SPEECH

DATE:	10/11/2011
SPEAKER:	Govenor Stefan Ingves
PLACE:	Swedish Bankers' Association, Stockholm

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

■ Basel III – regulations for safer banking

I would like to begin by expressing my gratitude for the invitation to speak at this bank meeting on the theme of "Basel III – regulations for safer banking".

In this presentation, I will briefly describe the Basel III regulations and the underlying reasons for them. Following that, I shall discuss the characteristics of the Swedish bank market that are significant for how we in Sweden shall implement Basel III. Before I finish, I would also like to illustrate how the authorities of a few other countries with large banking industries see the need for regulation.

Briefly, however, I intend to start by describing the background of bank regulation – why advanced economies need a financial system, and the risks this entails.

Banks are important to the economy

The banks are of fundamental importance to the national economy. The banks are the single most important participants in the financial system, and their basic functions are often considered to be three. The system converts savers' money into productive investments, ensures that we can pay each other when we exchange goods and services, and allocates risk among those who are willing to take risks and those who are not.

Through these functions, a meeting place is formed by the financial system (and particularly the banks) for the economic activities of households and companies. Perhaps it could be likened to a motorway junction for the economy. In the financial sector, the income and expenditure of households and companies meet like traffic flowing from all directions. A robust construction is needed to make this interaction proceed smoothly. When a lot of traffic is moving at high speed, the construction must also have a clear focus on safety. The higher the speed limit, the greater the safety margins must be.

SVERIGES RIKSBANK

Financial crises have major macroeconomic costs

Just like driving on a motorway, the financial system entails risks. On the roads, these risks do not just affect the driver's own vehicle, but the entire flow of traffic. In the same way, the economic costs of a financial crisis are significant. Nobody could have missed this in recent years.

We know that financial crises have permanent effects on growth. It is often not possible to recover from the major fall in GDP that is the consequence of a deep financial crisis in the period following such a crisis. Normally, we see a downwards shift in GDP level trend even if good times *may* then mean a return to the same *rate* of growth.

The economic costs are significant. Of course, any estimate would vary depending on the crisis and assumptions, but a mainstream assessment would be just over 60 per cent of pre-crisis GDP. So transposed to Swedish conditions, around SEK 2 000 billion is at stake. This happens to be in the same order of magnitude as the balance sheet total of three of the four major Swedish banking groups.

And, of course, this kind of shock to the national economy would not spare the country's citizens in their role as taxpayers. Financial crises impact severely on the public treasury. A recently-presented British investigation – the so-called Vickers report – shows how the financial crisis, since 2007, has increased the United Kingdom's public net debt by about 100 per cent of GDP.

Basel III is strengthening the system's airbags...

The crisis of recent years has made us painfully aware of the financial system's vulnerability and its importance for the real economy. The need for bigger and better airbags is obvious. These lessons lie behind the global Basel III agreement.

The most important areas of Basel III deal with the quantitative requirements for capital and liquidity being placed on the banks.

...with a substantial amount of equity...

The Basel Committee's analysis has concluded that the banks need substantial resilience. The crisis has shown the risk of considerable losses.

So capital requirements are being increased in Basel III, above all for *Common Equity Tier 1*.[1] The minimum requirement for the banks' equity is being set at 4.5 per cent of risk-weighted assets – more than double the requirement under Basel II. A capital conservation buffer of 2.5 per cent, added to a contra cyclical buffer, will create a stronger shock absorber than previously was the case. This contracyclical buffer is built up when times are good to then provide a safety margin during downturns. The capital adequacy requirement is also complemented with a pure leverage ratio measure, meaning that equity may not fall below 3 per cent of total assets.

Under earlier frameworks, other capital, of lower quality, could have accounted for a large part of capital adequacy. This applies to both *Additional Tier 1*, i.e.

[1] In principle, Basel III defines Common Equity Tier 1 as share capital and previous profits.

other instruments that cover losses while the bank is active (*going concern*), and *Tier 2*, which is to say financing instruments that can cover losses if the bank should fail (*gone concern*) – for example, unsecured debts with long maturities that cannot be redeemed. The crisis has shown that, above all, it is Common Equity Tier 1 that can be counted on when the tide turns for the worse.

All in all, the banks' capital position will be strengthened considerably compared with previous regulations, contributing to the boosting of confidence in the individual banks and in the system as a whole.

...clear measures for liquidity...

In the autumn of 2008, we saw how a lack of confidence in the financial markets rapidly led to liquidity problems. So one priority for increasing financial stability has been to ensure the banks are able to manage liquidity problems in the short and long terms. The Basel Committee is thus introducing quantitative liquidity requirements for banks for the first time. Basel III works with two liquidity measures – one short-term and one long-term. The short-term measure is based on, in principle, every bank having sufficient liquid assets to survive for at least 30 days. It is difficult to see such a requirement as unreasonable. The long-term measure, in principle, limits the gap between the maturity of a bank's assets and the maturity of its debts. This limits the duration risk of the bank.

