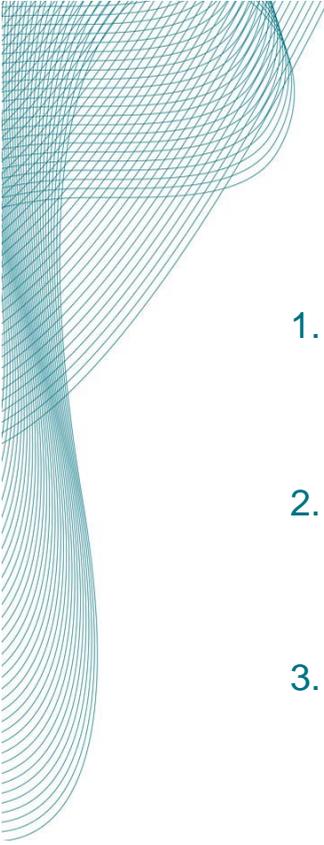




Some regulatory and supervisory lessons from the financial crisis

The Financial Market Crisis - Causes, Remedies and Prevention
Frankfurt 22 October 2009

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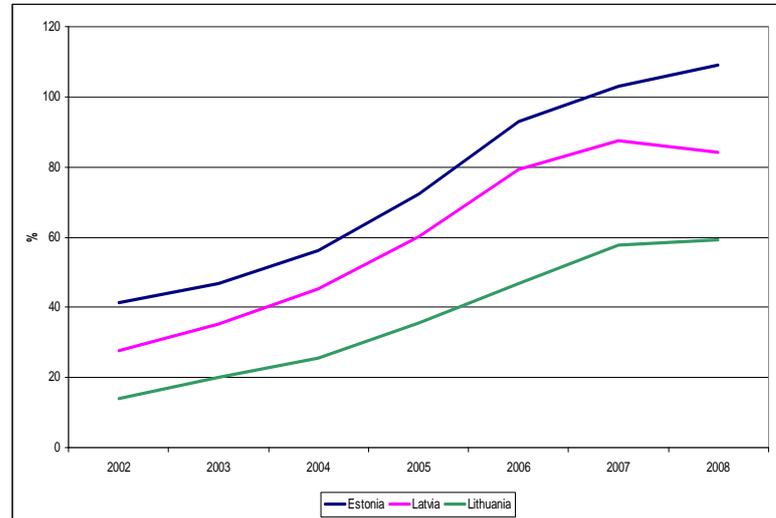
A taxonomy of supervisory and regulatory lessons

1. Unbalances we observed, had the tools to handle, but did'nt react to
→ **Requires a new supervisory culture**
2. Problems we faced and lacked the legal basis to deal with properly
→ **Requires regulatory changes**
3. The risks we simply did'nt understand
→ **Requires both**

