FINANSINSPEKTIONEN

2013 Supervision Report

28 MAY 2013

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Foreword

The purpose of the Supervision Report is to describe some of Finansinspektionen's (FI's) most important experiences in the past year related to supervision and regulatory development.

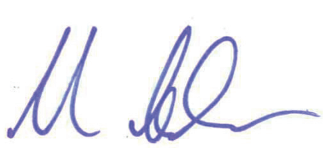
The emphasis of this year's report is on continued efforts to strengthen consumer protection on the financial market, chiefly within the areas of financial advice and insurance intermediation. Also developments in the insurance sector, for example with regard to offers to transfer from traditional life insurance to models that include fewer guarantees, are of significance for consumer protection.

In terms of financial stability, FI is continuing to work on the design and implementation of the new capital and liquidity requirements for Swedish banks that aim to create a more stable financial system. Developing the part of the financial supervision that focuses on systemic risks, "macroprudential supervision", will be another important assignment in the next few years. The report contains a discussion about, among other things, the central components that FI believes should be guiding this work. The report also touches on governance and control, an area that is very important for confidence in the financial system, from the perspective of the sanction decisions FI has made.

The hope is that this report will increase the knowledge about FI's activities and highlight important issues that affect the financial markets and our supervision assignments.

Finansinspektionen's Board of Directors decided on the report on 21 May 2013.

Stockholm, 28 May 2013



Martin Andersson

Director General

Summary

Many of the development trends in today's financial markets raise important issues for FI. For consumers, greater mobility and increasingly complex financial products represent not only more opportunities but also higher risks. FI needs to bring attention to these risks and resolve them. In Sweden and at the international level, financial supervision is being developed and expanded in the form of macroprudential supervision, which improves the stability of the system. At the same time, rules for financial firms are being developed and tightened with regard to capital and liquidity. Both the changes to the regulations and the supervision itself are quickly becoming harmonised on an international level. This introduces high and, in some cases, new demands on FI's work.

CONSUMER PROTECTION

FI has argued in several contexts for a **ban on commissions** for insurance intermediaries and advisors due to the recurring problems with conflicts of interest that have often arisen due to commission-based financing. From a consumer perspective it is important for advisory services to function well, and commissions may not be designed in such a manner as to put the consumer at a disadvantage.

The design of a ban on commissions is also complicated by, among other things, the possibility of regulatory arbitrage, i.e. that the party providing the service attempts to avoid the effects of a rule by qualifying for another rule. One example of this would be that the person actually giving the advice claims to be marketing a service or product. This is one reason why a general ban on commissions is not considered the most appropriate solution. In order to effectively counteract problems related to conflicts of interest without creating undesired side effects, FI is proposing as an initial step a commission regulation that bans the payment of commissions in direct connection with subscription to a product or insurance agreements, which are called *up-front* commissions. This would decrease the risk for unnecessary and, for the customer, expensive transactions.

Another primary issue for FI that is related to consumer protection is **life and pension insurance**, an area which has been experiencing an increase in activity for a number of reasons. There are more opportunities to transfer insurance policies and customers are receiving more offers to transfer policies or change the terms and conditions; in practice, this entails that the risk-taking is being transferred from the companies to the customers. The issues here are that the products are complex, the amounts of money in question are large and there are a large number of consumers who are affected.

In general, FI supports an expanded *right of transfer* in the life insurance sector. However, FI notes that difficult questions remain unanswered and additional investigation is needed before an extensive right of transfer can be implemented. There is a value in the consumer having the right to transfer, but there is also a considerable need for protection for people who do not want to or are unable to utilise this right.

Changes to the terms and conditions of life and pension insurance policies most of the time revolve around the transfer from a traditional life insurance policy to unit-linked insurance. Today, primarily due to the low interest rate level, there are strong incentives for many firms to lead their customers away from solutions that entail guaranteed commitments for the firms. A large number of customers have already received or will soon receive this type of offer. FI has tightened its regulations and general guidelines regarding information to ensure that policyholders receive relevant information in such situations.

FI investigated compliance with the regulatory framework for certain special categories of financial firms. Firstly, FI has been able to identify significant deficiencies among **firms offering payment services**, both in terms of the handling of their customers' money and the money laundering regulations. FI will therefore make the authorisation process for this type of firm more stringent. Secondly, FI's observations regarding **deposit institutions** confirm the authority's position that it has announced previously, namely that deposit institutions should fulfil the requirements for authorisation and supervision that apply to banks and credit market companies and be covered by the deposit guarantee.

FINANCIAL STABILITY

FI believes that **macroprudential supervision** fundamentally is a development and expansion of traditional, firm-based supervision, also called microprudential supervision. The aim of both macroprudential and microprudential supervision is the same – to ensure that the financial system is stable – and the tools are also the same in principle. The difference is that macroprudential supervision adopts a broader focus in its analysis and decisions to take action. It is important not to force a wedge between macroprudential supervision and microprudential supervision through the use of different tools managed by different entities. A coherent toolkit creates better conditions for effectively protecting the stability of the financial system.

The lessons learned from the financial crisis are now being translated into amended regulations and re-formulated methodologies for supervision and crisis management, both in Sweden and internationally. Two of the most important lessons of the financial crisis were that banks must have both **more and better capital** and that there must be an improved ability **to withstand liquidity disruptions**. The new international regulations aim to meet these needs. Sweden has chosen to introduce higher demands than those established by the EU regulations due to the presence of certain conditions that are unique to the Swedish financial market. The Swedish banks have already implemented significant improvements in their capitalisation and contingent liquidity, and in all material aspects already fulfil the requirements of the new regulations. Regulation is nevertheless necessary to ensure that this level is maintained in the long run, even during what appears to be calmer markets.

FI has observed that lending for housing purposes, within the framework for the IRB approaches the larger banks use to determine their capital need, results in a very low **risk weight.** This means that the probability for losses continues to be very low. Even if the model-based calculations are correct, it is risky to calculate the capital need solely on the basis of the extremely low historical losses, particularly since the mortgage market has undergone major structural changes in recent years. Another aspect is that this represents a very large portion of lending that must have satisfactory safety margins. FI is therefore setting a bottom threshold, i.e. a "floor", for how low risk weights may be.

GOVERNANCE AND CONTROL WITHIN THE FIRMS

Good governance, clear breakdown of responsibility, control of the operations and transparency are all important components for achieving both financial stability and consumer protection, in part by supporting confidence in the market. A significant portion of FI's supervision work, and not in the least many of the sanctions decided by FI, are related to governance and control within the firms.

During the autumn of 2012 and the spring of 2013, FI decided on six sanctions directed at different market participants that were directly attributable to deficiencies in their internal governance and control.

The financial crisis has also provided important lessons for supervisory authorities throughout the world in terms of deficiencies in governance and control. Given this background, the European Banking Authority (EBA) prepared a number of recommendations that to a large extent are implemented in Sweden as binding regulations. FI has also taken the initiative to strengthen the regulatory framework based on its own experiences. Three new regulations regarding governance and control will be prepared in 2013. Boards of directors, for example of banks, will be subject to clearer and stricter requirements with regard to knowledge and control.

EUROPEAN REGULATION

In the wake of the financial crisis, financial regulations and supervision have undergone several changes. One of the changes was the introduction of new organisational structures and another was the harmonisation of regulations on a pan-European level. This places new demands on not only FI, but the firms as well. In order to be able to make a difference, both strong arguments and action are required at an early stage.

Goals of Finansinspektionen's operations

Finansinspektionen (FI) has, by instruction and letter of appropriation, been given two main goals from the Government: to promote a stable and well-functioning financial system and to promote good consumer protection within the financial system. In order to reach these goals, FI has access to several tools and can intervene against firms that do not comply with the regulations.

Government regulation and supervision are fundamentally motivated by the fact that, due to a number of factors, the financial market does not function efficiently by itself from a national economic point of view. At the same time, government measures also involve costs that must be taken into account. Acheiving 100 per cent consumer protection and a completely stable system is not possible if the material functions of the financial system are to be preserved. Regulation and supervision must always be about weighing different goals and ambitions against each other. The measures taken by FI to achieve these objectives shall therefore always be weighed against potential negative consequences for the efficiency of the financial system.

FINANCIAL STABILITY

The financial system is a necessary infrastructure in a modern economy. The financial system reallocates savings, manages risks and handles payments. This means that society has a great interest in the financial system being resilient and functional.

Problems in a financial institution can affect the entire economy

In terms of supervision of financial stability, the presence of systemic risk in the banking system plays an important role. A crisis in a bank that has lost customer and market confidence can take a very rapid course, unfolding in the space of a few hours or days. Experiences show that a bankruptcy of a major financial institution, such as the investment bank Lehman Brothers in the US in the autumn of 2008, can have ripple effects that go far beyond the shareholders and lenders of the individual firm. Even if they does not go as far as bankruptcy, problems in the financial sector can have major implications for the economy, for instance through a credit contraction. At the same time, the decision-makers at an individual firm do not carry the entire cost themselves for the problems that affect the rest of the market and financial system.

In Sweden, we have experienced two serious banking crises in less than 20 years, generating strongly negative effects on economic growth and employment. Both the crisis of the 1990s and the latest financial crisis show the clear link between financial markets and the rest of the economy. For this reason, supervision must place tremendous effort on preventing future financial crises.

Taking care of the system is not just about crisis management

A wide-spread systemic collapse is the ultimate threat to the financial sector. To counteract, or in a worst-case scenario, be able to manage, this type of event is therefore of fundamental importance for society. At the same time it is important to not have a one-sided approach to stability work that only focuses on wide-spread system crises, but rather to also work with smaller problems and disruptions. For example, when the banks' online services are interrupted, this does not constitute a "crisis", but if this type of disruption occurs frequently and on a large scale, uncertainty and confidence problems may arise that in the long run affect both the financial sector's ability to function and its efficiency.

CONSUMER PROTECTION

The nature of the infrastructure in the financial sector also reflects the fact that, as consumers, we use financial services pretty much on a daily basis. Some of the financial products we use are crucial to our entire social situation. The products can also have a very long delivery time (pension savings, for example), and becoming familiar with them can be difficult.

The products are complex and hard to evaluate

A fundamental dimension in consumer protection in the financial area is that the products and services are often complex and hard to evaluate. This can apply to risks, return possibilities and costs, with the consumer being at a troublesome disadvantage in relation to the producer in terms of information. Even afterwards, it is difficult for the consumer to determine whether the product was good or bad, and in either case the extent to which this was the merit or fault of the producer. The possibility of changing suppliers can also be limited.

Why does the market fail to achieve sufficient consumer protection?

It is naturally in the interest of most firms in the financial industry to repay customers' funds and treat their customers well. However, situations may arise in which the advantages of providing inferior advice or making poor investments with the funds of others weigh heavier. Such behaviour not only affects the firm's customers but also confidence in other firms. When it is difficult for the customer to evaluate quality, it is not certain either whether it is worth it for individual firms to take the initiative for a measure that is good for general confidence on the market, but that gives rise to costs or a lack of revenues for the firm. In order to ensure that people are confident about the market, cooperation and coordination between companies are often required. Uncertainty and a lack of trust can otherwise lead to consumers, out of more or less well-founded fears of being cheated, refraining from using financial services. Here, regulations and supervision can act as a means of creating a more efficient market, to the benefit of firms and consumers alike.

Protection of assets, correct information and fair terms

Consideration for consumer protection means that it is not enough for firms of importance to the financial system to merely be stable. Legislation is based, for example, on requirements that all banks and insurance companies – not only the big ones – have sufficient equity. Government regulation in the consumer area is also largely about protecting the assets of consumers that are managed by the financial institutions. In this manner, the Government assumes part of the monitoring from the consumer who can, to a greater extent, rely on contracts being fulfilled.

In order to reduce the disadvantage of the consumer, in addition to stable firms, companies must also provide correct and clear information and fair terms. This is of particular importance as the products are being sold become increasingly complex.

