After the crisis – towards a more stable financial system

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The regulation of the financial system is an issue that becomes front-page news in every financial crisis. Naturally, the crisis we have recently been through is no exception. All sorts of recipes have been suggested for a more stable financial system, some more appetising than others. However, one view that the great majority share is that the rules of the game need to be tightened up. The only questions are how much and in which manner.

If it were only a matter of creating a more stable system, the answer would be relatively straightforward. However, the issue is equally one of creating an efficient financial sector in which the financial system's many useful social functions are not smothered by misdirected or excessive regulations. Finding a good balance between stability and efficiency is the primary and, possibly, the most difficult challenge lying ahead.

The fact that the financial markets have been functioning better for a while now gives no excuse for refraining from reforms. It is important to remember that the recovery has, to a large extent, been the result of massive government rescue programmes using huge amounts of tax payers' money. One of the primary justifications for reform is precisely to avoid a situation in which the stability of the financial system becomes dependent upon public support measures. It could also be put like this: It is unreasonable that the owners and employees of banks and other financial institutions can reap the benefits of profits when these companies are prospering, while tax payers have to foot the bill for losses when the same companies are in trouble.

The reform work that is currently underway is not really about discovering a new recipe for financial stability. Rather, it is a matter of adding more of the ingredients we already have. This is because, as we see it, the crisis can largely be explained by a lack of three things: There

[1] This article is based on a speech held by Deputy Governor Lars Nyberg at Samfunnsøkonomforeningen, Oslo, 5 February 2010 and has been translated from Swedish.

was too little capital. There was too little liquidity. And there was far too little focus on the overall system-wide risks that had built up in the global financial system over a longer period of time. In this article, we discuss how we can ensure that there will be more of these scarce resources in the future.

Capital – insufficient in quantity and quality

In the centre of the financial system stand the banks. The banks acquire and manage our savings, they provide us with loans for investments and they also ensure that we can execute our payments efficiently and securely. Public access to these services and public confidence that these services will be executed securely are fundamental conditions for the smooth functioning of the economy. This is the reason we usually talk about the need to maintain financial stability. And, as the banks form the hub of the system, they are the primary institutions that must be kept stable. This requires capital. Capital forms the primary line of defence against an unstable financial system.

More specifically, capital's function is to work as a buffer against losses. So that a bank's depositors and other lenders may feel secure when investing their money in that bank, they need to be satisfied that it will be the capital – that is, primarily the shareholders – and not themselves who will take the blow if problems arise.

The capital that the banks are obliged to retain under the present regulations has evidently been insufficient to create such security. The requirements placed on the banks' capital by bond investors and other creditors have exceeded by far both the regulatory requirements and the banks' actual capital holdings. And when the markets' capital requirements, regardless of whether or not these are justified, exceed the capital that actually exists, problems will arise. In the best case, funding for the banks will be expensive. In the worst case, no funding will be forthcoming. And if these problems are substantial enough to threaten the system as a whole, the government will be forced to intervene, either by injecting fresh capital or by lending the money that the market is either unable or unwilling to provide.

However, the question is whether the market has been correct in its view that capital has been insufficient in both quantity and quality. The simplest answer is that "the customer is always right". The banks are dependent upon their creditors and, if enough of these consider that capital is insufficient, the bank will be unable to stand on its own two feet. In this respect, notions of right and wrong are irrelevant: from a stability perspective, the market's view of what is right is the only thing that matters.

However, the basic question remains. Disregarding the market's view – has the existing regulatory framework forced the banks to hold a sufficient buffer to cope with the losses that have arisen? Neither in this respect has there been sufficient capital. In many cases, governments have been forced to use public funds to fill the gaps in the banks' balance sheets. In many other cases, great uncertainty still prevails regarding whether there will be enough capital to cover the losses in banks' assets.

We can thus make the observation that current capital requirements have not been sufficient, either to protect the taxpayers or to convince the banks' creditors. The result: financial instability and – in many countries – a gigantic crisis management bill for the government. It seems obvious that something must be done to correct this – but what?

