

EEA and the Financial Services Sectors in Sweden

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EEA and the Financial Services Sectors in Sweden

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Foreword

When EFTA approached Sveriges Riksbank last year with a request to provide background information for an EFTA study on the impact of the EEA Treaty in the field of services, we accepted on the understanding that a separate report on banking and insurance would be published, including a full presentation of findings from the research being carried out. Occasional Paper No. 9 contains the results from the research.

The purpose of the study is to provide an analysis of the impact of West European integration on Swedish financial markets. The work has been carried out by a project group in the Riksbank, led by Emil Ems, Head of the Financial Markets Department, and including Eva Blixt and Erik Blomberg. At the outset, it was made clear that responsibility for the project would lie with that group. Thus the views expressed in the Paper are those of the authors and do not necessarily reflect those of the Riksbank.

The paper consists of three parts. In Part I Mr. Ems describes the perspectives and methods applied in the research, provides a summary of the main findings in the banking and insurance studies and finishes by presenting issues of concern to the authorities that arose in the context of the studies.

Parts II and III present, in detail, the results from the research concerning, respectively, banking and insurance. The authors apply an identical outline, in order to facilitate comparative reading and understanding of the findings. They start by providing a comprehensive description of the Swedish regulatory system prevailing in 1980. Thereafter they identify the changes in that system as well as in other factors influencing developments up to the present time. Then, in Chapter 2, they analyze the impact of those changes on market conduct and structure in, respectively, banking and insurance.

The core of the research is presented in Chapters 3 and 4. The authors first present the EEA legal system in banking and insurance and delineate the remaining need for adaptation to that system in Swedish legislation. Thereafter they attempt to visualise how that adaptation, together with other driving factors, might affect access to the financial markets and eventually the conduct and structure of those markets.

Mr. Ems chose to carry out the work in close co-operation with two reference groups consisting of representatives from business and the authorities in, respectively, banking and insurance. The Riksbank and the authors wish to thank the members of those groups: in banking, Olle Djerf, Sven Båkman, Margareta Falk, Hubert Fromlet, Bo Greborn, Ann-Christine Lindström, Björn Rosengren and Göran Wikner; in insurance, Gunvall Grip, Carita Gundberg, Margareta Kettis, Linnea Perttu, Olle Sahlin, Jarl Symreng and Lars Wedin. In addition, Sune Lennstrand, Lars Nyberg and Gabriel Urwitz were kind enough to read and comment drafts of the report.

It is the hope of the authors and Sveriges Riksbank that the results from the study presented here will stimulate further thinking on the topic of financial integration, by the authorities, academia and enterprises, within Sweden as well as in other West European countries.

Claes Norgren

Deputy Governor September 1993

Introduction

EMIL EMS*

As integration in Western Europe proceeds, decision makers and scholars continue to investigate the merits of the European internal market. The foundation stone was laid by the EC Commission in its pioneering efforts to identify the overall economic impact of the »Europe of 1992« (EC [1988]). Going from there, the Commission began a series of studies where various sectors of the economies of Member States were scrutinised. A study of the industrial sector was finished in 1990 (EC [1990]) and research in the field of services sectors is soon to be completed. The EFTA states, in their efforts to increase co-operation with the EC, have followed suit and commissioned or carried out corresponding studies on their own account (Krugman [1988], Pintado et al. [1988], Gardener & Teppett [1992], and Henriksen et al. [1992]). At present, the EFTA states are jointly preparing a study in the field of services under the auspices of the EFTA Council.

The content of the report before you is the result of research carried out in the Riksbank as an integral part of that EFTA study. In order to prepare the reader for the analysis presented in the main parts of our study, allow me first to delineate the perspectives we applied in our research and the methods used. Thereafter a short summary of the main findings is given, highlighting the similarities and differences between banking and insurance in this regard. Finally I will attempt to delineate some issues left untreated in this paper that would concern Government authorities as well as the Riksbank in view of the changes in the financial services sectors foreseen in the report.

Perspectives and methods

When planning this study, we decided to follow the overall aims of the joint EFTA research, which attempts to isolate, as well as possible, the impact of the legal system, underpinning the Internal Market, on the structures of the various services industries. From this follows that the analysis is carried out from an outsider perspective, the perspective of an industrial economist. In that vein, our main interest lay in

investigating how market conduct and structure in the financial markets in Sweden would be affected by the changes in the legal system induced by participation in the integrated financial market.

Having said this, it is clear that some issues, pertinent to the study of financial markets, might not receive, in our report, the close attention they deserve. In particular, the issue of systemic risks inherent in the credit market is left outside the scope of the work. Also we tried, when preparing the study, to adopt the stance of neutral observers. Ours was not the primal task to develop insights to be used by the financial enterprises in their efforts to maintain or improve competitiveness. Neither did we attempt to propose ways and means by which the public authorities might be able to improve the efficiency and stability of the markets.

Nonetheless, the results of our research might be put to good use for both enterprises on the market and the authorities. What the study does provide is a broad picture of possible changes in market behaviour and structure, resulting from adaptation to the EC/EEA legal framework for financial services as well as other strategic driving factors affecting the markets. Such an analysis, carefully done and consistent with theoretical insights into the behaviour of markets, will hopefully stimulate decision makers in enterprises and the authorities to develop further their own positions vis-à-vis the changed market environment.

The methods of analysis used in the report are qualitative and inductive. To obtain the intuition needed to predict future effects of institutional changes we look into the past. As a starting point for the analysis we undertake a comprehensive description of the regulatory system for financial markets in 1980. We then describe the changes in that system as well as in the structure of the financial markets since those heydays of regulation. When discussing changes in the latter, an attempt is made to isolate the effects of regulatory changes from those of other factors influencing market developments.

A pervasive concept used in the analysis is that of *market contestability*. This concept links the conduct and structure of markets to barriers to entry. The lower these barriers, the higher is the competitive pressure on the market. Competition would not

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necessarily require a large number of firms if a market were contestable, i.e., had low barriers to entry. The mere threat of potential competitors would lead the companies on the market to behave in a »quasi-competitive manner« (Baumol, Panzar & Willig 1982). We assume that changes in contestability, or barriers to entry, caused by changes in the regulatory system as well as by other factors, constitute the main source of dynamism in the market place.

Results from the backward looking analysis are then applied to the future. As a preliminary, the essential features of the EC/EEA legal system concerning financial markets had to be described. Having identified those features, as well as other future driving factors, we attempt to visualise how those factors might affect barriers to entry and thereby the conduct and structure of the financial markets. In that process we concentrate on the Swedish market place. At first sight this delineation seems somewhat artificial, one possible effect of integration being the emergence of Europe-wide or regional financial companies. Nonetheless, from a Swedish perspective, that emergence would translate into possible entry of large foreign companies on the Swedish market or possibilities for large Swedish companies to expand abroad, those aspects being discussed in our analysis.

Main results

A summary of the findings in the separate studies on banking and insurance gains by presenting the two sectors side by side. Although the banking and insurance markets are compartmentalised by different regulatory regimes, in Sweden as well as in other European countries, they cater, in many respects, for the same private and social needs. An identification of similarities and differences in market response to regulation and subsequent deregulation provides us with valuable insights into the economics of regulation.

Since the study deals with the impacts of West European integration on the financial services sectors in Sweden, the question needs to be answered, in which ways the basic legal concepts governing the EC Internal Market concept are being communicated to the Swedish system. One can identify essentially three waves of influence. The first was one of inspiration. Quite soon after the publishing of the EC White Book on the Internal Market (EC [1985]), the main principles put forward there made the Swedish authorities aware of the external barriers sheltering domestic markets.

The second wave was one of unilateral adaptation. Already in 1988, Government issued a bill prescribing that due regard should be given to adaptation to EC standards in future legislative actions. As a result, in banking, several restrictions against foreign penetra-

tion of the market were lifted, e.g. the ban on branches of foreign credit institutions and that on foreign ownership of Swedish institutions. In insurance the ban on marketing of policies by non-resident companies was partly lifted and a decision to allow unit-linked life insurance companies was reached in the same context.

Sweden is at present subject to the third wave of influence. Concurrently with the completion of the negotiations on the European Economic Area (EEA), the Government prepared proposals for a comprehensive adaptation, to EEA law, of the legal systems governing banking and insurance. Parts of those proposals have already been adopted by the Swedish Riksdag and further implementation is proceeding according to plan. Thereby, free establishment and free cross-border trade will be introduced for banking, the securities market and insurance, as well as a more competitive business climate due to adaptation to the EC legislation on competition.

At the outset, in 1980, both banking and insurance were strictly and comprehensively regulated. In addition to regulation by credit market and insurance legislation, policy rules and recommendations issued by Sveriges Riksbank as part of its monetary policy, as well as exchange controls, determined to a high degree the conduct of institutions, mostly in banking. Changes in that regulatory system, be it for domestic reasons or due to foreign influences, are among the major factors influencing the contestability of the financial markets, although other factors certainly also have substantial impact. The following sections will concentrate on the effects of regulation, as far as they can be discerned, referring the reader to the more comprehensive analysis in the separate studies on banking and insurance.

The opening of markets from »within«

During the 1980s, a substantial domestic deregulation took place prior to and concurrently with developments in the EC. The most important of those changes were the abolishing of the Riksbank's rules governing the conduct of banks and its rules concerning allocation of assets in banks and insurance companies. In addition, in insurance, the traditionally harsh principles for monitoring market entry by domestic contestants were alleviated, and new forms of insurance business such as captives and unit-linked insurance accepted, with the result that new companies outside of existing groups were established on the insurance market for the first time in four decades.

In terms of contestability, the main effects of these domestic changes in regulation can best be described as *the opening up of markets from »within«*, that is, an increase in competitive pressure arising mostly from

domestic sources. The resulting developments on the financial markets resemble, at least in banking, a classic deregulation cycle, with an initial expansionary surge, followed by elements of crises and, eventually, consolidation and restructuring of the market.

The banking sector, having been relieved of quantity restrictions and interest regulation by the mid-1980s, reacted by rashly expanding credit, accompanied by a continuing strong increase in the number of finance companies. Lending by banks, finance companies and mortgage institutions rose by some seventy per cent (in terms of GDP share) within a few years after the domestic deregulation, each institution seeking to take advantage of the more liberal business climate by trying to expand its market share. This sudden expansion in activities, concurrent with the prolonged economic boom of the 1980s, fuelled a speculative bubble in asset prices, especially real estate prices.

Profits in the banking sector at first seemed to rise, in the early dramatic years of adaptation. Soon, however, it became apparent that banks and finance companies had overextended their activities into high-risk projects and loans in foreign currency. This resulted in a sharp downturn of profits in the early 1990s and the advent of a financial crisis, affecting mainly those two types of institution, when the economic boom ended and the speculative bubble burst. A major weeding out and restructuring of enterprises occurred during that downturn period: banks diminished in number by some 25 per cent between 1988 and 1992, mortgage institutions by about 15. Finance companies suffered most, more than half of them disappearing. One can expect the consolidation phase to continue in the years to come.

In insurance, events were not quite as dramatic as in banking, since that sector had retained a large part of the essential features of regulation prevailing in 1980.

As an aside, this difference in the pace of deregulation indicates a difference in perspective between the authorities monitoring the respective sectors. Apparently, in insurance, authorities to a greater degree distrusted market forces to bring about an efficient provision of services to customers, a distrust that is shared by most authorities in continental Europe.

Nonetheless, we can witness important changes also in the insurance sector subsequent to the domestic deregulation of that market. With the acceptance of captive insurance and, especially, the abolition of a needs test for granting authorisation, domestic entry on the market became a reality. Since then the number of nation-wide insurance companies has risen from 43 to 82. Moreover, since the introduction of unit-linked insurance, seven additional companies were established to service that market segment, of which one is part of a banking group and two are jointly owned by banks and insurance

companies. In that more competitive environment, traditionally strong co-operative links between the firms loosened. The companies increased their efforts to introduce new products and distribution channels, besides starting to promote their products more aggressively.

As in banking, the nation-wide insurance companies were apparently successful after the mid-1980s, with high operating returns throughout the decade. But also in insurance, the effects of deregulation (together with other changes affecting the market) were ultimately felt. Apart from returns from assets, the companies' net income followed a negative trend. That trend was hidden, however, by rising investment income, mainly due to rising asset values in the latter years of the economic boom. When the speculative bubble burst, strains on operating profits came out in the open in insurance as well as in banking.

Almost as an afterthought, the public authorities will, starting from 1994, introduce a new type of pension saving, that will intensify competition between credit institutions, investment funds and life-insurance companies in the field of pension insurance. The results of that introduction have yet to be seen but will certainly not be negligible.

We can expect that the opening of markets »from within« eventually will lead to »leaner«, more competitive enterprises in both banking and insurance. Market structure has become more centralised in banking, somewhat less so in insurance. This reflects a difference in regulation at the outset, implying more efficient barriers against establishment of new domestic companies in insurance. More important, the largest companies have, in both sectors, become more equal in size, thus diminishing the risk of market dominance by one or a few enterprises. Companies are also working hard to decrease administrative slack and operating costs have started to fall in recent years. In addition, the companies are beginning to introduce modern methods for risk management, the financial crisis having taught them the pernicious effects of negligence in that regard. Thus, on balance, the enterprises on the financial markets might now be in a better position to face the challenge of external liberalisation than if domestic regulation had remained unchanged since 1980.

The opening of markets from abroad

In contrast to domestic deregulation, adaptation to the EEA regime leads to an increase in competitive pressure mostly from abroad, although some parts of the adjustment could give rise to increased pressure also by domestic contestants, as will be discussed below.

As in most European countries, the Swedish financial markets were mostly closed to foreign

companies in 1980. During the 1980s, a gradual loosening of the prevailing barriers took place. Still, in 1990, foreign credit institutions could not yet establish branches in Sweden or purchase shares in Swedish institutions. Cross-border trade in banking was basically limited to »wholesale« trade (inter bank trade and banking services provided to large enterprises), »modalities« in foreign capital transactions still presenting effective barriers to ordinary customers.

In insurance, rules appeared on the surface to be more liberal. Foreigners were allowed to acquire domestic companies and establish general agents (but not to establish branches). Cross-border trade was also seemingly open. However, incentives for acquiring companies were low, since domestic life-insurance companies were not allowed to pay dividends on profit and a majority of companies, both life and non-life, were mutual, not being for sale due to their association statutes. Concerning cross-border trade, foreign insurance companies were still forbidden to actively market their products in Sweden, having to use brokers or Swedish insurance companies as an intermediating party. That limitation was effective mostly in mass-risk insurance, other types of insurance having little difficulty in surmounting the handicap.

When trying to foresee the ultimate effect of abolishing such barriers, one risks falling into the trap of the current visionary vogue. When the basic ideas of financial integration were first put forward, in the mid-1980s, a generally held opinion was that such integration would give rise to a considerable wave of establishments by non-resident companies and a substantially intensified cross-border trade. Through both these developments the large companies in the European financial markets were thought to be able to exploit economies of scale and scope, possibly attainable in full first at an international level of business.

As the internal market is now taking the final steps towards completion, this basic presumption has largely given way to a counter-proposition, albeit expressed in more cautious terms. Experts on Community affairs as well as representatives for the financial companies tend to stress that the effects of integration might after all be rather limited. These opinions are being mirrored by Swedish experts.

One of the arguments is that Sweden may be too small a market to kindle interest in companies from other European countries, rendering a wave of establishment from abroad unlikely. As to cross-border trade, one can point to a number of reasons why customers may continue to prefer domestic suppliers, such as brand loyalty and preferences for domestic products, differences in the legal system (in particular contract law), differences in currencies and so on.

Granting that nobody can look into the future, our research paints a more varied picture. It is hardly

appropriate to make statements about the financial markets at large; different market segments will be subject to foreign influence in different ways.

Wholesale banking, for instance, is already thoroughly internationalised and thus a counter-example to the above proposition. In insurance, reinsurance and the provision of large-risk products in non-life insurance are likewise subject to international competition. In both these market segments large customers, typically large companies, are already used to choosing their partners among internationally active suppliers. The direct effects of adaptation to EEA legislation would therefore be minor in these segments, although for reasons other than put forward above.

In the remaining markets, retail trade in banking and mainly mass-risk in insurance, our findings indicate that, at least in the long run, the structural effects could be considerable, though possibly more pronounced in insurance than in banking.

The costs of establishing an efficient presence in Sweden have substantially decreased since permission was granted to foreign companies to open branches. In addition, in banking, the acquisition of Swedish companies is now permitted making it possible for foreign banks to get access to a whole network of branch offices in Sweden at short notice. In insurance, if tax deductibility for pension insurance were to be extended to branches established by foreign companies, such establishment might appear attractive.

Concerning cross-border trade, remaining barriers might not be that difficult to overcome. Brand loyalty and preferences for domestic products are subsiding in importance in the aftermath of domestic deregulation and the financial crisis, customers of banking and insurance services increasingly being aware of the risks taken by domestic companies and of the high prices for financial products currently being charged to overcome the crisis' detrimental effects on profits. Among other factors that are loosening the traditionally strong links between customers and companies in the run up to completely free cross-border trade, are the prevailing taxes on interest return on savings in banks, and on return on assets in life insurance. In addition, brokers can be expected to contribute to a more efficient marketing of cross-border services. In insurance, such mediation is already fairly pronounced, and it might also start to penetrate part of the retail market in banking.

Thus, the barriers to entering the Swedish financial markets will be subject to a multitude of withering forces. The short run effect is unlikely to be entry by a large number of contestants from abroad. Also in cross-border trade an increase due to the EEA legislation would, in the short run, occur mainly in streamlined products such as standardised policies in life insurance. Instead we can, already in the short run,

count on an increased awareness of the threat of potential competition from abroad, inducing companies to adopt a more competitive behaviour, in accordance with the ideas put forward by Baumol, Panzar & Willig.

A contributory factor to the latter should not be forgotten. It relates to the enhanced professionalism and transparency in carrying out business and managing assets resulting from the adaptation to EEA legislation concerning rules on disclosure, accounting, solvency and management of assets. The effects would be more pronounced in insurance than in banking, credit institutions already having adopted new solvency rules as a result of international co-operation outside the EC and otherwise abiding by rules basically similar to those of the EC.

»In the *long run* we are all dead«; those words from the father of modern macroeconomics remind us that, apart from one's demise, nothing can be taken for granted when looking far into the future. Nonetheless, our analysis leads us to the general conclusion that foreign presence will gradually become more pervasive.

In banking, one could envisage one or several banks being acquired by a foreign bank striving to establish a pan-European or north European network. One might also see a continuing entry by small niche companies, being established as e.g. branches, catering to specific profitable niches in wholesale or retail banking. A comparable development could be expected in insurance, although foreign acquisitions might be less likely in that market. Furthermore, in life insurance, the establishment of branches and the further expansion of cross-border trade would be dependent on which direction future tax reforms take.

At the same time, the large Swedish groups in banking and insurance will not stand idly by while the foreign presence is increasing. They will react internally, e.g., by keeping their internal administration lean, continuously improving methods for risk management and asset management, rethinking their product strategies, introducing more competitive pricing (for instance, in banking, doing away with cross-subsidisation of products) and externally, by defensive regrouping of companies or, more offensively, by rekindling strategies for internationalisation, once the necessary consolidation after the financial crisis has been dealt with. We can only point to the possibility of such actions and reactions. To predict the precise outcome of the process of interaction is, of course, beyond the scope of research presented in the report.

Where to go from here?

Given the character and scope of our analysis it is natural to ask which matters would concern Govern-

ment authorities as well as the Riksbank in view of the changes in the financial services sectors foreseen in the report. Without attempting a thorough analysis at this stage, two issues emerge in my opinion as especially worthy of the authorities' attention. The first relates to the stability of the financial system. The second, closely linked to the first, concerns the Swedish legislative system for the credit sector and the roles to be played by Government, the Supervisory Authority and the Riksbank in that overall legal framework.

Addressing first the stability issue, much has been said and written on that subject, in Stockholm as well as in Basle and Brussels. Allow me therefore to concentrate my comments on the aspects arising specifically, in Sweden, as result of adaptation to the EEA financial system.

First the financial markets will, at least in the long run, experience a greater number of foreign companies being active on the Swedish market, thus drastically increasing the institutional interlinkages that could transmit financial disorder from failures in foreign institutions. This poses a particular problem in the EEA context, since with the principle of home country control, the main supervisory responsibility for affiliates of foreign financial institutions is reserved for the institutions' home countries. The Swedish supervisory authority, as well as the Riksbank, might experience that their grip on foreign institutions present in Sweden is curtailed. This new situation has to be considered and workable arrangements found for surveying those institutions in co-operation with authorities in other countries.

Secondly, the stability properties of the Swedish financial markets at large will change as result of the adaptation. The former regulatory system, prevailing until the 1980s, held a firm grip on financial institutions, but at the same time provided them with a sheltered and controlled business environment that protected and cushioned them from external disorder. With the existing and foreseeable domestic and external changes in that system, a competitive business environment is being introduced, leading to leaner companies with profit margins clearly below the comfortable levels of yore.

Even if the companies on the market do live up to the new challenges by introducing more elaborate cost control systems, risk management systems and efficient pricing strategies, this will not, with increased contestability, have a lasting effect on profit margins. In essence, financial companies will become more vulnerable to external shocks and mistakes in business strategies than they were a decade ago. Neither will the solvency rules introduced by the Basle Accord and the EEA Treaty essentially alter that basic consequence of heavier competition.

The implication of this greater vulnerability is that recurring failures in financial institutions are to be

expected, not only in times of heavy recession but also during periods of more ordinary business cycles. At first this risk will be more pronounced in banking than in the insurance sector, the latter to a considerable degree consisting of mutual companies, where failure occurs only gradually and in the form of diminished disbursements to policy-holders/owners. Over time, when more companies on the insurance market become incorporated, failure in the true sense of the word will become a common fact also in that market. It is clear that the strategies of the Government as well as of the Riksbank need to be overseen in view of this change in the pattern of stability.

The second issue relates to the Swedish legal system circumscribing the institutions on the financial markets, in particular in banking. It is true that this system will be fully adapted to EEA law within the near future. But it should be recognised that this adaptation represents just a starter in continuing efforts to provide Sweden with a consistent and well functioning legal system for the financial markets.

Lawyers and policy makers, when drafting new laws, have a tendency to conservatism, that is, to keep features of the old system as long as these do not seem to be in conflict with the new norms. When studying the new laws for credit institutions to be in accordance with EEA law, one discovers inconsistencies between the logic of the old system and the principles of EEA law, those conflicts not having been apparent when the new laws were being prepared.

For instance, in the old legislation, co-operative institutions like savings institutions or building societies accepting deposits from their members were outside the sphere of public regulation. In legal terms they were not considered to be credit institutions, since they did not accept deposits from the general public. EC law does not recognise such a distinction, leading to the conclusion that those bodies would be credit institutions under the EEA Treaty. However, by the new Swedish law in banking, credit institutions which are not banks will have to be incorporated, thus leaving no legal room for co-operative ventures.

Another heritage from the past, is the delineation of »banks« from other credit institutions. In Sweden, banks are defined as being the only credit institutions allowed to accept deposits from the general public. From this it follows that they are more strictly regulated by the authorities but also that they have access to clearing and financing facilities offered by the Riksbank and are under the guarantee of the Government and the Riksbank (as has been demonstrated by the support scheme installed in connection with the financial crisis). In that context two considerations might have to be made by the authorities.

First, the legal delineation of a »bank« has to be reconsidered and a better definition found for func-

tions or institutions needing special regulation by the Government. Second, it is not self-evident that all credit institutions defined as »banks« in Swedish legislation should have access to facilities offered by the Riksbank. Our research indicates that the boundaries between various financial institutions are becoming increasingly blurred and that one can expect a greater variety in the appearance of credit institutions in the future, be it in the form of Swedish companies or foreign affiliates. That indicates that the Riksbank might need to reconsider which institutions should have close relations with the Riksbank and in which form.

These examples do not exhaust the list but nonetheless convey the message that the regulatory system governing credit institutions, and possibly also insurance, might soon need another comprehensive review. The purpose of that review would be to arrive at a system flexible enough to allow desirable structural changes, but at the same time with appropriate provisions for safeguarding the stability of the financial sectors.

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II

Banking

ERIK BLOMBERG*

1 The regulatory framework and other factors affecting developments

In the present chapter, the main factors determining the industry's structure are identified. The regulatory system in 1980 is outlined as a starting point. Subsequent changes in this system and other factors affecting development are then described.

1.1 The regulatory system in 1980

In 1980, the financial system in Sweden was strictly regulated and markedly institutional (mainly bank oriented). The various types of credit institution (banks, finance companies, and mortgage institutions) were regulated by basically two sets of legal instruments: policy rules issued by the central bank (the Riksbank) as part of its monetary policy, and regulation by credit market legislation. Competition within as well as between various types of financial institution was, as a result, limited.

Monetary policy and foreign exchange policy in the post-war period were, up to 1986–89, implemented in accordance with the Act concerning Credit Policy Instruments, the Swedish Riksbank Act, and the Act on Foreign Exchange Control. The aim for the Riksbank was to regulate the total flow of credits, partly so as to allocate sufficient funds to the Government and housing sectors.