...and particularly the regulation of systemically-important banks

A particular focus has been placed on systemic risks and the most systemically-important institutions. To a great extent, this is a work in progress. So far, the Basel Committee has identified almost 30 global systemically-important banks (G-SIBs). The list was published last week and includes one of the major Swedish banks, as you may have noticed.

The Committee feels that it is particularly important that these banks have extra strong resilience. Those identified as G-SIBs should thus have an additional capital buffer, the size of which depends on how systemically important each bank is deemed to be on a global level. A framework should be put in place for how the authorities in different countries should handle them if they find themselves teetering on the brink. In addition, the supervision of these banks should be particularly intensive.

Work to identify which banks are systemically important on the regional and national levels will also start soon. This work is, of course, particularly interesting for us in Sweden.

Conditions in Sweden should be considered in the implementation of Basel III

The regulations I have just sketched will eventually enter the national legislation. They are to be fully implemented by 2019, with several milestones on the way.

The Basel Committee has been clear that the regulations and the implementation of them form a minimum standard. Financial systems differ from country to country and so there may be reason for certain countries to place higher demands than have been placed globally.

The Swedish banking system is distinguished by a number of characteristics that make it somewhat special from an international perspective – characteristics that either increase the risk of problems or the socioeconomic costs if problems should arise in the banking sector. Some of these characteristics are that the banking system is concentrated, large and international, with significant implicit state guarantees, a heavy dependence on market funding, particularly in foreign currency, and low risk weightings.

The Swedish banking system is concentrated

The Swedish banking system is highly concentrated. The four major banks stand for about three-quarters of both lending and deposits. The major Swedish banks have large exposures to one another, primarily through interbank loans and holdings of covered bonds.

Risks arising in a single bank's operations can thereby easily be spread to the other major banks. During the crisis, we also saw how uncertainty over future loan losses in individual banks spilled over to the others. In the eyes of a foreign investor, the Swedish banks were all travelling on the motorway in the same vehicle.

Swedish banks are large and internationally dependent

The Swedish banks are also large in relation to the Swedish economy. The assets in the total banking sector are equivalent to about 425 per cent of Sweden's GDP. One reason for this is that they have comprehensive international operations. At the same time, there are few effective international agreements on how to manage cross-border banking groups in a crisis situation. Consequently, the failure of a major Swedish bank would risk being difficult to manage. This also means that the cost for Sweden's taxpayers would risk being significant.

The market assumes that major Swedish banks have implicit state guarantees

The market also assumes that the major banks have an implicit guarantee from the state, as they are considered to be too big for the state to allow them to fail. This means that these banks can obtain cheaper funding than would otherwise have been the case. The implied state guarantees were clearly illustrated by our neighbour, Denmark, when Amagerbanken collapsed and the Danish authorities forced senior lenders to contribute. The result of this was that the credit rating agency Moody's lowered the credit ratings of several Danish banks and loan loss insurance became more expensive. Moody's justified this change by claiming that the implicit state guarantee had decreased.

SVERIGES RIKSBANK

Major Swedish banks have a large share of market funding in foreign currency

In addition, the major Swedish banks receive a large share of their funding – about half – from the financial markets. In addition, almost half of this market funding is in foreign currency. The integration of financial markets is basically a good thing. Much of foreign currency borrowing is necessary to meet lending needs. And market funding can be good for spreading financing risks. But at the same time, the risk of imported shocks increases. Borrowing in foreign currency for lending in Swedish kronor also increases dependence on the efficiency of the swap market. The liquidity risks taken by the major Swedish banks are also still larger than the European average. Unexpected negative events or disruptions on the international financial markets can thus cause considerable problems for the major banks and ultimately for the Swedish economy.

Swedish banks have low risk weightings

The low risk weightings in Sweden are particularly important for the Basel regulations on capital adequacy. At present, of course, the banks can calculate risk weights using internal risk-classification models based on historical data on loan losses. From an international perspective, these internal models generate very low risk weights for Swedish mortgages. The question is how well the last 20–30 years of history reflect the risks we may face in the future.

History warns us of low resilience in the financial sector

Even before the last crisis, we in Sweden had already seen warnings of insufficient capital levels. The credit deregulation of the mid-1980s coincided with the highest leverage ratios in Swedish banking history. As some of us remember, lending increased almost explosively during the second half of the 1980s. The low solvency of the 1980s created strong financial leverage that facilitated the excessively rapid growth of credit.

As most of us remember, this ended in disaster. The low level of solvency also made the banks far too vulnerable when growth slowed down. The crash at the start of the 1990s led to a banking crisis with three years of negative growth and steeply rising unemployment and public debt. As we all know, leverage can work both ways.

