# Dealing with banking crises – proposal for a new regulatory framework

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*The Swedish banking crisis in the early 1990s was an extraordinary event. The age-old assumption that the Swedish banking system was sufficiently stable to cope with any shock was suddenly found wanting and a massive government rescue operation was required to prevent the collapse of the Swedish financial system, in particular the payment system. This rescue operation proved a success: the acute financial crisis was relatively short-lived and does not appear to have had particularly serious repercussions in the real economy, and the Swedish banking system has since functioned well. However, a number of financial crises elsewhere in the world have shown that the Swedish banking crisis cannot be viewed as an isolated episode. Instead experience from the Swedish crisis and the way it was handled provides valuable insights when formulating the foundations for the efficient and effective regulation of the financial sector in the future.*

## The Banking Law Committee's crisis management solution

**The committee's final report proposes a regulatory framework that will not be activated until a crisis actually looms or arrives.**

Indeed, this view was reflected in the terms of reference for the Banking Law Committee, a government inquiry set up in 1995. The committee has recently published its final report *Public administration of banks in distress* (SOU 2000:66) to supplement its main report *Regulation and supervision of banks and credit market undertakings* (SOU 1998:160). The main report proposes a

*The author would like to thank Sonja Daltung, Lars Hörngren, Torgny Håstad, Göran Lind, Gustaf Sjöberg and Anders Vredin for their valuable comments.*

revised system for regulation and supervision under normal conditions that reduces the risk of serious crises in the financial system as effectively as possible and with a minimum of adverse side-effects. It is concerned with measures and regulations designed to *prevent* crises in the first place and involves revising and updating an already extensive regulatory framework. By way of contrast, the final report proposes a regulatory framework that will not be activated until a crisis actually looms or arrives and is concerned with measures and regulations governing the way in which banking crises are to be managed and resolved. At present there is very little regulation at all in this area in Sweden, as was the case elsewhere in the world until quite recently. However, the last decade has seen the problems of managing banking crises gradually beginning to be taken seriously which also has lead to new regulations in a few countries, including the USA.[1]

The purpose of this article is to outline the recommendations for the management of banking crises put forward by the Banking Law Committee and the analysis on which these recommendations are based. The recommendations presented in the committee's main report will be touched on only briefly and where needed to put the crisis management proposals in their proper context.[2]

The committee sought to draw on experience, both good and bad, from the Swedish banking crisis in its work. One of its points of departure, as in other areas of its work, was that the regulations proposed should focus on meeting clearly formulated objectives with a minimum of negative consequences for the ability of financial institutions to operate effectively in a competitive environment – in other words they should be in tune with the principles of the market economy.

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[1] Although the last decade has seen government deposit guarantee schemes being introduced in Sweden as well as many other countries, their primary purpose is to protect consumers and the current consensus is that they are not enough to deal with a systemic crisis. Nor has the central banks' classical function as lender of last resort ever been intended to handle banking crises: their purpose can better be defined as preventing crises by ensuring that liquidity in the banking system can be maintained.

[2] A more detailed review and analysis of the Banking Law Committee's main report can be found in Lind & Molin (1999).

## The Swedish banking crisis in retrospect

An overheated economy led to a speculative real estate price bubble that burst at the beginning of the 1990s due to a real interest rate shock.

Let us therefore begin with a brief recapitulation of the main features of the Swedish banking crisis and how it was handled.[3] The latter half of the 1980s brought the rapid deregulation of the Swedish banking sector and the banks suddenly found themselves free to determine their own lending growth, having previously been required to adhere to relatively restrictive limits laid down by the government. With an overheated economy, the banks were able to increase their lending rapidly, both in Swedish kronor and in foreign currencies like the US dollar and the German mark. The consequences included a surge in real estate and other asset prices, which in turn led to a speculative real estate price bubble. The culture of conservatism and prudence traditional in banking circles now went head-to-head with a new sales-oriented battle for market share; as real estate prices in particular began to soar, the latter view came to dominate and resulted in loans being granted without sufficient risk assessment and controls. The real estate bubble was then suddenly burst at the beginning of the 1990s by a real interest rate shock, caused partly by an international rise in real interest rates (often interpreted as a result of Germany's reunification) and partly by misplaced expectations of continued inflation in the prices of goods and assets in Sweden.

