

Mastering the Financial Crisis – The Swedish Approach¹

GUSTAF SJÖBERG

Introduction

This article primarily aims at describing the Swedish handling of the 2008–2009 financial crisis but also presents some relevant contextual elements and makes some qualitative remarks. Finally some conclusions are drawn.

Sweden has gone through two periods of serious financial distress during the past 20 years. Accordingly there should be plenty of experiences to draw from. As a backdrop the fundamentals of the crisis of the early 1990s and the way it was handled are presented. That crisis still influences Sweden, both in the way it affects people (and perhaps institutions) and in the way the recent crisis was handled legally. The main part of this article is an attempt at a straightforward account of events during this crisis. A naked account of events is of little value if there is no context to interpret it against. Therefore, supplementary figures regarding the financial sector and the institutional set up are presented.

When it comes to the solutions used to tackle the crisis the account at times goes into detail for several reasons. The details of the technical solutions used are of importance, since the devil is in the details also or perhaps particularly, in this area. Another reason is that problems during a crisis always arise in unexpected ways and accordingly have to be solved in a particular way. Remembering that and giving an account of the different situations add to the full picture. Finally, details add an invaluable flavor.

The ambition is to focus on measures aimed at financial stability and not on measures aimed at counteracting the crisis' effects on the general economic climate; however the boundary line becomes blurred in the midst of a crisis of this magnitude.

¹ Many thanks to Lars Hörngren and Eric Frieberg for valuable comments.

Background

General

Initially it can be said regarding the general course of the crisis that the Swedish financial sector did not experience substantial difficulties before the Lehman Brothers collapse in the autumn of 2008, which in turn was due to the fact that Swedish institutions did not have large exposures against the markets and institutions with the most substantial difficulties.² As was the case more or less worldwide, events took another direction after the Lehman collapse, but it can be said that the crisis in Sweden was more of a liquidity crisis than a solvency crisis. Most support measures were aimed at increasing liquidity in the system or assisting individual institutions with liquidity support. As an indication of the size of the support it can be mentioned that the value of the Riksbank's assets increased from SEK 212 billion 2007 to SEK 700 billion 2008 as a consequence of the measures aimed at facilitating the bank's financing and stabilizing the financial markets.³ The Government guarantee program of banks' securities funding peaked at SEK 350 billion in 2009.

Three of Sweden's four major banks issued shares during the crisis. The issues were placed on the market.⁴ So even though it was necessary to increase the capital base during the course of the crisis, it could be done on the market, which underscores that it was mainly a liquidity crisis and not a solvency crisis.

As is well known, Sweden and the other Nordic countries had a severe financial crisis in the beginning of the 1990s. The differences between that crisis and the present one are, however, fundamental. Drastically put, it can be said that during the 1990s crisis the banks remained liquid even though some of them were not solvent, whereas during this crisis the banks were solvent but not liquid. At least it can be said that the system was not able to cope without government measures in order to increase liquidity. The 1990s crisis was due mainly to domestic factors⁵ whereas the present one mainly has external causes (even though excessive lending in the Baltic region contributed to the severity of the impact of global events).

² The Riksbank's Annual Report 2008, p 24.

³ The Riksbank's Annual Report 2008, p 4. A further small increase in the value of the assets was recorded 2009, namely to SEK 709 billion, The Riksbank's Annual Report 2009, p 9.

⁴ See below under Capital Injection Program.

⁵ The most important factor was excessive lending to commercial property.

Short facts about the Swedish financial system

Sweden's financial system is quite large compared to the size of the country; at least if you count Swedish firms' operations abroad. Sweden's GDP is about SEK 3 100 billion or approximately EUR 300 billion and the domestic financial sector makes up around 4 per cent of that. The aggregate balance sheet total is roughly SEK 10 000 billion. Approximately 140 000 people are employed.⁶

There is close to 120 banks active in Sweden, out of which 26 are foreign banks operating cross border through branches and 53 are relatively small Swedish savings banks. Four major banks dominate the market, namely Handelsbanken, Nordea, SEB and Swedbank. Together they have a market share of roughly 75 per cent.⁷ Nordea is the largest banking group in northern Europe. The group's mother company is a Swedish banking company through which the Swedish business is conducted. There are subsidiaries in the other Nordic countries as well as in other countries, among others Russia and Lithuania. The operation in Latvia is a branch of the Finnish company. SEB and Swedbank operate through subsidiaries in the Baltic countries. Market shares are substantial and the banks are important to the economies of the Baltic countries. Handelsbanken has very limited operations in the Baltic region. Altogether, this means that the majority of the Swedish banks' operations in the Baltic region were not, or at least not directly, supervised by the Swedish financial supervisory authority, the Finansinspektion.

Finances

Sweden's central government debt was close to SEK 1 250 billion before the crisis (January 2007) and now (May 2010) it is approximately SEK 1 168 billion. This equals 38–39 per cent of GDP, both before the crisis and now. Reflecting the strength of the Swedish economy is the yield on 10-year government bonds. Both during and after the crisis, the yield has been on par with German government bonds and periodically substantially lower, despite differences in the size and liquidity of the respective bond markets.

The impact on the Swedish economy from the early 1990s crisis was fundamentally different. As a comparison, it can be mentioned that Sweden's

⁶ Homepage of The Swedish Bankers' Association: www.bankforeningen.se.

⁷ Ibid.

central government debt was 42.7 per cent of GDP in 1990 and 76.6 per cent in 1995. However, it should be remembered that the Swedish economy had unsustainable imbalances already at the outset of the 1990s crisis.