The Credit Policy Instruments Act and the Swedish Riksbank Act enabled the Riksbank to apply certain instruments to credit institutions. These instruments included liquidity ratios, credit ceilings, control of the institutions' bond issues (issue control), and cash requirements in order to control and direct total credit flows. With a view to controlling interest rates, the Credit Policy Instruments Act entitled the Riksbank to set interest ceilings on bank lending. To channel funds to the Government and housing sectors, this Act also provided for the imposition of investment ratios on banks and insurance companies. Besides the Government and housing sectors, some priority in the allocation of lending was given to parts of the business

sector. Effectively, credit restrictions mainly impinged on the household sector.

The rules issued by the Riksbank, along with the credit market legislation, were also selective in their effects on credit institutions. Most restrictions were aimed at controlling bank lending. There was usually some delay before regulatory measures were extended to other types of financial activity, carried out in non-bank institutions.

In addition to these domestic regulations, the Act on Foreign Exchange Control aimed at isolating Sweden, as far as possible, from international capital movements.

The Exchange Control Act was also a barrier to cross-border trade, since all payments had to be conducted through banks authorised by the Riksbank, and cross-border trade in securities was not permitted. Furthermore, Swedish citizens were not allowed to have deposit accounts abroad.

In Sweden, as in most other countries, *credit market legislation* was oriented towards institutions rather than towards financial functions. This meant that different types of credit institution were regulated by different laws. All credit institutions were, in general, more heavily regulated than non-financial enterprises in Sweden.

Banks. Traditionally, banks have had a central role among credit institutions with, in Sweden, the exclusive right to accept deposits on account from households, enterprises and local authorities (referred to in the following as the non-bank public). The Riksbank Act stipulated that only commercial banks were allowed to borrow from the central bank. However, since the savings banks and the co-operative banks each owned a commercial bank, all banking groups had access to this facility.

The regulation of banks was based on three laws with origins in the 1950s, one for each type of bank. After 1968, the legal conditions for conducting banking activities were basically the same for all banks. In 1980 the main remaining legal difference concerned the legal form of the business entity. Savings banks did not have direct owners and their corporate form resembled that of a foundation. The co-operative banks operated as incorporated associations. The commercial banks were limited banking companies.

* Erik Blomberg, Financial Markets Department, Sveriges Riksbank

The banking laws had three main components, dealing respectively with authorisation procedures, operational rules, and supervisory rules. The laws were in place mainly to assure the safety and soundness of the banking activities.

The bank *authorisation (charter) procedure* stated that the applicant had to satisfy certain minimum requirements for financial stability, managerial competence, etc. It also included a qualitative judgement, in that the applicant had to provide proof of a need for a new bank (i.e. a "market need" test).

The *operational rules* in the Swedish banking laws specified the types of activity a bank may engage in. Bank operations were limited to lending, borrowing, and related activities. This was accompanied by a number of restrictions, mainly concerning the assets which banks were allowed to acquire. These restrictions were designed to prevent banks from carrying out activities that were not considered sound banking business. For instance, Swedish banks were forbidden to acquire shares, the reason being that they should not be exposed to corporate risks other than those inherent in their banking operations. They were also forbidden to own real estate apart from such real estate as was considered necessary for the conduct of their business. The operational rules also included capital requirements, to safeguard depositors' money, and prudential rules concerning the granting of credit. The latter, however, were so generally formulated that they could be seen as a recommendation that a bank should strive to reduce the risk taken and that mismatches should be avoided as far as possible.

The *supervision of banks* was performed by the Bank Inspection Board.¹ Its main tasks were to ensure that banks complied with the laws and carried out their operations in a sound way. The Board also had significant powers to supplement the banking laws with its own rules and regulations.

Other credit institutions. In 1980, the legislation governing non-bank credit institutions was not notably uniform. Each institutional form was regulated as it emerged on the market. This meant that different groups of institution were regulated by different laws, though as a rule to a lesser degree than banks.

Prior to 1980, non-bank owned *finance companies* were not regulated as such, only by the Swedish Companies Act and, indirectly, by being debarred from certain bank activities (i.e. accept deposits on account). This gave them a comparative advantage stemming from liberal regulation.

In 1980, the Finance Companies Act came into

existence and the Credit Policy Instruments Act was extended to apply to such companies. Even so, finance companies continued to be less regulated than other forms of credit institution. No authorisation was required. Apart from rules on lending and a ban on refinancing with negotiable instruments of debt (i.e. certificates and bonds), the Finance Companies Act contained few rules concerning operations. However, a distinction was made between bank-owned and other finance companies: the former were not permitted to supply loans that could be provided by the parent banks (e.g. direct credit to households).

In that finance companies were brought in under the Credit Policy Instruments Act, all groups of credit institution were supervised by the Bank Inspection Board.

Mortgage institutions were either credit companies or co-operative mortgage institutions. Credit companies were regulated by the Credit Companies Act and co-operative mortgage institutions by separate laws for each institution.

Credit companies conducted lending operations against collateral in the form of mortgages. Each institution specialised in a certain business segment (e.g. housing institutions had the exclusive right to grant Government subsidised and basic loans that qualified for interest relief).

The three co-operative mortgage institutions had to operate on a non-profit basis. Their business was similar to that of credit companies. They had a semi-official character, since the Government to a great extent had guaranteed their ability to fulfil obligations.

Mortgage institutions were not permitted to borrow on the short-term market. They obtained funds primarily by issuing priority bonds in the banking and insurance sectors.

International aspects. In 1980, foreign-owned credit institutions were not permitted to compete on the Swedish market, either through establishment or by cross-border trade. One exception was that, from 1980 to 1983, the Finance Companies Act contained no explicit restrictions on foreign ownership.

Swedish commercial banks, on the other hand, were allowed to establish subsidiaries abroad. They were, however, not permitted to open branches. Savings banks and co-operative banks did not have the right to establishments abroad.

Finance companies were allowed to set up subsidiaries abroad, but not branches. Mortgage institutions were in practice prevented from expanding abroad by their by-laws or articles of association.

As mentioned before, the foreign exchange regulations also obstructed international competition; for instance, all transactions had to be made via authorised banks and Swedish citizens were not allowed to have deposit accounts abroad.

¹ The Bank Inspection Board and the Insurance Inspection Board were merged in July 1991, forming the Financial Supervisory Authority.

1.2 Changes in regulation

For most of the post-war period, the policy rules which regulated the business activities of banks and other credit institutions in Sweden were basically unchanged. It was not until the 1980s that the authorities adopted a policy of successive deregulation, mainly because the existing regulatory system was becoming ineffective, as new channels were created for the extension of credit.

The process of deregulation in Sweden started rather late in relation to that of several EC countries but it accelerated in the 1980s; most of the regulatory framework has now been thoroughly reformed, leading to substantially changed conditions for banks and other credit institutions.

Internal deregulation. The application of liquidity ratios had led the banks to limit direct lending in favour of increased holdings of so-called priority bonds. This created an interest and liquidity mismatch. After the liquidity ratios had been abolished in 1983, the banks were able to rectify the interest mismatch by reducing their bond holdings. Another change with a similar effect was the introduction of treasury bills (see Section 1.3).

In 1985, the recommendations for bank lending rates were abolished, as were the recommendations and regulations on credit ceilings for banks, housing institutions, and finance companies. In 1988, the Riksbank Act was amended, enabling all types of bank to borrow from the central bank, thereby putting banks on an equal footing vis-à-vis the Riksbank.

The current banking legislation, which dates from mid 1987, has also helped to make conditions more uniform than they were under the legislation from 1968. The new Banking Business Act applies to all banks and contains provisions regarding the activities in which a bank may engage, as well as other regulations concerning banking operations, for example, granting of credit, capital adequacy requirements, accounting procedures, and supervision. The new Acts concerning Banking Companies, Savings Banks, and Co-operative Banks, respectively, are confined to regulations regarding the formation of banks, bank management, shareholders' meetings, winding up and dissolution, mergers, etc. The major remaining difference in the treatment of the three types of institution concerns foreign establishment: only commercial banks are allowed to establish entities abroad.

Finance companies owned by banks used to be debarred from arranging loans that could be provided by the parent bank. This restriction was abolished at mid 1987, improving competition between finance companies.

In 1988, most of the remaining restrictions on mortgage institutions' terms for certificate and bond issues

were removed, except as regards the financing of new housing projects with Government loans. Mortgage institutions could now also compete on the market for loans with flexible interest rates and were also allowed to provide loans with short maturity.

Since August 1991, finance companies are permitted to refinance with negotiable instruments (i.e. certificates and bonds).

In 1991, changes in the savings bank legislation allowed these banks to become limited companies, the aim being to facilitate their acquisition of own equity capital.

The same year, new rules of ownership were introduced for banks and insurance companies. Swedish banks on the one hand and insurance companies on the other are now allowed to be linked by ownership, either by owning shares in each other or by belonging to the same holding company.

External deregulation. A strong impetus for change in national financial markets has been the growing liberalisation of cross-border capital flows. Until recently, foreign exchange controls and other restrictions on cross-border transactions were obstacles to trade in financial services and to the establishment of financial institutions in Sweden, and Swedish institutions abroad.

The restrictions have been dismantled, beginning in 1985, when foreign banks were allowed to establish subsidiaries in Sweden. Since 1987, moreover, Swedish banks are allowed to have branches abroad.²

Restrictions on foreign ownership in Swedish credit institutions were removed in 1990. Non-residents are now permitted to acquire such companies. Foreigners also attained the right of establishing subsidiaries that conduct finance company operations as well as securities trading operations. At the same time foreign banks were allowed to conduct banking business through branches in Sweden, though a formal banking licence is still required. The so-called market need test (described in Section 1.1) was abolished. In the following year, 1991, it also became permissible for foreign-owned companies to conduct finance company operations and securities trading operations through branches.

Most of the regulations concerning foreign exchange transactions via banks were abolished in 1989. Thus, non-residents are permitted to invest in Swedish interest-bearing securities and Swedish residents are allowed to invest in foreign securities without hindrance. For reasons of tax control and statistical purposes this was accompanied by new legislation on cross-border payments etc. This prescribed that pur-

²One advantage of a branch is that it can rely on the capital of the parent bank, whereas a subsidiary has to have an independent capital base.

chase or sale of Swedish securities, as well as payments to and from abroad, were to be conducted, as in the past, through a currency trader authorised by the Riksbank. Foreign securities acquired by Swedish residents had to be placed in deposit and individuals were not allowed to have deposit accounts abroad. However, by the turn of 1992, all these restrictions had been removed.

Prudential regulation. After the period of deregulation in the 1980s, supervisory coverage has been expanded, to harmonise and strengthen prudential standards, both in a national and in an international context, and to establish international co-operative arrangements.

The new Finance Companies Act, from 1988, includes an authorisation requirement for all financial activities aimed at consumers regardless of the amount.³ As a result, authorisation is now required for most types of financial activity in Sweden.

During the 1980s, international negotiations were conducted to establish common standards for banks' capital adequacy in relation to credit risks. In 1988, the G10 countries concluded the Basle Accord, specifying capital requirements for internationally active banks. According to this agreement, the minimum ratio of capital to risk-weighted assets is 8 per cent.

In Sweden, the standards agreed upon in Basle were adopted by Parliament in February 1990, and the 8 per cent minimum ratio has been in force since the beginning of 1993. The Swedish legislation is more comprehensive than the Basle Accord. The 8 per cent ratio is applicable not only to internationally active banks but to all credit institutions. Furthermore, it is applied both on a consolidated basis (in keeping with the Basle Accord) and to each credit institution that is part of a financial group.

The deregulation has made the supervision of the financial system more complex. Previously, the main task of the supervisory authority was to ensure compliance with the formal criteria. Today, more attention has to be paid to risk management systems, etc.

1.3 Other factors

Internationalisation and technological development.

The deregulation of the Swedish credit market in the 1980s must be seen in the light of the concurrent internationalisation of the economy and the development of market technology.

³The Act exempts companies whose activities mainly comprise the financing of goods or services which are sold by the company or other companies in the same group. Companies engaged solely in business finance have to be authorised if the net value of financial assets exceeds SEK 50 million.

Both the real and the financial components of the Swedish economy have gradually become more integrated with the international economy. International dependence has grown in two main respects. First, from the beginning of the 1960s, the international expansion of Swedish companies made it natural for Swedish banks to follow them abroad and offer them and their subsidiaries bank services in new markets and in new fields of activity.

Second, due to imbalances in Sweden's current account, international dependence as a borrower has been growing ever since the mid 1970s. A deficit on the current account appeared in 1974 and is now a recurring feature of the Swedish economy. Already in 1974, exchange regulation was amended to facilitate international financing of the deficit. These changes led in time to a marked accumulation of foreign debt in banks and other parts of the private sector. The financial markets became increasingly internationalised. As lending and borrowing in foreign currencies became more common, Swedish banks also took part in financial innovations and other activities associated with the international financial markets.

Technological developments have enabled credit institutions to supply new products (e.g. electronic transfer of funds, together with a wider use of plastic cards) and have reduced transaction costs. Technological innovation in computers and communications has also facilitated the introduction of new financial instruments. Futures, forwards, swaps and options have developed during this period. The secondary money and bond market has also grown significantly, creating new possibilities for financial intermediaries. Another important impact of technological development is the improvement of accounting and control systems within the credit institutions, thereby providing essential facilities for the growth of financial activities.

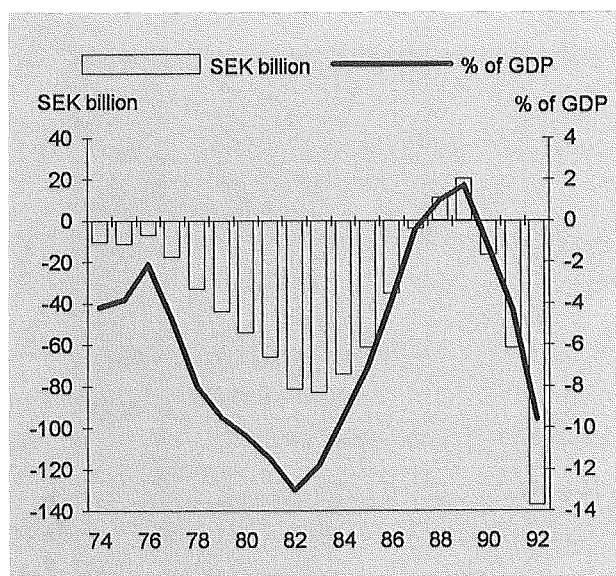
Internationalisation and technological development go hand in hand. Financial innovations can be spread immediately to intermediaries all over the world. After the deregulation of international capital markets, intermediaries face similar cost structures and have equivalent access to the new techniques. Thus, internationally active Swedish banks now operate on a competitive international market for wholesale banking services.

Securities market. In Sweden, trading with securities is conducted on the stock exchange, the money and bond market, and the market for derivatives.

The securities market satisfies essentially the same need as the institutionalised part of the financial system, namely allocation of capital and risks. The main differences lie in the organisational structure and the degree of product standardisation.

The development of the securities market in

Chart 1.1 Central Government budget balance



Source: Ministry of Finance

Sweden affected credit institutions in two opposite ways. Banks are heavily involved in the securities market in their capacity as issuers and providers of brokerage services. At the same time, the money and bond market is a competitor to the market for institutionalised credit, since it provides alternative channels for funding.

The money and bond market started to develop in 1980, when banks began to issue certificates of deposit. As there were no market makers initially, the banks had to guarantee the issues. In 1981 an electronic money market information system was introduced and an efficient primary money market was developed. However, the secondary market remained small, since bank certificates have short maturity and are normally tailor-made rather than standardised.

The Government budget deficit had started to grow in 1976 and reached a peak in 1983 at SEK 83 billion (Chart 1.1). The rising borrowing requirements could not be met by the traditional institutional buyers of Government paper. When the Government now turned to the non-bank public, it had to offer market conditions. The issue of short term treasury bills (Statsskuldsväxlar) at market terms began in 1982, and of bonds (Riksobligationer) in 1983. This laid the foundation for a rapidly growing, efficient money and bond market. This in turn had profound implications for the deregulation of the credit market since it accentuated tensions in the old priority system whereby banks, the National Pension Fund and insurance companies were forced to invest in low yielding priority bonds.

The new, market-oriented management of Government debt also created opportunities for other groups of borrowers. Finance companies, with primarily short-term funding, benefited from the emergence of

a short-term money market (see Chart 1.2). Similarly, mortgage institutions, funding long term, benefited most from an efficient bond market (see Chart 1.3).

The Swedish money and bond market has evolved from virtual non-existence in 1980⁴ to a point where it is highly developed and integrated with foreign markets. Today, all forms of instrument used in the international sphere are also permitted in Sweden (e.g. futures, options, swaps, zero coupon bonds, and asset-backed securities), and an electronic system for information about instruments traded on the Swedish money and bond market ensures efficient trading. Furthermore, clearing and book-entry systems have been developed.

Besides the reasons outlined above, the significant subsequent growth of the money and bond market had to do with the structure of the Swedish market, which with its large lenders and borrowers is well suited for mass trade of standardised financial instruments. Large lenders on the market are mortgage institutions and the state, as discussed previously. While the National Pension Fund, banks, and insurance companies were obliged, under the old regulatory system, to place large sums at low risk, they also had a need to do so. Thus, they placed large parts of their assets in Government securities and housing securities. The earlier regulation accordingly paved the way for the subsequent emergence of a liquid market in bonds.

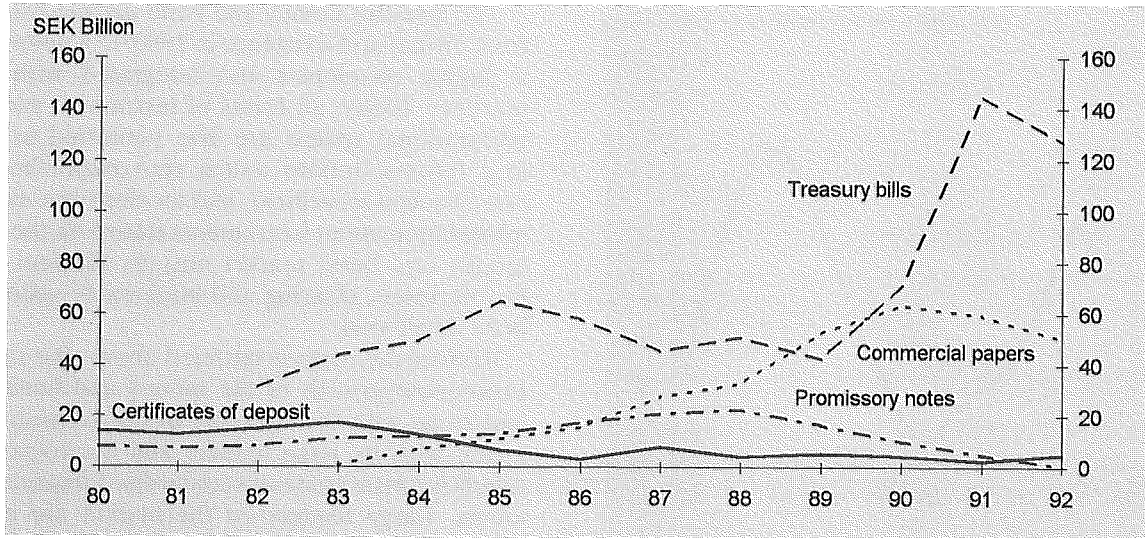
Taxation. The structure of the tax system and its reform are also important forces behind the changes in the structure of the credit market.

After an initial reduction of marginal taxes in 1983–85, the Swedish tax system was reformed comprehensively in 1990–91. Tax bases were broadened and marginal rates of income tax were lowered and harmonised with capital taxes. This greatly reduced both the tax rates on interest income and the deductibility of interest expenditure, the aim being to stimulate saving and capital formation. In addition, a withholding tax for Swedish citizens on interest income was introduced, as well as information requirements for banks, making tax evasion more difficult.

Another important element of the tax reform is the more equal tax treatment of different types of financial institution and of financial compared with non-financial institutions. This was done, for instance, by curtailing provisions for tax exempt reserves. Thus, whereas banks had a lower effective tax rate on corporate profits than other companies

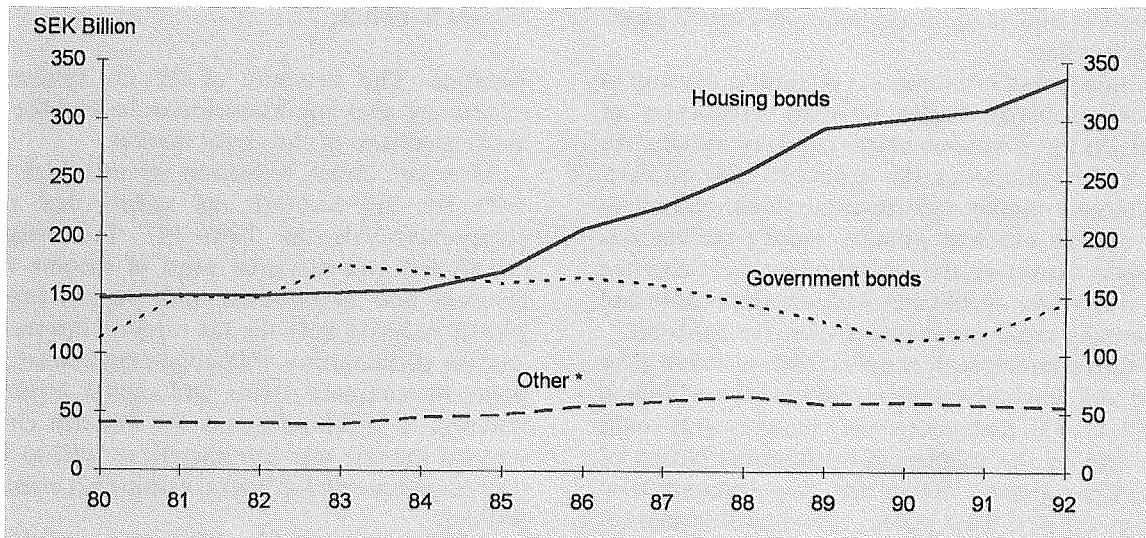
⁴The stocks of securities in Charts 1.2 and 1.3 in the early 1980s, instead of being traded in a secondary market, represented mainly funds that banks, insurance companies and the National Pension Fund transferred to mortgage institutions and the state in accordance with the regulations.

Chart 1.2 The Swedish money market
Year-end stock at real values (base 1980), SEK billion



Source: The Riksbank

Chart 1.3 The Swedish bond market
Year-end stock at real values (base 1980), SEK billion



* Other includes: Local authority bonds, other intermediary bonds, corporate bonds and bank bonds.

Source: The Riksbank

before the reform,⁵ they are now approximately on an equal footing.

Macro economic developments – financial crisis. Financial crises erupted in several countries in the 1980s, notable examples being the bankruptcies

⁵This is particularly the case for savings banks and co-operative banks, since they have had larger untaxed reserves than commercial banks.

among Savings and Loan Associations in the USA and the growing problems of financial institutions in the UK, Australia and Japan. However, the problems of the financial systems in the Nordic countries are doubtless the most severe. The basic reasons for the severity of these problems in the Nordic countries are the same. Each country experienced a series of years when lending expanded rapidly, mainly as a consequence of deregulation and strong economic

growth. These trends were then finally broken by economic downturns. Norwegian banks were struck first, in 1987, the triggering event being the sharp fall in oil prices. For Finland, the breakdown of the East European economies led to a slump for exports and subsequent financial decline.

In Sweden, the problems in the financial sector became apparent when the prolonged upswing turned into recession and several policy changes affected the credit market concurrently. The effect was a boom and bust cycle, mainly in real estate, which triggered the financial crisis. As a result of the old regulatory system, which gave priority to housing construction, Swedish credit institutions had more real-estate-related lending than their counterparts in most other countries.

The course of events is perhaps best described on the macro level, where a number of factors caused the financial markets to grow during the persistent upswing from 1982 to 1990.

First, the deregulation of the financial markets, in particular the abolition of credit ceilings in 1985, paved the way for an expansion of lending from banks, finance companies, and mortgage institutions.

Second, with the economy booming, fiscal policy was not sufficiently tight either before or during the boom and the role of monetary policy was restrained due to the fixed exchange rate regime.

Third, borrowing was stimulated by high inflation and expectations of further high inflation, together with the combination of high marginal rates of income tax and generous tax allowances for interest expenditure.

