



FINANSINSPEKTIONEN

Supervision Report 2012

MAY 2012



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Foreword

The purpose of the Supervision Report is to describe some of Finansinspektionen's most important experiences of supervision and regulatory development in the past year. Despite robust resilience in the Swedish financial system, the year has featured unease abroad and on financial markets.

The focus of this year's report is mainly on further efforts to strengthen consumer protection on the financial market, chiefly in the areas of insurance companies, insurance intermediaries and mortgages. In terms of financial stability, efforts continue to prepare capital and liquidity requirements for Swedish banks, which reduce the risk of problems threatening our national economy. The importance of placing stringent requirements on financial institutions, their owners and management is also addressed. Finally, it has been concluded that international work is now an integral part of Finansinspektionen's assignment.

It is hoped that this report will lead to better knowledge about Finansinspektionen's operations and the regulations applicable on the financial market.

Finansinspektionen's Board of Directors attended to the report on 20 April and 15 May 2012.

Stockholm 24 May 2012



Martin Andersson

Director General

Summary

The topics brought up in this year's Supervision Report are based on work relating to consumer protection on the financial market and to financial stability, as well as requirements on the firms' owners and management. The increased international work, primarily in the EU, is also addressed.

The main task of Finansinspektionen (FI) is endeavouring to ensure a stable financial system and good consumer protection, which occurs through influencing firms and consumers. The majority of Finansinspektionen's work consists of ongoing supervision that does not result in intervention or changes to the regulatory framework. Occasionally, however, issues emerge that require more fundamental consideration and analysis. A selection of these issues is presented here in the Supervision Report.

Safeguarding consumer protection

One of FI's main tasks is to endeavour to ensure good consumer protection. This can occur in two main ways. Partly, by monitoring firms to ensure that they are solvent and can meet their commitments, and partly by ensuring that they treat their customers correctly. Throughout the year, intense efforts have been under way in both of these areas.

New reality for life insurance companies and occupational pension funds

The financial unease that intensified in the second half of 2011 led to a poorer financial situation for the life insurance companies and occupational pension funds that had issued high guarantees of return to their customers. FI is understanding of the fact that the market climate has been difficult – particularly the very low Swedish government securities rates – and has offered a certain amount of patience with weak solvency, provided that the companies prepare relevant action plans. Although many firms have implemented measures in the past year, FI finds reason to monitor the firms' measures to reach a sustainable situation and ensure protection for policyholders.

Preparing and distributing complex products

In recent years, FI has, in several Risk and Supervision Reports, expressed its concern about the consequences of the increased complexity in financial products sold to consumers. It is difficult for consumers to understand the products and form an opinion about the risks involved in the investments. In 2011, FI therefore initiated a thematic study about complex products. FI can ascertain that, in order to lay the foundation for good consumer protection, better routines are required among the parties that prepare complex products for consumers. It can be, for instance, a matter of assessing how and to whom products should be sold that have a particularly high risk or return possibilities that are hard to understand.

Problems in the supervision of insurance intermediaries

In its ongoing supervision work, FI encounters many cases of customers having bought complex financial products through insurance intermediaries, without understanding the risks involved in them. FI has therefore increased its focus on the intermediaries in its supervision. One problem is that intermediaries that have been subject to special focus by FI

■ Banks interest rate and lending



http://www.fi.se/bru1eng_2012

choose to revoke their authorisation to conduct operations in order to avoid a sanction or negative publicity. Because no sanction has been issued, FI often lacks grounds to deny a new authorisation if the same people start up a new company with similar operations. According to FI, this shortcoming in the regulatory framework should be remedied in order for satisfactory consumer protection to be upheld.

Consumer protection on the mortgage market

FI's latest mortgage survey shows that the mortgage cap works. For the first time since 2002, the first year for which comparable statistics are available, households' loan-to-value ratio for new loans decreased. The share of households with very high loan-to-value ratios also decreased. Monitoring of the mortgage cap indicates that it has had a strongly normative effect. As part of efforts to increase transparency on the mortgage market, FI presents in a special report a simplified model of how banks' margins and funding costs for mortgages can be calculated. The model shows that the funding costs have been affected by experiences from the financial crisis, and also that the margins have increased.

In terms of consumer protection, FI does not only work with supervision of firms, but also has a special assignment to strengthen the position of consumers on the financial market by providing them with information and initiating training courses in personal finances. During the year, a special project has been carried out with labour market parties, "Protect your financial future".

Financial stability remains in focus

The financial crisis of the last few years, which seriously erupted in 2008, has shown just how large the economic costs can be when the banking sector experiences problems. Unease on financial markets and abroad has been a feature of this year too. FI works to ensure that the Swedish financial system is resilient and continues to contribute to a functional national economy.

Stricter requirements on capital and liquidity for banks

One of the most important lessons from the financial crisis is the need for stricter requirements on banks in terms of both capital and liquidity. FI believes, together with the Ministry of Finance and the Riksbank, that in order to safeguard financial stability, Sweden needs to go further in the requirements on banks than those according to the Basel 3 accord and the EU's forthcoming regulations. FI is also reviewing the risk weightings for mortgages, has investigated liquidity risk management and is working on preparing new liquidity regulations.

Increased collaboration in macroprudential policy

The financial crisis showed the importance of financial supervision not just relating to individual firms, but also the system as a whole. Besides systemic risk analysis, it must also be possible to convert the analysis into tangible measures. Both FI and the Riksbank have the task of working in a preventive manner for a stable financial system. During the year, a special council for cooperation on macroprudential policy was established between the authorities aimed at strengthening efforts to safeguard financial stability.

The banks' management of market risks

The risks in deficient management of market risks became clear in the case of HQ Bank in 2010, where the deficiencies were so serious that the bank's authorisation was revoked. Throughout the year, FI has carried

out a comprehensive investigation of market risk management at Swedish financial institutions and can, despite the identification of certain deficiencies, conclude that these currently do not constitute a threat to individual firms or financial stability.

Strict requirements on firms' owners and management

The financial system's central position in the national economy has brought about strict requirements being placed on senior management at financial institutions. FI believes that extra effort must be given to carefully scrutinising owners and senior management, because the costs for society for supervising and dealing with dubious players are so high.

In-depth ownership and management assessments

The financial crisis in recent years has shown the importance of financially stable owners and competent and suitable management. FI's supervision also shows the need for thorough assessment of the people to be granted authorisation to offer or mediate financial services and products. Subsequent verification is not enough – fundamental assessment of competence must be carried out from the start at a financial institution. During the year, FI has conducted a special project on how owner and manager assessment can be deepened. Also, judicial proceedings are under way that should contribute to clarifying the governing law in the area and that might lead to a need for further changes in the regulatory framework.

Internal governance and control

Great attention is paid to matters regarding internal governance and control, not just from FI but also international bodies. FI has again observed deficiencies at the Swedish firms. Several interventions have been carried out in light of these deficiencies, including in risk management and control functions. In the insurance area, FI was of the opinion that Försäkringsbolaget E.N. Sak Försäkring i Europa AB had such large deficiencies that its authorisation to conduct operations was revoked.

Listed companies and supervision

In 2011, FI decided on penalties in a large number of cases as a result of breaches of disclosure and notification rules. As part of efforts to reduce the number of future breaches, FI has prepared a guide for listed companies and insiders and has conducted seminars on this topic. In order to improve transparency in terms of insiders' holdings of securities in their own company, FI has submitted a letter to the Ministry of Finance with the proposal that reporting obligations should also cover holdings through endowment insurance.

The scope of international work is on the rise

In Sweden and other countries, supervision is going from being based on individual firms to becoming more international and focused on risks in groups of companies and the financial system as a whole. Several authorities have been established in Europe and cooperation has commenced, mainly through the three European supervisory authorities for the banking, insurance and securities markets as well as the European Systemic Risk Board. Integrated financial markets require that FI plays an active role in international efforts and regulatory development with a maintained focus on Swedish circumstances.

Goals of Finansinspektionen's operations

Finansinspektionen (FI) has, by instruction and letter of appropriation, been given two main goals from the Government: endeavouring to ensure a stable and functional financial system and endeavouring to ensure good consumer protection in the financial system. In order to reach the goals, FI has access to several means and can intervene against firms that do not comply with the regulations.

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

FINANCIAL STABILITY

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

Problems in a financial institution can affect the entire economy

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

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

CONSUMER PROTECTION

The financial sector's nature of infrastructure is also mirrored in the fact that, as consumers, we use financial services pretty much on a daily basis. Some of the financial products we use are crucial to our entire financial situation. The products can also have a very long delivery time

(pension saving, for example), and becoming familiar with them can be difficult.

The products are complex and hard to evaluate

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

Why does the market fail to achieve sufficient consumer protection?

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

Protection of assets, correct information and fair terms

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

In addition to stable firms, it is required that the companies provide correct and clear information, as well as fair terms, to reduce the disadvantage of consumers. This is of particular importance when the products sold become increasingly complex.

The consumer's own role

FI is working to reduce the disadvantage of consumers by placing demands on firms. In addition to this, better financial knowledge is a way of strengthening consumer protection. FI is therefore focusing on training projects at schools and workplaces. More knowledgeable consumers can, in turn, place higher demands on and even be more critical of the offers they receive.

INTERNATIONAL WORK

The fact that FI is a national authority with cross-border operations on a global market is a fact made clear in the latest financial crisis and the unease that has now arisen due to the sovereign debt problems in

Europe. International cooperation is necessary to reach solutions and efficient supervision at a national level too. FI must play an active role in the international debate and regulatory development with a maintained focus on Swedish circumstances. Largely all fundamental financial regulation applicable in Sweden is decided today at the EU level. The new European supervisory authorities have an important role in regulatory development, both as advisors to the EU Commission and as authors of new regulations, so-called technical standards or guidelines. FI therefore spends a lot of time on participating in the work of these authorities.

Negative effects of regulations must be taken into account

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

FINANSINSPEKTIONEN'S MEANS

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

Authorisation, regulations and supervision

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

Interventions

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

formal sanctioning means. However, sometimes the breaches are so serious that an intervention is necessary.

The responsibility of the firms

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

Consumer protection on the financial market

During the year, the work of Finansinspektionen (FI) with consumer protection on the financial market has been focused, for instance, on protecting the interests of insurance policyholders and verifying the market risks among life insurance companies with problems. FI has also called attention to how complex financial products are created and sold to consumers. A new mortgage survey has been carried out and the results show that the mortgage cap works.

