



Financial Stability

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What is Riksgälden (SNDO)?



- A government agency in charge of:
 - All aspects of central government debt management
 - Banking services to government agencies – the internal bank of the central government
 - Credit guarantees and loans to entities outside the central government
 - Deposit insurance and investor protection
 - Bank crisis management – resolution of failing banks and (in certain cases) support to solvent banks in difficulties

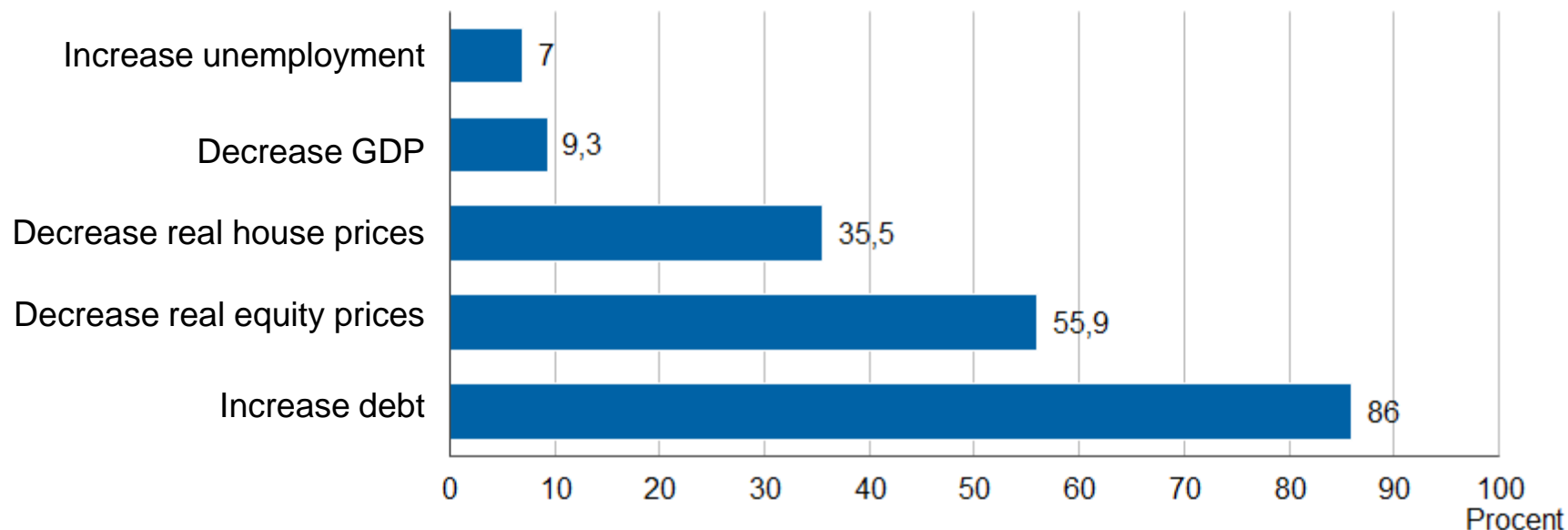
Why financial stability?



Photography: Alex Gunningham

Financial crisis are extremely costly

Effects of a financial crisis



Källa: Reinhart och Rogoff (2009)

Problems when the crisis hit in 2008

- No framework for how to handle big banks when they failed, neither in Sweden or in other countries
- Putting a big bank into ordinary liquidation can create chaos through loss of the services provided to firms and households by that bank and contagion effects on other banks
- Without the threat of liquidation, big banks are seen as guaranteed by the state
- The implicit guarantee created several incentive problems:
 - **Creditors** – and not just depositors covered by an explicit guarantee – felt protected and did not monitor banks as closely as they would other companies
 - **Owners** did not expect to be wiped out (although not in Sweden) as many Governments were not prepared to nationalize banks
 - **Management** was encouraged to take excess risk by the lack of external monitoring and was not sufficiently constrained by boards and owners
- No framework for international coordination of failing cross-border banks

The missing piece



Photography: CNBC

The resolution framework

- What we were looking for
 - Crises cannot be managed on an ad-hoc basis
 - Harmonisation of the rules
 - Cross-border cooperation
 - No more "heads I win, tails you lose"
- Resolution is the answer
 - A harmonised framework has been established
 - Tools which enable us to uphold market discipline
 - Ways and means for cross-border cooperation
- Essentially, this is also what has been put in place by the adoption of the resolution framework – BRRD
- In sum: we have come pretty far...