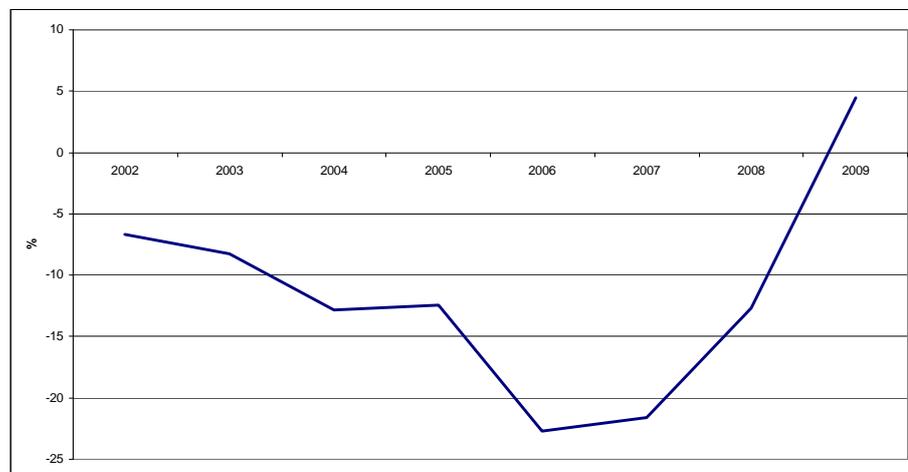


1. Unbalances we observed, had the tools to handle but didn't react to

Household plus corporate debt as percentage of GDP in the Baltics



Current Account Balance for Latvia Percentage of GDP



Source: International Monetary Fund

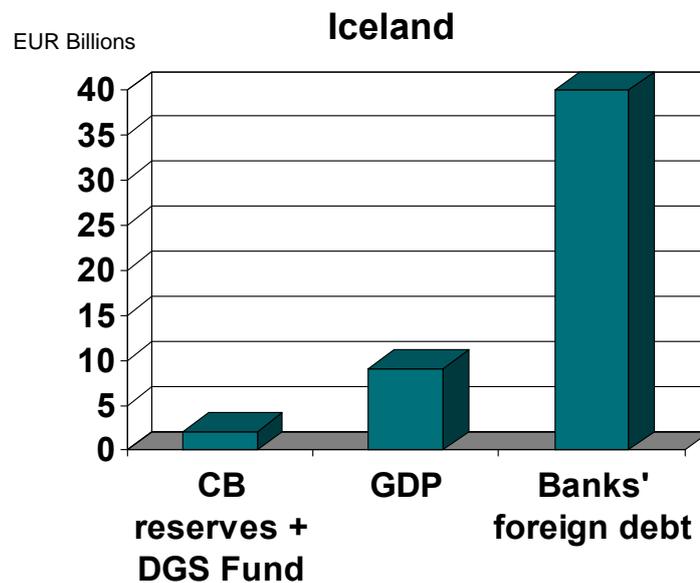


Why didn't we intervene?

- Despite Basel II, a focus on “formal” solvency and accounting measures
- Concerns for a level playing field
- Concern for FSA’s legal risk and reputation
- A classic home/host dilemma: Large risks for the host country, small risk for the home country - but many measures would only be effective on a group level



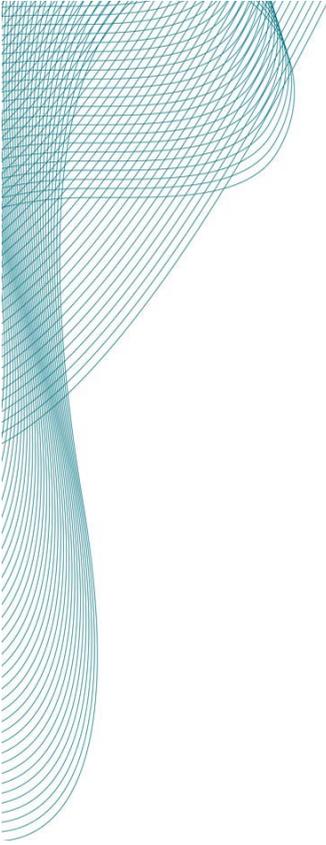
2. Problems we faced and lacked the legal basis to deal with properly





Problems we faced and lacked the legal basis to deal with properly

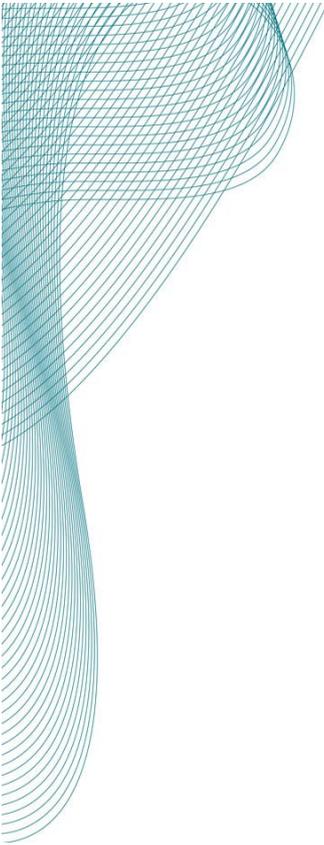
- In October 2008, the Swedish CB gave emergency liquidity to a subsidiary of Kaupthing. Resolution of the subsidiary dragged on until January 2009.
- The Swedish FSA found it could not withdraw the licence or force liquidation
 - **Ownership criteria?**
(The owner was bankrupt)
 - **Liquidity criteria?**
(No prospects of obtaining any funding before resolution)
 - **Solvency criteria?**
(No possibility of mark-to-market loans despite the impending sale. Few credits were yet “impaired”.)



Some necessary regulatory changes

- Powerful resolution schemes: Resolution first, haggling over price afterwards
- Quantitative liquidity regulations
 - establish best market practise
 - give authorities the necessary spine and time
- Supervisory power – perhaps through third-party consultants – to evaluate firm viability, as opposed to formal CAR
- Host country powers





3. Risks we simply didn't understand

“There is a growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient.”

