MINISTRY OF FINANCE

ENDING THE BANK SUPPORT

Ds 1995:67

This is an unofficial translation of the memorandum. In case of inconsistencies between the Swedish text and this translation, the Swedish text should be consulted. The two reports referred to in the memorandum from the Financial Supervisory Authority and Mr. Johan Munch, Justice of the Supreme Court respectively, are available in the Swedish edition.

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Contents

1 Summary

In the present memorandum, prepared in the Ministry of Finance in november 1995, it is proposed that the State undertaking, approved by the Riksdag in 1992, that banks and certain other credit institutions can meet their commitments on a timely basis, be terminated with effect from 1 July 1996. From that date no outstanding claims would then be covered by the undertaking. The termination of the undertaking does not affect existing support agreements.

The Riksdag's decision in 1992 stipulated that the undertaking is not to be ended until the rights of creditors are not at risk and when the stability of the financial system is no longer threatened.

In recent years the Swedish banking system has undergone a radical economic and financial recovery. Its earning capacity has been strong and lending losses have decreased markedly. There has also been an appreciable reduction of problem assets. Capital adequacy is internationally high and financing is functioning normally. The prospects of a persistently stable development and a further reduction of loan losses can be regarded as good. Even if the outcome were to be worse than can now be expected, the institutions can be considered capable of coping with it in the context of their current performance.

As regards the situation in particular institutions, in every institution the outlook is considered to be sufficiently stable. Conditions accordingly exist for ending the State undertaking without jeopardising the rights of any institution's creditors. An end to the undertaking requires a decision by the Riksdag.

2 Drafted laws

2.1 Draft law repealing the law (1993:765) on State support for banks and other credit institutions

It is hereby prescribed that the law (1993:765) on State support for banks and other credit institutions shall cease to be in force on 1 July 1996.

2.2 Draft law amending the law (1993:1539) on tax deductions for business losses

It is hereby prescribed that Article 13 of the law (1993:1539) on tax deductions for business losses shall have the following wording.

Present wording	*Proposed wording*
Article 13	
Deductions are not allowed for losses arising from transfers to the State, municipalities or county councils or to a company fully or predominantly owned directly or indirectly by them in cases covered by Section 5 of Article 2 of the law (1947:576) on state income tax.	
	If the State directly owns all shares or rights in a bank or other enterprise that has been eligible for support under Article 3 of the repealed law (1993:765) on State support for banks and other credit institutions, the enterprise - in the event of shares or rights being transferred - shall not be entitled to loss deductions for the part of the loss that arose prior to the tax year when the transfer occurred

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This law enters into force on 1 July 1996 and applies for the first time to 1997 tax assessments.

3 Introduction

The temporary State guarantee that banks and certain other credit institutions can meet their commitments on a timely basis was approved by the Riksdag on 18 December 1992. During the period of almost three years in which the guarantee has been in force the State has implemented sizable support measures of a financial and structural nature. The banking system has undergone a substantial economic recovery and stabilization. Against this background, the economic and legal conditions for ending the State undertaking are considered in the present memorandum. One conclusion is that conditions for a termination now exist.

By way of a background to the State undertaking, the memorandum briefly describes the financial system's increasing weakness in the early 1990s and the first State interventions in particular cases (section 4). The design of the undertaking to support banks, etc. is then outlined together with other organizational measures associated with the support (section 5). A general account of lending and operating losses in the banking system is presented, along with the various ways in which the stock market and bank customers have helped to cover losses and dwindling capital bases (section 6). The capital contributions and support measures from the State are then considered, for individual institutions as well as at total level (section 7). The background information concludes with a description of the banking system's recovery and stabilization (section 8). Much of the numerical information in these sections has been reported earlier in submissions to the Riksdag concerning the bank support (skr. 1992/93:251, skr. 1993/94:61, skr. 1993/94:238). The economic conditions for ending the support are then reviewed and certain matters to do with regulation and supervision are considered (section 9). Legal issues concerning the State's responsibility in connection with a termination of the support are dealt with in section 10. The continued operations of the Bank Support Authority are considered briefly in section 11. Finally, in section 12, it is proposed that the State undertaking ceases to exist as of 1 July 1996.

4 Background to the State undertaking

In the 1980s the loan losses of banks normally fluctuated between two- and five-tenths of one per cent of their loan stock. Even in 1989 loan losses in the banking system totalled less than 3 billion kronor or 0.3 per cent of the loan stock. Loan losses were small relative to earning capacity and therefore had no appreciable effect on operating profits. In the second half of the 1980s, moreover, profits were enhanced as a result of the massive expansion of credit that followed the abolition of the lending ceiling as a regulatory instrument. The picture of stable operations in the 1980s is confirmed by a rate of return that in large parts of the bank sector was relatively steady and high (around 20 per cent of shareholders' equity in the two largest private banks). The bank groups also recorded stable contributions from housing credit subsidiaries, where loan losses were normally very marginal.

The economic downturn in the early 1990s, however, had very marked repercussions in Sweden. The overheating and speculation in construction and real-estate markets, in large measure fuelled by almost uninhibited bank lending, turned into a steep price fall, in the first place for commercial properties. The slowdown deepened and spread to other sectors. Real interest rates rose abruptly and markedly.

In that prospects in the real-estate market were undermined by the economic downturn, the massive expansion of lending with real estate as collateral now became a source of increasing losses. Finance companies were hit first on account of a generally poorer collateral position and a greater risk propensity. Starting in 1990, finance companies soon faced a crisis that involved a number of failures, slimming and wind-ups. This crisis, however, was not considered to constitute such a threat to the payment system and credit supply that the State had reason to intervene with support measures. But the problems did occasion some new legislation on the companies' borrowing facilities.

However, the crisis also affected the banks to a growing extent, both via their lending to finance companies and on account of the increasingly weak real-estate market. In 1991 the management of Nordbanken

announced that a capital contribution would be needed in order to meet the stipulated capital ratio at the turn of the year. This caused the State, as the bank's main owner, to appoint a new management and initiate structural changes. More than 5 billion kronor was provided in additional capital.

Later that year it emerged that Första Sparbanken had also incurred large losses and that its financial position was seriously impaired. The bank applied to the State and a reconstruction was arranged with undertakings by the savings bank movement, while the State provided a guarantee for a contingent loan to the bank. Being ultimately responsible for the stability of the payment system, the State considered it necessary to contribute to a solution.

During 1992 the problem of the banks' growing loan losses was accentuated. The situation for Första Sparbanken seriously worsened again resulting in an enlarged state commitment. It also became clear that Gota Bank risked insolvency in the near future. Here, too, it was considered that the State would have to guarantee Gota Bank's commitments in order to maintain the payment system's stability. In this connection the State took over Gota Bank but left the parent company, Gota AB, to proceed into bankruptcy.

The crisis in the banking system was exacerbated by the extreme interest rate increases that were generated in the wake of the international currency unrest in the early autumn of 1992. The foreign exchange crisis occasioned interest rate increases up to 500 per cent in defence of the krona's exchange rate. Observers abroad became increasingly sceptical about many Swedish credit institutions. The financing situation of the institutions was generally vulnerable. The dependence on borrowing in the interbank market in Sweden and abroad was pronounced. Under these circumstances it was considered that a run on a Swedish bank could have knock-on effects that would be difficult to control and thereby jeopardise confidence in and the stability of the Swedish payment system as a whole. Such a development would rapidly worsen the economic crisis and have very serious social consequences. Following discussions with the Social Democrats, on 24 September 1992 the Government of the day announced that in a bill to the Riksdag that autumn it intended to request a broad authorization to take measures for strengthening the payment system and safeguarding the supply of credit.

5 The State undertaking

The Bill (1992/93:135) was tabled in November and on 18 December 1992 measures for strengthening the financial system were approved by the Riksdag (bet 1992/93:NU16, rskr. 1992/93:155). The State thereby guarantees that banks and certain other credit institutions can meet their commitments on a timely basis. The Government has been authorized to decide about measures of support to implement this undertaking. The measures are to be based on commercial principles and arranged in such a way that the long-term costs for the State are minimized and support paid out can be recovered. Moreover, the State shall not endeavour to become an owner of banks or other credit institutions.

The undertaking covers all the commitments of an institution except its share capital and perpetual debentures. It does not apply to commitments that obviously contravene sound banking practice. Support may be provided for institutions that are viable in the longer run. Other institutions are to be reconstructed or wound up in an orderly manner. Support may be provided in the form of guarantees, loans, capital contributions or in other ways.

Considering the exceptional nature of the support, the Riksdag also decided that its authorization to decide measures of support was temporary. The support system is to be terminated when this can be done without jeopardizing the rights of creditors. An end to the support is to be decided by the Riksdag. Even when the undertaking has been rescinded, current support agreements will, of course, be fulfilled.

The Riksdag also decided to set up a separate authority, the Bank Support Authority, to manage the support system and decide on measures. Decisions concerning support of principal significance, or of considerable weight in other respects, are to be submitted for Government approval. The Authority began its work in May 1993. Prior to that, the activities had been handled in the Ministry of Finance.

An Act (1993:765) on State support for banks and other credit institutions (prop. 1992/93:245; bet. 1992/93:NU35, rskr. 1992/93:440) was approved by the Riksdag in the spring of 1993. The purpose of the

Act was to ensure that support agreements could be concluded on the terms envisaged in the State undertaking. A new authority, the Appeal Board for Bank Support Issues, was set up acting as the final instance for assessing support terms in cases where the State and an institution cannot reach an agreement. An appeal is allowed provided the institution, in the absence of State support, would be insolvent, required to draw up an interim financial statement or short of its required capital ratio.

The law also entitles the State to redeem the shares in an institution if an agreement that has been assessed by the Appeal Board is not accepted or if an institution or its owners have not honoured a commitment of essential importance for a support agreement. A right of redemption also exists if the capital base of an institution amounts to less than two per cent of its investments. In such a critical situation, a State takeover is considered to be the only realistic way of managing matters and restoring confidence.

In the even of circumstances corresponding to those described above arising in a savings bank, a cooperative bank or a mortgage institution, compulsory management may be imposed.

