

## **Lars Nyberg: The financial crisis**

Speech by Mr Lars Nyberg, Deputy Governor of the Sveriges Riksbank, at HQ Bank, 15 October 2008.

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Over the past year my colleagues on the Executive Board and I have spoken on several occasions about the financial turbulence currently affecting the entire global economy. We have had reason to return to the topic because the turbulence is constantly taking new twists and turns. The turmoil has intensified during the autumn and once again we have reason to reflect on what is happening and what will happen. That is also what I intend to do in my speech here today.

I would also like to take this opportunity to speak about the role of the Riksbank and other authorities in relation to this situation and about what needs to happen to calm the unrest. However, I would like to begin with a brief glance at the past.

### **Run-up to the crisis**

The financial turmoil began over a year ago with the notorious subprime crisis. For a long time, US financial institutions had engaged in aggressive lending to borrowers with weak credit histories, after which the loans were repackaged and sold to investors all over the world. When the credit losses on these loans became unexpectedly large, it was clear that those who had invested had grossly underestimated the risks.

The subprime problem was primarily a US problem, but since the loans had been sold to others outside the United States the turmoil had a global effect right from the start. Since no one really knew where the losses would turn up, a situation quickly arose in which banks and other financial institutions became cautious about lending money to each other. They began to hoard liquidity to meet their own obligations and to deal with any speculations that they were affected by the subprime problems. As a result the conditions for interbank lending deteriorated, causing market interest rates to soar.

In this situation several central banks chose to act by injecting liquidity into the interbank market. This intervention achieved the desired effect in part, but did not eliminate the mutual distrust among banks. Northern Rock, one of the first casualties of the crisis, became well aware of this situation in September last year when it could no longer find private financing. It turned instead to the Bank of England – and as we all know, the story ended when, following a complicated process, the British government nationalised Northern Rock.

### **The turbulence deepens**

Now the turmoil was not just related to the US subprime market. More and more assets and markets became affected when even borrowers with better credit ratings were hit. Nor were the problems just a matter of inadequate creditworthiness of US borrowers any more, as the ability of European borrowers to pay now came into question.

During the spring the turmoil reaped its most startling victim so far. Bear Stearns, the fifth largest investment bank in the US, was forced to suspend payments after being unable to arrange short-term financing. It hardly needs to be said that Bear Stearns was heavily exposed to the subprime market.

Conditions on the credit markets temporarily eased after Bear Stearns. Although tensions continued, the market began to slowly return to more normal conditions and credit risk

premiums decreased sharply for a while. Confidence seemed to be returning to the financial markets.

However, the turmoil gained renewed strength during the late summer when Lehman Brothers was forced to apply for bankruptcy protection. Since then a number of banks in Europe and the United States have experienced severe problems. Banks and financial institutions that were forced into being sold or nationalised include heavyweights such as Fortis in Belgium, Merrill Lynch and AIG in the United States, and Hypo Real Estate in Germany. The financial crisis had progressed from being a subprime crisis in the United States into a global confidence and liquidity crisis.

### **Where can we find the explanations?**

In light of current events, the obvious question is how do we explain the situation? What we see is largely the result of an extended period of vast expansion of credit and growth of the financial industry's assets, which with hindsight has proven to be unsustainable. This development was made possible because for some time economic conditions in both the US and the rest of the world were extremely favourable, with low interest rates, low and stable inflation, and robust growth. The low interest rates resulted in increased indebtedness and willingness to invest, which in turn contributed to rising asset prices, especially in the property markets. Rising asset prices allowed further indebtedness, which once again fuelled asset prices.

Parallel to this trend, financial market participants engaged in increasingly aggressive strategies in the search for yield. Banks and mortgage institutions eased credit terms in order to gain market shares. High-risk loans were packaged in complex structured products that were perceived as more secure investments than they actually were.

At the foundation, the art of financial engineering that underpins the development of these products is undoubtedly positive, making it possible to convert illiquid loans into liquid securities and enabling investors to trade in credit risk without having to handle individual loans. However, it is essential that the products can be purchased and sold on a market where investors are offered clear and continuous pricing information. However, this was not the case. The variety of instruments became so immense and their complexity so great that few people – if anyone – were capable of assessing these markets.

One driving force behind the development was the large US investment banks, which in many cases were the creators of the new products and which were also highly leveraged and invested in these and other risky instruments. However, everything did not remain within the United States; large volumes of risky loans were packaged and sold in various forms all over the world. Investors showed a strong desire to buy and drove up the prices of many financial assets to levels that did not at all reflect actual risk.