Legal

As a background to the way in which the Swedish authorities handled the present crisis, it is almost necessary to go back in time to the 1990s crisis. During the acute phase of that crisis it became evident that the lack of a suitable legal regime endangered the possibility of a resolute response to the substantial solvency problems in some institutions. Under considerable time pressure, an act was produced which gave the authorities a legal foundation for negotiations and some coercive measures.⁸ It can, however, be said that legislation was enacted “after the fact” in so far that many of the most acute measures were taken without sufficient formal legal support or control over the banks in question.⁹ Perhaps the most important among these measures was a decision by the parliament, the Riksdag, to issue a guarantee promising that all Swedish banks would meet their obligations.¹⁰ In this context it should be noted that there was full political agreement regarding the way in which to handle the crisis. The act was abolished after three years.

The legal solutions used in the act were very similar, in fact almost identical, to the ones in the act now in force, with one notable exception namely that the authority in charge of the crisis management was separate and newly founded. As we shall see below, an existing authority was given that responsibility in the present crisis. Moreover, this time it was never necessary to invoke the Government’s power to issue a general guarantee.

After the crisis, a Government Committee was established with a broad mandate to review the banking legislation, supervision and related issues.¹¹ One important part of the work of the committee was to develop a special resolution regime for systemically important institutions. After having worked for five years and, among other things, proposed an entirely new Banking Act, the Committee also proposed a Special Resolution Regime

⁸ The Government Support to banks and other Credit Institutions Act (SFS 1993:765) enacted July 1, 1993.

⁹ SOU 2000:66, p 84.

¹⁰ That guarantee was issued in September 1992 but the formal decision in the parliament was not taken until December 1992.

¹¹ Banklagskommittén, Fi 1995:09. I was the Head Secretary to the Committee.

(SSR).¹² At the time, I would say, the proposed SSR was at the global forefront. It contained solutions that made it possible to let both shareholders and creditors suffer losses without letting the institution into bankruptcy. It also provided a possibility for the state to take immediate control over a failing institution via a mechanism that gave the authority in charge all votes at the shareholders' meeting. That control should, according to the proposition, enable the authority in charge to decide in all matters within the shareholders' ambit, including decisions regarding the bank's future business and capital structure.¹³ While the proposed Banking Act now is enacted,¹⁴ the proposed SSR never got that far. When the first signs of the current crisis emerged, work was still under way in the Government Offices with the Committee's proposal. The decision was made to abandon the work on an SSR and instead go ahead with a system modeled on the 1990s legislation.

The new act, the Government Support to Credit Institutions Act (the Support Act), was enacted October 29, 2008.¹⁵ As I understand it, the new act is not considered as anything other than a temporary solution and the ambition is to continue the abandoned development of a SRR as soon as time permits. Perhaps one of the main lessons learned is to legislate on the basis of experiences of a crisis before it is forgotten.

It should be noted that I do not suggest that the proposed SSR, or any SSR, would be sufficient in a crisis of this magnitude. Other measures outside the scope of an SSR would have to be employed when the whole financial system is at risk. On the other hand, that does not mean that some of the tools that were offered by the suggested SSR would not have been helpful in the crisis management process. One such example is the possibility to take control over failing institutions. A conclusion is that an SSR, properly designed, should be sufficient to cope with more "normal" crisis situations but that it has to be complemented by other measures in extremely severe situations. If an SSR is designed to be able to handle the most extreme situations imaginable it runs the risk of being suboptimal.

¹² Offentlig administration av banker kris, SOU 2000:66. There is an presentation in English available at the Riksbank's homepage: http://www.riksbank.se/upload/Dokument_riksbank/Kat_publicerat/Artiklar_PV/er00_3_artikel3.pdf.

¹³ According to the proposition a write down of the share capital had to be decided by a court and a decision to issue new stock had to be made by the shareholders due to the requirements in the second company directive.

¹⁴ Or at the least the essential features of the proposition.

¹⁵ SFS 2008:814.

The institutions

Ultimately it is always the state itself, through parliament and government, that is responsible for financial stability and crisis management. That is true both in the sense that the state is responsible for the appropriate structure, funding and division of powers between agencies involved in supervision and crisis management and also in the sense that when other agencies and the measures given to them fail, the responsibility falls back to the parliament and the government. Having said that, the institutions directly involved in the management of the current crisis is the Government,¹⁶ the Swedish central bank, the Riksbank, the Finansinspektion and the Swedish National Debt Office, the SNDO^{17,18}. The Finansinspektion and the Debt Office are authorities under the Government while the Riksbank is an authority directly under the parliament.

The Finansinspektion and the Riksbank are together responsible for supervision and financial stability in Sweden. The Finansinspektion has a broad mandate of financial supervision in different areas of the financial system.¹⁹ One of its overreaching goals is financial stability. The Riksbank has assumed a responsibility for financial stability, which now together with monetary stability is one of its two main areas of activity, even though the legal basis is quite narrow. As is the case with the ECB the legal responsibility is expressed as pertaining only to the safe and efficient working of the payment system. The Riksbank has a mandate to extend emergency liquidity assistance, ELA, to all institutions under supervision of the Finansinspektion (see further below). The Riksbank regularly publishes a “Stability Report” regarding the financial system. The Riksbank does not directly supervise and has no direct power to sanction financial institutions.