The provisions in the Act on State support for banks and other credit institutions regarding the possibility of appealing terms for State support and concerning the redemption of shares or compulsory management (Articles 6-26) are temporary and cease to apply at the turn of 1995. In a bill (prop. 1995/96:70) to the Riksdag, however, the Government has proposed a prolongation of one year, that is, until the end of 1996.

6. Summary of bank losses, etc.

To provide a background to the amount and direction of the support (section 7), the magnitude and distribution of the loan losses are summarized here together with the effects on the banks' capital bases and capital requirements. The information refers to the large bank groups, which dominate the Swedish banking system.

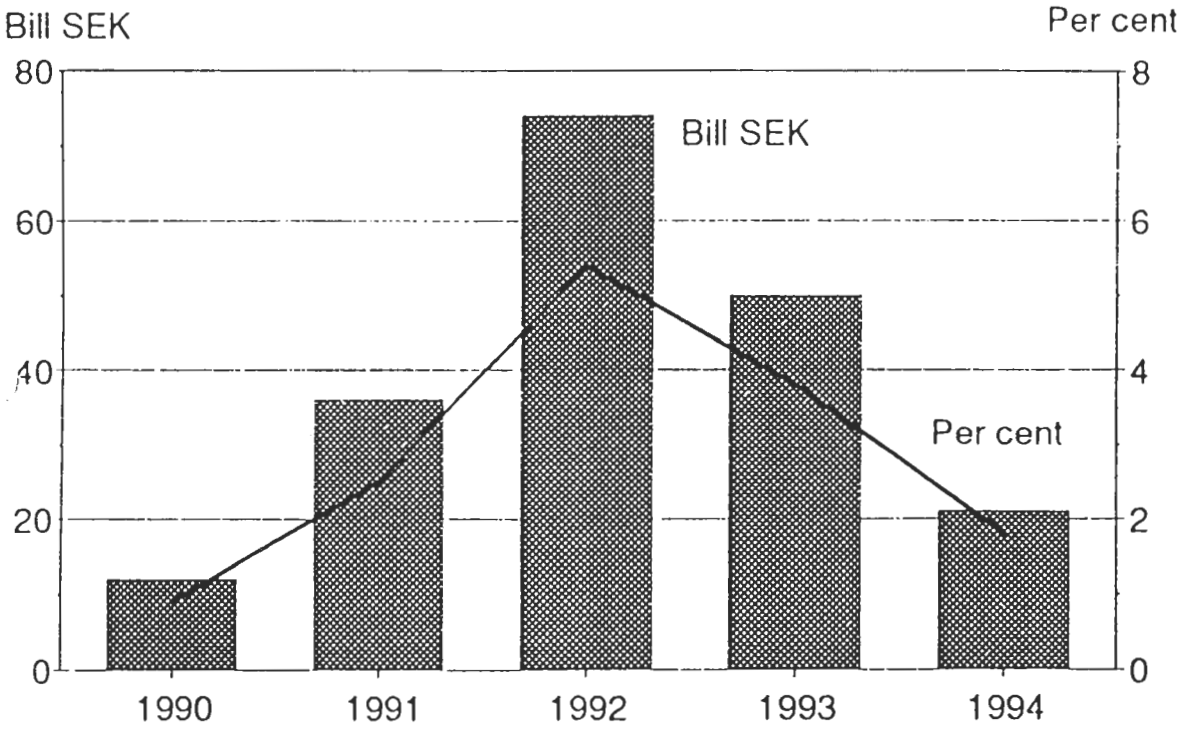
Loan losses

As a yardstick for the magnitude of the loan losses it can be noted that in the 1980s the annual total for the bank groups fluctuated between 1.5 billion and 2.5 billion kronor. Starting in 1990, the stock of problem loans rose sharply and with it the loan losses, which peaked at about 75 billion kronor in 1992 and decreased rapidly after that. For 1995 the level is estimated to have fallen back to 15 billion kronor. Over the five-year period 1990-94 the losses have totalled about 200 billion kronor.

As a share of the loan portfolio, the losses rose from around one-half of one per cent in the 1980s to more than 5 per cent in 1992. The corresponding figures for the parent banks are higher than this because the losses on the large loan portfolios of their housing subsidiaries were comparatively small. In the period as a whole the bank's losses add up to approximately one-fifth of their loan stock.

Behind these aggregate figures, however, there are large differences between individual banks. Of the six largest bank groups, four have had losses in the weakest years in the interval 3-5 per cent of their loan stock. For the other two the share has been appreciably higher, around 8 per cent for Nordbanken and more than 15 per cent for Gota Bank, though in the latter case the absence of a housing institution distorts the comparison. Another indication of this is that by far the largest share of the State support was provided for these two banks.

LOAN LOSSES OF BANK GROUPS 1990-94
SEK billion and per cent of loan stock



A thoroughly reliable picture of the sector distribution of the loan losses cannot be constructed from the available statistics (see, for instance, a report by Jan Wallander, published by the Bank Crisis Committee, utr. dir. 1992:105). But certain points can be made. The largest share of the banks' loan losses, estimated at more than 2/3rds, came from non-financial firms, a category that includes real-estate companies. Losses among households were smaller, well below 10 per cent, and those from finance companies also seem to have been of this order. It can be noted, moreover, that the dominant source of losses was loans connected with the real-estate industry or with real estate as collateral. While there are clear differences between banks in this respect, it applies in general and reflects the historical collapse of the commercial property market, where in the course of two years, prices and rents in the metropolitan regions fell by about 50 and 30 per cent, respectively.

The banks naturally differ in the composition of their loan portfolios and this would be expected to have some effect on the development of losses. Although the statistics do not permit any definite conclusions, the Bank Crisis Committee found that, compared with other large banks, Gota Bank's portfolio contained a higher proportion of business credits.

As regards the size distribution of loan losses it can be noted that for the large bank groups it is generally the case that a very high proportion of the total loss came from a very small number of loan commitments. For two of the major groups, for instance, out of a total of around 20,000 loan commitments that resulted in losses, about 50 accounted for between 40 and 50 per cent of the total amount lost. These commitments belonged to the size group above 50 million kronor (known as large commitments). While it is true that the inclusion of numerous, relatively small house mortgage loans in these figures has a marked effect on the proportions, it seems that they still clearly demonstrate a pattern in the bank crisis. The loan decisions that resulted in the major losses were thus made or, according to the rules, should have been made by central instances in the banks.

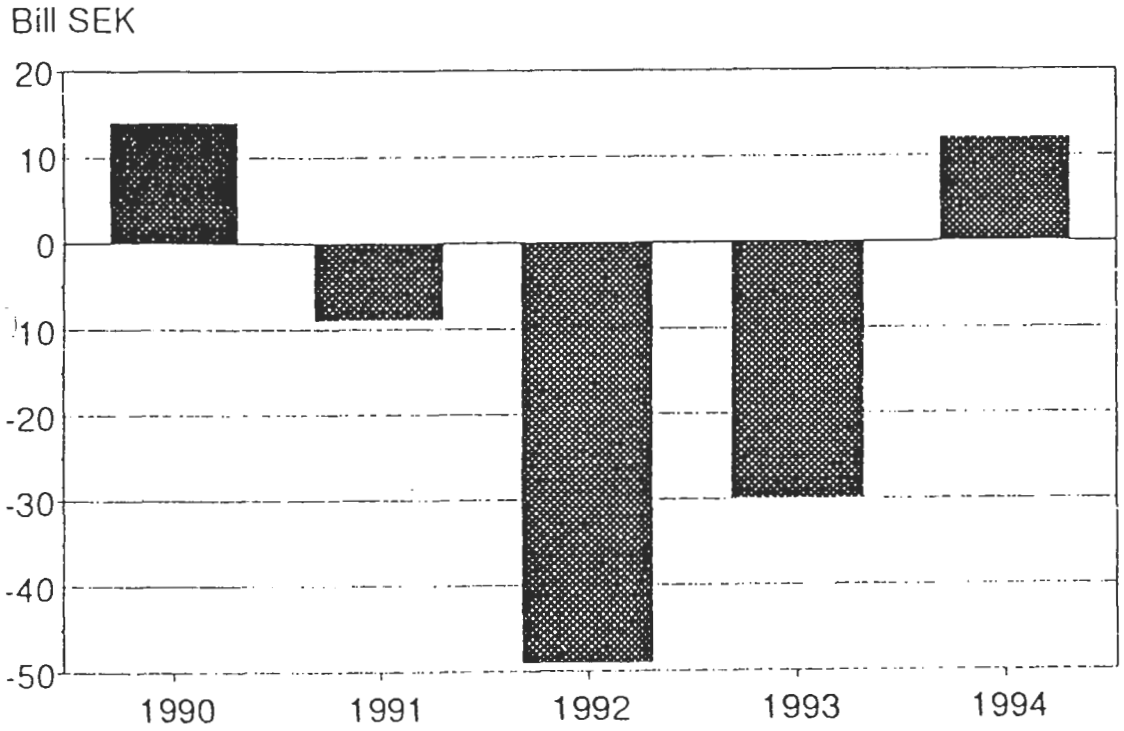
The size factor also illustrates the circumstance that the serious losses have been reported by the parent banks. The large loans to the commercial property sector, for instance, were provided by parent banks. The mortgage institutions, which mainly operate in the housing market, with residential loans to private individuals as a major component, have generally faced less of a crisis. House prices have fallen less markedly. The strains on many mortgage holders, although substantial in some respects, have been easier to manage in general. It is also the case that segments of these institutions' loans for commercial properties were transferred to the parent banks at an early stage. Still, the aggregate level of losses for house mortgage institutions has risen and it peaked at about 0.8 per cent of the loan stock. This can be compared with a maximum of some tenths of one per cent for losses in earlier periods. Although the level of losses is thus lower, however, the period of increased losses may be longer than for the banks. The problems are greatest in the case of loans to tenant-owner associations that were established in the late 1980s and early 1990s when costs for residential construction were very high.