The consumer's own role

FI is working to reduce the disadvantage of consumers by placing demands on firms. Another way to strengthen consumer protection is to improve the general public's financial knowledge. FI is therefore focusing on educational projects at schools and workplaces. More knowledgeable consumers can, in turn, place higher demands on and even be more critical of the offers they receive.

INTERNATIONAL WORK

FI is a national authority with cross-border operations on a global market. This has become very clear during the most recent financial crisis and the uncertainty that has now arisen as a result of the sovereign debt problems in Europe. International cooperation is also necessary to implement solutions and achieve efficient supervision at a national level. FI must play an active role in the international debate and regulatory development while maintaining a focus on Swedish circumstances. Largely all fundamental financial regulation applicable in Sweden is decided today at the EU level. The new European supervisory authorities have an important role in regulatory development, both as advisors to the EU Commission and as authors of new regulations, so-called technical standards or guidelines. FI therefore spends a lot of time participating in the work of these authorities.

NEGATIVE EFFECTS OF REGULATIONS MUST BE TAKEN INTO ACCOUNT

The measures taken by FI to achieve its objectives shall, according to the assignment in the letter of appropriation, be weighed against potential negative effects on the efficiency of the financial system. Regulation and supervision generally involve direct administrative costs for the firms, which to a great extent are transferred onto customers. The requirements can also change competitive conditions and the firms' possibilities to offer different services. Regulation can also sometimes create what is known as a moral hazard, i.e. change the behaviour in an undesirable way among the players and markets it was intended to make more efficient. As an example, it can be ascertained that guarantees for banks and government support programmes reduce the risk of a firm's bankruptcy causing problems for other parties in the financial system. At the same time, however, they can mean that the probability of problems occurring is greater. Knowing that they can rely on government support, firms can take greater risks without risking losing customers and lenders. FI therefore always conducts a consequence analysis in connection with regulation projects.

FINANSINSPEKTIONEN'S MEANS

FI has several means for meeting the objectives of a stable financial system and good customer protection. Regulations set limits for firms' operations. In supervision, monitoring is performed to ensure compliance with regulations, and when needed interventions penalise breaches. The ongoing dialogue with financial institutions is also very important for FI.

Authorisation, regulations and supervision

FI's primary means are authorisation assessments, regulations and supervision. These are closely intertwined with one another. The authorisation is a requirement for conducting financial operations. The regulations specify the conditions for firms and how they are to conduct their operations. FI has a primary responsibility to develop the financial regulatory framework based on authorisations from the Government and Swedish Parliament. FI also participates actively in the work of creating new regulations at the EU level. In supervision, compliance with the regulations and whether there are any other problems or risks are verified.

Interventions

FI attempts to steer the behaviour of firms that operate in the financial sector in a desirable direction. In order to take measures against firms that do not comply with regulations, FI has been equipped with a number of means of sanction. FI has the right, and the obligation, to use these means if required. However, this does not mean that FI shall always choose to exercise this authority when undesirable behaviour is discovered. Often, FI chooses to talk to the firm's management rather than use formal sanctioning. However, sometimes the breaches are so serious that an intervention is necessary.

The responsibility of the firms

Irrespective of FI's supervisory initiatives, the firms and their management bear the primary responsibility for ensuring that financial institutions are well managed. FI cannot monitor each financial player in detail – this would require thousands of financial inspectors. FI can, through regulation, attempt to create the right incentives that are then monitored in supervision and through sanctions, but FI cannot replace a healthy corporate culture and active efforts to promote sound corporate governance among the firms and their employees.

Protecting and supporting the consumer

Financial services and products are often complex, and their benefits, risks and costs can be difficult for the consumer to assess. Advice and intermediary services play an important role, which is why it is very important, for example, for commissions not to influence advice in a manner that is to the customers' disadvantage. The current changes toward more mobility in the life insurance sector, which are partly driven by regulations and partly by market conditions, enhance the importance of consumers being given opportunities to make well-grounded decisions.

A FOCUS ON ADVICE

Many financial products have complex constructions. This means that there are opportunities for consumers to design and adapt products to their individual needs. But this also entails risks, since it can be difficult to assess the costs and risks and make correct comparisons. This applies primarily in the areas of saving and insurance.

Complex products create a need for help at the decision-making stage. In general, for example through education, the Government can contribute in a number of ways, but there is also plenty of room for, as well as a need for, individual advisory services. It is completely natural and rational in this context, as in others, to seek help from others who are more competent than oneself, and to pay for this service.

Therefore, there is a considerable economic benefit in efforts to promote a high level of quality in advice and intermediation. If intermediation and advice do not function well, in practice this can *increase* instead of decrease the consumer's disadvantage. Problems arise when the advisor's or the intermediary's operations have conflicts of interest, i.e. when the advisor or intermediary has other incentives and goals than to look after the best interests of the customer, and in particular if the customer is not aware of these goals and incentives. For example, this can be the case if the advisor or intermediary receives commissions from the producer of the product.

A significant portion of FI's consumer protection work, as well as many of FI's interventions, are related to problems with the advice and sale of complex financial products. This chapter discusses a number of issues and cases related to this.

Two roads to decreasing the information gap

Two approaches can be used to decrease the consumer's informational disadvantage and FI is working actively from both directions. One is to ensure that consumers have access to correct, comprehensible information about firms and services. The other is to educate consumers so they find it easier to absorb and assess the information they are given, and can better formulate their requirements and needs.

In terms of the latter, FI is working actively in increase consumers' awareness about their personal finances. FI is carrying out several educational projects to increase the financial education available to private individuals. The educational projects are conducted in close cooperation with other authorities, firms and organisations, for example through the GDE Like Your

Finances national network. This network has gradually become an increasingly important base for FI's educational strategy. Around 50 members work together in the network to implement the central strategy - to teach the teachers, i.e. teachers, advisors and instructors, who are in a position to reach a broad segment of society through various channels. FI in particular has prioritised educational projects and support for school teachers, adult educators and advisors and instructors at municipalities, adult education associations and unions. During the spring of 2013, agreements were signed with five pensioner organisations to implement an educational project with the potential of reaching and training close to one million pensioners.

Themed investigations regarding complicated products

FI started a supervisory review in 2011 to review the creation and distribution of complex products. The survey focused on the risk that customers do not understand the products they are buying and on whether they receive inappropriate investment advice.

The background to the investigation was that, on several occasions, FI expressed its concern about the consequences of the greater complexity of structured products, which is one of the product types that can be classified as "complex". Structured products are today a relatively common method of savings and many structured products have features that, for some investors, can be attractive, for example offering limited market risk in a downward market. At the same time, it is often difficult for customers to understand the expected yield and the risks associated with these products.

What are structured products?

Structured products are financial instruments whose return is completely or partly dependent on the development of several other instruments or assets. Examples of structured products include equity-linked bonds, share bonds, commodity bonds, etc.

An **issuer** of a structured product could be a bank. The issuer issues the product and prepares a prospectus. The issuer sometimes offers the product in cooperation with an **arrange**r – another bank or investment firm that designs the product and organises the marketing and sale of the issue. The issuer and the arranger can also be the same organisation. This organisation can also be the **distributo**r, i.e. the party in contact with the end customer. Otherwise, examples of distributors include investment firms, tied agents and insurance intermediaries.

During the first part of FI's investigation, a review was conducted of nine **issuers and arrangers** (”product arrangers”) of structured products. FI's conclusions from this review are reported in the 2012 Supervision Report, where FI stated, among other things, that the product arrangers have a responsibility already at the design stage of the structured product to lay a foundation for good consumer protection.

The second part of the supervision report focused on the distribution of structured products. The investigation reviewed seven **distributors** of structured products. The review included, for example, how firms handle incentives and other conflicts of interest and which information the firms obtain from their customers to ensure that the customers are recommended appropriate products.

Distributors must improve the information they gather

A firm providing advice regarding structured products must adapt their advice to the customer's circumstances and may only recommend solutions that are appropriate for the customer. This applies regardless of whether the advice is given by a securities institution or an insurance intermediary. In order for a distributor of structured products to be able to make this assessment, the distributor must gather sufficient and relevant information about the customer.

FI's investigation shows that firms in many cases do not gather sufficient information about the customer's risk proclivity and risk profile – in several cases, for example, the information about the customer's risk proclivity and risk profile were insufficient to determine which risk level was appropriate for the customer. In several cases the documentation did not state if it was the company's risk analysis, the customer's desired risk or the proposed products' risk that was indicated by the documented risk level. In some cases, the documentation of the risk level only included three levels (low, middle and high), even though the advice referred to financial instruments with both difficult-to-assess and widely fluctuating risks.

In some cases the firms in the investigation did not document the grounds on which the advisor had offered his/her recommendation. If there is not sufficient documentation about which information was obtained about the customer's objective for the investment, the customer's financial circumstances or the customer's knowledge and experience with the product in question, it is difficult to determine if customers received appropriate advice. It is common for investment objectives such as, for example, "good return with low risk", "better return than before", "risk spread", etc. The objectives, in other words, are extremely general. FI's investigation shows that the firms distributing structured products must become better at gathering complete and relevant information about the customers before they offer any advice. Deficiencies in the information gathered by the firms and a deficient analysis of the information gathered increases the risk that the firms will recommend products to their customers that are not appropriate.

Distributors must become better at handling conflicts of interest

FI sees clear risks that customers' interests will be ignored when the sale of complex products are compensated for via commissions. Since some products generate higher commissions than others, distributors face financial incentives to give advice based on the size of the commission rather than the interests of the customer. In cases where the entire expense occurs initially and the distributor receives compensation upon subscription of the product also creates incentives for the distributor to propose to the customers new transactions and restructuring to maximise their own income rather than giving more long-term advice.

Both the regulations governing investment services and activities and the regulations governing insurance intermediaries contain extensive requirements on the information that shall be given to customers when a firm receives commissions from a third party. The information should give customers the opportunity to understand how compensation can influence the firm to act in a certain way and therefore enable them to make investment decisions based on more correct information. FI's investigation shows that the firms' information regarding commissions is not sufficient. The information given to a customer is often deficient and vaguely formulated. In many cases the information to the customer has been designed in such a manner that it is impossible for the customer to compare the compensation of different products and types of instruments. In order for the consumer to be able to make a well-grounded investment decision and compare offers, the information must in many cases be improved significantly.

A general conclusion from the investigation is that all participants along the chain, from the creation of structured products to their distribution, need to take a greater responsibility for customer protection. It is particularly important that all participants to a larger extent manage the conflicts of interest that arise both at the producers and during distribution of structured products. FI has seen deficiencies among the companies in the investigation with regard to the reporting of expenses and commissions. The provision of information must occur both in a manner that is comprehensible and fulfils its purpose. In this area FI will carefully follow up on developments since this is important to safeguard fundamental consumer protection. The focus of the supervisory investigation has been structured products, but FI also focused during its ongoing supervision on the difficulties with clear and correct information about costs and commissions. FI will therefore have a strong focus in the near future on these customer protection rules.

SANCTIONS

The problems related to complex products and their management have also recently been the object of a number of sanctions. Almost all of the firms in some way disregarded their information and documentation obligation and did not adapt their advice to the customers' situation and needs. In several cases, FI has been able to identify lacking competence, lacking documentation of advice given and insufficient gathering of information about the customer's situation and needs. Products have also been sold, in some cases expensive high-risk products, without providing clear information about costs and fees.

FI has been able to determine that many of the problems on the intermediation and advice market can be traced to the conflicts of interest that were previously described.

Example: Nordisk kapitalförvaltning AB – withdrawal of authorisation

The company sold complex, high-risk financial instruments without taking into consideration the customers' interests and needs. The products were very expensive for customers, but at the same time they generated considerable income for the company. There have been major deficiencies in the company's information to the customers and their documentation, and the advice has not be tailored to each individual customer. Furthermore, the company's employees did not meet the requirements on appropriate knowledge and competence. FI takes the position that the company has been deficient in its compliance with more or less all of the central components of the regulations. The measures the company has stated that they have taken are not considered to be sufficient to rectify the deficiencies.

