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The stability of the Swedish financial sector - A summary

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An uncertain environment

Economic observers have for a long time largely agreed that an economic recovery is on the way. Recently, however, the picture has changed; growth forecasts have been toned down and the expected upturn has been deferred. This is important in evaluating the stability of Swedish financial companies.

In this year's report on the stability of the financial sector, Finansinspektionen (Swedish Financial Supervisory Authority) has identified higher risks in a number of areas. The companies' ability to deal with these risks is good, but active measures are required.

A number of critical factors can lead to increased risks for both financial companies and for the macroeconomic developement. Moreover, financial problems arising from these risks can interact with macroeconomic factors. The most important are:

– profits in industry and commerce
– imbalance problems in the American economy
– risk aversion and "flight to quality" driving up the costs of capital, and
– the risk of war in the Middle East.

The correction of share prices that has occurred reflects an adaptation to more normal levels. It is not certain, however, that this process has reached its end. In addition, the accounting scandals have caused uncertainty with respect to the quality of financial information. Recently, the uncertainty related to the trend of earnings and loan losses in a number of international banks and finance companies has caused share prices to fall. On the whole, these factors indicate that there is still a risk of a continuing negative trend in profit expectations and share prices.

Problems of imbalance in the American economy have grown in recent years. This applies to the increased household debt, the growing deficit in the Federal budget and, last but not least, the deficit in the current account. This increases the vulnerability of the economy and the risk that events may arise that can contribute to instability, for example through the currency markets.

An armed conflict in the Middle East will affect financial markets in a number of ways, and this risk must be considered when evaluating stability.

The risk that the real estate market will be affected by the decline in prices of shares is also not insignificant. This applies to the United States in particular. A reversal in real estate prices is now also being noted in Sweden but are of less less concern due to the lower indebtedness in the Swedish household sector.

As a result of the uncertain conditions, a tendency toward so-called "flight to quality" has arisen. If this continues and becomes stronger, it will result in a decrease in the supply of risk capital, declining lending to borrowers with lower ratings, and to increasing interest rate spreads.

The general conclusion that Finansinspektionen draws from this, is that the probability of a negative trend involving greater risks in the financial system has increased during the course of 2002.

Banks

The conditions of the financial companies has been affected by important structural changes. In the case of the large banks and some insurance companies, geographical and operational diversification has taken place for a number of years. This is positive in terms of financial stability, due to the better diversification of risk achieved. On the other hand, this imposes new and stricter demands on boards and company managements to adapt an appropriate risk-control to these more complex conditions.

The trend of bank earnings during the past year shows a decline, due primarily to lower commission income and to reduced income in the groups' asset-management and insurance operations. Loan losses have been largely unchanged, but a certain increase in problem loans can be noted. The banks' internal ratings of their borrowers also indicate a certain decrease in credit quality.

As was the case earlier, it is important to continuously monitor and evaluate the targets for financial strength in terms of primary capital and total capital that the banks have established. In Finansinspektionen’s view, the bank groups have satisfactory capital strength relative to the composition of their portfolios and the focus of their respective operations. Considering the great uncertainty that prevails, capital strength is a key factor and the requirements for such strength may increase.

Even if the general macroeconomic situation should continue to be relatively favorable, and although certain possible negative incidents related e.g. to stockmarket developements or to certain sectors should be possible to absorb, there still remain substantial risks and question marks, in particular since a number of the risk factors that have been discussed are clearly linked and may interact and reinforce each other.

The following conclusions may be drawn with respect to the build-up and handling of the risks in banks:

Credit risks
The growth in lending has exceeded the nominal GDP growth for several years. A leveling-off has now occurred, notably in the case of loans to companies. Meanwhile, the level of lending to the household sector is still relatively high. Mortgage loans account for the greater part of this lending.

Where lending to certain risk sectors is involved, Finansinspektionen has analyzed loans to the telecom and real estate sectors in particular. Exposure to the telecom sector is fairly modest and is being monitored actively by the banks. Important here are the risks that can arise if the companies' market financing should be made more difficult and/or much more costly. This could give rise to a rapidly increasing demand for credit addressed to the banking system.

