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Norwegian State Finance Fund (GFC)

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Norwegian State Finance Fund (GFC)[1]

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Abstract

Following the Lehman Brothers bankruptcy in September 2008, Norway's banking system experienced a significant liquidity squeeze. Norwegian banks had relied extensively on short-term funding from foreign funding markets and as the financial crisis evolved, foreign funding dried up. To alleviate pressure, Norwegian authorities responded with a number of emergency programs. In early 2009, the government created the State Finance Fund (SFF) to recapitalize banks. The SFF was capitalized with a NOK 50 billion ($7.07 billion) equity investment from the Finance Ministry. In total, 34 banks applied for capital injections totaling NOK 6.7 billion. By the end of 2009, six banks had withdrawn their applications. The SFF injected a total of NOK 4.1 billion in 28 banks, most of them savings banks. Capital raising efforts both from private markets and from the State Finance Fund significantly improved Norway's banking system. By December 2009, the central bank's Financial Stability Report indicated that even in a high-stress scenario, bank Tier 1 capital ratios would remain above the regulatory minimum for the next three years.

Keywords: broad-based, broad-based capital injections, capital injections, Global Financial Crisis, Norway, Norwegian State Finance Fund

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Cases are available from the *Journal of Financial Crises* at https://elischolar.library.yale.edu/journal-of-financial-crises/.

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Norwegian State Finance Fund (GFC)

At a Glance

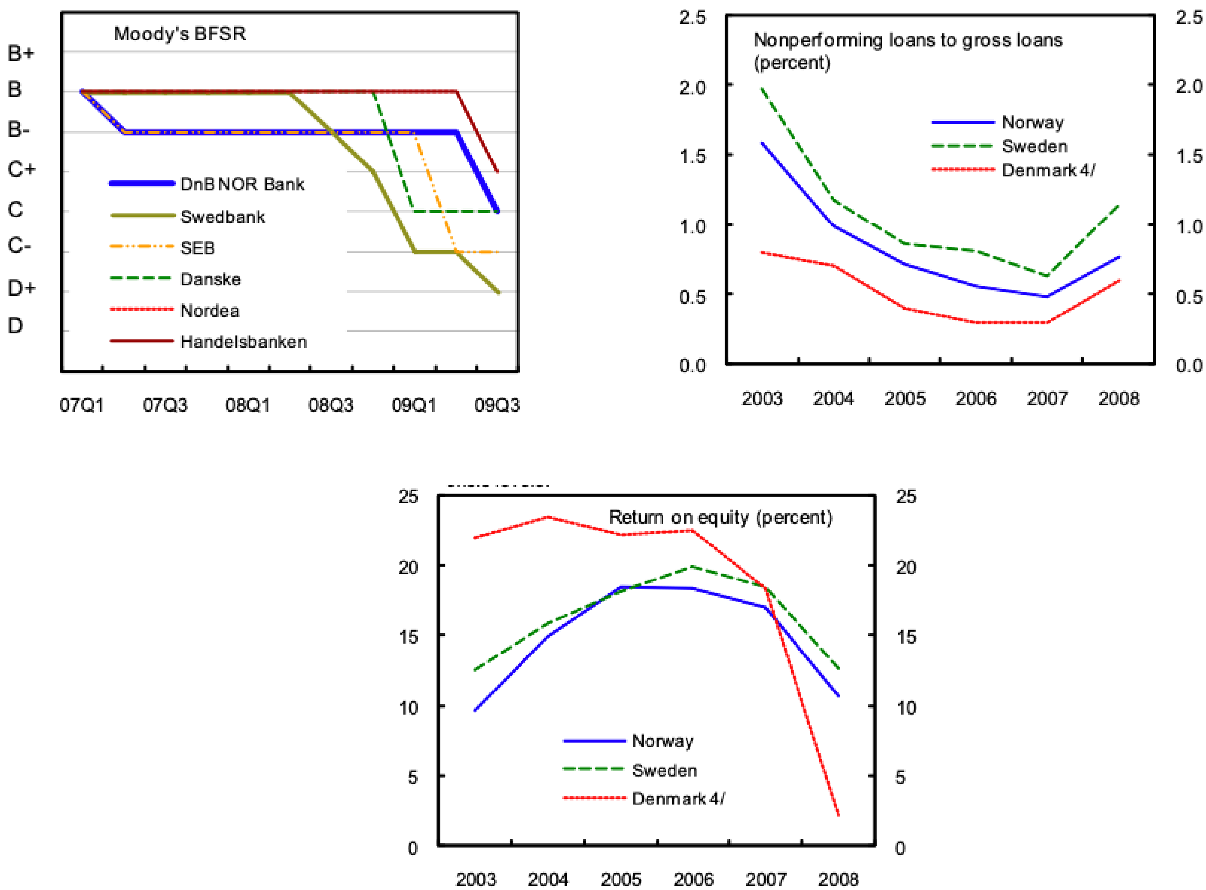
Summary of Key Terms	
Purpose: to provide temporary core capital to Norwegian banks to strengthen the banks and enable them to better maintain normal lending activities (Ministry of Finance 2009c).	
Announcement date	February 8, 2009
Operational date	March 6, 2009
Sunset date	June 30, 2014
Voluntary vs. involuntary	Voluntary
Program size	NOK 50 billion ($7.01 billion)
Peak usage	NOK 4.1 billion
Capital characteristics	Two options: fund bonds and preference capital
Outcomes	Improved Tier 1 capital adequacy in both participating and non-participating banks; improved lending ability
Key features	Participation encouraged by minimum capital regulatory requirements

