1996

The Management of the Bank Crisis -- In Retrospect

Stefan Ingves

Lind Goran

The management of the bank crisis – in retrospect

By Stefan Ingves and Göran Lind

What methods were chosen by the Swedish authorities to resolve the bank crisis? Why did they choose these methods rather than others, for instance those that had been tried elsewhere? Can the degree of success with which the bank crisis has been tackled be judged retrospectively?

A number of guidelines that have been used to handle the banks' problems are described in this article.

During the bank crisis in Sweden Stefan Ingves, now Deputy Governor of the Riksbank, was head of the financial markets department at the Ministry of Finance before he was appointed Director General of the newly established Bank Support Authority. Göran Lind, Senior Manager at the Riksbank, was answerable to the managing body for the Riksbank's handling of issues to do with bank support. This article is based on material that has been used in international seminars, for instance under the auspices of the International Monetary Fund and the International Bank for Reconstruction and Development.

Crisis no longer acute

The Swedish bank crisis is over. A massive cleaning-up operation remains and it mainly involves managing and disposing of the large stocks of real estate and other assets that the banks were obliged to take over to protect their claims. The difficulties and the magnitude of this task should not be underestimated but unlike the situation during the crisis, it does not threaten the banks' survival. Good news now has the upper hand. In 1995 the banks reported group profits totalling around SEK 18 billion. The level of loan losses for many of the banks is now below 1 per cent of their loan stock, which must be considered acceptable. Solvency (capital adequacy) is high even in an international comparison.

Diagram 1. Earnings and loan losses of bank groups

SEK billion

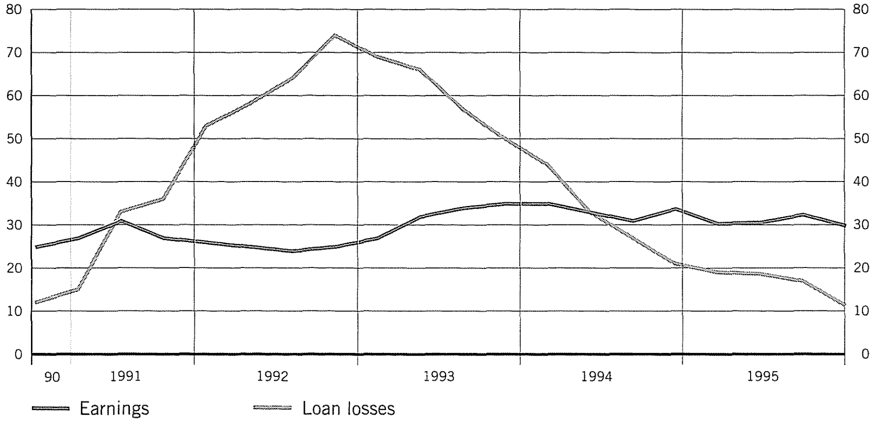
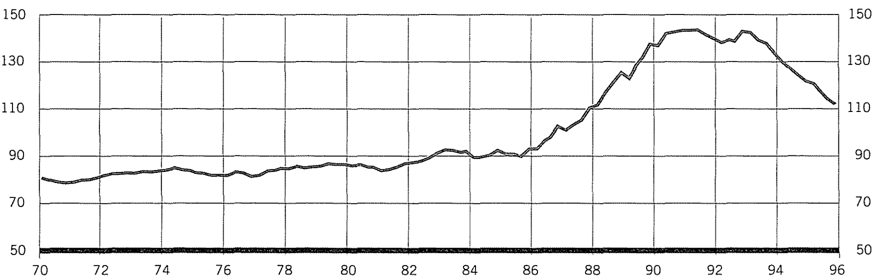


Diagram 2. Loan flow to non-bank public from Swedish credit institutions

Per cent of GDP



The bank support can be ended

In 1994 and 1995 bank group profits totalled around SEK 15 billion.

The Financial Supervisory Authority has undertaken a thorough assessment of all the 114 banks (of which 90 are savings banks) and other credit institutions that are covered by the State bank support guarantee from December 1992. The Authority has found that the institutions are now so strong financially that the bank support can be ended without jeopardising the stability of the financial system. The Riksbank shares this opinion. A proposal to end the guarantee with effect from 1 July 1996 will be presented in a bill to the Riksdag this spring. A system for protecting deposits, financed by the banks, was introduced at the beginning of 1996.

