

13 February 2019

**SYSTEMIC POLICY PARTNERSHIP LLP**

REPORT RELATING TO THE REVISION  
OF THE RIKSBANK ACT

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## Summary and conclusions

This Report seeks to contribute ideas and analysis for those responsible for proposing revisions to the legislation governing Sweden's central bank, the Riksbank (RB). While we have benefited from our interaction with the people with whom we engaged, the report is our own and contains our own observations alone. The focus is on RB's role in the delivery of financial stability (FS) policy and the governance considerations relating to it. The present architecture of Sweden's FS arrangements is taken as given. The Report draws on the experience of other jurisdictions in determining the role of the central bank's contribution to financial stability.

The Riksbank should be given an explicit financial stability mandate when the central bank act is revised. In the decades since the current central bank legislation in Sweden was fashioned, considerable changes have taken place in the environment in which central banks operate. The uncompromising, exclusive focus on price stability that was the result of a period of prolonged high inflation worldwide in the 1970s has been tempered by the realisation that financial stability is an important a public good in its own right and essential for delivering price stability. The financial crisis of 2007 to 2009 demonstrated just how high the costs of instability can be.

If RB were given an explicit financial stability mandate, it should

- be based on a clear articulation of the objectives for financial stability policy in order to foster collaboration amongst RB and other authorities whose decisions and actions bear on financial stability and to enhance their accountability in seeking to achieve these objectives
- articulate key areas where RB can make meaningful contributions to the financial stability objective, including liquidity provision and the identification and analysis of systemic risks
- take account of the fact that there are other important objectives such as price stability and efficiency that need to be met
- provide appropriate tools permitting RB to act swiftly, safely and impartially, in particular when modulating liquidity for financial stability purposes
- ensure that the actions of RB are joined up with those of other authorities responsible for separate but linked component areas of policy so that policy actions in this area are effective, transparent and accountable
- rest on accountability mechanisms appropriate for an institution that has a public policy mandate and serves as a steward of public resources and reports directly to the Riksdagen (RD)
- spread legal and governance provisions appropriately across the different legal, administrative and contractual instruments governing RB.

The legal and administrative provisions should ensure that RB has the capacity (i.e., powers and resources) to contribute to financial stability through its financial and other operations. In particular, it should be able to provide liquidity:

- to a solvent but illiquid institution (LoLR)
- to an institution in resolution (debtor-in-possession finance)
- to the financial system as a whole in the event of generalized market disturbances threatening financial stability.

Under current legislation, RB has an explicit mandate to provide liquidity to supervised institutions in the first two cases. Its mandate in the third area is implicit and derivative from its monetary policy and payment

systems mandates. Beyond these actions that would be reflected in RB's financial accounts, it could contribute to efforts to foster financial stability through:

- Provision of market intelligence relevant to systemic issues garnered through its monetary and payment system operations;
- Provision of relevant macroeconomic data which is necessarily compiled in pursuit of its price stability duties but which is of value in macroprudential analysis of conjunctural vulnerabilities [debt levels etc]
- Provision of expertise and skill sets relevant for the analysis of macroprudential vulnerabilities, together with contributing to the determination of optimal mix of instruments best suited for mitigating vulnerabilities
- Contribution to microprudential oversight of financial infrastructure in order to be able to carry out its responsibility for the payment and settlement system.
- Participation in and assessment of the adequacy of contingent preparations, both in conjunction with the resolution authority in relation to resolution
- Contribution to financial stability through ensuring adequate bank note availability in all circumstances
- Participation in ex post assessment of actions taken to foster financial stability which contribute to the learning process for all parties as regards calibration etc.

In Sweden, delivering financial stability requires the use of a broad spectrum of measures that are under the control of a multiplicity of semi-autonomous authorities, each with its own mandate and own governance arrangements. While the issue of how to join up financial stability actions of all the Swedish authorities is beyond the scope of the work of the Commission revising the legislation governing the Riksbank, there is good reason for it to consider how RB's actions and mandate in this area can be cast so as to deliver financial stability policy in a manner consistent with achieving other important social, economic and political objectives.

There are two main ways this can be done. The first involves adopting arrangements that foster collaboration. The second is for each authority to take the policy decisions of the other authorities as a given when making their own policy choices. We believe that the former is more likely to produce better policy outcomes and to do so more efficiently and at a lower overall cost to society. We also believe that collaboration in financial stability activities, if properly structured, does not compromise the autonomy of any of the authorities involved or weaken accountability to the relevant stakeholders.

## Introduction

The purpose of this report is to consider what changes in the mandate and governance arrangements for the Riksbank (RB) would help to enhance the accountable and effective delivery of policies to promote the resilience of the financial system both in peacetime and in times of crisis. It is intended to serve as an input into the work of a cross-parliamentary committee (Committee) established by the Swedish Parliament (Riksdagen, or RD) in December 2016 to review the Act governing RB. It is based on our interaction over a span of about six months with the Chairman of the Committee and members of the Committee Secretariat and with the full set of Swedish authorities responsible for financial stability: the Finance Ministry (FM), the Swedish Financial Supervisory Authority (Finansinspektionen or FSA), the National Debt Office (Riksgälden or NDO) and the Riksbank.<sup>1</sup> The analysis herein and the observations made are ours alone.

Prior to visiting Stockholm, we carried out extensive off-site research into arrangements in Sweden and elsewhere and circulated and received answers to specific questions on the design and operation of financial stability arrangements from a range of central banks. After visiting Stockholm and holding a series of bilateral meetings, we prepared a detailed annotated agenda that served as the basis for a multilateral workshop held on 5 June 2018.

We have benefited enormously from our interaction with the people with whom we engaged. They have had an opportunity to comment on what we have written, but the report is our own and contains our own observations alone.

The terms of reference of the Committee are broad. This report focuses on those issues cited in its terms of reference that are relevant to financial stability governance, in particular:

- ‘the Riksbank’s responsibility for financial stability’
- ‘the Riksbank’s institutional independence’ and its compatibility with arrangements to ensure that financial stability policy actions by different authorities are joined up
- ‘the democratic scrutiny of the Riksbank’ where we have given particular emphasis to accountability arrangements in relation to financial stability.

The architecture of Sweden’s financial stability arrangements is taken as given. In other words RB’s constitutional position under parliament as well as the allocation of micro and macroprudential policy to the FSA, and of the authority for resolution allocated to NDO, are not questioned. Attention is given to the implications of this architecture for the role of the central bank in fostering financial stability in both times of crisis and normal times, and to the question of how the policies and actions of the various authorities can best be joined up.

The report is in four sections. The first considers whether RB should have a financial stability mandate and, if so, what could or should it be. The second examines how RB’s financial stability activities can be effectively joined up with those of the FSA, NDO and FM in the interest of effective and efficient policy delivery. The third examines the implications of giving RB a more explicit (and perhaps greater) role in financial stability policy and the implications for its accountability and independence. Each of the first three sections begins with a presentation of the issue(s) and the context in which it arises. This is followed by a presentation and assessment of the arguments for different solutions which include our own observations on possible ways forward, taking account of international experience in the financial stability domain. The final section considers what legislative changes might contribute to more effective policy delivery, taking the current legislation as the point of departure.

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<sup>1</sup> A list of those with whom we engaged will be found in the Annex.

## 1. A financial stability mandate for the Riksbank?

This section of the report considers whether RB should have a financial stability mandate and, if so, what could or should it be in both a crisis and normal times, focusing in particular on liquidity provision, payments systems responsibilities and the use of monetary policy. It also considers what powers and tools RB might need and what decision-making arrangements might be the most efficient.

More particularly, the questions are

- i. *What **contributions** could RB make towards financial stability*
  - a. *in crisis?*
  - b. *in peacetime?*
- ii. *For **liquidity provision**, what should RB's involvement be in both times of crisis and in steady state or peace time, including implications for its balance sheet?*
- iii. *For **payments system and currency**, what are the implications of potentially profound changes in current practices?*
- iv. *On the basis of role and areas of contribution chosen, what **tools** should RB have?*
- v. *To the extent that the role is explicit and expanded, how should RB itself address **the efficiency of its decision making**?*

Broadly speaking, two types of financial stability arrangement are found, which differ primarily in the degree of concentration of authority. In one, the responsibility for delivery of policy objectives in relation to each of macroprudential, microprudential and recovery and resolution components are given to a single authority, most often the central bank (e.g., UK, Ireland, Hungary). The second involves allocating the responsibilities in these three areas to different authorities and providing a mechanism to join up the relevant policy actions (e.g., Sweden, Australia and Canada).

