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THE BANKING CRISIS IN FINLAND**

Artikeln berör ett antal av de väsentligaste aspekterna av den finsk bankkrisen i 1990-talets början. Bland de välkända krisorsakerna kan nämnas exogena ekonomiska störningar, de oväntade effekterna av den finansiella avregleringen, osunda kredit- och investeringsregler inom bank- och företagsvärlden samt en ekonomisk politik och övervakningsverksamhet som inte var anpassad till denna situation. En likviditetskris kunde avvärjas genom att skattebetalarna tvingades överta lejonparten av de mycket stora, delvis ännu orealiserade kostnaderna. Bland de lärdomar man i efterskott kan dra av krishanteringen är bl.a. vikten av att myndigheterna ingriper i ett tidigt skede, att banker kapitaliseras enbart en gång, att saneringsprogram ges strikta tidtabeller och att det politiska inflytande i processen har klara gränser. Dessutom är det osannolikt att marknadsdisciplin kan ersätta offentlig övervakning i små ekonomier.

In market economies, systemic banking problems arise from time to time. A number of macro-economic theories have been developed to explain the basic causes for developments leading to such problems.[1] These theories stress the role of exogenous shocks, psychological factors (including speculative behavior) or government interference in markets (including regulatory change). Such explanations usually do not compete with each other, but rather provide a list of possible causes for both the initial disturbance and the forces propagating it in the financial system.

In practice, most of the severe banking problems arise because of losses on loans and collateral, which have an impact directly on the capital and solvency of the bank. These losses arise either because bank governance and management have been inept for some time,[2] or because of unexpected and rapid major changes in incomes and relative prices. A clear distinction between the two causes is not always easy to make, because the extent to which bank management should be able to foresee changes in customer viability is open to debate.

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** *The views presented in this article do not necessarily represent those of the Bank of Finland.*
1 *See Davis (1992) for a comprehensive discussion, and Mishkin (1990, 1991) for a more selective view.*
2 *Typically evidenced by a period of rapid growth in lending and assets; for the Finnish experience, see Solttila and Vihriälä (1994).*

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CAUSES

The causes of the banking crisis in Finland were not exceptional in any major way, exogenous shocks combining with economic policies unsuited to a situation characterized by some spectacularly bad banking and investment decisions.[3] Financial market deregulation started in the early 1980s, domestic markets being fully deregulated in the middle of the decade and foreign exchange market at its end. Substantial increases in lending by banks with weak owner control followed during the latter part of the decade, and asset values were bid up dramatically. These developments were strengthened by capital imports made attractive by the fixed exchange rate policy,[4] other policy was not geared to reduce incentives to borrow (tax codes) or to tighten bank credit practices (supervisory regulation). Rising indebtedness and tightening monetary policy had already slowed the economy markedly when exports to the Soviet Union collapsed in 1991. After this, reductions in economic activity and rising real interest rates combined to generate a rapidly rising stock of nonperforming assets in banks' balance sheets.

Credit losses were large in most major banks in the first half of the 1990s. The situation proved worst in the savings banks sector, where a system of shared responsibility for group solvency meant that a number of deeply insolvent local banks in effect bankrupted the whole group. The cooperative bank group managed to retain its solvency, but transfers from solvent to insolvent local banks were large. Losses and low earnings eventually also proved too much for one of the two largest commercial banks (KOP) despite two recapitalizations by the private owners, and it chose to merge with its main rival (SYP) in 1995.

MEASURES

The instruments chosen by the Finnish authorities for addressing the banking problem were constrained by the necessity to avoid any default by a (major) bank. Such a default could have significantly reduced foreign confidence in the Finnish banking system and triggered a tightening of access to foreign financial markets for all Finnish banks, the resulting liquidity problems causing potentially severe macro-economic effects for the economy as a whole. Thus, when the problems of SKOP became acute in September 1991, the Bank of Finland assumed control of the bank and its operations to maintain confidence in the banking system. Similarly, when it had become obvious that the extent of the banking problem was larger than initially believed, the Parliament, in February 1993, passed a resolution requiring the state to guarantee that Finnish banks be able to meet their commitments on time under all circumstances.

