VI Bank Restructuring Operations and the Performance of the Banking Systems

It is generally considered important that a banking crisis be resolved quickly to minimize the adverse effects that arise from distorted incentives caused by the operation of insolvent financial institutions. Depending on the nature of the crisis, the authorities can apply a number of support measures. An injection of short-term liquidity into the affected banks would be sufficient in a mere liquidity crisis. In circumstances such as the Nordic banking crises that are characterized by widespread solvency problems, a more active government role is usually required. In such situations, authorities face the choice of providing capital to a troubled bank without any change in its ownership and operation (sometimes referred to as "open-bank assistance"), or taking the bank over and runing it as a publicly owned institution. Alternatively, the government may choose either to liquidate the insolvent bank and pay off depositors and other creditors (not necessarily in full) or to sell the troubled bank through a so-called purchase and assumption agreement. Regardless of which specific method of bank support is chosen, the incentives that accompany government bank support should be analyzed carefully to minimize the overall costs of the operation and to keep the distortions created by government intervention small.

In all three Nordic countries, the government and, to some extent, the central bank supported the banking systems. The government took over a number of large banks but only a very few (and mostly small) banks were liquidated. In the majority of cases, the authorities either assumed ownership (most often with the intention of finding a buyer for the bank in the near to medium term) or provided funds (mainly as equity injections) to banks that continued to operate as private institutions. Governments provided this direct support—in particular immediately after the crises broke—in the form of net worth certificates, promissory notes, and other forms of injection of capital, as well as by assuming debt or through guarantees to a bank without revoking its charter. This type of bank support can be controversial because it may imply subsidizing the bank's current shareholders by allowing the bank to continue to operate even though it may be insolvent. It is possible that such government assistance has terms (such as interest rates) attached that are below market. Guarantees are particularly difficult to price accurately. More generally, open-bank assistance can entail a form of subsidization that can noticeably distort competition among financial institutions.

In Finland and Sweden, nonperforming bank assets were in many cases lifted into asset-management companies; such arrangements were not utilized in Norway. The main objective for separating nonperforming assets from the viable part of a bank is to correct risk-taking incentives. Another argument in favor of transferring nonperforming assets to a separate agency lies in the fact that it is a once-and-for-all solution because the remaining healthy bank should be able to manage without further government involvement. In general, an asset-management company may represent less direct involvement for the government than an injection of capital or a guarantee of nonperforming assets. Moreover, a specialized institution that deals exclusively with the sale of nonperforming assets may be more efficient in recovering the maximum possible value due to economies of scale and specific expertise. However, it can also be argued that a private institution, such as an acquiring bank that shares in the proceeds of the sale of the bad assets, may have an even stronger incentive to maximize the recovery effort than a government-run agency.

In Norway, two separate agencies, the Government Bank Insurance Fund and the Government Bank Investment Fund, were set up in 1991 to deal with the banking problems. The former provided support mainly through the banks' own deposit insurance funds and the latter through direct capital investment in banks. Support from the banks' own deposit insurance funds was most substantial in Norway, where the funds contributed about one-third of bank support resources. In Finland, the corresponding contribution to savings and commercial banks was small, but the deposit insurance fund of the cooperative bank provided considerable support.

Unlike the Norwegian central bank, the Swedish central bank did not directly participate in the support of financial institutions. Although the Bank of

Finland played the lead role in the early stages of the crisis, the bulk of bank support was provided either directly by the government or by the Government Guarantee Fund.

Overall, the Finnish banks have received substantially more support than the other Nordic banks. The direct fiscal impact of bank support operations has been relatively small in Norway at 2.6 percent of GDP compared with 5.2 percent of GDP in Sweden and 10 percent of GDP in Finland. Unlike the Finnish and Swedish governments, the Norwegian government did not issue a general and public guarantee of banks' commitments. Instead, the government handled the Norwegian banking crisis by a quick takeover of the three largest commercial banks.

The Norwegian Experience

In the first phase of the Norwegian banking crisis (1988–89), the two industry-operated deposit insurance funds—the Commercial Banks Guarantee Fund and the Savings Banks Guarantee Fund—assisted a number of ailing banks and provided funds to facilitate mergers with stronger banks.[38]

Toward the end of 1990, accumulated bank losses had virtually exhausted the capital of the deposit insurance funds, and it became clear that the funds would not be able to meet the banking industry's increasing capital needs.[39] To shore up confidence in the banking system the government established a new fund in March 1991—the Government Bank Insurance Fund. Its objective was to provide loans to the Commercial and Savings Banks Guarantee Funds to enable them to supply capital to individual member banks.[40] To receive support, the beneficiary bank was required to present a business plan designed to improve operating profits and reduce its risk-weighted assets. In most cases, the support was conditional on the implementation of cost-cutting measures.

