Stefan Ingves: Financial stability – where are we heading?

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, to the Swedish Bankers' Association, Stockholm, 19 November 2009.

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The title of my speech today is "Financial stability – where are we heading?" Some people would no doubt answer this question, and perhaps with a certain amount of justification, by saying that we are moving backwards – back to a world in which the financial system in general and the banks in particular are constrained by additional regulations and restrictions. Those of us who have been around for a while have seen that there is a movement, a pendulum that swings backwards and forwards between more and less regulation, and right now the pendulum is swinging towards increased regulation. However, we are not moving back to the world we were in before the deregulation programmes of the 1980s. In this respect we are moving forward towards something new. Hopefully, we are heading for a more stable – and efficient – financial system.

Today I will discuss a number of proposals for changes in the international regulation of banks. It is not yet clear which of these proposals will actually be implemented. It is therefore important that legislators and authorities now conduct a thorough analysis of the proposals that are under discussion in the international debate before we can decide which of them really need to be implemented. I dare to promise, however, that in one way or another it is going to become more expensive to be a bank.

On the one hand, the repo rate is very low just now. We also count on keeping the repo rate low until the autumn of 2010 to meet the inflation target and support the recovery of the Swedish economy. We are also complementing the low repo rate with fixed-rate loans to the banks at longer maturities to ensure that monetary policy has the desired effect. The aim is to contribute to continued low interest rates on loans to companies and households. In this situation, generally introducing regulations that would make it more expensive for the banks to lend would directly contradict this aim. I would therefore like to emphasise that most of the regulatory changes that I will discuss today should not be implemented before the crisis is well and truly over and the situation in the financial system has returned to normal.

On the other hand, between 1993 and 2003 the assets of the major Swedish banks increased from 120 per cent of GDP to 140 per cent of GDP, and subsequently – in 2008 – to 370 per cent of GDP. Although the financial crisis is helping to temporarily slow down the rate of increase of the banks' assets as a percentage of GDP, the historical pattern indicates that the Swedish financial sector will remain sizeable or continue to grow. This means that the financial sector is of considerable importance to the national economy and it is thus reasonable that the State should intervene in the workings of the financial system.

In the wake of the crisis, one element of the discussion has been that regulation and supervision have to date focused too much on individual institutions and too little on the risks that were generated in other parts of the system. There is a lot of talk about the need to build structures that can prevent systemic risks, a so-called macroprudential framework. Exactly what a macroprudential framework contains is still unclear. It seems to mean somewhat different things to different people. I have therefore simply decided not to use this term today. Instead I intend to discuss the content of future efforts to prevent systemic risks without even mentioning the term macroprudential or its Swedish equivalent – a word that we have not yet invented.

About the crisis: something old, something new and something borrowed

Running a bank is about creating and maintaining confidence. When a bank makes losses – or it is feared that it will make losses – capital is required to cover these losses so that

confidence is not undermined. When the crisis became really serious, the banks did not have sufficient capital to retain confidence. This resulted in a liquidity crisis.

The liquidity crisis became so severe because the banks had become increasingly dependent on short-term market funding. When it became apparent that impaired loans were in circulation but that no one really knew where they were and to what extent, confidence in the banks disappeared. The market participants stopped lending to the banks. The banks also stopped lending to each other and when it also became impossible to sell previously liquid assets or to use them as collateral for loans the liquidity crisis had definitely arrived.

One lesson that we have learned from this is how quickly liquid markets can become illiquid. We also know that the participants and the authorities underestimated how seriously the markets would be affected by the crisis. But, when the price of an asset falls it is no longer possible to borrow as much money on this asset. Participants are then forced to sell the asset to acquire liquidity. If many small – or a few large – participants sell at the same time then prices fall even further. From the point of view of an individual participant it is rational to decide to lend less or to sell the asset. However, the collapse in market prices that is a consequence of these decisions affects everybody. The impact this has on the market is, in other words, a negative external effect.

Selling assets at “bargain-basement” prices should normally attract buyers. But exactly the opposite happened. There was uncertainty about the actual value of some complex and untransparent assets, which explains why the buyers disappeared. Another explanation is that the participants were too similar to each other – they had the same portfolios and used the same analysis models. In the situation that arose, they all reacted in the same way: they shouted “Sell!”.

Capital

It is primarily the responsibility of the banks themselves to ensure that they have sufficient capital to retain confidence when losses increase. Nevertheless, a conclusion that can be drawn from the crisis is that the capital adequacy regulations were and are too generous, both in terms of how much capital a bank should have and in terms of the quality of the capital.