Numerous inquiries into and analyses of bank crises have been undertaken in recent years. Besides covering the crisis in Sweden, they have looked at problems in the banking sector in other countries, for instance the Nordic group, the United States, Japan, the United Kingdom and France. The problems in these countries have many features in common but the methods for tackling them have varied. There are several explanations for this, for instance the political and economic situation in each country, the perceived roles of the State and the owners and so on.

The 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. When it then became clear that the crisis was systemic, a matrix of alternative solutions was constructed. There were certain basic guidelines as well as room for flexibility because the problems tended to differ from bank to bank and the solutions had to be adapted accordingly. Looking back, a number of guidelines can be discerned in the management of the bank crisis.

Different countries have used different methods to tackle banking problems.

Guidelines in the management of the crisis

Political consensus

Broad political support for the measures was important. If the political parties had disagreed about the support measures, not only would the latter have been delayed but the disagreement would also have attracted attention abroad, with serious consequences for the efforts to restore confidence in Sweden's financial system. Negative effects clearly resulted in some other countries where a political consensus on the management of the crisis was not achieved. Two of these effects are higher financing costs for the banks and decreased access to loans in the interbank market.

A political consensus in Sweden was promoted in various ways. Openness was highly important and included information to the general public from the Government and the authorities concerned (see "Enhancing Confidence" below). In order to prevent the bank support from becoming a source of political disagreement, the Government declared that it was prepared to share information about the support issues with other parties. The political opposition was also represented on the board of the Bank Support Authority.

Enhancing confidence

Openness and information to the general public are highly important.

In the autumn of 1992 confidence in the Swedish financial sector was low in Sweden as well as abroad. The most negative effect of this was a reduction in the supply of foreign credit. Besides affecting the banks and their borrowers, this had a general economic impact by generating a substantial net outflow of foreign exchange. The Government did manage to check this outflow by greatly increasing its borrowing abroad but this further curtailed the banks' external borrowing facilities. The Government and Riksbank concluded from this that a country, like Sweden, that is heavily dependent on external credit must restore confidence more quickly and vigorously than countries whose external position is stronger, such as Norway and Japan. This influences the choice of methods for tackling the problems.

The Riksbank approves the bank support guarantee on 18 December 1992.

The need for strong measures to enhance confidence led to the "bank support guarantee" that the Riksdag approved in December 1992. An important aspect of this guarantee was that, except for the shareholders, it protected all the banks' creditors. No upper limit was set for the State support. As confidence in the solvency of the State was unbroken, creditors could continue to provide Swedish banks with funds without risking losses.

The Riksdag's decision had to be followed up. The content of the support and the specific measures that were being planned to tackle the banks' problems were not known abroad. The need to spread this knowledge led to a whole range of information activities. Cabinet ministers and officials, mainly from the Ministry of Finance and the Bank Support Authority, made frequent visits to financial centres around the world to describe the situation and the measures that had been and would be taken. This was accompanied by a similar dispersion of information in Sweden.

The confidence-enhancing measures succeeded. The higher prices that Swedish banks were forced to pay for credit fell back relatively soon to a normal level. The inflow of credit turned upwards and stabilised at a satisfactory level. Swedish banks admittedly had their credit ratings lowered but not so much that financing could not be arranged.

Concerning confidence in the banks, it should be mentioned that at no time during the bank crisis – not even before the Riksdag approved the bank support – was there any serious distrust in the sense of a very large withdrawal of deposits.

In certain cases withdrawals were larger than normal for brief periods but the situation remained under control and there was no risk of a liquidity shortage.

Openness

Openness is a wider concept than information. It involves refraining from concealing both the extent and the nature of the problems. The practice of booking loan losses and valuing assets is not an exact science. The room it leaves for discretion enables banks and other firms to vary the picture of their financial position without breaking the law. One example of accounting flexibility, though this has been markedly curtailed in recent years, is the valuation of real estate as a long-term holding or at a current market value. In certain cases the question of when a loan loss can be said to have occurred, so that it is included in the bank's profit and loss account, is also a matter of judgement.

Method 1: Losses are deferred.

Two alternative methods have emerged in international discussions of banking problems. The first method involves deferring losses for as long as is legally possible and using the bank's current income for a gradual write-down of the loss-making assets. One advantage of this method is that it helps to avoid the bank being forced to sell assets, usually below their cost price. A serious disadvantage is that the method presupposes that the problems can be resolved relatively quickly; otherwise the difficulties soon mount up, leading to very much greater problems when these ultimately materialise. The handling of problems among savings and loan institutions in the United States in the 1980s is a case in point.

