The State as Last Resort in two Scandinavian Banking Crises

A comparative case study of Denmark and Sweden

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ABSTRACT

This article treats the role of the state in bailouts, i.e. government objectives and measures during financial crises. The purpose is to unveil the role of the state in the latest crises in Denmark and Sweden, and critically analyse which objectives justified setting up organisations for financial stability. We compare intrinsic principles and perceptions for government intervention, with a focus on bailouts and state-owned banks. We argue that the implementation of measures date back to the early phases of capitalism in the 19th century, i.e. is part of an historical institutional pattern. The similarities shown are limited to the bailouts schemes, and indicate that there is a common international standard for a public-private arrangement concerning financial stability. Our results relate to the discussion of launching effective and legitimate state policies after a severe financial crisis.

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1. Introduction

Crises are an indispensable part of capitalism, but with many negative externalities. If an economy is hit by a systemic banking crisis, the government has to take decisions regarding the extent and type of intervention that has to be undertaken.[1] It could leave the responsibility to the business itself. This calls for a structural change, where illiquid banks are bought up by liquid ones, while other banks are going bankrupt and disappear as independent entities from the scene. A second possible solution is that the central bank steps in, as a lender of last resort, by guaranteeing the payment system and increase the liquidity in the interbank market. The reason is a shortage of liquidity that triggers the financial stress in the market. A third type of solution is that the government intervene, targeting problems of liquidity and insolvency in the banking sector. This third type of intervention could take six different forms.[2]

1) deposit guarantees to help prevent bank runs;
2) explicit guarantees on liabilities to help banks retain access to wholesale funding;
3) capital injections to strengthen bank´s capital base;
4) purchases or guarantees of impaired "legacy" assets to help reduce the exposure of banks to large losses in their asset portfolios.
5) establish public-private organisations including take-over of non-performing loans, with guarantees from the state
6) state-ownership control in one or more insolvent banks.

The objective of these six forms is to bring back the confidence in the credit market. If the risk of insolvency is severe, and not reduced by the first four interventions above, the government has the alternative to set up new organizations for financial stability and take ownership control in one or more insolvent banks (five and six). Those are the most far-reaching forms of government intervention. The government rescue plans are not mutually exclusive, which means that they could be mixed, more or less simultaneously.[3] This article concerns two contemporary historical circumstances in which the far-reaching forms of intervention were

[1] The literature distinguishes between crises in individual banks and systemic crises, where the latter threaten the stability of the whole financial system.
[2] Østrup, 'Danish banking' (2010); Lammertjan/Kotter, 'Bank Bailouts' (2012); Woll, 'Power of Inaction' (2014); Culpepper/Reinke, 'Structural Power and Bank Bailouts' (2014).
[3] Panetta et al., 'Assesment' (2009).

present in Nordic capitalism, in the early 1990s (Sweden) and the Great Contraction in 2008 (Denmark).

Although the study is limited to Denmark and Sweden, there are great similarities with the other Nordic countries. A rapid transformation and international opening-up of the financial system in Finland, Norway and Sweden in the 1980s paved the way for a boom-bust cycle that ended with a severe crisis.[4] In Finland, capital injections were made to private banks, while the state-control of banks was relatively short-lived. In Norway, the state took over the three largest commercial banks.

During the latest crisis, Iceland experienced a crisis to outmatched most of what could be seen elsewhere, and the three major private banks were taken over by the state on a long time basis. Despite similarities in the Nordic co-ordinated market economies, the role of the state has been different historically. In Sweden, the state has been used actively for ownership and politically coordinated investments, while Denmark lacked the tradition for state ownership.[5]

The rationale for public bailout in the banking sector is a systemic risk caused by one or more financial intermediaries. The government calculate that there is money and reputation to save by giving financial support to the financial system. In a bailout, the government has to make strategic decisions. How many of the banks and how much of the non-performing loans have to be taken over, and for how long? A systemic banking crisis is an extreme event. In the long run, when the economy improves, the government must have other motives to keep bank assets than just rescuing illiquid banks. This calls for a general discussion of whether state-owned banks in a market economy are preferable or not. The banking crisis might have forced the government into state control, to restore financial stability and avoid a collapse of the credit market and losses among depositors. But the rationale of keeping state-owned banks is another and a much larger issue, which calls for a discussion of the appropriateness of using a government as a major shareholder in the banking system.