An example may illustrate what the capital adequacy regulations permitted and still permit. Assume that we a house buyer who borrows SEK 1 million and mortgages his house to 100 per cent. We can estimate the risk weighting for mortgages at 10 per cent. The risk-weighted assets for the loan will then be SEK 100 000. The total capital requirement is 8 per cent, which means that the bank must hold capital amounting to SEK 8 000. The more relevant Tier 1 capital requirement is 4 per cent, so the Tier 1 capital held must amount to SEK 4 000. Thirty per cent of the Tier 1 capital may be hybrids of different types. This means that a bank can get away with equity – real share capital and accrued profits – of SEK 2 800 to provide cover for a loan of SEK 1 million. Does SEK 2 800 in loss-absorbing capital provide sufficient resilience for a loan of SEK 1 million?

My answer is no, it does not. The market’s requirements are also often higher today. I welcome the international discussion on a general increase in the capital requirements once the crisis is over. More capital is needed. I also think it is positive that the quantity requirements governing the capital in the capital base and the regulations governing hybrid capital will be tightened up and harmonised. Better capital is also needed. Ultimately, resilience is measured by common risk-bearing share capital.

The discussion now underway in the international arena also concerns whether the banks’ resilience can be strengthened by having regulations that require the banks to build up capital buffers when times are good that they can then use when times are bad. To a certain extent, the build-up of capital buffers may also counteract the procyclical tendencies of the financial system by means, for example, of new regulations that increase the price of lending when times are good and reduce it when times are bad.

Another method that is similar in principle is to allow the banks to make provisions for expected losses in economic upturns. The banks would thus build up a buffer against bad times in their accounting. In this context, the international discussion centres around which method – capital buffers or provisions – is most appropriate. Using capital has the advantage that it provides greater transparency and is more difficult to manipulate than provisions.

We are also now aware that the capital adequacy regulations can allow too high a level of debt if the risk weightings used are based on data that is too short term. The introduction of a non risk-weighted capital requirement that simply aims to prevent leverage ratios becoming too high is thus being considered internationally. This capital requirement would be binding if the risk-weighted capital requirements fall below a certain level and would thus represent an ultimate limit for how much a balance sheet could expand.

At the moment, it is uncertain which of all these proposals will be implemented. However, I am convinced that the capital requirements will be tightened up in one way or another, although this will only be done once things have returned to normal.

Liquidity

Stricter capital requirements will generally strengthen confidence in the banks and thus reduce the liquidity risk. But this will not be enough. The banks must also take responsibility and ensure that they are adequately prepared to handle stress situations. The current crisis also gives us reasons to consider more direct and specific liquidity regulations.

When confidence in the banks disappeared and the sources of liquidity dried up, many central banks, including the Riksbank, were forced to provide liquidity to keep the system going. We provided liquidity not only in kronor, we offered loans in dollars too. It is easy for us to provide kronor – we produce them ourselves – but we have to acquire dollars in some other way. In this case we were able to do this through our swap agreement with the Federal Reserve.

One of the lessons of the crisis as far as the Riksbank is concerned is that our currency reserve must be large enough to meet the foreign currency needs of the Swedish banks in a crisis situation. One alternative that may be considered in order to dampen this need is for the Riksbank to introduce a reserve requirement in currencies other than kronor if the banks have substantial exposures in foreign currencies. This reserve requirement could in principle entail the banks building up a liquidity buffer in foreign currency via the Riksbank. We are at present studying the possibility of using reserve requirements in more detail.

The central banks should not need to provide liquidity in the way they have done over the last two years. It is therefore reasonable to also tighten up the requirements governing the banks' liquidity management. The Basel Committee is now working on a global standard for liquidity management. Under this standard, both short-term and long-term requirements will be imposed on the banks. The banks will be required, for example, to hold sufficient non-leveraged and highly-liquid capital to be able to meet the short-term need for liquidity in a stress situation. The long-term requirement relates more to structural aspects with the aim of preventing the risks that market funding and sizeable differences in maturities can lead to. This is a question of quantitative requirements for liquidity matching between the banks' funding and assets.

Governance to prevent systemic risks – the road ahead

I would now like to say a few words about the road ahead for the authorities' efforts to prevent systemic risks. Today, the Riksbank has an overall responsibility for the financial system. Finansinspektionen is responsible for the stability of individual institutions, but also has a responsibility for the system as a whole. Together, our task is to try to steer the financial system away from instability and towards stability. The main responsibility for this of course lies with the banks themselves.

The institutional frameworks give Finansinspektionen the effective tools that directly affect behaviour – the possibility to change the capital requirements, impose sanctions, prohibit or stipulate measures and, ultimately, to withdraw permits and licenses. The role of the Riksbank, on the other hand, is to exert influence by conducting a dialogue with the participants and issuing warnings about the risks that arise. The "Financial Stability Report", which we publish twice a year, is a central tool in this work. The idea is that our warnings should influence the banks in the following way: if the Riksbank points out that a risk has arisen at a bank, the bank itself should take action to retain the confidence of the market in its operations. If the bank itself does not take action, the bank's counterparties and customers should at least react and take account of the risk in their pricing.

