

**Sweden: Financial System Stability Assessment,
including Reports on the Observance of Standards and Codes on
the following topics: Monetary and Financial Policy Transparency,
Banking Supervision, Securities Regulation, Insurance Regulation,
and Payment Systems**

This Financial System Stability Assessment paper on **Sweden** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **July 10, 2002**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Sweden** or the Executive Board of the IMF.

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SWEDEN

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and European I Departments

Approved by Hassanali Mehran and Carlo Cottarelli

July 10, 2002

- The Financial System Stability Assessment (FSSA) is based on the work of an IMF mission that visited Stockholm as part of the FSAP during October 8–12 and November 12–20, 2001. The mission met with officials from the Sveriges Riksbank, the Ministry of Finance, the Financial Supervisory Authority, the National Debt Office, the Deposit Guarantee Board, as well as representatives of the banks, insurance companies, and the securities markets. The findings of the FSAP mission were discussed with the authorities on May 6–8, 2002, in the context of the 2002 Article IV consultation with Sweden.
- The mission was led by Mr. R. Barry Johnston and comprised Mr. Luca Errico, Mmes. Mary Zephirin, Jennifer Elliott, Jingqing Chai, and Cynthia Galang (administrative assistant) (all IMF-MAE); Mr. Balázs Horváth (IMF-EU1); and Messrs. Allan D. Fink (Federal Reserve Bank of Chicago); Tuomo Malin (Financial Supervisory Authority of Finland); Lutz Oehlenberg (German Federal Insurance Supervisory Office); Bruce White (Reserve Bank of New Zealand); Harm Jan Woltjer (De Nederlandsche Bank). Mr. Åke Törnqvist, Advisor to the Executive Director for Sweden, participated in the discussions.
- The mission's overall assessment is that Sweden has an advanced and overall sound financial system that complies well with international standards and codes. As is the case in other advanced banking systems, Sweden now confronts an environment that is less benign than in recent years and one that poses a number of challenges both to banks themselves—associated with maintaining profitability in a highly competitive market—and to the regulators and supervisors—associated with the large and complex nature of the financial institutions, the potential moral hazard risk in the financial system, and the potential contagion risks due to the high concentration of the financial system and the systemic importance of Swedish institutions in several other jurisdictions. The mission discussed a number of regulatory, supervisory, and crisis management arrangements that could help mitigate these risks. The authorities were aware of many of the issues at hand; were open to the mission's advice; and appeared to possess the willingness and resolve to address the outstanding issues effectively and in a timely fashion.
- This report is divided in two parts. The first part presents the mission's main findings and overall assessment, while the second part presents summary assessments of observance of standards and codes regarding banking supervision, insurance regulation, securities markets, payment and settlement systems, and transparency in monetary and financial policies. The FSAP report, containing detailed assessments of observance of international standards and codes, will be transmitted to the authorities.
- The authors of this report are: R. Barry Johnston, Luca Errico, Balázs Horváth, Mary Zephirin, Jennifer Elliott, and Jingqing Chai.

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GLOSSARY

BASMOD	Riksbank's macroeconomic model
BAV	Bundesaufsichtsamt für das Versicherungswesen
BSA	Banking Supervision Authority
CAR	Capital adequacy ratio
CLS	Continuous linked settlement system for foreign exchange transactions
CMA	Crisis Management Authority
DGB	Deposit Guarantee Board
DGS	Deposit Guarantee Scheme
ELA	Emergency liquidity assistance
EC	European Commission
EU	European Union
FI	Financial Supervisory Authority (<i>Finansinspektionen</i>)
FMFGs	The four major financial groups
FSAP	Financial Sector Assessment Program
GDP	Gross domestic product
IAIS	International Association of Insurance Supervisors
ICS	Investor Compensation Scheme
ICT	Information and computer technology
IOSCO	International Organization of Securities Commissions
IT	Information technology
LCFIs	Large and complex financial institutions
MML Act	Act on Measures against Money Laundering
MOU	Memorandum of Understanding
NDO	National Debt Office
NPLs	Non-performing loans
PAYG	Pay-as-you-go system
RIX	Riksbank's large-value payment system
RTGS	Real time gross settlement system
VPC	Central Securities Depository

Overall Stability Assessment

1. ***Sweden has an advanced, complex and overall sound financial system that complies well with international codes and standards.*** Financial service activities are centered around four major banking/financial groups whose activities and geographical scope of operations have expanded rapidly in recent years through mergers, acquisitions and bank branching. The groups are now active in insurance and securities as well as cross-border banking, and with extensive operations throughout the Nordic area, and, in some cases, the Baltics, and Germany. Profitability of the groups has been good, buoyed by the strong real economy, the rationalization gains that accompanied the mergers and acquisitions, and the very strong equity markets that enhanced commission income. The good economic performance also strengthened corporate and household balance sheets.

A. Financial Soundness Analysis

2. ***The indicators of financial soundness, which had improved during the second half of the 1990s, showed a weaker tendency*** with the fall in equity prices from mid-2000 and slowing in economic growth beginning in the first half of 2001.

- ***The FMFGs*** experienced a drop in income from fees and commissions, a rise in their average cost/income ratio, and a drop in operating profits. Non-performing loans have increased but remained low. Capital adequacy varies between the major banks and has been broadly stable to improving.

- ***Pension institutions' and insurance companies'*** solvency positions have been weakened by the fall in equity prices. A further downturn in the equity market would raise concern over the solvency of some of the insurance companies.

- ***Independent mortgage institutions and small niche banks*** on average posted stronger capital adequacy and asset quality and lower cost structures than the FMFGs, and are a source of strong competition in the retail market.

- ***Swedish money, securities and foreign exchange markets*** are well developed, liquid and efficient, and employ a wide array of financial instruments. Large counterparty exposures, concentration of activities among the FMFGs and residual risks in the securities settlement system are, nevertheless, areas of potential vulnerability.

- ***Corporate and household balance sheets positions*** have shown some tendency to weaken with corrections in equity prices, and increasing debt levels, but their indebtedness appears to be in line with their ability to pay.

3. ***Stress testing of the four major financial groups*** indicates that currently the FMFGs are robust to shocks to equity and real estate prices, as well as exchange rates and interest rates and to a temporary economic slow down. A combination of these shocks would represent significant challenges for the life insurance subsidiaries of the FMFGs. The capital

adequacy of the FMFGs would be vulnerable to a prolonged economic downturn, especially if the economic slow down had an impact on a major counterparty of the groups. As the groups have fairly large concentrations of exposures to certain common counterparties, including each other, the risks to the economy posed by adverse financial sector developments could be substantial in these circumstances.

B. Compliance with Codes and Standards

4. *While the financial regulatory and supervisory arrangements demonstrate a high degree of compliance with international codes and standards, two weaknesses were identified in FI's capacity to fully implement regulation of the financial sector.* These relate to (i) the lack of resources and insufficient numbers of experienced staff at the regulator; and (ii) the regulator's lack of authority to take interim or corrective action measures. The authorities are cognizant of the resource needs of FI, and FI has asked for substantial budgetary enhancements. Envisaged changes to respond to the new Basel Capital Accord and proposed regulatory changes are expected to enhance the interim corrective action powers of the regulator.

5. *The assessments indicated specific areas where some strengthening of the regulatory framework or procedures would be appropriate.* Among these are the following:

- *Basel Core Principles:* Certain deficiencies were found in the observance of the principles dealing with the control on the fitness and propriety of banks' management, the extent of consolidated supervision, the loan loss provisioning, connected lending and remedial actions.
- *IAIS Insurance Core Principles.* There was full or partial compliance with the principles; certain deficiencies were found in the observance of the principles dealing with licensing and changes of control related to the supervisors capacity to conduct fit and proper tests.
- *IOSCO Principles.* Oversight of the exchanges and clearing and settlement systems should be improved, and the rules regarding issuers and mutual fund companies, especially those owned by financial groups, could be strengthened.
- *CPSS Principles:* The RIX-system complies with the core principles except that full cost-recovery is not achieved.
- *CPPS/IOSCO recommendations for securities settlement systems.* The settlement systems of VPC do not comply with all the CPPS-IOSCO recommendations. Risk management measures should be implemented to prevent unwinding and to contain the present systemic risk in the clearing, and supervision of clearing and settlement should be improved.

- ***IMF's Code of Good Practice in Monetary and Financial Transparency.*** Sweden has a culture of transparency, and demonstrates a high degree of compliance with the IMF Code. The responsibilities of the Riksbank and FI, and cooperation between the two institutions concerning the supervision of payment systems should be clarified.
- ***IMF's Draft Methodology Document on Anti-Money Laundering.*** Sweden has a comprehensive body of legislation and rules to prevent money laundering. Some strengthening of the laws and regulations for insurance companies and mutual funds would be desirable.

C. Challenges to Financial Sector Public Policy and Recommended Responses

6. ***The Swedish financial system, like other advanced financial systems confronts an environment that is less benign than in recent years, and one that poses a number of challenges.*** Among these are challenges to banks themselves—associated with maintaining profitability in a highly competitive market—and to the supervisors and regulators in responding to a more complex financial environment.
7. ***Increasing competition in a more difficult market environment may require a further rationalization in the banking industry.*** The route for rationalization through mergers among the FMFGs appears to have been closed by concerns over concentration in the Swedish domestic banking market. The FMFG's profitability will depend on their success in adjusting their costs and operations. The more efficient banks have been better positioned to handle the recent economic slow down.
8. ***Sweden's supervisors and regulators are dealing with a range of issues*** associated with the large and complex nature of the financial institutions.
 - ***Supervisory challenges:*** The FMFGs pose additional regulatory and supervisory challenges due to the cross-sectoral and cross-border nature of activities.
 - ***Moral Hazard:*** Sweden, like many other countries, is facing a “too-big-to-fail” problem with regard to the FMFGs. The potential moral hazard problem is aggravated by the systemic importance of the groups in several jurisdictions and Sweden's provision of a blanket guarantee to banks' debtholders as a response to the systemic banking crisis in the first half of the 1990s.
 - ***Concentration and contagion:*** The FMFGs face three types of contagion risks: intra-group contagion effects from one business area to another; interbank contagion effects from one major bank to another through interbank markets; and contagion between different national financial systems. Large counterparty exposures among the FMFGs are a potential source of vulnerability.

9. ***Responding to these issues creates challenges for supervisors and regulators generally.*** Nevertheless, a number of different regulatory, supervisory and crisis management arrangements could be considered to help mitigate the above-identified risks.

- ***Supervision of bank soundness.*** Effective consolidated supervision is a key element of the supervisory regime for Sweden's FMFGs. FI's new risk focused approach to supervision is an important step forward and should be supported with the necessary resources and authority to conduct a more pro-active supervisory process, and emphasis on corporate governance in the institutions themselves. Consideration should also be given to "setting the prudential bar higher" to capture the systemic risks posed by the FMFGs, including by more active monitoring of large exposure risks, and continued close monitoring of capital adequacy.

- ***Risk proofing the financial system.*** Potential systemic and contagion risks could be reduced through stronger risk management practices in the VPC securities settlement system. Counterparty risk in the interbank market could be reduced by promoting collateralized transactions through the greater use of repurchase agreements. However, fully dealing with the large counterparty exposures among the FMFGs will be a challenge while Sweden remains outside the Euro zone.

- ***Emergency liquidity support.*** The design of emergency liquidity support arrangements is particularly complex given the cross-border nature of the Swedish major financial institutions. Greater cross-border harmonization of approaches to distinguishing between liquidity and solvency problems and implementation of ELA could help.

- ***Procedures for handling insolvency in large financial institutions.*** A lacuna in current legislation is the absence of a legal framework for dealing credibly with a solvency problem in a major financial institution. There appears to be broad agreement in Sweden on the need for legislation that would allow for the orderly winding up of financial institutions, and there would appear to be merit in adopting an approach involving the enactment of enabling legislation for this purpose. A credible regime for winding-up financial institutions would need to be underpinned by a greater harmonization of national legal, supervisory, and regulatory frameworks, in the countries where the Swedish financial institutions are systemically important.

D. Responses by the Authorities

10. **The authorities were in agreement with most of the conclusions and priority actions recommended by the mission,** and have used the results to further strengthen their operations and enhance improvements to the supervisory and regulatory frameworks.

- Most of the legislative measures brought to the fore by the assessment are either under current legislative consideration, e.g., in the context of the proposals of the Banking Law Committee, or are planned to be processed in the near future, e.g., the government commission currently working on an overhaul of the 1990 Mutual Funds Act. A proposal to

reform the regulation for banks and other credit institutions has been put forward for public comment with the objective of submitting legislation to parliament this year.

- Substantial strengthening of prudential oversight on the activities of the Stockholm Stock Exchange and VPC is expected to derive from a new supervisory approach focusing on group-wide risk assessments that the FI began implementing in 2002. Moreover, the VPC is implementing a two steps approach to comply with the IOSCO-CPSS standards. As a first step, new rules were implemented on May 8, 2002 eliminating indirect participation in the VPC effective October this year. As a second step, the VPC is working on a new model for its settlement operations that would eliminate the present “unwinding procedure.” Clarification of the supervisory responsibilities of the Riksbank and FI and cooperation between the two institutions concerning payment systems would be achieved through the exchange of a Memorandum of Understanding (MOU).
- The FI has already prepared a comprehensive strategic plan for implementation of risk-based prudential supervision and has requested substantial budgetary enhancements and expects to be provided with the resources needed in the years ahead.

SECTION I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. FINANCIAL SYSTEM OVERVIEW

A. Financial Institutions and Markets

11. *The key institutions in Sweden’s highly developed financial system are banks, mortgage credit institutions, insurance companies, pension and mutual funds.* Banks and mortgage institutions are the key credit institutions, accounting for some two-thirds of financial sector assets at end-2001 (Table 1). Other key financial intermediaries include the insurance companies and the National Pension Fund (Table 1). The pension system was recently reformed with a number of innovative features (Box 1). The Swedish financial institutions are well integrated into the world, and especially the European financial system, and are at the forefront of developing and applying new technologies and financial products.

12. *Swedish money, securities and foreign exchange markets are well developed, liquid and efficient,* and employ a wide array of financial instruments, including interest and foreign exchange-linked derivatives. The Riksbank conducts monetary policy primarily by setting the interest rate on its weekly repo operations. The National Debt Office (NDO) is responsible for government debt and cash management (Box 2); a regular issue calendar in domestic currency debt and an Authorized Dealer System has helped promote liquid primary and secondary markets in government debt. The Stockholm Stock Exchange, which conducts spot share trading as well as equity and financial derivatives transactions, is supported by a well-developed system of mutual funds and investment firms that have promoted wide share

ownership in Sweden. The VPC is the single depository and securities clearing and settlement system.

13. *The Swedish financial system is highly concentrated, dominated by FMFGs* which have evolved through cross-product (financial services) and cross-border mergers and acquisitions. At end-2001, the Nordea group, SEB, FöreningsSparbanken (Swedbank) and Handelsbanken accounted for two-thirds of financial sector assets, four-fifths of bank deposits and of assets under management in mutual funds, and each owned a life insurance company ranked among the seven largest in Sweden. These FMFGs are the principal counterparties in Swedish krona interbank and foreign exchange trading, and are also the largest Riksbank counterparties in the money markets, as well as the largest authorized dealers of the NDO in the government bond market. These banks also own VPC and have majority ownership in BankGiroCentralen, the most important retail payment system in Sweden. Mergers and acquisitions strengthened and broadened each financial group's activities during 1997-2000.¹ In addition to each institution's strong presence in Finland, Norway and Denmark, they also play dominant roles in some Baltic countries.

14. *While private ownership of financial institutions is predominant in Sweden, the state still maintains shares in some institutions*, notably an 18 percent stake in the Nordea Group and nearly 10 percent ownership of the OM Group, parent company of the Stockholm Stock Exchange (Table 2). The Riksbank owns the RIX large value payment system.

B. Regulatory Framework and Safety Nets for the Financial System

15. *The Swedish legal system provides a clear and comprehensive framework for regulation of the financial system.* The duties and responsibilities of the central bank and the financial sector regulatory authority and their relationship to parliament and government are set out in detail in legislation. Swedish law is codified and thus authority over regulated entities is tightly defined in legislation governing the financial sector. Formulation of legislation for the financial sector rests with the Ministry of Finance, with specific rule making authority codified under each law. In addition, financial sector laws are governed by EU directives and regulations.

¹ The Nordea group emerged from a conglomeration of Nordea Bank (Sweden), Merita Bank (Finland), Christiania Bank (Norway), and Unibank (Denmark). Following its restructuring, Nordea Bank Finland will hold the bulk of the group's assets and equity. Nordea recently acquired Postgirot Bank. Handelsbanken acquired a large Swedish mortgage institution and a life insurance company; SEB acquired a large Swedish insurance company and a mid-sized German bank; and Swedbank emerged from the domestic merger of the Swedish Savings Bank and Föreningsbanken, a bank resulting from a merger among several cooperative banks some years earlier.

16. ***The Riksbank is appointed central bank under The Constitution Act and reports directly to parliament.*** The Riksbank is independent and under the *Constitution Act* and the *Sveriges Riksbank Act* is given responsibility for monetary policy. The objective of the Riksbank is to maintain price stability, and for this purpose it follows an inflation-targeting regime. The Riksbank is also entrusted with promoting safe and efficient payment systems.
17. ***FI, the unified supervisor, is an independent agency reporting to the Minister of Finance.*** FI is responsible for its own decision and rule making, and Swedish law prohibits interference by government in FI's day-to-day decision making. Under the *Banking Business Act* and *Insurance Business Act* FI may refer decisions of "fundamental importance" to the Minister of Finance for consideration. FI relies on the Ministry of Finance for its budgetary requirements and is also given an annual statement of instructions from the Minister of Finance, outlining its responsibilities and priorities for the year.
18. ***FI is the sole responsible regulator for the banking, insurance and securities sectors.*** It is given authority, including the licensing authority, over banks, credit institutions, insurance companies, insurance brokers, market intermediaries, mutual funds, exchanges and issuers. In implementing its supervisory responsibilities FI presently focuses on the 13 important financial institutions or groups listed in Table 2.
19. ***The Swedish system makes extensive use of self-regulatory organizations—both formal and informal.*** Regulatory responsibilities are delegated to the Stockholm Stock Exchange, an exchange and self-regulatory organization, and VPC, the securities clearing and settlement system and central depository—both of which are supervised by FI. FI relies informally on industry associations including the Bankers' Association, the Swedish Insurance Federation, the Industry and Commerce Stock Exchange Committee, the Mutual Funds Association and Securities Dealers Association to provide industry best practices. These best practices are often treated as if they are legally binding.
20. ***Regulation of the financial sector is supported by highly developed bankruptcy and consumer protection laws and an efficient court system.*** General bankruptcy law also applies to financial institutions. Sweden's ordinary courts decide commercial disputes, while administrative courts handle matters related to the administration of regulations and the activities of the independent agencies. Consumer protection law in Sweden is well developed.
21. ***Financial safety nets in Sweden have been shaped by the 1992 systemic banking crisis and by EU Directives.*** Currently, Sweden operates a Deposit Guarantee Scheme (DGS) and an Investor Compensation Scheme (ICS), both administered by the Deposit Guarantee Board (DGB), a public authority under the purview of the Ministry of Finance. The DGS came into force on January 1, 1996, shortly before the Banking Support Authority was wound-down (Box 3) and the ICS on May 1, 1999. Both schemes provide for a maximum amount of compensation to eligible claims of SKR 250,000 per depositor/investor per institution and are allowed to borrow from the Swedish NDO should the need arise.

II. MACROECONOMIC RISKS AND FINANCIAL SECTOR EXPOSURES

A. Macroeconomic Environment

22. *Sweden regained macroeconomic stability and policy credibility following a severe financial crisis in 1991-92.* The crisis—triggered by inconsistent policies in the wake of a boom following financial liberalization—precipitated Sweden’s deepest recession since the 1930s. The krona was floated in November 1992 and wide-ranging policy reforms were put in place. The Riksbank successfully switched to inflation targeting in 1993, gradually acquiring credibility through a consistent and transparent implementation of monetary policy. This was complemented by sustained fiscal adjustment that was placed in a formal medium-term framework from 1997, and the deregulation of key markets prompted by Sweden’s EU entry in 1995.

23. *Following rapid expansion in 1998–2000, economic activity became subdued from the first half of 2001* (Table 3). Sound policies and a supportive international setting facilitated growth averaging around 4 percent in 1998-2000, a surge in employment and a rapid build-up of household wealth on the back of real estate and equity prices buoyed by a booming ICT sector. Inflation remained around the lower end of the Riksbank’s target band of 2 percent \pm 1 percent, the budget and current account registered surpluses of several percent of GDP, and gross public debt fell by a fifth to 56 percent of GDP at end-2000. Swedish share prices, dominated by ICT stocks, more than doubled through mid-2000. The global downturn, sharply reduced equity prices, and reduced foreign demand adversely affected domestic demand through confidence and wealth effects in the first half of 2001. Headline inflation rose to above 3 percent by fall 2001 but subsequently fell back to 2½ percent in May 2002. Real prices of commercial properties have stabilized following increases in the past few years, and remain below their pre-crisis level.²

24. *Macroeconomic swings were accompanied by changes in industrial structure and were closely reflected in private sector balance sheet developments.* During the 1990s, Sweden’s industrial structure shifted toward services and export-oriented activities in ICT, investment and durable consumer goods dominated by large multinational companies. With Swedish households’ equity market participation among the highest in the world, volatile equity markets led first to a rapid rise and then a fall in household financial assets. Household debt relative to income has increased to levels not seen since before the financial crisis; however, interest payments remained low in relation to income. While nonfinancial enterprise profitability has declined with the economic slow down, their debt to equity ratio

² The large price increases in residential apartment blocks reflected the structural change associated with changing over to tenant-owner apartments from rental apartments, for which the rents are regulated. Thus, the Riksbank does not consider the higher prices a problem for financial stability.

remained stable. More recently there has been a modest up turn in the rate of corporate bankruptcies.