Operating losses and erosion of capital bases

With the rapid increase in loan losses, the banking system's aggregate operating result swung sharply from a profit in the region of 15 billion kronor to a loss in 1991 of about 10 billion. For the three-year period 1991-93 the operating losses (incl. Securum) totalled almost 90 billion kronor. It was not until 1994 that the banking system again showed an

overall profit.

OPERATING RESULT FOR BANK GROUPS
(incl. Securum 1993)



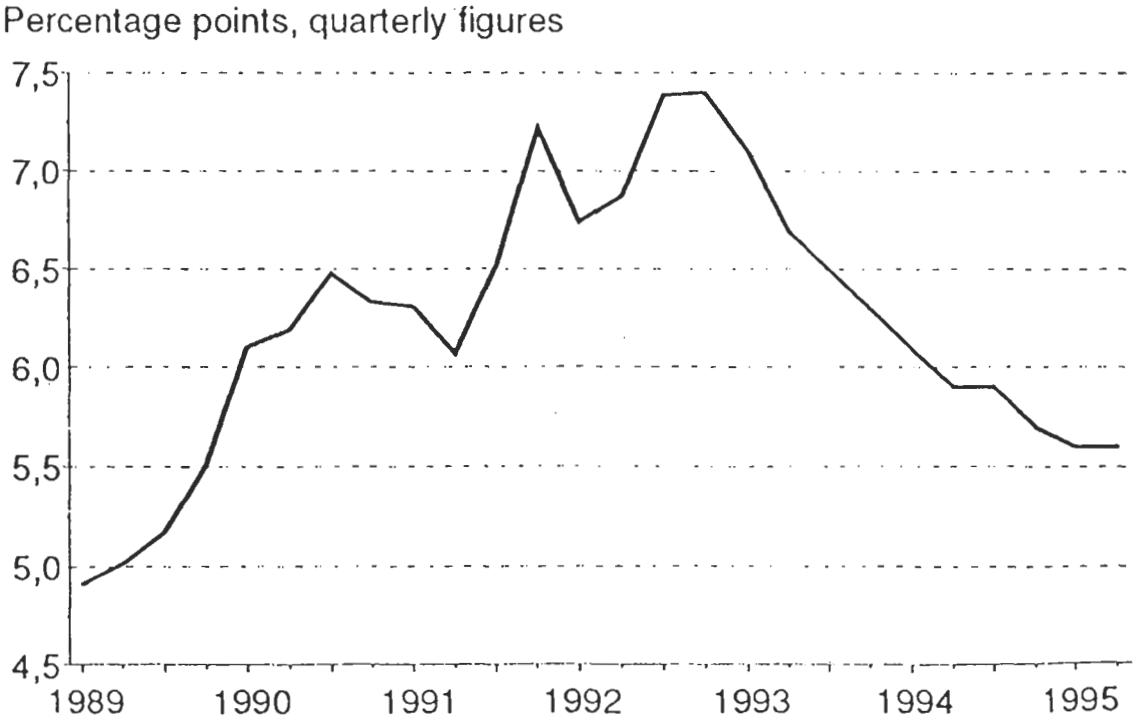
The accumulated operating losses can be compared with the bank groups' combined capital base, which at the end of 1991 amounted to just under 10 billion kronor. Just over 70 billion kronor of this was core capital (mainly shareholders' equity and thus the basic capacity to absorb losses). Other capital consists in principle of subordinated debentures. The stock of core capital "melted away" in as short a period as three years. Here it must be noted that these aggregate figures conceal major differences between the banks. But the financial situation has been very strained in general and all the large banks have had to rely on external capital contributions to meet their capital requirement.

Banks are required by law to maintain a capital base (shareholders' equity, reserves and subordinated debentures) that is equivalent to 8 per cent of risk-weighted assets. The loan losses of the banks and the attendant erosion of their capital bases have been covered in various ways and by different groups. To some extent the banks themselves have managed to reduce their capital requirements by means of more efficient capital management. This has mainly taken the form of asset sales and a

shift towards assets, such as government securities, that require less capital cover.

Bank customers, in the first place households, have had to pay for a part of the loan losses in that, for instance, the difference between lending and deposit rates was widened by up to about two percentage points at the beginning of the 1990s. Today this difference is appreciably smaller, which reflects a more stable situation in the banks as well as growing competition. An increase in the interest difference of one percentage point is approximately equivalent for households to two to three billion kronor in increased expenditure/decreased income. Households have also been burdened with an increased interest difference among housing credit institutions. For bank employees the crisis has been very tangible on account of staff reductions and office rationalization.

DIFFERENCE BETWEEN BANK LENDING AND DEPOSIT RATES
Quarterly data



Note. Not fully comparable over time.
Source: Sveriges Riksbank.

The stock market has provided the large bank groups (apart from Nordbanken) with a substantial amount of capital in the form of new

share issues totalling about 13 billion kronor.

It is the State, however, which has contributed the largest share of the capital that was lacking in the banking system as a whole. Virtually all of this support (more than 98 per cent) has gone to two banks. The amounts paid out total about 65 billion kronor. The nature and composition of the State support are summarized in the next section.

7 The support measures

The Bank Support Authority was instituted on 1 May 1993 to handle the State support. In its work on support cases the Authority has undertaken thorough, systematic analyses of institutions applying for support. In addition to financial analyses, the aspects considered have included strategies, efficiency and internal controls. The Authority has also commissioned considerable inputs from consultants. The support measures have been designed so as to keep their utilization to a minimum. The institutions have had to make undertakings to implement operational plans and rationalization.

The support that has been provided is summarized below. More detailed accounts of the support measures have been presented in Government documents (rskr. 1993/94:61, 1993/94:238) and the support has also been described in the context of Budget Bills (prop. 1993/94:100 bil. 8, 1994/95:100 bil. 8).

Specific support measures

Nordbanken

The first State interventions on behalf of the banking system were made in the autumn of 1991 and thus prior to the State undertaking. Greatly increased loan losses had placed Nordbanken in an acute financial crisis and in its capacity as the bank's major owner, the State guaranteed the whole of a new share issue totalling 5.1 billion kronor and also subscribed for 4.2 billion. In the autumn of 1992 this new issue was followed by an additional owner's contribution of 10 billion kronor. In conjunction with this, moreover, the State bought up all the minority shareholdings in the bank for a total of just over 2 billion kronor. In conjunction with the reconstruction of Nordbanken (Bill 1991/92:153) in 1992, non-performing loans and other commitments that were burdening its earnings potential were transferred to Securum AB, which was established for this purpose.

Assets in Nordbanken for a gross figure of 67 billion kronor were taken

over by Securum for 50 billion, which represented their book value in Nordbanken. Securum financed this acquisition in part by means of two State guarantees, which were utilized for a total of 23 billion kronor. The remaining 27 billion was financed with a loan from Nordbanken, of which the State guaranteed 10 billion. On 1 January 1993 the State took over Securum from Nordbanken by acquiring all the shares for 1 billion kronor. Since then, Securum's financing has been changed by appreciably reducing Nordbanken's commitment, which is now to be regarded as a normal business relationship.

Sparbanken Första

Sparbanken Första AB (formerly Första Sparbanken) was already in financing difficulties, like Nordbanken, in the autumn of 1991. In December 1991 the Riksdag therefore approved a State guarantee of 3.8 billion kronor for a loan that was intended to safeguard a reconstruction of the bank (prop. 1991/92:63, bet. 1991/92:NU12, rskr. 1991/92:52). A month or two later this guarantee proved to be inadequate and in March the State guaranteed an additional loan of 3.5 billion kronor (Bill 1991/92:168) and the first guarantee was converted into a subsidized loan. The latter loan was arranged by the National Debt Office and went to the savings bank foundation (Sparkbanksstiftelsen Första), which then transferred the borrowed amount as an unconditional owner's contribution to Sparbanken Första AB. The new guarantee for 3.5 billion kronor concerned a loan that the eleven savings bank foundations arranged and transferred to Sparbanken Första AB.

The support agreement with the savings bank foundations has subsequently been renegotiated because part of the guaranteed commitment was met in June 1993. As the support commitment concerns the bank's owners, the current agreement lies outside the Act on State Support for Banks and Other Credit Institutions (1993:765). The original agreement concerned a total commitment of 6.8 billion kronor to guarantee loans to a company, Sparbanksstiftelsernas Förvaltningsaktiebolag, that is wholly owned by the eleven savings bank foundations and was specifically formed to manage the loans and handle the support agreement with the State. As security for these loans with the State guarantee, the company has pledged to the State its holding of shares in Swedbank (known in Sweden as Sparbanken Sverige AB), which now includes Sparbanken Första AB.

When the support agreement with the savings bank foundations was

renegotiated in March 1994, the remaining interest subsidy on the principal (3.8 billion kronor, maturing at the end of 1999) was expressed as a visible item. This subsidy, which has burdened the Government budget, was calculated to have a present value of just over 1 billion kronor.

The State's guarantee commitment to the management company has been reduced to 3.6 billion kronor in connection with the disposal of the company's shares in Swedbank in May 1995. The receipts from this sale were used to repay a part of the loans guaranteed by the State. Further share sales and loan repayments are to be expected before the support agreement expires at the end of 1998. The State is to receive a regular commercial fee for the guarantee when the loan is repaid.

Gota Bank

In September 1992 the Government issued an undertaking that Gota Bank would be able to meet its commitments on a timely basis. When the parent company, Gota AB, was declared bankrupt in December 1992 all the shares in Gota Bank were taken over by the State. In arbitration proceedings the value of these shares was subsequently found to be nil. In the course of 1993 two guarantees against losses were provided while the bank was reconstructed and prepared for sale. The reconstruction involved transferring the non-performing loans to a new company, Retriva AB, for which the Bank Support Authority provided equity capital for 3.8 billion kronor. In addition, the State guaranteed a debenture loan to Retriva for 3.5 billion kronor. Calculations indicated that 20 billion kronor was lacking in Gota Bank's balance sheet and the State covered this before the non-performing loans were transferred to Retriva. The reconstruction of Gota Bank and the financing of the Retriva group were decided in December 1993 by the Bank Support Authority and subsequently approved by the Government.