[38]Funds relied on deposit insurance contributions by banks.

[39]At the end of 1990, the Commercial Banks Guarantee Fund's capital was NKr 3.8 billion. However, in December 1990, the Commercial Banks Guarantee Fund had provided Fokus Bank with an equity capital guarantee of NKr 1.5 billion for which it had not made provisions, and it had set a quota of NKr 2 billion for the supply of preference capital to member banks. Thus, the scope for the Commercial Banks Guarantee Fund to provide additional support funds was severely constrained. The Savings Bank Guarantee Fund, for its part, had guarantee liabilities of NKr 1.2 billion, but capital of only NKr 38 million at book value (Wilse, 1995).

[40]The interest charged on the loans to the Commercial Banks Guarantee Fund or Savings Banks Guarantee Fund was to correspond to that on the government's account in Norges Bank.

To deal with the crisis, the Norwegian parliament adopted several new measures in November 1991 that were intended to reinforce the guarantee system, raise bank profitability, and accelerate the recapitalization of ailing banks. These measures included:

(1) An increase of NKr 6 billion in the capital of the Government Bank Insurance Fund.
(2) The extension of the mandate of the Government Bank Insurance Fund to allow it to provide distressed banks with Tier 1 capital.
(3) A budgetary allocation of NKr 1 billion to the Savings Banks Guarantee Fund.
(4) The creation of the Government Bank Investment Fund, with a capital of NKr 4.5 billion. Its objective was to participate on commercial terms and together with private investors in bank equity issues.

The government's stake in the commercial banking system was to be managed by the Government Bank Insurance Fund, which was established as a short-term facility, and the Government Bank Investment Fund, which was assigned to manage long-term state investment in the banking sector. The government planed to wind down the operations of the Government Bank Insurance Fund by 2000–2002, when the Commercial Banks Guarantee Fund was expected to be fully reconstituted. To this end, procedures have been established for the eventual transfer of the Government Bank Insurance Fund's liquid assets to the treasury and the sale of its commercial bank shareholdings to the Government Bank Investment Fund. In contrast, the Government Bank Investment Fund had an indefinite mandate to secure a substantial element of national ownership in Norwegian banks. By maintaining indefinitely at least a one-third interest in the two largest commercial banks, the government intended to ensure, first, that the focus of these banks remained on financing Norwegian industry and, second, that the imprudent lending that contributed to the banking crisis would not be repeated.

Bank Support Measures

A small commercial bank, Norion Bank, which was founded in 1987 and pursued an aggressive asset growth strategy, was placed under public administration in 1989, and was liquidated after interim accounts indicated that its share capital was lost. All bank depositors received full compensation one week after the bank was closed, which was facilitated by a loan from Norges Bank and a guarantee from the Commercial Banks Guarantee Fund.

In August 1991, the Government Bank Insurance Fund provided the Commercial Banks Guarantee Fund with two support loans totaling NKr 2,450 million (Table 13, footnote 4). The loans were used to

Table 13. Norway: Funds Used in Rescue Operations[1]
(In millions of Norwegian kroner)

		Savings Banks Guarantee Fund		Commercial Banks Guarantee Fund	Government Bank Insurance Fund		Government Bank Investment Fund	
		Guarantee	Equity	Equity	Guarantee	Equity		
1988	Sparebanken Nord-Norge	600			200			
1989	Sparebanken Nord-Norge	650	1, 456		500			
	Sunnmorsbanken			580				
	Norion Bank			305	73			
	Other savings banks	73	288					
1990	Sparebanken Nord-Norge	650	7					
	Sunnmorsbanken			466				
	Other savings banks	567	172					
1991	Den Norske Bank			940				
	Fokus Bank			2,150[2]			475	
	Christiania Bank			2,724			5,140	
	Sparebanken Midt-Norge		525					
	Sparebanken Rogaland		600					
	Sparebanken Nord-Norge	800						
	Oslobanken							63
	Other commercial banks			22				20
	Other savings banks	138	504					
1992[1]	Den Norske Bank					600	4,750	1,675
	Christiania Bank						1,900	
	Sparebanken Midt-Norge		75			200	600	
	Sparebanken Rogaland		144					
	Other savings banks							1,070
	Total	3,478	3,768[3]	7,187[4]	773	800	12,865	2,828