There are several notable features of Sweden's financial stability arrangements, given the architecture that has been chosen. One feature is that the central bank's financial stability mandate is not explicit. It derives from its other explicit responsibilities (monetary policy, payment system oversight, bank note issuance etc.). Its capacity to modulate liquidity in the economy is a particularly important reason why it can and does contribute to financial stability. In addition, it has real time access to information about the condition of financial institutions and financial markets arising from its market operations and its role in the payment system that permits it to detect early signs of emerging distress.

For these reasons, RB should play a role in fostering financial stability. Moreover, there is good reason to make its role explicit rather than relying on an implicit mandate derived from other powers. This would make it clear what RB should (and should not) do when fostering financial stability and help to hold it to account.

In considering precisely what RB's role should be and how its actions can most efficiently be joined up with those of other authorities., it is useful to distinguish between actions in times of crisis and peace.

### Times of crisis

In times of crisis, RB's actions are, and should be, focused mainly on liquidity provision. This is because it has a balance sheet with a size and structure that permits it to furnish both domestic and foreign currency liquidity swiftly and in amounts commensurate with the potentially very large needs of Sweden's banks. In the financial crisis in 2008-09, RB set up new lending facilities for expanded periods at fixed and variable rates to provide banks with funding security, including in USD. It quickly reduced its main refinancing rate in several steps to an historic low in anticipation of the economic recession. It also provided emergency liquidity assistance to two institutions, Kaupthing Bank Sverige Ab and Carnegie Investment Bank, in the autumn of 2008 as their potential failures were deemed to threaten financial stability. These actions were undertaken

under legislative provisions that permit RB to provide liquidity to institutions regulated by FSA in exceptional circumstances.

Clearly RB actions in times of crisis are warranted. Current legislation enables RB to provide liquidity to regulated financial institutions in exceptional conditions. We would however make two observations for the future. First, given the potentially disruptive changes in the financial industry wrought by digitalisation and related technologies, the nature of payments and financial intermediation could change radically. Second, and following on from this, it is not difficult to think of circumstances where there would be a need to provide liquidity to unregulated institutions in the interest of financial stability. If the two points are given due weight, it could argue for relevant changes to be considered when revising the RB Law.

## Peace time

During peace time RB contributes to financial stability by ensuring that Sweden has a safe, sound and efficient payment and settlement system (including through the use of banknotes) and by “leaning against the wind”, in other words by setting the repo rate at a level consistent with price stability but compatible with other, subsidiary policy objectives. It is also an active participant in the public discussion of appropriate financial stability actions and engages with the FSA and the NDO on matters relating to financial stability.

Having a responsibility to contribute to financial stability in times of crisis in both our view and in the light of international practice implies that the central bank should have a role in peacetime in mitigating the vulnerabilities for instability and not simply acting as a bystander. This is because the likelihood of a crisis and the need for liquidity in exceptional conditions is determined by what is done (or not done) in peacetime. Equally, the skill sets needed for handling crises can be honed through involvement in trying to mitigate such vulnerabilities. In determining RB’s role in peace time, it is important to ensure that its actions are supportive of, and complementary to, the actions of other authorities with primary responsibility for financial sector regulation.

We would observe that internationally we are aware of few if any cases where the central bank plays no role in vulnerability mitigation during peacetime apart from using monetary policy for financial stability ends. And in that respect RB would be in a position to contribute to the peacetime activities for each of the three components of financial stability policy (macroprudential policy, microprudential supervision, and preparations for recovery, resolution and crisis management) in the following ways, and consistent with practices in many other jurisdictions.

- Provision of market intelligence relevant to systemic issues garnered through its monetary and payment system operations; such information and analysis can both be of value to those with microprudential oversight responsibilities and help to identify macroprudential vulnerabilities, sometimes at an early stage, which could usefully inform macroprudential policy decisions made by the FSA
- Provision of relevant macroeconomic data which is necessarily compiled in pursuit of its price stability duties but which is of value in macroprudential analysis of conjunctural vulnerabilities [debt levels etc]
- Provision of expertise and skill sets relevant for the analysis of macroprudential vulnerabilities, together with contributing to the determination of optimal mix of instruments best suited for mitigating vulnerabilities
- Possible use of the interest rate in the sense of ‘leaning’ for which RB has decision-making power as one of a set of several measures alongside other measures to be deployed by FSA and which might be collectively applied should vulnerabilities demand
- Contribution to microprudential oversight of financial infrastructure in order to be able to carry out its responsibility for the payment and settlement system.
- Participation in and assessment of the adequacy of contingent preparations. This includes both in conjunction with the resolution authority in relation to resolution planning given the role RB needs to

play in potential liquidity provision, as well as for crisis handling arrangements and the processes by which liquidity could be injected

- Contribution to financial stability through ensuring adequate bank note availability in all circumstances
- Participation in ex post assessment of macroprudential actions taken and processes which contribute to the learning process for all parties as regards calibration etc. issues

The basic issue here is that the entire financial stability role of RB is now built on a fairly broad interpretation of the responsibility for the stability of the payment and settlement system. Some might say that it is pushing the envelope. If RB's financial stability mandate were made explicit, its role in payment system stability (including fintech) could be made more specific.

### International experience

In the aftermath of the global financial crisis that started more than a decade ago, central banks have been given a greater and more explicit role in the maintenance of financial stability and management of financial crises.

- In the **United States** the ability of the Fed to conduct more intensive and intrusive supervision of any systemically important institution has been increased once the Financial Stability Oversight Council determines that the institution is systemic. In addition, its capacity to provide financial support was altered to ensure that such support is provided equitably and without distortions to competition. This means that lending to an individual institution must take place within the context of a programme for which other similar institutions are eligible.
- In the **EU**, the ECB has been given explicit supervisory responsibilities through the creation of the SSM; it also exercises macroprudential responsibilities.
- In the **United Kingdom**, supervision has been brought back to the Bank of England after it was transferred to an independent authority a decade earlier, and both recovery and resolution powers have been assigned to it.

Similar developments have occurred in smaller countries.

- In **Ireland**, the Financial Services Authority of Ireland was re-integrated into the central bank. The previous dual board structure was scrapped and replaced by a new, unitary, Central Bank Commission.
- In **Iceland**, the central bank has been given responsibility for preparing decisions on macroprudential policy and other financial stability measures decided upon by a financial stability committee that consists of the governor, the finance minister and the head of the supervisory authority.



<b>Table 1</b>	<b>Examples of Financial Stability Mandates</b>
Norges Bank	The NB has a mandate to promote a robust and efficient financial system. This includes payment system supervision but no macroprudential powers
Denmark's Nationalbank	DN has a mandate to ensure efficient payment systems but has no explicit FS mandate or powers
Bank of Finland	Financial stability is one of BoFs core tasks but it has no explicit FS mandate or powers
Swiss National Bank	SNB is responsible for macroprudential policy, including the countercyclical capital buffer and additional requirements for systemically important banks
Bank of England	BoE has an explicit FS mandate, executed by its Financial Policy Committee. Its powers of direction include the counter cyclical buffer, leverage ratio and LTV and DTI caps
Banque de France	The BdF has an explicit FS mandate. Macroprudential decisions are taken by the High Council for Financial Stability after proposal by BdF
National Bank of Belgium	The NBB is the designated macroprudential authority in Belgium
De Nederlandsche Bank	The DNB is the designated macroprudential authority in the Netherlands
Reserve Bank of Australia	The RBA has primary responsibility for the maintenance of overall financial system stability, including stability of the payments system

Note to Table 1. In the three other Nordic countries, the legislation governing the central banks contains wording indicating that the central bank will contribute to financial stability in one way or another.

Our observation would be that in common with many other jurisdictions, consideration might be given to provide clarity of the areas where RB would be expected to contribute, which would enhance the overall efficiency and effectiveness of Sweden's financial stability arrangements.

The following parts of this section provide context for such consideration.

### Liquidity provision

Given that it provides the ultimate means of settlement as a result of its monopoly on the issue of kronor banknotes, RB plays a pre-eminent role in liquidity provision in domestic currency. This is recognized in existing legislation which empowers RB to lend 'in support of liquidity' in an emergency even without an explicit financial stability mandate. A second area of focus is RB's ability to provide liquidity in foreign currency as a result of holding foreign exchange reserves and being able to arrange currency swaps with other central banks permits it to provide liquidity in foreign currency.

In considering RB's role in liquidity provision for the purposes of contributing to financial stability, it is useful to distinguish between three different circumstances in which it might decide to act.

The first is the provision of emergency liquidity assistance to an individual institution that confronts a loss of confidence but is solvent (lender of last resort). In such cases RB, like other central banks, provides against adequate collateral and generally at penal interest rates.

Secondly, RB could provide liquidity to an institution that is being resolved in order to help assure the continued provision of essential financial services. The funding for the resolution should in essence come from the bail-in of subordinated holders of TLAC/MREL and, potentially, a resolution fund. However, interim financing may be needed, and RB can provide it in the event that it is not available in the market as long as the institution is supervised by the FSA. In this case, the solvency of the institution could be assured through a guarantee from the resolution authority (NDO).