One of FI's primary tasks is to endeavour to ensure good consumer protection. This can occur in two main ways. Partly, by monitoring firms to ensure that they are solvent and can meet their commitments, and partly by ensuring that they treat their customers correctly. The section about life insurance companies in this year's consumer chapter is about the first method, i.e. monitoring to ensure that the firms have sufficient assets to meet their commitments. The sections on complex products and mortgages are first and foremost about how customers are not always offered suitable products. In terms of insurance intermediaries, a special problem is touched upon relating to how dubious intermediary companies can avoid sanctions and counteract the purpose of the regulatory frameworks for authorisation assessment. In addition to this, FI is conducting special initiatives to increase consumer knowledge, with a focus this year on a successful collaboration with the trade unions.

NEW REALITY FOR LIFE INSURANCE COMPANIES AND OCCUPATIONAL PENSION FUNDS

The financial unease in the past year has had several unfavourable effects for life insurance companies and occupational pension funds. The value of the companies' assets has decreased as share prices have fallen, while lower interest rates have led to a rise in the present value of their liabilities. This has resulted in a poorer financial situation for the companies and solvency ratios have fallen, in some cases sharply. This has affected occupational pension funds the most. However, the deterioration in solvency is also tangible among life insurance companies which have issued high return guarantees to their customers. Although many companies have implemented measures in the past year, FI finds reason to monitor the companies' further measures to reach a sustainable situation in the long term and safeguard the interests of policyholders.

Monitoring policyholders' interests is particularly important on occasions where there is a risk of conflicts of interest. In the winter of 2012, a major and complex transaction was carried out on the Swedish insurance market when Livförsäkringsaktiebolaget Skandia ("Skandia Liv") bought Försäkrings-aktiebolaget Skandia ("Skandia") from Old Mutual plc. FI had to monitor to ensure that the interests of policyholders were not overlooked and that unlawful profit distribution did not occur.

How the regulations protect policyholders

The regulations in the insurance area place several different requirements on the insurance companies so that they may deliver on their promises to policyholders. Policyholder protection is important because it is often a case of very long-term saving for the individual, the products and

risks are often hard to understand, and it can also be difficult for dissatisfied customers to move their savings from one insurance company to another. Also, in mutual companies, policyholders carry the majority of the financial risks without having any real influence on the operations. As indicated by FI in the 2010 Supervision Report, unlike in the banking area, there is neither any government guarantee system for consumers' savings in insurance. It is therefore particularly important that the regulatory framework can contribute with thorough consumer protection.

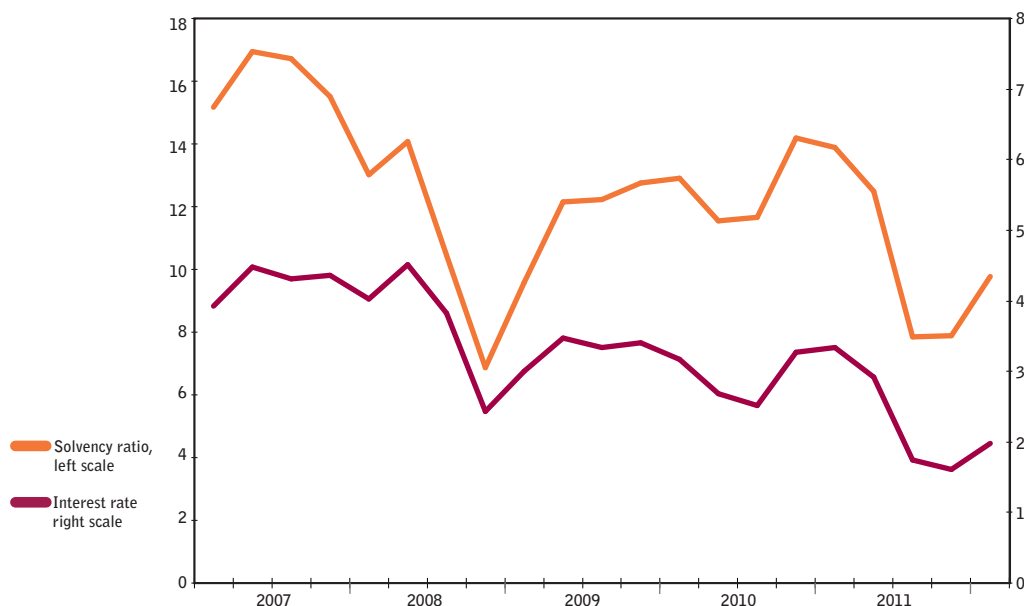
The most important components in the protection are the rules about liability coverage and the solvency regulations. The liability coverage regulations involve the policyholders having priority on assets that, at the least, correspond to the value of the liability owed to them in the event of bankruptcy, and also place requirements on the characteristics of these assets. Adding to this are solvency regulations, which place requirements on the insurance company constantly maintaining a capital base amounting to just over 4 per cent of the value of the liability to policyholders, so that there is a margin for unforeseen events.

The value of the liability is determined by future obligations being discounted by prevailing market rates. This means that when interest rates fall, the liability increases in value. This is logical because a lower interest rate makes it more difficult for the firm to reach a given guaranteed return. If the statutory requirements regarding solvency and liability coverage are not met, the law provides FI with various possibilities and obligations to intervene. For example, the firm might have to draw up a plan to restore its financial position. FI also has the possibility to limit the right of disposal of the assets, or revoke the firm's authorisation.

An unpleasant awakening

The fundamental problem in many pension companies is the high guarantees that are offered, meaning that many customers have the right to a high guaranteed annual return of perhaps 3 per cent or more. Guaranteed interest is as high as 5 per cent in some cases. The transition from the high-rate environment of the 1980s and 1990s, with government bond rates comfortably exceeding 10 per cent, to the current low-rate environment, must be managed and has not been followed by sufficient downward adjustments in guarantees in new agreements. Because of old surpluses, the effects on solvency were not previously considered alarming and the companies have, to a certain extent, refrained from reacting to the trend.

DIAGRAM 1: Solvency ratio and the ten-year rate.



At the beginning of the autumn in 2011, the market trend led to a sharp deterioration in the solvency of several life insurance companies and occupational pension funds. In order to clarify that the companies must themselves take the necessary measures to reach a solution that is sustainable in the long term, FI sent a letter to insurance companies and occupational pension funds at the end of September.¹ FI shared the view that the market climate was difficult – particularly the very low Swedish government securities rates – and offered a certain amount of patience with weak solvency, provided that the companies prepared relevant action plans.

Requirements for measures

Unease on financial markets persisted in the autumn, and FI held close-knit dialogues with several life insurance companies and occupational pension funds, which were working on drawing up and implementing action plans with varying content and effects. At profit-distributing insurance companies, a capital injection from the owner is a natural measure. It is also generally the case that many companies have recently altered their product offering by, for example, lowering guarantee rates, creating products that enable adjusting the guarantees for future premiums, or by completely discontinuing traditional products with guarantees, instead transitioning to products for which customers carry the financial risk. FI's task is not just to monitor consumer protection in the form of the long-term stability of the companies; it must also ensure that individual customers receive correct information in order to be able to make relevant decisions if a company offers altered terms.

In the autumn, many life insurance companies and occupational pension funds also made efforts to reduce the risk in asset portfolios and improve matching between assets and liabilities.

Further need for measures

Now that interest rates are at record-low levels again, there is a greater need for the insurance companies to undertake measures to become more resilient. At the same time, overly rapid actions from many compa-

¹ <http://www.fi.se/Utredningar/Skrivelser/Listan/FI-vill-ge-forsakringsbolagen-extra-tid-for-aterhamtning/>.

nies may risk further stressing an already stressed situation. FI has therefore demonstrated patience and understanding, but requires that the companies and the occupational pension funds review what will happen to their financial position in the event of a prolonged low-rate scenario. The companies must ensure that future agreements do not promise guaranteed rates that are too high and hard to meet, that they improve maturity matching and achieve a more risk-based approach in their operations. Many of these measures will also be required in the forthcoming Solvency 2 regulations.

However, it appears that several occupational pension funds, for instance, have been hesitant in attending to the fundamental problems. There are two main ways of remedying a situation in which existing pension commitments are not sustainable in the long term. In such a situation, employers can make extra contributions, or the commitments in existing agreements must be reviewed. Such solutions are controversial and can be difficult and time consuming to implement. However, they might be necessary in order to revert to a healthy situation in the long term.

Policyholders' interests in hybrid companies

In addition to the ongoing supervision of life insurance companies, during the year FI has had particular reason to review the situation of life insurance policyholders in so-called hybrid companies. A hybrid company is a limited company managed in accordance with the principles of reciprocity. The articles of association of such a company do not permit profit distribution. The share capital is very small and all risk in the company – both business risk and financial risk – is borne by policyholders and the insured through their collective premiums. At the same time, policyholders in a hybrid company have very small possibilities of exercising real influence over the operations and risk-taking.

The possibility afforded by legislation to hybrid constructions entails a risk of conflict of interests. Saving in life insurance can amount to large amounts and be of great importance to the individual. Life insurance products are, in turn, complex by nature and the consumer can easily end up at a disadvantage in terms of information in relation to the insurance provider. In a hybrid company, it is even more difficult for the consumer to understand the risks and which information is relevant. The possibility of influence is non-existent in practice and the possibility to change providers is limited, which makes this even more serious. It is therefore particularly important that FI performs efficient supervision of such companies. The focus of the supervision must be on conflicts of interest between owners and policyholders that can result in different forms of prohibited profit distribution, such as through non-commercial intra-group agreements, non-commercial internal transactions or unfavourable asset management structures.

The case of Skandia (from a hybrid to a mutual company)

Skandia was previously owned by Old Mutual of the UK. In turn, Skandia owned mutual company Skandia Liv. In March 2012, the Board of FI decided to grant Skandia Liv authorisation to acquire the shares in Skandia and indirectly the shares in, for instance, Skandia Fonder and Skandiabanken. The decision was preceded by investigative and analytical work at FI that was much more complex and challenging than for a customary owner assessment. The reason was not only that the purchase price was very high (SEK

22.5 billion) and that several financial institutions were being indirectly acquired, but mainly because Skandia Liv is a hybrid company, i.e. a limited company managed according to principles of reciprocity. FI therefore played a particularly important role in monitoring to ensure that the interests of policyholders were not overlooked and that unlawful profit distribution did not occur.

