Barbro Wickman-Parak: Financial stability in focus

Speech by Ms Barbro Wickman-Parak, Deputy Governor of the Sveriges Riksbank, at the Swedish Chambers, Gothenburg, 29 October 2009.

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Two years of global financial crisis have shaken the economies of the world to their foundations. Central banks and other authorities around the world have implemented extensive measures to deal with the problems created by the crisis. I am sure that many people are asking what it is that is so special about the financial sector - and particularly the banks – that justifies this intervention on the part of the authorities. It is hardly likely that such massive efforts would be made for any other commercial or industrial sector. To answer this question, we need to remind ourselves of the importance of the financial sector to the economy as a whole. If our modern societies are to work effectively, we must be able to make and receive payments quickly and safely. It must also be possible to efficiently channel our savings surplus to those companies and households that need to borrow so that, for example, important investments can be made. Trust and confidence are cornerstones of this system. If we are to accept money – cash – as a means of payment we must have faith in its value. And if we are to deposit our money in various bank accounts we must have faith in the banks concerned.

Money – a smart invention

What do we really need money for? Bartering is a complicated and time-consuming process. Someone who wants to sell an item has to find a buyer who wants that particular item at that particular time. And the buyer must also be able to offer something in exchange that the seller wants. The need for a third item that could serve as an intermediary in the bartering process thus arose at an early stage in the history of civilisation. *Metals* of various kinds, especially silver and gold, soon acquired a central position as a currency for trade as they are relatively durable and easy to transport and divide.

An important step in the development process was taken when people began to use the metals to mint *coins*. This made it possible to use an authorised stamp that guaranteed that the metal content and weight were correct.

The next logical step was taken when people realised they could use pieces of paper to *represent the value of a metal coin*. In other words, notes that could be exchanged for metal coins on request. This made handling and transportation even easier and worked as long as the public accepted the notes as a means of payment and had confidence in those who issued them.

A further stage in the development process was reached when it became possible to issue money *without the back-up of reserves* in the form, for example, of gold and silver. Instead, the value of the notes was set, for instance, by royal decree, that is the king or queen simply decreed what value the notes should have. Such money is sometimes called ”*fiat money*”. This is money that has no link whatsoever to metals or other material objects. Faith in such money must thus be created in some other way.

We can view money as a "good" with special properties. It can be used to pay for things and it has a special information value, it is a measuring stick that makes it possible to compare prices. It also acts as a means of preserving value, it can be stored and saved to be used for future consumption. It is in this context that price stability comes into the picture. If inflation rockets, the money we have saved loses purchasing power. It was therefore quite natural that the central banks – when they were eventually given the monopoly for issuing notes – were also given the task of safeguarding price stability. In Sweden, the state, in the form of the Riksbank, first acquired the sole right to issue notes in 1903. One of the reasons the Riksbank was given this sole right was the desire to create a uniform and stable payment system. Previously, the banks had been able to fund their operations by issuing their own notes. However, when a bank went bankrupt its notes became worthless. Here we can discern the two core tasks that the Riksbank still has: to maintain price stability and to promote a safe and efficient payment system.

Banks are of central importance

Nowadays, a very large part of what we normally refer to as money consists of *funds in accounts at the banks*, and a very large proportion of the payments made take the form of transfers between the accounts provided by the banks. The banks therefore play a central role in the financial system.

Although banks in various forms have existed for many centuries, it was not until the 19th century that the financial sector began to develop on a large scale. The emerging industries needed funding. There was also a need for major infrastructure investments, for example in the railways. The banks acted as credit intermediaries, thus enabling the investments to be made. They gathered together our savings surplus and converted it into loans.

Even though the financial markets are much more sophisticated today than they were in the 1800s, the basic role is the same, that is to mediate credit and provide payment services. These functions are indispensable to a modern society. If they were to fail, the entire economy would suffer extensive and indiscriminate damage. This is what gives the financial sector its unique position.

