SPEECH

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The development of a modern financial sector in Sweden

I am honoured and grateful that you have invited me to speak here today. This is an institute of development research so it is appropriate for me to talk about development in the financial sector. It has become gradually more acknowledged by academics as well as by practitioners and policymakers that a well developed financial sector is necessary to a country's overall economic growth and stability. It also improves the services provided to the individual citizens. A well-functioning financial services industry facilitates the transformation of savings into productive investments. It assumes, transforms and distributes risks to those willing and prepared to hold them. It facilitates payments between people and companies. The financial sector is an instrument to promote the smooth functioning and sustainable development of the whole economy.

Conversely, experience has clearly shown that a badly-managed or inadequate financial system is detrimental to the stability and development of society. It may provide inefficient and expensive services and it may run hidden or explicit losses, which in the end may have to be covered by private and public money. It may also distort competition.

The conclusion is obvious: Arguments for social and economic development speak in favour of conducting reforms with the aim of creating a well-functioning financial system. Such a system should offer a wide variety of financial services. Since providing the necessary financial functions is more important than the exact set-up of institutions, we should be flexible as to the means to achieve the desired services.

In practice, most countries' financial systems contain banks, other financial institutions, markets and exchanges, and payment and settlement systems. I will later elaborate on why the financial system must be well regulated and supervised, in accordance with modern and globally-acknowledged practices, for instance those formulated by the Basel Committee for Banking Supervision. Moreover, the development of a well-functioning financial system depends on a number of external factors, such as macroeconomic stability, an adequate legal and judicial structure, robust rules for accounting and auditing, and a financial safety net to deal with problems occurring in the financial institutions and markets.

In my presentation today I will discuss all of these components and I will base it on my experiences of transforming the Swedish system from highly regulated and inefficient to a modern one that today competes successfully on the international scene. The Swedish experience might in some ways also be relevant for other countries, although one must always take into account the specific domestic circumstances. The basic conditions underlying a sound financial system are similar for all countries.

I will first give an overview of the regulated system we used to have in Sweden and some of its objectives and consequences and I will then turn to deregulation and the challenges we faced. The second half of my presentation deals with the modernization of the banking system, of other segments of the financial system, and of the underlying regulation and supervision. I will also discuss some of the most recent developments in financial services and in regulation.

A highly regulated financial system

The Swedish financial system was heavily regulated from the late 1930s to the beginning of the 1980s. The intention was to ensure a stable financial system which could provide cheap financial services to the consumers and the export industry and, in particular, financing prioritized purposes such as the fiscal budget deficit and apartment housing construction at low cost. More than half of the amount available for bank lending was channelled into these prioritized fields. In addition, the pension funds and the insurance companies were forced to allocate large parts of their funds to similar priority purposes.

Competition between the banks was curtailed; for instance, the authorities set floors and ceilings for bank fees and interest rates. Credit expansion was also regulated by the central bank, with the aim of avoiding excessive credit growth in relation to the overall growth of the economy. There were also strict liquidity and cash reserve requirements as an instrument of the central bank's monetary policy. The establishment of new banks was decided by the authorities only if they found that there was a "need" for the proposed bank. The same type of test was conducted before a Swedish bank could receive a permit for opening branches within Sweden.

Capital movements and certain current account transactions in and out of Sweden were restricted. Companies were only allowed to transfer funds abroad in order to finance their overseas investments if they could prove sound economic reasons for doing so, such as if the investments might eventually lead to increased exports from Sweden. Companies were allowed to borrow abroad, but only in foreign currency and there were also requirements from the Riksbank on the minimum maturity of the loan.

Physical persons were only granted a small foreign currency allowance for travel, and had to apply to the central bank for any additional sums such as for acquiring a house or apartment abroad. Foreign companies were generally not allowed to issue securities in the Swedish markets.

Foreign banks were not allowed to operate in Sweden and Swedish banks had to obtain permits when they wanted to establish subsidiaries abroad; branches were not allowed at all.

These restrictions on capital movements had several aims.

One was to ensure a stable Swedish currency, with a fixed exchange rate, insulated from any sudden capital flows. Originally, and in particular during and immediately after the Second World War the restrictions supported the rationing of the scarce foreign currency revenues available to the Swedish economy. The restrictions also ensured orderly conditions on the securities markets: The Riksbank arranged a queue for the issuance of new securities and monitored the timing and sequencing of issuance in order to match it with the available liquidity and investor appetite. Another aim of the restrictions was to make it more difficult to circumvent the domestic restrictions on the credit market through overseas transactions. Finally, I must admit that there was a degree of protection of the Swedish financial institutions from foreign competition.

