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ASSESSMENT OF FINCANCIAL STABILITY REPORTS:

SVERIGES RISKBANK

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Abstract

This paper analyses the financial stability report of Sveriges Riksbank, and is organized as follows:

- The first section deals with understanding the mechanism of financial stability, transparency in relation to financial stability and bank failure.
- The second section deals with a case study on issues related to the assessment of financial stability of the Bank of England.
- In the third section is included a research summary of the financial stability reports of Sveriges Riksbank.
- The fourth and final section includes a conclusion of the research efforts pertaining to financial stability assessment and the Sveriges Riksbank stability reports.

From this study, it can be concluded that it is important that Riksbank survey the activities of other Nordic countries with which it shares banking ties. It is also essential that public policy, how it affects the financial market and other institutions be held in high priority to ensure the health of Sweden's financial system.

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1. Assessment of Financial Stability by Central Bank: An Overview

It is integral that central banks continually assess financial stability on an annual basis as well as maintain a forward looking and optimal level of financial stability. The financial stability of Central Banks and the economy is assessed through financial stability reports which are prepared on an annual basis by a financial stability committee. This committee consists of advisors, economists and experts in the field of banking who are in a position to do a significant and thorough analysis of the central bank. Apart from the crucial objective of maintaining price stability i.e. controlling inflation, it is important that central banks maintain an overall and stable degree of financial stability. According to a study by the IMF about 130 of the 180 member countries suffer from problems related to the financial market since the 1980s and this problem had become even more pronounced since the Asian Financial Crisis especially with central banks located in that region.

1.1 Definition of Financial Stability

The concept of financial stability broadly means ensuring the strength and smooth functioning of all components within a financial system. It denotes the absence of stresses within the financial system to ensure that no harm is done to the economy at large and that the variations of prices within the economy are maintained at a manageable level.
Financial stability can be understood more clearly according to the following terms: [1]

- Ensuring stability of all components within the financial system.
- Ensuring stability of financial markets and related activities.

Another implicit, yet strategic, aim of financial stability is to prevent bank failure.

[1] Kaufman, George G (1998), "Central Banks, Asset Bubbles, and Financial Stability"

1.2 Maintenance of Financial Stability

Financial Stability is maintained by central banks within the economy through various measures to ensure stability of financial system components and stability of the financial markets at large. For example some of the measures adoptable by a central bank in tandem with maintenance of financial stability are as follows:

- Ensuring an integral safe and efficient payment system through effective use of technology and planning.
- Avoiding the collapse or disruption of the banking system which may be caused by asset bubbles or a contagion of inter bank or financial institution failure.
- Ensuring the stable functioning of related financial intermediaries such as insurance companies to avoid the ill effects of a financial contagion threatening the stability of the financial system.
- Mitigating the effect of international spillovers or financial crises to ensure that they do not affect the domestic financial system under consideration.
- Minimizing the collapse of asset prices within illiquid markets through timely and effective liquidity measures as the case may be relevant.
- Monitoring and combating risks in the financial sector which may arise from time to time due to strategic changes within the financial sector.
- Management or crisis within the financial system through the supervision of risks taken by banks and other financial institutions.
- Ensuring that the sound health of the economy and financial system are maintained during the time of financial crises

1.3 Transparency and Financial Stability

It is essential that a high degree of transparency within the financial system particularly with reference to the central bank be maintained in order to ensure a high degree of financial stability.[2] It is necessary that a powerful ex-ante communication of the central banks be available for public scrutiny. It is also necessary that specific information about firms and financial entities be released to ensure market discipline and prevent moral hazard. Also in the

[2] Gai, Prasanna and Hyun Song Shin (2003), "Transparency and Financial Stability"

event of the dynamics of asset pricing affecting the working of an efficient market, regular central bank intervention does help to play a role.

1.4 Causes of Bank Failure

A large number of studies come to the conclusion that the occurrence of bank failures is inversely correlated with business cycles i.e. increasing with recessions and decreasing with expansions. Benston and Kaufman, 1995; Bordo, 1986; Kaufman, 1994; Mishkin, 1997.