After the reconstruction it was decided to sell Gota Bank. In a thorough tendering process in which foreign interests participated, the value of the tenders was compared with what the State stood to gain from a merger between Gota Bank and Nordbanken. Three independent advisors undertook valuations. After renewed tendering it was found that the bids did not match the merger's calculated value. In December 1993 the Bank Support Authority decided to transfer the reconstructed part of Gota Bank to Nordbanken. As the State owned both these banks, the Authority considered that the capitalization of Gota Bank was a matter for

Nordbanken. In this way the transfer of the Gota Bank shares to Nordbanken could be arranged with an owner's contribution without any compensation from Nordbanken. The Government approved the Authority's decision.

In accordance with an earlier decision to privatize Nordbanken on a suitable occasion, in October 1995 the first step was taken with a market offer of 34.5 per cent of the shares in this bank. The price was set at 92 kronor per share. After sales costs and discounts, about 6.4 billion kronor accrued to the Government budget from the sale.

Föreningsbanken

In addition to the measures mentioned above, support has been provided for Föreningsbanken in the form of a temporary safeguard for its capital ratio in the period 1994-96 in the event of unforeseen large loan losses on the bank's existing commitments. This safeguard paved the way for a new share issue. The support is available if the capital ratio of the bank falls below 9 per cent. The maximum capital contribution from the State is 2.5 billion kronor, for which the State receives the equivalent in preference shares. This support has not given rise to any payments. The support agreement, concluded in November 1993, can be dissolved if the bank during a certain period is able to report a satisfactory capital ratio.

Banks that recalled support applications

In December 1992 Skandinaviska Enskilda Banken notified a probable need of State support and an application was submitted to the Bank Support Authority in February 1993. After discussions with the Authority, the bank later announced that its capital base would be strengthened by issuing new shares. The bank withdrew its application in August 1993.

Swedbank (Sparbanken Sverige) likewise submitted a formal support application to the Bank Support Authority in February 1993 but withdrew it in November that year. In connection with the withdrawal the bank announced plans to direct a new share issue to a few institutions, followed one year later by a stock exchange listing. The new issue was carried out in March 1994 and the bank was listed on the Stockholm Exchange in June 1995.

The items of State support during the bank crisis are summarized in the following table.

State bank support
SEK million

	Total commitment	Paid out	Carried on the Budget
Savings bank foundations			
guarantee	3 250	0	0
interest subsidies	1 028	1 028	1 028
Total	**4 278**	**1 028**	**1 028**
Nordbanken			
share subscription 1991	4 191	4 191	4 191
share purchase 1992	2 055	2 055	2 055
capital contribution 1992	10 000	10 000	10 000
Total	**16 246**	**16 246**	**16 246**
Securum			
guarantee 1 1992	9 850	9 850	9 850
guarantee 2 1992	13 150	13 150	13 150
share purchase 1993	1 000	1 000	0
guarantee 1993	10 000	0	0
Total	**34 000**	**24 000**	**23 000**
Gota Bank			
capital contribution 1993	20 000	20 000	20 000
guarantee on shareholders' capital	231	231	231
Total	**20 231**	**20 231**	**20 231**
Retriva			
capital contribution 1993	3 800	3 800	0
guarantee 1993	3 500	0	0
Total	**7 300**	**3 800**	**0**
Föreningsbanken			
capital ratio safeguard 1993	2 500	0	0
Total	**2 500**	**0**	**0**
TOTAL BANK SUPPORT	**84 555**	**65 305**	**60 505**

The amounts paid out in bank support accordingly total just over 65 billion kronor. The total carried on the Government budget is about 5 billion kronor less than this because the capital inputs in Securum and Retriva have been financed in part with loans from the National Debt Office. Almost 19 billion kronor of the total undertaking for bank support consists of guarantees provided by the State as part of the reconstruction of institutions obtaining support.

The Bank Support Authority's activities

Besides handling the State undertaking and support cases, the Bank Support Authority has managed the State's ownership in Nordbanken, Securum and Retriva. In practice, the Authority completed all the support cases in the course of fiscal 1993/94. Its work now mainly involves handling issues to do with ownership in the institutions. Expenditure arising from handling support activities is debited to institutions that are entitled to support. The regulations for this are contained in the Ordinance (1994:890) on State Support for Banks and Other Credit Institutions as well as in the regulations for the Bank Support Authority.

The State is still incurring income and expenditure for bank support. In fiscal 1994/95 guarantee fees yielded 65 million kronor, while 1 billion was received in dividends from Nordbanken for the 1994 accounting year. In connection with the recent initial sale of Nordbanken shares, the State obtained an extra dividend of 2 billion kronor. The sale of 34.5 per cent of the shares yielded 6.4 billion kronor, net. The main current expenditure item is about 350 million kronor a year in interest on loans that the Bank Support Authority has obtained from the National Debt Office for the financing of Retriva and the purchase of Securum.

Overview

To sum up the State inputs, particular support measures have concerned four banks, of which two, Nordbanken and Gota Bank, have obtained more than 98 per cent of the total amount paid out. Indirectly, however, the State undertaking has concerned every institution by having a general stabilizing influence on the ongoing international financing as well as on the possibility of raising new risk capital in the market. The latter has no doubt been crucial for enabling many institutions to operate without any or only limited State support. It can also be noted that the situation has

been so uncertain for two banks that they submitted formal support applications but were subsequently able to withdraw them. This indicates that at the time the market evidently needed a broad State undertaking.

The capital contributions have gone very largely to banks and companies that the State owns today but which are to be sold. Via Nordbanken, in 1994 and 1995 the companies have generated a considerable income - Nordbanken has paid a total of about 3.6 billion kronor in dividends to the State. Moreover, the initial sale of 34.5 per cent of the shares in Nordbanken yielded about 6.4 billion kronor, net. Thus, the net figure for expenditure on the bank support amounts at present to about 55 billion kronor. The counterpart to this is substantial assets that are still owned by the State. The State's remaining holding of Nordbanken shares is equivalent to about 10 billion kronor, calculated on the basis of shareholders' equity (the market value is higher). Securum and Retriva have 12 billion and 4 billion kronor, respectively, in equity capital. A very considerable reduction of the aggregate net expenditure on bank support will be feasible via the disposal of these State assets.

A quantification of the general economic costs is, of course, very difficult. The bank crisis constitutes one aspect of an economic crisis in which a collapse of the real-estate market and a general fall in asset prices were central features. It is hardly possible to separate the various factors and their effects. In banking the extent of the effects has left its mark on lending and interest rates and thereby on the economy in general. Moreover, the acute bank crisis and the State's rescue work may have had psychological consequences which reinforced the changes that the economic crisis elicited in consumption, investment and saving behaviour.

At the same time, the critical situation for the banks and their problems with financing abroad clearly posed potential economic costs and risks that were very much greater. Had the bank crisis become more uncontrolled, then public confidence in the payment system would have been seriously weakened, with unpredictable social consequences. The support has fulfilled its primary function of maintaining the payment system's stability and providing the banking system with a respite and conditions for its necessary recapitalization and structural adjustment. The support measures have also played an essential part in rectifying the instability that prevailed in much of the real-estate market.

The structural effects of the support and the crisis naturally vary in kind and degree. Only some of the more visible institutional changes will be mentioned here. In the first place the support has entailed the acquisition

by Nordbanken of a medium-sized bank, Gota Bank. It is envisaged that this can yield structural gains which promote a more cost-effective credit market.

To this should be added considerable changes in structure and ownership in the two major categories of bank that have been involved in support agreements: the savings bank group and the cooperative bank group. Since their form of association has been changed to that of a limited company, the tendency has been to increase the element of external ownership. The crisis has also compelled all banks to make substantial structural adjustments in the volume of their non-performing real-estate loans. These loans have been entirely or partly transformed into real-estate assets and transferred to separate subsidiaries or liquidation companies. In this context a complete legal separation from the former parent bank has been arranged in the case of the two State-owned companies, Securum and Retriva. In a number of cases the real-estate assets held in the companies and by the banks are very large, on a par with holdings in large property companies.

Another institutional tendency that has no doubt been accentuated in the wake of the crisis for the established banks is the emergence of new niche banks. This has rendered the structure of Swedish banking more heterogeneous, with a greater degree of competition.

8 The banking system's recovery

This section presents the economic and financial recovery and stabilization that have occurred in recent years in the Swedish banking system. The material for the account includes the report on the economic and financial situation of the institutions that the Financial Supervisory Authority submitted to the Government in November 1995. The Authority's analysis covers the period up to the autumn of 1995. On the basis of the findings and perceived trends the Authority has also assessed the outlook in the coming year. The authority´s own material and experience has been supplemented with the institutions' own assessments of the current and future economic situation. Other external observers have also been consulted. The institutions, moreover, have been asked for their view of an end to the State support.

In its assessments the Financial Supervisory Authority has paid particular attention to a number of key figures, such as problem commitments, loan losses, operating performance and capital adequacy. Additional information has been obtained in those cases where the analyses of particular institutions have revealed persistent uncertainty or doubt. In addition, a general sensitivity analysis has been made with respect to the overall development of interest rates and the real-estate market.

