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The Guarantee Scheme for Bank Funding in Finland (Finland GFC)

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Guarantee Scheme for Banks' Funding in Finland[1]

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Abstract

As the global financial crisis raged in October 2008, its severe impact on global credit markets impelled governments to enact stabilization measures to calm and protect their domestic economies. The Republic of Finland, though not directly affected, designed preemptive interventions to mitigate disruption to its financial system. Among them was the Guarantee Scheme for Bank Funding in Finland (the Guarantee Scheme), announced on October 22, 2008, and implemented on February 12, 2009, which aimed to support banks and mortgage institutions with their short- and medium-term financing needs. Under the program, the Finnish State Treasury made up to €50 billion available to guarantee new debt issued by any Finnish deposit bank or mortgage institution considered to be solvent by authorities. Initially, types of debt covered by the Guarantee Scheme included new certificates of deposit, unsecured bonds, and other non-subordinated instruments with maturities of greater than 90 days but less than three years. Covered bonds with maturities of up to five years were also eligible. Although the Guarantee Scheme was amended and prolonged twice, it was never utilized and concluded with the expiration of the issuance window on June 30, 2010.

Keywords: Finland, short-term debt, medium-term debt, mortgage banks, credit institutions, government guarantee, guarantee scheme

[1] This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering the responses to the global financial crisis that pertain to bank debt guarantee programs.

Cases are available from the *Journal of Financial Crises* at https://elischolar.library.yale.edu/journal-of-financial-crises/.

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Guarantee Scheme for Banks' Funding in Finland

At a Glance

In the midst of the global financial crisis in October 2008, disruption to international credit markets prompted governments worldwide to enact stabilization measures to both calm and protect their domestic markets. Finland announced on October 22, 2008, a set of interventions that included the Guarantee Scheme for Banks' Funding in Finland. The program was designed to support the short- and medium-term financing needs of banks and mortgage institutions by providing for the issuance of up to €50 billion in government guaranteed debt.

Eligible participants included solvent Finnish deposit banks and mortgage banks, as well as Finnish subsidiaries of foreign financial institutions. Instruments covered under the Guarantee Scheme included senior debt with maturities of greater than 90 days but less than three years. Covered bonds with maturities of up to five years could also be guaranteed. Participation fees varied based on the length of maturity of the debt to be guaranteed as well as the soundness of the issuing bank.

Summary of Key Terms	
Purpose: To support the short- and medium-term financing needs of Finnish banks and mortgage institutions by providing government guarantees for certificates of deposits, unsecured bonds, covered bonds, and other non-subordinated debt instruments	
Announcement Date	October 22, 2008
Operational Date	February 12, 2009
Date of First Guaranteed Issuance	N/A
Issuance Window Expiration Date	Originally April 30, 2009; later extended to June 30, 2010
Program Size	€50 billion, later reduced to €17 billion
Usage	None
Outcomes	N/A
Notable Features	Originally required defaulting banks to transfer mortgages to the State, which was legally impossible

Despite having been prolonged and amended twice, the Guarantee Scheme was never utilized. It was terminated with the expiration of its issuance window on June 30, 2010.

Summary Evaluation

The Finnish government later noted that certain initial design features, such as a relatively short issuance window and strict conditions for participation, may have contributed to the non-use of the Guarantee Scheme.

Guarantee Scheme for Banks' Funding in Finland: Finland Context	
GDP (SAAR, Nominal GDP in LCU converted to USD)	$256.6 billion in 2007 $286.0 billion in 2008 *Source: Bloomberg*
GDP per capita (SAAR, Nominal GDP in LCU converted to USD)	$48,415.00 in 2007 $53,554.00 in 2008 *Source: Bloomberg*
Sovereign credit rating (5-year senior debt)	As of Q4, 2007: Fitch: AAA Moody's: Aaa S&P: AAA As of Q4, 2008: Fitch: AAA Moody's: Aaa S&P: AAA *Source: Bloomberg*
Size of banking system	$195.3 billion in total assets in 2007 $233.7 billion in total assets in 2008 *Source: Bloomberg*
Size of banking system as a percentage of GDP	76.1% in 2007 81.7% in 2008 *Source: Bloomberg*
Size of banking system as a percentage of financial system	Data not available for 2007/2008 *Source: World Bank Global Financial Development Database*
5-bank concentration of banking system	99.5% of total banking assets in 2007 98.1% of total banking assets in 2008 *Source: World Bank Global Financial Development Database*