In brief, mispricing, imbalances and complicated structures evolved over a long period of time and when the US subprime borrowers were unable to repay their loans to a greater extent than expected, the ball was set in motion.

As I said initially, concerns about the US mortgage market soon expanded into a general distrustfulness of the overall condition of the global financial system. The issue today is less about the original US problems, but rather about a general confidence crisis and how banks around the world will manage in the future. Just as in the United States, the global financial markets have long been characterised by favourable macroeconomic conditions and aggressive growth strategies among financial institutions. As business activity now declines, concern about the European banks is expanding from previously mainly involving losses due to exposure in US markets, to dealing more with the credit quality of their own loan portfolios.

As a result of this uncertainty, participants who usually are active in the credit markets are withdrawing, causing disrupted pricing along with a drastic decrease in liquidity. When the

markets deteriorate or cease to function in this way, individual financial institutions are also hit hard, especially the banks. We have seen the consequences of these developments now during the autumn, causing central banks and governments to take powerful measures to avoid a full-scale systemic crisis.

Although most banks have satisfactory solvency levels today, the turmoil has developed into a serious liquidity crisis, based on distrust of the banks' ability to survive in the future. The entire problem can actually be summarised in a single word; confidence. Currently there is a lack of confidence in the financial sector as a whole.

So what needs to happen to restore confidence? Before I attempt to answer that question, I thought I would say a few words about the situation in the Swedish financial system and about the role of the Riksbank and other Swedish authorities.

### **The situation in the Swedish financial system**

Even if the situation has worsened in recent weeks it is important to remember that the Swedish financial system is far from the epicentre of the crisis. According to Finansinspektionen (The Swedish Financial Supervisory Authority) – and according to our own assessment – the Swedish banks continue to have strong balance sheets. Their capital situation is strong, credit losses are low and profitability has reached historic highs. The Swedish banks have been relatively conservative in their lending, and have not been exposed to any great extent to the worst-hit markets or institutions.

However, although we are not the source of the turmoil, it now has a considerable impact even on the Swedish financial system. Several parts of the credit market are not working as well as usual. For example, due to uncertainty among investors we have seen a sharp increase in demand for Swedish government securities and a corresponding decrease in demand for mortgage bonds. As we know, this development caused the Swedish National Debt Office to auction extra treasury bills and use the money to buy mortgage bonds.

The uncertainty has also had an impact on those markets where the banks borrow money, as it has become more difficult to borrow over longer time periods, and on the international markets. Even if the major Swedish banks are lending to each other, international investors are less willing to invest, which has reduced the supply of loans and driven up the banks' cost of borrowing. However, I would like to point out that higher borrowing costs do not mean that the banks have problems (in the sense that their financial situation is threatened). It is true that the Icelandic bank Kaupthing's Swedish subsidiary did suffer from an acute liquidity need due to developments on Iceland and was forced to turn to the Riksbank. However, the major Swedish banks do not have – nor have they had – any of the liquidity problems that Kaupthing and banks in other countries have had.

Nevertheless, there is a significant risk that the credit supply to Swedish companies and households could worsen considerably if the problems on the credit markets take hold and persist. Not only would the effects of such a credit squeeze be unfortunate for companies and households – they would harm the entire economy. It is in part against the background of this risk that we should view the Riksbank's liquidity support measures over the past few weeks. It is also one of the reasons for The Riksbank's most recent decision to cut the repo rate by 0.5 percentage points.

### **Role of Swedish authorities**

One of the main duties of the Riksbank is to promote a safe and efficient payment system. More specifically, this means that the Riksbank continually analyses risks and threats to the stability of the Swedish financial system. The purpose of the analysis is to discover any changes and vulnerabilities that could lead to a serious crisis. In the event that a crisis should occur, certain tools are at our disposal to handle the situation. Over the past few weeks you

have seen several examples of how we can assist the banking system in various ways with liquidity-supporting measures when the situation so requires.

The Riksbank is not the only authority that is responsible for ensuring financial stability. Finansinspektionen also plays an important role as a regulatory authority. In the current crisis the National Debt Office has also helped to improve liquidity conditions in the financial system by auctioning extra treasury bills. Ultimately, the Government and the Riksdag also have a responsibility for financial stability if it becomes apparent that the initiatives of the authorities are unable to bring a crisis under control.

These days the Riksbank is working very closely with other authorities to monitor developments and discuss how to handle the situation. Like other Swedish authorities, we are also in frequent contact with our foreign colleagues and with market participants.

As I mentioned previously, the Riksbank has helped where we could to improve liquidity and market conditions. But what have we actually done?