The main causes of bank failure are the following:

- *Irrational euphoria*: Banks often get caught in a heady cycle of economic expansion through credit in sectors that are subject to the greatest increase in demand and prices e.g. stock market and real estate. These loans are collateralized by assets and in course of time borrowers resort to short term debt. As a result the safety margin of borrowers pertaining to the servicing the debt repayment declines and approaches zero. Hence this leads to a piling up of debt responsibility which can lead to bank failure.
- *Prominent change in strategic macroeconomic indicators*: Banking crises are observed in most countries a number of months after declines in both aggregate output and the stock market and increases in real domestic credit and bank deposits.
- *Improper/Lack of Risk Mitigation*: It is important that various risks within the economy such as credit risk, interest rate risk, foreign exchange risk, liquidity risk, operational risk, legal risk, legislative risk and fraud risk be properly managed from time to time, if not it can adversely affect the bank leading to a crisis situation.
- *Prevalence of asset price bubbles*: Any prolonged inflationary increase in prices particularly in real estate or the stock market which is not combated through proper monetary policy measures can lead to a banking failure.
- *Insufficient capital structure*: A central bank with a weak, suboptimal or improperly managed capital structure can fail.
- *Excessive Leverage*: A central bank following a policy of excessive leverage i.e. indulging in too much of borrowing can pave the way for its eventual failure.
- *Improper management of short term losses*: If the central bank is not prudent to manage short term losses then that could increase the probability of a major financial loss in the future leading to potential bank failure.

1.5 Banking sector stability in the EU

The potential risks identified in the European Union Banking Sector are constantly large current account deficits, probably combined with more volatile short-term financing in the future, reckless financing of lending booms, increasing currency mismatches in the banking and corporate sector, substantial exchange rate volatility, and lagging legislation and supervision. [3] The risks as described above can be limited by the following measures:

- Benefiting advantage of the presence of foreign banks
- Maintaining current account deficits within limits
- Considering financial stability while determining exchange rate policies
- Guaranteeing the independence of the central bank and supervisory authorities
- Strengthening law enforcement.

Macroeconomic stability is identified as an important factor in permitting the stability of the banking sector as well as financial stability. A lack of macroeconomic stability can in fact weaken the solidity of the financial system. It is important that important macroeconomic indicators such as inflation and economic growth be well gauged otherwise it could lead to a wrong assessment of bank credit risk, in the financial stability assessment exercise. Financial regulation, supervisory independence as well as the import of sound advice from foreign banks can certainly contribute to EU financial stability.

[3] Brouwer, Henk , Ralph de Haas and Bas Kiviet(2002), "Banking sector development and financial stability in the run up to EU accession"

2. Assessing Financial Reports: Bank of England - A Case Study

In the assessment of stability by the Bank of England a wide range of potential early warning signals of crisis are assessed relative to some threshold values. In the event of any of these indicators crossing a threshold, an amber light is flashed flashing prompting the need for a detailed assessment of the risk. It has been observed that there is a growing amount of literature pertaining to the Bank of England's identification of potential leading indicators of financial stability as well as their interaction.

There is a considerable amount of work done pertaining to refining and extending the list of indicators routinely monitored by the bank to ensure financial resilience as well as health of the financial sector. A large number of studies have been conducted pertaining to the evaluation of output or fiscal costs of banking as well as currency crises. A significant number of studies have been observed also pertaining to the evaluating the welfare costs of inflation. However with reference to the Bank of England there seems to be little literature pertaining to the trade-off between financial stability and financial efficiency.

The Bank of England is currently investigating methods to improve the quantitative calibration of financial stability risks.[4] The Fan Chart for example, based on a subjective probabilistic assessment of the inflation outlook is based on a macroeconomic model and draws on a wide range of information, including market expectations, surveys and policymakers' judgment. It is used to summarise inflations as is observable in the Banks Quarterly Inflation Report.

[4] Haldane, Andrew G, Glenn Hoggarth and Victoria Saporta(2004), "Assessing financial system stability, efficiency and structure at the Bank of England"

3. Assessment of Financial Stability: Sveriges Riksbank

It is important for the financial system to be stable as it fulfils a number of functions that are essential to society. The three most important functions are usually said to be:

- Converting savings into financing,
- Managing risk and
- Supplying efficient means of payment.

