Stefan Ingves: Can regional financial sector assessments provide additional values to the EU countries?

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, at a seminar arranged by the National Bank of Belgium, Brussels, 13 June 2006.

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What is needed for financial stability?

I am honoured that you have invited me to speak tonight, setting the scene for tomorrow's seminar. I am in the enviable position of having inside knowledge of the strengths and weaknesses of the IMF-FSAP framework and at the same time in my new position being free to think ahead without necessarily being mindful of internal IMF policies on every detail. That said, although I have moved from the IMF I feel strongly about the financial stability assessments, such as the FSAPs, and I sincerely think that they can make a difference.

My message to you today could be summarised as follows:

- The main value of the FSAPs so far conducted is that they link together the various parts of national financial systems; identifying strengths, weaknesses and vulnerabilities.
- However, the national focus becomes increasingly irrelevant due to the rapid development of cross-border establishments and other financial interlinkages. Hence, we need a multilateral approach, such as a regional one.
- The EU-area is well suited to perform regional financial stability assessments since cross-border integration has come a long way in Europe. In fact, I believe that the EU countries should set up a system to conduct their own regional self-assessments.

The large numbers and high financial and social costs of the financial crises in many countries in the 1980s and 1990s convinced decision-makers that concerted measures had to be taken on an international level. Through the increasingly global character of the financial system, problems in one country tended to spill over to other countries exacerbating the problems and the costs. The measures taken included setting global norms and standards and increasing the surveillance of financial systems.

Agreements were reached on various means of identifying and reducing vulnerabilities in financial systems. International standard-setting bodies such as the Basel Committee, the IOSCO , the CPSS and the IAIS were requested to establish frameworks of sound regulatory practices in their respective fields. These so called core principles are now broadly accepted as minimum standards, to be applied by all countries.

But good standards are not enough. We must also ensure that they are applied in an environment of adequate preconditions, such as the rule of law and property rights, fair and competent accounting and auditing, and arrangements for predictable and fair resolution of the problem of failing institutions. There must also exist an adequate institutional framework, e.g. for an efficient division of roles and responsibilities between different public and private institutions. A crucial part of the financial institutional framework, whose importance is sometimes neglected, is the payment system and its infrastructure.

A country's financial system is also susceptible to the vagaries of economic and political developments. For instance, while a fixed-exchange rate regime in certain circumstances tends to support financial stability in a country (or group of countries – to refer to the European context) there might be situations in which such a system could have the opposite effect. To underpin financial stability, economic developments should be sustainable, transparent and predictable. This also applies to political decisions, which affect the financial system directly or indirectly.

Completing the circle and reverting to my first observations on the increased global linkages, most countries' financial systems are influenced by developments outside the domestic economy. Linkages come through different channels: macro economic events having international repercussions, for instance through international markets, or "micro events" such as via banks' cross-border affiliates.

The FSAP – an attempt to tie together the loose ends

Given the various pieces needed to shape and maintain a stable and efficient financial system we need a bird's-eye view to see that they are all in place and that they do not counteract one another. The approach should also identify weak spots from which the financial system potentially might be destabilised.

This need for a bird's-eye view resulted in the creation of the FSAP. The FSAP is intended to cover the pieces I just mentioned – standards, preconditions and institutional setting and the interplay of these factors in the context of the domestic economy. The FSAP is also expected to include implications of international interlinkages but I admit that this part has become gradually more difficult as a result of the increased scale, scope and complexity of financial institutions and markets conducting cross-border activities. To be blunt: How do you assess the effects on the Swedish financial system from our internationally-active banks which practice centralised funding activities and even to some extent credit registration? How do you look at banks organised along product lines, while regulation and supervision mostly is national? This is the rationale for moving to regional FSAPs in order to catch issues we might miss if we focus on monitoring single country financial systems only.

The FSAP has significant added value embedded in its integrated approach. The integrated approach implies that we assess, for instance, whether weaknesses in public institutions or in other preconditions undermine efficient regulation and supervision; or whether volatile macro economic conditions hinder the effective functioning of financial markets and institutions. We also assess whether there is an appropriate balance in the financial sector; as an example, some countries are excessively reliant on a dominating banking sector. Finally, stress tests are performed to identify possible causes for threats to financial sector stability and also to identify where the first signs of instability might emerge – such as in banks, other financial intermediaries or in the payments system. This approach links together the different parts and presents an integrated view of the overall situation. In the early days many did not like the stress tests, but this has changed and today stress tests are an established part of the toolbox.

