FINANSINSPEKTIONEN

Risks in the financial system

OCTOBER 2010

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Foreword

The 'Risks in the Financial System' report highlights the risks that Finansinspektionen considers to be the most serious in the financial sector. This includes risks affecting financial stability and consumer protection and risks that can affect the functioning of the markets.

Since last year's report, the development on the financial markets and in the Swedish economy has been mostly positive. However, the recovery could be undermined by events in the surrounding world.

At Finansinspektionen we carry out a risk analysis to prioritise our supervisory work. By sharing this analysis, we also expect companies to take action against the risks. In the immediate future we will place special focus on the role of the board of directors and management in risk management and the internal governance and control.

Stockholm 29 October 2010

Martin Andersson

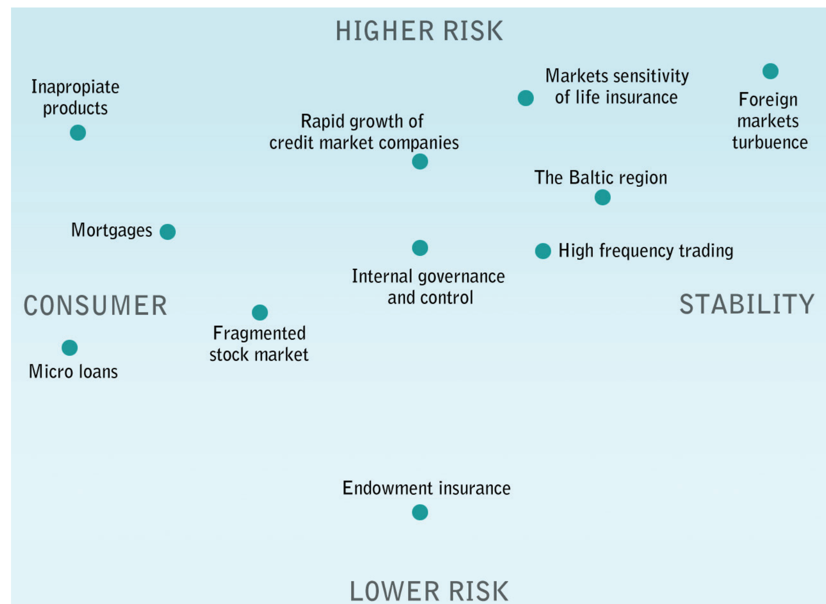
Director General

Summary

Finansinspektionen (FI) highlights in this report the most important risks affecting financial stability, consumer protection and the efficient functioning of the financial markets. The situation on the Swedish financial market in general has improved over the past year. When limiting the analysis to the Swedish economy and Swedish financial companies, there have been many positive signs. However, uncertainty has increased with regard to the world economy and the economies of several European countries, which could have an effect on the Swedish financial market primarily through problems with market funding for financial companies.

FI develops a composite risk picture for its work analysing financial market risks and prioritising between supervisory actions. This picture reflects the main risks for financial stability and consumers as well as risks that in the longer term can impact confidence in the financial markets and their efficient functioning. This year's report highlights risks associated with the rapid credit growth of many credit market companies, the sensitivity of life insurance companies to an extended period of low interest rates and risks arising from an altered and more fragmented stock market. One scenario that has potentially significant consequences for the liquidity of large banks in particular is widespread foreign market turbulence. This scenario could become a reality if problems related to central government finances were to once again escalate in parts of Europe and is pointed out as a major risk by our international panel of experts.

Finansinspektionen's composite risk structure 2010



RISKS FOR FINANCIAL STABILITY

More than one year has passed since the peak of the financial crisis and the financial markets are now demonstrating improved stability and more normalised risk premiums. During the spring, a new wave of uncertainty emerged due to problems in some European countries

related to their central government finances. After the EU finance ministers, the International Monetary Fund (IMF) and the European Central Bank (ECB) agreed on support measures, the situation improved but the underlying issues of large debt burdens and high budget deficits remain.

In the past year, the banking sector benefited from Sweden's strong economic development and increased stability on the country's financial markets. The entire sector's balance sheet increased by approximately 4.5 per cent compared to one year ago. To a large extent, the strength of the financial recovery in Sweden and its surrounding markets will determine the strength of continued growth and the scope of credit losses. Even if the improvements in the Baltic operations exceeded expectations, there is still uncertainty about the future development of these countries. FI's stress tests do show, however, that the large banks have adequate capital for withstanding even very negative scenarios.

Liquidity risks for the banks are still a primary focus. The financing situation for Swedish banks has improved and future funding risks are primarily linked to the risk of foreign market turbulence and potential contagion effects for Swedish banks. However, direct exposures are small and the Swedish financial system and its well capitalised large banks should be able to well withstand moderate foreign market turbulence.

RISKS FOR CONSUMERS ON THE FINANCIAL MARKETS

An important part of the supervision of consumer protection is to ensure that companies on the financial market are stable and can fulfil their commitments. Consumer protection in this context is closely related to the supervision of the financial system's stability.

Companies should also provide consumers with relevant information, good advice and comprehensible contract terms. Many of the risks for consumers are linked to deficiencies in the information and advice offered by financial companies. Products are often complex and it can be difficult, for example, for a consumer to compare different types of savings or insurance products. FI believes there is a risk that consumers will be offered products that are not appropriate for their needs. Some companies are attempting to circumvent the legal requirements for financial advice, and occurrences of investment fraud are also increasing.

Since last year's report, FI has spent a considerable amount of time evaluating the risks on the mortgage market. Sharp increases in indebtedness and higher loan-to-value ratios on homes could expose consumers to large risks if house prices fall. On 1 October a new loan-to-value ceiling went into effect that should give consumers incentives to limit their indebtedness. FI will closely follow companies' application of the new requirement and the development on the mortgage market during the coming year.

Last year's report highlighted the risks associated with the rapid increase in microloans. FI is now seeing a positive trend in that the number of cases with the Swedish Enforcement Authority related to unpaid microloans is decreasing.

RISKS FOR THE FUNCTIONING OF THE MARKETS

Some risks on the financial market are difficult to categorise as affecting either financial stability or consumer protection. Many risks represent more of a threat to confidence in the financial markets in the long run,

and subsequently the markets' ability to function effectively. For example, FI is concerned about the rapid growth of some credit market companies and the risks associated with their operations. Depositors with these companies are in general protected by the deposit guarantee and the effects for consumers in the event of a default should therefore be limited. Furthermore, the companies are not large enough to have a negative impact on financial stability. However, if several of these companies are affected by the same problems, this could have a negative impact on confidence in the savings market.

There are other risks that primarily constitute a risk for consumers, but that could also have an impact on financial stability. For example, low interest rate levels over a long period of time could cause problems for Swedish life insurance companies with guaranteed commitments. Some companies might have difficulties generating the returns they need while at the same time fulfilling the solvency requirements. This comprises a threat to policyholder protection. Concerns regarding solvency in the sector could lead to a vicious circle where insurance companies decide to decrease their risk profiles by selling shares and purchasing interest-bearing assets, which puts downward pressure on both the stock market and market interest rates, which in turn stresses the companies' solvency even more.

On the stock market, the combination of increased competition between different market places and rapid technological development has contributed to more fragmented market for stock trading and the introduction of new risks. For example, it has become more difficult to compile a general overview of prices and identify actors that have criminal intent.

Deficiencies in internal governance and control represent another general risk area that deserves attention. Such deficiencies are the underlying cause behind several of FI's recent enforcement actions, including against HQ Bank AB.

Finansinspektionen's expert panel

This year's international expert panel highlights the risk of a crisis in central government finances in Europe and the consequences of the central banks' expansionary monetary policy, as important issues for the future development of the financial markets. In terms of the economy in general, several members of the panel think that there will be low growth in many countries, but do not believe that there will be a return to a widespread recession.

Every year Finansinspektionen turns to a group of renowned experts to assess risks to the macroeconomic situation and the financial system from an international perspective. This year's panel members are Markus K. Brunnermeier (Princeton University), Douglas W. Diamond (University of Chicago), Raghuram G. Rajan (University of Chicago) and René M. Stulz (Ohio State University).

MAJOR ECONOMIC DEVELOPMENTS AND RISKS

- What do you see as the major macroeconomic risks in the next 12 months, in terms of its impact on the financial system? Do these differ across major regions (US, Asia, Europe)?
- What risk do public debt burdens pose to recovery? How urgent is, and what risks entail, respectively, significant budget consolidation in major economies?
- How do you weigh the risks for accelerating inflation versus deflation?

The panel is divided as to whether there is a risk that the global economic recovery will halt. Although several members definitely expect growth to be low in many countries, they do not believe there to be a significant risk of another widespread recession. However, one member does believe that there is a significant risk of a renewed recession in many countries.

All panel members identify problems in central government finances in Europe as a source of macroeconomic problems. Renewed uncertainty over the most exposed countries (Greece, Ireland, Italy, Portugal and Spain) could have contagion effects on the European banking system. This could then lead to widespread rescue measures, which could have repercussions outside Europe as well.

Uncertainty in the U.S. is mainly related to the exposures of small and medium-sized banks to the real estate sector. Although the problems are manageable, they do affect lending to small and medium-sized companies. One panel member pointed out that the actual size of the U.S.'s national debt and future costs for health care and pensions are causes for concern, particularly if the political situation becomes more deadlocked following this year's Congress elections.

In terms of managing government deficits, all members of the panel agree that the rising public debt burdens are a problem. However, they also believe that a too rapid adjustment of these budget deficits could lead to a renewed recession. Several panel members think that it is more important to have long-term and reliable plans in place than to rush budgetary adjustment. However, there are major differences in the

impact that debt burdens have on different countries. In turbulent times, investors move to major economics, such as Germany, the U.S. and Japan, which strengthens the currencies of these countries and leads to lower national interest rates. Japan, for example, has a very high national debt, but its currency has still become stronger during the crisis. However, small countries that have imbalances have reason to be concerned.

The expansionary monetary policy in the U.S. and in Europe is a source of uncertainty and a surplus of liquidity now could cause problems in the future. The incentive for investors to take major risks to increase their returns can be very strong in a low interest rate environment. Another issue related to the expansionary monetary policy of the central banks is the risk of 'competitive devaluations', where countries try to increase their competitiveness by lowering their exchange rates. There is a particular focus on the tensions between the U.S. and China about the need to strengthen the Chinese currency.

The pursuit of returns as a result of low interest rates has also resulted in major capital inflows into emerging markets. Although these countries are showing strong growth, this could suddenly change if the foreign capital disappears.

The panel is divided over the question of deflation and accelerated inflation. Some members think that the central banks can handle deflation, but that this could be at the expense of having inflation above target levels. One member sees a definite risk of deflation. Most think that there is a low risk of very high inflation. However, one panel member does see a risk of accelerated inflation resulting from the excess liquidity that is in the system and the political pressure on the central banks.

RISKS FOR SPECIFIC SECTORS AND INSTITUTIONS

- In your opinion, how far have banks and financial institutions come to recover since the last risk report?
- How do you view the risk that a major financial institution will fail in the next twelve months?
- Which sectors will be the most vulnerable in the next twelve months?

The panel agrees that although the major banks in the U.S. are well on the road to recovery, there are still risks for small and medium-sized banks that have a lot of exposures secured by real estate collateral. Like last year the panel members are more worried about possible hidden losses in the European banking system. One member sees a need for decisive action from supervisory authorities to force new share issues, rather than adapting operations by reducing balance sheets and recapitalising through future profits, which could lead to damaging credit contractions.

The panel believes that there is a low risk of a disorderly failure of a major bank. A shock in central government finances could take down a major European bank, but everyone expects there to be national or European rescue actions if a major bank runs into problems. In terms of risks for different sectors, one panel member brought up credit losses linked to commercial properties again, while another mentioned the risks facing the retail sector, which has borrowed heavily, particularly in

the U.S. One member reiterates that a dominant factor is the problems with central government finances.

DESIRABLE AND EXPECTED ACTIONS BY AUTHORITIES

- What is your view on what is known so far of Basel 3? What is your view on the relative costs and benefits of higher capital and liquidity requirements?
- What is your view on the Dodd–Frank Wall Street Reform and Consumer Protection Act? What parts of the Act are particularly desirable/undesirable?
- What need, if any, do you see to further regulate hedge funds, private equity funds and the like?
- What is your view on restrictions on short-selling?

The panel is mainly positive about the future international regulation of the banks' capital and liquidity (see more about Basel 3 on page 17). In terms of the costs associated with regulation, several members believe that these costs will depend on how the banks react to the new requirements. The costs for society will increase if the requirements lead to a reduction in lending and the sale of assets, rather than new share issues. There is also a risk of the banks circumventing the regulations by finding new ways of taking risks. One panel member points out the fact that liquidity buffers will never be enough in the event of a wide spread liquidity crisis and that central banks therefore will have to act. However, tightening the requirements on liquidity and capital may reduce the risk of a crisis occurring.

Most panel members are also positive about the new U.S. legislation for the financial sector, but point out that it is far from clear how it is actually going to work in practice, as there is still a lot of work that needs to be done to concretise the proposals. Several panel members think that the new authority for research and data collection, the 'Office of Financial Research', is a step in the right direction, as it is important to have information about system risks and data for stress tests. One panel member thinks that it is important for there to be a clear separation between different kinds of activities at the banks. System-critical functions, such as payment systems and clearing, should not be linked to investment banks, for example. Several panel members think that it could be a good idea to have one special authority for consumer issues, the 'Bureau of Consumer Financial Protection', but it is unclear where the focus of such an organisation would lie.

In terms of hedge funds and private equity firms, the panel agrees that these companies have not caused any major problems so far. However, they do think that it would be a good idea to have better supervision of system-critical hedge funds; in particular for analysing the links, for example through financing, to the rest of the financial system and the banking sector.

