BANKS IN SWEDEN
Crisis of the 1990's and the Situation 2003

I am very grateful to Nikko Asset Management for giving me this opportunity to share with you how Sweden successfully dealt with its banking crisis in the 1990's. Towards the end of my presentation I will briefly also describe the Swedish banking sector as it looks today.

Background of the crisis
Towards the end of the 1980's, Sweden experienced a couple of years of bubble economy. A significant factor driving the bubble was the domestic credit market. In 1985, Sweden deregulated this market which resulted in a very strong credit expansion due to a pent-up credit demand. This expansion resulted in a business boom, a huge lending to the real estate sector, rising asset prices - and overheating.

Finally however, the bubble years came to an end and the economic situation changed dramatically. In 1990, the boom in real estate ended and asset prices started falling. Also at this time, there was a governmental crisis and a pressing need for tighter fiscal policy. The introduction of a much awaited tax reform turned out to be ill-timed and exacerbated the situation as it created higher interest rates for borrowers. The problems were aggrevated further by the crisis hitting the European exchange rate mechanism in 1992. A capital outflow followed and the creditworthiness of Swedish banks were further undermined.

All this caused a sharp contraction in the Swedish economy resulting in rising credit losses for the banks. The massive expansion of lending with real estate as collateral had now become a big problem. The rise was quite dramatic. In the 1980's, the loan losses of banks normally fluctuated between 0,2 and 0,5 percent of their loan portfolio. In 1992, at the height of the crisis, credit losses amounted to more than five percent of total loans. For the banking sector as a whole, this represented a rise from around two billion SEK to 75 billion SEK.

The so called finance companies were first hit, and soon after the banks were affected. In 1991, two major banks announced that they needed new capital in order to meet the stipulated capital ratio of eight percent. As the main owner of one bank (Nordbanken), the state injected new capital. For the other bank (Första Sparbanken), a loan guarantee was provided. The situation deteriorated further, and in 1992 a third bank's commitments had to be guaranteed (Gota Bank). In the autumn of 1992, the stability of the financial system was at risk. What first had been seen as isolated cases now proved to be a systemic crisis. It became obvious that comprehensive measures were needed.

In December 1992, the Swedish Parliament passed a bill addressing the situation. Firstly, a state guarantee was provided in order to restore confidence and to ease the immediate pressure on banks. Secondly, a framework for an all-encompassing work-out process was put in place, including the establishment of a Bank Support Authority.

The State bank gurantee
The state bank guarantee: Through this far-reaching decision, the state guaranteed that banks and certain other credit institutions could meet their commitments on a timely basis. The purpose was to ensure the stability of the payment system and to safeguard the supply of credit. This guarantee protected all the bank's creditors, except for the shareholders. And there were no upper limits. But the state would not endeavour to become an owner of banks or other institutions. These measures, which were temporary, were also based on commercial principles. Support could come in the form of guarantees, loans or capital contributions. Also important, the guarantee was not directed to any specific creditor. Despite the potential negative effects on the functioning and efficiency of financial markets of introducing such a guarantee, this measure was nevertheless seen as necessary in the highly uncertain and critical situation that had developed.

The work-out process - The Bank Support Authority
A fundamental component of the work-out process was the establishment of a Bank Support Authority. This authority became responsible for managing the support system, and for evaluating each and every one of the affected institutions. The authority's mission was to provide government support to those institutions that were viable in the longer run and that would need only temporary government assistance. The method was to classify the credit portfolios of the banks at market prices, to assess the value of the property collateral, and to carry out sensitivity analyses. Thereafter, a decision was reached.

Setting up a new and separate authority of this type meant extra work, but was necessary for a proper and genuine work-out process. Assigning these new support tasks to any existing institution, such as the Bank of Sweden or the Financial Services Agency, would have been problematic. Organizing a work-out process of this nature could have been in conflict with their other tasks.

Separate the bad loans from the good ones
Another part of the restructuring work was to separate the bad loans from the good ones within each bank. The sizeable volume of non-performing loans in certain banks also made it appropriate to transfer these loans from the regular operations into separate work-out companies. This was a rational exercise as bad loans require a different management expertise compared to normal credit operations. As a result, the Bank Support Authorty became engaged in setting up and capitalizing two such companies (Securum and Retriva).

Capital injections
Another crucial step was deciding on capital injections. Here, private owners did contribute in the recapitalization of the banks. The state, however, contributed the largest share of capital (83 percent). Virtually all of the state support went to two banks (98 percent - for Nordbanken and Gota Bank). Important already from the outset was the government's intent to become only a temporary new owner in the banking sector.

Privatization should follow once the time was right (Nordbanken, after the takeover of Gota Bank, was partly privatized in 1995).

As it turned out at the end of this process, three banks did receive government support (Nordbanken, Sparbanken Första (through savings bank foundations), Gota Bank). The other four leadings banks (Föreningsbanken, S-E-banken, Swedbank, Svenska Handelsbanken) did not receive any assistance, although one of them had been granted government support in the form of a temporary safeguard for its capital ratio (Föreningsbanken), and two of them had initially applied for support (S-E-banken, Swedbank).

