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Banking Crises: lessons from Sweden and Norway

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Banking Crises: lessons from Sweden and Norway

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This note brings together narratives of two banking crises in Sweden and Norway in the early 1990s and describes the remedial action taken by central governments. It was of interest at the time of the UK and global financial crisis in 2008.

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1 Sweden

The main text of the following account is taken from *The Swedish Banking Crisis: Roots and consequences* as published in the Oxford Review of Economic Policy, Vol. 15, no. 3, by Peter Englund.[1]

I. INTRODUCTION

The purpose of this paper is to survey the Swedish banking crisis against this general background. Since the Swedish crisis appears to have all eight elements outlined above, this offers a natural chronological organization of the paper. We focus on the following set of questions.

(i) To what extent did the deregulation contribute to inflated asset prices and a general macroeconomic situation which prompted the banking crisis?

(ii) What was the role of new shocks in breaking the asset price bubble and initiating the crisis? Did the bubble burst 'by itself' or did it take exogenous shocks?

(iii) What was the relation between the banking crisis and the currency crisis? Would having let the currency float at an early stage have altered the course of the crisis?

(iv) What could the government have done to prevent the crisis? What was the role of the safety net once the crisis occurred? How did government actions succeed in dampening the macroeconomic consequences of the crisis?

II. THE SWEDISH ECONOMIC ENVIRONMENT

By the mid-1980s Sweden had experienced at least a decade of higher inflation rates than many other countries This resulted in an ongoing real appreciation of the exchange rate, interrupted by occasional devaluations, six times after 1973. The most recent had been in 1982 by as much as 16 per cent, and had given Sweden a temporarily undervalued currency. But the real appreciation continued, by 8 per cent only between 1982 and 1985.4 Naturally, this fostered renewed devaluation expectations that were reflected in high interest rates. During the second half of the century the Swedish (1 year) interest rate was consistently 1– 2.5 per cent above the international average. In periods of currency speculation, as in 1985, the difference rose to as much as 5–6 per cent.

[…] High inflation interacted with a nominal tax system with full deductibility of interest payments making real after-tax interest rates low or even negative. […] It is only in connection with the crisis of the early 1990s that Swedish households met positive costs of borrowed funds for the first time in three decades. It is natural to ask how an economy could operate with negative borrowing costs for such a long time. Part of the answer no doubt lies in the prevailing credit market regulations, regulations that were soon to be lifted.

III. DEREGULATION 1983–5

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[1] Peter Englund *The Swedish Banking Crisis: Roots and consequences*; Oxford Review of Economic Policy, Vol. 15, no. 3.

Swedish banks, and the Swedish credit markets in general, remained heavily regulated long after the Second World War; Banks, insurance companies, and other institutions were subjected to lending ceilings, and placement requirements (liquidity ratios) required them to invest in bonds issued by the government and by mortgage institutions. Large budget deficits and an ambitious programme for residential investment led to a situation where banks were required to hold more than 50 per cent of their assets in such bonds, typically with long maturities and with interest rates being fixed for 5 years at below market levels. Combining this with a ceiling on lending, banks were, in effect, transformed into repositories for illiquid bonds, crippled in fulfilling their key function in screening and monitoring loans for consumption and investment.

[…]

The Riksbank's views on proper bank behaviour were communicated in weekly meetings between the Governor and representatives of the major banks. This was not an environment where banks aggressively expanded lending of any sort, subject to formal limitations or not. Nor was it an environment where good risk analysis was very important. This made banks ill prepared for the environment that they would enter a few years later.

[…]

In the early 1980s the stage was set for deregulation. Although advocated by economists for a long time, it had been stubbornly resisted by the Riksbank and by politicians. When it took place it happened with a swiftness that surprised most observers. An early step was the abolition of the liquidity ratios for banks in 1983. Interest ceilings were lifted in the spring of 1985, and finally the lending ceilings for banks and the placement requirements for insurance companies went away in November 1985. The main driving force behind the deregulation was probably the rapid development of financial markets, e.g. the growth of an active money market in certificates of deposit and Treasury Bills in the early 1980s, a development that was stimulated by the mounting budget deficits that was financed in the domestic market.