The panel is negative about a general ban on short selling. A ban would immediately lead to greater uncertainty, as investors would be worried about not being able to sell out of their positions. In addition, these regulations can often be circumvented. Two members think that short-term, targeted bans on the short selling, for example, of shares in system-critical financial companies, could be of some use.

The economic situation

In the wake of the financial crisis, the unrest on the financial markets has recently been caused by debt problems in several European countries and uncertainty over the global business cycle. However, the recovery in Sweden has been quicker than expected.

The global economy has recovered since the heavy fall in 2009, with several countries reporting strong growth in the first quarters of 2010. According to the Swedish National Institute of Economic Research, the Swedish economy is expected to grow by as much as 4.3 per cent in 2010. However, there is still uncertainty about the strength of the recovery and there are signs of several countries already slowing down, which could effect Sweden and Swedish financial companies.

Since April several troubled European countries, primarily Greece, Ireland, Italy, Portugal and Spain, that have large budget deficits have been affected by a strong increase in interest rates for government bonds. Concern over the ability of these countries to deal with their national debt escalated during the spring, creating further problems on the financial markets and leading to a crisis of confidence in the Euro. After EU finance ministers and the International Monetary Fund (IMF) agreed to set up a European financial stabilisation mechanism, the situation has improved, but the underlying issues and the need for decisive budget consolidation still remain in many countries.[1]

At the same time, the interest rates for government bonds are at historically low levels in many other countries, including the U.S., Germany and Sweden.

THE FINANCIAL MARKETS IN THE WAKE OF THE FINANCIAL CRISIS

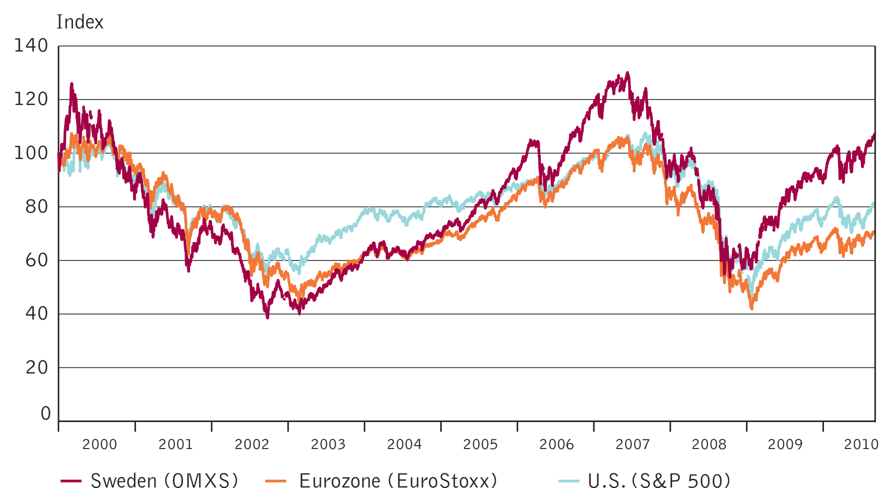
Two years has passed since the peak of the financial crisis. The substantial support packages from central banks and governments started to be phased out in the spring, but renewed concerns have led many central banks to take further actions in recent months. The balance sheets of the central banks have therefore continued to increase by substantial amounts.

The European Central Bank (ECB), the Federal Reserve (Fed), the Bank of Japan and the Bank of England have all stated that they intend to keep the current record-low interest rates for some time because of the uncertainty over the economic recovery. However, the Riksbank, Sweden's central bank, has increased its repo rate on three occasions, from 0.25 per cent to 1 per cent, and has signaled that it intends to continue to do so.

The low interest rates for government bonds in the West have already led to investors taking greater risks to achieve higher returns. This can be seen, for example, in the strong increase in capital flows to emerging markets.

1 More information about the financial stabilisation mechanism can be found at http://www.consilium.europa.eu/showFocus.aspx?id=1&focusid=478&lang=EN

STOCK MARKET DEVELOPMENTS



Source: Reuters Ecowin

Since the autumn of 2009 the stock market has been cautiously positive, following the strong rise from the low that was reached in March 2009. The Stockholm Stock Exchange has improved more than the stock exchanges in the U.S. and the eurozone, reporting its highest level for the year in the autumn.

The Swedish krona has recovered from the sharp depreciation during the financial crisis and is now slightly stronger than before the start of the financial crisis.

The U.S. dollar has weakened in trade-weighted terms during the summer and autumn. The euro weakened against the dollar during the period of increased concern for sovereign debt, but has since appreciated. The yen has appreciated, reporting a 15-year high against the dollar, and the Japanese authorities decided to intervene on the market in an attempt to weaken their currency. Several emerging markets have taken action to slow the appreciation of their exchange rates. Most actors think that the Chinese currency is undervalued, and many countries believe it should be strengthened. Although this has rekindled the discussion about foreign exchange policy, which in a worst case scenario could result in protectionist measures, the tone has calmed down recently.

Financing markets

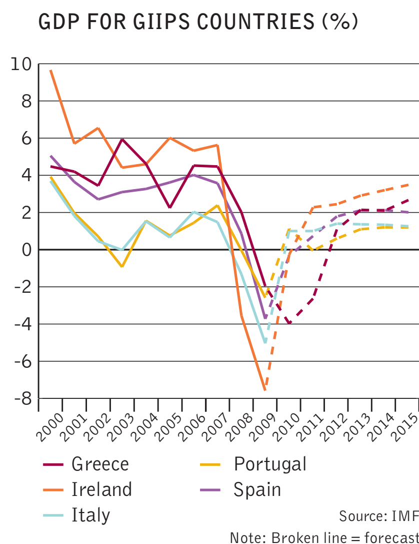
Access to financing has gradually improved for non-financial companies. According to the National Institute of Economic Research, only 19 per cent of the Swedish companies asked in September said that it was more difficult than normal to gain access to financing. This figure was 36 per cent in the summer of 2009. In the U.S. the banks' lending to companies is falling slightly, but it is increasing in Europe. One explanation could be that the American companies have been making greater use of market financing, a trend that we have begun to witness in Sweden and Europe. Proof of this are the record levels of corporate bond issues in 2009, which have remained high in 2010.

Financing for financial companies has also improved this year. The European banking system faced a drop due to new financing problems related to the uncertainty over central government finances in the spring. This led to Swedish banks experiencing some problems with foreign market financing. However, the Swedish major banks are well capital-

ised from an international perspective and earnings are good, which is reflected by an improving financing situation.

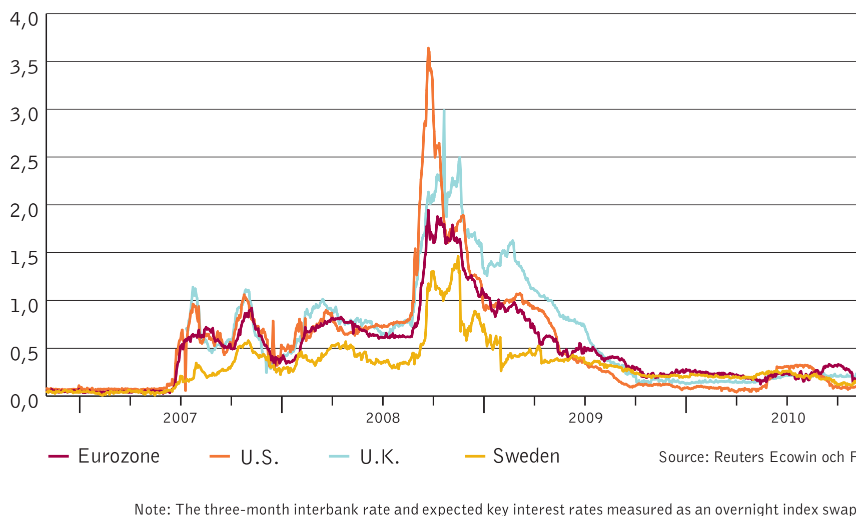
The risk premiums, measured as the difference between interbank rates and expected overnight rate, have remained relatively stable at low levels over the past year since the autumn of 2009. The risk premiums for banks have fallen back to more historically normal levels during the summer and autumn.

GDP FOR GIIPS COUNTRIES (%)



Source: IMF
Note: Broken line = forecast

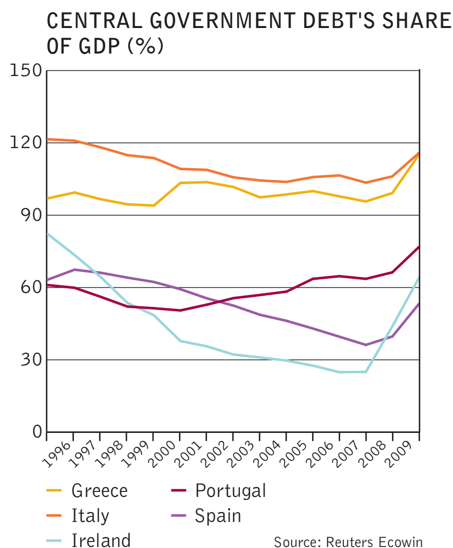
RISK PREMIUMS (percentage units)



Source: Reuters Ecowin och FI

Note: The three-month interbank rate and expected key interest rates measured as an overnight index swap.

CENTRAL GOVERNMENT DEBT'S SHARE OF GDP (%)



Source: Reuters Ecowin

Uncertainty over central government finances

Over the past six months problems in the central government finances of some European countries have been in focus, particularly in Greece, Ireland, Italy, Portugal and Spain ('GIIPS countries'). The central government finances of these countries have worsened considerably in recent years. Uncertainty over the countries' finances made it more difficult for them to secure financing during the spring and also led to problems on the funding markets. These problems also impacted Swedish banks.

The EU and the IMF gave Greece substantial loans to deal with its financing problems. However, several countries were still having problems and were confronted with mistrust, which led the EU and the IMF to launch a more extensive support package on 9 May in the form of a financial stabilisation mechanism. In this support package, the EU countries and the IMF placed EUR 720 billion at the disposal of the euro countries to cover any financing needs. The ECB also decided on a range of actions to tackle the problems on the financial markets.

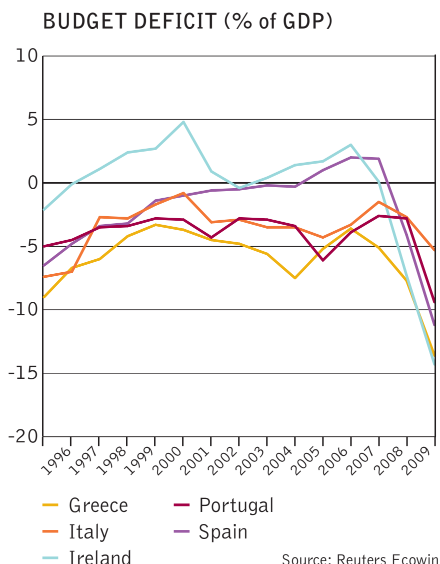
High borrowing needs and high interest expenses are leading to a rapid increase in the national debt of GIIPS countries. The size of the national debt is a problem for Greece and Italy in particular. Spain is struggling with major unemployment problems and its property market has collapsed. The Irish real estate market has also collapsed and the country has major problems due to its need to recapitalise its banking system with state funds.

Following the turbulent spring, the level of uncertainty decreased on the financial markets at the end of the summer. Confidence has been growing for the most exposed economies, following early signs that the budget adjustments are proceeding more quickly than planned in these economies and coupled with budget constraints in several euro countries and stronger growth than expected.

■ The EU's stress test

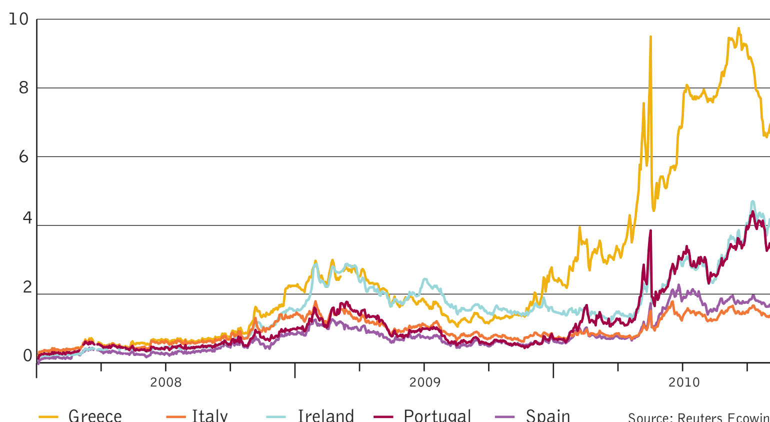
Committee of European Banking Supervisors' (CEBS) stress test of Europe's major banks: http://www.fi.se/Utredningar/Skrivelser/Listan/EUs-stresstest-av-storbankerna/

BUDGET DEFICIT (% of GDP)



Source: Reuters Ecowin

DIFFERENCE IN TEN-YEAR INTEREST RATE BETWEEN GIIPS COUNTRIES AND GERMANY (percentage units)



Source: Reuters Ecowin

Concern for the banking system was also alleviated following the stress tests carried out by the Committee for European Banking Supervisors (CEBS). However, the GIIPS countries are still facing major challenges and cuts are needed. It is clear that the problems for these countries will remain for some time to come and there is still a high risk of another set-back. This has led to the interest rates for government bonds remaining very high for the GIIPS countries. Proof of this can be seen in the increase in the difference between interests rates in long-term government bonds in Germany and these countries.

Possible contagion risks from the uncertainty on foreign markets caused by national debt problems are described in a special section on the risks for Swedish banks on page 18.

ECONOMIC DEVELOPMENT

So far the global economic development for 2010 has been stronger than what could have been predicted following the financial crisis. Some countries, including China, Germany and Sweden, showed much stronger growth than what was expected. However, question marks still remain over the strength of the recovery.