Sources: Commission on the Banking Crisis (1992); Organization for Economic Cooperation and Development (1995).
[1]No official support was provided to banks after 1992.
[2]Indicates also subordinate convertible debt.
[3]Indicates NKr 539 million made on the basis of support loans from the Government Bank Insurance Fund.
[4]Includes NKr 2.45 billion made on the basis of support loans from the Government Bank Insurance Fund.

inject preference capital into Christiania Bank and Fokus Bank to allow them to meet the statutory capital adequacy requirements.[41] Furthermore, in October 1991, the Government Bank Insurance Fund supplied the Savings Bank Guarantee Fund with NKr 320 million in support loans that, in conjunction with a NKr 1 billion allocation from the government, was used to finance NKr 1,125 million capital injection to Sparebanken Midt-Norge and Sparebanken Rogaland. As a result, by the end of October 1991, the Government Bank Insurance Fund had disbursed NKr 2,770 million, over half of its capital, in support loans.

[41]At the same time, the Commercial Banks Guarantee Fund provided a further NKr 300 million of its own resources to Christiania Bank.

It became clear that the three largest commercial banks, Den Norske, Christiania, and Fokus, which together held 85 percent of total commercial bank assets, were in greater difficulty than previously thought. Christiania and Fokus had negative equity capital positions after their share capital and a sizable portion of preference capital were written off. Den Norske applied for an infusion of preference capital in October and November 1991 when it became clear that it was unable to raise capital in the private market.

The direct fiscal impact of the banking crisis in terms of funds used in rescue operations during 1991–92 amounted to about NKr 19.2 billion (2.6 percent of GDP) (Table 13). The bulk of these funds (NKr 17.8 billion) was allocated to the three largest banks (Den Norske, Christiania, and Fokus) to enable them to meet the capital requirements,

which was crucial if Norwegian banks were to maintain foreign financing and international creditworthiness. By the end of 1991, the government had become the sole owner or the majority shareholder of the three largest commercial banks, accounting for about 85 percent of the total assets of all commercial banks.[42]

The Swedish Experience

In Sweden, the first bank to face problems was Nordbanken, the third-largest bank at the time. (For more details, see Bank Support Authority, 1993.) Because the state was the major owner of the bank in late 1991, it ended up subscribing SKr 4.2 billion (0.5 percent of GDP) of a SKr 5.1 billion new share issue that it had guaranteed. New management was appointed immediately. One year later, the government purchased all minority share holdings. In return for the transfer of nonperforming assets to Securum AB (an asset-management company), Nordbanken received an additional capital injection of SKr 10 billion (1 percent of GDP).

By mid-1992, the government explicitly recognized that it needed a coherent strategy to deal with the crisis. Its overriding concern was to avoid a systemic collapse of the banking system and to avert the loss of foreign lines of credit. It therefore chose a centralized approach to providing assistance. In September 1992, the government announced that it would guarantee that all bank commitments be met on a timely basis and that no depositors, creditors, or other parties would suffer any losses (see Bank Support Authority, 1993). Subsequent legislation confirmed the guarantee; only share capital and perpetual debentures were excluded from the guarantee. The government was authorized to provide support flexibly in the form of loan guarantees, capital contributions, and other appropriate measures. There was no upper limit on the amount that could be spent on support operations.

The Bank Support Act (December 1992) stipulated that the long-term fiscal costs should be minimized and that paid-out support should be recovered to the fullest extent possible. Moreover, it was explicitly stated that the government should not endeavor to assume ownership of banks and credit institutions. Rather, the blanket guarantee scheme was considered to be exceptional and temporary; in fact, it was actually repealed by the parliament and replaced by a limited deposit insurance scheme on July 1, 1996.

To support the objectives of the act, parliament set up a separate agency, the Bank Support Authority, to manage the support system and decide on measures. The authority was only set up formally in May 1993 when banks had started to recover and most of the restructuring was completed. In 1996, the Bank Support Authority was reduced to a dormant body with one permanent employee.

Bank Support Measures

Unlike many other countries, where special government bond issues were exchanged for nonperforming bank loans, Sweden's main form of assistance consisted of the guarantee of banks' liabilities, which were to be financed from the budget as required. From late 1992, such assistance was offered to the entire banking system. Although several of the major banks availed themselves of these guarantees, nearly 98 percent of all the state's assistance was given to two large banks (Nordbanken and Gota Bank) and their associated asset-management companies (Table 14).

