

Lars Heikensten: The Riksbank's work on financial stability

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, at Göteborgs University, Göteborg, 25 November 2003.

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First a word of thanks for the invitation to address you today. I feel privileged to be speaking at a Felix Neubergh lecture.

In autumn 1992 a decision at very short notice was required of Sweden's government and parliament: should they choose to support Swedish banks without really knowing how large the support might have to be, or risk a financial crisis with unforeseeable consequences for the Swedish economy? All the Swedish banks had incurred large loan losses. And regardless of how much a particular bank had lost, the international credit market had little confidence in the Swedish banking system. The banks faced severe financing problems that might ultimately have led to their failure and could have made it difficult in the shorter run for Swedish companies to cover their funding requirements.

The decision was the only reasonable alternative - to rescue the Swedish banks. The government issued a general guarantee for the banks' liabilities and set up an authority, Bankstödsnämnden, specifically to cope with the banks that were in serious difficulties. The government, explicitly supported by the opposition, acted just as vigorously and promptly as the situation required. But this did entail making a decision - on the basis of insufficient information about the causes and depth of the crisis - that could have burdened the government budget with at least a hundred billion kronor. That is an experience we do not wish to repeat.

Sweden recovered from the crisis on that occasion and in many instances our way of resolving it has served as a model for other countries. The crisis also focused attention on the work for financial stability. With the growing complexity of payment systems and the financial sector's expansion, financial stability has become an increasingly important issue for the Riksbank, as it has for other central banks around the world.

A review

The bank crisis spawned a certain amount of self-criticism, not least in the Riksbank. In practice, the Bank had not backed up its function of promoting a safe and efficient payment system with any systematic analytical work. The problems that arose had taken the Riksbank, along with many others, by surprise. So we started to build up knowledge and an analytical capability in the field of stability. The work was initiated on a modest scale with just a handful of staff. It had a narrow focus on the early detection of weaknesses in the banking system that might lead to another bank crisis.

The Riksbank also decided to publish a report that would discuss the situation for bank sector stability. Internal reports had been produced earlier. In autumn 1997 the Riksbank accordingly presented its first more cohesive public analysis of financial stability. The new report was intended to signal the importance the Riksbank attached to work on stability and it also helped to focus and develop the internal efforts. The experience of work on the Inflation Report had been encouraging, so it seemed natural to build up the work on and communication about issues to do with stability in the same way.

By launching the Financial Stability Report or, as it was called initially, the Financial Market Report, the Riksbank was the first central bank to issue a public account of its appraisal of financial system stability. Its example has been followed to date by about thirty other countries. Recurrent financial crises have made it clear that there will always be problems which the authorities are obliged to address in some way and it may therefore be of some assistance to have a clear, structured presentation of the approach to financial stability. This has led the International Monetary Fund, for example, to pay growing attention to these issues. Since 1999 the IMF and the World Bank are engaged in joint evaluations of national financial systems in what is called a Financial Sector Assessment Program. Matters to do with stability are also on the agenda almost every time I meet my colleagues from other countries.

Principles for financial system oversight

First I should perhaps reiterate what we mean by the financial system. It is the system that provides payment services, converts savings into financial resources for investment and consumption, and contributes facilities for managing risk. In other words, the financial system performs a number of important social functions. If any of these functions were to be disrupted, the social costs could be very high.

The damage inflicted by a disruption would probably be particularly great if it involved a vital component of the payment system. This is readily understood when one considers the enormous flow of payments. In Sweden, for instance, the payment system has a daily turnover of around SEK 500 billion, which means that the equivalent of our annual gross domestic product has to be handled in less than a week. Studies show, moreover, that in the past fifteen years there have been more than a dozen crises which cost the countries concerned at least 10 per cent of their GDP.

So there are good reasons for state supervision of the financial system. The Riksbank has a function here in that the Riksdag (Sweden's parliament) has made us accountable for promoting a safe and efficient payment system. A major ground for making us responsible for efficiency and stability is that, along with the banks, the Riksbank is a central player in the payment system and provides means of payments. The banks distribute notes and coins, keep transaction accounts linked to giro systems and operate credit card systems. The Riksbank in turn provides accounts in the payment system, RIX, that is available for large-value interbank payments.

