

Lars Heikensten: The Riksbank and risks in the financial system

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, at the Risk Management conference, Stockholm, 16 November 2004.

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Thank you for the invitation to speak at this conference on corporate risk management. I founded listed in the programme for this two-day conference concepts such as confidence, risk evaluation and communication of existing risks. These are concepts that regularly come up in the Riksbank's work on financial stability - work that has been given increasing focus in recent years.

This is no surprise. Let me take you back in time twelve years, to autumn 1992. All of the Swedish banks had suffered substantial loan losses. The international credit market had almost no confidence in them as a group, regardless of how great the losses the individual banks had suffered. They were facing severe financing problems.

The Government and the Riksdag (the Swedish parliament) therefore faced a choice - to make a very rapid decision to provide the banks with support without actually knowing how extensive this support would have to be or to suffer a financial crisis with unforeseeable consequences for the Swedish economy. The decision made was the only reasonable solution - to save the Swedish banks. However, the Riksdag was forced to make a decision, without the necessary information on the extent and causes of the crisis, which could have cost the central government budget SEK 100 billion or more.

Even countries that have not experienced a financial crisis at first hand are now spending more time on stability work. Although financial stability issues have always been important to central banks, the speeches made by my colleagues at other central banks more often take up these questions now. These issues also appear more often on the agenda of the international meetings I participate in. The increased complexity of the financial markets with new operators and new instruments and the fact that connections between the countries have increased have contributed to added emphasis on stability work.

Why is financial stability important?

Why should the authorities spend time and energy on this? The primary reason is the important role played by the financial system. Every day each of us sitting here uses the financial system in some way; either to make payments, to save or borrow money or to obtain help with some form of risk management. A huge amount of payments flows through the system. The Swedish payment system has a daily turnover of around SEK 500 billion. This means that in less than a week the turnover corresponds to the entire annual Swedish GDP!

While the importance of the financial system has increased, the number of crises in different countries' systems has also increased. The crises that break out are proving more costly. Calculations made show that the crises that took place between 1975 and 1997 have on average cost developing countries 10 per cent of GDP in lost production.¹ The corresponding cost for emerging economies was 12 per cent. Most of the crises - around 30 of them - have taken place in emerging economies.

Oversight of the financial system is necessary because the system fulfils important functions and the effects of a financial crisis can be extensive. The banks' inherent properties make oversight particularly difficult. Their methods of financing - deposits or loans from other banks - could rapidly disappear, while their assets take longer to realise.

Problems in one individual bank could spread to other banks and thus create risks for the entire system. One reason for this is that the banks have liabilities to one another because of loans or securities trading or quite simply because they all participate in the payment system. Another reason is that they all have similar operations and can therefore suffer in the same ways if problems arise in the world around them. As in the case of the Swedish banking crisis, contagion effects can arise merely as

¹ "Financial crises' characteristics and indicators of vulnerability", IMF World Economic Outlook, May 1998, Chapter 4.

a result of other operators suspecting that there are links between the institutions, even if this is not the case. These suspicions can be self-fulfilling prophecies.

The latter shows how important it is that the participants and users of the financial system have confidence in its functioning. The Commission on Business Confidence wrote in its final report that it is important to have a basic assumption that agreements will be upheld in the economy as a whole, and that this is essential in the financial sector.

If this trust is lost, it can create difficulties for the banks to conduct their activities and thereby for the financial system's functioning. However, it is not merely confidence in the individual banks that is essential to the efficient functioning of the financial system. The participants in the system must be able to rely on all of its parts. This means that the oversight role in practice covers more than just the obvious work of overseeing the banks in the payment system. The Riksbank must also to some extent analyse developments in the financial markets and any tendencies in these that might lead to threats to stability.

What is financial stability and why should the Riksbank concern itself with it?