“The improved resilience may be seen in fewer bank failures and more consistent credit provision: consequently the commercial banks may be less vulnerable today to credit or economic shocks.”

(Global Financial Stability Report, April 2006)

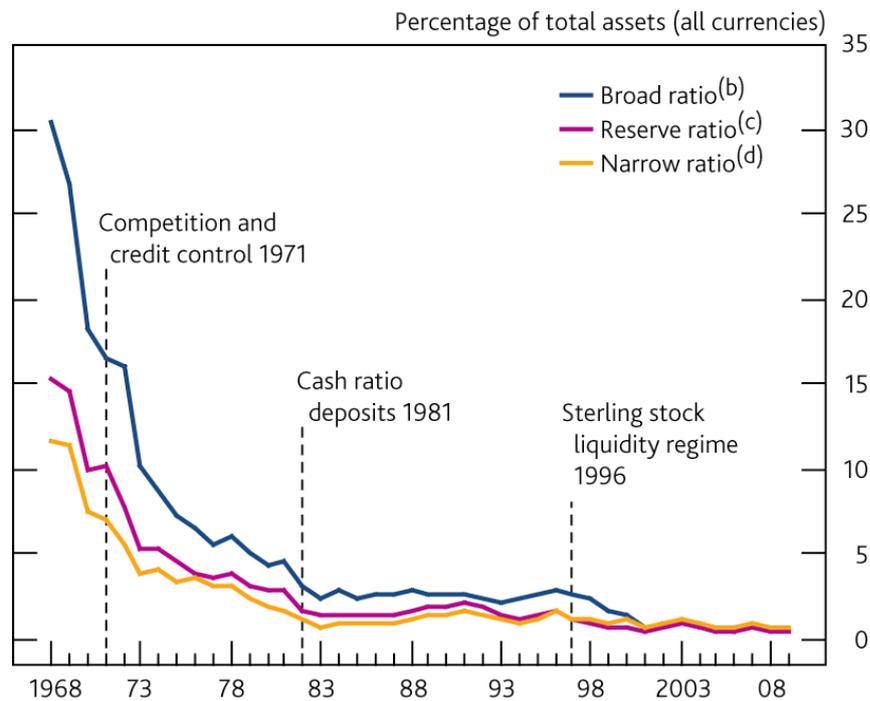


Some of the things we did not understand

- The extreme extent of duration mismatch, hidden off the balance sheets
- The complexity – and therefore potential illiquidity – of structured products
- The new logic of too-big-to-fail: institutions that are too complex, with too many counterparties, to either evaluate or resolve
- The true nature of retail deposits: Even with 100% DGS coverage and timely payouts promised, depositor bases are not stable



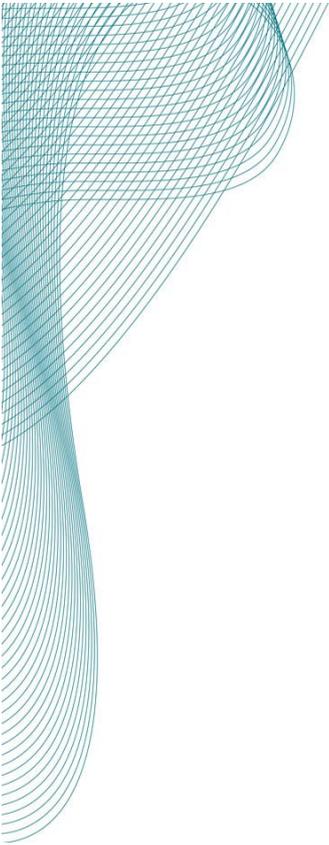
UK banks' liquidity



A new supervisory regime is needed

- Difficult for authorities to also be contrarians
 - It might be different this time
 - Negative examples of actions are more visible than positive ones
 - Timing issue (when to “prick”...)
- Need to formalise a framework for early intervention
- Must act on judgements, not only in relation to regulations
 - E.g. more active use of Pillar II
- Problem of evaluation and accountability





Lessons from the financial market crisis (BIS 1999)

- Need to restrict leverage in the financial system
- Lack of market discipline
- Need for more transparency
- Better monitoring and transparency regarding OTC derivatives
- Underestimated the impact of contagion due to interlinkages in the financial system