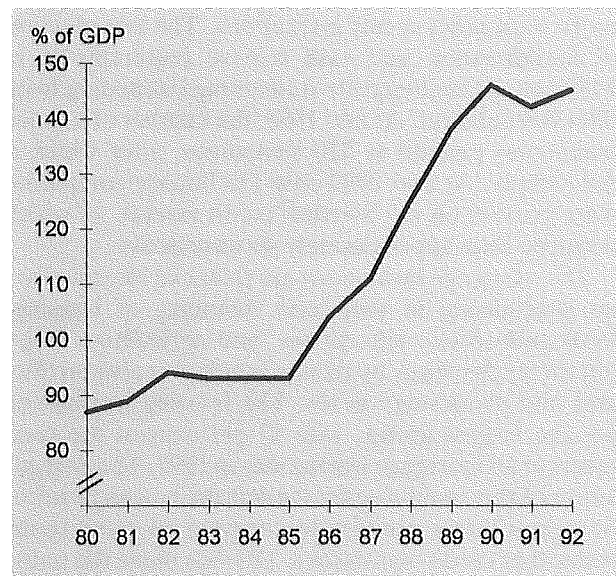
As a result, lending by credit institutions shot up to 150 per cent of GDP just a few years after the deregulation (Chart 1.4). Asset prices, especially in real estate, soared, further fuelling the expansion of credit without sufficient risk management by the credit institutions.

This lending boom was finally broken by a combination of:

- a contraction of the economy: the GDP growth rate dropped from 2.4% in 1989, to 0.4% in 1990, and -1.1% in 1991;
- the reform of the tax system, which drastically increased interest costs net of taxes;
- decreasing inflation: the rate of inflation went from high to low (the problem lies, not in the low rate of inflation, but in the transition from a high rate) and real rates of interest rose substantially (the real rate of interest after tax went from -7.7% in 1980 to 8.6% in 1992);
- decreasing subsidies to the housing sector.

The financial crisis is having a major impact on the structure of the banking industry. For a discussion of these effects, see Section 2.6.

Chart 1.4 Credit institutions' total lending
As a percentage of GDP



Source: The Riksbank

2 Structural development of the Swedish credit market

2.1 Basic features

The main characteristics of the different forms of credit institution can be described as follows. *Banks* maintained the strength in their traditional activities throughout the 1980s: commercial banks specialised in short-term credit to businesses, savings banks mainly in channelling household savings to the housing sector and to local authorities, and co-operative banks in receiving deposits from and lending to the agricultural sector. However, during the second half of the 1980s and the early 1990s, diversification has become more prominent. The big savings banks, as well as the co-operative banks, have been merged and transformed into commercial banks, thereby sharply reducing the total number of banks from 190 in 1980 to 108 in 1992.

Finance companies are heterogeneous as to ownership, size, and kind of activity.¹ The main activities of finance companies are leasing, factoring, credit card financing, and conventional lending. Their strengths have been flexibility and active marketing. Finance companies originally emerged as complements to the banks' lending activities, the latter having been

¹ From this it follows that the features presented in this chapter do not necessarily give a correct picture of individual companies.

fettered by regulation. Therefore, the changing environment in the 1980s, with more equal regulation among credit institutions, affected finance companies more than other credit institutions. The introduction of authorisation and cash reserve requirements in 1988 ended the competitive advantage stemming from liberal regulation. At mid 1988, the number of finance companies peaked at 320 companies, after which it fell steeply. At end 1992 only 133 finance companies were present on the Swedish credit market, of which no more than approximately 40 were active.

The *mortgage institutions* are financial intermediaries specialising in long-term financing of housing, local authorities, enterprises, and agriculture. They obtain funds mainly by issuing bonds, but also certificates and promissory notes. The housing institutions are the largest group, with 87 per cent of the total assets of all mortgage institutions in 1992. The deregulation of the credit market has left the housing institutions in a better position to compete on equal terms with other credit institutions. This has made the housing institutions more market-oriented, one example being the development of new products (i.e. on the lending side: short-term lending and loans with flexible lending rates; on the funding side: bonds issued directly to households).

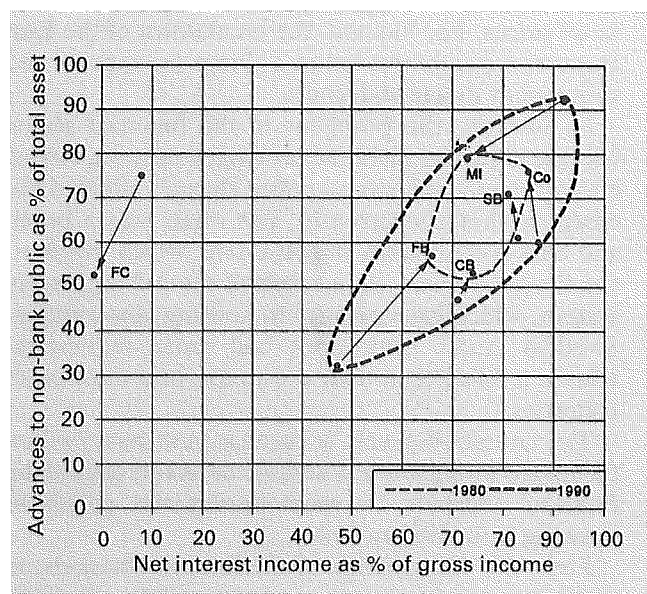
Another important feature of the Swedish financial market is the dominance of *banking groups*. In the 1980s they accounted for about 60 per cent of total assets in the financial sector. Bank groups can comprise banks, finance companies, mortgage institutions, etc. and, lately, insurance companies. Within these groups, the differences between types of institution can be exploited to mutual advantage. Banks have the advantage of access to information about the customers' debit side, information that can be used in other financial institutions in the group.

2.2 The structure of activities

In order to interpret the aggregate changes in the credit market it is necessary to analyse the main activities of its institutions and how they have changed over time. Chart 2.1 presents a general picture of how advances to the non-bank public and net interest income changed for the various types of institution in the 1980s. The chart indicates that, except for finance companies,² the traditional institutional boundaries have become less distinct. In 1990 the range of services and activities was more similar than in 1980, as illustrated by the closer cluster in the chart.

² Finance companies moved in the opposite direction to other credit institutions and in 1990 their net interest income (excluding leasing) was negative.

Chart 2.1 Main activities of different kinds of institution in 1980 and 1990



Note. CB: commercial banks, FB: foreign banks (1986 instead of 1980), SB: savings banks, Co: co-operative banks, MI: mortgage institutions, FC: finance companies.

Source: The Riksbank and Statistics Sweden

Since all kinds of bank are increasingly engaging in broadly similar activities, and since mortgage institutions have successively diversified their services, competition between the institutional groups has become more pronounced.

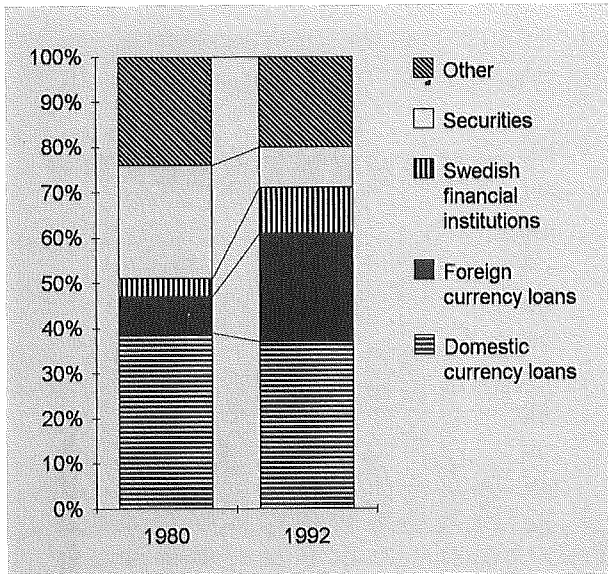
The relative weights of the various activities of credit institutions have thus changed considerably since 1980. These changes are presented in the rest of this section in terms of balance sheet items.

The traditional activities of Swedish *banks* are mainly represented by loans on the asset side and the non-bank public's deposits on the liability side (see Charts 2.2 and 2.3). Loans in domestic and foreign currencies are the most significant assets; after the abolition of liquidity ratios for banks in 1983, the importance of loans became even more pronounced. Banks were then able to reduce their holdings of Government securities and housing bonds; they replaced them with loans to the non-bank public and to financial institutions. The benefit of this substitution lay in potentially higher earnings but the downside was an increased credit risk. It was mainly loans in foreign currencies that grew up to 1992. For the banks, this has the disadvantage of a smaller interest margin compared with domestic currency loans. The lower interest margins in foreign currency loans are mainly explained by more homogeneous products and a more transparent market, which creates a more competitive environment.

The liabilities side can be used to analyse the marginal cost of raising funds. The cheapest form of

Chart 2.2 Banks' assets in 1980 and 1992

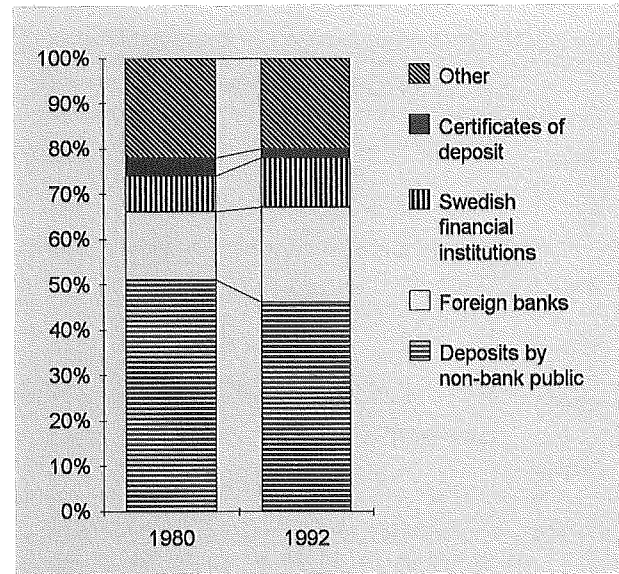
Per cent



Source: The Riksbank

Chart 2.3 Banks' liabilities in 1980 and 1992

Per cent



Source: The Riksbank

funding is a bank's traditional deposit accounts. Decreased deposits by the non-bank public accordingly implies increased borrowing costs.³ While such deposits still dominate the banks' fund raising, their importance is tending to decline and banks are having to resort to more expensive kinds of funding. The latter, so-called hot money, is more sensitive to price differences, thereby creating pressure on banks' interest margins. Banks then became more vulnerable to sudden external changes, such as the financial crisis, reducing their credit worthiness.

Banks are dependent on net interest income as the main source of earnings. Co-operative banks and savings banks have been most dependent (see Chart 2.1 above), since they have mainly been active in retail banking.

The assets of *mortgage institutions* consist largely of loans to the non-bank public, though the share for such lending has decreased from 92 per cent in 1980 to 85 per cent in 1992. This has been counterbalanced by an increase in claims on Swedish financial institutions. Mortgage institutions have primarily financed their operations by issuing bonds, but they also issue certificates and promissory notes. These securities are mainly purchased by banks, insurance companies and the National Pension Insurance Fund; other investors, such as enterprises and households, have recently become more important. Since the abolition of foreign exchange controls in 1989, mortgage insti-

tutions have also been able to arrange financing in markets abroad.

Mortgage institutions depend on net interest income as the main source of earnings, although the share has decreased (see Chart 2.1 above). The decline reflects the shift from lending to the non-bank public to other assets.

Finance companies differ considerably from other credit institutions in the composition of their assets. For them, lending to the non-bank public has declined significantly, from 75 per cent of the balance sheet total in 1980 to 45 per cent in 1992. The share for leasing has grown correspondingly. On the liability side, the share for funding from the non-bank public has decreased considerably, especially after the finance company crisis. This has been offset by borrowing from financial institutions, mainly banks.

The main source of earnings for finance companies is leasing, which has grown in importance from 37 per cent of gross income in 1980 to 83 per cent in 1992.

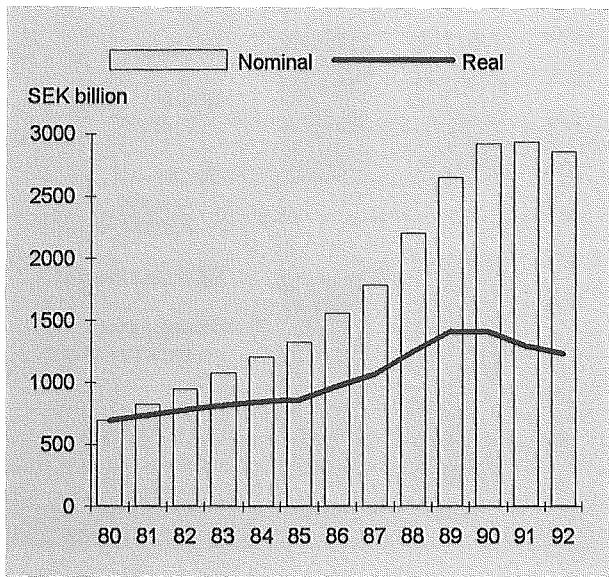
2.3 Market size and shares

The credit market expanded rapidly in the 1980s, mainly as a consequence of changes in regulation. In the period 1980–92, the total assets of banks, finance companies, and mortgage institutions grew at an annual rate of 12.8 per cent.

The removal of credit ceilings in 1985 is reflected in the substantial growth of the balance sheet total for credit institutions in the second half of the 1980s (see Chart 2.4). Most of this increase occurred between

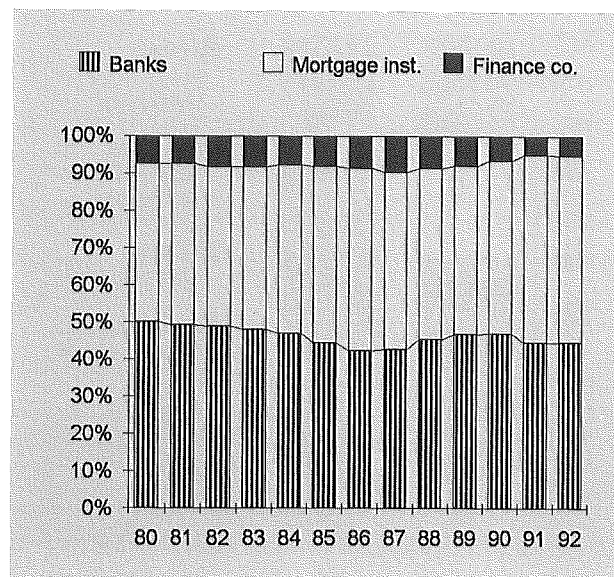
³This probably does not apply to small banks (e.g. foreign-owned banks in Sweden), since they are not likely to gain from economies of scale related to deposits.

Chart 2.4 Credit institutions' total assets
Nominal and real values (base 1980),
SEK billion



Source: The Riksbank

Chart 2.5 Lending to the non-bank public
Shares of total year-end stock



Source: The Riksbank

1985 and 1989. After 1989 the trend changed, as mainly changes in taxation and the economic recession reduced demand for credit (it was primarily household demand that fell).

The market shares of different credit institutions have also altered, mainly as a consequence of regulatory changes and the financial crisis. When the new legislation put the different types of institution on a more even footing, the institutions started to encroach on each other's territory, as shown in Chart 2.1.

Banks lost market shares until 1986, partly due to an expansion of high risk activities on the regulatory fringe where finance companies were most active. The abolition of lending ceilings then made it possible for banks to enlarge their advances, mainly at the expense of finance companies. The subsequent decrease in the banks' market shares is due to the financial crisis.

The major change in the structure of the credit market in this period comes, however, from the continuous growth of market shares for mortgage institutions. By 1992, these institutions accounted for 50 per cent of all lending to the non-bank public in Sweden, compared to 42 per cent in 1980. Several factors contributed to this expansion. First, the very high level of construction in the 1980s. Second, deregulation was followed by an increased provision of mortgage loans tied to existing real estate. Third, mortgage loans were the cheapest form of borrowing. Fourth, lending has been transferred from banks to affiliated mortgage institutions with the aim of specialising each company in the group. Recently, however, this trend

has been reversed in order to meet increased competition and comply with tighter capital adequacy requirements. Finally, housing institutions have been successful in adapting to the new market conditions.

As stated in Section 2.1, banks have increasingly co-ordinated various activities within a joint banking group by including mortgage institutions and finance companies within the group. Therefore it is important also to analyse the bank groups' market shares in order to find out if they are losing out to other parties on the financial market. According to Table 2.1 there has indeed been a clear reduction of market shares for banking groups, although the reduction is somewhat smaller than for the banks alone. This is a consequence of increasing market shares for bank-owned mortgage institutions.

Table 2.1
Bank groups' shares of the financial market
as measured by year-end balance sheet total, per cent and SEK billion

	1980	1985	1990	1991	1992
Banks	47	43	41	39	38
Bank-owned Finance co.	2	2	1	2	1
Bank-owned Mortgage inst.	11	11	17	16	15
Market share on group level	60	57	59	57	54
Total (%)	100	100	100	100	100
(SEK Billion)	963	1 856	3 874	3 990	3 996

Source: The Riksbank

2.4 Contestability and concentration

A market can be considered fully *contestable*, and thereby efficient, when potential entrants have free access to it and face cost structures similar to those of companies already in the market. This implies that barriers to entry are not present. On the Swedish credit market, mostly its retail part, barriers to entry have traditionally been high, due to the inherent characteristics of the services offered and to public regulation. In both these respects, conditions changed considerably in the 1980s.

First, because of high customer loyalty, one of the most important implicit barriers to credit market entry is goodwill. However, the financial crisis is likely to have lowered the credibility of existing credit institutions and this may have weakened both goodwill and the strong links that existed between banks and their customers. Second, credit institutions, banks in particular, used to be sheltered by regulatory barriers, as described in Chapter 1. The lowering of these barriers through deregulation has blurred the institutional boundaries between different types of credit institution and between insurance and credit market mediation. Barriers to entry from abroad were also reduced in the 1980s, although the major changes did not occur until the 1990s.

The total number of credit institutions has fallen from 323 in 1980 to 262 in 1992 (see Annex 2). The number of bank branches has likewise been cut from 3659 in 1980 to 2908 in 1992; more than half of this reduction occurred among savings banks. The diminishing numbers of companies and branches mirror both an initial over-establishment in certain segments and the move towards a more cost-efficient structure as a result of the more contestable environment. Credit institutions have increasingly adopted a more competitive behaviour, in contrast to the earlier era of co-operation. Efforts by commercial banks to improve competitive positions mostly resulted in larger entities via mergers and acquisitions. This process was accelerated in the early 1990s when savings banks and co-operative banks both merged to form basically one bank each.

This trend towards fewer entities was not opposed by the authorities, which believed that larger units would render the credit institutions more stable.

To a lesser degree, the partially lowered barriers to entry have enticed new entrants to the markets, including foreign owned banks. However, the full effects in this respect have yet to materialise as the financial crisis ebbs and the adaptation to EEA legislation promotes free establishment and free cross-border trade in financial services.

Concentration at bank level is measured in this study by the market share of the four largest banks. Concentration in this sense has increased from 54 per cent of total bank assets in 1980 to 81 per cent in 1992

(see Chart 2.6). Within the group of large banks, however, competitors have become more similar in size. Thus, the increased concentration does not represent a move towards absolute dominance by a single firm and thus to monopolisation.

For the four largest banks, assets and gross income per employee and branch are higher than the average (see Chart 2.6). This suggests that the four leading banks are more efficient, perhaps as a consequence of economies of scale. If so, concentration is likely to continue, since smaller banks will tend to become less profitable and thereby less competitive. But studies, mainly in the United States,⁴ show that the existence of economies of scale in banking is questionable. According to Swedish studies (SOU [1989]), it is also hard to find evidence of economies of scale in Swedish banking. An alternative hypothesis, put forward there, is that banks of average size have difficulties in being competitive on the Swedish market. One explanation might be that average-size banks are burdened with large fixed costs for providing a full range of services to customers and do not have a sufficient volume to reap the potential economies of scale. In contrast, small banks would not have a cost disadvantage as long as they did not try to be full service banks and concentrated instead on "niches".

Concentration among credit institutions does not show as clear a tendency as that among banks. In terms of gross income, concentration decreased from 1980 to 1991. In terms of assets there was a decrease up to 1989, followed by renewed concentration from 1990 (see Chart 2.7). This increase is mainly explained by mergers and acquisitions from 1990.

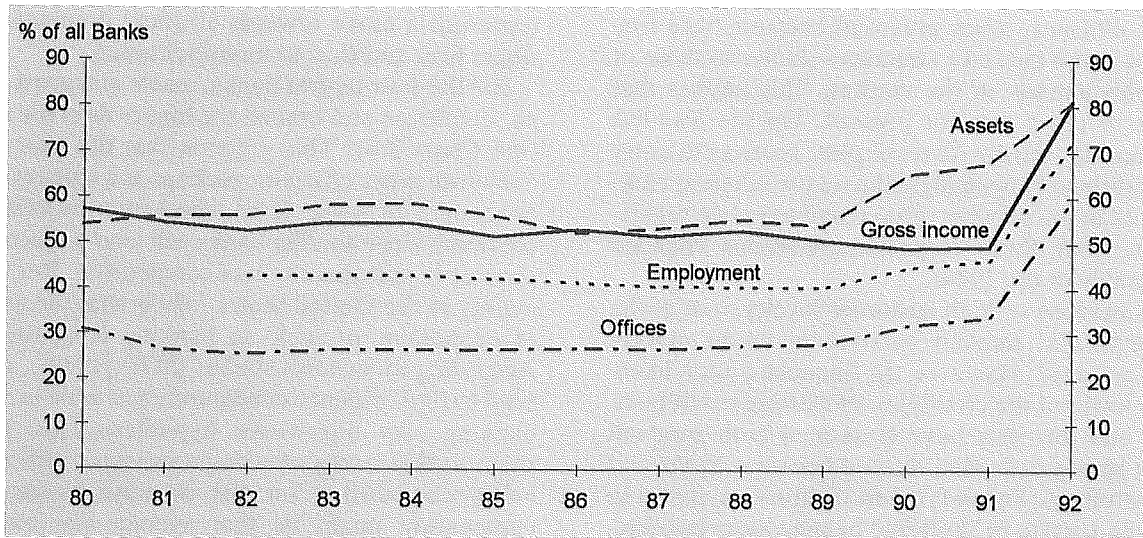
The increased concentration in the late 1980s and early 1990s is mainly a result of companies merging into larger entities. This is likely to be part of a defensive strategy in the less sheltered environment. Spain and France, which deregulated during approximately the same period as Sweden, are also experiencing increased concentration (Gual and Neven [1992]).

2.5 Performance

In broad terms, in the first half of the 1980s the three kinds of credit institution have maintained a steady return on equity. In 1986, banks considerably increased their rate of return as a consequence of expanding volumes after the deregulation and falling interest rates. Since then, however, their performance

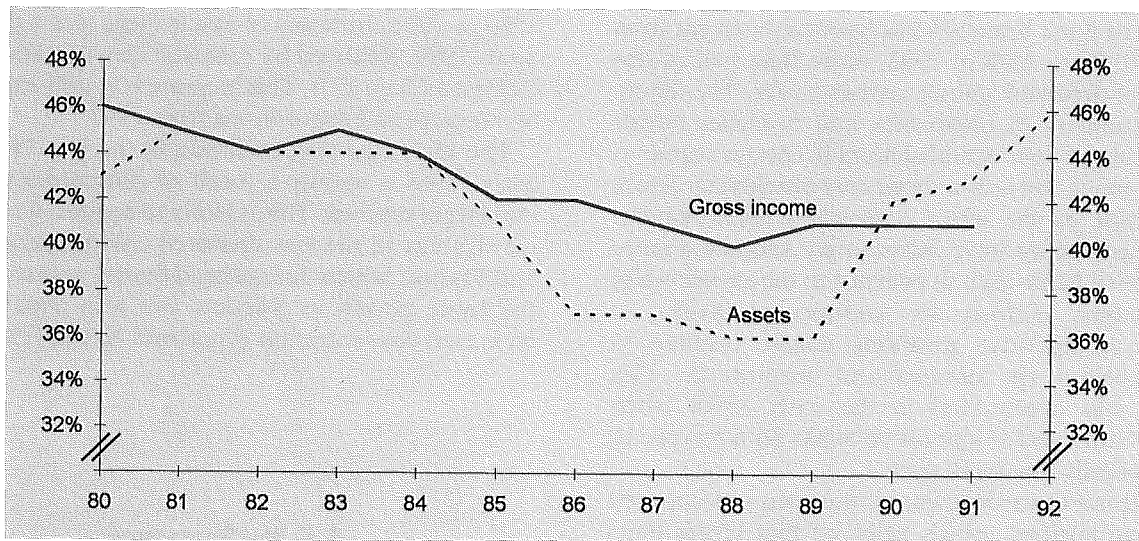
⁴For a summary of results from a number of studies on economies of scale and scope, see J. A. Clark [1988].