The SNDO is through the Support Act appointed as the agency in charge of support measures.²⁰ The Support Act gives the SNDO the power to intervene on behalf of the state if a financial institution should encounter such

¹⁶ Government here is used in the meaning the Cabinet of ministers and the Government Offices.

¹⁷ The Swedish name is Riksgäldskontoret, but I will use the English short form.

¹⁸ Acts are decided by the parliament, the Riksdag. Note that the Government has considerable powers under the Support Act, see below.

¹⁹ See the homepage www.fi.se for a presentation of its mandate.

²⁰ Theoretically the Government could, at any given moment, decide that another agency should be appointed as the agency in charge of support measures or create a new agency for the task, but nothing at all indicates that.

grave financial difficulties that there is a risk of serious disruption to the Swedish financial system. The SNDO has a relatively broad mandate to implement the support measures called for in the situation at hand. However, many of the economically most important decisions are by statute to be taken by the Government.

The SNDO's role as the agency in charge of support is relatively new and perhaps it can be said that it was given the role by more or less unforeseen events, since the first acute signs of the crisis emerged within the jurisdiction of the SNDO (or at least that the SNDO was the first to react on the signs). It can also be said that the role is a natural extension of the SNDO's responsibility for the Deposit Insurance Scheme. During the 1990s crisis a special government agency was created to take care of the crisis management – the Bank Support Authority.

To handle disputes arising under the Support Act a special body has been created, the Examination Board.²¹ Its three members are elected by the Government and two of them have to be judges or former judges. The Examination Board is a court of law in the meaning of the European Convention of Human Rights. The decisions of the Board cannot be appealed.

Early responses to the crisis

The SNDO

Since long before the crisis, the SNDO was running a repo-programme aimed at upholding a functioning market for treasury bills. The SNDO had (and has) a commitment towards its so-called primary dealers – banks retained to help distribute debt instruments – to supply them (through repos) with treasury bills when needed. The pricing of the transactions being such that demand in normal market conditions was limited. However, the demand for safe treasury bills increased heavily during the crisis and accordingly the repo volume increased.²² After the collapse of Lehman Brothers, demand increased even more and a point was reached where market participants, at the given price, had an almost unlimited demand for treasury bills. Such a demand cannot be met without increasing government debt too much and creating a cash handling problem for the SNDO. If the market

²¹ In Swedish: *Prövningsnämnden för stöd till kreditinstitut* (*Prövningsnämnden*).

²² Demand for repos was high already in the first phase of the liquidity crisis in the second half of 2007.

was to realize that there is a limit to the SNDO's possibility to meet its commitment, expectations can trigger a situation where demand increases out of control and the repo-programme has to be abruptly shut down.

The situation was quite dramatic. At 10 a.m. September 18, 2008 the repo-programme was shut down with the announcement that further information would be given at 3 p.m. During the day the decision was made to replace the repo-programme with frequent auctions of large volumes of treasury bills at short intervals (several times a week). Since the situation at hand originated from the global unrest on the interest rate markets and was not confined to Sweden or Swedish treasury bills, the decision was made after consultation with the Riksbank and the Government Offices were informed. Auctions have several advantages; they are open to all, the volumes offered are known and there is full transparency in the pricing process. The decision was to issue SEK 50 billion (approximately EUR 5 billion) in the next couple of days and that the total volume would be limited to SEK 150 billion. At the first auction the bids did not reflect a panic situation and the interpretation by the SNDO was that when investors realized that there would be no acute shortage of treasury bills they would postpone their purchase rather than buying at a very high price.²³

The money received when issuing treasury bills the SNDO placed in Swedish banks, through repos in covered mortgage bonds, thus supporting the domestic mortgage bond market and, indirectly, mortgage lending. The result of the whole operation was that the banks received more liquid treasury bills in return for covered bonds that, as a result of the collapse of market confidence, were illiquid and not acceptable as collateral for interbank loans. In turn, the banks could use the treasury bills as security when borrowing from other banks, which helped the distribution of liquidity between banks.

Subsequently, the demand for repo transactions with the SNDO decreased, not least because the Riksbank started to lend SEK against security in covered mortgage bonds which achieved the same effect more directly; see the next section for details. As a consequence, the SNDO gradually reduced its special auctions and by March 2009 all the extra treasury bills had matured.

Since the decision to issue extra volumes of treasury bills was not taken in order to fund the state, it could be argued that it did not have sufficient legal foundation at the time. That situation was changed through a broadened and

²³ The SNDO report, *Statsupplåning – Prognos och analys 2008:3*, p 13 ff.

unequivocal mandate given retroactively to the SNDO as part of the general stability plan on October 20, 2008.²⁴ At the same time, the SNDO was appointed the authority responsible for support measures.

The Riksbank

Like other central banks around the world, the Riksbank supplied the banks with large amounts of liquidity in order to make it possible for the banks to continue performing their functions. This entailed various general measures that extended the banks' possibilities to borrow from the central banks in both domestic and foreign currencies at maturities longer than those normally offered. A wider range of securities than normal was accepted as collateral for these loans.

As far as the Riksbank is concerned, these measures have included offering the banks loans in SEK at longer maturities than normal and loans in USD. As has been mentioned, the possibility to borrow using mortgage bonds as collateral was extended. Since the beginning of November 2008 the banks were also able to fund their lending to companies by using a credit facility at the Riksbank against collateral in securities newly issued by non-financial companies. This credit facility is specifically intended to facilitate the supply of credit to companies. At the end of 2008 the banks had used SEK 8 billion of this loan facility. Demand ceased entirely during 2009.

