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## **One year with the new macroprudential policy**

Hello and thank you for inviting me here to talk about macroprudential policy and the extended assignment that Finansinspektionen has been given. What is macroprudential policy, how do we conduct it and, not least, why is it important? These are the things I intend to talk to you about. Let me start with why.

### **Crises lead to changes in regulation and supervision**

In Sweden we suffered a banking crisis in the early 1990s. Finansinspektionen had just been created then by merging the Bank Inspection Board and the Private Insurance Supervisory Service. Following this crisis, a comprehensive review was made of the banking legislation in Sweden. The overall theme was that state measures should focus on safeguarding systemic stability. Finansinspektionen's instructions were amended in 1995 so that the overall objectives for its operations would be to contribute to the stability and efficiency of the financial system and to promote sound consumer protection.<sup>1</sup> So for Sweden, this idea of macroprudential policy in the form of acting to promote financial stability is nothing new, but rather it has been part of Finansinspektionen's assignment for 20 years now.

The most recent crisis reached its culmination when US investment bank Lehman Brothers collapsed in September 2008. Unlike the Swedish banking crisis, this was a financial crisis that swept across the entire world. The financial system was much more fragile than people had thought. Problems in one bank spread quickly and the banks had insufficient capacity to manage losses and liquidity shortages. Some countries were hit harder than others, but we in Sweden also learned an expensive lesson. Our major banks lost billions in the Baltic region and Sweden's GDP fell by around 5 per cent in 2009, the largest fall since the war year 1940. Homes lost their value, people lost their jobs and everyone was worried.

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<sup>1</sup> See section 2 of the Ordinance (1994:1538) on amending Finansinspektionen's Instructions Ordinance (1992:102). This amendment entered into force on 01/01/1995.

This was the largest international crash since the Great Depression in the 1930s, and it was obvious to all that changes were needed. The years following the financial crisis were therefore a period of producing new regulations – globally, within the EU and in Sweden – to cover the deficiencies the crisis had exposed. Similar to events in Sweden following the banking crisis, these regulations have meant that policy in many countries has put a clearer focus on systemic stability. Many states have extended their toolboxes and measures have been taken to strengthen the stability of the financial system. Higher demands on the banks' capital, larger liquidity buffers and new bonus regulations are all direct results of the regulations that have been introduced since the financial crisis.

### **Finansinspektionen's assignment has been extended**

Regulation and supervision are motivated by what economists commonly call market failures. A market failure means that a free or unregulated market is unable to attain an efficient use of resources in society. This could involve information asymmetries, that is, all agents do not have the same information. It could also involve external effects, that is, a transaction or a decision affects the utility for a third party in a way that is not reflected in the cost of the transaction or decision.

The classical example of an external effect is when a company pollutes the environment without paying for it. But this type of phenomenon can also be found in the financial sector. A clear example of an external effect is when banks take on major risks, that give them a high yield if they turn out well, at the same time as they can pass on the cost to society if they turn out badly. An example of information asymmetry is when consumers are to negotiate the interest rate on their mortgage with their bank, where the bank typically has more information on what affects the interest rate the consumer can pay.

Finansinspektionen is thus responsible now for macroprudential policy in Sweden. This was announced in autumn 2013 and has now been formalised in the instructions that govern Finansinspektionen's work. At the same time, we have had responsibility for financial stability for 20 years, that is, not just the supervision of individual companies. Unlike many other countries, the choice of us as macroprudential policy authority does not entail any major changes in principle. The main change for us is that we have been given the opportunity to invest greater resources in this type of authority than before. What is actually new for us is that we are at the same time to counteract financial imbalances to stabilise the credit market.

The assignment has been extended because history has shown that it is not enough to only act to promote financial stability in the sense that the financial markets can carry out their fundamental functions, which are mediating payments, converting savings into financing and managing risk. The financial market and financial developments have a broader impact on the economy than

this. An imbalanced credit market can cause problems for the economy through overinvestment and excessive indebtedness in some part of the economy, and through the subsequent restructuring of balance sheets this sooner or later necessitates. Such credit-driven excessive investment in real estate occurred in Spain and Ireland during the years prior to the financial crisis.

### **Macroprudential policy entails making decisions under uncertainty**

The research on macroprudential policy and financial imbalances is still at an early stage. There is thus not very much theory to lean on with regard to how to conduct macroprudential policy. Moreover, many of the measures have not been used to any great extent. This means that nor is there particularly much empirical evidence on the effects of various measures. One can liken this to navigating without a proper map or reliable compass.