The new environment of active financial markets contributed to make the regulations increasingly inefficient. This was acknowledged in the official statement from the Riksbank announcing the deregulation, where it was argued that 'the aim of restricting credit expansion is not attained, whereas permanent usage of regulations has a destructive effect on the structure of credit markets'.

The Riksbank realized that the deregulation would stimulate bank lending and increase competition on the credit markets. To counter this effect, non interest- bearing cash reserve requirements for banks were increased from 1 to 3 per cent. But in no other ways did monetary or fiscal policy change as a result of the deregulation. Banks, mortgage institutions, finance companies, and others now entered a new environment where they were free to compete on the domestic credit market.

IV. CREDIT EXPANSION, 1986–90

The impact of the deregulation was immediately apparent. The rate of increase of new lending from financial institutions, which varied between 11 and 17 per cent per year during the first half of the 1980s, jumped to 20 per cent in 1986. Over the 5-year period, 1986–90, lending increased by 136 per cent (73 per cent in real terms).

Deregulation also opened up new opportunities for competition over market shares. The institutions most directly hit by regulations now expanded most rapidly, banks by 174 per cent and mortgage institutions by 167 per cent between 1986 and 1990 (see

Figure 3). […] Now that banks entered into the markets previously in the domain of the finance companies, these were pushed into higher-risk markets. Not being able to receive deposits nor to issue bonds, finance companies were financed partly by direct borrowing in banks and partly by issuing marknadsbevis (company investment certificates). New issues of marknadsbevis were typically guaranteed by banks. As a result, banks became indirectly exposed to extra credit risk.

Applying hindsight to the crisis that followed, it is obvious that all actors took higher risks than before. To what extent this extra risk-taking was understood as a conscious decision at the time, and seen as an instrument for competition over market shares, is an open question. To many of the actors it simply seemed very profitable with positive interest flows coming immediately and credit risks manifesting themselves only later. A measure of risk-taking is the maximum loan-to-value (LTV) ratio for mortgage loans to owner-occupied housing. This LTV ratio was held constant at 75 per cent for 3 years after deregulation, indicating no extra risk-taking at this stage. This sluggishness can probably be explained by the pent-up credit demand in 1985, which gave little reason for banks to compete aggressively over new lending, when administrative and other factors restricted a faster expansion. In 1988 the LTV ratio was increased to 90 per cent. In early 1991, when the crisis was under way, it was again reduced to 75 per cent and further lowered for apartments in cooperative associations to 60 per cent in 1992.

[…]

Summing up, the evidence suggests that, although the 1983–5 deregulation certainly contributed to rapid credit expansion, it was not a very dramatic event. The immediate impact on consumption and investment appears to have been limited. Expressed differently, the rationing effects of the abolished regulations do not seem to have been quantitatively important for the real decisions of households and corporations. On the other hand, there is no doubt that financial flows were affected in an important away. Credits were increasingly channelled via financial institutions, such as banks and mortgage institutions, rather than directly between firms (e.g.trade credits) and between households (e.g. seller financed housing loans). Loans were also increasingly used for high-leverage financial investments. These effects on financial flows may, via their impact on asset prices, have had important effects on the banking crisis.

V. THE IMPACT ON ASSET MARKETS

[…] The main reason for the claim that the deregulation initiated a price bubble comes from the market for commercial real estate. […] the rate of price increase for prime location commercial properties in Stockholm was much higher than elsewhere in Europe. Note, however, that prices rose much faster prior to deregulation than after it. The increase was 275 per cent between 1980 and 1985 compared with 140 per cent between 1985 and 1990. The latter number differs only slightly from the European average of 135 per cent during the same period.

[…]

Summing up, it is difficult to explain 1990 prices of real estate, and perhaps also of other assets, purely in terms of fundamentals. There are two rival explanations for the price boom. One is that it reflects excessive volatility ('bubbles') induced by a recently deregulated credit market allowing high leverage investments. Alternatively, it may be regarded as the result of several major shocks to fundamentals—high inflation, expansionary macro policy, and low post-tax real interest rates—propagated by the 'normal' market-price dynamics. My interpretation, based on the studies quoted above, is that the deregulation did not play a decisive role in triggering the price boom. However, once the price boom was under way it was amplified by the new borrowing opportunities and by lax risk analysis in financial institutions. Both inexperience in a new environment and competition among credit institutions unleashed by deregulation played important roles in this process. The crisis that was to follow could be seen as the logical next step of the credit and asset price cycle initiated in the second half of the 1980s, but it was also affected by new shocks that occurred at the turn of the decade.