Foreign involvement in banking system	85.0% of total banking assets in 2007 84.0 % of total banking assets in 2008 *Source: World Bank Global Financial Development Database*
Government ownership of banking system	Data not available for 2007 0% of banks owned by the state in 2008 *Source: Call et al. "Bank Ownership – Trends and Implications"*
Existence of deposit insurance	100% insurance on deposits up to $36,000 in 2008 *Source: OECD*

I. Overview

Background

In light of the international credit crunch and severe market volatility occurring in October 2008 as a result of the global financial crisis (GFC), governments worldwide sought to implement stabilization measures to calm and protect their domestic economies. Although Finnish banks were not under immediate threat of insolvency, it became clear that frozen money markets and soaring interbank lending costs had the potential to impact the daily operation of healthy institutions at a time when access to liquidity was considerably restricted (European Commission 2008). The Republic of Finland thus authorized the creation of the Guarantee Scheme for Banks' Funding in Finland to support the short- and medium- term financing needs of banks and credit institutions and, in turn, the mortgage market. Along with two other preemptive interventions—a state-funded investment program for deposit banks and a commercial paper acquisition scheme for the State Pension Fund—the Guarantee Scheme was designed to mitigate the negative spillover effects of the global crisis on the Finnish financial system.

Program Description

On November 11, 2008, the Finnish Ministry of Finance introduced to the European Commission (EC) a draft of the Guarantee Scheme for Bank Funding in Finland (the Guarantee Scheme). The EC found the terms of the program to be in accordance with State Aid rules and granted its approval on November 13, 2008, citing the "severely impeded access to liquidity for many banks" (European Commission 2008). The program was announced publicly as one of three interventions by the Finnish Cabinet Committee on Economic Policy on October 22, 2008, and implemented on February 12, 2009, after having undergone modifications to its terms on February 5, 2009.

The Guarantee Scheme was governed by the Act on State Lending and State Guarantees (449/1988) and administered by the Central Government Debt Management branch of the State Treasury. The Finnish program was designed to support the short- and medium-term financing needs of domestic banks.

Per Parliamentary Decision No EV 110/2008 vp of December 12, 2008, up to €50 billion in debt issuances could be guaranteed by the government, though this was subsequently reduced to €17 billion. Eligibility was restricted to all Finnish deposit banks and mortgage banks, including the Finnish subsidiaries of foreign financial institutions, considered to be solvent (i.e. possessing a Tier 1 capital ratio of at least 7%) by Finnish authorities (European Commission 2008). Furthermore, deposit banks were allowed to apply either individually, on behalf of their parent company, or as a representative member of a group. Types of debt eligible for coverage under the Guarantee Scheme included certificates of deposit, unsecured bonds, and other non-subordinated debt instruments with maturities of greater than 90 days but less than three years. An exception was made for covered (mortgage-backed) bonds, which could have maturities of up to five years. Debt of any type had to be issued within six months of the initial notification of the Guarantee Scheme to the European Union (i.e. by April 30, 2009). The Guarantee Scheme was not subject to any currency restrictions, and there was no minimum amount required for each issuance.

Caps on individual institutions' participation varied based on the maturity of the debt to be issued. For short-term debt with maturities of up to 12 months, the overall limit was equal the nominal value of such short-term debt outstanding on October 17, 2008. Additionally, the government imposed a monthly limit equal to the total nominal value of the debt that matured during the given month. For medium-term debt with maturities of between 12 months and five years, the overall limit was equal the total nominal value of bonds maturing between October 17, 2008, and December 31, 2009. There were no restrictions placed on the issuance of non-guaranteed debt by participants.

