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### Denmark Guarantee Scheme

Keni Sabath

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## Denmark Guarantee Scheme

Keni Sabath<sup>1</sup>

January 16, 2019

### Abstract

The international financial system had been experiencing challenges for almost a year before the crisis truly manifested in Denmark during the Summer of 2008 with the sudden demise of Roskilde Bank, Denmark's eighth largest bank. As more Danish banks became distressed in the fall of 2008 after the collapse of Lehman Brothers, the government determined that it was necessary to intervene in the banking sector through actions such as taking over and winding-up distressed banks, giving guarantees to the sector, and providing capital injections and liquidity support. This paper focuses on the two different types of guarantee schemes which were both implemented at the outset of the Global Financial Crisis by the Danish government in the fall of 2008 and in early 2009. The main difference between the two guarantee schemes was their breadth. While the Original Guarantee Scheme was a blanket guarantee--covering essentially all Danish banks and all unsecured debt regardless of maturity, complexity, or any other terms or conditions of the instrument--the New Guarantee Scheme required applications by individual credit institutions. Both programs were heavily utilized. Under the Original Guarantee, almost all of the Danish banking industry in terms of market share was covered, with only 14 small banks out of almost 140 opting not to be covered. Similarly, by the time the issuance window of the New Guarantee expired in December of 2010, it had guaranteed debt issuances of about 50 institutions that totaled approximately DKK 193 billion (approximately €26 billion).

**Keywords:** Denmark, Danish, Original Guarantee Scheme, New Guarantee Scheme, Transition Scheme, Credit Scheme, Credit Guarantee Scheme

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# Denmark Guarantee Scheme

## At a Glance

The Global Financial Crisis hit Denmark during the Summer of 2008 with the sudden demise of Roskilde Bank, Denmark's eighth largest bank. As more Danish banks became distressed after the collapse of Lehman Brothers, the Danish government determined that it was necessary to intervene in the banking sector. This paper focuses on the two different types of guarantee schemes implemented by the Danish government in the fall of 2008 and in early 2009. While the Original Guarantee Scheme was a blanket guarantee--covering essentially all Danish banks and all unsecured debt regardless of maturity, complexity, or any other terms or conditions of the instrument--the New Guarantee Scheme required applications by individual credit institutions. Both programs were heavily utilized. Under the Original Guarantee, almost all of the Danish banking industry in terms of market share was covered, with only 14 small banks out of almost 140 opting not to be covered. Similarly, by the time the issuance window of the New Guarantee expired in December of 2010, it had guaranteed debt issuances of about 50 institutions that totaled approximately DKK 193 billion (approximately €26 billion).

## Summary Evaluation

While it can be difficult to isolate the overall effect of any specific policy measure used as part of broader response to the Great Financial Crisis, both guarantee schemes are regarded by the Danish government as having helped Denmark's financial sector recover.

Summary of Key Terms	
<b>Purpose:</b>	Both guarantees were implemented to revive interbank lending and meet banks' liquidity needs.
<b>Announcement Date</b>	Oct. 10, 2008 (Original); Feb. 2, 2009 (New)
<b>Operational Date</b>	Oct. 11, 2008 (Original); Feb. 4, 2009 (New)
<b>Date of First Guaranteed Loan Issuance</b>	N/A (Original) Feb. 2009 (New)
<b>Issuance Window Expiration Date</b>	Sep. 30, 2010 (Original); Dec. 31, 2010 (New)
<b>Program Size</b>	Estimated losses between DKK 10-35 billion (€1.34-4.69 billion) (Original); Estimated guaranteed debt up to DKK 600 billion in debt (€80.41 billion) (New)
<b>Usage</b>	Total amount of guaranteed debt by over 133 banks is not readily available (Original); DKK 193 billion (€25.87 billion) in guaranteed debt by over 50 institutions (New)
<b>Outcomes</b>	DKK 22.5 billion (€3.02 billion) total cost for winding-up banks and paying on defaults, and DKK 2.5 billion (€335 million) total in profit from fees (Original); DKK 193 billion (€25.87 billion) in guaranteed debt by over 50 institutions (New)
<b>Notable Features</b>	Industry group extensively involved in the design and funding of the Original Guarantee