Following the Lehman Brothers bankruptcy in September 2008, Norway's banking system experienced a significant liquidity squeeze (IMF 2010). Norwegian banks had relied extensively on short-term funding from foreign funding markets and as the financial crisis evolved, foreign funding dried up (IMF 2010). Credit ratings of Norway's largest banks deteriorated, the ratio of nonperforming to gross loans rose, and profitability decreased during the crisis (see Figure 1) (IMF 2010).

To alleviate pressure, Norwegian authorities responded by providing liquidity in currency markets and creating a covered bond swap program (IMF 2010). The Norges Bank, Norway's central bank, also eased collateral requirements for banks using its liquidity facilities in October 2008 (IMF 2010).

In early 2009, the Norwegian government (the State) created the State Finance Fund (SFF) to recapitalize banks (IMF 2010). The SFF was capitalized with a NOK 50 billion equity investment from the Finance Ministry (Mayer Brown 2009). In total, 34 banks applied for capital injections totaling NOK 6.7 billion (IMF 2010). By the end of 2009, six banks had withdrawn their applications, as they were able to raise private capital (SFF 2009a). The SFF injected a total of NOK 4.1 billion into 28 banks, all but one of which were savings banks (State Finance Fund 2012).

Figure 1: Credit Ratings, Lending Quality, and Profitability of Norwegian Banks: 2003–2008



Source: IMF 2010.

Summary Evaluation

Capital raising efforts both from private markets and from the State Finance Fund significantly improved Norway's banking system (IMF 2010). By December 2009, the central bank's Financial Stability Report indicated that even in a high-stress scenario, bank Tier 1 capital ratios would remain above the regulatory minimum for the next three years (IMF 2010).

Banks that received a capital injection from the SFF elevated lending rates in the aftermath of the financial crisis when compared to other banks (SFF 2009a). According to the SFF's annual reports, the fund effectively reduced uncertainty in capital markets; fund bond premiums peaked in 2009 at 7 percent above NIBOR but had declined to 5 percent above NIBOR by the end of 2009 (SFF 2009b).

By the end of 2009, surveyed banks indicated that credit conditions had eased (SFF 2009a). Quarterly surveys conducted by Norges Bank of credit practices of a selection of the largest banks in Norway found that banks had eased credit practices in the third and fourth quarters of 2009 and that capital adequacy was highly correlated with easy credit practices (SFF 2014).

The SFF's final annual report, issued in 2014, concluded that it had strengthened financial stability by:

- Increasing Tier 1 capital adequacy in participating banks;
- Making it easier and cheaper to raise core capital in the markets for banks that did not use the State Finance Fund;
- Strengthening Tier 1 capital, making other deposit and loan financing cheaper;
- Improving lending ability to companies and households (SFF 2014).

In 2014, the SFF had an operating budget of NOK 3 million (Parliament of Norway 2015). Total operating costs were NOK 1.6 million, resulting in a NOK 1.4 million profit at the close of the accounts, as well as NOK 1.7 million in earned equity (Parliament of Norway 2015).