BAN ON CERTAIN COMMISSION MODELS

If the consumer is given the impression that the advisor or the intermediary is a neutral actor who is only working for and on behalf of the customer, but the advisor/intermediary at the same time is receiving commissions from the producers of different savings and insurance solutions, situations may arise in which the intermediary or the advisor act in a manner that benefits themselves at the customer's expense. Recently, the discussion has focused on insurance intermediaries' commissions, for example given the fact that the insurance intermediaries' content in many cases, in reality, is shifting toward capital investments and management instead of insurance in the current meaning.

Advice and a re-investment activity that to a large extent are steered by the terms and conditions of commissions and are not known by the customer can seriously damage the consumer's interests. Customers risk to much too large of an extent receiving expensive, and in some cases unnecessary complex or risky, products, and shouldering unnecessary and expensive – although lucrative for the seller and intermediary – transactions. Another negative consequence can be the weakening of confidence in financial advice in general. To create healthier incentives and design appropriate restrictions in terms of commission funding in this perspective are important assignments for FI. This issue has been the subject of discussions on multiple occasions, but at the same time is also complex.

Commission problem

Even if the majority of the industry has made significant advancements in terms of customer information, and implemented extensive measures to raise the competence of intermediaries,[1] there are still problems.

In many cases, a large portion of the commissions are paid out in conjunction with signing the agreement for the product (*up-front*).[2] In these cases there is a clear risk that the insurance intermediary will not make decisions that are long-term in nature if large parts of the compensation for the insurance period are paid directly in conjunction with the signing of an insurance policy or an agreement for a financial instrument.

The ideal consequence of a general ban on commissions would be that intermediaries and advisors would switch to a system where they invoiced their customers for their services. However, it is not probable that this would be the main effect. The effect could be that some advisors would instead become "marketing agents" and continue as before, although outside the scope of supervision.

Given this potential outcome, FI intends to recommend to the Government that, as an initial step, a commission regulation be implemented that focuses on up-front commissions, i.e. commissions that are paid in conjunction with the signing of an agreement for a product or an insurance policy. The proposal entails that the product companies must make regular commission payments to the intermediary over time. This would have the greatest impact where the problems are the greatest, at the same time as FI judges the risks for new problems or negative side effects as a result of the regulation to be limited. The bank would to a large extent remove the incentive of signing solutions with high initial costs and even decrease the incentive to recommend transfers with the aim of generating new

1 Primarily the ”Insursec” certification programme

2 ”Up-front” is defined differently in different contexts. Here the reference is to initial compensation in general.

income. By allowing commissions to be paid on a regular basis, the intermediary receives compensation as long as the customer does not terminate the customer relationship, which also creates incentives to promote the interests of the customer.

It should be added that there is also another fundamental method for reducing the problem with conflicts of interest, namely to improve transparency. That would make it clear for the customer that commissions exist and explain how they work. A considerable number of these types of measures have also been taken, in part at the initiative of the industry itself. This is an important contributor to making the conditions on the market healthier, but this type of measure is not enough on its own since a wide range of problems related to the identification and management of conflicts of interest will still exist.

The regulations governing insurance intermediaries and securities business, both of which are related to this area, are undergoing changes at the EU level in the forthcoming amendments to the IMD and MIFID directives. None of these will include any long-term commission bans other than for independent advisors. But neither will either of the regulations prevent Sweden from implementing a ban at the national level. FI believes that Sweden should take advantage of the opportunity to go a bit further, at least with regard to insurance intermediation, i.e. within the framework for IMD.

TRANSFERRING INSURANCE

Much of what is happening in the area of insurance today is related to the fact that activity is increasing for two reasons. The first is the financial pressure on life insurance undertakings due to the low interest rate level. This raises strong incentives for the undertakings to convince customers to replace their traditional life insurance policies with unit-linked insurance, and thereby transfer the investment risk to the customer. The second is the proposal for new rules that will increase opportunities to transfer life insurance within and between different firms. This will have an effect on potentially very large amounts of money, as well as a very large number of policyholders, both directly and indirectly.

Advantages and disadvantages to transfers

On 1 January 2000, it became possible to transfer the value of a pension insurance to another insurance without any tax effects. However, this right of transfer was voluntary since it required that the parties had agreed on such a possibility. As of 1 January 2006, new legislation gave policyholders what was basically an unconditional right to repurchase an individual life insurance policy. The rule has since then be gradually modified to expand the possibilities for transfer. The life insurance investigation is currently under consultation and includes proposals for transfer possibilities.[3]

FI in principle supports the right of transfer – the legislator's starting point must be to counteract lock-ins and make it possible even in the life insurance sector for a customer to "vote with their feet" and switch suppliers. At the same time, the life insurance sector is unique in several respects and is subject to more complications and required considerations than other areas. Fundamentally the issue is about whether the

3 Förstärkt försäkringstagarskydd (Enhanced policyholder protection). (SOU 2012:64). FI's consultation comments about the investigation are available at www.fi.se

insurance is based on an equalisation of risks within a collective. It is easy during the analysis to spend too much time focusing on the rights of parties that want to transfer their funds. There is also a considerable need for the protection of parties that cannot or do not want to transfer their funds. Therefore, a careful analysis must be conducted of the circumstances under which transfers should not be allowed or are considered inappropriate.

There are a number of issues that FI believes must be analysed and clarified before a general right of transfer can be introduced, for example:

- At what point can a life insurance undertaking decline a transfer or decrease the transfer value? This should be clear since disputes can easily arise between firms and policyholders in such situations.
- Which general principles should apply to safeguard the fair treatment of policyholders, given the insured's health and the nature of the insurance?
- Should it be possible to limit the right of transfer given the solvency of the firm in question?
- How much of the surplus in a ceding firm can be paid out without there being a risk that the yield for those not transferring their funds declines?
- The consequences of the transfer right's impact on firms' possibilities for long-term investments should be investigated, as well as the economic effects of this.

Other examples of important issues are related to occupational pensions, where a distinction is required between *the employee's* (the individual's) and *the employer's* (the policyholder's) right of transfer. For defined-contribution occupational pension insurance policies, the employer fulfils its pension promise to the employee by paying a contribution, i.e. the pension premium. On the other hand, for defined-benefit occupational pension insurance policies, the employer has a residual responsibility to fulfil the pension promise during the entire payment period. FI indicated in its consultation comment to the investigation that the practical and legal difficulties related to the right of transfer for the employee in the latter case are so large that this right is hard to justify.

During an evaluation of a potential transfer, there are so many difficult considerations to be taken by the policyholder that it is difficult to make a good choice. This requires that both the ceding and the accepting firm must provide information that enables a comparison of the insurance policies. In addition, these firms must clearly state the advantages and disadvantages of different situations and be able to refer to independent comparisons. The customer information must include information about, for example, guaranteed amounts/capital, payment in the event of death or illness and an illustration of the expected pension payment. In addition, an explanation is needed of the other factors in the insurance agreement that are affected by a transfer. For example, will fees or lifespan assumptions change after the transfer? To date, the pedagogy in the transfer information about the distribution of surplus/deficit has often been deficient. It is important that the customer actually understands the principles behind their rights and the rights of the other insured to surpluses and how the distribution of surplus is carried out. This will also require an increased focus in terms of supervision.

To summarise, it can be said that even if the right of transfer is fundamentally positive by representing greater options and influence for the consumer, there are still a number of questions that need to be resolved before a more extensive right of transfer can be introduced.

Fewer guarantees, more risk for the customer

Another current phenomenon in the life insurance sector is originating in the prevailing low market interest rates, which have created problems for some life insurance undertakings. Lower interest rates mean that the present value of the undertakings' liabilities have risen higher than the current value of their assets, which has a negative effect on the solvency.[4] Most tangible is the deterioration of solvency among undertakings that previously issued their customers high yield guarantees for traditional life insurance policies. There are therefore strong incentives for the undertakings to convince their customers to switch to other solutions in which the guaranteed benefit is decreased or removed completely. Changes of this nature to the terms and conditions do not need to be negative for the customer, but there is also a risk that life insurance undertakings will present the information from the perspective of their own interests of decreasing their commitment, rather from the needs of the customer. It can also be assumed that hundreds of thousands of customers this year and in coming years will receive this type of offer. For example, one firm is planning on offering one-fourth of its 800,000 customers new terms and conditions for their insurance policies. From an annual guarantee of 3–4 per cent the firm is now offering a guarantee of 1 per cent. At the same time, customers also will have the capital fees lowered to 0.45 per cent from the previous 0.75 per cent.

It is particularly important to protect the interests of the policyholders when they are offered to transfer insurance or if significant changes are made to the terms and conditions since these changes are related to conditions that are very important for individual customers' financial situations. For this reason, special regulation is needed for these kinds of offers. Even if the Solvency 2 regulations, when they are implemented, will contain requirements on more consumer information, FI believes that some changes already need to be made now. FI has therefore implemented more regulations that the insurance firms, in such situations, must make it clear for the policyholder what the impact of an offered transfer of the insurance's value or the changes to the terms and conditions would be. This information should as a minimum contain a description of the differences in the contractual insurance amount, other insurance benefits, fees and the financial risk that arises for the policyholder as a result of the change.

PAYMENT SERVICES AND DEPOSITS – LESSONS FROM SUPERVISION

Firms offering payment services – deficiencies in customer protection and measures against money laundering

Several years ago, regulation was introduced via an EU directive that opened the door for non-banks to conduct payment services. The Payment Services Act has now been in force for almost three years. Firms offering payment services handle payments that, in contrast to the banks' payment services, are *not* based on the customer having a deposit account with the firm. In April 2013 there were 24 payment institutions,

4 See the section below about the interest rate floor

49 registered firms offering payment services and 468 agents for domestic payment institutions active in Sweden. Foreign firms also offer payment services to Swedish consumers. The Swedish firms offering payment services handled payments totalling SEK 136 billion in 2012.

In their applications, the companies have described how they intend to carry out their payment activities. Since 2012, FI, by conducting, for example, onsite visits at a number of firms, verified how reality reflected the stated intentions. This control proved itself to be necessary. During its visits, FI identified deficiencies in how customers' funds were handled and how the firms work to prevent money laundering. Deficiencies in the handling of customer funds could result in losses for the customers, and deficiencies in the management of money laundering risk could create loopholes for illegitimate money in the economy.

The problems that were identified among the firms offering payment services demonstrate that there is an inherent conflict between how much information should be verified during the assessment of an application and the requirements that the handling of the application be simple, quick and inexpensive. There is a risk that a quick, simple assessment of an application – which can be desirable to facilitate the establishment of business and competition – can give less capable or less serious actors the opportunity to start a business. This then creates problems in the ongoing supervision, for consumers and for the market as a whole.

FI needs to find a balance between what is required during an assessment so that, on the one hand, the process is not unreasonably burdensome for the firms and, on the other hand, the assessment is not insufficiently thorough. FI has drawn the conclusion that its procedures for the granting of authorisation need to be improved, for example so that, in addition to the review of the written material, more interviews are held with representatives of the party applying for authorisation. The objective is to verify that plans and intentions have a proper foundation and are not just obligatory statements on a form.

Money laundering

In the report "Money laundering and financing of terrorism". In "Improved risk management" FI states that many firms have difficult identifying risks that they will be used for money laundering and the financing of terrorism.

http://www.fi.se/Tillsyn/Rapporter/Rapporter/Listan/Penningtvatt/

FI's report on money laundering and the financing of terrorism

In the current Money Laundering Act, which has been in force for almost four years, firms have the possibility and obligation, in a manner that is deemed reasonable and based on a risk assessment of the operations, to allocate resources and design measures to prevent the risk of the firm being used for money laundering and the financing of terrorism.