The third case involves actions affecting the liquidity of the entire financial system for financial stability purposes when the threat is not institution specific but is generalised. As discussed below, the statutory basis for this type of liquidity support is not as explicit as it is in the first two cases.

Having a distinction in either legislation or operating procedures between “general liquidity support” and ‘monetary policy transactions’ is unusual. All monetary operations necessarily provide liquidity - to the market and to individual firms. Central banks conduct monetary policy by setting short term interest rates. To set them at a level consistent with their policy objective(s), they must supply the right amount of base money/reserves. Liquidity is just the quantity side of the price that central banks set in the market. And if there is financial instability, that will change monetary conditions. Providing extra, market-wide liquidity is exactly what is needed to achieve both price stability and financial stability. In other words the operations are completely intertwined. In the case of the ECB, a decision of the European Court of Justice provides a judicial basis for this. The Court ruled in a case brought by the German Federal Court that the ECB could undertake certain “general liquidity support operations” (Outright Monetary Transactions) as long as such operations observe the principle of proportionality. In other words the ECB can undertake such operations as long as they do not go beyond what is needed to achieve the objectives set out in the EU Treaties.

### Balance sheet issues relating to liquidity provision

Liquidity provision, whatever its purpose, involves the use of, and relies on the integrity of the balance sheet, and can also affect central bank earnings.<sup>2</sup> Current legislation in Sweden recognizes the need for the integrity of the central bank balance sheet in the event that operations give rise to losses, as there are provisions for topping up reserves if these fall below a statutory minimum.

Similar arrangements exist in other countries. For example, in the UK any financial operation by the Bank of England that entails a risk of loss must be approved. However, in this case approval is given by the finance ministry (HM Treasury) rather than Parliament because the Bank of England was nationalized by the government in 1946 and the government is the sole shareholder.

The purpose of capital and reserves in the balance sheet of a central bank is different from what it is for private banks or private companies. It is to ensure the integrity of the policy-making process and permit the central bank to achieve its mandated objectives, rather than to serve as a means to absorb losses in the pursuit of profit.

Because central banks are not subject to insolvency procedures and have the backing of the taxpayer, they can operate, and have on occasion operated, with negative capital. By contrast, some central banks operate with very substantial financial buffers that enable them to operate independently and to marshal huge resources in the event of a financial crisis. It is exactly at that time that doubts may emerge about the capacity of the government to provide a credible guarantee or to issue debt in adequate amounts or quickly enough to meet unexpectedly large liquidity needs in the financial sector. A study of the financial buffers of a set of 14 central banks showed that they ranged from about +33% to about -23% of the balance sheet total.<sup>3</sup>

This wide dispersion is the result of the confluence of a variety of forces. One force is the decisions of others. Central banks sometimes perform quasi-fiscal functions at the behest of governments. Unlike core central bank functions, these can and do consume financial resources. Another force is the central bank’s fiat money creating capabilities that generate revenue and can be used to cover any current loss, including those arising from financial stability operations, and retained to provide the financial integrity necessary for the exercise of policy functions.

The central bank’s financial accounts reflect the use of resources employed when carrying out policy functions. For example, transactions that affect liquidity are conducted by buying and selling financial claims

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<sup>2</sup> Central banks engage in off balance sheet operations, but these generally involve contingent assets and liabilities that can appear on the balance sheet at a later date and are documented in notes to the accounts.

<sup>3</sup> See <https://www.bis.org/publ/bppdf/bispap71.pdf>

or making loans and taking deposits. These are reflected in the accounts and provide information that can be used to hold it to account. The legislation governing virtually all central banks sets out clear rules relating to financial reporting. RB is required to submit its accounts to RD for approval (Chapter 10, Article 4).

Given the variety of reasons why central banks conduct financial operations, views can differ on the extent to which the central bank itself should have control over such operations and the way that they should be recorded in its financial accounts. At the time of the financial crisis that began in 2007, some central banks such as the Fed undertook off balance sheet operations. Since the financial accounts are an important means to hold the central bank to account, having as many operations as possible on balance sheet facilitate efforts to hold the institution to account.<sup>4</sup>

The answer to the question of the amount of resources at the disposal of the central bank and its discretion with respect to their use should, in our view, be found in the middle ground. Neither the balance sheet of the central bank nor that of the public sector should be a residual. The relevant question in the case of a central bank and its financial accounts are what financial resources does the CB need? How should they be provided? How should decisions be made about their use? And what accountability arrangement are most suitable for ensuring that they are used in the most appropriate manner? The strong reporting requirements to RD and the procedures for the approval of RB's accounts currently in place provide the statutory basis for finding a suitable middle ground.

## Payment systems and currency

RB's current financial stability role is derived in part from its statutory responsibilities for payment systems and banknotes. These are both areas where technological change has the potential to generate profound changes. There is reason to ensure that there are no gaps in powers to oversee fintech players, infrastructure providers and market activity that could pose a threat to systemic stability. The degree of disruption taking place in financial services provision as a result of fintech should not be underestimated, so our observation would be that it could be wise for any new legislation to allow for this.

In addition, the prospective disappearance of bank notes would have implications for RB's balance sheet and for its capacity to finance its operations through its financial activity - an issue well recognized by RB of which the Commission will wish to take note in its consideration of the RB Act.

## Tools

RB has two principal tools it can deploy for financial stability purposes. The first consists of financial market operations reflected in its balance accounts. The second consists communications policy such as statements by the Bank about risks and the potential response to them. Both of these can be employed by RB to contribute to financial stability.

Current legislation gives RB the authority to set reserve requirements. However, this power is restricted. It can only be used for monetary policy purposes. If RB wished to use this authority to create liquidity buffers within the banking sector for financial stability purposes, it would, under current legislation, need to establish that its action is compatible with and subservient to the objective of achieving price stability and that the measures are proportionate. While there are decisions of the European Court of Justice confirming the legitimacy of such an approach, statutory clarification would remove any residual doubt and provide a firm foundation for the use of this instrument for financial stability purposes if it was deemed desirable for RB to have such powers.<sup>5</sup> Since the FSA has the authority to set liquidity requirements (eg. the liquidity coverage

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<sup>4</sup> Making the financial condition of the central bank the consequence of decisions by others would hamper these efforts and risk converting it into a quasi-fiscal instrumentality of government. On the other hand, if there were no limits whatsoever on what the central bank could do, the public sector balance sheet could in theory be determined by its actions alone.

<sup>5</sup> See Mersch (<https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180906.en.html>)

ratio LCR and net stable funding ratio NSFR), the actions of the RB and the FSA would need to be joined up to ensure that the overall liquidity buffers for the regulated institutions are optimal.

The questions here is what tools should RB have available to foster financial stability in peacetime and how the use of these tools should be governed, or in other words, how the decisions on their use should be made. RB can “lean against the wind” in the conduct of monetary policy. There has been a vibrant debate amongst members of the Board and in Sweden more generally about the extent to which, if at all, it should do so. While such an approach might contribute to the attainment of financial stability (and other economic policy) objectives, the question that arises is whether alternative ways to arrive at a suitable policy mix (joint deliberation on policy settings) needed to achieve financial stability objectives would be superior. This question of joining up policies and addressing trade-offs including the role of the Financial Stability Council is discussed in section 2.

Given its role in liquidity provision in both domestic and foreign currency and its fiduciary responsibility to ensure that the financial resources that it has at its disposal are used in a manner that achieves its public policy objectives in the most effective and efficient manner, RB has a legitimate interest in the condition of its counterparties.<sup>6</sup> This interest could be met by having potential counterparties pre-qualify for loans when credit lines are being negotiated, by giving RB the power to require potential counterparties to hold liquidity buffers or by providing a mechanism for RB to liaise with the FSA on matters relating to liquidity regulation to provide satisfaction to both. The LCR and the NSFR are decided by the FSA which is responsible for prudential supervision. Alternatively, it could liaise with the FSA so that the LCR and NSFR decided by the FSA were set at levels that both felt to be appropriate for their purposes. In any case, some form of consultation or collaboration is in our view needed to ensure that policy measures in this area are complementary and mutually supportive. In addition, a similar form of coordination with the NDO could be desirable in resolution cases.

## Decision-making

At present decision-making authority on all matters relating to policy and the management of RB is vested in the Executive Board, consisting of six full time members appointed by the General Council. It makes decisions on monetary policy, including whether to lean against the wind. It makes high-level decisions relating to financial operations, and it has overall responsibility for management, which is delegated to the Governor.

