SPEECH

DATE:	2010-04-15
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The importance of being savvy - lessons on European crisis management

Crisis management is messy, time-consuming and costly.

Thank you for inviting me to this renowned institute. My talk today will focus on crisis management. I have seen enough crises to be able to draw a conclusion or two from them. I learned my first lessons from the Swedish banking crisis of the early 1990s. After this I worked at the IMF, assisting in crisis resolutions in many parts of the world. During my time at the IMF, I also benefitted from discussions with a Spanish colleague of mine - Aristóbulo de Juan. His experiences from dealing with the Spanish banking crisis of the 1980s, working at the resolution authority – Fondo de Garantía de Depósitos – proved a valuable source of knowledge and inspiration.

As you all know, the IMF is located in Washington. And working there, you not only learn about crisis management, but you also pick up a few local habits. For instance, Washingtonians like to use the word 'savvy' - it sort of means being a bit cunning and perceptive. On reflection, being savvy pretty much sums up how you should behave when handling a crisis.

Lately, a lot of attention has been given to preventing the crisis we have just experienced from repeating itself. Given the huge bills we, as taxpayers, are facing, that is very understandable. I welcome the ongoing discussion and many of the regulatory tools and changes that are being introduced. But while many of these new preventive tools – such as heightened capital requirements and liquidity regulation – will strengthen the resilience of the financial system, we can never completely eradicate the risk of a financial crisis.

Also, over time, people either tend to forget or to put too much faith in some new remedy. This time, sophisticated risk management techniques and new models of financial intermediation fostered complacency among investors and regulators. Everyone seemed to believe that history would not repeat itself. But it always does. Regardless of the preventive measures we introduce, crises will reoccur.

And when they do, you need to act effectively and swiftly with the regulatory framework you have at hand. Today, I am going to focus on what I see as the core principles of effective crisis management. I am going to give you some examples of what I see as good crisis management, but I will also show the detrimental outcome that may result when these core principles are violated. In addition, I will also touch upon how regulation may facilitate - but sometimes also hinder - the application of these crisis management principles.

One of the lessons I have learnt is that resolving a financial crisis takes time. It is a messy process and it costs a lot of money. Therefore, to handle a crisis effectively and minimise its detrimental effects on the overall economy, you need to stick to three basic principles: firstly, cooperate; secondly, act swiftly; and thirdly, be economically savvy. This holds true regardless of what caused the crisis, and regardless of the solution. Let me explain to you in more detail, starting with the first principle.

Principle 1: Cooperate

Without cooperation between central banks, supervisory authorities and finance ministries, there is no such thing as effective crisis management. There are several examples of situations in which inadequate or failed cooperation has resulted in a deepened and prolonged crisis.

In fact, we recently experienced such a cooperation failure in my country, with the situation concerning Swedish banks operating in the Baltic countries. We, at the central bank, saw the build up of risk as problematic and believed that remedial measures should be applied. We also pointed to these problems in our Financial Stability Report. In retrospect, we should have been clearer, especially regarding the potential consequences of these problems. But more importantly, we failed to reach agreement on this with the authorities in the Baltic countries and with our own Swedish supervisory authority (as you may know, we have a separate supervisory authority - in contrast to Spain, where supervision is undertaken under the umbrella of the central bank). I am not pointing a finger at any particular authority in any particular country – let me be clear about that. But I firmly believe that if we had cooperated better, our countries would probably not have been as severely affected by the global repercussions of the credit crunch.

To avoid this kind of cooperation failure, you need a clear division of roles and responsibilities. You need to share information and coordinate your actions. And to manage a crisis effectively, you need to be prepared. This requires planning ahead. By establishing, in normal times, what is usually referred to as a Domestic Standing Group - bringing together the supervisory authority, the central bank, the finance ministry and perhaps certain other relevant authorities – you can enhance preparedness by developing suitable crisis management tools and routines. Creating recovery and resolution plans together with the banks is another productive approach. By conducting crisis simulation exercises, you can also test these tools and plans on various possible crisis scenarios.

However, as banking is becoming increasingly internationalised, merely cooperating within your own country will not be enough. Cooperation must also be extended across borders. This is particularly true for countries whose banking sectors have a high degree of cross-border activities. Spain and Sweden share this characteristic, despite the fact that banks in our countries run their cross-border activities in very different ways.

But cooperating across borders is difficult. There are all sorts of reasons for this. To mention a few, legal barriers, political pressure or even language and habits may all prevent fruitful exchanges between countries from taking place. During my years at the IMF, I have seen this pattern repeat itself – and it is not a pretty sight.