The work on financial stability is undertaken in three main ways. One concerns the rules and regulations that set the bounds for the operations of financial companies. Another is the continuous surveillance of the system that is performed by Finansinspektionen (Sweden's Financial Supervisory Authority) as well as by the Riksbank. Thirdly, the state needs to be able to manage any crises that nevertheless occur. The work on stability calls for highly developed cooperation between the Finance Ministry, Finansinspektionen and the Riksbank.

The laws governing financial operations are enacted by the Riksdag, with the finance ministry as an important agent. More detailed regulations are issued by Finansinspektionen, which also monitors their observance. The Riksbank's contribution to the work on rules and regulations consists in the first place of submitting opinions; in addition, the Bank participates in international efforts to develop the regulatory framework.

The role of the Riksbank in surveillance work is central and focuses on the functioning of the financial system as a whole and the risks that may arise. The identification of risks in the system as a whole means, moreover, that the individual institutions and the financial infrastructure have to be scrutinised.

It is primarily Finansinspektionen but to some extent also the Riksbank that need to keep a continuous eye on the individual banks. Due to the central functions of the banks, a crisis in the banking system might swiftly have serious consequences for the payment system as well as for the supply of credit.

But it is not just the significance of the banks in the payment system and as a source of credit that warrants their supervision. As The Economist wrote last spring, banks are "the most hazardous economic institutions known to man". That may sound rather drastic but there is some truth to it. It is not that bankers are a tribe of irresponsible gamblers but that their much-needed function in the economy requires them to act in certain ways. Banking is essentially a matter of taking risks. A bank's funds (its deposits or its loans from other banks) are liable to disappear at short notice, while realising assets takes longer.

Moreover, problems in one bank are liable to spread to other banks. This systemic risk exists because the banks have liabilities with each other in the form of loans or securities transactions and because they participate in the payment system. The similarity of their operations also means that problems elsewhere may hit the banks as a group. Contagious effects may occur, moreover, simply because people suspect that the banks are inter-connected.

To a growing extent, oversight of system stability calls for oversight of the financial infrastructure in the sense of the systems that are needed to effect payments and to trade in and deliver financial products. Bankgirocentralen is a case in point. If these systems function properly, there will be less risk of problems either spreading between the participants and from the financial markets, or arising because the system as such is disrupted.

The third aspect of surveillance work - crisis management - has to do with the possibility that the state needs to act to prevent a crisis from jeopardising system stability. In order to manage a crisis, the state

must be able to judge what the consequences will be if a distressed institution were to fail and, if these consequences are likely to be serious, what measures can be taken to mitigate them. The solution in some cases may be to contribute to an orderly closure, while in others it may be to provide financial support. An example of the latter is the general bank guarantee the state provided during Sweden's bank crisis.

In certain cases it may be up to the Riksbank to provide assistance with liquidity. If a bank's problems were to be so serious that stability is threatened - and the bank is considered to be viable in the longer run - the Riksbank can grant credit on special terms and act as what is usually known as the lender of last resort.

The continuous surveillance and crisis management are closely connected with each other. Oversight is essential for the Riksbank's ability to judge whether or not a crisis constitutes a threat to financial stability. Without a continuous analysis of the banks, it would be difficult to determine whether and how any support should be provided in a crisis.

The work on oversight and crisis management

The Riksbank presents its analysis of system stability every six months in the Financial Stability Report. The Report basically aims to provide a picture of the Swedish banks' ability to stand up to any disruptions. The purpose is to identify conceivable risks and present a sound analysis that influences the market's participants. The task of the Riksbank can perhaps be described as to keep cool and restrain undue optimism when there seem to be no problems in an upward phase, and to fill in the picture, if necessary, in a downward phase to allay concern about serious loan losses.