GDP international, annual rate

	2008	2009	2010f	2011f	2012f
Sweden	-0,4	-5,1	4,3	3,4	3,0
Eurozone	0,5	-4,1	1,7	1,5	1,8
U.S.	0,0	–2,6	2,6	2,3	3,0
China	9,6	9,1	10,5	9,6	9,5

Note: f=forecast

Source: National Institute of Economic Research and IMF

Growth in the U.S. also weakened at the beginning of 2010. The effects of the fiscal policy stimuli are subsiding, U.S. consumption is developing weakly and the development on the labour market continues to be poor. The American mortgage market, which has still not recovered from the crisis, is also having a negative impact on consumption and investments. Weak growth and the risk of deflation led the U.S. central bank, the Fed, to signal that it was considering buying more securities to help lower the interest rate.

The business cycle in the eurozone is divided, with some countries, like Germany, reporting strong growth. The European countries that have been badly affected by the national debt crisis have seen weak growth and need to implement far-reaching savings measures in the near future.

The economic development in Asia has been good and countries there have dealt with the economic downturn relatively well. The recovery in this area has been helped by fiscal policy support packages and good central government finances. However, there are also signs of a deceleration in the Asian countries. China is carrying out a controlled slowdown, as the support package is ebbing away and growth is expected to weaken in coming years.

The business cycle is also affected by the write-downs needed by the banks. In its Global Financial Stability Report the International Monetary Fund (IMF) estimates that the total write-downs during the financial crisis, from the second quarter of 2007 to the fourth quarter of 2010, amount to USD 2,200 billion.[2] There has been a slight downward revision since the previous report. According to the IMF a total of USD 550 billion in losses still needs to be written off.

QUICKER RECOVERY IN SWEDEN

The Swedish economy has recovered quickly following the sharp downturn during the financial crisis in 2008 and 2009. This turnaround can be explained by a better economic climate on surrounding markets, which has benefited the Swedish export sector, and by the expansionary economic policy both in Sweden and abroad. Sweden also has good central government finances, which means that unlike many other countries it does not have to reduce its public expenditure. Household consumption and companies' stock build-up are also contributing to the good business cycle. Although employment is increasing, unemployment remains high and is only expected to fall slowly in the coming years. The confidence indicators are strong; for example the National Institute of Economic Research's confidence indicator for September for households and trade and industry is the highest it has been since 2000.

GDP, inflation and unemployment for Sweden

	2008	2009	2010f	2011f	2012f
GDP growth	-0,4	-5,1	4,3	3,4	3,0
Inflation (CPI)	3,4	–0,3	1,1	1,6	2,1
Unemployment (ILO)	6,1	8,4	8,5	8,2	8,0

Note: f=forecast

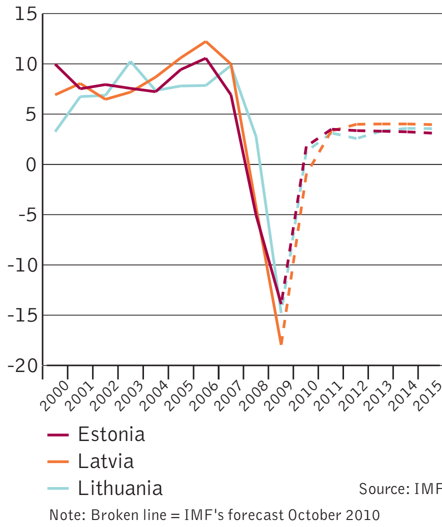
Source: National Institute of Economic Research

However, a slowdown in the global economy is also affecting the development of the Swedish economy, and downside risks in the global economy could therefore be a cause for concern for the business cycle in Sweden.

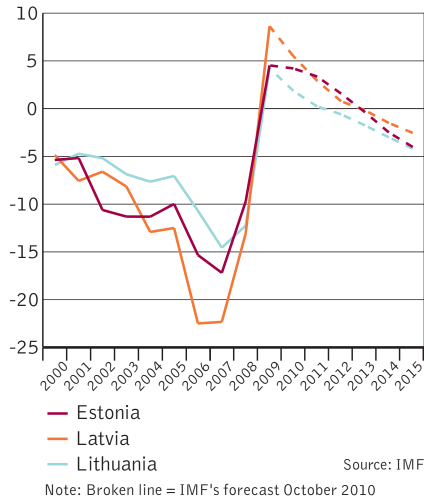
Although the monetary policy in Sweden continues to be expansionary, the Riksbank increased the repo rate from 0.25 per cent to 1 per cent in the summer and autumn. More increases are also expected from the Riksbank according to their repo rate forecast; at the end of 2011 the

2 IMF's Global Financial Stability Report: http://www.imf.org/external/pubs/ft/gfsr/2010/02/index.htm

GDP IN THE BALTIC REGION (%)



TRADE BALANCE IN THE BALTIC REGION (%)



repo rate is expected to be two per cent. The Government's and Riksbank's support measures for the banks have in principle been phased out in 2010 and Sweden is leading the world in this respect. Once the Riksbank's extraordinary fixed-rate loans to the banks finished in the autumn, the large surplus on the krona market disappeared. Although this led to some disturbances on the Swedish interbank market, the phasing-out of the support measures has generally been smooth.

The Baltic region

The Baltic countries are now recovering from the extreme hardship that they experienced. The internal devaluations are starting to have an impact, while an increase in demand from the rest of Europe has helped the Baltic countries. This crisis has led to a need to adopt a fiscal restraint policy and to implement structural reforms to make their economies more competitive. The parliaments in these countries have therefore made big savings. One evidence of the strength of these reforms is Estonia's planned accession to the euro on 1 January 2011.

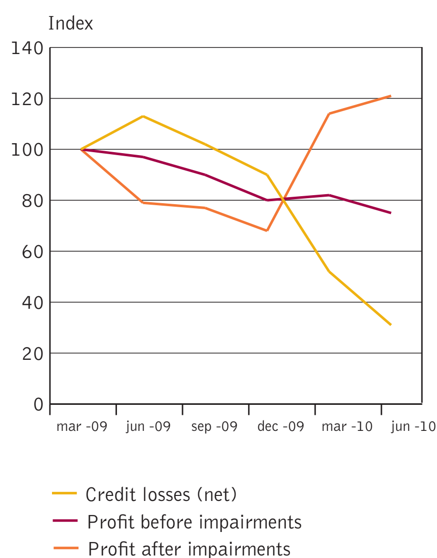
A deceleration in the global business cycle could place further pressure on the Baltic economies and lead to a more drawn-out recovery. High unemployment and the continued drop in pay mean that lending to households and companies remains low, and the creditworthiness of the Baltic households and companies will remain low for some time to come. (You can read more about the Baltic region on page 18 in the chapter 'Banks and investment firms'.)

Banks and investment firms

In the short term Finansinspektionen (FI) believes that the economic recovery in the Nordic region and the Baltics will continue to strengthen the banking sector's results. However, there are still several risks in the slightly longer term. Uncertainty over the economic recovery and European central government finances remains. More specific risks include the strong growth of the credit market companies, and risks associated with internal governance and control.

The banking sector[3] has benefited from Sweden's strong economic development and increased stability over the past year. Its assets have grown by around 4.5 per cent compared with a year ago. To a large extent, the strength of the financial recovery in Sweden and its surrounding markets will determine the strength of continued growth and the scope of credit losses. Even though the improvements in the Baltic operations have exceeded expectations, there is still uncertainty about the future development. However, FI's stress test confirms that the major banks are well capitalised.

PROFITABILITY OF THE MAJOR BANKS



Source: Interim reports from the large banks

■ Net interest income
The difference between income from lending and debt securities and the costs of deposits and other interest bearing funding.

■ Net commission income
The difference between income and costs for different fee-based services.

DEVELOPMENTS DURING THE YEAR

Earnings, credit losses and profitability

The 2009 financial year was characterised by major credit losses, particularly for banks operating in the Baltic region. However, the four major banks have experienced a much more positive trend in 2010. The profits of the major banks have been strengthened by improved economic climate in Sweden and abroad and, in particular, by quicker stabilisation in the Baltic region than expected. This increase in profits can be explained almost entirely by lower credit losses.

Both net interest income and net income from financial transactions have fallen from 2009 levels, which was partially compensated by an increase in net commission income. However, the third quarter reports show that there has been a further increase in the banks' net interest income.

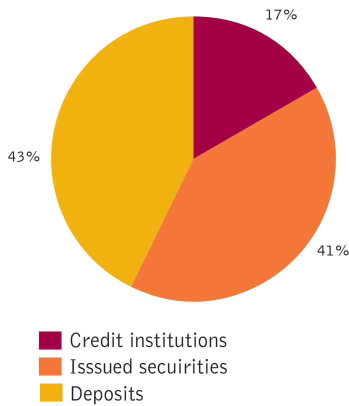
Net interest income makes up more than half of the major banks' earnings. Since the first half of 2009 net interest income has fallen, mainly due to lower lending margins and higher costs for borrowing that has longer maturities than before the crisis.

Apart from a few exceptions, the smaller banks, including the savings banks, are continuing to generate profits and their credit losses are continuing to fall. However, the banks' operating profit was lower than the same period last year, which can partly be explained by a fall in net interest income.

Earnings for credit market companies have increased due to higher lending volumes. The operating profits of investment firms are also demonstrating a positive trend compared with the same period last year. As commission income accounts for the majority of their income and is

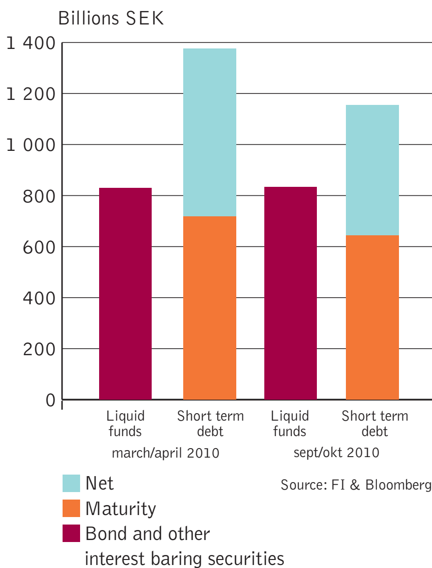
3 In this report the banking sector refers to major banks, other banks, investment firms and credit market companies. The banking sector is dominated by the four major banks, Handelsbanken, Nordea, SEB and Swedbank, which together account for 84.4 per cent of the total assets on the Swedish market.

THE BANKS' SOURCES OF FINANCING



Source: FI

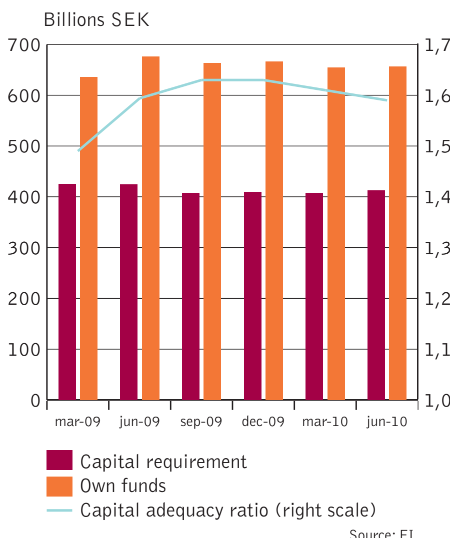
THE LIQUIDITY OF THE MAJOR BANKS



Source: FI & Bloomberg

*Net interbank shows the difference between the banks' borrowing and lending from other financial companies. This figure highlights the fact that major Swedish banks are in debt to the international banking market.

THE BANKS' CAPITAL ADEQUACY RATIO



Source: FI

strongly linked to the development of the stock market, profitability is expected to continue to grow, provided that the economic recovery continues.

FI believes that profitability in the banking sector will continue to improve in the coming quarters, partly due to lower credit losses in the Baltic region. Profit before credit losses will be supported in the short term by rising short-term rates. However, there will be pressure on net interest income in the long term from tighter regulations for liquidity and risk management. The market's requirements have already led to the major banks extending the maturities of their financing and increasing the size of their liquidity reserves.

Lending and funding

While lending growth to households remains high, lending to companies is still falling, but to a lesser extent than before. This can be partly be explained by low demand, but is also a result of major companies gaining access to direct financing through bonds and commercial paper, which has led to them asking for smaller loans from the banks.

Deposits from the general public make up the largest share of the banks' funding. The major banks have seen an increase in deposits, but at a lower rate, while smaller banks and credit market companies have seen an increase in deposits over the past year. Issued securities represent the second largest source of funding, with covered bonds accounting for the largest share of these securities. The Swedish covered bonds market has remained relatively stable during the financial crisis.

Liquidity of the major banks

The liquidity situation for the four major banks on the whole has become stronger. They have extended the maturities of their borrowing, and the volumes of long-term debts that mature over the next 12 months are currently lower for all banks than they were six months ago. In the same period net borrowing from other banks has fallen, while the major banks' liquidity buffers of bonds and debt securities have generally remained unchanged.

Capital adequacy

Capital adequacy measures the buffer capital that the banks hold to manage future losses. The capital adequacy ratio shows the relationship between own funds and the capital requirement, with the figure for the banking sector as a whole standing at just under 1.6, which is the same as the same period last year. Although own funds have fallen marginally, this has been compensated by a fall in the capital requirement. This reduction in the capital requirement for the major banks has been caused by lower risk weights for private lending and corporate lending in the first six months of the year. The reduction in the major banks' own funds compared with last year is a result of some subordinated loans not being renewed, which has not been fully compensated by profits earned.

Smaller banks, credit market companies and investment firms have generally a higher capital adequacy than the major banks because their operations are smaller, making them less diversified. On average the capital in investment firms is as much as two and a half times higher than the minimum requirement.