Chart 2.6 The four largest banks' shares of total bank assets, gross income, employment, and branches
Per cent



Note. The four largest banks are determined annually from market shares of total bank assets.
Source: The Riksbank and Statistics Sweden

Chart 2.7 Market shares of the four largest credit institutions
Per cent of all credit institutions



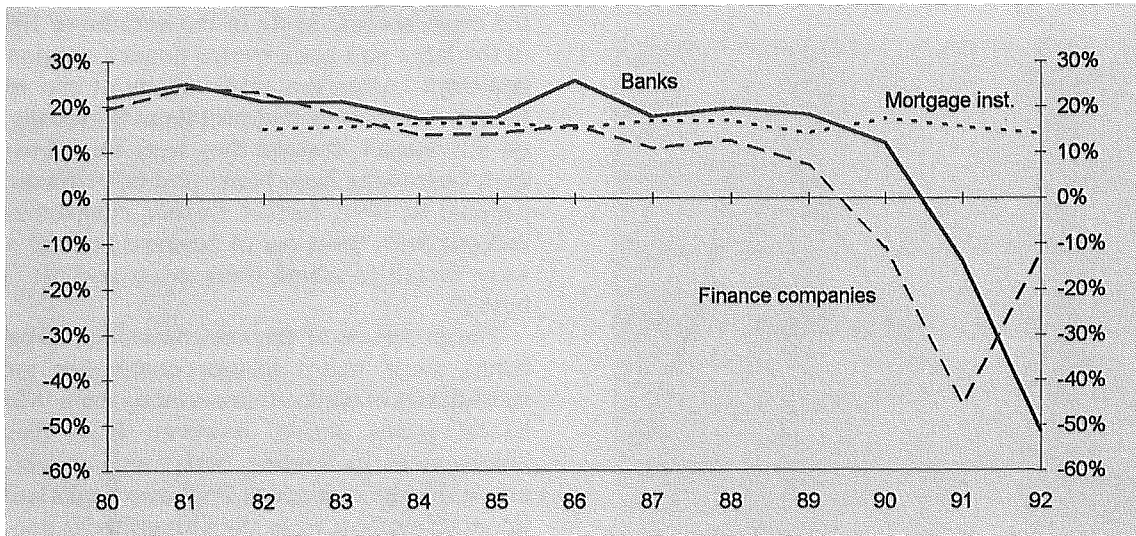
Note. Gross income for 1992 is omitted due to extremely large extraordinary earnings for two of the largest credit institutions.
Source: The Riksbank, Statistics Sweden and annual accounts

has declined, although it was not until 1991 that banks showed negative figures. The profits of finance companies followed a downward path, though an upturn was noted in 1992 due to the weeding out of companies in the previous two years. Mortgage institutions, on the other hand, have maintained their profits.

A look at the operating profit and its components

(see Chart 2.9) shows that bank profits have not kept pace with the growth of balance sheets. When the removal of regulatory restrictions enabled the banks to expand lending, it seems that priority was given to volume and market shares instead of to profits. This was done not so much through price competition as through greater acceptance of risky projects and an expansion of foreign currency loans, which have

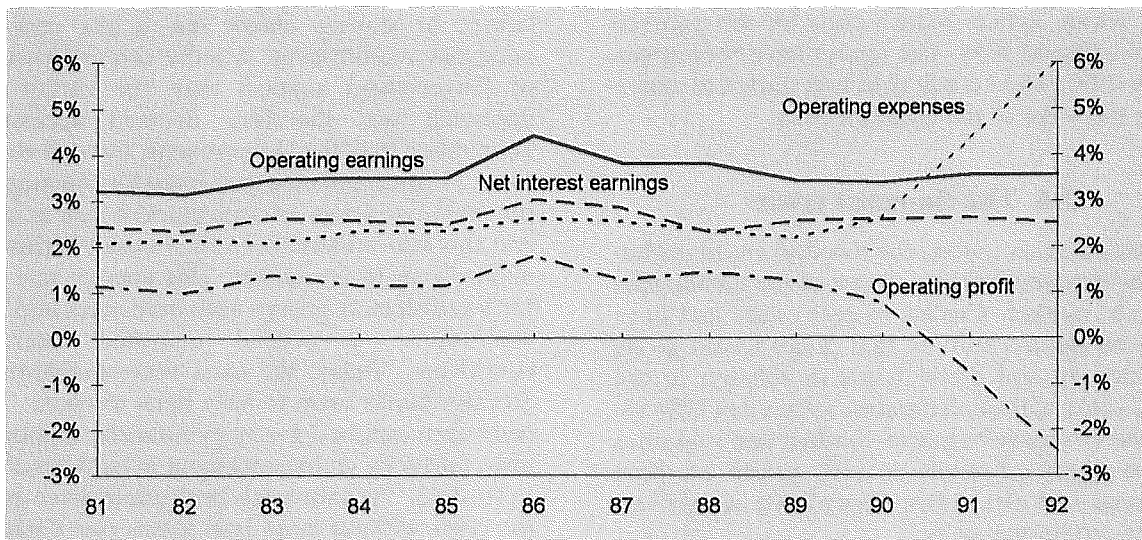
Chart 2.8 Return on equity for the three main groups of credit institution
Per cent



Note. Return = operating profits; equity includes 100% of untaxed reserves. Excluding Securum, a state-owned institution to divest bad assets from Nordbanken.

Source: The Riksbank and Statistics Sweden

Chart 2.9 Banks' operating profit and its components
Per cent of average balance sheet total



Note. Operating profit = operating earnings – operating expenses (including provisions for bad debt and loan losses).

Source: Statistics Sweden

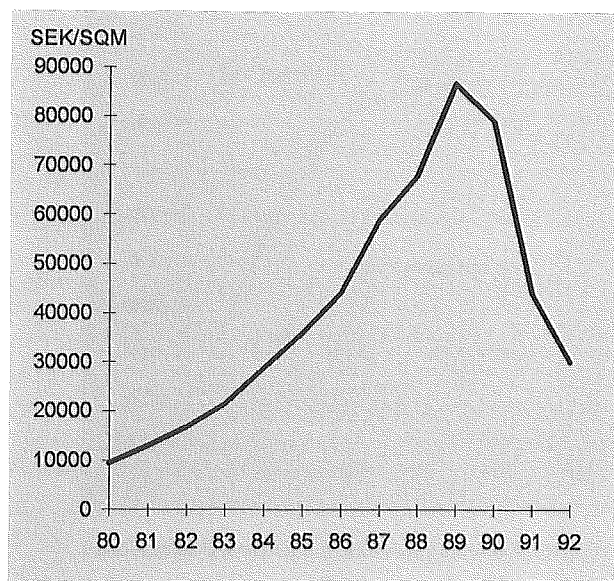
lower margins than loans in SEK. As a result, the banks' operating earnings started to deteriorate after 1986. However, the main reason for the diminishing profits is the growing share of loan losses since 1990. As a consequence, operating profit turned sharply downwards in 1990 and was highly negative in 1991 and 1992.

An alternative measure of performance is added

value or economic rent. Broadly speaking, a company or an industry achieves a positive added value if it has a lead over other companies or industries, for instance due to a superior capacity for innovation, reputation, or competitive edge in sales channels (Wirth [1992]). However, high added value may also be achieved through a monopoly-like position and does not necessarily imply high efficiency.

Chart 2.10 Market value per square meter for an office building in central Stockholm

At nominal values



Source: Enskilda Research

For Swedish credit institutions, added value over input cost's⁵ was positive in the period 1980-90. This is probably explained by low competition in the period up to 1985, and subsequently by spurious profits, which include hidden costs for the underestimation of credit risks. The figures have been negative since 1991, when credit risks first started to materialise in the wake of the financial crisis.

2.6 The financial crisis

The financial crisis among the Swedish credit institutions was initiated by the collapse of the commercial real estate market. Credits to real estate had been granted on the assumption that prices would go on rising strongly and credit limits in relation to the assessed value of the collateral were raised in 1989-90. When the economy began to contract and real rates of interest net of taxes soared, prices on both commercial real estate (see Chart 2.10) and private dwellings fell dramatically.

Finance companies were the first institutions to run into problems. Their market shares were already weakening in 1988, mainly due to stiffer competition as conditions for different credit institutions were made more uniform. The overestablished market for finance companies at that time also led to narrower margins. Some finance companies chose to expand

⁵ Added value: profit before tax – costs of capital; input costs: staff expenses + costs of capital; costs of capital: $E \cdot (i/100)$, where E is equity and i is Government bond yield. For a discussion of the added value concept, see for instance Gouzouli et al. [1992] and Wirth [1992].

total assets in order to sustain profits. This resulted in a marked deterioration of asset quality. With the sharp fall in asset prices and rising real interest rates, the crisis became acute in the autumn of 1990. Most of the large non-bank owned finance companies went bankrupt. After this crisis, many of the remaining finance companies had problems borrowing directly on the market. Instead they were forced to increase their borrowing from banks and other financial institutions. In 1991, further finance companies, mostly independent, went out of business and the survivors were forced to shrink their assets and get "back-to-basics".

The problems of finance companies spread to the banks since many finance companies are either subsidiaries of banks or financed by them. Most of the banks' losses derive, however, from their direct involvement in lending based on commercial real estate. By the summer of 1992, two banks had needed financial support from the Government due to large loan losses which reduced the banks' capital bases below the stipulated 8 per cent "Basle" ratio. They were regarded as individual cases and the solutions were therefore constructed on an ad hoc basis.

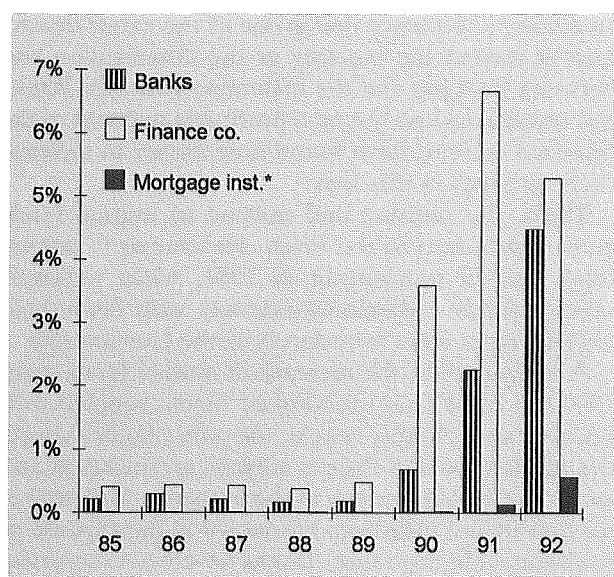
At its most pressing stage, in the summer and early autumn of 1992, the financial crisis threatened to turn into a general liquidity crisis, primarily caused by decreased foreign lending to Swedish banks. Several major banks also indicated that they might have difficulties in staying above the 8 per cent capital adequacy requirement. A more comprehensive form of Government support than the earlier ad hoc approach was therefore deemed necessary. In September 1992 the Government, through the Ministry of Finance, issued a guarantee for commitments of the banking system to depositors as well as creditors and this was underwritten by a broad Parliamentary majority on 18 December. This unequivocal backing for Swedish bank groups and some other major credit institutions was needed to restore international confidence. Today, the most acute problems of the Swedish banks seem to have been resolved. This has been accomplished partly by financial support measures, partly by an improvement in bank results.

To date, the mortgage institutions have managed the crisis without large loan losses (see Chart 2.11). At group level the banks' loan losses are therefore lower in relation to balance sheet totals.

As a result of Government measures, two of the major banks (Gota Bank and Nordbanken) are at present fully owned by the state. In both cases so-called bad banks have been created to deal with the bad loans. This direct participation has forced the Government to take an explicit part in restructuring the industry.

However, the structural effects of the financial crisis and its aftermath have just begun to appear and will mainly materialise in coming years.

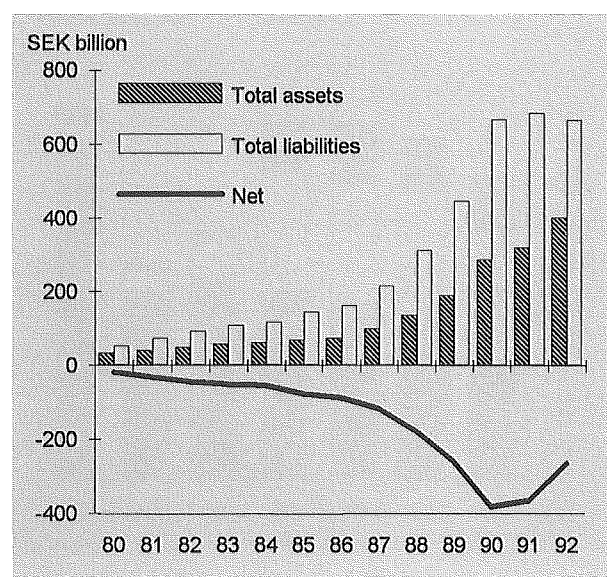
Chart 2.11 Loan losses in per cent of average balance sheet total



* No figures available prior to 1988.

Source: Financial Supervisory Authority

Chart 2.12 Swedish banks' assets and liabilities abroad
Year-end, SEK billion



Note. Securities not included until 1984.

Source: The Riksbank

2.7 Internationalisation

The Swedish banking industry became increasingly internationalised in the 1980s. This can be seen both in cross-border transactions and in direct investment by banks.

Since the mid 1970s, the Riksbank has gradually liberalised exchange controls to induce enterprises, local authorities and others to arrange their borrowing in foreign currencies. The objective was to increase private sector financing of the current account deficits. The banks have participated by borrowing in foreign currency for on-lending in Sweden. Banks have also been lending abroad, mainly to finance business in which Swedish enterprises are involved.

As regards direct investment, Swedish credit institutions are obviously more active with outward direct investment than are foreign credit institutions in Sweden. The subsidiaries and branches of Swedish banks abroad have previously been active mainly in wholesale banking, but in recent years some have expanded towards the non-bank public.

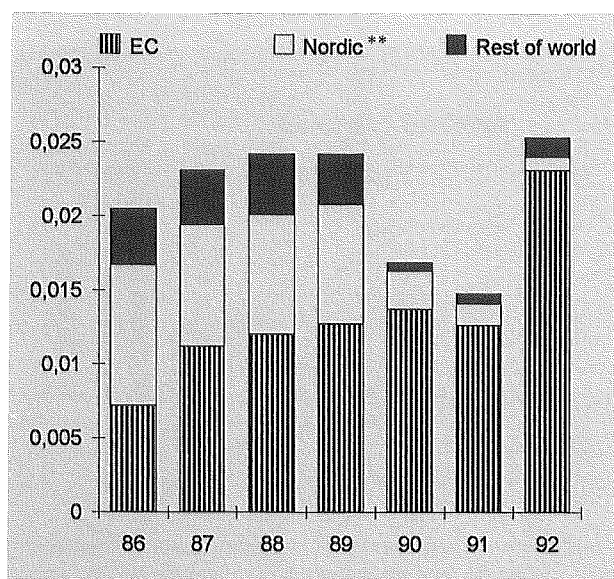
At end 1992, Swedish banks had 48 subsidiaries and branches abroad (see Annex 3), as well as 46 representative offices. There were 23 subsidiaries and branches in EC countries, 5 in Nordic, non-EC countries, and 20 in the rest of the world. It is especially the branches that have grown substantially in number and volume in recent years. At end 1992, they accounted for more than 16 per cent of all banks' total assets, compared to less than 6 per cent in 1989.

Foreign owned banks were first permitted to operate in Sweden in 1985, but only through subsidiaries. By 1986, 12 foreign banks were authorised to conduct banking in Sweden. Of these banks, six were from EC countries (all but one from France), and four were from Nordic non-EC countries. In 1990, the regulations were amended to allow foreign branches. This had no immediate effect because Swedish tax law prohibited the transfer of deductions for losses from a subsidiary to a branch. When this was changed in 1992, it initiated a number of conversions from subsidiaries to branches, starting with OKO-bank, a Finnish bank.

The main activities of foreign banks in Sweden have been inter bank business and business with corporations. The foreign banks held 2.1 per cent of banks' total assets in 1986, and 2.5 per cent in 1992 (see Chart 2.13). Foreign banks increased their market shares significantly in 1992, no doubt as a result of the financial crisis, which has not affected foreign owned banks as much as Swedish banks. It should also be noted that the capital adequacy requirements have tended to result in foreign owned banks acting as intermediaries in lending to their parents abroad. Consequently, the actual market share of foreign banks is larger and will soon show in the statistics, as subsidiaries are converted to branches.

Generally, foreign owned banks have not initially succeeded in making profits in Sweden. There are several reasons for this. First, they have mainly been active in wholesale business, where competition is high and margins are low. Second, by opening

Chart 2.13 Foreign banks' share of all banks' total assets*



* All banks' total assets excluding Swedish bank branches abroad.

** Nordic, non-EC countries.

Source: Banks' annual accounts

subsidiaries, foreign banks took on higher costs for business which they had previously done through representative offices. As a result of unsatisfactory profitability, some foreign owned banks, mostly Nordic, have left the Swedish market. These circumstances illustrate the difficulties in entering a national credit market and the time it takes to achieve satisfactory results.

However, results have improved in the last two years, in contrast to Swedish owned banks. Since foreign owned banks concentrate on wholesale operations, they did not experience large loan losses in the financial crisis. They were also able to earn high profits from trading in the period of currency unrest in Europe, especially during 1992.

2.8 Broadening of activities

As mentioned in Sections 2.2 and 2.3, there has been a strong trend towards diversification on the Swedish credit market since the early 1980s.

First, banks have increasingly offered extensive advisory services. This is necessary as the financial system becomes increasingly complex and sophisticated, confronting both clients and investors with a wider range of investment opportunities.

Second, Swedish banks and insurance companies have a long tradition of co-operation. In a banking

perspective⁶ this relationship is fruitful in that existing distribution channels can be used for insurance products. More recently, co-operation has been replaced by fierce competition for this new category of customer, a tendency that is one of the major driving factors behind the blurring of the demarcation line between banking and the insurance business. Banks not wanting to lose out on a profitable segment of the financial market, have found it necessary to increase their activities in this area.

Third, the number and volume of mutual funds grew significantly in the 1980s. Placements in mutual funds gained momentum in 1984, when national-savings funds (Allemanfonderna) with favourable tax treatment were introduced by the Government.

A large part of the increase in mutual funds since 1990 has come from unit-linked funds, coupled with life insurance. In this system, the policy holder selects the funds in which his/her savings are invested and accordingly has more say in the outcome. The market for unit-linked insurance has grown at the expense of traditional life insurance. Banks have been successful in marketing these funds, especially S-E-Banken which had over half of the total market in 1992. Reasons for this may be that the new product is well in line with existing products, leading to comparatively low operating expenses, and that the banks have large customer bases which might be interested in the product. Thus, banks can work this market efficiently.

Fourth, the securities market is playing an increasing role in the financial system. Securitization poses a threat to banks but also offers possibilities. Both have the effect of broadening banking activities, since banks change their lines of business to maintain their central role in financing.

The growth of the securities market has tended to diminish the importance of the market for institutionalised credit. Banks have to deal with increasing competition on both sides of the balance sheet. On the asset side, this has taken the form of mortgage institutions increasing their lending and funding themselves on the money and bond market. Moreover, now that the securities market in Sweden and abroad has become sufficiently sophisticated, large companies are making more use of the capital market for funding, instead of borrowing from credit institutions. Competition has also become more intense on the liabilities side, due to the increasing access to mutual funds and money market instruments.

At the same time, securitization represents opportunities. With stricter capital adequacy requirements and financial fragility, credit institutions have considered the merits of securitising assets in order to economise on capital. Such securitization, which involves pooling and repacking of assets into so-called asset-backed securities that are sold on the market, has been very limited so far and has been undertaken

⁶For an insurance perspective see the parallel insurance study.

mainly by mortgage institutions.⁷ The probable reason is that mortgage institutions themselves can be seen as a border-line case of securitization. Thus, the increase in mortgage-backed lending in Sweden served as a substitute for proper securitization. It remains to be seen whether securitization will gain in importance in the aftermath of the financial crisis or whether the credit institutions will be able to attain an appropriate capital adequacy in other ways.

3 Legislative and regulatory adjustments occasioned by participation in the EEA

The EEA agreement provides for free cross-border trade in financial services, freedom to establish credit institutions in all EEA countries, mutual recognition of regulatory regimes, and a set of minimum supervisory and prudential rules. Through the EEA agreement Sweden will adopt almost all of the EC legislation relating to financial services. The main exception is relations with third countries, where the EC requires reciprocity for opening a subsidiary in its domain.

In addition, one related principle in the EC single market concept is that capital shall be allowed to move across borders without hindrance. Free movement of capital is necessary for free provision of financial services and is also provided for in the EEA treaty.

Even before the EEA negotiations started, the Swedish authorities were giving priority to the introduction of EC standards in Swedish legislation (see Government Bill 1987/88:66, Sweden and West European Integration). Sweden is well on its way in adopting these standards in financial services. Parliament approved the basic legislation in this vein in January 1993 and the rest will be implemented when the EEA treaty comes into force.

In this analysis of the impact of changing legislation and regulation, 1 January 1990 is used as the benchmark date for adjustments arising out of participation in the EEA and the likely participation in the EC.

3.1 Credit institutions

The internal market in banking rests on three principles: a single licence, home country control, and harmonisation of essential rules.

⁷So far in Sweden there have been two cases of mortgage-backed securities; Svensk Fastighetskredit has led the way with 8 issues (Osprey 1-8), followed by Öhman. Lately there has also been a case of securitization of car loans, so-called CARs (certificates of automobile receivables)

Table 3.1
Market access on the Swedish credit market

	January 1990	January 1993
Freedom of establishment		
Subsidiaries	Yes	Yes
Branches	No	Yes
Acquisition	No	Yes
Freedom of cross-border trade		
Payments	No*	Yes
Deposit accounts abroad	No	Yes

* Trading and payments were free but restrictions on intermediaries and payment channels discriminated against foreign competition.

Single licence and home-country control. The purpose of the single licence and home country control is to remove restrictions against foreign competition by introducing free establishment. Together with mutual recognition of regulatory regimes, these principles also imply free cross-border trade.

On 1 January 1990, most restrictions on market entry were still in force in Sweden. Establishment of foreign owned credit institutions was still limited. Neither were foreigners allowed to purchase shares in Swedish credit institutions. This meant that foreigners were at a disadvantage in competition with Swedish credit institutions. In fact, the only way for a foreigner to compete on the Swedish market was to open a bank subsidiary.

Cross-border trade was also very limited at that time. Although trading in securities had been deregulated the previous year, the modalities for transactions were still restricted. Payment had to be conducted through authorised exchange banks, foreign securities had to be deposited in a bank authorised by the Riksbank and individuals were not permitted to have deposit accounts abroad.

The abolition of restrictions on free trade for credit institutions continued in 1990. As of August, foreign banks were allowed to open branches in Sweden and foreigners were permitted both to acquire shares in Swedish credit institutions and to establish subsidiaries in Sweden. At the same time, the market need test for granting licences was replaced by a purely qualitative assessment. One year later, non-bank financial institutions were also permitted to open branches in Sweden. By the turn of 1991, all legal restrictions on foreign ownership in Swedish credit institutions had been abolished. However, foreign citizens could still be prevented from acquiring a company's shares by means of a restrictive clause in the articles of association. The possibility for a Swedish company of having restricted shares was revoked as of 1993.

Concerning cross-border trade, the restrictions on the modalities for executing transactions and the ban

on deposit accounts abroad were lifted on 1 January 1993.

Harmonisation of basic requirements. Free establishment and free cross-border trade imply that each EEA member state has to recognise the other member states' regulations. In order to avoid undue "competition through rules", a set of common minimum standards was adopted for all EEA countries. This harmonisation concerns such matters as: own funds, solvency, rules concerning large exposures, deposit guarantees, and annual accounts.

On 1 January 1990, the Swedish rules had not yet been adjusted to those in the Community, though the regulations were not dissimilar.

On 1 February 1990, Sweden introduced uniform international capital adequacy requirements for all credit institutions. Full adoption of the 8 per cent capital requirement in accordance with the EC Directive was implemented at year-end 1992.

In 1991, the Financial Supervisory Authority in Sweden issued recommendations concerning large exposures that follow the EC recommendations from 1987.

In December 1992, the Community adopted the Directive on monitoring and controlling large exposures of credit institutions, which states that by year-end 2001, not more than 25 per cent of own funds may be placed with any one client or group of clients. This Directive has not yet been incorporated in the Swedish legal system. Some Swedish credit institutions would not be able to comply with these rules today, which means essentially that lending will have to be redistributed. Sweden has been granted a transitional period until 1 January 1995, to implement the Directive on large exposures.

A problem for credit institutions concerning large exposures stems indirectly from corresponding investment rules for life insurance companies (see Part III: insurance), since the latter might render funding more difficult and costly for housing institutions. Today, several Swedish insurance companies exceed the limit prescribed for them, implying a need to reduce their holdings of housing bonds. Sweden has been granted a transitional period until 1 January 2000 and housing institutions will have to adapt to the new rules in that period.

Sweden has been granted a transitional period until 1 January 1995 to implement the Council Directive on annual accounts and consolidated accounts of banks and other financial institutions. However, during the transitional period, Sweden is obliged to recognise the annual accounts of other EEA countries in accordance with the Directive. This means that branches of credit institutions of other EEA countries established in Sweden shall not be asked to publish separate annual accounts.

The EC has adopted a common position for the

Directive on deposit-guarantee schemes. It contains an anti-competitive measure in the form of a "no export" clause, whereby branches are not permitted to offer deposit protection exceeding that of the host state. Sweden has not yet adjusted the relevant rules to those of the Community, since it has been unclear how the latter would be formulated. Also, the present unlimited guarantee from Parliament for banks' obligations to depositors and creditors in practice implies a comprehensive and rather generous protection to depositors.