The analysis concentrates on the four major Swedish banks because their size makes it likely that they are relevant for system stability. The failure of one of these banks might jeopardise stability, though this is by no means certain.

The durability of the banks is dependent on a number of factors. The Riksbank analyses the main categories of borrower, developments in the bank groups and the financial infrastructure.

Borrowers are analysed in terms of the corporate and household sectors in general, with particular reference to levels of debt and the future ability to pay. The real-estate sector is considered separately because the companies here account for as much as one-third of the banks' corporate lending. The prices of commercial properties and private housing are also analysed because they reflect the value of the collateral that is pledged for loans from banks and mortgage institutions. In that Swedish banks are expanding their operations in the other Nordic countries and the Baltic region, developments in those countries are becoming increasingly important for them. Borrowers abroad now account for approximately half of the banks' total loan stock. The analysis of borrowers has therefore been extended abroad.

The major bank groups are analysed in various respects. Profitability trends illustrate the ability of the banks to build up reserves for unexpected losses. Moreover, there is always the strategic risk that a bank with weak profitability will be tempted to try out new, bold lines of business in order to generate a higher return on equity.

The analysis of the banks' credit portfolios can provide an indication of how loan losses are likely to develop in the coming year or two. Another aspect of the analysis is the banks' liabilities. Traditional banking involves accepting deposits and using the funds for making loans. People's growing propensity to save in other instruments than bank accounts has forced the banks to finance the growth of credit by borrowing in the capital market. The structure of bank funding provides an indication of the risks in bank liquidity. Monitoring this is perhaps the most difficult part in that the liquidity situation is liable to change very rapidly.

If problems in one bank group spread to other players in the system via the banks' mutual commitments, the payment system may be affected immediately. The Riksbank therefore keeps an eye on interbank exposures.

Oversight of the infrastructure concentrates on the systems that are vital for the functioning of the financial market in Sweden. Besides RIX, the system for large-value payments provided by the Riksbank, these are primarily the central securities register (VPC), the Stockholm Stock Exchange and the clearing system for retail payments (Bakgirocentralen or BGC).

The Riksbank has also chosen to work on practical matters to do with risk management. These issues are invariably complex. Financial crises can arise at very short notice, not least on account of the massive payment flows and because banks tend to have a large element of short-term funding. The ongoing integration may have made things even more difficult.

The Riksbank has therefore built up an internal crisis organisation and clearly documented who does what in the event of a crisis, including those who are to be contacted and put in the picture, how the press is to be informed, and the legal consequences of various measures. Another important element in the work on readiness is regular crisis exercises.

Crisis management has also come to feature prominently in Sweden's international profile. This has to do with our experiences as well as our basic stand on the importance of transparency. The Riksbank is leading Nordic and European working groups in this field. One of the articles in the latest Financial Stability Report that was published yesterday deals with the role of the Riksbank as lender of last resort. It discusses the principles that determine the situations in which the Riksbank can consider providing support for distressed banks and the terms for the support. Many other countries are reluctant to talk about these matters openly for fear that banks will be tempted to take greater risks. The Riksbank, on the other hand, sees openness as a means of deterring greater risk-taking. Clear game rules mean that the banks know more about what to expect.

Future stability work

Much has been done with the Riksbank's work on stability in the past seven years but it is not hard to pick out fields where there is room for improvement. The analysis of borrowers abroad will be enhanced. The Riksbank needs to acquire a better understanding of how the banks manage their liquidity, select sources of funding and the effects of this on their durability. The analysis of stability also needs to be supplemented with methods for stress tests, that is, ways of analysing the sensitivity of bank durability.

To obtain further inspiration for the work of improving the analysis, the Riksbank has commissioned an external evaluation of the work on financial stability. This evaluation is in the hands of a trio representing the international research frontier, the central bank world and the Swedish bank sector. They will be bringing their individual perspectives to bear in a joint effort to evaluate the quality and focus of the work we have built up. We intend to publish their report and then issue invitations to a broad discussion on our work's future direction.