If any of these functions suffers a serious shock, the costs to society can be considerable. According to the Sveriges Riksbank Act, the Riksbank shall "promote a safe and efficient payment system". The payment system covers the entire infrastructure of marketplaces, institutions, payment instruments and the technical and administrative systems used to make payments and transfer securities.

3.1 Responsibilities of the Riksbank in assessing financial stability

The Riksbank has been given responsibility for this task because:

- It is the authority in Sweden that issues banknotes and coins, and
- It acts as banker for the other banks in the commercial system.

It is important that payments can be made safely and efficiently to enable the economy to function smoothly. The smoother and safer the transactions are, the lower the costs and the risks in producing goods and services will be. This benefits growth and employment in the long term.

A necessary condition for a safe and efficient payment system is that there is stability in the financial system as a whole, especially among the financial institutions supplying payment services. The fact that the stability of the financial system may sometimes be threatened is clearly exemplified by the Swedish banking crisis at the beginning of the 1990s. The government was then forced to intervene at short notice to save the banking system from collapse.

The financial system has become increasingly complicated and difficult to monitor. At the same time, society has become more vulnerable to shocks linked to financial markets and financial institutions. This means that it has also become more important to understand the risks and threats to the stability of the financial system. The Riksbank works in many different ways to promote stability in the financial system.

The Riksbank has been an innovator among central banks, concerning financial stability issues. It was the first central bank to publish a separate financial stability report in 1997 and has also put in place, procedures to deal with a crisis.

3.2 Action Plan of Riksbank to avoid a financial crisis

Among the actions that the Riksbank can take relating to a financial crisis, are the following:

1. *Ensure the integrity of the payment system*: The mandate of the Riksbank is to promote a safe and efficient payment system. This includes ensuring that the technology of the payment system is as reliable and effective as possible, by minimizing operational risk.
2. *Avoid disruption or collapse of the banking system*: In some crises, it is possible that some banks may go bankrupt altogether as a result of real estate or stock price bubbles.
3. *Ensure the stability of other financial intermediaries*: Banks and other financial intermediaries such as insurance companies, pension funds, mutual funds, etc, are linked through many transactions and the disruption of one part of the financial system can spread to other parts.
4. *Mitigate the effects of international spillovers*: As some Swedish banks are heavily involved with other Scandinavian countries, it is possible that financial crises in these countries could spill over into Sweden.
5. *Minimize asset price collapses in illiquid markets*: If there are many asset liquidations in illiquid markets, then asset prices may fall drastically, causing bankruptcies and liquidations.
6. *Monitor new risks*: Due to innovations and the changing structure of the financial system of the country, crises can arise from different causes. Central banks and regulators must be vigilant for potential threats and risks to the economy.

7. *Crisis management*: It is important that the Riksbank and regulatory bodies have an understanding of how to react in crisis situations. It is advisable to have procedural guidelines on how to react during a crisis, so that in a crisis, the damage can be minimized.
8. *Ensure the robustness of the financial sector and the economy when the crises occur*: A long run objective of the Riksbank should be to ensure that the financial and real sectors can withstand shocks with as little disruption and cost as possible, and that policy

The framework must be structured to minimize damage through the supervision of banks and other financial institutions.

3.3 Riksbank's Methods of Promoting Financial Stability

The Riksbank's methods of promoting financial stability can be summarised as follows:

- *Stability analysis*: The Riksbank makes regular analyses of the risks and threats to the stability of the financial system. Twice a year the Riksbank publishes its assessment of stability in the Financial Stability Report. The analysis is largely focused on systemically-important institutions, primarily the major banks, and on the financial infrastructure in the form of the large systems for payments.
- *Oversight of the financial infrastructure*: The Riksbank also has a more direct oversight task with regard to some of the technical and administrative systems used for payments and the transfer of securities. The purpose of these is to reduce the risks and increase the efficiency of the system's design. This entails, for instance, making assessments of whether the systems comply with international standards. The Riksbank also operates the Swedish central system for interbank payments, RIX.
- *Preparedness for financial crises*: The Riksbank's task of promoting a safe and efficient payment system means that the Riksbank must be prepared to manage a potential crisis in the financial system. This work is done in co-operation with other authorities, both Swedish and international.
- *Influence*: The Riksbank is also active in bringing about a sound regulatory structure both in Sweden, and internationally. This is achieved through participation in various international regulatory bodies, as well as in opinions expressed in consultation on draft

legislature. The Riksbank also takes part in the public debate, through speeches and articles.

