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■ New international regulations for banks – a welcome reform

Over the past three to four years the world has undergone the largest financial crisis since the Great Depression of the 1930s. The scope of the crisis and its catastrophic economic consequences quickly led to the realisation that something had to be done to avoid this happening again. As soon as the worst phase of the financial crisis was over, extensive work began on correcting the inadequacies in the regulatory systems that had come to light. The reform work is conducted in many forums at both national and international levels. And not least at EU level. But today I shall focus on the reform work in the Basel Committee on Banking Supervision, in which both the Riksbank and Finansinspektionen (the Financial Supervisory Authority) participate. This Committee is the international body that has established frameworks for bank regulation since 1974.

In line with internationalisation that has taken place in recent decades, banks in different countries have become increasingly dependent on one another. This also applies to our Swedish banks, which to a great extent fund themselves on the international markets. Both Swedish banks and Sweden in general therefore benefit from banks around the world becoming more resilient. Because after the recent crisis, no one can have missed noting how much Sweden is affected by financial developments in other countries. So it is a major step forward that there is now international agreement on the need for tougher bank regulation. The reform package that has been agreed is called Basel III, and the proposed regulations will appear both in EU directives and Swedish legislation.

In brief, the Basel Committee's proposals entail tightening the regulations in four important respects. Firstly, the banks must hold more capital. Secondly, this capital must have better quality. Thirdly, a minimum requirement for the banks' liquidity is being introduced, and this is completely new. There has been no regulation on this previously. Fourthly, there are stricter requirements regarding the banks' risk management. This is what I will talk about today.

It has not been easy to reach agreement on these issues. The process has been punctuated by negotiations and compromises all the way to the end. The reform package has nevertheless been produced relatively quickly, given the complexity of the issues and the many different interests involved. Some would

probably say too quickly. But we at the Riksbank welcome the fact that the work was completed quickly. When the first spark of a crisis appears, awareness dawns at first slowly and only to a few, then the spark becomes a blaze and the drama begins. When the acute phase of the crisis is over, the memory fades with the ashes and interest in crisis prevention work and regulations for crisis management soon wanes. It is better to strike while the iron is hot.

The Basel Committee has achieved a difficult balancing act. Regulations are needed to prevent crises, but wrongly-constructed or overly rigid regulations can have a negative effect on the economy if they make it more expensive or difficult for households and companies to borrow. The whole reform package is not yet complete in the sense that all of the details have been worked out. But agreements have been reached on several major issues and so far we at the Riksbank consider that the proposals presented attain a reasonable balance.

Part of the compromise has involved a long period of implementation for the various parts of the regulatory framework. Some parts need not be fully introduced until 2023. It is reasonable to have a transition period in which the banks can adjust. But at the same time, one may worry that it is too long in some areas. It is important that all parts of the framework are in place before new turbulence or even new crises arise in the financial system. The longer time that passes, the greater the risk that interest in implementing the changes will wane.

But what exactly does the Basel proposal involve? What consequences will it have? How will our Swedish banks, households and companies be affected? But before I go into these issues, I would like to briefly describe the background to the reform package.

Financial system close to total collapse in autumn 2008

The global financial system was close to a total collapse in autumn 2008. The large rescue packages implemented by central banks and other authorities around the world succeeded in preventing an even worse financial crisis than the one we experienced. One hardly dares speculate as to what might have happened if the rescue packages had not succeeded in restoring confidence in the banking system, because without confidence developments can be quick and drastic. The most classic example of this is a bank run. This means that the bank's customers become concerned for their savings and rush to the bank to withdraw them in time. But the money isn't in the bank, it has been lent out. Which is the whole point, of course. At the same time, the banks are unable to renew their loans in the market as they mature, which means they cannot meet their obligations to deposit customers or creditors in the market and they collapse like a house of cards. And without banks the financial system cannot function. If not even the most basic functions can be upheld, people will not receive their wages and will not be able to pay their bills. The economy will grind to a halt.