In the spring of 1992, it became clear that Nordbanken was in serious difficulty. To facilitate restructuring, the state bought all outstanding shares (for about SKr 2 billion) and then split the bank into a "good bank" and an asset-management company. The asset-management company, Securum, took over the bad assets, with a book value of SKr 67 billion, while Nordbanken was left with the performing assets. In addition, the state provided Nordbanken and Securum with equity capital (SKr 10 billion and 24 billion, respectively) and gave Securum SKr 10 billion in loan guarantees.

By September 1991, Gota Bank (the fourth largest bank) was incurring losses at a rate such that it would not meet the capital adequacy requirement at year-end and was in danger of becoming insolvent. To bolster confidence in the banking sector and safeguard the payments system, the government decided to meet all the commitments of Gota Bank, but not those of the parent company, Gota AB, which was declared bankrupt. The government assumed full ownership of Gota Bank at no cost (following arbitration, the value of the shares was declared to be zero). During 1993, two guarantees against losses were provided while the bank was being restructured. The reconstruction involved transferring the nonperforming loans to a specially created asset-management company, Retriva AB, which was endowed by the government with equity capital of SKr 3.8 billion. Nordbanken and Gota Bank received 98 percent of the budgetary assistance, but the

[42] By December 1992, the state-run Government Insurance Fund was sole owner of Fokus Bank and owned 98 percent of the shares in Christiania Bank. The state also owned 55 percent of the shares of Den Norske Bank through the Government Bank Investment Fund.

Table 14. Sweden: Funds Used in Rescue Operations[1]
(In millions of Swedish kronor)

	Total Commitment	Paid Out	Charged to the State's Budget
Savings bank foundations			
Guarantees[1]	6,803	—	—
Interest subsidies	1,028	1,028	1,028
Total	7,831	1,028	1,028
Nordbanken			
Share subscription 1991	4,191	4,181	4,191
Share purchase 1992	2,055	2,065	2,055
Capital contribution 1992	10,000	10,000	10,000
Total	16,246	16,246	16,246
Securum			
Guarantee 1992[2]	9,850	9,850	9,850
Guarantee 1992[3]	13,150	13,150	13,150
Share purchase 1993	1,000	1,000	—
Guarantee 1993	10,000	—	—
Total	34,000	24,000	23,000
Gota Bank			
Capital contribution 1993	20,000	20,000	20,000
Guarantee shareholder's equity[4]	231	231	231
Total	20,231	20,231	20,231
Retriva			
Capital contribution 1993	3,800	3,800	—
Guarantee 1993	3,500	—	—
Total	7,300	3,800	—
Föreningsbanken			
Capital adequacy protection 1993	2,500	—	—
Total bank support[5]	88,108	65,305	60,505

Sources: Swedish Banking Association; Ministry of Finance; Bank Support Authority (1996).
[1]No official support was provided to banks after 1993.
[2]At the time of the agreement, the guarantee to the savings bank foundations was about SKr 5.5 billion, calculated at present value.
[3]The guarantee to Securum has declined by SKr 1 billion, through Securum working this claim after propagation of the 1993 year-end financial statements.
[4]The prior guarantee of SKr 3 billion of shareholders' equity in Gota Bank to Nordbanken was discharged in an amount of SKr 231 million after the year-end financial statements were approved.
[5]In addition to the above charges of SKr 60,586 million against the national budget, the appropriations to strengthen the financial system were charged with a further SKr 2,722 million.

government also provided financial support to Sparbanken Sverige and extended large guarantees to other banks that, in the event, were not used.

In 1993, Nordbanken and Gota Bank were merged, retaining the name Nordbanken, and became Sweden's fourth-largest bank. The two asset-management companies that were created to deal with the banks' nonperforming loans, Securum and Retriva, were merged in December 1995.