The bank sector as a whole

Given the 1994 annual accounts and the semiannual reports for 1995, it can be noted that in the past two to three years the banking system has undergone a radical financial and economic rehabilitation. The combined operating result for five large bank groups was transformed from a record loss of 50 billion kronor in 1992 to a profit of 12 billion for 1994. The recovery reflects the combination of a maintained earnings potential and a steady reduction of loan losses. The favourable tendency applies in general to all bank groups, though to a varying degree. A majority showed an annual profit for 1994 and all groups did so for the first six

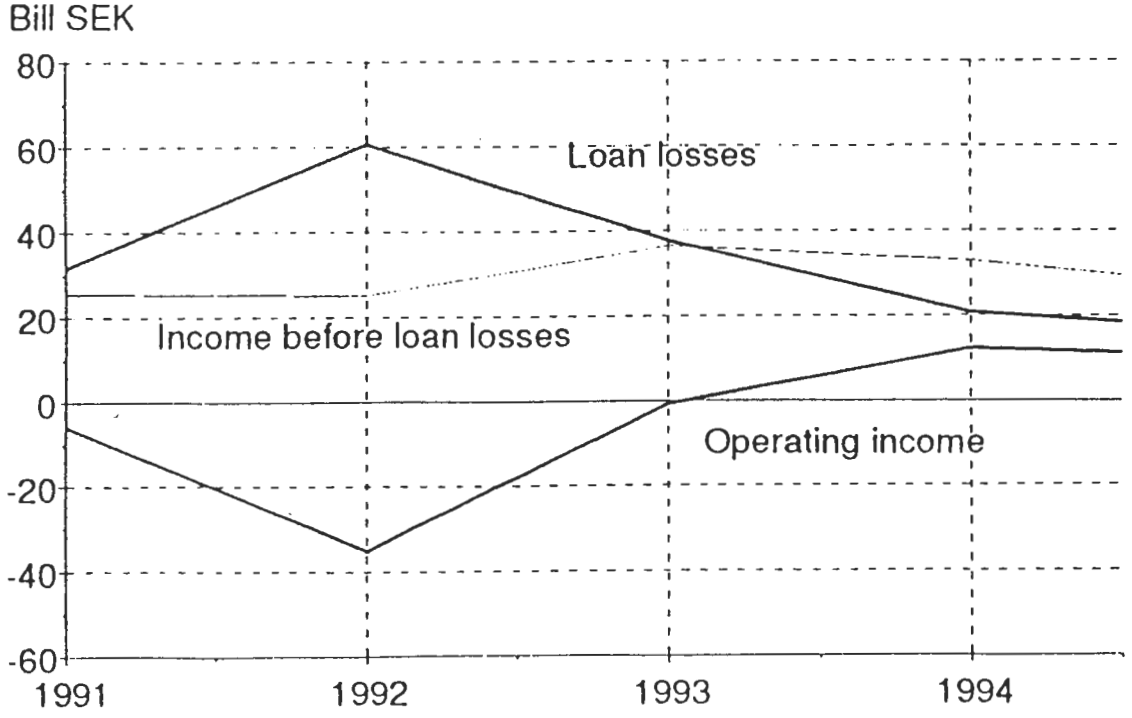
months of 1995. The recovery has slackened during 1995, mainly because loan losses are being reduced at a diminishing rate, credit demand is still weak and competition is growing.

The weak lending trend has conferred good liquidity, which to a growing extent has been invested mainly in treasury paper and certificates. Another trend is the marked reduction of lending in foreign currencies, from around 50 per cent of the total balance at the end of 1991 to about 39 per cent at mid-1995.

Strong earnings

In general it can be said that the banking system as a whole has managed to maintain strong earnings in the 1990s even though the stock of problem loans has weakened net interest earnings. A wider difference between lending and deposit rates has partly countered the latter effect. But it is mainly other sources of income, such as dealing in securities and foreign exchange, that have been very strong at times, as have various categories of commissioned services. In addition, vigorous rationalization of offices and staff has restrained costs compared with earlier periods.

BANK GROUPS' RESULTS
12-month figures



A record result in 1993, when falling interest rates also yielded sizable capital gains on the banks' securities portfolios, was followed by some fall in aggregate earnings in 1994 and some decline is also reported for the first half of 1995. The tendency is partly explained by increased competition and more compressed interest margins but also by calmer trade in securities and foreign exchange.

As regards costs it can be noted that comparatively heavy rationalization led to appreciably lower costs in 1993. For 1994 and the first half of 1995 the picture is more varied and the aggregate level of costs shows a small increase, partly due to increased efforts in the Nordic countries and in internal telephone banks. After the deterioration in the early 1990s, the bank sector's total income/cost ratio has been strengthened.

Diminishing loan losses

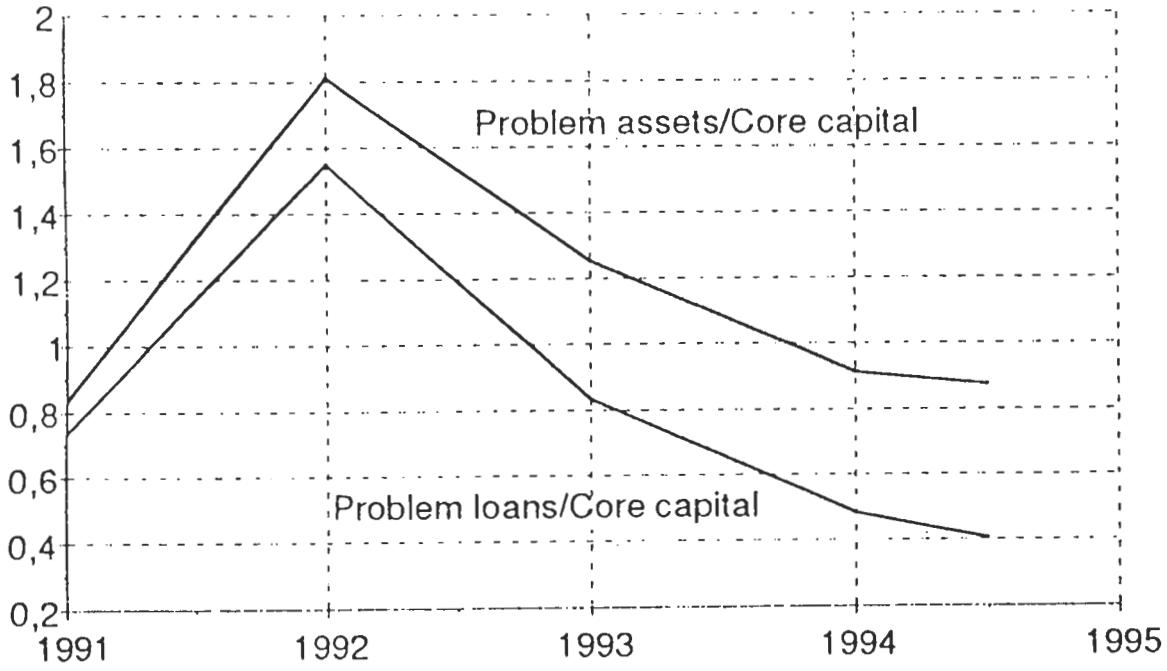
After the disastrous development in 1992, loan losses have fallen markedly. They were more or less halved in both 1993 and 1994, which brought the aggregate absolute figure down to the level from 1990. The downward trend continued at a slower rate in the first half of 1995. In relation to loan portfolios, the level of bank group losses has been reduced to 1 per cent, which is still somewhat above the level of less than one-half of one per cent that was generally prevalent earlier.

The reduction of loan losses reflects the property market's stabilization after the sharp price fall in 1990-92 as well as the general economic recovery. There has been no general "third wave" of mass losses on lending to households, which could not be ruled out earlier in the crisis. New incurred losses stem to a large extent from recognized problem commitments for which provision had already been made. Although there are exceptions, the losses are thus largely not "new".

The positive trend also applies to non-performing loans (loans on which no interest and/or principal has been paid for 60 days and loans on which interest has been reduced). The stock of non-performing loans, net of provisions for losses, has decreased from over 8 to 3 per cent of loan portfolios. This is important for net interest earnings because it reduces the cost of financing non-performing loans. It should be added, however, that, in order to protect claims, the banks have converted large amounts in non-performing loans into real-estate assets (about 35 billion kronor) which the banks have taken over. The aggregate level of problem assets in relation to the balance-sheet total has also fallen back, though not to

the same extent. In relation to core capital the level has been halved since 1992. The assets are to be incorporated at market values, which means that, ideally, they do not carry any risk of losses. For some types of property, however, altered conditions can make a true market appraisal difficult. The assets have mainly been placed in separate management companies. In order to facilitate a disposal of the real-estate holdings the Government recently presented a bill (prop. 1995/96:104) whereby the banks are enabled to distribute earnings in the form of shares in a subsidiary without this having tax consequences.

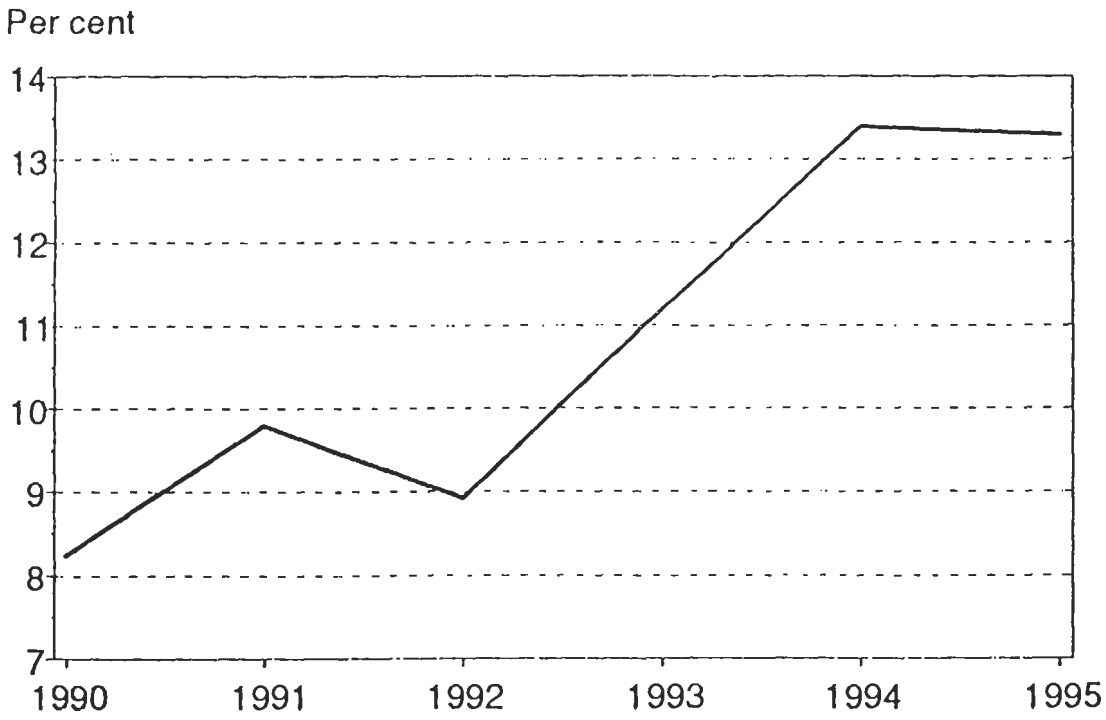
PROBLEM LOANS AND PROBLEM ASSETS
Bank groups



Stronger capital adequacy
The capital ratio is a central item in an appraisal of the banking system's recovery and resilience to future losses. As reported in earlier sections, appreciable improvements have been achieved in this respect with a combination of State capital contributions, owner contributions and internal capital enhancement. In 1994 the overall operating profit contributed to a continued reinforcement of the capital base. A stable consolidation is confirmed by the picture for the first half of 1995.