Banks entail bank crises

The expansion of the banks also led to bank crises. In Sweden, for example, the expansion of the 1870s ended in the severe crisis of 1878-1879. One of the causes was that the private construction of railways had been excessively boosted by the ample supply of capital during the expansion. The crisis hit those trading companies and banks that had been far too optimistic in their provision of loans. Stockholms Enskilda Bank, headed by A.O. Wallenberg, suffered the most when the public stormed the bank to withdraw their money. The finance minister of the time was forced to intervene and Stockholms Enskilda Bank and other problem banks were able to get liquidity assistance with the help of foreign loans.

Lack of experience and underdeveloped risk culture paved the way for the crisis of the 1990s

If we take a leap forward in history, then many of us probably remember the domestic financial crisis that began in the early 1990s. For a long period following World War II, the financial markets had been kept under very strict regulatory control by the Riksbank. However, the phase-out of the regulations began in the second half of the 1980s and culminated when the foreign exchange controls, which originally were part of the crisis regulations introduced during the war, were abolished in 1989. When the floodgates were opened there was no way to stop the rapid increase in the demand for loans, and there was no incentive to say no to loan applications. The risk culture at the banks was still underdeveloped. One consequence of this was that the credit risks on the overheated property market were underestimated and underpriced. Once again, careless lending became one of the causes of a crisis in the financial system.

A factor worth mentioning in connection with the crisis of the 1990s is the role of the finance companies. The credit regulations had gradually creating a breeding ground for a "grey" credit market. The less strictly-regulated finance companies had been given room to expand by providing loans to the rapidly-expanding construction and property markets. The financial companies largely financed themselves in the short term by issuing so-called commercial papers on the money market. When the property market folded, it was also a financial company, Nyckeln, which in September 1990 was the first to throw in the towel when it could not renew its funding. Other financial companies then followed suit.

Many of the financial companies were owned by the banks. And the banks were tied by both formal and informal commitments to these finance companies. The fact that a large part of the banks' exposures to the property sector were *indirect* in this way concealed the real extent of the banks' loan losses for a long time. When the losses of the finance companies subsequently appeared on the balance sheets of the banks in 1991, it became clear that the banks also had serious problems. The bank crisis had become a reality. Many of us remember the consequences for the real economy.

Global imbalances laid the foundations for the current crisis

If we now move on to the current global financial crisis we can see that there are both similarities and differences compared to the Swedish bank crisis of the 1990s. The circumstances that formed the background to the outbreak of the current crisis in the summer of 2007 included the considerable global imbalances that had developed, with an enduring savings surplus in some countries and deficits in others. The surplus was invested on the global financial markets and the substantial capital flows there helped to push down interest rates. As a result, demand and prices on many asset markets around the world increased explosively and there was a general fall in the premiums for credit risk. The explosion in asset prices was fuelled by a rapid expansion in credit. Money was lent more carelessly than previously. Housing bubbles developed in several parts of the world. In the USA, the development of such bubbles was reinforced by the inadequate regulation of the mortgage market and a political agenda that aimed to promote house ownership among people on low incomes.

The search for yield drove investors to borrow more in order to achieve greater leverage in their investments. Financial innovations also helped to drive this development. A steady flow of new and increasingly complex instruments were created to satisfy the demand for investments with a higher yield. At many banks around the world, although not at Swedish banks to the same extent, it became common to "securitise" different types of credit. Previously, the banks has specialised in developing long-term customer relations and in continuously evaluating and monitoring credit risk. Now the banks simply lifted some of their loans out of their balance sheets, repackaged them to form various securities and sold them. These securities could then be bought and sold by different investors on a secondary market. Many banks thus changed their business model.

One might think that the banks used securitisation to get rid of a large proportion of their credit risks. Unfortunately, this was largely an illusion. The banks set up special intermediaries – SIVs and conduits and so on – off their balance sheets to hold and structure the loans that they removed from their balance sheets and then converted into different types of security. This made it possible for the banks to increase indebtedness both on and off their balance sheets and thus to circumvent part of the authorities' capital adequacy requirements. However, the banks' explicit and implicit guarantees to these special companies meant in practice that the risks led directly back to the banks' balance sheets.