Beginning in September 2008 the Riksbank together with several other central banks set up temporary reciprocal currency arrangements (swap facilities) with the Federal Reserve with the aim of dealing with the strained situation on the markets for short-term borrowing in USD. The arrangements meant that the Riksbank and the Federal Reserve agreed on a swap facility amounting to USD 10 billion. The swap agreement was prolonged twice during 2009. The Riksbank had a similar agreement with the European Central Bank regarding the provision of euros. Using the swap agreement with the Federal Reserve and its own reserves, the Riksbank did lend dollars to Swedish banks to deal with the strained situation in the market for borrowing in USD.

As an indication of the size of the support measures it can be mentioned that by the end of 2008 the banks' long-term borrowing in SEK from the Riksbank amounted to SEK 265 billion. The banks' loans from the Riksbank

²⁴ Change through SFS 2008:817 in section 1, lagen (1988:1387) om statens upplåning och skuldförvaltning. See further below.

in USD corresponded to SEK 196 billion by the end of 2008. The volume increased slightly during 2009 but when market rates fell under the Riksbank's minimum rate for loans in USD the demand vanished totally.

Financial assistance for Iceland and Latvia

It is not enough to tackle problems at home in a crisis of this magnitude. Several neighboring countries were badly hit by the crisis. There was a risk that the situation in Iceland would spread to the financial markets in Sweden and neighboring countries. A similar situation also arose in Latvia as a result of the country's economic problems. In order to reduce the risk of the domestic problems of those countries having a negative impact on international confidence in the financial markets in Sweden and the surrounding region, the Riksbank offered the central banks in Iceland and Latvia short-term loans in euro in exchange for their domestic currencies. Other lenders also entered into similar agreements with the two countries.²⁵

Emergency liquidity assistance (ELA)

Under the Riksbank Act the Riksbank has the responsibility as Lender of Last Resort (LoLR).²⁶ As mentioned before, the Riksbank has a mandate to extend ELA to all institutions under the supervision of the Finansinspektion. Even though there is no absolute obligation for the Riksbank to extend ELA to institutes with liquidity problems, the responsibility for financial stability makes it more or less unavoidable if the institute in question is of systemic importance. In times of world wide financial unrest the threshold to being regarded as systemically important is very low. During the crisis two relatively small institutes received ELA. In both cases it was assumed that a default would result in a serious disruption in the financial system and seriously undermine the confidence in the payment system.²⁷ On October 8, 2008 Kaupthing Bank Sverige AB received ELA in the form of a credit up to SEK 5 billion. October 27, 2008 the Riksbank extended ELA to Carnegie Investment Bank AB in the form of a loan in the amount of SEK 1 billion. Two days later another loan of SEK 1.4 billion was extended and a limit of SEK 5 billion was set (see further below under Carnegie).

²⁵ The Riksbank's Annual Report 2008, p 27.

²⁶ Chapter 6, section 8 in the Riksbank Act, lagen (1988:1385) om Sveriges Riksbank.

²⁷ The Riksbank's Annual Report 2008, p 25 and 29.

Government Stability Plan

October 20, 2008 the Swedish Government announced a Stability Plan with the aim to safeguard the stability of the financial system. The Support Act was an important part of the plan. In the proposal for the act, the seriousness of the situation on the financial markets was stressed and it was assessed that it would last for a considerable time.²⁸ The importance of a mandate broader than what is customary for the Government to be able to handle the situation was also emphasized. It was not regarded as possible to specify what kind of support measures that would be needed or the amounts needed. It was expressly said that the support measures were not limited to certain amounts and not in time.²⁹ It was clearly stated that the aim of support under the Support Act should be to counteract systemic risk, which is the risk of serious disruptions in the functioning of the Swedish financial system, since such disruptions can give rise to serious economic consequences for the entire society.

In addition to the Support Act, the Stability Plan was said to consist of four parts, namely:

1. The short term funding of the institutes should be handled via measures undertaken by the Riksbank and the SNDO. The SNDO was given an extended mandate to undertake measures aimed at upholding a functioning market for treasury bills.
2. A guarantee programme to support the institutes medium term funding.
3. The creation of a Stabilization Fund in the form of a (notional) account with the SNDO with an unlimited overdraft. This account is to be used to fund all support measures and all incomes from such measures are channeled to the account. It was also announced that the institutes would be charged a “stability fee” to be credited to the account, with the purpose of securing that future stability problems in Swedish institutes would not burden taxpayers. To demonstrate readiness to act SEK 15 billion of budget funds were transferred to the account.
4. The Finansinspektion was given the task of seeing to that the support measures benefits households and enterprises

²⁸ The Government’s proposal to the act, Proposition 2008/09:61, p 33 and p 34. Proposals (propositioner) have a very strong standing as preparatory works in Swedish law.

²⁹ Ibid. p 34.

The Support Act

The Support Act was enacted nine days after the Government Stability Plan was presented, using emergency rules in the legislative procedures.