Despite temporary rescue operations in 1991, the crisis came to engulf the entire banking sector in 1992 and guidelines on the management of the crisis had to be unveiled during the autumn.

Many finance companies quickly collapsed and the banks were dragged deeper and deeper into the crisis by rapid growth in nonperforming loans. Despite temporary rescue operations following acute problems at Nordbanken and Första Sparbanken in 1991, the crisis worsened in 1992 and engulfed the entire banking sector. The risk of the Swedish banking system collapsing altogether, with serious implications for the payment system and credit supply, was considered sufficiently great by the early autumn of that year to warrant drastic action by the government. An emergency package was duly unveiled in September 1992, setting out guidelines for the management of the banking crisis. Its most important features were as follows.

[3] There have been a number of excellent analyses of the Swedish banking crisis, such as Ingves & Lind (1996), Bäckström (1998) and the other contributions to the issue of Ekonomisk Debatt (1998) entirely devoted to the subject. See also Andersson & Viotti (1999).

Firstly, a general government guarantee was issued for the repayment of all claims on the Swedish banking sector and much of the rest of the financial services sector. A guarantee of this kind was considered necessary to prevent lenders from calling in the Swedish banks' loans in the international interbank market in panic.

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Secondly, a rescue operation was set up in the form of a new government body, the Bank Support Authority, created to support banks in distress. The principles for this support were defined unambiguously: the cost to the government of supporting the banks was to be kept as low as possible, which meant that banks requesting support would have to agree to a comprehensive review of their operations; any injections of government funds would be on as close to normal commercial terms as possible; and the government guarantee did not extend to the banks' shareholders.

Secondly, a rescue operation was set up in the form of a new government body created to support troubled banks.

Thirdly, the importance of managing the banking crisis as openly as possible was stressed. This was essential for retaining confidence in the viability of the Swedish banking system in international financial circles as well as for keeping the Swedish populace abreast of what was happening.

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The Swedish strategy for handling the banking crisis proved a success and is now regarded as something of a textbook example in the international debate. The Bank Support Authority's way of structuring its operations with a broad-based board, a small but efficient staff and the use of the top international consulting firms to analyse the banks requesting support has been studied in detail – as have the "bad banks" set up by transferring non-performing loans from the banks to special asset management companies. Given that the acute phase of the crisis can be considered to have been over by the autumn of 1993, it is tempting to draw the conclusion that the crisis was managed so well that we should be able to depend on this happening again in a future crisis. In this case there would be no need for specific crisis management regulations.

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# The need for a regulatory framework

**The response to the Swedish banking crisis was improvised without any clear role models or regulatory support.**

In my opinion – and that of the Banking Law Committee – this conclusion has a number of flaws. Appreciating these flaws is important for understanding the analysis underlying the Banking Law Committee's work on both its main report and, in particular, its final report. It is beyond dispute that the design and implementation of the government's response to the Swedish banking crisis was improvised without any guiding precedent or regulatory support. A critical factor for the success of this improvised response was thus that the entire emergency package was considered credible, right from its announcement in September 1992. However, the level of preparation required for the legislation of the package meant that formal parliamentary approval could not be granted until December that year. The tiniest doubt on the part of international investors as to whether this approval would be given would have brought funding problems for the Swedish banks and could quite possibly have triggered the payment system crisis that the package was intended to prevent. Due to the widely felt sense of crisis, there was such broad political consensus on the need for far-reaching action to save the Swedish banking system that no such doubt ever arose. However, this degree of political unity cannot be taken for granted in a future crisis. The sense of crisis in the Swedish political system was unusually widespread when the banking crisis occurred. The economy was in freefall on almost every front and the drastic steps taken to support the krona (the Riksbank hiked up its overnight lending rate to 500%!) provided spectacular evidence of the severity of the situation. We would probably have to go back to the Second World War to find a similar degree of consensus across the political spectrum.

Thus, there is no guarantee that banking crises will strike only in situations where persistent deterioration in the economic climate has built up a general sense of crisis in the political system. In several of the countries hit by the Asian financial crisis in 1997, the crisis arrived almost out of the blue without macroeconomic indicators giving any clear warning of its approach.