Norway Context 2008 - 2009	
GDP **(SAAR, Nominal GDP in LCU converted to USD)**	\$469.39 billion in 2008 \$388.85 billion 2009
GDP per capita **(SAAR, Nominal GDP in LCU converted to USD)**	\$96,944 in 2008 \$79,978 in 2009
Sovereign credit rating (5-year senior debt)	As of Q4 2008: Fitch: AAA Moody's: Aaa S&P: AAA As of Q4 2009: Fitch: AAA Moody's: Aaa S&P: AAA
Size of banking system	\$496.76 billion in 2008 \$485.83 billion in 2009
Size of banking system as a percentage of GDP	105.83% in 2008 124.94% in 2009
Size of banking system as a percentage of financial system	85.62% in 2008 82.36% in 2009
5-bank concentration of banking system	98.84% in 2008 96.44% in 2009
Foreign involvement in banking system	16% foreign owned in 2008/2009
Government ownership of banking system	33% state owned in 2008/2009
Existence of deposit insurance	Yes
Sources: Bloomberg; World Bank Global Financial Development Database; World Bank Deposit Insurance Dataset.	

Key Design Decisions

1. **Purpose/Part of package: The SFF was announced alongside another government fund, the State Bond Fund.**

On February 8, 2009, the Norwegian government announced two emergency fund facilities: the State Finance Fund and the State Bond Fund (IMF 2010). The Finance Ministry capitalized each fund with NOK 50 billion (Mayer Brown 2009).

The State Bond Fund was intended to provide temporary core capital to Norwegian banks to strengthen the banks and enable the banks to better maintain normal lending activities (Ministry of Finance 2009c).

1. **Legal authority: Regulations pertaining to the SFF were passed into law on March 6, 2009, through the State Finance Fund Act.**

The government passed legal regulations pertaining to the SFF on March 6, 2009, through the Act on the State Finance Fund (Ministry of Finance 2009a). The government passed subsequent regulations specifying the SFF's operations and responsibilities on May 8, 2009 (SFF 2009a). The SFF was also subject to the Securities Trading Act and the Public Procurement Act (SFF 2009a).

The European Free Trade Association (EFTA) Surveillance Authority approved the SFF program in March 2009, as required by the Agreement on the European Economic Area (EEA) (EFTA Surveillance Authority 2009). Norway is not a member of the European Union (EU) but is part of the EEA and EFTA. The European Commission reviews actions by EU member governments, such as bank recapitalizations, that could have anti-competitive effects. The EFTA Surveillance Authority makes such determinations for non-EU EFTA members.

2. **Communication: The government announced the SFF on February 8, 2009, along with the State Bond Fund, and the SFF released annual reports.**

The government announced the SFF on February 8, 2009, along with the State Bond Fund (Mayer Brown 2009). The SFF released annual reports between 2009 and 2014.

3. **Governance/Administration: The SFF was a separate legal entity under the purview of the Ministry of Finance. The SFF Board consisted of three members, appointed by the King.**

The SFF was established as a separate legal entity under the purview of the Ministry of Finance (Ministry of Finance 2009a).

The SFF was administered by a board comprising three members (Ministry of Finance 2009a). The King appointed the members, including a chairman and deputy chairman (Ministry of Finance 2009a).

The Ministry of Finance appointed an external auditor to audit the SFF every year. In 2009 the appointed auditor was Deloitte (SFF 2009a). From 2010 until liquidation, the appointed auditor was Ernst & Young (SFF 2014).

4. Size: The State allocated NOK 50 billion to the SFF. In total, NOK 4.1 billion was injected into 28 banks.

The State allocated NOK 50 billion to the SFF for capital injections (IMF 2010). In total, 34 banks applied for a total of NOK 6.7 billion from the fund (IMF 2010). The deadline to apply was September 30, 2009 (IMF 2010). The first round of capital was injected on September 30, 2009, and the last on December 17, 2009 (SFF 2014).

By the end of 2009, 28 banks whose assets represented 14 percent of Norway's total banking assets had received NOK 4.1 billion from the SFF (SFF 2012). Of the banks that applied, 18 had capital adequacy of greater than 12 percent (SFF 2012).

Six banks withdrew their applications by the end of 2009 as they had been able to raise private capital (State Finance Fund 2009a).

5. Eligible institutions: Norwegian banks and foreign-owned banks operating in Norway that were "fundamentally sound" could receive capital injections.

Only Norwegian banks and foreign-owned bank subsidiaries (though not foreign-owned bank branches) operating in Norway were eligible to apply for the SFF program (SFF 2009b). Additionally, in compliance with EFTA Surveillance Authority (ESA) rules, the SFF could lend only to banks that the Norwegian bank supervisory authority determined were "fundamentally sound" based on capital adequacy ratios, asset quality, and other measures (SFF 2009a). SFF analysis to determine soundness took "into account probable development in the near future" and therefore factored in capital raising efforts (SFF 2009a). While participation in the program was voluntary, banks faced an 8 percent capital adequacy requirement and a 4 percent Tier 1 capital requirement which likely motivated banks to apply (IMF 2010).