The perception of the role of the state has not been treated explicitly, which motivates a comparative study of government interventions in terms of state-owned banks. Which

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[4] Honkapohja, ‘Financial Crises’ (2014); Jonung/Kiander/Vartia (eds) *The Great Financial Crisis* (2009); Knutsen,’Why do banking crises’ (2013).

[5] Fellman et. al. ‘Creating Nordic Capitalism’ (2008).

objectives justify public bank ownership? And, in the context of Danish and Swedish banking crises, how were objectives executed, and to what extent were they similar and historically rooted?

To study banking crises in relation to bailouts and state-owned banks is crucial for our understanding of public policies following a crisis. Often, public bailout and state-ownership of banks are treated separately. However, since bailout turn out to be the prologue of state-ownership, it is reasonable to analyse them in a sequence, to examine what triggers the government to pursue the grip taken during the stage of bailout. Government intervention is regarded as a useful and recommendable strategy for solving structural banking crises. This suggests a capability for key actors to implement appropriate forms of measures in due course, in order to gradually reduce risks in the financial system. However, a historically rooted perception of government intervention also means restrictions for the key actors.

In the following section, the rationale for state intervention is highlighted, with a discussion of pros and cons for bailouts and state-owned banks. The next two sections are devoted to the context of the Swedish and Danish banking sectors and the most recent systemic banking crisis in each country. Then we provide a comparative analysis of intrinsic principles and perceptions of bailouts and state-owned banks. Our main findings are summarized in the conclusion. The article is based on a combination of previous research on Nordic capitalism and access to archival material.

2. The rationale for government intervention

In case of banking crisis, the motive of government intervention is often to compensate for various types of market failures (social externalities, asymmetric information and enforceability).[6] Another reason might be to increase the competition in the credit market. State-owned agents with less shareholder value incentives open up for interest rates below the prices in the private market (kind of state subsidy). There could also be political and social motives, if profitable investments are underfinanced by the private sector and the existence of state-owned banks are believed to enhance certain public investments. Thus, the state could have at least four objectives for government intervention: maintain the safety and soundness of the banking system; mitigate market failures that stem for the presence of asymmetric

[6] La Porta et. al, ‘Government’ (2002).

information; finance socially valuable but financially unprofitable projects and promote financial development by giving access to competitive banking services to residents of rural and isolated areas.[7]

A comparative study of lending responses to financial crises - 764 major banks headquartered in 50 countries over the period of 1994–2009 - found that government-owned banks played a role of balancing between risk profiles. Since state-owned banks increased their lending during crises relative to normal times, while private banks' lending decreases, the former actually counteract the lending slowdown of private banks. This finding suggests that the state can play an active counter-cyclical role in their banking systems directly through state-owned banks.[8]

Governments could pursue state ownership in the banking sector in order to reduce agency costs. The economic reasoning of state-owned banks would be to look after needs of public firms and organisations, and for example give service to the payment system in the public sector. The argument is that state-owned banks compensate for various market imperfections, including forthcoming banking crises. In the latter case, one or more state-owned banks ideally will function as benchmarks for sound banking. This might reduce the problem of moral hazard, when private banks are harvesting the ripe fruits of their customers by increasing bonuses and dividends in good times, while counting on public help during bad times, i.e. bailout by the state because of too high risks in a previous period.[9]

The moral hazard problem is often discussed in relation to public bailouts in the banking sector to find out to what extent this type of safety net leads to additional risk taking. A study of the German banking sector 1995-2006 confirms a moral hazard effect, since a change of bailout expectations increased the probability of official distress from 6.6 per cent to 9.4 per cent.[10] The pessimistic view of state intervention is confirmed in another study of German commercial banks, during the 2008-crisis.[11] The losses of the state-owned banks studied were three times larger than those of their private competitors and the financial and managerial competences of