FI concluded that there were conditions to grant authorisation to Skandia Liv to carry out the acquisitions and that the transaction did not involve an unlawful value transfer from the life insurance company to its owners. Following the transaction, Skandia Liv is now owned by a foundation, and in time (within around a year and a half), the foundation will ensure that Skandia Liv's operations become purely mutual. Even now, the transaction involves a significant reduction in the risk of prohibited profit distribution. However, just as for all mutual insurance companies, the issue remains of policyholders having very limited influence over the company and its management, and of the potential risk of operational governance being affected than interests other than those of the policyholders. There is therefore a sustained strong need for supervision of how policyholders' interests are protected at Skandia

PREPARING AND DISTRIBUTING COMPLEX PRODUCTS

FI has, in several Risk and Supervision Reports, expressed its concern about the consequences of the increased complexity in structured products.² It is difficult for consumers to understand the products and form an opinion about the risks and return possibilities involved in the investments. Because of this, in 2011 FI initiated a thematic study about complex products. The purpose of the study is to follow how these products are developed from start to finish, i.e. from producer to customer, to identify where risks can arise and analyse which measures can be taken to reduce problems.

Supervisory review of complex products

In 2011, FI carried out an initial step of the review through a supervisory review comprising nine issuers and arrangers of structured products. The thematic study continues in 2012 with a closer review among a selection of distributors to investigate, for instance, the competence of advisors and other factors that affect customer protection.

Scope of the supervisory review

The study comprised the process of firms in terms of preparing the products, including the measures they take to ensure the products are adapted to the envisaged target group and what the approval processes are. Additional factors investigated were the firms' distribution strategies, the channels used, whether there were any restrictions on the distribution of certain products and remuneration structures. Finally, the investigation also included reviewing how incentives and other conflicts of interest with regard to the products were managed.

² See, for example, more about risks related to complex products in the 2011 Risk Report s 29 ff. <http://www.fi.se/Utredningar/Rapporter/Listan/Risker-i-det-finansiella-systemet-2011/>.

Better routines are needed in preparing products

The assessment about whether or not a product is suitable shall be made from a customer perspective. In most cases, it cannot be said that a certain product is generally unsuitable for all types of investors. On the other hand, the increased complexity in structured products means that the characteristics can be such that they are probably only suitable for a very limited customer group. Firms must take account of this.

The investigation demonstrates that the preparation of products at many of the investigated firms is primarily based on informal processes. In many cases, there is a lack of a clear structure with written routines, that include quality controls and stress tests of the products, and for which a clear target group has been identified based on criteria regarding the product's suitability for the group. Often, a basis for decision-making with documentation about the grounds for approval of the products is lacking, which makes it more difficult to monitor the products afterwards.

FI can ascertain that better routines are required among the product arrangers to lay the foundation for good customer protection at an early stage. It can be, for instance, a matter of assessing to whom products should be sold that have a particularly high risk or a return structure that is hard to understand. The product arrangers should also ensure that material facts about the products are transferred to the distributors and that they monitor that the products are not sold to customers to whom they are not suited. It is also important that the company's internal control functions are active in the processes in order to both prepare and monitor the products. Besides the distributor, the product arranger therefore has a responsibility of protecting the interests of customers and for the market impact of the products.

Arrangers must assume responsibility for their distribution strategies

Another important aspect that is of significance in terms of the quality of the advice given to customers is the responsibility assumed by the product arrangers for their distributors. Where funds are concerned, there are an expressed responsibility and regulations regarding the requirements that a fund management company must place on its distributors. There are no such detailed requirements for e.g. banks and investment firms that arrange and/or issue structured products and that use external distributors for their products, but these too must also take account of how the products are distributed. External distribution can occur through, for instance, other banks, investment firms, tied agents, insurance intermediaries and marketers.

The distribution strategy and its choice of channels affect the risk of a product being sold to a customer for whom the product is unsuitable. A product arranger must lay the groundwork for good customer protection by also placing requirements on and monitoring its distributors. Distribution through several different channels requires more monitoring and control from the product arrangers, especially if distribution occurs through insurance intermediaries, marketers or tied agents.

Both the initial verification and monitoring of the specially listed distribution channels in particular should be extended and become more active. The initial verification should secure expertise at the distributor corresponding to that in securities legislation, and that other routines and processes regarding advisory services also comply therewith. Investment firms are obliged to protect the interests of their customers and oth-

erwise act honourably, fairly and professionally. Consequently, the companies should place requirements on and monitor the players they appoint to distribute their products.

Commissions and other conflicts of interest must be managed

In its supervision, FI has seen that there are clear risks of customers' interests being overlooked when the mediation of complex products is remunerated by means of commissions. In last year's Supervision Report, FI raised the question about a commissions ban on insurance intermediaries in order to limit the risk of conflicts of interest in the operations.

The problems relate fundamentally to the conflict of interest that arises when the party that recommends purchasing a financial instrument has a major financial gain to make on the transaction going through. In many cases, it can be suspected that the recommendation was influenced by the remuneration level to the advisor rather than the customer's interest and what is suitable for the customer. Efficient management of commissions and other conflicts of interest are also prerequisites for investment firms in order to protect customer interests.

Commissions on the distribution of e.g. funds and structured products occur to a great extent today on the market. There is no ban on commissions, but in terms of investment firms, there are several different regulations aimed at limiting the negative consequences of commissions on customer protection.

In its supervision, FI has identified deficiencies in firms' routines to identify and manage the incentives created by commissions. For example, information given to customers is sometimes deficient and vaguely formulated. Firms must therefore improve in informing customers clearly and comprehensibly.

Besides the information requirements, according to securities legislation a commission must be structured so that it raises the quality of the service concerned and does not prevent the institution from protecting customers' interests. Product arrangers must, to a greater extent, perform this evaluation and justify why the commission increases the quality of the service offered.

OBSERVED PROBLEMS IN THE SUPERVISION OF INSURANCE INTERMEDIARIES

One type of distributor of complex products is an insurance intermediary. In its ongoing supervision work, FI encounters many cases of customers having bought instruments through intermediaries without understanding the risks they involve. FI has therefore had a particular focus on the supervision of insurance intermediaries. A problem that has arisen in this supervision is that intermediaries under review have chosen to revoke their authorisation to conduct operations in order to avoid a sanction or negative publicity. Because there has been no notification of revoking an authorisation due to a breach of regulations, FI often lacks grounds to deny a new authorisation if the same people start up a new company with similar operations. According to FI, this shortcoming in the regulatory framework must be remedied in order for satisfactory consumer protection to be upheld.

Besides this problem, FI wishes to call particular attention to uncertainties in insurance intermediaries' order management in insurance.

A simplified authorisation process leads to circumvention of the rules

According to current regulations, both legal and natural persons can apply for an insurance intermediary authorisation on FI's website based on a relatively simple and inexpensive authorisation process. FI's possibilities of placing requirements on intermediary companies in the granting of authorisations are more limited than for other financial institutions such as investment firms. Unlike for other financial institutions, there is not a more general requirement on the suitability of individuals in a firm's management; it suffices for people to meet certain formal requirements stipulated by law and FI's regulations.³ This structure was deemed necessary when the law was introduced because the suitability assessment is not just performed by FI as an authority but, in the case of tied agents, by the insurance company itself.⁴ A barrier to obtaining authorisation is, however, if a person has previously worked at an intermediary company that had its authorisation revoked by FI due to breach of regulations. Combined with the fact that it is simple and inexpensive to obtain a new authorisation, this means that a company itself can choose to have its authorisation revoked if it suspects that FI is about to revoke its authorisation due to breach of regulations, and then return with a new company with the same operations.

A tangible example of problems in intervening

In the autumn of 2011, FI initiated an investigation of a company with an authorisation to conduct insurance mediation because senior executives at the company had already been present at another company in which FI had identified major deficiencies in an investigation in 2009. During the processing of the sanction case, the old company requested that its authorisation be revoked, which meant that FI could not intervene against the company due to the observed deficiencies.

The new investigation showed that there were a number of serious deficiencies in the operations of the new company as well. The primary focus of the operations was, on the company's own contact initiatives, to systematically advise old people (with no further knowledge about financial instruments) to invest often large amounts in so-called leverage certificates in the framework of life insurance policies. A leverage certificate is a type of derivative product that is very complex and extremely risky. The product was therefore a highly unsuitable investment for the average consumer with no great insight into financial markets.

Mediation of the products generated high remuneration levels for the company – 10–20 per cent of the invested amount, without the company clearly and comprehensibly providing information about the remuneration received by the company.

In FI's opinion, on the whole the company disregarded its customers' interests in favour of its own remuneration in a remarkable way. The deficiencies noted were so serious that FI was considering revoking the company's authorisation. However, in the same way as for the other company in 2009, the company chose to request to have its authorisation revoked in connection with FI communicating the observed deficiencies. Hence, there were no longer any legal grounds to intervene against the company. With the current

3 Insurance Mediation Act (2005:405) and Finansinspektionen's regulations and general guidelines (FFFS 2005:11) regarding insurance mediation.

4 See 65 ff. proposition 2004/05:133 ahead of Insurance Mediation Act (2005:405).

regulations, there is nothing to expressly prevent the people in question, following a fresh application, from obtaining authorisation to conduct insurance mediation operations under a new company name.

FI believes that the problems relating to an overly simplified authorisation process are serious. Current regulations have made it too easy to enter the insurance mediation market. FI is reviewing its own regulations in the area, but believes that a review of statutory requirements is also needed to achieve the desired result. A proposal about how this should occur will be submitted to the Government separately.

Intermediaries' order management in insurance

There is a need for FI to clarify which investment services insurance intermediaries can offer within depository insurances. In depository insurance, customers themselves handle the administration of the financial instruments included in the insurance. Customers' risk exposure is in principle the same as when they own the instruments themselves in their own depositories. The need for consumer protection in these cases is therefore just as large as in offering investment services that do not feature insurance, i.e. services that can only be offered by investment firms.

