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Abstract

In the Spring of 1992, the Swedish government faced a dilemma. The country was in the midst of an economic downturn stemming from the collapse of asset prices (especially in real estate) that had spiked as a result of a credit boom that followed the deregulation of the Swedish banking system in the mid-1980s. Initially the impact of the downturn on the country's banks had seemed to be limited to a small number of specific firms that the government moved to assist on an ad hoc basis in 1991. However, evidence was mounting that the banking crisis was reaching a systemic level.

Guided by such principles as the need for broad political consensus, prompt action, transparency, and the imposition of strict conditions including shareholder losses in exchange for support, the Swedish government crafted a response centered around a blanket guarantee of all bank liabilities, an immediate recognition of all bank losses, support for banks that was based on each bank's specific financial condition and prospects, and the use of asset management companies to resolve the troubled assets of struggling banks. This approach, coupled with an improving economy, helped restore the Swedish banking system to profitability by 1995. While the fact that the Swedish banking sector of the early 1990s was much less complex than most major financial systems today cautions against drawing any firm conclusion about the appropriateness of deploying specific Swedish policy responses in new crises, the various principles that guided the Swedish response could well be of interest in addressing future systemic events.

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[1] This case study is one of four Yale Program on Financial Stability (YPFS) case modules considering Restructuring and Forgiveness in Financial Crises. The others are:

- *Restructuring and Forgiveness in Financial Crises A: The Mexican Peso Crisis of 1994-95.*
- *Restructuring and Forgiveness in Financial Crises B: The Asian Crisis of 1997.*
- *Restructuring and Forgiveness in Financial Crises D: The Japanese Financial Crisis of the 1990s.*

Cases are available from the Journal of Financial Crises.

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1. Introduction

In the Spring of 1992, the Swedish government faced a dilemma. The liberalization of the country's banking system in the mid-1980s following years of regulation-induced credit rationing had produced a credit boom that saw Swedish banks increase their lending significantly. Banks channeled this increased lending primarily to asset markets—commercial real estate, housing, and the stock market. As a result, asset prices jumped dramatically. Yet by 1990 events were occurring in the global economy that would ultimately trigger an economic downturn in Sweden. When a spike in Swedish interest rates in 1991 halted the credit boom and encouraged consumers and businesses to save rather than spend, asset prices began to tumble, taking the broader economy down with them.

Initially the effect of the downturn on the Swedish banking system appeared to be limited. The Swedish government intervened on an ad hoc basis to assist the two major lenders—Nordbanken and Första Sparbanken—that seemed to be in distress. However, the continued deterioration of these two banks and problems that emerged at a third major lender, Gota Bank, convinced the government that the banking crisis was reaching a systemic level and that more general responses were necessary.

Guided by such principles as the need for broad political consensus, prompt action, transparency, and the imposition of strict conditions including shareholder losses in exchange for support, the Swedish government crafted a response centered around a blanket guarantee of all bank liabilities, an immediate recognition of all bank losses, support for banks that was based on each bank's specific financial condition and prospects, and the use of asset management companies to resolve the troubled assets of struggling banks. This approach ultimately resulted in gross payments by the Swedish government in support of banks of SEK 66.4 billion[5] (or just over 4% of GDP),[6] the vast majority of which stemmed from the nationalization of two banks—Nordbanken and Gota. With recoveries on non-performing loans taken over from Nordbanken and Gota and the eventual privatization of the firms (now combined), the net cost of bank support has been estimated at SEK 35 billion (or approximately 2% of GDP).

The Swedish government's response to the crisis, coupled with an improving economy, helped restore the Swedish banking system to profitability by 1995. The system had remained largely intact, with limited government ownership. Following the issuance of the blanket guarantee in response to concerns about foreign funding drying up, there had been no bank runs or significant credit crunches. These facts, coupled with the relatively low cost of the Swedish government's support, have led many to deem the Swedish response to the banking crisis a model of success. While the fact that the Swedish banking sector of the early 1990s was much less complex than most major financial systems today cautions against drawing any firm conclusion about the appropriateness of deploying specific Swedish policy

[5] Beginning in 1977, the Swedish krona was pegged to a trade-weighted basket of foreign currencies dominated by the U.S. dollar. In May 1991 this peg was replaced with a peg to the European Currency Unit (ECU). When it became impossible for Sweden to defend the ECU peg during the depths of the crisis despite raising overnight interest rates to as high as 500%, it allowed the krona to float freely beginning in November 1992. During the crisis years of 1990-94, the U.S. dollar was worth between 5.0 and 8.5 krona.

[6] Sweden's GDP in the early 1990s in current currency was approximately SEK $1.5 trillion (or $250 billion) for about 8.5 million people. This compares with U.S. GDP of approximately $6 trillion for about 250 million people at that time.

responses in new crises, the various principles that guided the Swedish response could well be of interest in addressing future systemic events.

