SPEECH

DATE: 25 November 2003

SPEAKER: Deputy Governor Lars Nyberg

LOCATION: The Riksdag Standing Committee on Finance

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

Current financial stability issues

Allow me to begin by thanking you for your invitation to come here and speak about the Riksbank's work on financial stability. In the same way that the Standing Committee has the opportunity to regularly question the Riksbank Governor about monetary policy, it is natural that the Committee should also be able to learn about the Riksbank's stability efforts.

In the aftermath of the banking crisis, the Riksbank began to develop its expertise and analytical capacity with regard to stability issues. In autumn 1997, the Riksbank published the first report with a more coherent analysis of financial stability. The Riksbank became the first central bank to present its view of stability publicly. Other countries were more hesitant about speaking openly about stability in the financial system. Their opinion was that it would nevertheless be impossible to be open about these issues in the event a crisis should occur. The Riksbank's attitude, however, was that it is better to be open. Discussing risks and vulnerabilities at an early stage would enable crises to be avoided. Moreover, the experiences of transparency in the area of price stability were positive.

Today, some thirty countries have followed suit. Repeated financial crises have made it clear that there will always be problems to take account of and that authorities can therefore be benefited by a structured approach to financial stability.

Banks are the focus of our work on financial stability. This is because banks are the institutions that ensure the functioning of the payment system. Experience shows that if individuals and companies are unable to make ordinary payments, or if the credit function in society is disrupted, this has highly adverse effects on the economy. Insurance companies are also important in society, but they are not system-critical in the same way as banks. I intend to return to the subject of insurance companies later on as they are undeniably in the spotlight at present.

But banks are not only important for stability; their balance sheets also contain a built-in source of instability. Banks' funding is generally short term in nature and can quickly disappear, while their assets have long maturities and cannot be realised as quickly. Should depositors and financiers lose confidence in a bank, it could face an acute liquidity crisis. Moreover, problems in one bank can spread to other banks. This can happen because they have liabilities to one another due to loans or securities trading, or because they participate in the payment system. Contagion effects can also arise if other economic players suspect that there are connections between the banks. Banks can then encounter difficulties, even if the original suspicions were entirely unfounded.

As a result of these factors, banks operate within the bounds of a strict regulatory framework and are subject to public supervision. Finansinspektionen has primary responsibility for prudential supervision of individual banks. The Riksbank oversees the banking system as a whole and attempts to assess the risks that could arise in it in both the short and long term. Of course, there is some overlap in the tasks of both Finansinspektionen and the Riksbank, but it is sometimes fruitful to approach a problem from somewhat different angles. I am also of the opinion that the cooperation between the authorities works well.

If a crisis were to actually occur in spite of regulations and supervision – and this can happen as we know – the Government may need to take action. The Riksbank's task in a crisis is to provide emergency liquidity assistance (ELA) to the banks that have run into liquidity problems. Allow me to underscore, however, that it is far from certain that a bank in difficulty will be given ELA. Since all our experience says that it is easier to provide assistance than not, especially when decisions have to be made under time constraints, there is reason to carefully consider such a measure – and to be well prepared. It would be serious if the banks were to feel certain that they would automatically be given assistance in the event of difficulties. Such thinking could cause them to take unnecessary risks. Were the crisis to spread to other healthier banks than the bank that requested ELA, perhaps the Riksbank should concentrate its liquidity injections to these banks in order to rescue the system rather than the bank itself.

If the problems in a bank are of a more serious nature, whereby its solvency - that is the bank's ability to meet its long-term obligations - rather than its liquidity is in question, this is more an issue for the Government than the Riksbank. Even in such cases, there is reason to question whether the bank really is systemically important before taking measures. In practice, every crisis should entail intensive cooperation between Finansinspektionen, the Riksbank and the Ministry of Finance. I am keen to stress how important it is to be well prepared for such cooperation, especially given how quickly crises can develop in today's financial markets.