In Europe, we face a particular and somewhat peculiar cooperation problem. This is sometimes described as the trilemma of banking supervision. A trilemma is similar to a trade-off, and means that you want to pursue three objectives but you can only achieve two of them. One needs to be given up. The three objectives in this context include, first of all, effective banking supervision and crisis management, secondly, national sovereignty of supervision and crisis management; and, finally, an integrated European market and all the benefits coming from more competition.

In the EU, we have chosen the latter two – economic integration and national sovereignty of supervision and crisis management. This national sovereignty is manifested in what is known as the home country principle, meaning that the supervisory authority in the country where a bank is domiciled takes complete responsibility for the supervision of its branches abroad. This home country principle is combined with economic integration and allowing banks to establish operations across Europe. In choosing these two objectives, the third objective - effective supervision and crisis management - has been forsaken.

This is clearly manifested in Europe's current approach towards supervising banks and managing crises. Economic integration and the EU's pursuit of a single market for financial services have meant that some banks have expanded beyond the means of their home countries. In addition, this expansion has also fostered the development of complex banking structures and, in some cases, unsustainable business models. The Icelandic banks are illustrative examples in this respect, attracting depositors' money from the UK and the Netherlands and investing these funds in high yield structured products overseas. When their balance sheets had grown to around ten times the size of the Icelandic economy, it was quite clear for anyone to see that, if turmoil broke out, managing the situation was not going to be easy. But to be fair, it was difficult to anticipate the perfect storm in advance. Another lesson from this – and the strenuous and protracted negotiations between Icelandic and, primarily, British politicians that followed - is the need for establishing deposit guarantee schemes that are built up before a crisis occurs.

The international expansion of banks and the home country principle have also had other effects on crisis management. Authorities have simply not kept up with developments in the banking system. Contingency arrangements between home and host countries are not highly developed and neither are there any concrete suggestions for how to share the costs of a crisis. While we have achieved economic integration and maintained national sovereignty, we have renounced effective supervision and crisis management.

But national sovereignty does not mean that our hands are tied. The remedy is quite simple, at least on paper: we need better and more extensive cooperation between supervisory authorities, central banks and finance ministries in Europe. This is the only feasible option. But how does one accomplish this, in practice?

In fact, we have already taken the first steps. In 2008, the supervision authorities, central banks and finance ministries of the European Union signed a Memorandum of Understanding aimed at improving cross-border cooperation.

This European memorandum encourages Member States with common banking groups to enhance crisis preparedness by developing permanent cooperation structures. These cooperation structures, or so-called Cross-Border Stability Groups, should include a clear division of roles and responsibilities between the authorities and ministries. They should share information; discuss potential problems and solutions; and establish procedures on how to coordinate actions in a crisis. Over the longer term, such cooperation may also make it clear to the authorities involved that legal and regulatory harmonisation is a good thing.

That looks good on paper. But the proof of the pudding is in the eating. Despite the fact that all EU Member States signed this memorandum almost two years ago, cooperation between authorities in different European countries remains limited. For instance, as far as I know, only one Cross-Border Stability Group is presently being established. I am quite proud of the fact that the Swedish finance ministry, the supervisory authority and the Riksbank - together with the other authorities and ministries in the Nordic and Baltic countries – are among the signatories. This Nordic-Baltic stability group has a clear governance arrangement and a comprehensive list of responsibilities. This certainly enhances our preparedness for managing a crisis in any of our common international banking groups. And this will hopefully help us to avoid the type of situation I described earlier, when we failed to take remedial action to prevent the build up of risk in Swedish banks operating in the Baltic countries.

But our Nordic-Baltic Cross-Border Stability Group was not built in a day. We have, in fact, held productive exchanges between our countries for years. One milestone was the Nordic-Baltic crisis management exercise we ran in 2007. We based this exercise on the scenario of a major crisis in a cross-border Nordic bank. By trying to handle an imaginary crisis using actual banks, and applying the institutional and regulatory structures of the different countries, we learnt many lessons on how to overcome stumbling blocks and clarify the distribution of roles and responsibilities.

So what I am trying to say is that establishing a well-functioning cooperation structure takes time. So for those countries that have not done so, I recommend an immediate start. And do not be dissuaded by the fact that it is time-consuming. It is this process - leading to closer cooperation - that builds trust between the authorities involved. And when it comes to crisis management, this trust is the glue that holds everything together.