B. Financial Environment

25. *The financial environment in Sweden has improved during the second half of the 1990s aided by a strong economic performance. Weaker trends emerged with the fall in equity prices from mid-2000, and slowing in economic growth beginning in the first half of 2001.*

26. *Swedish credit institutions improved their capital adequacy asset quality and probability throughout the later half of the 1990s* (Table 4). The FMFGs reached an average risk-based total capital ratio of 11.4 percent and tier 1 capital ratio of 7.5 percent at end-1999, comparable to banking system averages in the EU. Reflecting a favorable credit climate, the average share of NPLs in total loans for the FMFGs declined to 1.1 percent of total loans at end-1999. The FMFGs registered an average rate of return on equity of 19 percent in 2000, comparing favorably to many European banking systems. Income was buoyed by increased deposits and lending volumes, a favorable credit environment, and strong non-interest revenue generation through brokerage fees and commissions. While retail banking is by far the most important source of income, the expansion of the FMFGs into asset management and investment banking has underpinned the improvement in their revenue generation since 1996 (Table 5).

27. *Despite this generally favorable position, weaker economic conditions have more recently created a more challenging environment for the FMFGs.* FMFGs income from fees and commissions has fallen sharply with the correction in equity prices, and their average cost/income ratio increased by 5 percentage points by March 2002 since end-2000. The return on equity fell to 13 percent in 2001, reflect the economic slow down. Banks have been seeking to strengthen their tier 1 capital and at end-March 2002, their average tier 1 capital adequacy ratio was 7.1 percent, and overall risk weighted capital adequacy was 10 percent. FMFGs' NPLs are still quite low, despite the economic slow down.

28. *Although the liquidity of the Swedish credit institutions has on average declined slightly, it has not appeared to be a problem for their liquidity management.* Swedish credit institutions have also gradually begun to benefit from the money market of the euro area where deep and liquid cash, repo, and derivatives markets broaden the scope of liquidity management in Sweden, facilitated by the fast growing interbank foreign exchange market.

29. *Corporate and household borrowing remain the two most important uses of institutions' credit in Sweden* (Table 4). Residential mortgages (mostly on flexible rates) accounted for two thirds of lending to households, and losses on this type of lending have historically been very low. The use of bank credit by the corporate sector has declined since 1996 reflecting, inter alia, the increasing use of European corporate bond markets by the large Swedish corporate firms. The sectoral distribution of corporate loan portfolios highlights a continuing high concentration of loans to real estate management companies in

some banks, although the concentration is lower than that prior to the 1992 banking crisis. Direct lending from the FMFGs to ICT-related businesses was limited to below 2 percent of their total lending at end-2001.

30. ***The indebtedness of households and corporate sectors appears to be in line with their ability to pay.*** At end-March 2002, while household debt as a percentage of disposable income reached 110 percent, the interest expenditure after tax was around 5 percent of disposable income, remaining at a historically low level. The debt to equity ratio of the nonfinancial corporate sector has remained at a stable level and interest coverage ratios remained comfortable.

31. ***The solvency positions of the pension institutions and insurance companies have been weakened by the fall in equity prices and to a lesser extent the depreciation of the krona, although the solvency ratio in the majority of the insurance companies remains comfortable.***³ The market risks facing the life insurance companies on the assets side mostly concern the holdings of equities and fixed-income instruments, which account for nearly 80 percent of total exposures.

32. ***The Swedish credit institutions outside the FMFGs on average posted stronger capital adequacy and asset quality,*** reflecting the relatively strong capital position and low credit risk in mortgage institutions and small niche banks. Independent nonbank credit institutions (finance companies, credit card companies, and investment banks) are small and pose no systemic risk to the financial system in Sweden.

C. Stress Testing Exercise

33. ***A series of stress-test exercises performed by the Riksbank and the FI quantify the potential exposures of the financial sector to macroeconomic risk factors.*** The stress tests focus on the four largest financial groups (Nordea, S.E.B., Handelsbank, and Swedbank), and are carried out for each group as a whole, i.e., including banks, insurance companies, mortgage and finance company subsidiaries.⁴ To the extent that the groups' accounts are consolidated at the group level, the stress tests cover not only their domestic (Swedish)

³ Solvency ratio is the ratio of available margin (the difference between market value of assets and liabilities) to required margin (minimum level required by relevant EU directives).

⁴ Owing to EU accounting rules, the assets and liabilities of mutual companies (practically all life insurance subsidiaries of the major financial groups are such) belong to the policyholders and are thus not consolidated into the group's balance sheet. Separate stress tests were conducted for these companies, with the results reflected in the assessment of the impact of the shocks. The groups have limited non-life insurance activities, which are included in the consolidated accounts, and hence in the stress testing results. Transfer of risks through credit derivatives is immaterial.

activities, but also those of their foreign subsidiaries. The stress tests include six sensitivity tests estimating market risk exposures associated with exchange rate, equity and real estate shocks (scenarios 1-6), and a stress test scenario of three years of zero growth (scenario 7) estimating credit risk exposures. Stress test details are discussed in Box 4.⁵

34. ***The sensitivity test results suggest that currently the FMFGs are robust to market-risk shocks in the near term.*** The individual sensitivity estimates suggest only modest losses that would have little effect on the four major groups' solvency or on their ability to regain profitability after the shock.

- ***The impact of the equity shock on banks is small, although that on life insurance subsidiaries is less trivial, reflecting more substantial equity exposures in insurance.***⁶ Since the banks have very low direct exposures to equity, a further decline in equity prices has only limited direct impact on the asset values in banks' trading books and, to some extent, banking books. However, because the four major banking groups' life insurance subsidiaries have substantially higher equity exposures—amounting on average to some 40 percent of their risk exposures—the impact reduces the market value of their margin (the excess of the market value of their assets over their technical provisions, i.e., over the present value of their future liabilities) by 25 percent to 150 percent.

- ***While the losses associated with banks' direct property holdings are mild, the credit losses relating to the lending to the commercial real estate sector could be sizable.***

Concerning direct losses, one financial group showed a loss of SKR 6 billion, still a small impact relative to its capital base, and aggregated direct losses relative to total capital remain below 2 percent (banking and non-life insurance) and 5 percent (life insurance). Concerning credit losses, most of the losses relate to the lending to the commercial real estate sector. If the credit losses from a 40 percent decline in commercial real estate prices were added, the capital adequacy of the four groups would remain above the prudential minimum levels. However, should these prices fall to the levels immediately following the 1992 crisis (an adjustment of 60 percent), these credit losses could bring the capital adequacy of two groups to the prudential minima. Household mortgages are collateralized and typically have an excellent repayment record.

- ***The impact of exchange rate shocks is modest, reflecting the small net exposures to foreign exchange risk.*** Further depreciation of the krona affects one of the financial groups

⁵ The stress tests do not explicitly account for stress related to the ICT sector. Indirect effects on banks' insurance subsidiaries have been incorporated in the stress tests through changes in the value of insurance companies' ICT equity holdings.

⁶ The stress test did not take into account the second-round effect of the equity shock on the households' net worth. Historical experience suggest that falls in equity prices have had limited impact on households' ability to service debt.

negatively, while it increases the asset values in the other three groups. The impact is particularly small for one of the groups in either direction, suggesting that its foreign exchange positions are highly hedged. Losses on life insurance companies remain below 6 percent of their margins.

- ***The impact of interest rate hikes on the FMFGs is sizable. The first round effect is even greater for their insurance subsidiaries, which have larger exposures to fixed-income assets in their balance sheets.*** The estimated impact of a long-term interest rate hike on the groups is smaller than that of an upward shift in the whole yield curve. The latter shock's impact amounts in aggregate to 5 percent of combined capital base, whereas the margin in life insurance companies fall by 7 percent. However, the impact on life insurance assets would be mitigated by the adjusted present value of future liabilities as a result of the immediate increase in the discount rate.

- ***If several of the shocks in the above sensitivity tests were to occur, the combined effects would represent significant challenges for the life insurance subsidiaries of the financial conglomerates.*** Separate calculations were performed for these subsidiaries, since they were not included in the individual stress tests. The subsidiaries have significant exposures to fixed income assets, equities and real estate. As a result, the margins could be exhausted in four of the financial groups' life insurance subsidiaries. Because life insurance companies have the option of reducing their payouts to policyholders by a substantial margin (bonus) as long as they pay the guaranteed minimum, they can potentially absorb much of the shock without affecting the rest of the financial group. When the margin falls below the prudentially required level, it is assumed that the parent company would inject sufficient capital to reach the minimum level.

35. ***The stress test scenario, which assumes a consistent set of shocks leading to zero growth in the coming three years, indicates that the major financial institutions are somewhat vulnerable to credit losses should there be a steep and prolonged economic downturn.*** The banks would be strained in this scenario; with their aggregated losses reaching 0.6 percentage points of the four groups' combined tier 1 capital ratio over a one-year period. If losses over three years were used, all four financial groups would see their risk-based capital adequacy ratios (both tier I and total) fall below the prudential minimum requirements. However, over this longer period, it is highly plausible that this impact would be substantially mitigated by the earnings from the groups' continuing operations, and by cutting costs. As a result, none of the groups would face an immediate danger of insolvency.

36. ***The stress test results suggest that insurance subsidiaries in the financial groups may adversely affect the banking component.*** This is a result of the banking arms having little direct exposure to commercial real estate and equities whereas insurance companies have significant exposures to both asset groups. The externality arises through two channels. First, there is a potential that the severe losses on the insurance side could imply reputation risks for the banking member of the conglomerate. Second, if the losses are severe, there may be a need for a capital transfer from the banking arm.

37. *The risks to the economy posed by adverse financial sector developments could be substantial in certain circumstances.* While banks' capital base has remained adequate, the precipitous drop in the stock market has lowered their commission income, and adversely affected insurance and securities companies through the shrinking value of their investment assets, as well as households by lowering their financial wealth. Historically, however, in Sweden household consumption has responded only moderately to developments in financial wealth, and mortgages are collateralized and typically have an excellent repayment record. Larger risks may be posed by adverse developments in the corporate sector, especially if an economic slow-down has a more severe effect on a particular sector where banks are more heavily exposed. Moreover, as noted elsewhere, banks have fairly large concentrations of exposures to certain counterparties. In this event the stress scenario would underestimate the potential loss and strains on the financial system. Finally, other risks, which have not been included in stress tests, could materialize. These include the possibility of a rapid cross-border propagation of shocks stemming from the financial groups' extensive foreign operations, of contagion from life insurance companies facing losses from demographic changes raising longevity, and unforeseen losses due to the increase in operational risks inherent in the large and complex financial institutions. Alternatively, if Ericsson (Sweden's leading telecom company), were to be downgraded to non-investment grade (as warned recently by Moody's), Swedish banks could be called upon to provide large credit lines to replace dried up bond financing for the company, raising their share of risky assets.

38. *On balance, barring prolonged further deterioration of economic conditions, Sweden is likely to keep an overall sound financial system.* This conclusion is based on evaluations of possible future scenarios, as well as macroeconomic developments over the last 6 to 12 months, both domestically and globally. As it is typically the case, some caution needs to be used to avoid misinterpretations of the results owing to the simplified assumptions that were used. While insurance companies are shown to be more vulnerable than banks to market risk, their underlying core business income is currently good. Moreover, they have the ability to reduce their payouts to policy holders by a substantial margin (bonus) and/or raising premiums. Hence, they have the ability to absorb much of the shock without affecting the other parts of the group. Additionally, when interpreting the estimated impact under various scenarios, it should be kept in mind that substantial mitigations to the shocks would derive from the groups' continuing operating income, as well as possible cost-cutting measures.

III. REGULATORY, SUPERVISORY, AND TRANSPARENCY ARRANGEMENTS

39. *The adequacy of Sweden's regulatory, supervisory, and transparency arrangements has been assessed against the main international codes and standards:* the Basel Core Principles for Effective Banking Supervision; the IOSCO Objectives and Principles of Securities Regulation; the IAIS Insurance Supervisory Principles; the Core Principles for Systemically Important Payment Systems and Recommendations for Securities Settlement Systems; the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies; and the Draft Methodology Document on Anti-Money Laundering. Summary assessments of observance of financial system standards and codes are provided in Section II

of this report. The following provides an overview of key findings and potential vulnerabilities identified by the assessments.

40. ***While the general prerequisites for adequate supervision are largely in place, the assessments pointed to two broad areas of concern in FI's capacity to fully implement regulation of the financial sector.*** Sweden possesses a well-developed and stable overall institutional and legal infrastructure, with modern actuarial, legal and accounting practices. However, while the legislative framework, complemented by FI's detailed rules, sets a high standard of regulation, the lack of resources and insufficient numbers of experienced staff at the regulator has made it difficult for FI to supervise implementation of these rules at a detailed level. There are skill shortages within the regulator in the areas, for example, of complex risk models, mutual funds and clearing and settlement. In view of FI's lack of legal authority to take interim or corrective action measures and its limited enforcement authority, FI has relied on moral suasion in coordination with possible sanctions to influence corporate behaviour.⁷

41. ***The authorities are in the process of tackling these issues.*** A proposal from the Ministry of Finance to reform the regulation for banks and other credit institutions has been put forward for public comments with the objective to submit a bill before parliament in the autumn 2002. The proposals include measures that give the FI more means of intervention and greater flexibility to determine which measure to take such as to use warnings more widely, to issue observations and to use penalty fees. Furthermore, FI has developed proposals for staff increases to carry through the supervisory developments, including to implement a new risk based approach to supervision, to prepare for the implementation of the new Basel Accord on capital adequacy, and to strengthen market supervision.

A. Banking Sector

42. ***The assessment underscored some weaknesses in the prudential and regulatory framework, limited pro-active supervisory powers, and deficiencies in certain Basel Core Principles.*** The supervisory authorities have limited pro-active powers at their disposal to help prevent problems worsening to the extent that the only effective measure left is the revocation of a bank's license. Deficiencies were found in the observance of the Basel Core Principles dealing with the control on the fitness and propriety of banks' management; the extent of consolidated supervision both at the national and cross-border levels; loan-loss provisioning; connected lending; and remedial actions.

43. ***The FI has used moral suasion—in combination with a number of sanctions that can currently be applied—as a supervisory technique*** to have banks respond to regulatory and safety and soundness shortcomings. While moral suasion may well have a place in the

⁷ The sanctions include issuing a warning to withdraw a license and refusing to authorize new business activities after a warning has been given.

FI's tool-kit and has worked well thus far, the supervisory authorities should also have available legislative discretion and empowerment to take pro-active action when they see it fit. A scale of sanctions starting with a warning and ending with the withdrawal of the license would be desirable.⁸ The main report of the Banking Law Committee⁹ did include provisions proposing pro-active general powers to the supervisory authorities and the Ministry of Finance has now issued for public comment reform proposals for the regulation of credit institutions that includes new powers from FI to issue a public reprimand and impose monetary penalties. These provisions are expected to be presented to Parliament in the autumn and to become effective January 2004.

44. *FI may need to play its role of lead supervisor for the Sweden-headquartered LCFIs operating in the Nordic region more prominently.* While preserving the overall collegial climate and traditional consensus approach, the FI should develop its role of lead supervisor for the LCFIs headquartered in Sweden, including on the formulation and implementation of the joint supervisory process. FI should also build effective working relationships with all host supervisors, notably in the Baltic States where Swedish banks have dominant market shares.

B. Insurance Sector

45. *The assessment of the IAIS Principles of Insurance Supervision underscored that deficiencies in certain aspects of the regulatory framework as well as staff resources have weakened FI's capabilities for effective risk-based supervision of the insurance sector.* The absence of a requirement for fitness and propriety of insurance companies' senior management in the Insurance Business Act does not provide the FI with the ability to carry out this test in the licensing process and when evaluating changes in control. Deficiencies in staff resources have resulted in a lack of thoroughness in the independent evaluation of reports submitted by supervised companies, investment policies, reinsurance contracts, and market conduct.

46. *The Insurance Business Act should be amended* to explicitly require a "fit and proper" test for insurances' senior management in the context of licensing and changes in control, including the criteria of sufficiency of qualification, experience, and suitability to help reach full compliance with all IAIS Core Principles.

⁸ For instance, the supervisors should have the ability, within a short time frame, to limit the scope of a bank's activities; to prevent the distribution of dividends in cases of insufficient loan-loss provisions; to mandate increases in banks' capital adequacy ratios above and beyond the legal minimum level; to require banks to hold economic capital against risks other than market and credit risk; and to require banks to strengthen their lending practices and increase loan-loss provisioning and reserves if warranted

⁹ "Regulation and supervision of banks and market credit undertakings" (SOU 1998:160).

C. Securities

47. *The framework for regulation and supervision of the securities markets is well developed and satisfactory—there is full or partial observance of all IOSCO Principles.* Rules related to market intermediary business conduct and trading practices, and disclosure by issuers could nevertheless be improved—current work at the EU level will help address these issues. More attention to staff inspections could improve the quality of supervision.

48. *As in the banking area, FI lacks sufficient authority in legislation to adequately enforce compliance with securities laws or to react effectively to non-compliance concerns short of withdrawing a license.* FI lacks the ability to apply penalties, including fines, directly to regulated entities—it relies instead on the public prosecution function and as a result, enforcement tools are limited. Furthermore, FI has a limited ability to impose measures on regulated entities in order to address non-compliance in a proactive way. Enforcement is further hampered by a lack of authority in FI over individual employees of investment firms and to compel evidence or production of documents from third parties.

49. *Supervision of the Stockholm Stock Exchange is weak, although the exchange has been designated as one of FI's 13 priorities.* A large part of regulatory responsibility for issuer disclosure and market intermediary trading rests with the Stockholm Stock Exchange, a for-profit public company, and yet these functions have not been subject to audits or inspections. The potential conflicts of interest in a private for-profit regulator also have not received adequate attention.

50. *The concentration of mutual fund companies within large bank-owned financial institutions creates a regulatory challenge:* 80 percent of the mutual fund sector is controlled by banks. These large institutions also act as trustees or custodians of the funds—contrary to best practices—and may also carry out trading services for the fund company. There are few rules governing the use of related companies by the fund company and this can lead to unmanaged conflicts of interest. Given the nature of the market, FI has not required the banks to use competitors as custodians and has relied on the banks' own internal risk management systems to manage potential conflicts of interest. Some of these conflicts of interest issues will be taken care of by the implementation of certain amendments to the EC/UCITS-directive. Furthermore, a government appointed committee on mutual funds will submit a report in 2002 including proposals to new legislation as regards the functioning of the mutual funds market. The committee will among other things investigate the need for additional rules governing the use of related companies.

51. *Sweden's issuer regulation has not kept pace with international standards.* The prospectus review process requires improvement, continuous disclosure requirements and protections for minority shareholders are lacking and the administration of the bulk of issuer regulation by the Stockholm Stock Exchange is not balanced with appropriate supervision. Sweden's insider reporting requirements and insider dealing legislation are satisfactory, although the lack of enforcement powers vested in FI hampers investigations. Increased

attention to continuous disclosure, and to minority shareholder rights (more stringent rules regarding public float, take-over bids, voting shares and non-arm's length transactions) could improve the environment. A more balanced division of labor between FI and the Stockholm Stock Exchange combined with increased oversight of the Stockholm Stock Exchange would also raise the quality of issuer regulation. A government commission is currently working on an overhaul of the 1990 *Mutual Funds Act*. As noted elsewhere, the commission's report is expected to address many of the issues underscored above, including the outsourcing and trustee/custodian activities performed by banks on behalf of mutual funds they own.

D. Payment Systems and Clearing and Settlement Systems

52. ***The RIX payment system, administered by the Riksbank, is well managed and functions smoothly and broadly complies with the CPSS Core Principles for Systemically Important Payment Systems.*** The Riksbank and the banking sector appear to work in close cooperation—making adjustments to ensure the system's smooth functioning. Although it functions well, the system does not operate on a cost recovery basis due to the small number of payments in a concentrated banking sector. In cooperation with the banking sector, the Riksbank is currently considering integration of the infrastructure for large value and retail payments, which would bring forward the outsourcing of the operational task of the Riksbank, and broaden the RIX-system's economic base. Some co-operative arrangements among the central banks in the Scandinavian region are being considered as a possible alternative.

53. ***The retail payment system has a complex and fragmented appearance.*** There are a large number of systems for different types of instruments, each system with a different owner and governance structure gives the appearance of undue complexity and has been included as an item for the Riksbank's upcoming review of the system. The exchange of payments between the Postgiro and the BankGiroCentralen circuits is also inefficient. On the positive side, the extraordinary popularity of e-banking has decreased the cost of payment handling and broadened access to the market for foreign and new banks. As any new business, the growing use of internet devices increases operational risk in the banking sector—this is an issue that should also be addressed in reviews.