The regulations on the domestic credit market as well as of capital movements resulted in a highly rigid and underdeveloped Swedish financial sector. However, given the oligopoly situation the sector was rather profitable. You might conclude that the priority purposes were subsidized at the expense of the banks' savers.

Regulation, policy mistakes, and their consequences

Starting from the late 1970s it became gradually more obvious that the restrictions did not function as planned. The financial sector became gradually more inefficient since it could not progress in line with external developments and it could thus not provide the necessary new financial services to support the overall economy which was undergoing modernisation. The restrictions were in various ways circumvented by the institutions themselves and by other market participants. Instead of promoting financial stability the restrictions led to increasing vulnerabilities, for instance when the share of lending provided by less regulated entities increased. The restrictions on capital movements meant that imbalances in the Swedish economy were not always identified as early as they should have been. In addition, the large Swedish exporting companies learnt how to evade the restrictions on capital movements which gave them a competitive advantage over smaller competitors also in the domestic market.

The increasing deficits in the fiscal budget and in the current account made the restrictive system non-operative. The government finally decided to abolish them, although in a careful and gradual fashion to minimise disturbances to the markets and the economy. During a period spanning the late 1970s and the early 1980s the domestic regulations and the restrictions on capital movements were gradually scrapped. The credit market restrictions were finally rescinded in 1985 and the capital movements' restrictions in 1989. This was very late compared to most other European countries.

However, domestic policies were not adjusted to an environment of free capital flows and a free credit market. The fiscal policy and the tax system induced borrowing and monetary policy could not act as a brake since it was geared to the fixed exchange rate regime. Consequently, a few years after the completion of the deregulation, a financial crisis broke out. In today's presentation, I will not go into detail about the manifold reasons leading to the crisis but instead focus on the aspects relevant to the financial sector.

First, the earlier strict regulations on lending meant that banks did not really acquire the skills to evaluate the creditworthiness of customers and loan projects – only those with very high creditworthiness had had access to the limited amounts available for bank lending to non-prioritised purposes. The restrictions on lending to other purposes led to a large unsatisfied demand from potential borrowers. After deregulation, bank lending increased extremely rapidly without banks' credit managers really having much experience on how to evaluate borrowers' creditworthiness. A similar weakness applied to the supervisory authority – they had supervisors with good skills to check the banks' formal compliance with laws and regulations but not to evaluate credit decisions. At the outset, the central bank took the erroneous view that the loan expansion in the banks could to a large degree be explained by old loans moving out of the former "grey sector" and into the banks. Since this had different implications than an extension of new loans, the central bank found that there was no need for the authorities to worry.

Second, a large share of bank lending went into the real estate and commercial property business. There was a building boom in Sweden during the 1980s and prices rose rapidly – paving the way for additional lending. When real estate prices collapsed in the early 1990s the value of the collateral for many bank loans fell sharply and banks suffered huge credit losses from non-payments.

Third, the industrial sector had also borrowed heavily during the export boom period of the 1980s, but when the recession occurred in 1990, they had overextended themselves and in many cases were unable to repay their debts. Many borrowers had their loans denominated in foreign currencies but earned their main revenues in the domestic currency. Their debt payments increased drastically in the end of 1992, when the Swedish currency was suddenly and sharply depreciated by some 25 percent. This led to further loan repayment problems.

Losses for these and other reasons led to a severe and systemic banking crisis in Sweden. The costs to bank owners and to the general public to re-stabilize the banking system were huge, and in addition the overall macroeconomic development and welfare of the citizens suffered for several years. As an example, unemployment soared rapidly from 2½ to some 14 percent. But the crisis is not the main theme for today's presentation so I will only make a few observations.