Had we had better cooperation and a reasonable level of trust between the authorities concerned, I am convinced that many of the recent European cross-border banking failures would have been handled very differently. For instance, in the Fortis case, I doubt that Dutch and Belgian ministries would have broken up the bank along national borders, in an instant probably destroying vast economic value. The Icelandic case could also have turned out differently, had there been better cooperation with British and Dutch authorities. With frequent interaction with its foreign counterparts, the inertia of the Icelandic supervisory authority would have been unlikely. I could continue providing examples, but the point is that, in most cases, the outcome would have been very different – and far better.

For whatever reasons authorities and ministries have not cooperated across borders, there is no excuse anymore. We need better coordination. And setting up a Cross-Border Stability Group is an important step in the right direction.

But, despite all its virtues, cooperation does not always work. Legal barriers, political motives and cultural clashes may all inhibit willingness to cooperate. I therefore believe the new European supervisory structure - currently being considered by the Council and the Parliament – is an important step in the right direction. Among other things, this new structure will include formal European Supervisory Authorities. These authorities will be equipped with a number of tools to use when cooperation fails: they will be able to mediate when supervisory authorities do not agree on supervision and remedies; they will be able to take action when national supervisory authorities neglect community law, and so on. In short, the European Supervisory Authorities will provide supervisory authorities with the means to question other Member States' supervisory practices and prudential decisions. Imagine what that could have meant for the UK, the Netherlands and Iceland in the Icesave case.

Of course, this new European supervisory structure means loosening up national sovereignty of supervision. But if we want more effective supervision and crisis management, it is either that or forsaking economic integration. And given the benefits the single market offers, I do believe you would agree with me that forsaking economic integration is not an option.

Principle 2: Act swiftly

The new European supervisory structure is also relevant for crisis management in other ways. Apart from establishing European Supervisory Authorities, it also includes setting up a European Systemic Risk Board. The role of this risk board is to monitor the more macro-oriented aspects of the financial system, seeking to identify the build-up of risks in the system as a whole – so-called systemic risk. The buzz-word is "macroprudential"supervision. And when such systemic risks are identified, the risk board delivers risk warnings and recommendations to the authorities in the country or region in question. For instance, a good set of first recommendations from the systemic risk board would be to urge certain European countries, including my own, to consider loan-to-value ratios and restrictions on foreign exchange lending.

Listening to such warnings may prevent a crisis from occurring. But even if a crisis is inevitable, being warned in advance will enable you to limit the detrimental effects of a crisis by starting remedial action early and taking action fast. And that is vital, because for banks, sunshine turns to rain quickly. Banks typically operate with so much leverage on their balance sheets that even a relatively small loss can wipe out much or all of their capital in almost an instant. This means that a bank that has a high and very satisfactory level of capital in one quarter can become insolvent in the next! We have a recent Nordic example of this - Capinordic. This Danish bank - with a branch in Sweden - stood at 33 percent capital adequacy in the third quarter of 2009. The next quarter, that capital had vanished. Credit losses consumed it all.

When a situation like this emerges, confidence tends to deteriorate fast. And when confidence leaves, funding follows. Capinordic was a minor bank and its problems had few repercussions in the financial system. But when a larger bank is in trouble, confidence in the entire system may evaporate. When that happens, contagion is already at work. Liquidity dries up. Banks and investors will be forced to sell, depressing asset prices, which triggers further sales. A systemic crisis is in full swing.

So, when the first alarming signs appear that something is wrong, markets will be watching. If you want to maintain confidence, you simply do not have the luxury of time. But even if you cannot hinder a crisis, addressing it as early as possible and with determination can at least limit its effects. So my second principle of effective crisis management can be summed up as acting swiftly.

While this principle is easy to support, crisis management in practice is often characterised by the opposite: taking too little action, too late. Essentially, there are two main reasons for supervisory and other authorities to neglect taking sufficient action in time – they lack either the willingness to act or the ability to act – sometimes both.

There are many reasons for supervisory and other authorities to not want to act. Pressure from the industry and politicians is one of the first that springs to mind. Sometimes – consciously or unconsciously – supervisory and other authorities also want to let banks gamble on turning themselves around. And banks and their shareholders are often more than willing to play along - they face a one way bet as they approach the brink of failure. But in the end, the longer you wait, the harder you fall. For that reason, I don't have a high opinion of regulatory forbearance or other excuses for supervisory inaction.

Ability to act may also be constrained. First and foremost, the ability to act is, of course, dependent upon the tools available. This partly concerns the tools enabling supervisory or other authorities to step in early to handle a crisis in an individual bank. But it is also valid outside crisis management – this is also a matter of the tools that authorities can use to address and counter systemic risks. Unfortunately, I think most European countries currently lack an appropriate set of tools in both these respects.