54. ***An unprotected netting of trades in the VPC poses a risk of default, which, if it resulted in the failure of a large bank, would cause serious damage and contagion in the system.*** The VPC does not fully comply with CPSS/IOSCO Recommendations for Securities Settlement Systems. Clearing of trades is concentrated in the FMFGs—these institutions are dominant in the market and also act as clearing members or payment banks for investment firms and for small banks for whom access to the clearing and settlement system is not open or too costly. Market risk in the fixed income and equities trades during the settlement cycle are not collateralized. Furthermore, liquidity arrangements in the event of default in the settlement of a fixed income or equity trade are lacking. A default and especially a default of a clearing member or payment bank could therefore cause the distress to spread to the rest of the banking sector. Such a default would also bring forward losses to the investment firms and smaller banks that use that clearing member/ payment bank. In line with the

CPSS/IOSCO Recommendations, timely settlement should be guaranteed under all circumstances and unwinding should be prevented. On December 7, 2001, the FI requested the VPC to take appropriate measures to promptly address these deficiencies, and the VPC is implementing a two-step approach to comply with the IOSCO-CPSS Recommendations. As a first step new rules will be implemented to eliminate indirect participation in the VPC; as a second step the VPC is working on a scheme to eliminate the “unwinding” procedure.

55. *Supervision of clearing and settlement systems for securities by FI must be strengthened to address operational, legal and governance risks within the system.*

Supervision is underdeveloped—on-site examinations are not well developed and there is no regular reporting of risk assessments to the regulatory authority. The FI appears to lack the necessary expertise to fully supervise the range of risks in the complex clearing and settlement systems at VPC and the Stockholm Stock Exchange. Furthermore, there has been a lack of clear division of responsibility and formal framework for cooperation between FI and the Riksbank, where the latter in the Central Bank Act is also explicitly charged with the oversight of payment and clearing and settlement systems. Consideration should be given to enhancing the Riksbank’s legal powers to give regulations on payment systems and securities settlement systems and an explicit framework for cooperation between the FI and the Riksbank should be developed. A MOU is planned that would clarify the responsibilities of the Riksbank and FI and cooperation between the two institutions concerning supervision of the payments system. Consideration should also be given to enhancing the Riksbank’s legal powers to give it authority over clearing and settlement systems.

E. Transparency of Monetary and Financial Policies

56. *The Swedish system of formulating and implementing monetary and financial policies is highly transparent.* The roles, responsibilities and objectives of the Riksbank and FI are clearly defined, as are those of the NDO. The laws and regulations defining the roles, responsibilities and objectives of the Riksbank and of FI are readily available to the public, and each institution publishes detailed information about its activities in regular reports and through other channels (e.g., published Minutes of Board meetings and speeches by senior staff).

57. *While the system performs very well overall, some aspects of transparency could be improved. The following aspects are noted:*

- The Riksbank’s objective of promoting a safe and efficient payment system is, on its face, transparent. However, the Riksbank’s responsibility may not fully encompass all aspects of maintaining the functioning of the payment system as, under the present legal framework, there is lack of clarity in the procedures for dealing with the insolvency of a systemically important financial institution.
- More explicit and transparent understandings between the Riksbank and FI on their respective roles and the modalities of their cooperation in the supervision of payment and

clearing systems and in safeguarding these systems' stability and efficiency would be beneficial. These issues will be addressed by the envisaged MOU, as noted previously.

- While the authorities publish extensive data on the financial sector in the context of their financial stability reports, it would be useful also to make available consistent time series on financial stability indicators on a regular basis.

F. Anti-Money Laundering Arrangements

58. *Sweden has a comprehensive body of legislation and rules designed to prevent money laundering, and an effective system for supervising compliance.* The legislative framework criminalizes money laundering (ML) with appropriate sanctions, imposes customer identification, record keeping, and suspicious transactions reporting requirements; provides for confiscation of assets and instrumentalities used in ML offenses and for international cooperation in criminal matters, including ML. The legislative framework for combating the financing of terrorism will come into force on July 1, 2002. Terrorist-type crimes are provided for in the Penal Code, and the EU Directive on freezing of funds of those persons listed by the EU has been transposed in Sweden. A process for collecting, analyzing and disseminating suspicious transactions is in place. Integrity standards are broadly imposed in all the relevant sectors. FI has the authority to share information with domestic and foreign counterparts, and agreements have been put in place to facilitate the process. FI works in consultation with financial institutions to provide guidelines on AML/CFT matters, and ensure that they observe the regulations.

59. *The public institutions working to prevent and detect ML play complementary roles in a cooperative and coordinated manner.* Financial firms, including bureaux de change and remittance offices, but with the exception of property insurance companies and mutual funds, are covered by the Act on Measures against Money Laundering (MML Act) and FI regulations for the prevention of money laundering. The system could be strengthened if fit and proper requirements were extended to a wider range of employees and owners of entities covered by the MML Act, and if FI had the resources to carry out more specialized inspections. It would be desirable for mutual fund companies to be included among the companies subject to the anti-money laundering legislation, as is being discussed.

IV. CHALLENGES CONFRONTING THE SWEDISH FINANCIAL SYSTEM AND RECOMMENDED RESPONSES

60. *The Swedish financial system confronts an environment that is less benign than in recent years, and one that poses a number of challenges.* Among these are challenges to banks themselves—associated with maintaining profitability in a highly competitive retail market with increasing loan loss provisions and reduced commission incomes—and to the regulators and supervisors associated with operating in a much more complex financial environment.

A. Challenges Confronting the Financial Services Industry

61. ***The FMFGs face a number of strategic challenges.*** The most critical near term challenge is to respond to the negative effects on income of the correction in equity prices and the slow-down in economic activity. The FMFGs are adopting different strategies: retrenchment in activities and cost cutting is being given a high priority in some, while others see retrenchment by competing groups as an opportunity to expand business and gain market share.

62. ***Overall competition for banking services is increasing.*** Within Sweden the FMFGs face increased competition from niche banks for household deposits, and on the lending side, increased competition from other credit institutions, including those that specialize in mortgage lending and from the increased use of European bond market by large corporate clients. Outside Sweden, the Swedish banking groups are competing with major financial groups in a wide range of regional and global markets. However, it is generally acknowledged that even the FMFGs are too small to compete effectively as global players. The existing expanded range of activities has heightened the potential operational risk associated with the FMFGs' internal risk management and control systems, and a further expansion of operations into new areas could strain these further.

63. ***The increasing competition may require a further rationalization of the balance sheets and structure of the FMFGs.*** The route for rationalization of the banking industry through mergers among the FMFGs appears to have been closed by the recent ruling of the EC against the envisaged merger of Swedbank and SEB. The FMFGs might themselves become targets for mergers and acquisitions. However, discussions with the industry suggest that this is unlikely to happen in the near term. The industry points to the following reasons: the relative complexity of their operations, which, in some cases, are still being rationalized within the groups; the relatively small size and highly competitive nature of the Nordic market due to the lower cost structures of the niche banks; and the existing capacity to compete for the business of larger Swedish corporations. As a consequence, the rationalization may have to occur on the balance sheets and the cost structure of the FMFGs.

64. ***Sweden's looming demographic shock will shape financial sector developments.*** Sweden's share of population aged 64 and over is set to rise by 6½ percentage points during the next three decades from its present level of 17 percent, prompting the government to put in place a new pension system (Box 1). Financial enterprises are also facing the implications. For instance, insurance companies may experience losses as further gains in longevity overtake earlier actuarial assumptions, resulting in underfunded annuities.

65. ***Maintaining liquidity in the money, bond and security markets may be an issue if Sweden remains outside the euro area.*** Large Swedish companies with access to international corporate bond markets increasingly operate outside the domestic market. Liquidity in the government securities market could be adversely affected by ongoing budget surpluses, but this effect is ameliorated by (i) the government's long-term objective of raising the share of krona-denominated government debt; and (ii) by the NDO's current approach—

with the professed aim of minimizing costs—of incurring new foreign exchange-denominated debt by borrowing on the domestic market, and swapping liabilities into foreign exchange (also adding to liquidity in the derivatives market in the process). Concentration due to the limited number of major market makers would remain an issue. Should Sweden decide to join the euro area, its financial markets would be fully integrated into the euro-wide market, eliminating most of the structural considerations of maintaining liquidity in a relatively small, concentrated financial market.

B. Challenges Confronting the Supervisors and Regulators

66. *As is the case in all advanced banking systems, Sweden’s supervisors and regulators need to deal with a range of more complex issues than hither-to-before experienced.* These are associated with the large and complex nature of the financial institutions, the potential moral hazard in the financial system and the contagion risks due to the high concentration of the financial system and the systemic importance of Swedish major financial groups in several jurisdictions.

Large and Complex Financial Institutions (LCFIs)

67. *The large and complex nature of Sweden’s FMFGs poses additional regulatory and supervisory challenges.* In particular (i) they have a higher systemic risk potential owing to their major role in payment and settlement systems; (ii) they make liquidity problems harder to distinguish from solvency problems (and make the early detection of such problems more problematic) owing to the complexity of their balance sheet and organizational structures; and (iii) they make eventual work-outs and/or winding-ups more difficult owing to their functional and geographical diversification.¹⁰

Moral hazard

68. *Sweden, like many other countries, is facing a “too-big-to-fail” problem with regard to each of its FMFGs.* The moral hazard arises because of the systemic importance of Sweden’s FMFGs in several jurisdictions; the absence of credible winding-up procedures for such groups; and the current discretionary approach to crisis management. A perception of an implicit guarantee that the government would not allow any of the FMFGs to cease payments at short notice can be traced back to the authorities’ response to the 1992 systemic banking crisis where a blanket government guarantee was extended to all Swedish banks’ debtholders, even as the authorities sought to reduce moral hazard by *not* bailing out banks’ shareholders and by replacing bank management in most cases. The consequences of moral

¹⁰ The international community has recently launched a number of initiatives concerning LCFIs such as the G-10’s Ferguson report; the EU Economic and Financial Committee’s Brouwer report; a draft EU Directive for a special supplementary supervisory regime; and the Financial Stability Forum’s project to develop a crisis management simulation exercise.

hazard are that risk premiums on banks' funding costs may be too low and weaker market discipline.

Concentration and contagion

69. *Three types of contagion risks face the FMFGs and, in combination, they constitute a potential threat to the stability of the Swedish financial system as a whole.* The first type of contagion risk concerns the intra-group contagion effects from one business area to another within the same financial group. The second risk relates to the interbank contagion effects from one major bank to another through interbank markets. The third refers to contagion between different national financial systems due to the systemic importance of Swedish FMFGs in several jurisdictions. An important source of interbank contagion in Sweden is the high concentration of large exposures among the FMFGs and the common counterparties among the FMFGs large exposures. While FI monitors Swedish banks' large exposures with maturities exceeding one year, the liquidity and credit risks facing the FMFGs in the form of shorter-term, uncollateralized, unsupervised individual counterparty exposures are not systematically captured. Riksbank's analysis indicates that these exposures are fairly concentrated among the FMFGs. Each of the FMFGs' often have large counterparty exposures to the other three, and the groups are exposed to a number of common counterparties. Based on end-June 2001 data, the failure of the largest counterparty could bring the tier 1 capital ratio to below 4 percent in two of the FMFGs.¹¹

C. Recommended Regulatory, Supervisory, and Crisis Management Responses

70. A number of different regulatory, supervisory, and crisis management arrangements could help mitigate the above-identified risks. These would build on the existing work to enhance supervisory arrangements and to coordinate across jurisdictions, as well as the proposals of the Banking Law Committee on crisis management. Some additional elements could also be appropriate, such as greater attention to risk management in the financial system.

Supervisory arrangements

71. *Effective consolidated supervision is a key element of the supervisory regime for Sweden's LCFIs.* Consolidated supervision of a LCFI requires (i) close cooperation among domestic sectoral supervisors and home and host supervisors abroad; (ii) focus on capital adequacy and large exposures measured on a consolidated basis; and (iii) qualitative assessments of risks posed on the total operation by the various group entities.

¹¹ See Riksbank's "*Financial Stability Report*" (2001:1) for a study on counterparty exposures. These calculations assume zero recoveries, which is a conservative assumption.

72. ***The establishment of a joint supervisory group for the largest group, Nordea, is a major step toward ensuring effective consolidated supervision.*** This supervisory group consists of representatives from all concerned national supervisory authorities under the lead of Sweden's FI and operates under a MOU. A comprehensive risk assessment report was finalized in October 2001, and follow up actions are now in progress. In addition to the actions that are already underway, greater attention to corporate governance issues, especially the role of the Board of Directors and management in controlling risks, may be advisable. This approach could be developed and extended to the other LCFIs headquarters in Sweden and elsewhere, where feasible.

73. ***FI's new risk focused approach to supervision of the systemically important financial institutions is an important step forward.*** Resources will need to be assigned to this work on an ongoing basis to fully implement the approach for all the systemically important financial institutions; to further refine and update the risk focused approach based on experience; and for necessary follow up examinations. The proposed enhancements to FI's budget are appropriate.

74. ***The enhanced oversight of the LCFIs should be accompanied with more pro-active supervisory powers to address incipient financial difficulties at an early stage.*** The additional powers to FI should include, but not be limited to, the ability to (i) mandate increases in capital adequacy ratios above the statutory minimum requirements; (ii) mandate higher loan loss provisioning; (iii) remove banks' management; (iv) prevent a bank from paying out dividends; (v) restrict banks' activities; (vi) take proactive action as regards connected lending; and (vii) levy fines and penalties on third parties to compel evidence in investigation. The proposed reforms to the credit institutions regulations will go some way to addressing these issues.

75. ***Consideration should also be given to "setting the prudential bar higher" to capture the systemic risks posed by the LCFIs,*** especially when assessing their capital adequacy, liquidity conditions and large exposures. In accordance with the relevant EU directive, large counterparty risks in the interbank exposures are not presently covered by FI's large exposure prudential regulations. The Riksbank monitors these exposures for possible contagion risks, but data is collected only quarterly. These large counterparty risks have tended to increase and are a source of potential financial vulnerability. While the Riksbank is among the most advanced in requiring reports on these exposures, more frequent monitoring and specific attention to these exposures in risk assessments, as well as to the limits set on large exposures by the financial institutions and the monitoring of the exposures against the limits would be advisable. Fully dealing with these exposures will be a challenge for Swedish banks, while Sweden remains outside the Euro zone.

Improved risk management of the financial system

76. ***Potential systemic and contagion risks could be reduced through addressing the residual risks in securities clearing and settlement systems.*** As noted above, options to address current weaknesses in the VPC are under consideration.

77. *Counterparty risk in the interbank market could be reduced by promoting the use of collateralized transactions through the use of repurchase agreements.* In this connection, FI has already moved to eliminate disincentives to the use of repos in its capital adequacy regulations. Participation of banks, especially the FMFGs, in the CLS system for foreign exchange transactions when this becomes operational for Swedish krona transactions will also help reduce risk.

Early warning systems

78. *Early warning systems to monitor the financial condition of systemically important institutions could help detect difficulties at an early stage and allow for corrective actions.* The financial stability reports prepared by the Riksbank and FI already provide an excellent basis for detecting problems in the financial system that take into account both broad macroeconomic and financial sector considerations in the Riksbank's report and industry specific factors and vulnerabilities in FI's assessments. Further work on cross-functional analysis, contagion risks, and cross-border cooperation to understand and monitor the full range of activities of complex financial institutions may be useful. Also more frequent data reporting from banks with regard to large exposures, including interbank exposures, would be helpful to monitor contagion risks in the system by identifying any visible pattern linking otherwise sound institutions to any known problematic counterparty. Although increasing the frequency of data collection may give rise to practical problems and high costs, it would seem useful to point out that banks themselves ought to establish such monitoring capabilities to strengthen their own internal risk management frameworks.

Emergency liquidity assistance

79. *The Sveriges Riksbank Act provides the Riksbank with the ability to grant ELA.* The guiding principles on the provision of ELA are (i) situations of systemic crisis, i.e., where the operation of the high value RTGS interbank payment system may be disrupted; (ii) to illiquid, but solvent institutions; (iii) under (i) and (ii) ELA may be granted against lower quality collateral, no collateral or at a special interest rate; and (iv) foreign banks, as well as Swedish nonbank financial institutions, notably clearing organizations, may qualify, too.

80. *The Riksbank has established a crisis organization under the leadership of a deputy governor to handle ELA situations.* The ultimate level of the ELA decision-making process is the Riksbank's Executive Board chaired by the Governor of the Riksbank. A great deal of attention has been devoted to ensure the smooth implementation of ELA in practice, including check lists of legal conditions and requirements that must be met and relevant legal documentation; master contracts for lending and for taking collateral; and arrangements for

securing collateral. Regular crisis simulation exercises are undertaken to help hone and improve existing arrangements.¹²

81. ***The design of emergency liquidity support arrangements is, however, particularly complex given the cross-border nature of the Swedish LCFIs.*** As underscored in a recent report prepared by the Nordic central banks, a liquidity crisis could be exacerbated by (i) uncertainties about which central bank(s) could be approached for support; (ii) operational complications in the likely event that a plurality of authorities are involved (supervisory authorities and ministries of finance, in addition to central banks, involving up to 15 different authorities in 5 jurisdictions); (iii) differences in current institutional arrangements concerning the ELA decision-making and implementation processes in different jurisdictions; and (iv) differences in the degree of crisis preparedness in the various Nordic countries. The report's conclusion on the need for ex-ante co-ordination among concerned central banks and greater harmonization in current institutional arrangements is, therefore, entirely appropriate.

82. ***Direct (within conglomerate entities) and indirect (across borders) contagion could easily turn an LCFI-specific event into a region-wide liquidity problem.*** In the absence of better-defined "rules of the game" there may well be a tendency toward automatic support of large institutions, with potentially strong moral hazard consequences. Therefore, to facilitate effective use of the ELA for crisis management, and crisis prevention too, the following additional measures may be appropriate:

- ***Distinguish more clearly between market events and institution-specific events in the assessment of liquidity problems and responses.*** Liquidity analysis should identify all the potential sources of liquidity problems by carrying out assessments of vulnerabilities to market liquidity encompassing not only individual institutions, but also the markets where these institutions trade. Similarly, it should distinguish between the conditions where it would be appropriate to provide liquidity to the market—which implies providing liquidity to all primary dealers through standing facilities or repos—and where it would be appropriate to provide liquidity only to the institution in question.
- ***Seek a greater cross-border harmonization of approaches to distinguishing between liquidity and solvency problems, as well as implementation of the ELA.*** In the event of a liquidity problem, decisions will need to be made in different national jurisdictions on whether an institution is eligible for ELA support and the modalities for this support. One approach might be to assign a clearer responsibility in cross border cases to the lead supervisor to provide a view on the solvency position of the group. In any event, terms and

¹² Recent drill runs included (i) Y2K (jointly with the FI); (ii) a large security firm collapse; (iii) a bank experiencing operational problems; and (iv) a potential contagion in the wake of adverse market sentiment.

conditions for the ELA support (e.g., interest rates and collateral requirements) would need to be harmonized.

- ***Conduct regional joint crisis simulation exercises involving all concerned central banks and supervisory authorities*** in the Nordic area, as is planned for June 2002. These exercises would provide a very valuable means to form common views on key issues and hone joint procedures and processes to address these issues.

Handling insolvency in large financial institutions

83. ***A lacuna in current legislation is the absence of a legal framework for winding-up financial institutions that takes account of the special circumstances of such institutions.*** Recent proposals prepared by the Banking Law Committee sought to address this issue through new legislation to provide an intermediate capacity to intervene a bank (a so-called public administration regime). The Committee also proposed to distinguish between “ex-ante and ex-post” guarantees on a bank’s commitments, taking the public administration’s order as the cut-off date.¹³

84. ***There appears to be broad agreement in Sweden on the need for legislation that would allow for the orderly winding-up of financial institutions, but there are various concerns about other aspects of the Committee’s proposals.*** One design flaw identified by the mission is that the blanket “ex-post” guarantee on new commitments entered into by banks under public administration may complicate banks’ liquidity management by encouraging existing creditors and depositors to “run” the bank at the first sign of a problem, thus adding to financial stability risks. Another concern is the proposed broad range of circumstances, which might trigger intervention, aggravating the moral hazard problem.

85. ***There would appear to be merit in adopting a more flexible approach leading to a credible capacity to manage the insolvency of a major financial institution.*** This would involve the enactment of enabling legislation for winding up financial institutions. This would help achieve the objectives of eliminating the current ambiguity that supports the assumption of an implicit guarantee on the FMFGs, while providing sufficient flexibility to the authorities to address crises on a case-by-case basis. This approach could help avoid some of the criticism on the Banking Law Committee proposals.

86. ***Additionally, a credible regime for handling insolvent financial institutions would need to be underpinned by a greater harmonization of national legal, supervisory, and regulatory frameworks,*** as well as a clearer ex-ante assessment of whose laws would apply

¹³ “*The final report of the Banking Law Committee: Public administration of banks in distress*” (SOU 2000:66). The Committee also recommended the establishment of a separate government agency called CMA to assume overall responsibility for the public administration regime.

under different scenarios. Swedish-tailored arrangements might not sufficiently capture the increasing regional dimension of Swedish LCFIs owing to the existing differences in current legislative, supervisory, and regulatory frameworks in the Nordic countries. Resolution of these issues could be facilitated by the forthcoming EU directive on winding-ups.