While nobody could argue that FSAP assessments will identify all weaknesses, I have observed that in most of the assessments shortcomings and vulnerabilities show up quite clearly. While on this theme, I would also like to express my strong disagreement with the view expressed by some that "country circumstances are highly different so it is fully legitimate that they have very different legal and institutional underpinnings". While I am not opposed to different approaches, as long as they do the job, my impression after having visited or analysed the majority of the IMF's 184 member countries is that the circumstances are usually not all that different. My conclusion is that the necessary prerequisites for financial stability are much the same in all countries and this includes sound fiscal balances as well as macro economic structures and developments. Frankly, the talk about "special circumstances" could often be seen as an excuse for not being prepared to apply necessary but unpopular measures. In this, we Europeans are not better than anybody else.

This brings me to another added value of the FSAP – the fact that the assessment is conducted by somebody outside your own country, such as the IMF or the World Bank. I think we can all admit that even with the best of intentions it is difficult for us to take a fully objective view of our domestic structure of laws and institutions, in particular when looking for weaknesses. The role of being the scapegoat for bringing bad tidings from the results of the FSAP assessments is well-known to the IFIs from their traditional work and it is actually a much appreciated role by the domestic authorities. On an FSAP mission it is quite common that high officials from the country concerned, in private, remind the IFI representatives not to forget to mention certain shortcomings. If you plan to conduct FSAP-like assessments without the involvement of the IMF or World Bank, it is important that you establish a process which ensures the integrity of the assessment.

The FSAP is not only a way to identify weaknesses but also a tool for prioritisation of remedying these weaknesses and for providing technical assistance. An important part of the FSAP outcome is to leave behind a list of recommended remedial action, setting out the priorities. Since the scope of the FSAP is broad, prioritisation should become easier and more balanced than if assessments were conducted following a piecemeal approach. The FSAP process also contributes by informing about new research findings and about good practices used in other countries.

The future FSAPs

By now, FSAPs have been performed in more than 130 countries. This covers almost all important countries in a global financial perspective, with a few notable exceptions such as the US and China. It is thus natural to start thinking about the future of the FSAP process. Several alternatives could be envisaged, and they are not mutually exclusive:

- Simple updates of earlier FSAPs to ensure that countries have taken care of their weaknesses and that no new ones have developed.
- A change in the scope of FSAPs, for instance to better take into account the cross-border aspects of financial sector strengths and vulnerabilities.
- A different dimension is whether future FSAPs should be open to all countries or mainly to those having a bearing on the stability of the international financial system.
- Another discussion involves to what extent there could be closer integration between the FSAPs and the Article IV processes.

Some of these "future FSAPs" have in fact already started, albeit on a small scale and could be regarded as trial assessments in the search of the ideal format. There have been some FSAP update missions and the IMF is at this very moment embarking on so-called regional missions, in the BeNeLux and Nordic-Baltic regions. From what I have seen so far, these FSAPs are off to a good start, focussing as they should on the interlinkages between the large cross-border financial groups operating in these regions.

Moving to regional FSAPs will substantially increase the complexity of the assessments. These will include analysing the interplay of different regulatory and supervisory systems and also different legal and institutional arrangements, for instance when dealing with problems in cross-border financial institutions. There will also be assessments of the implications of one country's weaknesses and vulnerabilities on some financial institutions and financial infrastructures which are active in that country but which have their main activities in another country – maybe even outside the region. The analysis will be compounded by the fact that the national governments and authorities may select policies and approaches which are not compatible simply because their national interests differ. For regional FSAPs in European Union and EEA countries the work becomes somewhat easier since there exists a common minimum framework of legislation. But there may also be complications such as in the Nordic-Baltic FSAP due to the mixture of currency arrangements – one country is already using the euro, some are outside and still others in a transitional mode.

Notwithstanding the difficulties of conducting regional financial stability assessments I sincerely believe that they imply a major positive and even necessary shift. In today's world, where financial sectors are often closely knit across the borders, it makes little sense to analyse financial stability on a standalone domestic basis pretending that external events do not matter or can be reduced to simple parameters in the stress-testing models.

How could FSAP-like assessments provide additional value in a European context?

In order to answer this we first must define what the "European context" is. Whatever the criticisms, European integration has come a long way, not least in the financial field. The acronym "FSAP" in its specific European meaning has been successful in bringing increased efficiency and access, and lower costs to many, but more needs to be done, for instance for retail transactions.

The flip side of integration is increased dependence and greater risk for contagion from developments in other countries. In the financial field we face this mainly in the cross-border operating banks and other major financial institutions and also in the infrastructure for the conduct of payments and settlements. But financial stability may also be indirectly affected by real sector developments, such as real estate prices.

I can see two alternative ways of structuring a regional European FSAP. It could either be founded on a "whole region-approach" identifying the general situation and then analysing how various developments affect overall stability; or it could start from the individual countries and analyse how each country might be affected by influences from abroad – be it through their financial groups at home, abroad or through other channels, including the payment infrastructure such as regional exchanges. The analyses of a number of countries could then be added together to form a relevant

region, which could be the EU, the euro area, the EEA, some subset thereof or even one of these regions plus one or more financially important systems in the neighbourhood, such as Switzerland.