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# I. Overview

## Background

The international financial system had been experiencing challenges for almost a year before the crisis truly manifested in Denmark during the Summer of 2008 with the sudden demise of Roskilde Bank--Denmark's eighth largest bank with a balance sheet of almost DKK 43 billion<sup>2</sup> and approximately 105,000 customers. Roskilde's collapse was symptomatic of a more systemic weakness in Denmark's banking sector, namely an increased dependence on short-term market financing that had reshaped the industry in recent years. This weakness was challenged in the fall of 2008 when foreign credit institutions and money market funds started to doubt the health and creditworthiness of Danish financial institutions. In the wake of Lehman Brothers' bankruptcy in September 2008, Danish financial institutions were even more severely cut off from access to liquidity on account of the international crisis of confidence between financial institutions.

As more Danish banks became distressed in the fall of 2008, the government determined that it was necessary to intervene in the banking sector through actions such as taking over and winding-up distressed banks, giving guarantees to the sector, and providing capital injections and liquidity support. Throughout the financial crisis and its aftermath, Danish authorities implemented these various measures to help safeguard financial stability in consecutive stages now known as the six Bank Packages. The first two Bank Packages at the outset of the crisis involved guarantee programs that are the focus of this paper. The Bank Package I guarantee scheme was introduced with the October 2008 passage of the Financial Stability Act, and the Bank Package II guarantee scheme was based on a February 2009 amendment to the same Act. The main difference between the two guarantee schemes was their breadth. While the first was a blanket guarantee--covering essentially all Danish banks and all unsecured debt regardless of maturity, complexity, or any other terms or conditions of the instrument--the second required applications by individual credit institutions.

## Program Description

### Bank Package I

The first Bank Package implemented in October 2008 consisted of two main components. First, it established an unlimited government guarantee for all claims of depositors and other unsecured creditors in Danish banks (who were members of the Private Contingency Agency, a private consortium of Danish banks established in 2007) to the extent such claims were not otherwise covered by other programs such as the Danish Deposit Guarantee Scheme.<sup>3</sup> Around the time of its implementation, this component of the package was often

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<sup>2</sup> DKK 43 billion is approximately €5.76 billion according to the average Jun. 2008 through Aug. 2008 exchange rate (€1 = DKK 7.4614)

<sup>3</sup> Act on Financial Stability specifies, "By simple creditors, this Act means depositors and creditors whose claims are not covered by sections 132 and 136 of the Financial Business Act. Creditors whose claims are based on

referred to as the “Guarantee Scheme” or the “Original Guarantee Scheme.” Its purpose was to “set up a safety net for two years” to “safeguard financial stability by contributing to the resumption of interbank lending” (*State Aid NN51/2008*). This blanket state-backed guarantee scheme expired in September 2010.

Secondly, the Bank Package I legislation also created a Winding-up Company, owned by the State, with a mandate to handle distressed firms and administer the guarantee scheme. If any scheme member banks failed, the Winding-up Company would ensure that “depositors and other ordinary creditors can be repaid pursuant to the guarantee in the context of an orderly winding up” (*State Aid NN51/2008*). In such a situation, the Winding-up Company would provide capital to a newly established company which would take over and wind-up the failing bank. The Winding-up Company was originally designed to continue operating indefinitely after the two-year guarantee expired and still exists today. The Winding-up Company was named Finansiel Stabilitet and is also referred to as the Financial Stability Company, Finansiel Stabilitet Afviklingsselskabet, or Finansiel Stabilitet A/S.

The Original Guarantee Scheme operated on an all-in or all-out approach to the banks’ participation under the scheme rather than on applications for a state guarantee of individual issues of debt. The scheme’s underlying legislation, the Act of Financial Stability, was based on an October 5, 2008 agreement between the State and the Private Contingency Association (PCA) (a group simultaneously represented by the Danish Bankers Association) which stipulated that the PCA would be charged for the government guarantee through annual payments. The guarantee scheme covered only banks that requested by October 13, 2008, to become a member of the Danish PCA.<sup>4</sup>

The PCA’s extensive involvement in the design and funding of the Original Guarantee Scheme highlights Denmark’s collective, collaborative, industry-focused approach to addressing financial crises. The PCA was formed in 2007 by the banking industry. From 1994 until then, Denmark had operated a public deposit insurance that was ultimately judged to be in violation of EU state aid rules in 2007 (Woll 2014). As a result, the Danish banking industry banded together and established the PCA as a private alternative for distressed banks. In 2008, the PCA was first tested when Roskilde Bank became distressed; the PCA took over joint ownership of Roskilde with Danmarks Nationalbank (the central bank of Denmark). However, the failing bank’s major losses exhausted the PCA’s funds and thus underscored the need for an expanded government role in future windings-ups and financial sector interventions.

