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The Stability of the Swedish Financial Sector – a summary

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Stability analysis and the supervisory task

An environment marked by rapid structural change sharpens the demands on the ability of the supervisory authority to closely monitor macroeconomic development and trends in the financial sector and its sub-sectors. In particular, it is necessary to be able to analyse and assess the nature of the links between macroeconomics and structural trends in industry on the one hand, and corporate exposure and risk management on the other.

This report should be viewed from this perspective. Firstly, this is a central document for the direction and planning of Finansinpektionen's supervisory work, and is aimed at gaining an aggregate and forward-looking analysis in an effort to provide a decision-making base for operations over the next twelve months. Secondly, the fact that the report is released publicly means that Finansinpektionen's public and private stakeholders gain the opportunity to study significant development trends and monitor the appraisals made in supervisory operations. Thirdly, the report represents an information base for interested sections of the public.

The supervisory mission involves identifying, measuring and analysing risks and risk structures that may lead to disruptions in the financial system. This means that Finansinpektionen should not only analyse the most likely sequence of events but should also be able to assess the implications of low-probability events, the effects of which – if they were to arise – could lead to wide-ranging disruptions and financial instability. Thus, the fact that Finansinpektionen underscores the importance of this type of more or less improbable threats is not an expression of a "professionally pessimistic" bias in attitude. Instead it is aimed at gaining an appraisal of the risk management and risk absorption capacity offered by the financial system – where are the strong points, where are the Achilles heels and how can the system be made more robust?

Finansinpektionen's supervisory operations proceed on the basis of four main risk areas, as follows:

- Credit and counterparty risks
- Market risks and liquidity risks
- Insurance risks
- Operational risks

In a forward-looking analysis of these risks, Finansinpektionen must appraise the projected trend against the background of current business circumstances and general economic conditions, and assess whether there is a significant build-up of risk in companies under Finansinpektionen's supervision that may threathen financial stability.

The external conditions: a favourable trend – but not one without risks

From the perspective of the general macroeconomic trends and, also, from a more structural viewpoint, external conditions are undoubtedly very favourable – economic growth is good, inflation remains flat, and interest rates continue to be low. Also, restructuring in the financial sector continues at a brisk pace, driven by globalisation and technical development, leading to productivity gains and thus long-term earnings potential.

Overall, corporate credit losses are low and profitability and capital adequacy are favourable. Moreover, in general terms there are no signs of risks building up that give rise to concerns. Accordingly, the main scenario is continuing healthy development and sustained financial stability.

However, as regards developments on a more general front, there are at least two reservations – apart from the obvious, though occasionally suppressed, fact that booms don't last forever.

- First, too good a boom may lead to overheating, notably in the real estate and stock markets, which raises the height of fall and rapidity in the subsequent downturn and can badly bruise the financial sector.

- Second, the international financial imbalances built up in recent years, combined with the natural uncertainty prevailing in many financial submarkets in the wake of major and rapid structural changes, entail stability risks that must not be neglected. These are risks of a macroeconomic nature, as well as risks associated with the liquidity status and functional capacity of certain financial sub-markets.

Compared with the situation a year ago, the likelihood of certain disruptions has declined, while others have increased; the general decline in share prices over the last months has probably reduced the risk of major international market plunges, whereas widening disequilibrium in terms of current account imbalances and exchange rates has certainly increased. One aspect of falling stock values is that they may entail a latent stability problem insofar as – according to certain observers – there is a good deal of unrealised losses among various financial intermediaries worldwide, which, if this is so, reduces the margins in the event of various disruptions.

However, developments are unlikely to have seriously strained the major, international banks. The triggering of a serious sequence normally requires market trends to take an abrupt and unanticipated turn, such as last occurred in 1998. No signs of this type of widespread instability have appeared during the current year, although there have been signs of genuine uncertainty and shortcomings in market liquidity.

Last year's report observed that the appetite for risk among the major financial players had generally declined since autumn 1998 as a result of the disturbances that occurred at that time, notably in the form of the LTCM crises, when players cut their exposures and their commitments. Thus counterparty risks were reduced – but in return, market liquidity dried up. Viewed from a stability perspective, this was a development that included both positive and negative factors. The trend during the past year points largely at an unchanged situation in these respects.

The rise in risk aversion has resulted in price pressure, particularly in the market segments involving securities with an inferior rating and credit risk. In the major international markets, sharp price corrections took place in 2000, not least in the case of companies in the new economy.

Of course, weighing up these risks and probabilities for the various conceivable sequences is a very arduous task. However, it may be reasonable to draw the conclusion that the likelihood of external shocks, viewed from the perspective of the financial sector, remain pretty much unchanged from last autumn.

Assessing the probability of the occurrence of a certain shock – such as a crash in the stock or real estate markets – over a certain period and appraising its consequences is an almost impossible task. Moreover, it frequently emerges that the crises and disruptions that have actually occurred have seldom been even identified beforehand, much less being the object of any probability assessment or analysis. But nonetheless they have happened and will certainly do so again in the future. The important lesson from all this – for companies and governments alike – is that it is essential to identify and evaluate the relevant risks as far as possible, as well as building up mental, financial and practical preparedness to handle the risks and problems that are viewed as *not* lending themselves to prior identification and assessment.

The presentation below provides a more detailed review of some more specific risk areas associated with the structure of risk types that Finansinspektionen has monitored and analysed over a number of years. These involve four main categories: Credit risks, market risks, insurance risks and operational risks.