Furthermore, decisions need to be taken extremely quickly once a banking crisis threatens to become acute. The explosive growth in trading in securities, derivatives and foreign exchange witnessed in recent years has meant that banks increasingly are involved in complex and extensive systems for handling large payments. The counterparty exposures that arise at times are huge and extremely difficult to get a clear overview of, especially at the aggregate level. Should confi-

dence in one or more of the big banks suddenly deteriorate, this will probably lead almost immediately to funding problems in the interbank market, with uncertain and possibly severe consequences for the entire banking system.[4] In this scenario it may be just a matter of hours before the nation's payment system is paralysed unless steps are taken to restore confidence in the banking system.

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Coming up with an effective crisis management strategy from scratch at very little notice is no easy task. Although the management of the Swedish banking crisis can be considered as successful overall, it was not without its problems. Above all, the absence of a regulatory framework made it difficult to get the banks' owners and lenders to bear the losses. The conclusion has to be that it would be wrong to assume that a crisis management strategy can be improvised at short notice and be guaranteed broad political backing in the event of a future crisis. Instead a regulatory framework is needed that specifies which government bodies are to be involved if a crisis looms[5] and details the powers and duties they are to have. It should also provide directions as to how the crisis is to be managed and the legal backing needed to demand that owners and lenders of banks in distress accept their share of the responsibility.

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## Which issues do the regulations need to tackle?

Having now established the need for the explicit regulation of the management of banking crises, we need to consider which issues require particular attention when formulating these regulations. Banks play a

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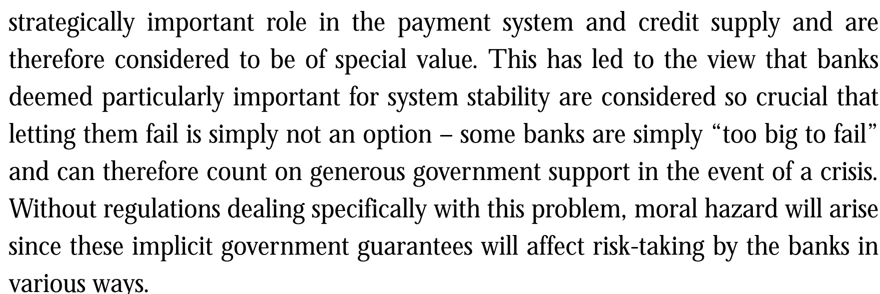
[4] The problem of bank runs arises here, albeit in a slightly different form to that discussed in the textbooks. In this instance it is not ordinary depositors who spark off the panic since they generally benefit from some level of deposit insurance. Instead these runs can be triggered by the large interbank players which lend to each other on a short-term basis, often without formal collateral.

[5] The management of the Swedish banking crisis was assumed by the Bank Support Authority on the initiative of the Ministry of Finance. The Riksbank and the Financial Supervisory Authority had relatively peripheral roles for much of the crisis.


strategically important role in the payment system and credit supply and are therefore considered to be of special value. This has led to the view that banks deemed particularly important for system stability are considered so crucial that letting them fail is simply not an option – some banks are simply "too big to fail" and can therefore count on generous government support in the event of a crisis. Without regulations dealing specifically with this problem, moral hazard will arise since these implicit government guarantees will affect risk-taking by the banks in various ways.

> One key task when drafting regulations on the management of banking crises should be to deal with the classic moral hazard issues as effectively as possible.

During the Swedish banking crisis the government issued a general bank guarantee. The fact that this was announced and considered credible by market players during a crisis was of crucial importance for the subsequent management of the crisis. Given banks' particular sensitivity to sudden heavy liquidity drains, it is difficult to imagine any form of crisis management that does not include some kind of government guarantee. But if it is widely perceived that a general guarantee like that seen during the Swedish banking crisis will be issued again in the event of a future banking crisis, the classic moral hazard dilemma will arise. If a guarantee covers all the banks' creditors, both the banks and their lenders will behave as if all lending to banks is effectively free from any credit risk. This, in the same way as deposit insurance on overly favourable terms, will lead to the banks being able to fund high-risk activities at an excessively low cost. Ultimately the government – and so the taxpayer – will end up paying a high price for a guarantee of this kind. It is rarely possible for moral hazard issues to be resolved in a market economy without any cost at all but it is normally possible to reduce this cost markedly. One key task when drafting regulations on the management of banking crises should therefore be to deal with moral hazard issues as effectively as possible.