Sweden will in time also have to adapt to other EC legislation, in pre pipe-line or foreseen, such as regulations and administrative provisions relating to the reorganisation and the winding-up of credit institutions and prudential supervision of financial groups.

3.2 Securities market

The purpose of harmonising trade in securities within the EEA, as well as in the Community, is to establish a common securities market, where credit institutions and other institutions acting on the market are treated equally.

The principles of a single licence and home country control for the securities market were enacted with the adoption of the Directive on investment services in 1993. Earlier, these principles applied only to Undertakings for Collective Investments in Transferable Securities (UCITS) and related areas. Besides introducing those principles, the EEA agreement contains rules such as minimum requirements for stock exchange listed securities. Companies listed on an official stock exchange shall regularly publish information, report changes in major holdings of shares, and prohibit insider trading.

Other components of EC legislation regarding the securities market are still in preparation. They will eventually be included in the EEA treaty, making it necessary for Sweden to adapt to them.

In 1990, the securities market in Sweden was still restricted in several ways, one being the Stockholm Stock Exchange's exclusive right to organise exchange trading in shares.

Since then, the securities market legislation has been reformed to bring it into line with EC legislation. The new Mutual Funds Act, from 1991, represents an adjustment to deregulated capital markets and the removal of currency restrictions, but is also an adaptation to the UCITS Directive. In the same year, new insider rules and the Securities Business Act replaced earlier regulation as an adjustment to EC Directives in these areas. When new Stock Exchange legislation came into effect at the turn of 1992, the stock exchange monopoly was replaced by freedom of establishment in accordance with EC rules.

This freedom enables companies, including foreign enterprises, to gain authorisation as an exchange or

Table 3.2
Market access on the Swedish
securities market

	January 1990	January 1993
Freedom of establishment		
Subsidiaries	No	Yes
Branches	No	Yes
Acquisition	No	Yes
Freedom of cross-border trade		
Payments	No*	Yes
Securities trading	No	Yes

* Trading payments were free but restrictions on intermediaries and payment channels discriminated against foreign competition.

market place. As a result, foreign UCITS and banks that are permitted to participate in exchange trading in their home country, can become members of the Swedish stock exchange. Foreign companies' branches can also receive authorisation as an exchange or market place in Sweden. Foreign companies may also obtain approval for conducting clearing operations for options and futures. Following the abolition of the Foreign Payments Act, there are no restrictions on cross-border provision of services related to securities transactions.

The single licence and home country control will apply fully in the securities market when the Directive on investment services is implemented in Swedish law.

3.3 Difference between membership in the EEA and the EC

Almost all EC legislation concerning the financial services sector will be included in the EEA. There are mainly two important areas which will be left outside, becoming applicable to Sweden only as a member of the EC. These are: third-country regime and participation in the EMU.

Third-country regime. The EC member states are free to decide whether to admit branches of third country institutions in financial services. Access for subsidiaries, however, is governed by joint EC rules. Approval is dependent on reciprocity.

In the EEA, authorisation from one EEA country of an institution with its parent company in a third country is valid throughout the EEA with the following proviso: If the third country in question imposes restrictions on institutions from any EFTA country, but not from the EC countries, the authorisation will be valid throughout the EC, but not in EFTA, unless

individual EFTA countries decide otherwise. If the EC finds that reciprocity is not practised by the third country, then an application can be rejected. An EFTA country can still grant an authorisation, but this would only be valid in that country unless other contracting parties decide otherwise.

Adopting the EC's third-country regime will require that Sweden suspends or even rejects applications to open subsidiaries in Sweden from institutions in third countries that do not satisfy the Community's reciprocity conditions. Currently, Sweden applies an *erga omnes* regime concerning establishment. This will have to be changed if Sweden is to become a member of the EC.

European Monetary Union (EMU). When the EMU is established, with Sweden as a member state, there will ultimately be only one currency in the area. A single currency enhances financial integration by reducing both risk exposure and the cost of cross-border transactions. Thus, the effects discussed in the next chapter will be more pronounced.

3.4 Conclusion

The existing and future adaptations in Swedish legislation will have substantial effects on the structure of the credit market.

Firstly, the remaining barriers for foreign competitors that still existed in Swedish legislation in 1990, have ceased vis-à-vis EEA countries. Secondly, credit institutions in Sweden will have to adapt to new regulations and thereby to new market conditions. This means that the existing credit institutions will have to make a variety of business adjustments.

The discriminatory pieces of legislation in 1990 were the ban on Swedish branches of foreign credit institutions and securities dealers, the exclusion of foreigners from shareholding in Swedish credit institutions, and the severe restrictions on cross-border provision of financial services. All these ways in which foreigners were prevented from competing on the same terms as Swedish credit institutions have now been abolished (see Tables 3.1 and 3.2). This enhances the contestability of the Swedish credit market.

Of the adaptations to harmonised basic requirements, the main area where Swedish credit institutions will have to adjust is the limitations on large exposures. Today, these restrictions would be binding mostly for insurance companies. Their implementation will affect the structure and funding regime of mortgage institutions.

4 Outlook

4.1 Factors affecting developments in the 1990s

In this chapter an attempt will be made to identify the main factors affecting the development of the financial system in the 1990s, as well as possible outcomes in terms of changing market conduct and structure. This is done against the background of West European integration. Three broad groups of driving factors are of relevance in this context.

First, changes in the legal system underpinning the financial sector will continue to have an impact in the 1990s, mainly because of EEA and EC considerations. This will give more leeway to market forces and improve contestability. The EEA treaty, with a single licence and home country control, reduces barriers for foreign competitors both in the form of establishment and in cross-border trade (see Tables 3.1 and 3.2 above).

Second, the financial crisis in Sweden and its aftermath will have implications for the structure of the Swedish credit market, especially since the Government is directly involved in the process through the institutions it has been obliged to take over. The financial crisis is likely to speed up the process of broad restructuring triggered by the earlier deregulation and reinforced by the adaptations to the EEA system.

Third, technological changes will continue to play an important role in the 1990s. In the 1980s, the rapid introduction of new technology, mostly justified by not losing ground to competitors, did not always leave time for afterthought and appraisal. In the 1990s, we can expect investments in technology to be more structured and geared to profitability. With an increased awareness of the risks inherent in banking, a large part of investments in production technology is likely to be in systems for managing and reducing risk. On the distribution side, technology might be put to use in particular to improve retail payments, mainly cross-border payments.

4.2 Emerging trends

The future trends that might arise as result of the three factors mentioned above will be discussed under the following headings: contestability, profitability and risk, business conduct, and market structure.

Contestability. The adjustment to a new legal system as a consequence of the EEA and the EC is likely to go on reducing barriers to entry and increase competitive pressure compared to the situation before 1990. Retail banking is likely to be most affected by financial integration, while to a large extent wholesale banking is already open to international competition.

Nevertheless, Swedish retail banking will probably, at least in the short run, hold its ground because of implicit barriers to entry stemming from national differences (e.g. history, language, and tradition) as well as customer loyalty.

Barriers to entry are also diminishing as a result of the financial crisis. Existing credit institutions are cautious in expanding lending, while maintaining wide interest margins in an effort to cover their loan losses. Moreover, the financial crisis has impaired confidence in Swedish credit institutions, affecting customer loyalty.

Previously, only one form of *market entry from abroad* was available: subsidiaries. Today, all four possible forms of market entry are permitted in Sweden: subsidiaries, branches, acquisitions, and cross-border trade. Given that a subsidiary is the most difficult form of market entry, barriers to entry from abroad have thus been lowered substantially.

The competitiveness of foreign owned credit institutions is improving as a result of deregulation in accordance with the EEA treaty as well as the financial crisis. An institution with sufficient capital might find it profitable to penetrate the Swedish market. In the case that the foreign owned bank would want to compete on a full scale, the most relevant way would seem to be to buy one of the existing banks.

As a consequence of allowing foreign owned securities dealers in Sweden from 1990, banks are also facing increased competition in the area of securities trading.

The financial markets in Europe would become even more integrated with the establishment of a monetary union. The effects of a monetary union on retail banking would lie mainly in the area of cross-border trade. It would also be natural to expect sizeable effects in the area of currency trading – loss of income and a redistribution of trading to the remaining currencies.

While competition between different types of financial institution is becoming more symmetric, competition between credit institutions and *non-financial institutions* remains asymmetric. It is becoming easier for non-financial institutions to diversify into banking, while credit institutions are having problems with diversifying out of finance due to regulation.

Non-financial companies have been competing on the wholesale market for a long time. They have done this by setting up finance companies, obtaining funds directly in the securities market and doing their own currency dealing. A likely trend in the 1990s, in the aftermath of the financial crisis, is intensified competition from non-financial institutions in the retail market. Examples are already to be found in retail food chains and housing co-operatives, inviting deposits from customers and members. However, if

non-financial institutions intend to compete in this field on a full scale, they would have to become credit institutions, thereby losing the competitive advantages stemming from the fact that they at present largely stay outside the regulatory system.

With large budget deficits, the Government will have a great need to borrow in the money and bond market in the years to come, thus increasingly competing with credit institutions for domestic funds. In addition the Government, as well as other issuers, will be forced to seek funding abroad to a greater extent than previously. However, this is getting easier in an integrated European financial area. The role of rating will probably grow and interest rates will have to be further differentiated to attract investors to riskier non-Government securities.

Profitability and risk. The industry structure that evolves will depend on the types of institution or market that remain profitable over time.

Profits were high throughout the 1980s but have subsequently fallen to historically low levels due to the financial crisis. A return to the high levels earned before the deregulation is unlikely since both the deregulation and internationalisation have created an environment where a high economic rent cannot be maintained in the long run.

With the phasing out of untaxed reserves and reduced profitability, credit institutions will be more vulnerable to credit risk. Nor will these institutions reap short-run profits by acquiring high risk assets at the cost of ultimately having to face loan losses, since after the events in the 1980s, supervision is likely to become stricter and the banks' attitude to become more cautious. The risks, moreover, are likely to be more interrelated with the rest of the world. In addition, increased disintermediation will mean that the more risky parts of the portfolio are likely to stay in the credit institutions, thereby raising their overall risk exposure.

Since risk will prevail while profit margins may not be as high as before, volatility will have more severe implications than previously. In such an environment, the appropriate managing and pricing of risk is likely to be one of the keys to success in the years to come. We can expect to see new and better techniques for managing risk in all viable credit institutions, for instance, internal systems that adjust the returns on capital for the amount of risk taken (Risk Adjusted Return On Capital, RAROC).

Business conduct. Heavier competition and reduced profitability will have a strong impact on business conditions. These changing conditions are likely to lead credit institutions to search actively for new ways of conducting existing business, as well as for new areas of possibly profitable activities.

In the 1980s, the prevalent pricing strategy was

cross subsidisation, which means that the price of a specific product or to a particular customer does not exactly mirror the cost and risk involved. For example, savings accounts have traditionally subsidised transaction accounts. However, as competition is intensified, this cross subsidisation will no doubt be more difficult to uphold. Enterprises specialising in narrow niches would be prone to compete in market segments where diversified banks overcharge due to cross subsidisation. Thus, for instance, the number of institutions specialising in savings accounts could well increase if banks continue to use those accounts to subsidise transaction accounts and advisory services. Under these conditions the financial groups can be expected to have more directly cost-related pricing in the future.

The earlier regulatory regime enticed domestic banks to over-establish branches. The large number of branches today is an implicit barrier for new entrants. However, the main activities of branches lie in the distribution of standard products. In the years ahead, these services will probably be available to a greater extent by telephone and data links. The branch network will then be a less effective barrier to entry. In that the Swedish market appears to be over-branched, at least locally such as in major cities, a reduction in the number of branches can be foreseen. This process had in fact started before the financial crisis and was accentuated by it.

As discussed in Chapter 3, in order to comply with the limit on large exposures, several Swedish insurance companies will have to reduce their holdings of mortgage bonds. Under the new conditions, some of the largest housing credit institutions will no doubt have trouble in finding sufficient alternative buyers for their issues on the Swedish money and bond market. Conceivable solutions would be more active issuing of bonds abroad or securitization of assets (asset-backed securities).

As a response to increased competition from the securities market, credit institutions might attempt to compartmentalise assets by degree of risk and collateralize them in a more systematic form to attract investors (e.g. by securitization). In the 1980s this was done on a very limited scale (see Section 2.9). In the 1990s it might be an attractive alternative for achieving lower borrowing costs and a better use of capital. Another advantage is that the institutions might find it easier to satisfy the international capital adequacy requirements. Finally, it might become easier to attract foreign funding, since that new type of instrument would be more transparent. At present these developments are hampered to some extent by the fact that the Government guarantees all commitments made by bank groups and other major credit institutions. Thus, in the short run these guarantees distort the market incentives for urgently needed changes in risk management.

One can expect bank groups to expand into some new areas, while individual mortgage institutions and finance companies return to their basic activities, at least in the short run. Banks might offer more extensive advisory services, partly in response to competition from securities dealers. This might also be needed as the financial system becomes increasingly complex and sophisticated, confronting savers and investors with a wider range of investment opportunities. Related areas where advisory services might be needed are taxation and insurance.

Further expansion into non-banking areas, such as insurance services, is also likely. For instance, in an attempt to increase the competitive environment for insurance, from 1994 onwards, banks in Sweden will be allowed to offer pension savings schemes with premiums deductible for income tax. This is an area with growth potential (albeit limited by ceilings on deductibility), particularly as the state pension scheme is due to be reformed in the near future (see Part III: Insurance).

Moreover, as a result of the financial crisis, banks will have large portfolios of real estate which formerly constituted collateral for failing loans. The way these portfolios are managed will have implications for future bank profits as well as for other companies in these segments of the market.

With the growth of the securities markets, banks will further expand their off-balance sheet activities, trying to gain shares in those markets. Thus, banks may get more involved in assisting investments through guarantees and back-up facilities.

Finally, in the 1990s, banks will again put more effort into low-risk activities that did not have priority in the 1980s. This implies more emphasis on possibly profitable segments of retail banking.

Market structure. While the existence of economies of scale in banking may be questionable (see Section 2.4), there are other arguments in favour of large groups. One is the gain from producing and providing new instruments, due to economies of scope and established credibility on the inter bank market.

At the same time, the existence of new financial instruments tends to erode the potential economies of scale and scope. Thus niche-companies can use the new instruments to diversify risk even with small and homogeneous portfolios. So while one can expect major groups to continue to take large shares of the financial market, there is also likely to be a parallel trend towards specialisation or niche-playing.

The Swedish establishments of foreign owned banks are currently tending to change from being subsidiaries to branches. This is a natural consequence of legislative amendments following the EEA treaty permitting branches. For foreign banks, the main advantage of a branch compared with a subsidiary is that the former relies on the parent

bank's capital base, giving it more leeway in lending and a better rating. Another aspect is that home country control will apply, which can confer a competitive advantage instead of previous disadvantages if regulation is less restrictive in the home country.

The Swedish securities market is also being transformed from a virtually closed market to freedom of establishment under EEA rules. This will provide opportunities for specialisation and niche-playing which are likely to spur the emergence of new, smaller enterprises that trade on own account, participate in securities issues or as back-office companies. On the stock market, the abolition of the exchange monopoly may lead to additional exchanges (market places). A larger share of "cross-border" trade in securities is also likely, in which case foreign market places, such as Copenhagen, could take even larger shares of the trade in Swedish securities.

Since technology is fuelling innovation in financial instruments and market places are becoming sophisticated, a growing number of investors and borrowers will find the securities market an attractive alternative to the market for institutionalised credit. It is therefore to be expected that the securities market will continue to grow at the expense of the credit market.

Given free capital movements and liberalised cross-border payments, tax evasion may become more prevalent as a consequence of higher taxation on capital income and wealth in Sweden compared with some other countries. Swedish credit institutions might then be induced to assist customers by maintaining a presence in the form of subsidiaries in tax havens such as Luxembourg. On the other hand, Swedish establishments abroad will be restrained in the near future by the current financial fragility. In addition, the benefits of having foreign establishments have been reduced by the abolition of exchange regulations, making cross-border trade easier. With the international harmonisation of capital adequacy requirements, moreover, there will be less scope to exploit lower requirements elsewhere. On balance, one might expect that some Swedish banks will withdraw from foreign locations.

4.3 Conclusion

In the aftermath of the financial crisis and the adaptation to the legal system in the EEA, barriers to entry are being reduced. This points to a further increase in credit market competition in the 1990s. The structure of the financial market can be expected to move towards further diversification across traditional boundaries. At the same time, the degree of concentration on the Swedish credit market is likely to remain high, with a few bank groups as dominating players. However, smaller niche-companies may compete for profitable segments, thereby ultimately

reducing the scope for cross-subsidies in the major groups. Competitive pressure also has the effect of eroding profits, making the credit institutions more sensitive to risk and thereby necessitating more advanced risk management systems.

The securities market is likely to grow at the expense of the market for institutionalised credit in the 1990s, due to ongoing innovation in financial instruments and market development. Besides being a strong competitor with the market for institutionalised credit, however, the securities market will also provide more opportunities for credit institutions to participate with off-balance sheet activities. Furthermore, changes within the securities market, permitting freedom of establishment in accordance with the EEA treaty, will also make the securities market itself more contestable.

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Annex 1

Calendar of driving factors

Internal deregulation

1983

- Interest rate regulation for banks replaced by a recommendation.
- Less restrictive issue control.
- Bank liquidity ratios abolished.
- Company financing with certificate programs permitted.

1985

- The recommendation concerning bank interest rates abolished.
- Lending ceilings for banks, finance companies and housing credit institutions abolished.
- The Riksbank introduces an interest rate scale for lending to and deposits from banks.

1987

- Bank-owned finance companies permitted to lend directly to private citizens.
- New banking legislation (still in force).

1988

- The new Finance Companies Act comes into force.

1991

- New regulations permit banks and insurance companies to own organisational shares in each other and belong to the same holding company.
- Savings banks allowed to transform their business into a limited liability company.
- Banks allowed to acquire shares (subject to narrow limits) for their own investment operations.
- Finance companies entitled to obtain finance with negotiable instruments (i.e. certificates and bonds).

1992

- Freedom of establishment ends the Stockholm Stock Exchanges exclusive right to organise exchange.
- Co-operative banks allowed to transform their business into a limited liability company.

External deregulation

1982

- Stocks may be sold, though only to a limited extent, to foreign owned companies active in Sweden.

1985

- Foreign owned banks allowed to establish subsidiaries in Sweden.

- Authorised exchange banks obtain wider possibilities of trading in foreign currency futures.

1987

- Some of the restrictions on the acquisition of foreign shares are removed in this and the following year.
- The Swedish market for stock and index bonds is opened to non-residents.
- The right to extend permits for outward and inward direct investment are further delegated to the authorised exchange banks
- Swedish banks allowed to establish branches abroad.

1988

- Abolition of the ban on providing credit against collateral of foreign guarantees.
- Authorised exchange banks allowed to extend credit to non-residents without a Swedish connection and to procure foreign currency bonds.
- Acquisition of units in foreign mutual funds that hold at least 75 per cent of assets in equity permitted.

1989

- Exchange regulation virtually abolished.
- Removal of currency restrictions leads to shares in certain unlisted foreign owned companies being offered publicly in Sweden.

1990

- Foreign owned banks allowed to open branches in Sweden.
- Foreign ownership permitted in Swedish banks and other credit institutions.

1991

- Foreign owned companies, subject to approval, allowed to conduct finance company operations and securities operations through branches in Sweden.

1992

- At year-end all remaining modalities on cross-border payments are abolished
- At year-end Swedish individuals are permitted to have deposit accounts abroad.

Prudential regulation

1988

- Authorisation requirements introduced for almost all forms of financial operations.

1990

- Stricter capital adequacy regulations for banks and other credit institutions (in accordance with the Basle agreement).

1991

- Approval required for professional trade in securities.
- Stricter insider regulation.

1992

- An 8 per cent capital requirement to be met by all credit institutions at year-end.
- EC recommendations for monitoring and control of large exposures implemented in Sweden

Other driving factors

1980

- Free interest setting on industrial bond issues.
- Banks allowed to issue certificates of deposit and bonds.

1981

- Introduction of an electronic information system on the Swedish market.

1982

- Treasury notes (statsskuldväxlar) introduced for Government borrowing.

1983

- National Debt Office starts issuing bonds at market terms (Riksobligationer).

1984

- "Allemanssparandet" (national savings: deposits and unit trusts) introduced.
- New auction process for the sale of Government securities.

1985

- Futures contracts in interest bearing paper introduced in Sweden.

1986

- Interest options introduced.
- Authorised exchange banks allowed to issue currency options.

1988

- Government bill (1987/88:66) announced that Sweden should harmonise its regulations with the European Community.
- Abolition of most of the remaining issue control.

1990

- Reform of the Swedish tax system to stimulate saving and capital formation (1990-91).
- Share certificates essentially abolished with the introduction of a book-entry system, the VP system.
- The Government announces its intention to apply for membership in the European community.

1991

- Zero coupon bonds and indexed bonds may be issued.
- From 17 May, the Krona is maintained at a fixed rate against the ECU.
- Completion of the EEA agreement between EC and EFTA.

1992

- The EEA agreement is signed on 13 May and ratified in December.
- Sweden switches to a flexible exchange rate on 19 November.

Annex 2

Number of institutions in Sweden at year-end

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Commercial banks	14	14	14	15	15	15	14	14	14	14	12	9	10
Foreign banks*							12	11	10	10	9	8	8
Savings banks	164	162	160	155	149	139	119	115	110	109	104	101	90
Co-operative banks**	12	12	12	12	12	12	12	12	12	12	12	1	-
Finance companies	107	117	127	164	203	213	244	278	292	215	180	152	133
Mortgage institutions	22	20	21	21	22	23	24	25	25	26	26	23	21
Total	319	325	334	367	401	402	425	455	463	386	343	294	262

* In 1985 foreign banks were allowed to open subsidiaries in Sweden.

** In 1991 the 12 regional banks merged. In 1992 the co-operative bank was transformed into a limited banking company.

Source: The Riksbank

Annex 3

Internationalisation of banking

Swedish bank presence abroad

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Subsidiaries (over 50 % ownership)													
EC	N.A.	N.A.	6	8	8	8	9	10	9	11	11	11	12
Nordic*	N.A.	N.A.	-	-	-	-	-	1	2	2	3	4	3
Rest of world	N.A.	N.A.	2	3	3	3	5	6	6	6	7	7	7
Total	N.A.	N.A.	8	11	11	11	14	17	17	19	21	22	22

	1987	1988	1989	1990	1991	1992
Branches						
EC	2	3	3	5	7	11
Nordic*	-	-	-	-	1	2
Rest of world	4	9	11	11	12	13
Total	6	12	14	16	20	26

Foreign banks' presence in Sweden (subsidiaries and branches)

	1986	1987	1988	1989	1990	1991	1992
Country of origin							
EC	6	5	6	5	5	5	5
Nordic*	4	4	2	3	2	1	1
Rest of world	2	2	2	2	2	2	2
Total	12	11	10	10	9	8	8

* Nordic Non-EC Countries.

Source: The Riksbank

III

Insurance

EVA BLIXT*

1 The regulatory framework and other factors affecting developments

This introductory chapter describes developments in the regulatory system as well as in other factors determining the structure of the insurance industry. The account starts with a comprehensive description of the system as it was in 1980. Although this is done in the past tense, the subsequent changes have not been as great as for credit institutions – at the beginning of the 1990s the insurance system was basically unaltered.

1.1 The regulatory system in 1980

In 1980, the Swedish insurance market was strictly regulated, mainly in life insurance, primarily on the basis of the 1917 *Insurance Business Act* with amendments from 1948, when the main principles for regulation were established. The essence of these principles is presented in Box 1.1. Insurance companies were also the subject of Government ordinances, and of directives or recommendations from the Insurance Supervisory Service and the Riksbank. The regulations covered virtually all the activities in insurance companies. The main regulatory aim was to protect policy holders by ensuring the solvency of insurance companies, »sound« asset management and »sound« market development.

Establishment and acquisition of domestic companies.

In 1980, any company carrying out insurance business in Sweden was required to have a licence. The application for a licence had to be accompanied by a plan of the intended business; for life insurance there were also specific provisions concerning technical bases.¹ The 1948 Insurance Business Act required that the company was needed and would contribute to the sound development of the market.

The *principle of need* was motivated by concern, in the light of experience prior to 1948, that excessive establishment might lead to recurrent market instability. No new company proposing to carry out traditional insurance would be admitted unless there was a need for more competition in the intended line of business. Furthermore, the intended business should not be an obstacle to the sound development of the insurance industry at large, the *principle of soundness*. Besides the restrictive stance vis-à-vis establishment the authorities have, since the 1950s, encouraged mergers in order to ensure market efficiency and financial strength. All in all, this led to a high degree of concentration and a marked reduction in the number of companies operating nation-wide.