The Basel Committee[2] is currently undertaking thorough reform work on the international standards forming the basis of the regulation of many countries' banks, the Basel II regulations. The main part of this reform programme deals specifically with the banks' capital. It mainly deals with two areas: Ensuring that there is *better* and *more* capital in the banking sector.

BETTER CAPITAL

The work of creating *better* capital is one of the most significant and eagerly awaited areas of this reform work. This is because, for a long period of time prior to the crisis, the regulatory framework had allowed the banks to successively reduce their amounts of "real" capital - that is, common equity and retained earnings. Instead, the capital base has been filled with other types of instrument, existing somewhere in the border between debt and equity. Even before the crisis, there were many, including the Riksbank, who pointed out the risks of diluting capital in such a manner. However, our voices were not heard. But once the crisis had thrown the banks' balance sheets into disarray, it turned out that we had, to a large extent, been right. These hybrid capital instruments did not provide the banks with the robustness in which many had hoped and believed.

Consequently, the present demands for banks to have a larger proportion of common equity are very welcome. It is equally welcome to see a tidying up of the plethora of other types of instrument that will continue to be counted as capital in the future.

A new type of capital that is being discussed – and which is also being considered by the Basel Committee – is contingent capital. The

2 The Basel Committee is a committee under the Bank for International Settlements (BIS) which, among other tasks, develops international standards for the regulation and supervision of banks.

special characteristic of this capital is that, under normal circumstances, it has the same characteristics as a regular debt, but during a crisis, for example when a bank's capital adequacy falls below a predetermined threshold, it can be converted into equity. In this way, the bank's capital will be strengthened when it is most needed. When correctly designed, this type of capital can be of satisfactory quality. This was actually tested in Sweden, during the crisis of the 1990s. However, if investors are to be willing to invest in instruments of this type, they must be constructed so as to provide a reasonable balance between risk and return. How this will be done in practice remains to be seen.

MORE CAPITAL

The Basel Committee's proposal for *more* capital is made up of several different components. Without going into more detail about each and every one of these components, we will confine ourselves to observing that the proposals, on the whole, seem to be well-considered. For example, it seems reasonable that considerably higher capital requirements will be placed for the risks taken by banks when trading with bonds, shares and other financial instruments.

However, there are a couple of examples of proposals that will require more thorough analysis and calibration before implementation. One such proposal suggests that the banks should be forced to build up their capital buffers in "good times" so as to have something to fall back on when times are worse. We will return to this point later in the article.

Another such proposal deals with the introduction of a supplementary capital requirement – a leverage ratio – alongside the capital requirement already existing. This basically involves establishing a fixed and simple limit for how far capital may be allowed to decrease in relation to the size of the bank's assets. No such limit currently exists. The present requirements are instead related to the *riskiness* of the bank's assets. The higher the risk, the higher the capital requirement, and vice versa.

Let us start by observing that risk-based capital requirements, as such, are not the problem. On the contrary, the gains to be made through such requirements are significantly greater than the disadvantages. However, there can arise problems if the models forming the basis for the calculation of the capital requirement underestimate the actual risks. One such example would be if the risk models were built on too short-term data and thus did not capture the losses risked by the banks in a recession.

The intention of the new requirement is not to replace the old one. Instead, it is supposed to function as a floor if today's more complex and

risk-sensitive requirements allow capital to fall too low. Even if the intention is sound, there is reason to think very carefully when determining the level at which this lower limit should be set. This is because, if the lower limit is calibrated incorrectly, the risk exists that one of the basic intentions of the present risk-sensitive capital requirements will be lost – that is to say, encouraging sounder risk-taking in the banks.

Liquidity and confidence

High and good-quality capital will get us far, but not all the way. An equally important ingredient is liquidity.

