RIKSREVISIONEN
The Swedish National Audit Office

Maintaining Financial Stability in Sweden

Experiences from the Swedish banks' expansion in the Baltics

RiR 2011:9

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To the Riksdag

Date: 2011-02-10
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RiR: 2011:9

We hereby deliver, in accordance with Section 9 of the Act (2002:1022) on auditing of state activities, etc., the following performance audit:

Maintaining Financial Stability – Experiences from the Swedish banks' expansion in the Baltics

The Swedish National Audit Office has audited the Riksbank's and Finansinspektionen's work with financial stability during the time-period 2005–2007 in light of the risk that the banks' expansion in the Baltik region entailed. The result of the audit is presented in this audit report.

Representatives for the Government Offices and public authorities concerned – the Riksbank and Finansinspektionen – have had the opportunity to factually scrutinise the report and otherwise state their views on the draft of the final report.

The report contains conclusions and recommendations that mostly regard the Government, the Riksbank and Finansinspektionen.

Auditor General *Jan Landahl* had decision-making authority in respect of this report. Audit Director *Thomas Hagberg* was responsible for the presentation of the report. Audit Director *Jörgen Appelgren* and Audit Director *Lena Unemo* assisted in producing the final version of the report.

Jan Landahl Thomas Hagberg

For attention:
Regeringen, Finansdeparementet
Riksbanken
Finansinspektionen

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Summary

The Swedish National Audit Office (SNAO) has audited the Riksbank's (the Swedish central bank) and Finansinspektionen's (the Swedish Financial Supervisory Authority) work for financial stability from 2005 to 2007 in light of the Swedish banks' expansion in the Baltic region and the risk that it entailed.

Background of the audit

Motive: The financial system is of great importance for the functioning of the economy and a financial crisis can be very costly for the Government and the overall economy. The Government has, therefore, taken upon itself the responsibility to uphold stability in the Swedish financial system. It is of great significance that the Government's work to maintain stability in the financial system is carried out in an appropriate and effective way. Several tools are available to reach this goal, and the Riksdag (the Swedish parliament) has passed many laws to regulate the financial market and its participants.

Purpose: The audit shall, from observations of the supervision of the Swedish banks' operations in the Baltic region during the years before the 2008-2009 crisis and the risk that these operations posed for the Swedish financial system, draw lessons for the Government's task of maintaining stability in the Swedish financial system.

Implementation: In this audit, we mainly study how the responsible authorities assessed and reported the risks that arose in the Swedish banking system before the 2008-2009 crisis. We have, therefore, chosen to focus on their auditing work for the period 2005-2007, though some issues are considered in a longer perspective. The audit does not cover how the crisis was managed.

The audit is primarily based on document studies and interviews with current and previous representatives from Finansinspektionen, the Riksbank and the Ministry of Finance.[1] Furthermore, interviews have been carried out with representatives from the Estonian and Latvian regulatory authorities as well as with the CEO of Skandinaviska Enskilda Banken (SEB).

1 See Appendix 2 for a detailed list over the interviews carried out.

The audit's results

The audit has resulted in the following main conclusions and observations:

The banks increased their risks by expanding in the Baltic region. The Swedish banks increased their risk profiles by the fast expansion of their operations in the Baltic countries. The risks rose greatly due to the increasing imbalances resulting from the uncontrolled growth of the region's economies. Among others, the credit expansion there was extreme, with lending volumes that increased by 40–70 per cent a year during 2005–2007. In Riga, apartment prices quadrupled in just three years. Other signs of a high risk level were that lending was done in foreign currency and that salaries rose by 20–30 per cent while the countries had a fixed exchange rate policy. All in all, the risks increased up to the point that they were materialised during the financial crisis.

The authorities underestimated the risks. In the beginning of the banks' establishment in the Baltic region, the Swedish authorities considered the risks limited. After some time, concerns became more substantial as the imbalances in the Baltic economies grew. Nonetheless, the risks were considered to be manageable during the entire period of the study, 2005–2007, in part because of the references made as to the banks' good capital adequacy. The authorities underestimated the credit risks but, most importantly, they misjudged the liquidity risks, especially those regarding the banks' foreign financing. However, this was a mistake shared by almost all other central banks, supervisory authorities, academics and the investor community across the world.

The authorities' mandates should be revised. Sweden has two government authorities with the responsibility to maintain stability in the financial system, the Riksbank and Finansinspektionen, but their tools and analysis functions differ. The Riksbank has the analysis tools for the financial system as a whole, whereas Finansinspektionen focuses on individual institutions. It is also Finansinspektionen that has the power to apply sanctions if a financial institution falls short in, for example, capital adequacy or risk management. An expressly legislative support for the management of risks in the financial system as a whole, a macroprudential policy, does not exist.

Supervision of banks with operations in several countries. The Baltic authorities felt that they had few tools and could not control the development of their credit markets. A contributing factor was that they could only apply a strict legal framework on local banks, whereas the branches of foreign banks could not be included in modified rules. An inquiry for a stricter legal framework for these branches was sent from Estonia in 2005 to the regulatory authorities in the home countries, among them to the Swedish Finansinspektionen, but the inquiry was dismissed with reference to the law in effect.

Finansinspektionen did not formally report this event to the Government. This omission can be subject to criticism. The development in the Baltic countries shows that the issues with the foreign banks and their regulation, as the Estonian authorities pointed out, were an actual problem that later had an effect on Sweden's financial stability.

After the crisis, a new structure and several new regulations have been created in the EU to handle, among others, issues regarding cross-border banks. This should improve conditions so that the issues that branches of foreign banks brought upon the Baltic region will be easier to manage from now on.

Finansinspektionen's and the Riksbank's communication. Communication is pivotal to convey a message. It is about what messages one wants to convey and which channels are used to reach the recipients. From our interviews, it can be seen that there is a gap between the Riksbank's view on the actions it took concerning the risks in the Baltic region and the picture that the Baltic authorities has described of the Riksbank. There are signs that there has also been a gap between the Riksbank's and other parties where the representatives of the Riksbank seem to be of the opinion that they had sent out a stronger message on the risks than what the recipients perceived. The fact that the Riksbank discussed the risks in the Baltic region in their stability reports seems to have had a small effect on the banks' actions.

There are more channels to send out a message than just producing stability reports and keeping direct contact with bank managements. A public arena with regular hearings on financial stability in the Riksdag would force both Finansinspektionen as well as the Riksbank to take a clear stand on the risks and spread it to a broader circle.

The authorities' coordination. The institutional structure chosen in Sweden poses large demands on the coordination between, on the one hand, the Riksbank and Finansinspektionen, and on the other, between these authorities and the Ministry of Finance. The audit of the work for financial stability has not shown that the cooperation between Finansinspektionen and the Riksbank has fallen short. On the contrary, the interviews with representatives from both entities show that there is a good climate for cooperation, aided by personal contacts between members of staff in both entities. However, it is important to secure operations and methods for collaboration that not only build on personal contacts. Since 2003, there has been an agreement between the Riksbank and Finansinspektionen on the methods for collaboration. However, the collaboration has not been evaluated.

Overly-cautious assumptions in the stress tests. Assessments on financial stability are based on how well capitalised the Swedish banks are and what risks they face. Which assumptions are made in the stress tests carried out by the authorities are important for the final assessment. According to the Riksbank, the stress tests should indicate the banks' ability to handle unexpected shocks.

With this in mind, the stress tests seem to be built on much too modest assumptions. One should keep in mind that the purpose of the stress tests is not to make exact forecasts over various risk scenarios. Nonetheless, it is important that the tests are as reasonable and close to reality as possible in order to give a good picture of the risks that exist. The tests are based on relatively normal economic downturns, which could hardly be described as unexpected. Also, one of the tests has assumed a strong recession in the Baltic region, whereas the banks' other markets remained unaffected. It is, however, unusual that individual countries go into a recession while global growth remains strong. A more plausible test would have assumed that the Baltic countries had problems at the same time that the rest of the world was facing an economic downturn. By using cautious assumptions in stress tests, the banks' strength was overrated and the risks on financial stability were underrated.

The Government's implicit responsibility. The Government has an implicit guarantee to support the banking system when crises emerge. The Icelandic example shows that the guarantee can be unreasonably costly when the banking sector grows very fast in proportion to the rest of the country's economy. Today, the Swedish Government has no tools to limit the size of the banking sector and, thus, the implicit guarantee.

Since the Swedish banks had a dominant role in the Baltic payments systems, the Swedish Government received an implicit responsibility for these and, thereby, for the countries' economic stability. The development shows that the Swedish Government can have an indirect responsibility for other countries' economies when banks' branches abroad achieve a dominant role in the credit market.

Recommendations

The Government should revise and clarify the Riksbank's and Finansinspektionen's mandates and tools to safeguard financial stability in a broad sense. It should examine how a regulation framework for a so-called macroprudential policy could be developed and who is to be responsible for it. Such a revision should also include the meaning of soundness according to Chapter 6, Section 4, of the Banking and Finance Business Act (2004:297).

The Riksbank and Finansinspektionen should consider other methods of communication with banks and the general public. The Riksbank has taken a step in this direction in its December 2010 Financial Stability Report and the recommendations publically stated in it.

The Riksdag could also examine the possibility to regularly organise public hearings on financial stability.

Given that the institutional framework of two separate entities that both have the responsibility of upholding financial stability remains, the Riksbank and Finansinspektionen should continue their close cooperation on the various aspects of the work to maintain financial stability. To safeguard that this work continues, the entities should report on how the cooperation has been carried out during the year to the Riksdag or the Government. It should also be deliberated whether one ought to have an external evaluation on how the cooperation is organised and has functioned, rather than the internal evaluation that the agreement between the Riksbank and Finansinspektionen suggests.

The Riksbank should be clear with what the stress tests aim to measure and make sure that the stress test assumptions reflect the risks. A future possibility would be to do stress tests assuming downturns of different magnitudes in the economy, which would provide more information on the banks' strength.

The Government should examine whether the risks in the banking sector and the implicit state guarantee can be limited.

The Government should make sure that it is regularly made aware of the risks, besides those regarding the banks' capital adequacy, which Finansinspektionen continuously supervises, such as those that the banks' operations in other countries can entail to the Government. It is doubtful that these risks can be reduced without restricting the banks' possibilities to expand abroad. However, an awareness of the risks should help the Government to get prepared to handle them.

1 Introduction

1.1 Background and reasons for the audit

The financial system is of great importance for the functioning of the economy, and a financial crisis can lead to high costs for the Government and the economy as a whole. The Government has, therefore, taken upon itself the responsibility to maintain stability in the Swedish financial system. Several different tools stand at the Government's disposal to reach this goal and the Riksdag has passed many laws to regulate the financial market and its actors. Finansinspektionen has, in its instruction, the assignment to "work for a stable and well functioning financial system".[2] The Riksbank also has the task to safeguard stability in the system as stipulated in Chapter 1, Section 2, of the Sveriges Riksbank Act (1988:1385) which establishes that "the Riksbank shall also promote a safe and efficient payments system." Besides carrying out stability analyses, the Riksbank has the responsibly to uphold liquidity in the financial system through its role as a lender of last resort. In Chapter 6, Section 8, of the Sveriges Riksbank Act, the following is dictated "In exceptional circumstances, the Riksbank may, with the aim of supporting liquidity, grant credits or provide guarantees on special terms to banking institutions and Swedish companies subject to the supervision of the Financial Supervisory Authority."

Besides these two entities, the Government has several other tools to maintain stability in the financial system. For example, the deposit insurance, besides protecting consumers from a possible bank failure, also decreases the risk that depositors, in a panic, decrease their bank deposits in solvent banks during times of crisis.

Thus, the Government has a far-reaching responsibility to maintain stability in the financial system. As stated above, the work for financial stability is divided between at least two public authorities, where the first, Finansinspektionen, has the Government as its principal, and the second, the Riksbank, is under

[2] Ordinance (2009:93) with instruction for Finansinspektionen. This instruction has been changed several times since 2005, but all of the instructions have regarded financial stability.

the Riksdag. The Riksbank focuses mainly on issues regarding stability in the whole financial system while Finansinspektionen's work focuses on individual institutions. Finansinspektionen supervises and issues permits to run financial operations. Both Finansinspektionen and the Riksbank publish reports on their analyses of the stability in the financial system once and twice a year, respectively.

The authorities' ability to maintain financial stability is tested in times of crisis. In the summer of 2007, there were clear signs of disturbances in the financial markets, though it was not until the fall of 2008 that a severe crisis developed. The most effective way to prevent financial instability is to avoid the accumulation of risks or at least to make sure that they are under control. With this in mind, it can be fruitful to consider both how the authorities acted when the crisis was building up, as well as how they acted in the crisis to handle the stability problems once they had arisen. This audit encompasses only issues regarding the preventive stages: how the Swedish authorities acted in the period during which the financial risks grew.