Results?
How did it all go? The direct costs for the state totaled 65 billion SEK, which is roughly four percent of GDP. Much of this was then later on recovered through dividends and privatizations. The work-out period lasted four years, which was shorter than had been expected. This was partly thanks to a swifter than expected economic recovery in Sweden. Currency depreciation, government budget consolidation and lower interest rates had created a favorable macroeconomic environment. The economic cycle picked up and the banks' balance sheets soon improved. As a result, the state was able to abolish its guarantee as of 1 July, 1996.

Why was the rescue successful?
There are a couple of explanations. A broad political consenus and insight into how serious and acute the situation was created the necessary framework for bold decisions. The conservative government at the time and the social democrats in opposition acted in unison. Also, the rescue package came early. The fact that Sweden at the time experienced three parallell crises - a currency crisis, a fiscal crisis and a banking crisis - added to the sense of urgency. Important was also that the rescue package was comprehensive and fully transparent. Vested interests were not protected - neither the management of banks nor owners. The engagement of foreign and private experts in the fields of corporate restructuring and real estate was likewise crucial. Also important was how well the government, the central bank, the Financial Services Agency and the Bank Support Authority cooperated. The end-result was a quick return to a robust and competitive banking system.

Was the bank support necessary?
And did it have to be this extensive? Two leading Swedish officials at the time - Stefan Ingves and Göran Lind - have asked the same questions. They concluded that such questions must be assessed in relation to the situation as it was in the autumn of 1992. Confidence in Sweden's financial sector, as well as in its currency, was very weak. A very acute problem had to do with the banks' dependency on sizeable and continuous foreign currency borrowing. The government concluded that without a prompt restoration of confidence, the stability of the payment system was clearly threatened, and with possible grave consequenses for the economy as a whole. In this situation, far-reaching and clear measures were needed in order to demonstrate ability and

determination. The desired results were achieved. In retrospect, it is impossible to know if other actions would have had the similar speedy and positive effects.

Swedish banking market today

Today, the Swedish banking market is controlled by four banking groups. Together, they account for more than 80 percent of the industry's total balance sheet. These four banks have all chosen different ways to compete. As a result, they each hold strong market positions but differ as regards customers, pricing of services and ways of distribution. Two of these four banks were seriously affected by the crisis in the early 1990's and survived thanks to the support provided by the government. One of them had initially applied for government support. Today, they are all quite profitable.

Nordea is the largest financial services group in the Nordic and Baltic Sea region, but now with only 250 branch offices in Sweden. Nordea originates from four Nordic banks - from Sweden (Nordbanken including Gota Bank which it acquired in 1993), Finland, Denmark and Norway. As of December 2001, all operations in this Nordic area are carried out under the same brand name of Nordea. *Handelsbanken* has through a recent acquisition become a leading player in the Swedish mortgage market. By having had a policy of prudent lending in the late 1980's, Handelsbanken managed without applying for government support during the banking crisis. *SEB* become a key player in insurance through the acquisition of a large insurance company in 1997. With the purchase of a German bank in 2000, SEB became a truly European bank. This means that over half of the bank's employees are now working outside Sweden.
FöreningsSparbanken, which has become known as the bank for the small-sized companies, was established in 1997 through a merger between the Savings Bank of Sweden and Föreningsbanken.

What are the present trends in the Swedish market?

The first e-banking services were launched in 1996 - that is banking over the internet. After only five years in operation, approximately 45 percent of all Swedes regularly used the e-banking system. According to recent polls, as many as 35 to 40 percent of bank customers said they now use the internet as their main way to communicate with their bank. This is now putting pressure on the local branch office structure of the banks as the traditional way of serving the customer is changing. Traditional offices are more and more being replaced by offices focused on counselling.

Niche banks are emerging**.** These banks are focused on the private consumer and mainly distribute their services via the internet or by telephone. During 2001 and 2002 for instance, two of the biggest supermarket chains in Sweden started their own banks. Within their selected niches, these banks can be significant competitors to the major Swedish banks. The niche banks' offer of higher interest rates to the depositor is now forcing the larger banks to improve their own offers.

During the 1990's, there have been a number of mergers and acquisitions in the Swedish banking sector. The number of banks has declined sharply, a tendency that is most obvious among the savings banks. From some 450 savings banks in the early 1950s, the number today is just above 75. With increased concentration, regional banking is disappearing as a way to compete. The regional banks that do want to remain independent have taken different kinds of initiatives in order to enhance regional cooperation and to stimulate a favourable economic development in their regions. Only by having strong local companies emerge will they secure future business for their banks.

Further consolidation can be expected. In 2001, plans for a merger between SEB and FöreningsSparbanken were presented. However, these plans were rejected by the European Commission. The constant pursuit of efficiency and profitability forces the banks to look for new ways to cut costs and strengthen market positions. Some say that the Swedish market is too small for four major banks. Mergers with, or takeovers by, other European banks are not unlikely. In addition to increased consolidation, this would also mean a further internationalization of the Swedish banking sector.