Stefan Ingves: Introduction to the Financial Safety Net Conference, 19 May, 2015, Clarion Hotel Sign, Stockholm

Financial crises occur now and then. We can see plenty of examples of this in history.

In Sweden alone, severe banking crises have occurred no less than nine times in the past 250 years.[1] On average, then, the Swedish financial system appears to face serious threats around once every 30 years.

For example, things were on the verge of going very badly in the late 1870s. At that time, the railway network in Sweden had tripled in size in just a few years. Railway bonds were all the rage. But many of those who had issued bonds to eager investors were unable to meet their obligations. It all ended in a heap of suspended payments and a general banking crisis around 1878-79.

There was a similar situation in the early 1920s. The economic boom that began just after the First World War ended with many so-called issuing companies going bankrupt. This caused a serious crisis for the banks in 1921-22.

In Sweden, many of us still remember the 1990s banking crisis. And we remember the loan feast that took place prior to that, when the credit taps opened up at the end of the 1980s after fifty years of strict credit regulation. Then, the property speculation by financial companies and the credit granting by the banks led to the devastating 1990s crisis.

Common to all three cases here was that extensive government intervention was needed to save the day. It was ultimately the tax-payers who had to be relied upon to strengthen confidence in the banks and secure their liquidity.

Similarly, but on a broader scale, tax-payers around the world have had to step in as ultimate guarantors for stability during the worst ravages of the global financial crisis and have had to bear the consequences of the banks' risk-taking.

Financial crises are costly for society. But it is not usually the fiscal costs that are the worst. It is instead the costs in the form of severe declines in production and

[1] See, for instance, Hagberg, Axel, 2007, Bankkrishantering: Aktörer, marknad och stat (managing banking crises: actors, market and state), PhD thesis at Stockholm School of Economics, Stockholm, 2007.

employment that are the most serious ones. This underlines the importance of trying to reduce the likelihood of extensive financial crises.

For this reason, and in particular in view of the recent global financial crisis, there has been extensive international work on reducing the risk of new crises. The efforts to reinforce the regulation and supervision of the financial sector have been made under the umbrella of, for instance, the *Financial Stability Board*, the *Basel Committee on Banking Supervision* and the *EU*. Among the most important regulatory changes to increase the resilience of the financial sector are tougher capital and liquidity requirements for large banks.

However, despite stricter regulations, we still cannot rest on our laurels. Although tougher capital requirements make the banks more secure, these requirements are not nearly tough enough to avoid future banking crises. Remember that the banks still operate with a very high leverage, that is, their capital levels are very low in relation to their total exposures. Such low capital levels would, in any type of company other than a bank, entail such risks that they would not be accepted by its shareholders and creditors. And ironically, this high level of risk-taking can be tolerated by the banks' investors partly as a result of the financial safety net we have built up to safeguard the stability of the financial system, and which has given its name to this conference. This safety net doesn't only protect the banks' depositors, but to some extent also the banks' shareholders and creditors, which affects their incentives to take risks. We usually refer to this as moral hazard.

Moreover, memories of financial crises appear to fade after a while, and history repeats itself, with some variations. Financial cycles tend to follow certain patterns, where the seeds of a financial crisis are sown in good times. Often some particular occurrence contributes to a general sense of optimism. This can be some form of technological advance, such as railways or IT. Or it can be a sudden deregulation. Or it could be something quite different – which sets off an optimistic trend that takes the shape of boosted investments and increasing asset prices. And these tendencies are usually fuelled by increased lending. Gradually, the elements of loan-funded speculation intensify, and the market becomes increasingly overheated. Existing regulations are circumvented with the aid of various financial innovations. Risk-taking increases, at the same time as the existence of risks is increasingly denied. "This time

is different". This state of euphoria and denial then continues until something finally happens to burst the bubble.

When this happens, the downturn is usually the greater for it. Asset prices plummet. The price fall means that loan collateral suddenly loses value. Credit granters begin to refuse new loans and to demand better collateral for loans already granted. Investors begin to introduce investment stops. Borrowers begin to sell off assets. This leads to even greater panic and further sales and price falls, resulting in company bankruptcies and loans losses for the banks. The risk of bank failures increases, and the negative spiral in the economy is reinforced.

So, collective amnesia regarding earlier crises, regulatory shortcomings and moral hazard are thus factors that contribute to financial crises reoccurring at certain intervals.

And when they do occur, there must be ways of dealing with banks in distress that do not worsen the crisis. When a large bank is failing, it cannot be dealt with through usual bankruptcy procedures without great risk of contagion to the rest of the banking system. Effective regimes for dealing with distressed banks are therefore important. It is a good thing that a harmonised resolution framework is now being put in place. An important objective of the new resolution regime is for shareholders and creditors to bear the losses, rather than tax-payers, when a financial institution suffers a crisis. This would, of course, lessen the moral hazard problem I mentioned earlier. The idea of a "bail-in" rather than a "bail-out" should be seen in this light.

However, "bail-in" remains untested on a larger scale. And a lot of work still remains to get the regulatory framework to function in practice. A number of questions still need to be answered.

One important question is *at what stage* one should activate the resolution of a bank in distress. The decision should not be made too late. And which creditors should be "bailed in" and by how much? One does not want the decision on resolution to start a flight of investors from the banking market in general. A lot depends on how well one succeeds in assessing the scope of the problems and the potential effects of various options.

One of the greatest challenges involves dealing with cross-border banks. This places considerable demands on cooperation between authorities in different countries. Measures and messages need to be synchronised. For this to work in a crisis, the cooperation between the authorities needs to begin at the planning stage. Everyone realises this. However, it is not always easy to reach agreement. And it probably doesn't get any easier in an acute crisis situation.

And we must not forget that many other actors on the financial markets are gaining an increasingly important role in the financial system. More and more central counterparties and large insurance companies, for instance, have become what we usually call "systemically important". This indicates that frameworks need to be developed to manage crises in this type of company, too.

A gradual adaptation to a new crisis management regime is ongoing around the world. In Europe, the Bank Recovery and Resolution Directive is being implemented in national legislation. The process is moving at different speeds in different countries. At the same time, new institutions such as the Single Supervision Mechanism, the Single Resolution Board and national resolution authorities have been established or are being built up. The European financial supervisory authorities are working on completing technical standards and guidelines. Resolution colleges for cross-border banks are taking shape.

We don't yet know how the new crisis management framework will work in practice. This applies in particular to crises that are systemic in nature. And, unfortunately, we cannot be sure that it will be 30 years before the next financial crisis occurs. The remaining question marks underline the importance of making high demands that the banks have adequate capital and a good loss-absorbing capacity both as "going" and "gone" concerns.

Possibly, we will have answers to some of the questions here today and tomorrow. The many exciting topics and interesting speakers on the programme would certainly indicate that we will have a stimulating and rewarding conference.

Once again, warmly welcome to Stockholm!