Stability in the Swedish financial system

The Riksbank presents an analysis of system stability twice a year. This comprises partly a review of developments in banks, mainly the four major banking groups, and partly an analysis of the financial infrastructure. The analysis of the banks discusses how borrowers' indebtedness and their ability to service this debt has changed and how the banks themselves have acted. The analysis of the financial infrastructure discusses problems and risks in the rather complicated technical systems that are currently used to transfer payments, for example RIX, VPC and BGC.

The Financial Stability Report enables the Riksbank to describe the banks' ability to cope with unexpected disruptions. We can point to conceivable risks and dampen any exaggerated optimism during an upturn, when everything appears problem-free. Similarly, we can modify the picture during a downturn and, with the help of thorough analysis, ease concerns about serious loan losses. We can also call attention to risks and discuss these with the banks. However, the day will never come when the Riksbank indicates in a Financial Stability Report that the risk of a financial crisis occurring is high. In such a case, the crisis would materialise immediately, as pricing in the financial markets is based on expectations of future developments.

Following this background information about the Riksbank's stability efforts, I intend to discuss the most recent assessment of the Swedish financial system that was published in a Financial Stability Report yesterday.

As always, the point of departure is the general picture of economic activity. An improvement in activity usually enhances bank profitability and thereby the resilience of the financial system. I should probably add here that this applies in the short term, as a prolonged economic upturn can lead to over-optimism and price imbalances in asset markets, which subsequently affect the banks in the form of loan losses. At the moment, there is no doubt that the overall economic outlook appears more positive than it did six months ago, both in Sweden and abroad, even if it is somewhat mixed. Prospects for an acceleration in growth are favourable for the United States and a number of emerging markets, but less so in Europe.

The major Swedish banks have now begun to increase profitability for the first time since 2000. This is partly because the equity market has strengthened again, but also because the banks have cut costs while their interest income from lending has continued to increase. Banks have thereby improved their ability to cope with unexpected losses. Loan losses remain low. There has not been any expansion in credit other than in mortgages to households. The Tier 1 capital of the four major banks has risen over the past two years and now averages just over seven per cent, which is satisfactory given current economic conditions. Developments in the coming year are expected to lead to a further increase in profits and capital adequacy ratios.

Neither are the banks' borrowers – of which half actually reside outside Sweden – expected to cause the banks any considerable losses in the period ahead if economic activity strengthens in accordance with the Riksbank's main scenario. The corporate sector, which is the largest borrower group and the group that previously has caused the banks' biggest loan losses, has reduced its debt burden somewhat in relation to equity. Companies should also be able to benefit from an improved economic situation and thereby lower their interest expenditure in relation to income. Property companies have been feeling the effects of a decline in office prices and rents, but their debt is moderate and their earnings continue to be well above interest expenditure. We are far from the situation that existed at the end of the 1980s.

However, households' debt burden has increased throughout the slowdown. The main reasons have been higher disposable income and low interest rates, which has led to high house prices. Debt in relation to income is now approaching the levels seen before the crisis at the beginning of the 1990s. The difference, however, is that interest expenditure makes up a considerably lower percentage of income than it did then. This makes the high debt levels possible to endure.

There is reason for vigilance regarding growth in household debt, even if households have never caused the banks' losses that have posed a threat to financial stability. But it is also possible that the increase in indebtedness is partly an adaptation to a low-inflation economy. The pattern of rising household borrowing is evident in many industrialised countries that have got the better of inflation in the past decade. When there is less uncertainty about future inflation and thereby interest rate levels, lenders are more willing to grant credit and also demand a lower risk premium for this credit. Loans become cheaper. This makes borrowers more inclined to borrow, also because they are less uncertain about their future costs. Thus, they can accumulate more debt.

However, households' willingness to borrow tends to boost demand for housing and thereby raise house prices. This has been observed both in Sweden and other countries. House prices in Sweden have risen 56 per cent since 1997 at current prices. Also, unlike commercial property prices, they have not declined during the economic slowdown of recent years. In addition to low financing costs, increasing disposable income and the low housing supply have also contributed to the price rises.