My leaning would be toward the second one. The first one, which we may call the pan-European approach, has tended to produce a lot of numbers on aggregates and averages in the financial stability analysis. No country wants to stick out in the assessment; they hide behind these broad numbers. But you cannot identify weaknesses and vulnerabilities through averages. "On average", banks' credit portfolios and capital ratios may be robust but an FSAP should look for the outliers – the ones which will break first.

Whichever approach you select, you would need to include a detailed analysis of those major financial groups which cross the borders between the European countries and sometimes also operate outside the region. These groups are in many cases so large that they could influence countries both positively and negatively depending on developments. Let me give you a recent example from my own country:

Icelandic investors have bought large stakes in Swedish financial firms. The investments are rather small from the Swedish point-of-view but significant for their parents in Iceland. Recently, there has been volatility in the Icelandic financial and currency markets. Luckily, the investments in Sweden are doing very well and have rather contributed to strengthening the Icelandic financial system. But in another situation the reverse could have been true – had the Icelanders made these investments during the Swedish banking crisis in the 1990s the Swedish holdings would have contributed to weakening the Icelandic economy.

My point is that, in addition to analysing vulnerabilities in individual countries and general macro-economic linkages between countries, you also need to look in particular at the major cross-border financial groups and financial infrastructure. The good news is that these are not so many, after all. Of the approximately 8,300 credit institutions in the EU, only nine are defined as truly pan-European and less than fifty have cross-border establishments in more than two countries. When assessing preconditions, regulation and supervision you need to look not merely at individual countries but also at whether there are major differences or gaps in the application between countries or between financial sub-sectors and if this might lead to vulnerabilities, in particular in a crisis situation. As we all know, a common European approach to bank problem resolution has so far not been developed. In a potential or actual crisis situation, we may face "the prisoners' dilemma" in which the optimal solution may not be achieved since each country would tend first to look to its self-interest.

Hence, it is important for a regional FSAP to identify vulnerabilities stemming from potential conflicts between home and host countries in the resolution of a failed financial group, which for instance might have systemic importance in the host country but not in the home country. The common thread in all this is that an FSAP should focus on two things: The weak spots as well as the channels for contagion of weakness. This is what the IMF is doing in its single-country FSAPs. In a multi-country FSAP you must give increased emphasis to the cross-border weaknesses and channels in addition to the domestic ones.

A regional FSAP might include an analysis of efficiency aspects. The financial system may be robust but is it efficient? It is possible to regulate a financial system to ensure a very low level of risk, but the cost in terms of reduced efficiency may not be worth the gain. But on the other hand, the cost of a crisis can be so large that building adequate prevention makes good sense. A reasonable balance must thus be found between on the one hand efficiency and on the other hand the degree of regulation and the ways to implement it.

Conclusion

The whole FSAP process, which uses large resources in manpower and financial costs, was created to meet a specific purpose: to reduce the incidence of financial sector problems. It is as yet too early to prove whether this goal has been met. It is a fact that there have been fewer cases of major financial crises since 1999, when the FSAPs started, but this might also be attributed to the fact that global economic development has been generally positive during this period. It is also a fact that compliance with preconditions and with regulatory standards has improved since the FSAPs started – as an important example, the minimum capital ratios for banks have increased globally.

However, we can all see that much remains to be done worldwide, including in our own countries. What makes our task harder is that the goalposts are moving all the time. Ever increasing complexity

and interlinkages in the international economic and financial system mean that legislators and standard-setters must run just to try to catch the moving train.

In the European context, cross-border integration has progressed further than in other parts of the world, which strengthens financial development and presumably also stability. But integration means increased risks for contagion and we must be vigilant to identify and deal with any vulnerability in the system. Regional FSAP-type assessments are at the same time broad and focused and thus useful for this purpose.

In my view, it would be totally wrong to regard the FSAP as a process where the IFIs are the providers, the countries the recipients and the other stakeholders form an interested but passive audience. We need an ongoing dialogue to understand and improve the process. Hence, I am particularly grateful to our Belgian hosts for having arranged this seminar which will give us an opportunity to discuss these important issues.

Thus my final conclusion, which answers the question posed in the title of this speech, can be very short:

Yes, I strongly believe that regional financial stability assessments in the EU and EEA areas can provide additional values to financial stability and to a better understanding of how the cross-border interlinkages between the financial groups and the infrastructural financial arrangements under certain circumstances may add to the vulnerability of the systems. The IMF may certainly to some extent assist Europe in such assessments, but the EU should also make its own arrangements for self-assessments.