But even though we managed to save the financial system through rescue packages, the costs of the crisis have been immense. The reason for this is that a crisis in the financial system has far-reaching consequences for the *whole* economy. The financial crisis causes large falls in production, rising unemployment and increased budget deficits as incomes fall and expenditure rises in the wake of the recession. There is thus a big difference, from society's

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point of view, between banks in distress and ordinary companies suffering problems. This is why we need special regulations for the banks.

It is no news to us Swedes that crises are extremely expensive. We only need to look back to the crisis in the 1990s for a reminder. But this time the crisis was on a global scale. For the first time since the Second World War we have experienced a fall in production in the world economy. It is clear that the world will suffer the consequences of this for a long time to come. But we Swedes have also been hit hard this time, too. Not least because we are a small, export-driven economy that is very vulnerable to developments abroad. Because when the credit taps are turned off, orders that have been made are withdrawn and no new ones are made. In 2009 total production in Sweden, GDP, fell by around 5 per cent - the largest fall in a single year since the 1940s. Such a large fall in the production flow entails an irrevocable dent in the long-term curve. Gone forever. If one converts it, it corresponds to about SEK 20,000 per Swedish inhabitant. This is money we could have used for consumption and welfare. And let us remember that this is just *one* of the effects. Add to this the reduction in wealth in the form of falling values of companies, financial instruments and other assets.

Contagion effects in a globalised financial market

The origins of the crisis lay in US subprime mortgages. Although Swedish banks had very little exposure to this type of asset, the crisis nevertheless affected them. Like the Swedish economy as a whole, the Swedish financial system is very dependent on other countries. For example, only half of the banks' funding is deposits from private individuals, companies and institutions in Sweden. The rest is borrowed on the market, and a large part of this on international markets. Moreover, most of the funding is relatively short term. This is not unique to Sweden. The advantage is that it reduces the banks' funding costs, which in turn makes it cheaper for households and companies to borrow money. But there are also disadvantages.

As the banks have made themselves more dependent on the outside world, they have of course become more vulnerable to problems arising abroad. When the international money markets slammed on the brakes in autumn 2008 the Swedish banks' funding was immediately affected. Not least because they had borrowed money in the short term. So unlike the crisis of the 1990s the crisis we have just experienced is largely an imported one. But the Swedish banks had also become involved in activities that proved to be risky. I refer to their lending in the Baltic countries. These exposures also affected confidence in Swedish banks during the crisis.

As we are affected very directly by disruptions on the international financial markets, it is in our interests to have functioning global regulation. We therefore welcome the proposals made by the Basel Committee. Hopefully, the new regulations will contribute to preventing new crises in the financial system, or will at least alleviate their dramatic effects.

More capital of better quality provides larger buffers

I shall begin by describing the new requirements regarding the banks' capital. Because this is what a large part of the changes agreed by the Basel Committee

concern. One can say that this capital is the money at the bottom of the treasure chest that the financial supervisory authorities require the banks to always hold.

The banks have long been obliged to observe special minimum levels regarding the size of their capital. There are two main reasons for this. The first is that the capital is to reduce the costs to the state if the bank fails. Even though Sweden escaped relatively lightly on this occasion, we know from experience that such costs can be very extensive. For instance, the state may be forced to take over bad assets or have to pay money to depositors under the Swedish deposit guarantee scheme.

But the role of capital is primarily to reduce the risk of a bank failing at all. When the bank suffers losses it should have a capital buffer to meet them and thereby be able to continue its operations. What this means for the banks in the end, as for the rest of us, is that they must try to earn more money than they spend and have sufficient reserves to cope with the periods when they don't. The banks manage this by constantly assessing the risk that a borrower will experience difficulties in meeting interest payments or paying off the loan. If this risk increases, the bank leaves a good margin for it by adjusting its lending or allocating reserves for potential losses. But as borrowers are affected by so many factors that are difficult to judge – for instance, economic recessions have very different impacts on different sectors and geographical areas – it is easy for the bank's losses to become larger than expected. The minimum capital required by the regulations should act as a buffer against such unexpected losses.