What is financial stability? There is no unequivocal definition of stability. It is often described as a negative - the absence of instability in the financial markets that would hamper growth. The Riksbank usually focuses on *systemic risk* in its analyses and the aim there is to prevent problems spreading from one operator to others and having repercussions for the real economy.

The work on financial stability has many dimensions. We must look at the institutions active in the financial markets; monitor how borrowers and other operators who could affect the banks behave and how the infrastructure supporting the financial system functions.

It is difficult to determine which problems could constitute a threat to the system. Let me take the IT bubble in 1999 and 2000 as an example. If the banks had financed the many newly-started IT companies, they would have been hard hit when the air went out of this market. This would in turn have had repercussions for the real economy. However, it was not the banks who acted as venture capitalists here. This meant that the risk of shocks in the economy as a whole was less.

Another example is what happened at Barings Bank a few years ago, when one of their foreign exchange traders speculated and lost around SEK 10 billion. The Bank of England refrained from intervention and did not provide the bank with any support, although a major bank was suffering serious problems that eventually caused its failure. This is because Barings' problems were not expected to have any serious repercussions for the system as a whole and thus were not a stability issue. As in other sectors, bankruptcies do occur. This is normal and also important for market discipline.

The fact that the concept of stability is slightly vague and difficult to define, as well as covering many different functions and operators, is of course one reason why it is difficult to determine when a threat to the system arises. It is also very rare that crises can be forecast. If we describe a crisis, it is probably already happening.

It is difficult on the whole to describe different nuances of financial stability. Perhaps a financial system is either stable or instable. When is one situation more stable than another? The lack of clearly measurable goals for financial stability makes it difficult to be clear on this point. One means of dealing with this, apart from discussing possible threats and risks, is to focus on the resilience of the system. How large a shock can the banks manage without any threat to their survival? By testing how hard potential risks would hit the banks' resilience, we can gain an idea of how robust, or stable, the system is.

The Riksbank's most important tool for influencing financial stability is our analysis. Credible and knowledgeable analysis can probably often be used to influence and convince market operators. Our analysis can also provide support to the Government and to Finansinspektionen who have more instruments at their disposal.

Given all of these difficulties, why should the Riksbank devote itself to stability work? One reason is the central role we play in the payment system. The Riksbank, together with the commercial banks, forms the hub of this system. Together we supply instruments of payment. The banks distribute the banknotes and coins we issue. They also hold current accounts connected to the giro system and

operate charge card systems. The Riksbank supplies accounts in the RIX payment system that the banks can use to make large-value interbank payments.

Another reason is that there is a correlation between the other objective of our operations - to maintain price stability. A stable financial system is a necessary condition for successful inflation-targeting. The Riksdag has therefore given the Riksbank the task of "promoting a safe and efficient payment system".

How does the Riksbank work with financial stability?

Our task can be said to consist of two parts - preventing crises and being prepared to manage them should they nevertheless arise. The preventive work involves overseeing the financial markets and the institutions active in them, and also participating in the design of the regulatory framework.

Oversight

The regular oversight of stability entails both detecting potential risks that can arise in the financial system and assessing the financial institutions' strength to resist any problems that nevertheless arise.

The Riksbank presents its analysis of possible risks and of the banks' resilience in its Financial Stability Report, published twice a year. The next report will be published in two weeks' time. The intention is to convey our view of the risks and the banks' resilience to participants in the financial markets, as well as to others with responsibility for, or interest in, these issues. Hopefully, the report can contribute to a well-informed debate on the stability of the Swedish financial system and influence those participating in the system. The Riksbank can also use the Financial Stability Report to show how we work to achieve the objectives the Riksdag has set us.

The layout of the report provides a good insight into the way we work. It begins with a review of international events, describing growth and prices in the financial markets and on various assets. In this context, the analyses and assessments of developments outside the Swedish borders play an increasing role, in line with the ongoing internationalisation process.

After describing the environment in which the banks and their borrowers operate, we devote a chapter to a survey of how the borrowers - households and firms - have been affected. What is the level of indebtedness and the ability to service debts? Are there any risks entailed in their actions? If things go well for the banks' borrowers, they normally go well for the banks.