Participation fees were assessed in accordance with both Government Decree No. 67[3] and the "Recommendations on Government Guarantees on Bank Debt," set forth on October 20, 2008, by the European Central Bank. The fee charged for short-term debt with maturities up to 12 months equaled 50 basis points (bps) on an annual basis. The fee scheme for medium-term debt with maturities of more than 12 months was more complex and took into account banks' credit default swap (CDS) spreads or credit ratings. Banks with neither a credit rating nor CDS data derived their applicable CDS spread from the median value of the five-year CDS spread over the same period but for the lowest rating category.

Participants issuing medium-term debt with maturities greater than 12 months also had to pay an add-on fee of 50 bps on an annual basis. If issuing guaranteed covered bonds, participants paid a reduced add-on fee of 25 bps on an annual basis.

This fee structure remained constant throughout the duration of the Guarantee Scheme unless a participant's Tier 1 capital ratio fell below 7%, in which case an additional five basis points would be assessed as a supplement to the add-on fee.

The program initially included special conditions "aimed at eliminating or minimizing any spillover effects which may distort competition," although these conditions were eliminated before the program was launched (European Commission 2008). Under those conditions, the Finnish Supervisory Authority, in particular, was charged with the task of monitoring participating banks to ensure that their aggregate growth in balance sheet volume did not exceed the higher of "the annual growth of Finnish nominal GDP in the preceding year, the average historical growth of balance sheets in the Finnish banking sector during the period 1987–Q3 2008, or the average growth rate of balance sheet volumes in the banking sector in the EU in the preceding six months" (European Commission 2008).

Other restrictions included prohibitions on mass marketing of the Guarantee Scheme and the significant expansion of activities that would not have occurred in the absence of the program, in addition to limits on wage increases, bonus payments, board remuneration, and

[3] Government Decree No 67 laid out fees applicable to temporary State guarantees to deposit banks and mortgage banks of 12 February 2009.

bank executives' severance packages during the guarantee period. A ban was placed on buy-back programs through which a bank repurchased its own shares. Similarly, savings banks were not allowed to buy back basic fund shares, while cooperative banks were not allowed to refund cooperative capital, additional cooperative capital, or cooperative investment capital except for the purpose of terminating their membership in the cooperative.

In the event that the guarantee were to be triggered, the Finnish State Treasury assumed responsibility for all principal (or deposits) and interest, up to the participant's individual cap. If the triggering participant were a mortgage bank that had issued covered bonds backed by mortgages, the mortgages needed to be transferred to the State (European Commission 2009b).

On February 5, 2009, a week before the program's implementation, the European Commission approved a request from the Finnish government to amend the terms of the Guarantee Scheme. Significantly, the modifications included a provision to allow participating banks to roll over some short-term debt (with maturities ranging between 90 days and up to 12 months) to medium-term debt (unsecured bonds with maturities of up to three years). According to State Aid documents, "participating banks can renew the previously guaranteed short-term debt as medium term debt and still retain the same State guarantee" (European Commission 2009a). A total of €5 billion of the €50 billion overall cap would be made available for rollovers. The individual cap available under this provision was the participant's share of the total lending of all eligible banks as of December 31, 2008. A monthly limit equal to the amount of short-term debt maturing in a given month would also be imposed (European Commission 2009a).

The February 5 modification of the Guarantee Scheme also provided for the repeal of the participation restrictions regarding balance sheet growth and buy-back programs. Additionally, the conditions for participation regarding management wages and other remuneration changed to reflect the principles of the competitive remuneration system for state-owned and associated enterprises of 2007 (European Commission 2009a). Other restrictions regarding the general prohibition on activities that would not have taken place in the absence of the Guarantee Scheme, as well as the program's mass marketing, remained in place.

On April 30, 2009, the European Commission approved a request by the Finnish government to amend and prolong the Guarantee Scheme until December 31, 2009. Eligibility was expanded to include instruments with maturities of up to five years. Previously, only covered bonds with maturities of up to five years were allowed coverage. These new terms also applied to medium-term debt that had been rolled over under the February 5 modification of the Guarantee Scheme. A maximum of €16.66 billion (i.e., a third of the program's total cap) was earmarked for the guaranteed issuance of debt with a maturity of greater than three years and less than five years.

The Finnish authorities also repealed the requirement that mortgages be transferred to the State in the event that the guarantee was triggered.