If RB were given a more explicit role in FS policy, the question arises about how decisions should be made. There are two obvious options. The first would be to vest the responsibility in the Executive Board. The second would be to create a separate FS committee, possibly with external members, responsible for making decisions on FS. It could, for example, take the form of the current Executive Board plus the Chairman and Deputy Chairman of the General Council as full members of the FS committee.

The main argument in favour of the first is that it permits FS policy to be joined up with other policies for which RB is responsible. If the primary means to foster financial stability at the disposal of RB is “leaning against the wind” (LAW)<sup>7</sup>, the need to calibrate market operations in a manner that is compatible with MP

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<sup>6</sup> In our discussions in Sweden, the question arose whether the RB’s balance sheet should be a residual. In our view, the question is something of a red herring. A residual is a mathematical concept, not a governance one. A term in an equation or a set of equations is a residual or it is not. There is no middle ground. A balance sheet is a snapshot in time of the assets and liabilities arising from transactions by an entity, public or private. Clearly a central bank (or any public authority) should have some discretion of the operations reflected in its balance sheet at any point in time, but equally clearly, not complete and unfettered control.

<sup>7</sup> LAW strategies relate to the way monetary policy (or, more precisely, the way operations affecting the short-term policy rate) should be used. There is a vibrant and healthy discourse amongst policy makers, observers and scholars about whether central banks should LAW and if they do, what they should be trying to achieve. One thought is that they should move the policy rate beyond (below or above) the rate needed to achieve price stability in order to achieve some other legitimate public policy objective (lower unemployment, reduced cyclical fluctuations, less overheating in the housing market, curtailing excessive ebullience leading to speculative euphoria, etc) as long as this action does not jeopardise the achievement of price stability. Another thought is that the central banks should set the policy rate at a different level from the one implied by model forecasts using qualitative

and FS objectives speaks in favour of this approach. By contrast, if RB has other FS instruments (including “open mouth” policies) at its disposal, there is a case for a separate decision-making committee, perhaps with external members and a skills orientation towards financial stability understandings, as long as there is enough substance to be discussed and decided upon.

## Conclusion

It is clear that the revised central bank legislation should provide RB with an explicit financial stability mandate. Our view is that such a mandate should

- be based on a clear articulation of the objectives for financial stability policy
- articulate key areas where RB can make meaningful contributions to the financial stability objective, including liquidity provision and the identification and analysis of systemic risks
- clarify the role of the balance sheet of RB and other central bank accounts
- take into account the fact that there are other important objectives such as price stability and efficiency that need to be met
- provide appropriate tools swiftly, safely and impartially, including in particular the capacity to provide liquidity
- ensure that the actions of RB are joined up with those of other authorities responsible for the three separate but linked component areas of policy<sup>8</sup>
- rest on accountability mechanisms appropriate for an institution that has a public policy mandate and serves as a steward of public resources that report directly to the Riksdagen
- spread legal and governance provisions appropriately across the different legal, administrative and contractual instruments governing RB.

The above attributes reflect both our own thoughts prompted by the discussion at the workshop, together with our understanding about emerging practice generally since the GFC. The question that they lead to is the precise way in which they should be reflected in the RB Law.

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information not captured by simulations. Clearly the use of LAW strategies for financial stability purposes is only one of the prospective reasons for “leaning against the wind”. In this case the questions are 1) whether LAW is appropriate to this end and 2) whether there are other measures that should be used with it or in place of it. While decisions on the first question are among those that RB can and should decide upon, the second question is broader. RB may have a view and its analysis may be highly relevant, but clearly it cannot decide upon measures that are in the remit of others. Consultation and collaboration with others are therefore needed.

<sup>8</sup> These are i. macroprudential early warnings and vulnerability mitigation; ii. microprudential oversight of individual banks, firms and FI; and iii. preparations for recovery, resolution and crisis handling arrangements and operational handling of crises if they should occur.

## 2. How should RB's financial stability activities be most effectively and efficiently joined up with those of the FSA, NDO and FM?

This section of the report examines how RB's FS actions could be joined up with those of other authorities in a manner that is consistent with the regulatory architecture that provides separate authorities with the authority to decide on specific instruments bearing upon financial stability as a whole. In particular, it considers

- i. Should there be a **definition of financial stability and objectives** and, if so, what should they be?*
- ii. Could operation of **the FSC** be altered to make it a more effective instrument for joining up policy action?*
- iii. How should inevitable **conflicts of policy** be managed?*

Financial stability policy requires the use of a multiplicity of instruments, and its effectiveness depends in part on the choice of the suite of measures and on their calibration. Sweden confers 'ownership' of instruments to individual authorities. As such, each authority has the final say on the use of instruments under its control, though there is informal consultation and sometimes a legal obligation to inform or consult. Allocating responsibilities for particular measures across several authorities has the advantage of preventing concentration of power.

A challenge that arises in Sweden is how to join up the actions to ensure that measures taken by different authorities are coordinated, complementary and mutually re-enforcing, so that policy objectives are met in the most effective way. This requires reaching consensus on the analysis of the severity and nature of the risks and the most suitable combination of measures to address them. It may be possible to achieve financial stability objectives in such circumstances, even if each authority acts autonomously. However, given the fact that financial stability will be impacted by the collective endeavours of several autonomous authorities, questions will arise about whether the objective could be achieved more effectively and efficiently with a different combination of measures.

For example, in a situation of ebullient asset prices and rising levels of debt, the authorities may wish to act. A suitable cocktail might involve a combination of stricter prudential measures (stricter loan to deposit requirements, higher capital charges, etc.), monetary policy measures (adding on a FS premium to the target policy rate needed for price stability), fiscal measures (adjustment in the tax deductibility of interest payments), higher MREL/TLAC as a contingent precaution to provide resilience to be used in the event of a financial distress, etc. In the absence of a mechanism to forge consensus on an appropriate combination and calibration of such measures, the authorities may find themselves in a situation where they feel compelled to act individually, independently and potentially sub-optimally. For example, the central bank may decide to raise interest rates more than it would otherwise do if it feels that the prudential measures to secure FS have not been sufficient ("lean against the wind"). While there is no consensus about the advisability of leaning against the wind in the central bank community even in conditions when macroprudential settings are optimal, there is reason to think that leaning against the wind in a financial stability sense may be a poor substitute for choosing an appropriate mix of measures that are suitably calibrated. It may equally have an unknown impact on the reaction function of agents in relation to monetary policy objectives.

### Definition and objectives

At present Sweden has no explicit definition of financial stability and no over-arching objective relating to financial stability in legislation that could serve to join up the actions of the separate authorities whose decisions and actions bear upon financial stability. Having a common objective which would bear on all the relevant authorities would help to instil a sense of mutual endeavour where the relevant authorities are autonomous and have exclusive authority over particular instruments. The objective could be made concrete by setting out operational objectives for the different components of FS policy.



An example of a definition and overall objective is:

*Financial stability is a state in which there are no substantial discontinuities in the functioning of the financial system and in which it is able to withstand shocks without giving way to cumulative processes that may impair the allocation of savings to investment, the inter-temporal shifting of consumption, effective price discovery (of financial and real claims), prudent management of financial risk or the operation of the payments system of the economy.*<sup>9</sup>

Such a definition provides sufficient guidance to help determine what actions foster financial stability. It is both forward looking but rooted in the present and can be used to join up the efforts of individual authorities responsible for different tools which affect financial stability. The overarching objective would be to work towards financial stability.

Setting more specific, or operational objectives, which are designed to bear on all authorities contributing to financial stability, would help to operationalize the over-arching objective. These would specify key functionalities required to deliver policy in each of the component areas. In Sweden, the formulation of operational objectives is facilitated by the fact that each of the three component areas are primarily allocated to a single authority. However, to ensure the activities and contributions of all other relevant authorities are supportive, a means would need to be found to ensure that the other authorities have regard to them as well.

Examples of operational objectives might be:

For macroprudential policy ‘in the interest of attaining the ultimate objective [overall financial stability] the operational objective is to provide an early warning system, in relation to both conjunctural and structural issues, to identify, monitor and analyse risks and vulnerabilities in the financial system as a whole, to propose possible remedies and, subject to an agreed decision-making process, to ensure that these remedies are put into effect.’

For microprudential policy: ‘in the interest of attaining overall financial stability the operational objective is to (a) promote structural strength by ensuring high quality supervision of individual entities (b) take account of the systemic consequences of supervisory decisions relating to individual institutions, and (c) contribute to the maximum to the processes of macroprudential and crisis management policies.

For recovery and resolution policy: ‘in the interest of enhancing resilience and hence attaining overall financial stability, the operational objective is to be prepared for, (and have in place successfully tested arrangements for) handling swiftly, accountably and cost-effectively the activities involved:

- in peacetime
- early intervention and recovery;
- resolution of relevant banks, firms and infrastructure;
- agreement on triggers for moving into crisis mode;
- and, should crisis occur
- handling of resolution and crisis.

