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Financial Markets Department
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The Finnish Banking Crisis and Its Handling

(an update of developments through 1993)

SUOMEN PANKIN KESKUSTELUALOITTEITA • FINLANDS BANKS DISKUSSIONSUNDERLAG

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Abstract

The paper is an update through early 1994 of a similarly titled paper (Bank of Finland Discussion Papers 8/93). It gives a brief description of the evolution of the Finnish banking crisis and its handling. In the first section, the salient features of the Finnish banking system are described. We then briefly discuss the liberalization process, macroeconomic and regulatory policies, and the subsequent credit boom and its development into a recession of unprecedented depth. Next, we document the impact on bank profitablity of the drastic changes in macroeconomic conditions. The collapse and rescue of Skopbank are summarized.

In section 2 we describe the public safety net, starting with the pre-crisis arrangements. This is followed by an exposition in section 3 of the new measures taken in 1992 and 1993, with the emphasis on the establishment of the Government Guarantee Fund, its organization, powers and principles of operation.

Section 4 gives an account of the support measures taken by the Goverment Guarantee Fund in the course of 1992 and the whole of 1993.

Finally, in section 5, we discuss the banks' current economic environment and their prospects in the near future, now also brought forward into early 1994.

The paper includes references to recent articles and discussion papers dealing with important aspects of the current banking crisis. The list of references is by no means exhaustive, and it is designed mainly to help foreign readers to find supplementary material. Therefore only those papers in Finnish or Swedish which have to do most with the current crisis are included.

Tiivistelmä

The Finnish Banking Crisis and Its Handling x/94 on uusittu laitos aikaisemmasta samannimisestä keskustelualoitteesta (Suomen Pankin keskustelualoitteita 8/93). Uusittu laitos kattaa tilanteen vuoden 1994 alkuun saakka ja siihen sisältyy lyhyt kuvaus Suomen pankkikriisin kehityksestä ja sen hoidosta.

Ensimmäisen luvun alussa kuvataan Suomen pankkijärjestelmä pääpiirteissään. Sen jälkeen käsitellään lyhyesti säännöstelyn purkamista, makrotaloudellista ja säännöstelypolitiikkaa, luottoekspansiota ja sen kääntymistä ennennäkemättömän syväksi taantumaksi. Luvun lopussa esitetään, miten rajut muutokset taloudellisissa oloissa ovat vaikuttaneet pankkien kannattavuuteen, ja käydään lyhyesti läpi Skopin kriisi ja pelastusoperaatio.

Luvussa 2 kuvaillaan julkista turvajärjestelmää kriisiä edeltävistä järjestelyistä lähtien. Luvussa 3 käsitellään vuosien 1992 ja 1993 toimenpiteitä, erityisesti Valtion vakuusrahaston perustamista, sen organisaatiota, valtuuksia ja toimintaperiaatteita. Luvussa 4 selvitetään Valtion vakuusrahaston tukitoimia vuosina 1992 ja 1993. Luvussa 5 käsitellään pankkien tämänhetkistä taloudellista toimintaympäristöä ja tulevaisuuden näkymiä, myös alkuvuoden 1994 osalta.

Lopun kirjallisuusluettelo sisältää viimeisimpiä pankkikriisiä käsitteleviä artikkeleita ja keskustelualoitteita. Luettelo ei pyri olemaan täydellinen; se on tarkoitettu lähinnä ulkomaalaisille lukijoille avuksi lisämateriaalin löytämiseksi. Sen vuoksi mukaan on otettu vain ne suomalaiset ja ruotsalaiset artikkelit ja keskustelualoitteet, jotka ovat tärkeimpiä tämänhetkisen kriisin kannalta.

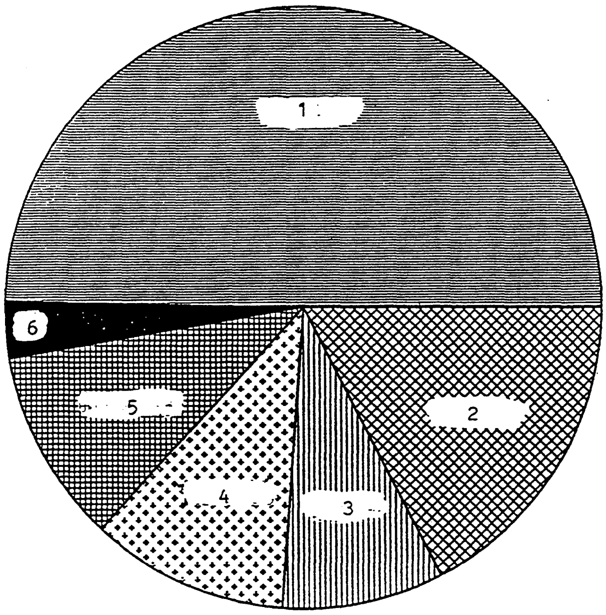
Contents

1 Banks and the Finnish Economy

1.1 Bank intermediation dominates

Deposit banks are central to the Finnish financial system. The bulk of financial intermediation takes place through deposit banks. Thus, some 50 per cent of the financing needed by the public (the corporate and household sectors) is provided directly by deposit banks (Chart 1). In addition, banks have guaranteed about half of the lending by insurance companies. Also, with one exception, all mortgage institutions and the largest finance companies are subsidiaries of deposit bank groups. In all, about two-thirds of the credit risks associated with the borrowing by the public is carried by the banks. The role of the banks is especially predominant in the case of households and small and medium-sized businesses.

Chart 1. **Composition of the liabilities of the public, 31 Dec. 1991***



[1] Banks 49.7 %.
[2] Insurance institutions 17.5 %.
[3] Other financial institutions 8.6 %.
[4] Public 10.7 %.
[5] Foreign sector 10.6 %.
[6] Public sector 2.9 %.

* Statistics Finland: Financial Market Statistics 1992:24.

In the second half of the 1980s, securities markets developed rapidly and the abolition of exchange controls allowed the private sector to borrow from and invest abroad freely. This improved the availability of finance from sources other than the banks. Particularly foreign borrowing was widely used, starting in the mid-1980s, although more than half of this financing was intermediated by the banks. The increase in the share of non-bank finance may partly reflect exceptionally favourable macroeconomic conditions, and might not have obtained quite such a high level in more normal times despite increased competitive pressures.

The role of the banks in Finland is important not only as a source of finance but also as regards the control of companies. The Finnish banks are of the universal type and are thus engaged in various investment bank activities and have significant stakes in non-financial companies. Therefore, banks are able (and quite often willing) to exercise strong influence over financial and strategic decisions in many enterprises.

The banking system comprises five major bank groups and a number of smaller commercial banks, some of which are fully-owned subsidiaries or branches of foreign banks. Formally, there are a large number of individual banks, as the co-operative banking group consists of 304 individual banks and the savings bank group of 39 savings banks (end-1993 figures). However, in many important respects, the co-operative banks operate as one entity, as do the savings banks. Despite some specialization, all major banking groups are active in most geographical and business areas.[1]

1.2 Excess banking capacity

The banks' service network in Finland is large and technically very efficient. However, because of its size, it is also costly.

Up to the mid-1980s, direct price competition was all but impossible due to regulation. Competition took the indirect form of attracting low-cost deposits by building large branch networks and investing heavily in automated payment and other banking technologies. The result was that Finland now not only has more banking personnel and branches per capita than the neighbouring Nordic countries, but also one of the densest and most advanced networks of automated teller machines and point-of-sale terminals in the world (Table 1).

The extensive resource use is reflected in operating costs, which are high by international standards. However, banks' total income is not exceptionally high (Table 2).[2] Therefore, the high operating costs result in weak underlying profitability and constitute evidence of substantial excess capacity in the industry.

In recent years, banks' use of resources has started to decline. The number of employees had been cut by some 30 per cent by the end of 1993 from its peak in 1989 (Chart 2). A similar change has occurred in the number of branches. However, labour costs have not come down correspondingly.

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[1] For a fairly recent general description of the Finnish financial system, see Bank of Finland (1991). A detailed account of the banking system is given by the Finnish Bankers' Association (1991).

[2] International comparisons are obviously problematic, as institutional set-ups and economic environments vary a great deal between countries. For example, in bank-dominated economies (Germany, Japan, Finland) banks' balance sheets are bolstered by low-income, low-risk intermediation, which in other countries may be taken care of by special housing finance institutions or by securities markets. Given the many similarities of the Nordic countries, comparisons between them are likely to be the most useful ones.

Table 1. **Banking capacity in the Nordic countries**

	Per 10 000 inhabitants End of 1991					
	Branches		Staff		ATM	EFTPOS
Finland	6.2	(8.2)[1]	93.6	(104.4)[2]	5.8	67.0
Sverige	3.7	(5.9)[1]	55.0	(83.1)[3]	2.5	9.7
Norway	3.9		59.2		4.1	37.4
Denmark	5.0		99.5		2.1	37.8

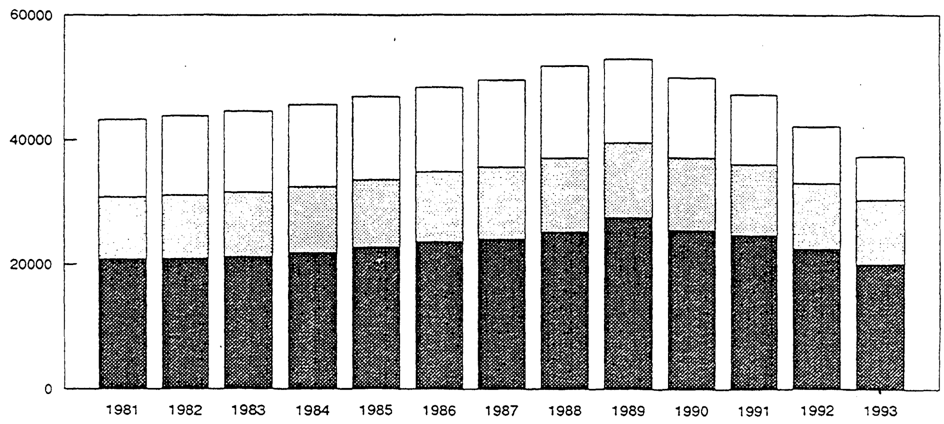
[1] Incl. post offices.
[2] Incl. post office personnel in customer service (5 420).
[3] Incl. post office personnel in customer service (18 415), personnel of the postal giro system (3 840) and personnel in the housing finance institutions.

Table 2. **Bank profitability in selected countries**
Per cent of balance sheet total, average 1985—1990*

Country	Net interest income	Non-interest income	Total income	Operating expenses	Net income before provisions
Finland	1.98	1.98	3.97	3.19	0.78
Denmark	2.74	1.14	3.89	2.24	1.65
Norway	3.24	1.05	4.28	2.96	1.32
Sweden	2.29	1.01	3.30	1.97	1.33
USA	3.44	1.49	4.92	3.29	1.64
Japan	1.13	0.34	1.47	0.92	0.55
Germany	2.19	0.62	2.81	1.80	1.00
France	2.38	0.48	2.81	1.88	0.93
U.K.	3.17	1.92	5.09	3.33	1.75

* The widest available aggregate for each country

Chart 2. **Banking employment, number of personnel**



- Saving banks[1]
- Co-operative banks
- Commercial banks (incl. Postipankki)

[1] SBF included in the savings banks.