On December 17, 2009, the European Commission approved a second request by the Finnish government to amend and prolong the Guarantee Scheme, this time until June 30, 2010. According to the EC's assessment of Finland's position, "renewed difficulties in banks' access to market funding would cause serious repercussions for households' and firms' ability to refinance their own obligations" (European Commission 2009c). Due to the improved conditions in short-term lending markets, however, two modifications were made to greatly reduce the overall size of the program and focus assistance on banks and institutions issuing medium-term, rather than short-term, debt. The overall cap of the program was reduced from €50 billion to €17 billion, and the minimum maturity for all eligible debt was increased from 90 days to twelve months ("Second Prolongation").

Outcomes

Though in operation for nearly two years, the Guarantee Scheme for Bank Funding in Finland was never utilized. A section in the European Commission's approval of the first prolongation of the program, dated April 30, 2009, detailed potential reasons for the lack of usage, at least initially: until April 17, 2009, no bank or mortgage institution had applied to issue guaranteed debt. Finnish authorities blamed the non-use on the relatively short issuance window (February 12, 2009–April 30, 2009); the brevity of the three-year maximum maturity for debt instruments other than covered bonds; the fact that banks could obtain short-term funding from the national central bank and from the ECB with more lenient participation restrictions; and the requirement that mortgage banks transfer their mortgages to the State in the event the guarantee were triggered (European Commission 2009b).

The program concluded with the final expiration of its issuance window on June 30, 2010.

II. Key Design Decisions

1. The Guarantee Scheme was announced on October 22, 2008, by the Finnish Cabinet Committee on Economic Policy as part of a package of three preemptive interventions enacted in response to the global financial crisis together with a State-funded investment program for deposit banks and a commercial paper acquisition scheme.

The main purpose of the Guarantee Scheme was to support the medium- and short-term financing needs of Finnish banks and mortgage institutions and, in turn, the mortgage market.

To further assist large-scale businesses, the government introduced a State-funded investment program for deposit banks whereby the State Treasury would offer banks interest-bearing subordinate loans that could be considered Tier 1 capital. Additional provisions allowed the State Pension Fund the right to acquire commercial paper "of significant and financially solid Finnish companies" (Mayer Brown 2009).

2. Legal authority for the Guarantee Scheme derived from the Act on State Lending and State Guarantees (449/1988), while the overall cap had to be approved by the Finnish Parliament prior to implementation.

According to the Act on State Lending and State Guarantees (449/1988), the Ministry of Finance would decide all design decisions relating to the creation of the Guarantee Scheme, with the exception of the overall cap. Approval for the maximum program size was granted by legislative vote in Parliamentary Decision No EV 110/2008 vp of December 12, 2008.

3. European Commission approval was required for the implementation of the Guarantee Scheme.

Having found the proposed framework for the Guarantee Scheme to be in line with State Aid rules, the European Commission issued its "Decision not to raise objections" (IP/08/1705) on November 13, 2008 (European Commission 2008). As discussed in more detail in KDD #5, the need to structure the Guarantee Scheme in such a way as to ensure EC approval significantly influenced the design of certain program features.

4. Initially, up to €50 billion was guaranteed under the program.

This maximum amount remained constant until the second modification of the Guarantee Scheme on December 12, 2009, at which point it was decreased to €17 billion. This decrease in the maximum amount that could be guaranteed was tied to the elimination from eligibility of short-term debt. In addition, the minimum eligible maturity increased from 90 days to 12 months as described below (European Commission 2009c).

5. The Guarantee Scheme was made available to all Finnish deposit banks and mortgage banks that were considered to be solvent by Finnish authorities.

Finnish subsidiaries of foreign financial institutions were also eligible for coverage under the Guarantee Scheme.

The applicant could be either a deposit bank or its parent company. If a bank was a member of a group, it could apply either individually or on behalf of the group.

Solvency was determined according to the requirements stipulated in Section 55(1) of the Act on Credit Institutions. At the time of the Guarantee Scheme's proposal to the European Commission, all Finnish banks were required to maintain a Tier 1 capital ratio of at least 7%; if they could not meet that requirement, the add-on fee payable was 5 bps higher. At the time of the guarantee, all Finnish banks had tier 1 capital ratios of at least 7% (European Commission 2008).