Basel 3 – new regulations for liquidity and capital

After the financial crisis it became clear that the banking sector's capital and liquidity needed to be strengthened. FI is a participant in the Basel

Committee on Banking Supervision and was involved in the negotiation of the new international regulations for banks. The final agreement from the Basel Committee will be presented in November. This will signal the start of a process in which these international regulations will be implemented at the EU level and in Sweden. The requirements are expected to come into force gradually through 2018. FI is generally very positive about these new regulations and believes that they have an important role to play in creating a more stable financial sector.

Basel 3 in brief

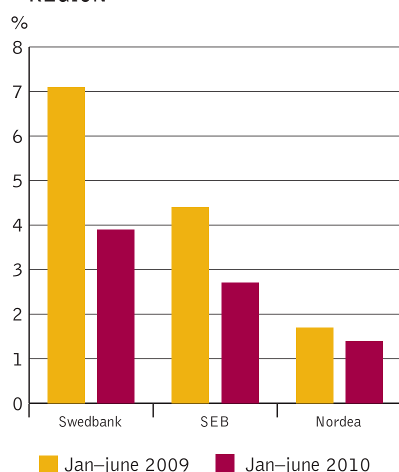
The capital requirements will be increased, with a requirement for at least 4.5 per cent of common equity and additional buffer capital of 2.5 per cent, making a total of 7 per cent. A countercyclical buffer will also be introduced, which can vary between 0 and 2.5 per cent depending on the business cycle and credit growth. The capital requirements will cover more risks and will become much stricter for market risks.

A non-risk-weighted leverage ratio was presented to prevent circumvention of these regulations, over-indebtedness and risk accumulation when times are good. However, this ratio will not normally be binding initially; but act as an aid in supervision.

The requirements on the banks' liquidity risk management will increase and banks will have to maintain an adequate liquidity buffer to deal with liquidity stress during 30 days. There will also be a limitation how short term funding can be in relation to lending.

The banks will also incur more costs as a result of stricter requirements for liquidity and capital. Some of these costs will be passed on to their customers, which means that we will probably have to live with slightly higher loan interest rates in the future. However, investors likely demand the same high profit margins from banks that are more stable, so some of the costs can be offset through lower dividends. According to the Basel Committee's impact study[4], this should only have a limited effect on economic growth, making costs significantly lower than the benefits that society will gain from having a more robust financial system with fewer financial risks.

CREDIT LOSS LEVEL IN THE BALTIC REGION



Source: Interim reports from the banks

RISKS FOR BANKS AND INVESTMENT FIRMS

The Baltic region

As stated in the previous chapter on economic development, 'The economic situation', the Baltic economies have developed more positively than expected over the past year. The stabilisation of the Baltic economies in 2010 has been reflected in much better results and much lower credit losses for the Swedish banks' Baltic operations. However, this development is vulnerable and there are still considerable credit and earnings risks that could materialise if there is a renewed decline or a drawn-out recovery.

Despite the falling credit loss levels, the Baltic region still presents a significant risk to the major banks that operate there. However, FI judges that most of the credit losses have now been realised and loss levels are

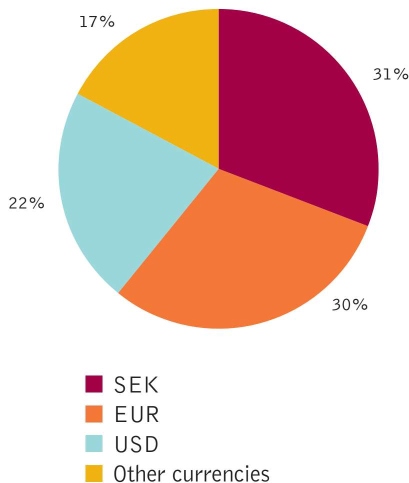
4 The Basel Committee's analysis of the effects of these new regulations is available through the following link: http://www.bis.org/press/p100818.htm

returning to normal. FI has carried out extensive investigations of the Baltic operations as part of its supervision work. FI also collaborates closely with the Baltic supervisory authorities in the supervisory colleges to produce an overall capital assessment of the banks.

Uncertainty on foreign markets and liquidity risks

Liquidity risks have been in focus since the start of the financial crisis and will continue to be an area that FI and companies will need to pay particular attention to. Liquidity has improved on the international financing market over the past year. However, the turbulence during the second quarter caused by the central government finances in several EU countries (for more detail, see the previous chapter 'The economic situation') has shown that the situation is still unstable. The cost of interbank financing shot up for European banks and there was a temporary lack of US dollars.

CURRENCY ALLOCATION



Source: Banks reports and FI

The dependency on foreign market financing is illustrated by the allocation of currencies for securities issued by the major banks.

However, the market for covered bonds in Swedish kronor generally continued to function throughout this period and therefore proved to be a relatively stable source of financing for the major Swedish banks. Setting up the European financial stabilisation mechanism managed to regain some trust, but underlying problems still remain. The Swedish banks only have low direct exposures to the most indebted GIIPS countries (Greece, Italy, Ireland, Portugal and Spain) and they are well capitalised and have good earnings. This means that the Swedish financial system should be able to effectively handle a limited amount of uncertainty on foreign markets. However, problems could arise if the debt crisis becomes more serious or if other factors create uncertainty over financing. Swedish banks have a very high share of foreign market financing.

■ Liquidity regulation

See the following link for FI's work with liquidity regulation: http://www.fi.se/Regler/Likviditet/

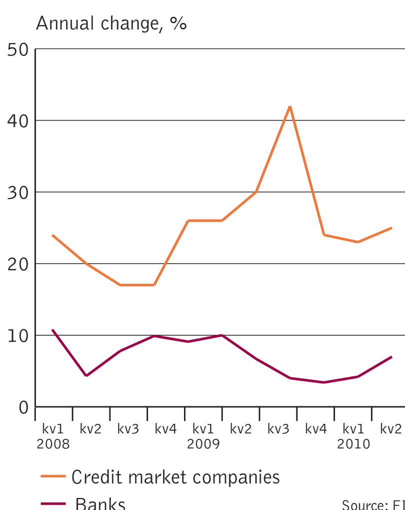
Other sources of uncertainty on the foreign markets include the consequences of phasing out support measures in the future and the stricter requirements for liquidity in Basel 3. In Sweden the support schemes from the Riksbank and the government have virtually all been phased out. However, many European banks are still heavily dependent on central bank financing, which could make it complicated to phase out this kind of support.

Tightening liquidity regulations will generally lead to an increase in financing costs, and this could have discernible effects on banks that do not have adequate liquidity risk management.

FI believes that it is necessary to tighten the requirements on liquidity risk management and its supervision. Just like in other EU countries, FI has recently decided to implement new regulations for liquidity risk management. This is the first stage in a process that will be followed by the future Basel 3 regulations, which contain quantitative requirements.

GROWTH IN DEPOSITS

Annual change, %



Source: FI

Rapid growth of credit market companies

In recent years many credit market companies have grown very strongly, attracting a large amount of new deposits. Many smaller credit market companies are completely reliant on deposits as a source of financing. The average growth in deposits for credit market companies was around 25 per cent during the year, compared with only seven per cent for the banks. The extreme rise in 2009 can be explained by a few companies that attracted large deposits from the general public by offering high interest rates.

FI has also seen more interest in setting up credit market companies. Increasing the deposit guarantee to SEK 500,000 during the crisis, which

will increase to EUR 100,000 in the future, has made deposit financing an interesting alternative for many companies who used to be financed by borrowing from banks or markets. FI therefore believes that this trend will continue.

In general terms deposits are a stable source of financing for banks and credit market companies. However, this is not necessarily the case for some credit market companies. Smaller credit market companies often compete for deposits by offering much higher deposit interest rates than other companies. It is not improbable that customers attracted by these offers would also be likely to move their capital to another actor that can offer even higher deposit interest rates.

Rapid expansion in financial operations also presents risks. The credit market companies that have been able to increase their balance sheets in a very short period of time are now facing major challenges. If they are going to be able to pay higher deposit interest rates, they have to invest their money in assets that produce a sufficiently high return. This could lead to them taking too high risks, which would demand a lot from their internal governance and control and risk management (see the section on this topic below). If several of these companies were to fail, this could dent the trust in the market as a whole, even though the the deposits that are being made are normally below the deposit guarantee amount.

FI will carefully monitor future developments and will carry out an in-depth investigation of the internal governance and control and the risk-taking of these companies.

Internal governance and control

Requirements for internal governance and control are at the heart of the business regulations for financial companies. These requirements have developed from focusing originally on strict checks to now expecting the companies to demonstrate a holistic approach to their operations, in particular the board of directors' work on targets, risks and monitoring.

In recent years FI has seen several cases in which deficiencies in internal governance and control have led to errors in valuations and reporting. These include deficiencies in the company's organisation of risk management and control functions, issues relating to the division of responsibility, and board of directors and management that did not have adequate knowledge of the risks in their own operations and the regulations that they need to follow. They have also clearly allocated far too few resources to carry out these tasks.

■ HQ Bank AB

See more about the HQ Bank case at: http://www.fi.se/Sanktioner/Finansiella-foretag/HQ-Bank/

Case study - HQ Bank AB

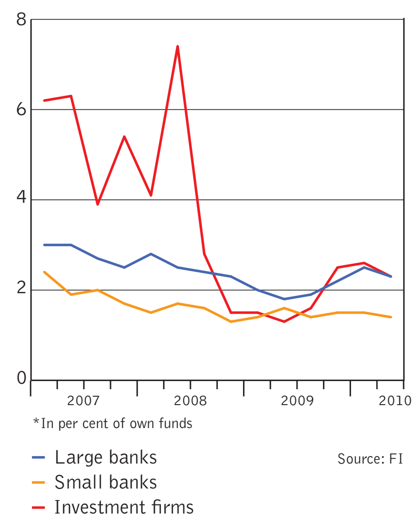
On 28 August 2010 Finansinspektionen revoked HQ Bank AB's licence. In its decision to revoke this licence, FI said that HQ Bank had demonstrated serious deficiencies in its internal control and governance. HQ Bank had overvalued its trading portfolio for a long time, which led to the bank's financial position being reported inaccurately. A correct valuation would have shown that the bank had been undercapitalised since December 2008. The bank was therefore in violation of accounting and capital adequacy regulations. The bank had taken risks that were so large as to compromise its survival. The bank lacked sufficient risk management and the board of directors and the managing director had not limited the level of the bank's risk taking as was required by law. In practice the bank lacked effective risk management. Nei-

ther the board nor the managing director had acquired sufficient knowledge and information about the trading operations and the risks associated with them.

Over the next year FI will be placing particular focus on internal governance and control and the board's responsibility for ensuring that companies have adequate control of their risks. This will apply in particular to operations that include instruments that are hard to value.

Market risks in banks and investment firms

CAPITAL REQUIREMENTS MARKET RISK*



*In per cent of own funds

Source: FI

The cases of HQ Bank AB in 2010 and Carnegie Bank AB in 2008 are both examples of poor management and reporting of market risks in trading operations. However, in terms of capital adequacy, market risk does not present a significant risk for Swedish banks and investment firms. Market risk only accounts for 2-3 per cent of the total capital requirement. However, this assessment does assume that the companies measure and report their risks correctly. This is why FI will be paying particular attention to this area in the coming year.

There has been a generally stable development in the capital requirement for market risk in relation to own funds since the beginning of 2009. The rapid fall in the capital requirement for investment firms in the second quarter of 2008 can by explained by the fact that some larger investment firms, in particular Carnegie, drastically reduced their exposures. In terms of savings banks, the capital requirement for market risk is only 0.2 per cent of own funds.

Risks in commercial real estate

Risks associated with lending for purchasing commercial real estate have been highlighted internationally and in conversations with our panel of economic experts. Commercial real estate lending also accounts for a substantial share of lending in Swedish banks (around 18 per cent of total lending from the major banks[5]). However, the experiences gained from the Swedish banking crisis in the 1990s have led to Swedish banks being generally more cautious with their loan-to-value ratios and focusing on cash flows when making credit assessments. FI therefore believes that the risks for commercial real estate lending are similar to other kinds of lending. However, it is also clear that the Swedish commercial real estate market is affected by changes on foreign markets and by the willingness of foreign actors to make property investments in Sweden. Both the financial companies and supervisory authorities should therefore continue to pay attention to this risk in the future.

STRESS TEST OF THE MAJOR BANKS

FI's internal stress test was carried out in the third quarter of 2010, using the first quarter of 2011 as the starting point. This test confirms FI's previous assessment that the major banks are well capitalised.

In FI's stress test we estimate the banks' resistance in a three-year scenario which sees a rapid halt to the recovery and a renewed recession in Europe. This scenario leads to the banks suffering lower earnings and higher credit losses, which has a negative impact on capitalisation. It also assumes that new lending ceases, and the average risk weight goes up. It is assumed that the banks will distribute 40 per cent of their net profit if they report a profit and nothing if they report a loss.

5 Including lending to tenant-owners' associations.

The scenario assumes very high credit loss levels, although they are slightly lower than those assumed in the stress test last year. The main reason for this is that we are assuming lower credit losses in the Baltic region. Most of the bad credits in the Baltic region have already been written off and the forecasts for economic development have improved considerably. However, this year's stress test assumes higher credit loss levels in the commercial real estate and mortgages sectors, which accounts for a sizeable proportion of the banks' lending.

FI judges this scenario to be improbable but not impossible. Compared with the stress test carried out by the Committee of European Banking Supervisors (CEBS) in July this year, the credit loss levels for the major Swedish banks are much higher in FI's stress test. The accumulated credit loss level in FI's stress test amounts to 3.99 per cent, while the figure in the CEBS stress test amounted to 1.70 per cent. However, the CEBS stress test also contained a shock to central government debt, leading to valuation losses on the mark-to-market bond portfolios. However, FI's stress test results in much higher losses on the whole.