FI has previously expressed that insurance intermediaries can provide advice to customers about financial instruments included in an insurance policy. In its supervision, FI has discovered, however, occurrences of insurance intermediaries receiving orders in financial instruments on behalf of their customers, and transmitting them to an investment firm for delivery to the depository tied to the insurance policy. When receiving and transmitting orders of a complex financial instrument, investment firms are obliged to assess whether it is suitable for the customer, including ensuring the customer will be able to understand the risks associated with the investment. The regulations also place requirements on securities institutions in terms of how orders should be handled and how any conflicts of interest that could have negative implications for the customer should be managed.

When an insurance intermediary in such cases receives and transmits orders in a professional capacity, the question therefore arises about whether it should be considered insurance mediation, or if it entails performing the investment service reception and order transmission according to the Securities Market Act.

FI concludes that, with the exception of investment fund units, the regulations do not provide scope for an insurance intermediary to be able to receive orders from a customer or insurance company and transmit such orders to an investment firm. Such order management may only be conducted by firms with authorisation to conduct securities operations. Insurance mediation is therefore limited to meeting the customer's wishes in terms of rearrangements in the insurance policy by the intermediary managing this directly with the insurance company, which places the order with the investment firm. In this case, however, insurance intermediaries that are tied agents to securities institutions may manage orders according to the specifications of the Securities Market Act.

This clarification from FI defines the boundary between the applicable regulations, and clarifies the applicable customer protection regulations for parties conducting securities transactions in depository insurances.

CONSUMER PROTECTION FOR MORTGAGES

FI's latest mortgage survey shows that the so-called mortgage cap works. For the first time since 2002, the first year for which comparable statistics are available, households' loan-to-value ratio for new loans decreased. The share of households with very high loan-to-value ratios also decreased. Monitoring of the mortgage cap also shows that it has had a strongly normative effect. In order to improve transparency on the mortgage market, FI has also presented in a special report a simplified model of how banks' margins and funding costs for mortgages can be calculated.

The significance of mortgages for consumers

Since the mid-1990s, household indebtedness has risen sharply in parallel with house prices. Households' loan-to-value ratios, i.e. the size of mortgages in relation to the market value of the homes, increased throughout the first decade of the century. In light of this, FI decided to issue general guidelines limiting the size of loans collateralised by homes, known as the mortgage cap, which came into effect on 1 October 2010.⁵

The largest part of households' debts consists of mortgages, and almost two thirds of Sweden's population own their own house or apartment. Mortgage lending is therefore an important part of FI's analysis of risks, both to financial stability and consumer protection in the financial markets. FI has therefore carried out an extensive mortgage survey this year too. Its purpose was to monitor the effects of the mortgage cap and assess potential risks.

The survey was carried out in the autumn/winter of 2011/2012 and the Riksbank also participated in the work. The material gathered consisted of three parts: a form with aggregated information, loans granted to individuals consisting of a selection of around 12,800 borrowers collected during the period 26 September – 6 October (the random sample) and qualitative questions that the banks were asked to answer.⁶

2011 mortgage survey

Households' loan-to-value ratio for new loans decreased in 2011 for the first time since 2002 – the first year comparable data was available. Just under nine per cent of the households in the sample have a loan-to-value ratio that exceeds 85 per cent. This is half of the corresponding sample of 2009, when just over 20 per cent had a loan-to-value ratio of over 85 per cent. In the youngest category of the sample (16–25 years old), around one person in ten has a loan-to-value ratio over 85 per cent. In the 2009 sample, the share was over 50 per cent. The declining loan-to-value ratio for new loans and the decrease in the proportion of new loans with very high loan-to-value ratios is also confirmed by the banks in the qualitative part of the survey.

Fourteen per cent of the households in the sample for new loans had a loan-to-value ratio of exactly 85 per cent, which gives a clear indication that the mortgage cap has had a strongly normative effect. In the young category (16–25 years old), 35 per cent had a loan-to-value ratio of exactly 85 per cent.

■ The Swedish Mortgage Market



<http://www.fi.se/Folder-EN/Startpage/Publications/Reports--summaries/Listan/The-Swedish-Mortgage-Market/>

⁵ The guidelines state that a loan collateralised by a home may not exceed 85 per cent of the market value of the home. For more information, see the decision memorandum for Finansinspektionen's general guidelines regarding limitations to the size of loans collateralised by homes (FFFS 2010:2).

⁶ For further information about the mortgage survey, see Finansinspektionen's report "The Swedish mortgage market" of 13 March 2012.

Of the households with a loan-to-value ratio that exceeds 85 per cent, practically everybody (98 per cent) repays by instalments the part of the loan exceeding the mortgage cap. The repayment period for these loans is relatively short, at ten years maximum. However, repayment periods have generally increased, however, and a larger portion of new mortgages are not repaid in instalments.

Stress tests performed by FI of the data show that most households have a strong repayment capacity and can withstand increases in interest rates. A stress test shows that an interest rate increase of 5 percentage points on the borrower's actual rate would mean only 7 per cent of people who have taken out a new mortgage having a deficit in their discretionary income calculation. Even when simultaneously applying assumptions of sharp drops in house prices and sharp rises in unemployment, only a limited portion of the households in the random sample are affected, which indicates that Swedish mortgages are currently not a threat to financial stability.

Based on the current situation on the mortgage market and the results of the survey, FI does not see any reason to change the general guidelines regarding limitations to the size of loans collateralised by homes. However, FI will continue to conduct the mortgage survey annually and the trend on the Swedish mortgage market will be carefully followed in coming years too.

The banks' mortgage margins

In order to strengthen financial stability and avoid future financial crises, new regulations for the banking sector are being prepared. The regulations include higher capital adequacy requirements. The Government has given FI the assignment of reviewing on a quarterly basis how the adaptation of credit institutions affects lending to businesses and households, and their terms.

In this initial report, FI has chosen to focus on mortgage lending and the mortgage margin trend. A mortgage is often a person's largest financial commitment. However, the surrounding information is often complex and it is difficult for a consumer to really understand what the banks are charging for. Using a simple model to assess the banks' costs, we wish to attempt to increase transparency.

Several factors have contributed to an increase in the banks' funding costs following the financial crisis. The Riksbank has gradually raised the repo rate and the price of risk – such as liquidity risk, credit risk and interest rate risk – has risen.

The mark-up for the various risks was around zero for a time prior to the financial crisis. The actual lending rate paid by the customer has, however, increased more than the banks' funding costs. FI can thus ascertain that the margin on mortgages, i.e. the difference between the lending rate and the funding cost, has gradually increased in the past year. It was at 1.1 per cent at the end of the first quarter of 2012. However, in the period before the financial crisis, the margin was under pressure.

The banks also have other costs. When these were removed, the margin amounted to 0.4 percentage points at the end of the first quarter, according to FI's calculations. Based on the model used by FI, the banks' return on equity is therefore around 22 per cent on mortgages. This can be compared to 10–13 per cent for their entire operations.

There should thus be scope for mortgage rate negotiation. On average, customers who have negotiated their terms pay 0.20 percentage points below the list price. It is important that customers are also aware of the costs they pay on other banking services and products, and not just look at the mortgage offering.

KNOWLEDGEABLE CONSUMERS

In terms of consumer protection, FI does not only work in relation to firms, but also has a special assignment to strengthen the position of consumers on the financial market by providing them with information and initiating training courses in personal finances. The training initiatives being implemented can be referred to as an educational program for the general public. Customers that are more knowledgeable provide better consumer protection because they can themselves analyse and question the information provided to them in the sale of financial products.

The project "Protect your financial future" and the training course in personal finances through workplaces have potential to reach a great number of employees in the next few years. Also, FI has put special priority on initiatives and support for school and adult education teachers, including in the framework of the SFI (Swedish for immigrants) program.

"Protect your financial future"

The GDE LikeYourFinances network was formed in 2010 with FI as one of the initiators. Several projects have gradually started up to increase the general public's knowledge about personal finances, strengthen people's self-confidence and their will to act in the best interests of their own personal finances. The network brings together both private and public sector players. In the framework of the network, FI and the Swedish Pensions Agency have worked together during the year with the trade unions of the Swedish Confederation for Professional Employees (TCO). A large amount of communicators from the trade unions are given basic training so that, in the next stage, they can offer training courses at workplaces with a focus on employees' questions on budgeting, loans, saving, national pension and occupational pension. FI assumes project management responsibility and runs the activities alongside TCO and the network's member firms and authorities. The programme is run under the name "Protect your financial future". Similar training programmes are given in parallel by teachers at Folkuniversitetet. Through this channel, employees at firms and municipalities are offered training meetings at workplaces and the general public is also invited to attend evening lectures.

Supervision of financial stability

The crisis of recent years has shown just how large the economic costs can be when the banking sector experiences problems. Establishing higher and better requirements on banks' capital and liquidity has remained a priority for Finansinspektionen (FI). In the past year, FI has also established a council for cooperation on macroprudential policy with the Riksbank aimed at working preventively to counteract risks threatening financial stability. In addition, a major investigation into banks' market risk management has just been completed.

Working to ensure the stability of the financial system is an assignment that FI shares with others, mainly the Riksbank and the Swedish Ministry of Finance. Banks are the focus of supervision of financial stability, on the one hand because they are often highly leveraged, and on the other because their business model makes them particularly vulnerable to liquidity problems.

NEW CAPITAL AND LIQUIDITY REQUIREMENTS FOR BANKS

One of the most important lessons from the financial crisis is the need for stricter requirements on banks in terms of both capital and liquidity. FI believes, with the Swedish Ministry of Finance and the Riksbank, that Sweden needs to go further in terms of requirements on banks than the minimum requirements according to the Basel 3 accord and the EU's forthcoming regulations, in order to safeguard stability in the Swedish financial system. FI is reviewing the risk weightings for mortgages, has performed investigations of liquidity risk management and is working on preparing new liquidity regulations.

