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Testimony of Bo Lundgren

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BACKGROUND

The Swedish banking crisis in the early 1990s was mainly the result of a real estate bubble following the well over-due deregulation of credit markets in 1985. In an economic environment with high inflation and a tax system that stimulated borrowing, the stage was set for speculation. The fact that exchange controls were retained until 1989 accentuated this development. There was what you might call a 'bathtub effect', where predominantly speculative investments were more or less confined to the limited domestic commercial real estate market.

When the bubble burst, as real estate prices started to fall in 1990, all of the seven largest banks, with a market share of 90 per cent, suffered heavy losses, primarily from loans to commercial real estate. Credit losses in those years added up to approximately one fifth of total lending, which was equivalent to 12 per cent of Sweden's annual GDP. The stock of non-performing loans was much larger than the banking sector's aggregate equity capital. Five of the seven largest banks needed, and obtained, additional capital from either the Government or from their owners.

The crisis in the financial sector emerged at the same time as the real economy entered into recession. Households, which had also increased their indebtedness substantially since the deregulation of the credit market, increased their savings to repay their loans. There was a considerable decline in domestic demand, resulting in negative growth, and a substantial increase in public sector deficit.

When I assumed political responsibility for the financial sector in October 1991, immediate efforts were required to manage the situation at two banks: Nordbanken and Första Sparbanken. Nordbanken was partly in private hands, but the Government was the majority owner and had a special responsibility (we later bought the shares that were privately owned in order to manage the problems in the bank more efficiently). Our analysis of Första Sparbanken, Sweden's largest savings bank, showed that it was 'too-big-to-fail', not least because of huge foreign funding. That made it necessary to contribute to a solution.

Our initial approach was to separate the treatment of problems that arose at particular banks. Meanwhile, the Government introduced measures to allow foreign banks to establish subsidiaries in order to mitigate the effects and enhance competition. We also abolished property tax on commercial real estate to help stabilize the market.

One key objective was to ensure that our crisis management would be characterised by the greatest possible transparency. This would contribute towards bolstering confidence in the financial sector and in our crisis management as such. One step towards this was the introduction of clear rules for how non-performing loans would be reported and property valued.

POLITICAL CONSENSUS

During the spring of 1992, the situation got worse for the two banks that had already received support and severe problems arose for a third, Gota bank. It became clear to us that we were approaching a systemic crisis. We began to work on general measures that would be needed to avert a collapse.

Conditions in the Swedish economy continued to deteriorate and the position of the banks became gradually more strained. Gota bank was unable to continue operations without Government support. In September, in the face of a general loss of access to foreign currency funding, it was deemed necessary to issue a blanket guarantee for all non-equity claims on Swedish banks.

We endeavoured to establish broad political consensus. Discussions with the main opposition party, the Swedish Social Democratic Party, (which had supported previous measures) resulted in it being possible for an action programme, introduced in September 1992, to be approved by a substantial majority in the Riksdag (Swedish Parliament). This meant that we achieved the desired effect prior to the formal decision by the Riksdag.

BLANKET GUARANTEE AND BANK SUPPORT

The cornerstone of this package of measures (see Appendix) was a general guarantee for all creditors and depositors (Sweden did not have a deposit guarantee at that time) with Swedish banks. Risk capital, in the form of share capital and perpetual subordinated loans, was not covered by the guarantee. The principle was that the share capital was first to be used to cover credit losses and write-downs.

The guarantee would remain in force until the stability of the financial system was no longer under threat and could be discontinued without jeopardizing the rights of creditors. We stated that discontinuation would require a new decision by the Riksdag.

This undertaking meant that the lender of last resort, the Riksbank (Sweden’s Central Bank), was in a position to provide banks with liquid assets in domestic or foreign currency so they could unquestionably meet their commitments. In particular, foreign currencies were deposited with the banks on a very large scale to make up for decreased foreign loans. Gradually, banks could also resume their funding in interbank markets, backed by the support from the Government guarantee.

The Government was also given the mandate to implement such measures as might be required to restore the stability of the financial system. This involved support for the continuation of operations at sustainable banks or support for the orderly reconstruction or winding up of banks that could not be expected to become profitable in the long term. Support could be granted in the form of loans, guarantees, or injection of capital.

One vital issue was the scope of financial frame we should request of the Riksdag. If we were to choose a frame that was too small, we might be compelled to ask for further funds, which might then be perceived to mean that we did not have a firm grip on the situation. On the other hand, if we asked for too much, this might be perceived as indicating that the situation was far worse than it actually was. The solution decided on – in consensus with the political opposition – was an unlimited frame.

BANK SUPPORT AUTHORITY

We decided that bank support issues would be dealt with by a separate authority, the Bank Support Authority, so that other essential work within the Ministry of Finance was not impeded. Decisions made by this authority were to be submitted to the Ministry of Finance for final approval.