Macroprudential policy is therefore to an unusually high degree a question of taking decisions under uncertainty. We will not have all the information before we have to take action. The strategy we have chosen is therefore to take one step at a time and to evaluate the effects of each measure before we take the next step if it is necessary. We are trying to find and deal with potentially major problems while they are still manageable. At the same time, we do not know exactly what effect our measures will have and if we act too strongly, we risk doing more harm than good. By taking measures gradually, we can analyse their effects and, if necessary, extend them or take other measures.

Taking macroprudential measures also entails a balance between financial stability and economic efficiency. Regulation involves increased costs, limiting competition or lowering the rate of innovation. For example, credit rationing could make the financial system stable, but not particularly efficient. The challenge for regulation and supervision is therefore to strike an appropriate balance between stability and efficiency.

### **An intellectual framework for the stability work**

Sweden has a large and interlinked financial system, with large banks that are all dependent on market funding. This is because Sweden is a developed economy. Swedish households have plenty of money, which they save or invest in a home. Their savings are more often in the form of shares than in traditional bank savings. The homes we buy are fairly expensive, which leads to a large banking system that has fewer deposits than loans. The banks therefore need to turn to the market for funding.

Part of their funding is Swedish pension money, but the banks also have foreign financiers. Moreover, the banks lend money to one another to cover or invest deficits and surpluses. They own one another's bonds, not because they want to provide one another with credit, but because they need to manage their own liquidity.

This gives the financial system certain properties that can cause problems when shocks or disruptions occur. We call these vulnerabilities. One such vulnerability is that Swedish banks are dependent on short-term market funding. This makes the banks dependent on maintaining investors' interest. Finansinspektionen is unable to prevent shocks or disruptions, like the Lehman Brothers fall, from occurring and when they do occur, they can create problems as a result of the prevailing vulnerabilities.

What we can do is to design regulations and exercise supervision that creates a good resilience so that the banks and other financial companies can manage such a disruption on their own. For example, we require that they hold liquidity buffers so they can manage if market funding becomes uncertain or even disappears for a time. And we require that the banks have sufficient capacity to cover losses for the risks to which they expose themselves and the system. None of these measures prevents new disruptions from occurring. But with a better resilience, the financial system can maintain its core functions, despite a change in financial conditions.

We are also to counteract financial imbalances. We have interpreted this to mean that the financial system should not create or aggravate fluctuations in the real economy to any great extent. At present, the problem primarily concerns household debt. International experiences indicate namely that households with a high degree of borrowing are more sensitive to changes in economic conditions. Households continue to pay off their loans even if their incomes decline. However, they are forced to cut back on other consumption, which can aggravate the economic downturn. It is now part of our task to also try to make households more resilient.

Measures aimed at counteracting financial imbalances mean that we touch on other policy areas. When we introduce measures with the purpose of stabilising the credit market, such measures will often have effects on the real economy and also in terms of the distribution of income. It is also the case that other public authorities may have better tools for managing a problem that we have identified. When this happens, we will raise the question where necessary.

Here the Financial Stability Council is an important forum as several authorities can meet and discuss problems and what measures are required to deal with them. However, this does not mean that either we or other authorities in the Council can disclaim responsibility from taking action on the assumption that some other agent will take a particular measure.

### **Our work in practice**

Macroprudential policy involves reducing the risks of the financial system being shaken or the financial system rocking the economy. An important factor is then to stay one step ahead and try to deal with the problem as quickly as

possible. This means that a decisive factor is how good one is at both finding and understanding what will cause problems in the future. Our means of working therefore has to be *forward-looking*. At the same time, macroprudential policy is not a question of becoming popular. If one looks for problems at an early stage, one will be regarded as someone who always questions things and asks difficult questions.

Another important factor is *decisiveness* when one detects a problem. Making decisions under uncertain conditions does not mean remaining passive, but beginning to introduce measures that gradually reduce the risks one sees. This applies to all forms of supervision, but it is particularly important to remember with regard to macroprudential supervision as we can rarely see the entire picture, and the consequences of not taking action often lie far in the future. But if we can see that the potential damage caused by not taking action can be very great, we must take action despite not having the complete picture.

Macroprudential policy requires a lot of strength, a belief in our ability and perhaps most of all professionalism. This is because these decisions often have major consequences for firms and households. We must neither be alarmists who are quick to take costly measures that are later proved unnecessary, nor be unconcerned and assume that all will go well. Interventions arouse fears, anxiety and in many cases anger among those affected. At the same time, it is necessary for all that we make these decisions to avoid greater dangers further ahead. One good example recently is when we introduced the mortgage cap in 2010. This decision was questioned by most at the time, but now many think we did the right thing.