Resolution – objectives and principles

- Main objectives of the resolution framework:
 - Make it possible to handle a failing bank so that its critical functions are maintained and without creating financial instability or triggering contagion
 - Reduce the state’s risk of having to recapitalize or otherwise support failing banks
 - Reduce moral hazard from expectations that lenders to (big) banks (or even shareholders) will be kept whole – “bailed out”
- Fundamental principles
 - Shareholders and creditors shall bear full responsibility for losses – write down and conversion through “bail-in”
 - Strict rules on when and how public funds can be used
 - “No Creditor Worse Off” – to protect property rights in a framework that gives the state far-reaching powers
 - Proportionality – do not go beyond what is justified to achieve the resolution objectives
- In short: Resolution tries to replicate a bankruptcy in terms of the impact on shareholders and creditors while ensuring that critical services in the failing bank are provided without interruption
- Banks that are not systemically important shall not be put into resolution – liquidation and pay out under the deposit insurance scheme the natural end station

Bail-in: Debt write-down and conversion

Bank in crisis

Restructured bank

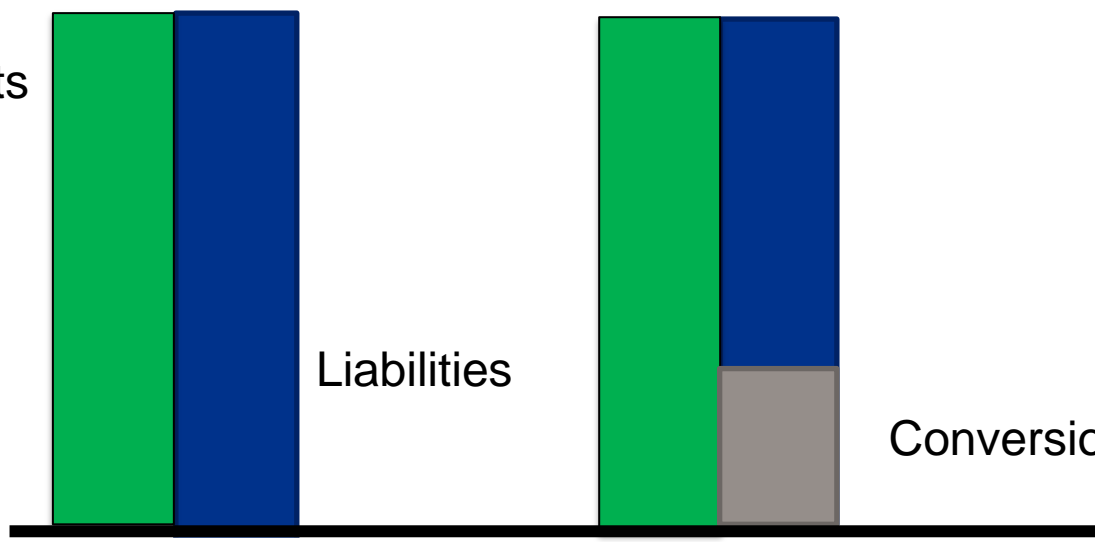
Assets

Liabilities

Conversion of debt to equity

Capital instruments

Equity



Resolution powers

- Important objectives justify major powers:
- Out of resolution:
 - Power to reorganize banks and demand changes to business plans to make them possible to handle in resolution
 - Power to require banks to issues minimum amounts of equity and liabilities that can used for bail in (MREL)
 - Power to charge fees to put in fund to finance future resolution costs
- In resolution:
 - Power to take control of banks that are failing or likely to fail
 - Power to sell the equity in banks
 - Power to sell whole or parts of the business
 - Power to write down equity and debt to make up for losses
 - Power to convert debt into equity to recapitalize banks (bail-in)
 - Power to change contracts and delay payments
 - (...)