But even with the best toolbox imaginable, you also need timely information of high quality to exercise judgement and act vigorously. Having an accounting system that recognises losses early and fully is a prerequisite. Not all would agree with me on that. Some believe that not recognizing losses or delaying their recognition is better. To me, that is more like closing your eyes and hoping the problem disappears. Normally, it does not. And when you open your eyes again, the problem will probably have grown even larger.

Principle 3: Be economically savvy

When it is too late to prevent the crisis, you are left with two principal options for each failing bank. The first one is rather uncomplicated – you let the bank fail and wind it down using ordinary bankruptcy procedures. But while this option is uncomplicated, its consequences may not be – if you let a bank fail, you run the risk of unsettling the financial system.

The second option – intervening to save the bank in part or as a whole - takes a little more cunning. But let me be very clear about one thing - banks are not saved because they in themselves deserve to be saved. On the contrary, their managers and shareholders have usually played a decisive role in getting the bank into trouble in the first place. Some banks are saved because they are necessary for the real economy to operate. Actually, governments do not save banks, but rather the functions that banks provide to society.

But you can never be entirely sure in advance how the financial system (and ultimately the real economy) will be affected by a bank failure. In other words, knowing which banks to save and which ones to let go is complicated. You need to weight the costs of unsettling the financial system in relation to the costs of saving the bank. This is not an easy task. But despite the substantial uncertainty, you can be sure of one thing – whether you let a large bank fail or rescue it, either way you will incur substantial costs and I am not only talking about financial costs but also about social dislocations!

However, deciding to save a bank does not imply being spendthrift. On the contrary, being economically savvy is my third - and perhaps most important - principle of crisis management. So how does that principle manifest itself in practical actions? Thankfully, history offers us a number of both good and bad examples from which several useful lessons can be drawn.

The first lesson is to perform a thorough due diligence to clarify the extent of the problem in the troubled bank. But, in line with my previous principle, ideally you need to do this fast. Once you have a firm grasp of the bank's difficulties, its time to carefully assess your support options. This assessment will, of course, include direct costs, but indirect consequences for the financial markets and the overall economy should also be taken into account.

The second lesson is to opt for the least-cost solution. This may sound obvious, but many examples show that the lesson is not always heeded by decision-makers. In some cases, a least-cost solution means a state guarantee against losses on assets or a funding guarantee. But when that does not suffice, brokering a private solution – such as a takeover from another, sounder bank – is another option. This usually also includes some elements of guarantee in order to sweeten the deal for the acquiring bank. But guarantees may skew the incentive, so you need to tread carefully. Such skewed incentives are, in fact, good examples of the indirect costs you need to weigh in your assessment of alternative solutions.

If neither of these solutions is possible, you are simply left with one single option – injecting capital into the bank. Textbooks in economics typically describe the functioning of central banks as lenders of last resort. A paraphrase can be used to describe the role of states in banking crises – states have had to become owners of last resort.

But before the money goes in, make sure that the bank's managers go out. You simply cannot rely on the same people who jeopardised the bank in the first place. It is also a signal to the markets that things are about to change in the way that the bank is run. Of course, the bank should continue to be run on purely market-based terms, even though the state may become a major, or even the only, shareholder.

Another thing you must ensure, before you join the ranks of investors, is that the bank's assets are conservatively valued. Otherwise, you risk overpaying and instantly transferring taxpayers' money into the hands of existing shareholders. Diluting the owners' share of the bank – or, in some cases, even taking over the bank completely - also ensures an equitable upside for the taxpayers over time. And this is important, as capital injection does not mean permanent ownership.

The idea, of course, is to exit the bank as soon as this is possible in an economically justifiable manner.

A good restructuring plan turns the odds of such an exit in your favour. That is the third lesson. Profit maximisation should be the guiding principle in this restructuring process. Maximising profits, in turn, hinges on banking skills. So make sure the restructured bank is run by the most skilled professional bankers you can find! In some cases, to return to profitability and prosperity, the restructured bank will need to get rid of its most troubled assets. In the Swedish crisis of the 1990s, this was achieved by splitting the most troubled banks into a good part that we sold, and a bad part that we wound down and sold separately. If you opt for this solution, make sure that an independent asset management company, staffed with people with the right experience in handling troubled assets, runs the bad bank.

