



FINANSINSPEKTIONEN

Risks in the financial system 2011

15 NOVEMBER 2011





TABLE OF CONTENTS

FOREWORD	3
SUMMARY	4
Risks to financial stability	4
Risks to consumers	5
Risks to the function of the markets	6
THE ECONOMIC SITUATION	7
Intensified sovereign debt crisis	7
BANKS AND INVESTMENT FIRMS	11
Development during the year	11
Stress test of the major banks	18
INSURANCE AND FUNDS	21
Development during the year	21
Risks to insurance and funds	23
SECURITIES MARKETS	26
Risks to the securities markets	26
RISKS TO SWEDISH CONSUMERS	31
Risks to Swedish consumers	31
Consumer risks on the lending market	34
FINANSINSPEKTIONEN'S EXPERT PANEL	37
Significant economic developments and risks	37
Risks for specific sectors and institutions (banks, insurance companies, management companies, households)	38
Desired and expected regulatory changes and actions by authorities	39
GLOSSARY	40

Foreword

The ‘Risks in the Financial System’ report highlights the risks that Finansinspektionen considers to be the most serious in the financial sector during the coming year. This includes risks affecting financial stability and consumer protection as well as risks that in the long run could affect confidence in the financial market.

Since last year’s report, the European debt crisis has intensified. Swedish growth is still strong, however, despite the negative effects from international developments. The financial markets, primarily in Europe, have been characterised by extreme uncertainty throughout the year.

At Finansinspektionen we carry out a risk analysis to prioritise our supervisory work. By sharing this analysis, we expect firms and their management teams to also take action against these risks.

Stockholm 15 November 2011



Martin Andersson
Director General

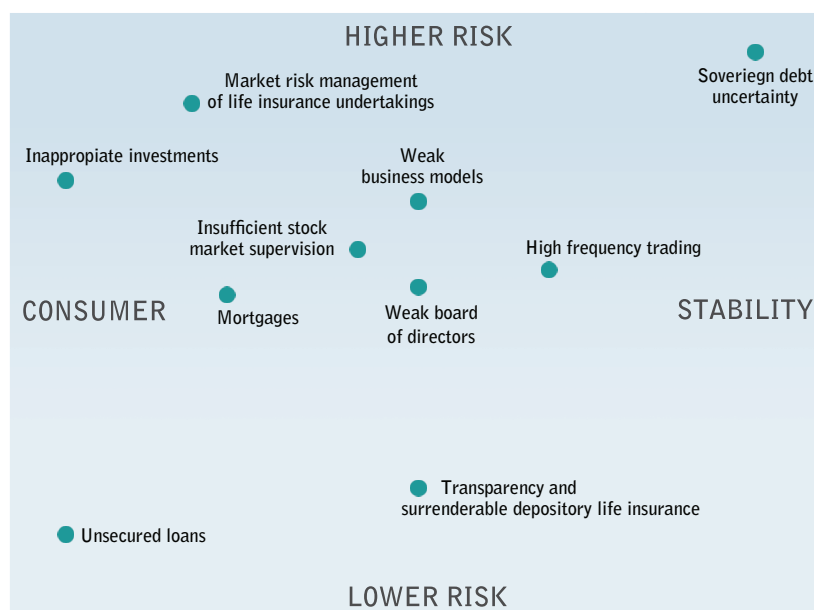
Summary

In the report, "Risks in the financial system", Finansinspektionen (FI) highlights the most prominent risks to financial stability, consumer protection and confidence in the financial markets. Since last year's report, the uncertainty surrounding the world economy and the economic situation of several countries in Europe has increased. There is a risk that this will have an impact on the Swedish financial market, primarily with respect to the possibilities of financial institutions to secure market funding. Historically low interest rates for government bonds in Sweden and falling stock markets are also placing an inordinate amount of pressure on life insurance undertakings.

As part of its work analysing the risks on the financial market to prioritise the focus of its supervisory activities, FI compiles a comprehensive overview of current risks. This overview contains the most prominent risks facing financial stability and consumers as well as risks that from a longer perspective may affect the way financial markets function. This year's report highlights the risks associated with the financial institutions' possibilities for securing market funding, deficiencies in how life insurance undertakings' have managed risk and the risk that consumers will make inappropriate investments.

If the current sovereign debt crisis in Europe takes a turn for the worse, the consequences may be quite serious, primarily with regard to the major banks' financing options, but also in terms of life insurance companies' ability to fulfil their commitments.

Finansinspektionen's Comprehensive Overview



RISKS TO FINANCIAL STABILITY

When last year's report was published (October 2010), the financial markets were demonstrating improved stability and risk premiums had returned to more normalised levels. Since then, uncertainty on the finan-

cial markets has risen due to the sovereign debt crisis and, as a result, global growth forecasts have fallen. The sovereign debt crisis has intensified and spread to more countries. This had had a major effect on the European banking system, which in turn has meant that many European banks are finding it difficult to secure financing from the markets. The Swedish financial system, which has well capitalised banks, has to date demonstrated that it has the resources to withstand this uncertainty and should be able to handle a moderate escalation in the turbulence on foreign markets.

Over the past year, the Swedish banking sector has benefitted from the strong growth in the Swedish economy. Combined with a quick stabilisation in the Baltics, this upturn has strengthened the profits of the major banks after credit losses despite the uncertainty stemming from the deteriorating sovereign debt situation in Europe and significantly subdued growth forecasts. Lower global growth also means that the recovery in the Baltics may take place at a slower rate than expected. This increases the risk of contagion effects.

RISKS TO CONSUMERS

FI shall strive to ensure that the consumer protection within the financial system is satisfactory. An important part of strengthening the position of consumers on the financial market and counteracting abuse is FI's supervision of financial institutions and financial regulation. This arrangement closely connects consumer protection to the supervision of the financial system's stability.

Financial institutions should not only be stable, they should also provide consumers with relevant information, reliable advice and comprehensible terms and conditions. FI sees a prominent risk that consumers will be offered unsuitable products. This may occur due to deficiencies in the information and advice that are given, but products are also often so complex that it can be difficult for consumers to compare different types of savings or insurances. Some institutions also attempt to circumvent the statutory requirement governing financial advising. FI has in previous years reported that there is a risk that the commissions paid to insurance intermediaries may lead to intermediaries prioritising their own earning potential over their customers' need for good advice.

The risk that some life insurance undertakings might find it difficult to generate the return they guaranteed to their policyholders was mentioned in last year's report. Since then, the stock exchange and market interest rates have continued to spiral downward and, as a result, Swedish life insurance undertakings are under considerable pressure. The greatest threat is to policyholders' protection and one consequence may be that pensions will be lower in the future. If the sector were to experience comprehensive solvency problems, this could lead to a vicious circle where lower interest rates and stock prices force a continued flight from equity to interest-bearing assets under very unfavourable market conditions.

On 1 October 2010, FI introduced a general guideline that limited the size of loans collateralised by homes, i.e. a mortgage cap, to stop the trend toward higher loan-to-value ratios. Several years of historically low interest rates on the Swedish mortgage market have had a significantly positive effect on consumers in their role as borrowers, but this has also contributed to a rapid growth in indebtedness. If indebtedness is high at

the same time as the loan-to-value ratios of homes are high, consumers will be exposed to major risks if housing prices were to contract. During the winter of 2011, FI will carefully monitor the development on the mortgage market and the institutions' application of the mortgage cap. This will enable FI to not only follow up on the effects of the implementation of the mortgage cap, but also gain an overview of the mortgage market's trends, risks and the weaknesses in households' indebtedness.

Last year's report called attention to the risks associated with unsecured loans. A new Consumer Credit Act entered into force on 1 January 2011 which in part stipulates that all prospective lenders must undergo a credit assessment. The changes during the year have been positive and the number of cases related to unpaid unsecured loans being pursued by the Swedish Enforcement Agency has decreased.

RISKS TO THE FUNCTIONS OF THE MARKETS

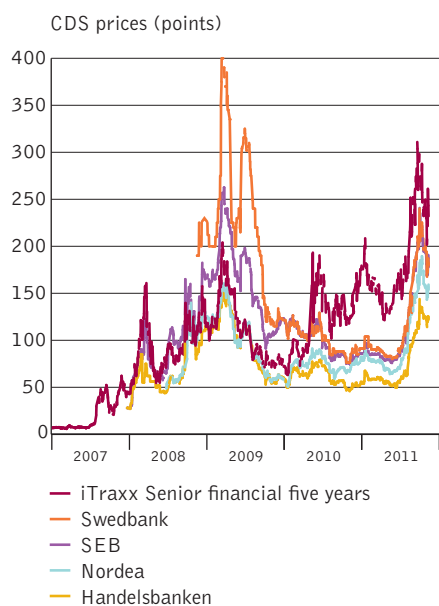
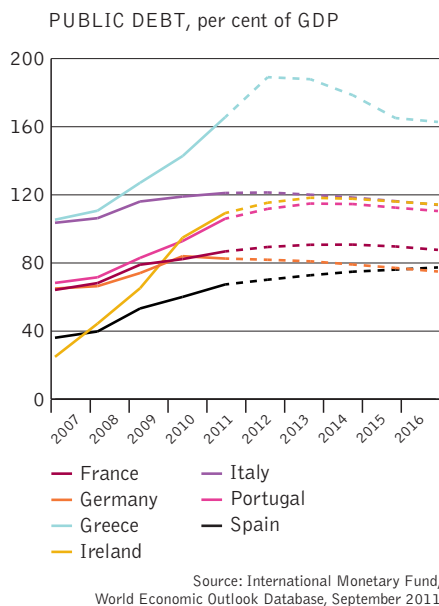
Some risks are primarily a threat to confidence in the financial markets and, as an extension of this, to the ability of the markets to work efficiently. In last year's report, FI raised the issue that the credit market companies' rapid growth represented a risk. Even though this growth has slowed the situation on the market has deteriorated, which indicates a need to highlight risks related to the companies' business models. Depositors to these companies are in general covered by the deposit guarantee, which means that the effects of potential defaults should be small for consumers, even if the inconvenience for the customer should never be underestimated. Most of the credit market companies are not large enough to have an impact on financial stability on their own, although if several of these firms were to start experiencing problems at the same, this could influence the efficiency of the market.

On the stock market, greater competition among trading venues and rapid technical advancements have both created new challenges for FI's supervision. Trading is now taking place in various locations around the world, which places considerable demands on international coordination with regard to monitoring and supervision. These changes have also resulted in more favourable conditions for high frequency trading. During the autumn, FI has started an investigation into high frequency trading and any potential associated risks.

Another general risk is that financial institutions have weak boards of directors. A well functioning and responsible board of directors is a prerequisite for conducting satisfactory internal governance and control. Insufficient governance lies behind several of FI's interventions in recent months, such as the interventions related to HQ Bank AB and Marginalen Bank.

The economic situation

Problems stemming from public finances have increased the uncertainty on the financial markets in the past year and, as a result, forecasts for global growth have been adjusted downward. During the end of the summer and the autumn, the debt crisis intensified and spread to more countries. The European banking system has also been affected due to holdings of large amounts of government bonds issued by the debt-burdened countries. Potential losses could strangle the supply of credit in the long run, thereby threatening the economic recovery. Swedish growth was strong during this period, but it is now slowing, in part as a result of the uncertain financial situation.



INTENSIFIED SOVEREIGN DEBT CRISIS

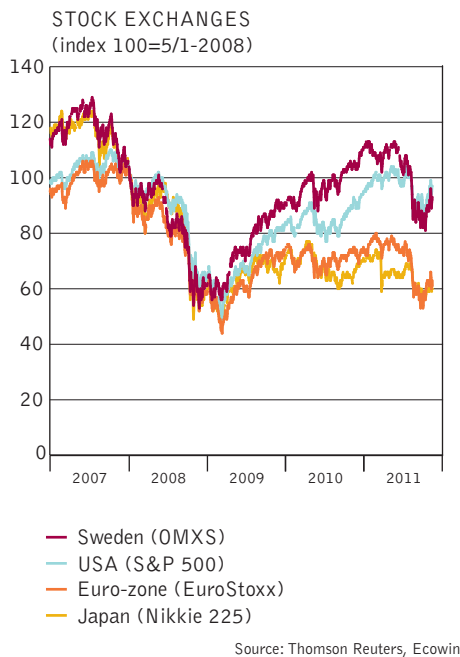
The public finances in a number of countries are extremely problematic. Low growth and high expenses have meant that several European countries cannot secure funding in the market. Since the last risk report (October 2010), two more countries, Ireland and Portugal, have needed to apply for funding from the EU and IMF. In addition, Greece has been forced to apply for its second support package, since it is believed that the first package was not large enough. Greece is having difficulties meeting the conditional requirements for receiving a support loan, and there is currently great political uncertainty about how the crisis should be handled.