BRRD: An assessment

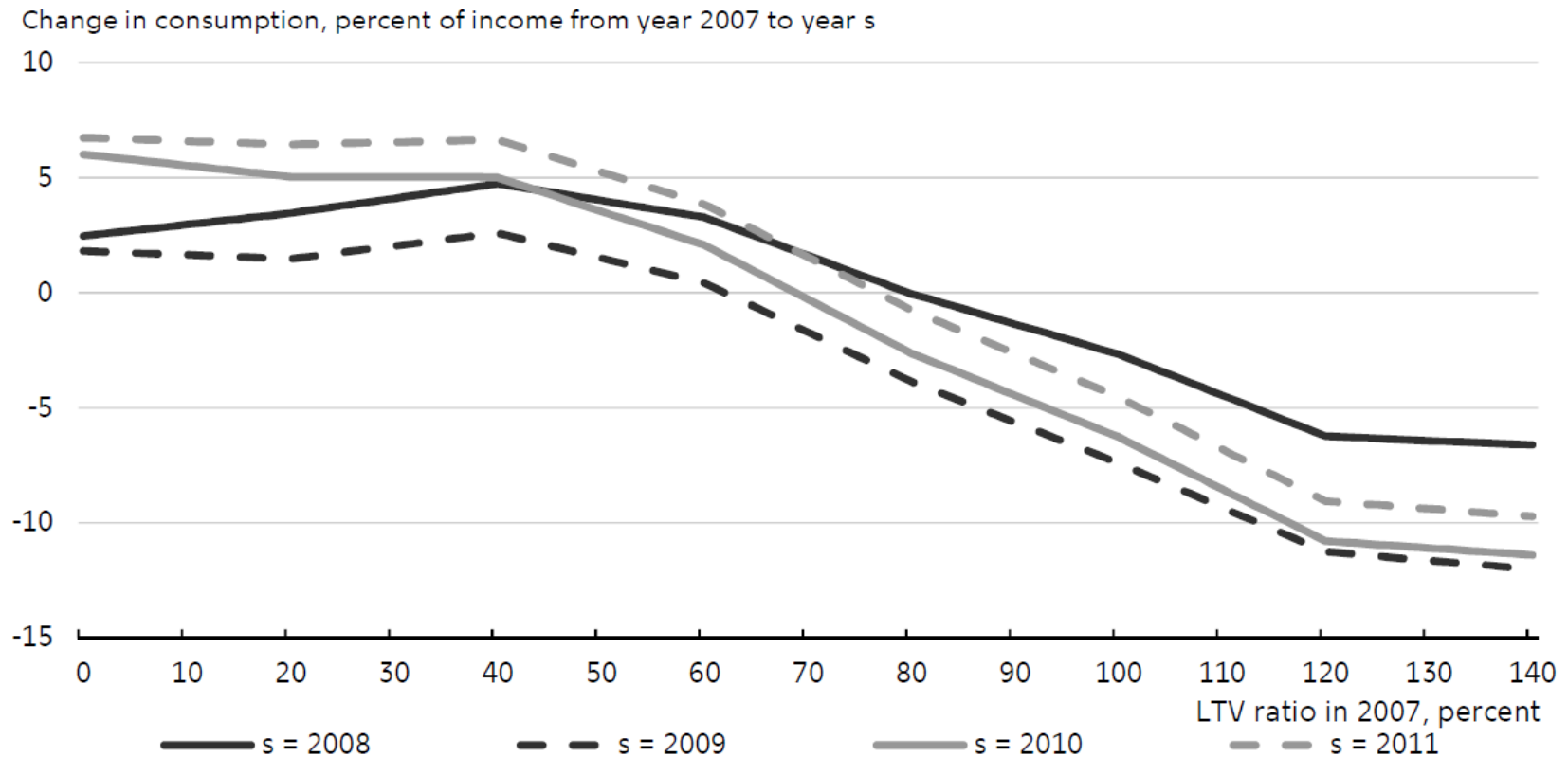
- A financial stability regime must have a well-designed crisis management framework
- BRRD is based on the right objectives and appropriate principles
- Appropriate to use bail-in to mimic bankruptcy
- BRRD gives authorities major powers, like bail-in, but also constrains their use
- Contagion effects could be counteracted by liquidity support to solvent banks, e.g., guarantees, but BRRD restricts also such measures
- The right balance between strict rules to maintain incentives and protect tax payers, on the one hand, and the flexibility needed to effectively deals with severe crises?

Why are house prices and household debt important?

- Business cycle
 - Wealth effect on consumption
 - Residential investment
- Financial stability
 - Large part of households' balance sheet
 - Financial crises preceded by sharp house price increase turn out worse
 - High household debt increase risk of sharp adjustment to shock
- What about the Swedish situation?

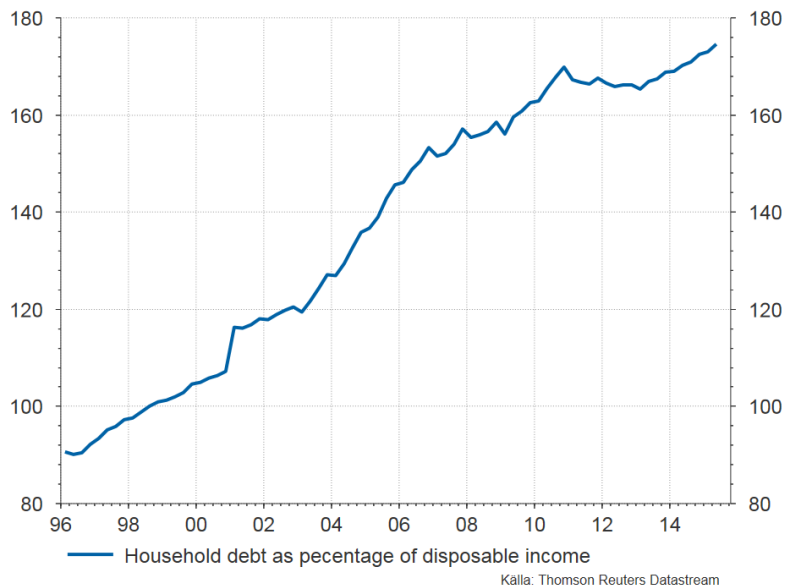
How can individual household debt become an economy-wide problem?

