Svein Gjedrem: Financial crisis – lessons from the Nordic experience

Article by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), in the Financial Times, 3 February 2009.

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With the financial crisis gathering strength and spreading to the real economy, it is instructive to learn the lessons from the Nordic crisis of the mid-1990s. There are some important similarities today: but also some important differences.

The financial strength of the banks, and hence their ability to continue to supply a steady flow of financing, can be bolstered in either of two ways: by injecting capital; or by removing high-risk loans from the banks' balance sheets – and in turn creating a "bad bank". In the Nordic banking crisis 20 years ago, we did both, and learned three important lessons:

First, government crisis resolution measures do not have to be costly for the taxpayer. The state injected equity capital, while private share capital was written down on the basis of a realistic assessment of loan losses. This ensured that the equity capital injected by the state could benefit from upside opportunities. In Norway, the state assumed 100 per cent ownership of the three largest banks. The board of directors and senior management in each bank were replaced. Then, in the years following the crisis, the state gradually sold its shares in the nationalised banks – at a profit.

Second, it is not always necessary to take the bad loans off the banks' balance sheets. In Norway, the banks dealt with the problem loans themselves, and there is good reason to try to achieve this, where possible: the originating banks themselves are the best placed to deal with the problem loans. However, this presupposes that the problem loans account for only a limited proportion of total lending, so that the banks are able to continue to operate normally. Sweden and Finland established a "bad bank" that took over the high-risk loans. But this was in most cases done only after the state had nationalised the banks and was thereby able to control the kinds of loans that were transferred to the "bad bank".

Third, banking crises do not need to be prolonged. In the Nordic economies the prompt and extensive writing down of problem loans and recapitalisation of the banks limited the economic downturn, which lasted only around a few years. This experience stands in contrast to that of Japan, where loan losses were recognised too slowly, with substantial and decade-long consequences for economic developments.

All that said, however, the challenges facing banks today require a broader set of instruments than those used by the Nordic authorities 20 years ago, for two main reasons:

First, the situation for banks is more complex. The authorities have to distinguish more clearly between insolvent banks and banks that are solvent but in need of more capital in order to increase lending. The lessons from the Nordic banking crisis can be drawn on for the insolvent banks. For the solvent banks, the challenge is to maintain their lending capacity. This is particularly important given that other credit markets are not functioning normally, so that it is difficult, or impossible, for businesses to acquire funding directly from bond markets. But without more capital, the banks are not willing to accept new loans on their balance sheets. The main challenge facing the authorities today therefore is to ensure that solvent banks increase their financial strength and thereby their lending capacity. At the same time, it is important to have an exit strategy so that capital injections today do not translate into an increase in state ownership when the crisis is over.

Second, cross-border banking has been increasing. Twenty years ago, all the main Nordic banks were national banks. Today, for example, four of the five largest banks in Norway are foreign-owned (three branches and one subsidiary). A national authority cannot be expected to bolster the financial strength of branches of foreign banks: indeed, it could be complicated to do this even for foreign-owned subsidiaries. While we were able to choose national solutions to the banking crisis 20 years ago, any effective solution to today's situation will require an internationally harmonised approach.

As today's financial crisis progressively gets resolved, it will be necessary to start the process of preventing future crises. This will require substantial reform of the regulatory framework. Banks will have to strengthen their capital and their liquidity buffers. And financial regulation must have a less pro-cyclical effect. The objective must be to enable the banks to curb the impact of shocks on the economy, rather than to amplify them, as is the case now, where negative spirals are generated between the financial system and the real economy.

Because of the global character of today's financial crisis, the authorities must work in concert to find solutions, both in terms of recapitalisation of the banks and regulation of the financial sector.