The crisis was clearly *not* a result of deregulation. However, shortcomings in the deregulation process did contribute to the crisis. As I mentioned, bank managers and also the supervisory authority were not prepared for the transition from strictly regulated banks to a situation in which banks were allowed to assume more risks. Thus they did not recognise, manage and monitor the risks properly, which led to problems. Another shortcoming was that no authority had taken on the responsibility to oversee the financial sector as a whole, to promote overall financial stability, which is different from the supervision of individual institutions and markets. If we had had such an authority, the events and developments outside the financial sector that eventually undermined its stability might have been detected earlier. Corrections might have been implemented that could have prevented or at least reduced the impact of the crisis. Monitoring overall financial stability has now become one of the primary tasks of the central bank, the Riksbank.

Let me stress this again: The fact that deregulation in some countries, also in South East Asia, was followed by banking problems does not imply that you should not deregulate. The conclusion is rather that deregulation must be carefully planned, succeeded by other and more modern types of regulation and monitoring, and supported by a sound macro economic policy. I will speak more about this in the following.

The development of the banking sector in Sweden

For many years there has been consolidation in the banking sector in Sweden as well as in other countries; this development was accelerated by the crisis. Banks merged and larger banks acquired smaller banks. For instance, the large network of *co-operative* banks merged into a single bank which later merged with the bank that emanated from the network of the major *savings* banks – forming one large bank. In this way, several hundred banks became one very large bank.

Is bank consolidation a good or a bad development? The answer is not clear-cut. Sometimes the large resources in manpower and funds that are available in large banks are needed to develop and manage the complex activities which are part of modern banking. Large institutions have a better chance of diversifying their risks by entering into different activities and geographical areas; hence they become more stable. But on the other hand – if there is a problem in a large bank rather than in a small bank, this may threaten the overall financial stability and become a problem also for society at large.

In my view, there is room for large as well as small institutions, which could be specialised in certain activities and services. Anyway, the composition of the banking sector is generally not for the authorities to decide by regulation as long as the institutions are safe and sound.

An issue in geographically vast countries with remote villages such as India but also Sweden is how to ensure that people in remote and small villages also have access to basic financial services. We have tried to solve this in different ways. Internet and telephone banking improve access for some people and services. Payment orders may be sent through the ordinary mail. Another method might be to allow "authorised retail shops" to act as intermediaries for taking deposits and receiving simple loan applications on behalf of a bank.

In fact, after the consolidation phase we have witnessed a period in which the number of banks and bank-like institutions in Sweden is increasing. The new ones have mostly been small banks specialising in certain activities and services, for instance linked to major retail store chains and benefiting from the cash flow from the stores' customers. We call them "niche banks".

Sweden never had a large share of state-owned banks in its financial system. In the crisis one bank had to be nationalised during the resolution phase but that bank was rapidly merged with another bank. Another of the banks which suffered during the crisis was state owned already at the outset but the shares of this bank were gradually sold to private investors as soon as the bank had recovered its financial health. The Swedish government remains a shareholder in the bank but holds only 19 percent of its total equity capital. Today, this bank which is named Nordea, is highly profitable and has formed a large group which has significant market shares in the countries in the Nordic region.

As a government official deeply involved in the banking crisis, I took the decision that although some banks had to be rescued by public funds, the management of the banks should be left to professionals, without undue operational interference from the government. The banks should be run in accordance with market conditions just like any other bank.

This brings me to the trend of the Swedish banks in recent years to open branches and subsidiaries in other countries, foremost in the Nordic and Baltic region but also elsewhere such as in Germany and the UK. At the same time foreign banks operate in Sweden – the restriction on foreign banks which I mentioned earlier was abolished many years ago - and a Danish bank has acquired a significant market share in Sweden of more than ten percent in some activities. This leads to the question: Which are the benefits and challenges from cross-border banking?

From a stability view, diversification is a benefit. The bank group can diversify its risks between several countries and thus protect itself against volatilities in macro economic and other developments among its customers. Hopefully, if there is an economic downturn in one country or sector, this can be compensated for by good economic conditions in another country or sector where the bank group operates.

A cross-border bank may become more profitable because of "economies of scale". Many bank investments in new products and systems, in particular IT systems, are initially very expensive, but the cost of adding more customers to the same product or system is marginal. Of course, the bank can obtain the same benefits by growing domestically, but the major Swedish banks have already reached so large market shares that further domestic growth is limited.

A bank can also profit if it is more competent than its competitors in some areas, for instance in offering certain services or if its organisation runs smoother and more efficiently or if it is regarded as being more reliable or customer-friendly than other banks. For various reasons, Swedish banks have rapidly gained market shares in other markets. It has proved more difficult for foreign banks to gain inroads into the Swedish market, with the exception of the Danish bank I mentioned.