Capital creates confidence and reduces the risk that depositors and investors will abandon the bank when storm clouds gather. However, we have also seen how relatively well-capitalised banks have been forced to go to the government cap in hand. When confidence in the financial system collapses and the money runs out, not even the best capitalised can avoid problems – unless, that is, a sufficient liquidity buffer is held. The crisis has also exposed severe shortcomings in this area. The main evidence for this is that the world's central banks, with few exceptions, have been forced to provide the banks with massive liquidity support to replace their short-term market funding. For periods during the crisis, the central banks acted as intermediaries for, in principle, all interbank transactions. The sources of funding that had previously been taken for granted dried up, and there were no contingency plans of which to speak.

Access to liquidity is decisive for the stability of the financial system. A lack of liquidity can sink the entire banking system, and – as was mentioned above – even drag the healthiest banks down with it. This has to do with the banks' actual basic function: To take on short-term and liquid deposits and convert these to long-term and more illiquid lending – the process of maturity transformation. This mismatch in duration of assets and liabilities implies a risk if the banks cannot renew their liabilities or repay them with their existing assets. This is basically what happened during the crisis, when confidence in the banks disappeared and several financial markets collapsed. The supply of new loans decreased sharply, as did the market prices of those assets that could be utilised to obtain liquidity. The banks affected the most severely were those having extensive maturity mismatches and which had also relied upon being able to sell or borrow against complex and previously relatively untested financial assets. The most striking example of this is the British bank Northern Rock.

However, the solution to the problem is not to forbid banks from conducting maturity transformation. Despite everything, this is what we, as banking clients, demand when we deposit savings and borrow to make

investments. Instead, it should be ensured that the banks have sufficient liquidity buffers to cope with temporary stress, and, in addition, that maturity transformation does not become excessive. While it is not clear where the limit should be set, when we encounter a situation like that of the US investment banks, we know that matters have gone too far. These banks had such short-term funding that they had to roll-over approximately one-third of their liabilities every day.

One part of the Basel Committee's reform package is a proposal to introduce, for the first time, a global standard that places quantitative requirements on the banks' liquidity management. This will establish a lower limit for the banks' liquid assets which will ensure that they can meet their short-term liquid requirements in a stress situation. Furthermore, a limit will be set for how short-term a bank's debt may be in relation to its lending – that is, how much maturity transformation may take place.

It may seem remarkable that this type of regulation has not existed previously. This reflects an excessive confidence that liquidity would always be available on the markets, in all situations. But there is no point in crying over spilled milk. The important thing is that a regulatory structure will now be in place – not least to let central banks avoid having to provide liquidity in the manner that they have done over the last two years.

The system perspective – the missing piece of the jigsaw

One of the main reasons for the regulation and supervision of banks is to avoid systemic risks – that is, risks posing a threat to *the stability of the entire financial system* and, ultimately, the economy as a whole. It may seem superfluous to mention this after our recent experience of one of the worst crises in history. However, the fact remains that, to a large extent, these were precisely the risks that were neglected or underestimated.

In many areas, regulation and supervision have instead been excessively focused on the health of individual institutions. Too little attention has been paid to broader trends, such as the expansion of credit in the economy, the effects of fiscal, monetary and exchange rate policies on the financial markets or the links between different institutions within the financial system, to give a few examples.

Above all, financial supervision has not sufficiently considered the risks of financial problems becoming highly contagious as a consequence of the financial institutions' significant exposures to one another and of their often similar exposures. It is precisely these contagion effects that may have the most serious repercussions for the financial system and the

real economy. One particular problem in this regards is posed by those participants who, due to their size or function, individually can cause major disruption to the system.

The unusual depth and comprehensiveness of the crisis was also a result of the behaviour of the market participants, which contributed towards amplifying the decline. When everybody ran for the door to save their own skins, a downwards spiral developed, aggravating the situation across the entire system. Feedback or cyclical effects of this type are also a type of systemic risk that has not been considered sufficiently in regulation and supervision. In actual fact, the reverse has been true: Certain characteristics of the financial regulatory system, such as the capital adequacy requirement and areas of the accounting framework, have acted to fuel rather than dampen the cyclical tendencies of the financial system.