These measures proved sufficient, and no major liquidity problems arose despite the gradually unfolding and deepening banking crisis. The downside consequence of avoiding a liquidity crunch was, however, that those costs arising from bank restructuring and not covered by banks' own capital would have to be carried by present and future taxpayers. Because losses from past loans and other investments largely were both unavoidable and fixed[6], any savings would have to come from avoiding additional losses from newly made loans or

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3 *See Nyberg and Vihriälä (1993).*

4 *The combination of increased foreign currency debt and an eventually unsustainable exchange rate were taht monetary policy got caught in an impossible situation. A continued fixed exchange ran the risk of a rising interest rate and declining profitability in the export industry, threatening bankcruptcy among export companies and companies with heavy markka debts. A devaluation, in turn, ran the risk of bankrupting companies with heavy foreign debt (which was what eventually happened).*

5 *Though some loans and assets lost value because of the continued decline of economic activity and asset prices, these developments had to be taken as given by the authorities responsible for the restructuring of the banking system.*

6 *This "bad bank" (Arsenal) was created in October 1993 to make possible the split-up of the savings bank sector, and was initially endowed with assets valued at almost FIM 40 billion. At present this concern has a personnel of some 750 (in concern as a whole) and is likely to continue operations for the rest of the decade. For a somewhat more detailed discussion of the savings bank decision see Nyberg (1994).*

from managing existing assets badly.

To help ensure this, several measures were taken. All banks were offered subsidiary capital (totalling FIM 8 billion) by the government in 1992; the offer contained particularly strong incentives to improve profitability. Bad assets from the merged savings bank sector were transferred partly to the Bank of Finland and, mostly, to a government-owned massive asset management company.[6] Some changes were made in the management of banks requesting support, but the smallness of the Finnish market for professional bankers made rapid wholesale replacements difficult. Finally, bank support was provided in stages only, thus making it possible, in principle, to monitor how lending and costs developed before committing the whole amount of support needed.

In addition to liquidity and capital support, banks were indirectly supported by raising their domestic market shares and thereby, hopefully, also their permanent earnings potential. This was done through closing the recapitalized and merged savings banks and selling equal shares of their good assets to their four major domestic competitors, simultaneously transferring their deposits to these banks. The extent of this indirect support is unclear and dependent on how the future earnings flows from transferred deposits are estimated; nevertheless, the acquisition was entirely voluntary and its economic advantages publicly greatly acclaimed by representatives of some of the buyers.

EFFECTS

Little time has elapsed since the onset of the banking crisis, and no substantive study exists on the total effects of either the crisis itself or the restructuring policy chosen. What follows, therefore, is primarily in the realm of hypothesis rather than proven fact.

A systemic liquidity crisis with its attendant huge real costs was averted. Restructuring decisions could therefore be made according to domestic timetables and preferences. It should be recalled, however, that the same can be said of all industrial countries which recently have experienced banking problems.

Despite the widespread weaknesses in the banking sector, only banks with estimated negative own capital were directly taken over by the authorities. This had two important effects:

(a) few bank owners lost their equity and ownership rights as a consequence of the banking crisis, but the threat of government ownership remained a deterrent for requesting bank support; and

(b) even some banks with large solvency and profitability problems were allowed to continue independent operations, restructuring efforts being strictly their own responsibility. The systemic restructuring in Finland was largely limited to the sale and eventual dismantling of banks requesting government support.

Thus, the banking crisis was only to a limited extent utilized by the authorities either for reducing moral hazard or for strengthening surviving individual banks by cleaning up their balance sheets. This may have been unfortunate, given the challenges of increased competition (see below) and growing integration-driven adjustment needs in the real sector. Despite systemic difficulties and weak prospects, it proved virtually impossible for still independent banks to agree on necessary cuts in capacity or on sectoral restructurings of their defaulting big customers during the crisis itself.[7] Similarly, a large amount of effort must have been spent by management in some banks on delaying unavoidable book losses rather than on improving future profitability. The initial slowness of restructuring both in the banking sector and among unprofitable but refinanced customers may well have increased the total

7 The lack of significant cost reduction measures early in the crisis may indicate the presence of moral hazard, banks assuming that support conditionality in practice would prove weak. As total support and political irritability mounted, another reason for this may, later, have been owner's fear of losing their equity as a consequence of the greater need for government support. One exception is the Savings Bank of Finland (SBF) in the year before being sold to competitors. However, the reductions in staff and other improvements in their operations were not enough to convince the owners of its viability.

economic cost of the both the crisis and the necessary recapitalizations.