The main challenge from cross-border operations comes from the new risks to the bank. It will start operating in a new legal environment and in a new customer market. If the bank has not prepared itself carefully, it may run into unexpected problems because it approaches the new situation in an erroneous way.

A challenge for the cross-border banks as well as the authorities is to monitor the activities on a consolidated basis for the whole bank group in all countries where it operates. It is important for the head office and the supervisor to identify early any indication of problems in the entities abroad and to take the necessary measures. If this does not take place, the problems may grow and threaten the survival of the bank. In a crisis situation, the bank together with the authorities must decide on the appropriate course of action. This can lead to difficult questions such as whether a bank branch or subsidiary abroad should be closed or rescued. The issue is all the more difficult since the host authorities of the bank branch or subsidiary may have a different view. For them, the bank may have an important role in the market, whereas the bank group is fairly insignificant in the home country.

Sweden and other EU member states grapple with these issues. Some steps have been taken, for instance to sign Memoranda of Understanding so that central banks and supervisors in different countries undertake to inform one another and cooperate in problem bank situations. But talking and sharing information is not enough to solve the problems. This is, of course, not only an issue for Europe and I believe that the issue of solving crises in cross-border financial groups should be discussed more on the global level, such as in the Financial Stability Forum.

Before concluding this part, I wish to say a few words on deposit guarantee systems. This topic is relevant both for domestic banks and for cross-border banks.

For a long time there was no unanimous view on the benefit of such systems. Those who argued against them said that depositors might become lazy in their screening of banks and would put their money only in the banks which offered the highest returns, even if these banks took excessive risks in their activities. There would be a lack of discipline on the banks from the depositors. Also the bank owners and managers might venture into excessive risk-taking knowing that the depositors would be taken care of under a guarantee system. This would be bad for financial stability.

The general view has now shifted and speaks clearly in favour of countries implementing an explicit deposit guarantee system, inscribed in legislation with all its terms and conditions. Such a system should focus on the small depositor. A major reason for such systems, apart from the aspect of protecting the small depositor, is that they greatly facilitate the resolution of problem bank situations and they may even prevent problems from occurring. In a situation where depositors hear negative rumours about their bank, guaranteed deposits might make them less inclined to "make a run on the bank" - to withdraw their cash and thus exacerbate the bank's problems. A further major reason for introducing explicit guarantee systems is that experience from many banking crises has shown that the authorities feel obliged to reimburse depositors anyway, for political reasons. This is often done in an unpredictable and sometimes unfair manner favouring certain segments of the population. The cost of such implicit deposit protection is often higher than that of explicit guarantees.

A guarantee system makes it easier for the authorities to close problem banks. Where such a system is lacking, the authorities tend to delay the unpleasant decision of closing a bank since they are afraid of the negative repercussions on depositors and other counterparties. But such supervisory forbearance only leads to growing problems and costs. It will always be difficult to close banks, but with a deposit guarantee at least the issue of the depositors is partly solved.

What I just described fits in with the development in Sweden. When the bank crisis came, we had no deposit guarantee system but the government found it necessary instead to issue a general guarantee, sometimes referred to as a blanket guarantee protecting all depositors but also other counterparts to Swedish banks, with the exception of the shareholders. This guarantee was in fact much broader, and potentially more expensive, than a limited deposit guarantee. After the crisis, Sweden has introduced legislation on a system of explicit limited deposit protection. All current deposits up to a certain amount, approximately 35 000 US dollars, are covered. For this, the banks pay a yearly premium, currently 0.10 percent on average of the total amount of deposits.

Other parts of the financial sector

In my presentation I have focussed on the banks, but an efficient financial sector must also contain a broad range of institutions and markets. They can specialize in certain activities and instruments and improve competition and diversity. They may also reduce the risk concentration on the banking system which implies that the overall economy will be less gravely hit if there ever is a systemic banking crisis. Compare for example Thailand in 1997, where the banks played a dominant role and Russia in the same year where banks played a minor role. Both countries were hit by financial problems but the overall effects on the economy were much worse in Thailand.

In Sweden many different types of institutions and markets perform specialized roles alongside with the banks. There are also rapid developments in these in the form of volume growth but also in new or improved activities and instruments.