[7] Yeyati et.al.,'A Reappraisal' (2007).
[8] Brei/Schclarek, 'Public bank' (2013).
[9] Moral hazard could be defined as actions of economic agents in maximizing their own utility to the detriment of others, in a situations where the agents do not bear the full consequences of their actions, due to uncertainty and incomplete or restricted constraints which prevent the assignment of full damages to the agent responsible. Kotowitz, 'Moral hazard' (1989).
[10] Lammertjan/Kotter, 'Bank Bailouts' (2012).
[11] Hau/Thum, 'Subprime' (2010).

supervisory board members were statistically significant lower in state-owned banks (based on 593 biographies in the 29 largest German banks). The study concludes that state ownership comes at the cost of weaker monitoring of bank managers, possibly higher risk exposures and higher bank losses in a financial crisis. Not surprisingly, the authors suggests that "state ownership in banking should be reduced as far as possible", and whenever avoidable, the financial competencies of the supervisory board should be strengthened.

In a study based on non-financial and financial firms from the European Union, it was found that government ownership was associated with lower governance quality. However, this was not true for all countries: while state intervention was negatively related to governance quality in civil law countries, it was positively related to governance quality in common law countries. The author also found that the preferential voting rights of golden shares were especially damaging to governance quality.[12] Since both Denmark and Sweden have civil law, we might, on basis of these results, expect lower governance quality in state-owned banks compare to private banks. Finally, the state intervention might appear as a result of maturity mismatch, the tendency of a business to mismatch its balance sheet by possessing more short-term liabilities than short-term assets and having more assets than liabilities for medium- and long-term obligations. When every economic actor is part of this mismatch, authorities have little choice but intervening, creating both current and deferred social costs, according to a recent study.[13] This observation underlines our hypothesis of seeing the state as the last resort.

Evidently, the problem in a post-crisis period is to find a trade-off between government failures and market failures. The crisis might have revealed shortages in the private banking sector, but is state-owned banks a better choice in the long run? There is obviously an economic, political and social rationale for state-ownership in the banking sector, if the government should decide to keep control after the bank crisis. However, there are also many arguments and empirical evidences for the opposite, i.e. to close the banking-emergency organization as fast as possible and leave banking to the business of private investors.

If the collective inaction by the industry during a banking crisis force the government to intervene, the outcome of the negotiations and steps taken seem to depend on three factors: the

[12] Borisova et. al., 'Government ownership' (2012).
[13] Farhi/Tirole, 'Collective' (2012).

public view of private banks, the relative importance of the banking sector domestically and the effectiveness of the coordination of activities.[14] It seems that the public handling of bailouts differs over time between countries. However, there is no such thing as an Anglo-Saxon or liberal market economy solution, nor a bank-based or a state-coordinated solution, and no small open economy solution.The domestic weight of large banks has been labelled a structural power, meaning a deliberate use of their role in the economy as a resource in bargaining with the government (separated from lobbying).[15] Where large banks exercised structural power in negotiations with the government, as in the UK and Germany, where most of their revenues came from other jurisdictions, the banking sector has been able to prevent the government from imposing an industry-wide solution. Consequently, the bailouts schemes in Germany, the UK, Iceland and Ireland have been more costly than the ones in France, the US and Denmark, in terms of net fiscal impact.[16]

The studies above treat forms of government intervention. Obviously, the far-reaching form of state-owned bank has been more criticised than bailout schemes. Empirical studies show that state-owned banks have been underperforming compared to private banks. This gloomy prospect applies to banks in the developing world as well as in state-controlled, co-ordinated and neoliberal welfare state economies respectively. The public bailout seems to have high legitimacy among academic scholars, politicians and in society as large. The reason might be the urgent situation to at least temporarily solve insolvency problems during an acute banking crisis. However, there are fiscal costs involved in every public intervention.