An agreed definition and shared overall objectives can help to foster a sense of mutual engagement towards a common purpose to support the production of a consistent set of policy measures. An advantage of setting objectives in legislation is that it provides a legally robust benchmark against which performance can be

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<sup>9</sup> From Framework for Financial Stability in Iceland (2012) [https://www.government.is/media/fjarmalaraduneyti-media/media/skjal/Framework\\_for\\_Financial\\_Stability\\_in\\_Iceland.pdf](https://www.government.is/media/fjarmalaraduneyti-media/media/skjal/Framework_for_Financial_Stability_in_Iceland.pdf)

gauged. In the absence of legislated objectives however, MoUs or other administrative arrangements can serve to articulate them. Please see sections 3 and 4 on accountability and legislation.

### Operations of the Financial Stability Council

In Sweden, as in many other countries, the Financial Stability Council (FSC) is a forum for the organized discussion of a set of FS topics.<sup>10</sup> Its origins lay in the crisis, which required close collaboration among the different authorities to decide on how to manage unexpected and potentially pernicious events. As in many other countries, it was thought that collaboration in peacetime would be worthwhile. Table 2 below gives some examples from different jurisdictions. Further information for central banks that are members of the ESRM will be found in Tables 9 and 10 of a report on the macroprudential roles of different authorities in [https://www.esrb.europa.eu/pub/pdf/recommendations/2014/ESRB\\_2014.en.pdf?600ec3fed1d5300e6a16ef0767b75cc5](https://www.esrb.europa.eu/pub/pdf/recommendations/2014/ESRB_2014.en.pdf?600ec3fed1d5300e6a16ef0767b75cc5)

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<sup>10</sup> See <https://www.bis.org/publ/arpdf/ar2018e.pdf> pp 70 to 71 for a discussion of roles and powers of FSCs in a range of countries. The most common purpose is discussion and coordination.



Table 2. Coordinating financial stability policy

Over the past decade, different countries have taken varying approaches to ensure that financial stability measures are co-ordinated in both normal times and periods of crisis. Typically, the central bank has been afforded a stronger financial stability mandate, sometimes in conjunction with the (re-)integration of banking supervision under the central bank's authority. The central bank is frequently designated the country's macroprudential authority. However, the trend has been to create an institutional focus of authority with influence to distil the views and mandated instruments of the various parties into a joined-up approach to mitigating vulnerabilities

In any case, the issue of policy co-ordination in the area of financial stability remains pertinent. The role of the central bank as lender of last resort often gives it a crucial role in preventing liquidity-driven defaults and contagion. In many countries, a financial stability council has been set up to co-ordinate, and sometimes enforce, macroprudential measures.

A well-known example is the Financial Policy Committee (FPC) in the United Kingdom. The FPC is chaired and hosted by the Bank of England, but has a majority of non-BoE members, including a non-voting member from the Treasury. The FPC has a broad mandate and is vested with both powers of direction and recommendation.

Denmark's Systemic Risk Council (SRC) was established to "monitor, identify and contribute to limiting systemic risks". The SRC is chaired by the central bank and has members from the supervisory authority, economic ministries and independent experts. The council has no direct decision-making powers but makes policy recommendations on a comply-or-explain basis. Neither Norway nor Finland have established formal councils but have bilateral or trilateral MoUs governing information-sharing and co-operation on financial stability measures between the authorities. In Finland, although the Financial Services Authority supervisor is a separate entity, making independent decisions in its supervisory work, its administration is connected with the Bank of Finland.

In France, coordination across institutions is achieved through the High Council for Financial Stability (HCSF), chaired by the Minister of Finance, with members from the other authorities. HCSF takes macroprudential decisions on proposals by Banque de France.

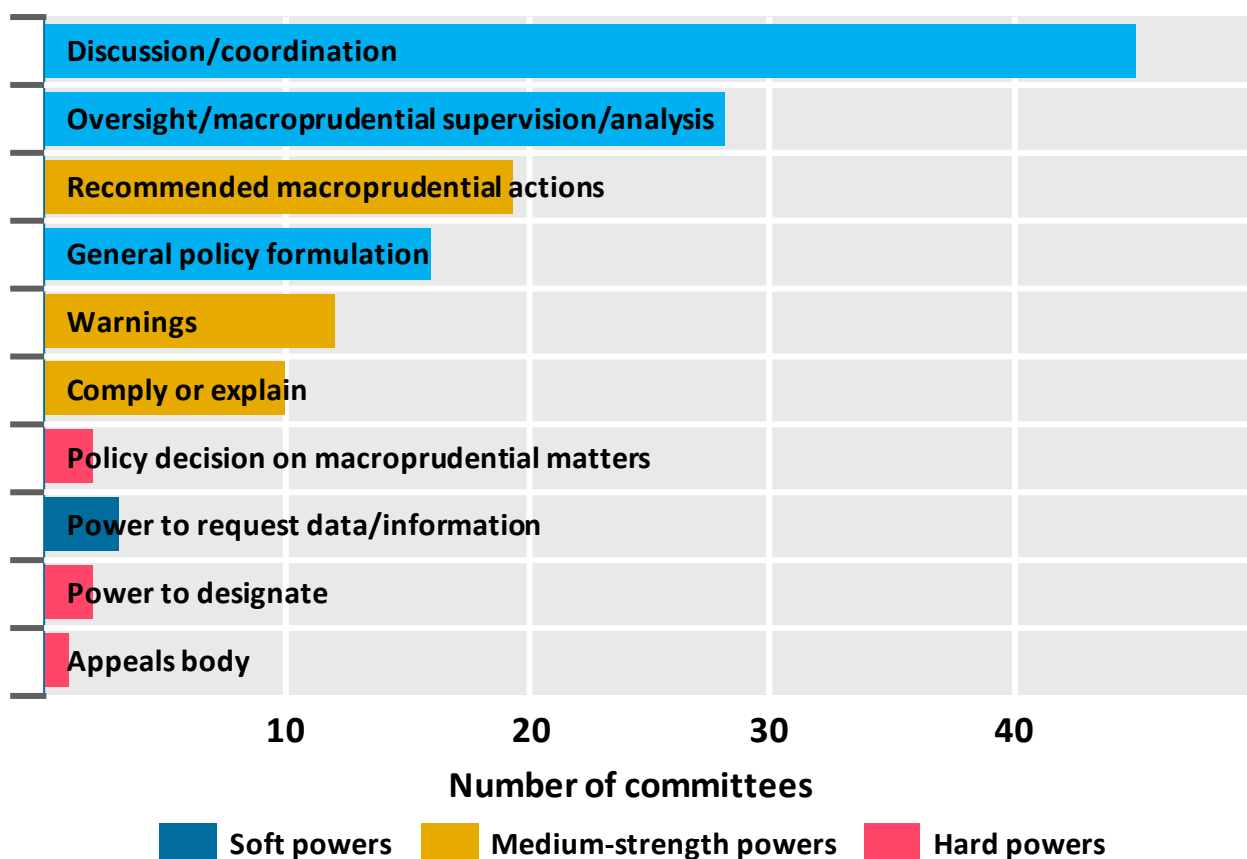
In Belgium and the Netherlands, financial stability is firmly within the remit of the respective central bank. In the Netherlands, De Nederlandsche Bank coordinates its actions with the Ministry of Finance and the Authority for the Financial Markets through the Financial Stability Council.

In Australia, the Reserve Bank of Australia [RBA] has primary responsibility for the maintenance of overall financial system stability, including stability of the payments system, and for providing liquidity support to the financial system or to individual financial institutions where appropriate. Responsibility for the regulation and supervision of the Australian financial system is vested in four separate agencies, the Council of Financial Regulators, which consists of RBA, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Australian Treasury. This non-statutory body's role includes promoting stability of the Australian financial system and serving as a coordination forum for assessing vulnerabilities and considering possible response options.

If RB is given an explicit financial stability mandate (ie. a duty or a right to contribute to the operational objectives of financial stability to financial stability, the FSC could be a suitable conduit for how it would be able to do so. Hence the effectiveness of the FSC is relevant for the revision of the central bank law, even if the operation of the FSC is not governed by this law.

The FSC affords an opportunity for the principals of the relevant authorities to meet regularly in order to discuss financial stability matters in peacetime. It does not have any powers over specific instruments or the power to recommend actions to those with control over the instruments. While the preparatory work for the meeting engenders useful interaction among the staff of the participating institutions, the agenda for the meetings is sometimes narrow and does not touch on all the policies, especially structural policies, relevant for FS. It does not aim to reach consensus on the nature and severity of the vulnerabilities and the sets of policies suitable for addressing them.

## Inter-agency committees have mostly soft powers



Source: BIS Annual Economic Report 2018. The survey covered 52 jurisdictions.