In conclusion I would like to say something - without prejudicing the trio's findings - about the issues that I believe will have growing importance in the future. A natural starting-point for such a discussion is to identify forces that will be driving future financial developments. Three of the main forces are:

- growing cross-border integration in Europe,
- more advanced risk management by the banks, and
- more and more of a focus on aspects of efficiency.

Consequences of European integration

It is perhaps the increased international dependence that affects us most clearly. While the banking systems in Europe are still largely national, integrated systems have started to appear in certain regions. This trend seems to have come furthest in the Nordic-Baltic region but there are grounds for expecting greater integration elsewhere, too. As a result, national banking systems will become increasingly interdependent.

This has a number of dimensions for the Riksbank's work on stability. One component of our work consists in promoting integration by influencing the construction of rule systems. We do so out of a conviction that integration as such favours economic growth.

The current rule systems were not designed for an integrated European bank market that transcends national borders. Moreover, the common legislation takes integration into account to only a limited extent. In order to achieve an inner market for financial services, the EU is striving to produce as uniform a set of rules as possible for financial companies throughout the Union. Banks can then compete on equal terms and give rise to a common market with the most competitive enterprises.

The Riksbank supports this admirable ambition. But it is also important to avoid conceivable pitfalls that may hamper this development. One danger is that the rule system becomes excessively detailed, that harmonisation starts from the strictest existing system instead of proceeding from an entirely open discussion.

Integration also affects the regular supervision and oversight. The current principle is home-country supervision. In other words, a bank's legal country of domicile is responsible for the supervision of the bank's branch offices; a banking subsidiary, on the other hand, is supervised by the country in which the subsidiary is legally domiciled. But it is still the legal country of domicile of the parent bank that is responsible for supervision of the bank group as a whole.

This solution ought to work as long as the foreign operations of the banks are fairly modest. But what will happen when the banks' foreign branches become systemically important? How much responsibility are the home countries willing to take for financial stability in the countries where foreign branches are located? And are the authorities in the latter countries prepared to relinquish the responsibility for an essential part of their financial system to the home country of the parent bank? These are not just abstract issues, as can be seen from the fact that Nordea, domiciled in Sweden, is now the largest bank in Finland and that Swedish banks own the major part of the banking systems in the Baltic states.

Thus, it seems that the supervision of international bank groups could lead to problems of coordination and duplication. On the whole, there appears to be no lack of incentives to supervise cross-border banking operations. The problem is rather that in certain cases the rule system prevents the most active countries for exercising supervision, so that this is liable to fall between two stools. On the other hand, an excessively generous right to supervise can lead to the burden of supervision being unduly heavy for individual banks. That could hamper integration as well as efficiency.

Formalising crisis management is more difficult than other parts of the work on stability. Discussing crisis management can be perceived as sensitive and troublesome because to some extent it concerns the state's willingness to assist the financial sector with liquidity. The dividing line between whether or not this should be discussed openly often runs between countries that have experienced a financial crisis and those that have not. Those which have lived through a crisis are generally in favour of a transparent process. A clear-cut arrangement for the management of crises can be difficult to construct in advance.

It is hard to tell at present how these problems should be resolved. In principle there are two conceivable approaches. One involves continued cooperation on agreements, joint principles and regulatory frameworks. The other is to have more supranational management. It is probably a combination of the two that will be needed. The important thing today, however, is that a debate on these complex issues gets under way before we find ourselves in a situation where it is necessary instead to deal with them in an emergency.

More advanced risk management

Another factor that will probably affect future work on the supervision and oversight of stability is the banks' increased possibilities of managing risks.

The assessment of risks is one of banking's traditional functions. Things have changed markedly in this respect since the mid 1990s. Technical progress and new financial theories have led to a refinement of the methods for and possibilities of measuring credit risks. This has been accompanied by facilities for trading risks with additional financial instruments in increasingly international markets. All this has enhanced the ability of the banks to manage risks.

Banks in general - not just the largest international groups - have invested in new systems for risk management. The trend, which began earlier, has been accelerated by the new capital adequacy rules, Basel II, that have just been produced.