Method 2: All expected losses are reported.

With the other method, an open account of all the expected losses and write-downs is presented at an early stage. This clarifies the extent of the problems and the support that is required. Provided the authorities and the banks make it credible that no additional problems have been concealed, this procedure also promotes confidence. It entails a risk of creating an exaggerated perception of the magnitude of the problems, for instance if real estate that has been taken over is valued unduly cautiously in a market that is temporarily depressed. This can lead, for instance, to borrowers in temporary difficulties being forced to accept harsher terms, which in turn can result in payments being suspended.

The Swedish authorities opted for the second method: disclose expected loan losses and assign realistic values to real estate and other assets. This method was consistent with the other basic principles for the bank support, such as the need to restore confidence and to place the banks' accounting principles on an equal footing in order to make a fair assessment of their need for support.

A Valuation Board is set up by the Bank Support Authority.

The Financial Supervisory Authority tightened its rules for the definition of probable loan losses as well as for the valuation of real estate. In order to obtain a more uniform valuation of the real estate holdings of banks applying for support, the Authority also set up a Valuation Board with real estate experts.

Looking back, it can be said that in general the level of valuations was realistic. The real estate holding companies that were established by the banks on the basis of these valuation principles are yielding a direct return that is close to the market rate.

Organisation and division of labour

Bank Support Authority established under the Ministry of Finance.

At an early stage in the bank crisis it was already clear that the Ministry of Finance was not equipped to manage broad support for the banking system. The current legislative tasks of the Ministry would be crowded out and its staff did not possess all the various qualifications that were needed for analyses and negotiations with the banks. Assigning the bank support operations to the Riksbank or the Financial Supervisory Authority was not considered appropriate because this might conflict with interests involved in other operations of these authorities. It was therefore decided to establish a new authority, the Bank Support Authority, to manage the bank support under the Ministry of Finance.

The Government assigned limited organisational resources to the Bank Support Authority. In order to avoid duplication, the expertise of the Riksbank and the Financial Supervisory Authority was utilised by arranging for a continuous and mutual exchange of information. These authorities were also given a statutory right and duty to consult with the Bank Support Authority on all important issues to do with the support. Moreover, the Bank Support Authority made considerable use of Swedish and foreign consultants, most of whom already had experience of bank crises in other countries, such as the United States and Norway. The consultant services were costly (and were paid for by banks applying for support) but as the corresponding expertise and capacity were not available in other ways, they conferred the essential benefit of saving time. The network established in this way proved to be effective; decisions in support cases could be made at the very short notice that the acute nature of the measures often called for.

As an acute lack of liquidity, particularly in foreign exchange, was a feature of the bank crisis on a number of occasions in the autumn of 1992, in the course of its normal operations the Riksbank took steps to secure the financial system's stability. As described in the Bank's annual reports, this included sizeable short-term lending in the domestic as well as foreign currencies and depositions in the banks. The loans and deposits were arranged at normal interest and repayment terms. In that the State guarantee protected bank creditors, there was no departure from the Riksbank's principle of confining its loans to solvent banks. The measures for supporting liquidity functioned as intended; after a short period the loans and deposits could be terminated.

A common yardstick

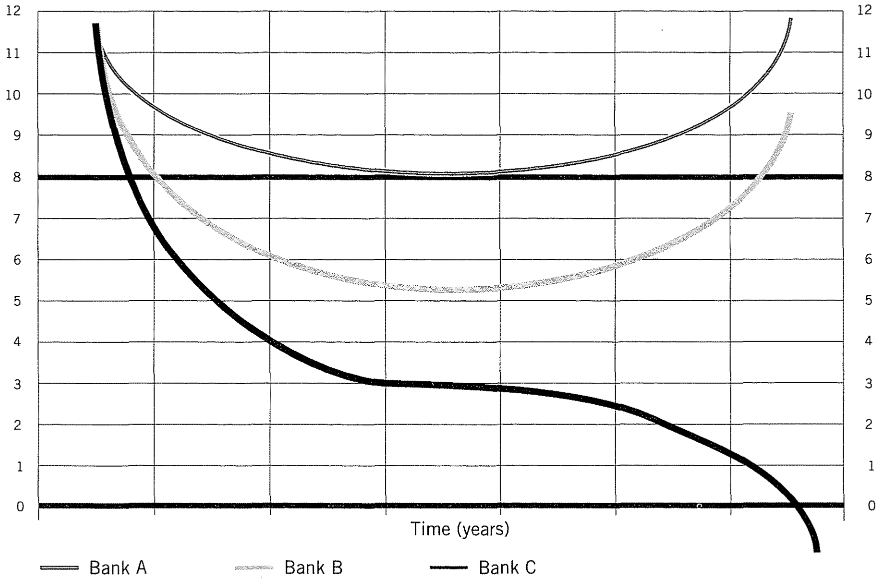
Objective criteria were needed for the treatment of banks applying for support. A basic approach in the assessment of the support – its size and forms – was to construct probable scenarios for future development in the light of known and forecast data on a bank and its financial and economic environment.