The remainder of the case is organized as follows: Section 2 summarizes the conditions that resulted in the Swedish banking crisis and outlines how the crisis manifested itself. Section 3 discusses initial, ad hoc steps taken by the Swedish government before it became apparent that a systemic crisis was underway. Section 4 then provides a detailed analysis of the policy responses adopted by the Swedish government in reaction to the crisis reaching a systemic level. Finally, Section 5 discusses the results produced by these policy responses and what lessons can be drawn from the manner in which the Swedish banking crisis was resolved.

Questions

1. What were the key features of the asset management companies used by Sweden to address the troubled assets of struggling banks? Is the use of asset management companies necessary for successful crisis resolution?

2. How important to the successful resolution of the crisis was the broad political consensus achieved by the Centre-Right coalition working closely with the opposition Swedish Social Democratic Party? Can crises be successfully resolved in the absence of such political consensus?

3. What steps did the Swedish government take to manage the public perception of the crisis, and how did this perception affect the resolution of the crisis?

2. Background of the Crisis

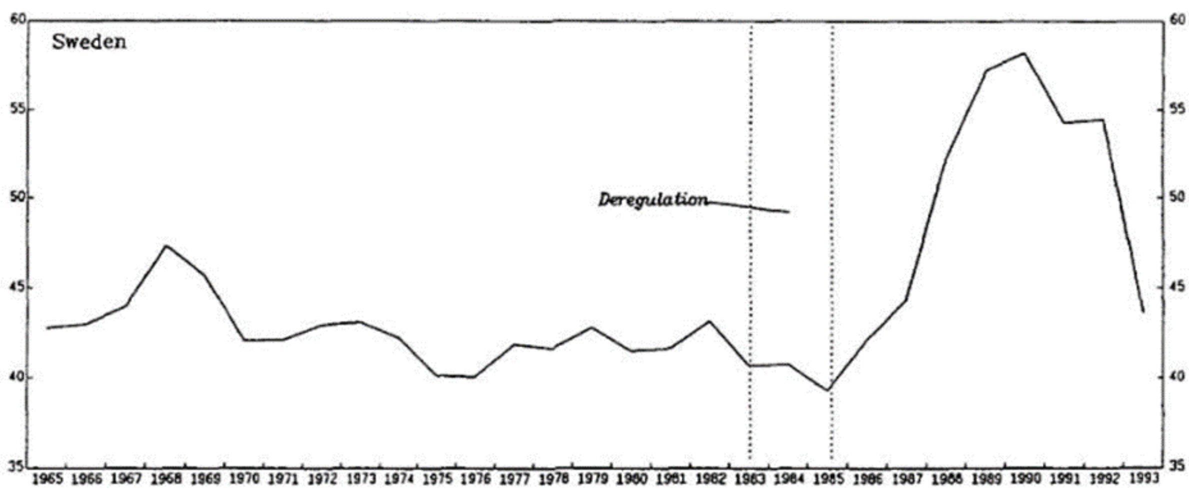
Prior to a period of liberalization beginning in earnest in the mid-1980s, the Swedish government heavily regulated the country's banking sector with the intent of promoting a stable banking system, maintaining low and stable interest rates and channeling credit to certain favored sectors like housing. This regulation took a variety of forms. While there were no limits on the amount of interest a bank could charge on a given loan, the average interest charged across all loans could not exceed a cap tied to the base rate set by Sweden's central bank, the Riksbank.[7] This regulation, coupled with national tax policy that favored the deductibility of interest payments on all kinds of debt, produced negative real, after-tax interest rates that ensured extremely strong demand for credit. Yet because the Swedish government effectively prohibited banks from expanding lending to meet demand, both through direct quantitative lending ceilings and through requirements that banks invest a certain amount of capital in government and housing bonds, credit rationing was endemic. In this environment, lending was typically done on the strength of relationships between banks and favored clients rather than through an analysis of specific transactions. Banks' market share and profitability were predictable and stable. The seven largest banks in Sweden accounted for approximately 90% of the market (Bäckström 1997). This state of affairs was further maintained through prohibitions on the establishment of subsidiaries or branches by foreign banks. (For a detailed discussion of the regulation of the Swedish banking sector prior to liberalization, see Drees and Pazarbasioglu 1995.)

[7] Founded in 1668, the Riksbank is considered to be the world's oldest central bank. The Bank of England, founded in 1694, is the world's second oldest central bank.