While many firms, based on a survey conducted by FI, state that they are satisfied with their work in this area, FI can state that many firms clearly find it difficult to identify the risks in their operations and take appropriate measures to counteract these risks. FI draws the conclusion that many of the firms need raise their ambitions in this work, and FI presents in the report a number of factors that are of fundamental importance for the firms to properly carry out their risk management activities. In its supervision, FI will continue to direct more targeted and in-depth investigations into areas that are of particular importance when it comes to risk management.

Deposit institutions – risks for depositors

All financial operations that target the general public are not under the normal scope of FI's supervision. There are a few hundred smaller financial firms that conduct some types of operations that must be registered with FI (and thus fulfil certain requirements) but that otherwise are not subject to full supervision. This creates some problems, not in the least because it is probably difficult for customers to understand the difference between only being registered with FI on the ona hand and being subject to FI's supervision on the other.[5]

One example of such a category is deposit institutions, which may receive money – at the most SEK 50,000 per depositor – from the general public. There are currently 32 of these firms and associations registered with FI. A significant difference from the consumer's point of view is that deposits made with a deposit institution are not protected by the government deposit guarantee. Neither are there any limitations for how the deposit institutions may use the funds. For example, these funds can be used to pay the firm's normal operating expenses.

In order to become registered and maintain the registration, the firms must fulfil certain requirements on an ongoing basis. One such requirement is that their restricted equity may not be less than SEK 10 million[6]. Finansinspektionen annual reviews that the requirements are fulfilled.

The requirement on a minimum level of restricted capital is not directly aimed at protecting existing deposit customers, since the level is static and independent of the number of deposits and they type of risk exposure the institution has. Rather, the requirement is there to create a certain threshold for new businesses and to decrease the risk that dishonest actors will enter the market. Neither are there any requirements that the institutions must have sufficient cash and cash equivalents to handle temporary peaks in withdrawals. FI has previously made the point that all firms which have the right to receive deposits should be subject to full supervision and have sufficient capitalisation in relation to their risks.[7]

Case study: Fundior Finans och Försäkring

A specific case with regard to the problems with deposit institutions is the review of Fundior Finans och Försäkring AB, which is a deposit institution. Fundior F&F had circumvented the consumer protection rule in the Deposits Act limiting deposits from consumers to SEK 50,000 by, in addition to pure account deposits, receiving large deposits within the framework of an endowment insurance product, which was not covered by the deposit guarantee, either. In addition to this, in the spring of 2012, the institution's auditor submitted a modified auditor's report and in particular highlighted that the institution might not fulfil the legal requirements on restricted equity. After an investigation, which was made more difficult by complex intra-Group financial ties, the institution opted to withdraw its registration; the institution quite simply was not able to demonstrate that it had the level of restricted

5 FI discussed this in its report, ”Tillsyn och registrering” (Supervision and registration), published April 2011 (in Swedish). The report, which was written on assignment from the Government, proposed that deposits should remain with banks and credit market companies and that a new type of firm (other than banks and credit market companies) that issues loans to consumers, i.e. consumer credit firms, should be created. This category would capture firms specialising in unsecured loans. In both cases, this would improve clarity and opportunities to intervene. A proposal regarding firms specialising in unsecured loans has currently been submitted for consultation.

6 Corresponding requirement for a bank is EUR 5 million, almost five times higher.

7 see footnote 5 above

equity that is required. Fundior Finans och Försäkring AB is in the process of winding up its deposit stock, which should be completed during 2013. According to information in the media and as well as from consumers who contacted FI, Fundior is having difficulties repaying the deposits on time.

FI also withdrew the institution's insurance intermediation authorisation.

This case strengthens FI's belief that deposit activities should remain with banks and credit market companies, for which there are rules on capital requirements that reflect the institution's size and risk profile, as well as countless other rules that aim to protect the stability of the firm. Given today's regulations, deposits with a deposit institution should be viewed as a risk investment rather than savings in an account.

CONSUMERS AND MORTGAGES

The development on the mortgage market is important from a number of perspectives. Mortgages represent the single largest portion of the loans that households take and also represent a significant portion, almost 50 per cent, of the total lending in the Swedish economy. For these reasons alone mortgages can potentially have a major influence on the macroeconomic development, total credit risks and, thus, the stability of the financial system. Last, but not least, mortgages are important for the financial risk-taking of a very large number of individual households.

After a long period of rising household indebtedness, house prices and loan-to-value ratios, FI decided to implement general guidelines limiting the loans collateralised by homes. The mortgage cap, as the general guidelines are referred to, entered into force on 1 October 2010. The aim of the mortgage cap was to counteract unhealthy lending practices on the mortgage market and rising loan-to-value ratios, which could have resulted in an unacceptably high financial vulnerability for many households.

■ 2013 Mortgage Report

"Swedish Mortgage Market 2013" reports that few households have mortgages above the cap of 85 per cent and they have become better at amortising.

http://www.fi.se/Tillsyn/Rapporter/Rapporter/Listan/Den-svenska-bolanemarknaden1/

Since then, FI has followed up on the effects of the mortgage cap on two occasions. The most recent report, which was published in March 2013, stated that the trend of steadily rising loan-to-value ratios for new loans was broken. In addition, a lower share of households are currently taking mortgages with a loan-to-value ratio exceeding 85 per cent compared to before the mortgage cap was introduced. Another positive effect of the mortgage cap is that more or less all of the loans with a loan-to-value ratio exceeding 85 per cent are amortised, and the amortisation is occurring at a faster rate than before. This means that households, in cases where they despite everything have a loan-to-value ratio exceeding 85 per cent, will build up a safety margin more quickly against potential falls in prices on the housing market. According to the most recent report, loans with a loan-to-value ratio exceeding 75 per cent are also being amortised to a greater extent and at a faster rate than before. This means that the banks currently are applying the Swedish Bankers' Association's recommendation of amortisation for all mortgages with a loan-to-value ratio exceeding 75 per cent.

FI can state that the mortgage cap has been effective for rectifying the rising loan-to-value ratios on new loans as well as the low rate of amortisation on loans with high loan-to-value ratios. However, loans with loan-to-value ratios under 75 per cent are amortised to a more limited extent and in cases where they are amortised the actual repayment periods are very long. The long terms effects that this may have on financial stability must be investigated. This investigation will be conducted within the framework of an analysis group appointed by the Council for Cooperation on Macroprudential Policy, and the first report will be presented to the Council during its meeting in October 2013.

FI is also following the lending and loan terms of credit institutions to firms and households, in part with reference to the mortgages. The report on the first quarter of 2013 states that the banks' margins on mortgages continue to rise.

The Government has assigned FI the task of investigating and reporting possible measures for how credit institution can increase customer insight into how the actual lending rates for mortgages are determined in relation to the rates these institutions publish. The assignment also includes the preparation of an action plan and schedule for conceivable measures. The aim is to make it easier for consumers to compare lending rates between banks and increase consumers' understanding for which factors affect the interest rate. In addition, FI also received an assignment from the Government to analyse the conditions for an appropriate regulation that will allow credit institutions to propose to new mortgage customers or existing customers who increase their loans individually adapted amortisation schedules.

Financial stability

In the wake of the financial crisis, intensive work is currently underway both internationally and nationally to improve in the future the prevention and management of financial crises and stability problems. Debates are also being held about how this should be designed. This includes the new concept, "macroprudential supervision". FI has a central role in all of the work that is related to financial stability. During the year, FI continued its work with the new regulations for capital adequacy and contingent liquidity. Furthermore, work is underway to establish functional rules for how financial institutions in a crisis should be effectively managed.

The focus of the stability supervision is on the major Swedish banks, in part because they play a dominant role in the Swedish financial system and in part because their business model makes them particularly vulnerable to liquidity problems. Working to ensure the stability of the financial system is an assignment that FI shares with others, mainly the Riksbank and the Swedish Ministry of Finance.

MICROPRUDENTIAL AND MACROPRUDENTIAL SUPERVISION – TWO SIDES OF THE SAME COIN

During the acute stage of the financial crisis in the autumn of 2008, central parts of the financial system more or less stopped functioning both in individual countries and at the global level. The system's fundamental functions were able to be upheld thanks to major support measures from governments and central banks. The financial crisis revealed large deficiencies in how banks and other financial firms conducted their operations.

New institutions and tools

The lessons from the financial crisis resulted in intensive international efforts to develop the regulations and supervision. Within the EU, a new organisational structure was created that consists of the three supervisory authorities, EBA, ESMA and EIOPA, and the European Systemic Risk Board (ESRB) in response to the deficiencies that became obvious in conjunction with the crisis.

The purpose of the last-mentioned body has been to better capture and address market- or system-wide risks, which usually is called *macroprudential supervision*. These efforts are also underway on the national level and are tackling not only institutional issues, primarily who will be responsible for the macroprudential supervision, but also the issue of which tools should be used. The objective is clear - the developments we witnessed in recent years must not be repeated. In Sweden, the Financial Crisis Committee produced a report that contained proposals for how the macroprudential supervision in Sweden should be designed.[8]

The purpose of both microprudential and macroprudential supervision is to preserve the stability of the financial system. Supervision measures related to, for example, capital requirements, contingent liquidity, etc., can be targeted at specific firms or the entire industry. The difference between microprudential and macroprudential supervision is defined by what primarily initiates the supervision activity – firm-specific or mar-

8 See Preventing and managing financial crises, SOU 2013:6.

ket-wide/macroeconomic conditions. The following two examples provide an illustration of this:

- FI discovers that a bank has been deficient in its risk control in a certain area. FI takes measures against the bank in question. This is a typical *micro*prudential measure.
- FI determines that the risk weights for mortgages are too low since the method used to calculate them is not judged to provide a correct overview of the risk associated with this type of lending. FI takes measures, in this case, against all major banks and defines a minimum level for the risk weight. This can be viewed as a typical *macro*-prudential measure.

However, several of the measures FI is implementing are not purely microprudential or macroprudential, but rather a combination of the two. They are also often a combination of system stability measures and consumer protection measures. For example, higher capital requirements for the major banks have a clear macroprudential dimension while they are, at the same time, directed at four specific firms. Furthermore, the mortgage cap can be described in general as a macroprudential measure[9] that also functions as consumer protection. In other words, microprudential and macroprudential measures naturally intertwine in the day-to-day activities related to financial stability. They are to a large extent two sides of the same coin, and so it should be.

Finansinspektionen's viewpoints on the proposals from the Financial Crisis Committee

Finansinspektionen (FI) supports the Financial Crisis Committee's proposal to establish by law a macroprudential policy council. The proposal is very similar to the cooperation council that FI and the Riksbank have already formed through an agreement between the authorities. A major advantage of establishing such a council is that it gathers different types of skills in the area, which is key for expanding the understanding of how systemic risks build up in a financial system.

FI supports the Committee's proposal that the Macroprudential Policy Council should consist of the Governor of the Riksbank, FI's Director General, one additional member from the Riksbank and FI, respectively, and two expert members who are independent of the authorities.

FI believes that the Swedish Ministry of Finance should have good insight into crisis prevention activities, but there are also strong arguments for such a council being politically independent. The Committee's solution for this is to have the Swedish Ministry of Finance participate in the Council as observers. FI supports this proposal.

FI presumes, as does the Committee, that the Stability Council will continue to exist in parallel with the Macroprudential Policy Council as a forum for cooperation regarding financial stability with a focus on crisis management. The Stability Council consists of representatives from both the Swedish Ministry of Finance and the Swedish National Debt Office, in addition to Finansinspektionen and the Riksbank. It is natural and necessary for the Swedish Department of Finance to chair the Stability Council, given the risk that the management of a financial crisis could have a considerable impact on government finances.

9 This type of restriction on loans, loan-to-value ratio (LTV), in principle can be applied to any asset eligible as collateral, e.g. shares or commercial properties.

FI does not object to the Committee's proposal to also give other authorities, in addition to FI, a responsibility for contributing to a stable and well functioning financial system. However, this statement is predicated on the assumption that the assignments given to the authorities to achieve this goal actually differ. It will otherwise be difficult to demand accountability.