A third factor is *clarity* in communication. Authorities responsible for macroprudential policy must adopt the way of thinking that communication is an important supervisory tool for managing and reducing risks in the system. By being more open about our stance, our way of thinking and by always signalling what risks we are concerned about, we can influence developments and sometimes we may be able to avoid the need for new rules. If our communication is to succeed, we must be seen as credible agents. This means both a clear mandate but also that the branch and agents have confidence in our analytical ability. People must believe what we are saying. And we must become better and talking about what we believe.

### **An example of our working method - household debt**

One area we work with a lot and which also functions as a good illustration of how we work on macroprudential measures is household debt.

Swedish households have substantial debts, mainly in the form of mortgages. At the same time, they have high incomes. But during the period 1995-2010, their debts increased faster than their incomes, which is reflected in the form of a rising debt-to-income ratio in this period. One important explanation is that

an increasing number of people own their own home. Previously, there were more rental properties that have now been converted to tenant-owned properties. A high level of household debt entails risks, primarily for the households themselves. Both financial crises and large macroeconomic adjustments mainly occur after a period when debts have increased much faster than incomes.

At present the debt-to-income ratio is around the same as in 2010. Growth in lending to Swedish households has been lower in recent years than it was at the beginning of the 2000s. This is an indication that developments are not so alarming. The fact that both the debt-to-income ratio and growth in lending have slowed down since 2010 can be partly due to Finansinspektionen having introduced a number of measures since then. First, the mortgage cap was introduced. Since then we have gradually raised the capital requirements for the banks to ensure they have the margins to cope with potential loan losses.

However, growth in lending has begun to rise again since the middle of 2012, and in a few years' time, rising housing prices and low interest rates may push up credit growth and the percentage of households with relatively high loan-to-value ratios even further. This could mean that vulnerabilities build up.

Most households who take out new mortgages make amortisation payments. The ones with the largest loans in relation to the value of their home always amortise in principle. On the other hand, almost every second household with a loan-to-value ratio in the interval of 50-75 per cent waits before making amortisation payments. This is a problem, as international comparisons indicate that households with loan-to-value ratios of more than 40-50 per cent can react particularly strongly to macroeconomic shocks. They do not stop paying interest and amortisation on mortgages. However, they cut back on a lot of other expenditure.

This can have major negative consequences for the economy as a whole and may aggravate economic downturns. To use economist language, this is an example of a market failure in the form of an external effect. The larger loan a household takes on, the deeper the next economic recession may be. An individual does not think about this, but if everyone acts this way, the risks for society as a whole increase.

If an unexpected event occurs, there is thus considerable risk that Swedish households with a loan-to-value ratio above 50 per cent will reduce their expenditure on consumption. Then it is worrying to see that the percentage of households with loan-to-value ratios higher than 50 per cent has increased in recent years, at the same time as many of these households are choosing to wait before amortising. This is why we have proposed introducing an amortisation requirement in Sweden. We want mortgage holders to be better equipped to face future economic disruptions. This will in the long run give households better resilience. The difficult balance here is once again not to do too much so

we create the problems we are aiming to avoid, but at the same time not to do too little so the risks escalate. We must therefore follow up the effects of the amortisation requirement, evaluate it and, if necessary, change it.

Our work regarding household debt has been going on for almost five years. I think that the way it has altered and developed captures well how macroprudential policy should function. During these five years we have first taken care of the acute risks we saw for households, where many were taking on loans that were too large, by introducing the mortgage cap. After that, we have improved the banks' ability to withstand credit losses by requiring that they allocate more capital for their mortgage lending. And now we have begun to manage the remaining risks for the Swedish economy, the macro risks, by requiring that households amortise more on their loans.

If we had tried to do all this at once, we would perhaps have created major problems. The housing market could have been put under considerable pressure and we would have created considerable uncertainty for both households and banks. Instead we have taken one thing at a time and introduced measures gradually. And if one looks at the results, they are positive. The housing market has not crashed, as some feared. And both households and banks have better resilience than before.

The actions regarding household debt also indicate another important lesson. That the most important thing is to have an identified target and a clear task, an understanding of the relationships and access to the right tools. The question of who has the responsibility is less important. It is sometimes claimed that the Swedish solution with an advisory body and a supervisory authority with all of the decisive power is a mistake. The claim is that it is not possible to delegate macroprudential policy to an authority like Finansinspektionen as we answer to the government and therefore would not dare to take the necessary measures. There is talk of an "inaction bias".

If one looks towards the rest of Europe, however, one can see that this is not true. Finansinspektionen has actually taken more macroprudential policy measures since the financial crisis than any other EU country. Nor does it appear as if the way responsibility for macroprudential policy is divided between the different authorities plays any major role for the actual decisions; the most important thing appears to be that there is a clear allocation of responsibility.

Thank you!