Have lessons from previous bank crises been learned?

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Governor of the Riksbank and Chairman of the Basel Committee on Banking Supervision
2013-11-12, Geneva
Today’s agenda

- Financial crisis – nothing new
- Banks in crisis
- The Swedish 1990’s experience
- Response – new regulation
- Have lessons been learned?
Financial crisis – nothing new

- 1637 – Dutch ”Tulip mania”, first known speculative bubble
- 1772 – Credit crisis in Great Britain and its colonies
- 1857 – World wide financial crisis
- 1873 – US/Europe, ”The long depression”
- 1929 – Wall Street crash
- 1930’s – ”The great depression”
- 1970’s – Oil crisis
- 1990’s – Crises in Scandinavia, US, Asia, Russia
- 2001 – Dot-com bubble burst
- 2008 – Present crisis
Financial crises have significant long run costs

Source: BIS
The most recent crisis – in fact several crises

Financial crisis → Debt crisis → Macroeconomic crisis (recession)
What happens to banks in a crisis?
- Understanding a banks balance sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities &amp; equity</th>
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<tbody>
<tr>
<td><strong>Examples</strong></td>
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<td>Loans to firms</td>
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<td>Loans to households</td>
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<td>Loans to other banks</td>
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<td>Stocks</td>
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<td>Bonds</td>
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<td><strong>Equity</strong></td>
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<td><strong>Examples</strong></td>
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<td>Household savings</td>
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<td>Firms’ deposits</td>
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<td>Borrowing from other banks</td>
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What happens when the value of lending falls?
- a bank with equity exceeding losses
What happens when the value of lending falls?

- a poorly capitalised bank

Who should pay for this shortfall and how?

- Creditors?
- Household depositors as well?
- Government?
# Comparison between traditional bail-out and the bail-in tool

<table>
<thead>
<tr>
<th>Implication</th>
<th>Traditional bail-out</th>
<th>Bail-in</th>
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<tbody>
<tr>
<td>Government covers equity shortfall, letting creditors off the hook</td>
<td>Some creditors lose money, shielding taxpayers (to some extent)</td>
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<tr>
<th>Advantage</th>
<th>Can be applied quickly</th>
<th>May discipline banks</th>
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<tbody>
<tr>
<td>Risks</td>
<td>■ May undermine discipline</td>
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<td></td>
<td>■ Litigation with equity holders</td>
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<tr>
<th>Household contribution</th>
<th>Traditional bail-out</th>
<th>Bail-in</th>
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<tbody>
<tr>
<td>As taxpayer</td>
<td>As depositor or saver</td>
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The EU Banking Union and the asset quality review

- In 2015, ECB will take over supervision of large European banks

- A so-called asset quality review will be undertaken during 2014

- The purpose is to discover hidden losses and establish their magnitude
  - Increase transparency
  - Distribute costs
  - Revive banking sector
Financial analysis

Classification of Credit Portfolio
Valuation of Property Collateral
Valuation of Credit Portfolio
Sensitivity Analysis in the Financial Model
Evaluation

The Bank Auditors
The Bank Valuation Board
The Bank Auditors
Advisors
The Swedish experience – 1990’s crisis

Lending to GDP, per cent

Note. MFI’s lending to Swedish non-MFI as a share of GDP.

Sources: Statistics Sweden and the Riksbank
How do you handle a bank in crisis?

Capital adequacy ratio

A) Private handling
B) Partial private handling
C) Total restructuring

8%
Elements of the Swedish 1990’s bank resolution

- Unanimous and swift political action
- Blanket guarantee
- Differentiated resolution strategies for solvent and insolvent banks
- Bank support authority
- Transparency

MoF Press Release, 24 september 1992

The obligations of these institutions will be honoured. The implication of this is that households, enterprises and other holders of claims can feel safe.
Insolvent banks were split up into "good" and "bad".

"Good bank"
(Nordbanken, later Merita Nordbanken and Nordea)

Nordbanken AMC
Securum
Gotabanken AMC
Retriva
Corporate flow

Banks

Good Banks

Sales

Cash

AMC

Finance company

Corporations

Assets, illiquid

Cash
Underlying problems of recent crisis

- Too low quality and quantity of capital
- Too high leverage
- No liquidity framework
- Too big to fail
- Interconnectedness and systemic risk
Basel III – regulatory response to the financial crisis

- A key component of the official response to the financial crisis (G20)

- Objective: reduce the probability and severity of banking crises in the future

- Replacing and complementing the Basel I (1988) and Basel II (2004) frameworks
Basel III – regulatory response to the financial crisis

- Strengthened capital requirements
- New requirements on bank liquidity
- Cap on bank leverage
- Banks need more and better capital

An extra perspective on the banks capital

Two new measurements:
- Liquidity coverage ratio (LCR)
- Net stable funding ratio (NSFR)
Some countries have introduced stricter requirements

- **Basel III minimum**
  - Capital Conservation Buffer 2.5%
  - Basel minimum 4.5%

- **Switzerland**
  - Low-trigger CoCos 6%
  - High-trigger CoCos 3%
  - Capital Conservation Buffer 2.5%
  - To Big To Fail Buffer 3%
  - Basel minimum 4.5%

- **Sweden**
  - Other capital 3.5%
  - Capital Conservation Buffer 2.5%
  - Systemically Important Bank Surcharge 5%
  - Basel minimum 4.5%

**Note:** CoCos = Contingent Convertibles, a security similar to a convertible bond.
Swedish banks’ progress towards the new regulatory requirements

Note: the indicated positions in the diagram shows the average Basel III ratios for the major Swedish banks. For CET 1 Sweden has currently a higher requirement at 12 % CET 1. the Basel requirement is 9.5% if the contra cyclical buffer and capital conservation buffer are included.
Better regulation contributes to a more sustainable system

- Better regulation
- Enhanced financial stability
- Fewer and milder financial crises
- Stronger real economy
Have lessons from previous bank crises been learned?
Thank you