- *Dissemination of knowledge*: The Riksbank attempts to contribute to increased knowledge of the financial system and its functions. This is achieved through publication of the brochure "The Swedish Financial Market", through lectures and through research.

3.4 Financial Stability Report of Riskbank

An important task for the Riksbank is to regularly monitor and analyse risks and threats to the stability of the financial system. The Riksbank's overall assessment of stability is published twice yearly in the Financial Stability Report. The purpose of the analysis is to detect at an early stage any trends or vulnerabilities that could together lead to a serious crisis in the Swedish financial system. [5]

The major banking groups are a key element of the analysis. They are central participants in the financial system in general and in the payment system in particular. This is partly because the banks implement various payment services and supply the accounts through which many payment transactions are made. A very large part of the analysis therefore concentrates on overall developments in the four major banks, Föreningssparbanken, Nordea, SEB and Svenska Handelsbanken.

This entails both an analysis of the developments within the banks themselves and of the ability to pay among their main borrower categories – the household and corporate sectors. As a large percentage of the loans granted by the Swedish banking groups have property as collateral, developments in the property sector comprise an important part of the analysis. The report also contains an analysis of developments in the financial infrastructure – the system of instruments and technical and administrative systems that constitute the circulatory system of the Swedish financial sector.

[5] www.riksbank.com

Conclusions

The assessment of financial stability remains a crucial and indispensable task for every central bank. Some of the important methods employed by a central bank to maintain financial stability-

- Ensuring an integral safe and efficient payment system through effective use of technology and planning.
- Avoiding the collapse or disruption of the banking system which may be caused by asset bubbles or a contagion of inter bank or financial institution failure.
- Ensuring the stable functioning of related financial intermediaries such as insurance companies to avoid the ill effects of a financial contagion threatening the stability of the financial system.
- Minimizing the collapse of asset prices within illiquid markets through timely and effective liquidity measures as the case may be relevant.

Assessment of Riksbank Financial Stability Reports:

The Riksbank's objectives are very broad and indefinite in their terms. They should, instead, be explicitly stated, as are the Bank of England's in its Financial Stability Report, so as to make the Riksbank's role in undertaking its responsibilities relating to financial stability very clear, as well as to acknowledge that the Financial Stability Report serves as an accountability instrument.

- The Financial Stability Report does not carry information relating to the other financial intermediaries in the payment system, such as pension funds, insurance companies, mutual funds etc. In many other countries' Financial Stability Reports, the insurance sector and other parts of the financial system are also analysed. These entities are also important players within the financial system, and as mentioned earlier, a disruption among these entities can spread to the rest of the financial system and therefore, their stability must also be carefully monitored.
- Finansinspektion is proactively involved with monitoring stability issues in the banking and insurance industries. It is advisable to develop a close cooperation between Riksbank and Finansinspektion so that Finansinspektion can provide information about other

entities in the financial system which could possibly be integrated into the Financial Stability Report.

- Developments over the past five years, with the Swedish banks increasingly investing abroad, have meant that a substantial percentage of their borrowers are in other countries – mainly in the Baltic[6] region. This means that the Riksbank's analyses cannot focus exclusively on Sweden; they must also take into account developments in, for instance, neighbouring Nordic countries. Therefore, an analysis of regional economic conditions in the Scandinavian and Baltic countries, with which Swedish banks have close economic ties, might be desirable to include in the Financial Stability Report, as these have a high degree of relevance to the Swedish economy.
- The vulnerability of the financial system also depends to a great extent on public policy, as the policy framework affects institutions' behaviour and decision-making processes, and it is advisable to include information relating to this.

[6] Speech by Governor Lars Heikensten, 16 November 2004

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