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Resolution – a paradigm shift in terms of how we handle banks in crisis

Nearly ten years ago today, the American investment bank Bear Stearns went into a liquidity crisis under dramatic circumstances and was taken over by JP Morgan following measures by the Federal Reserve. I would describe this as one of the first indications of the financial problems in the banking sector that then took on global proportions. A little over six months later, Lehman Brothers followed suit and the financial crisis was a fact.

The international experience of the financial crisis has shown that in many countries, it cost the taxpayers dearly. In the absence of a functioning crisis management framework, states were forced to provide banks with various forms of financial aid. One of the most evident conclusions to draw from the crisis is that this was unacceptable, and consequently, in the years following the crisis, global principles for the management of bank crises were developed. These principles establish a new order for financial crisis management and have been translated into national regulations in many of the major economies of the world. In Sweden too.

In Sweden, the Debt Office is responsible for the new order. Today, I would like to shed some light on how it works and how it has changed the rules of the game and how we handle banks in crisis. It would not be an exaggeration to call it a paradigm shift. I will also touch upon what the Debt Office has done so far, and highlight a few of the conditions for our continued work.

We need both resilience and effective crisis management

Financial crises have been a recurring feature of economic history. They have come in different forms: from tulip and railway mania to inflated share prices and excessive debt. Regardless of the shape of the crisis, similar patterns have recurred with, for example, excessive debt, high risk taking and poorly functioning incentive structures. However, all the crises we have seen in modern times have revolved around banks in their role as financial intermediators. They are of central importance for the function of a national economy, which has meant that when the banks are in trouble, society as a whole is in trouble.

The fact that banks have been at the centre of these financial crises shows the inherent vulnerabilities of the financial system. Banks, for example, are vulnerable because they are funded by short-term borrowing while granting long-term loans to others. This creates an imbalance between what we refer to as illiquid and long-term assets and short-term liabilities. Not to mention that the banks are closely interlinked. Problems in one bank can therefore easily spread to others, resulting in confidence in the banking system being called into question. These characteristics mean that banks are fundamentally unstable. At the same time, the transformation of savings into investments is one of the main functions of the financial system. Financial stability is thus a precondition for the development of the real economy. This is also the reason why banks, unlike other businesses, are subject to a thorough and extensive regulation. Banks must be resilient to the risks that are intrinsically linked to their activities.

In order to protect the financial stability and the real economy, governments and institutions around the world have repeatedly chosen to support collapsing banks using public funds. At times, these *bail-outs* have been so extensive that they have caused budgetary ripple effects to entire states. Ireland is one such example from the latest financial crisis.

However, these problems not only undermine the national budget. As a rule, a severe financial crisis is also linked to other types of economic problems, such as credit crunches, increased unemployment and drastic declines in GDP. As you know, these are consequences that we ourselves suffered during Sweden's crisis in the 1990s.

History has thus shown that a financial crisis, along with its significant and long-lasting economic costs, is one of the worst things that can strike a nation.

Faced with this dilemma, the historical choice has been to let the taxpayer foot the bill to cover losses and recapitalise the banks. However, in the long term, this is not an effective way to deal with crises because the incentive structure rather encourages than dampens excessive risk taking

It is the responsibility of the Debt Office to manage financial crises

The role of the Debt Office in terms of financial stability is to handle banks and other financial institutions in a crisis. It will of course never be completely painless if a crisis arises. Regardless of what powers the Debt Office may hold, we will never be able to make all the problems of a financial crisis magically disappear. But there are two things that we *can* do. One is to ensure that the state does not need to use taxpayer funds to bail out banks during a crisis. The other is to handle failing banks in a way that effectively minimises the economic damage that the crisis must inevitably entail.

We were put in charge of crisis management in conjunction with the financial crisis of 2008–09. At the same time, we also started our journey towards the new crisis management regime that I mentioned, which has fundamentally changed the way we manage banking crises.

Ultimately, this means we no longer bail out banks using taxpayer funds. Instead, the risks and costs entailed by the banks' activities shall be entirely borne by their shareholders and other investors. But not by the bank being declared bankrupt and closing down, but through a process that allows the bank to stay open and to continue to provide its services that are critical to society. This process is called resolution. To sum up the concept of resolution in a single sentence, it is about *saving the function of the bank, but not its shareholders or other investors.*

This is a welcome change. It is a departure from the old regime, in which the bank's financial stakeholders reaped all the benefits in good times but where the state, and thereby society, as a rule had to bear the full cost when things turned sour. This created a damaging incentive structure which essentially meant that the most fundamental rule of the market economy was set aside in the banking sector – however paradoxical that might sound.

The new regime is more demanding than what it was when problems were solved by simply throwing money at the banks. The new crisis management framework therefore requires a much greater degree of preparation and planning. As the resolution authority, the Debt Office is to ensure that the banks are kept "resolvable", as we say. I am here today to explain what this means.

