Banking System Bailout - Scandinavian Style

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If you're going to use taxpayer money to prop up the banking system, what's the best way to do it? Bailout mechanisms include things like deposit insurance, direct loan guarantees, infusion of new bank capital in the form of debt or equity instruments, and liquidation and sale of bank assets and non-performing loans. There are pros and cons of each of these options, and they have been used to a varying degree to resolve systemic banking crises across the world. Below, I reflect on some lessons learned from the crisis resolution observed in Sweden and Norway during the Scandinavian banking crisis of the early 1990s.

Scandinavian crisis development

The Scandinavian financial crisis of the early 1990s followed a period of financial liberalization policies in the 1980s. These policies included liberalization of bank lending volume, removal of interest rate caps, modernization of bank capital requirements, and the innovation of new and relatively high-risk financial products. The liberalization caused a rapid expansion in the volume of bank loans made available for speculative investment. Banks, which are in the business of converting liquid short-term demand deposits to relatively illiquid long term investments, became much more sensitive to creditor default rates. In this more fragile state, negative economy-wide shocks exposed the illiquidity of the banks' loan portfolios and threatened the solvency of the banking system.

After a significant drop in the world oil price in 1985, Norway (a significant oil exporting country) experienced a shift in its current account from a surplus to a deficit, which in turn triggered a devaluation of the Norwegian krone in 1986 (Norway was pursuing a fixed exchange rate policy at the time). Recession began in 1988, which started a financial crisis among the country's savings banks, followed by collapse of major commercial banks and the real estate market in 1990-92. Sweden also experienced a recession, and the country's largest savings bank collapsed in 1991, followed by a collapse of two of the largest commercial banks. Property prices had dropped and the country experienced a currency crisis in the fall of 1992. The crisis ended in 1993 in both countries.

According to calculations by the International Monetary Fund, the cumulative fall in real GDP over the crisis period was greater for Sweden than for its neighbor (5.3% versus 0.1%). Loan losses in the peak crisis year was 2.8% of GDP in Norway and 3.8% in Sweden, while non-performing loans added up to 9% and 11% of GDP in each of the two countries, respectively. In Norway, it took two years for the banking sector to return to profitability, and four years before bank lending was back to its pre-crisis level. In Sweden, return to profitability also took two years, while it took as much as ten years before bank lending reached its pre-crisis level.

Norway: The Government Bank Investment Fund

In Norway, the banking industry privately funds two guarantee companies, the Savings Banks' Guarantee Funds and the Commercial Banks' Guarantee Fund. These were drawn down during the initial phase of the crisis (by 1991). In addition, several of the banks were merged and others were bankrupt and placed under temporary public administration.

The government initially started to fund the failed banks through its new Government Bank Insurance Fund in January of 1991. This insurance fund was an independent legal entity, with a mandate to provide liquidity to the two private guarantee funds. The fund was allowed to impose conditions both on the private funds and the banks receiving bailout money. These conditions concerned, among other things, management issues such as hiring and firing of key personnel, board composition, and major investment decisions.

The Norwegian government also implemented a division of labor between the Government Bank Insurance Fund and the Norwegian Central Bank. The former would channel support to banks that were largely insolvent, while the latter would provide liquidity in the form of loans to largely solvent banks. In the fall of 1991, the crisis reached systemic proportions with large losses reported by the three largest commercial banks. These three banks held about one half of the total assets in the banking sector.

At this point, the Norwegian parliament created a second financing vehicle: the Government Bank Investment Fund (GBIF). While the insurance fund continued to pour liquidity into insolvent banks, GBIF began to purchase securities floated by (still) relatively healthy banks. This included purchases of “preferred capital”, an equity-like contract which was convertible into common stock. In preparation for GBIF’s purchase of this convertible preferred security, the Norwegian parliament amended the existing banking law, allowing the government to write down a bank’s common stock to zero against its losses. The purpose of the amendment was to prevent equity-holders from holding up (forcing bargaining with) the government as it proceeded to bail out the banking system.

Subsequent common stock write-downs resulted in the GBIF becoming the sole owner of two of the three largest commercial banks, and the dominant owner of the largest (Den Norske Bank or DnB). By the end of the 1990s, the government had sold most of its banking shares to private investors, with the exception of a “negative majority” (34%) held in DnB. The negative majority allows the government to block a takeover – perhaps a benefit for some local interests but surely at the cost of reducing international competition for Norwegian banking assets.

The Norwegian economy started to recover in 1993 and the banking crisis was essentially over. Research at the Norwegian Central Bank indicates that, based largely on direct cash flows, the overall benefit of the government’s intervention likely exceeded the direct cost (which include direct payments and interest rate subsidies) – even without accounting for the value of various loan guarantees that never had to be called.

Sweden: the “good bank/bad bank” model

The crisis in Sweden began with heavy losses reported by the country's largest savings bank in 1991. Later that year, the third-largest commercial bank (Nordbanken) also began reporting large losses. At the time, the Swedish government owned 71% of the bank's common stock. The government proceeded to purchase a new share issue and to buy out the private shareholders at the equity issue price. This was in contrast to Norway, where the private equity was forcibly written down to zero before the government proceeded to fund the bank.