The financial uncertainty has primarily revolved around Greece and the other countries that today have received support from the EU and IMF, but other countries have also demonstrated warning signs. At the beginning of the summer, the uncertainty spread after demand for primarily Italian and Spanish government bonds fell, which caused interest rates to rise to high levels. The ECB began at that point to buy Spanish and Italian government securities while the countries' governments at the same time committed to implementing measures aimed at regaining the confidence of lenders. However, it has proven to be difficult to implement the promised measures, particularly in Italy. Since Italy's public debt is the third largest in the world, expressed in absolute numbers, uncertainty about the country's public finances quickly spread to the financial system and intensified the uncertainty around the debt-burdened countries.

The banking system and sovereign debt crisis

The sharp deterioration in public finances also had a negative impact on the already weak European banking sector, which holds large volumes of government securities issued by the debt-burdened countries. Many banks will not survive write-downs to the debt in more countries than Greece. This means that the banks' possibilities for borrowing funds have narrowed considerably. The problems for the banks are enhanced by the fact that they are closely linked to one another and are highly leveraged. Problems in one bank can therefore quickly spread to other banks, which in part has also caused the risk premiums of Swedish banks to rise.

Due to the funding difficulties facing the banking system, the ECB reinstated liquidity support for longer maturities, even in USD. In reality,



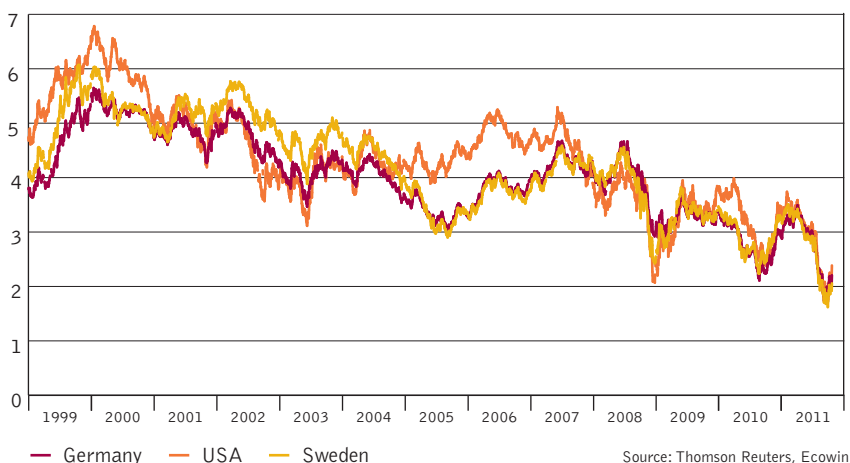
large portions of the European banking system are being funded by the ECB.

Since the high levels of public debt in many countries exist in parallel with high levels of private debt, it will most likely take a long time before the weak economic situation is alleviated, since both the private and the public sectors need to decrease their level of indebtedness. The debt problems could therefore affect both real and financial growth well into the future.

Turbulence in the financial markets

The development of the financial markets has primarily been affected by the sovereign debt crisis and subdued global economic growth. Demand for assets with high risk has fallen at the same time as the demand for assets with low risk has increased. Investors are moving money away from, for example, corporate bonds and shares into more secure investments such as government bonds or covered bonds from countries with low risk. This is reflected not only by the extreme fluctuations and falling prices on stock markets, but also the falling interest rates on government bonds from countries that are perceived to be stable. U.S. government bonds are still considered to be extremely safe investments despite the fact that the country was downgraded from the top credit rating,

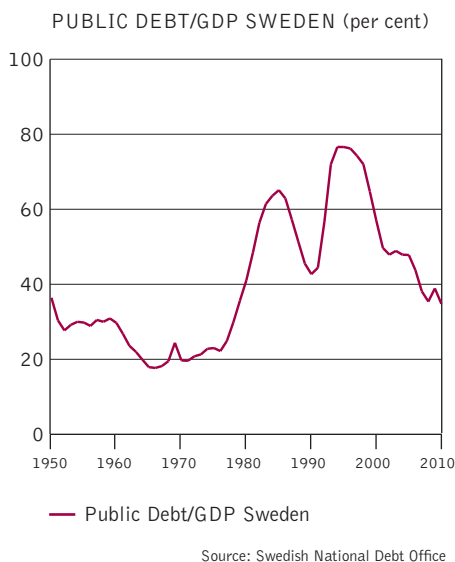
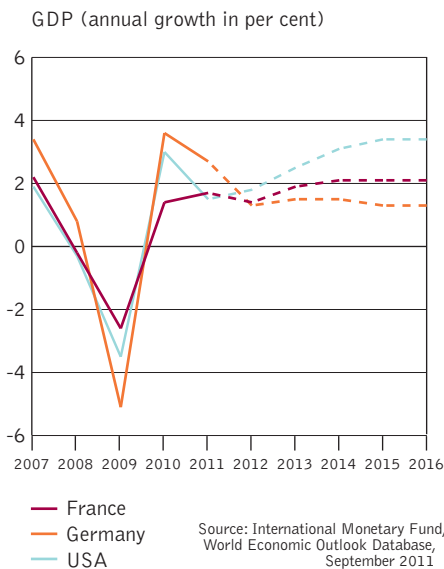
INTEREST RATES, ten-year government bonds (per cent)



AAA.

European initiative to handle the crisis

In an effort to stave off the financial crisis, EU's leaders have agreed on a number of occasions to implement various support measures. This has primarily resulted in additional funds being made available to the support fund, EFSF. As the crisis spread to larger countries such as Italy, it repeatedly became apparent that these measures were insufficient. In October, a more comprehensive package was decided that would address the problems at three different levels. First, private investors would be impelled to accept a larger write-down in Greek public debt than what was agreed during the summer. Second, an attempt would be made to make more effective use of EFSF via different financial solutions, but it is still not clear exactly how this will take place. It was also discussed if it would be possible to bring in capital from countries outside of Europe.



These two steps are expected to increase EFSF's financial resources significantly. Third, efforts would be made to ensure that banks have sufficient capital levels even after all holdings of government bonds are marked-to-market.

A number of significant questions remain regarding this support package. Many of the details have yet to be decided and the financial solution selected to increase the support mechanism's resources is being questioned. It is therefore too early to determine how much of an impact the package could have. Fundamentally, structural reforms are needed to resolve the sovereign debt crisis. In the best of cases, the support package can provide the time needed to implement these reforms.

Weak international economic growth

The global economy recovered relatively quickly after the financial crisis and showed strong growth during 2010. This recovery was propped up in a number of countries by an expansive fiscal policy and support for the financial sector, which resulted in large budget deficits and rising sovereign debt. Given the growing concern about the sovereign debt crisis, the fiscal policy of many countries has now become more contractionary. This reversal, combined with the considerable uncertainty about how the sovereign debt crisis will develop, has contributed to lower economic growth.

Global growth, though, continues to remain somewhat stable due to the growth economies, led by China. Some of these countries were previously close to overheating, but even the growth economies are now noting that their economies are slowing. Lower growth rates in these economies could mean that growth in Europe and the USA would slow even more.

Developments in Sweden

The Swedish economy continued to recover from the downturn in 2008 and 2009. The recovery has in part been due to an improved international economic climate and expansive fiscal and monetary policy, both internationally and, to a large extent, even in Sweden. Since the summer, however, the economic situation has deteriorated, primarily as a result of the sovereign debt crisis and lower international growth. This has had a negative effect on Sweden, mainly through lower demand for Swedish export products.

Uncertainty about how the economy will develop has also contributed to investors in Sweden demanding investments with low risk, which has resulted in an extremely turbulent and downward trend on the Swedish stock exchange. Demand for secure investments, for example government bonds, has increased sharply. The supply of government bonds is limited, though, since the government is taking steps to decrease its debt. The increased demand combined with the shrinking supply has resulted in a sharp fall in government bond rates. Fundamentally, though, decreased sovereign debt combined with low interest rates is a sign of strong public finances. Swedish sovereign debt is low, both from an international and a historical perspective. Furthermore, the need for credit in coming years is considered to be limited since the government has opted to implement a slightly contractionary fiscal policy.

Due to falling stock exchanges and increased economic uncertainty, households have become more careful. Savings have increased and con-

sumption has decreased. House prices are at an all-time high and, given the uncertain economic situation, there is a growing concern that these prices will fall, thus motivating households to be even more careful. Decreased demand for goods and services from households contributes to lower activity in the economy.

Despite the uncertain economic situation, the Swedish banking system is strong. Both the capital of the banks and their funding sources are stable. This decreases the risk that the supply of credit may be strangled if the economic situation takes a turn for the worse.

Firms have also been affected negatively by falling share prices and economic uncertainty. There is a risk that this will lead to the postponement of investment and employment decisions. The National Institute of Economic Research expects, therefore, that unemployment, which had fallen sharply during the year, will increase somewhat.

Inflation is relatively stable and in line with the Riksbanks target. The Riksbank slowly raised the interest rate during the year, even though monetary policy is still expansive. Increased concern about the economic development of the Euro zone in particular has meant that the market now expects the Riksbank to start to lower the interest rate in order to further stimulate the economy.

Banks and investment firms

Uncertainty about the public finances of some European countries and the economic recovery is causing turbulence on world markets. The sharp deterioration in public finances also had a negative impact on the already weak European banking sector, and many European banks are finding it difficult to secure funding. Despite this uncertainty, Swedish banks to date have had relatively good access to liquidity.

DEVELOPMENTS DURING THE YEAR

Over the past year, the Swedish banking sector¹ has benefitted from the strong growth in the Swedish economy and the increased financial stability. The growth of the Baltic operations exceeded expectations. However, the financial markets, in particular in the euro zone, are still shadowed by a cloud of uncertainty since the propensity to take on risk has decreased sharply and asset prices are falling. This means that funding for the major Swedish banks faces a greater risk and there is a risk that the recovery to the economy will slow, which increases the probability of bankruptcies and credit losses.

Earnings, credit losses and profitability

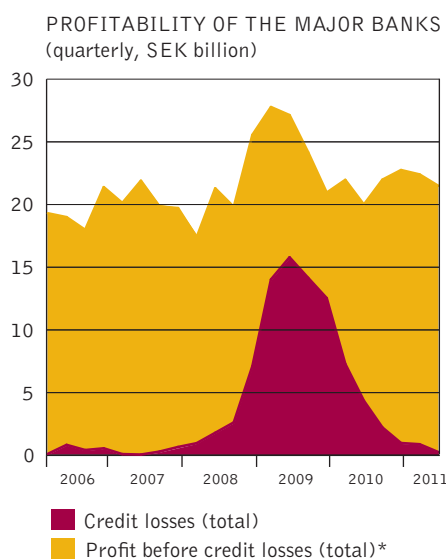
The four major banks had a strong year in 2011, which is a reflection of the economic recovery. The improved profits can be explained by both low credit losses (and recoveries of previous provisions) and higher earnings from higher interest rates. The net interest rate² comprises more than half of the major banks' earnings and has benefitted from rising margins on both deposits and lending, despite the fact that borrowing costs for longer maturities has become more expensive.

Apart from a few exceptions, the smaller banks, including savings banks, are continuing to generate profits and their credit losses are continuing to fall. The smaller banks' operating profits are stronger now than in the same period last year, which can be almost exclusively attributed to the rising net interest rate.

The operating profit of credit market companies is decreasing slightly due to greater credit losses, but this is partly offset by the rising net interest rate. Investment firms are also experiencing a negative trend compared to the same period last year. Since commission income represents the majority of revenue and is strongly linked to developments on the equity and capital markets, profitability will most likely be subject to pressure as long as the uncertainty about the financial markets remains.