Total commitments (including guarantees) amounted to SKr 85 billion (5.9 percent of GDP). However, because not all guarantees were paid out, budgetary support mainly took the form of capital injections (86 percent), with lesser amounts provided by share subscriptions or share purchases (10 percent) and interest subsidies (2 percent). The direct cost to the budget was SKr 61 billion (4.2 percent of GDP). Moreover, the net fiscal cost has been diminishing over time, as the asset-management companies have been recovering loan losses and the state has reduced its bank ownership. In October 1995, the government sold 34.5 percent of its ownership stake in Nordbanken for SKr 6.4 billion (0.4 percent of GDP). The value of the government's remaining equity in Nordbanken was estimated in mid-1996 to be about SKr 17 billion (1 percent of GDP). In contrast to the expectations in 1993, when the SKr 24 billion injections were expected to be written off over

15 years, it is now widely anticipated that 40–50 percent of the original equity capital will be recovered (0.6 percent of GDP).

The two asset-management companies, Securum and Retriva, have been quite successful in liquidating their assets and have recovered substantial amounts. After the merger and further reorganization, Nordbanken has become the most profitable bank in Sweden. The cost of the crisis has been estimated at 4 percent of GDP in cash and 6 percent including guarantees. Asset recovery and privatization receipts have reduced the cash outlays to an estimated 2.1 percent of GDP.

The Finnish Experience

Finnish bank support has been channeled through three organizations: the Bank of Finland, a newly established Government Guarantee Fund, and the state budget (see Nyberg and Vihriälä, 1994, for details on Finnish bank support measures). At first, the Bank of Finland was the only institution in a position to rescue a bank, such as Skopbank in late 1991. After the Skopbank experience had revealed the need for a new agency to deal with the spreading banking crisis, the Government Guarantee Fund (GGF) was established in April 1992.[43] Developments in 1992, however, demonstrated that the administration of bank support was inadequate. The GGF had no full-time staff of its own, and it was recognized that a conflict of interest could arise from the representation of the Bank of Finland and the Banking Supervision Office on the GGF's executive board. The Guarantee Fund in turn was accountable to a parliamentary committee. According to the new organizational structure, which was approved in February 1993, only the Ministry of Finance was represented on the GGF board. Moreover, the GGF now reported directly to the government, which would in the future decide on all bank support measures, rather than the GGF. In connection with the GGF's reorganization, parliament unanimously approved a resolution that reaffirmed the authorities' commitment to guarantee that Finnish banks were able to meet their commitments on time under all circumstances.

As a further step to improve financial supervision, the Banking Supervision Office, which had been part of the Ministry of Finance, became an autonomous unit within the Bank of Finland and was renamed the Financial Supervision Authority (see Aranko, 1994). At the same time, its responsibilities were extended to foreign exchange risk, an area that had previously been assigned to the Bank of Finland.

Bank Support Measures

The savings bank sector had been particularly hit by the banking crisis. A liquidity crisis in September 1991 prompted the Bank of Finland—at the time the only government agency equipped to conduct a rescue operation—to take over Skopbank. Two asset-management companies were formed: one took possession of Skopbank's industrial holdings, while the other took over the real estate holdings. Bank management was replaced, and a plan was drafted to reduce Skopbank's balance sheet and operating costs. As part of the rescue operation, the Bank of Finland committed about Fmk 14 billion in 1991 and 1992 (Table 15). In June 1992, the Guarantee Fund acquired Skopbank from the Bank of Finland for Fmk 1.4 billion, while the holding companies managing Skopbank's former corporate holdings and real estate investments remained with the Bank of Finland. By 1994, Skopbank had received Fmk 15.2 billion (3 percent of GDP) in bank support: Fmk 9.8 billion from the Bank of Finland, Fmk 4 billion from the Guarantee Fund, and Fmk 1.4 billion from the state budget. The loan and guarantee portfolio of Skopbank and its subsidiaries, Skop Finance Ltd. and Industrialization Fund Ltd., were sold to Sweden's Handelsbanken in June 1992. Skopbank continued to operate as a commercial bank and to serve the remaining savings banks as their central bank.

In early 1992, several savings banks developed financial problems, partly because of their stakes in Skopbank, but mainly as a result of their own aggressive lending in 1988 and 1989. Because savings banks were closely interconnected by a mutual solvency insurance scheme, a total of 41 savings banks (problem and nonproblem banks) were merged into the Savings Bank of Finland, which was subsequently taken over by the GGF.[44] In the process, the savings bank foundations lost their equity stakes in the merged banks. The Guarantee Fund provided a capital injection of Fmk 5.5 billion and subordinated debt worth Fmk 1.4 billion. In December 1992, an extra Fmk 4.7 billion was provided as capital to cover larger-than-expected write-offs of nonperforming real estate loans. At the same time, the Savings Bank of Finland was converted into a joint stock

[43]The fund was initially endowed with Fmk 20 billion (4 percent of GDP) for its operations, which included providing bank equity and granting loans and guarantees. In deciding on the appropriate support measures, the fund was guided by general principles, such as the transparency of support, relying on the bank owners' responsibility as much as possible, minimizing distortive effects, and ensuring public monitoring of supported banks.