6. New certificates of deposit, unsecured bonds, covered bonds, and other non-subordinated debt instruments were eligible for coverage.

In seeking and obtaining approval from the European Commission for the inclusion of covered bonds, Finnish authorities specifically cited the example of Denmark, where the non-inclusion of covered debt in a guarantee program was seen as resulting in the drying up of that market. As additional safeguards associated with the inclusion of covered debt in the Guarantee Scheme, Finland agreed that the amount of such debt that could be guaranteed would be limited to €250 million and that guaranteed covered bonds would have to mature in 2009 (European Commission 2008).

7. Initially, debt with maturities of more than 90 days but less than three years could be issued under the Guarantee Scheme.

An exception was made for covered (mortgage-backed) bonds, which could have maturities of up to five years.

Per the April 30, 2009, modification, all eligible debt with maturities greater than 90 days and up to five years could be guaranteed. The Finnish government requested this expansion based on its belief that the initial three-year maturity limit was contributing to the lack of use of the Guarantee Scheme. Up to €16.66 billion (i.e., a third) of the €50 billion program cap was earmarked to guarantee eligible debt with maturities greater than three years and less than five years (European Commission 2009b).

On December 17, 2009, the European Commission approved a request by the Finnish government to amend the minimum maturity restrictions from 90 days to 12 months. This request stemmed from Finnish authorities' belief that financial institutions could now access short-term funding at reasonable prices without relying on any guarantee. The Guarantee Scheme thus covered only those instruments with maturities of between 12 months and five years. A maximum of approximately €5.66 billion (i.e., a third of the reduced budget of €17 billion) could be used to guarantee issuances with terms over three years and up to five years. (European Commission 2009c).

8. The government allowed a limited amount of short-term debt to be rolled over into medium-term debt under the Guarantee Scheme.

On February 5, 2009, shortly before implementation, the government modified the original terms of the Guarantee Scheme to allow some short-term debt (those instruments with maturities ranging from 90 days to 12 months) to be rolled over to medium-term debt (unsecured bonds with maturities of up to three years). Participating banks were thus allowed to "renew the previously guaranteed short-term debt as medium term debt and still retain the same State guarantee" (European Commission 2009a). Up to €5 billion of the €50 billion program cap could be rolled over under these terms.

The individual cap available under this provision equaled the participant's share of the total lending of all eligible banks as of December 31, 2008. A monthly limit equal to the amount of short-term debt maturing in a given month was also imposed.

9. All currencies appear to have been eligible.

Program documents contained no references to restrictions on the currencies that would be eligible for the Guarantee Scheme.

10. The Ministry of Finance imposed caps on individual banks participation based on the maturity of the debt guaranteed.

For short-term debt with maturities of up to 12 months, the overall limit equaled the total nominal value of such debt outstanding October 17, 2008. The government also applied a monthly limit equal to the total nominal value of the debt maturing in a given month.

For medium-term debt with maturities of over 12 months and up to five years, the overall limit equaled the total nominal value of the bonds maturing between October 17, 2008, and December 31, 2009. There was no monthly cap imposed on the guaranteed issuance of medium-term debt.

11. Participation fees were assessed according to the maturity of the debt guaranteed and the soundness of the participating institution.

Both Government Decree No. 67 and the ECB's "Recommendations on Government Guarantees on Bank Debt" provided guidance on the fee structure.

For short-term debt with maturities of up to 12 months, the fee equaled 50 basis points on an annual basis.

For medium-term debt with maturities over 12 months, the total participation fee comprised two separate payments:

1) A fee based on the bank's CDS spread, determined as follows:

    a. Banks with CDS data were charged the median value of their five-year CDS spreads from the period spanning January 1, 2007, to August 31, 2008;

    b. Banks with a credit rating but without CDS data (or representative CDS data) were required to calculate an equivalent CDS spread based on a "representative sample of euro area large banks" (European Commission 2008). This derivation was taken over the same time period for the rating category of the bank in question;

    c. Banks with neither a credit rating nor CDS data derived their CDS spread from the median value of the five-year CDS spread over the same time period for the lowest rating category;

2) An add-on fee of 50 bps on an annual basis.