1.3 Bad banking and bad policies in the 1980s

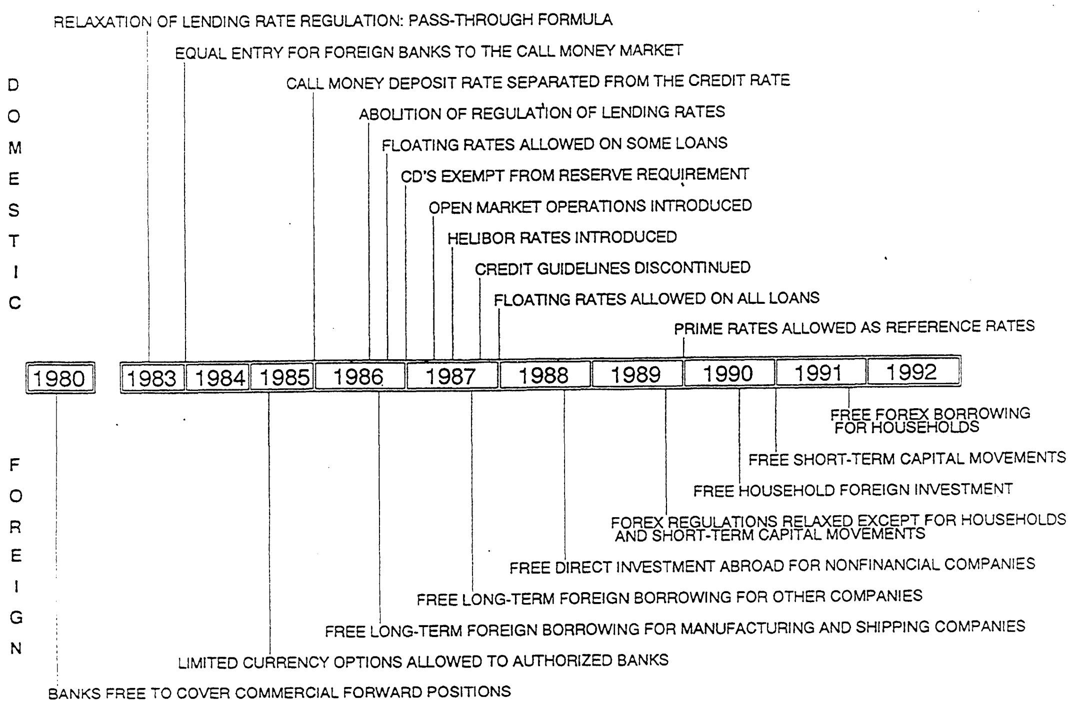
1.3.1 Financial liberalization

Deregulation of the financial markets started in the early 1980s (Chart 3). Already in 1980, the links to foreign short-term markets were greatly strengthened by allowing the banks to borrow freely in foreign money markets to cover the forward currency exposure they could equally freely supply to commercial customers. The first foreign banks were established (as subsidiaries) in the Finnish market in 1983, resulting in more intensive competition in the market for foreign exchange and in the emerging money market.

Interest rate deregulation got under way in 1983 with measures on the lending rate side. This gradual process was completed in 1986, when banks were allowed to determine freely the level of interest rates on new loans. Major steps to liberalize capital movements were taken in 1986 and 1987 by allowing long-term borrowing without restriction for selected sectors and for all nonfinancial companies.

A true money market was established by exempting bank CDs from the cash reserve requirement and agreeing on a code of conduct to be applied in money market operations (to ensure that the market operated in all circumstances, the Bank of Finland issued its own CDs as needed). Furthermore, the Bank of Finland discontinued its practice of periodically issuing guidelines on credit policy to the banks. Borrowing and lending decisions were thus left to the market participants alone for the first time in decades. Although the process of liberalization continued until 1991, the most important decisions were taken in 1986 and 1987.[3]

Chart 3. **Financial market liberalization in Finland**



1.3.2 Unconstrained stock adjustment starts

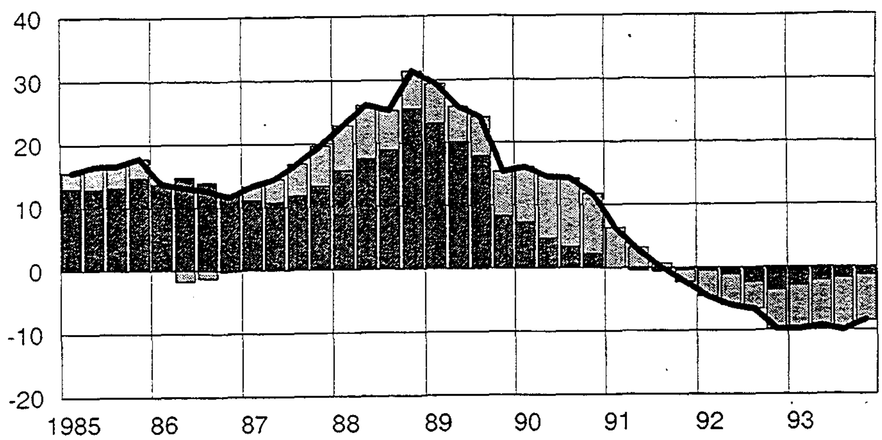
The liberalization of the domestic credit market and foreign exchange transactions was not accompanied by other reforms that would have significantly dampened the expansionary effects of liberalization. The incentives to borrow remained unchanged, economic policy in general did not adequately restrain domestic demand or price and income expectations, and banking supervision was not tightened.

Tax incentives to borrow were not changed significantly as liberalization proceeded. Because equity capital remained heavily taxed relative to debt, the latter continued to be the cheapest form of external finance to companies. Furthermore, households' interest expenses could be deducted from taxable income at a high marginal tax rate, making borrowing very attractive to households. Finally, tax exemption of interest earnings on low-yielding bank deposits constituted a subsidy to banks, boosting their capacity to lend.

[3] The liberalization process up to 1988 has been described and analyzed by Abrams (1989). A history of exchange controls is provided by Lehto-Sinisalo (1992). The lifting of regulations on foreign exchange is also discussed by Nyberg (1992a).

Previously, credit rationing had prevented the attainment of the preferred portfolio compositions implied by these borrowing incentives. With the lifting of the regulations such hindrances suddenly no longer existed. Understandably, a large-scale stock adjustment followed. Households as well as businesses started to borrow as never before. In the peak year of 1988, for instance, bank lending grew by no less than 30 per cent (Chart 4).[4]

Chart 4. **Bank lending to the corporate and household sectors**



Per cent change over 4 quarters

- Total lending
- Share of foreign currency loans at 1990 exchange rates
- Share of markka loans

In retrospect, it is clear that neither banks nor customers took adequate account of the changing financial environment. Banks, unused to recognizing, evaluating and controlling risks inherent in unregulated markets, continued to operate on the basis of partly outdated principles. Competition for market shares was the dominant objective and led to a lowering in banks' credit standards. Insufficient attention was given to the value and quality of collateral, trust being put in the historical unlikelihood of falling asset values. Credit risk was not correctly priced.[5] Likewise, interest rate risks attracted too little attention. By the same token, borrowers appear to have misjudged the risks associated with floating rate and foreign currency loans, being used to administered prices.[6]

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[4] For example, Brunila and Takala (1993) document the increase in the indebtedness of the private sector.

[5] Murto (1993) analyzes the pricing of credit risk in the savings bank sector using micro data.

[6] The exchange-rate risks associated with foreign currency loans are, of course, borne by the borrowers. Banks' total currency exposures have throughout been strictly regulated by the Bank of Finland. But to the extent that changes in exchange rates lead to credit losses, the banks also effectively carry part of the exchange-rate risk.

At the same time, regulators did not for several reasons strengthen supervisory efforts. As in many other countries, deregulation was accompanied by strong public and political pressures stressing the blessings of unregulated, private choice. Banking regulation focused on judicial compliance rather than risk evaluation. Furthermore, decisions by the supervisory authorities could be — and were — challenged in court, which probably raised the threshhold for introducing stricter supervisory practices.

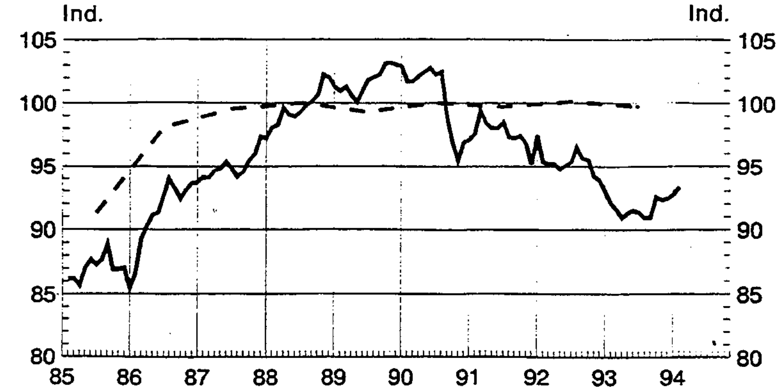
Macroeconomic policies were not geared to restraining the positive demand impulses stemming from financial liberalization. In part this was because the significance of the impulses was not fully understood. In part the cyclical situation was misjudged, and, finally, policies were constrained by objectives other than short-term demand management. Although government finances indicate some fiscal restraint in 1988 as well as in 1989, no major tightening took place. Rather, the longer-term objective of reducing direct taxation was given priority.

The Bank of Finland, for its part, did not take timely action to restrain credit expansion through monetary means, apart from some rather strong statements. Partly this was undoubtedly because the strength of the expansion was not foreseen. However, the lack of sufficient action was partly due to the overriding target of a fixed exchange rate, which made it difficult to raise money market rates. The implications of this constraint, on the other hand, were not fully understood more widely in the economy.

1.3.3 Positive shocks give a further boost

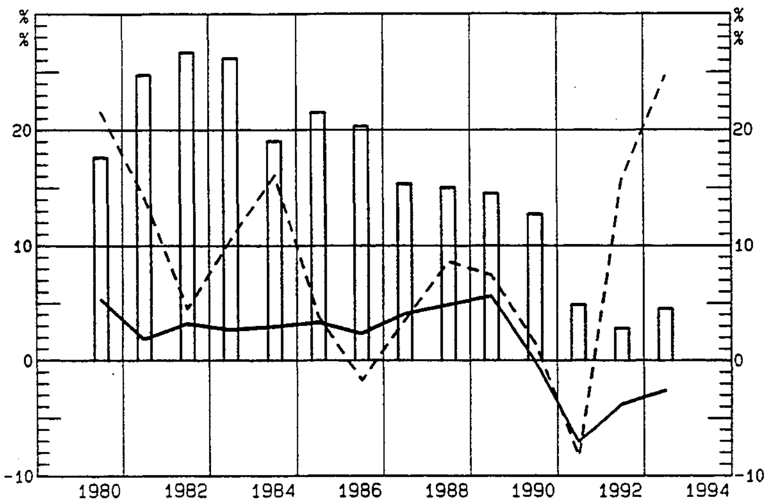
Simultaneously with the new freedoms in the credit market, national income was boosted by a significant improvement in the terms of trade between 1986 and 1989; oil prices declined in 1986 while export prices kept on rising (Chart 5). The world-wide relaxation of macroeconomic policies in the wake of the stock market crash of 1987 accelerated the growth of export markets. When these favourable shocks hit, the economy already had behind it half a decade of comparatively rapid and stable growth (Chart 6). In Finland, confidence was further boosted by the relative ease with which the oil shocks in the early 1980s had been overcome with the help of bilateral trade with the Soviet Union. The result was a highly optimistic atmosphere where reasonable constraints on growth and welfare appear to have been temporarily forgotten.

Chart 5. **Terms of trade**



——— Finland
------------- OECD Europe

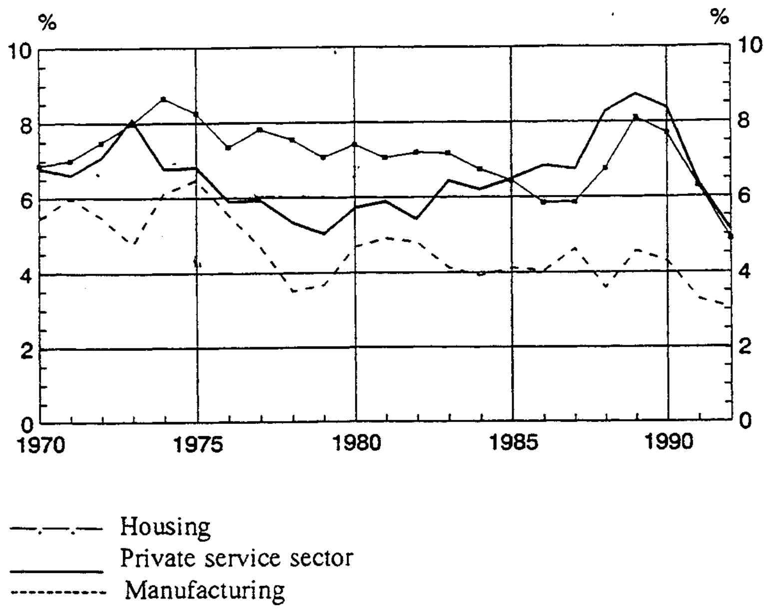
Chart 6. **Output and exports**



——— Growth of real GDP, %
---------- Growth of exports of goods
⊓ Share of Soviet exports in total exports

Demand not only for consumer goods but also for all real and financial assets increased substantially. Stock prices and real estate values soared. High asset values in turn boosted wealth and kept debt-asset ratios deceptively low. In part, new investments expanded the productive capacity of export industries. However, far more money was spent on investment in the closed sectors of the economy: retail trade, recreation and housing (Chart 7).