As the Bank Support Authority could not become formally operational until early May 1993, the work was initiated by a special group at the Ministry of Finance. In addition to the three banks that already had Government support, applications were received from three other banks: SEB, Swedbank and Föreningsbanken. Only one of the seven largest banks (Handelsbanken) did not apply for Government support.

The banks that applied for support had to be assessed according to objective criteria, in order to determine the extent and the forms of support. The bank's current situation, and financial and macroeconomic developments, formed a point of departure for this assessment. The banks were split into three categories (a method that I might mention was based on the categories used for a corresponding purpose when dealing with the banking crisis in the United States in 1933):

- A bank belonging to Category A was not considered to fall below the capital adequacy requirement, but may need support in the form of, for instance, temporary guarantees,

- A bank belonging to Category B could possibly fall below the capital adequacy requirement temporarily, but after a period satisfy the requirement once again. This type of bank might need more extensive government support in the form of loans or a capital infusion if the owners neither wanted to, nor had the capacity to, inject capital.

- A bank belonging to Category C was unlikely to become profitable, even in the long term. This type of bank should be completely or partly wound up at the lowest cost possible.

Banks eligible for support were obliged to comply with government requirements and submit to government supervision and control as to how the aid was used. Costs were to be carried by the bank that received the support but recovery of costs was put off until this became feasible with reference to the bank's financial situation.

It was an explicit objective to avoid government ownership of banks, but we did not exclude this option should it prove to be necessary. Any nationalisation would be temporary and would not involve the central government as owner running bank operations according to principles differing from those applicable to private banks.

TRANSPARENCY

When it came to the principles for assessing the need and structure of support for individual banks, a fundamental issue was how to calculate loan losses and the extent of non-performing loans.

There were two conceivable strategies. One involved calculating expected loan losses and write-down requirements on the basis of the current market values for existing collateral, usually in the form of real estate. That would provide a clear, open account of the magnitude of the problems and the support required. Given the broad acceptance of the methods behind the assessments, this ought to enhance the credibility of the process.

However, if, for instance, the property values were unduly low, it might also involve a risk of producing an exaggerated picture of the true extent of the problems.

The other strategy would be to try to defer reported losses for as long as is legally possible and use the banks' earnings to write the losses off gradually. One advantage of such an approach is that the banks might not be obliged to dispose of assets that they held as collateral at prices considerably less than their long-term market value. However, it has the very serious drawback of presupposing that the problems can be resolved comparatively quickly. Otherwise it might possibly exacerbate the problems. One example of this is how the savings bank crisis was dealt with in the United States in the 1980s.

For me, there was no doubt about which method to choose to build credibility. Our management of the bank crisis was to be based on openness and transparency. So a great deal of work began on valuing the loans and collateral held at each bank in order to ascertain how much support was needed and provide it without delay. A separate Valuation Board was set up to ensure that the values assigned to real-estate collateral were reasonably close to the mark. This Board checked the banks' valuations during the support process.

MORAL HAZARD

Of course, the general guarantee for creditors involves a risk that the banks might continue implementing transactions entailing considerable risks and that depositors and creditors would refrain from making their own assessments of the risks of an investment.

At the same time, this was counteracted by the strict handling of the banks and a clear message that the shareholders were entirely responsible for their own risks. If the Government needed to infuse any capital, the Government would also have a corresponding influence, even if this went so far as to involve nationalisation. Legislation was introduced to facilitate negotiations, whereby the Bank Support Authority was empowered to make decisions on support, even in cases where an agreement had not been reached with the bank.

However, the potential cost that might arise owing to the risks of undesirable conduct had to be balanced against the greater cost to the real economy that would be incurred owing to the continued lack of confidence if the general guarantee was not introduced. To abstain from responding to a deep crisis based on concerns for what might happen in the future is in any case not an option. A true crisis is not the time for such fine points.

TURNAROUND

In January 1993, it seemed to me that substantial support would probably be needed for all of the banks that had applied. During the spring, however, the macro-economic improvement contributed to a quicker recovery and a more favourable trend in the stock of non-performing loans.

This development in conjunction with tough conditions for government support (government capital would mean corresponding government ownership) made two banks, SEB and Swedbank, look for private capital. They withdrew their application for support in the autumn and repaid all of the Government's expenses. A guarantee was issued for Föreningsbanken, but never had to be used.

Gota bank was nationalized and Nordbanken, which was already government-owned, was reconstructed. The viable parts of Gota bank were later merged with Nordbanken

BAD BANKS

'Bad banks' (Securum and Retriva) were formed for the nationalised banks, Nordbanken and GOTA respectively and the main parts of the bad loans were transferred to these banks. The aim was first to allow the management to concentrate on normal banking operations and second to deal with the bad loans more efficiently.