In Sweden, the risk build-up regarding financial stability consisted largely of the Swedish banks' rapid expansion of their operations in the Baltic region. During this period, several signs showed that the imbalances that were building up in the Baltic countries would lead to increased risk-taking over time. A correction of these imbalances was generally seen as necessary even though there were many opinions as to how and when such a correction would be done.

The past years' experiences have shown how costly a financial crisis can be for taxpayers and the overall economy. This is why it is important that the Government's work to maintain stability in the financial system is done in an appropriate and effective manner. Thus, the purpose of the audit is, based on the observations on the supervision of the Swedish banks' operations in the Baltic region during the years before the crisis, 2008-2009, and the risk that the operations posed for the Swedish financial system, to draw lessons for the Government's work to maintain stability in the Swedish financial system.[3]

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3 The Government resolved on February 3, 2011, on a committee terms of reference (Dir. 2011:6) for the supervision of the legal framework for the management of financial crises, which the SNAO looks positively upon.

1.2 Audit questions

The audit questions are based on the Government's responsibility to maintain stability in the financial system and are as follows:

1. *Is the Government's work for financial stability appropriate and effective?*
2. *Do the responsible authorities have the tools and the capacity needed to carry out this job?*

1.3 Norms and judgement criteria

The Basel Committee on Banking Supervision, in which Sweden participates via representatives from the Riksbank and Finansinspektionen, has determined 25 Core Principles for effective bank supervision. The Principles, according to the Basel Committee, are "a framework of minimum standards for sound supervisory practices and are considered universally applicable". In order for the work to maintain financial stability to be appropriate and effective, these principles should be applied unless they stand in direct contrast to a specific Swedish circumstance. Principles 1, 14, 19 and 20 are of special importance for this audit[4]:

1. Objectives, independence, powers, transparency and cooperation: An effective system of banking supervision should have clear objectives and responsibilities for each authority involved in bank supervision. Each authority should possess operational independence, have transparent processes and be accountable for the performance of its duties. A suitable legal framework for banking supervision is also necessary. Arrangements for sharing information between supervisors and protecting the confidentiality of the information should be in place.

14. Liquidity risk: Supervisory authorities must control that banks have a liquidity management strategy that takes the risk profile of the institution into account, with processes to identify, measure and control liquidity risks on a daily basis.

19. Supervisory approach: An effective banking supervisory system requires that supervisory authorities develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on the safety, soundness, and stability of the system.

4 Paraphrased. The complete Principles can be read in Appendix 1.

20. Supervisory techniques: An effective banking supervisory system should consist of on- and off-site supervision and regular contacts with bank management.

Finansinspektionen and the Riksbank are the authorities that are responsible for the supervision of financial stability. The Government and the Riksdag must also make sure that these authorities have the tools needed to carry out the tasks entrusted upon them.

1.4 Implementation and limitations of the audit

In this audit, we examine mainly how the responsible authorities assessed and reported on the risk build-up that took place in the Swedish banking system before the 2008–2009 crisis. We have, therefore, chosen to focus on the supervisory work in the time period 2005–2007, even though some issues are considered in a longer perspective. The audit does not cover the crisis management.

The audit is mainly based on document studies and interviews with current and former representatives from Finansinspektionen, the Riksbank and the Ministry of Finance.[5] In addition to that, interviews have been conducted with representatives from the Estonian and Latvian authorities as well as with the CEO of Skandinaviska Enskilda Banken (SEB).

1.5 Outline of the report

Chapters 2 and 3 provide general background information on the banks' expansion in the Baltic region and the build-up of macroeconomic imbalances and risks in these countries. Chapter 4 discusses The Riksbank's and Finansinspektionen's understanding and description of the problems and Chapter 5, what actions the authorities took. Conclusions and recommendations are presented in Chapter 6.

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5 See Appendix 2 for a detailed list of the interviews carried out.

2 The banks' expansion in the Baltic region

At the end of the 1990s, several Swedish banks began to expand their operations in the Baltic region. Swedbank and SEB stood for the largest stakes but Nordea also regards the Baltic region as part of its home market.

At first, the Baltic operations were modest but they grew as the banks acquired new companies, increased their shares in jointly-owned companies, and because the Baltic market grew considerably faster than the traditional home markets. There are further indications that banks operating in the region prioritised growth over careful credit assessment, which contributed to the strong increase.[6] In 2003, the Baltic operations had grown significantly and stood for about 10 per cent of SEB's and Swedbank's operating profits. The already rapid credit expansion in the region increased strongly during the years that followed which, together with new investments, led to further expansion of the operations. In 2007, the Baltic share stood for almost one third of the operating profits in Swedbank and almost one fifth in SEB. For Nordea, the share rose at most to 3 per cent in 2008.

The Swedish banks gained a dominant role in the banking sector in the Baltic region. In 2007, the Swedish banks had a market share of 55–90 per cent of lending in the Baltic countries. Since monetary policy in these countries was powerless due to the fixed exchange rate regime together with a large amount of lending in euro, it was difficult for the central banks to influence the demand on loans. They did, however, have ways to affect the credit supply, for example, by imposing minimum reserve requirements. Since these were not applied, the Swedish banks were in reality responsible to a large extent for the rate at which lending grew. This was pointed out to the bank managements by, among others, the Latvian Central Bank Governor Rimsevics in his attempt to curb the development.[7] Fiscal policy measures; for example, a change in the tax on capital gains, could have decreased the credit demand. However, fiscal policy was hardly used for this purpose in the Baltic countries.

6 IMF (2006).

7 Interview with Rimsevics June 8, 2010.

The Baltic operations' increased magnitude contributed to the growing business risk of the banks since these operations were considered considerably riskier than those conducted in the traditional home markets. The banks themselves and the Swedish authorities, Finansinspektionen and the Riksbank, which supervised the banks and the banking system, agreed on this assessment. However, bank representatives considered that the banks had the risks under control even though they were high.

Nonetheless, the banks did eventually adopt stricter credit assessments in the Baltic countries. This was done not only due to the extremely strong credit expansion but also to the increasing macroeconomic imbalances and clear signals that the economies were overheated. The fact that the countries did not fulfil the Maastricht criteria and, therefore, had to postpone their intended entry to the EMU led to increased currency risk. In spite of the stricter credit assessments, lending continued to increase at a high, yet abating, rate long after the financial markets began showing clear symptoms of distress.

Therefore, the banks' risks increased for several reasons. The basis was an increased presence in the Baltic countries and a growing share of the credit portfolio in this region. The economic development in the Baltic countries with clear signs of overheating led to, besides a rise in the credit stock, an increase in the risk of an economic backlash over time. In addition to this, the currency risk increased further when the countries could not join the EMU according to their original plans. Finally, the countries were affected by the global risk climate, which deteriorated starting the summer of 2007.

According to concurrent information, the banks were well aware that the business risk was higher in the Baltic region than in the traditional home markets. However, in hindsight, it is clear that the banks underestimated the risks.[8]

[8] In Swedbank's Year-end report for 2007, the following can be read: "We expect the process of readjustment to continue and are confident in the continuing development of the Baltic economies and in the convergence of long-term living standards with those of the Nordic region. Operations in Ukraine have developed very well, confirming the tremendous future opportunities in this banking market." This was written at a time when the risks had already begun to materialise.

3 Development in the Baltic region

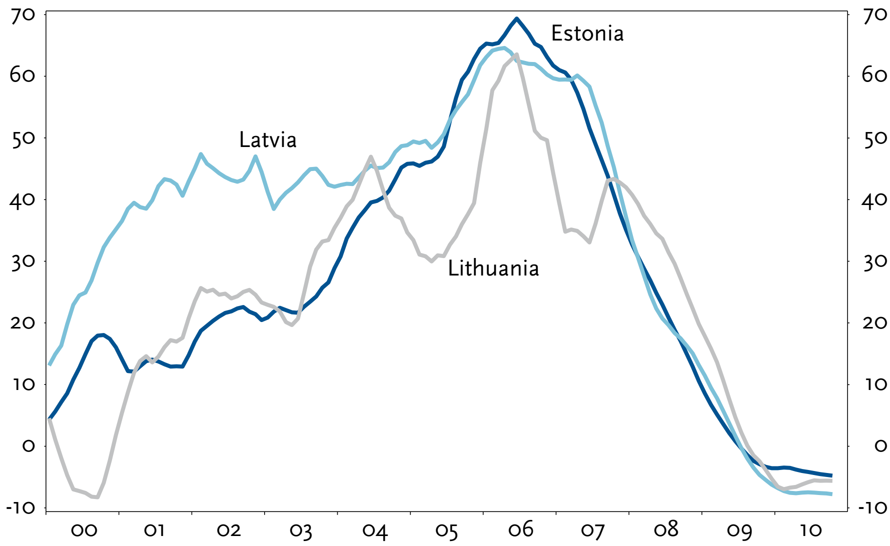
The Baltic economies already showed signs of imbalances when the Swedish banks began their expansion in the end of the 1990s. The venture, however, was done in an environment with strong growth and that considered a starting position influenced by a long-lived communist rule. For example, private ownership was limited and the credit market was underdeveloped when the countries gained independence. However, many households received the property rights for real estate and apartments after the independence from the Soviet Union, which is why private ownership of housing quickly became significant.

A factor that came into focus early on was the rapid credit expansion. The Estonian authorities pointed out this factor as early as 2002.[9] An already high rate of increase quickened further in 2004 after the interest rate in the euro-area was lowered to a record bottom level in the middle of 2003. During a few years, the lending volumes increased by 40–70 per cent a year. The increased supply of cheap credits contributed to the increase in demand of real estate and the steep rise in housing prices in all of the Baltic countries. From 2003–2007, real housing prices increased by over 150 per cent in Estonia and Latvia and by120 per cent in Lithuania.

9 Estonian Financial Supervision Authority Yearbook 2002.

Chart 1 Very strong credit expansion

% year/year 3m mav.



Source: Reuters EcoWin

The strong credit expansion, a factor that is considered the best single indicator to predict a bank crisis,[10] was pointed out in many contexts. Finansinspektionen, the Riksbank and the IMF have all at several occasions described the development and warned against the risk build-up that was going on. An IMF report[11] lines up the problems of the credit market in Latvia: extremely fast credit expansion, a large share of loans in a foreign currency, a likely underestimation of the exchange rate risk, foreign banks lessening credit assessments in order to win market shares and granting loans at values exceeding the market value of the collaterals. All in all, this constitutes a map of the factors that usually preclude a backlash. Also, the decision to fix the exchange rate meant that monetary policy could not be used to mitigate the credit demand.

A factor that contributed to the warnings not becoming more clamorous was that lending volumes in relation to GDP were not high, compared to more developed countries.[12] To a certain extent, the development was seen as a

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10 Brio and Lowe (2002).

11 IMF (2006).

12 See for example the Riksbank's Financial Stability Reports. A reason for the low level of debt was that many households, at least in Estonia and Latvia, achieved the right to own property and apartments after becoming independent from the Soviet Union. The starting point was thus a relatively broad private real estate ownership that was not mortgaged. This fact is not mentioned in the Swedish authorities' reports.

normalisation and an adjustment to a new equilibrium based on a functioning credit market. During the communist regime, private ownership was limited and the credit market was undeveloped.

Other observers concluded that the credit expansion was, nevertheless, unsettling.[13] In addition, the rate of increase of lending was considerably higher in the Baltic countries than in almost all other Eastern European countries, which shared a similar background.[14] A sign that large risks were building up in the real estate sector was that the rate of increase of prices was extremely high. In Riga, apartment prices quadrupled in just three years. Another warning sign was that apartment prices in Riga, when they were at their highest, were at 1,700 Euro per square metre and thus exceeded those of many small cities in Western Europe, which can be said to be strange considering the differences in income levels. A third reason to worry was information on speculation. According to surveys, speculators stood for 15–30 per cent of real estate purchases in Latvia during the years of ascent.[15] Even if such assessments are essentially uncertain, they indicate that speculation was a factor that drove the development further.