Through the PCA, the banking industry significantly contributed to the funding of the scheme, both by directly paying the government for the guarantee with DKK 15 billion and by contributing another DKK10 billion to cover losses. The PCA also committed to contribute another DKK10 billion to cover any further losses (although this second DKK 10 billion was never needed). The contribution of individual PCA-member banks was managed through the PCA. As a result of this funding structure, another way to conceptualize of Bank Package I

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covered bonds, cf. section 16 a of the Financial Business (SDO) Act, are not covered by the guarantee scheme in this Act.”

<sup>4</sup> In Danish the PCA is called the Det Private Beredskab (DPB) and is also sometimes translated as the Private Reserve Fund. Some translations of the Act on Financial Stability refer to the PCA mores specifically as banks which contribute to the Private Emergency Banking, Savings and Shareholders’ Compensation Fund

was as an industry-financed scheme where the State would only need to step in when losses exceed DKK 35 billion.

### **Bank Package II**

In January 2009, the Danish government implemented Bank Package II via a legislative amendment to the Act on Financial Stability. Bank Package II had two parts: the New Guarantee Scheme, and also a recapitalization scheme which gave banks access to capital through preferred shares acquired by the government, for a total of potentially up to DKK 100 billion.

The New Guarantee Scheme could cover newly issued debt with maturities of up to three years in order to “ensure the credit institutions continued access to medium term liquidity and by that, avoi[d] the banks cutting off loans and credits” (*State Aid N31a 2009*). The government does not appear to have established minimum maturity requirements for eligible debt. At the time of implementation, this guarantee was known by some as the “New Guarantee Scheme,” “Credit Scheme,” and/or the “Transition Scheme.” Under this program, all credit institutions which met minimum capital requirements, including commercial banks as well as mortgage credit institutions (which were not covered in the Original Guarantee Scheme), were able to apply for a state guarantee for individual issues of unsubordinated and unsecured debt and for issues of supplemental security for covered bonds or covered mortgage bonds. Any application for a state guarantee under this scheme had to be submitted no later than December 31, 2010.

Fees were calculated in line with the October 2008 recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt, and were based on the creditworthiness of the applying institution. For banks with CDS data, the calculation of CDS spreads was based on “(i) the median value of 5 year CDS spreads over a sample period starting on 1 January 2007 and ending on 31 August 2008, or (ii) the median value of the 5 year CDS spreads during the same sample period for the rating category of the bank concerned, whichever is the lowest” (*State Aid N31a 2009*). For banks without CDS data nor representative CDS data who still had a credit rating, an equivalent CDS spread could be derived from the “median value of 5 year CDS spreads during the same sample period for the rating category of the bank concerned” (*State Aid N31a 2009*). Banks without CDS/representative CDS data and without a credit rating, an equivalent CDS spread was to be derived from the “median value of 5 year CDS spreads during the same sample period for the lowest rating category” (*State Aid N31a 2009*). The total price of the credit guarantee also included the add-on fee of 50 basis points.

In order to achieve European Commission approval, the Danish government had to request an extension of the New Guarantee Scheme every six months. The terms of the New Guarantee remained the same during the first two extensions. These included “remuneration, behavioural constraints, and reporting requirements” (*State Aid N415 2009*). Failure to comply with risk restrictions or other risky behavior could lead to exclusion from the schemes, after which it would not be possible for such banks or branches to re-enter. However, during the third extension, new “viability review requirements and an additional reporting obligation” were introduced and the guarantee fee increased in accordance with European Commission guidelines for extended guarantees (*State Aid N257 2010*).