The fuelling of an existing trend through the actions of market participants, as well as by regulations and supervision to a certain extent, is not a mechanism that is only set in motion during downturns. The same forces also exist when economic activity and market conditions are favourable. This means that price and credit bubbles can build up, increasing the risk of problems arising later, even if the immediate and observable risk in each individual institution does not seem to have increased. In retrospect, it does not seem controversial to conclude that this was exactly the situation prevailing on most markets during the long period of favourable economic circumstances preceding the crisis.

The art of preventing systemic risks

Strategies for the prevention and management of these systemic risks are currently the subject of comprehensive international debate. There has been much discussion regarding the need to introduce what is often called a macroprudential framework.

Even if a considerable amount of thought has been dedicated to this issue before the crisis, it is still not a subject that has been developed particularly thoroughly. Most of the world's central banks have certainly devoted a great deal of thinking towards making system-wide stability analyses, but the risks identified have seldom resulted in any corrective measures. One important explanation for this is, quite simply, the lack of ready-to-use, well-defined tools to address the risks.

However, it is not merely a lack of tools. To tell the truth, central banks, supervisory authorities and other analysts did not succeed in pinpointing all of the risks that caused the crisis.

Creating an effective macroprudential framework is thus a matter of two tasks:

– developing and improving the existing analysis, and
– finding appropriate tools to prevent and correct the risks.

We have excluded the question of how this work of analysis should be developed in order to focus instead upon a few of the tangible ideas and suggestions for tools that have been put forward in the international debate.

MONETARY POLICY AS A TOOL…

One question that has been keenly discussed is that of the extent towards which monetary policy can be used as a tool to reduce the build-up of risk in the economy.

It seems likely that monetary policy can play a certain role, albeit a limited one, in this regards. A tightening of monetary policy would be likely to have a restraining effect on credit growth and asset prices and could thereby contribute towards dampening or limiting any bubbles or imbalances.

However, monetary policy can seldom do the whole job. In many cases, optimism and confidence are strong when a bubble is building up. In such cases, fairly large interest rate increases can be needed to brake the increase of property prices, for example – so large as to have serious negative effects on the real economy. Consequently, in such cases, monetary policy is not particularly effective at affecting asset prices, and a decision to implement it regardless could result in great damage in other respects.

In other situations, monetary policy may be tied to a low interest rate, with the aim of stimulating demand in a deep recession. In such a situation, monetary policy would quite simply be unavailable for correcting a bubble on the property market, for example. As we know, Sweden is currently experiencing a strong expansion of household lending and rising house prices at the same time as resource utilisation is low. If the situation on the housing market develops into a problem, it will not be easy to manage this by increasing the interest rate.

The view that the inflation target and the role of monetary policy must be reconsidered against the background of our experiences in the financial crisis is frequently encountered. However, it is far from certain that this is the correct conclusion. In Sweden and many other countries, we have flexible inflation targeting as a guiding principle. This has basically served us well, both as regards keeping inflation low and as regards limiting fluctuations in the real economy. However, always having monetary policy readily available for use against the development of various asset price bubbles is probably expecting too much of a single tool.

...BUT NOT THE ONLY ONE, AND HARDLY THE BEST ONE

The path to an effective macroprudential framework lies instead through other tools than monetary policy. In the international debate, discussion is currently focusing on various proposals entailing the inclusion of systemic risk perspectives into the regulation and supervision of individual institutions.

One such proposal is that the banks' provisions for loan losses should be allowed to vary in a way that dampens rather than amplifies cyclical fluctuations. The idea is that the banks could make greater provisions in "good" times, thus being able to report a more even level of loan losses over the cycle, so-called dynamic provisioning.

Another proposal, as mentioned above, is to introduce contracyclical capital buffers – that is, to require the banks to maintain larger capital buffers in boom periods when there is a tendency towards fast credit expansion, but smaller buffers in periods when growth is more limited. Allowing liquidity buffers and loan-to-value limits to vary with the economic cycle in accordance with a fixed rule of some type are also examples of proposals that have been discussed.