Securum and Retriva were capitalised on the basis of the valuation of the loans and were given the task of selling their assets at a pace that was feasible so that as much could be recovered as possible. We originally estimated that it might be possible to run the operation for close on 10 to 15 years, but developments moved considerably more rapidly than that. They were already wound up by 1997, with a better result than expected.

The technique of having 'bad banks' was also used by other banks, though entirely without any Government involvement. These cases therefore did not involve Government 'bad bank' that also received assets from private banks. Since each bank had its own ‘bad bank’, the issue of how to value the transferred assets did not become critical. An approximate value was sufficient since the bank and the ‘bad bank’ had the same owner.

FINAL COST

The blanket guarantee and the special legislation were abolished July 1st 1996.

Altogether, the amount paid out in support to the bank sector amounted to 65 billion kronor (SEK), the equivalent of a little more than 4 per cent of GDP at that time. The bad loans in Securum and Retriva were wound up more favourably and quickly (already by 1997) than I had dared to expect.

Securum and Retriva produced a surplus, which together with the partial privatisation of Nordbanken (now Nordea) and its remaining value, means that expenditure on bank support has been almost been totally recovered.

Of course, costs were incurred for the economy in general in the form of wider spreads and disruptions, albeit limited, to the supply of credit. However, the macro-economic recovery after the bubble had burst was faster because the banking crisis was handled in a decisive manner. Fundamentally, these effects should be seen as damages done by the events that led to the financial crisis. Once a bubble has been inflated, it is inevitable that the process required to bring the economy back on track entails significant costs to society.

THEN AND NOW

There are, of course, differences between the current crisis and the Swedish crisis, but there are also similarities, not least regarding the basic functions that have to be dealt with by the Government

Today's crisis, in contrast to the Swedish crisis, is global; it originates from a country that is significantly larger than Sweden and, even if it does have its roots in the real estate market, the situation is more complex owing to extensive securitisation and more developed financial markets.

Despite these differences, the main tasks for a government (and a central bank) are the same:

* To maintain liquidity in the financial system.

* To restore confidence in the financial system.

* To restore the capital base in the banking sector to counteract credit crunch.

In the current crisis, it was basically possible to maintain liquidity primarily by initiatives by the central banks. However, it is obvious that confidence is still impaired and that uncertainty prevails regarding capital supply.

In order to restore confidence in the financial system and facilitate sufficiently adequate financing from stakeholders other than central banks, it is necessary to convince investors that they are not at risk of being adversely affected by losses as a consequence of a crash.

This can be achieved in various ways. All banks were closed for a week in conjunction with the handling of the crisis in the United States in 1933. One bank in each Federal Reserve district was subsequently reopened following a review that showed that they were solvent. After that, other solvent banks were opened in pace with them having been analysed. In this way, a kind of government guarantee was provided for these banks.

When the situation became unsustainable in Sweden , we chose to issue the general guarantee for creditors. This restored confidence and we were able to move on and deal with the problems within each respective bank without the uncertainty that prevails today.

In my opinion, it should be possible to utilise methods that at least have similar effects as a general guarantee today as well. The cost that arises if a guarantee is utilised does not have to be more that what would ensue from the implicit guarantee that, in reality, prevails in most countries today.

There does not have to be a greater need for government capital infusion if the owners of the banks know that the Government will require ownership corresponding to their capital contribution. This will lead to banks endeavouring to find private capital. If they are unsuccessful, the Government must also act to avoid losses for creditors and to maintain the total capital base for lending.

A counter argument is of course the risk that banks will behave recklessly in the absence of market forces that limit their ability to take risks. It should be possible to reduce this through intensified supervision and clear rules regarding the responsibility of owners and the banks' management. However, the potential costs that might arise must be balanced against the high socioeconomic costs that would arise if confidence in the financial system cannot be restored.

The capital required to restore the capital dissipated owing to credit losses and write-downs of assets must be provided if lending capacity is to be maintained. This should be done in the first instance through private capital infusion. The Government must inject capital if this proves to be impossible. In order to encourage private solutions, the Government should, in accordance with the principles of a market economy, lay down conditions for government capital injections with a corresponding dilution of the existing capital, even when this may involve temporary nationalisation.

The other main conclusions that I believe you can draw from my experiences of the Swedish banking crisis are that:

- Government intervention is unavoidable if you are facing a systemic crisis.

- Prompt action is important. A comprehensive approach is better than a piecemeal strategy.

- Transparency enhances confidence and promotes the public legitimacy of the measures that have to be taken.

- Broad political consensus and resolute political actions taken by the political system are probably more important than any of the technical aspects on how to deal with the crisis. This also enhances confidence, not least internationally, in our ability to deal with the crisis.

- In order to limit moral hazard and get public support, it is important to have a stronger approach and deal with the banks firmly, enforcing the principle that losses are to be covered in the first place by the capital provided by the shareholders. If that means that banks must be nationalised, then so be it. They can be privatised again at a later stage.