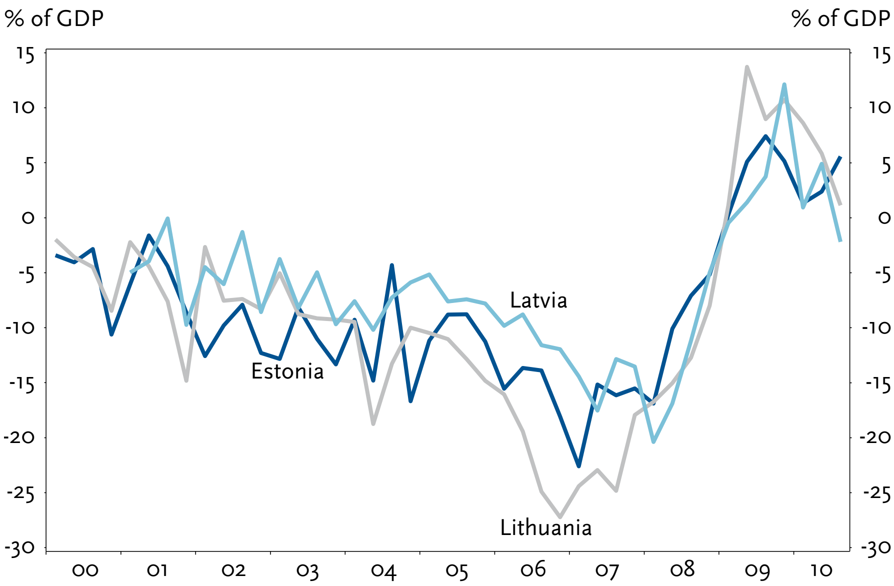
Another indicator of growing imbalances was the balance of current accounts, which as early as the beginning of the 2000s was negative and was continuously worsened. During 2005, the current account deteriorated to alarming levels. The combination of a fixed exchange rate and large current account deficits is usually seen as unsustainable in the long run. Some type of adjustment mechanism is needed. When it happens, part of the risks materialise in the banks' credit portfolio. The longer the adjustment takes, the larger the risks tend to become.

13 Gergely Kiss-Márton and Nagy-Balázs Vonnák (2006).

14 Bas B. Baker and Anne-Marie Gulde (2010).

15 Global Property Guide .

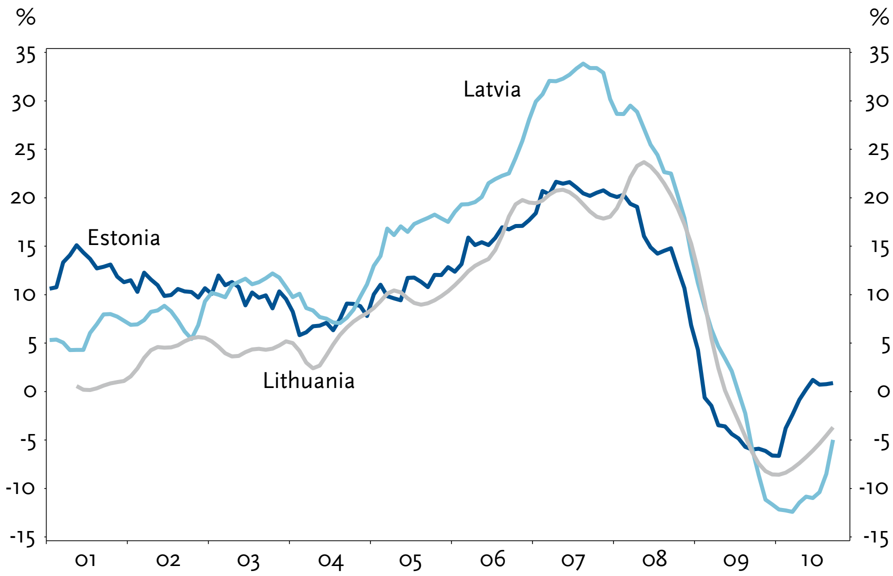
Chart 2 Large and growing current account deficit



Source: Reuters EcoWin

As further confirmation, the economic situation deteriorated by the increasingly more difficult situation in the labour market. Wages rose at a very fast rate, much faster than productivity, which deteriorated competitive strength. Consumer prices also rose increasingly in the Baltic countries, in part due to the high rate of wage increases. Thereby, the possibilities for these countries to join the currency union in a not too distant future disappeared, which added to the general uncertainty on economic development and caused the currency risk to be felt larger than before.

Chart 3 Very fast wage increases



Source: Reuters EcoWin

All in all, there were already imbalances in the Baltic countries when the Swedish banks began their expansion in the region. However, it was first in 2005 that it became clear that the situation was getting worse. The year after, Latvia's economic situation was considered vulnerable and the concern for the developments in Estonia and Lithuania increased quickly. The imbalances continued in general and, thus, the risks continued to grow up to the point that the financial crisis made the investors decrease their risk exposures. This had a large impact in countries with considerable imbalances, among them, the Baltic countries. The fast growth rate was interrupted and GDP declined in the Baltic countries as early as the first quarter of 2008, even though the sharp downturn was not registered until the end of that year. During 2009, GDP decreased by 14–19 per cent and internal demand, by 24–28 per cent. All of the important indicators showed that the imbalances diminished or disappeared. The price was a worse standard of living, a very large rise in unemployment and strongly decreasing asset prices (prices of apartments in Riga fell by over 70 per cent), and very large credit losses in the banking system.

4 The authorities' assessment and description of the problems

The past chapters have shown that the Swedish banks, mainly SEB and Swedbank, strongly increased their operations in the Baltic countries during a period when the macroeconomic risks in the region were growing. The Baltic market became an increasingly large part of the banks' operating profits. Thus, the development in the region came to gain importance in the financial system. In the following chapter, we describe how the Riksbank and Finansinspektionen understood and described the problems and risks that this development entailed.

4.1 The Riksbank's description of the Baltic risks

The Riksbank's view on the financial stability is presented twice a year in their Financial Stability Report. Below, we review how the development in the Baltic region has been commented on in these reports during the years when the risks were building up.

The reports in 2004 mentioned the sharp rise in lending and growth in the Baltic region. The Riksbank noted that there are always risks involved with a development like this. However, not much concern was conveyed in these reports.

In 2005, when the imbalances were becoming more apparent, the Riksbank still had a cautious standpoint. In the May report, it was noted that the Baltic households had increased their debt stocks by 40–80 per cent in annual terms. They said, however, that with the relatively low debt ratios, the banks faced no clear risks related to the Baltic household sectors.[16]

[16] Riksbank, Financial Stability Report 2005:1 p. 30.

In the next stability report, the sharp rise in lending in the Baltic region was noted but it was considered misleading to use traditional stability indicators on emerging market economies since indebtedness, for historical reasons, had been low. The conclusion was that it was unlikely that credit losses abroad would affect the banks' solvency.

In the same report, the Riksbank reached a somewhat far-fetched conclusion: ”operations in the Baltic states will probably make increasingly large contributions to the financial statements of the Swedish banks. This represents a positive diversification that is advantageous for stability”.[17] This conclusion can be said to be more of a theoretical nature in a general sense than one based on the risks associated with the Baltic countries' development of which the Riksbank was carefully beginning to warn against. It did, however, reflect the underestimation of the risk build-up that was taking place.

In the next stability report, from May 2006, the risks in the Baltic region were described in a clearer way. The credit expansion was described as unsustainable in the long-run since household debt had increased by 60–86 per cent a year in the Baltic countries. The economic situation in the Baltic region deserved, according to the report, extra attention. Furthermore, it was pointed out that imbalances could build up and eventually have consequences on both macroeconomic and financial stability. At the same time, it was noted that the development of credit losses did not seem to cause any problems. However, it was pointed out that that it was under conditions like these that banks – by relaxing their credit policies – paved the way for future credit losses. There was clear proof at this time that the granting of credits had been loosened.[18] The banks had placed the hunt for market shares in the centre.

The May 2006 reports show that the Riksbank basically knew what types of risks the Baltic operations entailed. However, it seems like the size of the risks and the connections to the liquidity risks were underestimated.

The tone did not change in the next report that came in December 2006. The first paragraph of the summary states that ”the Riksbank currently sees no serious threats to financial stability”.[19] On the same page, the Riksbank highlights the risks related to lending in the Baltic States, where the economies had problems with growing imbalances.

17 Riksbank, Financial Stability Report 2005:2 p. 39.

18 See for example, IMF (2006).

19 Riksbank, Financial Stability Report 2006:2 p. 7.

However, this report expanded on the risks in the Baltic States. The credit expansion, the risk of a fixed exchange rate and the often large current account deficits were described as issues that needed consideration.

The Riksbank started to carry out stress tests in December, 2006. A scenario was that the credit losses rose sharply in the Baltic States. The test showed that both SEB and Swedbank still would earn large profits.

In the May 2007 stability report, the Riksbank assessed financial stability to be sound. The developments in the Baltic economies did, however, pose a risk and the signs of overheating in the region became clearer. The credit risk in the Baltic States had risen, among other reasons, because the exposure to the real estate market had increased. The development in the Baltic countries bore, according to the Riksbank, "a number of features in common with the situation in countries where financial crises have occurred".[20]

The Riksbank, thus, made stronger conclusions than in earlier reports. There was a broader discussion on the problems, among others, a four page detailed look at the overheated Baltic economies. A strongly deteriorated development threatened, according to the report, to affect the Swedish banks. At the same time, the conclusion was that the probability of default was very low for the years 2007–2009. It was only one tenth of the levels that existed during the previous economic downturn in the beginning of the 2000s.

The stress tests showed that the banks still had ample margins to manage a deterioration of the creditworthiness of loan takers in the Baltic markets.

In the December 2007 report, the Riksbank noted that the risks had increased in the Baltic States and that the liquidity risks had risen globally. According to the report, the imbalances in the Baltic States had grown but the rate of increase had diminished. There were clear signs of overheating, but the authorities and banks had taken some measures to mitigate the overheating and the credit expansion.

The vulnerability and the credit risks had, all in all, increased in the region. At the same time, it was noted that the Swedish banks had become more and more dependent on the operations in the Baltic region and that a strong deterioration in the region, for which the risk of happening had increased, would noticeably affect SEB and Swedbank. The stress tests showed, however, that the banks could handle considerable setbacks like large credit losses either in the Baltic region or in general.

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20 Riksbank, Financial Stability Report 2007:1 p. 8.

The May 2008 report focused on the problems in the financial markets. Here, it was concluded that the Swedish banks' vulnerability to a negative development in the Baltic States had increased. The banks' lending in the Baltic States was a continuous source of worry. The financial distress had increased the risks for a more profound recession in the region with negative effects on the quality of the credit for the Swedish banks with affiliates there.

According to the report, the macroeconomic development in the Baltic countries posed a substantial risk. However, the Riksbank stated that the stress tests showed that the banks had sufficient capital to handle a downturn.

As the fall of 2008 approached, the financial crisis became a financial chaos, and policy was veered into helping the markets function. At this point in time, it was no longer possible to apply pre-emptive measures.

4.2 Finansinspektionen's description of the Baltic risks

Finansinspektionen supervises individual banks, their credit quality and processes, among other aspects. Systemic risks and the financial system's stability have not been the focus of Finansinspektionen, but the general standpoint has been that if individual banks follow the regulations and have a satisfactory capital base then the system is in good shape.

Nevertheless, Finansinspektionen has published a yearly report with a sector perspective: the stability of the Swedish financial sector. In 2004, the conclusion was that there were no signs that Swedish banks were taking unjustifiably large risks in their Baltic operations. Still, the risk build-up that took place had to be monitored closely.

In 2005, Finansinspektionen mentioned the fast growth of the Baltic market. Even then, the conclusions regarding the Swedish banks' risk-taking were the same, but it was still considered important to follow the development closely. In addition to that, it was noted that the Swedish banks had a large part of their balance sheets in foreign operations and that the development in foreign markets could have direct consequences on the financial sector in Sweden.[21]

Finansinspektionen made a general assessment of the risks for each banking group. It was regarded that Swedbank's acquisition of what was left of the Hansabank increased risk and Finansinspektionen expected the bank to increase its presence in the daily operations of the Hansabank. All in all, Finansinspektionen's assessment was that the bank's credit risks were

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21 Finansinspektionen, The stability in the Swedish financial sector 2005 p. 19.

reasonable.[22] After the acquisition of the rest of the Hansabank shares, the capital adequacy ratio was considered to be low and Finansinspektionen advised an intensified supervision.

Regarding the SEB, Finansinspektionen was concerned that the bank's strong credit expansion could lead to deterioration in the quality of credit. Still, Finansinspektionen assessed that the bank's credit risks were reasonable.

The next year's stability report, which came in 2006, stated that there were in general no threats against the stability of the system. The banks had a strong position, very low credit losses and a modest risk build-up. Furthermore, it was noted that the banks' credit portfolio had become more diversified as the business abroad had expanded. A problem was that the operations had thus become more complex and, possibly, more difficult to manage.

However, it was noted that the Estonian authorities had been concerned over the fast credit growth. Still, it was stressed that even though credit growth was indeed very fast, the development was structural in character and, therefore, less worrisome than if it had been due to the business cycle. The exchange rate risk that arose since much of the lending was done in euro was discussed as well.