Crisis resolution arrangements

87. *Government-to-government discussions may well be involved in resolving solvency problems in LCFIs, especially in the absence of a credible failure management capacity.* As the time factor would be crucial, prior understandings on how things would be handled in a crisis situation would be desirable. Hence, contact groups should include representatives from concerned ministries of finance and supervisory authorities in addition to central banks, and assessments of vulnerabilities should go beyond liquidity issues to also cover solvency questions. However, it may be inappropriate to be too specific on possible solvency support arrangements in view of the potential moral hazard that this could create. It would also be useful to reflect on whether different procedures should be followed if the solvency problem arises in a LCFI's banking arm or insurance arm.

Box 1. Reform of the Swedish Pension System

Sweden implemented a radical reform of its old-age pension system in response to the expected increase in the dependency ratio over the coming decades. The existing system was based on a national guaranteed minimum pension, a public defined-benefit pension financed on a PAYG basis, private pension insurance, and trade union or occupational pension schemes. The reform transferred responsibility for non-age related pension payments (survivors' and disability pensions) to the central government. In compensation, the National Pension Funds transferred SKR 45 billion each in 1999 and 2000 in government and mortgage securities and SKR 155 billion at the beginning of 2001, contributing to a substantial reduction in central government debt (Box 2). Public funds associated with pensions remaining after the transfers constituted the buffer funds: four large funds competing on an equal footing from 2001, and a smaller one with the objective of investing in small- and medium-sized Swedish enterprises not listed on the Stockholm Stock Exchange.

The new system was launched on January 1, 1999. It consists of a public PAYG pension scheme (income pension) with associated buffer funds; a fully-funded defined contribution scheme (premium pension); and additional, pre-existing components. Pension contributions amount to 18.5 percent of pensionable income, of which 16 percent finances the PAYG pension scheme. The remaining 2.5 percent is channeled by the Premium Pension Authority, a government agency, to privately managed pension funds offering fully-funded pension rights, chosen by the income earner.

The new pension system has a balancing mechanism consisting of an asymmetric indexing rule that minimizes the variability of pensions and ensures that the system remains able to meet its obligations with fixed contribution rates and benefit calculation rules. The balancing mechanism stipulates that the system's liability is indexed to the growth in average income as long as the present value of the system's revenues and assets, including the buffer funds, exceed its liabilities. If not, indexation is lowered until financial balance is reestablished, at which time the system reverts to the original indexation rule.

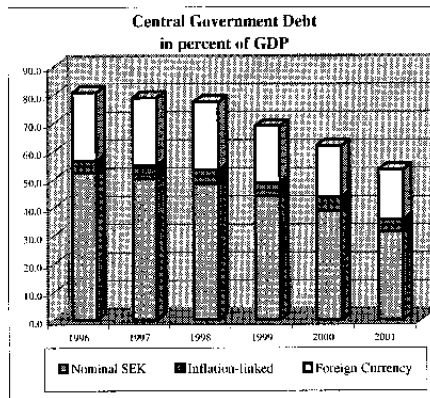
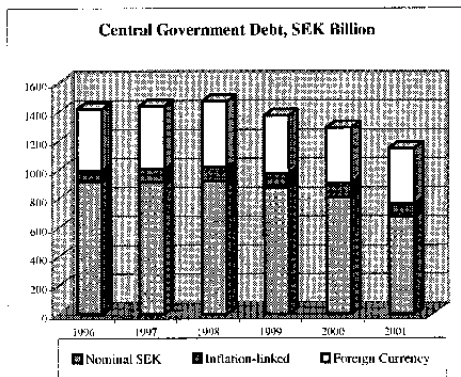
The pension reform has significant implications for financial markets. Initially, the foreign exchange market may have been most affected as a stock adjustment in public pension funds triggered by a relaxation of the foreign exchange exposure rules ran its course. However, a noticeable medium-term impact is most likely on the equity and bond markets, where the various pension funds will play an increasingly important role. The private pension funds are likely to go through a round of consolidation triggered by rising competitive pressures that could reduce their numbers substantially.

Pension funds are strictly regulated and supervised. Regulatory details on the public buffer funds are included in the AP Fund Act (Law 2000:192), while those for securities funds, including the privately managed ones associated with the premium pension scheme are in the Securities Funds Act (Law 1990:1114). FI supervises all mutual funds, including the privately managed ones associated with the premium pension scheme. The activities of the public funds are the subject of annual government evaluations performed each spring and published on June 1.

Box 2. Government Debt Management Operations

The Swedish NDO is responsible for managing central government debt based on a debt and funding strategy designed to minimize long-term costs while giving due consideration to the attendant risks and the demands of monetary policy. It can provide guarantees based on Acts of parliament and borrow funds on behalf of the central government to finance current deficits, amortize state debt and fulfill the Riksbank's requirements for currency reserves. It is also responsible for coordinating central government cash management and payments through a treasury single account system. The NDO employs sound practices and its activities—coordinated with monetary and fiscal policy—are transparent, based on annual published debt management guidelines from the government. To enhance accountability, parliament evaluates the government's guidelines, while the government evaluates the NDO's activities annually.

The government's long-term debt strategy calls for reducing overall public debt, and lowering the share of foreign currency-denominated debt (currently about a third). Nevertheless, this share increased temporarily as a result of krona depreciation and a pension reform-related transfer of bonds in 2001 from the National Pension Funds, resulting in lower krona debt. Raising the share of CPI-indexed debt is another strategic objective. More generally, the government also follows the evolution of net government debt.



Central government debt exceeds general government debt on account of central government securities held by the National Pension Funds and local governments. Its three main components are nominal krona-denominated debt (over 59 percent of the January 2002 total), inflation-linked krona debt (8 percent) and foreign currency-denominated debt (33 percent). The central government has been in surplus during the past four years, and small future deficits—projected in the range of 0 to 1 percent of GDP in the coming three years, in part to be financed through privatization receipts—imply a continued decline in the share in GDP of government debt.

The NDO is the dominant player on the Swedish government bill and bond markets, where it transacts through several authorized dealer financial institutions (currently, seven primary dealers for treasury bills enforcement securities and five primary dealers for CPI—index linked securities) within the framework set in its annual guidelines. The guidelines provide an explicit range for the net repayment of foreign currency denominated debt. In this regard, through mid-2002 the Riksbank purchases foreign exchange on behalf of the NDO at a pre-announced even rate, so as to avoid sudden surges in foreign exchange demand and thus minimize the impact on the exchange rate. Authorized dealers make all their bids as a principal, and are bound by their bids once the bidding is closed. After each sale by auction, they have an exclusive right to a trade at the average accepted prize up to a limit. They receive commission, and are responsible for compliance with relevant foreign laws and regulations in conjunction with sales to foreign investors.

Box 3. Banking Crisis Management in Sweden: the Historical Context

Sweden has a long history of ad-hoc government intervention to mitigate the socioeconomic costs of banking crises dating back to 1856-1857 with episodes in the 1920s and 1930s. The magnitude and scope of the banking crisis that erupted in 1992, however, called for an entirely new approach to crisis management. Following is a brief description of the sequence of events leading to the 1992 systemic banking crisis and the authorities' crisis management response.

In 1990, the strong economic cycle which had begun in 1985 ended and turned into a sharp recession, coinciding with a milder downturn in global markets, characterized by negative growth rates for three consecutive years. In the fall, credit losses began emerging in finance companies, but did not rise serious concerns. The situation changed in the Spring of 1991 when serious financial problems owing to sharp declines in the value of collateral spread to two banks, one of which was state owned. Ad-hoc support legislation was enacted. However, by the Spring of 1992, it became apparent that a systemic crisis was in the making as financial distress affected more and more banks and large mortgage institutions were experiencing difficulties in accessing international capital markets. In the fall of 1992, the government issued a press release where it announced its intention to present a bill to parliament to grant a general state guarantee covering all Swedish-chartered banks and their foreign subsidiaries, as well as mortgage companies. In the interim, the Riksbank had provided emergency liquidity assistance on a few occasions.

The Swedish government Bill "*Measures for Strengthening the Financial System*" (1992/93:135) was approved by parliament on December 18, 1992. Its key features included (1) an open-ended government guarantee to banks' depositors and other creditors;¹⁴ (2) the establishment of an independent government agency, the BSA, to manage the operational and practical aspects of the crisis. The BSA's main functions were to (i) evaluate applications for government assistance presented by troubled institutions; (ii) take over the management of the business of institutions admitted into the government assistance program; and (iii) take over ownership of institutions whose CAR was below 2 percent. Two Asset Management Companies so-called "bad banks" (Securum and Retriva) were set up to dispose of impaired assets; (3) an Appeal Board was established as administrative recourse against decisions taken by the BSA; and (4) a high level of transparency and accountability was sought, with the government undertaking to report to parliament at least annually, and members of parliament, including from the opposition, appointed to the BSA's Board of Directors.

The high degree of political consensus underpinning the new crisis management arrangements, the speed with which actions were implemented, as well as distinct information efforts directed toward both domestic and international markets contributed—together with the unlimited government guarantee—to a rapid restoration of confidence, which in turn facilitated the operation of the BSA.

Four banks were restructured. The actual government pay-outs under the restructuring program amounted to Skr65.3 billion, of which Skr.41.2 billion in capital injections (through shares subscriptions, shares purchases, and capital contributions), Skr.23.2 in guarantees, and Skr.1.0 in interest subsidies. Called guarantees and capital contributions to Securum and Retriva absorbed 42.6 percent of total pay-outs. Shareholders of private banks lost all their equity interests; creditors, on the other hand, were fully protected by the general government guarantee.

On July 1, 1996, the parliament approved a bill ("*Ending the Bank Support*" Ds 1995:67) presented by the government to withdraw the official guarantee as all institutions under the BSA's purview had regained financial viability, as certified by *FI*. The intention to remove the guarantee was announced well in advance to avoid taking markets by surprise; a DGS was established a few months before the removal of the guarantee. When the program was wound down after only four years of operation some 99 percent of the assets taken over had been sold, enabling the Swedish government to fully recover the cost of the whole assistance program, including BSA's own operating expenses.¹⁵

¹⁴ The guarantee was to the effect that "*banks and other credit institutions can meet their commitments on a timely basis.*"

Box 4. Stress Tests: Assumptions and Methodology

The Riksbank and FI performed a series of stress tests to analyze the macroeconomic and financial sector implications of potential shocks to the Swedish economy, and the four financial conglomerates were requested to apply the shocks described below to their consolidated books to calculate mark-to-market sensitivity for market risk at the group level. As for credit risk, using the credit loss and exposure data provided by the financial groups, the Riksbank estimated the parameters that relate net losses to the output gap and a term spread (the difference between the long- and short-term interest rates). The Riksbank's BASMOD model was used to produce simulated values for the output gap and yield curve data consistent with the scenario. The nature of the shocks reflects a shared assessment of the main macroeconomic risks facing Sweden at present. The resulting loss estimates were within the range of historically experienced crisis levels.

In the macroeconomic model simulation, a catastrophic drop in external demand for Swedish and other Nordic countries products, together with a sizable negative productivity shock lead to a sharp and sustained drop in business and household confidence, a large drop in consumption and in investment comparable to the fall in the early 1990s, and a fall in equity (5 percent) and real estate prices (12 percent), yielding a strong immediate growth response of -4.5 percentage points and a zero annual average GDP growth for 2002-2004. The macroeconomic policy stance was assumed to respond appropriately to these shocks. These assumptions were extended to the Nordic region in the context of assessing the group exposures to the major banks. While unlikely, such a shock is not entirely implausible in the event of a substantial and prolonged weakening of international demand and a bunching of several additional adverse shocks.

Six sensitivity tests were carried out, each calculating the estimated value loss for the type of risk specified. Each single-shock stress test assumes one of the following shocks effective on Monday, October 21 (i) a 20 percent drop in the values of groups' equity portfolios; (ii) a 40 percent drop in the price of both residential and commercial real estate in greater Stockholm, Göteborg, and Malmö; (iii) a 10 percent effective depreciation of the krona, as measured by the TCW index; (iv) a 30 percent effective appreciation of the krona; (v) a 300 basis point increase in the 10-year government bond yield, holding the 3-month government bond yield constant; and (vi) a 300 basis point increase in both the 3-month and the 10-year government bond yield. The same assumptions are extended for other countries and currencies relevant for the financial groups, with cross exchange rates assumed to remain constant. The stress test estimates concerning market risk were mark-to-market losses. Financial institution solvency was assessed on a hold-to-maturity accounting basis.

¹⁵ External conditions were supportive of the BSA's success as the Krona had been floated since November 1992 with an attendant significant depreciation and economic conditions had recovered both nationally and globally.

Table 1. Sweden: Financial System Overview, end-2001

Type of Institutions	Number of			Financial Sector Assets		
	Institutions	Branches	Employees	(Millions of Kro.)	(% of Total)	(% of GDP)
Four Major Financial Groups (FMFGs), consolidated	4	3,290	89,548	5,544,166	69.0%	255.8%
<i>Of which:</i>						
Nordea	1	1,245	42,017	2,246,697	28.0%	103.7%
S.E.B.	1	216	19,618	1,163,315	14.5%	53.7%
Handelsbanken	1	545	9,239	1,174,521	14.6%	54.2%
Swedbank (Föreningssparbanken)	1	1,284	18,674	959,632	11.9%	44.3%
Other Banks in Sweden	103	2,066	7,782	299,679	3.7%	13.8%
<i>Of which:</i>						
Niche banks 1/	6	7	1,231	48,871	0.6%	2.3%
Other financial institutions in Sweden (excluding FMFGs):	276	118	1,970	2,190,663	27.3%	101.1%
Mortgage credit institutions	8	1	86	316,192	3.9%	14.6%
Other credit market companies	62	102	1,884	348,617	4.3%	16.1%
Insurance companies	161	15	n.a.	1,525,854	19.0%	70.4%
<i>Of which:</i>						
Life insurance	35	n.a.	n.a.	1,091,091	13.6%	50.3%
Non-life insurance	126	15	n.a.	434,763	5.4%	20.1%
Pension funds	45	n.a.	n.a.	n.a.	n.a.	n.a.
All financial institutions incl. FMFGs' legal entities outside Sweden	383	5,474	99,300	8,034,508	100.0%	370.7%
All financial institutions in Sweden 2/	406	3,763	39,733	6,683,795	83.2%	308.4%
Memorandum:						
Legal entities of FMFGs in Sweden, incl. foreign branches	27	1,579	29,981	4,193,453	52.2%	193.5%
<i>Of which, by institution type:</i>						
Banks	5	1,558	28,643	2,625,210	32.7%	121.1%
Insurance companies 3/	11	n.a.	n.a.	416,928	5.2%	19.2%
Mortgage credit institutions	5	n.a.	74	1,037,905	12.9%	47.9%
Other credit market companies	6	21	1,264	113,410	1.4%	5.2%

Sources: Finansinspektionen, in-house database

1/ ICA Banken was established 2002 and has 2 branches and agent representation in 1648 ICA grocery stores.

2/ Includes foreign branches.

3/ One new company and two acquisitions.

Table 2. Sweden: Ownership Structure of the Thirteen Important Financial Groups, December 2001

Four Major Financial Groups (MFTGs)	Ownership shares (percent)	Six Major Insurance Companies	Ownership shares (percent)	Three Major Stock Exchange and Clearing Institutions	Ownership shares (percent)
Nordea		Skandia		OM Group, Stockholm Stock Exchange 3/	
Swedish State Institutions	18.3	Industrivärden	4.5	Investor AB	17.1
Public	18	Pohjola Grp Insurance corp	4.5	The Swedish State	9.5
Finnish Institutions	8.4	Robur Mutual funds (10 largest shareholders)	3.9	AMF Pension	4.8
Public	6		(33)	Robur Fonder	4.8
Danish Institutions	12.3	AMF Pension		Föreningsparbanken	4.4
Public	4.0	LO 1/	50.0	Olof Stenhammar & companies	4.1
Non-Nordic ownership	27.0	Svenskt Näringsliv 2/	50.0	Svenska Handelsbanken	3.4
				Nordea	3.4
				Alectra	2.5
				SEB Fonder	2.6
				Other non-Swedish owners	19.7
				Other Swedish owners	23.7
		IF...			
		Skandia	19.4		
		Skandia Liv	10.1		
		Storebrand	22.6	VPC AB (Securities Depository)	
S.E.B.		Sampo	38.1	Svenska Handelsbanken	24.7
Private individuals	18.0	Varma-Sampo	10.1	Northbanken	24.7
Foundations	14.0			SEB Fonder	24.7
Mutual Funds	11.0			Föreningsparbanken	24.65
Insurance companies	11.0			Other owners	14
Foreign Shareholders	21.0				
Other companies and institutions	25.0			Bankgirocentralen 4/	
				SEB	33.1
		LF Wasa Liv	Owned (96,5 %) by 24 regional non-life insurance companies	Northbanken	27.0
				SFB	25.4
				Föreningsparbanken	12.2
Handelsbanken				Danske Bank	17
Oktoگون Foundation	10.1			Other owners	14
Industrivärden	7.4				
Robur securities funds	4.5				
Skandia Liv	2.3	SPP	(Mutual insurance society, owned by policyholders)		
Nordea funds	2.7				
AMF-Pension	3.2				
Alectra (formerly SPP mutual)	3.4				
Other owners	66.4	Folksam	(Mutual insurance society, owned by policyholders)		
Swedbank					
Independent savings banks	20.8				
National Pension Insurance Funds	1.1				
General Public	10.8				
Foreign owners	28.3				
Other Swedish investors	30.6				

Table 3. Sweden: Main Economic Indicators, 1996-2001

	1996	1997	1998	1999	2000	2001
	(Percentage change, unless otherwise indicated)					
Economic and Credit growth						
Aggregate growth rates (real GDP)	1.1	2.1	3.6	4.1	3.6	1.2
Base money	5.3	3.0	5.1	12.0	1.9	8.8
M3	11.4	1.3	2.1	9.9	2.1	6.2
Open unemployment rate (In percent)	8.1	8.0	6.5	5.6	4.7	4.0
Fiscal Indicators						
General government financial balance	-3.1	-1.6	2.1	1.3	3.7	4.8
Revenue	59.3	58.9	60.0	58.8	58.4	59.2
Expenditure	62.3	60.5	58.0	57.5	54.7	54.4
Central government balance	-3.8	-1.6	1.0	3.7	1.1	9.5
General government gross public debt (as % of GDP) (Maastricht definition)	76.0	74.5	71.8	64.9	55.3	55.9
Balance of payments						
Current account balance (as % of GDP)	3.2	3.8	3.4	3.6	3.4	3.2
Net external debt (as % of GDP)	39.2	42.2	38.5	35.6	31.6	21.2
Gross external debt (as % of GDP)	113.4	117.2	132.6	145.0	169.6	171.8
Of which: long-term debt	51.6	59.5	60.5	63.7	62.5	65.3
Terms of trade index (1996=100)	100.0	98.9	99.4	96.0	92.7	90.0
Capital and financial account (billion Krona)	-40.0	5.7	-6.1	-61.9	-0.5	37.3
-FDI, net (billion Krona)	2.8	-12.8	-38.2	321.6	-157.7	68.0
-Portfolio investment, net (billion of krona)	-83.2	-89.5	-118.4	-295.0	-28.4	-136.6
-Other capital, net (billion of krona)	2.1	49.8	189.6	-52.9	188.0	143.4
Inflation						
Consumer price index	0.1	1.9	-0.6	1.2	1.4	2.9
Volatility in inflation						
-Stdev of 12 monthly percentage changes	4.1	Monthly figures January 80 - March 2002				
-Stdev of CPI Index	55.7	Monthly figures January 80 - March 2002				
Interest and exchange rates						
Exchange rate against US dollar (SEK, period average)	6.7	7.6	7.9	8.3	9.2	10.3
Exchange rate against Euro (SEK, period average)	8.5	8.7	8.9	8.8	8.4	9.3
Real effective exchange rate (TCW, jan 87=100)	1.7	3.6	10.3	-4.0	4.3	7.2
TCW -Index (annual percentage change)	-0.7	3.2	7.8	-4.1	2.9	8.3
Level of domestic real interest rates 1/						
Lending rates in banks (average)	7.4	7.0	5.9	5.5	5.8	5.7
Deposit rates in banks (average)	2.5	2.5	1.9	1.7	2.2	2.2
Source: Ministry of Finance; Statistics Sweden; the Riksbank; and staff estimates.						
1/ Bank average (to the general public), end-December. Figure for 2001 refers to end-September.						