The Debt Office sets out requirements for the banks to withstand a crisis

In December, we reached an important milestone of phasing in the new framework. This is when the Debt Office became one of the first government agencies in the world to establish resolution plans for all of the 162 banks and other institutions under its responsibility.[1] This means that there are now tangible and customised plans for managing each respective institution in the event of failure.

Resolution shall only be used when necessary. Institutions that are not considered to be systematically important are subject to the normal rules – meaning they go bankrupt in case of failure. The Debt Office plans for 10 of the 162 institutions to be managed through resolution in a crisis. In addition to the four major banks, this applies to Landshypotek, Länsförsäkringar, SBAB, Skandiabanken, Sparbanken Skåne and Swedish Export Credit Corporation. Our assessment is that the other 152 institutions can be declared bankrupt or enter into liquidation without threatening financial stability.

An important part of the planning is the requirements we set for the institutions to have sufficient resources for reconstruction and continued operation (under new ownership). In our business, this requirement is referred to as MREL and it means, simply put, that in addition to the capital requirement set by Finansinspektionen, the banks must have a certain amount of debt that can be written down or converted into equity. The requirement has been calibrated to allow us to recreate roughly the same amount of capital as the bank was required to have in its healthy state. We thereby double the bank's capacity to secure its own viability.

This requirement is our primary instrument to ensure that the taxpayer will not have to cover the cost of bailing out the banks and other institutions that cannot be allowed to go bankrupt due to their systematic importance.

In order to protect financial stability, and thus economic stability, Swedish authorities have gradually set up a number of bulwarks after the financial crisis. This has resulted in the major Swedish banks currently having higher capital- and liquidity requirements and a stricter MREL than other European banks. In addition, this has contributed to the major

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[1] In this speech the terms banks and institutions are used as a collective name for firms covered by the regulation.

Swedish banks being more profitable than other comparable European banks. It can therefore be said that the probability of the major Swedish banks going bankrupt has been reduced more than it has for other European banks since the global financial crisis.

New requirements have already proven effective...

Even if these decisions are brand new, we can already see several positive effects of the new regime. We have several indications from the financial markets that the resolution regulations and the Debt Office's implementation of them are viewed as credible.

One concrete indication is that the credit rating agency Standard and Poor's no longer considers it likely that the Swedish state will use tax funds to bail out the banks in the event of a crisis. This is a major change, and an important step in lowering the expectation that the state will always step in. It contributes to reducing what has come to be called the implicit government guarantee, which, as I said before, has been so damaging to the function and long-term stability of the financial system.

Studies carried out by the European Banking Authority, Bank of England and by us here at the Debt Office also indicate that the introduction of MREL have a positive effect on financial stability and the development of the real economy.[2] Partly because the requirement reduces the risk of a bank reaching a crisis, and partly because it reduces the effect on GDP, employment and public finances if a crisis arises.

... but there is more work to be done

All of this does not mean that we can now sit back and consider the job done. There is much left to do. Resolvability is not a black-and-white concept. In the resolution plans, we have set the course for the most important aspects of handling each bank in the event of a crisis. We now shift our focus towards further developing and refining the methods and frameworks that we will be using to make the resolution plans operational. Granted, we already have a model that we are convinced will work, but it is far from finished.

What we need to do now is to create and improve on the procedures required to execute resolution. This applies, for example, to the valuation of a bank, how bail in will be accomplished in a Swedish context, or how to set up a bridge bank pending new ownership. But it is also a matter of how to ensure the day-to-day funding of a bank in resolution.

It is not enough for us, as the responsible authority, to be prepared. The banks must also adapt. Not least in terms of changing their funding to meet the MREL I described earlier. At its core, this is a question of issuing a significant amount of the kind of debt that is best suited for write-down, in other words the issuing of subordinated debt. The Debt Office is continuously monitoring this development, and our assessment is that the banks are preparing well so far.

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[2] See e.g. Bank of England (2015), *The Bank of England's approach to setting MREL, Consultation on a proposed Statement of Policy* and Bank of International Settlements (2015), *Assessing the economic costs and benefits of TLAC implementation*.

But the banks will also need to make significant internal efforts to ensure that their processes and systems can be kept running in the event of a crisis. To give you an example: one of the first problems facing the authorities in the United Kingdom as they stepped into the Lehman Brothers' London office was that the electricity company had shut off the power. This type of operational aspect, that may seem trivial, must also be considered. But there may also be more complex issues, such as ensuring that financial agreements cannot be prematurely redeemed and that the legal structure of the bank is not too complicated.

The resolution regulations also have some teething problems that need to be remedied. There is currently a review underway of the EU Directive on which the resolution regulations are based. This review will resolve many of the initial problems.

One example are the new rules regarding ranking of debt in insolvency, which have already been adopted at EU level, and which enable the banks to issue debt with a higher priority than capital but lower than most other types of debt. It is essential for this change to be quickly introduced to Swedish law, and I am happy to say that the government has consulted on a bill to see that this happens. It will benefit the banks, but above all it will increase the Debt Office's possibilities to fulfil its assignment in terms of crisis management.