Lending and financing

The growth of Swedish banks' corporate lending has recovered from low levels, while the high rate of household lending declined during the past year. The major banks are increasing their deposits from the general

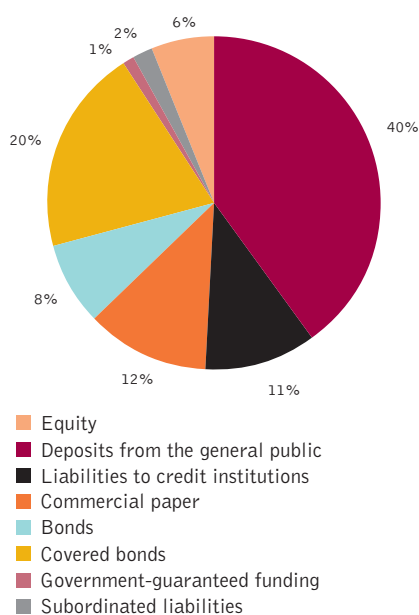


Source: Quarterly reports of the major banks
*adjusted for one-off items

1 In this report the banking sector refers to major banks, other banks, investment firms and credit market companies. The banking sector is dominated by the four major banks, Handelsbanken, Nordea, SEB and Swedbank, which together account for approximately 85 per cent of the total assets on the Swedish market.

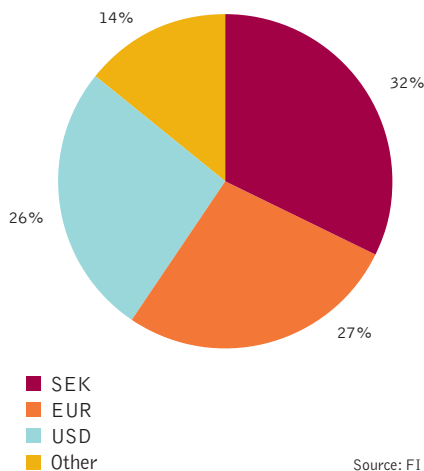
2 The difference between interest-bearing assets (such as lending) and interest-bearing liabilities (such as deposits).

FUNDING SOURCES OF THE MAJOR BANKS



Source: FI

CURRENCY BREAKDOWN OF MARKET FUNDING



Source: FI

public at record rates, compared to the smaller credit market companies, which are reporting lower growth rates over the past year.

The capital market continues to be the most important source of funding for the major Swedish banks, at 43 per cent, while deposits from the general public comprise the second largest source of funding. The majority of market funding is comprised of covered bonds, and the covered bond market has proven itself to be a relatively stable source of funding for the major banks during the turbulence of recent years. The Swedish banks have issued covered bonds at advantageous prices compared to other European banks, which has laid the groundwork for the good economic situation in Swedish households and the Swedish economy.

The combination of the coming regulatory changes and the market's requirement on more stable funding has meant that the major banks have for some time been extending the maturities of their funding and increasing the size of their liquidity reserves.

SEK is the single most important currency for the Swedish banks' market funding. EUR and USD comprise in total more than half of the outstanding market funding, which means that the banks are dependent on a functioning international funding market. The large share of EUR and USD can be explained in part by the fact that around 50 per cent of the major banks' operations are located outside of Sweden. It has become more difficult for European banks to borrow USD for short periods of time, which has led to a sharp cost increase. However, as a whole, the Swedish banks have had relatively good access to their funding programmes in different currencies even during the recent intensified market uncertainty.

Liquidity of the major banks

The liquidity of the four major banks grew stronger during the year. The liquidity reserves (see the insert about LCR and NSFR in the Swedish major banks) currently correspond to a total of around 12.5 per cent of the banks' balance sheet total, which is an improvement of more than SEK 600 billion since the start of the calendar year.

Finansinspektionen (FI) implemented new reporting requirements for liquidity in Swedish banks in July 2011. This data will serve as a basis for the coming quantitative regulation of liquidity risks that is based on the Basel 3 accord.

FI believes that it is necessary to implement the quantitative requirements ahead of schedule, primarily with regard to the Liquidity Coverage Ratio (LCR), for banks that are heavily dependent on market funding. The plan is to start the implementation in January 2013. Getting this regulation in place at such an early phase as possible is of utmost importance and will strengthen the Swedish financial system in the future.

LCR and NSFR for the major Swedish banks

Banks play a central role in a modern economy, but their construction is vulnerable. Banks often borrow at extremely short maturities while the maturity of the majority of their lending is significantly more long-term in nature.

This gap between liquid liabilities and illiquid assets means that banks are sensitive to the risk that they will not be able to renew their loans when they se fall due. In other words, banks are exposed to liquidity risks. These risks

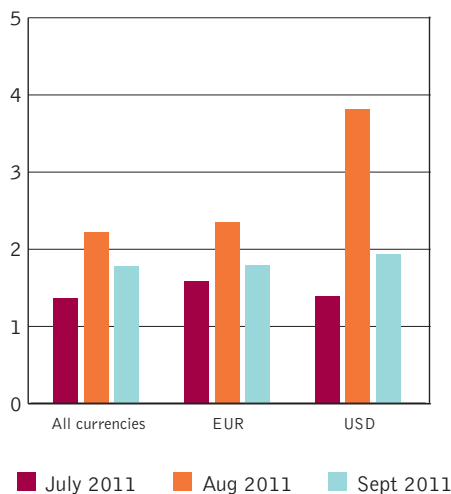
are enhanced by the fact that it is often difficult for lenders to distinguish between banks with good assets and banks with bad assets. As a result, banks without underlying solvency problems could also suffer from liquidity risks.

Since banks often lend large amounts to one another, the loss of funding in one bank can quickly lead to problems in other parts of the financial system. A bank that faces the risk of not being able to meet its loan commitments can attempt to protect itself by decreasing its lending to other banks. This will lead to a decrease in the supply of funding while demand simultaneously increases, and interest rates will rise as a result. In a worst-case scenario, the market would stop functioning and liquidity would dry up. The banks that do not successfully find new funding could be forced to sell assets at a loss in order to repay loans that fall due. Liquidity problems in one bank can therefore spread quickly to other banks and even affect solvency. This is why liquidity risks are not just a risk faced by individual banks, but rather by the financial system as a whole.

The financial crisis has shown that, in general, banks in both Sweden and other countries had taken on liquidity risks that were much too large. During the crisis, however, central banks have helped resolve this problem by providing banks with extensive liquidity support to safeguard financial stability. Fundamentally, however, it is not reasonable to expect central banks to carry the ultimate risk for the banks' liquidity supply in difficult times. Rather, the banks themselves must take into account liquidity risks. The Basel Committee is therefore developing new guidelines for how these risks should be managed. The guidelines contain two complementary measurements, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

LCR says, in brief, that banks should have sufficient liquid assets for handling a situation in which the funding markets are more or less closed for 30 days.

LCR (total for Swedish banks), ratio



Source: FI

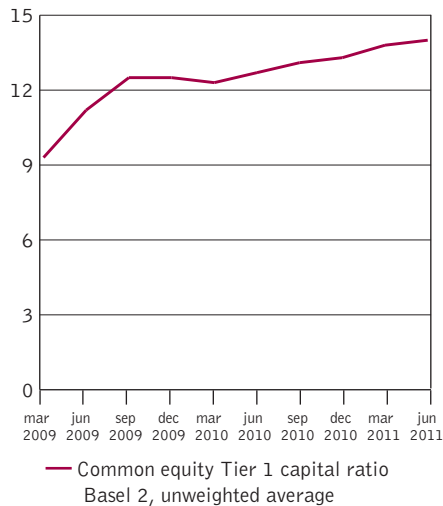
Liquid assets in this context primarily include government securities and, to a certain extent, covered bonds. If a bank were to have liquidity problems, it could then sell its liquid assets and in this way match the outflows that take place during the period. In order to ensure that the banks will be able to handle such a scenario even during extremely difficult conditions, it is also necessary for them to hold their liquid assets in the same currency as the expected outflows.

NSFR is proposed to act as a more long-term, structural measurement that comple-

ments LCR. This means that banks should to a greater extent fund long-term assets with long-term liabilities. The banking system should, in other words, decrease its maturity transformations compared to historical data. In addition to these two quantitative measurements, the banks are also required to improve how they report and account for their liquidity situation. This will improve transparency for both investors and supervisory authorities.

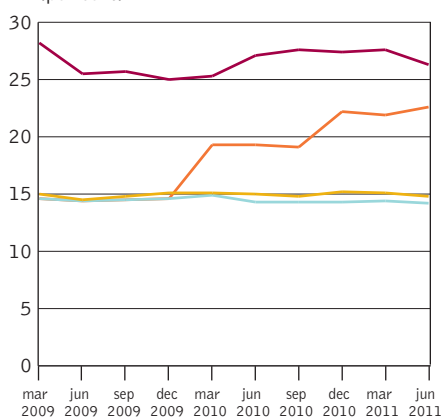
FI implemented an LCR reporting requirement in July 2011 and is also gathering data to calculate NSFR for Swedish banks. The idea is that the banks should have a ratio of at least 1 for both measurements. Data indicates that the banks to a large extent fulfil LCR both in total and for EUR

COMMON EQUITY TIER 1 CAPITAL RATIO (per cent) Major banks



Source: FI

COMMON EQUITY TIER 1 CAPITAL RATIO (per cent)

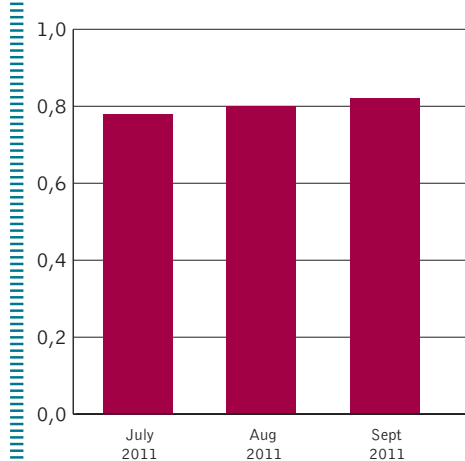


— Investment firms
— Savings banks
— Credit market companies
— Small banks

Source: FI

Not adjusted for changes within the group banking companies and savings banks (see the Credit Market Barometer, Quarter 2, 2011).

NSFR (total for Swedish banks), ratio



Source: FI

is evident in particular by the failure of the majority of banks to manage these risks. A consequence of this is that LCR and NSFR are not perfect measurements, either, even if they provide a good overview of the liquidity risks that banks are facing. It is therefore important to implement LCR and NSFR alongside other measures, which primarily comes as the banks themselves publishing information about liquidity risks. When combined with more detailed information about the banks' funding, LCR and NSFR can contribute to making the banking system safer and more stable in the future.

and USD separately. Their NSFR is significantly lower, but the design of NSFR is not complete and it could change before its implementation in 2018. The banks can improve their NSFR in several ways, for example by increasing deposits from the general public, decreasing their commitments that require long-term funding and transforming short-term market funding into long-term market funding.

Measuring and assessing liquidity risk is difficult, in part because the term "liquidity" itself is not easily defined. This

Capital adequacy

The Tier 1 capital ratio for the major banks as a whole is just over 14 per cent, which represents an increase compared to the same period last year. The Tier 1 capital ratio has gradually grown stronger as a result of rising retained profits and falling capital requirements.

In general, smaller banks, credit market companies and investment firms should have a higher capital adequacy than the major banks because their operations are smaller and, subsequently, less diversified.

New regulations "Basel 3/CRD 4"

All of the major banks, with the exception of Handelsbanken, have communicated the effects the coming transition to Basel 3 will have on their capital ratios.³ The estimated reduction falls within an interval of 1–2 percentage points.

Risk weights for mortgages to households

According to the Basel regulations, the capital requirement for lending is determined by the risk weight, which varies for each exposure class. Following the implementation of Basel 2, it became possible for banks to calculate the risk weight themselves using internal models that are based on historical data about credit losses. Strong economic growth in Sweden and high savings

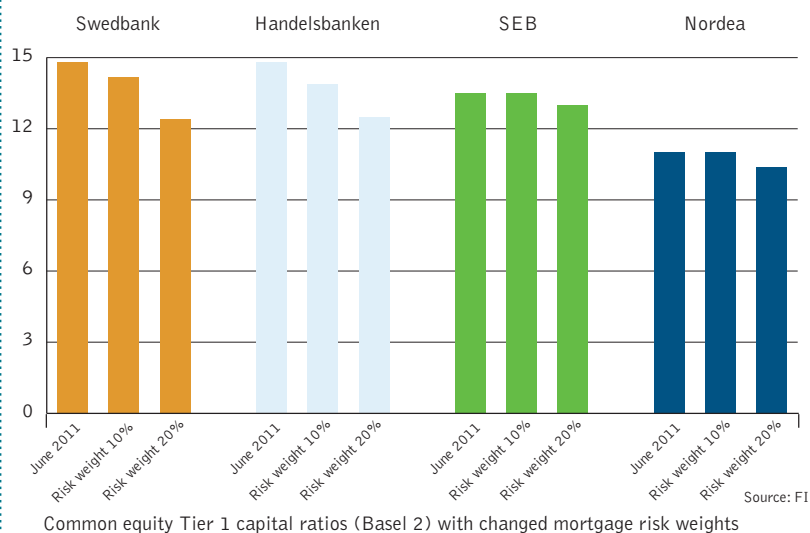
³ Swedbank's interim report Q2 2011 (1 per cent). Nordea's 2010 annual report (1 per cent). SEB's investor presentation Q1 2011 (1.5 per cent). This assumes that Swedbank has converted its preference shares before the regulations enter into force on 1 January 2013. If this does not occur, the common equity Tier 1 capital ratio will fall by an additional 1.8 percentage points. Handelsbanken has not communicated the effect on its common equity Tier 1 capital.

rates over a long period of time have meant that Swedish mortgage holders have been able to repay their loans, and the banks' Swedish mortgages in principle have not been subject to any credit losses. The risk weights for Swedish mortgages are therefore currently very low.