The Swedish government began the process of deregulating the banking sector in the early 1980s with the elimination of the requirements that banks hold government and housing bonds. Then, in 1985 it took two steps that would lay the groundwork for the conditions that resulted in the Swedish banking crisis of the early 1990s. First, the government lifted the cap on the average interest rate banks could charge on loans. Second, it eliminated the direct quantitative lending ceilings that prevented banks from expanding credit to meet demand. Banks could suddenly make additional loans to businesses and individuals long starved for additional credit, theoretically at higher rates of interest that would reflect market demand and the risk of the specific transaction. Indeed, if banks wanted to maintain market share and profitability in this new competitive environment, more aggressive lending seemed absolutely necessary.

The result of liberalization after a long history of credit rationing was thus not surprisingly a credit boom. As illustrated in Figure 1 below, immediately following deregulation bank loans as a percentage of nominal GDP rose dramatically, from approximately 40% in 1985 to nearly 60% by 1990.

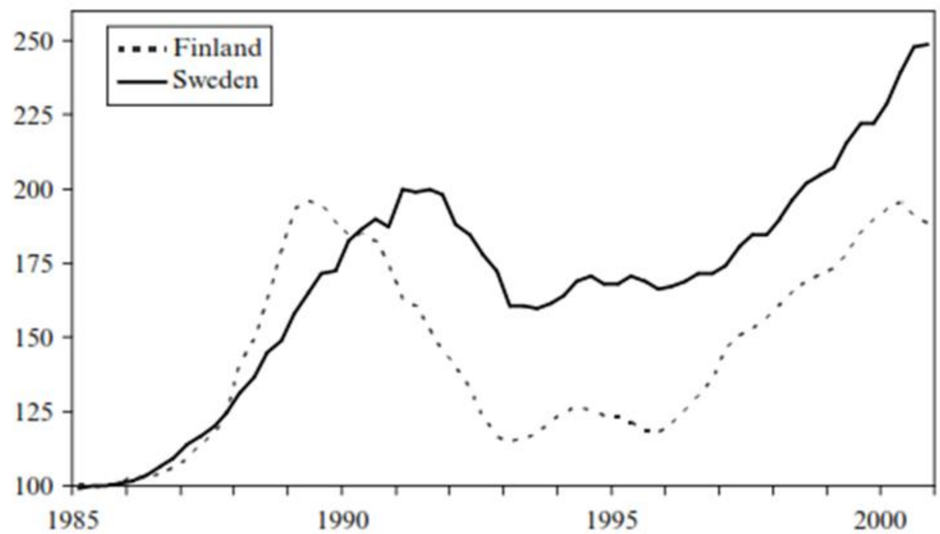
Figure 1: Bank Loans as a Percentage of Nominal GDP



Source: Drees and Pazarbasioglu 1995.

Banks channeled this significant increase in lending primarily to asset markets including commercial real estate, housing, and the stock market (Jonung 2009). The result was a rapid rise in asset prices. As seen in Figure 2 below, housing prices in Sweden nearly doubled in the span from 1985 to 1990, with a similar pattern prevailing in Finland (which also experienced a deregulation-triggered credit boom at about the same time as Sweden).

Figure 2: Housing Prices in Finland and Sweden 1985-2000



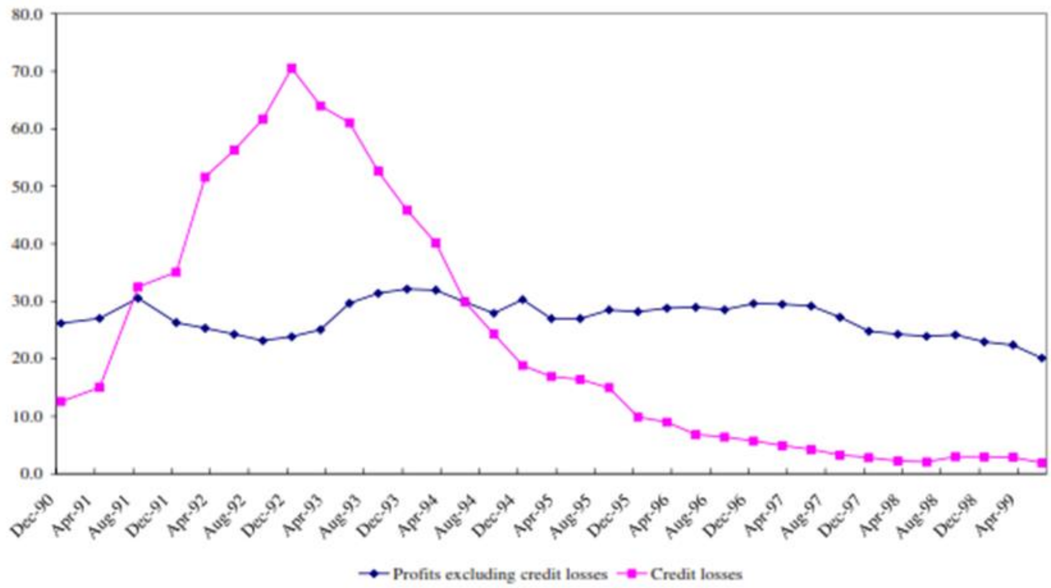
Source: Jonung et. al. 2009.