The Support Act Model and its Main Features

The Support Act is based on the model that the terms of support shall, if possible, be decided in a voluntary contract, a Support Agreement. A Support Agreement is entered into between the state (normally represented by the SNDO) on one side and the supported institution and/or its owners on the other side. The signing of a Support Agreement does not immediately effectuate a support; a decision from the state (via a competent authority, in many cases the Government) is also necessary and perhaps measures have to be taken by the institution as well.³⁰ If it in a specific case is not possible or suitable with a Support Agreement, the Government can decide about support measures anyhow. One example of such a decision is a general guarantee covering all or several institutions.³¹

To facilitate a voluntary contract the SNDO can ask the Examination Board to evaluate the terms of a proposed Support Agreement.³² It is not a necessary condition for such an evaluation that the potential contractual party has refused to enter into the proposed Support Agreement. In certain situations it may help the negotiations that the Examination Board in advance has declared the terms of a proposed Support agreement as not unfair. However, a practically more likely situation is when the potential contractual party refuses to enter a Support Agreement. As is well known, a systemically important institution and/or its owners may have a strong bargaining position when the financial system is at risk. Such situations can result in support on too favorable conditions if there is no way for the state to put pressure on the institution and/or its owners. In order to avoid extortion of that kind the shareholders are faced with the possibility of a compulsory share purchase if a proposed Support Agreement is rejected. A prerequisite is that the Examination Board has deemed the proposed Support Agreement acceptable (which means that it does not contain unfair contractual terms).

³⁰ The Government's proposal to the act, Proposition 2008/09:61, p 72.

³¹ The Government's proposal to the act, Proposition 2008/09:61, p 72.

³² Support Act, chapter 3, section 1.

A flaw to the system, which seems potentially fatal in some situations, is that in cases where time is of essence (as is often the case) there will be no time to get acceptance from the Examination Board beforehand. In turn, this means that the pressure of a possible compulsory share purchase (on this legal ground) is not present in the negotiations with an institution that is systematically important.

The SNDO may not implement support measures when not necessary. Consequently a general condition for an application to have the Examination Board evaluate a proposed Support Agreement is that the support measures are necessary given the economic situation of the institution. Further conditions for support will be dealt with below.

Compulsory share purchases can be used not only when a proposed Support Agreement is rejected, but also when the terms of a Support Agreement are not adhered to and when the financial situation of an institution is very bad (see below).

The SNDO's Role

As said before, the SNDO is on the basis of the Support Act appointed as the agency in charge of support measures. Even though the mandate given to the SNDO through the Support Act is relatively wide, the Government has, through ordinances, limited the SNDO's possibility to enter into Support Agreements on its own and has also given instructions regarding the content of such agreements.³³ It seems that the idea is that the SNDO shall be responsible for the practical day to day business and some decisions regarding support, but that the power to decide in substance shall lie with the Government. This may reflect the extraordinary fiscal powers given to the Government under the Support Act powers that can hardly be delegated in full to civil servants in a semi-independent agency. A similar relation existed between the Government and the Bank Support Authority during the handling of the crisis in the 1990s. However, the SNDO is given exclusive rights in certain matters, namely to apply to the Examination Board for an evaluation of a proposed Support Agreement or for a compulsory share purchase.³⁴ The details of the division of powers between the SNDO and the Government are not entirely clear, but of no great practical consequence since there is no

³³ Ordinance concerning Government Guarantees to Bank and others (2088:819) and Ordinance concerning Government support to Credit Institutions (2008:820).

³⁴ Support Act, chapter 3 section 1 and chapter 4, section 2.

reason to believe that the SNDO would obstruct the strategies of the Government.³⁵

Who can receive support?

Primarily it is credit institutions (according to the Swedish interpretation) that can receive support.³⁶ It is also possible to extend support to other enterprises with domicile in Sweden if they are established by a credit institution as part of a reconstruction.³⁷ Such an enterprise, which could be what is popularly known as a Bad bank, does not necessarily have to be owned by the founding credit institution. Support may be extended only if needed to counteract a serious disturbance of the financial system in Sweden. A further prerequisite is that the receiving institute is viable, or that support is necessary for a reconstruction or an orderly winding down of institutions that cannot be expected to be profitable in the long run.³⁸ An exception is made for what is called extreme circumstances; the intention being that this possibility should be used in situations where there is need for a guarantee comprising a number of institutions.

Forms of Support

In the proposal it is said that one intention behind the Support Act is to create a legal framework which gives a possibility to extend support at short notice. As said before, support measures may not be implemented when not necessary to the receiving institute and a further prerequisite is that the institution is viable. Given these limitations it is said that support should be extended in the form best adapted to the situation at hand, for example through guarantees or capital injections. It is further said that fundamental principles are that guarantees should be given to a wider range of institutions and that capital injections preferably should be through subscription of preferred shares with strong voting rights.³⁹ The act itself explicitly expresses a

³⁵ The issue could be of interest from one perspective, namely in judging whether the Government's appointment of the judges in the Examination Board is appropriate or not.

³⁶ That means bank companies, savings banks, member banks, finance companies and finance associations.

³⁷ Support Act, chapter 1, section 1.

³⁸ Support Act, chapter 1, section 2.

³⁹ The Government's proposal to the act, Proposition 2008/09:61, p 30 and 32.

few principles for support. One is that support should be given under such conditions that the institution or its owners primarily will absorb losses. Another is that support should be given on commercial terms and in ways that does not distort competition. Support measures should be structured so that the state contributions could be retrieved as far as possible.⁴⁰

Logically, it should follow from the above mentioned principle (that support may not be forced upon an institute that does not need it) that the form of support that is least burdensome to the institution should be chosen with due regard also to the other principles.

It is clear that the intention was that guarantees and capital injections should be the main forms of support. That follows both from what is said in the proposal and from the ordinances that are enacted regarding guarantees and capital injections.