Chart 7. **Investment by sectors, per cent of GDP**



1.3.4 Policy response: late and little

The record-high rates of credit expansion and other relevant data led the authorities to tighten monetary policy in early 1989. The markka was permitted to appreciate by adjusting the fluctuation range for the currency index. At the same time, expansion of bank lending was penalized by a special reserve requirement imposed on the banks by the Bank of Finland. Short-term market rates increased substantially towards the end of the year.

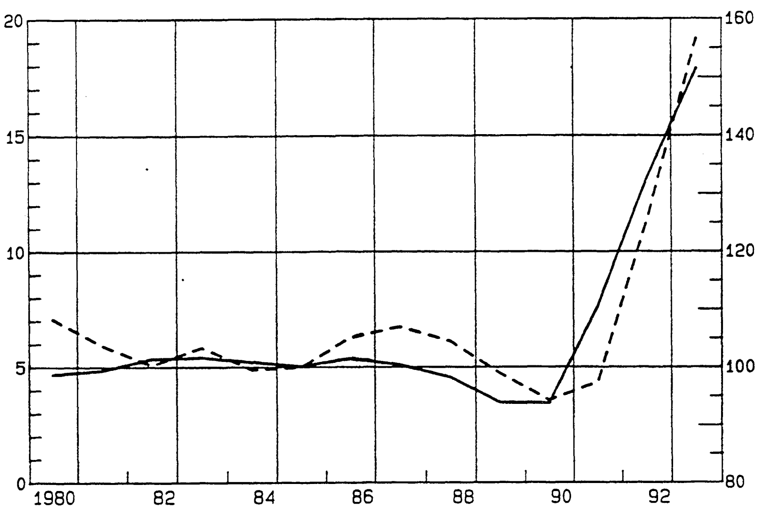
The markka lending of most banks started to decelerate rapidly. However, some banks in the savings bank sector chose to pay the new penal rates rather than curtail their rapid credit expansion. Furthermore, as markets were now free, borrowing in foreign currencies continued to increase at a high rate (partly through bank intermediation).[7] Higher markka rates made such borrowing look cheap on the assumption of broadly unchanged exchange rates. Given the widely-publicized policy of a fixed exchange rate pursued by the Bank of Finland and the successful defence of the markka in 1986, such expectations were understandable despite the recent revaluation.

[7] The special reserve requirement penalized commercial lending less than lending to the households. As, at the time, borrowing by households in foreign currency was still restricted while enterprises could borrow freely, foreign currency lending slowed less than markka lending.

The monetary tightening of the early 1989 was too late and too small to significantly affect overall demand conditions that year. Neither was there a clear shift in fiscal policy towards curbing domestic demand. Indirect taxes were raised and the growth of government spending reduced but household taxes were at the same time cut in line with the long-term tax-policy goals of the Government. As a result, 1989 was the second consecutive year with real GDP growth of (slightly more than) 5 per cent; housing production alone rose by 20 per cent.

As the unemployment rate was below 4 per cent, the economy was clearly in a state of overheating. This showed up in an acceleration of labour costs, further eroding external competitiveness, which had already been weakening for some time (Chart 8).

Chart 8. **The labour market**



——— Unemployment rate (left scale)

---------- Relative unit labour costs in common currency, competitors/Finland, 1985=100 (right scale)

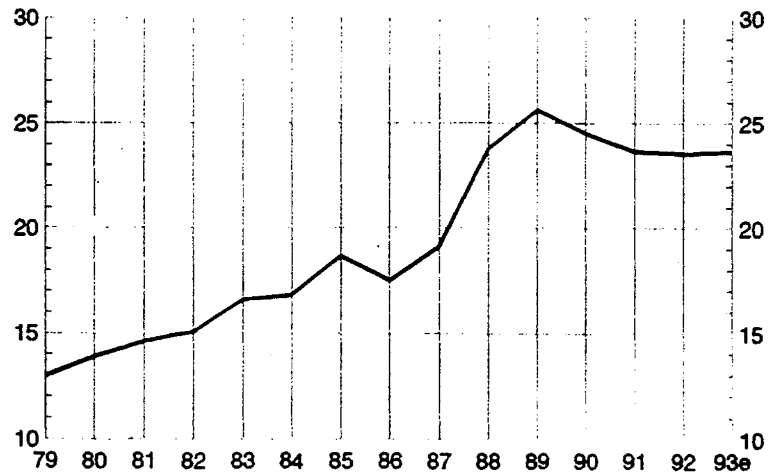
1.4 From boom to bust

1.4.1 Adjustment begins

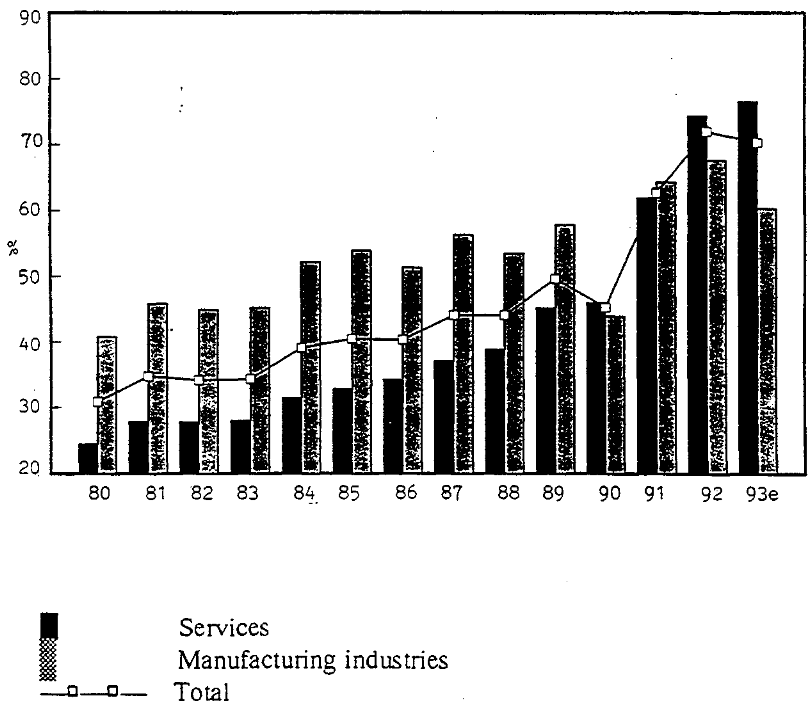
Towards the end of 1989, the tighter monetary conditions and high debt levels started to undermine domestic demand. Servicing the newly-raised debts took an increasing share of the cash flow of many enterprises and households (Chart 9). Particularly demand for real estate was quickly affected. Asset values and profits started to decline sharply (Chart 10). Unemployment bottomed out and income prospects weakened. At the same time, export performance deteriorated as market growth decelerated and market shares were lost in response to weakened price competitiveness. In 1990, the growth of the economy slowed to zero, reflecting both capacity constraints and weakening demand.

Chart 9. **Debt service burden**

(a) Households
Interest payments and estimated amortizations, per cent of household disposable income, 1979—1993 *

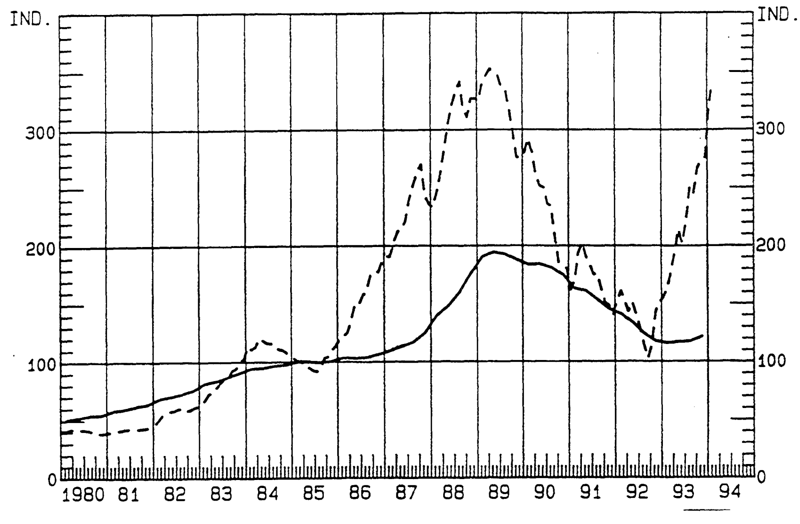


(b) Coprorate sector
Interest payments and estimated amortizations, per cent of value added, 1980—1993 *



* Source: Anne Brunila (1993).

Chart 10. **Asset values**



——— Housing prices, whole country, index 1985=100
--------- Stock prices, Hex-general index 1985=100

1.4.2 Output hit by bad luck

Following a gradual decline over several years, exports to the Soviet Union finally collapsed in 1991. Given the different commodity composition of exports to eastern and western markets and the weak price competitiveness of Finnish manufactures, only a very small proportion of the lost exports could be directly replaced by sales to other markets. The increasingly severe payments problem of that country also implied that at least part of Finnish credits to Russian importers could not be recovered on time.

The loss of Soviet export markets brought about a negative demand shock of the order of 2.5 per cent of GDP, including indirect effects. The resulting decline in incomes further increased the problems of those with relatively high debt-service obligations. As the adjustment of domestic demand to increased indebtedness continued with full force, total demand declined by 6.5 per cent in 1991. The unemployment rate reached 11 per cent by the end of the year.

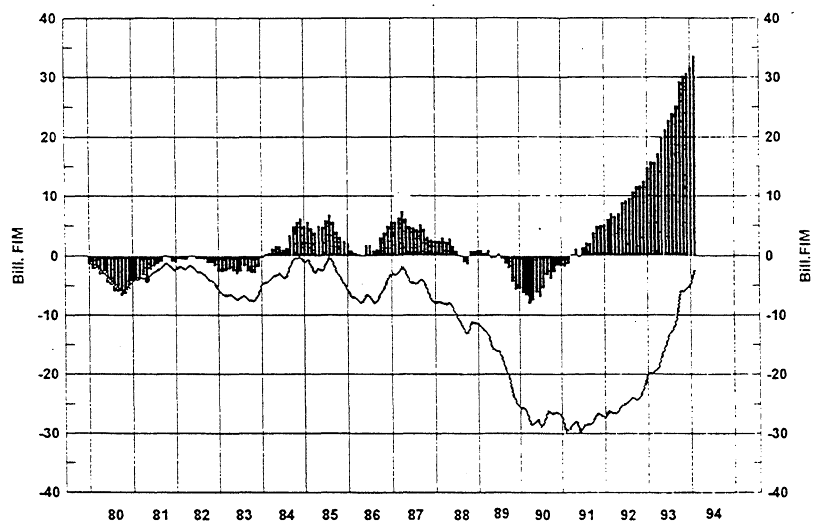
1.4.3 Financial risks materialize

The rapid decline in output was accompanied by serious balance of payments problems (Chart 11). This weakened confidence in the Finnish economy in general and in the fixed exchange rate in particular. Expectations of a devaluation of the markka started to gain strength. In an attempt to bolster confidence in the existing exchange rate, the markka was linked to the ecu in June 1991. That allowed nominal money market rates to decline for a short while, but real rates of interest generally moved higher in 1991. Strong expectations of an imminent devaluation pushed nominal short-term rates substantially higher in the autumn, and in November the markka was devalued by 12.3 per cent (Chart 12).