> Another major problem also derives ultimately from the fact that the banks are considered to be of special value and often as too big to fail.

Another major problem that the Bank Support Authority had to tackle was the possibility of the banks' owners and managers blackmailing it into granting concessions to which they were not entitled. This problem too derives ultimately from the fact that the banks are considered to be of special value and often as too big to fail; the moral hazard dilemma arises once more and for similar reasons to those cited above. In more concrete terms the problem stems from the fact that for various reasons the general regulatory framework for businesses in financial difficulties, namely the legislation on bankruptcy and

reconstruction, is ill suited to banks – in fact the latter is not in any way applicable to banks. To understand this we need to take a brief look at Swedish insolvency law and its purpose.

## General insolvency law in Sweden

While there may be major differences in its legal realisation, the basic reasoning underlying insolvency law is much the same in all market economies. Separate legislation for insolvency is required for several reasons. A company believed to be in such difficulties that there is a risk of it not being able to pay its creditors on time could easily be exposed to such pressure from its creditors to settle its debts quickly that the prophecy becomes self-fulfilling. The company could be forced to close for business even if it is profitable in the longer term. It is only natural for creditors to demand payment while there is still something to be had out of the company. Without a regulatory framework to govern the management of insolvency, creditors could therefore be tempted to carve up the company's assets on the mere suspicion of it having run into trouble.

The basic reasoning underlying insolvency law is much the same in all market economies.

Even companies in good health will see an increase in the cost of capital if investors believe that there is a risk of this kind of scramble in future situations where there is uncertainty regarding their rights as creditors. There are thus societal benefits to be gained from having a regulatory framework for the orderly handling of companies in financial distress. The standardisation of the procedure for dealing with insolvency reduces the risk to which creditors are exposed and so brings down the cost of capital. It should also reduce the risk of capital destruction in the real economy brought on by panicky fire sales of company assets.

Regulations to ensure that troubled companies are dealt with in an orderly manner make sound economic sense.

Under Swedish bankruptcy law, a creditor or the shareholders of a company may file for bankruptcy. A bankruptcy order is then issued by the court if the company is deemed unable to settle its debts rightfully now or in the near future and if this inability is not considered temporary. Once the bankruptcy order has been issued, an external manager (receiver) is appointed to take over the running of the company's affairs. The receiver's role in the first instance is to turn the company's assets into cash for distribution to its creditors in the

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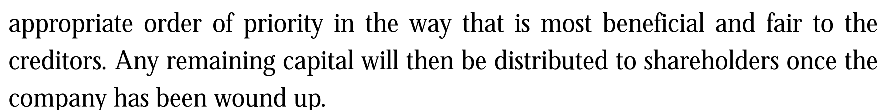

appropriate order of priority in the way that is most beneficial and fair to the creditors. Any remaining capital will then be distributed to shareholders once the company has been wound up.

**The bankruptcy legislation also contains provisions intended to help the manager to rescue viable companies from liquidation.**

The basic bankruptcy procedure is therefore relatively straightforward. However, its practical implementation does of course have countless complications. While there is no need for us to go into these here, a number of points are still worth noting. Although the procedure is intended to result in creditors being paid in cash, there is nothing to stop the company from continuing as a going concern. The appointed receiver may decide that it would be better to sell the company as a going concern rather than simply dispose of its assets. The legislation also contains provisions intended to help the receiver to rescue viable companies from liquidation. So, for example, loans may be taken out after the bankruptcy order has been issued if the receiver believes that this will benefit the company and so also its creditors. These loans are given priority over all other creditors so that the company is able to borrow the money needed for its continued operation. Similarly previous loans may be repaid even though the basic principle is that the company's balance sheet is to be frozen from the time the bankruptcy order is issued. However, it is a condition that such repayments must benefit all creditors, which is often difficult to prove, and so normally a receiver will think very carefully before exercising this option. Again to facilitate the survival of viable companies, new legislation on reconstruction was introduced relatively recently to supplement the bankruptcy rules. These rules allow reconstruction without creditors being paid in cash and without the company's management being replaced by a receiver.