It is necessary for everyone to be convinced the bank will survive in order for it to survive. If the bank is perceived as unsteady, the supply of money will be cut off. A lack of sufficient capital buffers can easily shake confidence in the bank. And this was exactly what happened when the crisis loomed large. People were uncertain how badly off the banks were. No one knew how large the losses would be and whether the reserve capital would suffice. Funding ran short. Because what financiers in the market would want to give loans to a bank that appears unsteady? And who would want money in an account in this bank? I am sure you will remember the pictures of the queues outside Northern Rock's branches in the United Kingdom. To restore confidence, the state and the taxpayers in many countries had to inject capital and go in as owners of the banks. This would not have been necessary if the banks had held more capital when the dark storm clouds gathered in summer 2007.

The Basel Committee has taken note of this. The current capital requirements are being raised substantially. If I may go into technical details, the new regulations require that the banks should have a Tier 1 capital corresponding to at least 6 per cent of their assets, or more correctly their risk-adjusted assets. The risk adjustment means that for each asset one recalculates the value, depending on whether the value of the asset can be regarded as certain. One sign of this might be, for instance, that the value of the asset has varied a lot. The higher risk an asset is believed to entail, the more capital needs to be allocated. At present, the minimum requirement for Tier 1 capital is only 4 per cent of the total risk-weighted assets.

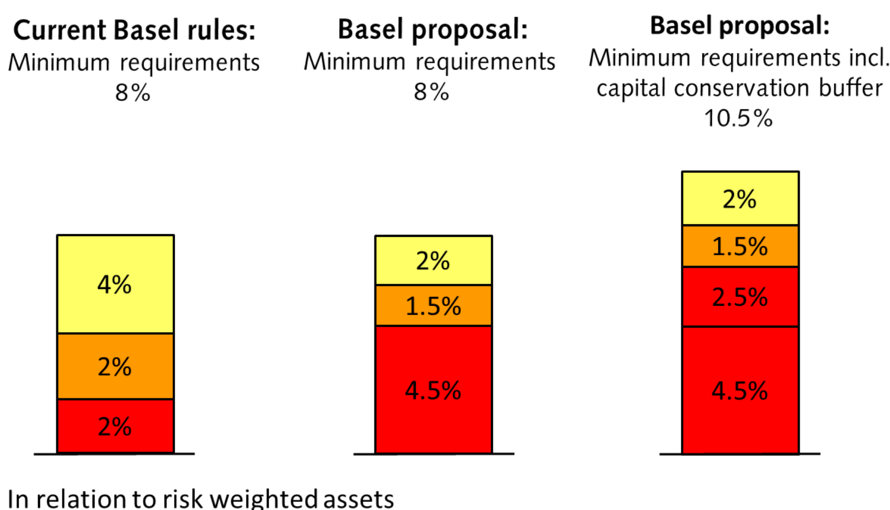
However, this comparison is not entirely valid, for two reasons. Firstly, the new regulations entail much stricter requirements regarding what is accepted as Tier 1 capital. In future a much larger share of this capital must be of the

highest possible quality. This "common equity Tier 1 capital" is made up of equity capital and withheld profits (the red part of the columns in the figure below). This capital can immediately and without complication be used to cover losses. In addition, one must have additional capital – what is known as other Tier 1 capital – of good quality, which can also be used to meet losses in going concern (orange colour in the figure). One must also have further capital in the form of, for instance, subordinated loans (yellow colour in the figure). This part of the capital differs from the other two in that it can only be used once the bank has gone bankrupt.