There is a risk that the historical data the forms the basis for the calculation of risk weights for mortgages is not representative of future business cycles. Swedish households' average indebtedness in relation to their disposable income has increased sharply in recent years. Even if most households in Sweden can meet their commitments even if their income were to fall, or if mortgage rates were to rise to significantly higher levels than today, there is a risk that a scenario where house prices fall at the same time as unemployment rises could unfold. As a whole, therefore, the implementation of additional safety margins when calculating risk weights could be justified. There are already limits for how low risk weights can fall, but FI believes that there may be additional grounds for further tightening this limit. To demonstrate this, we have calculated the effect of different floors for the risk weight of mortgages on the major banks' common equity Tier 1 capital ratios^{4,5}. In practice, an increase in the lowest risk weights would raise the capital requirement for the major Swedish banks, which FI believes is manageable since the banks already hold significant buffers to the statutory minimum requirements.

Risk weight floors of 10 and 20 per cent, respectively, have been used for the banks' exposures in the second quarter of 2011. The differences in the effects on the capital ratios are due to the differing composition of the loan portfolios (both differences in geographic distribution and what is classified as a mortgage) and different initial risk weights. The effect is largest for Swedbank and Handelsbanken since they hold a relatively larger share of Swedish mortgages with low risk weights. Even with a 20 per cent risk weight – which is in line with the average in Europe – the banks' financial positions do not change. Swedbank's and Handelsbanken's capital ratios fall the most, roughly 2.5 percentage points.

COMMON EQUITY TIER 1 CAPITAL RATIO OF MAJOR BANKS (per cent)



⁴ Full Basel 2 definition of risk-weighted assets

⁵ Total lending to the sub-group, real estate credits, within exposures to households

Finansinspektionen's view on future capital requirements for the Swedish banks

FI made it clear early in the year that the major Swedish banks should leave a buffer so that Sweden can phase in the new regulations faster than the schedule proposed by the Basel Committee. FI has previously announced that the requirements on the major Swedish banks are expected to be 15-16 per cent for total capital within a few years, of which 10-12 percentage points should consist of common equity Tier 1 capital. The minimum requirements are not static since the Pillar 2 assessment is individual – it is based on stress tests – and the size of the countercyclical buffer will per definition vary over time.

Sweden needs its major banks to fulfil strict capital requirements since a large banking sector can expose the society to material risks. The aggregate balance sheet total of the four major banks is roughly four times the size of Sweden's GDP. The major Swedish banks are also to a large extent dependent on market funding, which makes them sensitive to liquidity problems. The cost for society if one of these banks encounters problems or fails could be very large, while the increase in the banks' capital costs due to the new regulations – and thereby any impact on lending rates – is small.

EU's plan to strengthen the capitalisation of large European banks

On 26 October, the European Council agreed on a number of measures to strengthen the European banking sector. According to a proposal from the European Banking Authority (EBA), these measures include both the provision of lending guarantees and requirements on banks to increase their capital buffers. The aim of the capital reinforcements is to ensure that the banks can handle both increased risk in government finances and higher losses resulting from a potential downturn in the European economy.

The Swedish banks are some of the most well capitalised banks in Europe and they have very little exposure to governments with weakened finances. However, the EBA has opted to measure the capital ratio using the transitional rules from Basel 1, which is of considerable importance for several of the Swedish banks since assets with relatively low risk, e.g. Swedish mortgages, are assigned a significantly higher risk weight in the EBA's measurement than in the future Basel 3 regulations.

FI supports the EBA's plan to strengthen the capital in the European banking sector. This need is acute for many European banks and cannot wait until the new regulations enter into force. We therefore expect the major Swedish banks to meet the EBA's buffer requirements no later than 30 June 2012. The capital need in European banks, based on the capital situation at the end of September 2011, will be presented by the EBA in November. FI does not believe the affected Swedish banks will have any problems fulfilling the requirement since the deficit is relatively small given the banks' own funds and earning capacities.

RISKS TO BANKS AND INVESTMENT FIRMS

Uncertainty about public finances

Since the last risk report, uncertainty on international financial markets has grown. Sovereign debt problems in several European countries and lowered forecasts for global growth represent the greatest risks. Since the

summer, many European banks have found it difficult to secure funding on the markets. Nordic states and banks are perceived to be stable and the major Swedish banks have to date had relatively good access to funding. Compared to last year's risk report, however, the risk to the funding of the major Swedish banks has increased. The problems on the funding market for many European banks can make it difficult for firms and households to receive bank financing, which in turn can have a negative effect on the recovery of the international economy.

Funding and liquidity

Liquidity risks have been in focus since the start of the financial crisis and they have continued to require considerable attention from both the banks and FI. The major Swedish banks' dependence on market funding means that their situation can deteriorate if uncertainty on the financial markets increases. Given the uncertainty on the market, the liquidity on the funding market has, despite everything, been acceptable and all of the Swedish banks to a large extent have had access to their funding programs. Nordic states and banks are considered to be stable and the costs the banks pay for their funding is lower than for corresponding European banks. However, the turbulence during the second and third quarters caused by the sovereign debt problems in several EU countries (a more detailed description is provided in Chapter 2) shows that the situation is still unstable. The cost of interbank financing shot up for European banks and there was a temporary lack of USD.

The market for Swedish covered bonds has continued to function well and provides the major Swedish banks with a stable source of funding. The financial stabilisation mechanism that was established by the ECB partly resolved the funding problems facing European banks, but the structural problems remain. Even if the Swedish banks' direct exposures to the GIIPS countries⁶ are small, the banks are affected indirectly by the uncertainty since they are dependent on market funding. The stable Swedish public finances and the banks' capitalisation and high underlying earnings mean that the Swedish financial system should be able to handle limited foreign market uncertainty, even if extended. However, this situation could deteriorate if the sovereign debt crisis is not managed in a sustainable manner or if other uncertainty factors arise with regard to funding.

The Baltic region

The development in the Baltic economies over the past year has been positive. The economic stabilisation that has taken place in the region is reflected in the sharply improved profits and low credit losses (and recoveries of previous provisions) in the Swedish banks' Baltic operations. Even if the Swedish banks' operations in the Baltic region have shrunk over the past several quarters, the major banks that are active there are still subject to risk. Growth in the region is relatively vulnerable and credit and earnings risks are still present and could materialise in the event of a new recession. A downturn in the European economies could have a tangible effect on the comparatively small Baltic economies.

In its supervision, FI has paid close attention to the Baltic operations and carefully followed their developments. A considerable amount of collaboration also takes place in the supervisory colleges, where FI works with the Baltic supervisory authorities to conduct the supervisory review and evaluation process of each bank.

⁶ Greece, Italy, Ireland, Portugal and Spain.

Weak business models

In recent years many credit market companies have grown rapidly, attracting large amounts of new deposits. In last year's risk report, FI highlighted this rapid growth as a potential risk. The situation on the market has deteriorated, despite slowed growth, which indicates that there is a risk inherent in the companies' business models.

In order to pay high deposit rates, credit market companies need to invest their money in assets which give a high return (e.g. lending with higher credit risk). This increases the risk that their risk-taking will be too high. Because the business models are to date untested for a downturn in the market, this can lead to problems for these companies. Depositors with credit market companies are in general protected by the deposit guarantee and the effects for consumers in the event of a default should therefore be limited. Furthermore, most of the companies are not large enough to have a negative impact on financial stability, but if several of these companies were to have problems at the same time, efficiency on the market would be affected.

Weak boards of directors

A firm needs to have a responsible board of directors if it is to have satisfactory internal governance control. Requirements on internal governance and control are at the heart of the business regulations for financial institutions. These requirements have evolved from focusing originally on strict checks to now expecting the companies to demonstrate a holistic approach to their operations by including in particular the board of directors' work on targets, risks and follow-up.

Since the last risk report, FI has continued to focus on internal governance and control and spent a lot of time developing a dialogue with boards of directors about these issues.

Market risks in banks and investment firms

The incidents that captured headlines last year, for example HQ Bank, demonstrated that there was insufficient management and reporting of market risk in some companies' trading operations. During 2011, FI investigated the market risk management and evaluation methodology of the eleven Swedish firms with the largest exposures to financial instruments. The results from the investigation will be finalised during the winter of 2011/2012.

STRESS TESTS OF THE MAJOR BANKS

FI's internal stress test conducted during the third quarter of 2011 confirms the previous assessment that the major banks are well capitalised.

Stress tests are one of the tools employed by FI in its supervision of banks. The tests are conducted on a regular basis to assess the banks' resilience given various negative scenarios. The stress tests are also used in the annual supervisory review and evaluation process conducted for each bank. FI published the most recent results of its own stress tests in conjunction with last year's risk report (October 2010).

The stress test uses public information and is standardised. It does not use a specific macro scenario based on the current status of the market, and it does not take into consideration differences in the quality of each bank's exposures within various segments and markets.

The results confirm FI's previous assessment that the major banks are

well capitalised. Their resilience to unexpected credit losses has continued to gradually improve as loss-absorbing capital has been strengthened. The banks' resilience is observed using a three-year scenario that contains a sharp downturn to the economy in all areas. The scenario assumes that the banks experience lower earnings and higher credit losses. In the scenario, credit losses are high in all industries and regions, which has a negative effect on capitalisation. Compared to the current situation, this will apply in particular to lending for commercial real estate and mortgages. Even if the credit losses are generally high compared to today's levels, they do not reach the levels that were measured during the crisis in the 1990s. This also applies to the Baltic countries, which in the scenario continue to report relatively large credit losses even if these loss levels are lower than those actually experienced in 2009.

Results

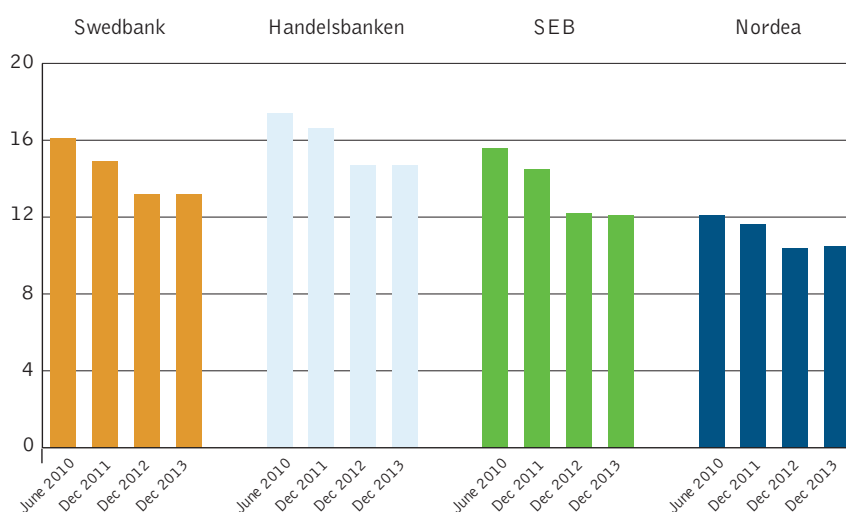
In the scenario, the Tier 1 capital ratios (pursuant to Basel 2) fall to 10.6 per cent.