## General insolvency law and the banks

**No banks were declared bankruptcy during the Swedish banking crisis because the consequences for the banking system as a whole were to be too great.**

As mentioned above, Sweden's reconstruction legislation does not apply to the banks at all but its bankruptcy legislation does. Even so, no banks were put into bankruptcy during the Swedish banking crisis: the government decided that this was not an option in a situation where many banks had run into trouble at the same time, because the consequences for the banking system as a whole were to be too great. The most important reason for this is that the system stability issue – the issue that it is absolutely

vital to tackle straight away – cannot be dealt with within the framework of bankruptcy law. The receiver is appointed to look after the interests of creditors and will therefore be unable to take the steps needed to safeguard system stability if they conflict with these interests. Nor can the receiver be expected to have the insight into the workings of the overall banking system to take the quick decisions needed to restore stability to it.

Some aspects of the general bankruptcy procedure are also difficult to apply to the banks. Freezing a company's assets and suspending its payments from the time the bankruptcy order is issued could have serious implications if applied to banks. A bank's liabilities do after all form an active part of its business operations, and its borrowing and interbank funding activities reflect among other things the banks' central role in the payment system. Suddenly freezing the repayment of these liabilities at one or more big banks could have immeasurable consequences for the banking system as a whole.

When a company runs into financial difficulties for some reason, its creditors and management will often enter into negotiations in a bid to resolve its financial problems. Sometimes the two parties are able to agree quickly that the company's financial future is bright and that the acute problems should be resolved through some change in the company's financing structure. The option of an bankruptcy order serves as a kind of end-point for this process: thus even in cases where problems are resolved through the negotiation of some form of voluntary arrangement, the risk of bankruptcy will play a role. Without bankruptcy functioning as a credible threat, there would be a risk of the negotiations dragging out or collapsing altogether.

During the Swedish banking crisis bankruptcy was not perceived as a credible threat by the banks applying for support from the Bank Support Authority. For the reasons cited above, letting a bank go bankrupt would effectively relieve the Bank Support Authority of control over the future management of the bank. This would in turn have implications for the credibility of the only heavy weapon with which the government can threaten troubled banks: revoking their charters. Under the capital adequacy rules a permanent drop below the statutory minimum capital ratio of 8% will in principle lead to a bank losing its charter, but this would immediately have led to insolvency and so this too was a far from credible threat.

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Without any credible end-point for the negotiations between the Bank Support Authority and a bank's owners and managers, the latter would be in a position to

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slow down the whole process in a bid to secure concessions to which they would not have been entitled had the bank been put into bankruptcy. To tackle this problem, a new law was passed during the banking crisis which in principle entitled the Bank Support Authority to take over the running of a bank through a compulsory take over of a bank's shares if its capital adequacy ratio fell below 2 per cent. However, this law applied only temporarily and is no longer valid.

## The Banking Law Committee's recommendations

The Banking Law Committee's recommendations break down into two main parts: a special scheme for the reconstruction and winding-up of banks and the creation of a special government body.

The analysis of the management of the Swedish banking crisis above should have demonstrated a need for the explicit regulation of the management of future banking crises. For one thing, it would be too risky to rely on improvising decisions in a crisis with the same degree of success as enjoyed in the early 1990s. For another, an attempt needs to be made to minimise the potential moral hazard problems in respect of creditors and shareholders/management. The Banking Law Committee's recommendations for resolving these issues break down into two main parts: a special scheme for the reconstruction and winding-up of banks termed "public administration" and the creation of a special government body called the Crisis Management Authority with the primary (but not sole) role of managing banks in public administration.

Both of these recommendations will be discussed in detail below. Please note that, when referring to the Crisis Management Authority in the section on public administration, no position has been taken on the exact status that the authority should be given.

### Public administration – a regulatory framework

Public administration is a regulatory framework designed specifically to deal with troubled banks.

Public administration is a regulatory framework designed specifically to deal with troubled banks – it was not considered possible to resolve the problems discussed above

within the framework of the existing insolvency legislation. The criteria that must be met for a bank to be sent into public administration are either (1) that it is unable or is not expected to be able to fulfil its obligations and that this inability cannot be considered temporary, or (2) that there are grounds to revoke its charter. The first criterion is effectively the same as that for the issue of a bankruptcy order. The decision to put a bank into public administration is to be taken by a court following a petition from the Crisis Management Authority. The bank cannot be put into bankruptcy for as long as it is in public administration.