Developments over the past five years, with the Swedish banks increasingly investing abroad, have meant that a substantial percentage of their borrowers are in other countries - mainly in the Baltic region. This means that our analyses cannot focus exclusively on Sweden; we must also take into account developments in, for instance, neighbouring Nordic countries.

The banks own actions can also affect the stability of the payment system. What strategic choices do the banks make? Profitability is an important component here - if the banks' profitability is poor, it may drive them to invest in more risky projects in an attempt to regain profitability. What loan losses might the banks suffer in the future? By looking at the quality of the banks' assets, we link the analysis of the banks to the analysis of the borrowers. Might the banks suffer liquidity problems? We study the banks' financing capacity to obtain an impression of this.

The final chapter contains an analysis of the financial infrastructure. This must function so efficiently that any problems arising within an individual financial institution or sub-market will not spread to other participants or markets. Nor should there be any problems in the infrastructure resulting from shocks to the systems themselves. Analysis of the infrastructure is made difficult by the fact that it also requires fairly detailed insight into how different computer systems are constructed - technological issues thus become more important here than in other areas.

Each report concludes with one or more articles. These articles give us an opportunity for more in-depth analysis of various fields or for presenting the results of various studies. This is all done with the aim of increasing our knowledge and making us even better at analysing and overseeing the financial system.

Although the standard layout of the report provides some form of framework for our analysis work, we are constantly developing our analyses. Conditions change, with new operators, risks and technological developments.

Crisis management

No matter how good we are at overseeing the financial system - and how well we succeed in making it more robust without losing too much efficiency - it is impossible to completely eliminate the occurrence of crises. We therefore need to be prepared to manage a crisis if one should nevertheless occur. If a crisis occurs, it is necessary to assess the scope and consequences as quickly as possible and to take the right measures to reduce the potential problems. We do not want a repeat of the dilemma faced by the Riksdag in 1992.

The Riksbank can provide emergency liquidity assistance to a bank suffering problems. The requirements for this are that the problems are so serious as to threaten the stability of the system and that the bank is sufficiently sound to be able to survive in the long term if given assistance now. In other cases, the Riksdag decides whether or not financial support should be given, as tax-payers may be affected.

One difficulty is determining whether a bank fulfils these requirements in a crisis situation, when there is often considerable confusion and everything happens so quickly. By being well-prepared we have the possibility to decide whether or not a bank should receive assistance from us. The enormous flows in the payment system mean that all banks are dependent on being able to receive incoming payments in order to send their own outgoing payments. If this chain of payments is broken, for instance, if a bank suffers liquidity problems, there is a risk of contagion effects. In our planning work for managing an acute financial crisis, we work on the assumption that we will have between two and three hours to make decisions on possible liquidity support. It would be impossible to make these decisions so quickly if we did not already have well-founded knowledge of the various banks. The day-to-day oversight work is thus a necessary condition for assessing whether financial stability is threatened in the event of a crisis.

Future challenges

A lot has happened in the Riksbank's work on financial stability. When we began our stability work in the mid-1990s we were almost pioneers. The work began with a handful of people working with a relatively narrow focus - to detect at an early stage any vulnerability in the banking system that could lead to a new bank crisis.

As I mentioned earlier, stability work has gradually become more important to a growing number of countries. Reminders of the effects of financial crises have rained down on us in recent decades - Mexico 1994, Asia 1997-1998, Russia and LTCM 1998 and Argentina 2001. To mention but a few. Many central banks have these issues on the agenda as often as monetary policy issues. As I mentioned earlier, they also play an increasingly important role in many of the international contexts we participate in.