Future capital requirements for Swedish banks

Basel 3 is to apply until 2013

Lessons from the financial crisis led to international efforts in the Basel Committee on Banking Supervision to prepare a new capital adequacy framework also comprising liquidity requirements (the Basel 3 accord). FI is highly positive towards the requirements that the Basel 3 accord recommends that countries introduce. The accord involves not only higher requirements on capital levels, but also quality requirements, so that the capital can bear losses when they arise. Where Sweden is concerned, it is clear that the banks are already close to the levels that will be required today. On 25 November 2011, the Swedish Ministry of Finance, FI and the Riksbank recommended in a press release that the future requirements should apply as of 2013 for all banks.⁷

Basel 3 and CRD 4

The Basel Committee on Banking Supervision has issued a new framework, Basel 3. The Basel Committee operates under the Bank for International Settlements (BIS), and develops, for instance, standards for regulation and supervision of banks. The proposals of the Basel Committee are recommendations that must be implemented at a national level to be binding regula-

⁷ Click on the following link for the press release: <http://www.fi.se/Press/Pressmeddelanden/Listan/Nya-kapitalkrav-pa-svenska-banker/>.

tion; in the EU this is occurring through a new capital adequacy regulation and a new directive (CRR and CRD4). The Basel 3 accord contains regulations in three areas:

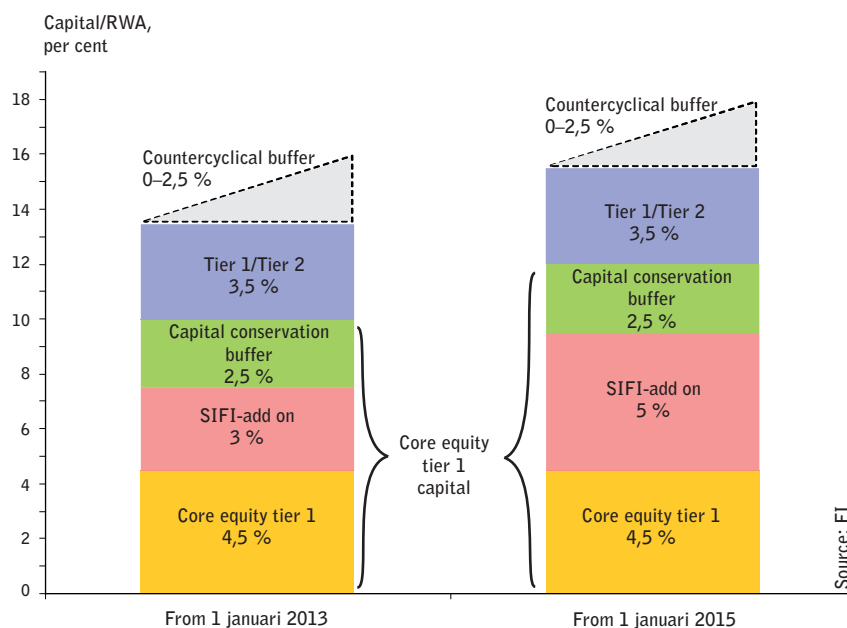
1. Capital adequacy
2. Leverage ratio
3. Liquidity regulation

The Basel 3 accord involves heightened requirements on the scope and quality of capital, improvements in capital requirement calculations primarily in terms of market risk, and the introduction of a leverage ratio and two liquidity measurements.⁸

Further requirements on major Swedish banks

In November 2011, the Swedish Ministry of Finance, FI and the Riksbank also recommended that the requirement on so-called common equity Tier 1 capital⁹ for the four major bank Swedish groups Handelsbanken, Nordea, SEB and Swedbank be at least 10 per cent as of 1 January 2013 and 12 per cent as of 1 January 2015. Adding to this are requirements on further Tier 1 capital and total capital.¹⁰ This means it is proposed that the major Swedish banks need to maintain more capital than the minimum expected requirement according to the EU regulation and the Basel 3 accord.

DIAGRAM 2. Proposed capital requirements for Swedish banks



⁸ To read more about the Basel 3 accord, click on the following link: <http://www.bis.org/bcbs/basel3/b3summarytable.pdf>.

⁹ Common equity Tier 1 capital denotes in principle equity, i.e. share capital and accumulated non-distributed profits. The exact definition to apply in the EU is being established in CRR/CRD 4.

¹⁰ This means, just as in Basel 3, that the Tier 1 capital requirement will be 1.5 percentage points higher than on common equity Tier 1 capital. The proposal thus involves 11.5 per cent Tier 1 capital as of 1 January 2013 and 13.5 per cent as of 1 January 2015. The total capital requirement will be 3.5 percentage points higher than on common equity Tier 1 capital, i.e. 13.5 per cent as of 1 January 2013 and 15.5 per cent as of 1 January 2015.

There are several strong reasons for placing strict requirements on the major Swedish banks. The major Swedish banks obtain a great extent of their funding by borrowing on international capital markets, which makes them sensitive to disruptions on these markets. The banks are also very large compared to the Swedish economy. If one or several of the major Swedish banks would need a bailout, this would mean tremendous costs for society and taxpayers. The markets have also learned from history and often presuppose that the government would step in to bail out major banks. The perception of an implicit guarantee from the Government means that the major banks can obtain funding more cheaply than what would otherwise have been the case, and take greater risks.

The exact structure of the proposals will be presented by the Swedish Ministry of Finance based on the results of the negotiations in the EU regarding the capital adequacy regulation and the directive (CRR/CRD 4). Intensive efforts will then be in store for FI in adapting current regulations and processes for capital adequacy assessment to the new capital requirements.

Risk weightings for mortgages

Capital adequacy corresponds to capital requirement in relation to risk-weighted assets. In the case of the major banks, the size of the risk-weighted assets is determined by their internal models. In its risk report from November 2011, FI concluded that the advanced models in the provisions of the international capital adequacy regulations, and which the major Swedish banks use to calculate the risks in their mortgages, can result in capital requirements that are far too low for the mortgage portfolios of the Swedish banks. This also applies following the introduction of the higher capital requirements for systemically important Swedish banks. FI is therefore currently investigating different possibilities of increasing the risk weightings for mortgages and hence increasing the resilience of Swedish banks to future financial crises, as well as confidence in the banks' capital strength.

Liquidity risk investigations

in 2011, FI carried out two major investigations to verify compliance with the regulations (FFFS 2010:7) regarding management of liquidity risks which started to apply in 2010 at the turn of the year. The regulations apply to all credit institutions and investment firms under FI's supervision.

One investigation comprised the policy documents of a large number of banks. Policy documents denoted documented risk tolerance, liquidity strategy, funding strategy and contingency plan. FI found that several firms needed to update their policy documents in order to comply with the requirements of the regulations. It is of great importance that the firms continually update the policy documents if material events occur during the year. In the autumn of 2011, the liquidity situation for many banks was strained and unsecured funding was only available to a limited extent. The experiences gained from this are to be incorporated into contingency plans and other policy documents.

The other investigation comprised the major banks' internal pricing models. The purpose was to verify that the banks have a suitable method for internal pricing which reflects the current refunding cost and hence also the liquidity risk. The investigation is not yet fully complete, but FI's preliminary assessment is, for example, that the banks in the investiga-

tion generally do not internally price unutilised loan facilities, credit guarantees and other contingent liabilities, which they should do.

Heading towards quantitative liquidity requirements

In July 2011, FI introduced new liquidity reporting requirements for Swedish credit institutions and investment firms with a balance sheet total exceeding SEK 5 billion (FFFS 2011:37). This means that 48 firms, all of which are banks or other credit institutions, are currently subject to the regulations. In 2012, FI commenced efforts to draw up quantitative requirements on liquidity buffers based on these reports. To start with, these will apply to a limited circle of firms with high dependency on market funding. As of 1 January 2013, FI will place requirements on these firms meeting a liquidity coverage ratio (LCR). LCR means that firms shall have a sufficiently large reserve of liquid assets to manage a situation where financial markets are in principle closed for 30 days and outflows occur.

FI's requirement will involve Sweden being ahead of the other EU countries. Stricter requirements on the banks' liquidity reserves are a way to reduce the risk of the Government having to intervene to guarantee banks' funding. FI believes this is an important step to safeguard financial stability. Tangible proposals and details about which firms are to be included will be in the proposal for regulations which is expected to be sent out for review by the summer of 2012.

COLLABORATION IN MACROPRUDENTIAL POLICY

The Swedish authorities involved have been cooperating for some time with regard to crisis management and acute threats to financial stability. The Swedish Ministry of Finance heads the so-called Stability Council with representatives also from the Riksbank, National Debt Office and FI. Both FI and the Riksbank also have a task of working in a preventive manner for a stable financial system. During the year, a special council for cooperation was created to deepen this preventive work.

What is macroprudential policy?

The financial crisis showed how important it is that financial supervision should not just cover individual firms, but also the system as a whole. Before the crisis, neither authorities nor firms had understood the ripple effects in the system. As the financial system has become increasingly complex in recent decades, it has become more difficult to understand the interdependence between firms and financial markets. Although comprehensive analysis of financial markets did exist before, a link from analysing risks in stability reports to tangible measures was missing.

Initiatives have therefore been taken to focus more on what is known as macroprudential policy, both in Sweden and abroad. Examples of circumstances that should be identified in macroprudential policy are whether problems in a firm lead to major problems for other firms, or if problems on a market lead to deteriorated conditions on other markets. In more tangible terms, the liquidity risks at many banks and the systemic problems in the so-called subprime loans should have been identified and counteracted before the financial crisis seriously erupted in 2008. Macroprudential policy should also take account of procyclical aspects in the financial system. It is clear that risk-taking and willingness to borrow against collateral have varied over time.

In an initial step to strengthen financial stability, better regulations are

required that involve more capital and liquidity in the banking sector. However, not all risks are captured by these regulations, and supervision must be structured in such a way that it takes account of the effects on the financial system as a whole. In macroprudential policy, more resources should therefore be allocated to analysing risks based on a holistic approach and to attempting to capture the fact that the level of systemic risks in the financial system varies.

Council for Cooperation on Macroprudential Policy

In the spring of 2012, FI and the Riksbank started up the Council for Cooperation on Macroprudential Policy. FI and the Riksbank have access to information and analysis with different perspectives and expertise, and can together increase the probability of identifying risks and discussing suitable measures to counteract them. The Council for Cooperation will meet twice a year and the minutes are published on the websites of FI¹¹ and the Riksbank.

THE BANKS' MANAGEMENT OF MARKET RISKS

The risks in deficient management of market risks¹² became clear in HQ Bank in 2010, where the deficiencies were so serious that the bank's authorisation was revoked. Throughout the year, FI has carried out a comprehensive investigation of market risk management at Swedish firms and can, despite the identification of certain deficiencies, ascertain that these currently do not constitute a threat to individual firms or financial stability.