The Danish experience:



Source: Andersen et al. (2014)

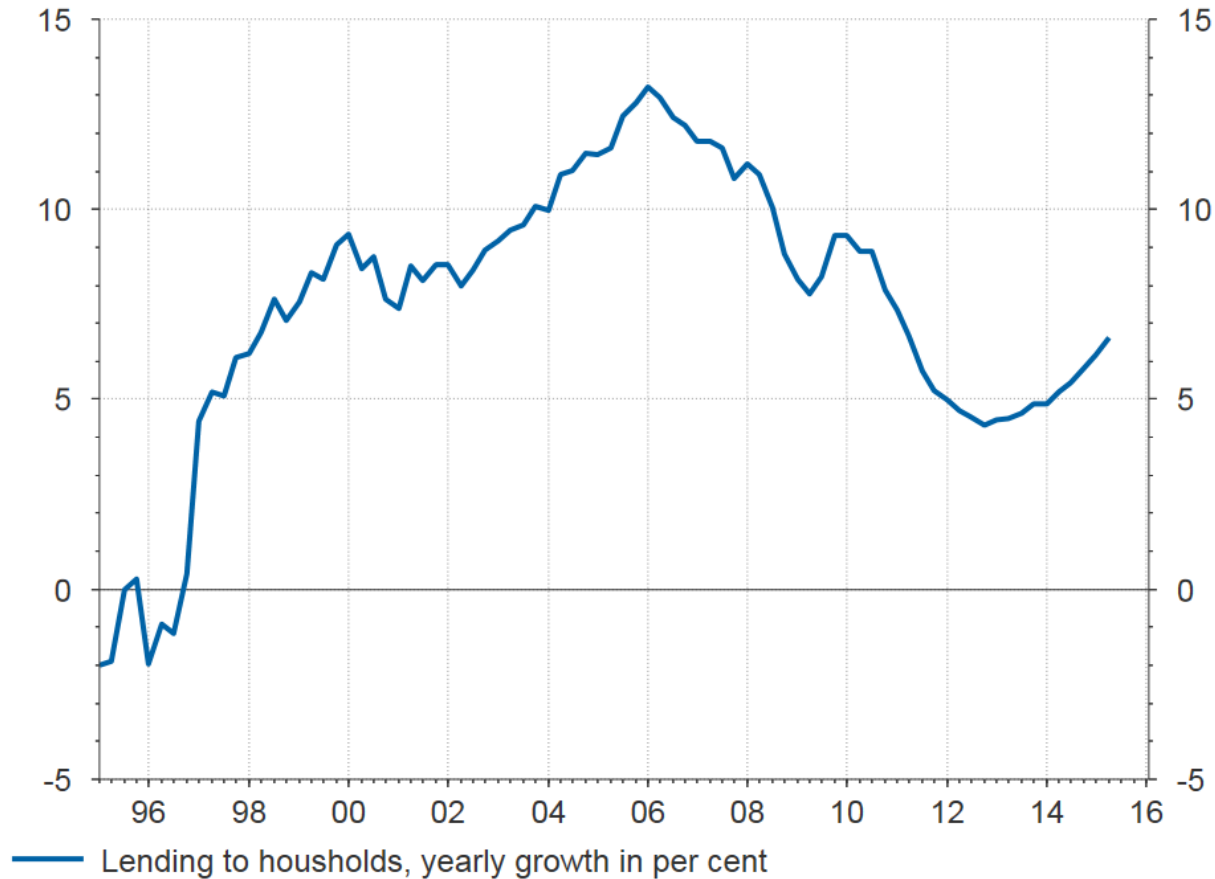
Household debt has doubled over 20 years



What have been the driving forces?