If I am to mention a couple of examples, these would be the Bank for International Settlements, which now devotes a much larger part of its analysis capacity to stability issues, and where we are members of a couple of groups entirely focussed on stability. The most well-known work is that being done on the new capital adequacy rules - Basel II. Another example is the work the Riksbank is heading in surveying central banks' work on oversight of the financial infrastructure. The Riksbank is also heading the work on reviewing the principles for how public authorities should work with regard to banking supervision.

Within the European System of Central Banks we are taking part in the work on producing a European stability report. The Riksbank is also heading the working group that analyses issues regarding cross-border banks with a special emphasis on crisis management. This group reports to both Frankfurt and Brussels.

The fact that our analysis work has developed since we published our first report in 1997 does not mean that we can rest on our laurels. We have taken outside assistance in our endeavour to focus and develop our analysis work. A few weeks ago, we presented the assessment of our work on the Financial Stability Report made by an American researcher, a manager at IMF and a manager from a Swedish commercial bank over the year. Happily, the three authors considered that we essentially devoted ourselves to the right issues and used the right approaches. However, they also presented some interesting suggestions for improvements.

Several of their recommendations concerned how we motivate and explain our role in the stability work. They thought we should be clearer when describing our objectives, and also with regard to the

boundary between our work and that of Finansinspektionen (the Swedish Financial Supervisory Authority) as well as to why we write a report twice a year. Most of what I have tried to describe now, in other words. These are good suggestions that we are taking into account in the report to be published in two weeks' time.

The authors had other suggestions that I think are good, but probably require more time for discussion within the Riksbank and for possible implementation. The possibility of including a standing chapter that describes our view of a number of current stability issues of a more political nature is interesting. One advantage is that it would give us a reason to jointly develop an overall view on issues of this nature a couple of times a year. Today this is done on an ad hoc basis, in connection with responses to submissions or in connection with some form of reasoning in the Financial Stability Reports. However, a change of this type requires considerable additional work for those working on the analyses and would also take up more of the Executive Board's time than at present. It therefore needs to be considered in the light of other commitments.

There are other areas of the assessment where I am more undecided. One of the recommendations was that we should regularly take into account other operators in the infrastructure than the banks and institutions. I agree that it is important to look further afield, not just in obvious places, when trying to identify threats and shocks. We should most probably take some steps in this direction. However, there are also risks entailed in this suggestion. One strength of our method of working has been the concentration on central, systemically-important issues. If we broaden our commitments we may be forced to give up some of this depth, and what we publish may be more difficult to grasp.

Some of the recommendations concerned international connections in the stability work. Increased international surveillance is one of their recommendations that we are happy to follow. The integration of financial systems is increasing all the time and requires that we raise our gaze to take in the world around us. We already have this aim, but much remains to be done.

Another aspect of internationalisation that is emphasised concerns crisis management. We are encouraged to continue with our crisis management exercises, but to carry them out together with our European colleagues. This is an important issue that we discussed in more depth in the Financial Stability Report published a year ago. We observed then that an integrated financial market has positive effects on the economy as a whole, but that it entails challenges for those of us who oversee the system. As the banking systems in different countries become more dependent on one another, the contagion risks will increase further. Given this, it is important to identify what roles are played by the different authorities. Who should bear the main responsibility if one of Nordea's Finnish branch offices were to suffer problems - we or our colleagues in Finland?

Conclusion

Let me round off with a hope that I have been able to arouse your interest in financial stability issues. As you of course know, developments in the financial system in recent years have been very rapid and made substantial, new demands on all involved. This includes the Riksbank.

Following our own crisis experiences, the Riksbank became engaged in these issues earlier than many other central banks. However, over time financial stability issues have moved further up the agenda in central bank circles. We are now engaged in a number of projects together with colleagues from other central banks, finance ministries and financial supervisory authorities in other countries.

Parallel with this work we are trying to gain a more in-depth understanding of our own and to develop our communication. Little by little we are taking up new issues that are important for financial stability. We have received further ideas from the assessment group we engaged last year. We clearly do not lack challenges. But this is what makes the work at the Riksbank so exciting.

Thank you!