Market risks arise in most banks' and investment firms' normal business operations, e.g. in client-driven trade or in lending/borrowing operations. In some cases, firms actively expose themselves to market risks in order to earn money, which is referred to as 'proprietary trading'. One conclusion from HQ Bank was that it may be necessary to conduct a detailed portfolio analysis, in some cases down to the level of individual positions, to determine if a firm has satisfactory control of its market risk. The measures suitable for measuring and controlling risk cannot be determined in advance but depend on the specific risk profile of the bank.

The investigation

In the autumn of 2010, FI decided to conduct an extensive investigation into the market risk management and financial instrument valuation of certain firms. Eleven firms were selected for the investigation. The main criterion for FI's selection was the firms' holdings of financial instruments in relation to their balance sheet totals. The investigation commenced in January 2011 and was concluded in December 2011. The purpose of the investigation was, on the one hand, to ensure the firms' management and capital coverage of market risks, and on the other hand to ensure that positions in financial instruments are correctly reported. The valuation of derivative positions at HQ Bank, where inhouse models were used to a great extent instead of available market data, was one of the deficiencies that led to the bank's authorisation being revoked.

In order to verify the methods of firms, FI collected large amounts of position data from each firm. Since then, FI has conducted a risk analysis

11 <http://www.fi.se/Utredningar/Samverkan/Listan/Protokoll-fran-Samverkansradet-den-24-februari/>.

12 Market risk is defined as the risk of losses resulting from fluctuations in interest rates, currencies, share prices or commodity prices.

of each firm's holdings and compared them to the firm's own reports and methods.

Conclusions and measures

As a whole, FI observed that the majority of firms included in the investigation in general do not satisfactorily prioritise their management of market risks. However, the observed deficiencies have not been of such a nature as to require sanctions, and the firms in question have committed to the rapid implementation of improvement measures. FI only found minor problems in the reporting of financial instruments. No firm came close to having such a large share of model valuation in their portfolios in relation to equity as HQ Bank did.

Four comprehensive areas for improvement were noted at the majority of the investigated firms.

- Weaknesses inherent to Value-at-Risk models and scenario analyses. A VaR model is an aggregate risk measure that can take into account a large number of risk factors. A VaR model estimates the greatest loss a firm could incur at a certain probability level during a certain time period using probability calculations which are often based on historic data. In its investigation, FI observed a number of weaknesses in VaR models in terms of the analytical structure and choice of risk factors. In several cases, FI found that there is a need for supplementary scenario analyses that have a particular focus on the limitations of the chosen VaR model.
- Absence of general market risk measures in operating activities. A general risk measure is a measure that includes all significant risks in a firm and, where applicable, a financial group. The general market risk measure is often only calculated in connection with the annual internal capital adequacy assessment. However, few of the firms which were investigated, and none of the smaller firms, use general VaR measures in their operating activities.
- Simplified risk matrices. A risk matrix is a simple simulation of gains or losses when applying different rates of change to prices and volatilities. Among the investigated firms, it was relatively common to omit significant risk factors, such as maturity and correlation. Firms should therefore continually evaluate the effect of risk factor omission on the risk level.
- Insufficient risk control in internal bank operations. In all of the firms in the investigation, the finance department operations (the internal bank) were significantly less transparent from a risk perspective than other areas of the firm. Less sophisticated methods and fewer risk measures are used in the internal bank operations and as a result a number of significant risks are generally not identified. In particular, FI identified exposures to cross-currency basis swap spreads¹³ and credit spreads as two areas in which many firms need to improve their risk control.

13 An interest rate risk that can arise when a bank obtains funding in one currency and lends in another.

Firms' owners and management

Placing requirements on the people who own and run financial institutions is an important part of Finansinspektionen's (FI's) operations. FI believes that both regulations and routines regarding ownership and management assessment must be strengthened. The regulations also place requirements on internal governance and control, remuneration and ensuring that insiders do not exploit their position. FI has intervened on several occasions during the year.

The financial system's central position in the national economy brings about strict requirements being placed on senior management at financial institutions. FI believes that extra effort must be invested in carefully reviewing who should gain entry to the financial market. In the past year, FI has also invested a great deal of energy in matters relating to how senior executives, owners and the firms comply with the regulations and manage their internal governance and control.

IN-DEPTH OWNERSHIP AND MANAGEMENT ASSESSMENTS

The financial crisis showed the significance of financially stable owners with competent and suitable management at firms. FI's supervision of consumer protection shows the need for thorough screening of the people to be granted authorisation to offer or mediate financial services to consumers. Efforts of previous years to facilitate the regulation burden and simplify the authorisation process for e.g. insurance intermediaries have proven to lead to far too many dubious players on the market. Furthermore, independent bodies such as the IMF in its report¹⁴ conveyed opinions about the need for heightened ongoing reporting to FI from financial institutions regarding information about the sustained suitability of owners, board members and CEOs.

Common European requirements on owner and management assessment at financial institutions have governed the development of the regulations to a great extent. At the same time, the existing regulations provide a certain scope for the various national supervisory authorities, and in the past year FI has therefore reviewed its routines and regulations regarding the assessment of owners and management at financial institutions. The purpose of this was to secure a practice with strict requirements, and further reduce the scope for dubious players.

The assessments performed by FI

FI carries out different assessments in applications for authorisation to conduct financial operations and in owner and management assessments for already established financial institutions. In the granting of authorisations, it is assessed, for example, whether the intended operations meet set requirements regarding, for instance, capital strength and internal governance and control. Furthermore, it is required for newly started and existing firms alike that owners with a qualifying holding in the firm (usually above 10 per cent) are considered suitable for exercising significant influence over the firm. In this case, factors such as the holder's reputation and capital strength must

14 IMF Country Report No. 11/172 Sweden: Financial Sector Stability Assessment.

be taken into account. An assessment shall also be made to ensure that persons to be board members of a firm or CEO, or replacements thereof, have sufficient insight and experience and are also otherwise suitable for such an assignment. The management of a legal owner of the firm is also subject to FI's assessment.

Ruling of the Administrative Court of Appeal provides insufficient guidance

In February 2011, FI decided that a person who had been on a board of a financial holding company with a subsidiary whose authorisation had been revoked due to serious deficiencies in the operations, was not deemed suitable to form part of the management of a fund management company. The decision was appealed to the Administrative Court, which shared FI's opinion. However, the Administrative Court of Appeal was of a different opinion and reversed the ruling of the Administrative Court and FI's decision.

FI has recently appealed the ruling of the Administrative Court of Appeal to the Supreme Administrative Court. FI believes that the ruling of the Administrative Court of Appeal does not provide a clear answer about the responsibility held by the management of a financial holding company. It is crucial that this is clarified because this type of organisational structure is common on the financial market.

The case also concerns where the burden of proof lies in management assessment cases. FI does not share the view of the Administrative Court of Appeal regarding the distribution of the burden of proof. FI believes that the applying firm should have the burden of proof in terms of the person subject to management assessment meeting the suitability requirements placed on the management.

The Supreme Administrative Court determines whether FI's appeal will be considered. In principle, the court only considers matters of interest in terms of setting precedents, i.e. that can provide guidance for rulings in other similar cases.

INTERNAL GOVERNANCE AND CONTROL

Great attention is paid to matters regarding internal governance and control, not just from FI but also internationally. FI has observed deficiencies at the Swedish firms this year too. Several interventions have been carried out in light of these deficiencies, including for deficiencies in risk management and control functions.

A firm's management, i.e. the board of directors and CEO, is responsible for the operations being conducted according to applicable regulations. To ensure this, internal control functions with sufficient expertise and resources are required. Also, regular reporting from the control functions to the board of directors is necessary for the latter to obtain necessary information about the operations. Furthermore, there should be guidelines and instructions for different operations at the firm.

Observed deficiencies and interventions

In its supervision in the areas of banking, funds, insurance and securities, FI has called attention to cases where the management of firms has been deficient in managing and organising the operations. In many cases, the control functions have not managed to fully perform the assignments incumbent upon them because of insufficient resources or

competence. Also, several firms have had functions for risk control and compliance that have not been independent of the operations they are supposed to control.

The risk control and compliance functions of many firms have also lacked adapted and up-to-date governance documents and have not reported sufficiently or regularly to the management of the firm. Thus, the management of the firm has not been able to monitor and evaluate risk management and compliance at the firm, which is crucial for sound internal control.

In most cases FI can, in a dialogue with the firms, influence them so that they rectify deficiencies and bolster the firm's governance and control systems. However, sometimes the deficiencies are so serious that FI has to intervene with sanctions. Interventions in the past year clearly show that deficiencies in internal governance and control are not symptomatic of any particular sector or firm size. Many of the deficiencies have been observed at relatively small fund management and investment firms such as Lannebo Fonder AB, but also at LF Bank AB which is Sweden's fifth largest bank. In the insurance area, FI was of the opinion that Försäkringsbolaget E.N. Sak Försäkring i Europa AB had such large deficiencies that its authorisation to conduct operations was revoked.

E.N. Sak Försäkring i Europa AB's authorisation is revoked

E.N. Sak Försäkring i Europa AB (the company) was a non-life insurance company that offered income protection insurance. FI commenced an investigation of the company in the spring of 2010 following recurring indications about deficiencies in the company's compliance with regulations. The investigation showed that there were several deficiencies in the operations. The most serious was that the company had had problems in reaching the statutory solvency ratio, and had failed to reach it on several occasions. Also, the company had reported its financial position erroneously and complicated the supervision process. The company also had deficient liquidity, which it attempted to resolve through unlawful borrowing. Additionally, in certain cases the company's funds had been used and the company failed to demonstrate that they were directly attributable to the company's insurance operations. There were also major deficiencies in the company's management of the register of assets covering technical provisions and a number of different policy documents.

The investigation presented a picture of a company management that lacked the ability and will to provide policyholders with statutory protection. For a period of two years, FI provided the company with guidance and attempted to persuade the company to rectify the indicated deficiencies. The company management's lack of control of the operations and deficient compliance with regulations meant a serious undermining of the protection that the regulations are intended to provide to policyholders. In light of this, FI saw no alternative than to revoke the company's authorisation to conduct operations. The company has appealed FI's revocation decision.