VI. THE CRISIS

At least until the autumn of 1989 there were no signs of an impending financial crisis. There was a strong recognition that the economy was overheated. The open unemployment rate reached an all-time low of 1.4 per cent in 1989, and prices continued to rise faster in Sweden than in other countries. The real exchange rate had appreciated by 15 per cent since the devaluation in 1982. Yet there was little parliamentary support for a restrictive fiscal policy, and monetary policy was tied up by a fixed exchange rate lacking credibility to an increasing extent. But apart from occasional episodes of higher interest rates to defend the exchange rate, there was nothing on financial markets that signalled a crisis. The stock market continued to boom and reached a peak in August 1989, 42 per cent above the level at the beginning of the year. The sub-indices, both for banks and real estate holding companies, followed a parallel development.

As a result of the price boom, investment in real estate (other than housing) had nearly doubled; the average for 1988–90 was 88 per cent above the average for 1983–5. During the autumn of 1989 one saw the first indications that the commercial property market had reached its peak, and there were reports of difficulties in finding tenants at current rent levels. The stock market reacted rapidly and from its peak on 16 August 1989, the construction and real estate stock price index fell by 25 per cent in a year, compared with 11 per cent for the general index. By the end of 1990 the real estate index had fallen by 52 per cent (against 37 per cent for the general index) from the peak level. Now one also started to see some indications of potential credit losses among the finance companies, but nothing signalled expectations of a widespread financial crisis. Prices of banking stocks fell only slightly more than stock prices in general, a decrease by 41 per cent from the peak to the end of 1990.

Simultaneously, the Swedish economy was subjected to sharply increasing interest rates. This is the result of at least three different impulses. First, international interest rates increased, following the German reunification. Second, domestic macro policies finally changed. In February 1990 the Finance Minister resigned over lack of support within the government for a more restrictive fiscal policy. This prompted the Riksbank to raise the interest rate, and gradually it became clear that macroeconomic priorities were changing to focus more on inflation than before. Third, the marginal tax on capital income and interest deductions was reduced from 50 per cent for most taxpayers to a flat 30 per cent as part of a major tax reform becoming effective in 1991.

In September 1990 one of the finance companies Nyckeln (‘the Key’), with heavy exposure to real estate, found itself unable to roll over maturing marknadsbevis. This was a sort of ‘run’; rather than actively running to the bank and withdrawing deposits, previous holders of marknadsbevis, otherwise routinely reinvesting, now refused renewed funding, in order to secure their investment in the face of an imminent bankruptcy. The crisis spread to the whole market for marknadsbevis, which dried up in a couple of days. Surviving finance companies had to resort to bank loans. The crisis also spread to other parts of the money market with sharply increasing margins between Treasury Bills and certificates of deposit. In the next few months a number of other finance companies also went into bankruptcy.

[…]

The crisis now spread rapidly to the banks. By the end of 1990 reported credit losses had increased to around 1 per cent of lending, two to three times as much as during earlier years. By the end of 1991 losses were running at 3.5 per cent of lending and at the peak of the crisis in the final quarter of 1992 at 7.5 per cent of lending, about twice the operating profits of the banking sector. Over the period 1990–3, accumulated losses came to a total of nearly 17 per cent of lending.

The crisis coincided with a sharp downturn of the real estate market, with prices in downtown Stockholm falling by 35 per cent in 1991 and by another 15 per cent next year. Handelsbanken, the only major bank to go through the crisis without need for government support, had the lowest rate of expansion and the lowest fraction of real-estate loans, whereas Gota, with by far the largest losses, is on the other end of the scale.