3. Swedish banking crises and government intervention

The Swedish state has a long tradition of ownership control in the business sector. Already at the industrial breakthrough in the late 19th century, the state established a symbiotic relationship with key industries, through technological procurement, personal networks and state subsidies for investments.[17] The institutions of the financial system, for example the possibility for banks to hold voting shares in non-financial firms, contributed to the corporativistic culture. The state influence in the banking sector increased in the early 1920s, in the aftermath of the deflations crisis, and especially after the Great Depression. In the 1950s and 1960s, there was a strong

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[14] Woll, 'Power of Inaction' (2014), p. 166-169.
[15] Culpepper/Reinke, 'Structural Power and Bank Bailouts' (2014).
[16] Woll, 'Power of Inaction' (2014), p. 166-169.
[17] Sjögren, 'Swedish' (2008).

ideological motive in the parliament, led by the Social-democratic party, to strengthen the state control in both society and business. During this period, private firms and whole sectors were nationalized, at the same time as new state agents were established, not at least in the financial sector. One incentive to launch a state-owned bank was to match the interest of certain private banks, not least challenge the power of the mighty private financial dynasty of the Wallenberg family.[18]

In the 1970s, the enlarged state intervention in industry was a response to the structural crisis in the shipyard industry and the mining industry. From the mid-1980s, when the neoliberal washed over the economy, the state started to withdraw from many ownership positions. However, in the case of the banking sector, this process was interrupted and reversed, when the economy was hit by a banking crisis in the early 1990s. Even this time, like in the 1920s and the 1970s, the state intervention was somewhat involuntary, as a result of insolvent key actors in certain businesses. However, since there was an alternative in leaving the problems to the market, the reasoning for the operations was ideological in terms of a belief in a strong and interventionist state.

In the 1980s, the Swedish financial sector underwent a substantial transformation. A market that for thirty years had been thoroughly regulated and shielded from the rest of the world was gradually replaced by several sub-markets with considerably more liberal guiding rules than before. During a relatively short period, loan ceilings for banks were abolished, along with interest rate and currency regulations. Meantime, new financial instruments were introduced and the number of financial actors in the market increased substantially. The situation gave rise to a number of imbalances which hounded the Swedish economy for years to come. Three types of systematic problems arose: institutional, i.e. associated with legislation and legal practice; organizational, i.e. conditional on inefficient business structures; interactive, i.e. the interrelationship between the behaviour of actors and regulations in the market.[19]

The deregulation of the financial market led to a considerable expansion in lending, which further increased already ample access to capital and in turn led to lower interest rates. The bank lending more than doubled from 1980 to 1990, in fixed prices. The most rapid increase appeared within private business. Between 1985 and 1990 the price index for residential blocks

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[18] Larsson, *Staten* (1998), 166-68.
[19] Larsson, *Staten* (1998), 205-13.

and commercial properties jumped from 100 to 248 respectively 230. A reason of this spiralling trend was the substantial increase in competition between banks and finance companies for lending in a deregulated market. To gain market share the agents accepted collaterals with high risks. The growth strategy was rewarded with profits in the short term but proved detrimental for many financial intermediaries in the longer run.[20]

Many institutions in the financial market were lifted, while other rules of the game in the economy remained the same. However, in the new context after the deregulation these rules *got another meaning*. Thus, a so-called institutional clash appeared. For example, while the restrictions on banks to lend money were lifted, the same old tax system that already favoured bank credits gave companies and households a further reason to increase their debt. Since it was possible to make substantial tax reductions for the interests paid on loans, the price of the credit was extremely low. Subsequently, private customers became less sensitive to increased indebtedness.

The institutional clash had many implications. Banks started to redefine their roles and risk preferences - from previously having strictly followed well defined rules and regulations to selling loans and services in a much more deregulated and competitive market. It was especially banks without a history of lending to large corporate clients and real estate companies, such as Gota Bank, Nordbanken and some savings banks, which took on huge credit risks (Table 1) by an aggressive policy of lending. By 1990 banks were still actively marketing their loans, although that year marked the turning point for the financial market´s success.

Table 1. Annual growth of total credit volumes in Swedish savings banks and commercial banks 1985–1989. Percentage.