Specifically, the guarantee fee was increased to be higher than the original pricing formula recommended by the European Central Bank in October 2008 at least by 20 basis points for banks with a rating of A+ or A, 30 basis points for banks rated A-, and 40 basis points for banks rated below A- or banks without a rating (*State Aid N257 2010*).

## Outcomes

While the total amount of guaranteed debt under the Original Guarantee is not readily available, the amount was clearly substantial. Because coverage extended to all institutions that contributed to the PCA, effectively all of the Danish banking industry in terms of market share was covered (Woll 2014). Only 14 banks with inconsequential market share chose not to be covered (Gry Braad 2008).

The effectiveness of the guarantee schemes in Denmark at avoiding bank failures must be evaluated with the understanding that Denmark's financial sector was dominated by small and medium-sized banks at the time of the Global Financial Crisis. For example, despite a total number of about 140 financial institutions operating in Denmark in 2008, only five had an operating capital of over DKK 50 billion and only an additional 12 had over DKK 10 billion in 2008 (Woll 2014). During Bank Package I in particular, the Winding-up Company known as Finansiell Stabilitet bought banking activities from eight failing banks. The amount of guaranteed debt that needed to be paid out and overall cost of winding-up distressed firms totaled around DKK 22.5 billion. However despite the losses, by the end of the program, estimates indicated that Bank Package I generated an upside of DKK 2.5 billion for the Danish government. By the time Bank Package II expired in December of 2010, it had guaranteed debt issuances of about 50 institutions that totaled approximately DKK 193 billion.

## II. Key Design Decisions

### 1. The Danish government passed the Original Guarantee Scheme as part of Bank Package I on October 10, 2008 and the New Guarantee Scheme as part of Bank Package II on February 2, 2009

The Original Guarantee Scheme was part of a two-part package that became known as Bank Package I. First, it declared that all banks that were members of the private consortium of Danish banks known as the Private Contingency Association (PCA) were covered by an unlimited deposit guarantee until September 30, 2010 unless they chose to opt out of the blanket guarantee. Second, it created a state-owned Winding-up Company called Finansiell Stabilitet that would secure payment of creditor claims to distressed institutions and handle the controlled dismantling of financial institutions that no longer met solvency requirements.

The New Guarantee Scheme was introduced as part of a multi-part scheme today known as Bank Package II. First, it introduced a guarantee scheme for newly issued debt (by banks and other credit institutions) to be administered by Finansiell Stabilitet. Second, it gave banks access to capital through preferred shares acquired by the government, for a total of potentially up to DKK 100 billion. The Ministry of Economic and Business Affairs administered the recapitalization scheme.

## **2. Both guarantee schemes were established pursuant to the statutory authority of the Danish Act on Financial Stability**

The Original Guarantee Scheme was based on an agreement from October 5, 2008 between the Danish government and a private consortium of Danish banks known as the Private Contingency Association. That agreement was then codified into law on October 10, 2008, in the Act on Financial Stability.

The New Guarantee Scheme was enacted on February 4, 2009 through an Act to Amend the Act on Financial Stability.

## **3. In accordance with European Commission (EC) Treaty state aid rules, both schemes required and received EC approval to be implemented**

The Danish authorities notified the European Commission (EC) on October 8, 2008 of the Original Guarantee and received the EC's approval on October 10, 2008 under a new, simplified protocol for emergency rescue measures. The Commission found the scheme to be "compatible with EU state aid rules because it [was] the most appropriate means to address the risk of a severe disturbance in the Danish economy, while keeping potential distortions of competition to a minimum through effective safeguard mechanisms" (*State Aid: Commission 2008*).

The New Guarantee Scheme was presented to the EC on January 23, 2009 and received approval by the EC on February 3, 2009. The EC found that the measures of Bank Package II were "limited in time and scope, require[d] market oriented remuneration and contain[ed] sufficient safeguards to avoid abuses" and thus compatible with the EC Treaty (*State Aid: Commission 2009*).

## **4. Both schemes were administered by Finansielt Stabilitet**

The Danish Act on Financial Stability set up a state-owned Winding-up Company called Finansielt Stabilitet (also known as the Financial Stability Company, Finansielt Stabilitet Afviklingsselskabet, or Finansielt Stabilitet A/S) to administer both the Original and New Guarantees and to wind-up distressed financial firms.