The bank were then assigned to one of three categories: A, B or C.

- An A bank was liable, in the worst case, to deteriorate towards the capital adequacy limit of 8 per cent but would subsequently be able to restore solvency. The problems of an A bank ought to be solved by its shareholders, possibly aided by some form of temporary guarantee from the Bank Support Authority in order to underpin confidence in the bank.
- A B bank might fall below the 8 per cent limit for a time but fulfil the capital adequacy requirement again later on. This, then, was a bank with short-term problems but a good prospect of future profits. Such a bank might need more extensive State support, including capital contributions or loans, if its owners were not capable of providing sufficient capital. In a macroeconomic perspective the bank's survival would still pay because the scenario indicated long-term profitability. A case in point was Föreningsbanken, where the owners were prepared to make capital contributions that would ensure a ratio above 8 per cent. This presupposed, however, that the uncertainty about the medium-term development of the bank's financial position was reduced; this was achieved in that the Bank Support Authority provided a temporary safeguard whereby a capital contribution from the State would be forthcoming if the capital ratio fell towards 8 per cent.

Diagram 3. Scenarios for A, B and C banks

Expected capital adequacy ratio, per cent



- A C bank was one that, according to the scenarios, would most probably never become profitable again; its capital would be gradually eroded and ultimately become negative. In such cases, e.g. Gota Bank, the State needed to take appropriate measures in order to minimise the macroeconomic losses. This did not necessarily entail the bank's liquidation; in certain cases a more favourable result could be achieved with other methods, such as selling off bad assets and then selling, or merging, the remainder of the bank.

A bank's capital losses have to be covered – in one way or another.

Irrespective of the category in question, the Bank Support Authority operated on the basis of certain "truths" about loss management. Firstly, a capital loss has to be covered – in one way or another. This "unpleasant truth" tends to be disregarded in the debate on bank support issues, in Sweden as well as elsewhere. The analysis becomes much easier if the parties can agree on the existence of a hole in a bank's capital that must be filled. Secondly, as a general rule the economic value of a bank to an investor is the present value of its future profits. From these two truths it follows that if the capital loss is too large in relation to the present value of profits, then no private investor will be prepared to contribute sufficient capital on economic grounds. Even in such cases, however, the provision of State support may be economically defensible, partly because this may reduce the final loss, e.g. by avoiding a forced sale of assets at less than cost price. Moreover, a controlled wind-up of problem banks tends to enhance confidence, which is socially beneficial.

Unduly stringent repayment terms make it impossible to sell a bank that has obtained State support.

This analysis also implies limitations on the terms for repayment of State support by a bank that is wholly or partly owned by the State with the intention of being privatised. As mentioned above, the total value that can be extracted from a bank is represented by the present value of future profits. If the State stipulates future repayments from the bank, its sales value will be correspondingly lower. With unduly stringent repayment terms, the bank becomes impossible to sell.

The scenario method clearly requires that the banks' assets and liabilities are valued and accounted for in a uniform manner (see above under Openness). It also involves the construction of a "bank model", using large quantities of data from bank balance sheets as well as general economic data on interest and exchange rates, the level of activity and so on. This model made it possible, for instance, to examine the sensitivity of bank profits to different economic scenarios.

Work-out units

The sizeable volume of non-performing loans in certain banks, as well as their legal and technical complications (e.g. real estate that needed renovating prior to sale), made it appropriate to transfer these loans from the regular operations to separate work-out companies. Examples of such companies in the context of the bank support are Securum and Retriva. Banks that did not utilise the bank support have also established similar entities in their organisation, e.g. S-E-Banken's Diligentia and Handelsbanken's Näckebro.