In total, 34 banks applied for the capital injection program (IMF 2010). The deadline to apply was September 30, 2009 (Ministry of Finance 2009c). Nearly all of the applications were submitted in the last half of September 2009, likely for a few reasons (SFF 2014). First, many banks waited for second-quarter figures to add to their applications (SFF 2014). Second, banks waited to see whether other banks would apply (SFF 2014). Third, banks waited as capital markets improved in spring and summer 2009 to see if private capital fundraising could replace the SFF (SFF 2014).

Banks were required to submit applications including:

- Favored capital instrument;
- Size of the desired capital investment;
- Annual account, annual report, and auditor's report for 2008;

- Adopted budget for 2009;
- Internal risk and capital assessment;
- Forecast for meeting solvency requirement (Ministry of Finance 2009c).

In reviewing applications, the SFF prioritized banks that were "important for financial stability" (Ministry of Finance 2009c). Ultimately, however, the SFF did not reject any applications.

Most of the banks that applied were savings banks (SFF 2009a). The savings banks that applied to the SFF constituted 50% of the total assets of Norwegian savings banks (SFF 2009a). All but one of the 28 banks that received capital were savings banks.

Figure 2: Total SFF Injected Capital

Bank	**Total capital injected (KOR)**	**Bank**	**Total capital injected (KOR)**
Sparebanken Vest	960 million	Kvinesdal Sparebank	31.5 million
Sparebanken 1 SMN	450 million	Hjelmeland Sparebank	30.5 million
Sandnes Sparebank	450 million	Selbu Sparebank	28 million
Sparebanken Sør	400 million	Tinn Sparebank	25 million
Sparebank 1 Buskerud-Vestfold	200 million	Ørland Sparebank	24 million
Totens Sparebank	132 million	Hol Sparebank	25 million
Klepp Sparebank	75 million	Bud, Fræna og Hustad Sparebank	25 million
Aurskog Sparebank	60 million	Blaker Sparebank	20 million
Lillestrøm Sparebank	60 million	Grong Sparebank	22 million
Nes Prestegjelds Sparebank	96.8 million	Seljord Sparebank	20 million
Holla og Lunde Sparebank	41 million	Verdibanken ASA	15 million
Rørosbanken Røros Sparebank	40 million	Gjerstad Sparebank	18 million
Indre Sogn Sparebank	33 million	Soknedal Sparebank	13 million
Bamble og Langesund Sparebank	30 million	Vegårshei Sparebank	9 million
Soknedal Sparebank	13 million		
Vegårshei Sparebank	9 million		
Total capital injected			**4.134 billion**

Source: IMF 2010.

6. **Individual participation limits: Banks faced individual participation limits capped by Tier 1 capital ratios.**

The SFF recapitalized banks only up to a designated Tier 1 capital ratio. Banks with Tier 1 capital adequacy below 7 percent could be recapitalized up to 10 percent. Banks with Tier 1 capital ratios above 7 percent could be recapitalized by up to 3 percentage points (Ministry of Finance 2009c). The SFF required any bank to provide additional documentation if it sought an injection that constituted more than a 2-percentage point increase in its total Tier 1 capital ratio or if the injection would raise its Tier 1 capital ratio above 12 percent (Ministry of Finance 2009c).

7. **Capital characteristics: The SFF injected capital in two forms: fund bonds and preference capital.**

The SFF's capital instruments came in two forms: fund bonds and preference capital (SFF 2012). Both instruments counted as Tier 1 capital but had no voting rights (SFF 2009a). Preference capital was close in design to shares or equity certificates (SFF 2009b). Both instruments required interest payment from the bank based on issuer risk (SFF 2009b). Fund bonds were more flexible and could be redeemed by the bank with only one month's notice, while preference capital had to be held for three years (SFF 2014). Last, preference capital was designed with a call option to convert to ordinary shares in five years if not redeemed (SFF 2009b).

Write-downs on SFF bonds to cover income statements in annual accounts could take place only after write-downs of: contributed share capital, paid-in primary capital certificate capital, primary capital in savings banks, and preference capital used for the injection of Tier 1 capital from the SFF (SFF 2009b). The fund bonds thus took priority over all existing capital and newly injected preferred shares under the SFF. Banks were mandated to write down bonds should their Tier 1 capital adequacy ratios fall below 5 percent or their capital adequacy fall below 8 percent (SFF 2009a).