When we now look back we must be self-critical and admit that we did not see the liquidity crisis that developed in the financial system in time. We did, however, issue repeated warnings about the development of risks in the Baltic countries and the fact that risk in general was priced too low on the financial markets. Unfortunately, our warnings in these cases were not sufficiently acted upon.

Another lesson to be learned from the crisis is therefore that we – the authorities and perhaps also the financial participants – must be better at seeing the whole picture and understanding the systemic consequences of individual decisions and actions. The authorities must also be given the opportunity to act when an untenable build-up of systemic risk is observed. This may require new tools. This does not necessarily mean that the Riksbank should be in charge of these new tools. Instead, the close cooperation between various authorities needs to be constantly developed.

In practice, "new" tools may mean applying "old" individually-oriented regulations more bluntly than previously. If, for example, the aim is to dampen mortgage lending, a blunter application of the regulations may mean that even banks that have been restrictive in their lending are affected by higher costs or stricter regulations, for instance because the authorities introduce higher capital requirements, amortisation requirements or regulations on loan-to-value. These new costs and restrictions will be motivated by systemic concerns rather than the need to safeguard the stability of an individual bank.

A lively discussion is also underway at present on whether central banks should use policy rates to a greater extent to correct imbalances on individual markets. For example, the Riksbank has been encouraged in the media to prevent a bubble developing on the housing market. We naturally take house prices into account in our macroeconomic assessments, and the Riksbank's interest rate policy has in turn, through its effect on the households' interest expenses, a considerable impact on the development of prices on the housing market. But the repo rate is not a suitable instrument for the fine tuning of individual markets. It affects, positively or negatively, demand in the economy in a very broad sense. At present, we are conducting the policy that we believe is necessary to meet the inflation target and support the recovery of the Swedish economy.

When it comes to preventing systemic risks such as a prolonged unbalanced development of the housing market, the repo rate is too blunt an instrument to do the job on its own. The repo rate should only be considered if the systemic risk is such that it affects our possibility to meet the inflation target and support the stabilisation of the real economy and the financial markets.

There are instead other and probably more important factors than the repo rate when it comes to avoiding an unbalanced development of the housing market. This perhaps relates above all to effective regulation and supervision. It is also important that the banks and the households make realistic assessments of housing costs in the period ahead and that they ensure that in all new borrowing there is a margin for higher interest rates than those we have today.

However, even though regulation and supervision are sharper tools in the work to promote stability than the repo rate, it is of course not the case that monetary policy has no impact in this context. An important challenge in the period ahead, as I see it, will be to try to find an

appropriate mix between regulation and supervision on the one hand and monetary policy on the other. So, how should the authorities act if, for example, they suspect that a property bubble is developing and that this may lead to a serious increase in systemic risk?

Dialogues with and warnings to the banks will continue to be important tools. However, our experience shows that warnings are not always heeded to the extent they should be. The authorities therefore need to be able to use more concrete and more costly measures, partly to achieve more effective communication and partly – if warnings do not help – to affect the behaviour of the participants more directly.

A recurring issue in international discussions is what types of measure are most effective in influencing risk behaviour. Can we influence behaviour best by controlling prices, that is by applying regulations that make lending more expensive, or by using quantitative regulations? Let me return to the mortgage example I used above. Controlling prices would in this case entail an increase in the capital requirement for mortgages. In the EU, for example, it has been discussed whether the capital requirement should to a greater degree depend on the leverage ratio. Quantitative regulations could include stipulating amortisation requirements or regulating the loan-to-value for mortgages. Economists usually advocate price control, but the arguments for price control are not as strong when we are facing an either/or situation – crisis or no crisis. In such situations, price control may entail too much uncertainty and thus make it necessary to control the behaviour of the participants in a more concrete way. The choice between price control and quantitative regulations thus requires a lot of thought, both on the general level and when designing specific regulations.

Influencing behaviour by regulating capital is however, not the only form of price control that is being discussed. More direct control by levying charges is also under discussion in various international arenas.

One element of this discussion concerns the regulation of systemically-important banks. Risks in systemically-important banks also entail the risk that problems will spread to other parts of the economy, that is there are external effects. It is thus not unreasonable to expect that this systemic risk should be internalised. Several different measures are therefore under discussion to achieve this. One possibility is to introduce a special capital surcharge for systemically important banks. Another is to introduce a charge for systemically-important banks. In Sweden, the latter idea could be realised by allowing a risk-differentiated stability charge to reflect the higher systemic risk that a systemically-important bank entails.