The insurance sector which was as restricted in its activities as the banks during the regulation years has grown strongly in Sweden after deregulation, both for non-life and life insurance products. The demography of Sweden is such that we have an ageing population. Thus savings for retirement, for instance in the form of pension schemes, have become increasingly important. Some of the insurance companies are owned by banks, forming financial conglomerates, but others are independent.

Mortgage banks have always played a strong role in Sweden. Most of them are owned by the major banks, but a few remain independent. The banks themselves are also allowed to extend mortgage credits so there is open competition. The market for mortgage loans is highly competitive because the product is simple and comparable so it is difficult to argue for a higher interest rate.

Credit market companies, leasing companies, factoring companies, and card companies provide specialised financial services. Some of them are linked to the bank groups while others are independent. Many of them are quite small.

Equity and bond markets and exchanges for specialised products such as derivatives have grown tremendously both in volume terms and in terms of offering a wide variety of instruments ever since the first Treasury bills were issued in Sweden in the early 1980s. Equity and bond financing have gained in importance relative to lending from banks. This diversification of funding is positive for financial stability, since the dominating role of the banks in providing loans is reduced. From the issuers and also the investors' viewpoint the existence of active markets ensures good competition, leading to efficiency and favourable loan terms.

To sum up, the Swedish financial sector contains many different types of institutions and markets and competition is strong. This is fine, because our crisis taught us the problems of being overly reliant on the banking system.

The tendency is that the other institutions take markets shares from the banks, for instance in providing channels for saving. But since many of those institutions form part of bank groups, the bank groups' overall share of the financial system is not reduced to the same extent.

Recent developments in the composition and structure of financial services

In addition to the developments in the institutions and markets, we are also witnessing new trends in financial services. Mutual funds, money market funds, equity funds etcetera are growing rapidly. Depositors seek higher yields than those offered by bank deposits and they invest in various securities and asset funds. Banks and other asset managers, including hedge funds, make large profits from this business. The effects on financial stability are unclear. On the one hand, the growth of the funds means more liquidity to the equity and securities markets so they can provide more financing of investments hence reducing the reliance on bank lending. The risks to the banks, particularly credit risk, will diminish. But on the other hand, the risks will instead be assumed by the institutions and the general public which invests in these funds. In the event that the value of the funds decreases the investors will suffer. This may in turn affect their behaviour in the economy, for instance it may reduce their consumption and also the value of property. We have not yet seen any such situation so the outcome is unclear, but we should not neglect the risks.

Another form of transferral of risks is taking place in the financial sector. Through the use of new instruments and structures it has become easier to transfer and redistribute risks. For instance, a bank may deem that it has too much exposure to one customer or to a sector. It could then divest itself of this risk through credit risk derivatives or by securitisation. The advantage from a financial stability view is that the risks become more widely dispersed between the various holders and that the individual bank can build a well-balanced portfolio. But at the same time a new risk has emanated – the risk that the new holder of the risk cannot fulfil his obligations. In the event that there is a credit default, the seller of the derivative to the bank may not have the necessary financial means. Or, there could be an unclear legal position about the risk transfer agreement. Such events might mean that the bank would have to suffer a loss although it thought it had protected itself. The conclusion is that the authorities must force the banks to assess whether the risk buyers have adequate financial and organisational capabilities and whether the legal arrangements are robust.

As in many other countries, there is a strong tendency in the Swedish financial sector to move from "bricks and mortar", such as having many branch offices, to providing their services through the Internet and telephone. About half of all payments of companies and physical persons in Sweden are made through the Internet and by phone. This has made it possible to increase bank efficiency in terms of staff numbers and branches. Each Swedish bank branch now services an average of 4,700 persons in the population compared to, for instance, only 1,900 being serviced by the German banks' branches in Germany. Of course, each country is free to choose its own service level and may prefer a higher level, although it brings higher costs.

Modern regulation

In my view, Sweden abolished its old-fashioned regulations for good reasons. Using the banks for directed lending and for other non-commercial purposes may seem handy for the government, but entails large risks and costs. If you want to subsidize some activities, regions or parts of the population you should at least do it in a transparent manner, so the costs become explicit in the fiscal budget, implying an open debate and decision by the Parliament or government. Our regulation was also erroneous in trying to micro-manage the banks in their own business decisions on lending rates, fees, liquidity management and so on. Experiences from many countries have clearly shown that the banks themselves, guided by market forces make better decisions than outside parties. Finally, the restrictions on the capital flows were wrong because they hid the signals from Swedish and overseas investors and other actors and also because they led to an unsound protection of the Swedish financial system and markets. With hindsight it is easy to see these shortcomings but when they were in force, the regulations represented the flavour of the day.