Almost impenetrable structures arose

The result of all these new instruments and artificial intermediaries was a structure that it was extremely difficult to oversee. Apart from the fact that it was difficult to value the instruments themselves, the complex links between the banks and their special companies made it difficult to see the actual exposures of the banks. Eventually, no one knew where the risks were. The increasing amount of loans not only made investors highly indebted in relation to their equity, many banks also did not really have enough capital in relation to the risks they took. When economic activity began to decline in the USA and prices fell on the US housing market, many institutions suffered major losses. Uncertainty about who might be exposed to impaired assets led to trade petering out on a number of financial markets. Many banks now found it difficult to find funding on these markets.

In September 2008, the major US investment bank Lehman Brothers filed for bankruptcy protection. This had extensive repercussions throughout the world. The global financial crisis escalated and the Swedish banks were also seriously drawn into the crisis. All over the world, banks and other financial institutions began to cut back their exposures and reduce their level of indebtedness. The decline in lending reinforced the downturn in global economic activity. This in turn accelerated the decline – many assets fell dramatically in value and the banks' loan losses increased. A vicious circle arose in the global economy in which the financial turmoil aggravated the weakening of the real economy and vice versa. This in turn led the authorities around the world to intensify their efforts.

Uncontrolled lending and regulatory arbitrage are common features

Although the current crisis is unique in terms of it extent and complexity, it is not difficult to see parallels to other, previous crises. Uncontrolled and careless lending in an economic boom is a common feature in the history of bank crisises. This is not the first time we have seen inadequate risk management.

Another interesting feature is the attempt to circumvent regulations in both past crises and the present crisis. In Sweden, the "grey" credit market appeared in the 1980s in an attempt to get round the credit regulations. The latest wave of securitisation of credit portfolios at international banks was driven in part by a desire to avoid costly capital adequacy requirements. The fact that loans in both cases were partly offered alongside the ordinary banking market in what is now called "the shadow banking system" concealed the real extent and location of the risks.

Why all these crises?

So why do such financial crises arise? The root of most financial crises can be found in the imbalance between assets and funding. The simplest way to illustrate this is to look at a fictitious bank's balance sheet. On the asset side there is lending to companies and households. These are assets that cannot be sold quickly without a substantial discount. In other words, they are illiquid. The bank's funding on the other hand largely consists of deposits from the general public and short-term borrowing on the interbank and securities markets. Their funding is thus very liquid.

In normal circumstances this is not a problem, as we do not expect all depositors and other lenders to withdraw their money or their funding at the same time. However, this transformation of illiquid lending into liquid funds in accounts makes the banks dependent on the confidence of the funders in the bank's ability to meet its obligations. Suspicions that the bank has financial problems could very quickly lead to a *bank run*.

At the same time, problems that arise in one bank can easily spread to other banks. This contagion can occur in different ways. Firstly, there can be a direct contagion through the exposures the banks have to one another in the payment systems and in connection with foreign exchange and securities trading. Serious chain effects can arise if the customers of a bank that is experiencing problems have their funds tied up at the bank as this makes it difficult for them to make payments to other households and companies. This can lead to liquidity problems that in turn may give rise to loan losses and payment problems for other banks and their customers.

Secondly, the banks are often exposed to the same sorts of risk. This increases the probability that, for instance, a macroeconomic shock may affect more than one bank. Problems can thus spread between banks as an indirect effect, through expectations that other banks may suffer similar problems to the one first affected, or via more well-founded suspicions of the banks' exposures to one another.

The contagion risks thus mean that problems in one bank can easily lead to problems for the entire bank system. The costs to society of a crisis that affects the entire bank system may be substantial.

The need for a "safety net"

The shareholders can never lose more capital than they have invested and individual depositors find it difficult to monitor a bank with widespread operations. They therefore lack sufficient incentives to take protective measures against crises that affect the financial system as a whole. Alongside the need to protect consumers, this is one of the crucial reasons why we now have a financial safety net in the form of special regulations, supervision and a deposit guarantee. It is also the reason why central banks have the possibility to provide various forms of liquidity assistance, that is to act as the "*lender of last resort*".

