M E M O R A N D U M

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Finansinspektionen and financial stability

Financial stability is the ability of the financial system to uphold its core functions in changing economic conditions. Besides resilience of the financial system, FI has been given responsibility for counteracting imbalances on the credit market. The purpose of FI's work is to prevent problems in the financial system from incurring costs for society.

What is financial stability?

In the financial system, services are rendered that are key to a modern economy, such as payment intermediation, credit supply and risk management. Financial stability is about the financial system not incurring unnecessary costs for society. Financial stability is a situation in which *the financial system can maintain its core functions and also has resilience to withstand shocks that threaten these functions.*

The financial system

The financial system consists of banks, insurance companies and other financial entities. It also includes financial markets and the financial infrastructure made up of of technical systems, with the rules and procedures required for making payments and exchanging securities. Financial regulations in the form of legislation and other rules and standards also count as part of the system.

Core functions

The core functions of the financial system are the mediation of payments, converting savings into financing and managing risks. The mediation of payments involves the financial system helping households and corporations when they pay for goods or services. The conversion of savings into financing involves the financial system taking care of the savings of households and corporations and participating in financing consumption and investments in e.g. homes and production capital. Managing risks involves the financial system helping households and corporations to diversify and allocate risks to the entities best suited to bear them. For example, this could be a household

which takes out a home insurance policy, or an exporter hedging itself against the foreign exchange risk in its customers' payments.

In the financial system, firms are connected with each other. This interconnectedness consists of a common structure, of the fact that transactions are carried out on the same financial markets, and of the agreements that are in place as a result of previous transactions. Interconnectedness is needed for the financial system to work, but makes monitoring it difficult and its dynamics complex.

A vulnerable system

Key components of the financial system, such as banks and financial markets, have inherent vulnerabilities. For example, a bank meets the requirement of depositing customers to have their money readily and rapidly available for withdrawal. At the same time, it meets the requirement of borrowing customers to borrow money in the longer term. The conversion of deposits into loans is of great value to the economy as a whole, but is also a vulnerability. If many depositors wish to withdraw their money because of loss of confidence in the banks, liquidity problems can rapidly arise even for a bank that is fundamentally profitable.

Because the financial system is closely interconnected, problems arising in one part of the system can quickly spread to other parts and threaten stability. The contagion of problems can occur in many different ways. The most obvious is when two entities have a contractual relation. If one cannot honour its commitment, the other suffers a loss. The loss-incurring party might, in turn, not be able to honour its commitments with a third or fourth party.

Problems can also spread in more subtle ways. Entities that are similar might be assumed to have the same type of problem. If a firm suffers a problem, it might affect other firms resembling that firm. Firms might have a business model that implicitly assumes that systemically important submarkets are upheld, or that their funding will be renewed. If confidence wanes and the submarket ceases to function, shocks can spread throughout the system.

Another way for problems to spread is though pricing in financial markets. If one entity is forced to sell, then this might supress market prices, affecting other entities which hold the same type of assets.

Financial stability

Financial stability is first and foremost about the financial system upholding its core functions. If banks cannot conduct payments on their own and customers' behalves, all parts of the economy are quickly affected. Major economic costs arise. Another example is a credit crunch, in which access to loans is restricted, e.g. because the banks are not able to fund their lending. Furthermore, if risk management through financial firms and on financial markets does not work, many transactions might be made more difficult and perhaps even impossible to carry out.

A shock could for example be that economic performance suddenly turns out worse than expected. It could also be a case of a large bank suffering acute difficulties that threaten its survival. Shocks can thus arise within the financial system, or come from the outside. The factors and events that could trigger a crisis can be difficult to pinpoint in advance. It is impossible to fully eliminate shocks. Hence, measures that focus on limiting vulnerabilities and bolstering resilience are most beneficial.

The resilience of individual firms increases if they have sufficient buffers in the form of capital and liquidity. It is also important that firms have sound governance, risk management and control, so that they can manage their operations. If firms have excessive exposure to an individual entity, sector or operation, this can make them more vulnerable. Those that operate in too many areas and markets are also vulnerable because they lack oversight and control.