As I have shown, there are forms of regulation which are harmful and should be terminated. Should there be any regulation at all? Yes, I think so. Let me explain why by using the example of banks, which in most countries dominate the financial sector.

Banks offer several unique and valuable services to society. As I noted in the beginning of my presentation, they receive deposits and transform them into lending. They assume, distribute and transform various risks. They facilitate payment transactions by the use of accounts in other banks and payment systems. However, performing these activities makes banks vulnerable, in particular receiving short-term deposits and transferring them into long-term loans. At worst, banks may fail and destabilize the whole financial sector and even the whole economy. To avoid such calamities from happening, society is willing, under certain specified circumstances, to rescue banks from failure by providing exceptional lending from the central bank or solidity enhancements from the government. Depositors may be protected by a deposit insurance scheme. But the willingness of the authorities to assist the banks and their customers must be matched by regulation and monitoring to ensure that the bank owners and others do not use, or I might say "abuse", the possibility of public support to further their own purposes.

Hence, there must be *some* regulation and supervision to make sure that banks behave in ways which are consistent with the overarching goals of society, such as financial stability and consumer protection. Regulation must also provide the necessary incentives for banks to act prudently and in fair competition with other banks and other financial institutions. An adequate level of domestic regulation is also necessary if you want your banks to do business internationally or if you allow foreign banks to do business in India. You should welcome foreign institutions but you should not open your markets to unregulated and unsupervised institutions.

Ideally, regulation should be limited to what is really necessary to obtain these overarching goals. In practice, authorities have a tendency to over-regulate since they are risk averse. In order to avoid excessive regulation you should always ask yourself if the benefits from introducing a new regulation are greater than the costs of implementation. Here I include both financial and non-financial costs and benefits in a broad sense. Admittedly, this is often very difficult to measure with any degree of precision.

Regulations should also conform to the way financial institutions and markets operate in practice. Hence, regulation should have a functional rather than an institutional approach. This implies that the same financial function should receive similar treatment, whether it is conducted in a bank or in another institution or market. Market-oriented regulations will cause the least interference to the regulatees and to the development of financial instruments and activities. As an example of modern regulation, the new framework for banks' management of risks and capital from the Basel Committee, the so called Basel II, allows the banks to apply their own risk measurement methods and other internal bank processes. But the rules also grant strong powers to the supervisors to take remedial action if the banks step outside the boundaries of the allowed framework.

Obviously, regulations must be transparent. There are still many examples of legislation where the institutions and even the authorities themselves must frequently call on legal advice to interpret their meaning. This causes uncertainty and undermines efficiency. Speaking about transparency, there should also be consultations between the authorities and other involved parties when drafting the regulations. Although the authorities must have the final say, the views of industry and thegeneral public will enrich the process and prevent the regulation becoming a theoretical concept, which does not reflect the way business is conducted in practice.

Modern supervision

Modern regulation must be accompanied by modern forms of supervision. You may remember me saying that the Swedish supervisors during and just after the deregulation did not have adequate knowledge of how to evaluate credit risks in our banks. But they fulfilled their given mandates, which focussed on checking the formalities – that bank operations were adequately recorded and reported; that legal requirements had been duly fulfilled; and that the required documentation was in place.

Modern supervision is risk-based. Given today's size and complexity of banking operations it would be impossible to give equal emphasis to all banks and to all operations and risks; the supervisor has to prioritize. This is done on several levels. Priority is given to supervising large banks and banks which pose high risks to the society, even if they are small. For each individual bank, priority is given to check the material risks, which often are different from one bank to the next. Today, the focus of supervision is much more on the substance and less on the formalities of a bank's business.

Supervision should be based on a combination of offsite observations, where the supervisor analyses financial and prudential reports and other information; onsite visits where the supervisor verifies the information it has received and focuses on the governance and control processes in the bank; and personal contacts with banks' auditors, owners, boards, management and staff in order to gain a good understanding of the bank's business and of the competencies of the leading personalities. Recently, more stress has been given to this latter issue because the increased complexity of banking makes the importance of good corporate governance and efficient control functions even more evident.