Experts are needed to manage bad loans.

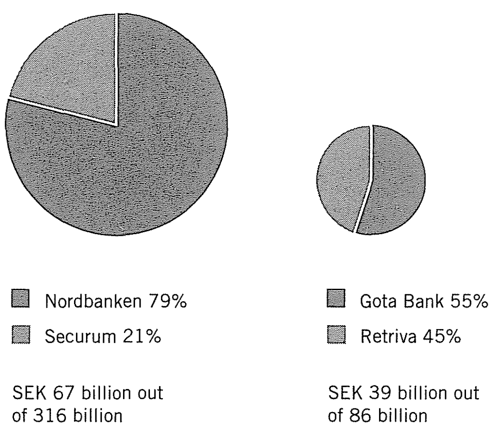
These items should be separated from the other operations for several reasons. The bad loans tend to call for specialists, e.g. in liquidation procedures and real estate management, who are not available in regular banking operations. The management of these loans also differs from the handling of normal credit. Separate organisations for regular operations and for the management of bad loans is therefore a rational arrangement. It probably also helps to clarify the economic incentives, with appropriate performance targets for the healthy operations and the work-out unit, respectively.

Sizeable resources were set aside under the bank support to create and capitalise Securum and Retriva. Nordbanken's bad loans were so massive that although support measures had reduced the financial risk, they would probably have retarded a recovery if they had been left in the bank. A transfer of non-performing loans and other commitments was therefore made to Securum for SEK 50 billion (after write-downs) and Securum received a capital contribution of SEK 24 billion to cover its costs in the work-out period. In Gota Bank the non-performing loans were very large in relation to total assets (over 45 per cent). The scenario analysis showed that the bank could not become viable in the longer run, making it necessary to separate the bad loans in order to sell the healthy part of the bank. Non-performing loans and other assets were sold to Retriva for a net value, after write-downs, of SEK 16 billion (39 billion before write-downs). The State also provided Retriva with a capital contribution of SEK 4 billion.

The transfer of bad assets to a work-out unit should be made at a realistic market price.

A fair valuation is important when bad assets are transferred to a work-out unit. The assets should be made over to the unit at a realistic market price. Besides involving the principal of openness, the valuation should establish a proper incentive for the management of the assets. Confidence in the State's bank support would also be impaired if the value assigned to the assets turned out to be too high, making it necessary to contribute additional capital, possibly more than once.

Diagram 4. Non-performing loan stocks of Nordbanken and Gota Bank
Per cent and SEK billion



Equity capital

The initiation of measures of State bank support calls for clear guidelines concerning the treatment of the existing owners' capital inputs. This is necessary for several reasons:

- To give the owners a clear perception of their position in negotiations with the State.
- To avoid undue utilisation of government funds.
- To show the taxpayers that the banks' owners are not being favoured at their expense.

It was already clear when the Riksdag approved the bank support that shareholders were not to receive the protection afforded to depositors and other creditors. In its discussions with banks applying for support the Bank Support Authority made it clear that to the extent that capital or other financial support was provided by the State, this would entail a corresponding reduction in the share capital of the bank's earlier owners. This principle is clearly exemplified in the agreement (which has not been activated) with Föreningsbanken, which stipulates that the State is to receive the equivalent of any capital contribution in the form of preference shares. The voting power inherent in these shares would grow over time, which means that if the support were to be utilised on a large scale over a long period, then the State would gradually acquire a majority holding.

Statutory provisions for compulsory share redemption.

A law was passed to enable the State to undertake the compulsory redemption of shares, following their valuation by an impartial body. The purpose of this law was to ensure that necessary measures for protecting a bank, perhaps with considerable economic assets at stake, could not be obstructed by a group of shareholders trying to use the situation to get more than the market price for their shares. The law, however, has not been used.

State ownership

Right from the start it was stated explicitly, for instance in the Riksdag's decision in 1992, that the bank support was not to result in the State becoming a long-term owner of banks. In so far as State ownership of a bank was necessary as a temporary measure, the aim should be to privatise the ownership as soon as this is feasible in a manner that is economically sound (as in the case of the plans for Nordbanken).

CONDITIONS

Conditions were attached to the support that banks received. They usually concerned measures that were needed to rectify flagrant shortcomings in earlier operations. A more appropriate and, at the same time, less costly organisational structure might be required, for instance, or better internal controls and risk management. Compliance with the conditions could be ensured in that State representatives were appointed to the boards of banks receiving support.