When a bank is put into public administration, the Crisis Management Authority will assume control of its business but not its formal ownership. Unlike with bankruptcy where there is a change of legal status, with public administration the ordinary corporate governing bodies will continue to serve in line with ordinary company law. However, the Crisis Management Authority will temporarily take over shareholders' voting rights and can therefore control the bank's general meeting and board. One key element in this system is that the bank must be able to continue trading while in administration and must be allowed to return smoothly to normal operation again if its problems prove to be such that it would best be reorganised and survive in its original legal form. This not being the case, the bank may be allowed to go into bankruptcy and liquidation in the normal manner if the Crisis Management Authority believes that this will be possible without impacting on the stability of the banking system.

When a bank is put into public administration, the Crisis Management Authority will assume control of its business but not its formal ownership.

The introduction of the public administration rules should serve as a credible endpoint for future negotiations of the kind in which the Bank Support Authority was involved during the banking crisis. This should make it easier to reach settlements whereby the bank's owners take care of its restructuring and recapitalisation. The Crisis Management Authority is to play an active role as a coordinator of the negotiations that can be expected to take place before it is deemed necessary to place the bank into public administration. The introduction of public administration of troubled banks should also impact on the behaviour of the banks under normal circumstances: the fact that shareholders cannot count on getting as much out in a crisis and that lenders may incur losses should, other things being equal, lead to better risk management and reduced risk exposure at the banks.

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As with bankruptcy, the rights of creditors must not be ignored.

As with bankruptcy, the rights of creditors must not be ignored – relative to both other stakeholders and fellow creditors. However, as stated above, it is much more problematic to freeze a bank's balance sheet than that of a non-financial company: a bank's balance sheet plays an integral role in its business in an entirely different way. The Crisis Management Authority should therefore permit those payments that it considers necessary to avert the risk of the bank causing serious disturbances in the banking system, in particular the payment system. Not until it is considered possible from a systemic point of view can a general suspension of payments be introduced. It should be noted that creditors are to be compensated for any (further) losses brought on by the delayed suspension of payments.

The Crisis Management Authority is to be entitled to issue a government guarantee – but only for debts arising after its issue.

How then has the Banking Law Committee sought to deal with the moral hazard issues that arise from the expectations of a bank's lenders that the government will again issue a general guarantee in a crisis? The committee is proposing that, in connection with the suspension of payments from a bank in public administration and with the consent of the government, the Crisis Management Authority should be entitled to issue a government guarantee – but only for debts arising after its issue.[6] This restriction of the scope of the government guarantee limits the moral hazard problem discussed earlier. It also has some consequences for the banks' funding. Firstly, the cost of medium/long-term funding should increase once these financiers realise that they could now lose their money. Secondly, there may be an increased risk of a bank being exposed to sudden drops in short-term funding following rumours of financial difficulties. The higher medium/long-term funding costs may of course have an adverse impact on the banks' earnings, but this can be seen as a good thing from an economic point of view since it stems from more accurate pricing of the banks' risk-taking. When it comes to the problem of acute bank runs, the idea behind the committee's recommendations is that this is the price that has to be paid for limiting moral hazard, but that the price does not need to be that high in terms of systemic risk.

This is best understood if we take a look at how it is intended that a crisis be managed under the new rules. Problems or rumours of problems at one or more

[6] There are parallels here to the way in which bankruptcy law deals with loans taken out after a bankruptcy order has been issued.

banks can obviously lead rapidly to difficulties with funding in the interbank market. As mentioned earlier, in these situations it may not be very long at all before the entire payment system collapses unless steps are taken quickly to restore stability. The Riksbank plays an important role when it comes to dealing with acute liquidity problems at the banks in its capacity as lender of last resort. In actual fact one might say that it is in these very circumstances that a central bank in a well developed financial system has grounds to issue emergency credit – in other words lend to the banks without demanding full collateral. The eligibility criterion for emergency loans of this kind is generally formulated such that the bank must be deemed illiquid but solvent. However, as has long been realised, this is not a definition that can be applied in practice, primarily because the time available before a decision has to be made on whether to grant the loan is normally impossibly short for this kind of assessment. At the same time the central bank's role is to shore up the banks' liquidity rather than supply them with risk capital. It is therefore important for the Crisis Management Authority to be given the role, partly by putting troubled banks into public administration, of reaching an assessment as quickly as possible of both the systemic risks and the bank's position and chances of returning to normal operation. As soon as the Crisis Management Authority believes there is reason to request government consent for the issue of a government guarantee for loans taken out after the bank was placed into public administration, the Riksbank's emergency loans can be replaced with normal lending in, say, the interbank market. Any need to recapitalise troubled banks would then be an issue for the Crisis Management Authority and thus the taxpayers as well as any private financiers.