In accordance with the *principle of specialisation*, in 1980 insurance companies were permitted to own only other insurance companies and non-insurance companies with certain activities closely related to insurance business. To prevent an insurance company from using a subsidiary to carry out business which it had no right to transact on its own, an insurance company's ownership in a non-insurance company was limited to five per cent of the total voting rights, unless the authorities consented otherwise.

Rules of association and product regulation. As to organisational form, an insurance company could be either mutual or incorporated. In the case of life insurance, the authorities' basic presumption was that the company's risks and profits were the joint concern of the policy holders. Thus, regardless of organisational structure, life insurance companies were bound to perform as mutual entities »in principle«. Dividends to share holders were not allowed; profits had to be retained in the company, the *principle of no profit distribution*.

On account of the differences in the nature of commitments and the duration of policies, separate legal entities were required for life and non-life insurance business, respectively, the *principle of separation*. Moreover, authorisation for credit insurance was only granted if these policies were offered in separate legal entities. For life insurance companies, they were debarred from selling »capitalisation products« (a life insurance policy without an element of insurance).

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¹ The technical bases had to include the company's rules on how to calculate premiums, premium reserves, surrender values, bonuses, etc. In addition, they had to indicate the limit for self-retention of the company with respect to the insured risks, the insured's right to repurchase and the paid-up policy etc.

Box 1.1 Principles for insurance business

Principle of solvency	Insurers shall be able to honour their commitments, which implies, for instance, that premiums must be sufficient to cover risks.
Principle of equity	The cost to the policy holders shall be equitable, and each class of insurance shall pay its own way.
Principle of no profit distribution	No dividends are allowed to be paid to the shareholders. (This principle was established in an agreement between life insurance companies).
Principle of separation	Insurance companies are prohibited from underwriting life insurance together with non-life insurance in the same legal entity.
Principle of soundness and need	Authorisation is not granted for new companies or new lines of business in an existing company, unless the need is clearly demonstrated. In addition, it must contribute to a sound development of the sector.
Principle of specialisation	An insurance company must confine its business to insurance, exceptions being granted only under special circumstances.

In accordance with product regulation, third-party insurance for automobile drivers was compulsory, to protect third parties. The provisions for calculating premiums for such insurance were therefore issued by the supervisory authority and controlled by an industry organisation.

Solvency. Before granting a **life insurance** licence, the authorities scrutinised the proposed technical bases to ensure that they complied with the *principles of solvency and equity*. The premiums then had to be calculated according to these bases and to actuarial assumptions, so as to be sufficient to cover risks. The risk assumptions on which premiums were based had to include a safety margin, which usually resulted in surpluses. This margin, however, was not to be unnecessarily large and had to be reallocated to the insured in the form of bonuses. The supervisory authority ensured that the cost to the policy holders was »equitable«.

To be able to honour policy commitments, life insurance companies had to reserve sufficient assets in the form of technical provisions² to cover underwritten liabilities. The technical provisions included vested bonuses, amounting to a guaranteed minimum return³ of 4 per cent on savings, as well as reserves for claims. The regulations also stipulated a »buffer reserve« known as the collective consolidation capital, to guarantee the company's long-term viability. The remaining liabilities consisted of bonuses allocated, but not yet vested, to the insured. If the market value of assets fell below the sum of the value of the technical reserves and allocated bonuses, the collective consolidation capital became negative. The supervisory authority could then step in and prescribe appropriate remedies, such as cancelling the allocated bonuses.

Non-life insurance companies were not required to submit technical bases. Instead, they had to adopt a »normalised business plan«, prescribed by the super-

visory authority for the calculation of technical provisions. There were no bonus provisions, in contrast to life insurance, since non-life insurance does not include an element of saving. The *solvency and equity principle* also applied to non-life insurance and the supervisory authority ensured that premiums were reasonable in relation to the insurance in question and other circumstances.

Investment rules. Insurance contracts, such as life insurance and some types of non-life insurance, establish long-term relationships between the company and the policy holder. Therefore the management of assets held by insurance companies had to be regulated in the interest of the insured. Investment rules aimed to ensure that the capital was not placed in assets which carry financial risks that could jeopardise the companies' obligations to policy holders.

The insurance companies were obliged to invest the major part (80 per cent) of the technical provisions in assets with a low credit risk, for example, bonds issued by the Government, local authorities and mortgage institutions, as well as industrial bonds and various kind of loans. For the remaining 20 per cent, the only restriction was that no shares were to be acquired. For the »free funds«, i.e. all funds other than the technical provisions, the only restriction was the above mentioned five per cent rule, applied to both life and non-life insurance companies.

These rules were part of the Insurance Business Act. Further restrictions were imposed by the *Credit Policy Instruments Act*, which prescribed that priority be given to Government securities and housing mortgage bonds. Net increases in the assets of insurance

²Included reserves such as premium reserves, claims reserve, and claim adjustment reserve.

³If the actual return was higher than the guaranteed, the excess was also allocated, but not vested, to the policy holders.

companies had to be invested in these securities whether or not these assets covered technical provisions.

Tax rules. Some types of life insurance received favourable income tax treatment since they represented quasi long-term savings with the effect of supplementing public pension schemes. Swedish tax legislation classified life insurance policy as either a retirement pension scheme or a capital (endowment) policy. Retirement pension schemes were those which offered regular disbursements, whereas capital policies gave a single disbursement at a predetermined date or at death. Retirement pension premiums were deductible from taxable income up to a ceiling (10 per cent of the income in 1980) but the disbursements were taxable. The opposite applied to capital insurance: premiums were not deductible but the disbursements were untaxed.

Corporate taxation distinguished between life and non-life insurance companies. For non-life insurance it took the form of a tax on profits, while for life insurance it was levied on the return on assets assigned for capital insurance, the return on other assets being untaxed. In addition, insurance companies could obtain tax relief by using untaxed reserves.⁴ The existence of these reserves meant that the non-life companies in particular could level out returns over a period of years in order to reduce the impact of short-term fluctuations in insurance and investment results.

International aspects. Insurance companies owned by non-residents could be established in Sweden only through a general agent as a representative of the company or through a subsidiary.

The general agent was considered to be, not an independent enterprise, but an integral part of the company. Thus the agent did not have to submit annual accounts, though an authorisation was required. General agents were regulated under the *Foreign Insurance Companies Act*, which stipulated that they had to deposit securities to an amount of SEK 10 million (at 1992 prices) in a Swedish bank. They were also required to report the volume of their Swedish business to the supervisory authority. Subsidiary establishments of foreign companies were regulated under the Swedish Insurance Business Act. Such establishments, being Swedish companies, did not face discriminating capital requirements.

Acquisitions of Swedish companies by foreigners had never been restricted, though they had not been frequent, at least in the form of Swedish life insurance companies being taken over by foreign competitors.

One reason for this was probably the regulatory system, which did not allow life insurance companies to pay dividends. Another was that many insurance companies were mutual and therefore not eligible for acquisition. Also, a foreign company acquiring a Swedish insurance company was permitted to sell only Swedish insurance policies (for which it had authorisation), not policies from its home country.

Provided domestic customers took the initiative, non-resident companies were entitled to sell them insurance policies cross-border already in 1980, but not to market their policies actively in Sweden. Foreign life insurance (i.e. issued by a non-resident company) was by definition capital policy, since retirement pension schemes had to be issued by an insurance company established in Sweden. Therefore, premiums paid for insurance policies issued outside Sweden were not deductible from taxable income, though the disbursements were untaxed.

Reinsurance had always been traded internationally without regulations. Reinsurance business was handled by large, competent participants and the authorities therefore saw no need for customer protection.

Portfolio investment in foreign assets was uncommon in 1980. For life insurance companies, the Insurance Business Act prescribed that assets in foreign currency could be held only if they covered technical provisions in the same currency. The assets covering the technical provisions had to be located in Sweden. For non-life insurance companies there were no such prescriptions. In addition, insurance companies had permission from Sveriges Riksbank to invest in foreign securities an amount corresponding to their technical provisions for foreign commitments, even though the *Exchange Control Act* precluded such investment by non-insurance companies.

1.2 Changes in regulation⁵

The deregulation of financial markets in Sweden started later than in many other countries. The process here began with credit institutions (see Part II, Banking). In insurance, most of the regulations and some principles were still largely unchanged in 1992. Initial deregulatory moves came in the first half of the 1980s, with some amendments to the Insurance Business Act in 1982 and 1985, and deregulation gained some momentum around the turn of the decade, aiming at a more competitive insurance market, partly in view of a possible future EC membership.

⁴ Both life and non-life insurance companies had various kinds of untaxed reserves, such as valuation reserves. Non-life insurance companies also had a contingency reserve, an equalisation reserve, and a regulation reserve for motor third-party liability.

⁵ For a calendar of events, see Annex 1.

Establishment and acquisition of domestic companies.

In 1985, to increase competition and market efficiency, the authorities abolished the principle of need. It then became easier to obtain a licence and also for existing companies to extend their licence to new lines of business, although the principle of soundness still applies.

Joint ownership of insurance companies and credit institutions became permissible in 1991, thereby modifying the principle of specialisation. These institutions are now allowed to own mutual shares or to be under a joint holding company. The insurance and credit activities still have to be carried out in separate companies.

A new participant in the insurance market, the captive company, was allowed in the early 1980s. A captive company is an insurance company which is owned by a non-insurance parent company and has the aim of insuring or reinsuring that company's risks in order to reduce the group's insurance costs. Until the late 1980s, the Government was rather restrictive in granting authorisation for captives. Together with the lower self-retention permitted in Sweden compared to other countries, this has led Swedish companies to establish their captives abroad.

Rules of association and product regulation. The agreement precluding payment of dividends to the shareholders in life insurance companies was enshrined in law in 1982. Previously, this principle of no profit distribution had not had statutory force.

From 1988, authorisation was granted for non-life insurance companies to underwrite credit insurance.

In 1990, a new product, fund-related life insurance (i.e. unit-linked pension insurance), was introduced. The aim was to offer new, more transparent insurance. In that the policy holders are free to choose to whom to entrust the management of the capital which accumulates on their life policies, better conditions would result for competition among insurance companies as well as between them and other institutions on the capital market.

Unit-linked insurance separates risk from fund management in a way that was not possible in a traditional insurance company. The share holder in a fund (i.e. the policy holder) may instruct the insurance company to switch savings from one unit-linked fund to another on the market. Thus, the policy holder is not confined to funds linked to his original insurance company. This differs from conditions for savings in traditional pension insurance, where a change of company is hardly possible. The policy holder accordingly determines the level of financial risk he is prepared to take. In traditional insurance, this decision is left to the company. Furthermore, unit-linked insurance companies cannot guarantee a minimum return on the savings. While the life risk is covered by the insurance company, the savings

component of the policy is administered by independent fund companies. This makes it possible to pay out dividends to the unit-linked company's share holders.

All this means that the Insurance Business Act does not apply to unit-linked companies in three respects: these companies may pay out dividends, the insured are free to move accumulated savings, and the returns on these are accounted for at market values.

Until the late 1980s, insurance companies had a mutual agreement, supported by the supervisory authority, not to use insurance brokers.⁶ In such a highly standardised market as the Swedish (at least until 1988), with basically uniform premiums and policies, there was relatively little demand for independent information from intermediaries. When households, during the 1980s, increasingly demanded foreign life insurance policies (because of lower taxes on the return on assets for capital policies), brokers emerged as a channel for distribution from those companies. In 1988, the mutual agreement was abolished, with the permission of the authorities, and Swedish insurance companies also began using brokers to distribute their life and non-life insurance policies. In 1990, the authorities followed suit by introducing regulation of brokers.

An insurance broker must be registered with the supervisory authority and be subject to its supervision. Both legal and private persons may apply to be registered. A broker is required to be independent of the insurer and be insured for his commitments. A private person is required to have adequate training as a broker and should be suitably qualified.

Solvency and investment rules. Apart from minor changes in the Insurance Business Act, the solvency and investment rules mentioned in Section 1.1 are still mainly the same. On the other hand, the rules determining investment ratios for priority bonds were abolished in 1985 for non-life insurance companies and in 1986 for life insurance companies.

International aspects. In 1990, non-resident insurance companies were given permission to sell policies actively in the Swedish market through insurance brokers or Swedish insurance companies. This has facilitated cross-border trade. If a Swedish insurance company acts as an intermediary for a non-resident insurance company, both companies must belong to the same group or have a co-operation agreement. This agreement has to be approved by the supervisory authority.

Portfolio investment abroad was restricted until foreign exchange control was liberalised in the 1980s.

⁶Until 1988, the insurance companies had a market agreement under which, among other things, they undertook not to pay insurance brokers for the sale of policies; see Section 1.3 about co-operation between firms.

Since 1989, insurance companies are entitled to invest free funds abroad. For assets covering the technical provisions in life insurance companies, the earlier legislation still applies. Such assets may be placed in a foreign currency only to the extent of the commitment in that currency.

1.3 Other factors⁷

Besides deregulation, the main factors affecting the development of the insurance market are self regulation, demographic trends and tax rules.

Co-operation between firms. At least until 1988, the private insurance industry co-operated through an extensive network, underpinned by common institutions and organisations. The major bodies in this context, with almost all major private insurers as members, were the Swedish Insurers' Federation, the Service Company of the Swedish Insurance Industry, the Actuarial Committee and the Automobile Insurance Classification Committee. The co-operation aimed to strengthen the insurance industry's bargaining position with legislative and other public authorities and to create common statistical bases. The supervisory authority condoned this close co-operation among insurers, believing that it would lead to uniform policy conditions and thereby benefit customers. Furthermore, the close co-operation would promote self-regulation of the insurance market.

In life insurance, the Actuarial Committee provided the basic assumptions for the calculation of premiums and settled questions of interpretation. It was also a forum for agreeing on proposals for new insurance policies before submitting them to the supervisory authority. Until the mid 1980s, legal provisions and self-regulation had led the life insurance companies to co-operate in offering standardised and essentially identical insurance policies and premiums, although bonus technicalities varied between companies.

Part of this co-operation ended in 1987, when one company disengaged and presented a more flexible life insurance policy without seeking prior consent by the Actuarial Committee. The policy was accepted by the supervisory authority. This was the first breach in the long-standing cartelisation of the Swedish life insurance market. An agreement on the technical bases, reached as far back as in 1964, was abolished in 1988, after criticism from the Anti-trust Ombudsman.

Non-life insurance companies had co-operated overtly in setting premiums until the 1960s. After that, anti-trust legislation compelled them to set premiums independently. Nevertheless, for activities

such as tenants' and home-owners' insurance, the companies have access to the same statistical background data, and thus use a common basis for calculating premiums.

One remaining area of close co-operation is in automobile insurance, where an association is responsible for the effective functioning of the compulsory third-party insurance, due to the specific regulation mentioned in Section 1.1. Matters to do with statistics and market conditions for automobile insurance are handled by a committee, which recommends tariff categories for different makes of car and also deals with »good driver discounts«. This discount is transferable between the companies but an agreement between them prevents contracts from being terminated free of charge except at the renewal date.

Demographic factors. The potential of the insurance market is affected by the size and structure of the population, e.g., larger populations imply more risks to insure, an ageing population a greater demand for pensions. Population growth in Sweden is slow; only 200,000 in the past decade to a current level of 8.6 million. In this period, however, the structure of the population has changed considerably, with a diminishing number of under-18s and a growing number aged 25-64. The number of single adults has also increased and with it the number of households. There are therefore more potential buyers of insurance and this has already shown up in an increased demand for the savings components in life insurance. The growth of the 25-64 age group is also affecting demand for non-life insurance of households, in particular home insurance and car insurance. In addition, the number of over-64s has risen and this tendency will become more marked in the 1990s.

Tax rules. High marginal income tax rates in the 1980s, together with favourable tax treatment for insurance saving, had generated strong demand for retirement pension schemes. This incentive was weakened when the 1990-91 tax reform lowered the ceiling on tax deductions for pension insurance and also cut marginal tax rates.

With the exception of a temporary tax in 1986, returns on assets reserved for retirement pension schemes in life insurance companies were untaxed until 1990. At present, such returns are taxed at 10 per cent. In 1992, moreover, the taxation of returns on assets reserved for capital policies was lowered from 40 to 25 per cent. The 1990-91 tax reform also meant that non-life insurance companies had to dissolve some of the untaxed reserves, thus curtailing their right to hold tax-exempt reserves.

The competitiveness of Swedish insurance companies relative to companies abroad is affected by tax laws mainly in two respects. Firstly, the taxation of capital returns differs between Swedish and non-

⁷See note 5.

resident life insurance companies. Often, the latter are taxed only on the profits from insurance business, not on the return, as in Sweden. To compensate for this competitive disadvantage, a specific tax of 15 per cent was introduced in 1991 on premiums for life insurance policies from countries where taxation is lower than in Sweden; if returns are taxed abroad, the 15 per cent tax may be reduced accordingly. Secondly, the fact that only the pension insurance premiums paid to Swedish companies are deductible (Section 1.1) gives them a competitive advantage over non-resident insurance companies.

2 Structural development of the Swedish insurance market

2.1 Basic features

The Swedish insurance market can be described as a three sector system, to be compared with the EC's »three pillar system« for life insurance.

The first sector is the *public social security* system, which includes public pension, health, occupational injury, unemployment and parental insurance. Like all public insurance, national pension insurance is a »pay-as-you-go« system. In the 1980s the Government found that, as a result of the ageing population and the increased benefits to be paid out according to the scheme, the national pension insurance system will be a growing burden on the state budget. In the late 1980s, this tendency was accentuated by the weak growth of real wages and GNP. The Government is therefore considering at least a partial reform of the pension system, implying increased self-financing and supplementing the pay-as-you-go system with funded pensions (see Chapter 4 for further details).

The second sector, *labour market insurance*, provides virtually all employees with benefits supplementary to public social security, such as pension, group life, sickness and industrial injury benefits. These insurance benefits are agreed upon by the parties on the labour market and administered by labour market insurance companies such as SPP and AMF.

The third sector, *private insurance*, consists of life and non-life insurance as well as reinsurance. The market is dominated by a few large nation-wide groups, such as Folksam, Länsförsäkringar, Skandia, Trygg-Hansa⁸ and WASA, each of which handles all kinds of private insurance. Besides these national groups, there is a large number of small local companies. Most nation-wide companies offer all kinds of policy (i.e. apply a full product strategy).

Box 2.1 The framework of Swedish insurance

Insurance	Financed by	Administered by
Public social security	Taxes and fees to the Government	Government/National Pension Fund
Labour market insurance	Employer's fees determined in collective labour contracts	Labour market insurance companies
Private insurance	Premiums	Private insurance companies

The life insurance sector can be divided, as of 1991, into traditional life insurance and unit-linked insurance. The *life insurance companies* offer life, health, accident and pension insurance for individuals and groups. Product development in the 1980s has headed in two directions, one being towards more flexible policies and tailor-made life insurance policies sold by insurance agents or brokers, and the other towards simple standardised policies that are easy to distribute and to sell by telephone or over the counter of a co-operating bank. *Unit-linked insurance companies* provide life insurance linked to investment funds (Section 1.2). They are generally owned by traditional insurance companies and/or banks. The largest unit-linked insurance companies are SEB Försäkring (part of a group including a bank) and Skandia Link.

Non-life insurance companies offer all kinds of insurance for both »mass risks« and »large risks«,⁹ except life insurance and retirement contributions. It should be noted that, in Sweden, fire and certain other types of insurance can be bought separately only in local companies. In nation-wide companies, such types of insurance tend to be included in an insurance package. Standard combinations are supplied to cater to the needs of most tenants or home owners. Among the various types of non-life insurance, credit insurance is unique in that one company, Svenska Kredit, dominated the market until the end of the 1980s.

Reinsurance companies operate to diversify risk, especially large risks. The law requires all insurance companies to transfer risk above a certain level to a reinsurance company. The reinsurance company retrocedes the reinsurance on the international reinsurance market, and receives in turn reinsurance from other companies.

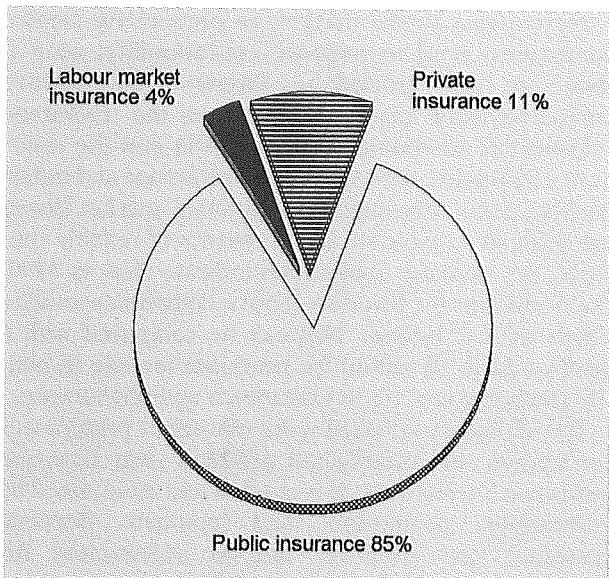
According to the National Accounts, the private insurance sector accounted for 1 per cent of the gross domestic product in 1980. This share then declined until 1985, but climbed back to 0.9 per cent in 1991. In all the Nordic EFTA countries, the private insurance sector accounts for about the same small share of GNP. Throughout the 1980s, the number of

⁸ Since 1991, Trygg-Hansa and SPP essentially form a partnership within Trygg-Hansa SPP Holding AB.

⁹ Mass risk is personal life and non-life insurance and large risk is industrial, commercial, and professional insurance.

Chart 2.1 Shares of the three insurance sectors in Sweden

By source of finance in 1990.



Source: Statistics Sweden

employees in Swedish insurance companies has fluctuated around 0.8 per cent of the total labour force.

The main difference between social insurance and the other two sectors is that the social system is mainly pay-as-you-go, whereas both private and labour market insurance operate according to the »premium reserve principle«. During the 1980s, the relative sizes of the three sectors hardly changed, with over 80 per cent covered by public insurances, Chart 2.1.

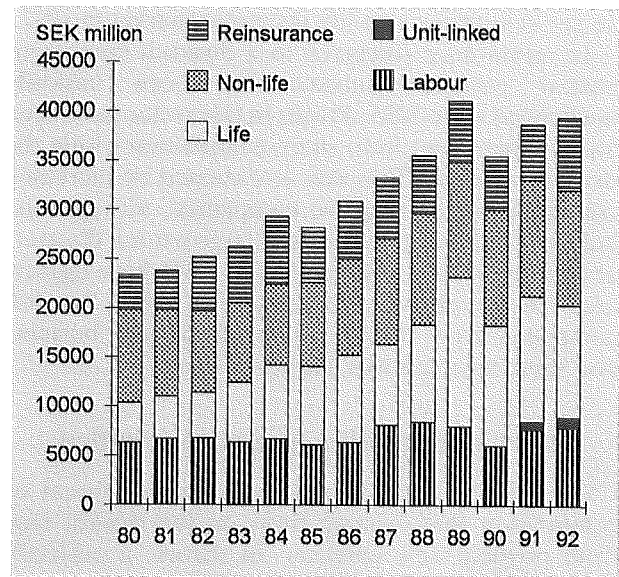
2.2 Market size and shares

In the following, insurance refers to the second and third sectors only, unless indicated otherwise. The size of the insurance market, thus defined, was boosted by the sustained economic boom up to 1989, with increasing premium incomes for the companies, as indicated in Chart 2.2. A breakdown of the changes in total real gross premium into labour, life, non-life and reinsurance reveals some notable differences in development.

The premium income for *labour market insurance* was virtually unchanged in the 1980s, since no major reforms were made. Not until 1990 did traditional life insurance companies gain access to some labour market insurance business. Employees became free to choose whether to place a small share of the pension premiums in a labour market insurance company or in a life insurance company. In 1992, 18 per cent of the policy holders chose to retain that share in a labour market company.

Chart 2.2 Total gross premium income

Real values (base 100), SEK million



Source: Financial Supervisory Authority

Life insurance expanded strongly in the 1980s, especially up to 1989. The favourable tax treatment for savings in insurance, demographic factors and increasing doubts about the future of the public pension system, all contributed to this. Another factor was that, in the late 1980s, insurance companies started to attract customers by promising high bonuses. Also, when the contents of the imminent tax reform were announced, many new policies were signed, to take advantage of the opportunities for tax arbitrage. The subsequent tax reform, in 1990-91, rendered life insurance less favourable than other financial investments and foreign insurances. This, together with the economic downturn, caused premium income to fall back in the early 1990s.

The introduction of *unit-linked insurance* resulted in the establishment of seven companies in 1991. One year later, their share of the life insurance market was 8 per cent.

In *non-life insurance*, up to the mid 1980s premium income declined in real terms. This can be explained by a modest increase in insurable objects, such as cars and houses. Subsequently, with the economy booming in the second part of the decade, premium income started to rise again as a consequence of increasing numbers of new insurable objects and higher private income.