Both the high and continually rising interest rates and the devaluation reduced the public's capacity to service its debt. By mid-1991 the number of bankruptcies had increased to a monthly average of some 600 from around 200 a year before (Chart 13). While the effect of higher rates worked through gradually, the depreciation of the markka abruptly raised the debt-service burden for firms in the domestic sector, with substantial borrowing in foreign currency.

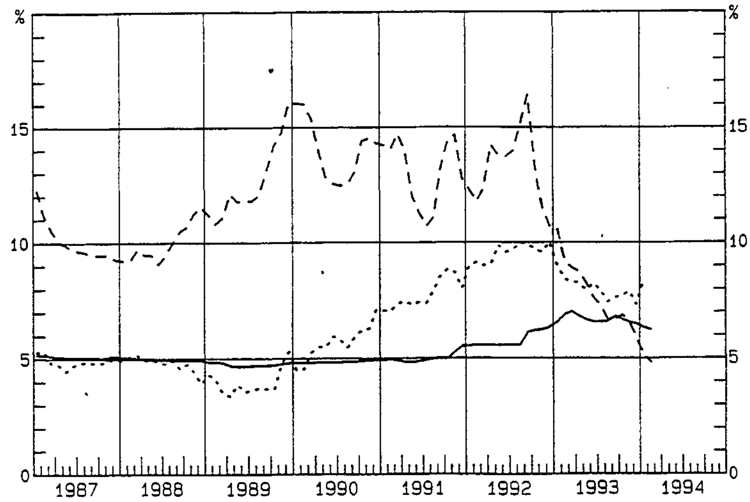
Combined with plummeting profits and declining household incomes these developments transformed a steadily increasing share of banks' loan portfolios into non-performing assets. Some 1.5 per cent of banks outstanding loans (about 1 per cent of the balance sheet total) had to be booked as credit losses in 1991. Given the weak underlying profitability, banks' aggregate profit before extraordinary items became negative.

Chart 11. **External balance, 12-month moving totals**



Trade account, Bill. FIM
Current account, Bill. FIM

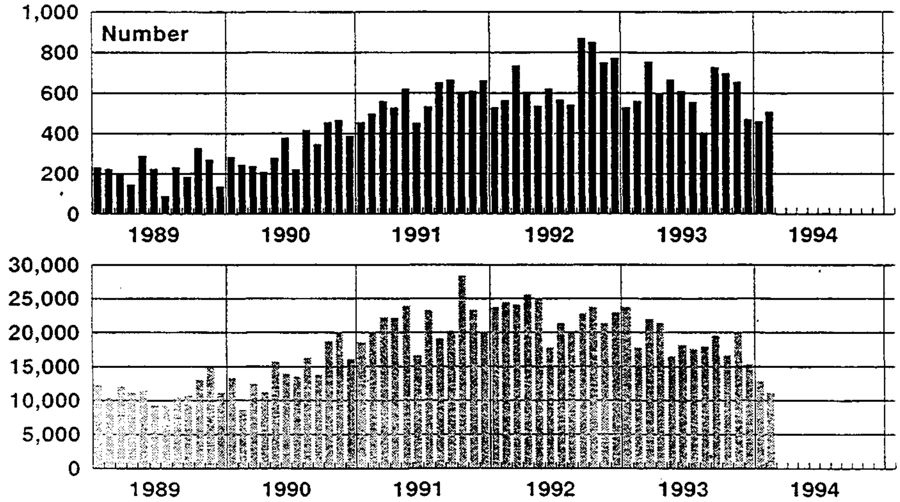
Chart 12. **The exchange rate and interest rates**



____________ Ecu index
--------------- 3 month helibor rate
.... Real lending rate*

* Average interst rate on outstanding markka loans minus annual CPI inflation.

Chart 13. **Applications for bankruptcy proceedings and new payment disturbances**



Applications for bankruptcy proceedings, montly.
New payment disturbances confirmed by the authorities.

Source: Suomen asiakastieto Oy

1.5 The first bank failure: Skopbank

1.5.1 Risky strategy backfires

The first bank to get into serious difficulties was Skopbank, the commercial bank that acts as a central bank for the savings banks. Skopbank had pursued an aggressive lending policy in the boom years. It had also acquired a majority holding in Tampella Oy, a multiproduct industrial group, presumably with the aim of making it the industrial flagship of the savings bank group. Being financially weak after large-scale investments, however, Tampella encountered severe profitability problems, as soon as the general economic climate took a turn for the worse.

Skopbank had been under the special and increasingly strict surveillance of the Bank of Finland and the Banking Supervision Office since autumn 1989. In October 1990, the authorities drew up a restructuring programme aimed at managing the bank's large risk exposures and strengthening its capital base. The savings banks were required to provide FIM 1.8 billion in fresh capital for their central bank as a part of this rescue programme.

1.5.2 Liquidity crisis prompts action

By the end of summer 1991, it became increasingly evident that Skopbank could not meet the goals of the restructuring programme. The authorities drew up a contingency plan as confidence in Skopbank collapsed on 19 September and the bank was faced with an acute shortage of liquidity. As there was no other authority equipped to deal with this type of operation, it was decided that the Bank of Finland must step in. The Bank of Finland then took control of Skopbank with immediate effect in order to retain confidence in the Finnish banking system.

The restructuring of Skopbank got under way immediately by setting up three companies to manage substantial portions of the assets of the bank. Scopulus Oy was created to own shares in Skopbank, Solidium Oy to take over most of Skopbank's industrial holdings (including Tampella) and Sponda Oy to administer Skopbank's share and some of its real estate holdings. Strict targets were set for reductions in the remaining part of Skopbank's balance sheet and in costs. The board of the bank was largely replaced.

The Bank of Finland has used a net total of almost FIM 14 billion to finance the operation. Of that almost FIM 4 billion was originally used for recapitalizing Skopbank, of which more than 2.5 billion have been recovered. Lost interest earnings amounted to about FIM 1.5 billion by the end of 1993 (not included in table 4 below) . Some FIM 11 billion remain outstanding to the holding companies, part of which may be lost in the future. The ownership of Skopbank was transferred to the newly-created Government Guarantee Fund in June 1992 (see section 3 below).[8]

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[8] Decisions on selling subtantial parts of the Tampella group have already been taken. In the early summer of 1992, stakes in the metal and engineering division were sold to foreign buyers. In March 1993, the paper division was sold to a Finnish competitor. Later Solidium has sold a large part of Tampella stock to private investors. At the moment, Solidium owns some 22 per cent of Tampella.

1.6 Banks' losses soar

1.6.1 The economy continues to contract

The rapid decline in output that had begun during 1989 continued all through 1991 and 1992. Although exports had already started to recover in 1991 and grew by about 9 per cent in 1992, this was not enough to offset weak domestic demand. Real GDP still fell by 3.5 per cent in 1992 despite increasing industrial production. Business failures, primarily in the domestic sector, continued at a high rate, reaching a high of 800 failures a month in the autumn.

At the same time, nominal interest rates continued to rise. This partly reflected the higher level of European interest rates. More significant, however, was speculation fuelled by expectations of a further devaluation of the markka, which kept interest rate differentials wide. By early September, the speculative pressure, strengthened by the general turbulence in the European currency markets, had become so intense that the Bank of Finland had to let the markka float. The markka depreciated initially by some 10 per cent. By early 1993, the cumulative depreciation since September had reached 20 per cent (the exchange rate index had risen by 26 per cent), but in April the markka appreciated markedly. Despite some initial fears, exchange rate developments appear to have influenced bankruptcies only marginally.

As a result of subdued demand, inflation remained modest and asset prices kept falling in 1992, despite the substantial currency depreciation. Consequently, real rates of interest continued to rise and collateral values to fall.[9]

1.6.2 Problem assets and losses mount

Not surprisingly, the stock of banks' non-performing assets grew rapidly during 1992 from FIM 42 billion at the beginning of the year to no less than FIM 77 billion by the end of the year.[10] Of this amount, some FIM 22 billion (4.8 per cent of total lending) was booked as credit losses.

Reflecting the structure of lending during the boom, some 40 per cent of the non-performing assets were related to construction, real estate and retail trade. Households accounted for 21 per cent of the total and foreign engagements for 14

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[9] For a discussion of the deflation process in Finland, see Honkapohja, Koskela and Paunio (1993). Three general analyses of the Finnish economic crisis and the role of economic policies are given by Bordes, Currie, and Söderström (1993).

[10] A loan is recorded as non-performing when the payment of interest or repayment of principal is in arrears by more than three months. Similarily, a bank guarantee is included in the stock of non-performing assets, if the underlying liability arises. Systematic collection of data on non-performing loans did not start until towards the end of 1991. Little is thus known about the development of problem assets in the early phases of the crisis.

per cent. Manufacturing accounted for less than 8 per cent of problem assets, reflecting the increased competitiveness and activity of that sector.[11]

Worst hit was again the savings bank group, which accounted for about half of the aggregate loss. As noted earlier, the savings banks had aggressively expanded their market share of lending during the boom years. This naturally made for weaker-than-average loan quality, in certain instances strikingly so. In addition, a significant part of the savings bank group's lending to the domestic sectors was denominated in foreign currencies, thus making the clients vulnerable to the depreciation of the markka.

The non-performing loans were largely responsible for the weakening of banks' net interest income. It was, however, also squeezed by shifts of deposits from low-cost, tax-exempt accounts into higher-yielding taxable accounts induced inter alia by the introduction of a low withholding tax on most interest earnings. Given the relatively low level of the Bank of Finland's base rate, to which almost half of all outstanding markka loans were linked, such shifts could not be compensated for by corresponding increases in lending rates. Consequently, banks' losses before extraordinary items increased by FIM 17 billion to FIM 22 billion in 1992, which became the peak year of bank losses. In 1993 the losses already declined substantially, although still remaining very high (Table 3).

Table 3. **The results of the Finnish deposit banks (groups consolidated), billions of FIM**

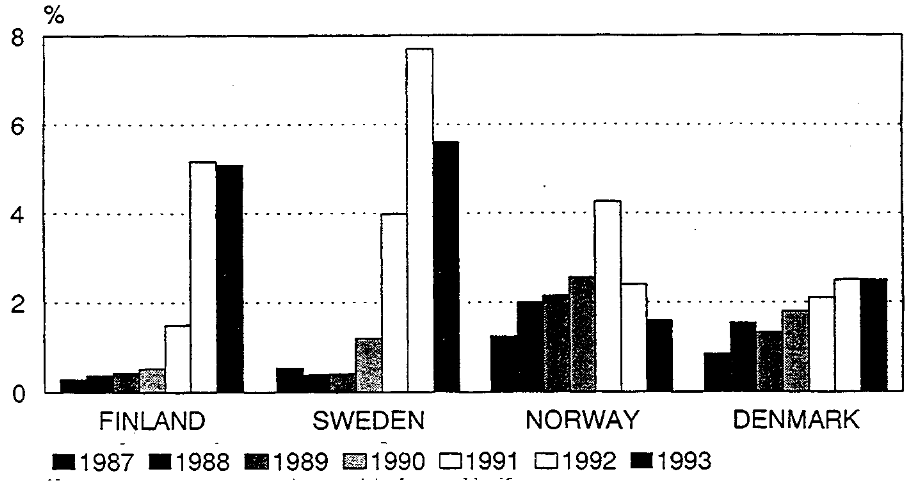
All deposit banks	1985	1986	1987	1988	1989	1990	1991	1992	1993
Income from financial operations	7.5	8.1	9.8	13.2	14.0	16.5	15.2	11.9	13.7
Other income	5.1	5.8	7.2	9.3	10.4	10.0	10.3	12.5	11.6
Total income	12.6	13.9	17.0	22.5	24.4	26.5	25.5	24.4	25.3
Expenses	8.1	9.3	10.7	14.1	16.5	17.9	18.7	19.3	19.4
Credit and guarantee losses	0.2	0.3	0.7	1.1	1.8	2.5	7.6	22.0	19.0
Operating profit	4.3	4.3	5.6	7.3	6.1	6.1	-0.8	-16.9	-13.1
Depreciation	1.5	1.6	1.8	2.5	2.9	3.7	4.0	4.8	2.6
Profit before extra-ordinary items, appropriations and taxes	2.8	2.7	3.8	4.8	3.2	2.4	-4.8	-21.7	-15.7
Lending to the public	213.7	247.5	293.3	382.2	447.3	491.3	492.0	461.3	420.1
Total assets	364.4	432.3	508.9	645.3	742.3	791.3	801.6	784.5	754.2

[11] An analysis of the structure of non-performing assets and credit losses is provided by Pensala and Solttila (1993). Some comparisons of the bookkeeping practices applied in a number of countries are also given in the paper. Peisa and Solttila (1992) analyze the backgrounds of a sample of firms with payment difficulties.