Besides deficiencies in the ability of firms to govern and control their operations, in the banking area FI has observed a case, Marginalen Bank AB, in which it deems that the board of directors were in breach of provisions by unlawfully delegating the right to decide on credits issued to closely related parties. A senior executive at the bank also participated in

credit decisions regarding a closely related firm. It should be mentioned that the bank has appealed FI's intervention to the Administrative Court and at the time of publication of this report there has not yet been a ruling. Also, Kredit AB Marginalen and Crédit Agricole Chevreux Nordic AB have been given sanctions for internal control deficiencies.

Specifically regarding remuneration structure regulations

At the turn of the year 2010, FI issued remuneration policy regulations for financial institutions. The regulations were revised in January 2011 (the remuneration regulations).¹⁵

Regulations regarding remuneration structures

The remuneration regulations implemented the changes in the EU's credit institution directive which is about remuneration policies and how they are to be applied. The new regulations place general requirements on the firms' remuneration policies and variable remuneration. The regulations also contain specific requirements on the firms in terms of adapting remuneration structures to their risks; for example regulations about performance assessment and risk adjustment as well as deferred variable remuneration. Firms should defer variable remuneration exceeding SEK 100,000 for employees who can materially affect the firm's risk level. Firms with risk-weighted assets over SEK 500 billion must also pay out a certain part of the variable remuneration to the senior management in the form of shares or other instruments.

In February 2011, the report "Bonus – are firms following the rules?" was presented. It was an investigation of how banks, investment firms and fund management companies had adapted to the remuneration rules. FI concluded that there were deficiencies in at least half of the investigated companies. The report thus demonstrated that the industry found it difficult to assimilate the new regulations. During the year, the deficiencies have been monitored and FI intervened against six firms where the deficiencies justified a remark combined with an administrative fine. In its supervision work in 2011, FI subsequently noticed a greater focus from the firms in terms of remuneration regulations. Since the remuneration regulations were revised and clarified in January 2011, FI has also noticed a certain improvement in the remuneration policies reviewed.

Interventions against companies with deficient management of variable remuneration (bonuses)

The firms against which FI intervened were Aktie-Ansvar AB, East Capital AB, East Capital Asset Management AB, Garantum Fondkommission AB, Nordea Investment Management AB and Nordea Bank AB. FI decided to issue each company with a remark and administrative fines of between SEK 400,000 and 3 million.

15 FFFS 2011:1 Regulations regarding remuneration structures in credit institutions, investment firms and fund management companies licensed to conduct discretionary portfolio management and FFFS 2011:2 General guidelines regarding remuneration policies in insurance undertakings, exchanges, clearing organisations and institutions for the issuance of electronic money.

The deficiencies related to, for instance, interpretation of the term “variable remuneration” and erroneous or overly narrow interpretation of the term “risk-taker”, which led to incorrect application of the regulations regarding deferred payment of variable remuneration (bonus). At many of the companies, the remuneration policy was not based on sufficient analysis of the risks associated with bonuses.

LISTED COMPANIES AND SUPERVISION

In 2011, FI decided on penalties for major shareholders, insiders and listed companies in a large number of cases as a result of breaches of disclosure and notification rules. As part of efforts to reduce the number of breaches, FI has prepared a guide for listed companies and insiders. The purpose of the guide is to increase knowledge about the regulations applicable to insiders’ and major shareholders’ reporting of their securities holdings.

It is of great importance that the securities market is transparent, not least in terms of maintaining market confidence. Interest in owning shares in the framework of endowment insurance remains high and has resulted in poorer transparency in terms of insiders’ securities holdings in their own company. During the year, FI has therefore submitted a proposal to the Swedish Ministry of Finance regarding shareholdings through endowment insurance also being included in reporting obligations.

Guide for listed companies

In 2011, FI drew up a guide for listed companies.¹⁶ The guide includes stock exchange information, major shareholding notifications, insider register, logbook, accounting supervision and other factors relating to listed companies such as share buyback programs and stabilisation trading.

Logbooks

The guide addresses the list to be kept on an ongoing basis by listed companies of natural persons at the company who, due to their position or duties, have access to price-sensitive information about the company. This list is usually called the logbook. In the autumn of 2010, FI conducted a survey to investigate how listed companies work with logbooks. The responses to the survey, and also the information obtained by FI from the Swedish National Economic Crimes Bureau (EBM), show that the management of logbooks varies a lot between listed companies in terms of content and quality. In many cases, the logbooks are so deficient that they do not fulfil their purpose and thus complicate FI’s supervisory work and EBM’s criminal investigations. FI’s conclusion of the investigation is that the companies must improve their routines for managing logbooks in order to meet statutory requirements. In the spring 2012, FI arranged a number of seminars about logbook management and will increase its supervision of companies’ logbook management during the year.

Finansinspektionen’s stock exchange information database

Another area addressed by the guide for listed companies is the

¹⁶ Click on the following link for the entire guide: <http://www.fi.se/Regler/Vagledning/Borsbolag/>.

company's obligation to disclose information about its operations on an ongoing basis. The disclosure obligation, which is regulated both by law and through stock exchange regulations, involves the compulsory disclosure of price-sensitive information. At the same time, the disclosed information shall also be sent to FI's stock exchange information database on FI's website, where it is stored and made publicly available. All major shareholding notifications are also stored here, so the stock exchange information database is an important source of information for the market.

Transparency and confidence in the securities market

Part of FI's ongoing supervision work consists of verifying compliance with disclosure and notification regulations, and in the supervision process many deficiencies in compliance are discovered. In 2011, over 400 investigations were commenced regarding the breaches of individuals. Also, a review was performed of insider reporting at listed companies. 175 companies were contacted and in almost half of these cases, further investigations were required. Following the investigation, it is assessed whether the breach is of such a nature for FI to announce a decision about a sanction fee. In 2011, FI decided to impose a sanction fee on insiders and major shareholders in 168 cases in total.

Endowment insurance gives reduced transparency

In endowment insurance, it is the insurance company – and not the individual policyholder – who owns the shares included in the insurance. This means that assets an insider invests in such an insurance are often hidden from the market, because only natural persons are covered by the reporting obligation regulations which would obligate them to report to FI's insider register. The number of insiders reported to the insider register has continued to decrease during the year, while the interest of insiders in moving their shareholdings to endowment insurance remains high. This leads to a decrease in transparency into senior executives' securities holdings in their own company.

In November 2011, FI submitted a letter to the Swedish Ministry of Finance in which FI proposes that insider regulations be reviewed so that they also comprise shareholdings through endowment insurances.¹⁷ FI proposes that the Swedish Reporting Obligations for Certain Holdings of Financial Instruments Act be supplemented with provisions stating that shares insiders have access to via endowment insurances must be reported to FI's insider register.

The reporting obligation to the insider register currently only applies to shares that are admitted to trading on a regulated market. However, in a proposal for an amendment of the Market Abuse Directive, the EU has proposed that the reporting obligation be extended to also include shares traded outside of a regulated market. The amendment would bring about greater trading transparency of insiders.

¹⁷ <http://www.fi.se/Utredningar/Skrivelser/Listan/Kapitalforsakringr-bor-vara-anmalningspliktig/>.

International supervision in focus

Supervision is becoming increasingly international and focused on risks in the financial system as a whole. International cooperation is necessary to achieve solutions and efficient supervision at a national level too. Several authorities and collaborations have been established; in Europe these are primarily the three supervisory authorities and the European Systemic Risk Board.

The fact that Finansinspektionen (FI) is a national authority with cross-border operations on a global market is a fact made clear in the latest financial crisis. Integrated financial markets require that FI plays an active role in the international debate and regulatory development with a maintained focus on Swedish circumstances. Decisions taken by the G20 and global standard-setting bodies are highly relevant indeed to FI's day-to-day work. It is particularly important for FI to be active in the new European supervision structure.

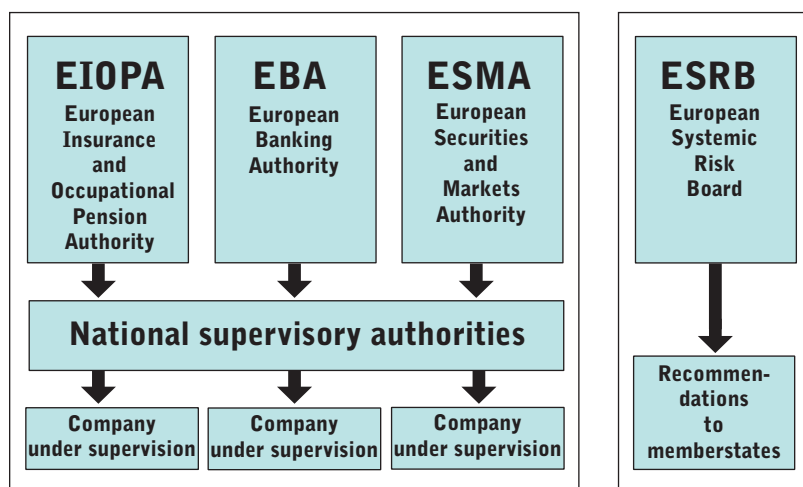
Another important element is improved cooperation in supervision and crisis management for major cross-border firms. Supervisory colleges have been established for both banks and insurance companies and FI is an active participant.

THE EUROPEAN SUPERVISION STRUCTURE

Largely all financial regulation applicable in Sweden is decided today at the EU level, which places requirements on FI actively participating in and contributing to regulatory work.

Cooperation between FI and European bodies

The three European supervisory authorities play a central role in regulatory development, both as advisors to the EU Commission (because they provide advice regarding new EU regulations), and in their capacity of authors of new regulations (because they produce directly binding technical standards or guidelines). FI participates in around 80 working groups in the three European supervisory authorities.



The three EU authorities: Based on mandates in directives and regulations, the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) have the assignment of issuing pro-

posals for technical standards that are then adopted by the EU Commission in the form of regulations. This means that FI participates in formulating regulations that will be applicable law throughout the EU. FI participates actively with experts in the regulatory work of the new authorities in terms of both technical standards and guidelines.