Given the speed with which Swedish banks aggressively expanded their lending and the fact that they had limited experience analyzing or pricing credit risk (particularly at the margins) prior to deregulation, how such lending would fare in a challenging economic climate should likely have given the financial community greater pause. And indeed, by 1990 events were occurring in the global economy that would ultimately trigger an economic downturn in Sweden. The immediate impetus was a spike in Swedish interest rates in 1991 stemming from higher German interest rates following reunification and the need of the Riksbank to raise domestic interest rates to fight off speculative attacks on the Swedish krona (which was pegged first to a trade-weighted basket of foreign currencies and later to the European Currency Unit). Additionally, in 1990-91 the Swedish government introduced "the tax reform of the century," significantly reducing marginal rates and the deductibility of interest, thereby raising real after-tax rates (Jonung 2009).

In the face of increasing interest rates, Swedes reduced borrowing and the fuel that had been propelling asset prices ever higher disappeared. As illustrated in Figure 1 above, bank loans as a percentage of nominal GDP peaked in 1990 and by 1992 were in free fall. Per Figure 2 above, Swedish housing prices had begun to fall by 1992 and would be down nearly 25% by the end of 1993, producing a negative wealth effect. The decline in asset prices was thus further exacerbated by asset fire sales conducted by firms and individuals seeking to protect their positions in the midst of the downturn. Unemployment jumped from just 2% in 1990 to 10% by 1993 (Ibid.).

The effect of these developments on Swedish banks was profound. As loans soured and collateral values collapsed, losses soared. Loan losses increased from 0.3% of loans in 1989 to 7.0% of loans in 1992 (Drees and Pazarbasioglu 1995). As shown in Figure 3 below, credit losses were soon far in excess of bank profits excluding such losses, and Swedish banks saw their capital positions rapidly deteriorating.

Figure 3: Bank Profits and Credit Losses 1990-1999 (billion SEK, 12-month moving average)



Source: Englund 1999.

3. The Response to the Crisis—Initial Steps

As Stefan Ingves and Göran Lind, leading figures in the Swedish government's response to the crisis, have noted, "[t]he methods for resolving the Swedish bank crisis were chosen initially on an ad hoc basis because remedies had to be found without delay for acute situations that at first seemed to be confined to a couple of banks where large sums of money as well as credibility were at stake" (Ingves and Lind 1996). The two major banks on whose behalf the Swedish government first felt it necessary to intervene on this ad hoc basis were Nordbanken (a large commercial bank already two-thirds owned by the Swedish government prior to the crisis) and Första Sparbanken (the nation's largest savings bank). In the case of Nordbanken, Swedish government officials have described feeling a special responsibility to intervene based on its existing ownership position. With respect to Första Sparbanken, the government's analysis concluded that the bank was "too big to fail" (Lundgren 2009).

By the Fall of 1991, credit losses at both Nordbanken and Första Sparbanken had left the banks in need of additional capital to meet the 8% capital ratio that was then required for Swedish banks to maintain their permits (and indeed, Första Sparbanken's losses threatened to wipe out its entire equity capital). In December 1991 Nordbanken sold SEK 5.1 billion in new shares, with the government purchasing SEK 4.2 billion and the bank's existing private owners the remaining SEK 0.9 billion (Borio et. al. 2010). The effect of this transaction was to enable Nordbanken to meet the necessary capital ratio and to further increase the government's ownership position.

To assist Första Sparbanken, the Swedish government guaranteed a SEK 3.8 billion loan to the bank's owners, a savings bank foundation. Approved by Parliament in December 1991, the guarantee was conditioned on:

a. The bank being reorganized as a joint-stock company;
b. The loan being used to purchase equity in the joint-stock company;
c. A new board of directors being approved by the government;
d. No dividend being paid while the guarantee remained in effect; and
e. A restructuring of the bank being undertaken (Borio et. al. 2010).

4. The Response to the Crisis—The Crisis Becomes Systemic

Despite these initial steps by the Swedish government, the situation at both Nordbanken and Första Sparbanken continued to deteriorate, and by Spring 1992 both were in need of further assistance. This fact, coupled with the emergence of significant problems at a third bank, Gota, caused the Swedish government to conclude that the crisis was approaching a systemic level and that more general responses would need to be taken (Lundgren 2009). In response, the ruling Centre-Right coalition worked closely with the opposition Swedish Social Democratic Party to establish broad political consensus in support of a package of measures that was introduced for Parliament approval in September 1992.