In full control of Nordbanken, the government now split the bank's assets into two parts: The "good" assets were continued within the bank, while the "bad" non-performing loans were spun off into a separate legal entity called Securum, created in 1992. Securum followed earlier "bad" bank structures in the U.S. in the 1980s, and was managed much like the Resolution Trust Company created by the U.S. government in 1989 to liquidate assets held by troubled savings and loan associations. A bad bank solution was also created for the fourth largest commercial bank, Gota Bank, when it failed in early1992. This time the bad assets were transferred to the asset management company Retriva. The remaining good assets of Gota Bank were auctioned off, ultimately purchased by Norbanken in 1993 with no payment to Gota Bank's shareholders.

Most of the troubled assets Securum acquired from Nordbanken were in the form of loans to various financially distressed companies, with the remainder consisting largely of real estate holdings. Securum financed the purchase with a combination of a loan from Nordbanken and a government equity infusion. Securum's mission was to liquidate in an orderly fashion the troubled assets so as to maximize recovery. The management company was dissolved in 1997 after successfully liquidating its assets.

It appears that Securum drove a hard but successful bargain with many of its troubled borrowers. Part of the loan mass was held by small companies, and it was not uncommon for the company founder/entrepreneur to pledge his own common stockholding in the company as collateral for the company's loan. Failing to service the debt, however, Securum had the right to seize the pledged collateral, thus effectively acquiring control of the distressed company without the need for a formal bankruptcy procedure. In Sweden, the bankruptcy code mandates a quick auction sale of the bankrupt firm (piecemeal or as a going concern). Avoiding bankruptcy, Securum also avoided the auction time pressure, and instead proceeded to develop the troubled company in preparation for its sale as a going concern down the line. To support this strategy, Securum's management team was deliberately chosen to have industrial management experience, which undoubtedly contributed to its success.

Unlike Norway, Sweden also issued (in the fall of 1992) a blanket guarantee of all bank loans in the Swedish banking system, effective until July of 1996. Naturally, this blanket guarantee greatly benefitted existing bank shareholders. Moreover, the Swedish Central Bank provided liquidity by depositing large foreign currency reserves in troubled banks, and by allowing banks to borrow freely the Swedish currency (at no risk to the Central Bank given the government blanket loan guarantee). Perhaps because of these additional moves, the Swedish government's cash infusion to end the banking crisis was almost entirely limited to Nordbanken and Gota Bank.

In sum, both Sweden and Norway created bank restructuring agencies to oversee the government's cash infusion in troubled banks. Existing shareholders were largely forced out of the failed banks. Both countries also established strict guidelines for companies receiving government support, including balance sheet restructuring targets, risk management, and cost cuts. Moreover, both countries engineered a public takeover of the largest troubled commercial banks, and promoted private bank mergers. However, only Sweden implemented a "good bank/bad bank" model, and perhaps most important, only Sweden issued a blanket creditor guarantee which greatly benefitted existing bank shareholders. The end result was similar in the two countries: a relatively speedy recovery and return to robust economic growth. The macroeconomic impacts of these banking crises were relatively short-lived.

Relevance for the U.S. bailout strategy

When comparing Scandinavia with the U.S., what stands out is the role played by government ownership of the failed banks in Scandinavia. This role was (and still is) politically acceptable as the government in these two countries have a long history of partnering with the private business sector. Also, nepotism and outright corruption is a minimal problem in these highly successful societies.

The current U.S. bailout strategy, however, has so far been limited to a specific loan guarantee to induce a failed-bank takeover by a private party (JP Morgan's purchase of Bear Sterns conditional on a $29 billion dollar government guarantee of Bear Stearns' debt), a cash infusion in return for a controlling equity position ($80 billion paid to AIG in return for an 80% equity stake in the insurance giant), and auction purchases of non-performing loans from failing banks. As an extension of these policies, the U.S. is also providing distressed loans to two industrial companies in the brink of bankruptcy (GM and Chrysler).

In the U.S. debate, government acquisition of controlling equity ownership positions in failed banks has proven to be controversial. The word "socialism" is rearing its ugly head – exposing a deeply rooted skepticism towards government ownership of private enterprise. However, as the Scandinavian experience suggest, the approach to this issue ought to be pragmatic: since the objective is to maximize tax-payer return from the bailout, a greater commitment to government acquisition of equity stakes in troubled financial institutions ought to be considered. It's a zero-sum game: if the tax-payer doesn't insist on the best possible deal, some other party to the bailout will reap benefits at the tax-payer's expense.

A clear case in point is the $8 per share windfall to shareholders of Bear Sterns, when the government debt guarantee of that firm caused JPMorgan to raise its takeover bid from $2 to $10. This type of shareholder windfall, which we also saw in Sweden as the stock market responded to the government's blanket debt guarantee, would have been avoided had the government taken an equity stake in the bailed-out bank.