Table 4. Sweden: Financial Soundness Indicators, 1996-2001
(end-period, in percentage)

	1996	1997	1998	1999	2000	2001
Households						
Household disposable income (percentage change)	-0.4	-0.2	1.3	3.6	2.9	3.0
Debt as % of disposable income	92.4	94.7	98.8	103.6	108.8	114.7
Interest expenditures as % of disposable income (after tax)	5.8	5.3	4.9	4.7	4.9	5.1
Savings ratio (percentage change)	-1.5	-2.6	-1.3	0.2	-1.1	2.6
Structure of household's financial assets (percent of total)						
Deposits in banks	19.1	15.9	15.2	12.6	12.4	13.7
Bonds	7.6	6.1	5.8	4.1	3.0	2.7
Equities (Shares and other equities)	31.1	37.0	38.2	44.2	42.9	38.9
<i>of which Swedish mutual funds</i>	7.1	9.6	10.4	13.6	12.6	10.9
<i>of which Swedish quoted shares</i>	14.3	16.1	15.6	16.6	14.4	12.2
Pension savings (including life insurance with mutual funds)	3.2	16.5	18.0	19.6	21.3	23.1
Currency and loans	3.2	2.9	2.5	2.4	2.4	2.6
Ratio of households' financial liabilities to financial assets in percent	70.2	65.0	63.0	51.0	64.6	65.4
Nonfinancial Corporations						
Debt stock as percentage of GDP	69.9	71.5	75.7	78.3	83.2	86.5
Debt to equity ratio (book value, median of large corporations)	160	150	140	160	120	n/a
Interest coverage ratio 1/	490	600	630	510	710	n/a
Lending from Banks (as % of total borrowing)	31.0	31.1	31.9	31.4	31.6	35.7
Government						
General government debt (in percentage of GDP)	76.0	74.3	71.8	64.9	55.3	55.9
Four Major Financial Groups (FMFGs)						
Capital Adequacy						
Risk-based capital adequacy ratio (CAR)	12.5	10.7	10.6	11.4	9.9	10.0
Tier 1 capital ratio	7.8	6.8	6.6	7.5	6.8	7.1
Equity/total assets	4.4	4.2	4.1	4.2	4.3	4.3
Asset Quality						
Non-performing loans (NPL)						
Non-performing loans (NPL) as % of total loans	3.2	2.2	1.6	1.1	1.7	1.6
Provisions as percent of NPL	52.7	50.4	52.8	65.9	65.4	66.3
Off-balance sheet exposure as % of reg. capital	..	225.0	233.0	184.0	192.0	183.3
Net foreign-currency denominated assets as % of total assets	-3.7	-4.3	-10.5	-7.9	-7.0	-11.7
Earnings and profitability:						
Return on assets (net income/avg. total assets)	..	0.6	0.7	0.7	0.9	0.8
Return on equity (net income/avg. shareholders' equity)	27.7	14.3	21.5	19.4	19.1	18.7
Net interest income as % of gross income	66.0	66.0	55.4	56.9	54.0	60.2
Fees and commiss. receivables as % gross income	18.6	25.2	24.2	30.2	31.5	27.7
Net profit or loss on financial operations as % gross income	11.7	4.8	9.4	5.3	9.5	7.0
Operating expenses as % of gross income	24.9	30.6	29.9	32.4	31.1	32.8
Liquidity						
Central bank credit to banks as % of GDP	0.5	1.7	1.0	1.3	1.5	2.3
Loans-to-deposits ratio	2.0	2.7	2.6	2.6	2.0	2.0
Liquid assets/short-term liabilities 2/	42.8	39.0	41.0	38.0	35.0	32.5
Credit institutions Sector						
Total (regulatory) capital / risk-weighted assets	..	..	11.8	12.4	10.7	10.0
NPLs / total gross loans (or exposures)	1.4	0.9	0.7	0.6	1.0	0.9
Off-balance sheet exposure as % of reg. capital	..	..	198.0	162.0	178.0	161.0
Return on (average) equity	..	19.2	22.6	21.4	29.2	18.7
Net interest income / total income	59.5	64.6	53.7	55.8	51.8	60.0
Liquid assets/short-term liabilities	..	..	43.8	39.1	37.0	44.2
Measures of secondary market liquidity:						
Interbank foreign exchange market turnover (Kr. Billions)	54	67	74	76	95	117
Interbank domestic market turnover (Kr. Billions)	22	25	22	17	6	7
Loan concentration						
Large exposures / total capital	72.1	71.6	77.7	78.6	51.9	59.0
Total outstanding credit (Kr. Billions)	2,409	2,817	2,939	3,033	3,402	3,685
<i>of which, share of loans to (in percent)</i>						
Household	29.5	26.6	27.2	28.7	27.5	28.3
Residential mortgages 3/	20.3	18.0	18.3	19.2	17.9	18.3
Public sector (government and state owned)	2.4	3.2	3.1	3.3	2.9	3.4
Non-bank financial institutions	11.3	11.7	13.0	11.9	13.4	13.0
Banks	15.8	15.5	14.1	13.7	14.4	14.1
Non-financial corporate sector	38.4	33.0	32.9	32.9	30.8	30.9
Foreign currency lending	12.0	14.3	15.3	14.8	17.3	20.3
Lending developments (annual percentage change, end-period)						
Outstanding credit to non-financial sector	3.5	6.4	6.8	5.6	9.1	8.9
Lending to household	2.2	5.5	6.4	9.0	7.4	8.9
Lending to non-financial corporate sector	..	0.5	3.6	3.4	4.9	8.8
Insurance sector						
Solvency ratio (available margin/required margin)						
Life insurance companies	1129	1093	1180	1325	1110	946
Non-life insurance companies	1498	1658	1826	2026	1722	1587
Stock Market developments						
Equity prices (OM Stockholm Stock Exchange Index) (y-o-y change)	38.9	27.8	16.9	71.0	-11.9	-19.8
Prices of single-housing dwellings (y-o-y change)	2.6	5.6	11.8	2.4	16.9	4.0
Equity prices of financial institutions, (y-o-y change) 4/	41.4	40.8	10.2	23.4	24.6	-19.9
Market capitalization /GDP	1.0	1.2	1.3	1.9	1.7	1.3

Sources: Ministry of Finance, Statistics Sweden, the Riksbank, and staff estimates.

1/ The interest coverage ratio is defined as operating income plus financial income divided by financial expenditure.

2/ Liquid assets include "Cash and balance with central banks", "Instruments eligible as collateral with central banks" and "lending to credit institutions", while short-term liabilities include "Liabilities to credit institutions" and "Deposits from the general public".

3/ Loans to households from mortgage credit institutions.

4/ Banks and insurance companies.

Table 5. Sweden: Operations and Performance of the Major Four Financial Groups, 1996-2001
(in SEK, billions, unless noted otherwise)

	Swedbank			SEB			Nordea 1/			Handelsbank		
	1996	2000	2001	1996	2000	2001	1996	2000	2001	1996	2000	2001
Total assets	502	929	960	551	1,123	1,163	...	1,967	2,247	571	1,020	1,175
<i>Of which, by sector (in percentage)</i>												
Banking group	55.9	53.6	59.2	...	80.0	83.7	...	76.6	76.0	80.4	65.7	67.1
Insurance company	0.0	0.0	4.5	...	6.4	5.7	...	9.9	10.0	...	1.8	1.7
Mortgage credit institutions	50.8	35.7	36.3	...	10.1	10.6	...	14.5	14.0	19.6	32.6	31.2
<i>Of which, by geographic location (in percentage)</i>												
Sweden	...	88.6	86.2	...	...	39.0	...	...	...	68.9	82.2	80.8
Nordic area	...	8.5	9.2	...	...	5.5	...	...	...	13.4	10.2	12.1
Other OECD	...	0.2	0.2	...	...	52.2	...	...	...	17.7	7.7	7.1
Baltics	...	2.8	4.4	...	...	3.3	...	...	...	...	...	...
Total outstanding credit	382	637	684	357	690	718	...	1,326	1,478	397	784	871
<i>Of which, share of loans to (in percentage)</i>												
Household	48.4	42.4	42.0	19.8	26.9	27.3	...	32.3	31.9	21.5	33.1	33.8
Residential mortgages	37.7	33.0	32.0	13.4	11.1	14.7	...	23.5	24.5	13.8	24.4	...
Public sector (government and state-owned)	3.8	2.2	2.0	9.0	12.1	12.3	...	1.8	1.7	0.0	0.0	0.9
Non-bank financial institutions	...	1.2	2.0	4.0	2.8	2.2	...	...	...	2.7	2.4	2.6
Banks	...	...	..	24.4	17.7	18.2	...	14.2	...	27.3	9.7	5.6
Non-financial corporate sector	45.5	52.6	..	42.9	40.4	...	...	51.6	...	48.5	54.8	57.1
ICT-related	..	..	..	..	..	..	...	...	...	...	1.7	...
Commerical mortgage and construction	2.1	1.5	1.6	9.8	9.0	...	...	...	...	11.9	17.7	...
Foreign currency lending	8.7	20.4	..	36.8	71.4	...	...	79.0	...	40.2	28.6	26.0
Off-balance sheet exposures	1,680	2,540	3,259	228	358	401	...	329	...	4,553	4,890	6,603
Activity in derivatives markets	1,569	2,285	...	61	64	53	...	8,435	7,753	4,383	4,433	6,426
Trading assets (as a percentage of total assets)	4.8	6.9	...	12.6	14.1	...	...	9.0	...	15.4	9.3	...
Non-deposit funding (as a percentage of total funding)	69.7	72.3	...	27.6	19.4	9.8	...	63.0	...	27.0	25.0	20.4
Total revenues	15	24	23	16	32	29	...	47	54	15	21	21.5
<i>Of which, in percentage</i>												
Revenues from fiduciary activity	...	0.2	...	...	5.4	...	...	...	...	0.2	0.5	...
Revenues from mutual fund fee	...	3.8	...	5.1	6.9	...	...	10.7	...	2.7	5.2	5.3
Revenues from trading	2.2	3.6	...	22.0	24.1	...	...	7.9	...	...	12.8	7.3
Revenues from mortgage markets	24.1	14.9	...	7.2	3.7	...	...	...	...	7.0	20.7	24.8
Assets under management (billions SEK)	92	288	...	402	910	871	...	927	...	94	211	...

Source: Finansinspektionen.

1/ Pre-2000 data is not applicable for the Nordea Group.

SECTION II—OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

- This section contains information on adherence to and consistency with major international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which the supervisory and regulatory frameworks have been adequate to address the potential risks in the financial system. It has also provided a source of good practices in financial regulation and supervision in various areas.
- Detailed assessments of standards were undertaken based on a peer review process, as part of the FSAP, by Allan D. Fink (Federal Reserve Bank of Chicago) and Tuomo Malin (Finnish Financial Supervisory Authority) for the *Basel Core Principles for Effective Banking Supervision*; Lutz Oehlenberg (German Federal Insurance Supervisory Office) for the IAIS *Insurance Core Supervisory Principles*; Jennifer Elliott (IMF-MAE) for the IOSCO objectives and *Principles of Securities Supervision*; Harm Jan Woltjer (De Nederlandsche Bank) for the *Core Principles for Systemically Important Payment Systems*; Bruce White (Reserve Bank of New Zealand) for the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies*. The team of assessors prepared detailed assessments by drawing on information provided by the Swedish authorities, including self-assessments, and fieldwork during the October and November 2001 missions. This section contains a summarized version of the detailed assessments included in the FSAP report, with the exception of the assessment on Anti-Money Laundering arrangements.
- The overall Swedish legislative and regulatory framework is based on the EU model. As such, the backbone of Swedish laws and prudential regulations is fundamentally sound. Moreover, the FSAP exercise underscored that Sweden's financial regulatory and supervisory arrangements generally demonstrate a high degree of compliance with international standards and codes. That said, the assessment also underscored two broad areas of concern in FI's capacity to fully implement regulation of the financial sector. These relate to the lack of resources and insufficient numbers of experienced staff at the regulator and the regulator's lack of authority to take interim or corrective action measures.
- The Swedish authorities are already preparing to implement several of the recommendations offered by the mission. This, coupled with new or upgraded legislation and regulations that are being finalized and recent new hiring of professional staff by FI, is expected to address many of the issues underscored in this section.

V. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION¹⁶

A. General

88. The assessment of compliance with the Basel Core Principles for Effective Banking Supervision in the supervisory work of the Swedish FI was performed on the basis of the Methodology of the Basel Core Principles and based on a self-assessment followed up with interviews with the supervisory authority and the industry. The main sources for the assessment were the laws and supervisory regulations and guidelines concerning credit institutions. Additionally, the assessors received relevant material from the Central Bank, FI and commercial banks.

¹⁶ Assessment performed by Messrs. Allan D. Fink of the Federal Reserve Bank of Chicago and Tuomo Malin of the Financial Supervision Authority of Finland.

B. Institutional and Market Structure Overview

89. In Sweden there are three different types of banks: commercial banks, i.e., limited liability banking companies, savings banks and a few cooperative banks. All these types of banks are entitled to engage in all types of banking activity. The number of banks has declined sharply as a result of mergers, a tendency that has been most notable among the savings banks. The market structure can be described as two-tiered with four large banks (Handelsbanken, Skandinaviska Enskilda Banken, Nordbanken and FöreningsSparbanken as well as the Swedish subsidiary of a major Danish bank) having a combined market share of about 75-85 percent; the residual market is shared among around 100 smaller banks.

90. FI is a government authority responsible to the Ministry of Finance. It exercises supervision over banks, credit market companies, and additionally e.g., insurance companies, insurance brokers and securities companies. The role of FI is to ensure that statutory regulations are complied with, that secure and sound practices are applied and that confidence is maintained in the stability and functionality of the financial markets. The legal framework for the banking sector is provided in the Banking Business Act that contains provisions regulating the business a bank may engage in. The act also contains essential provisions concerning the tasks of FI in the supervision of banks. The Act on Capital Adequacy and Large Exposures for Credit Institutions and Securities Companies contains rules on how to calculate the capital base and capital adequacy to cover credit risks and market risks. The act also includes provisions stipulating limits for the exposure of credit institutions in relation to their clients, and rules concerning consolidated supervision.

91. After the disbanding of the Bank Support Authority there have been no standing institutional arrangements for handling banking crises. New arrangements for the resolution of distressed banks have been proposed with in a Banking Law Committee paper of 1998. The purpose of the Act on DGS is to improve consumer protection in connection with the public's deposits at banks and certain securities companies by providing a guarantee for deposits of up to 250,000 Swedish kronor per customer at each institution. The act contains rules regulating which deposits are covered by the guarantee, when the right to compensation arises, and what fees shall be paid by the institutions covered by the guarantee. Administrative duties lie at the DGB.

C. Main Findings

Objectives, autonomy, powers, and resources (CP 1)

92. The FI's is the only agency in Sweden to exercise prudential supervision of the financial sector, including banks. FI's responsibilities and objectives are stated in the relevant laws and decrees concerning the agency itself and banking supervision in general. The supervisory agency is under the administrative control of the Ministry of Finance; it is funded by levies from the financial sector through the government budget; and it is independent in its operational decisions. The supervisor's personnel resources have been deemed to be insufficient in relation to the tasks involving the implementation of the new capital accord

and the supervision of large conglomerates. The supervisor cannot, however, with the present level of remuneration compete with the private sector. To improve its capacity to supervise particularly the more complex activities of banks, e.g., related to market risks, the supervisor has to be able to increase its competitiveness as an employer. FI issues licenses to banks; its sanctions are mainly limited to giving a warning prior to revoking a license. The supervisor does not have sufficient powers to be able to take proactive actions. FI has a policy of publishing extensively its policies and objectives. The position of FI in relation to other public agencies in possible crisis situations is not defined in law.

Licensing and structure (CPs 2–5)

93. Deposit taking has been defined as the privilege of banks, barring a few minor exceptions. Within the licensing process assessing the fitness and propriety of management is restricted to the board and the CEO. Changes in the ownership of banks as well as the major acquisitions are subject to the supervisor's authorization.

Prudential regulations and requirements (CPs 6–15)

94. The capital adequacy requirements are consistent with the Basel Capital Accord. The supervisor has no power to require a bank to raise its capital ratio above the legal minimum depending on the specific risk situation. Instead the supervisor monitors that banks adhere to their own goals of tier 1 capital. The supervisor has neither binding powers to require a bank to strengthen its credit-granting standards or to raise the level of provisions and reserves. Connected lending is regulated in law but the supervisor has not used the powers delegated to it to issue regulations on reporting of exposures to connected parties. Supervisory standards are yet to be issued on country risk, operational risk and exchange risk. Guidelines on liquidity reporting have only recently been introduced. FI relies to a large extent on the reports produced by the internal audit function of banks.

Methods of ongoing supervision (CPs16–20)

95. The supervisor has undergone a major reorganization approximately a year prior to this assessment. Stress has been laid on a non-institutional approach, the main functional processes of FI being supervision, stability analysis and regulation. Institutional supervision is co-coordinated by designated group managers who are essentially responsible for producing risk assessments for the major systemically important groups. Until the introduction of the new model FI has not regularly performed a systematic risk analysis of banks. The new model is being phased in; the goal is to use it to test the four major bank groups within the next year. FI has an intensive cooperation with the external auditors appointed by it; the relationship with the auditors chosen by shareholders is more remote, audit reports are not sent to the FI on a routine basis. The main legal basis for consolidated supervision is in place; as to global supervision FI is not obligated by law to assess the

supervisory preconditions in a host country. MOUs with some of the overseas supervisors supervising entities of Swedish banks are still to be finalized. The growing role of the complex multinational banking groups has posed FI with new challenges, and FI should continue to refine its role as the head supervisory of the Swedish based banking groups and extend the approach it presently applies to the largest banking conglomerate to the other banking groups.

Information requirement (CP 21)

96. Laws and regulations concerning annual audited financial statements are in place. The Institute of Authorized Public Accountants determines generally accepted auditing standards. Furthermore banks are to follow the general Bookkeeping Act. Banks shall apply the recommendations and statements on accounting matters from the Financial Accounting Standards Council that is assigned to implement the accounting standards issued by the International Accounting Standards Council. The supervisor lacks legal powers to revoke the appointment of an external auditor.

Formal powers of supervisors (CP 22)

97. The supervisor has a limited range of remedial actions available. The supervisor lacks legally binding measures to take a more proactive approach in order to prevent situations from arising where the only effective measure would be revocation of license. A committee has in 1998 proposed some additions to the powers of FI. Notwithstanding the proposed enhancements of FI's powers, the supervisor would not be empowered, inter alia, to restrict the range of activities of the bank, to suspend dividend payments, to bar individuals from banking, to replace managers, directors, or controlling owners.

Cross-border banking (CPs 23–25)

98. The supervisor is not by law empowered to prevent the establishment of branches in jurisdictions where the local supervisory arrangements are not adequate to the risks involved or the free flow of supervisory information is hindered by local laws or regulations. FI is also lacking in powers to require the closing of overseas offices or put limitations on the scope of activities. FI has entered into MOU's with all of the supervisory authorities of the EEA but FI has yet to conclude agreements on cooperation with supervisors of some of the countries where Swedish banks have established operations. The supervisor, as a licensing authority for the establishment of a foreign bank's offices, is not required by law to assess whether the home country supervisor practices effective consolidated global supervision or that an approval (or no objection) from the home supervisor has been received.

Table 7. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
Objectives, Autonomy, Powers, and Resources (CP 1)	To improve its capacity to supervise particularly the more complex activities of banks, e.g., related to market risks, the supervisor has to supplement staff resources and be able to increase its competitiveness as an employer.
Licensing criteria (CP 3)	The fit and proper tests ought to be applied to all the members of a bank's management, e.g., also to senior executives and managers of foreign offices. There are no detailed criteria for assessing the suitability of management. The economic situation of the principal shareholders is assessed only through public financial statements.
Loan evaluation and loan-loss provisioning (CP 8)	The supervisor should be given legally based powers to require a bank to strengthen its lending practices, level of provisions and reserves. Depending on the level of problem assets, the supervisor should have binding powers to make a bank adopt policies that will affect the overall financial strength
Large exposures (CP 9)	FI needs to require reporting on geographical concentrations in lending.
Connected lending (CP 10)	Supervision of connected lending ought to be enhanced by giving FI the authority to set individual limits to connected lending and deduct such loans extended on concessionary grounds from the bank's capital. Being authorized to do so in law, FI has yet to issue regulations on the more detailed contents of the register of connected lending that has to be kept in a bank. Arrangements should be for regular reporting to the supervisor on connected lending on an individual or aggregate basis.
Country risk (CP 11)	FI should issue regulations on the management of country risk in banks. FI currently relies largely on quarterly reports on banks' country risk exposures prepared by the Riksbank.
Other risks (CP 13)	FI should issue supervisory standards on exchange and operational risk. FI ought to be given powers to require a bank to hold capital against risks other than market and credit risk.
Internal Control and Audit (CP 14)	FI should be legally empowered to require a change in the constitution of a board due to shortcomings in the skills and knowledge of board members.

Reference Principle	Recommended Action
Consolidated Supervision (CP 20)	FI should be empowered to circumscribe the range of activities a bank can engage in through its foreign operations. FI ought to adopt the policy of actively assessing the supervisory arrangements in the host country in order to safeguard efficient home country supervision. The authority has yet to conclude agreements with some of the countries outside the EU where Swedish banks have established operations. In the supervision of complex multinational banking groups FI should adopt the active role of the lead supervisor in the context of coordinating the planning and performing of joint examinations by supervisors from different jurisdictions. In connection with major foreign acquisitions by banks FI has to adopt the policy of consistently assessing the safety and soundness of the bank's overseas operations.
Remedial Measures (CP 22)	The supervisor ought to be given a wider array of legally binding measures to take a more proactive approach in order to prevent situations from arising where the only effective measure would be revocation of license. The appropriate laws should also be amended to give the supervisor powers to take those measures enumerated in the essential criteria of the principle. The laws should include provisions that would explicitly prevent the possibility of supervisory forbearance.
Globally Consolidated Supervision (CP 23)	The supervisor ought to be empowered to prevent the establishment of branches in jurisdictions where the local supervisory arrangements are not adequate to the risk involved in the operations. FI also lacks powers to require the closing of overseas offices or limitations on the scope of activities.
Host Country Supervision (CP 24)	FI has yet to conclude agreements on cooperation with supervisors from some of the countries where Swedish banks have established operations. FI should have the authority to deny a license for a foreign branch on the grounds that the free flow of supervisory information is hindered by local laws or regulations.
Supervision Over Foreign Banks' Establishments (25)	The supervisor, as a licensing authority for the establishment of a foreign bank's subsidiaries or branches, ought to be required to assess whether the home country supervisor practices effective consolidated global supervision. The law does not state that the host supervisor needs to determine that approval (or no objection) from the home supervisor has been received for a foreign establishment.