In a September 24, 1992, press release outlining the package of measures, the Ministry of Finance set forth some of the principles that would guide the Swedish intervention:

a. That subsidies be minimized and paid back out of profits over time if possible;
b. That possible distortions of competitive conditions be minimized;
c. That banks receiving support be asked to make structural changes and rationalizations;
d. That banks receiving support be expected to be profitable in the long term; and
e. That the process of bank support be overseen initially by the Ministry of Finance before possibly being moved to a special authority.

To review the press release in its entirety, see Appendix 1 of Jonung 2009.

Government Guarantee of All Bank Liabilities

One of the cornerstones of the package of measures was a proposal that the Swedish government provide a blanket guarantee of all bank liabilities for the entire banking sector, to remain in effect until Parliament determined that the stability of the financial system was no longer in jeopardy and that the guarantee could be ended without harming creditors. With the balance sheets of Sweden's banks at approximately 100% of GDP in 1991, this was a major commitment on the part of the Swedish government (although not as dramatic a commitment as, for example, the Irish guarantee in 2008, where banks' balance sheets equaled about 300% of GDP) (Sveriges Riksbank 2011).

The immediate impetus for this guarantee was a loss of foreign currency funding (Lundgren 2009). With the rapid expansion of lending following deregulation far outpacing the increase in domestic deposits, Swedish banks had become increasingly reliant on foreign sources of short-term funding. At the time of the crisis, short-term foreign funding comprised an estimated 40% of total bank borrowing (Jonung 2009). Some have argued that, as this funding began to dry up in the face of the economic downturn and the pressure on Swedish banks, Sweden had no choice but to issue the guarantee to ensure the continued flow of funding (Ibid.).

It is widely agreed that the blanket guarantee had the desired effect of maintaining foreign confidence in the repayment of funding provided to Swedish banks. It has also been argued that the existence of the guarantee provided the Riksbank with additional flexibility to provide liquidity support to Swedish banks. Given that the government would be responsible for banks' liabilities anyway, the Riksbank could make deposits in domestic and foreign currencies to enable the banks to meet their commitments (Lundgren 2009). Thus, the blanket guarantee prevented the likelihood of bank runs and gave the Riksbank the opportunity to more actively support banks (Jonung 2009).

Program to Support Banks and the Establishment of the Bank Support Authority

Faced with the prospect of potentially having to support many more banks beyond Nordbanken and Första Sparbanken as the crisis became systemic, the Swedish government developed a more formal framework for evaluating bank requests for help. The foundation for this framework was the principle articulated in the Ministry of Finance's September 1992 press release—that only those banks expected to return to profitability in the long term should be supported. Adopting a method utilized in the United States during the banking crisis of 1933, the Ministry of Finance would analyze each bank applying for support and assign it to one of the following three categories:

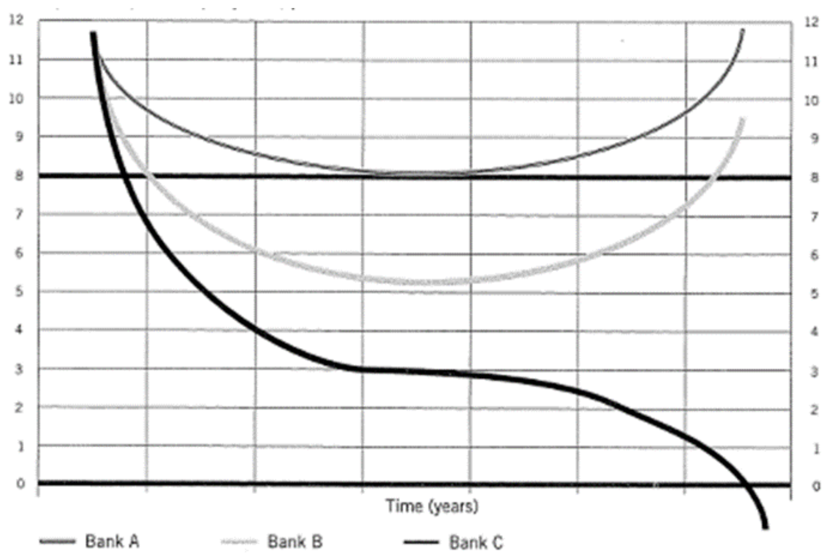
Category A: For banks not below the 8% capital ratio, but that may need support in the form of temporary guarantees to shore up confidence while the shareholders themselves solve the problem

Category B: For banks temporarily below the 8% capital ratio that may need more extensive government support in the form of loans or a capital infusion if shareholders are unable to provide capital

Category C: For banks unlikely to become profitable even in the long term and that therefore should be completely or partly wound down at the lowest possible cost (Lundgren 2009)

Figure 4 below presents a visual depiction of the expected trajectories associated with each of these categories.