Bank Guarantee Program

According to an ordinance, an institute has to apply to and sign an agreement with the SNDO to become part of the Bank Guarantee Program. In essence, a guarantee under the program means that the state for a charge guarantees parts of the institute's borrowing. The aim of the programme is to facilitate borrowing by banks and mortgage institutions and reduce their borrowing costs. In turn this may increase the credit available for businesses and households.⁴¹

The total financial limit for the guarantee programme is SEK 1 500 billion.⁴² There is a formula to calculate the ceiling of the guaranteed amount for each institute.⁴³ The programme has been extended four times and the most recent prolongation ends December 31, 2010.⁴⁴

The ordinance regarding guarantees gives exhaustive and detailed rules on how and on which terms guarantees should be issued. Without going into too much detail some of them can be mentioned. Guarantees can be ex-

⁴⁰ Support Act, chapter 2, section 2.

⁴¹ The homepage of the National Debt Office, www.riksgalden.se, under Bank guarantee program.

⁴² Ordinance concerning Government Guarantees to Bank and others (2088:819), section 7.

⁴³ The homepage of the National Debt Office, www.riksgalden.se, under Bank guarantee program.

⁴⁴ Government decision May 27, 2010.

tended only to solvent institutes, interpreted in capital adequacy terms.⁴⁵ The programme is restricted to debt with a fixed nominal value which provides a rate of return only in the form of fixed or variable interest computed on the nominal amount.⁴⁶ Subordinated and participating instruments are excluded.⁴⁷ The term of maturity must be over 90 days and under five years.⁴⁸ The Support Agreement between the SNDO and the institute should include conditions that restrict the use of the guarantee in the marketing activities and initially also restricted the expansion of the institute.⁴⁹ Also included in the agreement should be various conditions regarding the remuneration of a defined group of senior managers.⁵⁰

Totally seven institutes signed agreements to participate in the guarantee programme.⁵¹ Two of the major banks participated, namely Swedbank and SEB. SEB however left the programme without using it, in the sense that no guarantees were issued on the bank's behalf, when the programme was renewed during the autumn of 2009. At its peak the programme covered approximately SEK 350 billion, out of which Swedbank accounted for 90 per cent.⁵²

During the spring of 2010 Swedbank issued long term debt without state guarantees for the first time since the beginning of the crisis. Swedbank left the program when it was extended in April 2010. At the time of writing (May 2010), only one small bank is part of the program in the sense that it has an agreement with the SNDO enabling it to issue new guaranteed loans.

Capital Injection Program

Two ordinances regarding capital injections are in force. The first, from October 2008, aims at injections into insolvent institutes.⁵³ It is short and contains almost no rules regarding the terms of support which is quite natural

⁴⁵ Ordinance concerning Government Guarantees to Bank and others (2088:819), section 3.

⁴⁶ Ibid. section 4, 1 and 2.

⁴⁷ Ibid. section 5.

⁴⁸ Ibid. section 4, 3.

⁴⁹ Ibid. section 9, 1 and 4, the latter now abolished.

⁵⁰ Ibid. section 9, 2 and 3.

⁵¹ Carnegie Investment Bank AB, SBAB, SEB, Sparbanken Gripen AB, Swedbank AB, Swedbank Hypotek AB and Volvofinans Bank AB.

⁵² The SNDO report, Riksgäldens åtgärder för att stärka stabiliteten i det finansiella systemet (2010:1), p 4.

⁵³ Ordinance concerning Government support to Credit Institutions (2008:820).

since the power of decision rests with the Government. No Support Agreements were entered into under that ordinance.

A second ordinance gives the SNDO the power to enter into Support Agreements with solvent institutes, but subject to Government approval.⁵⁴ The program is limited to the amount of SEK 50 billion.⁵⁵ The aim of the program is to promote lending to Swedish households and businesses in order to avoid a serious disruption in the functioning of the financial system.⁵⁶ The injection of capital may at most result in an increase in the capital adequacy ratio of two percentage points.⁵⁷

Since the ordinance is structured similarly to the ordinance regarding guarantees, there is no use going into great detail regarding the terms for participation. It is sufficient to mention some points. Capital must be injected in such a form that the contribution complies with the definition of primary capital, that is shares or hybrid capital.⁵⁸ Capital injections according to the ordinance can be executed in two ways. One is that the SNDO participates in a market transaction on the same conditions as the others and thereby obtains at most 70 per cent of the issue.⁵⁹ The other is that the SNDO participates in a directed new issue on terms set by the SNDO.⁶⁰ In this case the terms are set on the basis of a model that reflects the risks associated with the institution and the return on similar instruments during normal market conditions. Stressed in the SNDO's communications are the various conditions regarding the remuneration of the senior managers.⁶¹

As has been mentioned earlier, three of Sweden's four major banks issued shares during the crisis. The fourth, Handelsbanken, did not need to strengthen its capital base. Swedbank made two issues⁶² and SEB and Nordea one each.⁶³ All the issues were placed on the market, with one relatively small exception. Nordea participated in the Capital Injection Programme. The Swedish state owns a 19.9 per cent share of Nordea and participated in

⁵⁴ Ordinance concerning Capital Injections to Solvent Banks and others (2009:46).

⁵⁵ Ordinance concerning Capital Injections to Solvent Banks and others (2009:46), section 11.

⁵⁶ *Ibid.* section 1.

⁵⁷ *Ibid.* section 10.

⁵⁸ *Ibid.* section 7.

⁵⁹ *Ibid.* section 8.

⁶⁰ *Ibid.* section 9.

⁶¹ The SNDO homepage: Capital infusion programme.

⁶² One in December 2008 and another in September 2009.