## Crisis management organisation and responsibilities

One of the points of departure for the committee's work was that the delegation of duties in the event of a future banking crisis must be established in advance. The fact that it is not considered appropriate to improvise a crisis management concept once a crisis looms does not necessarily mean that there needs to be an organisation in place under normal circumstances. Would it not be enough to have a fully formulated concept ready to be activated in an emergency? There are a number of reasons why the Banking Law Committee does not believe this to be the case. One of the most important has already been stressed above in several contexts: the need for quick and professional action from the authorities in times of crisis. Once a crisis

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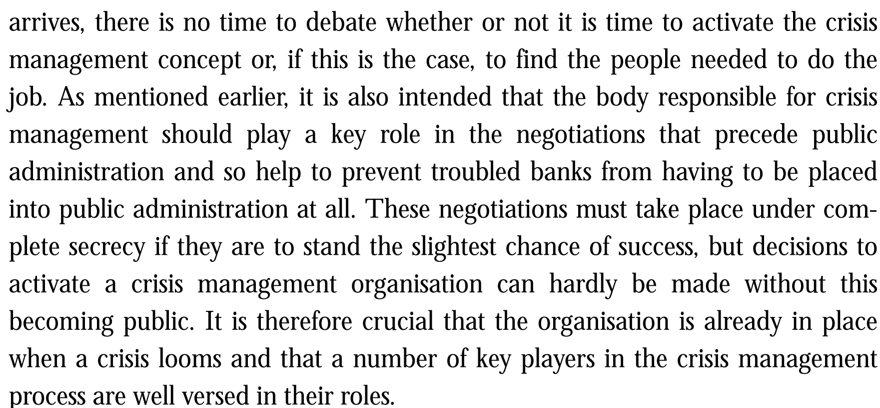


arrives, there is no time to debate whether or not it is time to activate the crisis management concept or, if this is the case, to find the people needed to do the job. As mentioned earlier, it is also intended that the body responsible for crisis management should play a key role in the negotiations that precede public administration and so help to prevent troubled banks from having to be placed into public administration at all. These negotiations must take place under complete secrecy if they are to stand the slightest chance of success, but decisions to activate a crisis management organisation can hardly be made without this becoming public. It is therefore crucial that the organisation is already in place when a crisis looms and that a number of key players in the crisis management process are well versed in their roles.

Since a banking crisis can come on very quickly, it is also important that those responsible for managing a crisis are given an opportunity to prepare in various ways. This might cover everything from practical training in handling the media in an emergency to in-depth scenario-based analyses of previous banking crises.

The Banking Law Committee has chosen to recommend that a new government body be created to manage banking crises.

The fact that there needs to be an organisation in place to handle banking crises does not necessarily mean that a *new* body needs to be set up specifically for this purpose. Responsibility for crisis management could be assigned to a number of existing bodies, such as the Riksbank, the Financial Supervisory Authority or the Deposit Guarantee Board. However, the Banking Law Committee has chosen to recommend that a new government body be created to manage banking crises. It is worth taking a brief look at how the committee reached this conclusion and also discussing its recommendations for the delegation of duties relative to other government bodies in the financial arena. However, it should be stressed that the exact nature of the proposals discussed here is not of the same fundamental importance as the committee's conclusion that there must be some form of crisis management organisation in place even under normal circumstances.

One reason why the Riksbank was not given responsibility for managing banking crises is that it would be inappropriate to mix the roles of liquidity manager and crisis manager.