Figure 4: Expected Capital Ratio, Per Cent



Source: Ingves and Lind 1996.

With aggregate bank losses totaling almost 12% of GDP, ultimately six of the seven largest banks in Sweden would apply for support (Bäckström 1997). Given that the work of overseeing the bank support process would have crowded out the existing tasks of the Ministry of Finance and that the Ministry's existing personnel lacked the expertise necessary for the job, the Swedish government decided to establish a new Bank Support Authority to manage bank support under the Ministry (Ingves and Lind 1996). To avoid duplication of resources the Authority also worked closely with the Riksbank and Sweden's primary financial regulator (the Financial Supervisory Authority), each of which had also been deemed unfit to oversee bank support because of conflicts with their other operations.

One of the key decisions faced by the Swedish government in establishing the Bank Support Authority was how much funding to provide it at the outset—a predetermined fixed budget or an open-ended amount. Sweden opted for the latter course, seeking to avoid the need to go back to Parliament for more money should an initial fixed budget prove insufficient (a fate that had recently befallen its neighbor Finland as it struggled with its own banking crisis). While the need to go back for additional funding could be interpreted as indicating that the government does not have a handle on the extent of the actual problem, an open-ended amount, on the other hand, might be seen as evidence of a firm resolve to do whatever necessary to restore stability (Jonung 2009). The decision to provide open-ended funding for the Bank Support Authority was thus consistent with the image of confidence and commitment that the Swedish government sought to project in handling the crisis.

Recognition of Losses

Another key decision faced by the Swedish government involved how the credit losses and non-performing loans causing banks to seek support should be calculated and reflected from an accounting standpoint. Swedish government officials have described weighing two different approaches:

1. Calculate losses immediately on the basis of the current market value of existing collateral

    a. Pros: results in an upfront account of the magnitude of the problem and the support likely to be required to resolve it
    b. Cons: if collateral values are temporarily depressed because of fire sales, etc., may create an exaggerated picture of the problem and require banks to unload collateral at lower values

2. Defer losses as long as possible, writing them off over time using future bank profits

    a. Pros: avoids banks having to realize losses and unload collateral at prices that may be temporarily depressed because of fire sales, etc.
    b. Cons: if the crisis is not resolved quickly, deferred losses could snowball out of control

The Swedish government opted for the first method, believing that being open about the full extent of the crisis from the outset was necessary to achieve its objective of restoring confidence in the banking system (Ingves and Lind 1996). Indeed, Bo Lundgren, Minister for Fiscal and Financial Affairs during the crisis, has stated that "[f]or me, there was no doubt about which method to choose to build credibility…[o]ur management of the bank crisis was to be based on openness and transparency" (Lundgren 2009).

To implement this approach, the Financial Supervisory Authority revised its rules for the definition of probable loan losses and for the valuation of real estate. Additionally, it established a Valuation Board to review real estate valuations and ensure uniformity.

Further Interventions at Nordbanken, Första Sparbanken and Gota

As noted above, despite the initial attempts of the Swedish government to assist Nordbanken and Första Sparbanken, conditions continued to deteriorate at both banks. By April 1992 it had become clear that Nordbanken could not meet the required 8% capital ratio despite the SEK 5.1 billion equity injection in December 1991. As a result, in May the government developed a proposal to acquire all shares in the bank that remained in private hands. Approved by Parliament in the third quarter of 1992, the plan called for private shareholders to receive the December 1991 offering price plus interest. This resulted in a price of SEK 21 per share at a time when the market price was SEK 18 and carried a SEK 2.1 billion total cost (Englund and Vihriälä 2009). Additionally, following the takeover the government injected an additional SEK 10 billion into Nordbanken as new capital, without which it would have had negative equity (Borio et. al. 2010).

Första Sparbanken similarly had begun to show signs of further distress in early 1992, and in June 1992 the Swedish government converted its earlier SEK 3.8 billion loan guarantee into a subsidized loan at a cost of approximately SEK 1.0 billion, while a new guarantee for an additional SEK 3.5 billion loan was extended (Englund and Vihriälä 2009). By the end of 1992, Första Sparbanken had merged with ten other regional savings banks to form a new bank initially called Sparbanken Sverige that is still in existence under the name Swedbank (Borio et. al. 2010).

At the same time as Nordbanken and Första Sparbanken were experiencing continued difficulties, a third bank, Gota, appeared headed to insolvency. In April 1992 Gota's owners had injected new capital into the bank in an attempt to enable it to meet the required capital ratio. When this injection proved insufficient, Gota's owners expressed an unwillingness to invest any more funds, and on September 9th the holding company owning Gota declared bankruptcy. This was followed by the Swedish government acquiring all of Gota's shares in December without compensation to shareholders following a due diligence report indicating that the bank had negative equity (Borio et. al. 2010). To address this negative equity, in January 1994 the government injected SEK 20.0 billion into Gota.

