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# Financial sector stability – October 2003

# Foreword

Finansinspektionen (FI), publishes yearly, by request of the Ministry of Finance, a report describing and analyzing the situation in the financial sector, focused on factors and issues relevant to financial stability. The report was published on October 15. Here, the main findings are summarized. Moreover, you will also find a brief discussion on structural factors relevant to FI:s work and organization in the coming years.

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# The Swedish financial sector – October 2003

## The life insurance sector

In the last decade, the insurance sector has undergone a process of deregulation, involving a greater freedom to use different types of assets in their balance sheets to achieve higher returns, and ultimately, to provide better pensions etc. for their customers. The process as well as its effects – considering both its positive and negative aspects – is in many ways similar to what happened in the banking sector in the late 1980's and early 1990's. On the negative side, the greater freedom to undertake certain financial risks in their portfolios – and in combination with the three-year decline in equity prices – have resulted in serious problems for a number of companies. Moreover, the trend towards lower interest rates that has prevailed until recently, have further aggravated the situation.

In terms of solvency, no company is, in FI: s view, facing any threat of failure, making them unable to fulfill their explicit obligations to their customers. However, in a number of companies the solvency ratios have declined in a way necessitating special attention by FI. To this end, FI has set up a special task force to continuously monitor these companies.

Another issue, widely and intensively discussed publicly, relates to the bonus cuts on outgoing and expected future pension payments. Basically, this is a natural consequence of lower asset values, and the need to distribute these effects in a fair and orderly way between present and future retirees. Some companies have implemented such a reallocation, and a number of others will, according to FI: s judgment, have to do the same in the near future. The problem here is mainly an issue of information, where many customers have regarded the high returns obtained in the late 1990's as a level that the companies have an obligation to deliver ever after. Consequently, much public anger and frustration have surfaced, and have been further aggravated by signs of corporate behavior characterized by, in some cases, lax cost control, dubious incentive systems etc.

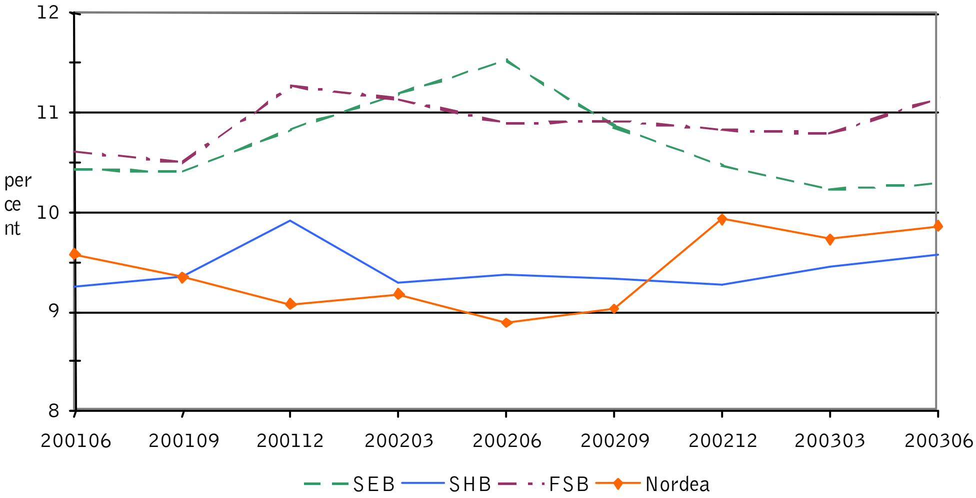
In FI: s view, the life insurance industry is facing problems that to a large extent are exogenous to the industry, i.e. the declining stock market. Nevertheless, in certain respects the industry has acted in a way that has made things a lot worse, the most obvious being the lack of relevant and understandable information to customers.

## The banking sector

In contrast to the insurance sector and other parts of the financial industry severely hit by declining stock market and the low general economic growth, the Swedish banking sector has performed remarkably well. Although lower stock market activity certainly has taken its toll on commission income received by banks, profitability has been good and stable. This reflects growing volumes of lending (primarily residential lending), growing commission income from payment services, active cost cutting, and, last but not least, a very low level of credit losses. Moreover, profitability has generally improved in the second and third quarters of 2003.