### **What has the Riksbank done?**

First of all, we have taken several general measures aimed at all of the Riksbank's counterparties. The purpose of the measures is to solve two problems with the Swedish banks: inadequate access to long-term financing in Swedish krona and a limited ability to gain access to US dollars.

The lack of long-term financing is due to the lack of mutual trust among the banks during the crisis, which have had a negative impact on the interbank lending markets. One consequence is that the banks have been forced to borrow for shorter terms. Even if it has been possible to get financing, liquidity management have become much more difficult for the banks and risks also have increased. To enable the banks to restore the situation to more normal conditions, the Riksbank has offered financing at longer terms than what the markets can currently provide by lending Swedish krona with maturities of three and six months.

The lending is designed so that we provide liquidity in the form of somewhat longer loans and absorb the same quantity of short term liquidity. Combined with the fact that lending takes place at market rates, this means that banks receive help with their strained financing situation at the same time that the measures do not have any direct effects on monetary policy. This is a very important point. The Riksbank is quite simply helping the banks replace their short-term financing with longer-term financing. In a broader sense, the Riksbank is assuming the role of market maker in the money market and by doing so ensuring its functioning.

The other problem is that a general shortage of financing opportunities in US dollars has arisen. Since the Swedish banks are not counterparties with the US central bank, they cannot be certain that they will receive any of the injections of liquidity that the Federal Reserve makes. That is why the Riksbank have offered their counterparties large loans in US dollars.

Together with the measures that the National Debt Office have taken, the Riksbank's lending of both Swedish krona and US dollars contribute to a general strengthening of liquidity primarily in the Swedish credit markets, thereby also creating conditions for the markets to return to more normal conditions and allowing financial stability to be maintained.

Second of all the Riksbank has – as I just mentioned – also provided special liquidity assistance to Kaupthing Bank Sweden. This loan is against collateral and with an interest rate that is above normal lending costs. Even if this measure is aimed at an individual bank, it should also be viewed as an initiative to safeguard financial stability and to maintain confidence in Sweden's entire credit and payment system. The decision is based on the assessment that although the bank is solvent, it is unable to perform its obligations without

liquidity assistance. What happens next with Kaupthing Sweden is mainly a question for the bank's owner, the Icelandic state.

The liquidity support to Kaupthing differs in many regards from the Riksbank's other measures. In this case the support is aimed at an individual institution and not at money market participants in general. In Kaupthing's case the point was to enable the bank to obtain any funding whatsoever and thereby continue to exist. An important similarity with the other measure, however, is that the liquidity that was injected via Kaupthing into the system also comes back to the Riksbank in the form of deposits from the bank(s) that have excess liquidity. In this way this measure does not have any direct monetary policy effects either.

The common denominator for everything the Riksbank has done to date is that all measures are aimed at strengthening liquidity conditions within the Swedish financial system. Unlike many other countries, thus far it has not been necessary for the Swedish authorities to provide the banks with any form of capital support from the government. This point is also important. However, it remains to be seen whether the Riksbank and other authorities have done enough. How the situation develops in the future is essentially a question of what happens outside of Sweden. Nevertheless, the Swedish authorities are prepared to take those measures that are necessary to ensure financial stability. For the Riksbank, this means that we will continue to provide the banks with the liquidity required for the financial system to function.

Let me now proceed to discuss paths out of the crisis.

### **Paths out of the crisis**

We are now in the middle of the most serious financial turmoil that the world has seen in a very long time. It is difficult to anticipate how the situation will develop in the future, which means that it is also difficult to talk about paths out of the crisis. However, let me share a few general thoughts.

#### ***In the short term***

Large imbalances have been built up in the global financial system over a long period of time. The risks that banks and other financial institutions have assumed have quite simply become too high in relation to the risk-bearing capital. Therefore the risk level must be reduced and capital must be injected. This adaptation process is in full swing and write-downs have been taken globally for a value of USD 637 billion. Lower asset values must be met with lower indebtedness, either by disposing of assets or by increasing equity. This process is also in full swing. Including the measures taken by the US government yesterday, capital injections of about USD 611 billion have been made so far, but additional capital will be needed as further write-downs will be made.

To put it succinctly, what is needed is that many financial institutions all over the world must shrink or disappear. This process will be both time-consuming and painful. Iceland is the current example of how just painful and spectacular the process can be. But the fact remains: only when the banks' balance sheets have stabilised and the markets have made certain that solvency levels are satisfactory will the situation normalise. Only then will confidence return to the financial markets, and only then will liquidity also return.