The Use of Asset Management Companies

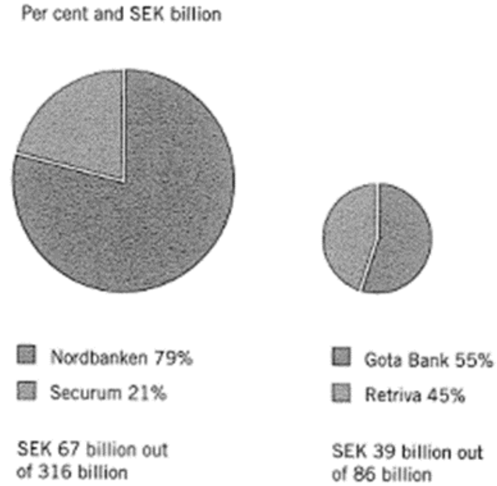
Having nationalized Nordbanken and Gota, the Swedish government set about the task of restructuring the banks in an attempt to return them to profitability. In each case, the government elected to establish a new asset management company, sometimes referred to as a "bad bank," into which the troubled assets of the banks would be transferred. Leading government figures have cited a variety of reasons for pursuing this strategy:

- Allowed bank management to focus on normal banking operations (Lundgren 2009);
- Allowed for bad loans to be dealt with more efficiently (Ibid.);
- Allowed specialists in liquidation procedures and real estate management to handle bad loans (Ingves and Lind 1996); and
- Allowed for differing incentive structures for normal banking operations and handling of bad loans (Ibid.).

In late 1992 the Swedish government established an asset management company named Securum to take over the non-performing loans of Nordbanken. Securum used its initial capital, consisting of SEK 24 billion in equity from the Swedish government and a SEK 26 billion loan from Nordbanken, to purchase SEK 67 billion in non-performing loans from the bank at a price of SEK 50 billion after write-downs (Englund and Vihriälä 2009). As indicated in Figure 5 below, this represented over 20% of Nordbanken's total loan stock.

Similarly, in January 1994 the Swedish government established Retriva as an asset management company for Gota's non-performing loans. The government made a capital contribution of SEK 3.8 billion in equity and extended loan guarantees used to secure additional funding. Retriva then purchased SEK 39 billion in non-performing loans from the bank at a price of SEK 16 billion after write-downs (Ingves and Lind 1996). As indicated in Figure 5 below, this represented a staggering 45% of Gota's total loan stock. Ultimately, the government had Nordbanken acquire Gota, and Retriva was merged into Securum.

Figure 5: Non-Performing Loan Stock of Nordbanken and Gota Bank



Source: Ingves and Lind 1996.

Critically, the Swedish government designed Securum and Retriva with long-term operation in mind. As independent companies rather than in-house subsidiaries of Nordbanken and Gota, Securum and Retriva were not subject to banking regulation that would have, for example, required them to sell assets as soon as market conditions permitted (Englund and Vihriälä 2009). The companies' capitalization levels were similarly designed to allow for extended operations. By not requiring an immediate liquidation of assets at fire sale prices, the design of the asset management companies helped stabilize markets and enabled the government to ultimately recoup more value.

Given that Securum and Retriva would be holding and managing assets over a longer timeframe, they had to be organized and staffed accordingly. The operation of the companies involved several distinct functions critical to success:

1. The management of the non-performing loans themselves, including decisions about when to realize on collateral;

2. The management and development of seized collateral, which given the nature of the collateral, required real estate expertise (primarily commercial) and (to a lesser extent) industrial management expertise;

3. The packaging of collateral in an effective way for ultimate sale; and

4. The sale of the collateral at the best possible price.

Recognizing the different skill sets required for these functions, Securum and Retriva created different units or subsidiaries to handle different functions. Retriva, for instance, had a finance company subsidiary to manage loans, a property management subsidiary to manage seized collateral consisting of real estate, and a management company subsidiary to manage operating businesses that had been taken over (Securum AB 2007). The different units and subsidiaries were staffed with individuals hired for their expertise in those areas, and the asset management companies themselves had professional management overseeing the whole organization.

Securum and Retriva also carefully organized their assets. Securum, for instance, grouped its real estate properties by geographic region and created separate units for specialized asset classes such as hotels and tourism and industrial operations (Ibid.). This allowed for the more efficient management of the assets. It also helped facilitate the ultimate sale of the assets by creating a structured form for their disposal. For example, Securum established separate companies for its regional real estate units and ultimately listed them on the Stockholm Stock Exchange, the first in 1994 and the remaining in 1997. Similarly, it established a company for its hotel and tourism unit and listed it on the Stockholm Stock Exchange in 1997. In 1994, Securum sold its majority stake in Nobel Industries[8] to Akzo NV of the Netherlands, creating the world's largest paint and industrial coatings manufacturer. Securum then sold its remaining industrial operations unit to a European private equity fund in 1996 (Ibid.).