All the major banks in Sweden are working actively on these issues, partly because they are expected to result in a smaller capital requirement. For the Riksbank, it is of course not a decreased capital requirement as such that is relevant so much as the fact that the new rules make better allowance for the actual risk in different credits. Finansinspektionen has a central role here in ensuring that financial companies honour not just the letter but the spirit of the Basel rules. This in turn should lead to a more adequate pricing of risk and thereby a more efficient financial system.

A problem that is being discussed in connection with recent methods for risk management and Basel II is the possibility of this development accentuating cyclical fluctuations in the economy. In that the basic idea behind Basel II is for the size of a bank's capital to be dictated by the credit risk in its lending, it is possible that bank capital requirements and thereby the cost of credit will co-vary with the business cycle. The increased credit risk associated with an economic slowdown means that the banks need more capital. This, it is feared, might lead to a contraction of credit in downturns and an expansion in upward phases and thereby make cyclical fluctuations more pronounced.

There are some grounds for this criticism. Experience of business cycles has taught us that the large credit risks tend to be taken as the business cycle approaches a peak. However, the solution to such problems does not lie in opposing the new risk management techniques or Basel II. They will help to promote financial stability. But there is a need for the banks to find ways of handling any effects that arise from an accentuation of cyclical fluctuations. It is important for economic development that credit and venture capital are available even when business activity is cyclically low - and perhaps somewhat less so when activity is peaking.

Besides influencing how the banks handle their capital, the more advanced methods for risk management have led to the creation of new financial instruments. Two examples are securitisation and credit derivatives. This enables the banks to divest themselves of the credit risk in their loans by hedging in the credit derivatives market or by simply selling the risk through securitisation of the loans. The credit risks in the economy can then be spread over more agents. That is fundamentally favourable for financial stability and market efficiency.

At the same time, the authorities must follow developments closely in order to understand where these credit risks end up. Their departure from the bank sector does not mean that they disappear from the economy; they turn up instead in a different form somewhere else, for instance in insurance companies or mutual funds.

Do the new risk management facilities also mean that banking operations will take a different direction? Will banks try to slim their large illiquid balance sheets by selling off loans or securitising assets? And will that mean that they can no longer be described as the most hazardous economic institutions known to man?

This development has come further in the United States, where market financing is considerably more important than in Sweden or the rest of Europe. So what would a similar trend, where the current predominantly relation-based lending is replaced by market funding, imply for the cyclical supply of credit in Sweden?

Stronger focus on aspects of efficiency

A third driving-force that most clearly affects the financial system is the stronger focus on aspects of efficiency. Permit me to touch on this briefly.

Improvements to the financial infrastructure in recent years have made this safer and more robust in various ways. For example, the settlement routines used by both BGC and VPC are considerably more secure than before. Every component of the infrastructure now has better solutions for continuity, which means that operations can be ensured even in connection with more extreme events.

Now that the most serious shortcomings have been rectified, the focus has shifted to enhancing efficiency in the given framework for safety. Considerable social gains are to be had by making the infrastructure more efficient. This applies to the central settlement systems and perhaps even more to the different payment instruments. Increased automation and a greater use of electronic payments instead of paper-based instruments and cash can generate large savings for society in general. Although they may amount to just a single krona or even less per transaction, the savings add up to a large amount because of all the payments that are required in a modern economy.

Economies and greater efficiency have featured prominently in the banks' activities in recent years. For the authorities it is always important to consider the conditions for competition and balance them against the forces for efficiency, such as economies of scale. It is also important to monitor developments to ensure that levels of risk do not rise again. Moreover, the Riksbank has been and is a major player in the payment system. We must also scrutinise this activity continuously to ensure that our approach does not impair economic efficiency in general.

From what I have said about the future work it is hopefully clear that the financial markets are changing rapidly and present a development that is exciting in many ways. The Riksbank will continue to be a central player in this work. Talking about such issues feels natural at a university. Perhaps I have even succeeded in inspiring some of you to become involved in questions such as these and contribute to future developments. Thank you.