The first signs that the losses caused solvency problems among the banks came in the autumn of 1991, when it became clear that two of the six major banks, Första Sparbanken and Nordbanken, needed new capital to fulfil their capital requirements. Being the major owner, the state injected new equity into Nordbanken. It also issued a guarantee to the owners of Första Sparbanken—a foundation—for a loan that enabled the bank to fulfil its capital requirement. Problems returned for these two banks during the spring of 1992, leading the government to issue a new guarantee to Första Sparbanken. The earlier guarantee was transformed into a subsidized loan at a cost of 1.3 billion SEK. During the spring, problems also surfaced in Gota Bank, the bank that in the end turned out to have made the largest losses. In April the bank's private owners put up new capital, but this lasted only a few months and on 9 September 1992 Gota went bankrupt.

The article continues by describing the action taken by the Swedish government:

It was only at this stage that it was dealt with as a systemic crisis. Sweden had no formal deposit insurance at the time, but now the government immediately announced that it guaranteed Gota's obligations, except its equity. The guarantee, which included all forms of bank debt, not only deposits, was extended to all other banks a few weeks later. The private minority owners were bailed out of Nordbanken, at a cost of 2 billion SEK, and the bank was reconstructed in the summer of 1992. A 'bad bank', Securum, was founded and a quarter of Nordbanken's credit stock, at an original book value of 67 billion SEK, was transferred to Securum. Subsequently, the state took over Gota (at the price of one krona) and Gota's non-performing loans were later transferred to Securum. Government payments to the banks are summarized in Table 2.

Out of a total of 65 billion SEK, only 3.1 billion went to the old bank owners—1 billion in interest subsidies to Första Sparbanken, and 2 billion in buying out the old owners of Nordbanken. By and large, the government followed the principle of saving the banks but not the owners of the banks.

In May 1993 a government agency Bankstödsnämnden (the Bank Support Agency) was formally created. Aided by international consulting teams, it conducted in-depth analysis of the credit portfolios and future prospects of individual banks (all major banks except Handelsbanken). It resulted in a special agreement with one of the remaining banks, Föreningsbanken, about a 'capital requirement guarantee', where the state promised to invest in new equity should the capital requirement ratio fall below 9 per cent. This was to be combined with an option for other shareholders to repurchase the shares before 1998. The guarantee was never used.

The key political lesson drawn by the author is:

In characterizing the government 'emergency treatment', two things should be emphasized. The first factor is the decisiveness and broad political support once action was taken. The government made it clear that it guaranteed Gota's obligations on the very day of the bankruptcy. The announcement of the general bank guarantee came only 2 weeks later, with the support of all parties except a small right-wing populist party (Ny demokrati). Broad political support was particularly important since, at this stage, the bank guarantee was just an announcement of a forthcoming bill to parliament; the formal decision in parliament came 3 months later.

The second factor is that there was, in principle, no direct compensation given to shareholders of the failed banks. Of course, the general bank guarantee was a valuable asset provided free of charge. In fact, its existence probably saved one or more of the surviving banks from bankruptcy, and thereby indirectly part of the wealth of the shareholders. But the guiding principle was to rescue the financial system with a minimum of wealth transfer to the original shareholders.

The article continues with a description of the currency crisis (contemporary with the UK's exit from the ERM) but this is omitted here.

VIII. THE SALVAGE

With the general bank guarantee in the background, there was no need for more direct government intervention in individual banks. As it turned out, the banking system outside of Nordbanken and Gota recovered, partly with new equity from their owners. The Swedish economy went into a major recession, with GDP falling for three consecutive years, a total of –5.1 per cent in 1991–3, and private investment plummeting by 35 per cent during the same period. While the banking crisis was aggravated by the macroeconomic crisis, it was eased by interest rates coming down as the krona was allowed to float. At the end of 1993 the overnight interest rate was 7.75 per cent, the lowest rate in over a decade.

Of interest now, in the light of some of the claims made by the Government that claims on the public purse may, ultimately prove to be quite small once the institutions revive, is the experience of the Swedish bank Securum, which had to realise the assets it bought through rescue packages.

On 1 January 1993, Securum started operating as an independent company. It was owned by the government to 100 per cent, i.e. not a subsidiary of Nordbanken, and run by a professional management that was given substantial independence by the owner. Its assets were a portfolio of nonperforming loans and the primary initial task was to rescue whatever economic values these contained. In the first phase this involved taking decisions on whether to have the debtors file for bankruptcy or not. In most cases bankruptcy turned out to be the solution, and Securum took over the collateral assets.