Secondly, one will to a greater extent assume that the asset values are overestimated. So the risk adjustments in the value of the assets that I mentioned will be much tougher. Quite simply, one will now assume that the values of many asset classes are more inflated than was previously assumed.

So despite the increase in Sweden being only around 2 percentage points for Tier 1 capital, it actually entails a much tougher minimum requirement. But above all, it means that the global minimum level is raised substantially. Especially with regard to common equity Tier 1 capital. But not only that. The banks should also hold buffers over and above the minimum requirements. One such buffer is what is known as the capital conservation buffer. The further a bank is from meeting the capital conservation buffer requirement, the more limited its capacity to pay dividends to shareholders. The reason is that one wants to prevent the banks from showering its owners with riches in the good times, and then being caught unprepared when the economic climate changes. If one adds this buffer, the requirements for common equity Tier 1 capital is 7 per cent. Moreover, national authorities will have the opportunity to force the banks to build up extra buffers during economic upturns, so that they can more easily weather difficulties when there are downturns.

The Swedish banks already comply with the capital requirements stipulated in the new Basel regulations. And this is an important condition for them to be able to fund themselves on the markets.



Liquidity regulations increase resilience when funding is difficult

But even if a bank is well-equipped in terms of capital, it can nevertheless come unstuck if it does not have sufficient liquidity buffers. And this is what happened to many banks during the crisis. To ensure the banks are better-equipped, the Basel Committee has agreed on introducing requirements regarding the banks' liquidity management. These are entirely new regulations – there have previously not been any regulations in this field at all.

Liquidity can be compared to the ability to pay one's bills as they fall due. Even if you have large capital, you may not have good liquidity. This is particularly important for the banks. While they receive money from depositors and borrow on the market at fairly short horizons, their lending is usually long term – perhaps 30 years or more for a mortgage. This ability to transform short-term saving into long-term loans is the banks' main function in society. It enables companies to invest and households to buy their homes.

Normally, a shortage of liquidity does not present a problem. Withdrawals from bank accounts follow normal patterns and the banks are able to monitor this. If special needs arise, the banks can manage the situation by selling assets and thus acquire cash. Normally the banks have also been able to manage their short-term borrowing without problems. But during the crisis problems arose on many markets. In some cases there were quite simply no buyers at all and market funding ceased functioning. And as the banks had become dependent on short-term borrowing, there was little they could do when their financiers decided it was safest to demand their money back. Money the banks could not get hold of.

In these situations there is not much a bank can do. The usual remedy is liquidity assistance from the central bank. But most central bank make tough demands regarding collateral for lending money to banks with liquidity shortages. Collateral which the banks in many cases were lacking during the crisis, or at any rate to the extent needed to compensate for the enormous decline in funding on the international capital markets experienced by many banks – in Sweden and abroad.

So central banks were forced to change the regulations so that the banks could pledge collateral with a less reliable value. But this solution is not sustainable in the long run, as it exposes the central bank – and ultimately taxpayers – to unacceptable risks. In practice, it means that the central bank is forced to act as dumping ground for bad assets as soon as there are problems in the financial markets. Of course, we want to avoid such situations in the future, and this is why the Basel Committee has produced a number of regulations aimed at making the banks less sensitive to liquidity problems.

So what do the regulations entail? In future, a certain part of the borrowing must be longer term. Moreover, it must come from more stable sources of funding. In concrete terms, the regulations mean that one multiplies the amount the bank borrows from each type of funding source by a stability factor – in roughly the same way as for risk adjustment of the value of assets when calculating capital requirements. This gives a stability-adjusted funding profile for each institution that should better match the maturities for the banks' lending.

One will also require that a certain percentage of the banks' assets are liquid, in the sense that they can be converted into cash relatively easily. This reduces the banks' vulnerability to sudden outflows of funds deposited or maturities of loans that cannot be rolled. Put simply, they require that the bank holds a liquidity buffer. The size of the buffer is calculated to ensure that the bank can manage a 30-day period with very large withdrawals of deposits and substantial loan maturities.