Conditions were attached to the support the banks obtained.

The State never set out to influence the regular operations of the banks. The support was confined to the financial requirement for a bank's survival, while its operations as such remained the responsibility of the bank management and board of directors.

GOAL FOR THE STRUCTURE OF BANKING

In the reconstruction of banks, the authorities had some general ideas about a desirable future structure of the banking sector. One important notion here was that with a number of banks with a solid future, active competition could be maintained. The merger of Gota Bank with Nordbanken was in keeping with this idea. The reconstruction of Swedbank and Föreningsbanken and their transformation into limited banking companies gave their ownership a stronger structure; in these cases the initiative came from the banks but it was furthered by the need to secure their capital base.

The crisis recedes

The bank crisis did not become as serious as many had feared when the situation was most precarious in the months around the turn of 1992. Confidence in Sweden's financial system soon stabilised after the Riksdag approved the support. The financial position of the banks gradually improved in 1993 and their losses declined. Two banks – Swedbank and S-E-Banken – that had applied for support at the beginning of 1993 reported in the summer that their owners would be contributing additional capital and they therefore discontinued the discussions with the Bank Support Authority.

Föreningsbanken has not had to activate the capital adequacy safeguard it obtained and its group capital ratio is now at the satisfactory level of 11 per cent.

Much of the State's financial support to Nordbanken/Gota Bank can be recovered by means of privatisation and share dividends because good profitability has now been restored. Substantial amounts can probably also be recovered from Securum and Retriva after the disposal of their assets.

The resolution of the banking crisis has exceeded expectations – the economic recovery has been a crucial factor.

In that the banking crisis has been overcome more rapidly than expected, it seems reasonable to suppose that the guidelines for resolving the crisis have had a favourable effect. This assumption is supported by the observation that the choice of different methods in other countries – for instance not to disclose the full extent of the problems – has accentuated instead of diminishing the difficulties. But regardless of the extent to which the choice of methods may have helped to resolve the crisis, there is an additional factor, not mentioned above, that has been crucial, namely macroeconomic development. After the turbulent situation in the autumn of 1992, the Swedish economy has become more stable. Measures were taken to reduce the Government deficit, interest rates fell and exports grew rapidly, partly as a consequence of the krona's depreciation. All this benefited the banks by raising their operating income and reducing loan losses as the solvency of many borrowers improved. The conclusion is clear: just as the acute phase of the bank crisis was triggered in part by macroeconomic unrest towards the end of 1992, so has the recovery in the banking sector been aided by the economic improvement from 1993 onwards. Without a sound national economy, measures to support the banking sector have only a limited effect.

Was the bank support necessary?

Did the bank support call for such an extensive framework: Riksdag decisions on guarantees and unlimited amounts, the establishment of a new authority, the detailed scrutiny of banks applying for support, and so on? Could the crisis have been managed more simply and cheaply? Such questions must be assessed in relation to the situation as it was in the autumn of 1992. Confidence in Sweden's financial sector, as well as in its currency, was very weak. There was a massive outflow of foreign exchange. A deep recession was in its second year. Asset prices had collapsed and the loan losses of banks had rocketed. There was an evident risk that the capital ratios of all the major bank groups, possibly with an isolated exception, would soon fall below 8 per cent. The law requires that in that case the authorities withdraw the banking permit (oktroj). A very acute problem had to do with the banks' dependency on sizeable and continuous foreign currency borrowing, in that their international counterparties had already begun to curtail or even close credit facilities on account of uncertainty about the solvency of the Swedish institutions.

In this situation the Government and the authorities concluded that without a prompt restoration of confidence in Sweden and its financial sector, the stability of the payment system was clearly threatened, which would probably have highly adverse consequences for the economy as a whole. In order to avoid this, the measures the Government chose to implement needed to be so clear and far-reaching that a strong determination and ability to tackle the problems would be immediately clear to the rest of the world. There was neither time nor scope for more than an approximate assessment of what the situation called for.

The bank support has contributed to a banking system in Sweden that is now financially robust, dynamic and competitive.

As discussed above, the effects of the bank support and whether alternative solutions would have yielded different results cannot be gauged more closely in retrospect. Sweden now has a banking system that is financially robust, dynamic and competitive. The overall economic structure is thereby strengthened in various ways. The support measures have accordingly helped to fulfil the primary long-term objective.