However, the work of developing internationally harmonised tools has just started. We still do not know exactly which path future regulation will follow, although the Basel Committee's reform programme does have a clear macroprudential focus. The new capital and liquidity standards mentioned above have been designed to prevent cyclical tendencies and contagion risks in the financial system. For example, the Committee has been influenced by ideas such as contracyclical capital buffers and the possibility of evening out loan loss provisions over time. In addition, it will consider whether it is necessary to place more stringent capital and liquidity requirements on systemically-important banks. However, one precondition for this to work would be the identification of a meaningful way of determining which banks are systemically important – something that would be easier said than done.

DIFFICULT CONSIDERATIONS

There are no obvious answers as to which of these tools is most appropriate. All of the proposals have their strengths and weaknesses which require careful analysis. However, below we point out a few general considerations that must be made when new tools are to be introduced.

Automatic or discretionary: One issue that must be considered is whether these macroprudential tools should be automatic, or whether it should be left to authorities to take a discretionary decision, that is in every individual case, as to when measures should be implemented. The

advantage with automatic tools is that they are transparent and predictable. They also reduce the risk that dangerous developments will not be corrected in time. However, the problem is that automatic tools reduce precision and are more indiscriminate than discretionary interventions based on ad hoc assessments. It is likely that the authorities may need a combination of automatic and discretionary tools in their toolboxes. However, it is important to note that the instruments for the tasks referred to here are not to be implemented in individual banks, but in a uniform manner in the entire banking system.

Transparency in the banking system: Another issue is that of how transparency in the banking system would be impacted by the introduction of regulations aimed at smoothening the banks' results and capital over the economic cycle. This is because such measures require that "reality" is abandoned in favour of assumptions of how various economic variables will develop over time – which is the entire point, of course.

However, the downside is that this approach inevitably entails a certain degree of uncertainty concerning the reliability of the banks' financial statements. It could also leave room for arbitrariness if the regulations allowed the banks too much scope to make their own assumptions and assessments. For example, too much flexibility in the accounting rules as a consequence of increased possibilities to deviate from the principle of valuing certain assets at their actual market value (fair value) would increase the risk that banks – or authorities too, for that matter – would be tempted to manipulate valuations to make a bank appear healthier than is actually the case.

Authority and responsibility: Another issue is that of who would be allowed to decide and who would take responsibility. When macroprudential tools are discussed, what is often being referred to are the more or less traditional supervisory tools implemented by supervisory authorities, but which, instead of being used to limit the risks in individual companies, are being implemented to influence the financial system as a whole. As discussed above, this could be a matter of more stringent capital requirements, but could also include other types of measure, such as setting limits for loan-to-value ratios or tightening amortisation requirements, for example. But applying a system-wide perspective to the oversight of the financial system in this way is a task that usually lies closer to the responsibility of the central banks.

The current situation could be described, somewhat exaggeratedly, as one in which *the central banks have the responsibility*, while *the supervisory authorities command the tools*. This gap between responsibility and powers must be addressed in some manner.

The obvious solution, of course, is to gather both responsibility and powers into one and the same authority, either at the central bank or at the supervisory authority. However, there are other alternatives. One such alternative could be to merge the supervisory authority and the central bank into a single authority, according to the model already applied in many countries. A less far-reaching alternative would be to strengthen coordination between the authorities in various manners.

One circumstance complicating the question of responsibility is that many of these macroprudential tools will affect lending in the economy, one way or another. Thereby, they will also have an impact on the growth rate and other real economic factors, which, in turn, are input variables in the central banks' monetary policy analyses. Consequently, it cannot be ruled out that, in certain cases, tensions may arise between the monetary policy objectives and the stability objectives.

In many parts of the world, discussions are currently underway regarding the manner in which responsibility should be allocated between central banks and supervisory authorities. We will just have to see where these discussions take us, given time. Maybe this issue does not need to be so controversial. It would actually be quite natural for the supervisory authorities to manage the individual banks and to have instruments for this, while the central banks handle the economy as a whole and have instruments for that.

However, it should be emphasised that the most important aspect is not who is to do the job, but that it is done at all. One authority or another must be granted the authority and the instruments to influence lending in the banking system as a whole.