One question worth considering is whether the FSC should move beyond having a general exchange of views in the macroprudential dimension to considering the palette of measures which might be most effective in mitigating perceived vulnerabilities. The prerogative to decide would remain with those who control the instruments. The aim would be to achieve a commonality of views about the nature of the problem(s), the causes and the most suitable suite or mix of measures to deal with it. While EU provisions prohibit national central banks from taking instructions on monetary policy matters, there is nothing in EU legislation that prohibits consultation with others as regards the optimal choice of policy measures to reach other public policy objectives such as financial stability.

Such an approach would enable the FSC to act as a ‘focus for clearing ideas’. In preparing the meetings, staff from the participating institutions could contribute differential expertise and information. For example, analysis that the FSA should undertake as part of its responsibility for macro-pru could benefit from the macro analytical capacity of the Riksbank and RB could benefit from information at the disposal of the FSA on the condition of individual banks that the Riksbank needs for both monetary and financial stability purposes.

The FSC could discuss potential mixes or whether and which single instruments might be most effective. It could also consider how ‘soft’ communication-led approaches could supplement (and perhaps substitute) the deployment of hard instruments. The FSC could also gather information on the impact and effectiveness of measures taken. The experience of calibration would be of value to all the authorities in pursuit of their individual mandates and decisions on the calibration of future measures.

If a move in this direction was determined to be desirable, the following changes could be considered

- Clarify the mandate by providing a statutory basis for the FSC or revising the MoU
- Make the FSC more effective by laying down rules of procedures

- Make the agenda less formulaic and more focused
- Enhance support arrangements for FSC
- Extend the duration/frequency of meetings
- Rotate chairmanship from year to year
- Replace the two separate Financial Stability Reports with a single report issued under the aegis of the FSC

## Financial Stability Reports

Financial stability reports serve a variety of purposes. They provide information on developments in the financial markets; they provide a platform for the presentation of analysis of the factors shaping financial stability; they serve to bring to the attention of the readership potential sources of financial instability; they can signal the authorities concerns and portend policy measures; they can serve as a document of record, setting out accounts of discussions and decisions in financial stability councils; and they can present recommendations with respect to actions that will attenuate financial stability.

In Sweden both the FSA and RB publish reports in relation to financial stability. Each publication is consistent with their respective mandates. This fact and the fact that the FSC does not publish such a report, shapes the role that they play.

Having two reports helps to create a market place in ideas and diverse analysis and suggestions for policy action. Taken together they are also consistent with the advanced approach towards transparency in Sweden. However, there are downsides. Disagreement in public may not be a productive way to engender cooperation of authorities towards a common set of objectives. Once published, opinions often become entrenched and even if they are not, commentators may see genuinely defensible differences in analysis and assessment as antagonistic and evidence of competition amongst authorities. If there is disagreement in public on the analysis and the set of measures suited to dealing with the problem, it can both affect confidence in the capabilities of the authorities to foster financial stability and make it difficult to use statements of concern or intent as a soft instrument of power, signalling the intention to action if conditions do not change. France, whose Financial Stability Council's composition is similar to Sweden's, publishes a single financial stability report. They have used it successfully to signal concern about the commercial real estate market, thereby engendering behaviour that eliminated the need to act. Our own observation, based on experience elsewhere, would place weight on these latter arguments.

In conclusion, the question is how best Sweden could use the FSC as a forum for policy coordination without impinging on the autonomy of the participating institutions in decision making. Naturally, whatever choice is made may have implications for the wording of RB Act.

## Conflicts relating to policy

Conflicts relating to policy exist on at least two levels. There is the question of trade-offs between broad societal objectives of stability and growth or stability and efficiency. Such major questions need to be addressed at a political level. For example, questions of the trade-off between distribution of income and wealth and overall efficiency of resource allocation are the stuff and substance of the tension between socialism and capitalism. Equally conflict can and often does exist as to how safe the system is meant to be, given that this can impact growth on the one hand, and the potential for instability on the other.

Financial stability and efficiency are on the whole complementary. The financial system cannot effectively allocate finance in conditions of serious financial instability. However there may be trade-offs between the risk of financial instability and efficiency if financial regulation stifles innovation or raises the costs of doing business through draconian compliance controls. The choice of how safe the system should be is political in its essence. It is possible to reach the public good of financial stability by heavy regulation of the financial

sector. But then the public good of an efficient financial market at the same time might be hampered. Within that overarching political choice there is room for experts and technocrats to provide information relevant for decisions and to implement this political choice in an effective manner when it is made.

On a more operational level, conflicts can, and often do, arise between individual authorities involved in financial stability policy. These can relate to the choice of instruments, e.g. between the FSA and RB on whether macroprudential measures or interest rate measures are the most suitable or in respect to forbearance between going concern [FSA] and gone concern [NDO] supervisors. They can also relate to calibration and timing of measures.

Such conflicts can be dealt with in several ways. One is to achieve clarity about objectives and to put in place ways to work toward those objectives. If the objectives risk being in conflict, a hierarchy can be used to reduce or resolve conflicts amongst objectives. In central banking, this sometimes involves placing price stability at the apex, so that other actions are taken without prejudice to the primary objective. In some cases, conflicts among equally ranked objectives such as price stability and full employment can be resolved by adopting an appropriately long horizon or through cross membership in committees deciding on different matters. Another mechanism entails articulating the conflicts and discussing them collaboratively. Still another is for the authorities to take the decisions of other authorities as given or exogenous, as in the case of monetary policy's consideration of fiscal policy. In the case of financial stability policy, such an approach could lead to 'leaning against the wind' more often than would be the case where a collaborative approach towards meeting a mutually acknowledged set of vulnerabilities is adopted.

There are two main ways to approach this matter. The first involves adopting arrangements that foster collaboration. The second is for each authority to take the policy decisions of the other authorities as a given when making their own policy choices. If a decision were made to move in the direction of the former, the question arises as to how best to encourage such collaboration. One approach would be for the General Council, as part of its appointment process of the Governor and other members of the Executive Board, to make the capacity to work with others, including other authorities responsible for financial stability, one of the criteria for selection. This criterion is one the FM uses when selecting senior officials responsible for financial stability policy in authorities under its aegis. It would be useful if there were greater clarity about the weight of this criterion (as well as of others), and how it is applied in practice. The capacity to collaborate is difficult to gauge.

### 3. Independence and accountability

This section of the report examines questions of RB's independence and accountability, which are relevant to consideration of any changes proposed for the RB Act.

Independence for a central bank (or any public policy authority) is a means to permit effective policy delivery and the performance of mandated functions. Accountability arrangements are intended to ensure that objectives are achieved and functions performed in a manner consistent with principles of good governance including impartiality, proportionality and observance of due process. The two concepts are thus closely allied. This section considers two related questions that arise if RB is given a more explicit (and possibly wider) financial stability mandate:

- i. *Given the constitution and architecture **how can RB's contributions be made without trammelling its independence?***
- ii. *Given an explicit (and perhaps greater) role in FS **how should and can RB's accountability be changed?***
- iii. *Independence*

The case for the independence of **monetary policy** rests on several propositions. One is that short-term electoral considerations will lead to inflation if decisions on monetary policy are subject to political influence. Another is that there is a time inconsistency involved in monetary policy choices relating to for example the differences in the slope of the Philips curve over different time horizons.

The case for independence in the conduct of **financial stability policy** is broader. Of course it is possible that decisions by politicians relating to regulation and financial support for banks and other financial institutions will be influenced by electoral considerations. But independence from pressure from vested interests in the financial industry or pressure from those impacted by distributional effects is also important. For this reason, independence in the conduct of FS policy needs to be framed so that political, financial and commercial pressures do not distort decisions on public goods like financial stability, while recognising that decisions on such matters as the degree of safety and the use of taxpayers' money are political.

The case for **central bank independence in general** rests on the desirability of striking a balance between reliance on technocratic expertise in highly complex financial matters and making sure that decisions on broad societal questions are made in a manner that accords them legitimacy. Providing autonomy to a central bank or any other technocratic body such as a court of justice where expertise and impartiality are needed, is part of the process of providing checks and balances, the need for which is now clear in an age of increased populism.

In Sweden there is a strong preference for having semi-independent agencies that make decisions based upon legislation decided in a democratic manner by the parliament and/or government. There are of course, as in all liberal democracies, constitutional restrictions when it comes to the exercise of power and guarantees for the exercise of rights as well as a system of checks and balances, including the judiciary system, public service media and the National Audit Office. RB enjoys some protections (e.g. prohibition on seeking or taking instructions in monetary policy) in the monetary policy domain that other semi-autonomous authorities do not enjoy. These protections are mainly based on efficiency arguments rather than constitutional arguments.

