Lessons from the Resolution of the Swedish Financial Crisis[1]

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Sweden experienced a twin crisis in the early 1990s, which marked the first systemic crisis in industrialized countries since the 1930s. It is usually argued that the Swedish experience with the resolution of the crisis can be regarded as a good example of a swift, effective and low cost resolution of banking crisis. This note aims to draw some lessons from the Swedish experience that can help us in resolving the current crisis. However, the Swedish crisis also has some differences from the current crisis and those differences are discussed to get a better idea about the extent of lessons that can be drawn from the Swedish experience.

Background

After a comprehensive deregulation of the credit markets in 1985, the Swedish banking system was in unchartered territory. Low interest rates, lax supervision and the expansion in loose credit led to an overheating property market where prices for commercial real estate more than doubled in the latter half of the 1980s.[2] In the Swedish crisis, finance companies played a role similar to that of SIVs in the current crisis. These companies were less regulated compared to banks and many of these companies financed their operations with a new type of commercial paper called *marknadsbevis*, which the banks had guaranteed. When one of these finance companies, called Nyckeln, folded in September 1990, the market for these securities dried up. When the finance companies ran into liquidity problems, banks found they had to keep funding the companies – to which they were actually closely linked to.

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[1] The views expressed here are those of the author and do not necessarily represent the views of the Federal Reserve Bank of New York or the Federal Reserve System.
[2] From 1987 to 1990 total credit rose from 90 percent of GDP to 140 percent of GDP.

Resolution

To resolve the crisis, Swedish authorities forced banks to write-down their losses, used capital injections, separated troubled institutions into “good banks” and “bad banks”, where asset management companies (AMC) have been employed to restructure and divest the assets of the bad banks.[3] First, banks were told to write down their losses promptly. The bank owners were then invited to inject the needed additional capital, or let the Swedish authorities deal with the situation, which implied financial support in strict terms such as wiping out shareholder capital and restructuring of their banks.

In the early stages of the crisis, there was not a comprehensive framework and the Swedish government tried to tackle problems case by case. By the fall of 1991, two of the six largest financial institutions, Forsta Sparbanken and Nordbanken, had inadequate capital and to keep them operating the state guaranteed a loan for Forsta and took over Nordbanken. Being the major owner of Nordbanken, the state injected additional capital into the bank, becoming the owner of 77 percent of the outstanding shares.[4] Furthermore, in November 1992, the state injected SEK 10 billion to absorb further potential losses and split Nordbanken into two entities by transferring most of the nonperforming loans to Securum, an AMC.[5] And, within a year, a third major institution Gota Bank experienced difficulties and was also taken over by the government. As in the case of Nordbanken, the government split Gota Bank into two entities: the good bank that focuses on normal banking activity and an AMC, called Retrieva.[6]

From that point on Swedish authorities recognized the need to restore confidence in the system quickly and comprehensive action was taken. While there were no significant

[3] AMCs can offer advantages over market-based solutions such as immediate liquidations that include: (i) economies of scale in administering workouts and in forming and selling portfolios of assets, (ii) benefits from the granting of special powers to the government agency to expedite loan resolution, (iii) allowing the good bank to focus on normal banking business such as issuing loans, and (iv) having longer horizons, AMCs can recover more compared to an immediate liquidation of assets.
[4] In the spring of 1992, it became clear that Nordbanken’s problems were more serious than anticipated and the state bought all the remaining outstanding shares.
[5] Securum took over assets, mostly real estate related loans, with a book value of SEK 67 billion, accounting for 4.4 percent of total banking assets.
[6] Retrieva took problem loans totaling SEK 43 billion, or 3 percent of total bank assets.

banks runs, Swedish banks' foreign creditors started to cut their credit lines. In December 1992, Sweden guaranteed all bank deposits and creditors of the nation's 114 banks, but not the shareholders. Furthermore, the parliament passed the Bank Support Act authorizing the government to provide support flexibly in the form of loan guarantees, capital contributions and other appropriate measures. To support the objectives of the Act, parliament set up a separate agency, the Bank Supervisory Authority, which had the authority to decide and manage bank support operation.

During 1993, Nordbanken and Gota bank were merged, retaining the name Nordbanken, and becoming Sweden's fourth largest bank. The bank was operationally restructured and partially sold to the private sector. Their respective AMCs—Securum and Retrieva—were merged in December 1995.

Exit

The exit from the guarantees as well as the divesting of the assets has been smooth and with low cost during the Swedish crisis. In 1996, Sweden rescinded the guarantees introduced during the crisis, replacing them with a bank-financed depositor-protection scheme.

Securum sold its real estate assets through public offerings on the Stockholm stock exchange and private sales to companies and individuals. Most of the assets were sold in 1995 and 1996, when the real estate market had started to recover, but nevertheless, prices were still low by historical standards. Securum wrapped up operations much faster than originally envisaged and it was dissolved at the end of 1997.[7] While most of the government shares in recapitalized banks have been sold, Sweden still holds a 20 percent share in Nordea.

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[7] Several factors contributed to the AMCs success. AMCs could rely on an efficient judicial system, which allowed them to force most of their debtors into bankruptcy when their operations did not prove to be economically viable. The restructuring of the assets was also facilitated by the fact that most of the assets transferred were real estate-related assets, rather than the complex nature of the assets in the current crisis.

Sweden shelled out 4 percent of its GDP, around SEK 65 billion or $10 billion, to rescue its financial system. After the recovery from the sales of assets, the cost ended up being less than 2 percent of GDP. Factors such as political consensus for the actions from the ruling party and the opposition, as well as decisiveness and transparency about the management of the crisis have been argued to contribute to restoring confidence and to the eventual success of the resolution of the Swedish financial crisis.

As well as the right policies, various other factors that may not be present in the current crisis, as discussed below, have been influential on this favorable outcome.

Main differences from US

While the Swedish experience with the resolution of the financial crisis provides valuable lessons, there are some major differences and challenges for the resolution of the current crisis. Below, I try to elaborate on these issues.

(i) Complexity of financial instruments: The current crisis is more severe and has stronger repercussions throughout the globe. An important issue is that the current crisis is exacerbated by the difficulty to assess the complex financial instruments and structures, off-balance sheet commitments and bank related vehicles such as SIVs, conduits etc. These complex instruments, valuation issues, and institutional arrangements make it more difficult for analysts and counterparties to banks to understand a bank's true financial position. This, in turn, makes the pricing of certain assets and risks extremely difficult.

(ii) Macroeconomic factors helped recovery in Sweden: Sweden had a fixed exchange rate before the crisis. Once the krona peg had been abandoned and the currency depreciated, Swedish goods regained competitiveness in export markets. Furthermore, a quick rebound in Swedish economy stemmed from an increase in economic growth in Europe. The strong international recovery helped push up real estate values in Sweden and improved the balance sheet of banks, which played an important role in the recovery process. While Sweden is a small economy compared to the rest of the world, the slow down in the US economy can drag the global economy down and such an export-led recovery may not be feasible for the US.