Mass-risk non-life insurance accounts for 67 per cent of the non-life insurance market. The largest product is automobile insurance (motor third party and motor vehicle insurance), with 33 per cent of the non-life insurance market in 1992. Tenants' and home-owners' insurance accounted for 21 per cent. In 1986, an authorisation for non-life group insurance

changed the packaging of insurance and lowered distribution costs. As a result, group insurance has become more important. The main component of large risks is business and real estate insurance, with 26 per cent of the non-life insurance market in 1992.

In *reinsurance* (received in a Swedish company), annual premium income has been basically unchanged since 1985. Profits in this sector have been hit by large losses from sharp competition within the market segment. This was accentuated by increased competition from captive companies, as explained below. In addition, the costs of large natural disasters abroad in the late 1980s and early 1990s have aggravated the situation. Consequently, most Swedish companies have reduced their reinsurance business and some have left this market.

2.3 Contestability and concentration

Contestability is defined as the potential threat of competition that existing firms on the market face from possible new entrants. In theory, a perfectly contestable market is one that is freely accessible to potential entrants, without any barriers to entry (Baumol, Panzar and Willig, [1982]). Such barriers include the regulatory system, high fixed costs for setting up production, brand loyalty and co-operative behaviour between firms on the market.

On the Swedish insurance market, regulation and supervision, applying the principles of need and soundness and accepting and sometimes supporting co-operation among companies, led to high entry barriers, these barriers being higher for life insurance than for non-life insurance. Reinsurance was practically unregulated and internationally traded without such barriers. The principle of need was dropped in 1985, which tended to lower the regulatory barrier and paved the way for new contestants. A new non-life insurance company obtained an authorisation in that year, granted for the first time in four decades. Since then, the number of nation-wide (both life and non-life) companies has gone up from 43 to 82, which illustrates the conserving effects of the abandoned principle. In addition, seven unit-linked companies were established in 1990. The regulatory authorities, moreover, no longer fully support co-operation among Swedish companies, which also makes entry easier.

After 1988, new authorisations for underwriting credit insurance were granted both to existing and to new firms. This opened up the essentially monopolistic credit insurance market. The strong expansion of credit (discussed in Part II, Banking) stepped up demand for credit insurance. The subsequent financial crises led to massive loan losses in credit institutions and large claims on the credit insurance companies. This, together with a tendency to skimp on reinsurance, made one of the new companies issu-

ing credit insurance go bankrupt in 1990. Svenska Kredit likewise became bankrupt in 1992. As a result, the main share of the credit insurance market is held by foreign companies at present.

Newcomers to the market, in particularly captive companies, tend to improve contestability, even if they are not located in Sweden. The captive companies took market shares from the traditional reinsurance companies and also from non-life insurance companies, mostly in credit insurance and industry insurance. The captive companies' market shares are difficult to estimate in the absence of reliable statistics, but industry spokesmen indicate that, in 1990, the premiums for Swedish captive companies totalled about SEK 2 billion. This can be compared with a total of SEK 20 billion for premium income in non-life (industry and credit) insurance and reinsurance.

Brand loyalty is based upon consumer preferences for known and established products over new and unknown alternatives. It is created and maintained by continuous promotion and contacts between customer and producer and is accentuated for Swedish companies relative to foreign, by implicit barriers favouring domestic suppliers (e.g. history, language and tradition). In insurance, as in most service industries, brand loyalty used to be rather stable, in contrast to goods markets (Sapir, [1991]). In addition, there existed high switching costs for savings in traditional life insurance companies. After the co-operative links between firms had been loosened in the mid and late 1980s (see Chapter 1), the insurance companies placed more emphasis on the development of new products, on the introduction of new forms of distribution and on more aggressive marketing. In the late 1980s, promises of high bonus rates was even used to compete for new customers. This may have weakened brand loyalty by making customers more aware of alternative producers and products.

The introduction of unit-linked insurance made it possible to switch fund managers and introduced, for the first time in insurance, transparency in fund management. This certainly had the effect of weakening the strong traditional links between the customer and the companies in life insurance, at least as regards fund management.

In addition, the substantial increase in insurance broker companies (from 14 to 155, with 506 employed brokers in the period 1987-92), besides encouraging cross-border trade, may have had the long-run effect of stimulating customers (both private and industrial) to »shop around« before buying insurance.

Finally, recent events in the financial crises (e.g. a banking subsidiary to one of the largest insurance companies facing severe financial difficulties; liquidity problems arising connected with financial subsidiaries; and drastically reduced consolidation occurring in several insurance companies) may have affected the credibility of insurance companies in

general and thus led to weaker brand loyalty, at least in the short run.

The existence of economies of scale and scope was traditionally regarded as a barrier to entry in insurance. It is now recognised that such economies may not be sufficient in themselves to protect existing firms from potential entrants. However, they seem to affect the degree of concentration on the market. According to somewhat ambiguous empirical results, these economies are attainable already in the range of small to medium-sized companies (Doherty, [1981]) and exist, if at all, mainly in the joint production of related insurance products (Skogh, [1982]).

In 1980, Sweden had a total of 578 insurance companies compared to 497 in 1992 (Annex 2). The vast majority were small local companies. The decrease in number was occasioned by numerous mergers and acquisitions, mainly among these small companies, but also among some nation-wide enterprises. This seems to corroborate the above-mentioned results. Furthermore, after 1985 a wave of new establishments occurred. This illustrates the »conservation« effects of the earlier regulatory system which, albeit with good intentions, seems to have impeded a necessary adjustment of the market structure.

Market concentration in terms of the four major companies' share of gross premium income (on a group level) was, in 1984, almost 70 per cent but declined to 64 per cent in 1991. For the eight major companies, the share was more or less unchanged, around 90 percent, with a slight fall in the late 1980s. However, within both of these leading groups (four and eight largest) the competitors have become more equal in size. Thus, concentration did not increase and the tendency towards absolute dominance by one or a few companies was reversed.

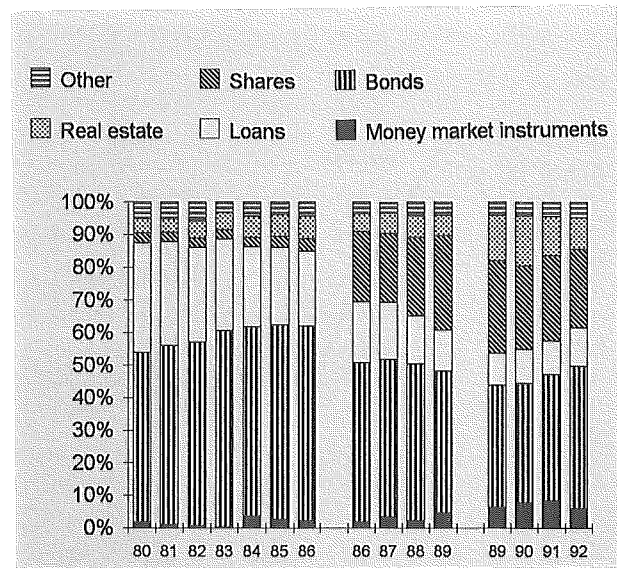
To sum up, developments such as the changes in the regulatory system during the 1980s, a less condoning stance by the supervisory authorities vis-à-vis co-operation, and the introduction of captive companies, unit-linked insurance and brokers, seem to have led to increased contestability, somewhat decreased concentration and less risk of absolute market dominance. The possible additional effects of adhering to the EEA will be discussed in Chapter 4.

2.4 Performance

The performance of insurance companies is dependent on asset returns, premiums and the composition of risks. To analyse asset returns, the asset structure will be discussed as well as asset yields.

The composition of assets is important for their yield. Assets covering the technical provisions in life insurance are strictly regulated, whereas assets covering other liabilities are not (Chapter 1). In 1985/86, when the Credit Policy Instruments Act

Chart 2.3 Asset structure of Swedish nation-wide companies
Per cent of total assets.*



* Both accounting and market values are given for Swedish listed shares in 1986, while in 1989, both accounting (except Swedish shares) and market values are given for all assets.

Source: Financial Supervisory Authority

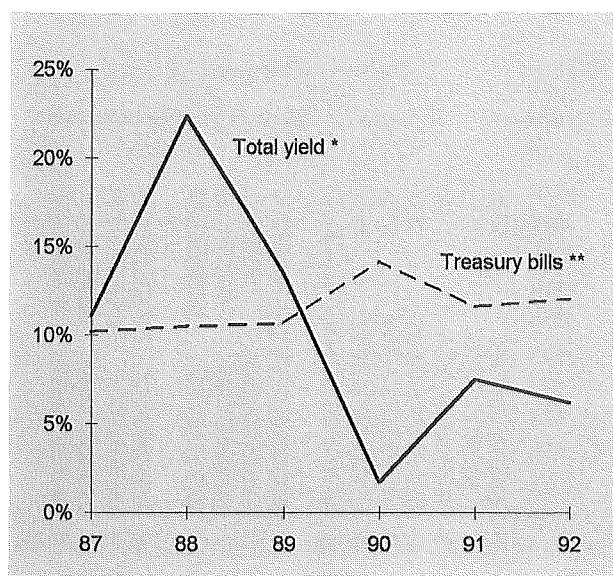
ceased to apply, it became possible to invest more freely. Nevertheless, apart from a slight decrease between 1986 and 1989, the overall share in bonds hardly changed (see Chart 2.3). Bonds still gave a higher yield than other assets allowed to cover technical provisions and therefore retained the overall share.

However, shares and real estate expanded at the expense of loans. This increase in the second half of the 1980s is explained by the economic boom, when asset prices rose sharply (see Part II, Banking). This led to an expansion of assets covering »free funds«, with overall increases in the proportions of shares and real estate in investment portfolios.

The total return on assets in life insurance companies is shown, in Chart 2.4, in relation to the yield on treasury bills. Until 1989, insurance companies' investment portfolios had a better yield than treasury bills. With the economic recession, which began in 1989-90, and the financial crisis, the return on shares and real estate dropped sharply, and so did the total yield.

In terms of overall results, the nation-wide companies, especially life insurance, were apparently successful in the 1980s, with high operating profits throughout the decade (Chart 2.5). Their business concepts as well as their management systems, although shaped by the earlier regulatory environment, seemed able to cope with the subsequent changes affecting their business.

Chart 2.4 Total return on assets in life insurance companies compared to 12-month treasury bills



* Total return on assets = A/B

A = direct yield + realised gains and losses + adjustments to the lower of cost and market value + changes in the surplus value of investment assets

B = market value of assets – financial liabilities + 50 per cent of net investments – 50 per cent of direct yield.

** Short-term securities issued by the Swedish Government

Source: Swedish Insurer's Federation and the Riksbank

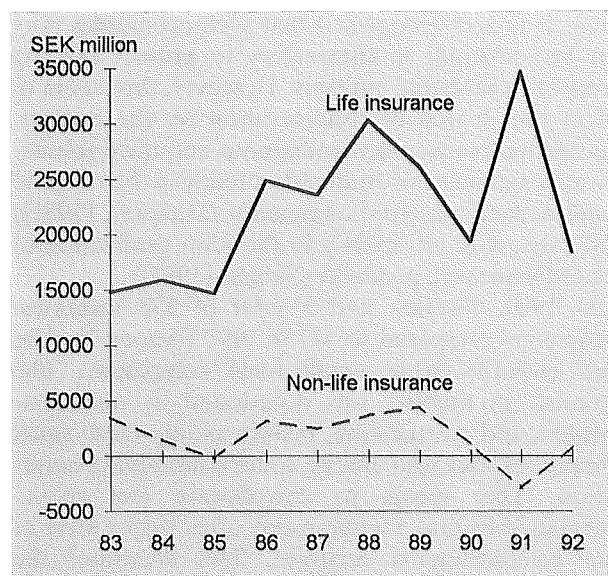
A closer look modifies this impression. »Net income from underwriting«¹⁰ followed a negative trend in the 1980s, premium income increasing more slowly than operating costs and claims. The on-going deregulation of the market, with increased contestability, may have begun to affect business. Until the financial crises, this negative trend was offset by rising investment income, due in part to the deregulation of investment rules but above all to assets rising sharply in value in the economic boom. The financial crises led to decreased investment income (except in 1991), with an increasing strain on operating profits. Insurance companies have started to react by reducing operating costs and to some extent by raising premiums. One indication of the former is that the number of employees in the industry began to fall in 1992.

2.5 Internationalisation

Three aspects of internationalisation are considered here: establishment, cross-border trade and portfolio investments abroad.

Establishment. Swedish insurance companies became more internationally active in the 1980s, mostly through foreign acquisitions and establishments.

Chart 2.5 Operating profits* in nation-wide insurance companies
SEK million



* Operating profits = Premium income – increase in premium reserve + investment income – claims – operating costs – other income/expenses – reinsurance retroceded.

Source: Swedish Insurance Society

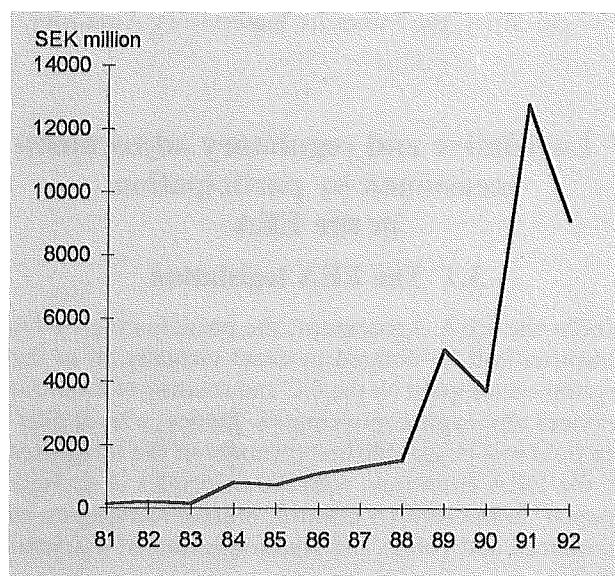
After a slow start, direct investment began rising strongly in 1988 and peaked in 1991 (Chart 2.6). At first, the main reason for establishment abroad was to follow the large Swedish non-financial companies as they became more internationalised. The surge in investments in the late 1980s was aimed, however, at preparing for participation in the forthcoming EC internal market.

The insurance companies conduct a broad range of activities abroad, the main items being large risks and reinsurance, but also some segments in mass risks insurance. The four largest companies focus primarily on countries in Europe and the United States.

The Skandia Group can be considered an international corporation with the Nordic countries as its home market. Its non-life insurance business primarily concentrates on mass risks and small businesses in the Nordic region, in a few European countries and in the United States. Skandia's life insurance is mainly unit-linked insurance, likewise offered in the United States, and with somewhat broader coverage in Europe. Trygg-Hansa SPP Holding AB acquired one of the leading large risk insurance companies in the United States in 1991, having already established

¹⁰ All net income except investment income.

Chart 2.6 Flows of gross direct investment, Swedish insurance companies abroad
SEK million



Source: The Riksbank

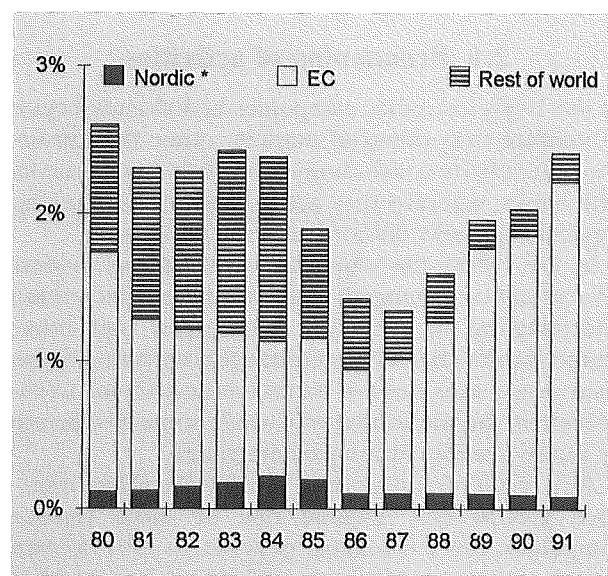
several subsidiaries in various European countries, also focusing on large risk, in the 1980s.

In 1992, the WASA group established a new company together with three European insurance companies, to form a company for European non-life insurance. Finally, Folksam has subsidiaries in both the UK and the United States, mostly concentrated on reinsurance. Folksam also has a partnership with insurance companies in Norway and Denmark. In 1992, half of the staff of these four insurance groups was employed abroad. Their premium income from abroad was about SEK 23 billion, which is 27 per cent of their total premium income.¹¹

The Swedish insurance market has been legally open for foreign insurance companies throughout the present century, but because of the implicit barriers to entry mentioned earlier, few foreign companies have set up establishments here. In 1991, they were fourteen in number, all in the non-life sector. Twelve were general agents and two subsidiaries. Their share of the non-life insurance market was 2.5 per cent in 1991, a slight fall from 1980. Among the foreign companies competing on the Swedish insurance market, those from the EC countries had the largest share in the 1980s.

Cross-border trade and co-operation. Cross-border trade in reinsurance has always existed; of all the retroceded reinsurance in Swedish companies, about

Chart 2.7 General agents' share (in premium income) of the Swedish non-life insurance market



* Nordic, non-EC countries

Source: Financial Supervisory Authority

75 per cent is international. Other Swedish insurance policies have been sold cross-border less frequently. Nevertheless, due to the differences in taxation of capital policies between Swedish insurance companies and non-resident companies (see Section 1.3), demand for this life insurance offered by foreign companies has risen sharply since the mid 1980s. The official statistics put the total submitted premiums at about 1.5 per cent of total Swedish premiums; on account of tax avoidance, the actual level may be several times higher.

Insurance policies sold cross-border are almost exclusively mediated by insurance brokers, traditional insurance companies or banks. Cross-border co-operation between insurance companies as well as brokers is common and both sides gain. Swedish companies can offer Swedish insurance policies abroad. The non-resident companies obtain opportunities for active marketing. The number of co-operation agreements rose in the 1980s, mostly with insurance companies from Nordic countries but also from other countries.

Portfolio investment abroad. After the abolition of exchange control in 1989, Swedish life insurance companies stepped up investment abroad in order to diversify portfolios, mainly by acquiring foreign shares but also, prior to the financial crisis, real estate. Although they are not required to balance foreign liabilities against foreign assets, the insurance companies normally do this to reduce the exchange risk. In 1992, foreign assets accounted for 12 per cent

¹¹ The foreign companies also include real estate companies and other non-insurance companies.

(9 per cent in shares) of the investment portfolio of insurance companies, compared with less than one per cent in 1980.

2.6 Broadening of activities

In the 1960s insurance companies had already begun to venture into financial markets other than insurance, mainly by concluding co-operation agreements with banks, whereby they acted as agents for banking services (as banks did for insurance services).

In the 1980s, the scope and form of this modest diversification changed, leading to an increasing intermingling of insurance enterprises and other financial institutions such as finance companies. Some insurance companies and banks have continued to co-operate in the traditional way, while some co-operate by jointly owning insurance companies.

As a result of this process, three of the major insurance groups now include one or more finance companies. Since it became possible, in 1991, to own a bank, one group also acquired a bank and another insurance group has part of a bank. The main aim was to use the bank's register of customers to offer tailor-made policies and, of course, to use the bank as a distribution channel. By the end of that year, about 10 per cent of the four largest groups' assets stemmed from the balances of credit institutions belonging to the groups. Thus, from the viewpoint of insurance, the financial broadening consisted mostly of the acquisition of financial institutions. Insurance companies do not seem to aim at offering other financial services in their ordinary distribution channels in the way that banks integrate insurance services in their business.

Another important factor behind the diversification of insurance business was the introduction of unit-linked insurance. Since the management of assets is separated from the insurance component of the product, insurance companies had to venture into fund management so as not to lose ground to banks and security brokers. In 1992, about 43 per cent of the assets from unit-linked insurance are managed by insurance groups, 8 per cent by jointly own unit-linked insurance companies and 49 per cent by a bank-owned unit-linked company.

As a result of the financial crisis, some insurance groups started to experience severe difficulties with their credit institutions. One of the banks mentioned above faced severe financial problems and was restructured by the Government, while some finance companies experienced liquidity problems. This led to a consolidation of these holdings by the large groups and a more guarded stance vis-à-vis that type of financial broadening. With the Government deliberating the introduction of pension saving schemes to be administered by banks and security firms, this stance is now being reconsidered (see Chapter 4).

In parallel with these developments and as a reaction to the blurring of boundaries between insurance and credit institutions, in 1991 the separate insurance and banking supervisory authorities were merged into a single entity, the Financial Supervisory Authority.

3 Legislative and regulatory adjustments occasioned by participation in the EEA

3.1 The EEA legislation

Under the EEA Agreement, the participating EFTA countries will be obliged to enact virtually all of the legislation adopted by the EC and relating to financial services and capital movements. Hence, a level playing field will be established throughout the territories of the EEA countries, with the principles of a single licence, home country control, mutual recognition of standards and rules, and harmonisation of essential rules.

The incorporation of these principles in EC legislation for the insurance sector has lagged behind that for other financial institutions. The EC adopted the third life and non-life Directives as recently as in 1992 and the comprehensive legal framework will not be in place until July 1994.

The insurance legislation which the EC had adopted by July 31, 1991, is already included in the EEA Agreement, and all the new instruments adopted thereafter will eventually be incorporated, with the exception of third country regimes. Monetary co-operation and the establishment of a single currency (EMU) have also been left outside the EEA Agreement (see Part II, Banking).

While the legal system for insurance does seem to be in place, there will still be obstacles to a fully integrated insurance market, e.g. differing contract laws and tax systems. As to contract law, the main principle is that the rules of the customer's country shall apply, the only exception being motor liability insurance, where some minimum contract standards have been adopted with a view to facilitating insurance of cars that move temporarily from one country to another. Differences between the EEA countries in the taxation of life insurance also represent a barrier. In 1992, the EC Court of Justice made a ruling implying that the deductibility of insurance premiums from taxable income may be limited by individual EEA countries to premiums paid to insurers *established* on that country's territories.¹²

¹²In what is known as the Bachmann case, the Belgian tax authorities denied Mr Bachmann, a German citizen living and working in Belgium, the right to deduct from his taxable income the premium paid for a life insurance to a German insurance company not established in Belgium. The European Court of Justice declared this to be compatible with EC legislation.

3.2 The necessary adjustments in Swedish legislation

In order to identify the adjustments that are needed in Swedish legislation and regulation to adapt them fully to the emerging EEA legal system for insurance, the present account starts from the situation on January 1, 1990.

Since then, some EEA legislation has been incorporated into Swedish law. In the Insurance Brokers Act in 1990, national provisions concerning insurance brokers were implemented. Unit-linked insurance was also introduced in 1990. The three Directives on civil liability in respect to motor vehicles have been largely implemented by amending the Motor Traffic Damage Act. A general bill covering the Directives that are already a part of the EEA Agreement, is due to be passed by Parliament in Autumn 1993. This bill and other forthcoming legal changes¹³ imply a far-reaching reform of Swedish insurance legislation, although still not providing all the necessary adjustments to EC legislation.

Single licence and home country control. Authorisation of insurance companies within the EEA will be governed by the principle of a single licence. This will permit an insurance company to do business throughout Western Europe, under either the right of establishment or the freedom to provide services. Any insurance company still has to obtain authorisation in the EEA state in which it wishes to establish business, either directly or as a subsidiary to a non-resident company. But such authorisation must be granted as long as certain requirements in the Directives are met. Branches and agencies of authorised companies are treated as integrated parts of those companies and may be established throughout the EEA without a licence.¹⁴ Supervision of these affiliates is the task of the home country. In accordance with the principle of mutual recognition, it will also be possible to sell insurance in another EEA country without establishment, that is, to carry out cross-border trade without any hindrance.

Under the Swedish provisions, an authorisation is granted provided the planned activity is not deemed to be incompatible with a sound development of the insurance system. As this rule cannot be said to exclude some assessment of need, it is likely to be modified to comply with the EC's fundamental principle of freedom of establishment. In 1990, the establishment of a life insurance company had to be preceded by the presentation of technical bases and a plan of the intended business, as discussed in Section 1.1. The business plan is similar to the scheme of

operations plan in EEA legislation and could thus be retained in an adjusted form. But it will not be possible to require or examine technical bases before granting authorisation, since provisions requiring the prior approval or systematic notification of general and special policy conditions, scales of premiums and other matters are not allowed under EC law. In this context, the provisions for calculating premiums issued by the supervisory authorities in the third-party insurance for automobile drivers is likely to be rescinded.

In 1990, establishment from abroad was allowed only in the form of subsidiaries and general agents. In the EEA, authorisation has to be granted for an EEA insurance company without requiring deposits. In the future,¹⁵ establishment of branches as well as agents will be free. Both are under the same jurisdiction as the parent company, which implies that a Swedish customer of a branch agrees to his savings being subject to foreign law. The Act concerning the right of foreign insurance companies to conduct insurance business in Sweden therefore has to be amended so that companies in the EEA countries do not face more stringent requirements than Swedish companies.