RB's autonomy rests on three pillars: its constitutional position as an institution directly answerable to the Riksdag<sup>11</sup>; the body of EU treaty law that stipulates central bank independence in the conduct performance

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<sup>11</sup> This makes the Riksbank more autonomous in relation to the government than in most other parliamentary democracies. However in a parliamentary system this may be of less significance than would be the case in a presidential system since the government also needs to be tolerated by the parliament.

of mandated functions; and the self-financing nature of RB's activities. Taken together, these features make RB one of the more independent central banks.

The potential problem of concentration of power arising from RB's independence is dealt with by providing RB with a mandate that is more limited than that of many other central banks rather than setting out override powers or double-key decision-making protocols sometimes used in jurisdictions where the central bank is an instrumentality of the government and subject to a degree of control by the finance ministry. This may be one reason why RB's financial stability mandate is still implicit while other jurisdictions have in recent years given their central banks an explicit financial stability duties and rights.<sup>12</sup>

Another feature of financial stability policy that bears upon the question of RB independence is the fact that delivering it requires the use of a broad spectrum of measures that in Sweden are under the control of multiple authorities. Independent use of a subset of the instruments is unlikely to suffice; some form of linking up of all the policy actions is in our view needed.

### Swedish and EU provisions

Article 13 of Chapter 9 of the Sweden's Instrument of Government (constitution) provides for RB's independence in two ways. It stipulates that RB is an authority directly under RD and it states that no public authority may determine how RB shall decide in matters of monetary policy.

The Maastricht Treaty, as well as the Lisbon Treaty, which was ratified by Sweden on 10 December 2008, specifies what "independence" means. It states that both the ECB and national central banks (including RB) that are members of the European System of Central Banks (ESCB) shall not seek or take instructions from any EU institution, the government of Member state or any other body, and that these institutions, bodies and governments shall not seek to influence the ECB or national central banks in performing their duties under the Treaty and Statute.<sup>13</sup>

These two basic legal instruments both provide for RB's independence when performing monetary policy and the other tasks according to the ESCB statute and conceive of it in a similar manner (freedom from interference by government). However, they go about providing for independence in different ways. The Swedish constitution does so by making RB an authority under Parliament and therefore subject to similar (but not identical) oversight, accountability and check and balance mechanisms that apply to the Government.<sup>14</sup> Accordingly, Government cannot give instructions to RB and RB cannot give instructions to Government (and by extension, instrumentalities of government such as FSA and NDO). Beyond that it explicitly states the no public authority may give instructions to RB in matters of monetary policy but it makes no mention of RB's other duties.

The approach of EU legislation is different. It starts by setting a primary objective for the ESCB (Article 127 of the Treaty), which is the maintenance of price stability. It then states that the ESCB shall support general economic policy (which includes promoting financial stability), and then prescribes that the ECB and the ESCB shall be independent in the performance of its duties.

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<sup>12</sup> A duty is an obligation and an obligation is something that limits independence. A right is a privilege to be used responsibly by an independent authority. In any case, what is appropriate in the financial stability space is situation specific. In some cases a duty may produce better results; in others, a right.

<sup>13</sup> The exact wording is "When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks."

<sup>14</sup> Although RB has been an instrumentality of Parliament since its establishment in 1668, it was the legislative reforms of 1999 that made it independent. Before that the Riksbank's policy choices were influenced by politicians in important decisions on monetary policy, at least to the same degree as other semi-independent agencies in Sweden.

## Financial autonomy

The RB's financial integrity has a significant bearing on its independence and policy delivery capacity. Like almost all central banks, but unlike most other public policy authorities, RB contributes to the public purse instead of drawing on it. This is important for policy autonomy because he who pays the piper calls the tune. If the central bank were to be funded out of budgetary allocations, questions could arise about just how independent it is in its policy decisions.

Except in cases of hyperinflation and at or below the zero bound, the issue of the impact of policy measures on the balance sheet generally does not arise in the case of monetary policy. However, because the dividing line between liquidity support and solvency support is tenuous, a central bank's financial stability operations expose it to the risk of financial loss. Consequently, a central bank with financial stability responsibilities that involve financial transactions should have adequate resources. This can take the form of capital, reserves, unconditional guarantees or other processes for top up.

Central bank capital may be built up through retained earnings. In the Swedish case the trend decline in the use of banknotes has eroded RB's earnings as seigniorage then declines. Alternative ways may then need to be found to assure RB's policy integrity.

Sweden has on several occasions witnessed debates about large RBs financial buffers should be. Financial buffers serve as a mechanism to reduce the risk that conditions hampering the ability of the central bank to perform its function will be imposed during the process of recapitalisation or the provision of additional resources. The debate about the how large the financial buffers is partly a debate about how well girded RB's independence should be.

There are two ways in which such buffers can be provided. One involves holding resources on the balance sheet as reserves of capital or in the form of contingent claims on future earnings. The second is through reliance on state guarantees or recapitalisation commitments by the state. In the latter case the commitments should be iron-clad and statutory to reduce the risk that inappropriate conditions are attached to the provision of resources.

## Conclusion

A central bank's needs vary over time and are situation specific. In normal times, a central bank does not need significant financial buffers because its operations do not normally entail the risk of financial loss. Indeed, central banks have on occasion operated with negative equity. However, in periods of systemic stress, the need for on balance sheet buffers can increase sharply precisely at a time when the credibility of the government's implicit backing may be impaired. Having dedicated and earmarked financial buffers on the balance sheet helps ensure that the central bank can perform mandated tasks even in times of severe systemic stress.

## Accountability

Democratic scrutiny of RB is more immediate and direct than in almost all other jurisdictions. Unlike many other central banks which are instruments of the government, RB is solely answerable to the legislature. As such, it is subject to the direct oversight of elected representatives and not indirectly through governments.<sup>15</sup> Parliament delegates some of its oversight to the General Council. The role of the General Council and of Parliamentary committees warrant consideration when evaluating the accountability arrangements in the financial stability area. So too do the transparency practices that RB has adopted in the period since the current central bank act was passed.

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<sup>15</sup> See Tucker (2018) Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State

## Oversight by Parliament and the General Council

RD has two principal means of holding RB to account. The first is through the power of the purse. RD approves RB's accounts and decides on the allocation of RB's profits. The second is through the appointment of the General Council. With 11 members, the General Council proposes the allocation of profit to RD and is responsible for the appointment (and severance) of all of the members of the RB board as well as the Governor. The General Council also has an oversight function. The Rules of Procedure state "that the General Council monitors operations in the Riksbank. In this capacity, the General Council may request that members of the Executive Board present reports at meetings of the General Council." The GC meets at the Riksbank every month and gets detailed information about all important issues dealt with by the Executive Board. Internal audit, however, reports to the Executive Board.

## Transparency

In the years since the last central bank act was passed, RB has become far more transparent and ranks among the most transparent central banks in the world. There would be reason to ground existing practice in statute or rules of procedures laid down by the General Council, to ensure that it continues in the years and decades to come.

While the General Council has been successful in appointing knowledgeable members to the executive board, the process by which the decisions are made is not as well articulated or transparent compared to some other countries. For example in the United Kingdom, the positions are advertised and candidates are vetted by a Parliamentary committee in sessions open to the public before they are appointed. Similarly, in Finland, the positions are advertised and the candidates must apply to be considered. In the revision of the act, consideration could be given to making the process in Sweden more transparent, in line with the general predisposition towards transparency in the country.

## External reviews

Parliament currently commissions quinquennial reviews of RB. These provide useful insights on how to improve policy making. To supplement these reviews and to provide greater depth, the General Council could put in place external, independent reviews of specific aspects of RBs functioning. As the quality of the reviews depends upon the time and degree of interaction with Swedish officials, they could be designed to dive deeper in specific areas or a permanent unit, reporting to the General Council, could be setup. The IMF, the Asian Development Bank and the Government of India all have such units. Among central banks the Bank of England conduct independent reviews of their operations.<sup>16</sup>

## Options for consideration

Our observations would be that the following changes could be considered on whether and how to enhance RB's accountability arrangements and taking account of the constitutional position

- As discussed in Section 2, set out a precise definition of financial stability to be used in setting an overall objective for the jurisdiction as well operational objectives. These can be used by RD and the General Council in assessing policy delivery and should ideally bear on all relevant authorities.
- Reduce the size of the General Council from 11 to about eight. Smaller oversight bodies are often more effective.

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<sup>16</sup> An example of a recent report evaluating functions at the Bank of England will be found at <https://www.bankofengland.co.uk/report/2018/independent-evaluation-office-report-evaluation-of-the-boes-resolution-arrangements>.



- Establish independent support arrangements for the General Council as in Norway
- Commission deeper and more intense external reviews beyond the quinquennial reviews now practised.
- Create an independent evaluation office operating directly under the General Council along the lines of those of the IMF and the Bank of England.
- Increase the frequency and duration of hearings by RD committees.