1.6.3 Nordic countries: some parallels

A Nordic comparison reveals that the onset of the Finnish banking problems closely resemble that of Sweden. In both countries, the problems started to emerge on a major scale in 1991 and peaked in 1992. In Norway, the process commenced earlier and banks' credit losses gradually crept up between 1987 and 1991, when there was a steep increase in losses. That remains the peak, as losses finally started to decline in 1992. In Denmark, losses have been smaller, although they have increased over the past years, and Denmark cannot be counted as a banking crisis country in the same way as the other three Nordic countries (Chart 14).

Chart 14. **Credit losses of deposit banks (parent companies), per cent of lending outstanding**



In Norway, Sweden and Finland, the backgrounds of the crises are similar. Financial markets were liberalized fairly rapidly, but economic or supervisory policies were not tightened. Lending criteria were eased as banks and other financial institutions competed for market shares in lending and sought to expand into new business areas. A favourable economic climate then led to rapid credit expansion, culminating in a general overheating of the economy.

In the case of Norway and Finland a single factor was important in halting and reversing this trend. In Norway, the shock was provided by the fall in oil prices while in Finland it stemmed largely from the collapse of trade with the Soviet Union. In Sweden, the more gradual effects of accumulating debt and slowing of growth in export markets appear to have dominated, although eg the tax reform had a strongly depressive impact on the housing market.[12]

[12] Koskenkylä (1992) and Koskenkylä and Pensala (1992) describe and discuss the evolution of the banking crises in the three Nordic countries. Inter alia, Lindblom (1993), Koskenkylä (1993) and Vartiainen (1993) discuss more specifically the Finnish case.

2 The Safety Net Prior to the Crisis

2.1 General approach

As in most western countries, bank instability was not considered a serious risk in Finland in the post-war decades. Fluctuations in aggregate economic activity were, given the active role of stabilization policy, generally thought to be too small to lead to massive losses of output and general deflation. Furthermore, the regulations introduced in the 1930s and 1940s – interest rate regulations and capital controls – helped to make banking a very stable business with highly predictable interest margins. Consequently, the public safety net and supervision arrangements were geared to tackling rather limited problems.

The systemic safeguards consisted of the risk and capital regulations incorporated in the banking legislation, security funds, supervision and the duty of the central bank to act as a lender of last resort.

Finnish banking legislation has not differed essentially from that of other countries where there is universal banking. In particular, capital requirements have generally been as stringent as elsewhere. Thus, when the current capital adequacy regulations, based on risk-weighted assets and broadly in line with EC standards, were introduced at the beginning of 1991, most banks easily met the 8 per cent minimum standard. The most significant shortfall as regards the legal requirements probably relates to the regulation of large exposures, which has allowed for substantially larger risks than, for instance, present EC rules.

Although the current legislation has been in force for only just over two years, amendments have already been passed by Parliament. The new legislation, which will come into force simultaneously with the agreement on the European Economic Area, fully harmonizes Finnish legislation with the EC directives. In terms of capital adequacy and risk regulations, the new legislation implies some tightening of the capital requirements for the local banks and a significant tightening of the regulations on large exposures.

2.2 Security funds

A compulsory security fund system (deposit insurance) was introduced in 1969. However, voluntary security funds had existed prior to that. The savings banks and the cooperative banks had had their own security funds since 1924 and 1932, respectively. A fund for commercial banks was established in 1966. Although based on law and supervised by the authorities, the funds are administered by the member banks.

The banks' security funds are responsible for repaying the claims of depositors if payment cannot be effected out of a bank's own funds because of bankruptcy. The responsibility is unlimited (no ceiling per depositor). In addition to compensating depositors, the funds may grant subsidies and loans to member banks.

Until 1992, only the resources of the security funds of the cooperative and the savings banks were utilized, and only for the purpose of support loans and grants to support individual banks or bank mergers. The system thus functioned as a vehicle whereby banks could collectively handle the problems of individual local banks. In this it was aided by a system of mutual credit insurance within the savings and cooperative bank sectors, respectively.

The resources accumulated were small in all security funds. In particular, the funds accumulated in the commercial banks' security fund were minimal in relation to potential compensation liabilities. Until now, the banks' contributions have been flat-rate ie independent of the estimated riskiness of banks' portfolios.

2.3 Lender of last resort

The central bank has traditionally had wide responsibilities in Finland. The Regulations for the Bank of Finland stipulate that "the function of the Bank of Finland is to maintain a stable and secure monetary system and to assist and facilitate the circulation of money in Finland". This clearly implies that the Bank of Finland has a role as lender of last resort as well as a responsibility for upholding systemic stability in the financial markets.

In taking control of Skopbank, the Bank of Finland acted as the ultimate provider of liquidity. But in the Skopbank case the Bank of Finland also assumed responsibility for the solvency of the bank in the interest of systemic stability. Given the lack of alternative responsible authorities capable of handling the situation at the time, the intervention was clearly necessary. Nevertheless, the intervention did not, of course, fall wholly within the realm of traditional central bank operations.

2.4 Bank supervision

In Finland, prudential supervision of the banks was in the hands of the Banking Supervision Office until October 1993 when bank supervision was reorganised (see section 3.8 below). The office was subordinated to the Ministry of Finance but was, to a large extent, self-financed through the supervision contributions of the banks. In the supervision of the large number of savings and cooperative banks, the Banking Supervision Office was assisted by semi-official supervision bodies of the savings banks and cooperative banks, respectively.

In recent years, the responsibilities of the Banking Supervision Office were substantially enlarged by new legislation, covering inter alia the securities markets. With the exception of insurance companies, basically all financial institutions were supervised by the Banking Supervision Office. Insurance companies were and are the responsibility of the Ministry for Social Affairs and Health.

The Bank of Finland also has some supervisory functions. In part, they are based on the Foreign Exchange Act, which assigns to the Bank of Finland the role of supervisor of the currency risks of financial institutions. In addition, the Bank of Finland has, of course, a supervisory interest of its own because of its role as a lender to the banks.

In line with the aforementioned perception of the nature of risks in banking, the Banking Supervision Office focused very much on the legal aspects of the supervisory functions. Relatively little work was carried out on quantitative risk analysis or in-depth risk appraisal of individual institutions. Thus, when the banks increased their risk positions in the newly liberalized markets, no clear warning or restraining action was forthcoming from the main supervisory authority. Similarly, the Bank of Finland failed to perceive at an early stage the full consequences of the credit boom.

3 Strengthening the Safety Net

The take-over of Skopbank by the Bank of Finland was, by necessity, an ad hoc measure. Subsequent to this rescue operation, the Government decided to approach the looming bank problems on a more systematic basis.

In January 1992, a special working group was appointed by the Prime Minister to review the banking situation. In its report published in March, the group suggested that two major steps be taken.[13] The first was designed to avoid a domestic credit crunch and consisted of a general capital injection into the banking system. The second was to speed up the establishment of the Government Guarantee Fund, which had already been under preparation for some time. The Fund was given responsibility for designing and implementing support measures for banks with acute problems.

In August 1992, the Government announced that the stability of the Finnish banking system would be secured under all circumstances. This first, exceptionally strong and comprehensive declaration expressed the basic principle of the Finnish banking safety net: no systemic problem would be allowed to materialize. Later this commitment was elaborated by Parliament (see section 3.7).

3.1 General capital injection

In March 1992, the Government decided to provide the banks with a capital injection totalling FIM 8 billion in order to support the supply of bank credit to customers. At the same time, the capital infusion would, of course, help banks avoid emergency support. It was offered to all banks regardless of their solvency and in relation to their risk-weighted assets. Banks could apply for the injection only twice, the last time being in December 1992. By that time virtually all banks had availed themselves of the facility, receiving, in all, FIM 7.9 billion in fresh capital.

The instrument used for the capital injection was a preferred capital certificate, which was designed for inclusion in banks' primary (Tier 1) capital. In particular, the investment carries a non-cumulative return, and the capital value of the investment can be written down to cover losses. The certificates can, furthermore, be converted into voting stock if

— interest remains unpaid for three years in succession or

— the bank's solvency ratio falls below the legally required minimum.

The certificates can be used to cover losses after the bank's distributable equity capital and the reserve fund have been exhausted.

The interest rate on the instrument was set slightly above the market rate. Furthermore, the rate gradually increases in relation to the market rate so as to create an incentive for the banks to repay.

[13] The report was published by the Prime Minister's Office (1992).

3.2 The Government Guarantee Fund

The Government Guarantee Fund ("Fund" or "GGF") was established by law on 30 April 1992 to help ensure the stability of the banking system and secure the claims of both domestic and foreign depositors. The Fund was authorized to use up to FIM 20 billion for these purposes. The administrative costs of the Fund are covered by contributions from the banks.

Support can be provided both directly to individual banks or indirectly, through the security funds administered by the different banking groups themselves. In practice, direct support has been the norm. Various techniques can be used as deemed necessary, including aquisition of bank shares, provision of other types of equity capital, loans, guarantees or other types of support. The Fund cannot, however, acquire all types of real or financial assets, thus being restricted from, for example, owning real estate or shares other than bank shares.

Of course, the establishment of the Fund affected the responsibilities of other public authorities. In particular, it was no longer necessary for the Bank of Finland to guarantee the solvency of a troubled bank, as had happened in the Skopbank case. The Bank of Finland was subsequently able to concentrate on the provision of liquidity to the banks. In addition to its normal lending, the Bank of Finland has occasionally extended short-term bridging loans to the Fund.

3.2.1 Organization

According to the original organizational structure, in force until mid-March 1993, decisions on support measures were taken by a section of the board, comprising the representatives of the Banking Supervision Office, the Ministry of Finance and the Bank of Finland. The Section was thus the executive body of the Fund. Banks were represented by three members on the board proper, where decisions on such matters as bank contributions and funding proposals were made. The supervisory board (with the same composition as the Parliamentary supervisory board of the Bank of Finland) supervised the board and its section and made necessary proposals to the Government.

In its work, the Fund has made extensive use of the staff of the Bank of Finland and the Banking Supervision Office. However, the Fund remains a distinct legal entity, with no formal affiliation to any of the afore mentioned authorities. As will be described later (section 3.6), the organization of the Fund was changed in March 1993.

3.2.2 Objectives and guidelines

The Fund's supervisory board drafted general guidelines governing board activities in October 1992. They are used primarily when interpreting and implementing the legal obligations placed on the board and should not therefore necessarily be seen as exhaustive.

According to the guidelines, systemic stability requires that confidence in the banking system is maintained among domestic as well as foreign depositors and investors. One important element of this is that banks conducting international business fulfill international capital adequacy requirements. Another, though separate, element is that bank deposits are safeguarded even though a bank may be unable to meet such obligations out of its own funds or even with the help of the security fund to which it belongs.

Any support programme for a bank should meet a number of general requirements. Their exact interpretation was left to the body making the support decisions (ie the section in the original organization) as they will be part of any particular programme. The requirements are, in full, as follows:

1. Support is transparent and public.

2. The attractiveness and public funding needs of the programme shall be minimized. The economic responsibility of the owners of the bank receiving support should be realized as widely as possible.