Implicit in the system of free establishment and free cross-border trade is the principle that participating countries recognise each other's regulations mutually. At present, the supervision of all insurance business in Sweden is carried out by the Financial Supervisory Authority. Foreign subsidiaries and general agents will continue to be supervised by this authority. Under EEA rules, however, the home country authorities supervise branches and agencies of their insurance companies and thus supersede the Swedish authorities. In the forthcoming legal framework, the Swedish supervisory authorities will accordingly play a subsidiary role as regards those affiliates.

In 1990, cross-border trade was still restricted in that, without an establishment, foreign companies could not actively market their policies in Sweden (Section 1.2). In the EEA the insurance companies will be free to market their policies cross-border, as will be the case in the EC from mid July, 1994.

Minimum harmonisation of essential rules. To avoid negative effects of applying principles of single licence and home country control, such as »competition through rules«, the EC legislation contains provisions on minimum prudential standards for the scope and size of technical provisions, investment rules for those provisions, solvency margins, and guarantee funds. These rules apply to both life and non-life insurance companies.

¹³ See SOU 1991:89 Försäkringsrörelse i förändring 1 (Insurance business in transition 1).

¹⁴ Free establishment will apply for branches and agencies in the EC, from mid 1994, and is in the pipeline in the EEA agreement.

¹⁵ See footnote 14.

Table 3.1 Access to the Swedish insurance market

	January 1990	In the EEA
1. Establishment through:		
General agent *	Yes	Yes
Subsidiary	Yes	Yes
Branch	No	Yes
Agency *	No	Yes
2. Cross-border trade		
	Yes **	Yes

* An agency is a general representative permanently resident in a host country. A general agent, under Swedish law, is an agency that is required to deposit a guarantee. In the EEA, no distinction will be made between a general agent and an agency.

** Passively, i.e. without active marketing. Otherwise through brokers or intermediating Swedish companies.

Technical provisions in the EC include every form of bonus to which the insured is entitled. The Swedish definition of technical provisions includes only vested bonuses. In order to comply with EC standards, technical provisions in Swedish life insurance companies may have to encompass the allocated bonuses.¹⁶

Investment rules for technical provisions in the EC concern diversification, spread, localisation of assets and currency matching. The basic rule prescribes that the mix of asset categories must match the maturity profile and other undertakings of the insurance business. To satisfy this principle, almost all kinds of asset are accepted as cover for the technical provisions, provided they give good risk diversification.

In 1990, the Swedish legislation had no rules for matching or for risk diversification. For Swedish insurance companies only some categories of asset were permitted for covering technical provisions. An adjustment to EC rules will mean allowing new types of asset such as shares and foreign investments of all categories. As a result, the investment rules for life insurance will be more liberal¹⁷ and more oriented toward risk management. For non-life insurance companies, these legal changes mean more regulation. The only investment rule that applied to them in 1990 was the five per cent rule. The EEA investment rules also prescribe caps on shares for a particular asset category and propose a limit to the size of holdings in one entity or in a certain asset. In 1990, no such restrictions existed in the Swedish legislation. One of the EEA caps concerns insurance companies' large exposures to mortgage bonds issued by housing finance institutions. Some Swedish insurance companies will exceed the limit. The EC has agreed to

a transitional period up to January 1, 2000, provided Sweden accepted a set of accompanying measures.

Assets must be localised within the EEA and the legislator is forbidden to specify, in which country to localise them. In addition, rules for currency matching apply.¹⁸ Swedish life insurance companies were, in 1990, prohibited from investing in foreign assets, with the exception of those assets covering commitments in foreign currency. Thus, new rules on currency matching and localisation of assets must be implemented in the forthcoming legal framework. This means, among other things, that assets covering the technical provisions can be located anywhere in the EEA.

Solvency margin is defined in the EEA as a margin that an insurance company must maintain to provide against business fluctuations. The directives contain detailed regulations for the calculation of the margin, which varies with the nature and extent of the insurance business. The margin consists of paid-up share capital, retained profits and free reserves. The EEA's solvency margin will be implemented in the Swedish legislation. With the present definition of technical provisions, Swedish companies have no difficulty in meeting this requirement. With a possible redefinition of the technical provisions (i.e. larger provisions and thus smaller free reserves), difficulties may arise, at least in a transitional period.

The *guarantee fund* represents a minimum capitalisation requirement that insurance companies must possess before obtaining authorisation to conduct business. If this fund falls short of a minimum requirement, it constitutes a signal to the supervisory authorities to intervene, which facilitates the Swedish supervisory authority's control of solvency.

Co-ordination with EEA rules also calls for changes in the present distinction between life and non-life insurance companies, which means that some companies that have been treated hitherto as life insurance companies, are likely to be assigned instead to the non-life category. The classification of non-life insurance in the EC differs in some cases from the Swedish system. Swedish non-life insurance companies often sell packages of insurance and the adjustment to the EC classification will tend to restrict the scope for combining different insurances.

Another change is that the annual and consolidated accounts must be altered so as to meet EC standards. For this harmonisation, a transitional period until 1995 has been granted.

Finally, co-operation between enterprises is generally forbidden in the EC, and corresponding rules

¹⁶ If so, the technical provisions would then amount to 90–95 per cent of the official balances of the life insurance companies, compared to roughly 65 per cent in 1990. For non-life insurance companies, they would include about 60 per cent of the balances.

¹⁷ At least for the part of assets assigned to the technical provisions, according to the traditional Swedish legislation.

¹⁸ Not more than 20 per cent of technical provisions may be placed in currencies other than the currency in which the commitment is to be met.

have been implemented in the Swedish legal framework. However, there is a group exemption in insurance which relates to certain agreements and practices otherwise illegal under competition rules. These apply, for example, to the establishment of common risk premium tariffs based on collectively ascertained statistics, the creation of common standard policy conditions, etc. As long as the co-operation benefits customers, i.e. improves comparability and transparency, it is allowed.

4 Outlook

4.1 Factors affecting developments in the 1990s

In this chapter an attempt will be made to identify the effects of West European integration on the structure of the Swedish insurance industry. The adaptation to the EC's legislative framework is, of course, only one of several influences on that structure. The account therefore opens with a brief look at the broader group of driving forces, namely socio-economic developments and legislative changes in general.

Considerable demographic changes are foreseen in Sweden, as in most EEA countries, including a significant increase in the retired relative to the working population over the coming decades. Social security reforms can also be expected, with the result that some administrative systems are transferred either to the parties on the labour market or to the insurance companies.

Economic development affects insurance companies in several ways. The recession that began in 1989, for instance, has slowed the growth of premium income compared with the early 1980s and impaired returns on assets. Together with the financial crisis, this has contributed to low insurance profits. In the years ahead it seems likely that an economic recovery, instead of accelerating into another prolonged boom, will resume the historical pattern of milder ups and downs. This will put increasing demands on asset management, since mistakes will not be disguised by rising asset prices as readily as in the 1980s.

Adaptation to EC legislation is likely to contribute to increased internationalisation in the 1990s. In particular, the EEA treaty reduces barriers to entry for both foreign companies in Sweden and Swedish companies abroad. The EEA drive towards a single licence, manifested in the second and third EC Insurance Directives, is likely to accelerate the pace of change. The insurance industry can be expected to review its policies and strategies in the light of new opportunities of operating throughout the EEA and the threat from increased competition. Part of the industry has therefore already started to increase its international presence (Section 2.5).

Domestic changes in the Swedish legal framework are already taking place and will no doubt continue, particularly in response to the above-mentioned demographic trends. In addition, the deregulation process will continue to affect insurance companies. In a more deregulated environment, as in the United Kingdom, the industry's profitability has fallen in some cases to levels only one-third of the profits earned in a regulated environment, as in Germany (Mutch, [1993]). Insurance companies are increasingly aware of the new environment they are likely to face and have begun restructuring operations, e.g. by cutting operating expenses in order to maintain profitability.

Among domestic legal changes affecting the industry are also the authorities' ambition to open the pension savings market to banks and mutual funds, which will have substantial impacts on the life insurance markets. In the longer run, moreover, there are effects of tax rules for Swedish insurance companies, such as taxation of returns on pension retirement schemes and capital policies.

4.2 Emerging trends

Given these factors influencing the development of the insurance industry, future trends can be discerned. These trends will be discussed under three headings: opportunities, contestability, and market structure.

Opportunities. It is now generally recognised that the existing public pension and health insurance schemes, together with other publicly subsidised schemes, are an excessive burden on the state budget and will have to be reformed in the near future. New business opportunities for insurance companies can therefore be expected from changes in the social security system and from demographic trends. Pension insurance, as well as other public or semi-public insurance services like health, work injury and unemployment insurance, are likely to be partly transformed into private solutions.

Various solutions are being discussed for the pension system. The issues include the choices between compulsory or partly voluntary, public or private, funded or pay-as-you-go. One solution could be a public system providing basic pension benefits on a pay-as-you-go basis, supplemented on a funded bases by insurance administered by a public institution or by labour market or life insurance companies proper.

Similar discussions are being held about other public insurances. In the case of the health and the unemployment insurance systems, for instance, there are proposals to transfer the responsibilities to the parties in the labour market and the administration to

e.g. the labour market insurance companies or to insurance companies.

We may thus witness a supply-driven shift of responsibility away from public insurance towards private schemes. In addition, increasing uncertainty about the future of public systems is already tending to boost the demand for supplementary private insurance as well as private savings. All in all, it can be expected that the potential for products providing retirement income will grow substantially for life and labour market insurance companies.

Contestability. In the 1990s, further deregulation, related directly or indirectly to EEA adaptation and to other foreseen changes in the legal system, is likely to continue lowering the barriers to entry. This process had already started in the late 1980s (Section 2.3). With this adaptation, it will be easier to carry out cross-border trade. More cost-effective means to establish a presence on the Swedish market are also being introduced in the EEA context. In addition, the EC legislation does not, in general, permit agreements that reduce competition. In the long run this is likely to have a considerable impact on the domestic Swedish insurance market.

EEA integration will afford increased opportunities to trade insurance *cross-border*, since it will allow active marketing in Sweden by non-resident companies. At least in the short run, mass risks will no doubt continue to be traded mainly locally, influenced by differences in legal systems, different currencies, by buying preferences, and other remaining barriers favouring domestic suppliers. However, cross-border trade is likely to increase in risks that require less administration and claims adjustments, like standardised policies in life insurance and large, commercial risks in non-life insurance.

In this context, differences in tax systems are affecting Swedish life insurance companies in competition with foreign companies' cross-border sales. In several EEA countries, taxes on the return on assets allocated for life insurance are considerably lower than in Sweden. The Swedish tax system may therefore lead to a continued reduction of demand for capital policies offered by domestic companies. This trend was already evident in the late 1980s and is likely to be reinforced. »Competition through taxation« may eventually lead the authorities to lower the tax for capital policies and, consequently, the 15 per cent tax on premiums for such policies from countries with lower taxation than Sweden. This would reinforce the competitiveness of Swedish life insurance companies at home as well as abroad, through cross-border trade.

In contrast to this, tax deductibility for premiums for retirement pension schemes paid to resident companies (Section 1.1) has the effect of sheltering

life insurance companies in Sweden from competition from cross-border trade, even though the returns on assets reserved for this policy are taxed at 10 per cent. This element of the tax system, being compatible with the EEA Agreement, is expected to remain.

The increased cross-border trade in large risks has to be seen in the light of looser ties between commercial customers and domestic insurance companies. These customers are already looking more actively for the best alternative among a broader range of suppliers. Liberalised in July 1991, industrial insurance in the EC has displayed an increasing price competition. After joining the EEA, the Swedish industrial insurers may increasingly be subject to this harsher competition as well.

While some obstacles to cross-border trade are expected to persist, as mentioned above, in the longer run they are likely to diminish as people circulate more within the EEA. Policy comparisons throughout the EEA will be facilitated by greater transparency of the companies, through harmonised accounting rules, and later also possibly through harmonised contract rules. It is then conceivable that »truly European« insurance companies will eventually be able to offer uniform products, under uniform conditions, throughout the EEA.

The EEA Agreement also implies increased opportunities for *direct investment from abroad*. The principle of a single licence does away with the need for authorisation when establishing branches. This principle also renders it unnecessary to deposit funds when entering the market with a general agent, from an EEA country. Indeed, the concept of general agent is likely to disappear in the EEA area, arising anew in the form of agencies proper.

Acquisitions of existing Swedish firms from abroad would, however, continue to be of little interest as long as the Swedish articles of association and the principle of no dividends remain unchallenged. At present, with the exception of unit-linked companies, Swedish life insurance companies are not allowed to pay out any dividends to the shareholders regardless of the form of organisation. Introducing the solvency and asset management rules prescribed in the EEA legal system would open the way for profit-making stock companies, even in traditional life insurance, possibly leading some Swedish companies to become incorporated in the true sense of the word. This might induce acquisitions or mergers, e.g. to cover the North European market with larger groups with a presence throughout the region.

Affecting the desirability of establishment in Sweden would also be a possible extension, to resident branches, of the deductibility of premiums paid for retirement pension schemes. If so, branches might become a prominent way of organising the provision of life insurance services from abroad, supplementing to some extent the cross-border trade and the inter-

mediating functions of agencies, brokers and claim adjusters.

Other factors tend to reduce barriers to, above all, *domestic entry*. These include the abolition of the needs test, the introduction of unit-linked insurance and the opening up of the market for pension savings to banks and mutual funds, all of which represents a changed supervisory attitude to competitiveness in the industry. The authorities are also trying to increase transparency by facilitating the comparison of performance between Swedish insurance companies. As of 1993, Swedish insurance companies are thus obliged to publish solvency information at regular intervals. Application of the EEA rules will enhance transparency in this regard.

At present, only pension retirement schemes provided by life insurance companies are tax deductible, which is a competitive advantage compared to other financial institutions in Sweden, as well as to foreign insurance companies. From 1994, the deductibility will be extended to pension savings schemes (capitalisation products) offered by banks, funds or securities brokers. This will face Swedish life insurance companies with keener competition from non-insurance companies for the long-term savings inherent in pension insurance, although the overall market potential can be expected to grow with this reform.

To sum up, the barriers to entering the Swedish insurance market will be subject to a multitude of withering forces. The immediate effect is unlikely to be entry by a large number of contestants. Instead, at least in the short run, there will be an increased awareness of this threat among the Swedish companies, inducing them to adopt more competitive behaviour. In the longer run, entry is likely to occur, with intensified cross-border trade and competition. This will eventually lead to structural changes, through market exit, mergers, acquisitions, etc. Thus, lower barriers pave the way for new configurations on the insurance markets. The full scope of these future events is naturally obscure but an effort is made below to identify some developments that seem plausible in the light of past experience and the new opportunities and pressures discussed above.

Market structure. An important consideration concerning future changes is the insight that the insurance market will not develop uniformly over the short or long term, the various segments being subject in different ways to new market opportunities and changed contestability.

Substantial changes in the *life insurance market* can be expected within the next few years. The introduction of pension savings in banks and mutual funds on the insurance market allows for a growing number of new contestants. Pension saving may then expand mainly in the direction of bank deposits or managed funds, to the detriment of traditional pension insur-

ance and partly of unit-linked insurance. In the longer run, some establishment of foreign firms seems likely, through affiliates or acquisitions, especially if tax deductibility of premiums is extended to branches of foreign companies.

The Swedish market for capital policies may continue to shrink through increased cross-border trade, due to tax differentials and modes for tax evasion. On the other hand, the reform of the social security system will result in an increased market potential for supplementary pension insurance, health insurance and the like, to be realised by the insurance companies. This might also result in a greater number and variety of enterprises, both life and non-life as well as labour market insurance companies.

The Swedish *non-life market for mass risks* is more mature than the life insurance market. Incentives for entry by foreign companies do not seem to be strong. The Swedish general public will continue to buy Swedish non-life insurance products, since neither tax nor other incentives seem to give a strong impetus to cross-border trade, particularly as brand loyalty is considerable. Some products, such as motor vehicle insurance, could become exceptions to this rule.

The *market for large risks* is already subject to strong competition and rather internationalised. As cross-border trade increases further, premiums and products are likely to converge in quality and conditions with those in Europe at large. This, together with the industrial customers' efforts to find »alternative coverages« like self-insurance, pools, and captives, is likely to lead to a smaller market segment for the existing domestic insurance companies, possibly even forcing them to exit the market.

For the *reinsurance market*, the adaptation to EC legislation will not involve any changes. As reinsurance has always been internationally traded, this market will be much less affected than life and non-life insurance.

As a consequence of increased cross-border trade, foreign insurance companies can be expected to enlarge their *co-operation with brokers* to reach larger groups of customers and lower distribution costs, and so with Swedish companies. Brokers are also likely to receive more requests from domestic customers to find the most suitable insurance policy within the EEA. Thus, brokers will continue to play an important role in the market.

Increased cross-border trade raises the issue of claim adjustments, since policies sold cross-border usually require settlement of the claims in the policy holder's country of residence. We are likely to see the *establishment of independent resident claim adjusters*; this need is probably being enhanced by non-life customers' preferences for domestic contacts in this regard. Such companies already exist in countries where cross-border trade is larger than in Sweden.

The *major nation-wide insurance companies* will not stand idle as their business is being dispersed in the wind of change. Adaptation is already evident in internal organisation and business strategies. The diminishing returns on assets during the recession and financial crisis, together with the competition from unit-linked funds and, soon, the pension saving schemes in credit institutions, are causing companies to increase the transparency of and improve the methods for asset management. This move is being encouraged by the supervisory authorities and will be reinforced with the introduction of new solvency and investment rules in the EEA.

In this context, the introduction of EEA rules prescribing diversification of assets covering the technical provisions may lead to increased flexibility in the composition of assets. At the same time, the »free funds« with an unregulated composition, are likely to become smaller or be absorbed into the technical provisions. The improved conditions for appropriate asset management are likely to put insurance companies in a better position to compete with banks and fund managers.

As one result, the management of risks can be expected to become more comprehensive, with increased attention to various market and credit risks inherent in the companies' assets, in addition to the insurance risks traditionally monitored by actuaries. A continued slimming of administrative expenses can also be foreseen in order to maintain competitiveness.

As to business strategies, earlier, more active efforts by the large insurance companies (i.e. groups) to diversify into other segments of the financial market (by acquiring banks, finance companies and other institutions) have come to nought during the recession and financial crises (Section 2.6). Instead, a more defensive form of financial broadening can be seen in response to increased competition in the pension market. The larger insurance companies may create special solutions to consolidate their earlier acquisitions and to prepare for competition from credit institutions. For instance, it is likely that several insurance companies will start a bank or buy a small existing bank so as to be in a position to participate in the forthcoming market for pension savings.¹⁹ By this, they would be able to circumvent a regulatory restriction whereby Swedish life insurance companies may not sell capitalisation products, this being permitted in other countries.

Another threat to the larger companies would be increased competition from companies concentrating on specific market segments or niches (a particular product, region, customer group, or channel). Recent analysis reveals that most of the top-performing companies in the EC are »niche companies« (Mutch,

[1993]); these companies have lower cost structures than the larger entities, because they concentrate on the most profitable market segments.

The large Swedish companies seem to be burdened by the size and complexity of their business activities. This posed no threat to their viability in the former regulated system but could be a competitive drawback in the new business environment. One can foresee efforts by some of the large companies to »mirror« the behaviour of niche companies by weeding out relatively unprofitable product segments and reorganising themselves into »multi-niche companies«.

The EEA Agreement self-evidently affords Swedish companies greater opportunities of establishing operations abroad or selling policies cross-border. Most of the Swedish companies seem, at present, to be concentrating on the domestic market and even withdrawing some activities abroad, although a few companies may go on expanding on the international market through their existing subsidiaries. In the longer run, it is not unlikely that Swedish companies will again seek to expand abroad, as they began to do before the financial crisis.

4.3 Conclusions

A reformed social security system is likely to lead to new business opportunities for the Swedish nation-wide insurance companies, both life and non-life as well as labour market insurance companies. In addition, other financial institutions will be affected by the increasing demand for private solutions to pension schemes, when deductibility for pension savings is allowed also in these institutions.

At the same time, barriers to entering the Swedish market are being lowered, through adaptation to EC legislation and domestic legal changes. Swedish companies are likely to meet more competition from abroad even in the short run, mainly in standardised capital policies and large risk insurance. Contestability from domestic credit institutions will grow with the introduction of tax deductible pension schemes. Plausibly, this will tend to force the existing companies to adopt more competitive behaviour, thereby further weakening the traditional co-operation among firms in Sweden.

The lower barriers to entry will pave the way for new configurations on the insurance market. New contestants in the form of banks, will enter the pension market. Also, if the deductibility of pension insurance premiums is extended to foreign branches, foreign life insurance companies may well establish in Sweden for the first time. In the light of increased cross-border trade, there might be an increased demand for brokers as well as for independent claim adjusters.

¹⁹ In September, 1993, Trygg-Hansa applied for a licence (oktroj) to start such a bank.

The large insurance groups will not be inactive during this process. They are likely to reduce operating costs and also increase the transparency of policy conditions and asset management, the latter being encouraged by new investment rules. These new rules might also pave the way for better risk management, which would strengthen the competitiveness of these insurance companies against new pension market contestants such as credit institutions. In addition, some large insurance groups will probably start or acquire banks to further improve their position relative to these institutions on the pension saving market.

There is also likely to be room for niche companies specialising in specific market segments, which poses an additional threat to the larger companies. The latter may then try to react by rethinking their product strategies, even possibly by reorganising into »multi-niche« companies.

Over time, the EEA Treaty will open up the markets in other countries, since the Directives and the increasing mobility of people within the EEA will make it possible to market standard policies over a wider group of countries. This, together with a necessary recovery after the financial crisis, could rekindle strategies for internationalisation in the large insurance groups.

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Annex 1

Calendar of driving factors (1980-92)

This calendar is in two parts. The first lists legal regulations and deregulation, the second covers other driving factors like self-regulation, broadening of activities, taxation etc.

Regulation

1980

- The enabling Act on Credit Policy Instruments is implemented by the Riksbank, and investment ratios for priority bonds are imposed.

1982

- The agreement on no dividends to shareholders of insurance companies is enshrined in law.

1985

- The principle of need is abolished, leaving only the principle of soundness.
- An entirely new company is granted authorisation, for the first time in 40 years.
- Abolition of the investment ratios for non-life insurance companies.

1986

- Group insurance is permitted for non-life insurance companies.
- Abolition of the investment ratios for life insurance companies.

1988

- The agreement not to underwrite non-life and credit insurance in the same entity is terminated.

1989

- Foreign exchange control is virtually abolished.

1990

- A new Act concerning life insurance linked to mutual funds comes into force.
- A new Act on insurance brokers comes into force.
- Foreign companies are permitted to sell insurance policies cross-border through a broker or a Swedish company, provided the transaction is initiated by the customer. The Swedish company must have an agreement with the foreign company, to market its policies.

1991

- Insurance companies and credit institutions are permitted to own shares in one another's company or belong to the same joint holding company.

Other driving factors

1984

- Self-regulation: the Marketing Committee rejects the use of brokers.

1985

- Self-regulation: The marketing agreement ceases.

1986

- Taxation: A temporary tax is levied on the capital of life insurance companies.
- Broadening: Skandia sets up a finance company to offer financial services mainly within the group.

1988

Self-regulation:

- The Marketing Committee's decision not to use brokers revoked.
- Abolition of the agreement on technical bases for life insurance.

Broadening:

- A non-financial company, Stora, establishes its own insurance company, mainly for credit insurance.
- PK-Banken establishes a life insurance company.
- Trygg-Hansa initiates leasing and financial business through a finance company.

1989

Broadening:

- WASA establishes a finance company. Sparbanken and Folksam start a jointly owned insurance company.
- RKA and Handelsbanken initiate co-operation.

1990

Self-regulation:

- A segment of labour insurance is opened for life insurance companies, through a decision by the parties on the labour market to let these insurance companies administer some of the insurance.

Taxation:

- Parliament reforms the Swedish tax system in 1990-91. Returns on pension capital reserved for occupational pensions are taxed at 10 per cent and other returns at 15 per cent.
- Some of the untaxed reserves in non-life insurance have to be dissolved.

Broadening:

- WASA acquires half of Bohusbanken's share capital, and also a finance company, Finax.
- Seven unit-linked companies are established.

Other:

- Njord, one of the newest insurance companies, is declared bankrupt.

1991

Broadening:

- The Financial Supervisory Authority is established.
- Skandinaviska Enskilda Banken starts a life insurance company.

Taxation:

- Premium tax imposed on foreign life insurance.

1992

Taxation:

- New tax ratios – 25% on capital insurance, 10 % on retirement pension schemes.

Other:

- Svenska Kredit and two subsidiaries are declared bankrupt; the business is continued by foreign credit insurance companies.

Annex 2

Numbers of insurance institutions

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Life insurance													
Traditional life	15	15	15	18	18	18	19	18	19	22	23	23	25
Unit-linked											7	7	7
Non-life insurance													
Nation-wide	33	33	33	32	32	35	38	40	44	45	55	56	57
Local	523	509	612	484	481	476	460	441	443	431	407	408	408
Reinsurance													
	7	7	8	8	8	8	7	7	6	7	—	—	—
Total	578	564	668	542	539	537	524	506	512	505	492	494	497

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