In 2007, one notices that Finansinspektionen's concern on the development in the Baltic States has increased. A sign of this is that they asked the Swedish banks for their opinions on the consequences of a Latvian devaluation. According to a memorandum from Finansinspektionen, the Latvian supervisory authorities were not particularly concerned as late as the fall of 2007. This information does not match the information provided by the Latvian authorities' representatives that we interviewed.

In the Stability of the Swedish Financial Sector report for 2007, Finansinspektionen noted that the risks in the Baltic region had increased, in part because the banks' operations in the region had expanded, and also because the risk for a sharp turn in the business cycle had increased. A hard landing could not be ruled out. Especially the economic development in Latvia was described as unsustainable.

Finansinspektionen judged, though, that the banks had enough capital to handle very large credit losses in the Baltic States. Not even very large problems in the Baltic economies necessarily posed a direct threat on the stability of the Swedish banks.[23] Finansinspektionen also stated that the financial turmoil had

22 Finansinspektionen had at this point in time a scale for risks: low, reasonable, significant and high risk.

23 Finansinspektionen, Stability of the Swedish Financial Sector 2007 p. 20.

led to an increase in the liquidity risks of the banks. The conclusion was that the banks were well suited for handling the situation even if the turmoil in the financial markets was to continue for a long time.

The banks had become more concerned over the risks which, among other things, caused Swedbank to tighten credit assessments – SEB began doing this in the end of 2006 – and the volume growth rate and market shares to be played down.[24]

In June of 2008, Finansinspektionen's board of directors discussed whether they were going to raise the capital requirements due to the exposures in the Baltic region after Lars Nyberg from the Riksbank brought up the subject. SEB and Swedbank were seen to have an adequate capital base, and this factor was definitive for Finansinspektionen's standpoint and decision not to take action. Besides, the banks' expansion phase was over in 2008 and an increase of the capital requirements would, therefore, not have had a pre-emptive effect.

4.3 Contacts with the Baltic authorities

The authorities in the Baltic States expressed early on a need for communication with the Swedish authorities. Meetings were held and there was continuous correspondence during the years. As credit growth continued and the Baltic authorities felt that they were not able to take actions to stop it, requests for help came from, among others, Estonia and Latvia.

The Latvian Central Bank Governor, Ilmars Rimsevics, stated that his sole means were trying to affect fiscal policy and convincing the bank representatives, including boards of directors and main share holders, to decrease their lending. These persuasion attempts did not lead to any significant changes.

The Estonian Central Bank and Finansinspektionen noticed the problems with the credit expansion as early as 2002. They tried to persuade the banks to tighten their credit assessment but were unsuccessful. Towards the end of 2005, they wanted to change the regulation in order to mitigate what they considered was an exaggerated level of lending and unsatisfactory risk assessments carried out by the banks. The problem was that Finnish, Latvian, German and Swedish bank affiliates stood for about 20 per cent of banking operations and they were regulated in their home countries. The Riksbank and

[24] Several examples of this were reducing the "debt service ratio" from 70 to 50 per cent for lending to individuals with high incomes, stricter application of the demand for final amortisation by retirement, focus on existing customers with good credit history, limiting marketing of new products, increased capital requirements and a more restrictive stand-point to risky credits.

Finansinspektionen received in December of 2005, as well as other authorities of the banks' home countries, a written petition to implement a stricter regulation. The answer, however, was negative. Finansinspektionen considered that it was incompatible with EU regulations to stipulate provisions that involve different rules for a bank's operations depending on where these were carried out. Estonia received the same answer from the other countries, except for Latvia, whose authorities were positive to a change.

In the middle of 2006, at a meeting with the Swedish Finansinspektionen and the Riksbank, the Estonian authorities tried to gain support to influence the banks. According to the representatives from the Estonian central bank, the representatives from the Swedish authorities were not as concerned for the development in Estonia. The Swedish Finansinspektionen was thought to show more interest on the SEBs activities in Germany than in the Baltic region. In time, however, the Riksbank's concern grew and the contacts increased.

As far as we have been able to see, the letter from Estonia in December 2005 did not lead to any concrete actions, either internal or in the form of reports to the Government. Finansinspektionen carried out in-depth studies on the banks' credit risks in the Baltic region in the second half of 2007, that is, a year and a half afterwards.

The laws in 2006 gave little space for measures against the banks as long as the banks' capital adequacy was deemed satisfactory. A potential concern for the banks' risk management and credit risks was handled by Finansinspektionen by means of a dialogue with the banks.

When Finansinspektionen answered the Estonian letter in February of 2006, new laws were in the making. During the fall of 2005, the principles that on June 14 of 2006 became the Directive 2006/49/EC of the European Parliament and of the Council on the capital adequacy of investment firms and credit institutions were adopted. As early as December 22 of 2005, a few days before the letter from Estonia arrived, the Ministry of Finance sent out a memorandum (Fi2005/6495) on how the new EC directive would be assimilated into Swedish legislation. Finansinspektionen's comments were sent on March 22, 2006.

The next law, which Finansinspektionen was well aware of, gave the supervisory authority a broader array of tools. Chapter 2, Sections1 and 2 of the Capital Adequacy and Large Exposures Act (2006:1371) gives Finansinspektionen the possibility to increase the capital requirement of a bank if it considers that the quality of their risk management is unsatisfactory and that it is not probable that any other measure would be enough to get the bank to correct the deficiencies within reasonable time.

Finansinspektionen did not use the possibility to act the way it was allowed to by the new law. To increase a bank's capital requirement was seen in the beginning of 2007 as a measure of last resort. However, after the financial crisis, Finansinspektionen's standpoint has changed.[25] According to the same representative, Finansinspektionen would now be willing to increase the capital requirement at an earlier stage if unacceptable deficiencies were found. Finansinspektionen's actions, on non-actions, can be explained in part by their position on the issue at that time.

After the crisis, a new European institutional framework has been created to handle cross-border banks. The supervision of such banks today requires cooperation between the home and the host country's supervisory authorities in what is called supervisory colleges. The Nordic and Baltic states have also created a permanent working group for crisis management. Also, the European Banking Authority (EBA) has been created to handle issues related to supervision across national boundaries. In 2009, amendments were made to, among others, the previously mentioned Directive 2006/49/EC with a new one, Directive 2009/111/EC. The amendments, called CRD II[26] and CRD III are to be assimilated into Swedish law and a draft is expected to be presented in the spring of 2011. The Directive states that the authorities shall take into consideration if and how their actions affect the financial stability of other countries. With the coming legislature, Finansinspektionen will thus take the financial stability other countries; for example, in the Baltic region, into consideration when making decisions.

4.4 Concluding observations

Both the Riksbank and Finansinspektionen wrote in their stability reports about the risks in the Baltic economies and the Swedish banks' operations there. At first, the assessments were that they did not pose a risk for the banking groups as a whole and that the banks had sufficient margins to handle a deterioration of the quality of credit. It was explained that the rapid credit expansion in the Baltic States was a natural development since the private sector's debt had been very low to begin with. In time, the risks in the Baltic branches were described in more detail, but their extent was underestimated. The liquidity risks received minimal attention, a misjudgement shared with the rest of the world.

[25] Interview with Uldis Cerps on January 21, 2011.

[26] Capital Requirements Directives.

The Baltic authorities were quick to notify their Swedish colleagues on the increasing imbalances in the economy and their limited possibilities to mitigate the credit expansion. Towards the end of 2005, Estonia sent a letter to the countries that had bank affiliates in Estonia, including Sweden, with a petition for stricter regulations for them. The reason was that Estonia wanted to check the local credit expansion but could not change the regulations for a fifth of the banking sector that was made up of foreign bank affiliates. The answer, however, was a negative one from most of the addressed countries; stating that such an amendment would be in breach of EU regulations. The fact that new legislation was to be passed, giving Finansinspektionen more possibilities to intervene, did not affect the authorities' position. Finansinspektionen's passive standpoint can to a certain extent be explained by the legislation at that point in time but it also reflects the perception of how the law was interpreted.

5 The authorities' actions

5.1 Perception, self-confidence and action

The view on how the risks developed is in line with many previous experiences. It is often possible to discover macroeconomic imbalances and risks but it is difficult to predict with any certainty how and when necessary adjustment mechanisms will arise.

A general scenario can schematically look the following way. In stage I, the imbalances are discovered but there is substantial uncertainty as to how large they are and how they will develop. In this stage, there is seldom a consensus on whether the imbalances pose a problem. Also, there is often a (wishful) hope that the imbalances will stop growing and wind-up on their own. In this stage, it is felt that it is much too insecure to apply countermeasures; more evidence is needed before one can act.

In stage 2, there is a general accepted picture that imbalances do exist, but the parties involved have different views on how serious the problem is and which measures could or should be applied. Measures in this stage will encounter protests and there are cases, as when it comes to banks, where the consideration of competition can make an authority doubt whether or not to apply measures at a national level that worsen the domestic businesses' competitiveness compared to foreign businesses. There is, in this phase, generally an implicit or explicit supposition that the economy is heading towards a soft landing that will lessen or dissolve the imbalances.

In the next phase, stage 3, the imbalances have grown to a point that it can be difficult and risky to try to diminish them. There is often a (perceived) risk that a bubble might burst if strict measures are introduced. In this stage, there is still a hope that the economy is going to land softly.

Most of the authority representatives that were interviewed agree with this general scenario. In order for a measure aimed to diminish the imbalances to succeed, it must be applied in stage 2 when there still is no established consensus on type and significance of the problem. At stage 1, the picture of the problem is not clear enough and there is not enough self-confidence to act. In stage 3, it is too late for pre-emptive measures.

One should keep in mind that when the imbalances are building up, it is often considered that the country is in a positive phase. When imbalances grow, it usually means that demand, for various reasons, is rising at a faster pace than the production capacity. The noticeable results are initially high growth, a quick rise in employment, high profits for companies, and rising asset prices. At the same time, however, imbalances are arising, such as, large deficits in the current accounts, strong credit expansion and rising inflationary pressure; but these often weigh lightly on the political balance scale. Therefore, there is often resistance, both from citizens as well as interest groups, politicians, and entrepreneurs, to interrupt progress that is mostly seen as positive.

It is partly with this in mind that many countries have chosen to let the central bank stand as an independent institution with the right to protect price stability without having to take different interest groups into account.

Thus, an opportune discovery of the problems is difficult to make and corrective measures can be expected to be met with resistance from parts of society. One can make two conclusions from this. There is a need for an authority that both has the capacity to identify problems in time and also has the mandate and confidence to make unpopular decisions.

5.2 The authorities underestimated the risks

A clear conclusion from the review of published reports and interviews with representatives from the Riksbank and Finansinspektionen is that the risks in the financial system were underestimated. Partly, one did not foresee the liquidity risks for the whole financial system and, partly, one underestimated the risk for a deep crisis in the Baltic economies. The Swedish authorities were, however, in good company; with only a few exceptions, the risks were underestimated by the other central banks as well as by supervisory authorities, academics and the investment body all over the world.

In the beginning, it was the extent of the problem that was underestimated; but in 2006, there was a clear view of the picture and all of its components. However, the magnitude was underestimated, as well as the potential depth of the economic backlash for which one realised that there was a large risk.

The latter becomes even clearer when we study the stress tests that, according to the Riksbank, should reflect less likely, but fully possible events. These scenarios were all more favourable than the actual outcome, as will be seen in section 5.3.

Finansinspektionen did not make its own macroeconomic assessments but leaned on the Riksbank and the National Institute of Economic Research. This reflects Finansinspektionen's position that it focuses on micro-, rather than on macroeconomic aspects.

Finansinspektionen did not make its own independent reviews of the banks' credit portfolios during the relevant period. Such reviews were carried out starting 2009. Instead, it relied on the data that the banks reported to it. It has come to light from the interviews that Finansinspektionen, as well as its equivalent institutions in the Baltic States, had difficulties focusing on the credit risks. Finansinspektionen had to take care of more and more tasks, such as, accounting issues, money laundering and take-over issues. The handling of matters at Finansinspektionen was substantial and amounted to 6000 cases per year. The introduction of EU-regulations is also mentioned, especially by the Baltic authorities, as a burdensome task.

It seems like every-day issues and the daily operation took a lot of attention away from the most important issues from a stability perspective. It raises a more general question on whether Finansinspektionen's resources and organisation were adequate in the years before the crisis.

