

IBC16's Bad Bank Bulletin

'Securum' and 'Retriva'

BACKGROUND



The Swedish financial crisis (1990-1994) was a housing bubble, that deflated during 1991 and 1992 and resulted in a severe credit crunch and widespread banking insolvency in Sweden. The crisis was the direct result of a combination of over-speculation in property assets and the exchange rate of the Swedish krona. Two of Sweden's largest banks, Föreningsbanken and Nordbanken, fell below their required capital levels amidst rising loan defaults in 1991.

To protect Nordbanken, the Swedish government guaranteed its liabilities and took over the ownership of the bank. A third large bank, Gota, was taken over while arranging a guarantee for Förenings. Just like that, three of the four major banks of Sweden had become insolvent within a year. Thereafter, policymakers acted quickly to separate the good from the bad.

The Swedish authorities engaged McKinsey & Company to help design a solution and chose to establish two bad banks, Retriva and Securum.

Retriva took over all the non-performing loans from Gota Bank, and Securum took over the non-performing loans from Nordbanken, with the good bank operations continuing as Nordea. The government retained a significant equity stake in Nordea.

POWERS AND DUTIES

The asset management companies Securum and Retriva were charged with managing and liquidating the bad assets of these banks, and with taking on the assets of the non-bank companies that were in default. Swedish legislators made sure that the companies were adequately capitalized, and granted them exemptions from regulatory rules that would have rushed their actions or limited their effectiveness, including a rule that required seized collateral to be liquidated within three years.



WAY OF FUNCTIONING

In December 1992, the Swedish Parliament passed legislation by an overwhelming majority and with no political infighting, to establish a Bank Support Authority, Bankstödsnämnd. The parliament decided that the Bankstödsnämnd was to be given open-ended funding, not a fixed predetermined budget. This was a deliberate choice to avoid the risk that the Bankstödsnämnd would be forced to go back to the parliament to ask for additional funding at a later stage. The open-ended funding underpinned the credibility of the bank resolution policy. It clearly demonstrated that there were no political misgivings about the financial commitment to support the banking system. The Bankstödsnämnd was set up as an independent agency at a distance from the government, the Swedish Central Bank, and the Finansinspektion (the financial supervisory authority). This construction fostered credibility and trust in its operations. The Social Democratic opposition was given full insight into its activities. It was staffed by professionals and it began operation in the spring of 1993, shortly after it was established. It worked closely with the Swedish Central Bank, the Finansinspektion, and the National Debt Office. In the few cases when these institutions were not in agreement, the Ministry of Finance acted as arbitrator.

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Banks that turned to the Bankstödsnämnd were dealt with in a way that minimized the moral hazard problem. In short, the aim was to save the banks – not the owners of the banks. By forcing the bank owners to absorb losses, public acceptance of the bank resolution was fostered. In this way, the taxpayers were likely to feel that the policy was fair and just.

The Swedish authorities' strategy was to divide the banks into three categories, depending on whether the statutory capital adequacy ratio would be breached and, if so, whether this breach was temporary. The first category included those banks that might deteriorate towards the capital adequacy limit, but would subsequently be able to achieve enhanced solvency on their own; the second category covered those that may fall below the limit for a time, but would eventually recover, and the third category was for those that were beyond hope. Each of these three categories was treated differently by the Bankstödsnämnd.

The Bankstödsnämnd paid special attention to the third category as these were the institutions that were not expected to become profitable; their equity would gradually erode and ultimately become negative. This category required active state involvement, ultimately in the form of an orderly liquidation of the ailing institution. However, if a more favorable result could be achieved with other methods, the Bankstödsnämnd was entitled to apply those as well.

For instance, by selling the bad assets and consolidating the remainder of the bank, either on its own or through a merger with other banks. Such an approach was adopted in the case of two major insolvent banks, Nordbanken and Gota Bank through the creation of Securum and Retriva.

The first measure employed by the Bankstödsnämnd involved the separation of assets into a viable part and a sick part with bad debts. The viable part of Gota Bank was merged with Nordbanken, which also received state bank support, while the bad debts were placed in Retriva. In addition, when assets were placed under the administration of Securum and Retriva, they were assigned low market values in the due diligence process, effectively setting a floor for asset values. Because the market participants did not expect prices to fall below this level, trading was maintained. The assets and claims in Retriva were restructured in order to be sold off in the long term and to be able to recover some of the funds that had to be put into the company. In 1996, the Retriva business was merged into Securum, a company that fulfilled the corresponding function for Nordbanken's bad debts.