At mid-1995 the total capital ratios of the large groups averaged just over 13 per cent, of which more than 8 per cent consisted of core capital. The ratios for the parent banks are about two percentage points higher. The overall ratio for the independent savings banks was somewhat higher again. Compared with the statutory standard of 8 per cent, the levels that have been reached should be considered satisfactory. International comparisons show that capital adequacy in the Swedish banking system is now good and one of the highest in the G10 group of countries.

CAPITAL RATIO
Bank groups, per cent



Note: half year 1995

Stable financing

Besides the prospect for profits and capital adequacy, an essential aspect of the banking system's stability is the state of financing. A major consideration that precipitated the introduction of the State guarantee in the autumn of 1992 was the vulnerable financing position of the banks and housing institutions. Conditions for borrowing abroad had been favourable for some time and the institutions were heavily dependent on borrowing in the domestic and external interbank markets. At the end of August 1992 total bank lending to the non-bank public exceeded deposits

from this sector by 230 billion kronor. The whole of the imbalance was in foreign currencies. Borrowing in the foreign interbank market totalled 350 billion kronor. When the credit facilities of Swedish institutions in foreign banks were cut back in the autumn of 1992, borrowing costs rose. In order to facilitate business financing abroad via banks, the Riksbank decided to place foreign currency deposits in the banks for the equivalent of almost 60 billion kronor.

Today the financing situation is entirely different. At 30 September 1995 the banks had an aggregate deposit surplus of 36 billion kronor and their lending surplus in foreign currency had been reduced to 84 billion. Borrowing by the Swedish banks in the foreign interbank market as of 30 September 1995 totalled 373 billion kronor, which was somewhat higher than three years earlier, but lending by the Swedish institutions to foreign banks had risen in this period from 109 billion kronor to 181 billion. Their net dependence on the foreign interbank market had therefore decreased by 42 billion kronor. Borrowing costs for Swedish banks do not differ from those of continental banks and the financing structure of the Swedish banks is now more robust than at the time of the crisis. The stronger financing position renders the banks considerably less vulnerable than before.

While the financing situation in the housing credit institutions has been generally less vulnerable on account of longer maturities, a clear improvement is also evident here. The loan stock is falling. Financing has been facilitated, moreover, by periods of high investment by the non-bank public in private bonds. Financing abroad makes up about 15 per cent of the total.

Institutional categories

The *large commercial bank groups* (Nordbanken, Svenska Handelsbanken, Skandinaviska Enskilda Banken, Swedbank, Föreningsbanken) all reported an operating profit for the first half of 1995, though as mentioned earlier the size of this differed greatly. The groups have also continued to improve their performance during 1995 with the exception of Skandinaviska Enskilda Banken, which reported provisions for large losses in the Luxonen commitment. For all the parent banks the economic situation can be considered stable.

Föreningsbanken is in a special situation in that it has a support agreement with the Bank Support Authority. The agreement guarantees a capital ratio of at least 9 per cent through 1996 but it can be terminated if the bank in the meantime is able to show a sufficiently high capital ratio. The matter of ending the agreement has not been raised. A termination would presumably be preceded by a thorough analysis of the banks' problem assets, etc. The particular structure of this bank's business has rendered the recovery less marked than for other groups. The loan losses also culminated later. From 1993 onwards, however, the result has improved continuously, with a steady fall in loan losses. An operating profit has been reported for the first half of 1995.

In the case of housing credit institutions, most of which belong to the large bank groups, the loan losses, which occurred later and were considerably less extensive than for the banks, turned downwards in 1994. These institutions have had a combined operating profit in every year. The profit was increased in 1994 and some reinforcement was also noted for the first half of 1995. The earnings potential is good and the income/cost ratio has steadily improved in recent years.

A general problem for the housing institutions is their loans to relatively new tenant-owned housing associations whose properties were built when construction costs were high in the late 1980s and early 90s. Decreased interest subsidies and a rising level of vacancies have hit these associations comparatively heavily. They account for a substantial share of the institutions' non-performing loans. Loan losses in this segment can be expected to continue in the years ahead but in relation to total lending the figures are not of a magnitude that would threaten the institutions' stability.

SBAB, the State-owned institution, is undergoing a reconstruction that the Riksdag approved in 1995. The portfolio of loans, with large potential losses, that were provided under the central government rule system which was in force up to the end of 1991, is being transferred to a separate State-owned company, Venantius, with the task of managing the loan stock to maturity on the best possible terms for the State. This has given SBAB stable conditions for concentrating on a commercial, sound loan stock in free competition with other institutions.

Smaller commercial banks is a category that includes established institutions as well as a number of relatively new banks. The category also includes some foreign-owned Swedish subsidiaries. Like the large banks, this category's operating performance has shown a positive trend

in recent years, with a profit since 1994. All of the smallest banks have shown a high capital ratio.

A characteristic feature of the new banks is a narrow range, focused on households, and a reliance on low-cost distribution without the traditional branch network. Market shares are still small; none of these banks has more than 1 per cent of lending. These banks have been operating for a very short time and their long-term profitability is difficult to assess but they must be considered to be completely stable.

Independent savings banks, of which there are about 90, range from medium-sized to very small institutions. The general picture here shows satisfactory stability and good capital ratios. The improvement in performance in the past year among the large and medium-sized banks has been stronger in general than for the small institutions. About ten banks have been identified by the Financial Supervisory Authority as somewhat weaker, with generally poorer key figures. But the problems are not considered to constitute a threat to these banks' stability. In the longer run, however, stronger earnings are said to be necessary for attaining a competitive profit level. One of the larger savings banks, Borås Sparbank, has incurred substantial loan losses even in recent years. As a solution to this bank's capitalization, it is being transformed into a limited company, with a capital contribution from Swedbank as an important minority owner.

For a number of the smallest savings banks (balance-sheet turnover less than 100 million kronor) the recovery has been more sluggish. In some cases there is the prospect of performance remaining relatively weak on account of decreased lending and narrower interest margins. The analysis by the Financial Supervisory Authority shows that although acute problems are not foreseen, in the longer run a better earnings capacity is needed. The structure of the savings bank sector has changed substantially in the past decade. Further adjustments among the independent savings banks are to be expected in future. This autumn, for instance, one of the smaller savings banks launched an initiative to merge with a neighbouring bank. This is a normal feature of a process whereby the savings bank sector becomes more concentrated and profitable. It is envisaged that, as in the past, this can continue to be handled by the institutions themselves.

The *institutions for business finance* are credit institutions with State affiliations (Sveriges Allmänna Hypoteksbank, Svenska Skeppshypotekskassan, AB Svensk Exportkredit, AB Industrikredit and Lantbrukskredit AB). These institutions, which differ in kind and assignments, show a

positive development over time, with generally satisfactory key statistics.

The situation for one of these institutions, Industrikredit AB, is in some respects less satisfactory. Half-owned by the State and otherwise by the commercial banks, the task of this company is to supply small and medium-sized firms with medium and long-term loans. Loan losses during the crisis have been substantial, mainly on loans to the real-estate market. The loan stock has been halved since the beginning of the 1990s. A notable recovery has been achieved in recent years and for the first half of 1995 the operating loss was marginal. But the proportion of problem loans is still relatively high.

The structure of ownership in this institution is not appropriate and the Government has therefore initiated changes to render ownership more stable and thereby achieve better and more reliable conditions for operations. The State and other owners have commenced discussions on altering the structure of ownership.

In conclusion it can be stated that the financial situation in the various categories of institutions has stabilised. The review of particular institutions by the Financial Supervisory Authority shows that, despite a recovery, a couple of institutions still face problems, with some uncertainty about the degree of stability. In these cases, however, changes have been initiated, primarily in ownership, with a view to creating stable operating conditions.

9 Conditions for ending the undertaking

The undertaking is temporary

The undertaking by the Kingdom of Sweden to guarantee that banks and certain other credit institutions can meet their commitments on a timely basis is exceedingly far-reaching. The measure was necessary, however, in the highly uncertain and critical situation that emerged in the autumn of 1992. The stability of the payment system and an efficient supply of credit are central functions in the economy. Serious disturbances in these respects jeopardize very considerable economic and social assets. It is a state's responsibility to ensure that stability and confidence in these fields are safeguarded.

Such an extensive undertaking, however, cannot be in force for a lengthy period without risking long-term negative effects on the function and efficiency of financial markets. Competitive conditions must be generally perceived as fair and sound, nationally as well as internationally. There is also an inevitable risk that, if the undertaking is perceived as permanent, agents will adapt their behaviour in various respects in ways that ultimately encourage risk-taking and inhibit efficiency and competitiveness. The occurrence of such effects is always difficult to demonstrate but countering them is no less important for that.

These are strong reasons behind the Riksdag's decision to make the undertaking temporary. The present support system is not compatible with a normal situation in the credit market. Thus the issue is not whether the undertaking is to be terminated but when this can be done without jeopardizing the rights of the creditors.

The possibility of a partial end to the undertaking has been discussed in various contexts, for instance by making it inapplicable to new establishments in the market or to new commitments. Besides the demarcation difficulties that such measures would encounter, the nature of the undertaking is such that it will have to be terminated all at once from a particular date. It was instituted from a specific date when the stability of the payment system could be guaranteed only by a State

commitment that covered all outstanding claims. Consequently, when the system's stability has been restored, the undertaking should cease to be in force from a specific date for all outstanding claims.