Does this give us reason to suspect that a speculative bubble is developing in the housing market? I don't believe so, even if we have glimpsed local tendencies, notably in Stockholm. We don't see any signs of housing being bought as an investment with a view to leasing it out until prices rise further. Such indications are evident in a couple of other European countries. As far as we can see, the price increases in the Swedish housing market appear to be due to fundamental factors and are not being driven by speculative behaviour. Low interest rates, rising income and limited housing construction goes a long way towards explaining current price developments.

Lower confidence in insurance companies

Recently, the media have drawn attention to the strained financial situation of life insurance companies. The crisis in these companies has been placed on a par with the banking crisis at the beginning of the 1990s, and there is concern that it could have equally serious repercussions for society. This is not the case. The actions of the life insurance companies do not jeopardise the financial system's basic functions – to transfer payments, provide credit and manage risk. What could happen is that those who have saved in these companies choose to transfer their savings elsewhere, in the event that they can do this. In any case, fewer people will be signing new life insurance policies. This is bad news for life insurance companies, but has limited significance for financial system stability.

It is unfortunate that the criticism of the life insurance companies, which is justified, also affects their products, especially traditional life insurance. Traditional life insurance is an excellent product for anyone hoping to have a long life. The insurance includes the “risk” of policyholders living a long life, that is, policyholders ensure that they will receive a predetermined income over life, which is enabled by evening out the risk in a large insurance portfolio. It is a unique product and a form of saving that deserves a better fate than that of disappearing because of a confidence crisis. Anyone that doesn’t know exactly when they’re going to pass away, and that means most of us, have reason to reflect over the advantages of life insurance.

In my opinion, the serious consequence of the life insurance companies’ problems is that confidence in the financial system as a whole may have taken a blow. As savers we feel cheated, both by broken promises about returns that have not been forthcoming and by the greed inherent in some perks and bonus programmes. Low confidence in financial market institutions tends to subdue capital formation, which we all lose out on in the long run. Functioning financial markets are a precondition for good growth.

As regards the life insurance companies, I personally believe that the root of the problem is found in their mutual construction, which has long been cherished since it means that all profits are given back to the policyholders. But as the companies have largely been affiliated to non-life insurance companies or banks, it has been natural for them to charge high fees for various services, such as sales and asset management. As profits go to policyholders, this is the only way to yield any gains from the affiliated life insurance companies. This is not a new problem, far from it, but it has come under the spotlight due to recent events, particularly the sale of asset management companies, where values that were previously difficult to establish have become evident.

It is especially annoying that the life insurance companies’ mutual construction and no-dividend rule has made policyholders responsible for the entire risk capital. Affiliated non-life insurance companies or banks have neither been able to nor had reason to contribute equity, in spite of the fact that they have controlled the life insurance companies in practice. For this reason, the board of Finansinspektionen has proposed that it should not be possible for the boards of the mutual life insurance companies to be controlled by affiliated companies. The fact that the mutual corporate structure is being investigated further as planned is, I believe, also necessary, though overdue.

It should be observed that the Insurance Committee called attention to the problems associated with mutual life insurance companies in its 1998 report and proposed that profit-making companies be established to clarify both ownership structure and control. Legislators adopted the Committee’s proposal and a profit-making life insurance company has since been established. In this case, moreover, the owner was forced to inject new risk capital as a result of the equity market decline.

Another confidence issue stems from the fact that many savers since the bursting of the equity market bubble naturally feel they were misled by the advice they received from banks, securities brokers, insurance brokers and life insurance companies. It has happened many times that salespeople at these institutions have been presented as advisers, which has created the credibility we associate with neutrality. Unfortunately, the advisers' competence has been rather superficial in some respects, especially with regard to assessing risk. Although information, particularly from the major banks and life insurance companies, has become appreciably better, much remains to be done so that savers with limited knowledge are not led astray. Whether companies' own efforts are sufficient in this respect is a delicate question. Strict ethical guidelines, drawn up by each company and followed up by Finansinspektionen, could be a start. In countries like the United States, where families have long been forced to plan their saving to finance their children's education and their own pensions, it has become natural to turn to independent investment consultants to discuss how much and in what way they should save.