D. Recommended Actions and Authorities' Response

99. The authorities are in broad agreement with the mission's assessment of FI's observance of the Basel Core Principles for Effective Banking Supervision. FI has asked for substantial budgetary enhancements to address the resource shortcomings noted. A proposal to reform the regulation of banks and credit institutions that would give FI powers to issue a reprimand and impose monetary penalties has been put forward for public comment, with the objective of submitting a bill to parliament by Autumn 2002. The authorities point out that as

concerns country risk, FI determines through onsite and offsite inspections that banks policies and procedures are appropriate and adequate.

VI. OBSERVANCE OF IAIS INSURANCE CORE SUPERVISORY PRINCIPLES¹⁷

A. General

100. This assessment of the observance of the Core Principles of the IAIS was based on the Insurance Core Principles Methodology of the IAIS adopted at the Annual Conference of the IAIS in October 2000. The assessment draws on the answers to the questionnaire submitted by the IMF prior to the mission, a self-assessment made on the basis of the Core Principles Methodology of the IAIS, information available on the FI website, key legislation relevant to FI, the Annual Report 2000 of the FI, the annual Financial Stability Report, and a range of other information provided by the FI. In addition, extensive interviews were conducted with FI and the industry.

B. Institutional and Market Structure Overview

101. Sweden has a well-developed middle-sized insurance market. The Swedish insurance sector primarily underwrites domestic life and domestic non-life business. 482 companies are licensed to do insurance business in Sweden. Of these, 437 are non-life insurance companies (excl. labor market insurance), 39 life insurance companies (excluding labor-market insurance), and 6 labor-market companies (life and non-life). Four of the non-life insurance companies cover about 83 percent of the market. One of the life insurance companies covers about 23 percent of the market. The life insurance sector is divided into 13 unit linked insurance companies and 26 traditional life insurance companies.

102. On July 1, 1991 the Insurance Supervisory Service was merged with the supervision of banks and other credit organizations into FI, the FI of Sweden. This merger was accompanied by legal changes that from August 1, 1991 permit financial conglomerates: insurance companies may hold shares in credit institutions and vice versa, and both types of companies may be owned by a holding company, thus forming a financial group. The Ministry of Finance is responsible for laws and regulation.

103. FI has a total staff of about 170 persons, of which about only 30 (or 18 percent) work in the Department of Insurance and Mutual Funds. This department is divided into three units according to the corresponding area of responsibility: Licensing & Legal Matters, Supervision, and Risk Analysis.

¹⁷ Assessment performed by Lutz Oehlenberg, Director in the German Federal Insurance Supervisory Office, BAV.

C. Main Findings–Summary

104. While the insurance legislation in its present form follows the EU-directives, this assessment of the IAIS Core Principles of Insurance Supervision underscores the deficiencies in certain aspects of the regulatory framework as well as a lack of staff resources, which have weakened FI's capabilities for effective risk-based supervision of the insurance sector. There is scope for changing the focus of supervision toward a more risk-based approach, a focus on corporate governance and risk management, and more reliance on the work of professionals such as accountants and actuaries. This process is already on the way in the FI and should be encouraged. However, the present difficulty in getting skilled staff and the resulting insufficient number of skilled employees has led to supervisory weaknesses in the insurance sector. Thoroughly examining the insurers' reports is one of FI's primary tasks, but because of the resource constraints, FI does not have the time desirable to do so. FI also needs to find time to continue to develop new methods that would allow a risk-based supervision approach.

The main findings by category of Core Principle are as follows:

Principle 1: Organization

105. Sweden formally observes the organization principle. However, in terms of professional resources there is scope for further improvement. The ongoing development of methods regarding risks related to insurance and the new responsibilities for the licensing and supervision of management companies and mutual funds call for additional resources of actuaries, risk experts, inspectors and legal counselors.

Principle 2: Licensing

106. Because of a shortcoming in the *Insurance Business Act*, FI is not able to carry out the fit and proper test for an insurance company's senior management/key persons (e.g., heads of the investment and legal departments, controller etc.).

107. Insurance companies should inform FI of all outsourcing contracts entered into when pursuing business. The corresponding requirement should be formulated as a regulation. Also, while the Appointed Auditor is required to review the outsourcing contracts if necessary, a legal basis for this requirement should be incorporated into the guideline for Appointed Auditors, and eventually integrated into the *Insurance Business Act*.

108. Insurers outside the EEA should receive licenses issued by FI only if the corresponding home insurance supervisory authority complies with the IAIS Insurance Core Principles. Thus, a license could serve as an incentive for complying with these principles.

Principle 3: Changes in Control

109. FI is not able to carry out the fit and proper test for an insurance company's senior management/key persons (e.g., heads of the investment and legal departments, controller etc.). For example, there is no fit and proper test for sufficiency of qualification, experience and suitability of the persons concerned.

Principle 4: Corporate governance

110. A comprehensive regulation of the management's functions and responsibility is stated in the law (Chapter 8 Insurance Business Act (1982:713)). The law is supplemented by general guidelines on management, internal information and internal control (FFFS 2000:3).

Principle 5: Internal controls

111. In accordance with guideline FFFS 2000:3, every insurer must set up a reporting system referring to internal control/risk management, and the management report is submitted to the Board of Directors. FI has the opportunity to review this report per its appointed auditor or per demand, but the report's submission to FI is not mandatory. In light of the enhanced importance of the risk-based supervision for insurance undertakings, the requirement should be included in the Insurance Business Act that the annual risk management report must be presented to FI for scrutiny.

Principles 6-10: Prudential rules

112. In accordance with the Chapter 7 Section 10g Insurance Business Act (182:713), insurance companies are required to include in annual reports their strategic investment policy. This report is submitted to FI on demand only. While parts of those reports are disclosed to the public, because of the shortfall of qualified staff, FI does not always have the possibility to react when, for example the reports from an insurer indicate a breach of investment regulation. Also, because of the shortfall of qualified staff, FI is not able to scrutinize the reinsurance contracts regularly

113. FI should continue to develop its models to calculate the technical provisions and large exposure risks, and should apply goodness of fit tests to improve the assumptions as data are collected.

114. Up to now FI could not comment on the requirement that the inflation of supervisory capital through double/multiple gearing or other financing techniques in an "insurance group" should be transparent. This is because the formulation of the corresponding regulation has still not been finalized. The appropriate regulation is expected to be introduced in 2002.

Principle 11: Market conduct

115. FI does not make regular on-site inspections at insurance-brokers. FI receives information about brokers' failing to fulfill the requirements, but does not have the resources to respond on such information.

Principles 12-14: Monitoring, inspection, and sanctions

116. The actuarial report needs to be amended:

- Life insurance: the Responsible Actuary should take into account the asset side when forming an opinion of the financial status of the company. A corresponding prescription should be incorporated into the *Insurance Business Act*.
- Non-life insurance: non-life actuaries are reporting more about the reserves' development. Hence to guarantee the quality of the actuarial report, the non-life Responsible Actuary should sign his report. This procedure should be written into an FI-regulation.

117. FI has the power to take remedial actions when necessary. On the whole FI is given the possibility of choosing an adequate sanction. However, it is not possible for FI to issue a formal criticism in cases where there is a need for a sharp reprimand but not obliging the company to take measures.

Principle 15: Cross-border operations

118. Within the framework of the system of home country control and the *Insurance Business Act*, FI has sufficient powers and practice to monitor cross-border operations.

Principles 16-17: Supervisory coordination and cooperation, and confidentiality

119. Within the framework of the system of home country control and the *Insurance Business Act*, the FI has sufficient powers and practice to ensure supervisory coordination and cooperation, and confidentiality.

Table 8. Recommended Plan of Actions to Improve Observance of the IAIS Principles

Reference Principles	Recommended Actions
Licensing and Changes in Control (CPs 2 & 3)	<p>Amend the framework of licensing and changes in control in Insurance Business Act.</p> <p>Require in a regulation insurance undertakings to inform FI of all outsourcing contracts entered into when pursuing business.</p> <p>Require an Appointed Auditor to review the outsourcing contracts into the guidelines for Appointed Auditors. In the long run integrate the requirement into the Insurance Business Act. In the short run establish a new guideline on general outsourcing contracts.</p> <p>Introduce the prescription that insurers outside the EEA should receive a license issued by FI only if the corresponding home insurance supervisory authority complies with the IAIS Insurance Core Principles. Thus, the license could serve as an incentive for complying with these principles.</p>
Internal Controls (CP 5)	<p>Implement the prescription into the Insurance Business Act that the submission of the insurance company's annual risk management report to FI should be mandatory.</p>
Prudential Rules (CPs 6, 8, 9 & 10)	<p>Review the distribution assumption of a normal distribution for a fitter distribution for the purpose of calculating reserves in non-life insurance, provided the collection of data is representative for the analysis concerned.</p> <p>Establish for derivatives and off-balance sheet items disclosure requirements.</p> <p>Enhance the professional staff resources at FI.</p>
Market Conduct (CP 11)	<p>Establish procedures to ensure that companies are in compliance with legislation and guidelines.</p> <p>Enhance the professional staff resources at FI.</p>
Monitoring, Inspection and Sanctions (CPs 12 & 14)	<p>Set up a legal basis for FI to issue a formal criticism when there is a need for a sharp reprimand rather than obliging a company to take measures.</p> <p>Incorporate the prescription into the Insurance Business Act that in life insurance the Responsible Actuary should take into account the asset-side when forming an opinion on the financial status of the insurance company.</p> <p>Prescribe in a FI-regulation that in non-life insurance the Responsible Actuary should sign his actuarial report to guarantee its quality.</p>
Cross Border Operations, Supervisory Coordination and Cooperation, and	<p>Take appropriate action to see that branches of Swedish companies in EEA member states are</p>

Reference Principles	Recommended Actions
Confidentiality (CPs 15 & 17)	supervised. Take appropriate action to maintain and ensure when shared confidentiality.

D. Authorities' Response

120. FI had no comments on the assessments and noted that it would do its best to implement the recommendations made in the report as soon as available resources permit.

VII. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION¹⁸

A. Structure and Role of the Securities Industry

121. The Swedish capital markets play a significant role in the Swedish economy. A range of equity, debt and derivatives products are available on the Swedish market. As a percentage of household savings in Sweden, investments in securities or mutual funds now exceed bank deposits. The number and value of investment has increased due to the recent move by the public pension authority to allow Swedes to invest directly 13.5 percent of pension contributions in mutual funds and other securities.

122. The securities industry is dominated by large market intermediaries—in large part by the four major banks or their subsidiaries. There are 107 licensed investment firms, 20 commercial banks licensed to conduct securities business and 70 savings banks with a more limited securities license (enabling them to process transactions for retail customers) and two foreign banks with a license to conduct securities business in Sweden. Of the very largest securities operations, there is only one independent Swedish investment firm. 80 percent of assets under management in the fund industry are managed by mutual fund companies owned and operated by the four large banks.

123. Sweden's only stock exchange, the Stockholm Stock Exchange, a public demutualized exchange, operates a fully electronic equity exchange featuring the SAXESS trading system. The Stockholm Stock Exchange ranks 15th largest stock market in the world, in terms of market capitalization. The Stockholm Stock Exchange also operates an electronic derivatives exchange offering trading in futures and options and a derivatives clearing and settlement system in which stockholmborsen acts as a central counterparty. The derivatives clearing system offers clearing for trades on the Stockholm Stock Exchange as well as the Oslo Børs, the Copenhagen Exchange and the OM London Exchange and undertakes clearing for custom over-the-counter derivatives. The Stockholm Stock Exchange also includes the Fixed Income Exchange—offering trading and trade reporting services for

¹⁸ Assessment performed by Jennifer Elliott, IMF-MAE.

corporate and government bonds. Bond trading can take place through the electronic SOX system, through a more limited transparency electronic dealer system or by telephone with electronic daily reporting. Stockholmbörsen also owns the OM London Exchange.

124. Equity and debt trades on the Stockholm Stock Exchange and the dealer market are cleared and settled through the VPC system which also acts as the securities registry. VPC is effectively controlled by the four major Swedish banks which own 98.6 percent of shares. It is a highly concentrated clearing and settlement system—the same four banks act as marketmakers in the bond and money markets, and act as clearing members for a large number of Swedish and foreign investors, and function as payment banks for most clearing members in the system. Securities are fully dematerialized in Sweden and, unlike in most countries, most Swedes have direct accounts at VPC and hold securities in their own names. Unlike the VPC system, the OM Derivatives clearing system acts as a central counterparty.

125. Sweden, more so than many countries, has opened up its border to cross-border trading and financial services activity. Of the Stockholm Stock Exchange's 63 members, 30 are remote members without residence in Sweden. The Stockholm Stock Exchange has entered into the Norex alliance with the Oslo Børs, the Copenhagen Stock Exchange and the Iceland Stock Exchange. There are two authorized marketplaces operating in Sweden—Aktietorget Aktiebolag and Nordic Growth Market NGM Aktiebolag—offering trading in small public company shares. The NGM market has recently applied for a license as a stock exchange. There is also an over-the-counter market in equities in Sweden. There are no formal requirements governing trading in this market.

126. The Swedish regulatory system makes extensive use of trade associations for self-regulation—these include the Mutual Funds Association (MFA), the Swedish Securities Dealer's Association (SSDA) and the Swedish Industry and Commerce Stock Exchange Committee (NBK). None of these organizations is officially recognized as a self-regulatory organization. The National Board of Consumer Complaints, set up under the Authority, handles consumer complaints on a voluntary basis. Most financial services companies have chosen to use the Board process to address complaints—it acts as an inexpensive and efficient alternative to court actions.

B. Main Findings

127. The general preconditions for effective securities regulation in Sweden appear to be in place. The legal system supports effective credit and capital regulation with efficient court systems and bankruptcy law. Legislation and FI rules combine to form a sound basis for regulation and FI enjoys most of the authority it requires over regulated entities. The authority could benefit from additional power to levy fines and other penalties.

128. FI has limited resources to implement its many rules and regulations. In recognition of this, FI has recently reorganized its supervision planning. FI has, on the basis of risk to the system, designated 13 institutions or groups of institutions as priorities for supervision. VPC and the Stockholm Stock Exchange constitute 2 of the 13 groups.

129. FI adopts a risk-based approach to inspections, rather than use of routine inspections—while this approach may make efficient use of limited resources, it is clear that current levels of on-site inspection work is insufficient to gauge compliance among market participants. Expertise appears to be lacking in the mutual fund area and in the area of clearing and settlement.

130. In general the clearing and settlement systems function smoothly although risk management in VPC requires attention. The OM Derivatives Clearing system is sophisticated and at par with current market practices. There is a well-functioning and robust securities lending market supported by the legal framework. However, the VPC should improve risk management for clearing and settlement.

131. The VPC clearing and settlement system does not adequately prevent an unwinding in the event of the failure of a participant to meet its obligations. This might introduce market risk, liquidity risk and even systemic risk in the event of a bankruptcy of a clearing member or payment bank. The system features an unprotected netting scheme for both equity and debt trade settlements. While a partial guarantee system somewhat mitigates the risks for equity trades, the risk in the debt market is significant. Payment banks are not required to guarantee trades of clearing members who use them as payment banks—leaving open the possibility of a default. The same is true if an indirect participant is not able to deliver the securities—VPC does not act as a central counterparty nor is collateral required to cover the market risk nor are there liquidity arrangements in place to cover liquidity risk.

132. FI has recently revised its supervisory plan with increased attention to VPC—this supervision plan should include on-site inspections, risk management assessments and a review of the VPC corporate governance structure. The VPC has chosen a two-step approach to address the risks in the system. As a first step, the VPC has proposed to eliminate indirect participants, and as a second step the VPC has put forward a new model for settlement operations that would eliminate the present “unwinding” procedures.

133. FI faces some limitations in responding to regulatory or non-compliance concerns regarding market intermediaries. All material changes to a license are required to be reported and FI has the right to object to the change. FI can also enjoin a regulated entity to cease an activity that contravenes legal requirements (or order the entity to cease operations). Enforcement tools are limited to warnings and revocation of license.

134. FI does not license individuals nor does it set proficiency requirements for traders, advisors, portfolio managers, compliance officers or officers and directors of the investment firms and mutual fund managers. FI plans to issue general guidelines on proficiency in the near future. Svedsec, a subsidiary of the SSSA, has been set up to register and license individual employees of investment firms. Svedsec—which began operations in April 2001—sets an examination for individuals and enters them into a public registry. Svedsec has set up a disciplinary committee and can take action against these licensees for a breach of SSSA guidelines or FI regulations.

C. Summary of Principle-by-Principle Assessment

135. **Strength of the regulator.** FI is an independent and accountable regulator employing high professional standards—however, FI requires additional resources and authority. More staffing resources are required in order to carry out a more robust on-site inspection program and FI should address the shortage of expertise in some areas (including mutual fund supervision). FI's authority over regulated entities could be strengthened—FI should have the ability to take interim action and should have the power to assess penalties and fines as a result of enforcement actions. FI observes high professional standards and has clear, consistent and transparent processes. FI routinely consults industry and stakeholder groups in implementing rules, makes a great deal of information available on its website and is subject to comprehensive freedom of information and privacy laws. FI has the right to share information and has entered into a number of information sharing arrangements.

136. **Self-regulation.** The regulatory system in Sweden makes extensive use of SROs, both formal and informal. The use of SROs is generally in compliance with IOSCO Principles—however, SROs should complement rather than replace regulation by the regulatory authority and, where the SRO is relied on to carry out supervision, that supervision should be subject to vigorous oversight by the regulatory authority. FI's efforts should be strengthened on both counts. Use of the informal SROs to carry out rule development should be balanced by FI's own work on public company and market intermediary regulation.

137. **Issuer regulation.** Prospectus requirements are in place but monitoring of compliance with the rules is weak for unlisted and O list securities (second tier listings on Stockholm's borsen). Continuous disclosure standards apply only to listed companies and are administered by the Stockholmbörsen. Rule-making initiatives in this area are generated by the industry association NBK and FI does not take a lead role in this area of regulation. Treatment of minority shareholders, stronger for listed companies than unlisted companies, could be improved with greater public float requirements, removal of voting right differentials and stricter take-over bid rules. Administration of these rules should not rest solely with the Stockholm Stock Exchange—particularly when the regulatory process is not subject to sufficient oversight. FI will have to revise its approach to these issues in view of the various EU-level initiatives underway—the proposed prospectus and market abuse directives particularly. Accounting standards are high and are moving toward compliance with IASC standards.

138. **Mutual fund regulation.** Mutual fund licensing requirements are generally satisfactory. Conflicts of interest rules, particularly in a conglomerate setting, could be improved and supervision of mutual funds should be strengthened. The particular problems associated with related depositories should be addressed. FI should give consideration to the consequences of these structures under stressful circumstances. Net asset valuation calculation should be monitored more stringently and there should be rules governing valuation of illiquid securities.

139. **Market intermediary regulation.** Full licensing and capital adequacy rules are in place for investment firms. FI has supervisory authority over investment firms and may carry out inspections or investigations of these firms. Inspections could be strengthened and the ability to take interim measures against an investment firm would improve FI's ability to enforce compliance with its rules. Capital regulation could be improved with more frequent financial reporting requirements and FI's practical ability to handle the failure of a major investment firm without undue market disruption would be hampered by its limited authority to take positive action. There are gaps in regulation of the client-investment firm relationship and few internal supervisory requirements applicable to investment firms, although most of these gaps will be addressed by proposed EU directives. Remote access members of the exchange are regulated by their home jurisdictions (having no dealings with Swedish customers) but are subject to surveillance by OM.

140. **Marketplaces.** FI has taken an advanced approach to marketplace regulation—setting clear and adequate standards for exchanges and alternative trading systems. Transparency requirements are adequate and rules are in place to detect market abuse. Supervision of the Stockholmbörsen requires improvement.

141. **Clearing and settlement systems.** There are weaknesses in the supervision of clearing and settlement systems—both at the Stockholm Stock Exchange and VPC. As a result the lack of adequate risk management for exposures in debt clearing but also in the equity clearing in the VPC system has been allowed to continue. In light of the potential risks these institutions pose to the financial system, serious attention must be given to supervision of the clearing and settlement systems and to addressing the conflicts of interest that arise as a result of the governance structure of both VPC and the Stockholm Stock Exchange.

Table 9. Recommended Plan of Actions to Improve Observance of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
Principle 3	FI should be granted authority over third parties. Legislation or licensing requirements should be amended to enable FI to take interim or corrective measures.
Principle 6	FI should consider its relationship to the informal SROs and take steps to balance its own activities and supervision of market intermediary and listed company regulation should that it has a presence in these areas.
Principle 7	The current intention to strengthen supervision of the Stockholm Stock Exchange and VPC should be vigorously pursued.
Principle 8	FI should be granted authority to compel evidence from third parties.
Principle 9	FI should be granted authority to carry out full enforcement proceedings and levy fines and penalties.
Principle 10	FI should increase resources devoted to inspections of investment firms, mutual fund companies and SROs.
Principle 11	FI should strengthen the supervision the regulation of listed companies by the Stockholm Stock Exchange. Prospectus review at FI should be strengthened. Continuous disclosure standards should be applied to unlisted issuers.
Principle 12	FI should enhance its activity in this area of regulation—minority shareholder rights could be strengthened and should also apply to unlisted issuers.
Principle 17&18	Adequate controls on conflicts of interest in dealings between related companies should be addressed through stronger requirements and on-site inspections. Owners of mutual fund companies should be subject to fit and proper testing.
Principle 20	A system for monitoring net asset valuation requirements should be established. Rules for valuation of illiquid securities should be developed.
Principle 22	More frequent reporting of capital positions should be considered.