This has provided a sound financial basis, which is reflected in the capital adequacy ratios for the four dominating banking groups.

**Capital adequacy (per cent) in the four largest Swedish banking groups, June -01 to June -03**




Looking ahead, FI holds the view that the levels and tendencies when it comes to risk exposures in different areas – credit risks, market risks and liquidity risks – should not be a case for concern. Moreover, since the macroeconomic forecasts indicate an upturn in economic growth in the coming 1-2 years, the prospects for continued stability appears favorable.

Still, it is important not to take a laid-back attitude: the macro-economic situation can suddenly, for unforeseeable reasons, turn much more negative and various operational risks can quickly pose severe threats. Banking is, and will probably always be, a business highly exposed to these kinds of risks.

Seen from a more structural perspective, the Swedish banks are continuing their expansion in the other Nordic countries, in the Baltic States, in Poland and in Germany. One aspect of this is that the risks and risk profiles of the banks will be more complex and more difficult to overlook. This underlines the need for deeper and wider collaboration between the supervisors in these countries.

## New challenges and new ways for financial supervision

The financial sector, in Sweden and elsewhere, is undergoing a process of rapid and profound structural adjustment, precipitated by deregulation, internationalisation and technological change. The effects of these trends are affecting the society, the economy and the financial companies themselves in a number of ways. One aspect of this is that the risks to systemic stability and to the consumer that are inherent in the financial industry changes in scale, scope and character. Naturally, they also affect ends and means when it comes to financial regulation and supervision.

More specifically, the agenda for financial regulation and supervision within the European Union is characterised by the need to adopt common standards to promote financial integration within Europe, ultimately to promote economic growth and prosperity. The so-called *Financial Services Action Plan*, issued by the European Commission constitutes the framework for a number of actions and initiatives, e.g. certain Directives, to this end. The main focus is to develop and to harmonise regulation and supervision in the securities' markets. Roughly speaking, the Financial Services Action Plan and its components have its main focus on creating efficient, integrated securities markets. It should also be noted that improving consumer and investor protection is one aspect of this, besides also being an issue in its own right. There are also important regulatory initiatives directly related to stability issues, with the new Basle Accord on capital adequacy (”Basle II”) as the prime example, something that will affect the supervisory agendas profoundly – and globally - in the coming years. Moreover, in the case of Sweden, a new legislation on Banking is to be implemented next year.

Another important feature in the new financial landscape is the increasing involvement and increasing systemic importance of the consumer. This is most obvious when looking at the equity market, which, at least in Sweden, has in the last ten years moved from a market exclusively dominated by institutional investors and a handful of wealthy individuals, to a market where more or less every citizen have a stake, directly or indirectly. This phenomenon also concerns e.g. the banking market, where consumers now user a much wider array of financial products and, also, a wider array of producers than before. Therefore, consumer protection and consumer confidence are issues growing in scope and importance.

All in all, these changes must and will affect the way supervision is focussed, practised and organised; financial supervision will be more forward-looking, more individualised and more proactive than before. It will also affect the amount and the mix of resources employed in financial supervision.

In the matrix below, the supervisory activity is, starting with the general public goal of economic efficiency, differentiated with respect to its main operational goals – systemic stability and consumer protection – on the horizontal scale. In the vertical dimension one finds the main forms of financial supervision – prudential supervision and market conduct supervision.

| | | Overriding public goal: ECONOMIC EFFICIENCY | |
|---|---|---|---|
| | | **Operational goal: Functionality of the system** | **Operational goal: Consumer Protection** |
| **Supervisory forms** | **Prudential supervision** | **Systemic stability**<br>Promoting financial and operational capacity | **Protecting consumers assets**<br>Promoting financial and operational capacity |
| | **Market Conduct Supervision** | **Systemic efficiency**<br>Promoting fair conduct and high confidence in financial markets | **Information to consumers and investors**<br>Promoting correct and relevant information and fair treatment |

In FI: s view, this provides a good and illustrative mapping of the main supervisory goals and activities, and will hence form a basis for the future organisation of FI. From 2004 on, FI will have one department focussed on prudential supervision for financial firms in all sectors (banks, insurance companies etc), and one department dealing with issues on market conduct, thereby involving consumer protection issues. In addition, there will be a departement for legal issues. The new organisation will be implemented during January 2004.