The company then faced the task of disposing of these assets. This involved first ensuring that the underlying economic activities were run efficiently, second repackaging the assets in such a way that the potential market value was maximized, and third selling them at the best possible price. This had to be done with an eye to the development of the real estate market. Securum was the owner of around 2,500 properties with an estimated market value of 15–20 billion SEK, corresponding to between 1and 2 per cent of all commercial real estate in Sweden. It was believed that putting all of this on the market immediately, e.g. by auctions, would have led to large losses and depressed the real estate market even further.

Assets were sold in three ways: initial public offerings (IPOs) on the Stockholm stock exchange; corporate transactions outside the stock exchange; and transactions involving individual properties. Securum was capitalized in order to be able to operate for at least a decade. Most of the sales were made in 1995 and 1996, when the real estate market had started to recover, but when prices still were low by historical standards. As it turned out, the process was much faster than originally envisaged and Securum was dissolved at the end of 1997. Jennergren and Näslund (1997) have calculated the result, ex post, from the perspective of the shareholder. The total investment by the state was 71 billion SEK, including the items listed in Table 2 and the value of the shares in Nordbanken when the crisis started (taken to be January 1991). On the income side are dividends from Nordbanken, proceeds from the partial privatization of Nordbanken in 1995, the market value of the remaining stateowned

shares in Nordbanken in 1997, and the estimated market value of remaining Securum assets including the proceeds of asset sales. Transforming these cash flows into current values in July 1997 Jennergren and Näslund calculate the final bill to the taxpayer to be 35 billion SEK, 2.1 per cent of GDP in that year.

Note: if this was to prove the case in the UK the public sector cost would be almost £30 billion – about 7.5 pence on the basic rate of income tax.

IX. SOCIAL COSTS OF THE CRISIS

[…]

The second major task of banks is the provision of credit to small and medium-sized business. The wave of bankruptcies that followed on the banking crises bears witness that the banks had failed in their function of monitoring their clients. This had social costs before the crisis by facilitating projects with negative present value, and it had social costs after the crisis in the form of interrupted production processes and underutilized resources. Further, the crisis left the banks poorly capitalized and, temporarily, less well equipped to take on new loans than under normal circumstances. Between 1990 and 1993 bank lending decreased by 21 per cent in current prices and the margin between the money market rate and the average bank lending rate reached a high of more than 5 per cent in 1992. This may be taken as evidence of a credit crunch, i.e. that shortage of capital had shifted the supply curve for borrowed funds. However, it could also reflect that balance sheets of households and corporations were weakened by falling collateral values, thereby increasing the fraction of potential borrowers that even under normal conditions would be denied a bank loan. Further, the uncertainty in society increased, stimulating savings and hampering investment demand. All these shocks are related to the banking crisis, but it is difficult to disentangle what fraction of the fall in lending depends on the credit crunch, the collateral squeeze, and the savings shock.

In several respects the effects of the crisis on the banking sector appear to have been short-lived. Already in 1994, various performance indicators were back at pre-crisis levels.[…] On the other hand, it took until 1998 before bank lending reached 1992 levels in nominal terms, but this is more likely to be the result of lack of demand than of supply restrictions. All in all, credit-crunch effects on the private sector appear to have been short lived.

X. LESSONS

Much has been made of the 1985 deregulation as the key explanation for the crisis. As the discussion above has indicated, that view may be too simplistic. One has to distinguish the different stages that led to the crisis. In the first stage, deregulation probably only played a minor part in triggering the general macroeconomic boom in the late 1980s. Rather, the boom should be explained by the interaction of an overly expansionary fiscal policy, a monetary policy that was constrained by the fixed exchange rate, and a tax system that transmitted constant pre-tax real interest rates into falling post-tax interest rates in an environment of increasing inflation. At a later stage the boom was amplified by excessive lending, where deregulation obviously played an important role. In particular, one should stress that deregulation stimulated competition between different financial institutions, where the upside potential from rapid expansion was given too much weight relative to the long-term risks.