TOTAL ASSETS UNDER MANAGEMENT

Securum started with a massive portfolio of loans in default as its most important asset. It acquired 3,000 loans with a face value of SEK 67 billion (USD 521 million). As part of the pricing and transfer, Nordbanken wrote down the assets by SEK 17 billion, making the “purchase price” of the portfolio SEK 50 billion. The government provided SEK 24 billion in funding in the form of equity while Nordbanken provided SEK 27 billion in loans at favorable terms, of which the government guaranteed SEK 10 billion. Securum’s portfolio was limited to assets from Nordbanken. The portfolio consisted of mostly nonperforming loans with a minimum size of SEK 15 million, most of which were related to real estate.

On the other hand, Retriva's portfolio consisted of SEK 42 billion in loans— an amount equal to nearly 50% of Gota Bank's total lending—and SEK 3 billion in assets. Gota Bank had written down the assets before the transfers more aggressively than Securum, with SEK 26 billion in total asset write-downs. Retriva was financed using SEK 3.8 billion in equity (compared to the SEK 24 billion for Securum) from the government and SEK 3.5 billion in government-guaranteed loans.

Overall, SEK 112 billion in assets at face value were transferred to Securum/Retriva at a transfer price of SEK 66 billion. After further write-downs and devaluation, the assets had an estimated market value of SEK 53 billion.

UNIQUE FEATURES

Sweden's approach was remarkably transparent. The magnitude of losses was established by a Bank Support Authority, which was independent of the Ministry of Finance and the central bank. Good assets were separated from bad assets, and the full extent of the government's involvement was clearly outlined.

Sweden also extended considerable political and financial independence to the asset management companies, which allowed them to carry out their task with adequate resources. Doing so served as a public signal that their operations would not be subject to changing political winds. Similarly, Swedish officials' relaxation of collateral liquidation requirements implied that the dispensation of assets would take place over an extended period of time.

Arguments can be made either way about the best time to sell assets – selling early returns assets to private use and avoids investor anxiety about debt overhang while selling gradually sidesteps a distressed-pricing feedback loop. In any case, asset managers were given the flexibility to make their own decisions about the trade-off.

To restore credit flows, Sweden moved quickly to provide incentives to bank owners to inject additional capital into their banks or to inject government capital into banks directly, when necessary. Asset management companies played a key role in restoring the financial health of the non-bank companies they were operating. Some viable corporations were allowed to survive through capital injections, though in return the government acquired a majority of their shares so that taxpayers could profit from any upside. Recapitalized institutions could return to ordinary operation, gradually rebuilding the creditworthiness of the overall economy.

HIGHLIGHTS TILL DATE – SUCCESSES AND FAILURES

The performance of Securum has been analyzed by many, such as Claes Bergström. While the figures are debated, depending on the initial costs and the time frame, the cost was no more than 2% of GDP (an extremely good result), and eventually, both the bad banks made a positive return. Nordea has been considered one of the strongest and best-performing banks in Europe. Even though the lifespan of Securum was previously decided to be 15 years, the company proposed closure in 1997. Securum had disposed 98% of its assets at the time of its dissolution. Most of the criticisms that can be leveled at the Swedish crisis resolution are easy to make in hindsight.

Overall, Sweden's financial crisis containment and resolution strategy largely avoided mistakes that would skew uninsured investors' incentives going forward. Its policies were enacted transparently, insured political independence, and attempted to restore credit flows in the broader economy. The Swedish case illustrates the trade-offs and considerations of market discipline that crisis managers must address if they are to minimize taxpayer losses and speed up the return to a rebalanced, growing economy.

ONE THING NARCL CAN TAKE FROM IT

International commentators such as Brad DeLong and Paul Krugman have suggested the Swedish bad banking model be adopted internationally. The Swedish model was deemed successful due to four underlying principles:

1. Transparency: Anticipated losses were recognized and revealed early on.
2. Political independence: The AMCs or 'bad banks' were free of politics and could shut down banks for economic reasons only.
3. Market discipline: Uninsured depositors have strong incentives to enforce discipline by raising their cost of funding when they are forced to swallow more risk. This can be undone if the government promises unlimited liquidity. Sweden sidestepped the problem by refusing unlimited liquidity but guaranteeing bank liabilities.
4. The creditworthiness of the real economy must be repaired: Banks may get fixed, but unless credit truly starts flowing the exercise is self-defeating.

Authorities in India can inculcate these principles in the functioning of NARCL. The authorities will have to unify, keeping aside their political standings, and will have to be highly transparent in order to receive public support for this new venture.