## **5. The estimated cost in terms of losses under the Original Guarantee Scheme was between DKK 10 and 35 billion, and the maximum amount that could be issued under the New Guarantee Scheme was DKK 600 billion**

The total amount covered by the Original Guarantee Scheme is not readily available. However, when the Original Guarantee Scheme was enacted, the Danish government estimated the cost of scheme in terms of losses would be at least DDK 10 billion. The Private Contingency Association committed to contributing up to DKK 35 billion to cover initial losses on guaranteed debt. The Danish government committed to covering any and all losses exceeding the DKK 35 billion.

With the New Guarantee Scheme, the Danish government estimated that the maximum amount issued would not exceed DKK 600 billion.

**6. The Original Guarantee Scheme automatically covered all 137 existing members banks of the Private Contingency Association (PCA), and some banks were able to apply for PCA membership and thus guarantee-coverage in the days immediately after the scheme was enacted. Under the New Guarantee Scheme, all Danish banks and credit institutions that met certain solvency requirements were eligible to apply for guaranteed debt**

The Original Guarantee Scheme covered all Danish banks which no later than October 13, 2008 had requested to become member of the Private Contingency Association and had not actively opted out of the scheme. Foreign banks registered in Denmark, including subsidiaries of foreign banks, could join the scheme fully. In addition, debt obligations of banks to foreign nationals were covered. Banks and branches participating in the Original Guarantee Scheme could not subsequently withdraw from the scheme. Failure to comply with risk restrictions or other behaviors could lead to exclusion from the Guarantee Scheme; it would not be possible for such bank or branch to re-enter.

Under the New Guarantee Scheme, Danish banks, subsidiaries in Denmark of foreign banks and Danish credit institutions which satisfied certain capital requirements in the Danish Financial Business Act were eligible to apply for a state guarantee granted on a case-by-case basis. The terms of the state guarantee were set out in an individual guarantee document with terms determined through negotiation between the credit institution applying for the state guarantee and the Winding-Up Company, Finansiel Stabilitet.<sup>5</sup>

**7. The Original Guarantee Scheme covered almost all unsecured debt that was not otherwise covered, regardless of type. Under the New Guarantee Scheme, existing and new non-repayable unsecured debts and supplementary collateral were all eligible**

The Original Guarantee Scheme guaranteed all depositors and ordinary creditors against losses to the extent that those claims were not otherwise covered (cf. sections 132 and 136 of the Danish Financial Business Act). The guarantee did not include covered bonds (cf. section 16 a of the Financial Business Act), nor did it cover claims based on tier 1 and 2 capital in the form of hybrid core capital and subordinate loan capital (cf. Sections 132 and 136 of the Financial Business Act).

The New Guarantee Scheme covered existing and new unsecured debts and supplementary collateral (junior covered bonds), including commercial papers, senior unsecured bonds, supplementary securitized capital covered bonds, and new loans covering existing debt. Subordinated debt was not covered.

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<sup>5</sup> Also known as the Financial Stability Company, Finansiel Stabilitet Afviklingselskabet, or Finansiel Stabilitet A/S.

**8. Under the Original Guarantee Scheme, debt of any maturity could be guaranteed, but the guarantee on that debt expired by September 30, 2010 regardless of the debt's actual maturity. With the New Guarantee Scheme, eligible debt could have a maturity of up to three years maximum. The government does not appear to have established minimum maturity requirements for eligible debt under the New Guarantee Scheme**

**9. All currencies appear to have been eligible for both guarantees**

**10. Neither scheme capped the extent to which an individual institution could participate**

**11. The fee for participating in either scheme depended on the creditworthiness of the eligible institution**

Under the Original Guarantee Scheme, the Private Contingency Association (PCA) paid an annual fee of DKK 7.5 billion for two years in addition to an initial DKK 10 billion. The PCA committed to paying another DKK 10 billion if losses surpassed DKK 25 billion; however, this condition was never triggered. Fees for individual banks were risk-adjusted and calculated by the PCA in relation to each bank's required capital and solvency rules.