Resilience is needed in uncertain times

Only a few years ago, we came close to seeing history repeat itself. In late 2008 and early 2009, Sweden stood on the brink of a new banking crisis. The low level of confidence on the financial market and great uncertainty over developments in the Baltic countries made it difficult or impossible for Swedish banks to obtain funding on the market. The measures adopted by the Riksbank, the Ministry of Finance, Finansinspektionen and the Swedish National Debt Office were decisive for saving the situation.

The Swedish banks have had comparatively minor loan losses and provisions since 2008. But there is nothing to say that the banking sector will not be affected more severely next time. Allow me to use a rough estimate to give you

an idea of how a crisis can impact the banks' equity. In 2007–2010, 35 of the largest banks in the EU had loan losses and provisions of about SEK 350 billion. Today, these same banks have Common Equity Tier 1 of about SEK 780 billion. So if we incur similarly large loan losses in the next few years, about 45 per cent of the banks' Common Equity Tier 1 would disappear.

The important point here may not be the exact amount of the total loan losses – the estimate has been, and still is, uncertain. The important point is that, in such a situation, confidence will be a hard currency. Uncertainty over the banks' resilience affects confidence. When confidence is undermined, the banks' funding disappears. For the Swedish banks, this could be particularly devastating.

Other countries with large banks have more stringent regulations than Basel III

Earlier experiences, not least from the latest financial crisis, have also been studied by other major banking countries. Authorities in these countries wish to proceed faster and set higher requirements than the minimum standards of Basel III. These include the two European countries whose banking sectors have greater assets in relation to GDP than the Swedish banking sector – Switzerland and the United Kingdom.

In Switzerland, an expert committee has proposed progressive capital adequacy requirements. The larger and more important to the economy a bank is, the higher these requirements will be. The two major banks – UBS and Credit Suisse – have a capital adequacy requirement of 19 per cent, at least 10 per cent of which is to be Common Equity Tier 1. The remaining 9 per cent can be supplied by what are known as contingent convertibles (CoCos) – which is to say debt instruments that can be converted to equity under certain circumstances.

In the United Kingdom, the Vickers commission proposes a structural separation of retail and investment banking. Major retail banks will have an extra capital buffer of 3 per cent. The proposal also includes forcing certain debt instruments with long maturities to cover losses when a bank encounters problems – by introducing what are known as bail-in bonds. In total, equity and bail-in bonds in major banks are to amount to 17–20 per cent.

It is time to take the discussion one step further

Considering the characteristics of the Swedish bank market, historical experiences and international developments, we at the Riksbank feel that there are several areas that still require attention. The Swedish system needs extra-large airbags.

We consider that capital requirements for major Swedish banks need to go beyond the requirements of Basel III. The costs of higher capital adequacy requirements are limited and largely private, as opposed to the true economic costs. The advantages in the form of a safer banking system are considerable. A reduced risk of financial crises is good for the real economy, good for taxpayers and also good for the banks' shareholders. The Riksbank will soon present a report that clearly shows that the benefits of higher capital adequacy

requirements exceed the costs. An increased capital adequacy requirement may also need to be matched by a tighter leverage ratio requirement.

The European Systemic Risk Board (ESRB) has recently submitted recommendations covering lending in foreign currency. We could see the risks of this type of lending to households at close quarters in the Baltic countries a few years ago. A few of the ESRB's recommendations are (i) better consumer information and credit reviews of borrowers, (ii) taking exchange rate risk into consideration in the national capital adequacy requirements, and (iii) supervision of the risks in liquidity management. Swedish banks need to limit these risks better in the future.

The Swedish banks' liquidity measures need to take into account that it can be difficult to obtain certain currencies in stressed situations. Basel III's short-term liquidity requirements also need to be met on a per-currency basis. Furthermore, we are examining whether the Riksbank's reserve requirement can play a part in this regard.

The low Swedish risk weights are a cause for concern. Historical data does not always predict the future and so we should not place too much confidence in models. A floor may be necessary to prevent the combination of low risk weights and high leverage from becoming unreasonable.

Most of what I have been saying here has been said by us at the Riksbank for some time. We have encountered both counterarguments and cries of encouragement. We have also been asked if we couldn't be more precise. Consequently, I thought I would wrap up by telling you a little about what will be happening in the immediate future.

The Riksbank will clarify its recommendations soon

When motorway junctions are planned, the traffic planners take many factors into account to ensure that the traffic flows smoothly and safely. Benefit is balanced against cost – and safety is given a high priority.

We at the Riksbank take the same approach when we and other authorities are considering how to implement Basel III in Sweden.

The Riksbank will soon announce its view of the measures that should be adopted. One example is how much higher we think that the capital adequacy requirements for the major banks should be – in addition to the minimum levels in Basel III.

One important step is this year's second Financial Stability Report, to be published on 29 November. In connection with this, we will also publish a report analysing the economically appropriate capital adequacy requirements for the major Swedish banks.

I hope that these reports will be interesting reading and thank you for having me here today.