An assessment of whether the economic conditions for ending the undertaking, including the general economic picture, can be said to exist is presented below. Consideration is also paid to the supervisory situation and to certain regulatory matters.

Conditions for credit institutions

The above review of the economic and financial situation of the institutions has shown that the Swedish credit market has reacquired good financial stability. This is generally true of each of the institutional categories as well as of the different size groups. In a number of cases the Financial Supervisory Authority has identified remaining problems but these are considered to be manageable in the light of the consolidation and earnings potential that have been achieved. In the case of two companies, Borås Sparbank and Industrikredit AB, changes in ownership have been considered necessary to create conditions for continued stability. Various measures have been taken here during the autumn with a view to eliminating the problems.

The Authority's analysis demonstrates a general increase in competitive pressure and narrower margins. At the same time, the downward trend in loan losses has remained stable even though interest rates have fallen back more slowly than many had expected. The trend is expected to continue even though the losses in the real-estate market have not yet ceased entirely. The more pronounced interest rate fall this autumn is also strengthening the property market and reducing the risk of further large loan losses.

The level of problem loans is still relatively high in some institutions but a successive increase in provisions should limit the consequences of further actual losses. Under these circumstances there is a good prospect of maintaining operating results, though of course the outlook varies between the institutions. As a buffer for any unforeseen losses, moreover, capital cover in the banking system is strong.

The stable international financing shows that foreign investors have confidence in the Swedish institutions. In the current situation the rating institutions generally consider that the State support is of no major consequence for creditworthiness. The temporary nature of the support

has been discounted. Independently of the support, the banks' ratings differ somewhat on account of such factors as the quality of loan portfolios, earnings potential and capital adequacy.

When the undertaking ends it can be said in general that ratings will also undergo a formal normalisation from the earlier, partly artificial basis. Even if a termination has already been discounted, it is likely to attract attention. There may be some downratings, partly as an expression of short-run psychological reactions. This should be seen as a natural feature of a normalisation and does not threaten the financing facilities of the banks and housing institutions.

Overall, the analysis shows that operations have normalised. This is confirmed by the fact that, when asked by the Authority, virtually all the institutions considered that the time had now come to end the State support without jeopardising creditors. A normalisation does not preclude ongoing structural adjustments. Future profitability will depend increasingly on cost effectiveness. But that is a different problem from those which the banking system has now overcome.

The Authority's analysis also includes a general assessment of how sensitive institutions are to an unfavourable development in interest rates or in the real-estate market. In many cases an assessment of this type is difficult, for instance because of various ways of accommodating such a development. The generally good performance of the banks during 1994 despite the upward movement in bond rates shows that such ways exist. Still, an account of the problems does show that, on the whole, it should be possible for operating performance to absorb the negative consequences of, say, a general increase in interest rates. Capital adequacy would not be at risk. This conclusion refers to the situation at mid 1995. Since then, bond rates have fallen by well over one percentage point. The banks should therefore be in a position to weather a correspondingly larger interest rate increase. At the same time, the Authority notes that the banks in general are likely to be more sensitive than before to interest rate increases on account of their large bond portfolios and real-estate assets. Even a deterioration in the real-estate market, with a need for additional writedowns, is considered to be manageable with the prevailing level of operating results.

General economic conditions

The bank support was introduced at a time when the national economy was exposed to exceptional disturbances. There were clear signs of deflation, with sharply falling asset prices, a steeply rising real interest rate and a rapid increase in unemployment. Uncertainty and anxiety about the future were greater than ever before in the postwar period. Households and firms were compelled to give restraint and debt consolidation priority. In this generally weak and insecure economic situation it was highly important that the authorities shouldered the responsibly for safeguarding the payment system's stability. A series of bank failures would have had dramatic effects on the economy.

Today in important respects the economic situation is completely different. Stronger activity has elicited a rapid increase in industrial production, with strongly rising exports and investment as well as much improved profits. Positive tendencies are also evident in some service sectors. But construction activity is weak. Moreover, private consumption is restrained as a result of persistently high saving and substantial fiscal restrictions, though some upward tendency has been seen recently. Inflation has been low and stable for a number of years. GDP growth in 1994 was above 2 per cent and for 1995 is calculated to rise to 3.5 per cent. In the Growth Bill (1995/96:25) the Government foresees a continuation of good growth in the medium term and rising employment.

The economic recovery has not yet resulted in any general increase in credit demand. Firms and households have consolidated their balance sheets. Good profits have permitted a high degree of internal financing in manufacturing. Households have maintained un unusually high level of financial saving in the 1990s. Credit demand should pick up in time, probably starting in parts of the business sector. This is indicated, for instance, by the planned expansion of real capital formation.

Growth that is underpinned to an increasing extent by an expansion of credit has also been held back by high interest rates. Conditions for lower rates have been created, however, with the far-reaching programme for consolidating government finance. Interest rates have in fact fallen substantially since the spring. This has been accompanied by a notable appreciation of the krona. The tendencies indicate increased confidence in Sweden's economy and currency.

Compared with the beginning of the 1990s, the real economic situation is thus appreciably more stable. An expanding economy should provide

a foundation not only for increased credit demand but also for more stable asset prices and loan collateral.

Since the bank crisis stemmed in large measure from widespread failures in real estate and the banks now have large property holdings, the situation in the real-estate market is highly important. The recoil in commercial property prices in the early 1990s was dramatic; as mentioned above, property prices in city centres dropped more than 50 per cent. This had been preceded by a correspondingly steep price rise in the second half of the 1980s. Rents in the best localities followed a similar, though less pronounced, pattern. The changes in the housing market have likewise been largely similar but generally less dramatic.

A complete picture of the present market situation and the outlook cannot be derived from the statistics and we have limited historical experience of large price falls. A general conclusion, however, is that the very bleak situation associated with the downward price trend gave way about a year ago to greater stability. The upward tendency in prices and rents for commercial properties has been clearest in metropolitan centres, where vacancy ratios have fallen and renting activity has picked up appreciably.

The situation for residential properties also seems to be more stable than it was some years ago. Some price increases have been noted for apartment buildings and owner-occupied houses since 1994. The better economic situation and employment lie behind this. As mentioned earlier, the feared third wave of loan losses connected with house mortgages has not occurred. As pointed out above, financial problems in the housing market are greatest for certain categories of tenant-owned housing associations with properties constructed in the late 1980s and early 1990s. These properties, however, add up to only a limited share of the market.

Thus, although the recovery is still only partial and generally weak, it does represent a stronger economic foundation for the banks' real-estate commitments as a whole. The real-estate market is more balanced, with property prices that are more appropriate for the longer run, than a couple of years ago. But this more stable frame does include some persistent problems. A number of the problems have been clearly identified and are limited in relation to the institutions' overall situation. The bank groups' large holdings of commercial real estate are another, new element of a more structural nature, for the banks as well as for the real-estate market. A disposal of these holdings can be arranged in various ways and the time required for this differs. As mentioned above, the Government has

proposed measures to facilitate disposals by means of fission. Moreover, the recent fall in interest rates implies less risk of a need for further writedowns. All in all, the problems with the bank's real-estate assets must be regarded as manageable.

A conclusion from this review of the situation in credit institutions and in the national economy is that the economic conditions are now at hand for ending the bank support. There is no threat to the financial system and the rights of creditors are not at risk.

Regulation and supervision

The Swedish bank crisis makes it necessary to scrutinize the supervision of credit institutions as well as certain aspects of the regulations that apply to these as well as to the supervisor. The focus here is on the efficiency and direction of supervision and on the institutions' internal management and controls. Apart from the responsibility of the authorities, experience shows that the institutions themselves must be more responsible for enhancing the reliability of their operations. The scrutiny of institutions applying for support during the crisis revealed considerable shortcomings in the banks' systems for management, information and control.

In the domain of authorities the Financial Supervisory Authority now has a more function-oriented organization in which increased weight is attached to improving competence in risk management. One purpose is to tighten the requirements for the institutions' internal management and control of important risks. In the wake of the crisis it was found that in many cases normal prudential principles in traditional lending had been disregarded. Today the management of other risks is in focus internationally, in the first place trade in derivatives. The same applies in Sweden. Here, too, considerable supervisory inputs will be needed in the coming years to ensure that the institutions attain adequate competence and risk management. Another priority concerns stricter rules for the valuation and accounting of different types of asset. An important supervisory experience is that a larger number of on-site inspections is needed.

Experience has also revealed shortcomings in the rule system for the institutions' operations and in important aspects of supervisory conditions. In the spring of 1995 the Government therefore appointed the Committee on Banking Legislation (Dir. 1995:86) with terms of reference that

include appropriate rules for risk management, internal controls and decision-making in the institutions. The Committee is also to analyze the supervisory guidelines, consider the role of auditors and the need of new rules for sanctions. The concept of negligent lending is also to be examined, as are the conditions underlying liability for damages. Another field of major importance is the need of specific rules for situations in which a particular institution is in financial difficulties. The Committee is to complete its work before the end of 1996.

The work of enhancing financial market reliability must be undertaken in cooperation between authorities, institutions and other market agents. It should be noted that much of this work occurs in the context of EU cooperation and in various international organisations. With the insights in recent years and the measures that are being implemented, however, the authorities are now better equipped than before to promote increased security.

A Swedish deposit guarantee

For most of the postwar period up to the mid 1980s, conditions for the Swedish banking system were stable and strictly regulated. Economic development was also stable. As a result, the question of a special arrangement to guarantee bank deposits did not arise. Deposits by the non-bank public were regarded as completely secure. For various reasons, however, such guarantee systems were introduced in other countries where matters had been partly otherwise.

In the light of the Swedish bank crisis as well as the freer structure and increased competition that are now on their way, there are good reasons for also introducing a system in Sweden that permanently strengthens consumer protection when the temporary State undertaking has ended. Individuals are to be assured of protection for their bank deposits whereby the occurrence of a crisis in a bank does not jeopardize the amount deposited up to a reasonable level. Another and more binding reason for the introduction of a deposit guarantee system in Sweden is that this matter is regulated in a EU directive.