Supervisory colleges

Tangible supervisory work at the European level primarily takes place in the framework of what is known as supervisory colleges. In principle, such a college is formed for each cross-border financial institution of significant importance, consisting of the national supervisory authorities concerned with the firm's operations and with the domestic authority as chair. A number of Swedish financial institutions have relatively comprehensive foreign operations, so FI is currently responsible for leading the work at 13 such colleges – seven in the banking area and six in insurance. There are special provisions regarding the exchange of information and information between the Member States in the framework of colleges. In the event of discord between the supervisory authorities in a college, the relevant European supervisory authority can step in with binding mediation in certain cases.

The fact that the supervisory authorities must increase their analytical capabilities in order to take a stance towards potential macroeconomic risks is a matter that is relevant at national, regional and international levels. For this reason, the European Systemic Risk Board (ESRB) was established in 2011. The ESRB analyses the risks that can threaten financial stability in the EU and can issue warnings and recommendations to Member States and authorities. Together with the Riksbank, FI is included (although with no voting rights) in the ESRB's decision-making body and participates in a number of working groups and analyses that are also important to our own risk assessments.

European Banking Authority (EBA)

During year, work at the EBA has focused on the capital situation of European banks as well as other effects of the European sovereign debt crisis on the banking system. Factors of immediate importance in the regulatory area are all of the binding technical standards which the EBA has the assignment of drawing up as part of the EU's implementation of the Basel 3 accord.

One of the EBA's duties is also to participate in efforts to secure the function and stability of the EU's financial systems. As part of this work, the EBA monitors and analyses developments on financial markets to be able to identify potential risks and weaknesses. Tools used in this analysis include the EU-wide stress tests conducted by the EBA in cooperation with the national supervisory authorities. The four major Swedish banks have participated in all the years in which stress tests have been performed, which has involved extensive efforts from both the banks and FI. The EU's tests have shown, as have FI's own stress tests, that Swedish banks are well-capitalised. A new round of stress tests will be carried out in 2013.

Extra capital requirements due to the sovereign debt crisis

In October 2011, the EBA announced, following a decision by the Ecofin Council, that the major European banks must build up an extra capital buffer. The purpose is to manage the extraordinarily stressed situation on European capital markets brought about by the sovereign debt crisis, and to make it easier for European banks to obtain funding in the long term. The buffer requirement has a rather simple formulation so that the affected banks can reach a common equity Tier 1 capital ratio of 9 per cent by 30 June 2012 at the latest. In the calculation of the common equity Tier 1 capital ratio, government securities holdings are to be valued at market price. The four major Swedish banks are covered by the buffer requirement, but when the final calculation method was presented in December 2011, it was assessed that none of them have a capital deficit in relation to the requirement set by the EBA.

European Insurance and Occupational Pensions Authority (EIOPA)

In recent years, the EIOPA has had a major focus on formulating the new Solvency 2 regulations. Efforts are under way within the EIOPA to draw up guidelines and recommendations to be issued in 2013. Another prioritised area is the establishment of supervisory colleges for cross-border insurance companies.

The supervisory college is the most important cooperation body for the supervision of a cross-border insurance group. The governance and operations of the supervisory colleges place requirements on a regular and standardised exchange of information, establishing contingency plans and clear decision-making processes. One of the most important questions for many supervisory colleges is the review of an insurance group's internal model for calculating the solvency capital requirement in Solvency 2.

The EIOPA also performs stress tests and has followed the development of the sovereign debt crisis. For example, information is collected about the insurance companies' exposure to vulnerable countries.

European Securities and Markets Authority (ESMA)

In the ESMA, FI has been involved in formulating forthcoming technical standards regarding short selling and EMIR.¹⁸ The ESMA has also addressed the topical question of the significance of high frequency trading.

In November 2011, the EU Council and the EU Parliament voted through a regulation regarding short selling¹⁹, to come into effect on 1 November 2012. According to the regulation, the ESMA shall draw up details in the form of technical standards and provide technical advice to the EU Commission regarding certain parts of the regulation. As member of a working group in the ESMA, FI has actively participated in efforts to develop and establish proposals for technical standards and technical advice to the EU Commission.²⁰

18 The EMIR (European market infrastructure regulation) is the EU's regulation regarding OTC derivatives, central counterparties and transaction registers.

19 Short selling means selling a share or debt instrument that the seller does not own when entering the sale agreement. In order to deliver the sold instruments, the seller borrows them from long-term investors. Naked short selling means selling securities without borrowing them first.

20 <http://www.esma.europa.eu/content/Draft-technical-standards-Regulation-EU-No-2362012-European-Parliament-and-Council-short-sel>.

On 9 February 2012, a political agreement was reached in the EU regarding EMIR or the regulation regarding OTC derivatives, central counterparties and transaction registers, addressing clearing obligation requirements for certain types of OTC derivative contracts and the reporting of all derivative contracts to a transaction register. In the regulation, the ESMA is given the assignment of drawing up technical standards and FI has participated actively in this work.

FI has also participated in the ESMA's work to produce guidelines for high frequency and algorithmic trading. The guidelines are intended for trading venues, investment firms and supervisory authorities. The requirements place demands on the trading systems of trading venues and investment firms and the use of trading algorithms. They also address trading surveillance and the prerequisites to apply for offering customers the ability to trade directly in the trading systems. The guidelines came into effect on 1 May 2012.

FI's work with high frequency and algorithmic trading

In addition to its work in the ESMA, FI has worked with limiting the risks identified in algorithmic and high frequency trading. In the autumn of 2011, FI conducted an analysis of high frequency and algorithmic trading on the Swedish equity market. FI gathered information about automated trading via surveys, interviews and analysis of research and ongoing work on legislation.²¹ The purpose was to analyse high frequency trading as a basis for FI's future work in international groups and its own supervisory focus.

Research indicates that the impact of high frequency trading on financial stability is still limited. The business model of high frequency trading, of not taking overnight positions, involves only small ripple effects and hence a limited risk of a systemic crisis. However, FI's investigation showed that fears about heightened market abuse are great, which must be taken very seriously.

The Swedish players are concerned about share price manipulation having risen in connection with high frequency trading and that market surveillance is inadequate. This poses a risk of seriously undermining confidence in regulated trading. Equity trading is cross-border today, and a lack of coordinated market surveillance of marketplaces and national boundaries is an important reason for the heightened fears regarding market abuse. Many of the planned measures address this and will be incorporated into the framework of forthcoming EU regulations and by the ESMA.

The European Systemic Risk Board (ESRB)

Since it started up in 2011, the ESRB has issued three public recommendations.²² The first recommends that national supervisory authorities undertake a series of measures to counteract the systemic risks that can arise as a result of too great an extent of lending in foreign currency. At the beginning of 2012, the ESRB published another recommendation regarding measures that should be taken to avoid systemic risks associated with the US dollar as the funding currency for banks. The recom-

<http://www.esma.europa.eu/content/ESMAs-Technical-Advice-possible-delegated-acts-short-selling-and-certain-aspects-CDS>.

²¹ <http://www.fi.se/Utredningar/Rapporter/Listan/Kartlaggning-av-hogfrekvens--och-algoritmhandel/>.

²² <http://www.esrb.europa.eu/recommendations/html/index.en.html>.

mendation stipulates that the national supervisory authorities should strengthen their surveillance of funding in US dollars and that the national supervisory authorities must ensure that credit institutions have contingency plans to cope with any problems arising that relate to funding in US dollars. The third recommendation contains guiding principles for the structure and content for the EU Member States' macroprudential policy mandate. The ESRB should also be informed in advance about the measures taken to rectify systemic risks at the national level. In addition, the ESRB has emphasised in a public letter the importance of Member States having the right to place stricter requirements nationally if needed to safeguard financial stability, even in future European capital adequacy regulations.²³

DIALOGUE WITH THE INDUSTRY ON NEW EU REGULATIONS

The assignment of the European supervisory authorities of drawing up directly binding technical standards is new, both for the European supervisory authorities and FI. In 2011, intensive regulatory efforts were set in motion, mainly at the EBA and ESMA in terms of producing technical standards. The timeframes are strict, meaning that a large number of technical standards will be produced in a relatively short space of time. Many of the resources used previously for writing Swedish regulations are now needed to contribute to and influence regulation at the EU level. Some of FI's regulations need to be revised or in certain cases completely repealed when the technical standards are adopted by the EU Commission in the form of regulations or decisions, because they will be directly applicable in Sweden.

The technical standards must be adapted to the entire EU and there will be no possibility of adapting the regulations to specific national circumstances once the technical standards have come into effect as a regulation. The viewpoints of firms and industry organisations are therefore important when the technical standards are being developed. All European supervisory authorities have one or several interest groups to be consulted before a technical standard is submitted to the EU Commission. The European authorities will also hold open public consultation before a decision is taken on a technical standard. In FI's work, it is relevant to obtain the viewpoints more directly from Swedish firms and interest groups in the current work on new regulations. FI has therefore established a number of external reference groups for a number of questions, but FI sees scope to further develop communication with the industry.

23 <http://www.esrb.europa.eu/news/pr/2012/html/pr120402.en.html>.

Glossary

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

Basel 3 A new global framework established by the Basel Committee. The Basel 3 accord for the banking sector contains regulations regarding capital adequacy, leverage ratio and liquidity regulation. Basel 3 is to replace the regulations (Basel 2) which are the currently applicable regulations in Europe and elsewhere.

Capital requirements Regulations about the minimum amount of capital an institution must maintain to conduct operations.

Common equity Tier 1 capital Denotes in principle equity, i.e. share capital and accumulated non-distributed profits. The exact definition to apply in the EU is being established in CRD IV.

Host Member State The countries other than the domestic country where a firm conducts operations through branches or otherwise conducts cross-border operations without establishing a particular company.

Hybrid company Life insurance companies can be run as either profit-distributing companies or according to the principles of reciprocity (hybrid company). The principles of reciprocity involve operating surpluses accruing to policyholders. In insurance companies, this principle is upheld through the ban on distribution of profits, i.e. shareholders do not obtain any return on their invested capital.

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

Market risk The risk of losses resulting from fluctuations in interest rates, currencies, share prices or commodity prices.

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

Solvency 2 An umbrella term for the new regulations for the financial position and strength (solvency) of insurance companies being drawn up in the EU. To be introduced into Swedish law by 31 December 2012 at the latest.

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

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

Supervisory college A forum for international supervisory collaboration work that includes the concerned supervisory authorities for various units and countries in a financial group.



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