The debate about how macroprudential supervision should be structured frequently splits microprudential and macroprudential supervision into two separate entities. FI believes this division to be inappropriate for a supervision that aims to achieve financial stability. Effective supervision must include both aspects. A good analysis of systemic risk requires knowledge about what is happening among individual firms, and analysis of the risks in individual firms cannot be separated from macroprudential or systemic risks.

FI believes that a structure in which the different macroprudential tools associated with capital and liquidity requirements, as a primary example, are divided between different authorities is not appropriate. Such a division normally makes the assumption that microprudential and macroprudential supervision are fundamentally different. FI already currently has at its disposal the majority of the macroprudential tools and it has also implemented several of the macroprudential measures aimed at mitigating systemic risks and thereby contributed to a stable financial system. If these tools are divided between different authorities, there is a risk that problems related to the delineation of boundaries, inefficiencies and, in a worst-case scenario, contradictory supervision, will emerge.

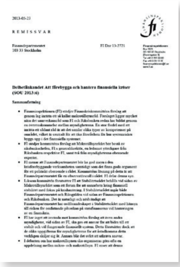
For the same reasons, the decision-making authority for the future countercyclical capital buffer should be placed with FI. A natural part of the supervisory review and evaluation process that FI conducts every year for the largest financial firms as part of Pillar 2 is to take into consideration the economic cycle and to conduct different types of stress tests. It is therefore natural to allow FI's overall assessment of each individual firm's capital need to be intertwined with the determination of the countercyclical capital buffer.

The Committee proposes that the Governor of the Riksbank be the permanent chair of the council and that the secretariat function be placed within the Riksbank. FI believes that the Riksbank's knowledge in this area will be an asset for the Macroprudential Policy Council, but that the chair should alternate between FI and the Riksbank. The secretariat function should also be split between FI and the Riksbank. In order to ensure that the secretariat and the ordering functions work efficiently, the starting point should be that the Macroprudential Policy Council - and not the participating authorities - request information from the secretariat. This will contribute to making the Macroprudential Policy Council a joint responsibility and ensuring that the requests made to the secretariat receive wider support.

The Committee does not expressly propose that an authority or a council consisting of several authorities should be able to formally give recommendations to another authority, to which this authority must then respond (a "comply or explain" model), since such a structure has not historically been present in the Swedish system. The Committee's assessment, though, is that this does not prevent an authority or a council consisting of several authorities from stating what it believes an authority should do - as long as it is not involved in decisions in individual matters or the application of the law. The Committee's assessment is that it will be difficult for the affected authority to avoid taking this statement into consideration. FI agrees with this assessment.

FI supports the Committee's proposal that the Macroprudential Policy Council's meetings should be documented by published minutes and that a press release should be issued in conjunction with the Council's meetings. It will

■ Financial Crisis Committee



In a consultation comment to the Financial Crisis Committee's report FI advocates that a Macroprudential Policy Council for the financial market be established.

http://www.fi.se/Regler/Remissvar/Svenska-forslag/Listan/FI-positiv-till-finanskrisforslag-men-vill-behalla-mer-makrotillsyn/

be an important part of the communication about assessments of systemic risks. The central role for the Council should be to discuss systemic risks and, to the greatest possible extent, strive to achieve a unified view of these risks. FI also believes that it is important for the minutes to be designed in such a manner as to clearly present if the members have made different assessments of the situation or if they have differing opinions about proposals for potential measures. Since the Council does not have a decision-making capacity – it will not make any formal decisions regarding macroprudential measures – rules of procedure, e.g. majority decision, are not required to handle differences of opinion in the Council. The central information from the Council is therefore the position reported in the minutes, whether this is with regard to a unified assessment or the differing assessments of individual members.

FI shares the Committee's assessment that FI has sufficient intervention possibilities and that the Swedish administration model allows FI to make independent decisions regarding macroprudential measures in line with the European Systemic Risk Board's (ESRB's) recommendations. FI furthermore shares the committee's assessment that an automated code of practice that forces FI to automatically intervene in the event of specific, pre-defined situations is not appropriate.

FI's consultation comments are available in their entirety at www.fi.se/

Measures from FI to contribute to financial stability

As mentioned, FI already has at its disposal a large portion of the tools that are considered necessary components of the toolkit for macroprudential supervision. The institutional framework that is in place today gives Finansinspektionen relatively broad possibilities for influencing the behaviour of financial firms, both individually and collectively. Additional possibilities will be added via the ongoing development of regulations within the EU. FI also took measures quite recently with the aim of contributing to a stable and well-functioning financial system that has both microprudential and macroprudential features.

The mortgage cap, which has been discussed earlier, is one such example. FI implemented this cap in the autumn of 2010. In addition to protecting consumers from risks that are too high, it is also important to highlight that a restriction on lending options like the type represented by the mortgage cap also is an important component of the macroprudential toolkit. The measure mitigates the risks for individual borrowers while at the same time suppressing total indebtedness and loan-to-value ratios in society as a whole. Another example is the **higher capital requirements**, where FI, in collaboration with the Ministry of Finance and the Riksbank, made the assessment that there is a need for higher capital requirements for the four major Swedish banks, Handelsbanken, Nordea, SEB and Swedbank, than what is required by Basel 3. The same applies to the higher **liquidity requirements** and the implementation of a **risk weight floor of 15 per cent** for mortgages. These issues are discussed in more detail in the next section.

NEW RULES FOR BANKS – ADAPTATIONS AND PROBLEMS

New requirements on the banks' capital adequacy and access to liquidity are about to be implemented within the EU and globally to reduce the effects of and minimise the risk for future financial crises. An important part of this work is Basel 3, the regulations that were developed by the Basel Committee on Banking Supervision. In Europe these regulations are being implemented via a new capital requirement regulation and a new directive (CRR and CRD 4, respectively). The new regulations, which after long negotiations have now been decided, are expected to be implemented in Europe at the earliest 1 January 2014. The new, higher capital requirements and quantitative liquidity rules shall be fully implemented by 2019. In Sweden, however, the size of the banking sector and its dependence on market funding have resulted in a faster implementation of the requirements than in the EU as well as higher requirements on systemically important banks.

Banks' adaptation to new capital requirements

The purpose of the banks having own funds is that these funds should be able to absorb losses, thus in part protecting the money of depositors and investors and in part decreasing the risks of defaults that would affect the system. The new EU regulations require that all banks have at least 4.5 per cent in common equity Tier 1 capital[10] as of 2019, and an additional buffer of 2.5 per cent, compared to the current regulations where the requirement is only 2 per cent.

However, there are several strong reasons for raising the requirements on the major Swedish banks. These four banks are very large compared to the Swedish economy. If one or more of the major Swedish banks must be saved, this could result in extremely large costs for society and taxpayers. Furthermore, the major Swedish banks obtain a considerable amount of their funding by borrowing on international capital markets, which makes them sensitive to disruptions on these markets.

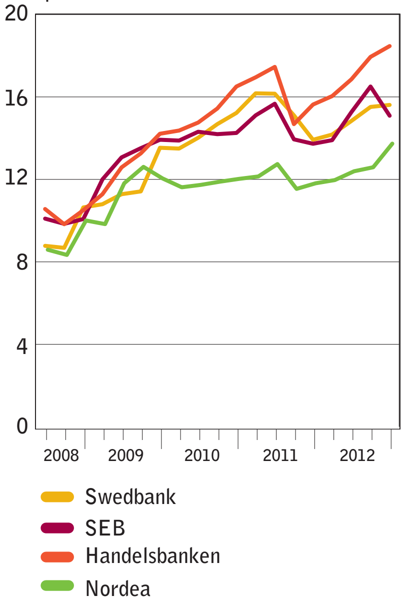
There is also a risk that the markets will assume that the government, in the event of a serious crisis, will intervene to save major or otherwise systemically important banks. This implicit guarantee from the state means that the major banks in particular can both fund themselves more cheaply than if they were not backed by this guarantee and take larger risks. Stricter requirements on the banks contribute to making future financial crises in Sweden less frequent and less harsh. FI also made the assessment together with the Ministry of Finance and the Riksbank that the gains for society clearly outweighs the costs of the higher requirements for the banks and bank customers.

The new, stricter European capital requirement rules are planned to be implemented in all Swedish banks on 1 January 2014 at the earliest. The Swedish authorities also recommend that the four major Swedish bank groups, Handelsbanken, Nordea, SEB and Swedbank, should also meet a higher level of requirements. The proposed level is that their common equity Tier 1 capital should amount to at least 10 per cent of their risk-weighted assets from 2013 and 12 per cent from 2015, including the new buffers. As a result, the requirements on the major Swedish banks will be higher than the EU's minimum requirements and they will be implemented earlier.

The exact technical details regarding how the increase will be implemented in Swedish law is currently being investigated by the capital requirement investigation. In its review and evaluation process, FI will review the banks' positions in relation to the pending regulatory framework. FI can already today make a decision about whether a specific firm should have higher own funds than the minimum level that otherwise applies if this is judged to be necessary to cover the risks to which the

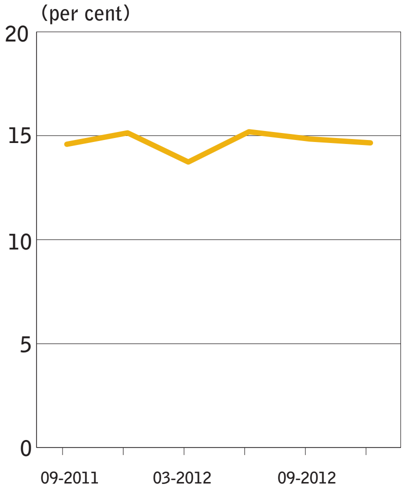
10 Common equity Tier 1 capital is the capital which initially absorbs losses.

CORE-TIER-1 EQUITY RATIO
(per cent)

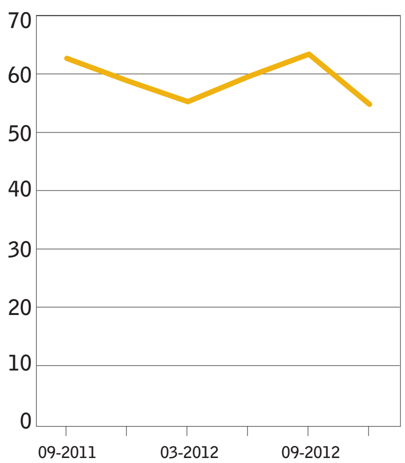


Measured in relation to risk-weighted assets, without the application of transitional rules from Basel 1.

FUNDING DUE WITHIN ONE YEAR, (per cent)



TOTAL FUNDING DUE AS SHARE OF GDP, (per cent)



firm is exposed[11]. FI reviews the firms' methods for managing and measuring risk with the aim of calculating the losses under strict financial conditions and evaluating and maintaining capital which, in its amount, type and allocation, is sufficient for covering these risks.

The major Swedish banks have gradually strengthened their capital adequacy in recent years. Three out of four major banks raised new capital through new share issues during the acute phase of the financial crisis in 2009. Capital was also strengthened thanks to the banks' continued high earning capacity. In addition, the risk-weighted assets decreased. The reason is that the banks have gradually applied more advanced credit risk measurement models, but they also shifted their activities to assets with less risk. All of the major Swedish bank groups therefore already fulfil the requirement of a common equity Tier 1 capital ratio of 10 per cent. This adaption to the forthcoming requirements on capital adequacy, in other words, has already been widely implemented. Three out of the four major banks also communicated new financial targets for their capital adequacy and these exceed the requirements that Finansinspektionen, the Riksbank and the Swedish Ministry of Finance have agreed on.

It is important to formalise these requirements to ensure that these levels are maintained even in the future. Without an express regulation, there is a risk that the banks, perhaps after several years without major problems on the market, will view the current capital levels as unnecessarily high and expensive and therefore decrease them.