Simplified profit and loss statement

SEK million, 2012–2014	Nordea	Handelsbanken	Swedbank	SEB
Profit before credit losses	105 243	47 299	40 551	40 646
Credit losses	116 922	54 842	49 586	50 580
Taxes	231	-	-	-
Profit after tax	-11 909	-7 544	-9 035	-9 934
Dividend	289	-	-	-
Change in equity	-12 198	-7 544	-9 035	-9 934

A more detailed description of the stress test methodology and the scenario is available on FI's website.

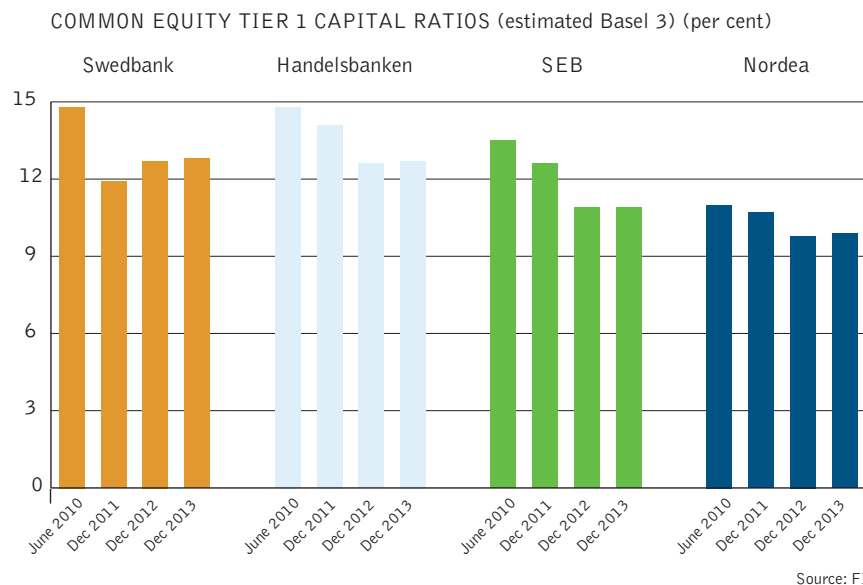
TIER 1 CAPITAL RATIOS (Basel 2) (per cent)



Source: FI

Common equity Tier 1 capital ratios "Basel 3"

In its estimation, FI has used the current definition of risk-weighted assets, which means that capital adequacy is slightly overestimated com-



pared to Basel 3.⁷ Deductions for investments in insurance operations as of 2013 will be drawn equally from common equity Tier 1 capital and Tier 1 capital. Swedbank's common equity Tier 1 capital during 2012 is around 1.8 percentage points lower because we are defining common equity Tier 1 capital in accordance with the change to the CRD 3 regulations.

At the end of the scenario the major banks have common equity Tier 1 capital ratios between 10.1 and 13.1 per cent, which means they have a relatively good margin to the requirement of 7 per cent in the Basel 3 proposal.

⁷ The calculated common equity Tier 1 capital ratios are based on a rough estimate that does not take into account that the definition of both own funds and the capital requirement will also change in Basel 3.

Insurance and funds

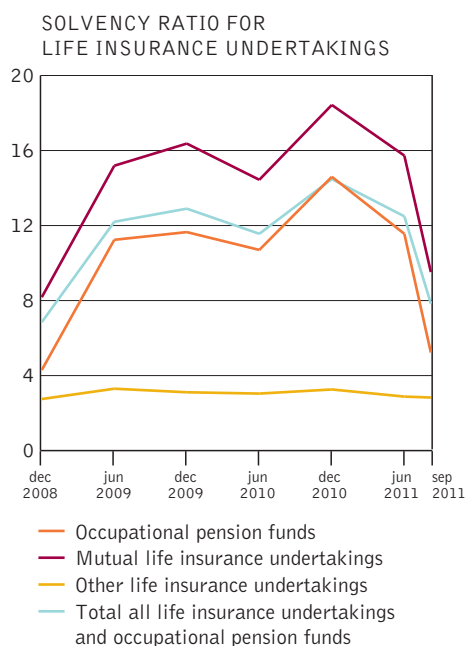
The intensified uncertainty on the financial market since the summer has caused the Stockholm Stock Exchange, like many other exchanges around the world, to fall sharply. Demand for high-risk assets has fallen while demand for more secure assets, such as government bonds, has risen, which has caused the interest rates of Swedish, U.S. and German government bonds to fall to historically low levels. This puts considerable pressure on the Swedish life insurance undertakings.

DEVELOPMENTS DURING THE YEAR

Life insurance undertakings

The solvency of many life insurance companies and occupational pensions funds deteriorated rapidly during the summer and autumn. The fall on the stock market decreased the value of share assets, and the present value of the companies' commitments has risen as market interest rates fall. To be fair, the fall in interest rates has also increased the value of the bond portfolio, but this increase has been overshadowed by a greater increase in liabilities. The fact that the value of the liabilities is affected more than the assets is a consequence of the companies' commitments having a longer average maturity than the asset portfolio. The companies' liabilities consist of pension commitments that can stretch more than 40 years into the future.

Despite the extremely low interest rates, life insurance companies in general have good solvency. The solvency ratio indicates how much capital a company has in relation to the statutory minimum requirement and thus should be greater than 1. Mutually working life insurance companies had an average solvency ratio of less than 10 as of 30 September 2011, while the occupational pension funds had a ratio of almost 5. These companies normally have very high solvency, because only the guaranteed commitments to policyholders are used when calculating their liabilities. The most dramatic decrease in solvency has occurred among the occupational pension funds, and the ratios of some funds fell by more than 50 per cent during the year. The group "other life insurance undertakings" includes profit-distributing life insurance companies and life insurance companies that only sell pure risk products. Profit-distributing companies do not have surpluses in the form of bonuses. All bonuses are instead conditional bonuses that are reported as a liability to the policyholders. The average solvency ratio for profit-distributing companies and life insurance companies that only sell pure risk products was just under 3 on 30 September 2011.



Market risk and solvency ratio

The following simplified example illustrates how a fall in share prices and interest rates affects a life insurance company's solvency ratio. The solvency ratio is defined as the company's available solvency margin divided by the capital requirement (the required solvency margin). For life insurance companies, the required solvency margin is approximately 4 per cent of the companies' liabilities, but the calculations differ based on the type of company. When the solvency ratio is larger than 1.0, the statutory capital requirement

Assets		Liabilities and equity	
Shares	50.0	Liabilities	100.0
Bonds	70.0	Own funds	20.0
	120.0		120.0

Results: Required solvency margin 4.0. Solvency ratio 5.0

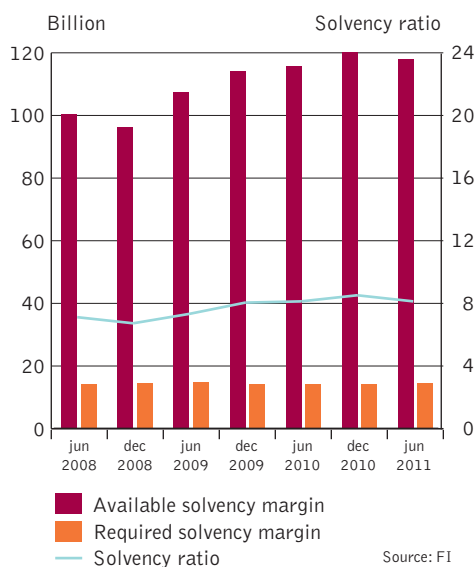
is fulfilled. A fictitious company has assets of 120 and liabilities of 100, giving equity of 20. The company's commitments have an average maturity of 15 years, which is significantly longer than its bond portfolio, which only has a maturity of 5 years. Since the required solvency margin is roughly 4 per cent of the liability, the solvency ratio is $20/4 = 5.0$. From its start, the

Assets		Liabilities and equity	
Shares	45.0	Liabilities	107.6
Bonds	71.7	Own funds	9.2
	116.7		116.7

Results: Required solvency margin 4.3. Solvency ratio 2.1.

company has five times more equity than the statutory requirement. The next table shows what happens when the share's value falls by 10 per cent at the same time as the market rates fall by half a percentage point. The change in the share price only affects the assets. The fall in interest rates affects both assets and liabilities. Bonds increase in value by 2.5 per cent, but the debt is both larger and more sensitive to interest rates and increases by 7.5 per cent. Sensitivity to interest rates is normally higher the longer the maturity of the interest-bearing security. A change in the market interest rate has a larger effect on the price of an interest-bearing security with a longer maturity since the difference in the total return is greater. In the example above, the available solvency margin is halved at the same time as the capital requirement increases. The solvency ratio falls to 2.1. The company now has only twice as much equity as what is required by law.

NON-LIFE INSURANCE UNDERTAKINGS



As a result of the market situation, Finansinspektionen (FI) is carefully following the solvency of the insurance undertakings. The largest life insurance companies and some occupational pension funds are reporting their solvency on a weekly basis for the time being. Even if the reported values are still not alarming, FI believes that there are a number of companies that can have problems with insufficient liability coverage and solvency if interest rates and stock exchanges continue to fall.

Non-life insurance undertakings

FI currently sees only very minor solvency risks in the non-life insurance area. The average solvency ratio for non-life insurance undertakings was just over 8 during the first six months of 2011. As of 30 June 2011, approximately 70 per cent of all non-life insurance undertakings had a solvency ratio of more than 5. A smaller number of undertakings had a solvency ratio of less than 2 while several had a solvency ratio of more than 20.

RISKS TO INSURANCE AND FUNDS

Market risk management by life insurance undertakings

FI believes that many life insurance companies and occupational pension funds have deficiencies in how they manage their market risk. The companies have issued guarantees to their policyholders that they cannot easily secure on the financial markets. The investment strategy is fully focused on high returns and there is often no plan for how they will meet their guarantees if they cannot achieve the high returns. During periods of high inflation and high interest rates, the return has been sufficient for meeting the guarantees. In today's situation, this is much more difficult. The companies still have many contracts with high guarantees. The guarantees introduce risks to policyholders. The guarantees in new contracts are also often adjusted slowly or not at all to new market conditions.

Policyholders receive returns in the form of guarantees/bonuses. The guarantees are the minimum return the company has committed itself to, while the bonuses are the surpluses that are created. A company with weak solvency has less of an opportunity to give bonuses and can have problems meeting their guarantees.

The life insurance industry as a whole, based on the requirements laid down by law, has sufficient buffers at the moment. However, it is not possible to rule out a scenario where an individual company reaches a stage where it cannot meet all of its commitments. In a company with solvency problems, there is a risk that the insured will not receive their guarantees and that some insured will benefit at the cost of others. The primary risk is that policyholders with a long period of time until payment will be affected negatively. Sweden does not have an insurance guarantee system that compensates the insured.

Insurance companies do not have the same kind of impact on financial stability as banks, but they can increase the volatility on the financial markets. Because of their guarantees, life insurance companies' liabilities are sensitive to interest rate changes. Their stock of bonds with long maturities is also small, which creates an imbalance between supply of and demand for interest rate risk. This imbalance makes it difficult to manage the risks associated with long-term guaranteed commitments.

Supply of and demand for interest rate risk

Life insurance companies have for a long time issued guarantees to policyholders that they cannot easily secure on the financial market since there are no risk-free bonds with sufficiently long maturities. These commitments give rise to a large liability that is sensitive to the interest rate. Matching the industry's collective interest rate risk by using ten-year bonds would require a portfolio worth SEK 2,060 billion. To put this in perspective, Sweden's public debt is SEK 1,020 billion. The stock of government securities, however, is less than the public debt. Outstanding government securities correspond to 410 billion ten-year bonds. In covered bonds this corresponds to 320 billion ten-year bonds. In other words, the potential demand for long-term bonds exceeds the total supply several times over.

A life insurance company that is under pressure can reduce risk by selling

liquid assets, such as shares, and buying bonds instead. Many of the companies have large, domestic portfolios and are major actors on the Swedish financial markets. When they opt to sell Swedish shares and buy Swedish bonds, they risk pressing share prices and market rates down even further. This would weaken the solvency of other actors in the industry, which means that other companies could also find themselves under pressure. Measures taken by the companies to reduce risk could thus contribute to the volatility on the financial market, particularly if these measures are taken at the same time as other actors with similar problems are taking similar measures.

The risk management of Swedish insurance undertakings is complicated by the fact that their portfolios are large compared to the Swedish bond and stock markets. The companies can turn to more liquid international markets, but they must then be able to manage currency risk and the imperfect correlation between Swedish and foreign interest rates. This places additional requirements on risk management competence and risk buffers in the form of surpluses. It is important that insurance undertakings dedicate considerable resources to managing their financial risks so that they will not be forced to buy and sell during unfavourable market conditions.