Here I should mention that the safety net for financial operations does not have only positive effects. One of the less desirable effects is that it can also lead to less cautious risk behaviour. As the safety net can in various ways make the bank's funders immune to certain risks, it may be tempting to allow the bank to take greater risks than is optimal from the point of view of the economy as a whole. Simply put, the safety net reduces the private costs of applying strategies associated with a higher level of risk; the bank's financiers gets the upside but not the downside of the increase in the level of risk. This phenomenon is usually called *moral hazard*.

The design of public supervision and regulation is important in the effort to reduce the problems relating to moral hazard. Not least, the conditions concerning aspects such as guarantees and liquidity assistance have a major impact on the possibility to counteract problems and reduce the costs they give rise to. If the state is forced to intervene and save a bank, it is important that the shareholders and other funders do not come out of the process unscathed. Designing a public safety net for financial operations thus entails a number of difficult considerations.

Crises change the role of the authorities

During the bank crisis of the 1870s, however, there was no real safety net to speak of. The Riksbank sat on the sidelines and had no role to play in the practical management of the crisis. At the time, the Riksbank had neither the mandate nor the desire to be the *lender of last resort*, that is the body that the banks can turn to when they suffer a shortage of liquidity. The Riksbank was instead more like a bureaucratic, state-owned commercial bank that competed with the privately-owned commercial banks.

There was, however, a growing realisation in the UK and other countries that it was important to have a liquid credit market and that the central bank could play an important role in safeguarding the stability of the banking system. One of the people who developed these ideas was Walter Bagehot, who was appointed edi-tor of the journal *The Economist* in 1860. The experience of countries that did not have a central bank, for example Switzerland, also pointed to the need for a central bank to safeguard the stability of the financial system. In connection with various bank crises in Switzerland the banks had tried to protect themselves by reducing lending, which in effect only made the crises worse.

In Sweden, it was not until the Riksbank Act of 1897 that the Riksbank was given an explicit role to stabilise the payment system. When Sweden and the rest of Europe were infected by the crisis in the USA in 1907, the Riksbank was prepared and maintained liquidity in the system. The crisis of 1907 was also, by the way, the event that hastened the formation of the US central bank, the *Federal Reserve*.

The Riksbank's stability work developed after the crisis of the 1990s

Almost one hundred years later, the Swedish bank crisis of the 1990s also acted as a wake-up call for the authorities. The crisis revealed several serious shortcomings, both at the banks and with regard to the authorities' preparedness. As I mentioned earlier, the risk management culture in the financial sector left much to be desired. But even authorities such as Finansinspektionen, the Ministry of Finance and the Riksbank lacked the overall view of the risks in the banking sys-tem required to predict and counteract the approaching crisis. Nor had any of these authorities been given the task of overseeing the system as a whole. After the crisis, however, it was natural that the Riksbank began to develop analyses and stress tests of risks and vulnerabilities in the banking system. Since 1997, the Financial Stability Reports have become a central part of the Riksbank's stability work and they represent an important starting point for a dialogue with the banks and other players.

The Riksbank has also worked for a number of years to strengthen its prepared-ness for financial crises, for example by running crisis exercises and entering into cooperation agreements on crisis management with other authorities in both Sweden and our neighbouring countries. The Riksbank has also long contributed actively in various ways to efforts to improve financial regulation, both in Sweden and abroad.

The efforts made to strengthen preparedness have probably contributed to the fact that the Swedish authorities were better equipped to deal with a crisis in the financial system this time than they were in the early 1990s. It is also probable that the lessons learned during the crisis of the 1990s have provided a number of insights and greater risk awareness on the part of many of the players in the financial sector; even though we can assume that some of these lessons have been forgotten. This should in turn mean that the Swedish banks were in a somewhat more favourable position at the outbreak of the current crisis than many banks in other parts of the world.