Banks' adaptation to new liquidity requirements

Liquidity risks have been in focus since the start of the financial crisis and will continue to be an area to which FI will need to pay particular attention. In addition to capital adequacy regulations, the Basel Committee's Basel 3 agreement also contains quantitative requirements aimed at reducing the liquidity risks of banks. Within the EU these rules are expected to be implemented in 2015.

From a global perspective, the Swedish banks are more dependent on market funding than banks in most other countries. As presented in the diagrams, the banks must refinance approximately 20 per cent of their assets every year. This corresponds to more than 50 per cent of Sweden's GDP, or approximately SEK 2,000 billion. Given this background, Finansinspektionen introduced a requirement on the liquidity coverage ratio, which went into affect already on January 1 of this year. FI's regulations are based on guidelines from the Basel Committee concerning the calculation of the liquidity coverage ratio, which was adopted at the end of 2010.

After FI introduced its regulations, the Basel Committee updated its calculation methodology (in January 2013). Within the EU, the rules for requirements on the liquidity coverage ratio are planned to gradually go into effect starting in 2015. However, the European regulations are not yet fully defined in such a way as to enable a calculation of the liquidity coverage ratio. FI is waiting for the final version of the European regulation before adapting its rules to the pending international regulations.

There are currently eight large banks that are covered by the quantitative requirements on the liquidity coverage ratio. The requirements apply at

11 The Pillar 2 assessment within the framework of the existing capital adequacy regulations.

aggregate currency levels, but also in the individual currencies EUR and USD. This is to ensure good liquidity management even in the foreign currencies in which Swedish credit institutions chiefly obtain funding, and where possibilities for liquidity support from the Riksbank are more limited. The requirement entails that institutions need to hold more liquid assets than they did previously. The requirement stipulates that there must be a liquidity buffer than can withstand a "stressed" period of 30 days. To be included as "liquid assets", holdings must be associated with low risk, for example deposits with central banks, government bonds and covered bonds with high credit ratings. In general these holdings have a low rate of return, and therefore result in an increased cost for the institutions.

Because the Basel Committee published the foundation of the new regulations already in 2010, and the banks had already been basing their reports on this published information, the banks had already adapted to the requirements when they entered into force on 1 January of this year. On average, the liquidity coverage ratio was 1.27 for the four major banks and 1.73 for all banks reporting at the end of the fourth quarter of 2012. The minimum requirement set out by the regulation is a liquidity coverage ratio of 1.0 and in the past two years the major Swedish banks have been stable, with ratios between the interval of 1.2–2.0. Going back further in time, with the help of other data, it is possible to see a clear improvement in the years after the financial crisis, i.e. 2009, 2010 and 2011[12]. In short, liquidity as well is significantly better today than it was before the 2008 international financial crisis.

However, increased financial stability is not a free good. The requirements, as expected, resulted in increased costs for the banks, which has also had an effect on their customers. In the report about the banks' deposit and lending rates for the third quarter of 2012[13], FI made standardised calculations of how lending rates to households and non-financial firms increased as a result of the banks' adaptation to new requirements on capital and liquidity. FI's calculations indicate that the new requirements resulted in higher costs for the banks, which in turn affected the interest rate to households and non-financial firms. These costs, though, should be put in relation to the gains from better resilience to disruptions and crises that otherwise may arise, and which experience has demonstrated can be very expensive.

Weaknesses in the banks' IRB approaches and the risk weight for mortgages

Since the introduction of the Basel 2 agreement in 2007, the banks have had the possibility of applying for permission from FI to use internal models to calculate the capital requirement for credit risk. The objective of introducing internal models was partly to more fairly take into consideration the capital requirement of the bank's various operations, and partly for the bank to get better at measuring and understanding its risks. All of the major banks and several of the mid-sized firms fulfil the requirements for using internal models and received permission from FI.

The calculation of the capital requirement and the use of the internal models are governed by detailed regulations. The banks estimate themselves the unexpected loss for each credit based on historical data, and this is then translated into a capital requirements using formula set out in

12 See the Riksbank's "Financial Stability" 2011:2, p. 58ff

13 Banks' interest rates and lending, 13 March 2013

the regulations. This capital requirement should correspond to the loss arising in a situation of high financial stress.

The models, in other words, are based on historical data, e.g. by identifying explanatory links between incurred losses and various indicators. A weakness in this method is that the forecast value of the historical relationship can be overestimated, which was rather brutally illustrated in the autumn of 2008. For example, if major losses only occur with extreme infrequency, the historical data series will not be able to reflect this properly. This is an unavoidable weakness that is inherent in all models, even those that extremely well constructed, that are based on estimates of historical data. If the conditions change, the model loses relevance. This applies very clearly in extreme crisis situations, but also for structural changes in general. Model calculations must always be supplemented and modified with qualitative assessments, which can capture such aspects.

With regard to the use of IRB approaches for Swedish mortgages, it is FI's opinion that the risks associated with these types of loans are not sufficiently captured.[14] Risk weights are based on historic loan losses in the banks during a period when the total mortgage debt and average loan-to-value ratio were significantly lower and amortisation schedules were significantly shorter. Today's high indebtedness among households, the high average loan-to-value ratio and the long actual repayment period for the mortgage stock naturally increase the risks. In addition, high indebtedness coupled with a fall in housing prices could lead to a decline in private consumption and an increase in the banks' loan losses from non-financial firms. Furthermore, a larger portion of loans with variable interest rates has made households more sensitive to changes in the interest rate. The structure changes that occurred on the Swedish mortgage market in recent years, in FI's opinion, are not sufficiently reflected in the models' risk estimates.

In order to strengthen the banks' resilience to future financial crises, FI has therefore chosen to implement a risk weight floor for mortgages of 15 per cent. The risk weight floor is implemented as a part of FI's supervisory review and evaluation process at the firms. It can be said that this measure locks an additional SEK 20 billion of common equity Tier 1 capital into the banking system. FI is of the opinion that, to a great extent, the banks have already taken account of the capital levels brought about by the measure in their capital planning. A discussion can naturally be held about what the risk weight floor should be. Other countries have opted to implement a higher risk weight floor for mortgages, and Norway, for example, has announced its intention to implement a floor of 35 per cent. FI believes that a floor of 15 per cent in combination with the higher common equity Tier 1 capital requirements of 10 per cent in 2013 and 12 per cent in 2015 is a good place to start. FI will continue to analyse the effects of the implementation of advanced models on the capital to ensure that the banks have enough capital.

14 FI has already communicated its view that, in some cases, the internal models lead to capital requirements for mortgages that are far too low. See the memorandum, ”Risk weight floor for Swedish mortgages” (2012-11-26)

Many of the largest participants currently have average risk weights down at around 5 per cent for these exposures. This can be compared to risk weights of 50 per cent in the regulations applicable until 2007 (Basel 1), and 35 per cent in the current standardised approach.

New arrangement for managing financial firms undergoing crises

Banks are different than other firms in terms of conditions for managing financial problems. In addition to contagion risks for other banks and the economy as a whole, it can be said that normal insolvency procedures are too drawn-out and are not appropriate for banks. This is because, in part, they are very dependent on market confidence and are volatile in terms of liabilities, and they have functions that are critical for society and must be upheld. Furthermore, major banks often conduct cross-border business, to which the insolvency proceedings are not adapted. A clear example is the bankruptcy of Lehman Brothers in September 2008, which is considered to have triggered the acute phase of the financial crisis. Even smaller banks with financial problems are difficult to manage effectively, which was also demonstrated in Sweden.

An important task after the financial crisis, therefore, has been to develop tools that will enable the better management of acute crises and stability problems arising on the financial markets, but important parts of the future regulations are not decided yet. There is strong support both in Sweden and internationally for the initiative. The main goals have been to decrease the mutual dependence between government finances and the banking system and to make the cross-border management of a crisis more effective. In practice this means that the banks' originators to a greater extent must carry losses.

During the year FI participated in the work on these new frameworks and in the work on Nordea's recovery plan. For example, FI participated in the development of the Crisis Management Directive, the banking union, the work of the Financial Crisis Committee and the work of the EBA (see Chapter 6), and worked with the recovery plans for the other major banks. In the next year, FI and other authorities will expand their work on these issues. FI will have an active role in particular with regard to preventive efforts related to the planning of stressed scenarios and the potential winding down of institutions. FI will also contribute and take measures in the actual crisis management phase.

Crisis management 2013

During 2013 several interesting crisis management proceedings took place in Europe. One was the government take-over of SNS Reaal in Holland, and another was the handling of the faltering Cypriote banking system. In Holland, the choice was made to not let senior creditors carry the losses. Rather, the Government injected capital itself to cover this area. In Cyprus, where the Government requested an emergency loan, the Government could not take on the commitment in its entirety due to its large sovereign debt. Instead, a one-time tax on all deposits throughout the entire country was initially proposed, which garnered extensive international attention. In the end, the solution was for the crisis banks' uninsured creditors to carry the losses, and as a result the support funds for Cyprus did not go to its banking system to the same extent. The importance of good crisis management by banks became apparent in both cases, and an international framework is one step in improving this.

Within the EU a directive was proposed[15] that will harmonise crisis management. The Commission published the proposed directive in 2012, and the EU Parliament and the Council are expected to decide on the

15 The Crisis Management Directive.

matter during the year. The directive is proposed to go into force in 2015. The framework touches on both preparations during economic booms and tools and strategies during crises.

Recovery and resolution plans

According to the pending regulations, plans should prepared that in part focus on how the bank itself can manage and recover from financial problems and in part on how authorities in an effective and fast manner can wind up a faltering bank. The recovery plans are primarily the firms' responsibility while the reconstruction and resolution plans are the authorities' responsibility. The recovery plans are based on different types of stressed scenarios and describe the measures the firms have at their disposal to manage these scenarios. Resolution plans outline, for example, that authorities should write down liabilities, break up banks and sell certain operations in an institution that are defaulting. In other words, resolution plans should be applied at a stage after the institution itself has tried to recover but failed.

The preparation of a serious recovery plan means in practice reviewing and analysing the bank's or group's operational and legal structure. The plan should list the alternatives the bank has to reinstate capital and liquidity levels on its own. The guidelines for the preparation of the plans, as well as the assessment of the results and the practicality of the implementation, is the task of the supervisory authority.

The Financial Stability Board[16] was formed in 2011 with a recommendation of preparing recovery and settlement plans for the global systemically important banks, which at that point in time totalled 29. One of these was Nordea AB, which during 2012 prepared a recovery plan, while the work with the reconstruction and settlement plan will be finished this year. During the year, FI reviewed Nordea's recovery plan and judged that it fulfils the criteria. In January, EBA issued a recommendation that all systemically important banks in the European market must create a recovery plan. In addition to Nordea, this includes Handelsbanken, SEB and Swedbank, which are working on the plans in 2013.

In Sweden, the Financial Crisis Committee has been working since 2011 on how to improve the Swedish regulations for managing financial crises. The Committee presented an interim report in January that primarily discusses macroprudential supervision and the division of roles between the various authorities.[17] The Committee is expected to present during 2013 proposals on how the Swedish framework for crisis management should be organised based on the EU's crisis management directive.

INTEREST RATE FLOOR FOR INSURANCE COMPANIES

Market valuation of commitments during periods of financial uncertainty

Since 2008 Swedish insurance undertakings and occupational pension funds have been valuing their actuarial provisions for all types of commitments using market rates, which means that the present value of promised future payments to policyholders is calculated using these

16 A forum through which the G-20 countries give recommendations about the international financial system.

17 Summary of FI's comments regarding the investigation is found earlier in the chapter.

rates. If the interest rates on the market fall, the provisions rise, and vice versa.

One advantage of the market valuation is that risks on the firms' balance sheets become visible at an early stage. Market valuations of commitments thus motivate insurance undertakings to manage their interest rate risk. But market valuations also have their downsides, particularly during periods of financial uncertainty, when the market values do not always reasonably reflect the underlying values. During periods of financial uncertainty, insurance undertakings, in part as a result of the rules on solvency and liability coverage, face incentives to mitigate their risk by selling shares and buying interest-bearing assets.