FI wrote an open letter to the insurance undertakings on 27 September and expressed its concern about a negative spiral on the financial markets. The companies were encouraged to gain control of the underlying problem - the level of guarantees - in order to create sustainable, long-term conditions. The companies can relatively quickly change their selection of products, but making changes to existing contracts is more difficult. FI wrote in the letter that the undertakings can expect some patience from FI with regard to low solvency as long as the interests of the policyholders are not threatened, provided that relevant measures are taken that will lead to improvements in the solvency situation in the long run. The letter also encouraged companies with problems to contact FI at an early stage to discuss possible solutions.

FI notes, however, that the change process is already underway on many fronts. New products have been created with lower guarantee levels and the guarantees have been lowered for new contracts in existing products.

Weak boards of directors in insurance undertakings and fund management companies

Deficiencies in the risk management of insurance undertakings can often be traced back to weak boards of directors with insufficient experience, involvement or competence. The boards of directors and management of insurance undertakings and fund management companies are responsible for handling large amounts on behalf of their customers/unit owners. It is important that they understand risk management and are involved in risk-related issues. FI sees variations between companies in this respect. The fact that some companies have been less successful than others at protecting solvency indicates that the boards of directors have demonstrated an insufficient level of insight into risk management, or at the very least a certain degree of passiveness. This could be a sign that the long-term consequences of a business model with high guarantees or premiums have not been sufficiently taken into consideration. It could also be a sign that the organisation does not have sufficient competence in risk management.

FI sees signs of insufficient awareness about current regulations in some insurance and fund management companies. These problems arise more easily if the operational and legal structures are separate or when a company joins a group that primarily falls under a different regulatory framework. Supervision shows that the boards of directors of small companies generally have less knowledge about the regulations than the boards of directors of large companies. For example, the boards of directors are responsible for ensuring that the control functions for risk management, compliance and internal audit exist and function well. If the boards of directors and management are not involved in their control functions, policyholders or unit holders could be negatively affected. The control functions must be designed based on their function in order to make it possible for the boards of directors to follow up on risk-taking. The boards of directors must also make sure that they receive the reporting they need to be able to follow up on the operations' risks. The responsibility for the handling of conflicts of interest also lies with the boards of directors.

In the past year, FI has had a number of meetings with the boards of directors of insurance companies to inform them about the importance of good internal governance and control. Special seminars for boards of directors have also been organised. FI intends to improve this close dialogue in order to create more of a focus on these important issues.

Securities markets

Europe's public finance problems are creating turbulence on the world markets. The combination of the uncertain economic situation and increased competition, technical advancements and structural changes has given rise to risks on the securities markets and new challenges for the supervision of these markets. The fluctuations of the stock exchange have sparked a discussion about the effect of high frequency trading on the market's volatility. Coordinated monitoring and supervision of trading venues are becoming more important.

The securities markets include not only the trading of shares, but also the trading of derivative instruments and interest-bearing instruments. Since consumers participate to a large extent directly on the stock market, this is where consumer risks can primarily arise. Finansinspektionen (FI), therefore, based on a consumer protection perspective, directs much of its supervision toward the trading of shares.

The structure of and trading on the stock market are both continuing to change rapidly. The implementation of the Markets in Financial Instruments Directive (MiFID) and rapid technological advancements have presented new challenges for the supervision of trading venues. Competition on the stock market has continued to increase, which means there is a risk that, for cost reasons, the supervision the stock exchanges are obligated to carry out by law is carried out only to the point that the minimum statutory requirements are met. In other words, there is a risk that supervision is insufficient. Fragmentation on the stock market has also created advantageous conditions for high frequency trading.

RISKS TO THE SECURITIES MARKETS

Insufficient stock market supervision

Trading on the Swedish stock market has undergone major changes in recent years. Before the introduction of the European regulation, MiFID, in 2007, shares were primarily traded on national stock exchanges in Europe. The primary aim of MiFID was to promote competition within the trading of shares, and a large number of new actors have started trading shares.

In Sweden, the stock exchanges are responsible for carrying out supervision and monitoring of listed companies. The Swedish stock exchanges' responsibility consists primarily of the supervision of public purchase offers, listed companies' disclosure of price-sensitive information, listed companies' financial reporting (accounting supervision) and monitoring of trade. Greater competition between exchanges and trading platforms introduces a risk that there are fewer incentives for exchanges to dedicate resources to supervision.

Cross-border supervision of trading venues

One consequence of MiFID is that Swedish shares are now traded on several different - and competing - trading venues.⁸ This development is most noticeable in the most traded Swedish shares. In July 2011, for

⁸ Trading venues are regulated markets (run by stock exchanges), MTFs and investment firms that organise trading in financial instruments.

example, NASDAQ OMX Stockholm reported 43 per cent of its turnover in the 30 most traded shares (OMX 30), the British trading platform Chi-X share reported 13 per cent and trading outside the trading venues stood at around 23 per cent.⁹

This shift in trading has resulted in new challenges for the supervision of trading venues. There is a need to monitor trading across national borders and, to a certain extent, have common European trading regulations.

Deficiencies in the coordination of monitoring and trading suspensions create opportunities for market abuse

The fact that a single security can be traded on a number of venues in different countries creates opportunities for actors to influence the price on one trading venue in an improper manner with the intention of influencing the price on a second trading venue. The lack of coordinated real-time monitoring between trading venues makes it more difficult to identify this kind of market abuse.

It is the responsibility of each trading venue to not only ensure that the actors follow the existing rules but also identify any trading irregularities. Effective monitoring becomes more difficult when trading in securities can be carried out at several different locations. At the moment, there is a lack of effective cooperation between different trading venues.

The rules for trading suspensions vary in Europe. If trading in a share is suspended on one trading venue, trading should simultaneously cease on other trading venues both in and outside of Sweden. Differences in the details of rules and ineffective coordination means that there is a risk that trading in Swedish shares on a foreign multilateral trading facility (MTF) will continue even if trading has been suspended in Sweden. There is a risk that the problems associated with the coordination of monitoring and trading suspensions will be exploited by some actors, enabling them to trade at incorrect prices.

Changes in the functioning of the market

Competition between trading venues has resulted in a more fragmented trading of shares, which has created business opportunities based on taking advantage of price differences between trading venues. Changes to the trading rules of these venues, such as decreases in the size of trading volumes to a single share and decreases in the smallest possible change in price (tick size), have made it easier to trade in small volumes. The average size of a transaction has decreased and, as a result, alternative trading venues have emerged alongside traditional OTC trade for large-volume trading. These trading venues characteristically do not display the buy and sell prices, and they are therefore sometimes called “dark pools”. In many cases, the buy and sell prices are not needed since the transaction is closed at a reference price, namely the best possible published price. Dark pools occur on regulated markets and MTFs and can be described as trading in hidden order books. They also occur via investment firms as more or less organised internal order matching systems. One important difference between these two is that all parties have access on equal conditions to a dark pool that is operated by a regulated market/MTF, while not all parties have access to the trading venue via investment firms since these firms can choose their customers.

⁹ Source: Thomson Reuters

Trade in Swedish shares

Trade in most traded shares (OMX30)	June 2011
Order book trading (continual trading)	63 %
Opening and closing auctions	7 %
Trade in hidden order books on regulated markets and MTFs	2 %
Negotiated transactions	3 %
OTC including internal order matching systems	25 %

Source: Thomson Reuters

FI does not have access to data about how large the portion of trading in Swedish shares that occurs via the investment firms' internal order matching systems is. However, there is data for all European shares that shows the amount in June 2011 was just over 2 per cent.

Market participants have indicated to FI that larger investors are increasingly opting to trade OTC, i.e. to place their orders with investment firms outside the public regulated markets and MTFs. In addition to the tendency of the public markets to move toward smaller transaction volumes, the problems associated with high frequency trading are also believed to be a cause behind this trend.

There is a risk that an accelerated move toward a larger share of OTC trading will split the market into small investors and high frequency traders on regulated markets and institutional customers via investment firms on unregulated markets. This could raise the uncertainty surrounding price information and increase the risk for a less functional price-setting mechanism.

Supervision assignment of the stock exchanges

The Swedish self-regulation model has functioned well for a long time, but as the competition between stock exchanges and MTFs increases, there is also a greater risk that the stock exchanges will dedicate a smaller portion of their resources to their supervision assignment. There is also a conflict of interest in that the stock exchange must exercise supervision of its own customers. The stock exchanges do have some incentive to conduct certain supervisory tasks well since the implementation of these tasks strengthens confidence in the stock exchange. In the long run, though, the lack of incentives can result in supervision tasks only being carried out to the point that the market place fulfils the statutory requirements by the smallest possible margin. FI is following this development and will analyse the need for legislation amendments in conjunction with the ongoing supervision of MiFID and the Market Abuse Directive (MAD).

FI determined in 2009 that the level of the stock exchanges' accounting supervision is not satisfactory. FI therefore has taken the position that a new process for the supervision of accounting should be investigated and implemented without undue delay. FI presented its position to the Government, which resulted in an investigation that was concluded during the spring of 2011 and should shortly be submitted to the market for review.

Until the new process has been implemented, the accounting supervision will continue as before with an unchanged responsibility for the stock exchanges to carry out this supervision pursuant to the requirements laid down by law and regulations.

High frequency trading

High frequency trading has experienced rapid growth over the past few years. The phenomenon is most prevalent within the trading of shares, but it is also present on other markets. A computer that trades with high frequency can, over a period of milliseconds, gather and analyse published market data and place orders based on pre-determined rules (algorithmic trade).

The risks associated with high frequency trading span several areas. For example, this type of trading can introduce new operational risks, such as that the systems at market places and stock exchange members can become overloaded. An incorrect algorithm, due to the speed and interaction with other algorithms, can have serious consequences over a very short period of time. This is what happened during the “flash crash” in 2010 when the New York Stock Exchange fell by nine per cent within roughly five minutes, only to return to more or less the pre-crash level around one minute later. Such events risk damaging confidence in the functioning of the markets.

One argument in favour of high frequency trade that is frequently voiced is that it improves liquidity, which in turn results in smaller spreads. Often, though, actors that are trading with high frequency are not under any obligation to provide liquidity. Unlike market makers, they can withdraw from the market during periods of market stress, when liquidity is needed the most. As a result, a market under normal conditions may give the appearance of being liquid, but when faced with financial uncertainty it may become illiquid.

FI is currently investigating high frequency trading in Sweden. The objective of the investigation is to gain a greater understanding for high frequency trading and any risks that may be associated with it, but also to create a picture of how all actors on the Swedish market are affected by this type of trading.

High frequency trading and algorithmic trading have been discussed within international forums. The European Securities and Markets Authority (ESMA) has published a proposal for guidelines related to high frequency trading. The proposed guidelines focus primarily on strengthening control functions and security systems. In addition, the EU Commission will address this topic in a number of places in its proposed MiFID Review directive. FI intends to continue the work within ESMA, MiFID and MAD.

Transparency and endowment insurance

People who hold an insider position in listed companies must report all changes in their holdings to FI. In last year’s risk report, FI drew attention to the fact that an increasing number of persons holding insider positions are using despository-linked endowment insurance to trade in shares in the company in which the insider position is held. This trade is not covered by the reporting obligation that normally applies to persons holding insider positions since the shares in the endowment insurance are formally owned by the insurance company. One consequence of this is that the transparency of trades made by persons holding insider positions is incomplete.

Via a decision on 10 March 2011, FI received an assignment from the Government to investigate if there is a need to improve transparency on the market by expanding the reporting obligation to also apply to shares

held via an endowment insurance. FI submitted its report to the Government in a memorandum on 31 October 2011. In the memorandum, FI proposed that the Swedish Act (2000:1087) on Reporting Obligations for Certain Holdings of Financial Instruments be amended. The amendments would entail that trades carried out by persons holding insider positions and their close relations via endowment insurances should also be reported to FI's insider register.

Risks to Swedish consumers

During periods when the stock markets and interest rate markets are showing a downward trend, there is a risk that complex products that promise a guaranteed return will increase in popularity. There is a risk that consumers will make an unsuitable investment as a result of marketers and insurance intermediaries or other advisors circumventing the statutory requirements regulating financial advice.