The current crisis has revealed new weaknesses

Despite the measures taken by the Riksbank and other central banks to promote stability, it is clear that hardly any of the authorities around the world predicted the global extent and complexity of the current financial crisis. The indications that could be discerned here and there that risks and bubbles were developing were not strong enough to convince enough people of the need for countermeasures. Above all, it seems that there was no clear overall picture of the possible global consequences if any of these bubbles burst. Previous financial crises have, after all, mainly been generated domestically and have thus been a primarily national concern. In addition, it has become far too difficult to monitor the financial sector with its large, complex institutions that have operations and commitments all over the world. And even if monitoring had been simpler and better, there are still no effective mechanisms for counteracting bubbles. The regulation and supervision that has existed has proved inadequate to prevent either exaggerated risk taking in upturns or destructive herd behaviour in downturns.

The global extent of the current crisis points to the need to further develop inter-national cooperation regarding financial regulation, supervision and crisis management. A number of proposals are accordingly being put forward at the international level concerning how regulation and supervision can be developed to reduce the risk of similar crises occurring in the future.

The measures that are now being discussed by authorities around the world largely stem from the fact that in many areas supervision has focused far too much on the state of health of individual institutions and far too little on broader development trends, for example the expansion of credit in the economy, and on the links between institutions in the financial system. Above all, financial supervision has not sufficiently taken into account the risk of financial problems becoming highly contagious. It is, after all, the contagion effects that may have the most serious repercussions for the financial system and, ultimately, the real economy.

Some factors have also been procyclical so that problems in the financial sector have had a negative impact on the real economy and vice versa. In good times, there is almost always a tendency to expand the provision of credit and to dismiss the risks this entails. However, when the downturn comes, the same players tend to run for the exit at the same time, which serves only to make the overall situation worse. Some of the characteristics of the financial regulations, for example the capital adequacy requirements and certain accounting regulations, have reinforced these tendencies towards herd behaviour among the financial players. We have been aware of these problems for a long time, but there have been no effective mechanisms for counteracting them.

Nor have the supervisory arrangements adequately reflect the increased internationalisation of the financial sector. In recent decades, the financial markets have become increasingly interlinked and large, complex financial institutions now conduct extensive operations in several countries. At the same time, supervision has mainly been conducted on the basis of national mandates and focused on companies within individual, national jurisdictions. Supervision has thus lacked the oversight required. In the wake of the crisis, a number of initiatives have therefore been taken that aim to create a clearer link between the supervision that focuses on institutions and the more system-oriented supervision of stability, and to sharpen the tools we use to promote stability in general.

So what needs to be done?

First, the authorities must become better at gathering and analysing information about conditions in the financial sector and the rest of the world in order to be able to better assess the risks of future crises in the financial system. One of the problems has been that the risks have developed during periods when the financial sector has appeared to be in excellent health, at least on the surface. This points to the importance of two things: We need a more transparent financial sector and we need ongoing research and development work to produce indicators that are better at revealing that systemic risks are developing, as well as other types of analytical tools. However, this is not only about discovering and understanding the risks, it is also about counteracting the development of the risks in a more concrete way.

This is why we also need effective corrective tools that enable the authorities to better influence risk behaviour in the financial sector and thus reduce the risk of crises in the future. This includes, for instance, finding ways to ensure that the assessments of the authorities have a sufficient impact on the risk behaviour of the financial players. Apart from effective communication, we also need to think about whether we have the "teeth" needed to put sufficient pressure on the players to make them change their behaviour. For example, the possibility to im-pose an extra capital adequacy requirement on particularly large and complex (and therefore systemically-important) banks has been discussed. Another proposal is to set a ceiling for the loan-to-value ratio, that is the size of the loans the banks may offer in relation to the value of the collateral. In addition, there are various proposals that aim to reduce the liquidity risks that have arisen because the banks have become increasingly dependent on short-term funding on the securities markets.

The corrective tools also include more or less automatic mechanisms that we can use to reduce the kind of procyclical behaviour in the financial sector that I mentioned before. These are tools that can hinder financial bubbles from developing and reduce incentives to take excessive risks. Proposals that have recently been mentioned in the general discussion include allowing the banks' reserves for loan losses to vary in a way that reduces rather than reinforces fluctuations in economic activity, so-called *dynamic provisioning*. Another proposal with a similar effect is to introduce contracyclical capital buffers, that is, that we should require the banks to maintain larger capital buffers in boom periods when there is a tendency for the provision of credit to expand, but smaller buffers in periods when growth is more limited.