Since the undertakings manage extensive assets, these types of reallocations can causes prices on the financial markets to fall even deeper. There is therefore a clear system stability dimension here. It can also weaken the undertakings' future ability to generate a return, which damages the interests of the policyholders in the long run.

Interest rate floor introduced in June 2012

The macroeconomic development in recent years had resulted in less demand for assets with high risk. Investors have moved money from, for example, corporate bonds and shares to more secure investments such as government bonds. This has been reflected by the extreme fluctuations and falling prices on the stock markets. But it also has meant falling rates on government bonds from countries that are perceived to be stable, for example Germany, USA and even Sweden. During the autumn of 2011 Swedish government bond rates fell to record lows and were pressed down even further during the spring of 2012.

FI believed that this development created a risk that the most pressured insurance undertakings would make major changes to their portfolios. On 7 June 2012 FI therefore issued a press release announcing that as of 30 June it intended to implement a temporary and time-limited floor for the market rates that should be used when calculating actuarial provisions.

The objective was to prevent the actions the undertakings take to mitigate their risk from leading to a downward spiral as described above. At the same time, FI was clear that a decrease in the pressure on the market and any improvements in profit/loss as a result of the interest rate floor were not allowed to be allocated to income in order to delay necessary structural changes or distribute profits to owners in profit-distributing firms. Undertakings experiencing problems in the current financial uncertainty would continue to work on managing their risks by acquiring more capital or reviewing their product selection, or both. The fact that the interest rate floor was a temporary and, from the start, time-limited measure strengthened this message.

Consequences from the interest rate floor are realised

After the fact, FI can state that the interest rate floor gave the intended effect and contributed to stabilising the situation for the insurance undertakings.

The market rates rose after the implementation of the interest rate floor[18]

18 On 7 June 2012, when the press release containing the proposal to implement an interest rate floor was released, market rates on 10-year Swedish government bonds rose from 1.13 to 1.47 per cent. However, it is hard to pinpoint how much of the market reaction was attributable to the proposed interest rate floor.

and have only on a few occasions in July 2012 fallen below the levels of 31 May 2012. The insurance undertakings and occupational pension funds have therefore not needed to utilise the possibility of using the temporary interest rate floor. The undertakings, on the other hand, benefitted from the market reaction. In other words, the measure may have had a similar effect as the capital injection programme that was introduced as a response to the financial crisis – the opportunity was not utilised in principle, but is still considered, via its mere existence, to have had a calming and confidence-inspiring effect on the market.

The temporary measure was intended to apply for one year, until 15 June 2013 . This was considered to be a sufficient period of time for the market to stabilise, and at the same time it was believed that a more long-term solution would not be needed since the Solvency 2 regulations were set to enter into force on 1 January 2014. During the autumn of 2012, however, it became clear that the implementation of the Solvency 2 regulation would be delayed, probably by at least two years. FI therefore felt that there was a need for a more long-term solution and on 18 February 2013 announced that a Solvency 2-adapted discount rate for insurance undertakings would be implemented as of 31 December 2013. FI thus decided to extend the interest rate floor until this date.

Another aspect that had an impact on the market that day was that the Swedish rates adapted to the market development of rising interest rates in the euro zone the day before, 6 June, during which the Swedish market was closed.

Responsibility, control and transparency

Good governance, clear division of responsibility, control of the operations and transparency are important for achieving the goals of stability and consumer protection. It is also important that small financial firms, which are not influential from a stability or consumer perspective, maintain respect for the regulatory framework and that the rules apply in the same manner for everyone. A significant portion of FI's supervisory work, and not in the least the sanctions that FI must occasionally issue, are related to these types of issues.

Compliance problems may arise in large firms which can affect both the stability of the system and a large number of consumers, but they may also be found in firms that have a very limited direct effect on stability and consumers in general. The causes may be poor control of the operations, but also deficient knowledge of the rules or, quite simply, nonchalance.

Regardless of the cause, and regardless of whether the problems are in a large or small firm, the situation requires intervention from the supervisory authority. If this does not occur, the result would be – in addition to distorted competition – a loss of respect for the rules, which in turn could lead to confidence problems and uncertainty, which gradually and on a broad front would have a negative effect on the market. There are, in other words, strong economic arguments for responding to breaches, regardless of whether it it is big and important or small and (at first glance) less important actors committing the breach. A large part of FI's sanctions are related to this type of problem.

OWNERSHIP AND MANAGEMENT ASSESSMENT

The experiences from both the financial crisis and a number of interventions have clearly demonstrated that there is a need to place strict requirements on the persons active in the financial sector. The previous assessment of the suitability of owners and management has been relatively standardised and, in order to better fulfil the objective of the regulations, FI has developed methods for an in-depth and more qualitative assessment of qualifying owners and senior management.

What ownership and management assessments entail

In order to maintain well-grounded confidence in the financial market, it is important that the owners and management of financial firms are competent and serious. The firms must have well-functioning methods for ensuring the appointment of appropriate persons to management positions. FI's ownership and management assessment supplements the firms' assessments. The assessment includes verification that certain minimum requirements are fulfilled through, for example, checks of criminal records, the business register and other public registers of Swedish authorities. In addition, FI focuses during the assessment on the person's conduct, documented competence and any conflicts of interest. The ownership assessment also considers financial strength.

In 2013 FI will develop special methods for a more in-depth financial analysis during ownership assessments by way of stress tests in specific situations and for interviews that will be a supplemental tool during FI's ownership and management assessment. An interview can in some cases be a good tool for a more in-depth ownership and management assessment. In some countries, for example Great Britain, in-depth interviews are a regular part of these types of assessments. Interviews can be appropriate in situations where it is difficult to assess the person's professional experience, knowledge, competence, etc. Other situations can include when a specific firm claims specific experiences that are difficult to interpret from a person's CV. Or when FI, based on the written documentation, finds it difficult to take a position on the person's appropriateness or when received documents need comments or explanations.

Ownership assessment in practice – Agasti Holding

FI presented a decision in which it rejected Norwegian Agasti Holding ASA's (formerly Acta Holding ASA) application to purchase the Swedish investment firm, H & P Fondförvaltning AB, since FI did not believe that Agasti Holding was an appropriate owner for a Swedish investment firm.

In its decision, FI states that Agasti Holding had major deficiencies for a long period of time in several of the company's subsidiaries that were subject to authorisation and that the company could not account for why the subsidiaries had these deficiencies. Given this background, FI made the assessment that with Agasti Holding as its owner there was a risk that H & P Fondförvaltning would be operated in a manner that is not in line with the rules that apply to the business.

Through its rejection decision, FI laid down that an owner has an obligation to stay well informed of the circumstances in subsidiaries that are subject to authorisation in order to be able to intervene as needed and steer the business in the right direction. The failure to do so, according to FI, is the same thing as the owner preventing the subsidiaries' operations from being conducted in accordance with applicable rules.

Agasti Holding has appealed the decision. The Administrative Court in Stockholm has not yet decided on the matter.

RISK MANAGEMENT, GOVERNANCE AND CONTROL

FI's experiences

FI's experiences indicate that boards of directors do not always have the necessary insight into the firms' risk exposure, risk management and internal control. One of the reasons for this is insufficient internal reporting. These deficiencies can, for example, be seen in that boards of directors receive reports with information that is too brief in nature or that it receives extensive information that lacks analysis. Reporting is therefore unclear and difficult to assimilate.

FI's experiences also show that the boards of directors do not always include risk management and internal control in the overall strategic planning. There is a risk that the firm's risk management and control are not adapted to the firm's risk exposure, and the risks also might not be handled in a sound manner.

Insufficient insight into weaknesses in risk management from the board of directors can result in the control functions being undermanned, lacking system support and lacking access to the information needed to carry out effective work. These functions may also not have the status and mandate that is needed to influence the organisation and management. This can lead to the the control functions' methods of working being underdeveloped, which in turn would result in the absence of comprehensive analyses of relationships between what causes risks, risk levels and measures that mitigate risk. Risks are not always measured or assessed in a systematic manner if the risk control function does not have appropriate and effective analysis tools and system support.

Often, the board of directors has not analysed the need for an effective and clear organisation that, for example, clarifies the division of responsibilities with regard to risk management and control. Finansinspektionen is currently preparing proposals for new regulations regarding governance, risk management and control. In these regulations, the division of responsibility with regard to risk management will be clarified and requirements will be laid down on separate and independent control functions for risk control, compliance and internal audits.

Insider and notification regulations – poor compliance

It is important that the participants on the market comply with the information requirements that apply in accordance with the notification and insider regulations. Since persons holding insider positions often have good insight into the company's operations, their trade in financial instruments in the company can send signals to the market. The notification rules aim to show major changes in ownership and give the general public insight into the ownership structure of listed companies. If there are deficiencies in the information given to the market, there could be a lower degree of transparency, which in the long run risks damaging confidence in the stock market.

FI issues on an annual basis a large number of sanction decisions against private individuals and firms for violations to the insider and notification regulations. Work with insider and notification reporting requires a considerable amount of resources. With the aim of decreasing the number of violations, FI has implemented ongoing informational efforts targeted at the senior management of listed companies. Guidelines have also been available for listed companies since 2011. However, the number of violations is still high. The most common violation is late notification of new members appointed to senior management in the company, late notification of a change in holdings and late major shareholding notifications.

The sanction fine for violations to the insider and notification rules can be as high as SEK 10 million. However, the majority of the announced sanctions are at a significantly lower level, between SEK 15,000 and SEK 100,000.

FI is concerned that the educational efforts taken with the aim of decreasing the number of violations has not had the intended effect. The number of issued sanctions in the area also does not appear to be a deterrent since the number of violations is relatively constant over the years. The tendency toward not treating the information rules with sufficient seriousness is negative for confidence in both the market as a whole and individual firms.

Several sanctions

In terms of internal governance and control, FI has observed situations as part of its supervision in which management has been deficient in governing and organising the operations. In several cases there have been no guidelines for, for example, conflicts of interest, compliance and independent audits. In earlier supervision reports, this problem has been raised when several different firms in a group conducting different types of businesses are operated as if they were a single firm. In these situations, conflicts of interest, for example, often arise between the different functions and the legal units.

Example: Forex and Panaxia

In May 2013 FI made the decision to issue a warning to Forex Bank. The decision was accompanied by an administrative fine of SEK 50 million.

During the autumn of 2012, as a result of the bankruptcies of the companies in the Panaxia Group, Finansinspektionen initiated a review that specifically focused on Forex's risk exposure to the Panaxia Group. The aim of the investigation was primarily to review Forex's risk management and internal control with regard to this risk exposure. The companies in the Panaxia Group provided cash management services to Forex. At the time of the bankruptcies, funds totalling approximately SEK 180 million that belonged to Forex were in the possession of companies in the Panaxia Group. Forex was also the majority shareholder in the parent company, Panaxia AB (publ).

Finansinspektionen investigated how the bank fulfilled its obligation to manage the risks in its operations. The results show that Forex did not meet the requirements placed on the bank to identify, measure, steer, report internally and maintain control over the risks associated with its business. Forex was also deficient in its obligation to maintain satisfactory internal control. Furthermore, Finansinspektionen has been able to determine that one of the members of the Bank's Board of Directors had a conflict of interest when the Bank's Board decided on 31 July 2012 to guarantee a planned new share issue in Panaxia AB. Company management, i.e. Forex's Board of Directors and CEO, are responsible for any operational deficiencies.

The deficiencies identified by Finansinspektionen are serious and apply to rules that are central to a bank's ability to fulfil its obligations. For this reason, a strong reaction is necessary. When determining the type of intervention, Finansinspektionen took into consideration, among other things, that Forex was issued warning and an administrative fine of SEK 50 million on 1 October 2008. Forex has now implemented a number of measures to resolve the identified deficiencies. For example, the Bank's Annual General Meeting replaced a large number of the Bank's earlier Board members. The Bank also implemented measures to improve the follow up of its cash management. Even though the Bank had previously received a warning, Finansinspektionen chose to intervene with a warning instead of withdrawing the Bank's authorisation. The warning is accompanied by an administrative fine of SEK 50 million.

