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A crucial lesson from the Nordic experience is the need for prominent state involvement in crisis resolution

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SINCE the onset of the current financial turmoil that began in the United States, policymakers have been looking at previous financial and banking crises to learn lessons about how to deal successfully with the fallout. Many have looked to the case of Sweden and other Nordic countries that went through financial crises during the early 1990s.

The Nordic upheavals of the early 1990s were the first systemic crises in industrialized countries since the 1930s, not counting the banking problems directly related to World War II. The Nordic crises were preceded by the widely studied U.S. savings and loan (S&L) crisis, which was not truly systemic, but affected a subsector within an otherwise functioning large financial market.

The Nordic banking crises were thus eye-openers. How could such problems occur in otherwise well-organized and managed economies and financial systems? The reason we are still thinking about them is that the Nordic countries showed how to effectively deal with such crises.

The Nordic countries taught the world powerful lessons about the need for prominent state involvement in the resolution process: it was the state rather than the private sector that led the systemic restructuring exercise, seeking to bring in private sector owners and investors as much as possible. The Nordic responses also showed the role of the state in the protection of asset values of banks when private asset markets collapse and how to use special asset management companies and loan workout units, which have to be government owned, if no private investors are available—as they seldom are in a systemic crisis. Such bodies can protect value through careful management and avoid the losses brought about by fire sales.

The authors were deeply involved in resolving the Swedish crisis of 1991–93, so this article focuses on the Swedish experience and how it relates to the present turmoil.

Patterns of crises

The present international financial turmoil has led many involved in the financial markets to reconsider long-held beliefs about how markets operate. Nevertheless, we have seen much of this before—albeit on a smaller scale.

Each banking crisis shows a different combination of causes, but the main ingredients are most always there, as they were in the Nordic countries: bad banking, inadequate market discipline, weak banking regulation and supervision, and inadequate macroeconomic policies related to financial liberalization.

Once under way, financial crises follow a common pattern:

- Underlying weaknesses become apparent.
- An acute crisis is triggered by a particular event.
- The crisis is propagated and aggravated.
- Steps are taken to mitigate and resolve the crisis.

Our analysis looks at some of the similarities and differences between the Swedish crisis and the present crisis and proposes ways to tackle the current situation.

Underlying weaknesses—some similarities

The underlying cause of most crises is loose granting of loans, often related to real estate, based on overly optimistic risk assessments in conjunction with easy money and macroeconomic imbalances. The cycles in real estate are fairly long, so investors and credit providers seem to neglect the likelihood of future downturns. They underestimate the risk and extend too much credit, thus supporting speculative bubbles.

The situation is often exacerbated by politicians' well-meaning eagerness to promote housing construction. Expanding and modernizing the housing stock is a highly cherished objective. Public incentives support demand for residential real estate, particularly for less creditworthy buyers. Before the liberalization of the Swedish credit market, legislation forced banks to allocate a substantial share of their resources to fund housing and other real estate projects. De facto public guarantees were provided for mortgage loans and for investment in residential real estate, similar to those of the U.S. mortgage giants Fannie Mae and Freddie Mac. In the Swedish crisis, large sums of taxpayers' money had to be spent to rescue municipally owned companies that owned apartment blocks.

Sometimes bank groups, other market participants, and even the authorities do not sufficiently take into account the implications of off-balance-sheet and other potential risks. In the present crisis, for example, financial and reputational risks emanate from structured investment vehicles (SIVs) and other credit instruments, as well as from demands on bank liquidity from off-balance-sheet commitments. In the Swedish crisis, finance companies played a role similar to that of SIVs. The companies were less regulated than banks and had picked up many of the riskier loans. When finance companies ran into liquidity problems, banks found they had to keep funding the companies—to which they were actually closely linked, even though the companies were legally independent.

Although this was not a decisive issue in the Swedish crisis, financial insurance is a common component in many crises. Insurance providers seem to take on too many commitments in good times. In a crisis situation, highly leveraged insurance providers add to the systemic problem.

The buildup of weaknesses is sometimes due to gaps in financial regulation and supervision. Financial development generally improves the effectiveness of financial intermediation and provides better and more varied services to customers. But it also entails new risks, which may not be fully understood by markets and authorities. In the Swedish case, the concentration of risk when lending too much to the real estate sector was not adequately taken into account. In addition, banks and authorities did not realize the potential dangers of providing loans in foreign currencies to Swedish borrowers whose earnings and assets were denominated in the local currency. In the present international crisis, it is obvious that neither banks nor regulators fully considered the implications of the originate-to-sell business model and in particular the use of SIVs and other derivatives-based funds.

Some key differences

The S&L crisis in the United States involved mainly commercial real estate, and the Swedish crisis a mix of commercial and residential; today's subprime crisis is mostly residential. But the one fundamental difference between the present crisis and that in Sweden is that today the underlying credit issues are exacerbated by the existence of highly complex instruments and closely linked markets—both domestically and internationally.

Although international links existed in earlier crises—for instance, foreign investors held bonds issued in crisis countries—the international repercussions are today more substantial and immediate. Failures of U.S. subprime loans and instruments leveraged on these loans have affected banks in many countries, including France, Germany, and the United Kingdom. Even remote municipalities north of the Arctic Circle in Norway suffered substantial losses on instruments based on U.S. subprime loans.