3. The terms of the programme shall support the efficiency of the banking system and contribute to necessary structural adjustments.

4. The distorting effects of the support programme on competition shall be minimized.

5. Distortive interest rate competition is not allowed.

6. Public monitoring of the activities of bank receiving support shall be ensured. In particular, the granting of credit or writing off credit on unusual terms should be avoided.

7. The employment terms of the bank's directors shall be reasonable and possible inequities shall be removed.

The exact terms of the support are, nevertheless, decided separately in each case. Accordingly, a lively discussion has, at times, been going on as to how these guidelines should be applied in individual situations. Particularly the extent to which the responsibility of owners should be realized and the usefulness of mergers as a means of rationalizing the banking sector have very much been at the centre of public debate. Nevertheless, the principles as such seem to have been generally accepted.[14]

3.3 Problem bigger than expected in 1992

The amount of funds the Government Guarantee Fund had to use to support the savings bank group in 1992 exceeded the projections made in the spring of 1992 by a substantial margin so that all but FIM 5 billion of the funds authorized had

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[14] The principles of bank support are discussed eg by Nyberg (1992b, 1993) and Aranko (1993). A banker's view is provided eg by Vainio (1993). Vihriälä (1993) discusses bank support and safety net issues more broadly.

been used or earmarked by the end of the year. Moreover, developments in the economy were worse than anticipated as deflationary forces were stronger and growth in export markets weaker than expected. It was therefore considered prudent to increase the resources at the Fund's disposal.

Also, the administration of bank support proved inadequate. According to its original charter, the Government Guarantee Fund had no full-time staff of its own. Staff was assigned from the Bank of Finland and the Banking Supervision Office to the extent needed. Furthermore, a very substantial amount of analytical work was done by staff not permanently assigned to Fund duties. As the number and complexity of bank problems increased it became apparent that the Fund needed a stronger organization. Full-time staff would be necessary, even though staff from the Bank of Finland and the Banking Supervision Office continued to assist the Fund.

The original organization proved problematic in two other respects as well. First, representatives of the Bank of Finland and the Banking Supervision Office could not simultaneously act as owners of the troubled banks and perform their supervisory duties without a conflict of interest. Furthermore, the sheer scale of the support operations implied that the funds should be controlled by a body politically accountable to Parliament, ie by the Government.

3.4 Comprehensive reform proposal

To rectify these shortcomings, the Government introduced a bill in Parliament in January 1993 providing for a comprehensive reform of the existing Act on the Government Guarantee Fund. The bill contained three main elements. First, the authorization of the Fund to grant support was to be raised from FIM 20 billion to FIM 50 billion. Second, the Fund was to be subordinated to the Government instead of Parliament and given permanent staff. Finally, the Fund was to set up and own shares in asset management companies ("bad banks"), into which problem assets of banks in distress could be hived off.

Although there was a broad consensus in Parliament on the need to increase resources earmarked for bank support and the administrative reform also received wide support, the bill failed to obtain the required 5/6 majority.[15] In fact, the main parliamentary groups agreed on the contents of the banking package after the idea of asset management companies had been dropped. However, the opposition refused to support the immediate enactment of the proposed amendment, as the Government was unwilling to commit itself to expansionary fiscal policies being demanded by the opposition.

[15] According to the Finnish constitution, the transfer of budgetary authority away from Parliament must be passed in the same manner as an amendment to the constitution. Immediate ('urgent') enactment of a constitutional amendment, in turn, requires a qualified majority of 5/6 of all votes.

3.5 More resources in a supplementary budget

After the rejection of the comprehensive bank support package, the Government asked Parliament to authorize an increase of FIM 20 billion in the amount available for bank support through a supplementary budget, which can be passed by a simple majority. Of the total, FIM 5 billion was earmarked for guarantees.

The amount was limited to FIM 20 billion because under supplementary budget procedure no more funds can be appropriated than can reasonably be expected to be used during the fiscal year. The actual need for funds in 1993 may, in fact, fall short of FIM 20 billion, as the authorization makes allowance for a number of worst-case assumptions about bank performance and the timing of support actions.

One important aspect of the new bill was that future support measures were to be decided upon by the Government, not by the Fund. In the budget bill, the Government nevertheless committed itself to apply the guidelines adopted by the Fund's Supervisory Board in October 1992. The bill was passed on 2 February, 1993.

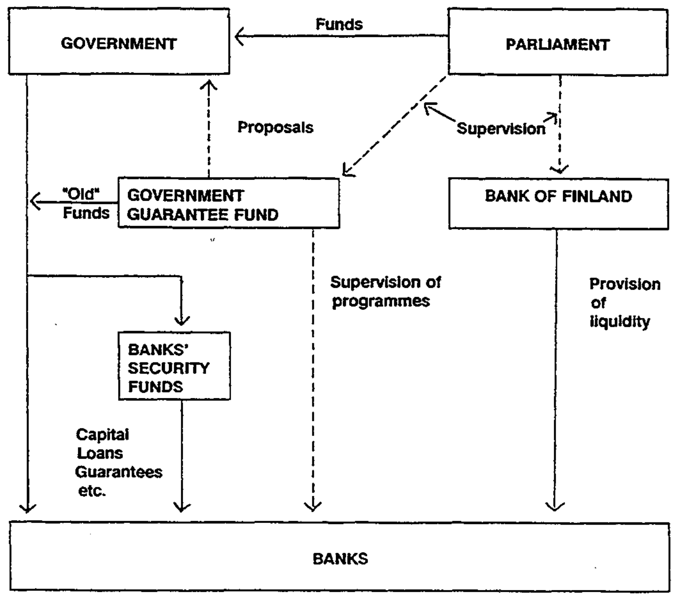
3.6 Administrative reform

In February 1993, the Government proposed an amendment to the Act on the Government Guarantee Fund that provided for a reform of the administration of bank support much along the lines of the more comprehensive reform bill rejected in January. The amendment was approved on 23 February. Under the amendment, the number of board members were reduced to five, only one of whom is a representative of a specified organization, the Ministry of Finance. The Fund reports to the Government, which makes all the support decisions on basis of a formal Fund board proposal.

The Bank of Finland and the Banking Supervision Office are not formally represented on the board. The links to the latter bodies remain, however, through permanent advisers to the board from both organizations. In addition, the Bank of Finland and the Banking Supervision Office continue to assist the Fund (Chart 15).

As before, the board is appointed by the Parliamentary supervisory board, which also retains its other supervisory functions. A manager and assistant manager head a staff of some 20 persons. The new board was appointed in mid-March 1993 and has remained unchanged since. Recently, the Government has indicated that the supervisory board may be redundant and should be abolished, but no formal decision on this has yet been taken. In fact, the present organizational setup may help ensure transparency and, indirectly, continued broad support for the measures necessary for stabilizing the banking system.

Chart 15. **Bank support in Finland**



3.7 Parliament reaffirms commitment to banks

When passing the amendment to the Act on the Government Guarantee Fund, Parliament unanimously approved a resolution endorsing and reaffirming the commitment of the Finnish authorities to safeguarding the stability of the banking system. The resolution reads as follows:

"Parliament requires the state to guarantee that Finnish banks are able to meet their commitments on time under all circumstances. Whenever necessary, Parliament shall grant sufficient appropriations and powers to be used by the Government for meeting such commitments".

The resolution is more explicit than the Government's declaration of 6 August 1992. It stresses that the entire political system stands behind the commitments made by the Finnish banks. It further asserts that, even though Parliament wishes to exercise control over the use of public funds through the normal budgetary procedure, it undertakes to grant all funds that might be needed to guarantee that banks can fulfil their commitments. The resolution is without parallel in Finnish parliamentary history, and remains in force for the time being.[16]

[16] Bank support policy of the Government is spelled out most recently in the Government's communication to Parliament on bank support (December 1993).

3.8 Reorganization of bank supervision

The failure of the supervisory authorities to detect early enough the emerging crisis speeded up plans to strengthen bank supervision. The reform took effect on 1 October 1993.

The basic idea of the reorganization was to increase supervisory efficiency by concentrating the supervision of banks, other credit institutions and securities markets in the hands of a new body called the Financial Supervision Authority (FSA), organized as an autonomous unit in conjunction with the Bank of Finland. The responsibilities of the new authority are essentially the same as those of the earlier Banking Supervision Office, with the exception that FSA carries out, for the Bank of Finland, certain supervisory tasks relating to the Foreign Exchange Act. However, the resources of the Financial Supervision Authority have been substantially strengthened. Most of the personnel of the supervision arm of the Bank of Finland was transferred to FSA, and all basic facilities ie. data processing, library, personnel management etc. are shared by the central bank and the supervisory body. The closer organizational ties between the supervisory body and the central bank should also help pooling the essential information on macro-prudential issues.

In terms of decision making, the Financial Supervision authority is no part of the central bank. The Authority has its own Board consisting of the director of the FSA, and representatives of the Bank of Finland, the Ministry of Finance and in some cases the Ministry for Social Affairs and Health. Most of the operational decisions are taken by the director alone. The decisions of the FSA can appealed to a court like any other administrative decisions.

4 Support Programmes Implemented

After the Skopbank operation by the Bank of Finland and the pre-emptive general capital injection, bank support has been administered by the Government Guarantee Fund. The Fund has supported the banking system in four cases. First, Skopbank was acquired from the Bank of Finland in June 1992 for FIM 1.5 billion. Secondly, also in June 1992, it was decided to support the 41 savings banks who were later to merge to form the Savings Bank of Finland (SBF). This was done with an original commitment of FIM 7.2 billion, of which FIM 5.5 billion in Tier 1 capital. During 1993 the SBF was further recapitalized and eventually sold to its main competitors. Thirdly, in November 1992, the Fund supported the merger agreed on between STS-Bank and KOP by conditionally agreeing to take over a large part of the former's bad assets. Fourth, the Government in principle agreed to provide Kansallis-Osake-Pankki, Union Bank of Finland and the security fund of the cooperative banks with guarantees to be used in connection with their recapitalization.

4.1 Skopbank

The acquisition of Skopbank by the Fund from the Bank of Finland did not involve any major change in the restructuring programme already under way at that bank. However, the holding companies managing part of the industrial holdings and real estate assets of Skopbank remained in the ownership of the Bank of Finland. The aquisition was purely technical, reflecting the new distribution of responsibilities after the setting up of the Government Guarantee Fund.

In addition to the original aquisition cost of FIM 1.5 billion, the Fund provided a further injection of capital of FIM 1 billion in December 1992. A further FIM 1.8 billion was used or committed in 1993.

4.2 Savings Bank of Finland (SBF) Rationalization Effort

A number of savings banks, many of them located in the main urban areas and with substantial amounts of problem assets, showed signs of increasing distress during the first half of 1992. Since the savings bank system was built on the principle of mutual financial responsibility for each other's solvency, the situation created potential problems for a number of other savings banks as well. Additionally, one of the major assets of a number of savings banks was stock in Skopbank, the value of which after the Bank of Finland rescue was a matter of administrative convenience.

It was concluded that the problem could be managed only through a massive merger affecting both problem and nonproblem banks. This was expected to ease the administration of the support and restructuring program as well as utilize the capital resources of the savings banks sector for the rescue. To resolve the situation without overextending the resources of the Fund, the Government Guarantee Fund (GGF) decided, in June 1992, to support the ailing savings banks on condition that 41 of them merged to form the Savings Bank of Finland and accepted a stringent restructuring program. Those forty savings banks which did not take part in the merger continued their activities mainly in the form of traditional savings banks.

The Fund initially provided the emerging SBF with a capital injection (including preferred capital certificates) of FIM 5.5 billion in June, together with a guarantee of FIM 1.7 billion for the issue of a subordinated loan. The subordinated loan was eventually taken up by the Fund itself up to an amount of FIM 1.4 billion while the rest of the facility (FIM 0.3 billion) was converted into additional capital support.