⁶³ Both in March 2009.

the new issue in proportion to the holding on the same conditions as the other shareholders. The funding came via the Stabilization Fund.⁶⁴

The Capital Injection Programme is prolonged to February 17, 2011.⁶⁵

Compulsory Share Purchases

In the Support Act it is stated that the state in relation to shareholders in credit institutions has the right to compulsory share purchases when certain criteria are met.⁶⁶ A general condition, pertaining to all situations, is that a compulsory share purchase must be of utmost importance from a public perspective.⁶⁷ In relation to the 1993 act this condition is a novelty. It should be seen against the backdrop of a change in the constitution which has given stricter criteria for expropriation.⁶⁸ The specific conditions relate to three alternative situations. The first is a refusal by an institute or a shareholder to accept a Support Agreement deemed not unfair (which mean that it does not contain unreasonable contractual terms) by the Examination Board.⁶⁹ The second is a breach of a material condition in a Support Agreement.⁷⁰ The third is a situation when only 25 per cent or less of the institute's capital base remains.⁷¹

As said before, the first situation is the base of the Support Act model. Without the pressure of a compulsory share purchase there would be no possibility to put pressure on institutes when negotiating the terms of support. The right to a compulsory share purchase comprises all shares if it is the institute that has refused to accept a proposed fair agreement. If it is one or several shareholders that have refused to accept a proposed fair agreement, the right relates to the individual shareholders shares. The same applies, *mutatis mutandis*, when a Support Agreement is not adhered to. In both cases relating to a Support Agreement the rights to a compulsory share purchase lapses if new circumstances, after the Examination Boards' evaluation, render the

⁶⁴ The SNDO report, *Riksgäldens åtgärder för att stärka stabiliteten i det finansiella systemet* (2010:1), p 9.

⁶⁵ Government decision May 27, 2010.

⁶⁶ Support Act, chapter 4, section 1.

⁶⁷ Support Act, chapter 4, section 1.

⁶⁸ Regeringsformen chapter 2, section 18.

⁶⁹ Support Act, chapter 4, section 1, 1.

⁷⁰ Support Act, chapter 4, section 1, 2.

⁷¹ Support Act, chapter 4, section 1, 3.

conditions unfair.⁷² In the third case the condition is connected to the institute's solvency measured in capital adequacy terms. An institute the capital base of which is only one quarter of what is required should normally be closed down as quickly as possible. Even though state ownership should be avoided, it is stressed in the proposal for the Support Act that in certain circumstances it is necessary in order to obtain an orderly and not systemically dangerous winding down.⁷³

It is the SNDO that applies to the Examination Board to have a dispute regarding the right to compulsory share purchase or regarding the purchase price adjudicated.⁷⁴ The Support Act states that the purchase price should be determined in relation to the circumstances when the application is made. Furthermore, the purchase price should be determined so as to correspond to a sale under normal circumstances, with the important exception that the value should be decided as if the institute was not receiving or expected to receive support.⁷⁵ The reasoning behind this rule that the shareholders of an institute that has received support should not be compensated for value added by the support. That would counteract the ambition that it is the shareholders of an institute who should take the first blow when the institute is failing, which in turn would affect the risk of moral hazard. In the proposition to the Support Act it is said that not only support given but also expected support should not be allowed to influence the price. The share market's expectations of support to an institute should consequently not affect the price after a compulsory share purchase according to the preparatory works.⁷⁶

Obviously, this is an important point. All valuation in extraordinary circumstances is difficult and on top of that this one involves an important principle, namely how support and expectations of support should be taken into account when valuing the shares (or for that matter the business as such). As has been pointed out earlier, there is a risk of support on too favorable conditions if there is no possibility of putting pressure on the institute in question in an acute situation involving systemic stability. On the other hand, institutes in a liquidity squeeze are very vulnerable even though they

⁷² Support Act, chapter 4, section 1, paragraph 2.

⁷³ The Government's proposal to the act, Proposition 2008/09:61, p 75.

⁷⁴ Support Act, chapter 4, section 2.

⁷⁵ Support Act, chapter 4, section 2 with reference to chapter 5, section 1.

⁷⁶ The Government's proposal to the act, Proposition 2008/09:61, p 55 f.

have a satisfactory solvency. Refusal to extend ELA from the central bank (or any other authority handling ELA) could force a perfectly healthy bank into bankruptcy within hours. If the valuation process is supposed to completely disregard all forms of state support, including the possibility for ELA, all institutes with acute liquidity problems would be deemed more or less worthless. Such an interpretation of the valuation rules does not seem reasonable. Extension of ELA from the Riksbank should not be allowed to in any major way affect the valuation of the institute. In my view ELA extended in exactly the same circumstances by the SNDO under the Support Act should not give another outcome of the valuation process.

Stabilization fund

As a part of the support programme, the Swedish parliament, the Riksdag, decided to establish a stabilization fund with the aim of financing measures in order to support financial stability. The fund is administrated by the SNDO. Initially, the parliament decided to provide SEK 15 billion to the fund through a special appropriation. According to the initial plans, banks and other credit institutions should pay yearly risk adjusted fees to the fund in order to accumulate a sum corresponding to 2.5 per cent of GDP within 15 years (today that would equal around SEK 77.5 billion or EUR 7.5 billion). Another aim was and is to include the deposit insurance fund, currently worth about SEK 20 billion, in the stabilization fund. However, the amalgamation of the two funds is at the moment postponed, as are the plans for risk adjusted fees. Although the fund was initiated through the original wording of the Support Act, the size of the annual fees was decided through an amendment to the law enacted December 30, 2009.⁷⁷ The fee is 0.036 per cent of the liabilities and appropriations of the institution. In addition to the fees, charges for bank guarantees and possible returns on other support measures are transferred to the fund.