These two regulations – on liquidity buffers and more stable sources of funding – entail less risk that the banks will be taken by surprise as they were during the financial crisis. But above all the regulations will lessen the contagion effects on the markets. Stable liquidity management reduces the risk of turbulence in individual markets or banks quickly spreading and creating financial problems for other banks.

Stricter risk management

The third part of the Basel Committee's reform package concerns what is perhaps the most important mainstay of the banks – the way they manage their risks. If risk management is inadequate, having plenty of capital or apparently good liquidity management will not help.

Risk management mainly concerns credit risks and market risks. Credit risk means that a borrower is unable to repay his or her loan. Market risk is the risk that the bank's assets will vary in value in a way that was not anticipated, and this makes it difficult for the bank to get hold of capital without making a loss. For example, fluctuations in interest rates and exchange rates can affect the value of the assets. In addition to these risks, there are what are known as operational risks. This can involve, for instance, a technical system failing to function, or a human error that puts the bank at great risk. Some of you may remember how the British bank Barings collapsed in 1995 as a result of speculation and unchecked risks taken by a single employee. Risk management is about protecting oneself against such undesirable and unexpected outcomes. In short, one wants to take calculated risks. According to earlier agreements within the Basel Committee, the banks have the possibility to develop models themselves to calculate the size of their risks and this is an opportunity most of the major banks have used. Over time, their risk calculation models have become increasingly sophisticated.

But during the crisis it turned out that not even the most advanced models managed to capture the real risks. Sometimes it was not the model that was inadequate; there was a lack of available data for assessing the risk. In many cases there was quite simply not enough historical data, as the financial instruments were such fresh inventions. You may have heard of various types of complicated derivative, such as CDOs, CDSs and so on. In other cases, there was a change in the relationships between prices and other factors that had been previously observed. The calculated probabilities quite simply did not reflect the reality.

It is easy to make a comparison with Swedish humorist Tage Danielsson's classical sketch about the probability of a nuclear accident: as Harrisburg had just happened, there was absolutely no risk that history would repeat itself. Or to look at it another way, as the complicated financial instruments had previously escaped sudden price falls, one need not expect any sudden price

fall in the future. Slightly exaggerated. Underestimating risks and taking excessive risks are two sides of the same coin. And this was just what happened, right up until the US house price bubble burst and the crisis was upon us.

It is thus clear that there is a need to ensure that risk management is tightened and that the deficiencies in the banks' balance sheets are corrected. The Basel Committee therefore requires that the banks assume that many financial instruments – including the derivatives I just mentioned – are much riskier than the banks previously assumed. So under the new regulations the banks must leave a good margin for substantial losses possibly arising when they buy and sell risky instruments.

Moreover, the Basel Committee is introducing a new risk measure – a leverage ratio. Behind this term lies a fairly simple measure of risk that is not based on any advanced risk calculation models. The bank's capital is examined in relation to all of its assets, even off-balance sheet items. And to meet the requirements, the capital must not fall below a certain ratio. One does not take into account historical risk relationships and other aspects usually used in the banks' risk calculations. The leverage ratio thus limits risk taking regardless of whether the banks' models show that their risk is low. Alternatively, the banks are forced to allocate much larger capital reserves than they do now. Otherwise, the leverage ratio will hamper growth in their lending. In this way, gross solvency functions as an additional protective layer against the type of incorrect assumptions in the banks' models and measurements that were revealed during the crisis.

Because the leverage ratio is a relatively uncomplicated measure, it is also more difficult to manipulate or misunderstand. This reduces the probability of the banks' boards of directors, financial supervisory authorities, shareholders and others being deceived or else misinterpreting information. In connection with this, I can mention that the Basel Committee recently agreed on a number of principles that aim to clarify the role and responsibilities of the board of directors and to reinforce the independence and competence of the risk management function.