Finansinspektionen (FI) strives to ensure that the consumer protection within the financial system is satisfactory.¹⁰ Important components of FI's supervision within the consumer market are to ensure that financial undertakings can fulfil their commitments, ensure that the undertakings comply with their obligations to the customer and promote financial awareness among consumers. Undertakings, on the other hand, must offer products that are suitable for the consumers and provide them with good advice and comprehensible conditions.

Important objectives are to strengthen the consumers' position on the financial market and counteract abuse. FI's assignment as a supervisory authority for financial undertakings is to safeguard the interests of the consumer in general, for example by monitoring how the undertakings provide their customers with information, how they formulate agreements and how they handle complaints. However, FI does not resolve disputes between undertakings and individual consumers, assess individual products or become involved in any similar activities for individuals. FI is of course interested to hear about what happens to individual consumers, because this can often reveal general problems.

Financial products can be difficult to understand since they are often both complex and refer to a long period of time. For example, compound interest and present value calculations are important concepts that are difficult for many consumers to understand. In these issues FI has an important role as the protector of a sound financial system, which ultimately benefits consumers.

RISKS TO SWEDISH CONSUMERS

Unsuitable investments

The assessment of whether an investment is suitable or unsuitable must be based on the consumer's perspective, for example the consumer's time horizon, financial position, proclivity to take risk and financial knowledge. The features of a specific type of product can be such that it is suitable for only a very small number of people, but it is not to these people that the product is marketed.

FI believes that undertakings providing such products should take a greater responsibility for implementing measures that ensure that different types of products are offered to the investors they are most suitable for.

There are many reasons why consumers make unsuitable investments. In some cases, products are complex regardless of the level of knowledge of

¹⁰ Regulation 2009:93

the consumer and in other cases the consumer does not have the knowledge that is required, which makes it difficult for them to make a good decision. Sometimes the consumers do not actually use the knowledge that they have. Another important component is that advice is not given based on what is best for the consumer, but rather which product will give the salesperson the largest commission.

The problem of complex financial products can to some extent be resolved by increasing the knowledge of consumers with regard to financial issues. FI has an important role here in promoting financial awareness in society. However, consumers themselves carry a large portion of the responsibility in that they must take the time to learn about financial issues in order to strengthen the consumer protection.

Complex products

There is considerable innovation on the market and new products with derivative components that are hard to analyse are regularly introduced. The complexity is rooted in the fact that the products are not only difficult to break-down but that they are also complicated. With regard to the former, it is difficult for consumer to get all of the relevant information. With regard to the latter, it is difficult to analyse the benefit of a product even if everything there is to know about the product is available.

FI believes that there is a risk that an insufficient understanding of the products' features by both consumers and advisors can lead to unsuitable investment decisions.

There are many possible reasons for why the market for complex products has grown. Due to the fluctuations on the stock market, from a consumer perspective it can be an attractive idea to invest in products with a certain level of guaranteed return (for example equity-linked bonds). This can also be interesting from a producer/intermediary perspective since the complexity makes it more difficult to compare prices. It is in general completely impossible for the consumer to calculate how large the total commissions are. The confusion increases when the complex products are also packaged as an insurance, with different types of fees and conditions.

It is worth noting that some products are by nature complex since they exist because of a complex need. Traditional life insurance is one example, since the payments will be made at some point far in the future and over an undetermined period of time, which makes it difficult to construct the products in a simple manner.

Complex products

The risks that are inherent in many structured products, and which make them complex, can be illustrated by a bond for which the yield is linked to the price of oil. The investor believed that the price of oil would rise, which also happened in reality – the price of oil more than doubled. Despite this increase, the security did not generate a return. The reason was that when the yield was calculated, the increase in the price of oil during the best six months was almost completely excluded - these months were included at only a 2.5 per cent increase. The months during which the price of oil went down, however, were included in full. The effect of this was that there was no yield and the investor only received the nominal amount upon maturity.

A description of how the yield would be calculated was included in the prospectus provided in conjunction with the issue of the security. However, most consumers do not read the prospectus, and even if some do, they must also understand what the consequences will be if the yield is calculated in the manner described above. In order to do so, a person must be very knowledgeable about how the price of oil usually or can fluctuate and the effects that this will have on the model.

In practice, the investment decision for the majority of private individuals is dependent on the advisor's recommendation. It is also normal for advisors to be absolved of responsibility since the purchase agreement refers to the comprehensive conditions in the prospectus.

Insufficient interest and knowledge from consumers

Even if Swedish consumers from an international perspective have a high general level of education, a number of studies and surveys from recent years show that financial behaviour and decision-making is far from uniform and rational.¹¹ The studies show that there are knowledge gaps that clearly influence how many consumers manage their pension savings. These gaps also make it difficult to compare savings forms such as interest and cost calculations for loans.

Even in a market that meets strict demands on facts, information and a competitive financial selection, there is a risk that the behaviour of consumers will be affected and steered by a lack of knowledge and interest. Deregulations and the transfer of responsibility and decisions to individuals and households over recent decades has meant that consumers are today facing higher requirements. Even if the best consumer protection is created by knowledgeable and active consumers, FI has an important role in promoting good consumer protection.

The act of giving advice

Financial advice is part of the sales process and FI believes that an important step in supporting consumers is to decrease the amount of documentation and facilitate a well-grounded decision-making process based on an individual's own financial position. Financial advice should fulfil two objectives: to provide the right product and to provide the right supplier of the product, i.e. the best conditions for a specific product. Consumers can receive advice directly from the producers, such as insurance companies and banks, but also from actors who have specialised in being advisors and intermediaries. There is a large need for advice during times of financial turbulence or when the supply of complex financial products is large.

FI has previously highlighted the problems related to the legal boundaries that apply to the meeting or conversation between a consumer and the person the consumer perceives to be an advisor. Consumers are often completely unaware of these problems at the time they meet or in any other manner talk to their advisor. What the consumer has perceived to be investment advice, i.e. that the advisor has recommended an investment, was only, according to the advisor, a marketing exercise. Consum-

¹¹ The most recent survey of knowledge gaps within households that FI conducted in 2011 was carried out in cooperation with a large number of advisors within the Financial Sector Union of Sweden and municipalities via budget and debt advisors and consumer counselors.

ers have often signed documents confirming this and thereby placed themselves in a weaker position, legally speaking.

For FI, it is a challenge to find out in an efficient manner what was said in the contact between the firm and the consumer. It is common for the consumer's observations to not agree with what is set out in the firm's guidelines and instructions and what was documented. The observations also do not agree with FI's perception of good consumer advice. Many of the disputes that are handled by the National Board for Consumer Complaints and the complaints that FI receives indicate that this is a problem.

Commission-based remuneration

A fundamental problem facing consumer protection is the incentive structures, which are built around paying advisors in the form of commission on the products they sell. A consumer looking for independent advice does not pay a direct fee for the advisor's services. This is a normal remuneration structure in insurance intermediaries, banks and insurance companies. There is a risk, though, that the advice that is offered will be steered by what is best for the advisor, not what is best for the consumer. Often, the largest commissions are linked to the most complex products with high risk, which means that that advice, or sales pitch, tends to be directed toward these products. At the same time, however, the need for advice is considerable since it is difficult for consumers to find truly independent advice that only focuses on what is best for the consumer. Even independent advisors' or intermediaries' advice tends to refer to products from a relatively narrow group of producers and the earning potential can influence the selection.

FI is of the opinion that the regulatory framework cannot effectively manage risks that are a consequence of the business model, and FI thinks a ban on commissions would be a positive step.

Another problem is that the regulations governing insurance intermediation were written during a time when advice on financial instruments was not as common in conjunction with the provision of insurance. This means that today's requirements on competence may need to be tightened with regard to advice on financial instruments in insurance, in particular given the increasing complexity of products. A project is underway within FI to review the regulations in this area.

CONSUMER RISKS ON THE LENDING MARKET

Unsecured loans

Consumer protection has not functioned particularly well in recent years with regard to unsecured loans. There is a risk that consumers will take on debt at unreasonable interest rates and not have the repayment capacity that should be demanded for such loans. In order to counteract this risk, a new Consumer Credit Act entered into force. FI believes that the risk associated with unsecured loans decreased following the enforcement of the act, mainly due to stricter requirements on credit assessments.

The Swedish Consumer Agency has taken action against incorrect fees and interest rates in its capacity as a supervisory authority. The Swedish Consumer Agency's supervision and sanctions, combined with the tightening of regulations in 2011, are thought to have had a restraining effect on the operations of firms specialising in unsecured loans.

On assignment from the Government, FI investigated in 2011 the system of registered firms (to which firms specialising in unsecured loans belong) that are not subject to supervision. FI has reached the conclusion that all firms that lend to consumers should be subject to an obligation to receive authorisation to become a consumer credit undertaking¹².

The combination of the stricter requirements in the new Consumer Credit Act and the placement of firms specialising in unsecured loans under FI's supervision would further alleviate these risks.

The Consumer Credit Act

The new Swedish Consumer Credit Act entered into force on 1 January 2011 and stipulates that anyone who wants to borrow money must undergo a credit assessment. The former exception provisions for small amounts and short maturities have been removed. All borrowers must now be told the effective interest rate on the loan and receive clearer information before entering into the agreement. In addition, a right of withdrawal has been introduced that is similar to the one that already applies for distance and doorstep selling. FI believes that this has reduced the risk of growing indebtedness. It will become easier for consumers to receive the factual data they need to make a rational decision. This should have a positive effect on the individual consumer, the financial market and the national treasury. Firms will have to meet higher standard requirements and competition on the market will become more like that among credit institutions.

Mortgages

Since last year's risk report, FI has spent a considerable amount of time researching the risks on the mortgage market. On 1 October 2010, FI's mortgage cap went into effect to give consumers an incentive to limit their indebtedness.¹³

The mortgage cap was preceded by several years of historically low interest rates on the Swedish mortgage market, which had a significantly positive effect on consumers in their role as borrowers, but it also contributed to a rapid growth in indebtedness. In order to stop this development, FI introduced new general guidelines on the loan-to-value ratio of properties with effect from 1 October 2010. These general guidelines meant that new loans must not exceed 85 per cent of the property's market value. The mortgage cap should counteract the use of higher loan-to-value ratios by banks and other credit institutions as a means of competition, and increase the incentives for households to limit their debt and thereby create better protection for the future. These rules only apply to new loans or extensions to existing loans that use the home as collateral.

During the first quarter of the year, FI asked the credit managers at seven Swedish banks to describe their experiences following the introduction of FI's mortgage cap. As a whole, the banks stated that they had become more restrictive in granting loans at higher loan-to-value ratios and that

12 <http://www.fi.se/Utredningar/Skrivelser/Listan/FI-vill-ha-tillsyn-over-snabblaneforetagen/>

13 <http://www.fi.se/Regler/FIs-forfattningar/Samtliga-forfattningar/20102/>

the mortgage cap therefore has had an impact. It is important to point out that multiple factors, such as higher interest rates and economic uncertainty, affect the behaviour of households, including the demand for mortgages. FI is currently conducting a survey about mortgages and will present the results in the beginning of 2012. The survey contains a large random sample and more detailed questions than the survey conducted in 2009. One of the main objectives of this survey is to study if FI's mortgage cap has had an effect on new lending.

Finansinspektionen's expert panel

This year's panel, which includes Markus K. Brunnermeier (Princeton University), Douglas W. Diamond (University of Chicago), Albert S. Kyle (University of Maryland), Marco Pagano (University of Naples Federico II) and Raghuram G. Rajan (University of Chicago), highlights the sovereign debt crisis in Europe and its potential consequences for the European banking system as the most important issues facing the future development of the financial market.

Every year, Finansinspektionen turns to a group of renowned experts to assess risks to the macroeconomic situation and the financial system from an international perspective. This year's panel includes Markus K. Brunnermeier (Princeton University), Douglas W. Diamond (University of Chicago), Albert S. Kyle (University of Maryland), Marco Pagano (University of Naples Federico II) and Raghuram G. Rajan (University of Chicago).

SIGNIFICANT ECONOMIC DEVELOPMENTS AND RISKS

- What do you see as the major macroeconomic risks in the next twelve months in terms of impact on the financial system?
- What risk do growing public debt burdens and fear for sovereign defaults or credit downgrades pose to recovery?
- What is your take on the trade-off between budgetary discipline and stimulus to the economy in affected countries?
- Should the central bank allow or even try to reach inflation targets that are significantly higher than 2 per cent in order to deflate debts?