[44]After the merger, 40 independent savings banks remained in business (Nyberg, 1994).

Table 15. Finland: Funds Used in Rescue Operations
(In millions of Finnish markkaa)

			Council of State			Government Guarantee Fund				
		Bank of Finland	State's capital investment	Preferred capital certificates	Share capital	Loan	Sub-ordinated loan	Preferred capital certificates	Share capital	Total
1991	Skopbank	4,330								4,330
1992	Skopbank	9,444	580					1,500	1,000	12,524
	Savings Bank of Finland		1,094				1,400	7,100	2,900	12,494
	Other savings banks		160							160
	Security fund of the savings banks					500			500	
	Okobank		422							422
	Cooperative banks		1,108							1, 108
	Postipanki		903							903
	Union Bank of Finland		1,749							1, 749
	KOP		1,726							1, 726
	STS-Bank		170							170
1993	Skopbank	–2,722		350				1, 200		–1,172
	STS-Bank		–170					3, 036		2, 866
	Savings Bank of Finland			750	250			950	150	2, 100
	Sale of Savings Bank of Finland		–1,094	–750				–3,756		–5, 600
	Asset management company Arsenal Ltd.				3,442				1,558	5,000
	Security fund of the savings banks					–345				–345
	Transfer to the Government Guarantee Fund					–357				–357
1994	Asset-management company Arsenal Ltd.				6,000					6,000
1995	Asset-management company Arsenal Ltd.				8,000					8,000
1996	Asset-management company Arsenal Ltd.				4,000					4,000
Support disbursed as of December 1996		11,052	6,648	350	21,692	–202	1,400	10,030	5,608	56,578

Source: Finnish authorities.

company, majority-owned by the GGF. By October 1993, the Savings Bank of Finland had received a total of Fmk 14.6 billion (about 3 percent of GDP) from the Guarantee Fund.

Fearing a credit crunch as the equity position of banks threatened to fall below the Basle capital adequacy requirements in 1992, the government offered Fmk 7.9 billion as a capital injection to deposit banks proportional to their risk-weighted assets. The preferred capital certificates carried a noncumulative interest rate slightly above market rates and could thus be counted as Tier 1 capital.[45] If interest was not paid for three consecutive years or if a bank's equity ratio fell below the minimum required, the certificates could be converted into voting stock. All banks took advantage of the capital offer.

In October 1993, the business activities and the share capital of the Savings Bank of Finland were sold for Fmk 4 billion in equal parts to the four remaining banking groups, Kansallis Osake Pankki, Union Bank of Finland, Postbank, and the cooperative banks.[46] The nonperforming assets of the Savings Bank of Finland, valued at Fmk 40 billion, were transferred to a new asset-management company, Arsenal, whose losses were expected to reach Fmk 16 billion (see Nyberg and Vihriälä, 1994). Arsenal was funded with a Fmk 28 billion guarantee by the government. In mid-1994, however, Arsenal purchased a majority stake in the Savings Bank of Finland for Fmk 4 billion (equal to the original sales price) and took over the remaining assets from the GGF. By the end of 1996, Arsenal had received public bank support of Fmk 23 billion (in addition to government guarantees). The GGF had received in all Fmk 7.2 billion from the sale of the Savings Bank of Finland.

The third rescue operation involved Suomen Työväen Säästöpankki Bank (from herein referred to as STS Bank), which had been converted from a savings bank to a commercial bank in the late 1980s. Like many other savings banks, it suffered large credit losses from its rapid credit expansion, and its owners were unable to provide the necessary capital to keep the bank viable. Under close cooperation with the GGF, a merger of STS Bank with Kansallis Osake Pankki (forming the largest commercial bank in Finland) was negotiated in November 1992, in which the GGF would have assumed financial responsibility for most of the problem loans by transferring them to an asset-management company. Parliament, however, did not approve the formation of an asset-management company, and the merger had to be postponed.