The SNAO noted as early as1994 that a relatively small part of Finansinspektionen's resources were used for operative supervision. The Government commissioned the Swedish Agency for Public Management in 2009 to review Finansinspektionen's resource situation. The agency noted that in 2008 between 14 and 18 per cent of the time was dedicated to operative supervision and that the share has remained relatively stable in the past years. Their conclusion was that ”rationalisation measures can and should be carried out in FI [Finansinspektionen] before it is given additional resources. There should also be a discussion on the level of ambition and, by the same token, the priorities of operational supervision”.[27]

The critical flaw in the risk assessment was, however, according to the interviews carried out, the underestimation of the liquidity risk. During the work with Basel II, one was not able to regulate the liquidity risks since there was much disagreement among the different countries on the need for such regulation. The authorities mentioned the liquidity risks in their reports but they were not the focus in the analyses. Attention to them increased when the financial markets started to show symptoms of stress. The collapse in the financial markets, and the ensuing liquidity problems, that occurred after the

[27] The Swedish Agency for Public Management (2009).

American investment bank Lehman's went bankrupt was, however, extreme and surpassed everyone's worst fears regarding liquidity risks by far. Several of the authority representatives we interviewed questioned whether the banks would have needed additional capital at all if it were not for the liquidity problem that got radically worse due to the Lehman bankruptcy.

5.3 The Riksbank's stress tests

Assessments on financial stability are essentially based on how well capitalised the Swedish banks are and what risks they face. Since December of 2006, the Riksbank carries out stress tests that are published in the Financial Stability Report to "judge how less probable but entirely plausible developments could affect the banks' resilience".[28] These tests play an important role for the conclusion on how stable the financial system is. It is, therefore, valuable to study why the stress tests did not give clearer signs of the risks than what they did.

The purpose of the stress tests is certainly not to make exact prognoses of the different risk scenarios. The underlying thought is more to give a precise basis for a discussion on which effects would arise if a certain scenario were to materialise. From this aspect, the stress tests cannot be evaluated in the same way as a regular prognosis. Nevertheless, it is valuable if the tests are as reasonable and realistic as possible as this gives a better picture of the risks.

5.3.1 The Riksbank's internal process

To be able to evaluate the banks' resilience, the Riksbank has developed a method to measure the banks' credit risk which was seen as the largest risk by far. Critical for the result of the stress tests is which assumptions are made regarding the credit rating of different lenders as well as which scenarios that are chosen. In addition to that, naturally, the banks' capital situation in the starting point is also of big importance.

The Riksbank's procedure to come up with the assumptions for the bank stress tests has several steps. First, the assumptions are discussed between the group that is responsible for the stress tests and representatives of the group that is responsible for macroeconomic prognoses. Then, a discussion with the entire section for financial stability follows. Next, officials from other sections are involved. Following that, management comes in and, after having

[28] Financial Stability Report 2007:1 p. 10.

discussed with a small circle of officials, the Riksbank's preliminary position is established. Finally, controls are made with the central banks in the Baltic States and bilaterally with the Swedish banks, before the stress tests are designed and the report published.

5.3.2 *Were the assumptions reasonable?*

To stress test banks is a developmental stage that the Riksbank introduced a few years ago. Thus, no stress tests were performed during the time period when it became clear that the imbalances and risks in the Baltic States started to grow. The first time the Riksbank presented stress test results in its Financial Stability Report was in December of 2006.[29] Two different stress tests were made. The first scenario started from a strongly deteriorated creditworthiness among lenders in the Baltic States. The second scenario tested how the banks would handle a global turn in the credit cycle like the one that occurred in the year 2000 and which had an effect on all markets.

The result from the first test, as from the second, was that the banks were resilient enough to handle the constructed scenarios, see table 1. The question is then whether the Riksbank's assumptions were reasonable. This question can be broken down into four parts. First, was it even *an adequate model*? Second, were the s*cenarios reasonable*? A third issue is whether *the assumptions should have changed as the risks increased*. Finally, we come to the question of whether *a downturn limited to the Baltic States* was a reasonable assumption.

Was the model adequate? The model focused on credit risks which were assumed to be the banks' foremost source of losses. The Riksbank was aware that other risks were not included in the model. Later, it was seen that the liquidity risks were much larger than what the Riksbank (and all others) had assumed. There were a small number of people[30] that foresaw that a large crisis was coming, but probably not even within this small group was there a perception as to how extensive the liquidity problem could become. The development came to show that liquidity risks can turn into credit losses during a financial crisis.

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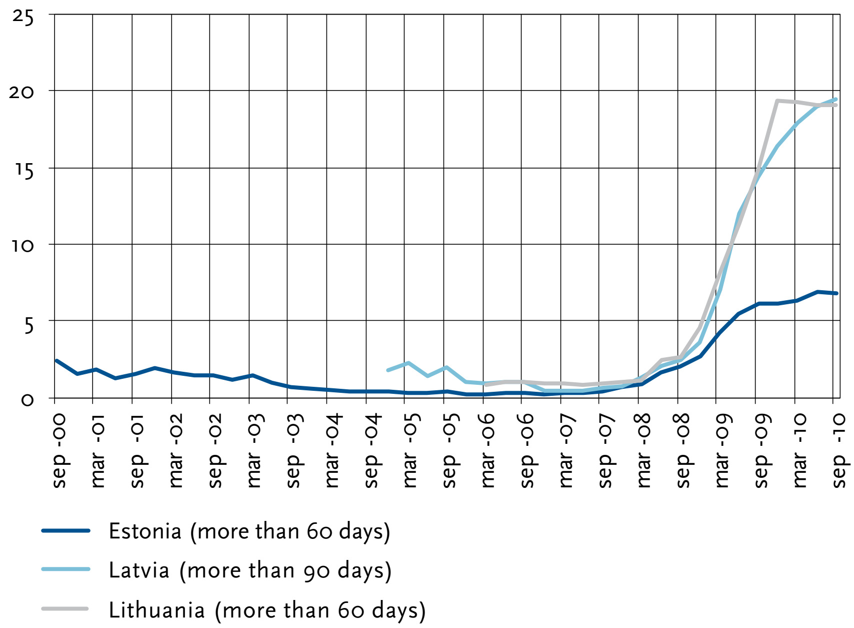
[29] It can be pointed out here that Swedish authorities were pioneers in publishing bank stress tests.

[30] Bill White, chief economist at BIS during the years before the crisis, was perhaps the one who most clearly pointed out the risks. See, for example, White (2006).

The model may, in hindsight, be said to have been too partial, as some risks were not taken into consideration.[31] At a later stage, starting in the fall of 2007, the Riksbank tested how the banks would be affected by increased financing costs. However, by then the liquidity problems were already a fact. Even in this stage, the extent and depth of the effects of the liquidity problems were underestimated.

Were the chosen scenarios reasonable? The Baltic scenario started from empirical experiences of how other developing countries had been affected by financial crises. According to the Riksbank, the probability of default in September 2010 was about 20 per cent in Latvia and Lithuania, while it was only about 7 per cent for Estonia (see chart 4). This can be compared to the assumed maximum level of 20 per cent three years after the crisis had begun (the Riksbank had assumed a probability of default of 5 per cent in year 1, 10 per cent in year 2, and 20 per cent in year 3).[32] All in all, it seems like the assumptions made in the stress tests were somewhat in line with the development that took place afterwards. However, the probability of default rose at a faster pace in Latvia and Lithuania than what had been assumed.

Chart 4 Late payments in the Baltic States



Source: The Riksbank.

[31] The Riksbank has developed a method to stress test banks' liquidity risks, see Financial Stability Report 2010:2.

[32] The Riksbank uses loans with late payments as an approximation for probability of default.

Even though the assumptions of probability of default were appropriate, the outcome differed greatly from the Riksbank's calculations in terms of profits for the individual banks. There was a large difference between Swedbank's actual result, which in 2009 was SEK -10.7 billion for the Baltic operations and SEK -10.5 billion in total; and the assessment of the stress tests was that Swedbank would make a profit of about SEK 3–4 billion. There was also a large discrepancy with SEB's calculated profit and the outcome.

Table 1 Outcome of the Riksbank's stress tests, in billions

	Expected profit in the Baltic scenario			
	Year 1		**Year 3**	
	SEB	Swedbank	SEB	Swedbank
2006:2	8,3	8,0	4,6	3,9
2007:1	8,8	7,8	4,5	3,2
2007:2	11,8	11,1	4,6	2,8

Partly, the difference was due the comparison being done between different units. The Riksbank's stress tests showed a total profit in the scenario with a downturn limited to the Baltic States, see table 1, whereas the actual outcome was based on a global downturn combined with a deep recession in the Baltic States, see table 2. Still, it is noteworthy that the actual outcome in the Baltic countries was much worse in the stress tests when the probabilities of default were in line with the expected probabilities.

The main explanation for the difference is that the development was faster than what the Riksbank had assumed. In the Riksbank's scenario, the crisis, from the start to its peak, took three years. In reality, the development was like the Riksbank's scenario for the first year, while the probability of default in the second year had already increased to the level that was supposed to be reached in year three. Thus, the credit losses were concentrated in 2009, which increased the pressure on the banking system compared to if they had been spread out over a longer period of time.

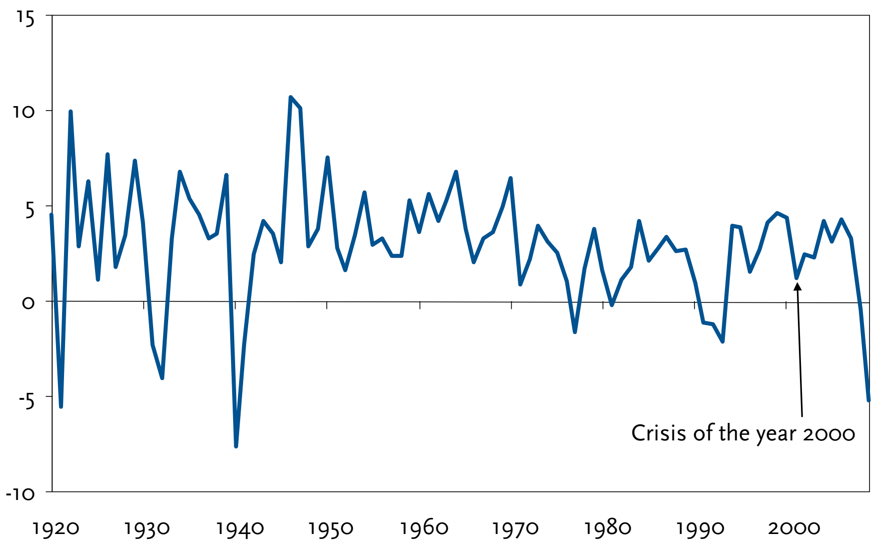
Table 2 Operating profit and credit losses in the Baltic States, in billions

	Operating profit		Credit losses	
	SEB	Swedbank	SEB	Swedbank
2008	1,4	3,3	1,8	1,8
2009	-0,8	-10,7	9,6	14,8
Q 1-3 2010	-0,9	-1,2	1,6	3,5

In the second scenario, a downturn in the business cycle in line with the one that occurred in the year 2000 was assumed. That downturn had been of a relatively normal magnitude. It is not stated in the stability reports why the Riksbank chose a normal downturn when one states at the same time that stress tests shall show how resilient the banks are when they are exposed to unexpected shocks. Normal fluctuations in the business cycle can hardly be described as unexpected shocks. In the interviews with representatives from the Riksbank they stated that, in light of the optimism that existed regarding decreased macroeconomic volatility the years before the crisis, the downturn from the turn of the century was seen as relatively severe.

With history in perspective, the downturn at the turn of the century was relatively limited, see chart 5. There are many examples of considerably larger downturns than the one the Riksbank chose as a starting point in the tests.

Chart 5 Swedish GDP



Sources: Hagberg and Jonung (2005) and SCB.

The risk scenarios that the Riksbank has presented in its monetary policy reports show that there was not much concern for a deep economic downturn. Growth in the risk scenarios has often been a few tenths of a percentage point beneath the base-line scenario. Such small differences can lead one to interpret that there has been a strong belief in the stability of growth. Maybe it can explain why the bank has assumed a relatively shallow economic downturn in its stress tests.

Table 3 Growth differences between the Riksbank's and the main scenario

	Risk scenario	One year after	Two years after
February 2007	Weaker growth globally	-0,55	-0,35
June 2007	Weak demand in the USA	-0,2	-0,2
October 2007	Lower growth in the USA	-0,3	-0,3
February 2008	Financial turmoil, falling housing prices in the USA	-0,1	-0,2
July 2008	Lower growth globally and higher inflation	-0,4	0,1

Source: The Riksbank's monetary policy reports.

Growth varies with several percentage points with the normal movements of the business cycle, which is much more that in the Riksbank's risk scenarios. It is thus difficult to understand that the risk scenarios have consistently been expected to lead to very small changes in growth.