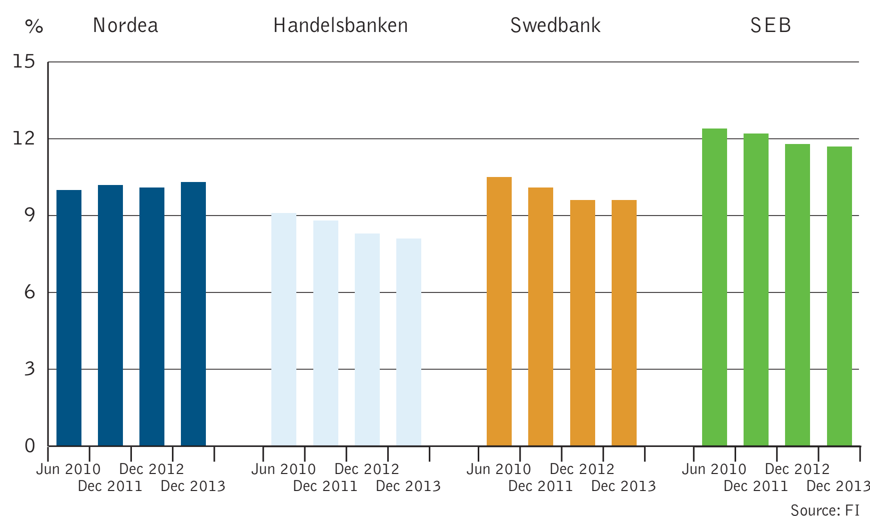
Results

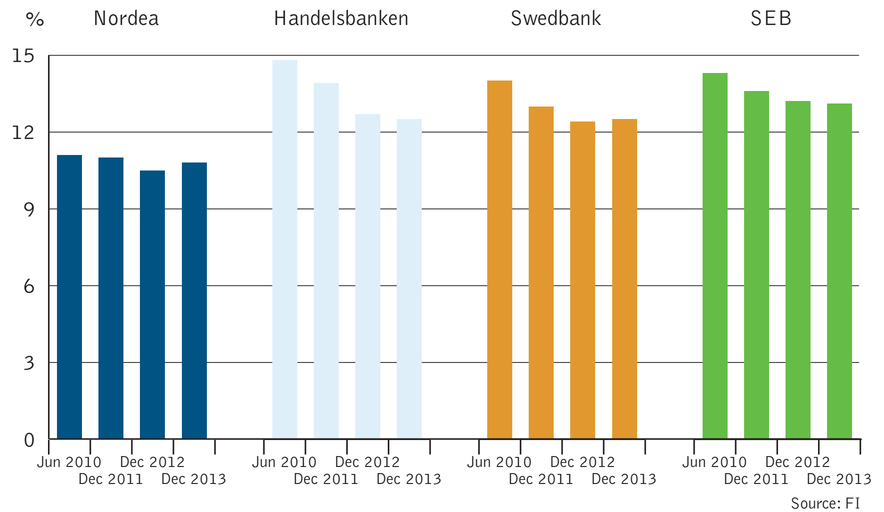
In the scenario all the banks have retained adequate buffers with respect to the minimum regulatory requirements with transitional rules. The Tier 1 capital ratios fall to 8.1% at their lowest. Without transitional rules, the Tier 1 capital ratios fall to 10.5% at their lowest.

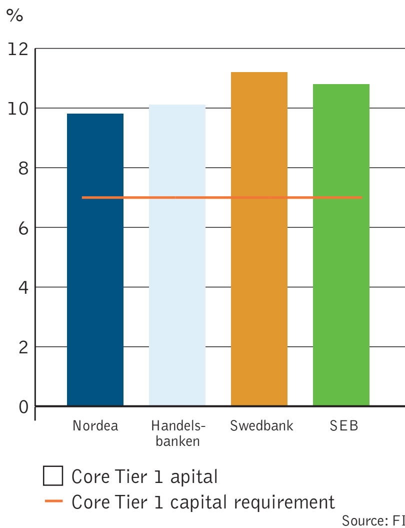
Profit for the major banks in FI's stress test

SEK million, 2011–2013	Nordea	Handelsbanken	Swedbank	SEB
Profit before impairments	104 396	43 373	34 325	34 532
Credit losses	116 900	57 821	46 828	46 886
Taxes	188	-	-	-
Profit after tax	–12 692	–14 449	–12 503	–12 354
Dividend	270	-	-	-
Change in equity	–12 962	–14 449	–12 503	–12 354

TIER 1 RATIOS WITH TRANSITIONAL RULES







Core Tier 1 capital ratios in the major banks without transitional rules.

A more detailed description of the stress test methodology and the scenario is available on FI's website: http://www.fi.se

Preliminary Basel 3 capital requirements

FI has also estimated how the results of the stress test relate to the future Basel 3 capital requirements. This has been carried out by using a core Tier 1 capital ratio of 7 per cent (see Basel 3 chapter on page 17). Note that in this estimation, FI has used the current definition of risk-weighted assets, which means that capital adequacy is slightly overestimated compared with the proposals set out in Basel 3.[6]

At the end of the scenario, the major banks have core Tier 1 capital ratios of between 10 and 11 per cent, which is a relatively good margin.

6 The calculated core Tier 1 capital ratios are based on a rough estimate that does not take into consideration the change in the definitions of both own funds and capital requirement in Basel 3. In terms of the Swedish banks, the difference resulting from the change in the definition of own funds will be relatively limited.

Insurance and investment funds

Although insurance companies are continuing to report good solvency, the low interest rate presents risks for life insurance companies in particular. With regard to fund management companies, Finansinspektionen (FI) wants to highlight the risks associated with depositaries not exercising enough control. It is important for all types of companies to focus on internal governance and control over their risks.

Supervising insurance companies mostly involves monitoring the companies' solvency, i.e. their ability to meet their commitments to their policyholders. Although insurance companies are being affected by the uncertainty on the financial markets and low interest rates, no insurance companies reported any problems in meeting the statutory solvency requirements at the end of the first six months of this year. However, FI can see that there is a risk that the continued low interest rates could make it difficult for some life insurance companies to meet their guaranteed commitments. Insurance companies will also have to adapt their operations to meet the future EU regulations for solvency, Solvency 2.

FI also supervises fund management companies and the depositaries that hold the assets of the funds. In its ongoing supervision, FI has noticed deficiencies in the control that the depositaries have over the fund management companies.

■ Solvency and solvency ratio

Solvency measures the company's ability to meet its obligations to policyholders. The solvency ratio is based on own funds calculated by the company (see glossary), which are related to and must exceed a calculated solvency margin (see glossary). This calculation aims to ensure that the company has enough capital to meet its commitments even if they are higher than assumed. A solvency ratio of, for example, 5 means that the company has five times as much capital as the applicable capital requirement.

DEVELOPMENTS DURING THE YEAR

The methods for measuring the solvency of insurance companies are currently being developed. According to current regulations, various standard calculations are used to determine the capital buffer that the insurance companies must have, known as the 'solvency margin'. As the current regulations are not risk-based, FI uses a number of stress tests, called the 'the traffic light', in parallel to this in its supervision work, which takes into consideration financial risks and insurance risks when calculating solvency.

Solvency 2 is expected to come into force in 2013. Like the traffic light, it is based on stress tests, but it is much more sophisticated and far-reaching (see more on page 27).

Non-life insurance companies

Solvency remains very good for non-life insurance companies. As of 30 June 2010, 68 per cent of all non-life insurance companies had a solvency ratio of more than 5. A small number of companies reported a solvency ratio of less than 2. No company had a solvency ratio under 1. The traffic light also shows that the companies have good margins and have on average reported a relatively stable traffic light ratio of more than 3 over time. Consequently FI thinks that there are currently only very minor solvency risks in the non-life insurance area.

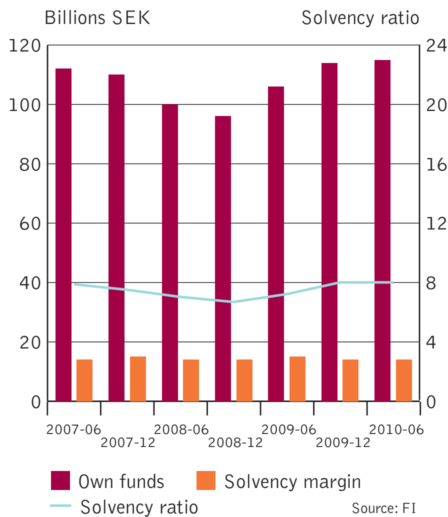
■ Traffic light - stress test for insurance companies

The stress test "the traffic light-model" forms part of FI's methodology in its supervision of Swedish insurance companies. The test measures the exposure of the companies to different risks. These stress tests take into account both financial risks and insurance risks. If a company does not pass the traffic light, FI starts an indepth investigation and dialogue with the company about the need for action.

Life insurance companies and occupational pension funds

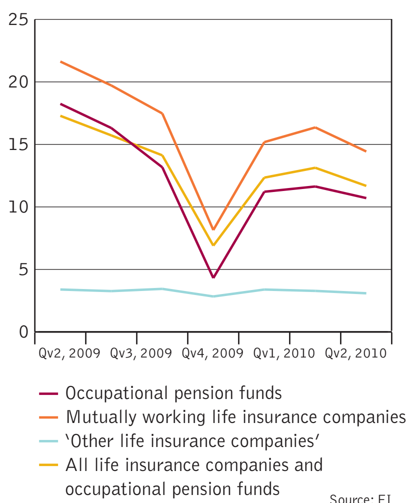
The solvency ratios for life insurance companies fell substantially during the financial crisis. This is because their commitments have a higher estimated present value with a lower discount rate. In addition, equity positions in particular have dropped in value due to the fall in the stock mar-

CAPITAL AND SOLVENCY IN NON-LIFE INSURANCE COMPANIES



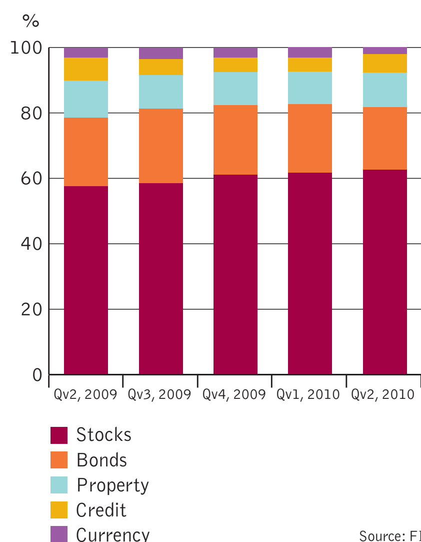
Source: FI

SOLVENCY RATIO LIFE INSURANCE COMPANIES



Source: FI

ALLOCATION FINANCIAL RISKS



Source: FI

ket, which has only been slightly compensated by the increases in the value of interest-bearing assets. The reason why low long rates affect the value of liabilities more than the value of assets is because the companies' liabilities, the pension commitments that can stretch more than 40 years into the future, are much more long-term than the average maturity of the assets.

According to current regulations, the solvency of life insurance companies is good following the recovery after the crisis, but this trend is starting to falter. Mutually working life insurance companies had an average solvency ratio of 15 as of 30 June 2010, while the occupational pension funds had a ratio of almost 11. These companies normally have very high solvency, because only the guaranteed commitments to policyholders are used when calculating their liabilities.[7]

The 'other life insurance companies' group includes profit-distributing life insurance companies. In these companies, a 'conditional bonus' is also considered to be a liability and requires capital. This is why the solvency ratios for companies that have this kind of bonus are generally lower. This group also includes life insurance companies that only sell personal risk products.[8]

Although the solvency situation is generally good, there are companies whose own funds are quite close to the solvency margin. The main risks for these companies are financial. FI is following the economic development of these companies closely.

Financial risks in the stress test "traffic light-model"

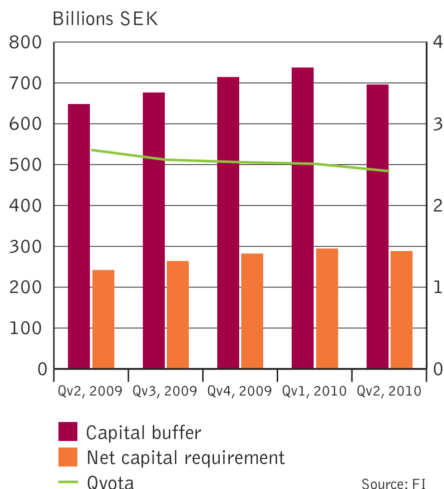
Sensitivity to financial risks represents an important part of the traffic light for life insurance companies that are not covered by the current solvency regulations. In general, 15 per cent of the capital requirement in the traffic light for life insurance companies comes from insurance risks, while 85 per cent comes from the financial risks. Equity price risks dominate in terms of financial risks, accounting for 60 per cent of the calculated capital requirement in financial risks. The traffic light's stress test for shares includes a 35–40 per cent drop in stock prices and a reduction in current market interest rates of around 1 percentage unit. Interest rate risks are generally the second largest financial risks for life insurance companies. However, the model includes a built-in risk reduction, as not all negative outcomes are assumed to occur at the same time.

The diagram to the left on the next page (Capital requirements of insurance companies) shows the recent development of life insurance companies in the traffic light. The reduction in the companies' average traffic light ratios from the second half of 2009 is a result of an increase in the total capital requirement increasing at the same time.

7 Bonuses that are only preliminary distributed to policyholders will instead go into own funds (known as the consolidation fund).

8 The operations of life insurance companies are run with less capital as large parts of the incoming premiums are soon paid out to their customers through insurance remuneration. The average solvency ratio in this group was around 3 during the second quarter, which is an acceptable level.