In April 1993, a new merger agreement with Kansallis Osake Pankki was concluded. STS Bank itself was in effect turned into an asset-management company and retained all nonperforming loans and bad assets, while the rest of its banking business was transferred to Kansallis Osake Pankki. Although Kansallis Osake Pankki remained responsible for 10 percent of the losses on the portfolio of bad assets and had formal ownership of STS Bank, effective control rested with the GGF. As a result, the GGF anticipated a loss of Fmk 2.5 billion on STS Bank's Fmk 3.4 billion of nonperforming assets.

By the end of 1996, the total amount of public bank support disbursed was Fmk 56.6 billion (about 10 percent of GDP), with Fmk 35 billion for savings banks including Skopbank (Table 15). In addition, public guarantees of Fmk 32 billion had been granted, bringing the total amount of bank support to Fmk 88.6 billion (equivalent to 15.6 percent of GDP).

Banking Sector Performance Following the Banking Crises

Restructuring efforts in the aftermath of the banking crisis have led to significant changes in the structure of the banking sectors in all three countries. About four years after taking full ownership of the three largest banks, the Norwegian government completely privatized Fokus Bank in 1995 and has reduced its holdings in the two largest commercial banks to 72 percent and 51 percent, respectively. However, the public sector still has a significant stake in the financial system; the state holds a majority stake in financial institutions that account for more than 70 percent of commercial bank lending and half of total lending. With the exception of the state banks and the Postbank, state ownership in the banking system has its origins in the bank rescue operations.

In Sweden, two large-scale merger operations took place in the cooperative and savings bank groups, resulting in the creation of two large banks (Sparbanken Sverige and Föreningsbanken), which are listed on the Stockholm Stock Exchange. In particular, all cooperative banks were merged into one commercial bank. The consolidation process also intensified in Finland. At end-1996, the three largest banks accounted for about 80 percent of total assets of the deposit banks. The assets of the largest bank, Merita Bank—which was formed through the merger of the two major commercial banks (Kop and Unitas) in

[45] The interest rate on the certificates increases gradually relative to the market rate to give banks an incentive to repay bank support early.

[46] As part of the sale of the SBF, the government received share capital of Fmk 1 billion from Kansallis Osake Pankki and Fmk 0.5 billion from Union Bank of Finland.

Table 16. Bank Profitability: International Comparisons, 1990–94
(In percent of balance-sheet total; average)

	Net Interest Income (Intermediation margin)	Net Noninterest Income	Net Banking Income (Overall gross margin)	Total Operating Expenses	Pre-Tax Profit
Belgium	1.39	0.43	1.82	1.26	0.30
Denmark	3.44	0.17	3.60	2.38	–0.19
Finland	**1.61**	**1.78**	**3.39**	**3.00**	**–1.14**
France	1.59	0.70	2.30	1.52	0.24
Germany	1.96	0.60	2.57	1.63	0.52
Italy	3.22	1.15	4.37	2.66	1.09
Netherlands	1.73	0.70	2.44	1.65	0.50
Norway	**3.48**	**0.93**	**4.40**	**2.88**	**–0.33**
Portugal	3.69	1.10	4.79	2.35	1.07
Spain	3.39	0.89	4.28	2.56	0.93
Sweden	**2.69**	**1.79**	**4.48**	**2.42**	**1.12**
Switzerland	1.54	1.58	3.12	1.65	0.58
United Kingdom	2.57	1.85	4.42	2.87	0.64
Mean	**2.48**	**1.05**	**3.54**	**2.28**	**0.41**

Source: Malkamäki and Vesala (1996).
Note: Figures are average ratios 1990–94.

mid-1995—represent about 50 percent of total bank assets.

Loan losses have decreased in all three Nordic countries since 1994, primarily because of the recovery of their economies (see Koskenkylä, 1994). The economic recession was most severe in Finland and Sweden, while in Norway real GDP growth was stable during the 1990s. Bank lending has not yet fully recovered from its decline in the early 1990s, particularly in Finland, as companies have continued to finance their investments mainly with retained earnings and new share capital, in an effort to further reduce their indebtedness. While the banking systems in Norway and Sweden had returned to profitability by 1993 and 1994, respectively, Finnish banks only regained profitability in 1996 (Table 7 and Malkamäki and Vesala, 1996).[47]

Since 1993, the capital adequacy of the banks in all three countries has improved significantly with the help of considerable state support. In 1996, the average capital adequacy ratios were 12.4, 14, and 16 percent for Finland, Norway, and Sweden, respectively.[48]

Among the three Nordic countries, Finnish banks had the lowest ratio of net interest income to total assets, reflecting the existence of a large amount of nonperforming loans and the lack of demand for loans (Table 16). In 1994, Finland recorded the largest amounts of nonperforming loans among the Nordic countries. The weak demand for bank loans has increased bank competition, which was also reflected in declining interest rate margins. Interest rate margins in Finland are expected to be subject to further downward pressure, which will reduce banks' profitability and require further streamlining of their operations. In contrast to Finland, in Norway and Sweden the ratio of net interest income to total assets has increased since the banking crisis (Tables 8, 9, and 10).