As the economic situation of the SBF proved to be worse than initially estimated, further capital support became necessary. A major reason for this was that the bank's auditors demanded that planned write-downs of real estate holdings had to be speeded up. In December, a further capital injection of FIM 4.7 billion was therefore provided, of which almost FIM 1.2 was in the form of share acquisitions. The total amount spent by the Fund on supporting the SBF had thus reached almost FIM 12.5 billion by the end of 1992. Until October 1993, the SBF received a further FIM 2.1 billion, bringing the total amount of support for the bank to a total of 14.5 billion.

The ultimate goal of the SBF restructuring programme was that the bank should become profitable again by the end of 1996 through eg reductions in operating costs and its branch network. The programme also included other requirements dictated by the general guidelines:

a Owners of the merging savings banks (primarily savings bank foundations) lost virtually all their capital on the banks' balance sheets. The employment terms of directors were trimmed and were to reflect the extent to which the support programme is fulfilled, thus creating incentives for compliance and efficiency.

b The bank undertook to convert itself into a joint stock company as soon as legally possible, the majority of voting stock (or convertible preferred capital certificates) to be held by the Government Guarantee Fund. After that, the Fund would be free to dispose of the stock in a manner which bes serves the general interest. The conversion took place in December 1992.

c Apart from the capital infusions, the Fund did not provide the SBF with any funding at special rates. The Bank of Finland did, of course, extended the same rights to the bank as to other major banks in Finland as regards fulfilling the criteria relating to eg solvency.

d The Fund appointed one member of the board as well as one of SBF's auditors. As owner, the Fund also had the right to appoint a sufficient number of members to the supervisory board of the bank. The bank was also, of course, obliged to report regularly and when so requested on its activities and on its economic and financial situation.

In its restructuring program, accepted by the GGF, SBF undertook to put more stress on retail banking as opposed to investment and commercial banking, to reduce costs markedly and to achieve a more balanced, longer-term funding structure. Risks were to be reduced by shortening the balance sheet.

Cost reductions were to be achieved by vigorously reducing the number of both branches and staff. Accordingly, staff was reduced by about 1500 persons in 1992 and a further almost 600 persons until October, 1993. The bank thus reduced its personnel by more than a quarter in less than two years. During the same period 160 branches were closed, reducing the branch network by almost one fifth. Actual costs savings, of course, lagged behind these numbers because of lay-off costs, and started to have an effect on financial results only during 1993.

Lending and risks were reduced primarily by drawing down credits denominated in foreign currencies, by reducing off-balance sheet items and by drawing down credits to high-risk sectors. By the fall of 1993 the balance sheet was thus reduced to some FIM 86 billion from almost FIM 96 billion by the end of 1992. Further cuts to a final balance sheet of FIM 65 billion by the end of 1996 were foreseen.

While cost and risk reductions remained well on track, performance as regards credit losses and funding was worse than foreseen.

Non-performing loans amounted to FIM 13.5 billion, net, at the end of 1992, after the write-offs of almost FIM 8 billion. During the first nine months of 1993, non-performing loans increased by FIM 3.5 billion which was substantially more than originally expected. However, credit losses were unlikely to increase in the same proportion. The increase in non-performing loans was primarily due to the recession being both deeper and longer than originally foreseen, particularly in the sectors where the bank for historical reasons found itself heavily involved. This represented a development over which the SBF had little control, but the effects on profits was, of course, negative.

Even before the creation of the SBF, the constituent banks were losing deposits at a steady though modest rate for several reasons. First, the savings banks were seen as less solid than other banks and this may have reduced their attractiveness in the eyes of depositors. Secondly, this situation was later actively exploited by the SBF's major competitors. Thirdly, the GGF required the SBF to stop paying the above-average deposit rates that had been agreed to with certain depositors by the savings banks involved in the merger. Since market interest rates gradually fell below the high fixed rate paid on part of these deposits inherited by the SBF, this made good commercial sense also for the bank itself.

The reduction in deposits was almost matched by a fall in SBF assets, which meant that the bank did not encounter acute funding difficulties. In all, deposits fell by more than FIM 3½ billion or some 7 per cent in the period between the end of 1992 and the end of September 1993. Though these developments were largely undramatic, the bank's weakened capability to attract deposits raised questions about SBF's viability in the long run.

Thus the restructuring of SBF proceeded largely as originally planned, though credit losses were larger than expected and some problems appeared on the funding side. However, both SBF itself and the authorities responsible for the handling of the bank were meeting increasingly vehement critisism. This originated both in other domestic banks, in political fora and in the press. It seemed unfair that a bank should be allowed to compete in the market while receiving so much public support[17]. It was also felt that something decisive should be done to rapidly reduce excess capacity in the sector, thus supporting profitability in the sector as a whole. Finally, there was a growing public demand for doing something to end what was seen as a the main focus on the Finnish banking crisis.

4.3 Sale of the SBF

On 22 October 1993, the Finnish Government, on the recommendation of the GGF, decided to sell the sound parts of the Savings Bank of Finland (SBF) balance sheet in equal parts to four of the bank's competitors for a total price of FIM 5.6 billion[18]. This reflected the GGF's view that other options were less advantageous and that restructuring the bank under the GGF's ownership would not prove feasible.

The SBF was split up according to branches. The buyers agreed among themselves on which bank would receive a particular SBF branch, with the constraint that the splitting-up should avoid as far as possible the creation of local monopolies[19]. Each branch is to be transferred with its balance sheet and customers, by May 1994. Of course, the customer is free to choose the bank with which bank he or she wants to do business.

The total value of the SBF assets to be transferred is about FIM 41 billion, which will be financed by deposits to a value of some FIM 49 billion. The buyers agreed among themselves on a temporary restraint on competition in force until 1 April 1994, in order to avoid disruptions in the practical arrangements for the transfer. Deposit and loan conditions of current SBF customers will not be affected by the transfer.

The non-performing assets of SBF are transferred to an asset-holding company (Arsenal Ltd.) financed at the government's risk. The assets include loans, real estate and other assets totalling FIM 30 billion and guarantees totalling FIM 9 billion. Further transfers of assets which turn non-performing or which perform badly may be made in 1994. It is estimated that these additional items could amount to some FIM 4 billion, implying a total risk of some FIM 43 billion. Losses may eventually reach FIM 15 billion. Arsenal Ltd may extend additional credit to its customers in cases where this reduces the total cost to the government.

The remaining part of the balance sheet will, for the time being, be kept on the books of SBF, which will be wound down within a relatively short time. The balance sheet of this entity will primarily consist of miscellaneous securities (of

[17] By summer, 1993, the banks that merged into SBF or that bank itself had received a total of almost FIM 15 billion in capital infusions or other financial support. This was more than one third of the total sum of capital injections and loans used for the banking sector as a whole.

[18] If the cost of closing SBF turns out to be small enough, a conditional outpayment from the bank's remaining value may raise the value recovered by the GGF to some FIM 7 billion.

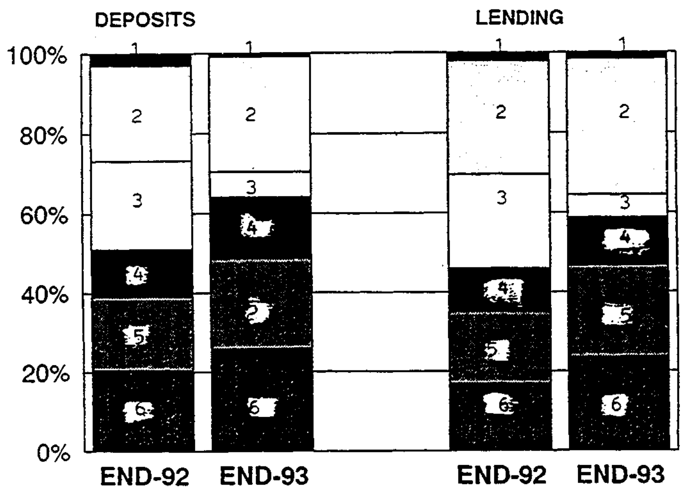
[19] Naturally, this can only be regulated in the initial stage of the transaction. Over time, banks will be free to trade branches among themselves if this makes commercial sense.

which FIM 10 billion remain from the previous SBF) including financing of Arsenal Ltd. and participations, all financed primarily by bank credits, notes and bonds. The SBF will cease to function as a bank within a relatively short time.

The role of Skopbank, in which the GGF maintains its majority shareholding, will not change in any way. It will continue its activities as before, though obviously the volume of its business will decline. It will also continue to function as the central banking institution for the remaining savings banks and to continue to serve its non-bank customers. It will also retain all the rights (to eg central bank financing) of a major Finnish commercial bank.

The sale of the SBF implies a very significant change in banking market shares in Finland. The savings bank group becomes much smaller and ceases to operate in large parts of the country. The cooperative bank group becomes the largest provider of banking services for households, while small and medium-sized businesses rely more equally on each of the four largest bank groups (Chart 16).

Chart 16. **Market shares ***



1 Other banks
2 Co-operative Banks
3 Savings Banks
4 PSP
5 UBF
6 KOP

* Based on parent company data, with the exception that KOP includes Kansallisluottopankki and co-ops include OP-Kotipankki. Other banks include STS-Bank, Ålandsbanken, Interbank and the Finnish subsidiaries and branches of foreign banks.

4.4 STS-Bank

In September 1992, STS-Bank asked the Government Guarantee Fund for support since its assets posed a considerable risk to the solvency of the bank. STS-Bank was a relatively small commercial bank whose status had recently been changed from that of a savings bank. Like many savings banks it was encountering serious profitability problems related to credit losses and reductions in the value of real estate holdings.

As the owners of STS-Bank were unable to provide additional capital and the bank functioned in areas where excess banking capacity existed, it appeared unviable as an independent entity. The Fund therefore encouraged negotiations on a merger between STS-Bank and Kansallis-Osake-Pankki (KOP), a major commercial bank. In November, STS-Bank announced that it was going to merge with KOP. In the same context, KOP bought the majority of STS-Bank shares at a price close to the going market rate, but substantially below their nominal value.

The merger was negotiated in very close cooperation with the Government Guarantee Fund and under its auspices. The Fund assumed responsibility for a substantial part of the problem assets of STS-Bank, subject to subsequent parliamentary approval. The bank's bad assets were to be transferred for eventual disposal to a separate asset management company ("bad bank"), in which the Fund was to have a large majority holding while KOP was to provide administrative expertise.

In the event (see below), Parliament did not approve the creation of such a company, which meant that the provisional agreement could not be finalized as planned. The exact conditions of the merger therefore had to be renegotiated, the situation being complicated by the fact that the amount of problem assets of the STS-Bank turned out to be substantially larger than originally foreseen by the Fund.

On 8 April 1993, the Government Guarantee Fund agreed on an arrangement for managing STS-Bank's problem loans, which totalled approximately FIM 3.4 billion and contained potential losses of some FIM 2.5 billion. These loans are to remain on the books of STS-Bank while other assets will be transferred to KOP. The Fund is responsible for 90 per cent and KOP for 10 per cent of the loan losses and STS-Bank management costs. Because of the unexpected increase in losses, KOP will, inter alia, pay FIM 75 million to the Fund. Finally, the joint security fund of the commercial banks and Postipankki Oy transferred all its assets, totalling approximately FIM 342 million, to the Government Guarantee Fund.

The former STS-Bank (renamed Siltapankki) will continue to function as a commercial bank but will, in its operations focus exclusively on the management of the stock of problem loans (in essence, becoming a "bad bank"). KOP retains ownership of STS-Bank but the effective control of the bank has been transferred to the Government Guarantee Fund under a separate agreement.

4.5 Guarantees provisionally provided to other banks

During 1993, the Government decided, in principle, to support KOP, UBF and the co-operative banks with guarantees to be used when raising risk capital on international markets. For this purpose a guarantee for FIM 1.8 billion was provided for KOP, FIM 1 billion for UBF and FIM 0.9 billion for the co-operative banks for a total of FIM 3.7 billion.

The guarantees are to cover interest and principal on issues of preferred capital certificates and subordinated debentures in the cases of KOP and UBF. In the case of the co-operative banks, the guarantee covers interest payments, for a limited time only, on debt instruments used for support of banks provided by the group's security fund (see section 2.2) to banks within the group.