Security and costs – a balancing act

A valid question here is how all this will affect the banks and the Swedish economy. Various representatives of the bank sector have complained about the new liquidity regulations, for instance. They claim these involve too much cost. But these are the rules of the game. The fact is that we at the Riksbank have spent considerable time estimating the effects of the regulations to be introduced. Next week we will publish some our estimates of the effects in our Financial Stability Report. And our calculations show – even if they, like all estimates are somewhat uncertain – that the negative effects will be fairly limited. Above all, the costs for the banks are expected to be slightly higher. It is expensive to create new systems and establish new routines to manage risks and money flows. Holding more capital means that one ties up money that could otherwise have been lent out and generated interest income. And the same applies to holding more liquid assets; there is a cost in the form of lower interest income than one would have had if the funds were instead lent out.

The banks will probably pass on a small part of these costs to their customers in the form of slightly higher lending rates. But here we are talking about

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changes of some few tenths of a percentage point for the average customer – perhaps slightly more for households and less for companies. One can probably also expect a dampening effect on the banks' profits, and it is fairly natural that the required rate of return for bank shares will decline as the banks become more secure. The banks may also experience increased costs for long-term funding. But this should be compensated to some extent by the banks becoming more secure and thus a fall in risk premiums on loans to banks. Although our calculations show that the costs of the new regulations are limited, it is unavoidably the case that stricter regulation entails various forms of cost. It is in the nature of the regulation.

The important thing is that these costs are seen in relation to the gains in the form of a more stable bank system. And there is no doubt that the gains are substantial, after what the world has gone through since the financial crisis began. Here I refer to the severe economic downturn I mentioned at the start.

But it is nevertheless important not to tighten the screws too much. This would mean that the banks only wanted to lend money to the most secure customers and investments. A lot of good investments would be missed. A lot of people would be unable to buy homes. Long-term economic growth would be slowed down and our total welfare would decline. We must quite simply ensure we do not put a spanner in the works so the banks reduce their lending too much. When I first worked at the Riksbank, in the 1970s and 1980s, the credit market was severely regulated and this is not a situation we should wish to return to.

Nor should we ignore the fact that banks have an ability to circumvent regulations and make use of loopholes in the law. And the tougher the regulations, the greater the reason for the banks to try to circumvent them. If they succeed, no one has won. Instead, there is a risk we will be lulled into a deceptive security, despite the risks merely being moved or hidden in other forms. I might also add that regardless of which regulations are introduced, one still needs effective oversight and supervision of the financial system as a whole and of individual institutions.

If we take all of these aspects into account, I believe the Basel Committee's proposals are a successful balancing act. They entail a substantial upgrading of the bank system in terms of resilience. And the costs to the banks and society are small.

Long phase-in period

The Swedish banks are well-capitalised and the costs of the new capital requirements are therefore small or non-existent. But we must remember that the situation is more difficult for many banks around the world. If we force the banks to observe the new teachings immediately, their ability to offer loans to companies and households may be impaired. This could jeopardise the economic recovery. Because although the world economy appears to be slowly recovering, the situation is still fragile. To avoid this, the Basel Committee has agreed on a long phase-in period. Some of the new regulations will begin to apply in 2013. Most of them will be phased in gradually. It will take a further ten years or so before all of the regulations apply in full.

Although one must give the banks time to adjust, and allow the legislation process to run its course, one may nevertheless consider the phase-in period to be longer than necessary. A lot can happen in ten years or more. Over the past

ten years, for instance, the financial market and the world economy have been subjected to a number of shocks: the bursting of the dotcom bubble, the subprime crisis and not least the debt crisis currently being experienced by some countries. There is nothing to say that we will not experience similar – and just as earth-shaking – events in the coming ten years. Postponing the implementation of the new regulations may be doing ourselves – and others – a disservice. But at the same time, I should mention that a number of countries have signalled that they will set tougher requirements than the minimum stated. Some countries are also talking about introducing the regulations sooner.