FI's mandate

FI's mandate is to help ensure that the financial system is stable, and also to counteract imbalances with the purpose of stabilising the credit market. At the same time, FI shall promote comprehensive consumer protection. Financial stability requires cooperation *between the authorities concerned.*

Motives for regulation

Regulation and supervision are motivated by what is commonly known as market failures. Market failures occur when all entities do not have the same information and level of knowledge, or when incentives for the individual do not benefit society. For example, private entities can take on risks that can benefit them when things go well, while at the same time society ends up getting saddled with the cost when things go wrong. Another example is when markets function poorly due to some agents being better informed than others.

FI shall promote financial stability

The Government has long expressed that FI shall work to ensure that the financial system:

"…is stable and characterised by a high level of confidence and has smoothly functioning markets that meet the needs of households and corporations for financial services, and provide comprehensive protection for consumers."[1]

The wording of the mandate sets out that stability at financial firms and in the system as a whole is key. However, financial markets are also associated with risks for consumers. Many financial services provided are complicated and difficult for consumers to judge. Therefore, the conduct of the firms on the market, and how they inform their customers, is important. FI has an important role in consumer protection. However, that role is not the focus of this report. [2]

FI shall also counteract financial imbalances

FI was recently given a supplementary area of responsibility, expressed as FI being responsible:

"…for taking measures to counteract financial imbalances with a view to stabilising the credit market, but taking into consideration the effect of the measures on economic development."[3]

History has demonstrated that financial imbalances can have extensive negative effects on growth, employment and public finances. Negative effects for society can arise in and be amplified by the financial sector, even if the core functions are upheld. Hence, it does not suffice merely to promote financial stability.

An imbalanced credit market can cause problems for the economy through overinvestment and excessive indebtedness in some part of the economy, and through the subsequent restructuring of balance sheets this sooner or later necessitates. Such credit-driven excessive investment in real estate occurred in Spain and Ireland during the years prior to the financial crisis.

One difficulty in the added responsibility is in the boundary with other policy areas. When FI takes measures with the purpose of stabilising the credit market, such measures will often have broad effects on the real economy and also in terms of the distribution of income.

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[1] See section 2 of Finansinspektionen's Instructions Ordinance (2009:93).
[2] In FI's yearly report "Consumer protection on the financial market", these matters are discussed in more detail, Ref. 14-4986 published 15 May 2014.
[3] See section 1, 3p of Finansinspektionen's Instructions Ordinance (2009:93).

The boundary with traditional stabilisation and income distribution policy has thus become less clear. According to FI's instructions, FI will therefore, in specific reports twice a year, describe:

"...the authority's analysis and assessment of financial stability, the measures taken and which may be taken to counteract financial imbalances arising, the effects of the measures on the economy and the need for developing rules in the area..."[4]

FI and other entities

FI is not the only authority with responsibility for financial stability and counteracting financial imbalances. The Riksbank, the Ministry of Finance and the National Debt Office all have important roles and thus also participate in the Financial Stability Council appointed by the Government. The Council shall enable a comprehensive analysis of current questions pertaining to these matters, capitalising on the expertise and knowledge of the authorities concerned. The Council does not make any formal decisions, neither does it express opinions or recommendations. This differs from how stability councils in many other European countries are devised.

The need for coordination also follows from the fact that financial stability affects and is affected by fiscal policy and monetary policy. It is the case for both preventive work and crisis management, with the authorities having different roles to play.

FI can impose formal requirements on financial firms; not on households, other authorities or non-financial corporations. Hence, it is through the financial firms that FI can influence other parts of the economy. The boundary provides FI's work with a clear-cut focus, but also naturally poses a limitation.

FI therefore does not always have the best tools in the preventive work. These can very well lie within the area of responsibility of another authority, or in another policy area. In cases where more appropriate tools are held by other authorities, FI should point this out. If that authority does not take appropriate measures, FI has a responsibility, however, to use available tools to ease the problems.

[4] See section 3, 5p of Finansinspektionen's Instructions Ordinance (2009:93).

From mandate to action

FI's practical work to increase resilience is aimed at the vulnerabilities that the authority has identified. Decisions regarding measures involve a trade-off between benefits versus risks and costs. The main trade-off is between stability and economic efficiency.

Focus on vulnerabilities

The Swedish financial system reflects the need of households and non-financial corporations for financial services, and the fact that Sweden is an advanced economy. The financial system is large, interlinked and dominated by four major banks. The vulnerabilities are mainly related to the banks, interconnectedness and households.