Competition in the urban banking market increased markedly when some of the smaller solvent domestic banks as well as some foreign banks started enlarging their branch network in Finland. This was probably partly a direct consequence of

(a) the reduction in the number of independent banks which increased the demand for new "second bank" relationships; and
(b) the continued weakness of the larger domestic banks which made it difficult for them to provide banking services on competitive terms without compromising their profitability. In fact, increased competition combined with reduced demand for loans, slow cost reductions, and low net yields on bank real estate holdings make it likely that profit margins will remain thin for Finnish banks in the near future.

The very substantial increase in banking concentration in Finland during the crisis is likely to have led to greater market concentration of banking in particularly the rural parts of the country. While this is unlikely to have any significant macro-economic effects, it could have local and regional consequences for the cost of financial intermediation in the medium term.

The high cost of bank support will tend to keep the tax burden relatively high in the coming years. Because integration has reduced the barriers to capital mobility, these higher taxes will have to be paid by households. This, in turn, may slow the recovery of growth in the markets for domestic goods and services.

The overhang of problem real estate in the asset management company may pose a conflict of interest to the authorities. On the one hand, minimizing the real net costs of asset recovery may require the company to restructure and sell its assets quite rapidly. On the other hand, this could depress asset prices in the economy, causing further losses among the banks now remaining solvent.

COSTS

In the period since 1990 banks (including the asset management company) have in aggregate lost almost FIM 70 billion[8] (taking into account interest costs of government support); private owners provided some FIM 10 billion of cover for this (partly in the form of reduced own capital in the banks), while the government provided the rest or some FIM 60 billion. Banks still operating at the beginning of 1995 had by then been supported by the government with some FIM 6½ billion to ensure their solvency. The rest had been paid out for covering losses primarily in the now defunct savings bank sector, including support for the asset management company.[9] Further government financial commitments (primarily guarantees) resulting from the Finnish banking crisis amount to some FIM 30 billion; in addition, the government accepted FIM 1½ billion in bank stock as part payment for the sale of the savings banks.

Total actual capital losses paid out by owners and the government for the banking sector[10] have therefore so far been almost one fifth of total bank lending to the public at end –1990 or 13 percent of present GDP (18 percent including commitments). The Finnish banking crisis has thus proved to be the relatively most expensive in the Nordic countries.[11]

However, total costs could still increase or decrease. The asset management company generates both operating costs (including interest costs) and revenues from asset sales as long as it remains in operation; net (present value) costs are likely to be higher the longer it continues

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8 Defined as the sum of book losses, increases in own funds and aggregate interest cost for government bank support during 1991–95 according to official statistics.

9 See Vakuusrahasto (1995) and data from individual banks' balance sheets. The eventual total costs will crucially depend on on net recovery receipts from the asset management company

10 Not counting any opportunity or indirect costs, nor any possible support arising from the sale of the savings banks.

11 See Koskenkylä (1995).

operating. Furthermore, the modest government holdings of bank and enterprise equity will change in value until they are sold. Government costs will also decline because the FIM 6½ billion mentioned above is likely to be eventually repaid by the banks and the aquired bank stock can be sold on the market.

Finally, if the specific crisis management solution actually chosen were compared to alternative solutions, indirect costs and gains arising from their different effect on the real economy could, in principle, be analysed. Such an analysis would prove fairly complicated, having to include assumptions regarding alternative government revenue and expenditure choices, as well as some judgement on the likelihood of cumulative effects from possible bank closures and creditor losses.