Likewise, the links between different domestic financial markets are much more apparent this time. Apart from the effects on the credit markets, funding for commercial paper, asset-backed securities, and interbank markets and for U.S. municipalities has been strongly affected. Markets for stocks and securities have clearly taken a hit both on prices and liquidity.

The most acute problem is the squeeze on liquidity. Lacking confidence, those holding excess liquidity are not willing to transfer it to where it is needed. The authorities can, and do, handle this problem in the absence of a market solution, which would be less costly and disruptive and thus preferred. Consequently, restoring confidence quickly must be the top priority. But it's harder now because the 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. They are asking, "Who is in fact ultimately exposed to the dud assets?"

Crisis resolution Swedish-style

Compared with the present turmoil, the Swedish crisis was more of a "pure" credit crisis and hence more straightforward to analyze and handle. The true extent of the credit losses and other damage done to the banks was assessed on a forward-looking basis. The bank owners were then invited to infuse the needed additional capital, or let the Swedish authorities deal with the situation—which implied financial support on strict terms, or even government intervention and restructuring of banks.

The Swedish authorities recognized the need to restore confidence in the financial system quickly. There were no significant depositor runs on banks, but Swedish banks' foreign creditors started to cut their credit lines. The creditors found it difficult to assess the situation of individual banks and thus reduced their risk. Banks and authorities had to do their utmost to restore confidence. Words were not enough; action was required.

> "Crisis resolution is mainly about restoring confidence. Transparency is key."

Transparency played an important role in restoring confidence. The authorities forced banks to disclose their true financial situation. The authorities were also prepared to inform the public about their plans and actions. Senior Ministry of Finance officials traveled to New York and London to meet with bankers and market analysts. This proved successful, and credit lines to Swedish banks were soon restored.

An important part of transparency is the ability to determine the value of banks' portfolios, which is difficult when the underlying asset markets are illiquid and do not provide robust price information. The Swedish authorities forced the banks to value their assets conservatively, in particular their real estate exposure. Consequently, the immediate financial situation of the banks appeared perhaps more grave, while at the same time a low floor was established. Price expectations were stabilized and the market turned upward again. In some crises, when the authorities have tried to smooth out price movements, the resulting uncertainty has lasted longer, thus delaying an upturn.

Political consensus is a prerequisite for creating confidence. In Sweden, all the main political parties agreed on the framework for crisis resolution. The framework included a structure to expedite and coordinate responses between the relevant authorities while preserving the integrity of each authority. A new authority was created—the Bank Support Authority (BSA). Before making a decision, the BSA had to obtain the approval of the Riksbank (central bank), the Swedish Financial Services Authority, and the National Debt Office. If agreement was not achieved—this happened only rarely—the issue was referred to the Ministry of Finance. Countries without political consensus or where the authorities have not acted in concert have found it more difficult to take quick remedial action.

Experience shows the importance of adequate legislation and institutions to tackle weak banks. Lacking these tools, Sweden had to improvise. The United Kingdom also lacked a dedicated bank resolution framework, which delayed the resolution of Northern Rock. The United States has a well-oiled structure of laws, institutions, and expertise that has gradually developed since the large-scale banking defaults of the 1930s. Nonetheless, the United States had to apply this framework in a flexible, nontraditional manner in order to accommodate solutions for institutions other than commercial banks, for example, Bear Stearns and Fannie/Freddie. The concept of "systemic threats" was broadened to formally acknowledge, for example, that investment banks could also pose such threats.

Countering risk aversion

Inadequate methods for granting credit in the real estate sector were clearly an underlying weakness in both the Swedish and the present crisis. The acute phase of both crises was triggered by a weakening of the overall economy, in particular the housing sector. Investors became more risk averse so risk premiums increased.

Both crises were propagated by liquidity squeezes and contagion to other institutions and markets. However, the present turmoil is more severe, since more markets are affected. It is also exacerbated by difficult-to-assess complex financial instruments, off-balance-sheet commitments, and bank-related vehicles (SIVs and other conduits).

The approaches to crisis mitigation are also generally similar. Liquidity has been provided on a broad scale—by concerted international action in the recent crisis and nationally in the Swedish crisis. In both cases, banks were nationalized, merged, or sold (sometimes with financial support from the authorities).

Indeed, one of the principal lessons from the Nordic experience is that policymakers cannot rely on the private sector or markets alone to solve systemic banking problems. Similar to the need for a lender of last resort to deal with systemic liquidity shortfalls, there is need for an investor or owner of last resort when all other sources of capital have dried up—and closing down an entire banking system is not a feasible option. There is also a role for a blanket government guarantee to restore confidence and prevent bank runs and a potential financial meltdown—with the wholesale destruction of value that such a scenario would imply.

Restoring confidence

To summarize, the present crisis contains many features recognizable from earlier crises, but they are compounded by the high degree of complexity in financial instruments and institutional arrangements and by close links between markets, both domestically and across borders.

The two crises, supported by experience from other crises, suggest that a crisis cannot be resolved until confidence is restored. Providing more transparency reduces uncertainty. Transparency implies more disclosure about which institutions are holding the risky assets and the realistic value of those assets. The authorities themselves must also be open, as far as possible, about the crisis situation and about their plans. ■

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