Lending to households and corporations, and international operations, make the banking sector large in relation to the Swedish economy. The banks' lending is greater than their deposits. The major banks must therefore issue bonds and other securities to fund mortgages and other assets. Reliance on this type of funding makes them vulnerable to a weakening of market confidence.

Deposits with Swedish banks are low in an international comparison because households mainly save in various pension solutions and funds. The majority of funds in pensions are managed by insurance companies in the life insurance sector. The fact that life insurance companies are major holders of the banks' bonds is an example of the interconnectedness of firms in the financial system. Because of the interconnectedness, problems at one of the major banks can spread to other banks and other parts of the financial system.

Households have substantial debts through mortgages, but also substantial assets, providing resilience to economic shocks. In FI's opinion, household indebtedness does not pose a great risk to the financial system, but is primarily a macroeconomic vulnerability.

FI's practical work focuses on the vulnerabilities it has identified. As the financial system and economy change, and measures against vulnerabilities are taken, the list of vulnerabilities might change. [5]

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[5] FI executes its mandate – contributing to financial stability and counteracting financial imbalances – through practical work with the vulnerabilities it has identified. In order to fulfil the recommendation of the European Systemic Risk Board on intermediate objectives and instruments of macroprudential policy (ESRB/2013/1), FI shall establish and endeavour to achieve intermediate objectives. FI's opinion is that the vulnerabilities constitute operational support and hence serve the same purpose as these intermediate objectives. Hence, FI meets the recommendation. Because vulnerabilities are complex and multifaceted by nature, FI also finds that mechanical decision-making rules based on indicators (e.g. credit growth) and specific instruments (e.g. the mortgage cap) sometimes advocated internationally ought not to be applied.

What does resilience of the financial system mean?

Resilience means that the banks shall have sufficient capacity to cover losses for the risks to which they expose themselves and the system. In 2014 FI further specified the November Accord providing a tangible example of a measure aimed at strengthening the solvency of the banking sector. [6]

It does not suffice for banks to have sufficient capital; they must also be able to manage risks associated with liquidity. The banks can end up with liquidity problems if they are excluded from the funding or interbank market, or because the cost of funding rises too much. Regulations for managing liquidity risks have been tightened considerably following the financial crisis. The banks must be able to cope with short-term shocks and have stable funding in the longer term.

Both solvency and liquidity are about resilience to changed economic conditions, but capture two perspectives that complement each other. Solvency is about the ability to honour commitments in the long term, while liquidity is about resilience in the short term. Another way of describing the difference is to say that solvency is about the extent of resilience of an institution’s balance sheet to price changes and unexpected losses, while liquidity is about having sufficient access to liquid funds to be able to honour commitments.

Risk concentration and contagion risks form a third area that presents grounds for taking measures. Risk concentration can be about several entities on the financial markets being exposed to the same type of shocks. Interlinkages imply the risk of the shock spreading and being amplified in the financial system.

FI has identified systemically important banks as part of managing risk concentration and reducing the probability of shocks spreading through the financial system. The systemically important banks therefore have a higher capital requirement than other banks.

What does counteracting financial imbalances mean?

High indebtedness is another example of a vulnerability. In FI’s opinion, financial stability is not threatened by household indebtedness, because households have substantial assets and resilience is sound. At the same time, international experience suggests that households with high loan-to-value ratios can cut back more on their consumption than those with lower loan-to-value ratios in the event of an economic slowdown. This could amplify an economic downturn. Counteracting financial imbalances is thus about reducing the

[6] The November Accord of 2011 between the Riksbank, the Ministry of Finance and Finansinspektionen comprised higher capital requirements for banks. See New capital requirements for Swedish banks, press release on fi.se, 25 November 2011.

vulnerability of households in order to limit the macroeconomic risks associated with the debt, despite them not posing any threat to financial stability.

Measures involve trade-offs

FI does not only have responsibility for financial stability, but also consumer protection. Measures for financial stability also affect consumer protection, market efficiency and confidence and competition, and can have effects on the distribution of income. It can also be the case that a measure that might increase the resilience of individual firms reduces resilience in the financial system as a whole. Decisions regarding measures must thus be preceded by a thorough analysis and will always involve a trade-off between benefits, and risks and costs.[7]

The main trade-off is between stability and economic efficiency. Measures in the form of regulation and supervision may reduce the scope of the problems in the financial system. If that work is successful and leads to credit supply, payment intermediation and risk diversification functioning smoothly and hence supporting the real economy, greater economic efficiency is achieved while financial stability is strengthened at the same time. However, excessive regulation involves increased costs, limited competition or a lower rate of innovation. For example, credit rationing could make the financial system stable, but not particularly efficient. The challenge for regulation and supervision is striking an appropriate balance between stability and efficiency.