In conclusion, the Riksbank's scenarios probably reflected faith that economic stability had improved and the risk for more severe backlashes had decreased. This was, however, not the case.

Should the assumptions have been changed as the risks increased? The imbalances in the Baltic countries grew during the 2000s and were prominent around 2005. The Riksbank pointed out the risks more emphatically starting with the May 2006 Financial Stability Report. As was described in Chapter 3, the imbalances grew increasingly with time. The larger the imbalances are, the larger the risk for more severe economic backlashes. The Riksbank's basic assumption in the stress tests, however, remained the same up to the point that the financial crisis had an effect in the stress tests in 2008. As mentioned previously, it seems like the assumptions, the way things have developed until now, reflected the probability of default in the matter of the end-level fairly well.

Nonetheless, one can question, from a general point of view, whether the stress tests' configuration should reflect the changes in the risk scenario.

Was it reasonable to assume an isolated backlash in the Baltic countries? The Riksbank has focused on the risks in the Baltic States by, from the start, having one of two tests be about a backlash in these countries. The underlying assumption that the Baltic States would suffer a severe backlash at the same time that the economic situation in other countries remained unaffected can, however, be questioned.

Experience has shown that imbalances in individual countries seldom correct themselves on their own in environments of a high global appetite for risks. Besides the Baltic States, many people considered Iceland to suffer from imbalances. But the imbalances could continue to grow as long as the global environment rewarded risk-taking. When investors finally wanted to get rid of the risk, the banking system and the entire economy collapsed.

It was, therefore, unlikely that the Baltic States would go into a recession at the same time that the global economy remained good. On the contrary, it was more realistic to assume that a dismantling of the imbalances in the Baltic States would occur as the global situation got worse.

Representatives from the Riksbank have mentioned in interviews the advantages of studying the risks in the Baltic States with a separate scenario for them. However, it would have been possible to have a scenario with a general downturn in the business cycle, like the Riksbank had in its financial stability reports, and a parallel one where all countries were influenced but where the effects in the Baltic economies were more pronounced. A discussion on the difference between these outcomes would have pointed out the specific risks with the operations in the Baltic region.

5.4 Finansinspektionen's stress tests

According to Basel II, the banks have to perform stress tests. These must, according to the requisites in Pillar 1, help the banks to evaluate how their internal model for risk classification reacts in a recession. Furthermore, according to the requisites in Pillar 2, stress tests should be used as a part of the banks' internal capital evaluation. The banks have, in this context, much freedom to form their own stress tests.

In order to test how the banks' work on stress tests was coming along, Finansinspektionen and the Riksbank carried out a pilot study in the fall of 2006. The study's macroeconomic assumptions were drawn up by the authorities, but the work itself was carried out by each bank. The banks had great liberty regarding what assumptions to make besides those decided by the authorities.

Table 4. Assumptions in Finansinspektionen's pilot study of bank stress tests

	Year t	t+1	t+2	t+3
GDP	2,7	-0,4	-0,1	0,8
Export	5,7	-1,1	1,2	3,0
Unemployment	8,3	9,2	10,2	9,5
SEK/USD	7,4	6,0	5,3	5,3
Stock market price (t=100)	100	95	87	74
Prices of small houses (t=100)	100	91	81	84
Commercial real estate (t=100)	100	85	75	75
Price of oil (USD/barrel)	60	120	150	100

Source: Finansinspektionen, The Stability of the Swedish Financial Sector, 2006.

The assumptions were based on a combination of several different events. One assumption was that the American economy would be weakened and another was that turmoil in the Middle East would lead to higher oil prices. All in all, these assumptions on global tendencies affected the development in Sweden mentioned above. The banks had to assume for themselves how other countries developed with the general conditions as a starting point.

These assumptions caused the stress test to be tougher in terms of a macroeconomic slowdown than the stress tests that the Riksbank carried out later that year. Since the banks were responsible for many of the assumptions of that which affects the way their credit losses and profits develop, it is difficult to compare the outcomes of the stress tests with each other. However, it can be seen that no bank had a negative operating profit in their stress tests.

There were no bank stress tests in the next report on the stability of the financial sector, published in October of 2007.

5.5 What measures did the Swedish authorities take?

Finansinspektionen did not take any specific measures to limit the banks' expansion in the Baltic States. On the contrary, the Estonian supervisory authority's petition for stricter capital requirements on the banks' Estonian branches was turned down. Finansinspektionen considered that the banks' capital adequacy was sufficient and, therefore, did not see any reason to intervene. To carry out measures aimed exclusively at the banks' affiliates in Estonia was considered an infringement on existing regulation.

However, Finansinspektionen carried out its regular controls of the banks' risk management, staffing, etc. and pointed out the shortcomings it found. This control of individual institutions that Finansinspektionen carried out seems to have generally worked as intended, but the result was not what one desired.

The Riksbank itself has no instruments to directly influence the banks or the development in the Baltic region. The stability reports underestimated the risks, which was a contributing factor to nothing more being done.

As the imbalances grew and the probability for a backlash increased, the Riksbank became more concerned. However, no measures were taken. It can also be noted that the Riksbank never made a formal inquiry to Finansinspektionen regarding the banks' risks in the Baltic region, much less called for an intervention. Lars Nyberg from the Riksbank asked the Board of Directors of Finansinspektionen in June of 2008 whether the capital requirements should be raised due to the exposure in the Baltic region. Yet no measures were taken. By now, the credit expansion had slowed down due to the economic downturn and decreasing real estate prices.

Since none of the authorities considered that the Swedish financial stability was threatened, they did not take any actions besides pointing out the risks in their reports and discussing them with the banks.

There was overconfidence that bank representatives had control over the risks they were taking. Several authority representatives, both in Sweden as well as in the Baltic states, have reported that they pointed out the risks to the bank managements. The answers they received were always the same: the banks stated that they were aware of the risks they were taking and that they were a part of the business strategy. The bank representatives claimed, according to concurrent information from the authorities, that they had total control. The message to the Baltic authorities was that the banks knew from their experiences from the Swedish crisis of the 90s what risks were involved and that they took them into consideration in their work. Annika Falkengren, CEO of SEB, confirms the notion that the bank thought the risks were under control. Nonetheless, SEB chose, as the first Swedish bank, to intensify the credit assessments and dampen the pace of expansion in order to decrease the credit risks which were believed to rise as the Baltic economies became increasingly overheated.

5.6 The coordination between the authorities and with the Ministry of Finance

The institutional system we have chosen in Sweden poses large demands on the coordination between the Riksbank and Finansinspektionen, as well as between these two authorities and the Ministry of Finance. In Finansinspektionen's instruction, it is prescribed that the authority shall cooperate with the Riksbank in issues regarding crisis preparedness and also consult with the Riksbank on important issues that have to do with the stability of the system of payments or the Riksbank's responsibility for the currency and credit policy and the system of payments. This cooperation and consultation has been established in an agreement between the Riksbank, Finansinspektionen and the Ministry of Finance, which meets once per quarter in a consultation group, the so-called Stability Council.[33]

The Stability Council described the risks in the Baltic region as manageable, the problems for the banks as temporary and that they were considered to have enough capital to handle large credit losses. The Ministry of Finance was, during the years before the crisis, mostly a recipient of information in this context. No proposals have come from the Stability Council to the Ministry of Finance to act upon the situation in the Baltic States during the years the risks were building up.[34]

The second part of the agreement thoroughly describes how the Riksbank and Finansinspektionen are to cooperate and exchange information. The heads of the divisions whose main responsibility is the stability of the banking sector, financial market statistics and supervision of clearing and settlement meet at least four timed per year to discuss issues of common interest.

The audit of the work with financial stability has not shown that the cooperation between Finansinspektionen and the Riksbank has failed. On the contrary, the interviews with representatives from both authorities reveal a good climate of cooperation, greatly due to personal contacts between staff members of both authorities. However, it is important to establish structures and procedures that not only build on personal contacts. Since 2003, there has been an agreement between the Riksbank and Finansinspektionen on the methods for cooperation. The cooperation has, however, not been evaluated.

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33 As early as 2003, the first agreement between the Riksbank and Finansinspektionen on the division of work for financial stability was published. In 2005, an agreement was made between the Ministry of Finance, the Riksbank and Finansinspektionen on cooperation on financial stability and crisis management. In the first part of this agreement, the cooperation between the three parties is established in the so-called Stability Council. Since 2009, through a new agreement, the National Debt Office has also been an integrant of this group. All three agreements include a description of how the work is to be divided and the cooperation between Finansinspektionen and the Riksbank is to be organised.

34 Interview with Peter Lindfeldt, Ministry of Finance.

5.7 Interpretation of the article on soundness

As mentioned above, it is of great importance that supervisory authorities have a clear mandate for their exercise of authority. Finansinspektionen has an extensive legal framework to observe in its role as supervisory authority. Finansinspektionen's possibilities to intervene when financial stability risks being threatened, however, are interpreted differently by various lawyers with experience from Finansinspektionen.

The Capital Adequacy and Large Exposures Act (2006:1371) gives Finansinspektionen the possibility to increase the capital requirement of an institution if it does not fulfil the requirements stipulated in certain sections of Chapter 6 in the Banking and Finance Business Act (2004:297) that deal with the general provisions of a credit institutions business. The first three sections are on solvency, liquidity, and transparency. Finansinspektionen has, with these laws and sections, a relatively extensive set of tools to manage problematic situations that arise. Chapter 6, Section 4 of the Banking and Finance Business Act (2004:297) states the following: "The business of a credit institution is to be operated in a sound way in other respects than those stipulated in sections 1-3." Present and past representatives from Finansinspektionen have claimed both that this section is so vague that it cannot be used for anything as well as that it is so vague that it can be used for everything. It can be seen the Government bill for this act that this section was meant to reflect mostly a consumer protection perspective. However, this perspective is very broad, as stated in the Government bill:

"The special quality provision is intended to meet infringements of other norms than those already covered here. It can apply to norms established as acts or other statutes, non-binding norms given by public authorities, norms from private institutions, such as, industry organisations or similar, or established moral or ethical norms."[35]

The section can also create problems for the credit institutions since there is no clear definition of the "soundness" that they have to uphold.

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35 Prop. (Government Bill) 2002/03:139 p. 285. (Own translation)

5.8 Concluding observations

Imbalances in the economy and the financial system are often built up in times of prosperity. The work to maintain financial stability demands, therefore, authorities that have the capacity to discover problems in time and with clear mandates and self-confidence to carry out restrictive and, thus, often unpopular decisions. Both the Riksbank and Finansinspektionen underestimated the credit and liquidity risks that the banks' expansion in the Baltic region entailed. No direct measures to restrain the development were taken. The stress tests that the Riksbank carried out were altogether much too conservative since they were based either on assumptions of a geographically isolated downturn in the Baltic economies or a normal business cycle downturn.

Sweden has chosen to allot responsibility for the financial stability to two authorities: Finansinspektionen and the Riksbank. An important condition for an efficient supervision and for the possibility to discover risks that are building up is that the coordination between these two authorities works. The audit has not shown that this cooperation has gone amiss. On the contrary, the interviews indicate that there is a positive environment for cooperation. The cooperation has, however, not been evaluated.

6 Conclusions and recommendations

This audit has seeked to find out if the Government's work for financial stability is efficient and purposeful and if the responsible authorities have the tools and the capacity needed to fulfil this task. The starting point has been the experiences and lessons that can be drawn from the supervision of the Swedish banks' expansion in the Baltic market and the latest financial crisis. The audit has exposed a number of weaknesses in the institutional framework regarding the work with financial stability and that it is necessary to develop and increase the number of tools available to the authorities.

6.1 The authorities' mandates are unclear

In section 5.1, it was stated that in order to prevent crises, one needs an authority that not only has the capacity to identify problems on time but that also has the mandate and confidence to carry out decisions that often are unpopular.

Sweden has two authorities with responsibility to maintain stability in the financial system, but the instruments and analysis functions differ between the Riksbank and Finansinspektionen. The Riksbank has, as previously mentioned, the tools for the analysis of the financial system as a whole, whereas Finansinspektionen focuses on individual institutions. It is also Finansinspektionen that has the authority to issue sanctions in those cases where a financial institution fails, for example, regarding capital adequacy or risk management. A specific legal framework for risk management in the whole financial system, a so-called macroprudential policy, does not exist.

Today, there is a noticeable discord between the members of the Riksbank's Board on whether the bank's decisions regarding the interest rate should consider the risk that real estate prices and the households' indebtedness could lead to future problems.[36] The authorities' mandate can apparently be

[36] See for ex. the 2010 Minutes of the Executive Board's monetary policy meetings.

interpreted in completely different ways, even within management. External observers also seem to have different views on what mandate the Riksbank really has.