- Low supply of housing
- Tax reforms
- Easier credit conditions
- Falling interest rates and higher incomes
- Increased home ownership

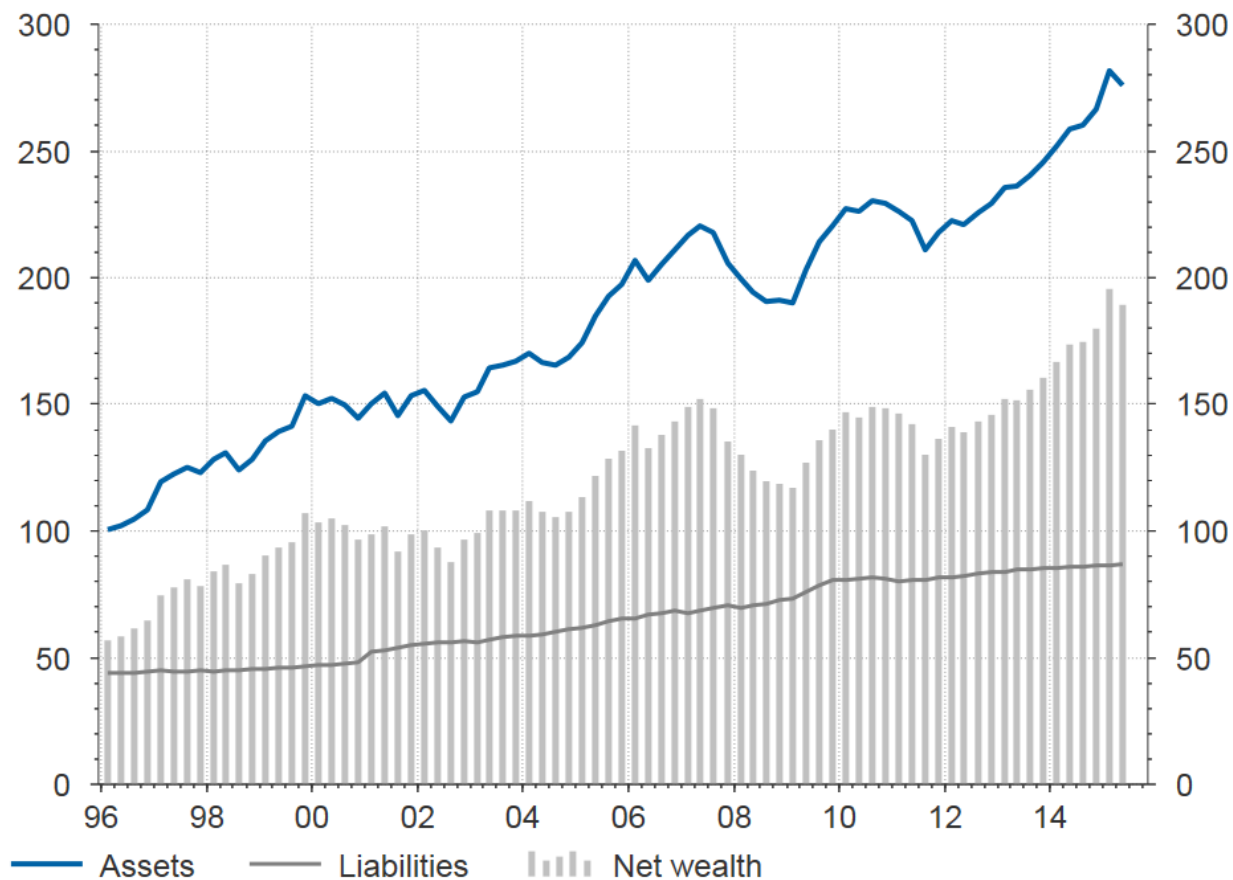
Lending to households accelerating again