The Government has submitted a bill (prop. 1995/96:60) on a Swedish deposit guarantee system that is to be introduced at the turn of 1995. The system is to be financed by the banks and constitute a guarantee that bank account deposits up to a level of 250,000 kronor per person and bank will

not be lost in the event of a bankruptcy. The primary purpose of the guarantee is to provide clearly-defined and reliable consumer protection. To some extent such a guarantee can also help to reduce systemic risks by diminishing the probability of a run on a bank in response to rumours and the like.

Role of the State in future bank crises

The temporary State undertaking is an illustration that the State is ultimately responsible for the payment system's stability. This responsibility is a consequence of the central economic functions of the payment system and the costs that may ensue if the system is seriously damaged and public confidence cannot be sustained. The financial crisis among the banks at the beginning of the 1990s was so profound and widespread, besides occurring in such an uncertain economic situation, that it bore the marks of a systemic crisis. The potential damage that a bank failure would inflict on the payment system and thereby on the economy was judged to be exceedingly great.

Under less exceptional general economic conditions it is not to be assumed that the State would rescue individual banks from bankruptcy or otherwise compensate their creditors. It is only when the stability of the payment system is seriously threatened that the State has a particular responsibility to take necessary measures of a more discretionary nature. An appraisal has to be made from case to case.

Under other circumstances that do not constitute a systemic crisis, the essential protection from a bank crisis should be provided instead by distinct consumer protection in the form of a deposit guarantee that the banks are responsible for financing.

As indicated in Section 5, the legislation concerning State intervention in a particular institution in a crisis is tied to the present State undertaking. An end to the undertaking also terminates this supplementary legislation. There is therefore reason to take a closer look at the statutory powers which the authorities should have to intervene in institutions that are in the process of seriously weakening their financial situation and accordingly liable to fail. The issues here are the possibility of correcting an unsound development in time and being able, when absolutely necessary, to take over an activity in order to reconstruct it.

One of the main arguments for this is that early intervention by the

authorities may be the most cost-effective way for society and its taxpayers to weather a crisis. Should the authorities wish to be in a position to obtain control of an institution, it is relevant, for instance, to consider tasks and powers that can be included in the coming system for guaranteeing deposits. There are examples abroad where corresponding guarantee systems can also be used in such contexts.

The above issues are included, as mentioned earlier, in the terms of reference for the committee that was recently appointed to consider amendments to the rules that govern the operations of credit institutions.

10 Legal issues

On 8 June 1995 Mr. Johan Munck, Justice of the Supreme Court, was instructed to investigate the legal conditions for ending the State bank support. In August 1995 he reported back in a memorandum, "Some legal issues connected with an end to the bank support".

Mr. Munck's memorandum deals first with the Riksdag's statements, in connection with the introduction of the State guarantee in 1992, to the effect that the State undertaking was to continue as long as it is needed and that a termination was to be arranged without jeopardizing the rights of the creditors. Mr. Munck finds that the State is not legally bound by these pronouncements, which pertained not to civil but to public law and had no specific addressees.

He notes, however, that the State can be presumed to consider that commitments arising from a reasonable interpretation of the Riksdag's decision are to be met irrespective of private individuals having no right to present claims in a court of law. The interpretation of the Riksdag's statements that immediately comes to mind is considered by Mr. Munck to be that, in connection with an end to the undertaking, the State's support undertaking will cease to apply, not only as regards commitments arising after the termination but also to claims existing at the time of the termination. The State has undertaken, in connection with a termination, to ensure that banks and other credit institutions can be presumed to have the capacity to meet existing claims on a timely basis and, if this is judged to be uncertain with respect to one or a few credit institutions, to make special arrangements in those cases.

Thus, if the Riksdag were to end the guarantee without the stipulated conditions being in place, it could not be claimed that this is unconstitutional; but in Mr. Munck's opinion a pledge of this nature to the market obviously could not be broken without serious consequences for future credibility in similar contexts.

The memorandum then considers the letters of comfort issued by the State in certain cases when banks and other credit institutions have issued bonds and certificates or concluded swap agreements and other commit-

ments. Mr. Munck cannot rule out that, by issuing a letter of comfort the State is to be considered to have undertaken, vis-a-vis the addressees, to honour the Riksdag's statements - at least as regards what is reproduced in the letter - concerning the terms for ending the bank support undertaking.

As regards the conditions under which such a conceivable undertaking might entail a liability for compensation, Mr. Munck considers that a reasonable position for the State is the same as indicated above concerning liability for statements connected with the bank support's introduction. Any State liability to the letter of comfort's addressees would thus be restricted to an obligation, in connection with an end to the support, to ensure that banks and other credit institutions can be reasonably presumed to have the capacity to meet existing claims and, if this is not the case for one or a few credit institutions, to make special arrangements for such cases. Only if the State were to be found wanting in these respects would there be a conceivable liability for compensation.

As the bank support undertaking has only covered the meeting of commitments on a timely basis, it is considered in the memorandum that the State in principle has no responsibility for any immediate loss of value that might occur in connection with an end to the undertaking. Neither need the State accept responsibility in the event of a credit institution being obliged to suspend payments because of developments that could not be foreseen at the termination of the guarantee system.

Concerning the possibility of the State being summoned to a foreign law court with reference to letters of comfort having been issued, the memorandum reasons from the principles of sovereign immunity. It is concluded that legal proceedings of this kind are not to be ruled out in theory. Mr. Munck is not prepared to voice an opinion on the outcome of the material assessment in such a case.

The memorandum concludes with proposals for measures in connection with an end to the undertaking. Considering what has been presumed to be incumbent on the State in that event, it is proposed that a termination be preceded by an appraisal of whether the credit institutions entitled to support can be assumed, with a sufficient degree of certainty, to have the capacity to meet existing commitments. In the even of such a capacity being considered to exist in general, the memorandum concludes that the law on State support to banks and certain other credit institutions can be rescinded without any need for particular agreements or transitional regulations.

If the capacity to meet commitments is considered to be uncertain for one or a few credit institutions, it is proposed that before the termination of the general undertaking, the State ensures that support agreements are concluded with those institutions and that the agreements are designed so that they cannot be annulled at the discretion of the institutions in question but remain valid against such an institution until it has attained financial stability. According to the memorandum, however, the Act on State support should be rescinded when the general guarantee undertaking is withdrawn. A transitional provision could be considered to the effect that even after the Act had been rescinded it can be applied in the event of cases where a State support undertaking is to continue to apply. According to the memorandum, however, such a transitional provision would not be required provided a support agreement of the above-mentioned design is concluded between the State and such institutions as are not judged to be sufficiently stable.

The reasoning in the memorandum drawn up by Mr. Munck on any State liability for statements made in connection with the introduction of the bank support undertaking and on account of the letters of comfort that were issued, is well founded. There is no reason to suppose that the responsibility of the State for an end to the general bank support undertaking would extend further than Mr. Munck has found in the memorandum; that is, an obligation in connection with an end to the undertaking to ensure that the institutions entitled to support can be reasonably presumed to have the capacity to meet existing claims and, if that were not to be the case for one or a few institutions, to make special arrangements for those cases. A conceivable liability for compensation would then only arise if the State were to be lacking in these respects.

11 Organisational matters

An end to the undertaking will have organisational consequences for the Bank Support Authority. The work of the Authority has focused recently on handling existing support agreements and managing the State's holdings in Nordbanken, Securum and Retriva. In the run-up to a termination the work of the Authority is likely to include information about this measure.

In connection with the proposed introduction of a deposit guarantee system from the turn of 1995 it has also been proposed that the Authority be responsible for building up that system. The tasks of the Authority in the longer run will be considered in a later context.

12 Proposal

Proposal: The State undertaking that banks and certain other credit institutions can meet their commitments on a timely basis shall cease to be in force from 1 July 1996. From the same date the Act (1993:765) on State support for banks and other credit institutions shall cease to be in force. The provisions in Article 27 of the Act restricting the right to deduct losses shall be transferred to the law (1993:1539) on tax deductions for business losses.

As indicated in earlier sections, the banking system as a whole has now recovered its financial and economic stability. The outlook for continued stability is also considered to be good. This assessment is also based on a general economic recovery and greater stability in the real-estate market.

As regards the situation for particular institutions, the outlook is considered to be sufficiently stable in every case. In two cases this means that stability is to be assured by changes in the structure of ownership.

There are thus good grounds for presuming that the banks and other credit institutions which might be entitled to support have the capacity to meet existing commitments on a timely basis.

Besides the economic conditions, this memorandum has considered other aspects of the situation and conditions for the banking system. These include various measures which have to do with supervision and statutory regulations and which aim to enhance the reliability of the institutions' operations. One conclusion is that considerable changes are in progress in these respects enhancing the possibility of controlling and maintaining the stability of the individual institutions and the banking system. One notable change is the permanent reinforcement of consumer protection with the deposit guarantee system that is due from January 1996 onwards.

Conditions are now accordingly at hand to end the undertaking - that banks and other credit institutions can meet their commitments on a

timely basis - which the Riksdag approved on 18 December 1992. The undertaking then ceases to apply to all outstanding commitments of these institutions irrespective of when they arose. The support agreements that have been concluded while the bank support undertaking has existed will be completed in accordance with what has been agreed in each particular case. The Act (1993:765) on State support for banks and other credit institutions should be repealed from the same date as the undertaking is terminated. It would be appropriate for the State undertaking and this Act to cease to be in force from 1 July 1996. Article 27 of the Act - introduced under an amendment from 1 January 1994 (prop. 1993/94:50, bet. 1993/94:SkU15, rskr. 1993/94:108) - includes a provision restricting the use of loss deductions if shares or participating rights are transferred in an enterprise eligible for support in which the State directly owns all the shares or participating rights. This restriction should continue to apply for enterprises directly owned by the State that have been eligible for State support. It would be appropriate to incorporate the provisions in the law (1993:1539) on tax deductions for business losses.