[…]

The many instances of 'bad banking' can probably be ascribed to a combination of three factors. First, bankers were not prepared or trained for the new environment. For one thing, the banks did not have information systems capable of handling the new situation with rapidly expanding credit portfolios. In many cases, banks lacked an overview over their credit portfolios, and did not have a clear picture, for example, of the fraction of the total stock going to a single borrower. The large share of lending to finance companies added to the information problem, since borrowers denied credits over a certain limit in banks often had loans with the finance company. Second, the rate of expansion and the apparent profitability of new lending created a difficult problem in allocating scarce human resources between credit evaluation and credit expansion.

With hindsight it is easy to see that it paid to be cautious, but the verdict could have been different under other macroeconomic circumstances. Third, it is conceivable that banks and finance companies close to insolvency realized that pay-offs were asymmetric and gave incentives for increased risk-taking.

2 Norway

This account is reproduced from a CFS Paper[2]

On March 18th 1988, Sunnmørsbanken, a small commercial bank in western Norway, issued an earnings report warning that it had lost all of its equity capital. This event marked the beginning of the Norwegian Banking Crisis, a four-year period in which 13 banks, representing over 95% of the total commercial bank assets in Norway, either failed or were seriously impaired.

[…]

Prior to the mid-1980s, regulations limited both the quantity and rates at which Norwegian banks could lend. So-called "interest rate declarations" set upper limits on average bank loan rates. Restrictive reserve requirements, regulations requiring banks to invest in government bonds, and direct controls on lending by state-owned banks facilitated the rationing of credit at the artificially low loan rates.

Deregulation began in earnest in 1984. In that year, authorities relaxed reserve requirements, allowed subordinated debt to be counted as bank capital, and opened

[2] Centre for Financial Studies, Frankfurt University; *Distressed Relationships: Lessons from the Norwegian Banking Crisis*,; CFS Working Paper 2000/01

up Norway to competition from foreign banks by allowing seven foreign banks to establish "daughter" banks inside Norway.

The year 1984 also saw the establishment of Oslobanken, the first new commercial bank to be opened in Norway since 1961. In 1985, the Norwegian government lifted all interest rate declarations, phased out bond investment requirements, and consolidated all bank oversight responsibilities under one authority, the Banking, Insurance, and Securities Commission (BISC). Further restrictions on competition were relaxed in 1986 when foreign banks were permitted to open branches in Norway. By 1986, the foreign banks, as well as five newly created Norwegian commercial banks, intensified the competitive pressure on existing Norwegian financial institutions.

Banks began to aggressively expand credit in an attempt to maintain market share. Between 1984 and 1986, the Kroner volume of lending by financial institutions to firms and households in Norway grew at an annual inflation-adjusted rate of 12%, roughly three times the average growth rate in the years prior to deregulation. A large portion of this unprecedented growth came from smaller commercial banks and savings banks and went to financing small and newly established firms, especially firms in cyclically sensitive industries like real estate, construction, and service industries (Drees and Pazarbasioglu (1995)).

The exuberant expansion in bank lending ended in 1987. Meanwhile bank loan losses began to accumulate. During 1986, the price of North Sea Brent Blend crude oil fell from $27 a barrel to $14.50 a barrel, precipitating a sharp decline in real asset values in the oil-dependent Norwegian economy. Subsequently, real loan growth slowed to 3.6% in 1988 and 2.8% in 1989. Existing loans to cyclically sensitive firms also came into jeopardy. Total bankruptcies in Norway increased from 1,426 establishment in 1986 to 3,891 in 1988 and 4,536 in 1989, with most increases occurring in the real estate, transport, construction, retail store, fishing, hotel, and restaurant industries. Paralleling these bank failures, commercial loan losses, measured as a percentage of total bank assets, rose from a level of 0.47% in 1986, to 1.57% in 1988, and 1.60% in 1989. The transition from a tightly regulated economy to a more competitive financial marketplace accentuated the losses through poor decision-making, high risk-taking, and outright fraud.