Finally, and just as important, there is a need to coordinate the gathering of in-formation and the use of various tools to promote stability between national and international authorities. Work is now underway in Europe to set up a new body, the *European Systemic Risk Board*. One of the tasks of this board, which will be located at the ECB, will be to gather and analyse information that may be of significance to the stability of the financial system in the EU. If the work of the council is to be effective, it is important that it will be able to be forthright about the risks it sees and that the message it delivers is not obscured by political considerations. In order to strengthen the coordination of financial supervision in the EU, the existing committees for collaboration on the supervision of banking, securities and insurance operations are now being converted into authorities. This will give these bodies greater powers to intervene.

Concluding thoughts

So, it is clear that financial crises are nothing new. What distinguishes this crisis from earlier ones is its global extent and extreme complexity. Basically, it is about the fact that the flows in the financial system have increased dramatically at the same time as the system has become increasingly complex and difficult to oversee. The mutual dependence of the various markets has increased. This means that crises can more quickly and more forcefully hit an increasing number of economies at the same time. The current crisis has demonstrated this in no uncertain terms.

This crisis has probably already passed its peak. Extensive efforts are now underway around the world to design a regulatory and supervisory system that will reduce the risks of a new major financial crisis. We need a better insight into the build-up of global risks. And to find the means to counteract the build-up of large imbalances the authorities must begin to think along new lines. This is important but also difficult work.

The financial sector is dynamic in the sense that new instruments, techniques and institutions are constantly appearing. This means that the risks are also constantly changing. Not least, the increase in the banks' cross-border operations and their increasing dependence on market funding pose new challenges to the authorities that are responsible for the stability of the financial system. This means that authorities like the Riksbank need to constantly reconsider and develop their methods. Ongoing and intensive everyday efforts are important, even when the crisis has receded and the spotlight is no longer aimed at the financial side of the economy.

Since the bank crisis of the 1990s, the Riksbank has developed the tools it uses to promote financial stability. But these tools are largely "soft". They entail persuading and convincing those involved with good arguments, something that is usually referred to as *"moral suasion"*. This distinguishes the Riksbank from, for ex-ample, Finansinspektionen, which has wider powers to intervene directly at individual institutions. When times are good, it may also be tempting to ignore the warnings of the authorities and it may be difficult to resist the opportunity to expand when all the indicators are positive. The dramatic credit expansion of several of the Swedish banks in the Baltic region in euro is one example of a behaviour that entails considerable risks, something that the Riksbank has long pointed out in its Financial Stability Reports.

There may therefore be good reasons for thinking about different ways to achieve a greater impact for our analyses and assessments in the future. Can we be clearer and more direct when formulating warnings and risk scenarios? Can we, for example, go public to a greater extent, for example by using open letters and so on, in order to increase the pressure on banks to change their risk behaviour? And how should we handle the increase in the banks' lending in foreign currencies? These are examples of questions that the Riksbank and other central banks must now address.

There is no doubt that the crisis has raised important and complicated questions. Wars and crises usually strengthen the position of the state. This crisis is no exception. The central banks have taken over the issuing of banknotes, but the provision of credit is still essentially conducted on private markets. The general view is that it is not appropriate for the state to work, for example, with the credit assessment or risk assessment of individual loans. The state can establish rules and regulations for the market, but not work in the market itself. At the same time, faith in the ability of the financial markets to work effectively in all situations has been undermined.

An effective financial sector contributes to growth and prosperity in the economy, and it is indisputable that more effective regulation and supervision are now required. In my opinion, however, it is important that the changes in the regulatory structures that are now being implemented are balanced and well considered. Above all, I believe that it is important to avoid the sum total of all the regulations that are introduced restricting growth or, in the worst case, giving rise to new crises. It would be a mistake to underestimate the inventiveness of the financial sector and its ability to circumvent regulations of different kinds. Producing a regulatory framework that makes the financial system safer and more secure without losing important welfare gains is really the major challenge that the authorities now face.

Thank you!