LESSONS

It is, of course, trivially true that the Finnish banking crisis was handled as well as possible, given the resource and political constraints existing at the time. Nevertheless, while not looking for alternative basic solutions, it is useful to think about what lessons can be drawn from the ways the crisis actually was managed in Finland.

Speed is essential in limiting the spread and costs of a systemic banking crisis. Once a bank approaches insolvency, both management and owners may have a common interest in increased risktaking (moral hazard); only a rapid change in governance will stop this.[12] Owners and management should therefore not, neither in principle nor in practice, be given the sole right to decide when a weak bank needs support.

A transparent numerical assessment, using uniform criteria and assumptions, of the viability and solvency of weak banks is a precondition for rationally judging both the total cost of bank support and its efficiency. This is so regardless of whether problem banks eventually are rehabilitated, merged, sold or closed. Unnecessary costs could arise both because nonviable banks are rehabilitated and because viable ones are closed.[13] Before committing itself to rehabilitating a bank, the government would be well advised to make sure that the bank in fact is operationally viable; similarly, if a rehabilitated bank shows promise of achieving operative profitability, it should not be closed.

The amount of recapitalization should be carefully judged to ensure an incentive for new management to exert themselves. Repeat capitalizations should be avoided for the same reason. The incentive structure, including ownership issues, for asset management companies should be clearly designed to maximize recovery of present asset value.

Establishment of definite timetables for reaching solvency and efficiency targets should be clearly established and adhered to, once the problem banks are rehabilitated. In a developed, open market economy, significant underachievement in these respects should lead to merger or closure.

Political influence in the process is absolutely necessary because so much common resources are being expended. It is therefore important that clear principles and rules are established for the crisis management, that the process is transparent to political decision makers, and

12 Gorton and Rosen (1992) argue that market discipline reduces the managerial return on risky investment without significantly changing management's incentives. By inference, moral hazard will then be a risk primarily whwn bank's approach or have reached insolvency; when bank's solvency is assured, interest in moral hazard will decline. Murto (1995) argues that owners also may have an interest in reducing earnings after recapitalization, if this reduces the likelyhood of repayment; however, the likelyhood of government support may also decrease owner's perceived risk of additional capital injections into a problem bank.

13 See Vihriälä (1993) for a critical evaluation of government's possibilities to effectively control asset valuation in a big problem bank. It should be recognized, however, that results can be different if the authorities take acrtive part in the valuation excersise rather than only monitor it on administrative basis.

that final decisions have governmental and parliamentary approval. However, it is important to limit such influence to only choosing between alternatives put forward by the officials responsible for crisis management. If political influence is exerted during the examination and planning stage itself, costs may not be minimized.

Some possibly attractive political restrictions limiting the restructuring alternatives available to the government are likely to prove expensive. For instance, if it is considered unacceptable for the government to take over ownership of weak banks, little influence can be exerted over credit policies, valuation practices, or loan recovery efforts of such banks. Similarly, restricting the number of eligible buyers of rehabilitated banks is likely to reduce government revenue from such sales, perhaps substantially.

Neither banking supervision, central banks nor market participants are likely to generally foresee or prevent a systemic banking crisis. Such crises have taken place under various regulatory and political regimes. Given the fact that politicians and civil servants on average are no smarter than people working in the financial markets, this is hardly surprising. However, it also indicates that future discussions on how to improve crisis prevention rather should concentrate on identifying early warning signs and ensuring a stable real economic development than on debating the ideal structure of banking or banking supervision. Crisis prevention requires an estimation of future bank earnings and cost flows rather than of present asset values.

It is likely that the present lively discussion on market discipline and deposit guarantee limits is, despite its theoretical relevance, of limited practical use in many small open economies. In such countries the macro-economic consequences of closing a major bank and of creating greater liquidity risks in the system could be severe. Market participants are unlikely to expect the authorities to take systemic risks, leading to a tendency for markets to judge at least some banks to be too big to fail. In this case, limits on creditor protection will be credible primarily in the case of relatively small banks, leading to a further concentration of banking markets but not necessarily to greater overall market discipline.

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