A speech at a Norges Bank Conference on Banking Crisis Resolution - Theory and Policy, in 2005 summarises the collapse and the response by the Norwegian government:

The resolution of the Norwegian banking crisis

By the end of 1990, key policy makers started to worry about the crisis becoming systemic. It was essential to maintain confidence in the financial sector and avoid a major credit crunch when the economy was already in a recession. The capital in the banks' guarantee funds was about to run out and it was apparent that the larger banks might also face problems. The Ministry of Finance thus proposed - in January 1991 - the establishment of a new guarantee fund - the Government Bank Insurance Fund and put 5 billion kroner in it [equivalent to around 0.6% of GDP].

The authorities were at that time actually ahead of events. The banks did not seem to be aware of what was under way. Thus, early in 1990, senior management of the largest bank - Den norske Bank - still expected a positive result for the year as a whole, and the chief executive officer of the second largest bank - Christiania Bank - was voted the best leader of the year.

The new fund was set up as an independent legal entity, located in and supported by technical staff from the central bank. Its mandate was initially to provide loans to the banks' guarantee funds to enable them to perform their roles. During that first year, another eight small to medium-sized banks received support.

Certain amendments were also made to the banking laws, which made it possible for the government to write down a bank's shares to zero. This ensured that share capital really could be written down if a bank's capital was lost.

At this stage, the crisis escalated rapidly. In October, it became evident that huge loan losses had wiped out the entire share capital of two of the three largest banks [Christiania Bank and Fokus Bank]. Their share capital was written down to zero by government decision. The government - through the Government Bank Insurance Fund - became the sole owner of the two banks.

By the end of 1991, most of the share capital in the largest commercial bank [Den norske Bank] was also gone. The bank received support from the government in the form of preference shares in early 1992. This was not enough, and in connection with further capital support later that year, it was decided that the bank's ordinary shares would be written down to zero. When the Government Bank Insurance Fund provided additional support to the bank, it became the sole owner.

Key features of the Norwegian crisis resolution

There are *five features* of the Norwegian resolution I would like to highlight:

Private solutions were explored before the government intervened.

Share capital was written down to zero before committing public funds.

The government acted swiftly to limit contagion, but did not provide a blanket guarantee.

Liquidity support was given to illiquid, but solvent institutions.

The government did not use an asset management company - as the other Nordic countries did later on.

I shall briefly comment on each of them:

Private solutions

Before the Government Bank Insurance Fund injected capital into crisis-stricken banks, efforts were made to attract private investors. However, these efforts did not succeed. The option of foreign takeovers was also considered by the authorities, but at the time this was not a viable option, due to current banking regulation and strong political preferences for national ownership of banks.

Banks' share capital was written down to zero

Before the government committed any funds to the banks, it made sure that capital was written down according to the best estimate of loan losses at the time. Strict conditions were also tied to all capital support from the Government Bank Insurance Fund. Thus, public support did not come as "free lunches" for the banks, and their activities were curbed to avoid giving them an unfair competitive advantage. Shareholders were forced to cover the bank's losses before tax payers' money was put on the table. To my mind, this was imperative in order to muster the necessary political support and acceptance for the rescue operations.

No blanket guarantees were given

Once the crisis had become systemic, the Norwegian authorities acted swiftly to limit contagion. But they did not issue any explicit blanket guarantee for the banks' liabilities.

However, in late 1991, the Ministry of Finance announced that the government would implement measures necessary to secure confidence in the Norwegian banking system, while Norges Bank announced that it would secure the necessary supply of liquidity to the banking system. No assurances were given that individual banks or bank creditors would be rescued. In the end, only two small banks were closed and all depositors were repaid in full through the banks' guarantee funds. Creditors also recovered their funds in full, except for some creditors in one of the small commercial banks that were closed.

Liquidity support was only given to illiquid, but solvent financial institutions

Norges Bank was a fairly active lender of last resort during the banking crisis. By and large, it stuck to the classic principle of only lending to illiquid, but solvent institutions.

In the first stage of the crisis, the bank extended liquidity support to several small and medium-sized banks. These loans were guaranteed by the banks' guarantee funds. Most loans were provided at market rates, although a few were provided at below market rates.

In the second stage of the crisis, once it had become systemic, a division of responsibility between the different authorities was established. Norges Bank contributed loans to institutions that were experiencing liquidity problems, but where underlying solvency was satisfactory, while the government insurance fund provided solvency support.