So far, no bank has utilized the guarantee facility. The use of the facility will probably be determined by both market developments abroad and by the timing and size of the banks capital needs.

4.6 Resources used

In all, the GGF had paid out 16.8 billion for various types of bank support by the end of 1993. The Government, in turn, had paid out FIM 10.7 billion and provided guarantees for a very provisionally estimated total of FIM 42 billion. The Bank of Finland had paid out more than FIM 11 billion in conjunction with the Skopbank operation (not counting interest foregone), including guarantees of FIM 0.5 billion to its asset recovery companies. Therefore, the total amount on general and selective bank support paid out until the end of 1993 was FIM 38.5 billion, supplemented by gurantees for a total of FIM 42.5 billion (of which a large part were either not used or represents rough estimates). The total gross funds committed to banks support were therefore FIM 81 billion or almost 18 per cent of nominal GDP.

The main part of the funds committed were earmarked for the savings banks sector including Arsenal Ltd., Skopbank accounting for FIM 11.6 billion (some 14.5 per cent of the total) and SBF (including Arsenal) for FIM 52.0 billion (some 60 per cent of the total). Other banks received funds or commitments either through the general capital injection in 1992 or through guarantees which so far mainly have not been utilized.

Apart from incurred and potential capital losses, the investments imply significant opportunity costs; for the Bank of Finland alone the estimated interest earnings foregone amounted to some FIM 2.5 billion by the end of 1993.

Most of the paid-out support has been in the form of investments counted towards Tier 1 capital (preferred capital certificates, shares). Decisions on providing guarantees were made for large sums during 1993 but not used. While only a small fraction of the Fund's support is in the form of ordinary loans, the Bank of Finland has significant amounts of loans outstanding on its books.

Table 4. **Bank support in Finland from 1991 to 1993, FIM million**

	Bank of Finland	Council of state				Government Guarantee Fund					Total
		State's capital investment	Preferred capital certificates	Share capital	Guarantee/ surety	Loan	Sub-ordinated loan	Preferred capital certificates	Share capital	Transfer[4]	
1991 Skopbank	4 330[1]										4 330
1992 Skopbank	9 444[2]	580						1 500	1 000		12 524
Savings Bank of Finland		1 094					1 400	7 100	2 900		12 494
Other savings banks		160									160
Security fund of the savings banks						500					500
Okobank		422									422
Cooperative banks		1 108									1 108
Postipankki		903									903
Union bank of Finland/Unitas		1 749									1 749
Kansallis-Osake-Pankki		1 726									1 726
STS-Bank		170									170
1993 Skopbank	-2 722[3]		350					1 200			-1 172
STS-Bank/Siltapankki		-170						3 036			2 866
Savings Bank of Finland			750	250				950	150		2 100
Sale of Savings Bank of Finland		-1 094	-750					-3 756			-5 600
Asset management company Arsenal Ltd				3 442					1 558		5 000
Security fund of the savings banks						-345					-345
Transfer[4] to the Government Guarantee Fund										-357	-357
Support disbursed as at 31 December 1993	11 052	6 648	350	3 692		155	1 400	10 030	5 608	-357	38 578
1992 Guarantees, of which to asset management companies	600										600

Table 4.											
	Bank of Finland	Council of state				Government Guarantee Fund					Total
		State's capital investment	Preferred capital certificates	Share capital	Guarantee/ surety	Loan	Sub-ordinated loan	Preferred capital certificates	Share capital	Transfer[4]	
1993 Guarantees/sureties, of which to asset management companies	-100										-100
Kansallis-Osake-Pankki					1 800[5]						1 800
Union Bank of Finland/Unitas					1 000[5]						1 000
Security fund of the cooperative banks					900[6]						900
Asset management company Arsenal Ltd					38 000[7]						38 000
Skopbank					300						300
Funds committed to bank support	11 552	6 648	350	3 692	42 000	155	1 400	10 030	5 608	-357	81 078
1993 State's other bank risk[8]											
Kansallis-Osake-Pankki				1 001							1 001
Union Bank of Finland/Unitas				445							445
Cooperative banks								700			700
Total	11 552	6 648	350	5 138	42 000	155	1 400	10 730	5 608	-357	83 224

1 Comprises share capital of FIM 2 000 million, a composition of FIM 1 900 million, including a claim of FIM 1 500 million on Oy Tampella Ab waived by Skopbank, asset management companies' equity capital totalling FIM 400 million and other items totalling FIM 30 million.
2 Comprises the transfer of Skopbank's real estate and shareholdings to asset management companies in the total amount of FIM 9 752 million and a loan of FIM 1 500 million to Skopbank; from these amounts have been deducted repayments totalling FIM 1 808 million, including the purchase price of FIM 1 500 million received from the sale of Skopbank's shares and preferred capital certificates.
3 Repayments, comprising repayments of loans raised by asset management companies and repayment of capital.
4 Transferred by the security fund of commercial banks and Postipankki Ltd to the Government Guarantee Fund.
5 Decision in principle.
6 Decision in principle on a guarantee for the repayment of interest.
7 Preliminary estimate of the State's guarantee commitments at the end of 1994.
8 Bank's shares and preferred capital certificates received in payment of the purchase price of the Savings Bank of Finland.

5 Outlook[20]

5.1 Macroeconomic situation

5.1.1 Exports grow but domestic sectors still weak

Banks' prospects for 1994 and 1995 depend crucially on the general macroecomic environment. As in 1993, the current macroeconomic situation continues to be characterized by highly disparate developments. Activity in many key domestic sectors still remains depressed, though the outlook has improved. Consumer sentiment has turned positive as have business expectations. In fact, retail trade in durables, as well as transportation and energy production appear to be picking up. However, construction continues to decline though apparently bottoming out. On the other hand, manufacturing output increased rapidly, the growth rate having been some 10 per cent during 1993, led by the strong increase of exports since mid-1991. Although export growth appears to start tapering off, total output now appears to have started increasing by mid-1993. On average, however, total output in 1993 is likely to have declined by some 2.5 per cent from 1992.

5.1.2 Interest rates down, share prices up

Interest rates have declined considerably following the floating of the markka. Initially, this was due to reduced turbulence on the European currency markets, but domestic developments helped, too. On 14 October 1992, the Government announced a new fiscal package designed, inter alia, to reduce borrowing needs. Furthermore, the Bank of Finland has cut its the base rate in all by 3.25 percentage points since the beginning of 1993. Consequently, Finnish short-term market rates had fallen to around 5 per cent by early 1994 from over 9 per cent a year earlier.

Bond yields have also come down substantially; the yield on 5-year government bonds had declined to around 6 per cent by early 1994 from over 10 per cent a year earlier. This suggests that markets do not expect there to be an acceleration of inflation though the fact that long interest rates were high relative to those abroad indicates some uncertainty. As noted above, the exchange rate strengthened at the same time.

Basic inflation (from which changes in public fees and taxes have been eliminated) is expected to remain around 2 per cent annually in the coming years. This implies present real annual interest rates of 3-4 per cent.

The stock market has risen very rapidly throughout the last year (in fact, since September, 1992). By early 1994, share prices had more than doubled from their value a year before, and the general index is almost at its high, reached in 1989. Foreign interest in acquiring Finnish shares seems to have increased, as a

[20] The outlook for the economy as a whole as well as for the banking sector in particular reflects the situation in early April 1994, and may rapidly become outdated, as new information becomes available.

result of the rising value of the markka and strong competitiveness in the industrial sector.

5.1.3 Growth picks up, external balance improves fast

Growth in Finland's main export markets is expected to gradually strengthen in the near future. This supports the expansion of exports which has been caused by the vast improvement in the price competitiveness brought about by the depreciation of the markka, stagnant labour costs and rapid productivity growth. Furthermore, new export markets have rapidly opened up especially in the Far East. However, at some point, maybe quite soon, capacity constraints as well as market saturation at the going price is likely to retard export growth. Domestic demand is likely to still remain very weak in 1994, partly because the savings ratio remains high, partly because investments remain sluggish. Because of this, total output is projected to pick up only slowly, possibly accelerating markedly during 1995.

Inflation will remain slow because of excess capacity, notwithstanding the contribution of higher import prices following the depreciation of the markka after it was allowed to float. There are signs of some cost pressures in the export sector, and surveys indicate modestly strengthening inflationary expectations.

With domestic demand stagnant, the external balance is improving rapidly. In 1992, the trade surplus more than doubled to FIM 12.5 billion and again to FIM 30.8 billion in 1993. The current account deficit, which was still FIM 22 billion in 1992, diminished to FIM 5.5 billion in 1993. In the course of 1994 the current account is expected to turn into a surplus.

5.2 Near-term prospects for the banking sector

With slow or negative overall growth in the economy, stagnating or declining domestic demand and the heavier debt-service burden of the domestic-sector firms with foreign currency loans, the fall in interest rates during 1993 was not yet sufficient to help banks to attain profitability. Problem loans and credit losses remained substantial. That continued to squeeze net interest earnings. Total balance sheets continued to contract in response to the reduction in bank lending. However, the fall in interest rates as well as the gradual bottoming out of total demand and production reduced bank losses by over a quarter, and the growth of non-performing loans decelerated markedly, even falling in net terms[21] (Table 5).

In 1994, the banks' situation should continue to improve. A substantial fraction of bad loans should have been written off by then, and net interest income should have started to recover as a result of lower money market rates and (probably) higher margins. The rationalization measures under way will make themselves felt in lower operating costs during 1994. In addition, the substantial

[21] The impact of Arsenal Ltd holdings of problem loans on the total is, however, difficult to assess precisely.

Table 5. **The results of individual banks in 1993 (1992), Million of FIM**

	Income and Expenditure by Major Categories 1993					Profit before extraordinary items, appropriations and taxes	
	Income from financial operations	Other Income	Expenses	Credit and guarantee losses	Depreciation	1993	1992
Unitas	2 166	2 515	2 884	3 772	601	-2 576	-2 702
Kansallis-Osake-Pankki	2 273	2 615	3 264	3 814	471	-2 661	-3 659
Postipankki	2 738	1 294	2 233	1 939	213	-353	-640
Skopbank	491	237	649	1 683	97	-1 701	-3 596
Okobank	853	872	976	450	178	121	84
Ålandsbank	103	55	72	48	6	32	27
Interbank	78	17	49	27	8	11	21
Savings banks except SBF	625	298	636		106	-104	-138
Cooperative banks	3 677	1 927	4 651		227	-2 049	34
Sub-total	13 004	9 830	15 414	11 733	1 907	-9 280	-10 569
STS-bank/Siltapankki	-64	202	489	1 441	78	-1 870	-474
Savings Bank of Finland (SBF)	771	1 509	3 332	2 839	631	-4 546	-10 740
Grand total	13 711	11 541	19 235	16 013	2 616	-15 696	-21 783

transfer of sound assets accompanying the increase in deposits associated with the sale of SBF should start to raise bank profits markedly.

However, the degree of improvement will depend very much on the macroenomic climate in the near term. The recovery is expected to continue during 1994, but thus far signs of rising domestic demand are provisional only. A faster-than-expected recovery in the main export markets could significantly boost overall activity in Finland, and thereby enhance the debt-servicing capacity of banks' customers. On the other hand, investment activity could be held back by a prolonged slowdown abroad or lack of finance due to ia. reduced risk tolerance by banks. This would not only postpone the recovery but also further weaken banks' profitability.[22]

Although the weak demand for credit has probably so far prevented a "credit crunch" from constraining investment to any marked extent, credit availability may become a significant impediment in the case of smaller weakly capitalized firms – in part due to lack of collateral – if the demand for credit starts to increase rapidly. The freer provision of financial services across borders brought about by the EEA agreement and the development of the domestic capital markets should, nevertheless, help solid borrowers to find alternatives to borrowing from domestic banks.

[22] The nature of the potential financing problems is discussed eg by Vihriälä (1992). Solttila and Vihriälä (1992) provide some evidence of the link between bank capital and credit supply. Brunila (1992) analyzes the debt problems in various production sectors.

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