## 4 How should the legislation be changed?

Swedish central bank legislation dates from an epoch where a different conception of central banking existed from the one that prevails today. It also of course reflects Sweden's legal, political and social conventions, including the absence of a supreme court that can adjudicate on constitutional matters and an aversion to the concentration of power. Both factors explain the shape of the legislation now in force.

This section therefore considers

- i. What lessons are to be drawn from **changes in the FS mandates of other central banks**?*
- ii. How should the **RB Act** be revised and with what degree of detail?*

Current Swedish legislation does not provide RB with any explicit financial stability mandate. Its activities in this domain are based on interpretation of various constitutional and statutory provisions, starting with the cautionary first article of the current act, which states that the RB can only conduct or engage in activities for which it has received authorization in Swedish legislation. There is no explicit statutory provision for the provision of liquidity to the financial system as a whole for financial stability purposes in peace time; RB would normally do this under the rubric of monetary policy. The statutory provisions on which RB's current FS operations are based are:

- Article 4 of Chapter of the Constitution gives the RB alone the right to issue banknotes and coins. This effectively empowers it to control liquidity as long as notes and coin, perhaps including digital central bank currency, remain the bedrock of payment and settlement.
- Article 2 of the RB law (1988:1385) states that the objective of RB's activities shall be to maintain price stability and that RB shall also promote a safe and efficient payments system. Again, these two objectives can be interpreted as giving the central bank implicit financial stability responsibilities since financial stability is a precondition for being able to conduct monetary policy and the payments system cannot be safe and efficient if the financial system is not stable.
- Chapter 6 relating to monetary and payments systems gives RB explicit powers to conduct financial operations needed to implement monetary policy and to exercise its payment system responsibilities. In addition, Article 8 of Chapter 6 gives it the power to lend to institutions supervised by the FSA "in support of liquidity". There is no mention of financial stability.

### Changes in central banks' FS mandates

In the decades since RBs current central bank legislation was fashioned, considerable changes have taken place in the environment in which central banks operate. For example, the single-minded focus on price stability that was the result of a period of prolonged high inflation worldwide in the 1970s has been tempered by a realisation that financial stability is just as important a public good worth pursuing. The financial crisis of 2007 to 2009 demonstrated just how high the costs of instability can be.

At the same time, and partly as a consequence of the independence given to central banks in the pursuit of price stability, greater attention has been given to the governance of these public policy institutions. There has been a trend towards providing them with clearer mandates. This has included giving them specific financial stability responsibilities and stating more clearly the circumstances and conditions in which they will provide liquidity including in times of crisis.

The US, EU and United Kingdom constitute prominent examples among the larger countries which have responded to these realities, but numerous examples can be found from among the smaller countries, rich and poor. In the US, the Fed has been given greater supervisory powers over systemically important institutions. In addition, the conditions under which it can offer ELA have been given greater specificity. In the EU, the ECB through SSM has been given greater supervisory oversight over systemically important banks and exercises macroprudential responsibilities together with the national central banks. In the UK

microprudential supervision has been brought back to the Bank of England, after having been hived off in 1989. In addition it has been given responsibility for macroprudential policy and for resolution.

Some of these changes have been wrought by changes in primary legislation, including the clear specification of objectives and delineation of the means to achieve them. Others involved interpreting existing legislation and reducing ambiguity through administrative process. In others, the changes have involved the adoption of new practices within the context of existing legislation. For example, the higher frequency of appearances by central bankers before Parliamentary committees has not required a change in legislation.

## Revision of the RB Act

The revised central bank legislation, whilst respecting the constitutional position and RB's independence, should provide RB with an explicit financial stability mandate. RB's actions in support of financial stability are based on interpretation of various provisions in the Constitution and the Central Bank Act that give it particular duties. However, while the legislation empowers or obliges RB to act, it does not specify the purpose of action.

*Purpose.* RB's mandate would be clearer and it would be easier to hold it to account if the purpose(s) for taking action in both normal and exceptional circumstances were stated. In addition to implementing monetary policy, one purpose could be contributing to the maintenance of financial stability. There is reason to make clear when and how the central bank should contribute and what it is working towards, by setting out a clear definition of financial stability and explicit objectives, both for financial stability in general and in relation to the operational objectives of each of the component areas.

If RB is given an explicit financial stability mandate, it would be useful to determine its relationship (subordinate or on a par) to other mandates, such as achieving price stability and or fostering efficiency. The language in the legislation in other jurisdictions sometimes provides such a ranking if only implicitly, by using such words as "supporting" or "contributing" to "promoting" financial stability. It is also useful to consider what instruments might be used to fulfil each the objective(s) and the circumstances in which they are used (crisis and/or peacetime) and how those circumstances are determined.

*Efficiency.* If fostering efficiency is made an explicit objective in parallel with contributing to financial stability policy, there needs to be clarity about what type of efficiency is in question. The broadest interpretation would be the overall efficiency of the Swedish economy in allocating resources. A narrower but still broad concept would relate to the efficiency of the financial system. More narrowly, RB could also seek to promote the efficiency of the payments system for which RB currently has a responsibility

*Determining trade-offs.* If there is no hierarchy or ranking of objectives, some mechanism for determining trade-offs needs to be put in place. The mechanism should specify who makes the decisions on trade-offs and how the decisions are made. The trade-offs between stability, growth and efficiency are broad and complex societal questions. The outcomes are affected by a raft of policies including those outside financial regulatory domain (e.g. education, immigration policy, etc). While these questions are complex, they should not be ignored so that the outcomes are the adventitious result of individual policies meeting particular objectives. Although explicit process to agree this is lacking in many jurisdictions, in democratic countries government and the legislature, representing the elected choice of the people, would expect to, and do, play, a role in determining the relevant stance. Regular hearings in parliament, open to the public, can contribute to this.

*Liquidity provision.* The current legislation is compatible with the Riksbank's provision of liquidity in a crisis (LoLR or debtor in possession financing) and in resolution as it states that the central bank can in "exceptional circumstances" take action "in support of liquidity" as long as liquidity is supplied to institutions supervised by FSA. However it is an open question whether generalized liquidity provision for financial stability does or should take place only in exceptional circumstances. There may be situations where such liquidity provision would be warranted to prevent a crisis. Under current legislation, RB can undertake a range of operations to

implement monetary policy that have a direct impact on liquidity in the system. Power to provide liquidity to the system as a whole for financial stability purposes is implicit.

Consideration should be given to making the power explicit and whether any conditions (eg subject to adequate collateral/guarantees being given which are provided in a manner that does not distort competition or constitute state aid under EU norms) should apply. Consideration should also be given to whether RB should have the power to provide liquidity to institutions that are not supervised by FSA or should have a role in determining the size of liquidity buffers of potential borrowers as this has an impact on the likelihood the liquidity support from RB will be needed.

*Other issues.* Although RB can and should be given a clear FS mandate when the current act is revised, it can be asked whether this is the appropriate legal instrument to establish an over-arching objective for all the authorities contributing to FS. In the absence of legislation, objectives can be agreed among the participating authorities.

In addition to the specific provisions relating to RB, there is the question of what other legislative or analogous changes should be made to ensure that the actions of all the relevant authorities (RB, FSA, NDO, FM) are appropriately joined up.

*Enhancing accountability.* Attention should also be given to accountability provisions. The ones relating to auditing and oversight of the accounts by Parliament should be retained. Consideration should be given to the role of both the General Council and transparency in the accountability process as discussed in section 3.

In all of these cases, there should be clarity about what contributing to financial stability actually means. One option is that this is a duty. The second that it is a right. Clarity on the intent will be needed for purposes of effective policy delivery and accountability.

## Conclusion

The revised legislation governing RB should provide **explicit** recognition of the central bank's role in contributing to financial stability contribution. This would be consistent with international practice that has developed significantly over the last 20 years, and it would bring RB into line with the FSA and NDO which have explicit mandates in this area. We are confident that this could be achieved whilst respecting the existing architecture for each of macroprudential and microprudential supervision, and the preparations necessary for resolution and crisis handling: and without undermining the essential constitutional features of independence of RB. We hope that the ideas in this Report will be of help to the Parliamentary Committee in considering the wisest way forward to foster continued financial stability in Sweden.

## ANNEX

List of those people with whom Systemic Policy Partnership engaged over the period of the project:

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### **Committee on Finance**

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### **National Debt Office**

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### **Commission Reviewing Riksbank Act**

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Susanna Engdahl, Secretary of the committee of inquiry on the Riksbank

Eva Forssell, Secretary of the committee of inquiry on the Riksbank

Göran Hjelm, Secretary of the committee of inquiry on the Riksbank

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Niklas Schüllerqvist, Secretary of the committee of inquiry on the Riksbank

### **The Riksbank**

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