Banks mainly applied for fund bonds (SFF 2009a). One bank applied for preference capital totaling NOK 27 million (SFF 2009a).

8. **Dividend/interest: The interest rate was calculated as a fixed markup (based on risk class) over six-month or five-year fixed-term Norwegian government securities interest rates.**

The SFF claimed a preferential right to a non-cumulative claim on annual interest payments, provided capital adequacy was 0.2% over the capital adequacy requirements. The interest rate was calculated as a fixed markup (based on risk class) over six-month or five-year fixed-term Norwegian government securities interest rates. (Ministry of Finance 2009c).

The markup was identified by first classifying banks in risk classes based on credit ratings from "an approved credit rating company," with corresponding markups. See Figure 3.

Figure 3: Interest Rate Markups Based on Risk Classes for Fund Bonds and Preference Capital

Risk class	Credit rating	Markup for fund bond	Markup for preference capital
1	AA- or better	5.0 percentage points	6.0 percentage points
2	From A- to A+	5.5 percentage points	6.5 percentage points
3	BBB+ or lower	6.0 percentage points	7.0 percentage points

Source: Ministry of Finance 2009c.

All banks chose a floating interest rate linked to the six-month treasury interest rate plus the risk class markup (SFF 2009a). Of the 28 banks that received capital from the SFF, three banks were placed in risk class 2, and 25 banks were placed in risk class 3 (SFF 2009a).

The interest was to be paid as long as banks' profits were sufficient to cover the interest payment (SFF 2009b). To incentivize banks to redeem their fund bonds, interest rates increased by 1 percentage point four years after the issuance of the bonds and a further 1 percentage point five years after issuance (SFF 2009a). Both mutual fund bonds and the preference capital instrument were perpetuities, with no maturity (SFF 2009a)

9. Allocation of losses for existing stakeholders: Research did not reveal any information on this.

Research did not reveal any information on this.

10. Debt restructuring plan: Research did not reveal any information on this.

Research did not reveal any information on this.

11. Fate of existing board and management: Research did not reveal any information on this.

Research did not reveal any information on this.

12. Other conditions: Participation in the SFF came with restrictions on senior executive salaries and bonuses, dividend payments, and utilization of capital injected.

The State imposed restrictions on senior executive salaries and bonuses (Ministry of Finance 2009b). Through December 31, 2010, benefits and salaries for senior executives could not be increased (Ministry of Finance 2009b). Senior executives with a fixed salary exceeding NOK 1.5 million could not receive bonuses in 2009 and 2010 (Ministry of Finance 2009b). The state also prevented senior executives from receiving shares or new stock option programs (Ministry of Finance 2009b). Banks could not extend or renew stock option programs (Ministry of Finance 2009b). Banks could also not pay out bonuses earned in 2009 and 2010 in later years (Ministry of Finance 2009b).

The SFF also entered into agreements with each bank stipulating restrictions on dividend payments and distributions. Dividends could not exceed 50% of a bank's unrestricted equity. (Ministry of Finance 2009c).

Regulations also stipulated that the banks had to use the capital injection "in accordance with the purpose of the scheme . . . and that the bank [could] not utilize the capital injection in its marketing or to implement aggressive commercial strategies" (Ministry of Finance 2009c). Moreover, any participating bank was not to, without prior consent of the SFF: make significant investments in affiliates, engage in merger or demerger, or make significant group contributions to a company in the same group as the bank except for dividends on ordinary shares (SFF 2009b).

13. Exit strategy: The King of Norway was to decide when SFF would be wound down.

The King of Norway was empowered to decide when the SFF would be wound down. By royal decree on February 14, 2014, the fund was to be terminated that year; it was ultimately terminated on June 30, 2014, with only a liquidation board remaining (SFF 2014).

Two banks redeemed fund bonds in 2010. In 2011, seven banks indicated in SFF surveys that they planned to redeem fund bonds in the second half of 2011. Two did so by August 1, replacing SFF bonds with capital raised in the markets. However, turmoil in markets in the latter half of 2011 caused the other five banks to reverse their plans. Three banks redeemed deposits in 2012, and 14 banks redeemed deposits in 2013. By 2014, only one bank, Lillestrøm Sparebank, had yet to redeem its deposits (totaling KOR 60 million), though it applied to redeem its deposit by 2014 (SFF 2014).

14. Amendments to relevant regulations: Research did not reveal any information on this.

Research did not reveal any information on this.

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