Another possibility that is being discussed is to ensure that systemically-important banks have sufficient capital by creating a debt instrument that is automatically converted into capital when capital adequacy falls below a certain level. During the bank crisis of the 1990s, I was in fact involved in designing such an instrument.[1]

In this context, the form of the regulations that govern the handling of distressed banks is in fact quite important. If the regulations are ineffective the systemic risk, all else being equal, will be higher. The cost that should be internalised in the banks operations will then be unnecessarily high, which in turn will make financial services unnecessarily expensive. It is, in other words, very important to create an effective regulatory framework that makes it possible to take decisive action to handle distressed banks at an early stage in both Sweden and abroad.

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[1] The Swedish Bank Support Authority promised Föreningsbanken that the State would acquire preference shares if capital adequacy fell below 9 per cent. At the same time, the State was given the right to acquire shares if the capital fell below 8.5 per cent. In order to give the bank an incentive to quickly phase-out this support in the event that the State did acquire shares, the agreement stipulated that the preference shares would be converted to common stock with extra voting rights if they were not redeemed within three years.

The internationalisation of the financial system – a challenge

Cross-border banks generate a particularly negative external effect. If a cross-border bank experiences problems in one country, the costs incurred are distributed between the countries in which the bank operates. From the authorities' point of view, the problem is that it is difficult today to prevent a systemic risk that arises and develops in another country.

The principle that is applied in the EU today, the so-called home country principle, states that it is the authority in the country where the company concerned has its registered office that is responsible for supervision. This means that if a bank has a branch in another country the authority in the bank's home country is responsible for supervision, but if a bank has a subsidiary bank in another country then the authority in the country concerned is responsible. The crisis has demonstrated that the home country principle in its current form is inadequate for preventing cross-border risks.

An example inspired by the situation in the Baltic countries may clarify the problem that cross-border banks pose to national authorities. Assume that we have a Swedish bank that borrows in foreign currency on the international market. The bank then forwards this money to a subsidiary bank in another country. The subsidiary in turn lends the money to an end customer. If we now assume that the borrower is unable to repay the loan, for example because he has borrowed in a currency other than the one he has his income in, then the subsidiary bank may find it difficult to repay its loan from the parent bank. The parent bank may then in turn find it difficult to repay its loan. This means that the liquidity risk in foreign currency ends up in Sweden although the lending that created the risk took place outside Sweden's borders.

The best solution for limiting the liquidity risk is that the central bank or the supervisory authority in the country where the risk develops takes action. However, if the authority in this country does not deal with the situation we must ask ourselves whether the situation poses a serious risk to the Swedish banks and, if so, whether we should act, for example by introducing a reserve requirement in foreign currency for the Swedish bank. Action on the part of the Riksbank is a second best solution, but this alternative is probably still better than doing nothing at all. We will therefore investigate the measures we can take to better limit the risks that are built up outside Sweden in the future. In this connection, the possibility to set reserve requirements is one of the alternatives we are investigating.

At the same time, it is important that central banks and other authorities develop their ability to cooperate across national borders, particularly within the EU. Not least, we must learn to accept that someone will have to put their foot down when a cross-border risk develops, even though this may create a certain amount of fuss.

The new European authorities – in the case of the banks primarily the European Banking Authority – are intended to act as arbitrators between national authorities on certain specific and limited issues. Although the right of the EU authorities to override the national authorities is limited, there are signs of a new tendency to transfer power to these international bodies.

A risk council – the European Systemic Risk Board (ESRB) – is also to be set up in the EU with a special responsibility for the supervision of macro-financial stability. Even though the powers of the ESRB will be limited, this still represents an important step on the road towards a better consensus regarding the cross-border risks that exist and how they should be dealt with. An issue which in my opinion should be high on the agenda of the ESRB is lending in foreign currencies.

Concluding remarks

At the beginning of this speech I expressed the hope that we are heading towards a more stable and efficient financial system. The crisis has shown that we must reform regulation and supervision so that we can better prevent financial crises. We need to concentrate more

on ensuring that we have a resilient system and not just resilient institutions. The sum total of all the resilient parts does not automatically mean that we have a resilient whole.

In the course of my professional life I have experienced two financial crises in my own country. This is at least one crisis too many and I definitely do not want to see a third. This is why I believe it is important to move from words to action and to make sure that regulations and tools that make it possible for us to conduct effective stability work are put in place.

However, now that the pendulum is swinging towards increased regulation, we must also be careful to ensure that the reforms retain the ability of the financial system to perform its functions effectively – that is credit supply, payment mediation and risk management. The banks themselves have a primary responsibility for a stable and efficient financial system. But the authorities also need to be able to apply regulations and tools more forcefully than previously.

Thank you!