Reference Principle	Recommended Action
Principle 23	FI will be required by proposed EU Directives to introduce more detailed rules for investment firms. This should be supported. Greater resources should be devoted to the inspection program.
Principle 24	FI should consider its practical ability to handle a large failure—consideration of the ability to act as administrator of an insolvent firm prior to bankruptcy proceedings so that client accounts may be transferred, preventing market disruption.
Principle 29&30	As noted in the securities settlement system portion of this report, it is strongly recommended that oversight of VPC and the Stockholm Stock Exchange clearing systems be strengthened. The current shortcomings of the VPC risk management system should be addressed.

D. Authorities' Response

142. The authorities were in broad agreement with the assessment—pointing out that many of the issues including enhanced standards for issuers and investment firms will be implemented as a result on on-going work at the EU. The current FI business plan also contemplates increased attention to both VPC and the Stockholm Stock Exchange and the authorities believe that once the new plan is fully operational oversight concerns will be satisfactorily addressed. The VPC is adopting a two-step approach to address the risks in the VPC, which will fully eliminate the present “unwinding” procedure.

VIII. THE CPSS CORE PRINCIPLES¹⁹

A. General

143. The assessment of observance of the CPSS Core Principles for Systemically Important Payment Systems of the RIX-System and the responsibilities of the Riksbank in applying the Core Principle in Sweden was performed on the basis of the methodology published in the CPSS-report on Core Principles for Systemically Important Payment Systems and the guidance note of assessing observance with these principles. Prior to the mission, the Riksbank submitted a self-assessment of the Core Principles with respect to the RIX-system and the responsibilities of the Riksbank in applying the core principles. The Bankgirocentralen (BCGs) also submitted a self-assessment on the functioning of the BCG. The main sources for this assessment were various publications, laws and regulations as well

¹⁹ Assessment performed by Mr. Harm Jan Woltjer of the Nederlandsche Bank.

as risk analysis performed by the Riksbank. Several meetings were held with officials of the Riksbank, FI, and representatives of the banking sector and financial markets.

B. Institutional and Market Structure

144. The major players/systems in the Swedish payment system are:

- *Sveriges Riksbank*. The Riksbank owns and operates the interbank settlement system RIX. The system operates on an RTGS basis and is primarily designed for large-value payments. RIX consists of two parallel but separate systems; K-RIX for settlement in Swedish kronor and E-RIX for settlement in euro. E-RIX is inter-linked to the ECB's TARGET system;
- *VPC*. VPC is the Swedish central depository and a clearing and settlement organization. It operates two securities settlement systems, one for equities and one for fixed income paper, and provides services as a central securities depository. Equities, bonds and money market instruments are all dematerialized in the VPC system. Cash settlement is made in central bank money via Riksbank accounts in the RIX system. Settlement is made on a multilateral net basis or on an RTGS basis. The latter is manually operated. In both processes, the cash settlement takes place at the same time as the settlement of securities. Delivery-versus-payment is thus achieved;
- *The Stockholm Stock Exchange*. The exchange clears and settles derivatives and acts as a central counterparty in the transactions that are cleared and settled. The clearing activity covers both derivative products traded on the Stockholm Exchange and products traded outside the exchange (OTC). All funds settlements are made via the exchange account in the RIX system on a multilateral net basis;
- *Bankgirocentralen (BGC)*. BGC manages and develops the Bankgirot system and offers its products and services to the banks. Retail payments, such as credit transfers, direct debits and card payments, but also certain large-value payments are processed. BGC recently adopted a new technical platform and new clearing and settlement procedures, which has led to the full integration of the RIX system, BGC's clearing information system and the clearing participants internal systems. The payments are settled on a bilateral net basis in the RIX system several times per day;
- *Postgirot*. Postgirot is essentially a system for credit transfers between accounts held within the Postgirot Bank. The Postgirot system processes retail payments to and from companies and households and government's payments. Settlement is made in commercial bank money. Postgirot Bank has recently become a full member of the Bankgirot system, which has led to interoperability between the two systems; and
- *Riksgäldskontoret*. The NDO, participates in the RIX system as the government agency responsible for the management and processing of government payments.

145. Payment and securities settlement systems are overseen by Riksbank as well as by FI. The Riksbank is charged in the Sveriges Riksbank Act with promoting a safe and efficient payment system and, within that framework, is responsible for the oversight of the financial infrastructure. FI is charged with supervision of Bankgirot system, VPC and Stockholmbörsen. The oversight of the Riksbank concerns the stability of a system or a market as a whole, while supervision of FI concerns the stability of each individual system provider. The oversight of payments system is not always clear and transparent for payment system providers and market participants because the scope of oversight/supervision of the Riksbank and FI overlaps. Other concerns are (i) the lack of regulatory powers of the Riksbank, which hampers the effectiveness of the Riksbank's oversight; and (ii) residual risks in the securities settlement system.

146. Most transactions in the wholesale financial markets as well as monetary policy operations are settled via the RIX-system which is well shaped, efficient, safe and fully automated. The RIX-system operates in accordance with the Real Time Gross Settlement (RTGS) principle. Payments are settled one by one and the cash that is transferred to the participants' account with the Riksbank is immediately available. The legal framework in Sweden fully supports the functioning of the RIX-system and all other payment systems. Especially finality of payments and electronic processing are well regulated. The Riksbank offers unlimited intraday credit against a broad range of collateral—including collateral in foreign currency—which ensures sufficient liquidity during stress-times in the markets. Crisis-handling is tested regularly.

147. Potential systemic risk and contagion risk might occur in the financial infrastructure due to the absence of adequate risk management measures in both netting schemes for settlement of securities transactions of VPC. Both systems settle their cash balances in the RIX-system.

148. Counterparty risk in the interbank markets, especially in the foreign exchange market and in the money market, could be reduced by promoting collateralization of interbank loans. The use of collateral in the interbank market could be facilitated by developing a full automated trade for trade settlement system for securities transactions that settles transactions on a real time basis and is capable to handle the settlement of repo-transactions, including the reversed transaction at the agreed point in time.

149. Another aspect that hampers the efficiency is the small time-window during which banks have to settle specific payment related to transactions of foreign customers. This causes liquidity stress during this peak-time and banks sometimes block all outgoing payments to ensure available liquidity during this time window. The time window is agreed upon in code of conduct between banks. Although the situation has already improved, further improvements might be possible by adapting the code of conduct and/or by introducing incentives for early settlement of payments.

C. Main Findings

150. The RIX-system has a well-founded legal basis. In Sweden the European finality directive is incorporated in law by the approval of the Settlement System Act. Within the framework of this law the RIX-system is designated by the European Commission as a designated payment system. In a designated system in Sweden, transfer orders vis-à-vis a third party shall be valid notwithstanding that a collective insolvency procedure has been started, provided that such orders have been placed in the system prior to the issuance of the decision with respect to the insolvency procedure. There are no judicial hindrances to citing electronic documentation in a court of law, as recently codified by the act on qualified electronic signatures. The rules and regulations of the RIX-system are transparent and the right and obligations of all involved parties are clearly stated.

151. A clear description of the functioning of the RIX-system and its key roles can be found in the publication of the Riksbank "Settlement of payments in the RIX-system, SKR and EURO." The RTGS-character of the RIX-system reduce overall systemic risk. The RIX-system has a waiting queue and participants can actively manage their liquidity position. The Riksbank extends intra-day credit to qualified participants and accepted a broad range of collateral to avoid gridlocks in the systems. However, the amount of credit available to the market is limited for the E(uro)-RIX-system due to the fact that Sweden is not a member of the Economic and Monetary Union (EMU). In emergency situations the Riksbank is allowed to grant credit or provide guarantees on special terms with the end of supporting liquidity in the system (Sveriges Riksbank act, Section 6:8.).

152. Due to the RTGS-character of the RIX-system, no netting of transactions takes place. Settlement is being effected throughout the day. A payment in the RIX-system becomes final for the sending participant when its account is debited and for the receiving participant when its account is credited. The receiving participant can immediately use the received cash. After the transaction is final the payment order cannot be revoked, reversed or make void by the sending participant or by any third party, or even in the event of insolvency procedures against a participant, except in cases of imperfections in the underlying transaction(s) or payment order(s) arising from criminal offences or fraudulent acts. The settlements takes place in central bank money, as well in kronor or in euro and no settlement bank risk occurs.

153. The operational reliability of the RIX-system is very high and contingency measures and measures to prevent unauthorized access are up to standard. Data integrity, authorization, authentication, non-repudiation and confidentiality are ensured. Adequate procedures are in place concerning procurement, development and modification to ensure that current production processes are not disturbed.

154. Although the RIX-system is efficient, fully automated and well-shaped, the RIX-system is not fully cost recovering due to the small number of payments in a highly concentrated banking sector and due to the fact that Sweden, in order to be able to join the EMU, has to operate two systems one that settles in kronor and in one in euro. However, the Riksbank is fully aware of this problem and develops at the moment, in cooperation with

banking sector, a longer-term strategy to broaden the economic base. Inter-alia outsourcing of the operational tasks the Riksbank to the private sector and cooperation with other central banks in Nordic countries will be examined.

155. The RIX-system has objective and publicly disclosed access criteria, permitting fair and open access. However, in order to reduce the strong concentration risk in especially the securities markets it might be recommended that the Riksbank evaluate its access criteria for the RIX-system and allow also access to all investment firms. However, broadening of the access criteria will only make sense if the annual fee of SKR 200.000 is lowered substantially, while this fee is too high a threshold for smaller banks and investment firms.

156. Although the Riksbank fully owns the RIX-system, the banking sector and other relevant participants participate on different levels in the adaptation of the present system and the development of a strategy for a new generation large value system.

157. The Riksbank has fully disclosed its oversight role in the articles published in the Financial Market Report 1997-1 and in the Sveriges Riksbank Economic Review 2001. A specific department, the financial stability department, is created and charged with the analysis of the financial stability and the oversight of the financial infrastructure. Part of the oversight task is to ensure that the RIX-system fully complies with the core principals. The Riksbank does not have sufficient legal authority over payment system and cannot make regulations. The supervisory responsibilities of the Riksbank and FI and cooperation between this two institutions concerning the payments systems should be clarified.

Table 10. Recommended actions to improve observance of CPSS Core Principles and Central Bank Responsibilities in applying the Core Principles

Reference principle	Recommended action
Efficiency and practicality of the system <i>i.e., CP VIII</i>	Strengthening the efficiency in the system by broadening the timeframe for the settlement of foreign clients or FX related payments (banking sector has to change the code of conduct). Investigate incentives to minimize the free rider problem with respect to liquidity and the input of collateral (Riksbank). Investigate incentives (differentiation of fees, schedule of percentage of payments to be done before specific moments of time during the day etc.) to promote a smoother payment flow during the day and to reduce the liquidity stress during peak hours (Riksbank).
Criteria for participation <i>i.e., CP IX</i>	Evaluate access criteria and fee structure in order to reduce the concentration and contagion risk in the securities settlement business (Riksbank).
Central Bank Responsibilities in applying the CPs <i>i.e., Responsibilities A-D</i>	<ul style="list-style-type: none"> • Reinstate the regulatory power of the Riksbank with respect to its oversight task in the Riksbank Act (parliament). • Develop an explicit regulatory framework for the oversight of payment and securities settlement systems in which the objectives of the oversight are stated and the international codes and standards are been worked out and the involvement of the overseers in crisis-situations is incorporated (Riksbank/FI). • Develop a protocol on cooperation, division of tasks and information sharing (Riksbank/FI).

D. Authorities' Response

158. *Efficiency and practicality of the system (CP VIII)*. The Riksbank is of the opinion, that in a small country like Sweden with highly concentrated banking sector it is not possible to charge enough to cover the cost, especially considering the cost to keep the security level high.

159. *Oversight and Central Banks responsibilities in applying the core principles*. Both the Riksbank and Finansinspektionen share the view of the assessment that the co-operative arrangement between the Riksbank and Finansinspektionen for the oversight of payment systems and securities settlement systems needs to be formalized and made more transparent. Both organizations have agreed to develop and publish a MOU about oversight-methodology on payment and securities settlement systems, the responsibility of the respective institutions and the cooperation arrangements between them. FI will introduce a new supervisory

approach for the oversight of payment and securities settlement systems, especially, with respect to VPC and the Stockholm Stock Exchange. And in 2002 the rules and regulations of VPC have been changed in such a way, that, as per October 1, indirect participants will no longer be allowed in the systems and the clearing member who has them as customer will be fully responsible for their obligations. Also a new clearing and settlement model will be introduced to eliminate the existing unwinding procedure.

IX. TRANSPARENCY OF MONETARY POLICY²⁰

A. General

160. This assessment of the transparency of monetary policy was conducted within the framework of the IMF's Code on Transparency of Monetary and Financial Policies. For the purpose of this assessment, monetary policy is broadly understood to encompass the overall framework within which the Riksbank seeks to maintain monetary stability in Sweden. Hence, it is concerned not only with the transparency of the framework for the Riksbank's decision-making and operations to manage the krona interest rate (and exchange rate), but also with its roles and responsibilities in respect of the institutions and infrastructure which make up the monetary system within which its operations are conducted.

161. The assessment should be read in the context of Sweden having had a long tradition (for some 250 years), which is supported by the current law, of official agencies' activities being conducted according to principles of openness and transparency. The principle underlying the law and practice is that the public may have access to official documents unless there are specific grounds (in terms of the Secrecy Act) for rejecting a request. If access is denied, that decision may be appealed against at the Supreme Administrative Court. This tradition underpins a high degree of transparency in public policy in Sweden.

162. The assessment was undertaken on the basis of a self-assessment by the Riksbank followed up with interviews with representatives of the Riksbank and financial sector; and reported by a review of the key legislation relevant to the Riksbank (notably the relevant clauses of the Constitution Act, The Foreign Exchange Rate Policy Act and the Sveriges Riksbank Act); and a range of Riksbank publications, including its *Annual Reports*, quarterly *Inflation Reports*, and twice yearly *Financial Stability Report*.

B. Summary of Main Findings

163. The monetary policy system in Sweden is characterized by a particularly high level of transparency. The policy process is open to public scrutiny, and policy decisions are actively explained, through a variety of media—including the Riksbank's website. This occurs within

²⁰ The assessment was prepared by Mr. Bruce White of the Reserve Bank of New Zealand.

an institutional framework which is underpinned by structures and practices that provide a basis for public confidence in the integrity of the processes.

Clarity of roles, responsibilities, and objectives of financial agencies

- The roles and responsibilities of the Riksbank, as monetary authority, are transparently defined, as are the objectives to which they are to be directed. The institutional framework of monetary policy is clearly defined. The Constitution Act provides that the Riksbank is the Central Bank of Sweden and is an authority under the Riksdag (the parliament), and is responsible for monetary policy. Elaboration on the roles and responsibilities of the Riksbank is provided in the Sveriges Riksbank Act, in terms of:

- the specification of price stability as the objective of its monetary policy operations;
- promotion of a safe and efficient payment system as another objective;
- responsibility for the provision of banknotes and coins;
- the implementation of the foreign exchange rate system decided by the government; and
- acting, at its own discretion, as a lender of last resort to illiquid, but not insolvent financial institutions that are subject to the supervision of FI.

164. Together these roles and responsibilities provide an integrated framework for the maintenance of monetary stability in Sweden. The legal and institutional framework is clear on how the broad areas of responsibility assigned to the Riksbank relate to each other and to those of other official agencies with financial sector responsibilities. In this regard:

- The government is responsible for general foreign exchange policy issues. The government chooses the exchange rate regime and the Riksbank has operational independence in implementing the chosen regime;
- Financial supervision of credit institutions is a responsibility of FI;
- The financing of government operations and public debt management are unambiguously responsibilities of the NDO. The Riksbank is expressly prohibited from directly lending to, or from purchasing debt instruments directly from, the government;
- The Riksbank has an overall responsibility for promoting a safe and efficient payment system, while FI is responsible for supervising the proprietors of individual systems and their member credit institutions (as part of its financial supervision of these intermediaries); and
- Provision of financial support to a distressed institution by the Riksbank, under its lender of last resort facility, is expressly confined to providing liquidity support. Solvency

support from official sources cannot be provided by the Riksbank but would have to come from the government budget, or, if it takes the form of a guarantee, from the government, endorsed by the parliament. In the absence of such support being forthcoming, an insolvent bank would be liquidated in accordance with the normal company liquidation procedure, and compensation for depositors would be provided by the DGB, in accord with the terms of the DGS it administers.

165. While the assignment of roles and responsibilities generally is highly transparent, the assessment noted that some ambiguity remains on two points:

- The arrangements for handling the failure of a systemically important bank. Specific recommendations have been made by a Banking Law Committee to establish failure management arrangements and a clear assignment of responsibilities that take account of the special circumstances surrounding the failure of a systemically important bank. These recommendations are under consideration.
- The division of responsibilities for supervising the payment system, as between the Riksbank and FI.
- In addition, it is theoretically possible for the government's choice of exchange rate regime to be at variance with the monetary policy objective (price stability). However, this is not viewed by the authorities as a concern. The government's right to choose the exchange rate regime is subject to prior consultation with the Riksbank, and the Riksbank decides on the application of the foreign exchange rate system and would have the discretion in choosing the central rate and setting intervention bands if the government were to move to a fixed exchange rate system. Vice versa, the Riksbank can ask the government to make a decision on the exchange rate system, and the government must deal with such an application speedily.

Open process for formulating and reporting of financial policies

166. Responsibility for decision-making in the Riksbank is vested in the Executive Board. As noted, the law makes clear that with respect to monetary policy, the Riksbank is independent of the government. The Executive Board, including the provisions governing appointment to and removal from it, is established by the Riksbank Act. The membership of the Executive Board is public. An advance schedule of the monetary policy meetings of the Executive Board is published in press communiqués as well as on the Riksbank's website.

167. **Monetary policy formulation** is undertaken within an inflation-targeting framework. A feature of this framework, in common with the approaches of other central banks that have adopted a formal inflation-targeting approach to monetary policy, is a highly transparent decision-making process and an emphasis on **giving account** for policy (inflation) outcomes. The means by which this transparency and accountability is achieved include publication of

the minutes of the meetings of the Executive Board at which monetary policy decisions are taken (generally with a lag of about two weeks).

168. The Riksbank actively and regularly consults with relevant counterparties on changes to the terms, conditions and procedures that govern the operation of its monetary policy instruments. Similarly, changes to the RIX (high value) payment system operated by the Riksbank, and to regulations on statistical reporting requirements, are the subjects of consultation with participants and/or other entities concerned. Consultations usually take the form of inviting relevant counterparties to give written comments within a specified time period. Comments and suggestions by representatives of counterparties on amendments to current agreements are also presented and discussed at regular meetings with the Council of the Payments System (Betälningsystemrådet), an informal group of Riksbank staff and representatives of major counterparties.

169. In February 2002, the Riksbank released a framework for communicating information on **foreign exchange market interventions**. Prior to such interventions, the Executive Board would make two separate decisions, one on the motivation for the intervention and one on an intervention mandate. The mandate would specify the intended period during which intervention would take place, and the scope of intervention (with the amount of detail to be provided depending on the circumstances). It would normally apply no longer than until the next monetary policy meeting of the Executive Board. The responsibility for implementing and communicating the intervention would be delegated to the governor of the Riksbank in consultation with one or more members of the Executive Board.

170. To ensure full transparency on the *motives for the interventions*, the minutes of the Executive Board's deliberations would also be published, with a lag of at least one month, but no more than one year, after the intervention mandate had expired. However, the Executive Board's deliberations on the *mandate for the interventions*, (in effect, the Riksbank's strategy for dealing in the market) would be recorded in separate minutes, so that confidentiality in this regard could be maintained for longer. The precise timing for lifting confidentiality for the respective minutes would hinge on a case-by-case assessment of whether information in the minutes could counteract the purpose of the intervention.

171. This framework for communicating intervention decisions is in keeping with the Riksbank's particularly high standards of monetary policy transparency, with the confidentiality constraints being fully in line with the provisions of Chapter 3, paragraph 1 of the Secrecy Act.

Public availability of information on monetary policy

172. Besides publishing the minutes of the Executive Board's monetary policy meetings, the Riksbank publishes an *Inflation Report* four times a year, a *Financial Stability Report* twice a year, and an *Annual Report*. The Riksbank also publishes a bulletin of analytical and policy articles—the *Economic Review*—four times a year, as well as a series of reports and working papers related to the Swedish economy and economic research. These are translated into English and published on the Riksbank's website. Overall the Riksbank's publications

program is comprehensive and the various publications are of high quality. This publications program is supported by an active, and extensive, speaking program by the governor and other members of the Executive Board.

173. Sweden has subscribed to the Special Data Dissemination Standard (SDDS) and has been approved by the IMF as meeting the SDDS specifications for the coverage, periodicity, and timeliness of the data and for dissemination of advance release calendars. The Riksbank is also particularly transparent in disclosing information about its foreign exchange reserve assets. The information disclosed includes, with a lag, details on the distribution of the currencies, target duration, and benchmarks used.