Achieving a long-term sustainable financing system outside the central government budget is said to be a motive for creating the Stabilization Fund. The ambition is that the fund will be able to absorb all costs of future support measures.

⁷⁷ SFS 2009:1418. The result of the technical solution is that banks with a financial year ending December 31, 2009 had to pay the fee relating to that year. The fees for 2009 and 2010 are reduced by half.

Carnegie

The first and most controversial case under the Support Act involved both support measures and at the same time sanctions under the banking legislation. This makes it an atypical support case, but it can still give some guidance as to how the Support Act works (and how immensely complicated things tend to be in the midst of a crisis). The following is a very condensed version of the complicated events that took place.

The relatively small Carnegie Investment Bank AB (Carnegie) was one of the most reputed investment banks in Sweden. After an acute liquidity crisis, the Riksbank on October 27, 2008 extended ELA to Carnegie with the amount of SEK 1 billion. Carnegie was deemed to be of systemic importance. Two days later another credit of SEK 1.4 billion was extended and a limit of SEK 5 billion was set. Carnegie furnished security and Carnegie's parent company pledged the shares in Carnegie and the sister company Max Matthiessen Holding AB (an insurance broker) as security for the loans. The Support Act was enacted the day after these loans were made.

In accordance with the Support Act, the SNDO liaised with the Riksbank and the Finansinspektion regarding the handling of Carnegie. It emerged that Carnegie was undergoing a supervisory review process that involved allegations of such gravity that it could lose its license. The SNDO could ascertain that if the ongoing process regarding Carnegie's license would result in a revocation, that would lead to liquidation. It also became clear that the Riksbank probably would revoke the ELA if Carnegie lost its license, which in turn most likely would cause Carnegie's bankruptcy. Under the prevalent market conditions both scenarios would cause serious disturbances to the functioning of the financial system and probably a great decrease in value.

After evaluating different options in the situation at hand, the SNDO decided to give Carnegie a loan under the Support Act. According to the terms of the Support Agreement, which was negotiated during the weekend November 8–9, a loan would be extended that repaid the loan from the Riksbank in case the license was revoked. The Government approved the terms of the Support Agreement on November 10 and the same day the loan agreement and an agreement regarding security for the loan were signed. As before, Carnegie's parent company pledged the shares in Carnegie and Max Matthiessen as security for the loan.

When the Finansinspektion did revoke Carnegie's license, the pledged shares were taken over by the SNDO. Shortly after that, the Finansin-

spektion returned the license to Carnegie, citing the state as a reputable and responsible owner as justification.⁷⁸

Based on terms in the Support Agreement, the SNDO made an external evaluation of the value of the shares at the time of the apprehension of the pledge. It indicated a value less than the loan, implying that the shareholders would not receive anything. The shares in Carnegie and Max Matthiessen were sold by the SNDO in May 2009. The price was roughly commensurate to the ELA extended to Carnegie, meaning that the state could recover most of the support extended to Carnegie.

There are disputes between the SNDO and the previous owner regarding these events in both the Evaluation Board and the Stockholm District Court. In the Evaluation Board the issue is the method of valuation, e.g. the interpretation of the effect of state support as discussed above. In the District Court it is mainly the legality of the take over of the shares pledged to the SNDO by the mother company.

Lessons to be learned

Since Sweden has faced serious financial distress two times during the last 20 years, there should be plenty of experience to draw from. As has been said earlier, the nature of the 1990s crisis was quite different to the recent one, which makes it difficult to make unequivocal conclusions. Or perhaps that is the strongest general conclusion to draw; there are not two crises that are alike. The direct causes and the course of events always differ from crisis to crisis, even though the fundamental causes (at least somewhere in the world) are the same.

Undeniably, it is ironic that Sweden, as one of the first countries, had a special resolution regime very far into the pipeline when this crisis became evident, but was unable to enact that regime in time for it to be used. One lesson seems to be that it is unwise to wait too long after a crisis to implement mechanisms aimed at preventing or dealing with the next crisis. The political interest in discussing financial crises and how to resolve them is limited in good times. On the other hand, it seldom seems very urgent to implement measures immediately after a crisis. It is better to have a proper investigation done and lift the perspective above the direct and concrete lessons from the

⁷⁸ The Finansinspektion decision November 11, 2008. Dnr 08-10273.

last crisis since, as said before, the next crisis is seldom or never the same as the one before.

One lesson that Sweden learned during the 1990s crisis which has been of great value in the present one is the importance of strong public finances. This lesson has been emphasized through other countries' experiences. Weak public finances or too weak a public sector compared to the country's financial sector can make it difficult or impossible to master a financial crisis.

Finally, there is a more detailed but nevertheless very important point to make. Experiences both from Sweden and other countries show the importance of the state authorities being able – and politically willing – to very quickly (within hours) take control over institutes in acute distress in order to avoid the blackmail situations that can arise when a systemically important institute can negotiate about the terms of support (described above). Such situations can result in support on too favorable conditions if there is no way for the state to put pressure to bear on the institution and/or its owners. The mechanism employed has to be very quick but does not necessarily have to involve assumption of ownership. Normally, ownership transfers can not be executed with sufficient speed. A regime without this mechanism bears the risk of being inefficient in the most acute situations.