Guaranteed covered bonds received a special pricing structure consisting of the issuing institution's CDS spread and a lesser add-on fee of 25 bps on an annual basis.

Regardless of the type or maturity of the eligible debt, the add-on fee increased by 5 bps if the Tier 1 capital ratio of the issuing bank fell below 7%.

12. The Finnish government initially imposed restrictions on growth and compensation as conditions of participation before ultimately loosening such restrictions.

Guidance issued by the European Commission in October 2008 on the creation of credit guarantee programs called for the inclusion in programs of a set of safeguards "to minimize . . . distortions and the potential abuse of the preferential situations of beneficiaries brought about by a State guarantee" and "to avoid moral hazard." This guidance did not specify exactly what safeguards a program should include, but required "an adequate combination" of elements, including restrictions on advertising based on the guarantee, balance sheet growth, share buybacks, and executive compensation, some of which Finland adopted (European Commission 2008).

The Finnish Financial Supervisory Authority was to be responsible for ensuring that the aggregate growth in balance sheet volume of participating banks not exceed the higher of:

1) "The annual rate of growth of Finnish nominal GDP in the preceding year,

2) "The average historical growth of balance sheets in the Finnish banking sector during the period 1987–2008 (Quarter 3), or

3) "The average growth rate of the balance sheet volumes in the banking sector in the EU in the preceding months" (European Commission 2008).

Additionally, the government imposed restrictions on wage increases, bonus payments, increases in board remuneration, and bank executives´ severance packages. Relatedly, banks were generally not allowed to engage in activities that would not have otherwise occurred in the program's absence, such as the mass marketing of the Guarantee Scheme, "except when required by law or other regulations" (European Commission 2008).

Participating banks were also prohibited from creating buy-back programs for their own shares. Relatedly, savings banks were not allowed to buy or otherwise acquire against payment their bank fund shares, while cooperative banks were not allowed to refund cooperative capital, additional cooperative capital, or cooperative investment capital "for any other reason than termination of membership in the cooperative" (European Commission 2008).

Before the program was implemented, the restrictions on balance sheet growth and buy-back programs were repealed in the February 5, 2009, modification of the Guarantee Scheme terms. All conditions on compensation and management wages were also modified to reflect the principles of the competitive remuneration for State-owned and associated companies (European Commission 2009a).

13. Initially, the Guarantee Scheme required participating mortgage banks to transfer their guaranteed mortgages to the State if the guarantee were triggered. This requirement was ultimately abandoned.

Due to legal restrictions on the transfer of these mortgages, this requirement was repealed in the April 30, 2009, modification to the Guarantee Scheme.

For any institution defaulting on its liabilities and triggering the guarantee, Finnish authorities committed to file individual restructuring/liquidation plans within six months (European Commission 2008).

14. Initially, the window for issuing guaranteed debt was set to expire on April 30, 2009. It was ultimately extended to June 30, 2010.

On April 30, 2009, the European Commission approved a modified extension of the Guarantee Scheme issuance window to December 31, 2009. On December 17, 2009, the EC approved a second prolongation of the program to conclude on June 30, 2010. These extensions occurred despite the fact that the Guarantee Scheme had not yet been used. In their requests for extensions, Finnish authorities noted that while Finnish banks had access to medium-term funding without resort to the Guarantee Scheme, such access was fragile and could be quickly jeopardized based on any negative news (European Commission 2009c). Thus, the extension of the Guarantee Scheme, despite its lack of use appears, to have been a precautionary step intended to provide a backstop should conditions worsen.

III. Evaluation

As noted in the Outcomes section, the Finnish government notified the European Commission that certain design features, such as the relatively short issuance window and the strict conditions for participation, may have contributed to the limited usage of the Guarantee Scheme, at least initially (European Commission 2009b). Based on the justifications provided by the Finnish government in seeking to extend the Guarantee Scheme despite its lack of use, Finnish financial institutions ultimately appear to have been able to access short- and medium-term funding without resort to the guarantee. The Guarantee Scheme appears to have served as a precautionary backstop to ensure continued access to funding should conditions have deteriorated further.

Due to its lack of utilization, there has otherwise been very little formal evaluation of the Guarantee Scheme.

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