The Riksbank's Board has asked the Riksdag to clarify the mandate as it, according to their point of view, is not clear what is included in the task to promote a safe and efficient payments system.[37] They write in their submission to the Riksdag that "it should be examined if the Riksbank should be given special tools that may be used for the sole purpose of promoting stability in the financial system irrespectively if it is to fulfil the price stability target or not and irrespective if there is a financial crisis situation or not". Plainly said, this is about having the means to act pre-emptively to avoid future threats against the economy's stability.

6.1.1 *Finansinspektionen and the interpretation of the law – the soundness section*

Of special meaning for the mandate of an authority is that the law it has for its exercise of authority is clear. As discussed in section 5.7, several prominent people that work or have worked at Finansinspektionen have stated that the so-called soundness section; Chapter 6, Section 4 of the Banking and Finance Business Act (2004:297), is so vague that it is difficult to use as well as so wide that it can be used in almost any situation. It is not reasonable that there is uncertainty on how the act, in this sense, is to be interpreted. The risk of the unclear wording is that it is either a tool for Finansinspektionen that cannot be used or that it may allow for a use that the legislator did not intend.

Recently, the soundness section has been used as a motive for the general advice of a mortgage cap of 85 per cent of the home's value. In the circulation for comments for the adoption of the mortgage cap, it was questioned whether the institution of a cap is really a measure for consumer protection, as Finansinspektionen claims[38], or rather a stabilising policy measure to diminish the risk that many households end up in a debt crisis that could enhance the business cycle fluctuations due to decreased private spending. It is doubtful that this type of regulation (macroprudential regulation) has legislative support. Finansinspektionen's standpoint today is that it does not have the mandate to take macroeconomic stability into consideration in its supervisory

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37 2009/10:RB4.(Own translation)

38 In its proposal regarding the mortgage cap, Finansinspektionen states that "the goal of the suggested regulation in the form of general advice is to discourage unsound lending in the mortgage market and thus strengthen consumer protection. Finansinspektionen considers that it is dangerous that companies can begin to use high loan-to-value ratios to compete which in the long run leads to unacceptable risks for consumers and damages the confidence in the credit market" (own translation).

work. However, a general lesson from the financial crisis is that a so-called macroprudential policy is important to maintain financial stability. It is therefore an open question if Finansinspektionen has the mandate necessary to fulfil the goal of financial stability that it has in its instruction and if the current legislature is sufficient for it to be useful.[39]

Recommendations

The Government should review and clarify the Riksbank's and Finansinspektionen's mandate and tools to safeguard financial stability in a broad sense. It should be studied how a set of regulations for so-called macroprudential policy should be developed and, if so, who should be responsible for it. Such a review should also encompass the meaning of the concept of soundness according to Chapter 6, Section 4 of the Banking and Finance Business Act (2004:297).

6.2 Supervision of banks with operations in several countries

The interviews with the public authorities in the Baltic region showed that they did not think that they had the necessary tools to steer the development in the credit market (see Chapter 3). By maintaining a fixed exchange rate policy with the aim of joining the European Monetary Union as soon as possible, the central banks of these countries did not have the use of the interest rate "weapon". The majority of lending was done in euro; the interest rate was very low in the euro area and reflected in no way the situation in the Baltic States. The real interest rate was negative both in Estonia and Latvia during the boom. The situation was further complicated by the inability of the public authorities to regulate the foreign banks' branches.

Neither Finansinspektionen nor the Riksbank took any measures after the Estonian petition was sent in 2005 (see section 4.3). None of the authorities reported the event to the Swedish Government officially. However, it was mentioned to functionaries at the Ministry of Finance. Finansinspektionen claims that the situation that the Estonian authorities remarked on is a basic component in the EU's inner market for financial services. The legislator and the Government have thus been aware of this consequence since the decision to join the EU was made. The omission to report the Estonian petition to the Government, and the fact that a neighbouring country felt that the inner

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39 During the open question time in the financial committee on February 2, 2010, regarding the Swedish authorities' actions due to the crisis in the Baltic region, Finansinspectionen's Director General, Martin Andersson, said the following: "We have the instruments. It is sometimes discussed whether Finansinspektionen has the right instruments. Yes, it is my absolute conviction that we do. But we have to use them"(own translation).

market for financial services was causing problems when it came to taking measures to dampen what the authorities considered to be an unsound credit expansion can, however, be criticised. It would have been appropriate if Finansinspektionen had formally informed the Government about the Estonian letter and their response to it.

The fact that the Estonian authorities believed that the banks did not take the increased risk on the housing market in its lending into account did not lead to any immediate measures on behalf of the Finansinspektion. In-depth studies were carried out on the Swedish banks' risk management and credit risks in the Baltic region just one a half year later. The legislation that existed in the beginning of 2006 did not leave any room for Finansinspektionen to increase capital requirements on the banks as long as their total capital adequacy was seen as satisfactory. Still, Finansinspektionen did not use the expanded possibility to intervene given to them by legislation in 2007 and that they were aware of when the Estonian petition was answered. However, an intervention would have required Finansinspektionen to deem the banks' risk management as unacceptable and that it was improbable that any other measure would be enough to force the bank to correct the shortcomings within a reasonable amount of time.

The development in the Baltic countries shows that the problems regarding foreign banks and their supervision, which the Estonian authorities pointed out, were a real problem which came to affect stability in Sweden as well.

After the crisis, a large number of new laws and a new structure have been created in the EU to handle, among others, issues on cross-border banks. The supervision of these banks demands cooperation between the home and the host countries' authorities in so-called supervisory colleges. The Nordic and the Baltic states have also created a permanent working group to handle issues on crisis management. Furthermore, among others, the European Banking Authority (EBA) has been created. The EBA has the mandate to mediate between the home and the host countries' authorities. This should improve conditions so that the set of problems that foreign bank affiliates brought with them to the Baltic region will be easier to handle from now on.

6.3 The Riksbank's and Finansinspektionen's communication

Communication is pivotal for the dispersion of information. It is partly about what messages one wants to send out, and partly about which channels one uses to reach the intended recipients. Our interviews show that there is a gap between the Riksbank's view[40] on its actions concerning the risks in the Baltic region and the Baltic authorities' account on the Riksbank. There are indications that there also was a gap between the Riksbank and other participants where representatives from the Riksbank seem to be of the opinion that they had sent out a stronger message on the risks than what the recipients perceived. The fact that the Riksbank included the risks in the Baltic region in its stability reports does not seem to have had much impact on the banks' actions. The Riksbank has, however, taken a step in the right direction with its latest stability report[41] and the recommendations given in it.

Regarding the channels of communication, there are more ways to send out messages than by producing stability reports and having direct contact with bank managements. A bank management naturally stands behind its own business strategy and, in the Baltic region, the system of incentives has meant that management has been rewarded generously for pursuing high volumes.[42] One can therefore ask if the public authorities should have a broader scope of contacts with the parties behind a bank. It can be about meeting the board and, through a public discussion, send out its messages to the shareholders and others involved in society; for example, via open letters to the bank management or debate articles in the press.

Another way to reach a broader audience is to have regular hearings in the Riksdag on financial stability, which would force both Finansinspektionen and the Riksbank to take a clear standpoint on the risks and spread it further to a broader group.

Recommendations

The Riksbank and Finansinspektionen should consider other means of communication with the banks and the general public.

The Riksdag could try the possibility to regularly organise public hearings on stability in the financial system.

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40 Ingves (2010).

41 Financial Stability Report 2010:2.

42 The importance of this appeared when SEB actively chose a more cautious strategy that resulted in diminished market shares, which led to staff changing to the Hansabank, which has a more aggressive lending policy. Interview with Annika Falkengren.

6.4 The coordination between Finansinspektionen and the Riksbank

Sweden's institutional structure demands that the coordination and cooperation between Finansinspektionen and the Riksbank works efficiently and appropriately. Finansinspektionen and the Riksbank have, therefore, both through instructions and a common agreement, an organised method of cooperation and information exchange. As mentioned in section 5.6, the audit has not shown that this cooperation has failed or been ineffective. According to the agreement mentioned above, the cooperation between them shall be evaluated by the Director General of Finansinspektionen and a member of the Riksbank's Executive Board who is to participate in the cooperation. This has, however, not been done during the period for this audit.

The audit has shown that the work for financial stability was not highly prioritised by Finansinspektionen during the boom years (see section 5.2). As an illustrative example, one can point out that the cooperation between Finansinspektionen and the Riksbank was not mentioned a single time in Finansinspektionen's annual reports from 2006 to 2008, with the exception of the cooperation to produce statistics.

Bearing in mind the complexity and importance of questions on financial stability, it should be important that the cooperation between the Riksbank and Finansinspektionen is assessed regularly and that the evaluation of the work is conducted by a third party, rather than by those that participate in the cooperation themselves.

Recommendations

Given that the institutional structure with two separate authorities that have the responsibility to maintain financial stability remains, the Riksbank and Finansinspektionen must continue the close cooperation on the various aspects of the work to uphold financial stability. To safeguard that this work continues, the authorities should report how this cooperation has been carried out during the year to the Riksdag or the Ministry of Finance. It should also be deliberated whether an external evaluation on how the cooperation is organised and has worked should be performed, rather than the internal evaluation that the agreement between the Riksbank and Finansinspektionen recommends.

6.5 The Riksbank's and Finansinspektionen's stress tests

No stress tests were performed by the Swedish authorities during the first years of growing imbalances in the Baltic States. The first tests were done towards the end of 2006, when the imbalances had grown considerably. It should, however, be noted that the Riksbank and Finansinspektionen were the first public authorities in Europe to publish stress tests for individual banks.

The Riksbank's tests focused on the credit risk and, therefore, missed the importance of the liquidity risk. It was, however, a common misjudgement made by basically all parties, not just in Sweden but also globally. More startling was that the Riksbank decided to study a severe backlash in the Baltic States in a separate scenario in which other countries were not affected. Historical experiences speak against such a scenario. If the Riksbank had used a combined scenario, where the effects of a general downturn in the business cycle and a recession in the Baltic countries were added up, from the start then it would have given a better picture of the banks' resilience and, thus, the threat level on financial stability. The Riksbank has developed for its December 2010 stability report stress tests for liquidity risks in order to improve the overview of the banking sector and the financial system.

One can also question if the Riksbank should assume a modest downturn in the economy in its stress tests. If the purpose – as stated in the stability reports – is to find out what capacity the banks have to handle unexpected shocks, then the stress tests should contain tougher assumptions than a normal fluctuation of the business cycle.

Finansinspektionen's pilot study with the banks performing their own stress tests was based on more strained macroeconomic conditions – yet on somewhat incoherent assumptions – than the Riksbank's tests. It showed that the banks had a strong resilience against an economic downturn. However, since the banks decided themselves what assumptions to make, the value of the test is more difficult to assess for an external observer.

All in all, the assumptions chosen affected the stress test in a direction in which they did not fully detect the risks on financial stability. A plausible explanation is that the Riksbank was influenced by the favourable macroeconomic environment that existed. If a more historic perspective had been taken, the risks would surely have been appraised as larger.

Recommendations

The Riksbank should be clear with what the stress tests aim to control and make sure that the assumptions reflect the risks. A future possibility would be to perform stress tests based on economic downturns of varying degrees, which would give a wider set of information on the banks' resilience.

6.6 The Government's implicit responsibility

Since the Swedish banks played a dominant role in the payments systems in the Baltic States, the Swedish state had an implicit responsibility for these systems and, therefore, for the countries' economic stability. Carl B. Hamilton, Member of Parliament and of Folkpartiet, the liberal party of Sweden, has called for an investigation of the regulatory authorities' role in the events that led to the Government being made indirectly responsible for the three Baltic states.[43] This issue has been discussed further in the Riksdag's Committee on Finance in a public hearing.[44]

It is undoubtedly a complicated problem that Hamilton points out: who reflects over the implicit responsibility that the Government – as the guarantor for the Swedish banks – receives when Swedish banks expand to other countries and take a dominating position in them? Should it be the banks that, through their actions, control this? Or should the Government in any way have an opinion on the responsibility that is forced upon it by the banks' international expansion? In what way should it then be expressed?

In reality, there are two separate potential problems imbedded in this issue. First of all, the Swedish Government can have an implicit share of the responsibility for the economic development in a country when Swedish banks have a leading role in this country's bank sector. Second of all, an expansion abroad can make the banking sector – and, thereby, the Government's implicit guarantee for the banking system – become too large in relation to the Swedish economy.