Källa: Thomson Reuters Datastream

Households assets outpace liabilities

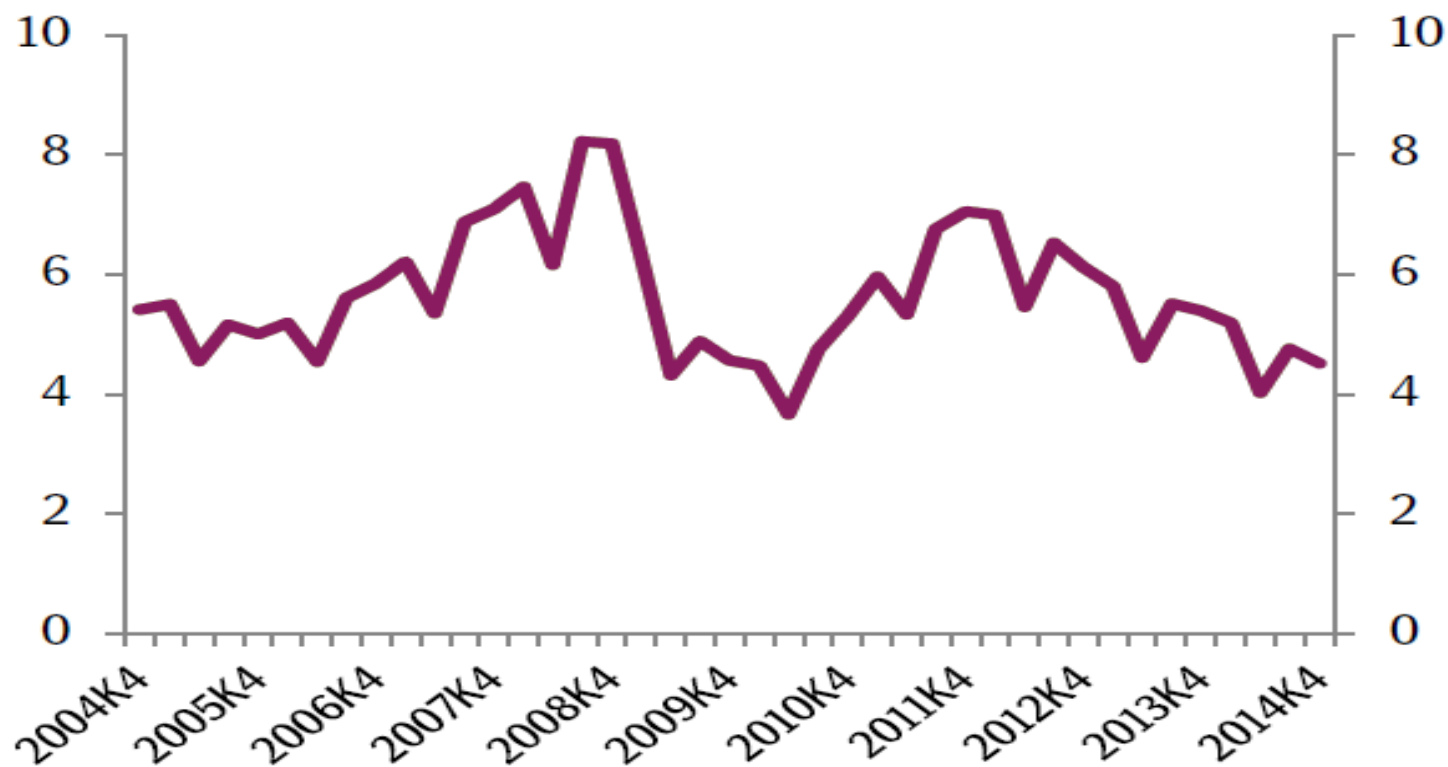
Per cent of GDP



Källa: Thomson Reuters Datastream

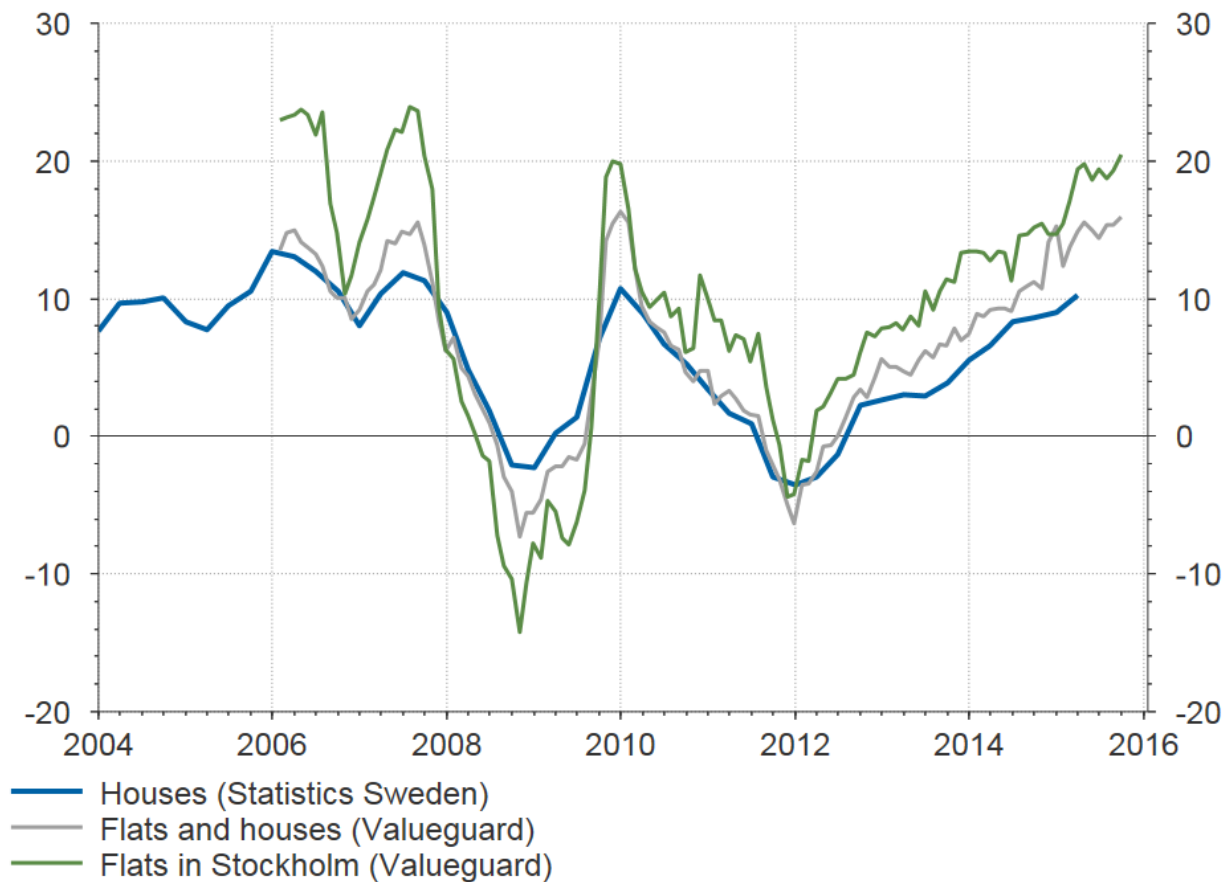
Household debt service

Percent of disposal income



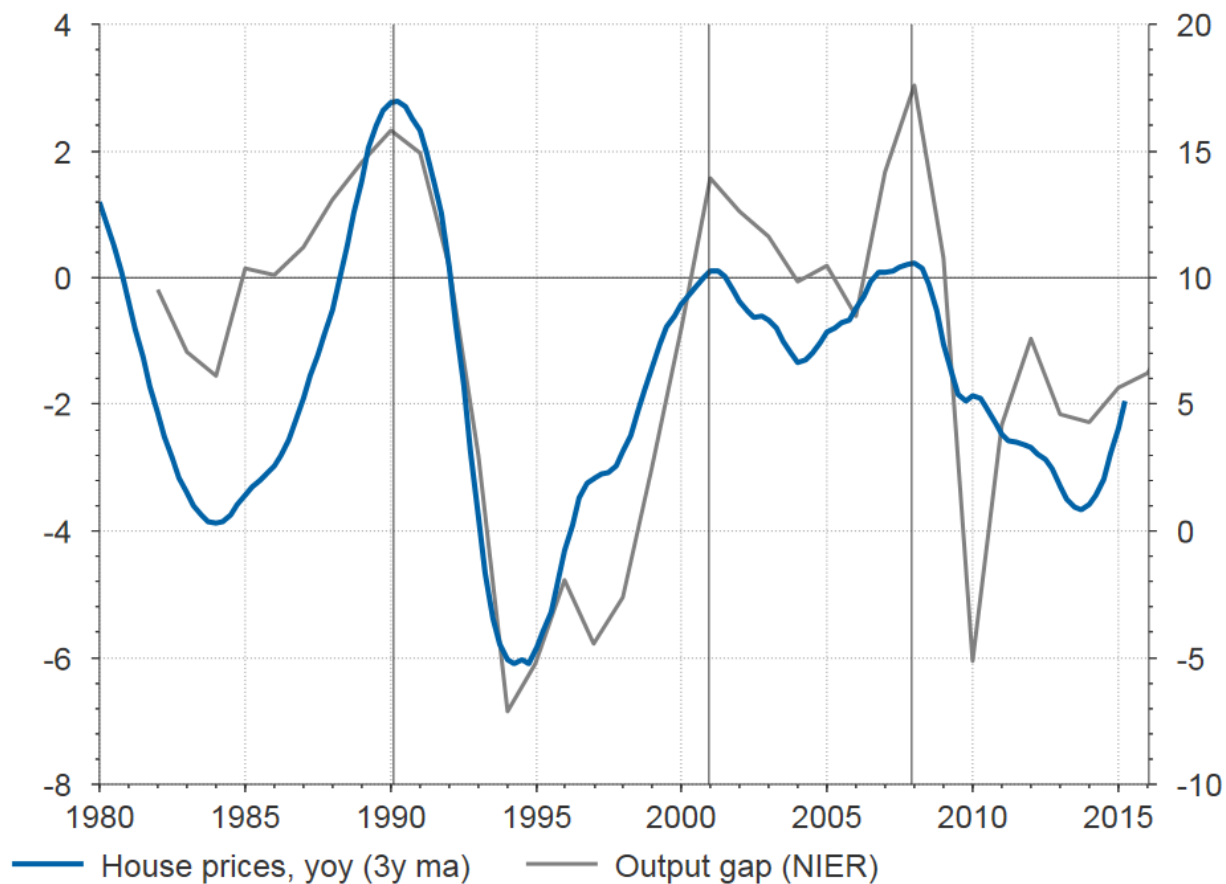
Accelerating housing prices