CAPITAL REQUIREMENT FOR LIFE INSURANCE



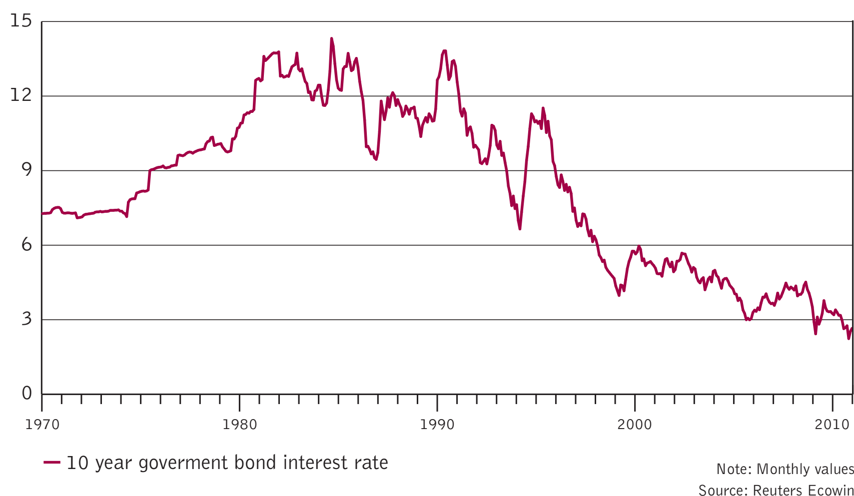
Source: FI

RISKS FOR INSURANCE AND FUNDS

Market sensitivity of life insurance companies

We currently have historically low interest rates. This has a major impact on life insurance companies in particular as they have high guaranteed commitments. Insurance savings in life insurance companies and occupational pensions funds amounted to SEK 1,900 billion in 2009. More than 70 per cent of these savings are linked to commitments based on long-term interest rate guarantees. The average guaranteed interest rate in the companies' portfolios is currently around 3.5 per cent. Many agreements are 15–20 years old and promise a guaranteed interest rate of 5 per cent, while new policies normally have a rate of between 2 and 2.5 per cent. The older agreements were signed under completely different conditions than today. The diagram below shows how the interest rate for ten-year government bonds has fallen in recent decades.

LONG MARKET RATE



Note: Monthly values
Source: Reuters Ecowin

If the current levels remain or interest rates continue to fall, this could make it difficult for life insurance companies with old agreements and lower capital buffers to meet their commitments. If the companies decide to reduce their risks by selling shares and investing in interest-bearing assets to protect their solvency, it could start a procyclical circle. As insurance companies are such major actors, this could lead to a further drop in share prices and further compressed market interest rates, which would worsen solvency and put further pressure on reducing risks.

The problems caused by the low interest rate and the risk of procyclicality are not only found in Sweden. Sweden and FI were driving forces in producing a model in the future regulations, Solvency 2, which will enable discounting for long commitments using a calculated long-term interest-smoothing rate[9], rather than current market interest rates. This model could reduce the problem of procyclicality.

The low interest rates are also resulting in a change in the range of products. One clear trend on the Swedish market is an increase in life insur-

9 The interest-smoothing rate is based on the inflation target and a real rate assumption and is applied for cash flows when it is judged that there is not a liquid market for fixed income investments. The rate that is now intended to be tested in a quantitative study will be 4.2 per cent in Sweden (2 per cent inflation assumption added to a real interest rate of 2.2 per cent.).

ance products such as unit-linked insurance, where the financial risks generally are borne by the policyholders.

The life insurance industry as a whole has good buffers at the moment. A continued drop in interest rates in the traffic light of around one percentage unit could be managed by the affected institutions, even though the stress tests were produced from a historically low interest rate level. However, it is not possible to rule out individual companies reaching a stage when they cannot meet their guaranteed commitments. This situation has never occurred in Sweden in modern times and the law does not set out any concrete principles for the rules that FI should apply for dividing the existing assets to the policyholders affected. In addition, Sweden does not have an insurance guarantee system to compensate policyholders if a company cannot meet its commitments.

FI will carefully follow the solvency situation of insurance companies during the period of time that remains until the introduction of the new risk-based solvency regulations, Solvency 2.

Adapting to Solvency 2 regulations

The new regulations for the solvency of insurance companies, Solvency 2, will come into force in 2013 and will replace current regulations. Solvency 2 will apply for the whole insurance industry in the EU. It is still not clear whether the occupational pension operations in Swedish life insurance companies will be included.

Solvency 2 regulations

In 2009 the EU decided on new solvency regulations for insurance companies, called the Solvency 2 Directive. It provides the framework for regulations for buffer capital, which all EU member countries will introduce into their legislation.

Solvency 2 strengthens the link between solvency requirements and the risks facing insurance companies. It will also provide better consumer protection. Like the Basel regulations, the Solvency regulations are based on three pillars:

1. Quantitative regulations for calculating capital requirements, with the option for companies to use internal models for calculating their requirements.

2. Qualitative requirements for risk management and internal control.

3. Requirements for public information.

Work is currently being carried out to draw up more detailed regulations based on the framework of the Solvency 2 Directive. This work is mostly being run by the Committee of European Insurance and Occupational Pensions (CEIOPS), with FI taking part in a number of its working groups.

The solvency calculations contain a minimum capital requirement that all companies have to meet at any time. There is also a higher solvency capital requirement and if this is not met, the supervisory authority will place requirements on the company to take action within a reasonable amount of time.

■ Solvency 2

See the following link for information about FI's work with Solvency 2 and quantitative studies: http://www.fi.se/Regler/Solvens

The effects of Solvency 2 on capital requirements

The Committee of European Insurance and Occupational Pensions Supervisors, CEIOPS, is carrying out a number of quantitative impact

studies to calibrate the future solvency requirements and the stress tests that will be used. The most recent study is for insurance companies in all EU countries and will be submitted to FI this November. It will be clearer what requirements the new regulations in Solvency 2 will lead to when the quantitative studies have been reported and evaluated.

A rough estimate of the future requirements indicates average solvency ratios for life and non-life insurance of around two in total. This figure can be compared with the stress tests in the traffic light where the average for the traffic light ratio is currently at around 2.7. These new regulations will clearly lead to tougher solvency requirements. However, these requirements have different effects on different kinds of companies.

A probable consequence of Solvency 2 and an increase in capital requirements for financial risks is that the sales of traditional life insurance based on interest rate guarantees will continue to fall and be replaced by unit-linked insurance. Another possible consequence of Solvency 2 is that it will cause problems for niche actors and we will see greater consolidation in the industry, through mergers, acquisitions or portfolio transfers in order to make the most of diversification effects. It is also probable that risk management in asset management will become more advanced, with a focus on matching assets and liabilities, and with an increase in the use of derivatives.

Solvency 2 will also place greater requirements on companies in addition to the actual solvency requirements, including requirements for internal governance and control and an increase in reporting. Many companies need to make major investments in staff and systems in the future. Several major companies are expected to develop internal models to calculate their solvency capital requirement. The requirements on boards of directors will increase as a result of Solvency 2 and their responsibilities in a number of areas will be clearly set out in the directive.

Internal governance and control

In its ongoing supervision FI also noticed deficiencies in compliance for internal governance and control in insurance companies and fund management companies. Internal governance and controls includes compliance with control functions, risk management and internal audits, which the board and company management is responsible for, but also a holistic approach to the board's work with targets, risk and monitoring.

Unfortunately the tendency in far too many companies, including those in the insurance and fund sector, is not to allocate enough resources for operations that deal with internal governance and control. Deficiencies in governance and control can ultimately lead to the unit holders and individual insurance customers being affected. FI has therefore decided to increase its focus on the role of the boards of directors and management and on how companies choose to design their control functions.

Deficiencies in control for depositaries

Depositaries play a very important function for the consumer protection of investment funds. Depositaries hold the fund's assets, but also have a controlling function to ensure that the fund management company follows regulations set out in law and fund provisions. The depositary must act independently of the fund management company and solely in the

interest of the unit holders. This will ensure that the fund's assets are kept separate from the fund management company, that the value of the fund units is calculated correctly and that the assets of the funds are used in accordance with regulations.

Deficiencies in the function of the depositaries can have far-reaching consequences and could lead to unit holders not receiving the intended protection. For example, this could lead to investment transfers in funds or concrete deficiencies in fund management companies not being discovered.

In 2009 and 2010 FI investigated some Swedish depositaries. This investigation shows that the controlling function of the depositaries is not working in a completely satisfactory way. For example, there were differences in how the depositaries controlled the funds that were being managed by a fund management company in the group and the funds that were being managed by an external fund management company. If a fund management company appoints a depositary that is in the same group, it can present a number of conflicts of interests, that have not always been managed in a good way.

FI's investigation also showed that the depositaries feel a certain amount of uncertainty about how they should design their operations and the controls that are expected of them. FI sees a need for more detailed regulations in the future.

FI believes it is positive that there are now more companies that want to start up depositary operations in Sweden. Both fund management companies and ultimately unit holders benefit from a market with several actors competing for the role of depositary.

The securities markets

The financial crisis showed the importance of having well-functioning and stable securities markets. Extensive work on regulations has therefore started in Europe. In addition, an increase in competition has led to more fragmented stock markets. Combined with rapid technological developments this has led to new risks and could threaten the functioning of the markets. This fragmentation has also increased the ways in which the markets can be used for criminal purposes.

Competition on the stock market has continued to increase. The introduction of the Markets in Financial Instruments Directive (Mifid) combined with rapid technological developments has led to the structure and trading on the stock market continuing to change rapidly. For example, it has become more difficult to compile a general overview of prices and identify actors that have criminal intent. The fragmentation of the stock market has also created good conditions for 'high frequency' and 'algorithm trading'. This kind of trading is automated and has increased in scope in recent years. This development presents new challenges for the supervision of the stock market.

Consumers are starting to become more directly involved in the stock market, which has led to the supervision of consumer protection being aimed more at equity trading, even though the securities markets also include trading with, for example, derivative instruments and debt instruments.

■ Mifid

The Markets in Financial Instruments Directive 2004/39/EC was introduced into Swedish law in 2007.

Last year's report discussed the system risks associated with central counterparty clearing and OTC derivatives in the wake of the financial crisis. This year extensive work has been carried out on regulations in the EU, in which Sweden has been involved. These include regulations being developed to ensure greater transparency in derivative trading and an increase in the use of central counterparty clearing. The EU Commission has also proposed a controversial regulation of short selling, which would mean stricter reporting requirements.[10]

FRAGMENTED STOCK MARKET

Trading on the Swedish stock market has undergone major changes in recent years. Before the introduction of the new EU regulation, Mifid, in 2007, equity was generally traded on national stock exchanges in Europe. One of the aims of Mifid was to promote competition in equity trading. During this time technological developments have also contributed to an increase in electronic trading. Trading in Swedish equities is now taking place at a greater number of competing trading venues. This development is most noticeable in the most traded shares. In June 2010, for example, NASDAQ OMX Stockholm reported 42 per cent of its turnover in the 30 most traded shares (OMX 30), the British trading platform Chi-X share reported 14 per cent and trading outside the trading venues stood at around 20 per cent.[11]

10 Here is the link to the proposal: http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf

http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf

11 Source: Thomson Reuters

The change from relatively concentrated trading on national stock exchanges to trading at several trading venues [12] has taken place over a relatively short period of time. This more fragmented trading has led to new challenges both for the market and the supervisory authorities.[13]

Lack of consolidated market information

So far there is only limited access to consolidated exchange information from all trading venues. This is because of the costs and the technical problems of compiling information from several sources. The exchange information that is currently reported in Swedish daily newspapers, for example, only contains information from the regulated markets. It does not include information from Burgundy, a Swedish MTF, foreign MTFs such as Chi-X or trading that is carried out outside the trading venues (OTC trading).

Trading in the most traded Swedish shares

Trading in OMXS30 on regulated markets and MTFs	
Order book trading (continual trading)	66 %
Opening and closing auctions	7 %
Trading in hidden order books	1 %
Negotiated transactions	4 %
OTC trading	22 %

Source: Thomson Reuters

Transparency is decreasing due to the growing proportion of OTC trading, in which the order information is hidden, also known as 'dark pools'. In this context, dark pools refers to both trading in hidden order books on MTFs and internal trading in securities companies. Although there are only small volumes of Swedish securities that are traded in hidden order books[14], critics claim that this proportion will continue to increase.

In a proposal from the Committee for European Securities Regulators (CESR), internal trading platforms that enable hidden order books will become MTFs if the turnover from internal trading/dark pools exceeds a certain limit. As a result, these trading platforms would be forced to publish their buy and sell rates and provide access to the trading system.

There are also quality problems associated with information about OTC trading, due to double reporting and incorrect prices. CESR has been consulting with the industry to take various measures to improve this situation. The proposals for new regulations have been submitted to the EU Commission.

All these deficiencies mean that it is becoming more difficult to gain an overview of the stock market. Deficiencies in market information create a risk of decisions being made to buy and sell shares based on misleading information about the market value of the share. It is also difficult for investors to value their holdings when the price information is incorrect.

Deficiencies in coordinating monitoring and trading halts

An individual security can be traded at several venues in different coun-

12 Trading venues = regulated markets (run by stock exchanges), MTFs and securities companies that organise trading in financial instruments.

13 See CESR Technical Advice to the European Commission in the Context of the MiFID Review and Responses to the European Commission Request for Additional Information, 29 July 2010. http://www.cesr.eu

14 See note above.

tries. This enables some actors to influence the price at a trading venue in an improper way, which then affects the price at the next trading venue. The lack of coordinated real-time monitoring between the trading venues makes it more difficult to discover this kind of market abuse.