Certainly, the responsibility for a country's economy lies primarily on that country's government and public authorities. But the Baltic example shows that foreign banks can have had a significant impact on an individual country's development. This applies both to increasing macroeconomic imbalances in good times and maintaining a functioning bank system in times of crisis. The failure of Swedbank or a cutback in its operations would probably have had devastating consequences for the Baltic economies. The Swedish Government got, through an implicit responsibility for Swedbank, also an indirect responsibility for the economic development in the Baltic region.

It has been said on different occasions that the Swedish loan to Latvia of 720 million euro (decided upon but not paid out yet) was granted partially because Latvia, without support, would have had to devalue.[45] This would have would

43 Carl B Hamilton, Är baltkrisen deras fel? (Is the Baltic crisis their fault?) DI debatt November 5, 2009.

44 Committee on Finance (2009/10 FiU:20).

45 See for ex. Forsberg (2010).

have had dire consequences for the Swedish banks through increased credit losses or at least that the credit losses would have emerged sooner and been pressed into a shorter period of time. Furthermore, a Latvian devaluation would have led to added pressure on the other two Baltic countries to devaluate, with further negative consequences for the Swedish banks as a result. The argument has been rejected by, among others, the Minister of Finance, who claims that the intention of the loan is solely to support Latvia in it's strive to handle the crisis.[46] At the same time, the Minister of Finance has stated that SEB and Swedbank probably would have gone "out of control" if Latvia has been forced to devaluate.[47]

The Baltic development shows that a situation can arise where a Swedish bank does not need support from the Government to survive but where a closure or a cut-back in operations could lead to substantial and even critical economic effects on a country's development, if the bank has a leading role in the country at hand.

The development raises the question of whether the Government should have an opinion on banks' foreign expansions that result in the gaining of a leading position in another country. Today, banks are free to expand to other countries as long as they fulfil the criteria in the Banking and Finance Business Act (2004:297). The meaning of Chapter 7, Section 12 in this act is that a credit institution must apply for a permit at Finansinspektionen if it aims to purchase property; for example, a foreign bank, for more than 25 per cent of its capital base. The regulation in this area aims to make sure that the banks have enough capital. The legislator has, however, not had any remarks on the fact that the Government thus risks having an implicit responsibility for a country's development if the Swedish bank gets into financial trouble and can indirectly force the Government into acting in one way or another.

The Icelandic example illustrates what can happen when the government does not have any views on the banks' expansion to other countries and their size. The Icelandic banks expanded greatly to abroad. In just five years, their assets rose from being twice as large as Iceland's GDP to being ten times larger. When the banking sector becomes too large in relation to the country's economy, it becomes difficult to handle and the government's implicit guarantee becomes very extensive. In the case of Iceland, the entire country's economy was put at risk without any measures from the public authorities.[48] In the end, the Icelandic Government was forced to intervene when the banks could no longer finance their operations.

46 Affärsvärlden, February 20, 2009.

47 Dagens Industri, January 19, 2011.

48 The Althingi Special Investigation Commission (2010).

The price for the crisis was extremely high for the Icelandic population. Before the crisis, the national debt, measured as a share of GDP, was 29 per cent. The Central Bank of Iceland expects this share to reach 113 per cent in 2010.[49] The population has not only been affected by the Government's measures to cure the state budget but also by strongly rising unemployment, decreasing asset prices, and rising inflation. The households' real disposable incomes decreased with 18 per cent in 2009 and an additional 9 per cent in 2010.

Finansinspektionen can control a Swedish bank's acquisition of a foreign bank if the purchase price exceeds 25 per cent of the capital base. Several small acquisitions, however, do not require permits. Furthermore, Finansinspektionen only has the right to base its investigations and decisions on individual objects, not on how large the total risk for the banking system becomes.

Thus, the Swedish Government has at present no tools to hinder the banking sector, and, thereby, the Government's implicit guarantee, from becoming disproportionately large. The Government has, however, in the aftermath of the financial crisis, created a stability fund (Government Support to Credit Institutions Act [2008:814]). The stability fund is to finance the Government's support measures for the financial system. According to the legislator, since banks and other credit institutions finance the fund by paying fees, a long-term sustainable system of financing that lies outside the government budget is created.[50] The goal is that the fund will grow to equal 2.5 per cent of the GDP. However, this level is not even close to being enough to finance a financial bank failure of the magnitude of the one that occurred in Iceland.

The fund cannot hinder the banking system from creating considerable implicit risks for the Government;[51] it is just so that the banking system itself may cover (a part of) the costs that the Government is forced to assume to support the institutions' survival. The other socio-economic costs that instability in the financial system incur in terms of recession, business bankruptcies, increased unemployment, etcetera, lie completely beyond the stability fund's area.

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49 National debt has certainly increased in all OECD countries, but the average increase is much more limited, from 73 per cent before the crisis to 96 per cent in 2010.

50 The stability fund's name suggests that the resources are funded. However, this is not the case. The banks' fees are not place in a fund; instead, they decrease the Government's borrowing needs. Thus, there are no reserved resources if and when measures are needed to support a credit institution. The Government has to borrow the amount needed to finance any support measures.

51 For an overview of the Government's risks and guarantees, see SNAO (Riksrevisionen) (2009).

Recommendations

The Government should study whether the risks in the banking sector and the implicit government guarantee connected to them can be limited.

The Government should make sure that it is continuously informed of the risks, besides those pertaining to the banks' capital adequacy and which Finansinspektionen continuously supervises, that bank operations in other countries can bring about to the Government. It is doubtful that these risks can be reduced without applying restrictions on the banks' possibilities to expand abroad. But being aware of the risks should lead to the Government creating a state of readiness to confront them.

References

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Appendix 1

Core Principles for Effective Banking Supervision (The Basel Core Principles)

Foreword to the review

1. This document is the revised version of the *Core Principles for Effective Banking Supervision*, which the Basel Committee on Banking Supervision (the Committee) originally published in September 1997. Along with the *Core Principles Methodology*, the Core Principles have been used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to be done to achieve a baseline level of sound supervisory practices. Experience has shown that self-assessments of countries' compliance with the Core Principles have proven helpful for the authorities, in particular in identifying regulatory and supervisory shortcomings and setting priorities for addressing them. The revision of the Basel Core Principles provides an additional reason for countries to conduct such self-assessments. The Core Principles have also been used by the IMF and the World Bank in the context of the Financial Sector Assessment Program to assess countries' banking supervision systems and practices. Since 1997, however, significant changes have occurred in banking regulation, much experience has been gained with implementing the Core Principles in individual countries, and new regulatory issues, insights and gaps in regulation have become apparent, often resulting in new Committee publications. These developments have made it necessary to update the Core Principles and the associated assessment Methodology.

2. In conducting this review of the Core Principles and their Methodology, the Committee was motivated by a desire to ensure continuity and comparability with the 1997 framework. The 1997 framework has functioned well and is seen to have withstood the test of time. Thus the intention was not to radically rewrite the Core Principles but rather to focus on those areas where adjustments to the existing framework were required to ensure their continued relevance. The review does not in any

way call into question the validity of previous work already conducted, not least country assessments and reform agendas based on the 1997 framework.

3. Another aim of the review was to enhance – where possible – consistency between the Core Principles and the corresponding standards for securities and insurance as well as for anti-money laundering and transparency. Sectoral core principles, however, are designed to focus on key risk areas and supervisory priorities, which differ from sector to sector, and legitimate differences have to remain.

4. To conduct this review, the Committee acted in close consultation with, and built on the work of, the Core Principles Liaison Group, a working group that regularly brings together senior representatives from Committee member countries, non-G10 supervisory authorities, the IMF and the World Bank. The Committee consulted other international standard-setting bodies – the IAIS, IOSCO, the FATF and the CPSS – during the preparation of drafts. Regional groups of supervisors were invited to comment.

The Core Principles

5. The Core Principles are a framework of minimum standards for sound supervisory practices and are considered universally applicable.4 The Committee drew up the Core Principles and the Methodology as its contribution to strengthening the global financial system. Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. The Committee believes that implementation of the Core Principles by all countries would be a significant step towards improving financial stability domestically and internationally and provide a good basis for further development of effective supervisory systems.

6. The Basel Core Principles define 25 principles that are needed for a supervisory system to be effective. Those principles are broadly categorised into seven groups: Objectives, independence, powers, transparency and cooperation (principle 1); Licensing and structure (principles 2 to 5); Prudential regulation and requirements (principles 6 to 18); Methods of ongoing banking supervision (principles 19 to 21); Accounting and disclosure (principle 22); Corrective and remedial powers of supervisors (principle 23); Consolidated and cross-border banking supervision (principles 24 and 25). The principles are:

Principle 1 – Objectives, independence, powers, transparency and cooperation: An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 2 – Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

Principle 3 – Licensing criteria: The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 4 – Transfer of significant ownership: The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 5 – Major acquisitions: The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 6 – Capital adequacy: Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

Principle 7 – Risk management process: Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 8 – Credit risk: Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

Principle 9 – Problem assets, provisions and reserves: Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

Principle 10 – Large exposure limits: Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 11 – Exposures to related parties: In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

Principle 12 – Country and transfer risks: Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Principle 13 – Market risks: Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 14 – Liquidity risk: Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Principle 15 – Operational risk: Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Principle 16 – Interest rate risk in the banking book: Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

Principle 17 – Internal control and audit: Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 18 – Abuse of financial services: Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Principle 19 – Supervisory approach: An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

Principle 20 – Supervisory techniques: An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

Principle 21 – Supervisory reporting: Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

Principle 22 – Accounting and disclosure: Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

Principle 23 – Corrective and remedial powers of supervisors: Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

Principle 24 – Consolidated supervision: An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

Principle 25 – Home-host relationships: Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

7. The Core Principles are neutral with regard to different approaches to supervision, so long as the overriding goals are achieved. The Principles are not designed to cover all the needs and circumstances of every banking system. Instead, specific country circumstances should be more appropriately considered in the context of the assessments and in the dialogue between assessors and country authorities.

8. National authorities should apply the Principles in the supervision of all banking organisations within their jurisdictions. Individual countries, in particular those with advanced markets and institutions, may expand upon the Principles in order to achieve best supervisory practice.

9. A high degree of compliance with the Principles should foster overall financial system stability; however, this will not guarantee it, nor will it prevent the failure of individual banks. Banking supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy, failures are part of risk-taking.

10. The Committee stands ready to encourage work at the national level to implement the Principles in conjunction with other supervisory bodies and interested parties. The Committee invites the international financial institutions and donor agencies to use the Principles in assisting individual countries to strengthen their supervisory arrangements. The Committee will continue to collaborate closely with the IMF and the World Bank in their monitoring of the implementation of the Committee's prudential standards. The Committee is also committed to further enhancing its interaction with supervisors from non-G10 countries.

Appendix 2

Interviewed people and institutions

Bank of Estonia

– Jaak Tõrs
– Jana Kask

Estonian Financial Supervisory Authority

– Raul Malmstein
– Andres Krugpold

Finansinspektionen

– Martin Andersson
– Per Håkansson
– Uldis Cerps
– Lars Frisell

Members of Finansinspektionen's Board of Directors

– Bengt Westerberg
– Gustaf Sjöberg
– Lars Nyberg

Previously at Finansinspektionen:

– Kerstin af Jochnick
– Gent Jansson
– Martin Blåvarg
– Tomas Flodén

Finansinspektionen's Director General during the relevant years, Ingrid Bonde, was offered, but declined, an interview.

Ministry of Finance

– Peter Lindfeldt

Latvian Central Bank

– Ilmar Rimsevics

The Financial and Capital Market Commission (Latvian supervisory authority)

– Janic Placis
– J. Lebedeva
– I. Rainska
– Anna Dravniece

Sveriges Riksbank (Swedish central bank)

– Lars Nyberg
– Mattias Persson
– Martin W Johansson

Previously at the Riksbank

– Lars Heikensten
– Martin Andersson
– Per Håkansson
– Lars Frisell

SEB

– Annika Falkengren
– Jan Erik Back

For more information on the SNAO,
please refer to our website:
www. riksrevisionen.se

The Swedish National Audit Office has audited the Riksbank's and Finansinspektionens' work regarding financial stability during the time-period 2005–2007 in light of the risk that the banks' expansion in the Baltic region entailed. The financial system is of great importance to the functioning of the economy and the Government has a general responsibility for the system's stability.

The audit reveals that the public authorities underestimated the risks – especially the liquidity risks – and that the stress tests carried out were based on overly cautious assumptions. Due to the Swedish banks' leading position in the Baltic system of payments, the Swedish Government received an implicit responsibility for the Baltic States' economic stability.

The Swedish National Audit Office recommends, among other things, that the authorities' mandates regarding the financial stability is reviewed and clarified and that the Government continuously should be made aware of the risks that the banks' operations in other countries bring about. The Riksdag could also consider organizing public hearings on financial stability.

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