[7] FI's approach in decisions differs in this respect from the decision-making models for macroprudential policy discussed internationally. A common view is that the macroprudential authority should specify intermediate objectives for financial stability, and link indicators thereto, such as credit growth and instruments such as capital requirements and mortgage caps. Indicators are economic variables that capture the build-up of vulnerabilities. When the indicator variables reach a threshold, the macroprudential authority should use the predetermined instrument, unless there is good reason to refrain from doing so.

The reason for linking indicators more clearly to intermediate objectives and instruments is to prevent passiveness and increase predictability. In terms of experience, authorities and other decision-makers in many countries have waited with, or completely abstained from, taking measures because costs are visible and immediate, while the benefits only become clear in the longer term.

FI's operations

FI operates in issuing regulations, authorisation assessments and supervision. In addition, communication is an important means. Measures for financial stability commonly consist of changes to regulations and supervisory actions, but also through communication.

Issuing regulations

Issuing regulations is the tool mainly used by FI in its work with financial stability and the complementary responsibility for stabilising the credit market. Through rules, FI can impose requirements on financial firms. The requirements influence incentives at the firms affected and other stakeholders such as the firms' customers and counterparties. Using appropriate regulations, FI can increase resilience in the financial system and counteract financial imbalances.

Laws and rules have an inherent hierarchy. FI is not fully free to choose and devise rules for financial firms. The powers of the authority are, in turn, regulated by superordinate laws. The laws set rules for the financial firms, but also set out the authorities' roles in e.g. interventions.

In many cases, the laws are general and can be difficult to interpret for the individual financial firm. In a great number of cases, Parliament has thus authorised the Government or the authority decided by the Government to decide on more precise rules within the bounds of the superordinate rules of law. In many such cases, the Government has often forwarded the authorisation to FI.

Given such a mandate, FI may decide on how a certain section of the law is to be interpreted. The interpretation can be conveyed by FI issuing regulations, which are as binding for the firms as a law. FI can also issue general guidelines, which provide guidance as to how a certain statute should be applied. The general guidelines show what FI finds a firm can do in order to meet the expectations on it. The firm can choose a different method if the selected method serves the same purpose.

Hence, the Government has delegated a certain amount of regulation issuance to FI. However, FI's rules may not breach other laws and ordinances that may exist, and must be appropriate. This is a reason as to why FI's rules are always submitted for consultation so that various stakeholders are given the opportunity to comment on the proposals. The purpose of the consultation procedure to ensure due process, but also leads to quite a substantial amount of time passing between FI identifying a problem and a new regulation being put in place.

FI must adhere to international legislation, such as the European Capital Requirements Regulation, and the Capital Requirements Directive recently transposed to Swedish law. Unlike the Basel regulations, according to which a country shall meet a certain minimum level but can introduce more stringent rules if so desired, these regulations aim to harmonise legislation in the EU. Hence, not only are minimum requirements limited, but also possibilities to introduce more stringent requirements. According to the decision of Parliament in the summer of 2014, FI is both the “competent” and “designated” authority referred to in the legislation. Hence, FI is the sole authority to have at its disposal a series of different instruments that may be used for the purpose of reaching the overarching objectives. The countercyclical buffer is an example of such an instrument. Other capital buffers which banks are expected to hold are also included, such as the systemic risk buffer.

Supervision

Conducting financial operations requires authorisation from FI. Authorisation assessment enables FI to ensure that financial firms, their owners and management meet the basic requirements for conducting financial operations – requirements aimed at upholding financial stability and promoting consumer protection. The entities that are not expected to meet the stability and consumer protection requirements can be excluded.