A new financial landscape?

Allow me to conclude by taking a look ahead to discuss a number of challenges we may encounter regarding financial stability. They are all tied to our increasing international dependence. Financial market integration is beginning to become a reality in several parts of Europe and this has led to increasing interdependence between these countries' banking systems. A problem in one country can spread in various ways to the banking systems of other countries. This places new demands on prudential supervision, oversight and regulations.

In order to create a single market for financial services, the EU is striving to introduce a regulatory framework that will be common to all financial companies within the Union. This will enable banks to compete on equal terms, thus allowing the evolution of a single market with only the most competitive companies.

This is an important initiative. Common regulations are often a precondition for enabling far-reaching integration. The integration we have seen so far has been very positive for growth, even if it is difficult to quantify the exact effects. Studies have indicated that increased financial integration in the EU could boost growth by around half a per cent per year.

The risk, however, is that harmonisation in itself will make regulations more extensive and onerous for the banks than really desired. In their eagerness to safeguard stability, regulators risk overlooking efficiency. If regulations are to be harmonised, there is a risk that the strictest rules in the Union will also be those that prevail, as the reluctance to ease already existing rules is often greater than the reluctance to tighten rules further. The biggest common denominator is a more natural choice than the smallest.

Neither can we have the ambition to regulate away all potential problems – for then we will also regulate away competition and efficiency, just as we did in Sweden up to the mid 1980s. Therefore, it is not unlikely that we will also witness bubbles in the asset markets in the future, as well as banks that have over-expanded or that have encountered difficulties for other reasons. We have to be able to manage such situations without them developing into systemic crises. Our ongoing work on financial stability is one way of dealing with these issues, not least as regards the financial system's sensitivity to bubbles. But we also need legislation that can bolster efforts during a crisis, which is something that is lacking in several countries, including Sweden. However, the Banking Law Committee put forward a proposal in 2000 for such legislation in Sweden. We have to hope that a Government bill will come before the need becomes acute!

Although harmonisation of regulations is desirable and opens up new possibilities, it also leads to problems that need to be dealt with, for example with regard to prudential supervision and crisis management. I intend to leave it at that as regards supervision, but would like to say a few words about crisis management.

Managing a domestic banking crisis can be tricky enough, but managing one across national boundaries is in all probability even more difficult. Let me give you an example. After its most recent restructuring, Nordea is a Swedish bank with subsidiaries in other Nordic countries. It has market shares of approximately 40 per cent in Finland, 25 per cent in Denmark, 20 per cent in Sweden and 15 per cent in Norway. The bank wants to change its subsidiaries into branches. This would make Nordea an entirely Swedish bank with branches that potentially could be systemically important in other countries. According to current EU legislation, prudential supervision and crisis management would in principle be an issue for Swedish authorities. But would the Finnish authorities accept that Sweden takes responsibility for the most important part of the Finnish financial system? And would we in Sweden be willing to resolve a banking crisis in Finland, with all that it would ask of the Swedish taxpayers, if Nordea were to run into difficulties? The answers to these questions are not straightforward. But it is fairly obvious that present EU legislation does not accommodate banks with systemically important branches. An article in the Riksbank's Financial Stability Report discusses this particular problem.

The Nordic central banks have a joint working group for discussing cross-border crises, and we have drawn up a memorandum of understanding for how we are to manage them. The supervisory authorities have a corresponding group for their purposes. Unfortunately, such cooperation is still uncommon at European level.

Thus, to sum up, we require harmonised rules for the financial sector in Europe, but it is important to resist the forces that seek to make them unnecessarily extensive. We also need legislation for crisis management in Sweden, which we have been waiting a long time for. And we need new regulations in the EU for managing cross-border banks. These are the main priorities for now.

Thank you.