One step in the right direction – more are needed!

Now that the requirements regarding capital and liquidity are increasing, the allocation of risk between the bank's owners and society as a whole is changed. The banks should themselves bear the consequences of high risk taking to a greater degree. One might therefore expect that the banks will actually take smaller risks in future. This, together with the strengthening of the banks' resilience, reduces the risk of the banks experiencing problems. But it does not make them immune to trouble.

Because although the capital buffers are much larger in the new system, they can be wiped out in an instant if the losses are big enough. Despite the liquidity requirement, banks may suffer a confidence crisis resulting in overwhelming bank runs and other funding difficulties. And risk management can never be entirely watertight. In short, we cannot rest on our laurels. Because even if we strengthen the banks, there is always a risk of banks failing. And the fact is that we currently lack the tools to deal with this properly.

We therefore support continuing reform work by the Basel Committee in this field. For instance, they are trying to ensure that financial supervisory authorities have the right tools to be able to manage what are known as systemically important banks. These are banks that are so important that the functioning of the entire financial system would be threatened if they failed. This could be due to their size, for instance. Or because they are involved in a large number of transactions with other banks or financial market participants. It is almost impossible to predict the effects on the financial system, and thus the costs to society, if such a bank were to fail. For this simple reason, we dare not take the chance. And both the systemically important banks and their customers realise this. They rely on the state to inject capital or provide some other form of assistance if they should get into trouble. In this way, the systemically important banks benefit from the implied state guarantees. For instance, through attracting more customers or being able to pay lower interest rates to their financiers. However, when the survival of smaller banks is threatened, they are left to their fate. The Basel Committee is now discussing the possibility of systemically important banks having an additional increase to the capital requirement I mentioned earlier. This additional requirement would further increase these institutions' resilience, as problems in these banks to a greater degree affect other parts of the financial system. Switzerland has decided to introduce such requirements anyhow.

But here in Sweden, too, we need to continue the work on strengthening the financial system. We must, for instance, ensure that we have an effective regulatory framework for winding up banks in distress so that their operations

can continue at the same time as the shareholders have to bear the costs. And this does not only apply to large, systemically important banks. In the wake of the HQ crisis, both Finansinspektionen (the Swedish Financial Supervisory Authority) and the Swedish National Debt Office have expressed concern regarding the difficulties in dealing with banks in distress. The Riksbank shares this view. Fortunately, the EU is carrying out extensive work on providing the conditions and tools to facilitate dealing with banks on the verge of bankruptcy.

As I mentioned earlier, it is good that the Basel regulations will make greater demands regarding the banks' liquidity. But they do not say anything about preparedness regarding liquidity in foreign currencies. This is particularly important to us in Sweden. Around 50 per cent of the banks' funding is through the markets, and a large part, around two thirds, through the international markets. This requires that we at the Riksbank can provide the banks with liquidity in foreign currency when funding runs short. We must therefore hold liquid funds in our foreign currency reserves, and this costs money. The Riksbank is thus supplying an insurance – an insurance that the banks know they can use but don't pay a premium for. This type of problem is not dealt with in the Basel regulations, or anywhere else for that matter, but it is something we need to discuss here in Sweden.

So although I hope I have made it clear that neither Finansinspektionen nor we at the Riksbank – nor our international counterparts – have been idle, there is still a lot of work that remains to be done to make the bank system less vulnerable and more resilient. Both globally and here in Sweden. And at the same time we must continue our daily work on maintaining financial stability. We at the Riksbank are constantly trying to refine our analysis so we can detect at an early stage any risks that could threaten the stability of the system. And we must be clear in communicating the risks we see. We also carry out stress tests on the banks to measure their resilience to negative events that would cause large losses. These tests are a very important part of our work, and we are also working on developing them further. When we publish the second Financial Stability Report of the year next week, you will see examples of this.