THE INTERNATIONAL DIMENSION

There is one additional aspect linked to the management of systemic risks that is yet to be discussed – the international dimension.

The internationalisation taking place on the financial markets in recent decades has meant that systemic risks have developed an increasingly cross-border nature. It is currently difficult or even impossible for national authorities to fully control these risks on their own. This is quite simply because these risks exist or are building up beyond the borders of the country in question. Clear evidence of this is provided by the manner in which we, in the Nordic countries, have been impacted by the crisis, even though we are far from its epicentre.

In this environment, it is easy to understand that conflicts of interest may arise between countries. To illustrate this, we can use a hypothetical example of a situation that could be faced by Swedish authorities. In the

Nordic countries, the banking sector includes a not inconsiderable amount of foreign banks conducting operations via branches. These branches are under the supervision of the country in which the bank has its registered offices, as opposed to the country in which operations are conducted. The foremost example in Sweden is that of Danske Bank's Swedish branch, which has a market share of over five per cent of the Swedish banking market. If the Swedish authorities decide to undertake measures, for example to limit the banks' lending for housing purchases, this must be discussed and agreed with the overseas equivalents. In the case of Danske Bank, this would be the Danish supervisory authority. Otherwise, of course, branches of foreign banks could continue their lending activities in Sweden as if nothing had happened, with the risk that the measures implemented by the Swedish authorities would be less effective.

This development towards increasingly integrated financial markets is fundamentally positive. But increased collaboration is needed by authorities in different countries to manage its "side effects". Partly this is a matter of coordinating the work of information retrieval and analysis across borders, and partly of determining how to manage the risks arising.

In this respect, the crisis has functioned as a wake-up call for the EU. Work is now underway to set up a new advisory body, the European Systemic Risk Board (ESRB). This body, which will be located at the ECB, will be given the task of identifying and analysing systemic risks within the entire EU.

Thanks to the creation of a joint body to monitor the entire financial system, it will be easier to avoid the mistake of focusing supervision too much on individual institutions and markets. By examining the risks arising from both macroeconomic trends and from developments within the financial system, the Systemic Risk Board will be able to identify both endogenous and exogenous threats to financial stability.

However, it remains to be seen how effective the Board will be. For example, reservations may be expressed regarding the fact that the Board has no binding powers at its disposal, which is obviously a problem from the point of view of efficiency. Nevertheless, the Board will provide significant added value in creating better coordination and consensus regarding the risks in the EU's financial markets and the manner in which these should be addressed. And, quite regardless, the situation cannot be worse than it was before – because then, of course, there was nothing.

SOME THOUGHTS ON CRISIS MANAGEMENT

So far, we have only discussed crisis prevention. But crises will always arise. It would be folly to believe otherwise. We must consequently exert

just as much energy on reforms to strengthen our ability to manage crises. Once a crisis has arisen, a system is needed in which the rules and regulations are clear and precise, right from the very start. Not starting to ascertain how a crisis should be tackled until it is already a fact only contributes to increased uncertainty. This also increases the risk that taxpayers will be left to foot the bill, a situation of which we have bitter experience in the Nordic countries.

What is needed – but which is absent in many countries, including Sweden – is a well thought-out and credible framework for managing banks in crisis. This is largely – but not exclusively – a matter of formulating tailor-made bankruptcy and reconstruction legislation for financial institutions. The need for this is primarily due to the banks' central role in the payment system, which forms the very heart of the financial system. Applying "normal" bankruptcy proceedings and stopping payments for a bank which conducts innumerable transactions on behalf of itself and its customers on a daily basis would be to risk bringing the entire financial system to a crashing halt. The consequences that this, in turn, would have for the economy are easy to imagine if we only consider how dependent our own private economies are upon a functioning payment system. Allowing banks to enter into regular bankruptcies is thus extremely costly and probably not something governments will allow. And if there is nothing else to fall back upon than the normal bankruptcy legislation, the only alternative is to rescue the bank in an improvised manner, using public funds.