5. The Outcome of the Response and Lessons Learned

The Outcome of the Swedish Government's Response to the Banking Crisis

By Spring 1993 the economy had begun to show signs of improvement in Sweden. This fact, coupled with the stringent conditions imposed by the Swedish government on those banks receiving support (including government ownership stakes), resulted in two major lenders withdrawing their applications for support by autumn (Lundgren 2009). Per Figure 3 above, loan losses, which peaked in late 1992, had fallen sharply by the end of 1993 and would fall below bank profit levels (excluding loan losses) in mid-1994 for the first time since 1991. By 1995, banks reported group profits totaling approximately SEK 18 billion. During the course of 1995 and 1996, the Financial Supervisory Authority undertook a thorough assessment of the 114 lenders covered by the blanket guarantee and found that they were sufficiently strong to end the guarantee. While noting that a massive cleaning-up operation remained (particularly with respect to disposing of the collateral banks had seized when loans soured), the Riksbank concluded that the banking crisis was over (Ingves and Lind 1996). In Spring 1996, the Riksbank submitted a proposal to Parliament to end the guarantee effective July 1, 1996.

As shown in Figure 6 below, total payments by the Swedish government in support of banks during the crisis amounted to SEK 66.4 billion, or just over 4% of GDP. Consistent with the government's commitment to limiting subsidies, just SEK 3.1 billion of this amount went to bank shareholders (SEK 2.1 billion to the private shareholders of Nordbanken during the nationalization and SEK 1.0 to the owners of Första Sparbanken in the form of an interest subsidy on the converted loan guarantee). Note, however, that this SEK 66.4 billion figure represents the gross government investment in bank support and that, because the government has been able to recoup some of its investment via the privatization of Nordbanken and the resolution of the non-performing loans held by Securum and Retriva,

8 Nobel Industries, whose predecessor companies can be traced back to famed Swedish inventor Alfred Nobel, went on an acquisition binge in the 1980s under the direction of controlling shareholder Erik Penser. When the debt used to fund these acquisitions overwhelmed the company in 1991, Nordbanken obtained a controlling position in Nobel Industries from Penser as part of a rescue.

the net investment is actually less. One estimate puts the net cost of bank support at approximately SEK 35 billion or about 2% of GDP (Englund and Vihriälä 2009).

Figure 6: Bank Support Payments in Sweden 1991-94

Date	Event	Value (billion SEK)
1991	*Nordbanken*, new equity	4.2
1992	*Nordbanken*, bailout of old shareholders	2.1
	Nordbanken, new equity	10.0
	Securum, equity	24.0
1993	*Gota*, new equity	25.1
1994	*Första Sparbanken*, interest subsidy	1.0
Total payments		66.4

Source: Englund and Vihriälä 2009.

In addition to the relatively low cost of bank support during the Swedish banking crisis, it has been argued that the other major indicator of the success of the government's response is how the banking system fared during and immediately after the crisis. The system remained largely intact, with limited government ownership. Following the issuance of the blanket guarantee in response to concerns about foreign funding drying up, there were no bank runs or significant credit crunches. The banking system moved out of crisis and returned to profitability quickly (Jonung 2009).

Lessons Learned from the Swedish Response

While the fact that the Swedish banking sector in the early 1990s was much less complex than most major financial systems today cautions against drawing any firm conclusion about the appropriateness of deploying specific Swedish policy responses in new crises, the various principles that guided the Swedish response could well be of interest in addressing future systemic events. Among the principles that have been identified by observers as being key to the Swedish response are:

1. Broad political consensus and resolute actions taken by the political system are important, perhaps more so than any of the technical aspects of the response (Bäckström 1997; Jonung 2009; Lundgren 2009);

2. Prompt action is important, with a comprehensive approach preferable to a piecemeal strategy (Borio et. al. 2010; Jonung 2009; Lundgren 2009);

3. Transparency enhances confidence and promotes public legitimacy (Bäckström 1997; Jonung 2009; Lundgren 2009);

4. In order to limit moral hazard and get public support, losses should be covered in the first place by shareholder capital (Bäckström 1997; Borio et. al. 2010; Jonung 2009; Lundgren 2009);

5. Strict conditions and restrictions imposed in exchange for support also help to contain moral hazard (Borio et. al. 2010); and

6. An adequate legal and institutional framework is critical, preferably backed by open-ended funding (Jonung 2009).

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