The ratio of banks' operating expenses to total assets has decreased most sharply in Finland although most of this decline took place prior to the banking crisis (Tables 8, 9, and 10). The declining trend in Finland bottomed out, notwithstanding the severity of the Finnish banking crisis. Although the numbers of staff and bank branches have been reduced considerably (Table 2), with the exception of Norway,[49]

[47]Banks' profitability was further weakened in 1995 owing to losses in securities transactions, which were not connected to the banking crisis.

[48]Bank for International Settlements (1996).

[49]During 1987–94, the number of staff years employed in the commercial and savings bank sectors declined by 35 percent and 9 percent, respectively.

these developments have not yet been reflected in the trend of expenses in Finland and Sweden. This may partly be due to higher restructuring costs, including more generous severance packages, compared with Norway.

Although the banks' situation has improved in the aftermath of the banking crises, competition in the banking sector has increased, and the demand for loans is projected to continue to be sluggish. With increased financial integration in Europe, foreign banks are likely to increase their supply of services in the Nordic countries, increasing competition and further heightening the need for the Nordic banks to improve their efficiency. The need to reduce costs, in particular for bank staff, is especially strong in Finland, where the banks have more employees than other Nordic banks.

Lessons from the Bank Restructuring Operations

The three Nordic countries have taken different approaches to bank restructuring, as described above. Although it is difficult to make a robust evaluation of the outcome of these operations, several factors seem to suggest that Sweden's approach has been the most successful. In Finland, the banking system returned to profitability only in 1996, and in Norway the government still remains the major shareholder of the banking system. The decision to adopt a comprehensive strategy enabled Sweden to weather a severe crisis, maintain the country's credit rating, and minimize the costs of the restructuring program. The main principles underlying the success of Sweden's bank restructuring strategy can be summarized as follows:[50]

The key element of the restructuring program was the formation of a broad political consensus. This consensus was supported by timely information to all domestic parties. Transparency and disclosure of information were crucial for regaining confidence domestically and abroad; the implications of support measures for depositors and investors were extensively reported.

It was decided that to place the lead restructuring agency within existing institutions, such as the Ministry of Finance or the Riksbank, might have interfered adversely with the roles of these institutions. Therefore, a separate institution—the Bank Support Authority—was created to implement the bank restructuring strategy. The formation of an institutional framework clarified the respective roles for the Ministry of Finance, the Riksbank, the Financial Supervisory Authority, and the Bank Support Authority. At the same time, there was a continuous exchange of information among the institutions.

Diagnosis was the first step in the restructuring exercise. A common yardstick—based on the capital adequacy ratio and other financial ratios—was designed to measure the degree of problems in banks. Initially, the banks were divided into two main categories: those that were considered viable and those that were not. While banks in the first category received support, the ones in the second category were closed or merged, and the banks' creditors were paid off.

Distorted incentives were minimized through the conditionality measures embedded in support agreements. The foremost conditions included changing management and upgrades of internal control and risk-management systems (which in most cases were found to be inadequate). The parliamentary guarantee did not cover owners' equity capital; in case of financial support by the government, owners typically lost their equity stakes.

Structural reforms of the accounting, legal, and regulatory framework and of prudential supervision were enacted. Clear guidelines on asset classification and valuation of banks' holdings of collateral (real estate and other assets) were set, with the Bank Support Authority monitoring compliance with these procedures.

The establishment of institutions for loan workout was given high priority. Problem assets were transferred, at an assumed market price,[51] to a separate asset-management company. As with other types of support provided to the banks, strict conditionality was attached to these operations. This approach facilitated the orderly sale of assets and allowed problem banks to continue their usual business without having to handle a large volume of workout cases. The asset-management company could recruit the specific expertise needed for transforming the bad assets into salable assets. The Bank Support Authority funded the asset-management companies and was their sole owner.

[50]These principles are outlined in Ingves and Lind (1996).

[51]The key concern was to make sure that all potential losses were borne by banks rather than the asset-management companies.