Yearly percentage increase



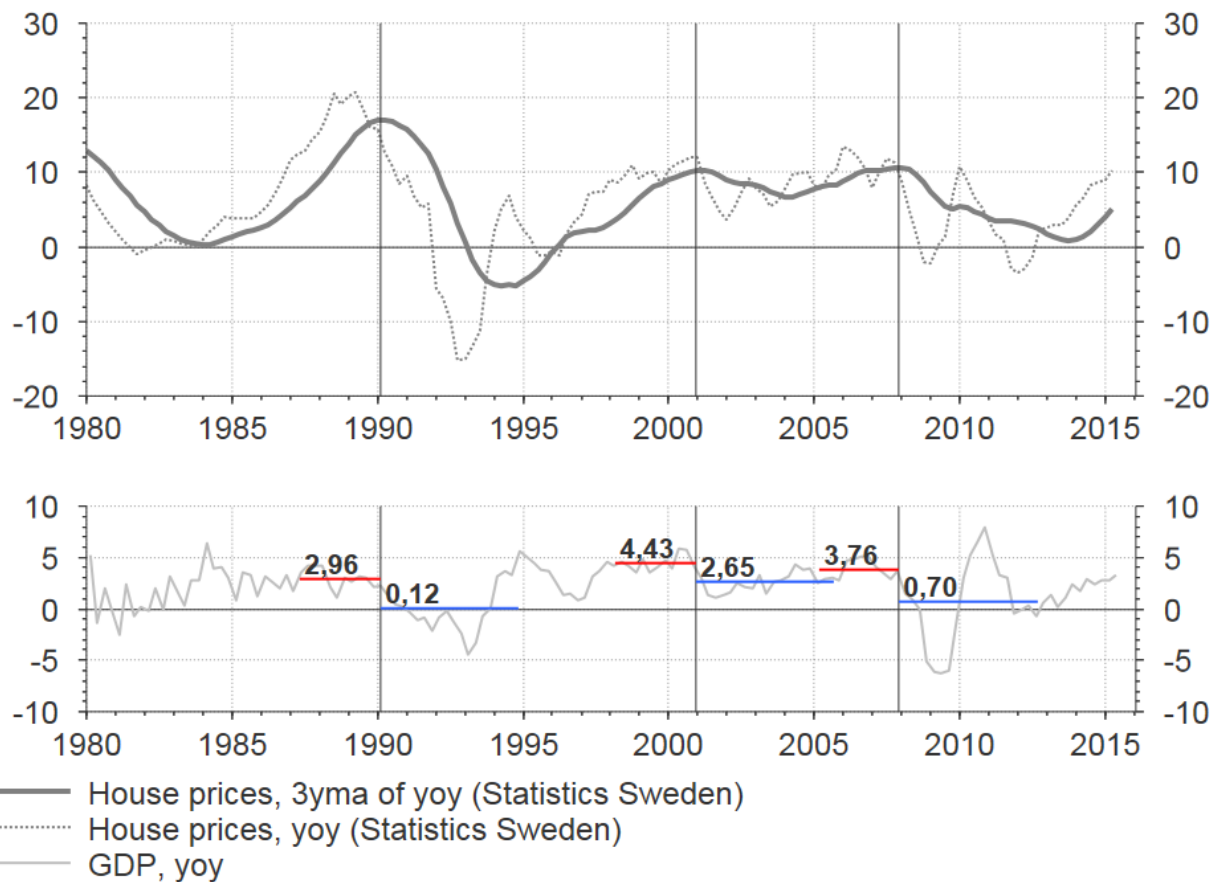
Källa: Thomson Reuters Datastream

House prices and business cycle move together



Källa: Thomson Reuters Datastream

House price peaks precede GDP deceleration



Källa: Thomson Reuters Datastream

Summary

- A financial crisis is a debt crisis
- Financial crisis are potentially extremely costly
- New framework how to handle banks in distress soon in place
- Owner will be wiped out and creditors have to carry larger risk

- Household debt and house prices are of importance
- Accelerating debt and prices are worrisome
- Households need to be able to handle a normalization of interest rates without killing growth