The Swedish Financial Crisis in the 1990s - How was it managed? –

Does it provide any ideas for handling the problems of today?

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Origins and results

The Swedish economy in 1992
- Diversified small open economy
- Large Public sector deficit and current account problem
- Rapid financial sector growth: from 90 to 140% of GDP over 4 years
- Rapid Real Estate prices growth: 25% a year since 1985 to 1992

Origins of the crisis
- Mismanagement of macroeconomic policy
- Badly timed deregulation of capital markets and tax cuts
- External shocks (Unification of Germany, Gulf war etc)
- Adjustment of asset prices to the new macroeconomic environment and expectations
- Devaluation 1993

Main Problem in the banks
- High exposure to the real estate sector (where prices fell by 50% in one year)
- Sudden increase in NPLs leading to solvency problems

Structure of the banking system

Before:
- 252 finance companies and 107 banks
- 6 largest bank groups: 75% of the system
- 40% of bank lending in foreign currency

After:
- 133 finance companies, 4 of the largest banks remained

Duration of The crisis
- First signs in the finance companies 1990/91. The first bank failures came during 1992 and the peak was during 1993 following the devaluation when 5 of the biggest 6 banks applied for support. The General bank guarantee was withdrawn 1995.

Result
- Expenses and guarantees 6% of GDP. Final cost less than 0.5% of GDP
The Swedish banking crisis
- Measures -


Finance company liquidations

SB 1 → NB → NB

Develop:
Worst case scenario
Consensus/awareness

The Bank support process

The general guarantee

The restructuring of NB (Today Nordea) was important

• Demonstrated Government’s determination and ability
• Practical example of what could be done operationally and financially
• Demonstrated important policies and principles → Later explicit in GG-law
• Identified necessary data requirements for modeling future performance and formulate requirement on the banks
Managing the crisis

Objective

• Restore confidence in the payment and credit system as quickly as possible to minimize macro costs
• Main focus: international capital markets

Strategy

• The State guarantees that banks of systemic importance can meet all their commitments on a timely basis. The state shall meet its undertaking by providing support for viable institutions…. or for the restructuring or orderly wind-up those that can not be expected to become profitable

Basis for the strategy

• A worst case scenario
• Obtain and Maintain political consensus
• Ministry of Finance responsible (in consultation with the CB)
• The Support Bill –” Unlimited resources”
• Thorough analysis and transparency

Tools

• Various forms of solvency support

Stile

• Business like
Guidelines /Principles and Conditions for support

Support should:
• Be voluntary and adapted to the specific conditions of each institution
• Be based on commercial principles so as to minimize the long term costs
• Be structured so that the banks had no grounds for requesting more than needed

Considerations:
• Non-viable institutions restructured or closed in on orderly manner
• Measures taken should be competitive neutral and account for factors like efficiency and variety
• The Government’s expenditures should be minimized and to the largest extent possible recovered

Requirements:
• Institutions applying for support should be required to produce plans for their handling of problem assets and for improving their core operations.

The question of ownership:
• Government ownership should be avoided unless considered appropriate with reference to capital requirements and the commercial interest of the state. In such instances the aim shall be to dispose of the shares when this is commercially suitable
The Bank Support Process
- Main components -

A perspective on the future structure of the banking industry

- Areas with potential for improvements
- Operational benchmarks

Stage 1
Stage 2
Stage 3
Stage 4

Application

Preliminary Assessment

The "Entry Agreement"

Assessment of need and structure of support

Assessment of the financial needs of support

Review of the bank’s control and risk-management capabilities

Assessment of strategic options and potential efficiency-improvements

Support agreement

- Support structures
- Fees
- Corporate Governance

Action-plans

Follow up

Monitoring

Market communication
Who takes care of problem assets?

Critical for:
- a) minimizing the final costs
- b) Restarting core banking

- All banks were required to develop plans for handling the different assets types
- The Government had a decentralized approach, ie each bank had their own AMC:

Centralized function in the bank

External Asset Management Company (AMC)

Maximize recovery and utilize resources efficiently

Refocusing the core banking business and cut costs

Asset size

Asset quality

Good

Bad

Branch network

Core bank

Medium sized assets

Large, complex, non-strategic assets

Small

Medium

Large
Assessment of need and structure of support
- The valuation process -

"Bad Bank model"

- Data Collection
- Credit Evaluation/Collateral Evaluation
- Data Base
- Stress Test Model

- Cash Flow Projections
- Balance Sheet Projections
- Income Statement Projections

- Estimated Cost of Support

"Good Bank Model"

- Data Collection

- • Balance Sheet Dynamics
- • Problem Assets & Reserves
- • Net Interest Margins
- • Fee Income
- • Expenses
- • Capital requirement
- • Lines of business

"Control"
- • Methods
- • Values/data
- • Terms of reference

"Processes"

- Credits
- Real Estate/VB
- Strategy
- Risk Control
- Good Asset Due Diligence

"Macro Assumptions"
- Real Estate Markets
- Procedures
- Methods

"Amount & Structure of Support"

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Restructuring individual banks

Analysis always a first step

Assessment of need and structure of support

- Assessment of the financial needs of support
- Review of the bank's control and risk management capabilities
- Assessment of strategic options and potential efficiency-improvements

Type of support available

- Orderly liquidation
- Asset guarantees
- Capital injection (Common or pref. shares)
- Operational and financial restructuring
- Other

Objectives

1. Restore solvency or minimize the fear of insolvency – Get it right the first time
2. Return to profitability and ensure management's focus on core banking
3. Improve transparency of the balance sheet to facilitate exit
4. Minimize the taxpayers’ final costs and if possible also the fiscal expenses
5. The shareholders shall carry all costs and losses.

Focus

a. Structure the support/Investment in such a way that an exit is facilitated.

b. Value maximization by improving:
   - management/operation of the core bank to maximize profit
   - management of bad assets to maximize recovery
The model case for restructuring - Nordbanken

Nordbanken before restructuring

- Bad loans
  - Large size
- Bad small size
- Good assets

Nordbanken After restructuring

- Liabilities
  - small bad
- Good assets
  - Loans to Securum
- Liabilities
  - Equity

Securum AB (An Asset Management Company)

- Assets
  - Loans from Nordbanken
- Equity

Focus: Improve core bank
Objective: Privatization

To:
- Capital ratio = 9%
- Expected profit one year after restructuring

Focus: Recovery

To:
- Allow for balanced cash flow and a normal solvency ratio
- Same cost of capital as other participants in the market
Success factors

1. Actions at a relatively early stage addressing the roots not the symptoms of the crisis
2. All decisions made in full political consensus – clear division of responsibilities
3. The authorities´ access to necessary instruments and sufficient resources
4. Early “model case” demonstrating what the Government was prepared to do
5. Prompt issuance of an explicit solvency guarantee for all banks when needed
6. Unorthodox stile of management with transparent objectives and operational principles
7. Strictly managed work process designed to handle a worst case scenario
8. Constant flow of information to the market and general public - Transparency