Supervisors should avoid trying to micro-manage the banks. When supervisors go too much into the details of the running of the bank, they will be seen to assume – in the eyes of the bank and also of the general public – a responsibility for the bank, which they should not have.

The operational independence of supervisors has lately become even more important. The higher degree of interdependence between the institutions and markets combined with their increased complexity and thus vulnerability implies that supervisory decisions and measures must be based on purely prudential grounds without listening to non-relevant arguments. Such operational independence is inscribed in the statutes of the Swedish supervisory authority. However, independence must be tempered by accountability so the supervisors will have to explain their decisions publicly in various ways, such as reports to the Parliament, and they must be prepared to take responsibility for them afterwards. Banks, their managers and owners, which are affected by supervisory measures must be able to appeal the decisions, although in some circumstances the measure must remain in force while the judicial process is underway.

We should not forget the importance of the so called preconditions, the major external factors which fundamentally affect the supervisors' ability to conduct efficient supervision. The preconditions are, for example, a stable and sustainable macro economic environment; adequate laws and a good judicial system; good accounting and auditing rules; and an adequate system to deal with problem banks and other institutions. In the Swedish pre-crisis situation there was macroeconomic instability with excessive price volatility. Inflation had been high and fluctuating, and current account and fiscal deficits had remained high for many years. This made it difficult for the authorities to assess the underlying financial stability of banks and other institutions.

Recent important regulatory issues for the financial institutions

As you are aware, countries around the world are presently preparing their banks and authorities for the implementation of the Basel II capital requirements. It implies huge financial costs and workloads, but is expected to provide benefits in the form of better managed banks, lower losses and more precise capital requirements. Swedish banks will start implementing the Basel II from 1 January 2007 so their preparations are now at full steam. We at the central bank stand ready to analyse the new capital requirements' effects on financial stability, in particular in situations when there is volatility in the macro economy and banks' credit losses may increase.

There is also the issue of implementing the new international accounting standards, IAS. A highly controversial but also interesting development is that the standards promote a higher degree of market-related valuation of many more categories of assets and liabilities in banks and other institutions. Banks are already used to market valuation for highly tradable assets, but the new standards go further and request banks to value also non tradable assets and even liabilities to assumed market prices. In general, and although I recognize the problem of market-valuation of items for which there is no ongoing market, I support the idea of more transparent and market-oriented valuation. I accept that it may lead to more fluctuations in the banks' balance sheets and also in their profits and losses. Although the financial strength of a bank in the long run will not be affected by using the new accounting principles there is a risk that the analysts and other readers of the financial reports will not understand the difference between the reported temporary results and the underlying issues. They may then panic because of seemingly bad short-term bank results or become excessively optimistic over temporary good results. I see a need for us in the authorities to explain the issues of market-based valuation to the general public. I also support the international recommendations to only gradually introduce the new market valuation principles for certain items, such as some assets and bank liabilities.

I have taken you on the journey from old-fashioned regulation to a modern banking system. Let me end with a few concluding remarks.

Concluding remarks

The development in Sweden from a highly restricted and limited financial system to a system which is quite open and flexible took more than twenty years and is still going on. The financial services sector has now become a source of strength to the overall economy.

We found, and we paid a high price for this experience in the form of the crisis, that the correct way to move is to go gradually and carefully, but not too slowly because you then lose momentum. The side effects of your actions must be considered in advance and mitigating measures may be needed, for instance in updating legislation and other regulations or the capacity and mandate of the authorities.

Modernising the financial system requires considerable effort and but it is well worth the price. Simply put: The industrial and service sectors of any economy can not run and develop smoothly and efficiently unless supported by a modern financial sector.

In my presentation I have focussed on the domestic aspects of having a sound and developed financial system. There are also wide-ranging international implications, not least in today's highly globalized institutions, markets and capital flows. Weaknesses and vulnerabilities in one country may affect other countries and financial systems. The benefits of having a globalized financial system are indisputable as long as it is well structured and managed, but the contagion risks of a weak or badly managed system are large. To create a stable and efficient international system we need good domestic systems but also strong international institutions and good cooperation.

I know that the authorities in India during recent years have taken major steps in modernising your finance sector and I wish you good luck in your future endeavours. I am confident that they will prove to be very worthwhile.