Profit maximisation also implies ensuring that the restructured bank is out of the reach of political influence. This is important for two reasons. Depositors and lenders of the bank may exert influence on politicians to run the bank in a manner that is favourable to them. This may of course compromise profit maximization. Also, public servants are typically not trained to manage banks. But apart from lacking the specific skills, there is also an obvious risk that running a bank will interfere with the regular operations of the public authorities, although these are probably not regular at all during a banking crisis

If you get these things right, you may secure that upside that I just mentioned. And you may recoup some (or perhaps even all) of the costs of the banking crisis. For instance, in the Swedish banking crisis of the 1990s, the government capital injections into the distressed banks rendered healthy profits for the taxpayers when (some of) that equity was eventually sold. Also, the independent asset management company managed to limit the losses on the troubled assets they took over from the Swedish banks. Something similar seems to be occurring right now in the UK. The British also applied the good bank-bad bank model in the restructuring of Northern Rock. While the good part of that bank is still in the red, the bad part looks likely to return to making a profit already this year!

So even though it is very difficult to assess all the direct and indirect effects of one particular solution in relation to another, those examples at least indicate that you can achieve better outcomes by acting economically savvy.

But following the principle of being economically savvy is important not only because recklessly spending taxpayers' money is irresponsible. It also serves other functions. One is combating moral hazard. Some people see the injection of state money as undue intervention, and look on it as a sign that you are abandoning the mechanism of private markets. Quite frankly, it signifies the opposite. To preserve the discipline in markets, it is important that shareholders and creditors are not allowed to walk away from a failure without suffering economic damage.

So, did investors and creditors suffer their fair share of the losses during the recent crisis? Unfortunately, my answer is "no". In many of the recent banking failures around the world, incumbent shareholders have maintained their ownership stakes or even remained in control of the bank. Creditors have enjoyed explicit or implicit guarantees. Thereby, public authorities have allowed moral hazard to prevail and a deficit of market discipline to arise in the banks. This problem must be addressed. And this is also what much of today's debate is all about.

One tool that could facilitate this is contingent capital – or dilution of ownership through contractually enforced debt-to-equity conversions when a bank runs into trouble. Such contingent capital can buy time or even reduce the need for governmental injections. No wonder this idea is currently being contemplated by banking regulators across the globe. The difficulty lies, however, in finding trigger mechanisms and other features that would cover a multitude of distressed situations while, at the same time, being difficult to game. Also, it is hard to see how contingent capital solutions would work for mutual banks and other forms of cooperatives, as these banks do not have common shares.

So, while contingent capital may reduce moral hazard and, in some situations, maintain a bank as a going concern, it is not a silver bullet. Some banks will fail in spite of their equity being propped up by the conversion of debt instruments. So there will still be a need for economically savvy behaviour by public authorities.

But when push comes to shove, such behaviour is very difficult to accomplish in practice. The main reason is that, in most jurisdictions, there are still significant shortcomings in the framework for the public management of banks in distress. Many governments are left with a general bankruptcy law as their only tool. For mutual banks and other forms of cooperatives, the toolbox is even more limited. Legal constraints also make it problematic to deal with banks in the so-called twilight zone – banks that breach the regulatory capital requirements but still remain legally solvent. Without specific and effective bank resolution schemes, it is often difficult to handle the distressed banks in an efficient manner, without simultaneously violating the legal rights of shareholders.

Even so, the crisis seems to have been a wake-up call for many regulators. For instance, in the aftermath of Northern Rock and other examples, the UK introduced a special resolution regime that facilitates a swift and efficient state takeover of banks.

Less messy, less time-consuming and less costly crisis management.

Unfortunately, most European countries do not yet benefit from having comprehensive resolution regimes. Establishing them is a lengthy process, so I urge countries without such schemes to act now. It is also important to take the opportunity and act while there is political will, in the immediate but very short wake of a financial crisis. In the Swedish crisis of the early 1990s, we clearly saw the need for a special regime for handling banks in distress. But it took us ten years to come up with a credible legislative proposal. And, by then, banks had returned to prosperity and the political window of opportunity had closed. Needless to say, Sweden still lacks a comprehensive special resolution regime for banks.

So, for those countries that have not already done so, it is high time to consider introducing new laws that enable a more effective handling of troubled banks. In order to facilitate the handling of failing cross-border banks, we must also ensure that the crisis management framework is sufficiently harmonised across jurisdictions.

By the time the next financial crisis hits us – which it will, sooner or later - such a framework will, hopefully, allow us to cooperate better and to act swiftly and with economic savvy. And that will be necessary to make crisis management less messy, less time-consuming and less costly.