Under the New Guarantee Scheme, beneficiary institutions paid a fee based on the Recommendations of the European Central Bank. These fees were risk-adjusted and based on the credit-default-swap spread for the applicant credit institution. For banks with CDS data, the calculation of CDS spreads was based on "(i) the median value of 5 year CDS spreads over a sample period starting on 1 January 2007 and ending on 31 August 2008, or (ii) the median value of the 5 year CDS spreads during the same sample period for the rating category of the bank concerned, whichever is the lowest" (*State Aid N31a/2009*). For banks without CDS data nor representative CDS data who still had a credit rating, an equivalent CDS spread could be derived from the median value of 5 year CDS spreads during the same sample period for the rating category of the bank concerned. The total price of the credit guarantee also included the add-on fee of 50 basis points. Banks without CDS/representative CDS data and without a credit rating, an equivalent CDS spread was to be derived from the median value of 5 year CDS spreads during the same sample period for the lowest rating category.

After the third extension of the New Guarantee Scheme, there was an increase in the guarantee fee based on European Commission's updated compatibility conditions for the renewal of guarantee schemes. Specifically, the guarantee fee was increased to be higher than the original pricing formula recommended by the European Central Bank in October 2008 at least by 20 basis points for banks with a rating of A+ or A, 30 basis points for banks rated A-, and 40 basis points for banks rated below A- or banks without a rating (*State Aid N257/2010*).

There were several other conditions relating to fees under the New Guarantee Scheme: For issues of junior covered bonds the guarantee premiums would be determined on the basis of a market based risk assessment. For both issues of unsubordinated and unsecured debt and issues of junior covered bonds, the maximum aggregate premium would not exceed 0.95 percent per annum. If the guaranteed loan was issued in a currency other than Danish

kroner, the guarantee premium could be increased to reflect the increased costs involved with making payments in another currency.

For banks using both schemes, the benefits of the New Guarantee were free until the Original Guarantee expired. As of October 1, 2010, banks that wished to be covered by the New Guarantee had to pay a fee for continued guarantees. By contrast, mortgage credit institutions and banks that were not members of the PCA had to pay a premium for the New Guarantee for its full duration.

## **12. Participants in both guarantees had to agree to several other behavioral requirements.**

Both guarantees shared the same additional requirement on executive compensation, dividend payment, balance sheet strengthening, reporting, and other behaviors. The Act on Financial Stability established a ban on dividend payments and share repurchases by banks as well as new stock options for management. Expiring stock option programs could not be renewed or extended. In addition, banks had to adopt a more cautious approach and strengthen their balance sheets during 2009 and 2010.

In addition, the schemes imposed other behavioral safeguards and monitoring and enforcement procedures. Banks participating in the schemes could not undertake mass marketing invoking the fact that the ordinary creditors were now insured against losses. Moreover participating banks could not undertake a significant expansion of their activities which would not have taken place in the absence of the arrangement. The Private Contingency Association committed to reporting to the Danish Financial Supervisory Authority on any abuse by its members. The Financial Supervisory Authority committed to monitoring the banks based on a series of quantitative indicators such as growth in loans, exposure to certain sectors, concentration risk, growth in risk-adjusted loans etc.

During the third extension of the New Guarantee, additional conditions were introduced including viability review requirements and an additional reporting obligation.

## **13. The deadline for issuance was Sep. 30, 2010 under the Original Guarantee Scheme and Dec. 31, 2010 under the New Guarantee Scheme.**

### **III. Evaluation**

While it can be difficult to isolate the overall effect of any specific policy measure used as part of broader response to the Great Financial Crisis, the Danish government regards both guarantee schemes as having helped Denmark's financial sector recover. In their 2014 report "The Financial Crisis in Denmark: Causes, Consequences and Lessons," the Danish Committee on the causes of the financial crisis posited that the Original Guarantee "was necessary and created stability in the sector," and that the New Guarantee successfully "facilitated a difficult transition on the cessation of Bank Package I." Some have noted that while the industry-financed nature of the guarantees and especially the Original Guarantee Scheme protected the Danish public budget to a larger degree than other countries' program, the result was that the guarantees were also costly for the Danish banking industry (Woll 2014).

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