No use of asset management companies

The authorities chose not to set up separate asset management companies - or "bad banks" - to handle problem loans. Bad loans were not considered to be excessive for management to handle "within" the bank. A bank knows its own borrowers best and has experience in working out defaulted loans. In addition, setting up an asset management company and transferring bad loans from the banks would have required complicated accounting and legal work, and it would have been hard to find a fair price at which the loans should be transferred. Last, but not least, such an asset management company would have required government funding. Thus, more taxpayers' money would have been put at risk. However, there was nothing to prevent the banks themselves, alone or jointly, from establishing subsidiaries to handle the bad loans. None chose to do so.

Resolution costs

Norway avoided a collapse of the banking system and an ensuing major credit crunch. The government recognized the severity of the problem at an early stage and showed a willingness to take the necessary measures. As a result, confidence in the financial system was quickly restored. Collateral values started to increase and loan losses fell. By late1993 the crisis was over, the banking sector was again profitable and started to raise private equity in the market.

Due to the quick resolution, the Government was able to contain the fiscal and economic costs of the banking crisis. The fiscal resolution costs have been estimated to about 2 % of GDP, which is low compared with many other crisis countries. However, the net fiscal cost turned out to be negative - the Government actually made a small profit of 0.4 % of GDP - when the government's shares in the banking sector were sold at a substantial profit.

The government became "owner of last resort" at the peak of the crisis when private investors were unwilling to invest. At that time, no one knew where the economy was heading. It was therefore reasonable that the government should benefit from its investment as the economy recovered.

An account of the Norwegian crisis can also be found in successive editions of the OECD *Survey of Norway.* The 1992-93 edition also attributes the ‘seeds of the crisis’ as the deregulation of financial services in the 1980s, itself a reaction to an overregulated system in the 1970s. It notes:

> In retrospect it is clear that the decision to open the financial system more fully to market forces was not accompanied by proper incentives for prudent private lending and borrowing decisions. Macroeconomic policies reinforced rather than constrained credit demands: monetary policy kept an accommodating stance, and fiscal policy turned expansionary in 1984-85.[3]

The financial sector too is blamed:

> Emerging from an era when regulations limited competition, private bansk were ill prepared to manage risks in a booming credit market. Lending practices became increasingly lenient as credit was more frequently extended without or with only little collateral….such a build up of risk was also evident on the liability side of banks' balance sheets, as at the same time, banking institutions funded much of the credit expansion on foreign and domestic money markets, rather than on more stable ordinary deposits.[4]

The government rescue plan involved grants to the bank Insurance Fund (which provided core capital direct to failing banks); direct support of the depositors guarantee fund and the taking of equity investment stakes. The central bank also provided extra liquidity support. At the start of the crisis the two industry funded insurance funds (which insured deposits and facilitated reorganisations and mergers) dealt with claims. By the end of 1990 however it looked as though they would soon run out of funds. The level of support is shown under the various headings in the table below:

Support for Norwegian Banking system *Krone millions*

Year	Savings Bank Guarantee Fund		Commercial Banks' guarantee Fund	Norges Bank	Government Bank Insurance Fund		Government Bank Investment Fund	Total	
	Guarantees	Equity	Equity		Guarantees	Equity		Kr million	% GDP
1988	600			200				800	0.1%
1989	723	1,744	885	573				3,925	0.6%
1990	1,217	179	466					1,862	0.3%
1991	938	1,629	5,836			5,615	83	14,101	1.8%
1992		219			800	7,250	2,745	11,014	1.4%
	3,478	3,771	7,187	773	800	12,865	2,828	31,702	na

Source: OECD

For comparison, over the whole period the average sterling krone exchange rate was a little under £1=kr100. Thus the total package was about £325 million, just under 3% of GDP. At its height, the government was the sole shareholder in the second and third commercial bank and the largest in the largest bank. By 1994 the sector had recovered profitability and most banks had capital adequacy levels at or above international standards. The Government embarked on a lengthy period of privatisations of its holdings over the 1995-97 period with a third stake in two banks remaining the other, Fokus Bank sold completely by 1995.

[3] OECD Survey, *Norway* 1992-93, p55

[4] Ibid p58