Supervision of individual firms aims to ensure that the firms continue to meet the requirements imposed by the authorisation, and identify and manage risks and vulnerabilities. In order for supervision to prevent problems, the work must be *forward-looking*. The focus of supervision shall be on the factors and circumstances that present the greatest risks. This requires FI to have a well-founded assessment of which factors are and are expected to be the most significant. A fundamental approach for FI’s work is therefore that it shall be *risk-based*.[8]

In the dialogue with firms under supervision and by applying practice, FI can endeavour to achieve its objectives in financial stability and consumer protection. An important element for financial stability is the internal capital adequacy assessment process conducted by the banks and FI’s practises through specific capital requirements (known as the Pillar 2 surcharge).[9] The Capital Requirements Directive gives FI the right to demand that the banks do not only hold capital for their own risks, but also the risks to which they expose the financial system.[10]

[8] This is discussed in more detail in FI’s memorandum “Supervision strategy” of 1 October 2014.

[9] See the memorandum “Capital requirements for Swedish banks” FI Ref. 14-6258 published 8 September 2014.

[10] This possibility has been implemented in Swedish law through the provision in Chapter 2, section 1 of the Special Supervision of Credit Institutions and Investment Firms Act (2014:968).

Through the periodic reporting and supervision dialogue, FI gains insight into individual firms and markets. FI can also request further information if needed. These are important tools for detecting and managing vulnerabilities in the financial system as a whole. The information from firms under supervision is combined with what is available in public sources and forms the basis for identifying and managing vulnerabilities. A part of the analysis is that FI studies whether several entities are vulnerable to the same type of shock and if problems can spread in the system.

For the financial firms, risk-taking is a natural part of the operations. The purpose of regulation and supervision is not to eliminate all risks. However, in order for customers and counterparties of firms to feel secure in that the firm can honour agreements entered, they must have control of their risks. A great deal of FI’s work is aimed at ensuring this.

Communication and setting standards

As supervisory authority, FI has many reasons for communicating externally. One way of counteracting the risks and problems identified by FI is to point them out to other stakeholders. The authority’s assessments of risks in the financial system are communicated by means of e.g. recurring reports such as “Stability in the financial system”, in which FI describes its risk assessment twice a year.

FI can also influence standards and conduct by explaining the consequence of a behaviour that is not sustainable. Often, it is more efficient that an agent is convinced of the benefit of altering its behaviour than the authority changing the regulations. Communication is also important in creating predictability in the authority’s actions and enabling accountability.

International cooperation

The regulations for all parts of the financial system have become more comprehensive and internationally harmonised over the years. Work on developing new regulations intensified in connection with the latest financial crisis and is far from complete. FI participates in this work and can, to a certain extent, influence how forthcoming regulations are devised.

International cooperation presents both opportunities and limitations in work with financial stability. The regulations developed internationally have provided FI with new legal instruments, but the authority cannot use them with full freedom.

FI must coordinate its measures internationally. When the authority takes measures within the bounds of European directives and regulations, there are in certain cases obligations to inform the authorities of other countries or even await approval before implementing a measure. In certain cases, other countries might need to take measures against firms in their own countries

which operate in Sweden[11]. Such measures reflect those taken by Sweden and the purpose is for the original measure to have full impact. Correspondingly, Sweden might need to take measures. In certain cases, mirroring the measures is compulsory, but optional in others.

Financial crises – contingency planning and management

FI and other authorities work to reduce the probability of financial crises, but cannot stop them from sometimes occurring. In order to limit the damage, both the firms themselves and the Government are required to have contingency measures in place to manage such situations.

Once a crisis actually breaks out, a new phase commences, in which the Government has a main role by necessity. It is a matter of the ability to provide financial support to the market and conduct the recovery or, at worst, resolution of individual financial firms that have defaulted and which could trigger a chain reaction if the Government does not intervene. In such a phase, the supervisory authority does not have the leading role. The primary role of supervision is, and will continue to be, preventing crises by promoting sound resilience.

Firms have been given a clear responsibility for facilitating crisis management. In the borderland between preventive work and crisis management, a new element has recently been added – recovery and resolution plans for systemically important banks.[12] Firms shall have a plan that is well-devised and approved by FI for how it will act to rid itself of problematic situations and, if this is not possible, a plan for how the firm can be wound up in an orderly manner. At the same time, the recovery and resolution plans partially involve a new role for FI in ensuring that crisis management works when needed.

[11] This is referred to as reciprocity.
[12] To this end, in the final report of the Financial Crisis Commission (SOU 2014:52), proposals were put forward regarding devising authority responsibility etc., on the basis of the EU Bank Recovery and Resolution Directive (BRRD).