The trading venues themselves have an important role to play in monitoring the trade in individual securities. They are responsible for ensuring that those involved in trading follow the applicable rules, and for discovering any trading irregularities. Effective monitoring becomes more difficult when trading in securities can be carried out at several different places. At the moment, there is a lack of effective cooperation between different trading venues.

When trading in a share has been halted, it means that trading should cease at the same time at trading venues both inside and outside Sweden. However, the rules for trading halts vary in Europe. Consequently, trading in Swedish shares can still be carried out, even when trading has been halted in Sweden.

The risk is that the problems associated with monitoring and trading halts will be exploited by some actors, enabling them to trade at incorrect prices at the expense of others.

Different market conditions

There has been an increase in the trading of many shares at different trading venues to the primary market, i.e. the market that approved the listing of the shares. This can affect the quality of the supervision, which has to be provided by the primary market in accordance with law and regulations. The primary market is currently responsible for supervisory tasks, including performing a suitability assessment of the company and monitoring to ensure that the company publishes price-sensitive information. This incurs costs for the primary markets. This leads to an increase in competition and puts pressure on prices, which could result in these supervisory tasks only being carried out in such a way that the trading venue with the lowest possible margin meets the statutory requirements. FI is going to be follow this development and if necessary take initiatives to implement changes to legislation and prevent a race to the bottom.

HIGH FREQUENCY TRADING

The fragmentation of the market combined with technological developments has also led to the development of very rapid computerised trading, also known as 'high frequency trading'. This trading is based on software that places orders in line with pre-set rules (algorithmic trading).

In high frequency trading, the computers search prices at a large number of trading venues in just milliseconds and then place orders. The rapid development in technology in recent years has led to the entry barriers for setting up algorithmic or high frequency trading falling dramatically. There is a clear trend of this kind of trading in the USA, with the proportion of automated trading in the last quarter of 2009 amounting to 42 per cent and this figure expected to increase to 54 per cent for the fourth quarter of 2010. [15]

Trading venues and securities companies are offering their customers

15 Source: Trends, risks and vulnerabilities in financial markets, CESR/10-697, see link: http://cesr.eu/popup2.phd?id=7015

different kinds of services with more rapid connection and access to trading systems in order to gain even more milliseconds. The fact that customers can now connect directly to the trading systems is placing higher requirements on securities companies to have adequate control functions for their customers' actions. Some actors are also being offered the opportunity to locate their computers next to the trading venue's computers, which has sparked off a discussion on the principle of equal treatment.

'Flash Crash' on 6 May 2010

In the afternoon of 6 May 2010 the largest drop in prices and subsequent recovery that had been seen on the New York Stock Exchange since the 1930s took place. The index fell more than 9 per cent in just under five minutes, before quickly returning to virtually the same level a couple of minutes later. This event is referred to as 'Flash Crash'.

The securities that were worst affected, which totalled just over 300, saw a drop of more than 60 per cent, leading to the stock exchanges cancelling more than 20,000 deals. Many of these cancelled deals were carried out at completely unreasonable prices, approaching zero.

Straight after the 'Flash Crash', it was thought that a combination of different factors came together to create 'the perfect storm', including the debt crisis in Greece, sell orders that had been manually entered incorrectly leading to sell orders being issued from algorithmic computer systems, the purchase of large sell options for hedge funds and technical problems in the distribution of price information.

However, the report from the American supervisory authorities SEC and CFTC[16] on 'Flash Crash' points mainly to a hedge fund which sold a very large block of index futures via a computer algorithm. Under normal circumstances this sale would have taken up to five hours to carry out, but because the algorithm was programmed to sell without consideration of price or time, the order was carried out in 20 minutes. The intense sales pressure rapidly spread to other markets and created major drops in indices and individual shares.

One argument that is usually given in favour of high frequency trading is its positive contribution to better liquidity. For example, one single computer can place up to 2,000 orders a second. However, it is important to point out that more than 90 per cent of the orders that are placed are cancelled within a few milliseconds. The order books are filled with orders that have been withdrawn before trade can be carried out at this price. This takes place continually, giving the impression that the order books are well-filled. This behaviour is controversial and there is a discussion as to whether this breaches the regulations on market abuse.

Speed barriers being developed further

Straight after Flash Crash, the American supervisory authorities started a investigation, in which they highlighted the lack of/inadequate halting functions ('circuit breakers') when there is a rapid fall in prices. The solution resulted in a trading halt of five minutes, which is automatically put into effect if the fall in prices of an individual security amounts to 10 per cent or more in under five minutes. Similar solutions have also been

16 Findings regarding the market events of May 6, 2010, US SEC, 30 Sep 2010: http://sec.gov/news/studies/2010/marketevents-report.pdf

introduced on Nasdaq OMX's Nordic and Baltic stock exchanges this autumn. In the USA there have also been discussions on the length of time an order must be available for trading before it can be cancelled.

Algorithmic and high frequency trading leads to system and operational risks that need to be taken into consideration. As this kind of trading is going to represent a larger share of trading in the future, a major price movement could spread rapidly between trading venues and also to different kinds of assets. This uncertainty could then be spread throughout the financial system. In Sweden, high frequency trading only accounts for a small proportion of trading, but the increase in cross-border trade means that we may also see a growth in Sweden as well. Finansinspektionen (FI) will be investigating this kind of trading in 2011.

■ OTC derivatives

Derivatives that are traded between two parties outside a regulated market place and with completely or partially hidden order information.

OTC DERIVATIVES

Trading in OTC derivatives has seen enormous growth this century. However, the financial crisis showed that major exposures to a counterparty through financial instruments can conceal risks that threaten the whole financial system. Since the crisis work being carried out on legislation has therefore focused on OTC derivative trading. Work on harmonising these regulations is being carried out to avoid, for example, differences between regulations being exploited in the EU. CESR will recommend to the EU Commission in its ongoing supervision of Mifid that OTC derivatives should be included. A reporting requirement will be introduced in Sweden on 1 September 2011 to tackle the problem of a lack of control over OTC derivative trading.

FI will continue to study all transaction reporting from companies to ensure that this is fair. If any incorrect or incomplete reporting from the companies is discovered, the cases will be submitted to see whether sanctions need to be imposed.

ENDOWMENT INSURANCE – A GROWING PROBLEM

People who have an insider position in listed companies must report all changes in their holdings to FI. However, insiders who trade shares via endowment insurance avoid this reporting obligation. Endowment insurance also causes problems with mandatory bid regulations and voting rights. These problems will grow as endowment insurance grows in popularity. FI does not have complete statistics for endowment insurance, but at the beginning of this year five companies[17] reported that they had a total of SEK 41 billion in their insurance accounts, compared with SEK 13 billion the year before. In addition to these five companies, there are foreign insurance companies that do not report to FI. The actor that has grown the most in recent years, Avanza Pension, currently has SEK 28 billion divided between 100,000 accounts, of which half is invested in individual shares.[18] It is clear that this savings form has increased significantly.

Poor transparency

One consequence of the increase in trading through endowment insurance is that it makes insider trading more unclear. An increasing number of insiders own their shares through endowment insurance, which means

17 Danica Pension Fondförsäkrings AB, Avanza Pension Försäkring AB, Swedbank Försäkring AB, Nordnet Pensionsförsäkring AB and Skandia AB.

18 Source: Avanza Pension 31 March 2010.

that they avoid having to report their transactions to FI. In recent years 50 insiders in about the same number of companies have notified us that they have moved their existing equity to endowment insurance accounts. However, this figure could be much higher as not everyone states that their equity is being sold to endowment insurance. Over the past ten years the proportion of insiders that do not report having made any deals has stood at around 60 per cent per year. In the first six months of 2010 this figure increased to around 70 per cent, which could indicate that more insiders are choosing to invest their equity in endowment insurance.

Another effect is that almost 30 per cent of the flaggings today are done by insurance companies that exclusively represent endowment insurances. These flaggings often do not have information value as they are often triggered by small changes that push the insurance company up and down across the threshold limits.

Owners who have flagged the most since 2008

Large Swedish owners	2008	2009	2010 (Jan-June)
AMF	18	18	10
Avanza Pension	24	50	86
Catella	17	20	9
Handelsbanken	6	3	8
Lannebo	13	25	9
Länsförsäkringar	2	16	20
Nordea	27	20	9
Nordnet Pension	12	51	12
SEB	21	30	27
Swedbank Robur	46	62	21

Source: FI's Capital Barometer 29 September 2010

■ About mandatory bids

Finansinspektionen has delegated issues surrounding mandatory bids to the Swedish Securities Council, see FFFS 2007:17. http://www.fi.se/Regler/FIs-forfattningar/Samtliga-forfattningar/200717/

FI believes that it is a priority to review the legislation surrounding the reporting obligation for equity holdings in endowment insurance.

Mandatory bid regulations

Ownership through capital insurance can also cause problems for take over situations. The mandatory bid regulations normally protect minority shareholders and give them the opportunity to leave the company if there is a shift in majority ownership. However, this situation becomes complicated when shareholding is hidden in endowment insurance. The Swedish Securities Council has made several statements saying that mandatory bid regulations do not apply in cases where the pension insurance company is the owner of shares representing at least 30 per cent of the share of the votes, but does not exercise its voting rights for these shares. This means that a shareholder can use endowment insurance to build up large holdings through one or more endowment insurances without having to flag this up and without being covered by the mandatory bid regulations.

Voting rights

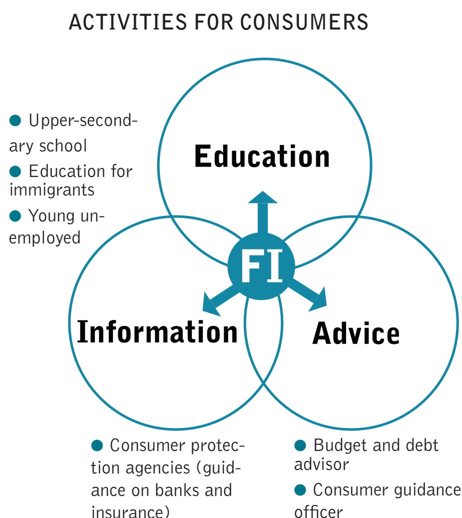
Listed companies can also be affected by the increase in popularity of endowment insurances. A large proportion of the small cap companies on Nasdaq OMX Stockholm and NGM Equity currently have an insurance company as one of their largest shareholders. They rarely use their voting rights, which could cause problems in the future at annual general meetings, as individual shareholders could gain greater influence in the company than what their shareholding actually represents.

Risks for Swedish consumers

Probably the most important part of the Finansinspektionen's (FI's) supervision of consumer protection is to ensure that companies on the financial market are stable and can fulfil their commitments. However, companies must also offer products that are appropriate for the consumers and provide them with good advice and comprehensible contract terms. There are a number of risks for consumers on the financial market at the moment. These include the sale of products that are not suitable for the individual customer, risks on the mortgage market, microloans and investment fraud.

One important objective of financial regulation and supervision is to strengthen the consumers' standing on the financial market and counteract any problems or irregularities. FI's assignment as a supervisory authority for financial companies is to safeguard the interests of the consumer in general, for example by monitoring how companies give information to their customers, how they formulate contracts and how they handle complaints. However, FI does not resolve disputes between companies and individual consumers, assess individual products or become involved in any similar activities for individuals. FI is of course interested to hear about what happens to individual consumers, because this can often reveal general problems.

ACTIVITIES FOR CONSUMERS



Many of the risks for consumers are linked to deficiencies in the information and advice offered by companies. Products are often complex and it can be difficult, for example, for a consumer to obtain facts and relevant information that allow them to compare different types of savings or insurances. FI can see a clear risk of consumers buying products that are not suitable for them because of marketing professionals circumventing legal requirements for financial advice.

Since last year's report, FI has spent a lot of time investigating the risks on the mortgage market and on 1 October 2010, a new loan-to-value ceiling came into effect that should give consumers incentive to limit their indebtedness. The 2009 Risk Report highlighted the risks associated with the rapid increase in microloans. In this area we are now seeing a fall in the number of cases reported to the Swedish Enforcement Authority.

UNSUITABLE PRODUCTS – DEFICIENCIES IN ADVICE

FI believes that financial advice is a way of ensuring that consumers are not at a disadvantage on the market because they do not have enough information. Serious and competent financial advice is extremely important for strengthening consumer protection. However, unclear conditions and dishonest advice can lead to investment decisions that are definitely not in the consumer's best interest.

FI has highlighted the risks and problems in the supervision of insurance mediation, but advice is an important issue for many financial companies. There needs to be a clearer boundary between operations that do not require a licence (marketing) and ones that do (investment advice). The complaints that FI receives indicate that it is common for consumers

not to understand the kind of products they have invested in and the risks they are taking in their investment. They may have invested in high-risk products that are not at all suitable for their finances and needs. This is due to negligent advice, so FI believes that supervision needs to continue.

■ Acta

FI requires Acta to rectify deficiencies: http://www.fi.se/Sanktioner/Finansiella-foretag/Listan/FI-kraver-att-Acta-rattar-brister/

Of the few cases of disputes that have been settled since the financial crisis, one that stands out is the Norwegian company Acta Asset Management and its Swedish branch. On Acta's advice, customers had bought credit-financed, structured products issued by the bankrupt Lehman Brothers. In 2009 FI issued a sanction against Acta with a notice to rectify the deficiencies in their investment advice and follow applicable provisions. However, in March 2010 the Swedish National Board for Consumer Complaints (ARN) judged that it was not possible to prove that the advice from Acta was deficient enough to hold the company liable to pay damages for negligence. This shows how difficult it can be for consumers to get redress afterwards if they believe they have been given poor advice.

There is a major supervisory activity being carried out among insurance brokers this autumn and an external investigator has been hired to investigate where improvements can be made to the regulations for financial advice and marketing.

