losses of a more significant scope run a higher risk of occurring is lending to the Baltic states.

Swedish banks conduct a significant portion of their operations in the three Baltic states, in particular Swedbank and SEB, where lending to these three countries represents 16 and 12 per cent of the banks' total lending, respectively. The Baltic economies have grown quickly, but lending has grown even more quickly. Rapid lending growth during upswings in the business cycle can be problematic in terms of risk assessment since many borrowers do not have a credit history and the financial capacity of business operations are not tested to the same extent as during cycle downswings. As a result, the risk for making erroneous credit decisions is higher. That the Baltic economies, albeit to varying degrees, are judged to be overheated further increases the risks. The banks have shown that they are aware of the risks and have implemented measures to mitigate them. FI believes that they have enough capital to handle a situation that could entail extremely large credit losses in any of these countries. The banks can also successfully handle a scenario where the three countries experience turbulence simultaneously. However, since the markets represent a far from insignificant portion of their earnings, there is a risk that such problems could also have additional long-term consequences.

Mortgage lending is another sector that has experienced significant risk accumulation. Lending continues to increase, amortization periods have been extended, lending ratios have risen and the share of variable interest rate loans is significantly higher today than before. Moreover, margins are being pressed from increased competition. Nevertheless, the risk for large losses in mortgage lending is not particularly high. Several overlapping events would have to occur for credit losses to reach dramatic levels. Unemployment would have to increase, interest rates would have to rise and residential property prices would have to fall, all over a long period of time. It should also be noted that the risks for such a scenario appear to have increased somewhat, with an apparent increase in inflation leading into a downturn of the business cycle. However, consumers would suffer significant losses before these problems reach such size and scope that they would affect the banks.

Given the main scenario – continued stable but slightly slower economic growth, continued low inflation and slightly rising interest rates – the overall growth development for Swedish banks is expected to be positive, at least in the Nordic market. Higher interest rates will cool demand for loans and affect the banks' earnings, while increasing interest rates combined with slower growth will lead to an increase in credit losses in both corporate and private lending.

Pension companies

Pension companies have the ability to fulfil their guaranteed commitments to their customers. Their resistance to unexpected events, both financial events and events resulting from insurance risk, has been strengthened during the past year, even after the recent turbulence on the financial markets. No companies are reporting a red light in FI's traffic-light model, which measures their exposure to financial risks and, as of this year, insurance risks.

The implementation of the occupational pension directive has helped companies improve their risk management and increase returns. Their capital requirement is lower today than it has been previously, due to the current interest rate level, and they have more freedom in their investments.

Pension companies have also expanded their investments into, for them, new types of assets, such as hedge funds, private equity firms and interest rate derivatives. An increased risk spread is positive for customers from both a risk and return perspective, although there are indications that the risk management and risk control of pension companies is not always suited to these types of investments, which can lead to increased risks for customers. The regulatory framework clearly states that companies may not invest in assets if they lack the competence and control systems that are necessary for specifically those assets. FI will therefore devote special attention to these issues in the future.

Non-life insurance companies

Non-life insurance companies are currently experiencing a boom. Forecasts indicate both positive growth in 2007 and good margins for handling unexpected damages. At the same time, positive growth has led to increased competition and price pressure, which constitutes an earnings risk.

Non-life insurance companies began reporting in accordance with the traffic-light model this year. The initial results show that they are well equipped for handling considerable price fluctuations on the financial markets as well as insurance risks yielding large negative outcomes.