All panel members agree that the main macroeconomic risk is posed by the sovereign debt crisis in Europe and potential contagion to banks. Many European banks have large exposures to countries with high sovereign debt and high indebtedness as well as weak capital. An uncontrolled default by Greece, possibly accompanied by haircuts on other sovereigns' debt, is likely to trigger bank insolvencies and bank runs throughout the euro area. Fear of default by Italy or Spain is a material risk, and this risk may be perceived to increase by a default of Greece. A general run on European banks could have a dramatic impact on economic activity, dragging not only euro-area countries but also their trading partners into a true depression.

Another major macroeconomic risk raised by a couple of the panel experts is a significant slowdown in China. Many countries today, including Germany, are greatly dependent on exports to China. Two members also mentioned the fiscal situation in the U.S. The limited budgetary resources to stimulate the economy, and to recapitalise banks, could result in lower growth in the U.S.

In terms of desirable policy, a majority of members concluded that relaxing budgetary discipline would only harm the economy of GIIPS countries. Economic stimulus at this point would only further destabilise these economies by worsening investors' expectations about their solvency, hence raising yields and destabilising domestic banks. Indeed,

safe-guarding the Euro in the current economic environment requires all its members to practice budgetary discipline.

On the question of monetary policy, the panel members agreed that accelerating inflation only would provide temporary relief. Even if central banks were able to produce unexpected inflation in the short run, thus deflating the real value of public debt, it would soon lead to higher interest rates. Some members also raised concerns that this kind of experiment would pose a great risk to central banks' credibility in the future.

RISKS FOR SPECIFIC SECTORS AND INSTITUTIONS (BANKS, INSURANCE COMPANIES, MANAGEMENT COMPANIES, HOUSEHOLDS)

- In your opinion, how far have banks and other financial institutions come in their recovery since the last report?
- Should European banks undergo a recapitalization and - if yes - when?
- What risks do you see from a prolonged period of very low interest rates?

The panel agrees that European banks as a whole are in a worse position than they were one year ago due to the intensified sovereign debt crisis and the lack of recapitalisation. U.S. banks are also worse off due to increased losses on real estate. Both European and U.S. banks are suffering from lower growth expectations than last year.

A couple of the experts brought up the deteriorating situation for insurance companies and mutual funds. These have been affected due to the large capital losses induced by sovereign debt price drops, which have also spilled over to equities.

Recapitalisation of European banks is the most urgent problem facing Europe. If European banks are not recapitalised, this will hamper credit supply and be a drag on economic growth. Furthermore, even if a Greek default can be avoided, the possibility of future defaults will still weigh down the European banking system and discourage lending. Several experts emphasised that recapitalisation should to the largest extent possible be done by private investors, e.g. in the form of rights issues, rather than at the expense of European taxpayers.

A majority of the panel members think that the major risk with a prolonged period of low interest rates is a renewed search for yield, i.e. that investors prefer riskier asset classes. One expert is particularly worried about the pension funds and insurance companies in this regard. Another expert brings up major capital inflows to emerging markets. These inflows lead to significant currency appreciation, which is hard to counter, and there is a risk that this capital will suddenly disappear if interest rates in Europe increase.

DESIRED AND EXPECTED REGULATORY CHANGES AND ACTIONS BY AUTHORITIES

- What is your view on the relative costs and benefits of higher capital and liquidity requirements? Is Basel 3 enough or do countries need to go further?
- Do you see a risk that requirements will be watered down during national implementation?
- Should “macroprudential” tools such as countercyclical buffers be entrusted with an independent authority/central bank or should they be kept under political control?
- Do you think there is a need for additional direct regulation of the shadow banking sector, such as hedge funds, or is it enough to regulate/monitor banks’ interactions with this sector?
- Do you see a need to regulate high-frequency trading? If yes, why?

The majority of the panel agrees on the importance of higher capital requirements. Significantly higher equity requirements improve the safety of the banking system and the overall economy, which means there are large social benefits that can be gained. Some mention it is not only the level of capital but also the design of new requirements, including ways of forcing banks to recapitalise. Some panel experts are in favour of much higher capital requirements than those in the current Basel 3 proposal.

A majority of the panel experts fears that the Basel 3 requirements may be watered down during national implementation. One reason for this is the close connection between banks and governments in many countries. A recapitalisation by new shareholders will lead to a dilution of the stakes of current controlling shareholders, which may be politically sensitive.

The majority of the panel agrees that macroprudential tools such as countercyclical buffers should be entrusted with an independent authority rather than placed under political control. The major reason for this is because the setting of macro-prudential policies must be coordinated with monetary policy. But it is also recognised that a distinction between micro- and macro-prudential regulations may lead to operational problems.

Direct regulation of the shadow banking sector is not needed according to a majority of the panel experts. Both the recent and previous financial crises have stemmed from the behaviour of banks. However, some of the panel experts do see a risk that tougher requirements on banks may cause some businesses to move to the shadow banking sector. It is therefore important that regulators collect data to be able to monitor such developments.

The panel is divided when it comes to the question of high frequency trading. Some members think that there is little evidence that high frequency trading contributes in a positive manner. Others argue that it is not clear that it does much harm either. In this situation, it appears rather premature to regulate or discourage high frequency trading, but it is an issue that needs to be very carefully studied and stay on the radar screen of regulators. In any event, it cannot be regulated appropriately at the national or even European level because high frequency traders would move to other markets: it requires a “global agreement”.

Glossary

Assets covering technical provisions The Insurance Business Act stipulates that the company must have liquid assets to cover its technical provisions. The purpose is to protect policyholders in the event of bankruptcy. Not all asset classes are eligible for coverage, and for less liquid assets the company may only include a smaller portion of the market value.

Basel Committee/Basel regulations The Committee that negotiates the regulations for banks and credit institutions that will apply on a global level. Examples of accords include capital requirements for credit institutions, liquidity reserve requirements and requirements on credit institutions to publish information. The first regulatory framework was created in 1988 and was called Basel 1. Basel 3 is currently being discussed and designed and it will enter into force in 2013.

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

Capital adequacy ratio Relationship between own funds and the capital requirement. For insurance undertakings, this relationship is represented by the solvency ratio.

Capital requirement According to the rules governing capital adequacy, the capital requirement is linked to the bank's current and future risk profile, a self-conducted measurement of risk and an assessment of risk capital needs. The capital requirement for insurance undertakings is reflected by its required solvency margin.

CDS Financial instruments that are constructed to transfer the credit risk in an underlying asset from one party to another.

CRD 3/CRD 4 (Capital Requirements Directive) CRD at its origin consisted of two EU directives on capital requirements for credit institutions. CRD 3 is an amendment directive decided in October 2010 regarding securitisation, remuneration policy and requirements on the capital requirements in the trading book. CRD 4 is the EU's implementation of the Basel 3 regulations. It will primarily consist of a directive and a regulation.

Common equity Tier 1 capital Consists of equity, i.e. share capital and accumulated non-distributed profits. This capital has the highest quality and therefore can absorb the most losses.

Common equity Tier 1 capital ratio Relationship between common equity Tier 1 capital and risk-weighted assets

Correlation A statistical measure of covariance. High correlation between different assets means that they have a tendency to rise and fall at the same time.

Covered bonds Bonds issued by banks and credit market companies, the issuance of which requires special authorisation. In the event the institution enters bankruptcy, the bond holders have a special right of priority to collateral that consists primarily of mortgages.

Dark Pools Trade where prices and volumes are not made public for third parties.

EBA (European Banking Authority) The EU supervisory authority that regulates the banks.

EFSF (European Financial Stability Facility) A legal entity used as a facility to lend money to euro zone countries that can no longer borrow on the markets. The facility is funded via guarantees from the Euro-area countries.

Endowment insurance A person who owns endowment insurance legally only owns the insurance and not the assets underlying the insurance. These securities are owned by the insurance company. A person who owns the shares indirectly through endowment insurance does not have any voting rights for these shares. Whether the insurance company votes for the holding or not is stated in each insurance company's owner policy.

ESMA (European Securities and Markets Authority) The EU supervisory authority that regulates the securities markets.

Exposure classes Exposures (e.g. from the banks' lending) are divided into different classes in order to determine the capital adequacy coverage. Two examples of exposure classes are exposures to corporates and exposures to households.

High frequency trading A type of algorithmic trading. Automated trading in which the investment decisions are made very quickly by a computer that has been programmed to read the market's movements and the behaviour of different actors.

Interest rate risk A measure of the sensitivity of financial assets and liabilities. Interest rate risk measures how the value of financial assets and liabilities changes when the market rates rise and fall.

Insider A person who, through their position in a listed company, is considered to be in a particularly good position to gain access to price-sensitive information about this company. Insiders must report to FI all changes in their holdings in order to prevent the abuse of price-sensitive information.

iTraxx A group of credit derivative indices that are monitored by International Index Company (IIC) for the purpose of increasing liquidity and transparency on the credit derivative market.

LCR Liquidity Coverage Ratio, a measure of liquidity.

Liquidity reserve Funds held to secure the institution's short-term payment capacity.

Liquidity risk The risk that an actor will suffer losses if forced into unfavourable transactions at a time when the market is illiquid. The risk is that the actor will be forced to buy or sell something at significantly lower prices than when the market is liquid.

MAD (Market Abuse Directive) Directive 2003/6/EC regarding insider dealing and market manipulation.

Market maker A party that has undertaken to list on an ongoing basis the purchase and sell prices of certain securities and thereby maintain a market.

Maturity The amount of time remaining until the payment of a liability or until a bond falls due. The longer the maturity, the larger the interest rate risk.

MiFID (Markets in Financial Instruments Directive) Directive 2004/39/EC on markets in financial instruments.

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

Net interest rate The difference between interest-bearing assets (such as lending) and interest-bearing liabilities (such as deposits).

NSFR Net Stable Funding Ratio, a structural measure of funding.

Operational risk Operational risk is defined as the risk of losses arising

from inadequate or failed internal processes, human error, incorrect systems or external events.

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

OTC derivative OTC derivatives are derivatives that are traded between two parties without using a market place and that are characterised by either fully or partly concealed order information.

Own funds Own funds are the sum of equity, untaxed reserves and some subordinated loans less intangible assets and dividends.

Required solvency margin The required solvency margin is the lowest permissible level for the available solvency margin (solvency requirement or capital requirement). The calculation of the required solvency margin is based on the company's nature and scope.

Risk-weighted assets By combining the value of all of the assets of a bank and risk-weighting these assets using certain weights, it is possible to produce a single value for the risk-weighted assets in the bank.

Savings ratio Households' savings in relation to disposable income.

Shadow banking Operations similar to those of banks which are conducted by firms not subject to supervision or unregulated banking operations by institutions that are subject to supervision.

Solvency The ability to meet liabilities or undertaken commitments to policyholders. One way to strengthen a company's solvency is to create sufficiently large equity reserves to cover potential future losses.

Solvency ratio The solvency ratio is the available solvency margin divided by the required solvency margin. If the solvency ratio does not exceed 1, the company has inadequate solvency.

Structured products Financial instruments or securities with a tailored yield profile. A structured product is often a compilation of a number of simpler financial instruments, e.g. bonds, forwards and options. One example of a structured product is an equity-linked bond.

Supervisory review and evaluation process (SREP) An internal, annual capital assessment that FI conducts on each individual credit institution. The SREP varies depending on the complexity and scope of each institution.

Tier 1 capital A simplified definition of Tier 1 capital is the restricted capital deposited in the bank. No other party may draw on this capital and it must be available to handle losses that arise. Tier 1 capital consists primarily of equity, share capital (the capital shareholders have contributed to the company), and profits in the company.

Tier 1 capital ratio. By combining the value of all of the assets (investments) of a bank and risk-weighting these assets using certain weights, it is possible to produce a single value for the risk-weighted assets in the bank. The share of Tier 1 capital of this total is called the Tier 1 capital ratio. For example, investments in treasury securities in the home currency are normally considered to be completely secure and, therefore, have a weight of 0, while, perhaps, a mortgage loan that is secured by residential property is given a weight of 50.

Traditional life insurance An insurance-linked savings product where the insurance company guarantees a certain low return on the savings. The insurance company carries the financial risk, as opposed to a unit-linked insurance where the policyholder carries the entire financial risk.



Finansinspektionen
Box 7821, 103 97 Stockholm
Street address Brunnsgatan 3
Telephone +46 8 787 80 00
Fax + 46 8 24 13 35
finansinspektionen@fi.se

www.fi.se