Central banks and other authorities need to accept their part of the responsibility while these processes are in progress. The task of the central bank is to provide the financial system with liquidity when needed. As we know, this has also taken place to a large extent. However, there are limitations to what the central banks can do. Other measures must be taken for banks with inadequate solvency. For these purposes a functioning order to handle banks in insolvency is needed. Where taxpayer money is involved, the process must be carried out on

condition that the socioeconomic costs are minimised and that the owners of the financial institutions that are taken under public administration must carry their own losses.

The coordinated crisis package that the Euro countries launched earlier this week contains the essentials and largely offers the desirable components for such a package. After the Lehman Brothers bankruptcy it became clear to financial market participants that even the largest financial enterprises could fall. This insight caused the freezing of the markets that has now lasted for almost a month. Promises by leading nations that this will not be allowed to happen again will hopefully help to thaw the financial markets. It is both welcome and desirable that the government support measures are accompanied by tough counter-demands on the banks.

The Swedish government has announced that it intends to carry out a nationally adapted version of this crisis package in Sweden. It is hoped that Swedish banks will not have to make use of the opportunity for government guarantees or capital injections, since the terms will probably be rather tough. However, we do not know the details of the proposal at this time.

However, what we do know is that the Government has decided to expand the deposit guarantee. This is an important measure to strengthen confidence in the Swedish banking system. At the same time it is important to add that measures of this type must be complemented in the long term with mechanisms that facilitate a sustainable financing of the system; in other words, those institutions that are covered by the guarantee must also carry its costs.

### ***In the somewhat longer term***

In a longer perspective there is reason to consider which structural changes are needed to prevent similar situations from arising again. An intense discussion is currently underway about the need for changed regulations and stricter supervision of the financial markets and institutions. The Riksbank has discussed these issues in various contexts for some time.

For example, the rules for management and supervision of liquidity risks need to be developed and improved. The financial sector needs greater transparency so that customers and investors can gain a better overview of the companies' commitments. For Sweden it is also important to create a functioning regulatory framework to handle banks in insolvency. And just for the sake of clarity, let me add that this view is in no way related to any such situation being present in Sweden. This is something that the Riksbank has advocated for a long time.

In light of what happened in the United States we should also consider regulation of institutions that do not take deposits from the public. Such institutions are often the subject to weaker supervision and regulation, which has been justified because they are not as important for financial stability. But as the developments in the US investment banks clearly illustrate, even such institutions can substantially shake up the financial system.

Given the global scope of the crisis it is important to coordinate both short-term and long-term measures among countries. If nations try to find separate solutions in this type of situation, the costs for handling the turmoil could become even greater than what they otherwise would have been, even for individual countries. Therefore, in all of the issues mentioned here, much can be won through international coordination and harmonisation.

Yet another example of an issue that requires international coordination is how to organise supervision and crisis management within the EU. Today several banks engage in significant operations in several EU countries, while the responsibility for supervision and crisis management is still national. Under such circumstances there is a risk that coordination problems and conflicts of interest could arise between countries, which obviously does not benefit financial stability. Cooperation within the EU offers a unique opportunity to discuss and agree on how to handle these problems.

However, dealing with all of these problems is not just a matter of changes in regulation and supervision. If I may once again take the US as an example, the problems there show that the incidence of financial crises can also have a clear political dimension. One important reason for the lending boom was that the country's political leaders had long pressured the mortgage lending institutions to increase lending to low income groups. Institutions such as Fannie Mae and Freddie Mac were quite simply forced to base their operations on political objectives rather than on sound credit risk policies. The fact that unfortunate political decisions such as these, as well as inadequate regulation, can help to create a crisis is an important lesson to keep in mind when we eventually close the books on this crisis.

I am aware that my wish list is long and requires extensive reform work. However, the course of events over the past year has clearly underscored the need to quickly deal with these issues.

Meanwhile, it is important to make clear that we must not become overly zealous about regulation. In times such as these it is easy for opportunism to gain the upper hand, resulting in measures that do more harm than good. The Riksbank supports the EU commission's motto of "better regulation" and that all regulation changes must be preceded by objective and extensive impact assessments and cost-benefit analyses.

### **Concluding remarks**

Let me now summarise.

The financial turmoil that began in the United States over one year ago has now spread around the world with full force. Strong distrust currently prevails in the markets, which in one way or another essentially afflicts all financial institutions. For Swedish banks this trend is mainly expressed by the fact that they are forced to borrow on much shorter terms than usual and at higher rates. In brief, although we are not responsible for the current situation we are certainly feeling its repercussions.

Both the Riksbank and Finansinspektionen still hold the opinion that the major Swedish banks have strong capital buffers, robust earnings and low loan losses. Consequently, conditions are good for handling the current uncertainties as well as for dealing with unexpected future losses in the economic downturn we see ahead of us.

Thank you!