The purpose of the review is to make some attempt to penetrate and look behind the general picture outlined above. It should be noted, of course, that this cannot represent a comprehensive study of all the relevant risk aspects in each area, but is instead a selection of factors and issues that Finansinpektionen regards as interesting in the current circumstances.

Build-up of risk is various areas

A summary of the situation as regards the risk areas mentioned in the introduction leads to the following conclusions.

Credit risks

The overall build-up of risk is moderate. However, in certain areas there are tendencies which could prove problematic if they persist. There are also areas in which more detailed survey and analysis are required in order to appraise the risks. Both cases require continuing analysis, monitoring and follow-up by Finansinpektionen. One such area is the *household borrowing*, where certain groups of households – due to a higher debt resulting from such factors as higher housing costs – may find themselves in a very vulnerable position in the face of interest rate hikes or loss of income. This may lead to credit losses for banks and mortgage institutions. In the main, however, this does not really represent a problem for financial stability, but is nevertheless important to from a supervisory point of view. Another tendency to be observed is the growing importance of uncollaterilised lending.

Although it has become more widespread, the question of using *stock as collateral* for borrowing is of marginal significance for total credit granting. Nonetheless, it does point at an essentially important question of risk management, namely, how collateral values should be estimated for this type of security. From Finansinpektionen's viewpoint, the methods used for this purpose are far too general and do not pay sufficient attention to the price volatility that characterises of this type of asset. Neither, in Finansinpektionen's view, do the new recommendations drawn up by the Swedish Bankers' Association devote sufficient consideration to this aspect.

What is commonly referred to as the *new economy* has so far been of marginal importance in view of this sector's share of aggregate bank lending – a share that is rather difficult to define in the first place. However, this sector is expanding and, according to certain indications, appears to be moving towards a more "normal" financial profile in the sense that bank loan capital is gradually assuming greater significance compared with venture capital. The relatively different character of these companies may impose other and somewhat new demands on credit ratings, monitoring and collateral, for example. Hence, it is important to track development in this area. Initially, it will be necessary to develop statistical and other tools in an effort to delineate and capture the relevant aspects and characteristics of this new economy.

The *real estate market* – notably the commercial sector – is one part of the real economy that can be expected to have the most immediate significance for financial sector stability, as clearly proved in connection with the financial crisis in the early 1990s. This special significance derives from its size in terms of credit volumes and collateral and because of the boom-and-bust character, which - due to production economics – characterises development in this industry. This area is displaying a very sharp price trend – notably in the major metropolitan areas – along with an incipient expansion in building. As regards the latter, this involves a sharp upturn from a very low initial level and, in terms of credit granting, the increase has been very limited to date. So far there aren't any firm indications of a growing share of "speculative" construction either. But the situation can change rapidly and the fact that the building and real estate sectors are obviously moving off the starting blocks makes it necessary for Finansinpektionen to carefully monitor future developments.

Market risks

As regards the major Swedish banking groups and independent securities companies, Finansinpektionen estimates that exposure to market risks via their trading operations is minor. The combination of limited risk-taking, plus a favourable trend in earnings and capital adequacy, provides a favourable point of departure.

This does not prevent the overall liquidity management of the major groups from being shaken by external events. Refinancing risks can rise. There is substantial dependence on trends in international capital markets and be contingency programmes must be available to meet situations in which rather extensive tightening impacts on liquidity risks. Against this background, in its new general recommendations concerning the management of market and liquidity risks, Finansinpektionen has detailed certain standard requirements that institutions are expected to fulfil. These include contingency plan requirements and stress tests for extreme developments and outcomes.

As regards the stock market, the question of the risk of hefty and rapid market downturns and their impact on financial stability has been discussed frequently in recent years, in line with the climb of market indexes toward ever-higher altitudes. As least as far as the Swedish stock market is concerned, one can conclude that the market trend entails only limited systemic risk potential, and that the height of fall for stock prices has also trended downward over the past six months, a tendency that was further strengthened during September and early October. Any continuing sharp declines in market capitalisation may have macroeconomic effects by, for example, impacting on household expectations, consumption and savings. Naturally, such changes in turn affect the operating base for financial companies. However, systemic threats are unlikely.

Insurance risks

The risks assumed by insurance companies in their operations are usually of very limited significance in the financial system as a whole. The primary social and supervisory interest in the insurance area involves consumer protection rather than stability. Also in this area, there is no sign of a build-up of risk than could threaten either the consumer protection objective or the stability target. One interesting change in business conditions for non-life insurance companies – and one that may eventually gain major importance for their operations – is what appears to be a trend towards greater frequency and scope of various value-related claims due to the effects of huge storms, floods etc. Global climatic changes represent the main factor in this development. In the future, this may impose totally different and more stringent demands on the non-life insurance industry in respect of this type of risk management

Operational risks

The development of IT has highlighted the importance of operational risks, even though such risks pertain to a wider spectrum than IT-related risks. Understandably, it is difficult to measure and assess these risks, or whether they are to be regarded as “high” or “low” and to what extent they change from one year to the next. A general assessment is that, on the whole, Swedish financial companies have relatively good risk management in this area, at least as far as “internal” risks are involved. However, the state of preparedness appears to be less impressive in terms of managing the risk of disruptions in the surrounding infrastructure. It may be mentioned that Finansinspektionen is dealing with these issues within the framework of the activities of the Basle Committee on new capital adequacy requirements. Accordingly, amendments to financial legislation will be called for in due course.

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