New EU guidelines

The most recent financial crisis has shed light on issues related to internal governance and control in both USA and Europe. The European Banking Authority (EBA) has prepared a number of recommendations in this area.

Large parts of EBA's recommendations are implemented in Sweden as binding regulations. Since February 2013, the recommendations also apply in their entirety as general guidelines in Sweden. [19]

In its work reviewing the general guidelines (FFFS 2005:1) regarding governance and control of financial undertakings and implementing EBA's recommendations in binding regulations, FI has analysed the recommendations on an ongoing basis. FI's intention is to implement in the national regulatory framework the parts that present clear rules that FI can apply in its supervision activities. At the same time, FI's ambition for the regulations is to give clear guidance for firms on how they should be organised to fulfil the requirements of the regulations on internal governance and control.

The objective of the regulation is also to increase the awareness of the members of the boards of directors about the firms' risks and its involvement in the governance and control of the firms, thereby ensuring that the firms establish necessary risk management systems and control systems. The regulations also aim to clarify the internal reporting to the board of directors and management with regard to risk and compliance in order to increase the board's insight into, understanding of and control over the firm's risks.

New regulations related to the parts of EBA's recommendations concerning the management of operational risk, primarily with regard to new products and continuity management, are also being developed. In addition to that set out in EBA's recommendations, regulations are planned for the management of IT systems, information security and deposit systems. Deposit systems mean that the bank, in cases where the deposit guarantee is activated, should be able to quickly produce correct lists containing depositors' names and their deposited amounts.

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European regulations

In the wake of the financial crisis, financial regulations and supervision have undergone several changes. One of the changes was the introduction of new organisational structures and another was the harmonisation of regulations on a pan-European level. This places new demands on not only FI, but the firms as well. In order to be able to make a difference in the international work, both strong arguments and action are required at an early stage.

EU'S SUPERVISION STRUCTURE

The regulations being developed in the financial sector today are to a great extent influenced by the international work. Within the EU the goal is to achieve a fully harmonised regulatory framework in the financial sector, which is called the "Single Rulebook". EU's financial supervision structure introduces greater cooperation at the EU level within the framework for the European System for Financial Supervision (ESFS), which consists of the three supervisory authorities[20] (ESA) and the European Systemic Risk Board (ESRB). Cooperation and exchange of information are the pillars of this network, which extends FI's obligations.

One important assignment for the three European authorities is to contribute to joint standards and methodology development to promote a high, even level of quality in the supervision and the consistent application of regulations. This is one reason why the authorities were given the authority to prepare technical standards for supervision and implementation[21], and to issue guidelines and recommendations. The issuance of regulations represents a significant part of the work of the European Authorities.

In cases where the legislator (the European Parliament and Council) delegate the authority to the Commission to adopt technical standards for supervision through delegated acts and implementation acts, the European authorities may prepare these standards if stated by the directive or regulation[22]. The European authorities prepare proposals that are decided by each supervision board of directors and are then submitted to the Commission for adoption in the form of regulations that apply directly in all Member States. The process for the preparation of the standards requires that the authorities have conducted an open, public consultation with analysis of the proposal and that they request comments from interest groups in the area in question.

Guidelines and recommendation represent part of the European authorities' regulations. Even if these are not formally binding, FI and the supervisory authorities in all of the other Member States are obligated to comply with them. Subsequently, guidelines and recommendations are very

20 European Banking Authority (EBA), European Securities and Markets Authority (ESMA), European Securities and Markets Authority (EIOPA).

21 Technical standards should be just that - technical - and not include policy choices. However, this does not exclude the fact that, in reality, there are technical standards, that contain policy-oriented provisions.

22 The delegation to the Commission occurs within the framework for Article 290 in the EUF treaty (delegated acts). A similar procedure applies for technical standards for implementation that are based on Article 291 of the Lissabon Treaty.

relevant for FI's regulations and supervision practices. In Sweden, these guidelines are at the same level as general guidelines. This means that they have a broad and direct impact on the firms as well.[23]

FI, through its representation in the authorities' boards of directors, is the Swedish body that affects the formulation of these technical standards, guidelines and recommendations. The formulation of this part of the EU regulation is reached via negotiation between the national supervisory authorities, not the governments, which represents a new and more important role in the design of regulations for the national supervisory authorities.

IMPORTANCE OF TAKING ACTION IN TIME

FI, like the other national supervisory authorities, has now worked within the framework of ESA for more than two years, and the operations have been very resource-intensive for FI. FI has worked from the basis that, for Sweden, which is a relatively small country, it is important to be able to take action effectively and from a well-supported base in these forums. This requires carefully considered prioritisations of the resources at FI's disposal – even with more resources FI will never realistically be able to be be influential in all issues.

Regulation at the international level consists of complex processes. The Council and Parliament control the speed of the regulation by laying down rules in regulations that are directly applicable or by deciding in directives which rules the European supervisory authorities should develop and when these rules should be finished. The timeframes are often tight, which also affects the process within the European authorities and thereby also for FI and other national supervisory authorities participating in the work. The fast tempo of the regulation process makes it even more important to present well-supported proposals and good arguments at an early stage. In general, opportunities to affect the outcomes – in particular for a smaller country like Sweden – to a large extent are dependent on assessing the consequences of different alternatives and developing and making clear arguments for the Swedish viewpoint at an *early* stage. When negotiations for a directive, guideline or technical standard reach the final stages or when they will be implemented into Swedish regulations, there are generally limited opportunities for being able to influence the outcome.

It is important that Swedish stakeholders, such a financial firms, industry organisations and other bodies, utilise the opportunities that are available for participating in the process. Sweden is currently represented in all interest groups. In addition, all technical standards and guidelines are issued for consultation before they are finalised, which means there are opportunities to submit both verbal and written comments.

However, in FI's experience, the opportunities to have an influence are not always sufficiently utilised. For example, it is not unusual for the industry's consultation comments to FI's regulations to present arguments that are in direct contradiction to the text of the directive. At that stage, it is too late to affect the text. Just as it is important for FI to have a close dialogue with the firms, it is also important that this occurs in forms that give all affected firms equal opportunities, for example that the same information be given to all parties at the same time. FI arranges

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to some extent its own reference groups in conjunction with international regulation projects. This is not possible in practice for all of the regulation projects that are, or will be, relevant in the next few years. The firms and industry organisations must therefore actively follow and influence the European regulation work themselves. The European authorities have published detailed work programs on their websites that make it possible to have an overview of the ongoing projects and the timeframes in question.

A LOT OF WORK IS ON THE HORIZON

Intensive preparatory work is currently underway at both EBA and EIOPA leading up to the implementation of CRD/CRR 4 and Solvency 2, two regulations that give the authorities extensive regulatory assignments. CRD/CRR 4 was adopted in April 2013. According to CRD/CRR, EBA will be responsible for producing more than 60 technical standards and around 20 guidelines during a concentrated period; most of these products are expected during 2013–2014. Negotiations are underway to finalise the changes in the Solvency 2 directive (the Omnibus 2 directive). EIOPA's assignment is to produce more than 50 technical standards to implement Solvency 2.

FI is already participating in EBA's and EIOPA's preparatory work and intends to earmark resources for continued regulation work. For example, FI worked intensively with the preparatory guidelines targeted at national supervisory authorities about how they should prepare for the implementation of Solvency 2. FI also participated in the development of a number of proposals for the future EBA technical standards that it is now possible to comment on.

Comprehensive changes are also currently taking place in the regulations in the securities area. Completely new regulations have been introduced, such as the short selling regulation (SSR), the Alternative Investment Fund Managers Directive (AIFMD) and the European Market Infrastructure Regulation (EMIR). A new regulation for Central Securities Depositories (CSD) is being deliberated in the Council. Existing major regulations (MIFID 2/MIFIR and MAR) are also being expanded and revised. The regulations have or will have a large impact on the Swedish securities market. For example, the new transparency rules for bonds in MIFIR will affect the way the Swedish government debt market functions. The regulation requires extensive work by ESMA, such as a large number of application standards, guidelines, new reporting procedures, etc. In total, ESMA intends to produce around 200 standards, guidelines and recommendations/// in 2013.

In addition, there will be other large regulation projects in the wake of directives that will be adopted in the near future, not in the least the Crisis Management Directive. In other words, there are a lot of large and very important projects on the horizon. This will be a significant challenge for both the government and the firms, and both will need to dedicate sufficient resources to ensure that the result for Sweden is as good as possible.

Glossary

Basel 3 A new global framework established by the Basel Committee. The Basel 3 accord for the banking sector contains regulations regarding capital adequacy, leverage ratio and liquidity regulation. Basel 3 is to replace the regulations (Basel 2) which are the currently applicable regulations in Europe and elsewhere. In Europe these regulations are being implemented via a new capital requirement regulation and a new directive (CRR and CRD 4, respectively).

Mortgage cap The mortgage cap came into effect on 1 October 2010 through FI's general guidelines FFFS 2010:2. These guidelines state that a loan collateralised by a home may not exceed 85 per cent of the market value of the home.

IRB approaches (internal credit risk models) Calculation models banks develop and, after receiving permission from FI, use to calculate how much capital is needed to cover various credit risks.

Capital requirements Regulations about the minimum amount of capital a financial firm must maintain to conduct operations. The requirement is linked to the extent of the firm's risk-taking and should function as a buffer if losses arise.

Common equity Tier 1 capital Denotes in principle equity, i.e. share capital and accumulated non-distributed profits, i.e the capital that absorbs losses first. The new CRD 4 regulations raises the requirement on common equity Tier 1 capital from 2 per cent to 4.5 per cent.

Liquidity risk The risk of not being able to meet payment obligations on the due date without the cost increasing considerably. Liquidity risk in financial instruments is defined as the risk that a financial instrument cannot immediately be liquidated without falling in value. This risk is often called market liquidity risk.

Liquidity Coverage Ratio (LCR) A requirement expressed within the framework of the new Capital Requirement Directive (CRD 4) requiring a bank to have sufficient liquid assets to fulfil its short-term obligations during a "stressed" 30-day period.

Pillar 2 The capital adequacy regulations are divided into three pillars. Pillar 1 is the minimum capital requirements for credit risks, market risks and operational risks that are calculated using explicit calculation rules. Pillar 2 entails the supervisory authority identifying risks and assessing the risk management from a broader perspective. This can result in an additional increase to the capital requirements calculated under Pillar 1. Pillar 3 defines various transparency requirements.

Risk weight When the capital need of a bank is calculated, the value of each asset, for example a mortgage or corporate loan, is multiplied by a risk weight. The risk weights vary between the various assets based on how large the credit risk for each asset is judged to be. By combining the value of all of a bank's assets, weighted at the different risk weights, it is possible to produce a single value for the risk-weighted assets in the bank.

Assets covering technical provisions An insurance company should have assets that cover obligations to policyholders. The company should invest and value the assets in such a way as to fulfil the provisions set out in the Insurance Business Act and the assets should be registered in a register of assets covering technical provisions.

Solvency 2 An umbrella term for the new regulations for the financial position and strength (solvency) of insurance companies being drawn up in the

EU. There is considerable uncertainty about when it will enter into force, but EIOPA's assessment is that Solvency 2 will enter into force in 2016.

Solvency ratio The ratio between the available and required solvency margin. For life insurance companies, the solvency requirement is calculated by taking 4 per cent of technical provisions (the companies' debt to policyholders) and 3 per thousand on positive sums at risk (the amounts a company risks paying out at death).

Stress test Analysis of various scenarios to test resilience to unforeseen and negative events.

Structured products Financial instruments whose return is completely or partly dependent on the development of several other financial instruments or assets. Often consists of a bond combined with a derivative, for example an option. Examples of structured products include equity-linked bonds or commodity bonds.

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