LIFE INSURANCE PRODUCTS ARE DIFFICULT TO COMPARE

The quality of financial advice is important because consumers only have limited opportunities to assess the risks and properties of financial products themselves. One kind of product that could benefit from better information is life insurance. Saving in life insurance with guarantees and where the company determines the investment policy, which is known as traditional insurance, is popular on the Swedish market, totalling around SEK 980 billion in savings.

It is important for the advantages and disadvantages to be explained when a consumer is buying an insurance policy, including what happens during the entire agreement period. Facts and information must also be provided to allow the consumer to compare different alternative investments and suppliers. It is true that the consumer receives a lot of information, but the differences in the organisation, structure and terms between different companies and products risk being misleading rather than being helpful.

Assumptions in life insurance companies

When payment from traditional pension insurance starts, the insurance company decides the amount that will be paid out annually to the policyholder. To do this, companies apply a set of assumptions, with interest and longevity being the most important. The amount is normally recalculated once a year. The assumptions that are used should reflect reality, but be so carefully worked out that the amount that is paid out does not normally need to be reduced.

During FI's supervision, it has found that the assumptions that are used vary greatly between companies and the rules are not transparent for customers. This can result in differences in the amount that is paid out, even though the conditions are the same.

The differences are almost impossible for a consumer to identify so it is

necessary for FI to review what assumptions that are being applied. FI could then use this information to provide guidance in this area.

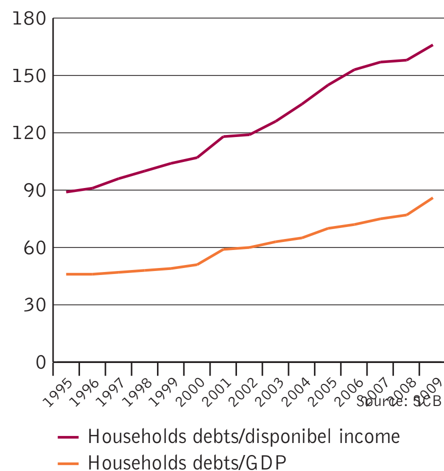
The insurance industry is currently working on producing more uniform fact sheets that will make it easier to make comparisons. FI intends to help with this process by publishing general guidelines setting out what the fact sheets should contain.

FI wants to make it easier for consumers to gain an overview of the following components and be able to compare them:

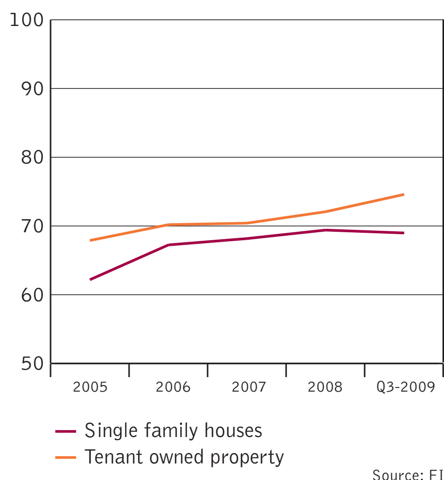
- Guaranteed commitments (pension amount or guarantee rates)
- Investment policy (for traditional products)
- Managing and allocating surpluses or deficits in profit-distributing companies or mutually working companies.
- Information about all fees for the pension capital, including asset management
- The payment regulations that are applied and that affect the final pension amounts, for example, the shortest or longest payment, forecast rates and longevity assumptions.

If the customer is not satisfied with their savings or if the pension company's finances worsen, it is essential for customers to be able to move their savings to another company (right of transfer). This leads to questions such as, what can you take with you when you move, how does it affect your insurance protection and how much does the transfer cost? The answers to these kinds of questions should be easily accessible to the policyholder.

HOUSEHOLD DEBTS



LOAN-TO-VALUE RATIO OF MORTGAGES (%)



CONSUMER RISKS ON THE MORTGAGE MARKET

Historically low rates on the Swedish mortgage market have significantly benefited consumers in their role as borrowers, but have also contributed to a rapidly expanding level of indebtedness.

Mortgages represent more than 90 per cent of the households' total debts. The Swedish households' total indebtedness is therefore closely linked to both the development on the real estate market and to practices at the banks for granting mortgages.

In the autumn of 2009 FI carried out a comprehensive investigation into companies' lending for mortgages. Its conclusion was that the mortgage market on the whole works well. The payment capability of the borrowers is a central factor and the companies use very prudent calculations. Most households could manage a significantly higher interest rate. The risks for the banks and the stability of the Swedish financial system are therefore assessed as being low.

However, in the investigation FI noticed that the households' loan-to-value ratios continues to rise and there has been a particular rise in the proportion of households with an extremely high loan-to-value ratio. Even modest falls on the housing market would mean that the mortgages of a number of households would exceed the value of the property.

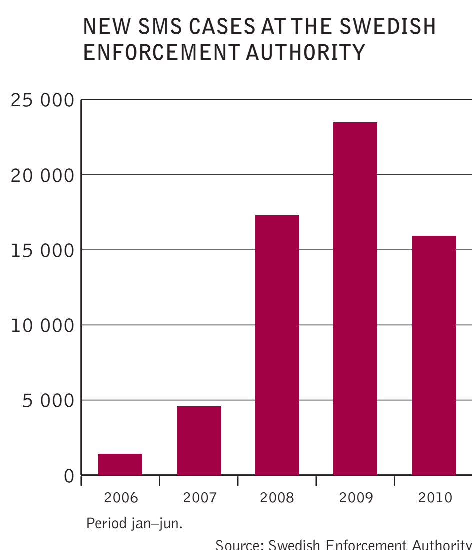
In order to stop this development, FI introduced new general guidelines on the loan-to-value ratio of properties from 1 October 2010. These general guidelines mean that new loans must not exceed 85 per cent of the property's market value. This rule will counteract the use of higher loan-

to-value ratios by banks and other credit institutions as a means of competition, and will increase incentive for households to limit their debt and thereby create better protection for the future. These rules only apply to new loans or extensions to existing loans that use the residental real property as collateral.

FI intends to follow up these new regulations in the coming year to see what effects this regulation has had and how it is being applied by companies.

MICROLOANS

NEW SMS CASES AT THE SWEDISH ENFORCEMENT AUTHORITY



Source: Swedish Enforcement Authority

For some vulnerable customer groups, the risks from securing financing from expensive, short-term microloans via SMS and the Internet have become more common in recent years. The Swedish Consumer Agency, the Swedish Enforcement Authority and FI have often brought up the issue of over-indebtedness with the government. The Consumer Agency has taken action against incorrect fees and interest rates in its capacity as a supervisory authority. The agency's supervision and sanctions, combined with the tightening of regulations for 2011 announced by the government, are thought to have had a restraining effect on the operations of microloan companies. For the first time since 2006 the Enforcement Authority has seen a reduction in incoming cases.

A new Swedish Consumer Credit Act will come into force on 1 January 2011, which means that anyone that wants to lend money has to be credit-checked. The current excemption for small amounts and short maturities will be removed. All borrowers will need to be told the effective interest rate on the loan and be given clearer information before entering into an agreement. In addition, a right of withdrawal will be introduced, which is similar to the one that already applies for distance and doorstop selling.

FI believes that this will reduce the risk of the problems of indebtedness getting worse. It will become easier for consumers to receive the factual data they need to make a rational decision. It will have positive effects on both the individual consumer and the finance market. Loan companies will have to meet higher standard requirements and the competitive situation will ressemble the competitive situation among credit institutions.

Companies that only issue or negotiate credits will continue to register with FI, but will be under the ongoing supervision of the Consumer Agency. Hopefully monitoring resources can be improved.

INVESTMENT FRAUD

Investment fraud carried out against Swedish investors shows no signs of abating. FI receives hundreds of enquiries every year about financial companies and financial instruments from investors and companies. After analysing them, FI can state that most enquiries are about fake companies and instruments. FI's warning list now has more than 2,300 companies. None of these fall under FI's supervision, even though some of them try to give the impression that they have received some kind of state approval.

There is also evidence that serious organised crime is trying to get into established and new financial companies that are under supervision in Sweden and abroad. A number of criminal investigations are currently ongoing, with FI assisting police and prosecution authorities. Fraud is an

international problem that has a serious and damaging effect on individual investors and often means that tax income is being withheld from the state.

Over the past year fraudsters have misled customers into investing in options that are traded at false trading venues. These trading venues are presented as seemingly reliable websites containing prices and volumes.

Widespread fraud takes place throughout the world, with investments in fake currency trading. Uninformed and inexperienced investors are misled into investing in foreign currencies by fake companies.

The fact that it is possible to start a Swedish savings association that does not fall under FI's supervision is used by fraudsters to attract investors in other countries. Swedish savings associations, in the form of economic associations, are presented abroad as Swedish banks, with the registration in the Swedish Companies Registration Office being used as 'authorisation', and they mislead savers into investing their savings with the promise of high interest rates. FI has recently become aware of three ongoing criminal investigations where considerable sums of money have been misappropriated. The Companies Registration Office has recently forced 22 savings associations into liquidation because they do not have a registered agent in Sweden. The criminal operations that are often behind these savings associations appear to be very well organised.

If the general public thought that the financial sector was being increasingly targeted by criminal activities, this could dent confidence, which would damage the sector's effectiveness and functionality. FI's work with authorities like the Swedish Economic Crime Authority is important in this context.

UNINFORMED CONSUMERS

The extensive investigation into the economic capability of Swedish households that FI carried out in the spring of 2009 (see FI report 2009:11) showed that there were many relatively satisfied and financially stable households, but which were also quite indifferent to financial issues. Most households admitted that they are relatively uninterested in their private finances and saw it as a 'boring chore'. Most households do not compare financial services or change suppliers.

The fact that consumers are uninformed about private finances and are not willing to get involved weakens their position on the financial market. Even when the information is available, its value can be quite limited if a consumer does not have the basic knowledge that is needed to understand it. Better knowledge would improve the consumers' position. In addition, knowledgeable and active consumers can put pressure on companies to develop good products and comprehensible information. This also reduces the room for manoeuvre for dishonest actors.

In light of this, FI has been commissioned by the government to work with information and to initiate training to increase the level of financial knowledge.

Glossary

Short selling Selling borrowed equity to earn money on a falling share price. If the buy-back price (including expenses) is lower than the sales price when you buy the equity and return it, you make a profit.

Central counterparty An institution that enters as the seller for all buyers and the buyer for all sellers for the financial instruments being traded.

Clearing is a process of mutually offsetting claims and liabilities to supply securities.

Depositary A depositary holds the assets of UCITS and non-UCITS funds and manages incoming and outgoing payments. A depositary must be a bank or another credit institution.

MTF Multilateral Trading Facility. Can be operated by an exchange or a securities company. Offers simpler trade alternatives than a regulated market place.

High-frequency trading A type of algorithmic trading. Automated computer trading programmed to trade at high speed in the event of specific market movements and the specific behaviour of different actors.

Insider A person who, through their position in a listed company, is considered to be in a particularly good position to gain access to price-sensitive information about this company.

Own funds The sum of equity, untaxed reserves and some subordinated loans less intangible assets and dividends. There is a consolidation fund (see definition in this glossary) for non-profit-distributing insurance companies.

Endowment insurance Endowment insurance (in the form of deposit insurance) is a savings instrument, where the owner only owns the insurance from a legal point of view and not the assets in terms of the securities contained within it. These securities are owned by the insurance company. A person that owns the shares indirectly through capital insurance does not have any voting rights for these shares. Tax is not paid on the sale of the securities; a standard net yield tax applies.

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.

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

Capital adequacy ratio Relationship between own funds and the capital requirement.

Consolidation fund Any surplus in a non-profit-distributing insurance company is placed into a consolidation fund, which forms the vast majority of the risk capital in the company.

Core Tier 1 capital In this context, FI has decided to define core Tier 1 capital as Tier 1 capital excluding the hybrid capital.

OTC (Over the Counter) Trade that occurs directly between a buyer and seller, but outside a regulated market place.

OTC derivative Derivatives that are traded between parties outside a regulated market place and with completely or partly hidden order information.

Tier I capital A simplified definition of Tier I capital is the restricted capital

in the bank. No other party may draw on this capital and it must be available to handle losses. Tier I capital consists primarily of equity retained (the capital shareholders have contributed to the company), and profits in the company.

Tier 1 capital ratio. By combining the value of all of the assets (investments) of a bank and risk-weighing these assets using certain weights, it is possible to produce a single value for the risk-weighted assets in the bank. The ratio of Tier I capital to this total is called the Tier I capital ratio.

Net commission income The difference between income and costs from taxable services.

Net interest income The difference between income from lending and debt securities and costs of deposits and other funding in a company.

Solvency The ability to meet liabilities or undertaken commitments to policyholders.

Solvency ratio The solvency ratio is calculated in the following way: Own funds/required solvency margin = solvency ratio. If this ratio does not exceed 1, the company has inadequate solvency.

Solvency margin The solvency margin is the lowest acceptable level for own funds. Its calculation is based on the company's nature and scope.

Savings association A savings and loan association (known as a savings association) is an economic association that has a maximum of 1,000 physical people as members in a limited circle. A savings association is both a deposit company and a financial institution, but is not under the supervision of FI. However, FI checks the company's owners, management and internal regulations against money laundering.

Covered bonds Bonds with a high credit rating that are issued by banks and credit market companies in order to secure access to beneficial financing of, in particular, mortgages. If the company fails, the holder of a covered bond has priority to specially selected security, known as the 'cover pool', which consists of various amounts of property credits and government and municipal credits.

Traffic-light The traffic-light is a stress test which is part of Finansinspektionen's supervisory methodology for Swedish insurance companies. The test measures the exposure of the companies to different risks.

Traffic light ratio The traffic light ratio that is presented in this report is the total capital buffer reported by the companies divided by their total capital requirement.

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