We have already touched on the role of the Riksbank. Besides safeguarding the value of money, it is tasked with maintaining a safe and efficient payment system. One critical success factor in this respect is a stable banking system and so the Riksbank is responsible for ensuring that the banking system fulfils its

key economic role when it comes to the payment system and the supply of credit. The Riksbank's oversight capacity in this area is reflected in its biannual stability reports containing analyses of developments in the banking sector with particular emphasis on risk exposure. Given the level of expertise that the Riksbank already has to maintain when it comes to financial stability, it might seem a natural candidate for the role of managing banking crises. However, one factor that speaks against such an arrangement is that it would be inappropriate to mix the roles of liquidity manager and crisis manager. In a crisis the Riksbank needs to be able to focus on its role of providing emergency credit to maintain liquidity in the banking system. It might also be problematic for the Riksbank with its special position to be given direct responsibility for decisions on rescue operations that can entail substantial costs to the taxpayers.

The Financial Supervisory Authority is responsible for the supervision of Swedish banks, a role which is set to change rapidly. This is reflected in both the Banking Law Committee's main report and the recently published proposals for reforming the Basel Committee on Banking Supervision's capital adequacy recommendations. Given the advanced risk management systems now in place in the financial services sector, simple quantitative limits are becoming increasingly inadequate and need to be supplemented with a more qualitative form of supervision based on a multifaceted analysis of risk exposure and capital adequacy at the banks and other financial institutions.

The Banking Law Committee recommends in its main report that the supervision of the banks should be based on three introductory provisions that set out requirements for the banks' solidity, risk management and transparency. This would give the Financial Supervisory Authority a more unambiguous mandate than is currently the case to intensify the supervision and demands made of banks believed to be at risk of ending up in the danger zone. It may be important for the Financial Supervisory Authority to be able to focus on this role in a crisis and not have to tackle the very different role of handling the public administration of banks.[8] One perhaps more important reason why the Financial Supervisory Authority should not be given responsibility for crisis management is the risk of a conflict of interests between the roles of crisis manager and supervi-

**One reason why the Financial Supervisory Authority should not be given responsibility for crisis management is the risk of a conflict of interests between the roles of crisis manager and bank overseer.**

[8] Similarly, the Deposit Guarantee Board has a clearly formulated role as insurer, which should not be combined with the actual management of a banking crisis.

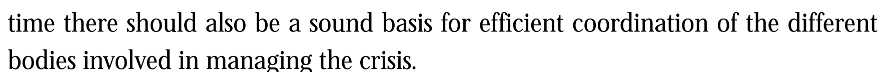
sor of those banks that have *not* got into trouble. The authority's role in a crisis should therefore be to continue to supervise the banks in accordance with the general guidelines in place.

## A separate crisis management body for initiative and coordination

The best basis for managing a banking crisis would be provided by a new Crisis Management Authority which remains in place even under normal circumstances.

The Banking Law Committee has therefore concluded that the best basis for managing a banking crisis along these lines would be provided by creating a new Crisis Management Authority which remains in place even under normal circumstances. The committee's report does not look at exactly how the authority should be organised, but the structure of the Bank Support Authority with its broad-based board and small permanent staff could provide one role model. Inspiration could also be drawn from experience in the UK. In connection with the reorganisation triggered by the new independent role for the Bank of England and the creation of a single supervisory body in the form of the Financial Services Authority, a special "memorandum of understanding" was drafted which sets out how the Bank of England, the Financial Services Authority and the Treasury are to cooperate and consult each other to prevent and manage crises in the financial system. To this end a special standing committee with representatives from these three bodies has been set up and meets regularly to discuss and analyse issues with a bearing on financial stability. In the event of a crisis the Governor of the Bank of England, the Director of the Financial Services Authority and the Chancellor of the Exchequer will head the committee work, while in normal circumstances they will retain the ultimate responsibility but delegate the work to civil servants with expertise in financial stability.

The Swedish Crisis Management Authority as proposed by the Banking Law Committee can be seen as a rather more formalised variant of this standing committee. The authority would be charged with ensuring constant analysis and assessment of the stability of the banking system in collaboration with the Riksbank, the Financial Supervisory Authority and, where appropriate, the Ministry of Finance. The authority's board, which should include senior representatives of these three bodies, would be kept abreast of the latest experience and information through these meetings. The Crisis Management Authority should then be in a position to do its job and take the initiative quickly if a crisis looms. At the same



time there should also be a sound basis for efficient coordination of the different bodies involved in managing the crisis.

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