All in all, these measures and initiatives, once completed, will contribute to making the Swedish banks resolvable. In other words, they will allow us to handle a possible crisis in one or more of these banks in a way that both safeguards financial stability and the taxpayers' money.

Effective crisis management requires cooperation

But this on its own is not enough. I cannot stress the significance of cooperation enough! A functioning cooperation between the authorities involved – the Debt Office, Finansinspektionen and the Riksbank – both in crisis and during the preparations is of the utmost importance. One example of this is the central bank's possibility to provide banks in resolution with liquidity support. Access to liquidity in resolution is central. Temporary liquidity support from the resolution reserve or central banks may therefore be decisive for an orderly and successful resolution process. But in order to create the conditions for effective crisis management, we also need to cooperate with the banks. They are the ones who must ensure that their activities can be managed throughout resolution, in other words, that they are resolvable.

Not to mention that the major banks are active in several different countries. This means that the Debt Office must have a functioning cooperation with our colleagues abroad as well. For this purpose, we meet regularly in different constellations, for example under the European Banking Authority, but also in the institution-specific so called resolution colleges established to discuss and make decisions regarding the resolution plans of the major banks.

In my opinion, we are well on our way in this regard, and here it is a matter of continuing down the same path.

Risks are not eliminated through the bank moving its head office

Allow me to also point out the dynamics of our assignment. Resolution planning is work that will never be finished. And this is of course mostly due to the fact that the financial landscape is in constant change. One such change, and one that is of great significance, is Nordea's decision to move its head office to Finland.

I have said it before in various contexts, but it bears repeating: Moving Nordea's head office is not synonymous with eliminating or even reducing the risks to Sweden. Quite on the contrary, there are significant risks involved as Nordea will remain one of the major players on the Swedish bank market. Nor will it influence the state's risk: regardless of where the bank's head office is located, its losses shall be covered by shareholders and lenders. The difference is rather that Swedish authorities will lose much of their influence over monitoring and crisis management in Nordea, and thus the possibility of adapting measures to Swedish conditions specifically. This applies to preventive measures as well as more acute phases.

For this reason, it is important that we work together to ensure that the authorities now taking over the responsibility – ECB as the supervisory authority and the Single Resolution Board as the resolution authority – maintain the levees that the Swedish authorities have been gradually building. If, on the other hand, we find ourselves in a situation where the requirements for capital, liquidity and subordinated debt are lowered, thus dismantling the bulwarks, this could lead to reduced resilience and resolvability in the Swedish banking system. If this happens, Sweden will be the biggest loser.

Resolution – a paradigm shift

Financial crisis are costly to the national economy. They always will be, in the sense that GDP, investments and employment will always be negatively impacted by instability in the financial markets. This in turn has *indirect* consequences on public finances.

However, this new way of handling banks in crisis, i.e. using resolution to ensure that stakeholders and lenders incur all the *direct* costs of supporting the failing bank allows us to ensure that the total cost to society is lower. We reduce the detrimental effects in the event of a crisis.

By forcing the bank's lenders to contribute their share to covering losses, we also give them a powerful incentive to ensure that the bank is handling its activities correctly. This puts them in a type of supervisory role. Most likely, this will also reduce the risk of a banking crisis even arising.

This new balance is something of a paradigm shift. As I have already touched upon, this requires a lot more preparation. It requires authorities having the force to make demands and it will require resolute action in the face of a crisis. But our experiences of the crisis ten years ago showed us once and for all that this is a journey worth taking.

Need for a broader analysis and coordination of regulations from now on

As I said in the opening, the financial system has intrinsic vulnerabilities that make it sensitive to disturbances. This creates the need for levees to reinforce its resilience, for example in the form of capital requirements and MREL. In addition, we need an effective regime to manage the banks that do fail.

Regardless of levees and effective crisis management, we cannot presume that economic costs will be eliminated in future crises. In this perspective, it may be questioned whether it is reasonable for management and boards of global systemically important banks to make decisions that are likely to adversely affect the economic development in a whole nation. For example, it would be interesting to look at the possibilities of strengthening the incentives for bank management to take less risk.

The need for regulation does not stop there however. In our current financial system, there are actors of a different dignity than previously, such as central counterparties. Due to their function as a hub for risks relating to derivatives transactions, they now have a decisive role in the global financial system. In addition, there are relatively few of them. This type of institution must also be appropriately phased in to the crisis management regime that has now been established for the banks. Globally , progress has been made in this regard, but unfortunately at the EU level, things are moving slowly.

Furthermore, there are many wondering about the role of the insurance companies. What would happen if a large and globally interconnected insurance company was to fail in the way that we have often seen with banks? What consequences would this have for the financial system as a whole?

And what do financial technology and new methods and habits of payment mean for the banks and the various payment service enterprises that are now emerging? These are questions that also need to be analysed.