174. Information on the Riksbank's weekly, and daily (fine-tuning), operations in the krona markets are disclosed on Reuters following each market operation. The banking system's net position against the Riksbank is also disclosed on a daily basis, as is a summary Riksbank balance sheet on a weekly basis.

175. Emergency financial support by the Riksbank during the financial crisis at the beginning of the 1990's was publicly disclosed. All remaining non-public information concerning the Riksbank's role in providing financial support during that period was released publicly after approximately five years. Initially the Riksbank declined to release the latter information, but subsequently agreed, in response to an appeal against its initial decision to the Supreme Court, under the provisions of the Secrecy Act.

Accountability and assurances of integrity by financial agencies

176. The legislation that established the Riksbank was designed with careful regard for ensuring **accountability and integrity**. There is a two-tier structure, comprising an 11 member General Council, elected by the Riksdag, and an Executive Board, which is responsible for the management of the Riksbank, and is appointed by the General Council. The Chairman and the Deputy Chairman of the General Council have the right to be present at meetings of the Executive Board with the right to speak, but without the right to make proposals or vote.

177. Removal of a member of the General Council can only occur by decision of the Riksdag, on grounds that are confined to where there is a case for making a financial claim against the member, or if the member has been prosecuted for criminal actions in connection with his assignment or employment. A member of the Executive Board can only be removed by the General Council if he no longer meets the requirements made on him to carry out his duties or if he is found guilty of serious misconduct.

178. Financial stewardship by the Riksbank is governed by a requirement that the Executive Board submit the budget for the Riksbank's administrative activities during the following accounting year for information to the Parliamentary Standing Committee on Finance and the Office of the Parliamentary Auditors, as well as to the General Council of

the Riksbank. Formal accountability for monetary policy decision-making and implementation is provided by a requirement that the Executive Board provide a written report to the Parliamentary Standing Committee on Finance twice a year. In addition, an annual report of the Riksbank's operations during the preceding accounting year (coincident with the calendar year) is required to be submitted by the Executive Board to the Riksdag, the Office of the Parliamentary Auditors and the Riksbank's General Council by February 15 each year.

179. The Office of the Parliamentary Auditors conducts audits of the Riksbank's financial statements. The auditor's report, which is publicly disclosed, is directed to the Riksdag, which approves the Riksbank's Profit and Loss Account and Balance Sheet, and determines whether the General Council and the Executive Board shall be discharged from liability. The consequence of not being discharged from liability is removal from office of the General Council.

180. Other elements of the arrangements by which the Riksbank gives account include:

- Publication by the Executive Board, four times a year, of an *Inflation Report*. (Two of these serve as the half-yearly report to the Parliamentary Standing Committee on Finance (see above);
- Publication twice each year of a *Financial Stability Report*;
- Appearance by the governor at least twice a year before the Parliamentary Standing Committee on Finance to explain and answer questions on the Riksbank's monetary policy;
- Attendance by the governor and other members of the Executive Board at the monthly meetings of the General Council, to inform it about monetary policy and other issues dealt with by the Executive Board; and
- Frequent public presentations on monetary policy issues by the members of the Executive Board, in particular by the governor and the first deputy governor.

181. Operational integrity of the Riksbank is underpinned by a number of provisions. First, there is a general prohibition on members of the Executive Board from accepting any other employment or assignment that would make them unsuitable for appointment as members of the Executive Board. However, the General Council may approve Executive Board members accepting additional roles or assignments, where it is satisfied that it would not compromise the member's suitability as a member of the Executive Board. Second, members of the Executive Board, and the Chairman and Deputy Chairman of the General Council, are required to report to parliament their financial statements (i.e., holdings of equities, bonds and mutual fund assets as well as their debts). These reports are publicly available. Other members of the General Council and about 100 members of the Riksbank staff are required to report to the Riksbank their financial assets. These reports are not publicly available.

182. Internal governance procedures are stated in the Rules of Procedure for the Riksbank. These are determined by the General Council, and are published in English and Swedish, both in paper form and on the Internet.

183. Riksbank staff are additionally subject to the Law on Public Employment. This provides that Riksbank staff members must not accept any spare-time occupation, assignment or other activity that may compromise confidence in their ability to act impartially in their work, or which may damage the reputation of the Riksbank. In addition, the Executive Board has adopted guidelines on ethics that members of the Riksbank staff are expected to observe. These guidelines are available to the public.

184. Riksbank staff are also covered by the Law on Damage Compensation, which provides the framework of law on the liability of public sector employees for damages caused in the course of their employment. The general position is that the employer normally has to bear the cost of compensation for any damage caused by error or mistake by its employees in the exercise of public authority in activities for which the State is responsible. An employer may seek damages from the employee, but only in exceptional circumstances.

Table 11. Recommended Plan of Actions to Improve Observance of IMF's MFP
Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	
	That the authorities seek to establish transparency, <i>ex ante</i> , with respect to how the insolvency of a systemically important bank would be managed, including specification of the roles of individual agencies and their interaction during the period necessary to determine insolvency, for the government to decide on its course of action, and for parliament to grant approval to it.
	The Riksbank operational discretion to determine the intervention band widths and the central rate for the exchange rate should be explicitly mentioned in the Foreign Exchange Rate Policy Act to remove any uncertainty that the government's choice of exchange rate regime could be at variance with the price stability objective of monetary policy.
	The authorities should establish greater clarity on the roles and responsibilities of the Riksbank and FI for supervising the payment and settlement systems.

C. Authorities' Response

185. The Riksbank concurs with the above assessment. The authorities plan a MOU to clarify Riksbank and FI responsibilities for supervision of the payments system.

X. TRANSPARENCY OF FINANCIAL POLICIES²¹

A. General

186. This assessment of the transparency of financial supervisory policies was conducted within the framework of the IMF's Code on Transparency of Monetary and Financial Policies. The assessment was undertaken on the basis of a self assessment by FI; discussion with FI and other financial sector authorities; discussion with the industry associations in Sweden for banking, securities dealing and mutual funds as well as with the stock exchange; review of a range of FI publications, including its *Annual Report* and annual report on *The Stability of the Swedish Financial Sector*; a review of the legislation that FI is responsible for administering and that govern its operations; and explanations given of the constitutional framework for administration by government agencies in Sweden.

B. Summary of Main Findings

187. There is a very high level of transparency in financial supervisory policies and practices in Sweden. Openness and transparency is prescribed for all public agencies by an ordinance issued by parliament (*Tryckfrihetsförordningen*), and is deeply embedded in the philosophy of public administration in Sweden. Its basic constitutional principle is that all types of official documents (minutes, decisions, regulatory codes etc.) are to be publicly available, with only limited exceptions as defined in the Secrecy Act.

Clarity of roles, responsibilities, and objectives of financial agencies

188. FI is a central administrative authority under the Ministry of Finance, with responsibility for conducting supervision of, and administering the related law and regulation that applies to, all regulated financial sectors in Sweden (the banking, insurance, and securities and investment sectors). As a government administrative authority, it is not established or governed by its own Act of Parliament. Instead, the institutional framework within which FI operates is provided by a hierarchy of documents issued by, or under the authority of, the Swedish Parliament.

189. Annual instructions (*Regleringsbrev*) are issued by the government to FI, which set out the policy objectives and priorities for the year ahead, and the framework by which FI is to report on the achievement of the objectives set. These instructions are prepared in consultation with FI, and are publicly available.

190. FI's mandate is also prescribed in the various Acts of Parliament governing the different types of regulated financial institutions and markets in Sweden. Each includes a chapter on the framework for the supervision by FI of the institutions covered by those

²¹ Assessment performed by Mr. Bruce White of the Reserve Bank of New Zealand.

respective Acts. The objective of FI's supervision in each case is generally stated as being to "further the sound development of the operations" of the institutions concerned.

191. The (internal) governance structure for, and (external) roles and responsibilities of, FI are generally clear and transparent. The Director-General is head of FI and chairman of its Board. The Board has both decision-making and advisory roles. In its decision-making capacity, the Board determines sanctions to be imposed by FI, makes licensing decisions of an "important character", and takes important supervisory actions, such as calling an extraordinary meeting of the shareholders of a supervised institution. It also approves regulations issued by FI and is responsible for FI's Annual Report. In its advisory role, it is consulted by the Director-General on important supervisory actions that fall within his decision-making jurisdiction. Appointments of members of the Board and of FI's senior officials are announced through media releases, and thus these appointments are matters of public record. If a person were to be removed from office, the fact and the reasons for that action would also be publicly disclosed.

192. The role and responsibilities of FI overlap with a number of other bodies. These include:

- The Riksbank. FI is required to confer with the Riksbank on matters regarding financial stability or the payment system, and to provide the Riksbank with the necessary information in relation to these matters;
- The DGB, which administers the Swedish deposit guarantee and investor compensation schemes;
- The Stockholm Stock Exchange, which performs certain supervisory roles in respect of its members, in a "self regulatory" capacity; and
- The Swedish Competition Authority, which is responsible for the administration of competition law in Sweden.

193. Additionally, FI has entered into an agreement with the Swedish Consumer Authority. This agreement governs the allocation of responsibilities for consumer protection between FI (principally to oversee that supervised institutions are discharging their responsibilities in respect of consumer protection) and the Authority (principally to deal with individual complaints).

194. All these arrangements are generally transparent. The division of responsibilities between the FI and the Riksbank in respect of supervision of the payment system would benefit from clarification.

195. Overall responsibility for the promotion of "a safe and efficient" payment system lies with the Riksbank (see ROSC on transparency in monetary policy). The Riksbank performs

this role as both an overseer of the payment system and in its own operational roles. The operational roles involve the Riksbank as operator of the RIX high-value RTGS payment system, and as issuer of bank notes and coin. The Riksbank does not have any regulatory or specific supervisory powers in respect of the payments system and thus, where it is not the system operator, needs to rely mainly on “moral suasion” in its role to discharge its statutory role.

196. FI, by contrast, does not have an overall responsibility for the payment (and settlement) system. However, since payment services are a core part of banking business, FI does take an interest in this aspect of the business of the institutions it supervises, mainly in the context of “operational risk”. Additionally, Bankgirocentralen, which is the main provider of retail payments services within the Swedish banking system (and is owned by the major commercial banks), and VPC (the settlement system for securities market transactions) are supervised by FI as the proprietors of those systems.

197. The nature and extent of FI’s supervision of Bankgirocentralen and of VPC, and the relationship between that supervision and the Riksbank’s responsibility for the stability and efficiency of the payment system, is not publicly disclosed. There is scope to clarify in publicly available information the respective roles and responsibilities of the Riksbank and of FI particularly in relation to the prescription and administration of risk mitigation standards.

198. Supervision of the securities market in Sweden traditionally has mostly involved “self-regulation” administered by the Stock Exchange. Over time, this has become more structured and formalized, due to changes in the size and scope of the financial market. The organizations that today retain self-regulatory responsibilities are limited to the Stockholm Stock Exchange and the VPC. FI’s supervision of these institutions includes oversight of the way in which they handle their responsibilities as self-regulatory organizations (SROs). In the relevant legislation, the duties of the SROs are specified in general terms. In addition, FI may, in some areas, issue more detailed regulations. The self-regulation administered by the Stock Exchange and VPC is generally transparent. The Stock Exchange publishes its requirements for membership and the terms of the listing agreements with issuers. Similarly, the terms and conditions for participation in VPC are published by VPC. Additionally, there are advisory boards and industry organizations which play a role in setting market standards.

199. FI has also established close bilateral and multilateral cooperation with several supervisory authorities in the Nordic area and in other countries, based on MOU. The MOU’s are publicly notified on establishment by way of press release, and are available from FI unless the other party or parties request confidentiality.

Open process for formulating and reporting of financial policies

200. The annual instructions issued by the government to FI are formulated by way of a process that involves the development of proposals by FI and consultation with the finance industry. The resulting proposals are sent to the government for adoption, and for the government to specify a reporting and performance evaluation framework (possibly

including the identification of some additional specific tasks to be undertaken by FI). The documents provided to the industry, and exchanged between FI and the Ministry of Finance, are publicly available.

201. The basic rules and requirements for all regulated financial institutions, and FI's administrative and supervisory role in respect of them, are stipulated in the relevant legislation. Additionally FI has a capacity to issue secondary (legally binding) regulation, subject to that capacity having been established within the relevant Act, and (non-legally binding) guidance to financial institutions. All such regulations and guidance notes are formulated by way of an open process, which provides interested parties with an opportunity to comment and make submissions.

202. FI's practice is to announce and publicly explain all significant changes in financial policies through public releases to the media, website information, special reports and/or publications. All amendments to Acts of Parliament are announced and explained in accordance with the normal law-making processes (which in Sweden are very open). Also, all new or revised regulations and guidelines issued by FI are posted on its website.

203. FI is at present strengthening its focus on risk analysis and risk assessment. New methods are being developed to evaluate how risks are measured and priced in financial firms. These will be detailed in FI's manuals and handbooks for on-site examinations, which, with limited exceptions, are publicly available.

204. The principal means by which FI reports on major developments in financial policies is its *Annual Report* (published each February). The *Annual Report* reviews FI's own operations as well as provides a summary of the developments and issues that have arisen during the year. FI also issues a series of reports, focusing on current financial issues and important policy objectives. FI published in 2001 a book containing survey articles by leading policymakers and researchers focusing on the challenges faced by FI and its achievements during its first ten years of existence.

Public availability of information on financial policies

205. The main means used by FI to publicly **explain** its objectives and operations are its *Annual Report* and its annual report on *The Stability of the Swedish Financial Sector*. While there is no legal requirement to publish the latter of these reports, it is viewed by FI as an important component of the overall process by which it provides information on developments in the Swedish financial system which have implications for the stability and efficiency of the system.

206. Additionally, explanation is provided by way of a brief (4 pages) pamphlet that describes FI's role and responsibilities, by way of speeches by the Director General and other senior officers, and occasional special releases to the media on current policy issues/decisions. Details on the methods used by FI to supervise the institutions for which it has a supervisory responsibility, and the basis on which it evaluates financial firms'

prudential standards, are set out in operational manuals and handbooks. Generally these are publicly available, on request, under Sweden's freedom of information laws.

207. FI has most of the elements of a comprehensive publications program in place. FI adopts a noticeably candid approach in its communications. Commentary and explanatory information is generally communicated in a simple and direct manner. A current priority is to develop explanatory material that puts the specific laws and regulations that FI is responsible for administering into the broader context of the new risk-based approach to supervision. This should help to bring out more clearly the principles and philosophy that underpins FI's operations and aid public understanding of the role of financial supervision in Sweden.

208. FI discloses and publicly explains all significant changes in financial policies through public releases to the media, website information, special reports and/or publications. In keeping with the normal Swedish law-making process, all amendments to Acts of Parliament are announced and explained.

209. In close cooperation, FI, Statistics Sweden and the Riksbank issue a series of statistical reports on the financial sector on monthly, quarterly and an annual bases. The statistics published mostly relate to aggregated balance sheet data, and financial market prices (e.g., interest rates and exchange rates). Statistics Sweden also releases such data in its quarterly *Financial Accounts* publication.

210. Additionally, the Riksbank and FI include in their respective "financial stability" reports numerous charts and tables showing developments in various financial and prudential data. These cover a wider range of data than those reported in the principal statistical publications and, in particular, canvass a range of risk and prudential indicators drawn from both the financial and corporate sectors. However, the reporting of the data is not systematized, by way of being reported on a regular basis in time-series form. The development and reporting of time-series data on variables such as capital adequacy, nonperforming loans, exposure concentrations, interest and exchange rate exposures, on an aggregated basis, and consistent with maintaining confidentiality requirements for individual institutions, would better facilitate independent analysis and assessment of financial risks and vulnerabilities in the Swedish financial system.

211. The mandate and operations of the Swedish DGB are established by an Act of Parliament. The Board administers two guarantee schemes, one in respect of bank deposits and another that provides compensation in the event of investor client losses that result from the bankruptcy of the securities firm (but not in respect of investment risk, which remains with the investor). Information on these guarantee arrangements is available on the Board's website www.ign.se, and by way of explanatory pamphlets that are available to the public. Banks and securities firms are required to provide information to their depositors/clients about (i) the guarantee scheme that is applicable; (ii) the level of compensation that that would apply; and (iii) the means by which a payment under the scheme would be made.

212. The publicly available information outlines the operation of these guarantee schemes. More detailed information is provided by way of the Acts of Parliament that establish them. The DGB also publishes an *Annual Report*, which reviews the functioning of the schemes during the year, and reports its financial position. While the information available from the DGB is clear and transparent, there appears to be a general view that the largest banking institutions could be “too big” to fail. Steps to achieve improved public understanding of the deposit/investor guarantee, and the extent that deposits are safeguarded could help counter any “too big to fail” presumption, and reduce moral hazard.

Accountability and assurances of integrity by financial agencies

213. The accountability requirements of FI are stipulated in *Förordningen om årsredovisning och budgetunderlag* (2000:605), a document that prescribes the form of annual reporting and financial statements required of all government agencies.

214. The FI gives account for its operations and performance in its *Annual Report*, which is subject to independent review by the Swedish National Audit Office. The *Annual Report* is addressed to the Minister of Finance and is publicly available. Additionally, a more summarized version of the *Annual Report* is published in a form that is more suitable for the general public. FI’s Director-General also appears as requested before the Standing Committee of the Parliament for Finance, typically once or twice a year.

215. The Board of Directors is required to comprise nine members, including the Director-General as chair, all of whom are appointed by the government. They are appointed to, and can be removed from, office by the government. The procedures that govern these matters are not specified in any FI-specific legislation. Instead, the general provisions of *Verksförordningen* (1995: 1322), which govern appointments to all government agencies, apply. In broad terms, the grounds for dismissal include non-performance, criminal conviction and incapacity. Dismissal would involve a process that was transparent to the public, and would be open to legal challenge (appeal). The term of appointment (for all Board members) is three years.

216. Each year a *Half-Year* and *Annual Report* is delivered to the Ministry of Finance, and a summarized version of the *Annual Report*, including summarized financial statements but not including a statement of accounting policies, is published. Both the *Half-Year* and *Annual Reports* are forwarded to the Swedish National Audit Office for audit. The audit includes an audit of the financial statements as well as a “performance audit” of the FI’s activities (on-site). The *Annual Report* contains information on how FI has achieved its goals, information on how it has used its budgetary grant, and a financial report. All the above-mentioned reports, including the audit reports, are publicly available.

217. The internal organization and administration of FI is governed by a document (*arbetsordning*) issued by the Director-General. This document addresses, inter alia, FI’s organizational structure, the allocation of responsibilities within FI, process management, procedures for the registration of documents, the decision-making roles of the Board of

Directors, the Director-General, and Department Heads, as well as FI's regulation-making role. Separately documented are the powers of delegation that apply within FI.

218. FI does not have a separate internal audit unit, largely on account of it having no financial role. However, there is a formal and regular quarterly process of internal performance review, which is focused on evaluating progress and performance against the objectives and priorities established in the Annual Plan agreed by FI with the government. This Plan is translated by FI into a detailed working plan, which is distributed to FI staff.

219. The above-mentioned documents—the internal work order, the delegations, and the detailed plan of operations—are publicly available.

220. FI has for many years given ethical guidance to its staff. All newly employed staff are educated in ethics, and a guideline on ethics is provided to all staff. FI encourages staff to discuss ethical problems when they arise with their superiors or colleagues. The union participated in the preparation of the ethical guidelines. Staff are forbidden to own shares in companies supervised by FI. Staff must also inform FI about investments in shares and similar investments within five days. The ethical standards are publicly available.

221. The legal provisions concerning the protections for FI staff from legal liability are the same as those that apply to employees in general in Sweden, under the Law on Damage Compensation. According to this law, the employer has normally to bear the cost of compensation for damage caused by error or mistake by its employees. An employer may seek damages from the employee, but this would apply only in exceptional circumstances, after taking account of the nature of action that caused damage, the position of the employee, the interests of the person who suffered damage and other relevant circumstances. Public information on this topic beyond what is already provided for in the general law has not been deemed necessary.

Table 12. Recommended Plan of Actions to Improve Observance of IMF’s MFP Transparency Code Practices—Financial Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Financial Policy	That the assignment of roles and responsibilities as between FI and the Riksbank with respect to the supervision of the payment system be made more transparent, particularly with respect to the prescription of systemic risk mitigation features.
II. Open Process for Formulating and Reporting Financial Policy Decisions	No recommendations.
III. Public Availability of Information on Financial Policy	That financial data on the prudential and risk dimensions be systematized and published in time-series form, preserving the confidentiality of data on individual financial institutions as necessary.
	That FI implement its plan to publish new explanatory material which explains the role and responsibilities of FI in the context of the new risk-based, as distinct from compliance-based, approach to supervision it is in the process of implementing.
	That steps be taken to increase public awareness of the deposit and investment guarantee schemes, particularly with respect to their institutional coverage (large as well as small banks) and the nature and extent of the protection afforded.
IV. Accountability and Assurances of Integrity by the Financial Agency	That the criteria for the appointment (and removal) of the Director-General and of other members of the Board of Directors of FI, be made more transparent, preferably in law.

C. Authorities’ Response

222. The Swedish authorities generally concur with the above assessment. However, they regard the roles of FI and the Riksbank as quite clear, although they agree that efforts to better communicate this to the public are worthwhile. The authorities also consider that the present form of governmental direction and control applying to FI (as well as other authorities) is good and does not constitute a major problem.