The problem here is not that the government intervenes. On the contrary, this is essential. The problem instead is that it takes place in an improvised manner and without prepared arrangements for dealing with the bank's owners and lenders. And, as we know, history tells us that, in situations of this type, it can be difficult for the government to "punish" the shareholders by forcing them to accept severe economic concessions, for example by removing their ownership. Instead, the government risks becoming embroiled in protracted negotiations ending in the bank receiving economic support, at the same time as the owners reap the benefits of this support. From the taxpayers' perspective, this is, of course, completely unacceptable. Nevertheless, it is a likely scenario unless a functioning bankruptcy and reconstruction legislation is available.

One of the most important components in a functioning crisis management framework is the government's right to take over a bank without ending up in protracted conflicts with the shareholders. In a crisis situation, there is no time to sort out possible disputes with the owners. In these cases, this must take place afterwards. And should it be established that the government has handled the situation incorrectly, in any respect,

the shareholders should, quite simply, be given reasonable economic compensation.

Implementing a smoothly-functioning crisis management system is not just important for limiting the economic damage once a crisis has taken place. It is also centrally significant for the prevention of crises. If we can succeed in creating a system in which the banks' shareholders and lenders cannot expect the government to foot the bill in the event of a crisis, this will, with the greatest probability, contribute to more responsible risk-taking in the financial sector. Consequently, the need to govern the banks' operations in detail with preventive regulations and supervision should also be decreased.

CRISIS MANAGEMENT IN AN INTERNATIONAL PERSPECTIVE

Considering the globalisation of the financial sector, it is a particular challenge to ensure that there also exist functioning crisis management systems on an international level. Of course, within the EU, we have succeeded well in integrating the markets for financial services in 'times of peace'. But we still lack a common view of the manner in which we should manage cross-border banks in crisis.

National crisis frameworks need to be adjusted so that authorities from different countries are allowed to interact and strive towards common goals. There is a great deal of work to be done here and many obstacles to be overcome. Many countries have clear ambitions on this issue, but so far there is no detailed roadmap and the debate is quite unfocused.

Certain countries wish to proceed in the direction of harmonisation and coordination, while others consider that national interests must be given priority. Among those advocating the latter, there exists a basic fear of being forced to pay for problems caused somewhere outside their own jurisdiction. Consequently, these countries prefer regulation and supervision striving towards a more nationally-oriented financial sector. However, this kind of financial protectionism would be both reactionary and costly.

Instead, we need to attempt to maintain the benefits brought about by financial integration. The key to success lies in finding a system in which countries feel confident that the costs arising in a crisis situation will not unfairly be passed on to their side of the border. One central precondition for the creation of this confidence is that we already start to discuss the management of cross-border crises in advance – because when the crisis comes, it is usually too late.

A difficult balancing act

The coming years will bring with them major changes to the regulatory structure governing the financial sector. This is natural after a deep financial crisis such as the one we have just experienced. It will take time for everything to come together. After the crisis in the 1930s, it took 4–5 years.

During the crisis, there was not much time to discuss future regulations. That discussion is taking place now, against the backdrop of the risks the taxpayers of many countries – including Sweden – have had to bear to shore up the financial system.

The risk of excessive regulation is obvious, and the extent of that risk is, to a large extent, dependent upon the banks' attitudes – both towards the current situation and towards events during the crisis.

This article has primarily dealt with the construction of a more stable financial system. As was mentioned in the introduction, there is, of course, another side to this issue which is probably just as important: The financial system does not just need to be stable – it also needs to be effective. And stability and efficiency do not always go hand in hand. It is thus important that we are alert and ensure that the regulatory reforms following the crisis do not impair the financial system's ability to fulfil its useful social functions.

In the end, reform work is basically an issue of finding a reasonable economic balance between the risks and returns of the financial system. How much risk should society allow and which consequences will the chosen level of risk entail in terms of increased or decreased economic welfare? Even if this question is almost philosophical in nature and cannot easily be answered, it is precisely what we constantly need to have in the back of our minds as we now call for more regulation.