A decline in the price of commercial properties and, to a certain degree in the prices of single-family homes, can be noted. It is, however, primarily the trend of commercial properties that is exposing the banks to greater risks. It may be noted here that the risks related to a decrease in price are generally modest, since the banks have good possibilities to cushion such a decline.

As regards external ratings of banks and corporations, a number of downgradings of nonfinancial companies are being noted. Ratings for the Nordic financial companies are stable, which can be seen as an indication of robustness in the financial system.

Finansinspektionen’s annual survey of risks and risk management in financial companies that are systemically important shows, with respect to the banks, no clear indications of increased risks. This reflects, among other things, the higher level of risk in lending by the banks that was already identified in last year's survey. A continued increase in interest-rate differentiation among borrowers, at the same time that lending is expected to increase, is also foreseen. More recently, however, Finansinspektionen has observed a modest but clear tendency to internal downgradings in the loan portfolios of the larger banks. This may be seen as a sign of an emerging decline in credit quality.

Market risks

The banks' exposure to market risks in currency and securities trading is limited and under control. The same applies to the banks' liquidity risks. Concerning risk-management, important development work has taken place in both of these areas in recent years.

It is worth noting, however, that new aspects of market risks resulting from banks' ownership of life insurance companies has come to the fore; life insurance companies have experienced substantial losses as a result of the downturn in share prices.

Operational risks

Vulnerability to operational risks has increased. This is due in part to the risk of sabotage and external disturbances that has become more evident, and in part to the more complex high-tech environment in which the financial industry is operating. One example of this, realized in connection with the problems surrounding WorldCom, is the dependence on various IT networks and on the suppliers that provide them.

In this area, the results of Finansinspektionen’s annual survey of risk show that companies, although in general having a good awareness of the issues and a good risk-management in this area, have to improve their procedures in certain fields, such as emergency-planning, the handling of information and in countering internal crime.

Insurance companies

The insurance sector is being affected substantially by declining share prices in combination with declining long-term interest rates. The so-called collective consolidation has fallen below 100 and solvency has been affected negatively, which is imposing demands for active adjustment measures in companies.

This trend has taken a number of life insurance companies close to the limits for the size of their capital base that is established by law. Earlier, in deliberations with life insurance companies, Finansinspektionen has announced stricter requirements pertaining to the adjustment of bonus rates and bonus techniques since it has become clear that most insurance companies will not be able to report satisfactory collective consolidation. In view of this, new general advice will be adopted by Finansinspektionen.

The extreme situation, with sharp declines in stock prices combined with reductions in interest rates, has exposed life insurance companies to special risks.

– Insurance provisions must be adjusted upwards if the so-called highest interest rate that discounts liabilities is adjusted downward due to lower market interest rates.

– A declining interest rate means that the bond portfolio is rising in value, but not enough to match the rising technical allocations, since the average maturity or duration of the bonds is not long enough.

– The decline in value of the share portfolio compounds the negative effect on earnings that arises in connection with a decline in interest rates.

The ability of insurance companies to fully hedge their market risk is thus limited; nor have life insurance companies taken full advantage of opportunities for matching of interest-rate risk that the markets have offered.

A change in the so-called highest interest rate, the cost of capital established by Finansinspektionen, reflecting the general trend of interest rates, has a direct impact on the capital base of life insurance companies. The present rate, 3,5 percent, will have to be re-examined if the interest-rate stays at the current level. Declining interest rates will lead to a lowering of the ”highest interest rate”, and hence to a lower capital base for all companies. Still, a solvency surplus will remain for the sector as a whole.

Nevertheless, Finansinspektionen believes that adjustment measures must be taken to counteract the risks of financial instability that have been identified. A number of companies may then need infusions of risk capital in order to meet statutory solvency requirements.

To sum up, Finansinspektionen’s analysis leads to the conclusion that increased risks could be clearly identified in a number of areas of the financial system. The ability of companies to deal with these risks is good, but active measures are required.