SPEECH

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After the crisis

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 we face.

The fact that the financial markets have been functioning better for a while now gives no excuse for refraining from reforms. We must remember that the recovery has, to a large extent, been the result of massive government rescue operations using huge amounts of tax 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.

In my opinion, the work of reform 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 I see it, the crisis can largely be explained by a lack of three things: There 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 the future, more of these scarce resources will be required. How we can achieve this is the theme of today's speech.

I shall begin with capital.

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, the capital's function is to work as a buffer against losses. To feel secure when investing their money in a bank, depositors and other creditors 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 hold 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. 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? No, there has not been enough capital in this respect either. In many cases, governments have been forced to use tax money 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 conclude 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[1] 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

[1] 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.

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

I would say that the work of creating better capital is one of the most significant and eagerly awaited areas of reform. 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. By this, I mean common equity and retained earnings. Instead, the capital base has been filled with other types of instrument, existing somewhere in the borderland between debt and equity. 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 current proposal to require banks to hold a larger proportion of common equity is very welcome. An equally welcome proposal is the 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 will also be considered by the Basel Committee – is contingent capital. The special feature of this capital is that, under normal circumstances, it has the same characteristics as 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 parts. I will not bore you with a review of each and every one of these today. Let me just say that, on the whole, these proposals 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 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. I will return to this point a little later.

Another such proposal deals with the introduction of a supplementary capital requirement – a leverage ratio – alongside the 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 banks' assets. No such limit currently exists. The present requirements are instead related to the riskiness of the bank's assets – the higher the amount of risk, the higher the capital requirements, and vice versa.

Allow me to state here that risk-sensitive capital requirements, as such, are not the problem. On the contrary, I am convinced that their benefits outweigh their costs. 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 recession2.

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 about the level at which this lower limit should be set. This is because, if the lower limit is calibrated incorrectly, the risk is that one of the basic intentions of the present risk-sensitive capital requirements will be lost, namely that of 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. Here, we have a clear connection between capital and liquidity.

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. Also in this respect the crisis has exposed severe shortcomings. 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 I recently mentioned – even drag the healthiest banks down with it. This has to do with the banks' 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

[2] Institutions with a very low amount of capital in relation to their assets, only approximately two per cent, could also be found in the United States during the financial crisis. However, the United States did not apply the Basel II regulations.

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. It is not clear where the limit should be set for the maturity mismatch between the banks' lending and deposits. However, 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 were forced to renew approximately one-third of their liabilities every day.

As a part of the Basel Committee's reform package, there is a proposal to introduce, for the first time, a global standard placing quantitative requirements on banks' liquidity management. A limit will be set on the amount of liquid assets a bank must have in order to meet its short-term liquid requirements in a stress situation. Furthermore, a limit will be set for how short-term a bank's deposits 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 credit growth in the economy, the effects of financial, monetary and exchange rate policies on 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 result of the financial institutions' significant exposures to one another and 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 requirements and certain parts 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

How to prevent and manage these systemic risks is currently the subject of comprehensive international debate. There has been much discussion regarding the need to introduce what is often called a macroprudential framework. (I will leave it to you to determine the correct Norwegian term, although one suggestion could be "Rammeverk for systemrisikoforebygging".)

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 rarely 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 many 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.

I do not intend to spend any time on a discussion of the manner in which the work of analysis ought to be developed. This is a difficult issue, dealing, as it does, with the timely identification of harmful imbalances or bubbles. However, above all, it is not the subject of today's discussion. Instead, I would like to focus 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 whether monetary policy can be used to a greater extent to reduce the build-up of risk in the economy. Let me say, at this point, that I believe 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 correcting 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 dampen the increase of property prices, for example – so powerful as to have serious negative effects on the real economy. Consequently, in such cases, monetary policy is not particularly effective at affecting asset prices, but a decision to implement it anyway 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 housing market, for example. As we know, both Norway and Sweden are currently experiencing a strong expansion of household lending and rising house prices, at the same time as resource utilisation, particularly in Sweden, 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. I am not at all convinced of this point of view. In Sweden and Norway, we have flexible inflation targeting as a guiding principle. As I see it, this has basically served us well, both as regards keeping inflation low and as regards limiting fluctuations in the real economy. However, we cannot also expect monetary policy to always be readily available for use against the development of various asset price bubbles.

…but not the only one, and hardly the best one

The path to an effective macroprudential framework goes 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, that I have already mentioned, 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 I mentioned previously 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

At this early stage, it is difficult to have a detailed view on all these proposals. However, let me share a few overall reflections.

Automatic or discretionary: One issue that must be considered is whether the macroprudential tools should be automatic, or whether it should be left to authorities to take discretionary decisions, 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 must be remembered that the instruments for the tasks referred to here are not to be implemented on individual banks, but in a uniform manner for 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 adjusting the banks' results and capital over the economic cycle. This is because such measures simply 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 reporting. 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 it actually is.

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 aimed at individual companies, are being implemented to influence the financial system as a whole. As was discussed above, this may be a matter of stricter capital requirements. However, it may also be a matter of 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 industry in this way is a task that usually lies closer to the responsibility of the central banks.

Thus, the current situation could be described, somewhat exaggeratedly, as one in which *the central banks have the responsibility*, while *the supervisory authorities hold 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 issue of responsibility is that many of the 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 wait and see where these discussions take us. 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, let me emphasise that the most important aspect is not who undertakes this task, but that it is undertaken 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 I have yet to mention – the international dimension.

The internationalisation of the financial markets that have taken place over recent decades has entailed that many of the systemic risks I have been talking about 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 outside 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 may arise. Let me take a hypothetical example that springs to mind. If Norway, for example, chooses to limit its banks' lending for housing purchases, this must be discussed with

Swedish authorities. Otherwise, of course, branches of Swedish banks could continue their lending activities in Norway as if nothing had happened, with the risk that the measures implemented by the Norwegian authorities would be ineffectual.

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 been 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, I am convinced that 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

As you may have noticed, so far I have only talked about 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 crisis management capacity. 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 both Norway and Sweden.

What is needed – but which is absent in many countries, including Sweden – is a well thought-out and credible system to manage 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 as a whole 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 for the government 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 creditors. 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.

Considering what I have just said, I am sure you realise that one of the most important components in legislation of this kind 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, most likely, 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, in my opinion, 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 creating such confidence is that we start to discuss the management of cross-border crises already in times of peace – because when the crisis comes, it is usually too late.

Concluding remarks

Let me round off.

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 largely dependent upon the banks' attitudes – both towards the current situation and towards events during the crisis. Unfortunately, I sometimes get the feeling that the banks have not fully understood this fact.

My talk today has primarily dealt with the construction of a more stable financial system. As I mentioned in my introduction, there is, of course, another side to this issue which is 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.

Thank you!