In the early 1990s, the Swedish economy began to weaken. Industrial production declined and real estate prices fell. In 1990, a number of finance companies experienced major losses, for example Gamlestaden, Independent and Nyckeln. In September 1990, Nyckeln suspended its payment. The situation for these companies was made worse by a substantial rise in interest rates, causing lower demand for loans and cutting into their earning capacity. The drop in real

[20] Larsson/Sjögren, *Vägen* (1995), 63 and 183.

estate prices was a hard blow especially to finance companies, since a large part of their lending was in this sector.

In the downward spiral, the value of collaterals for loans decreased rapidly, and lenders became more restrictive in their lending (credit crunch). Borrowers reacted by selling their collateral, which further contributed to falling prices. Business liquidations and bankruptcies among borrowers followed in quick succession. The financial institutions that were hardest hit by the crisis were obviously those that had taken the greatest risks and thus contributed to the speculation. In the early phase, this trend was magnified by an international recession, following the break-up of the Soviet Union. What had initially been a financial crisis caused by a price decline in one sector, the real estate market, now took on the appearance of a full-fledged industrial structural crisis. Business bankruptcies rapidly rose in number and added to banks´ credit losses. The large share of credit losses were attributable to commitments toed to finance and real estate businesses. Credit losses in the consumer lending sector, on the other hand, were kept at a relatively low level.

Since the crisis deepened, the government had to step in as a lender of last resort, to assume responsibility for the financial system. At this time the central bank was not an independent part of the government. In 1992, the government adopted a series of measures to strengthen the financial system, for example guarantee that banks and certain credit institutions would meet their commitments on a timely basis. This would be accomplished by providing financial support to viable organisations that could be expected to be profitable in the long run. The so-called Bank Support Authority (Bankstödsnämnden) was established in 1993 to implement these support means. The bank support was designed along the same line as was used in previous crises, since the early 19th century.[21] Most of the support this time went to the state-owned bank, Nordbanken, and the rest to the other banks that have adopted an aggressive policy of lending in the 1980s.

In June 1996, a total of approximately SEK 65.3 billion had been paid out via the government bank support. However, a substantial part of this money was recovered. The net cost for state has been estimated to SEK 35 billion.[22] This figure measures the reduced wealth of the state, but does not consider other effects on the state budget or any effects on the national economy,

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[21] Hagberg, *Bankkrishantering* (2007); Kärrlander, *Malmö* (2011).
[22] Jennergren/Näslund, 'Efter bankkrisen' (1998).

such as increased costs because of a higher rate of unemployment. The government has not only to decide about the depth of the support, but also the length of the intervention. In comparison with previous crises, the time of the rescue operation during the 1990s crisis was shorter. In the crisis of 1870s, it took 15 years before the railroad fund was eventually dismantled, and in the crisis of the 1920s, the government guarantee was retained for 15 years. However, the period of contingency was much shorter after the interventions in the 1920s.[23] In the rescue operations of banks following the 1990s crisis, the process was over in 6 years.[24]

Already before the crisis, the badly hurt Nordbanken was a partly state-owned bank, as a direct result of the state intervention during the banking crisis in the early 1920s. During the Deflation Crisis 1920-21, the private bank Svenska Lantmännens Bank suffered from huge credit losses. In the reconstruction of the bank, the state took 90 percent of the voting stock and the name was changed to Jordbrukarbanken. The intention by the government was also to take control over the largest commercial bank Svenska Handelsbanken in 1922, but this private bank was able to decline that proposal thanks to a successful reconstruction. In 1925, another financially distressed bank was reconstructed and became half state-owned, AB Göteborgs Handelsbank. The institute for carrying the reconstructions was AB Kreditkassan, founded in 1922 by the commercial banks and the central bank, where the state provided the major part of the capital injections. In 1951, the state ownership in Jordbrukarbanken was transferred into a larger commercial bank by the establishment of Kreditbanken. In a merger with Postbanken in 1974, into PK-Banken, the state ownership increased even further. The two main motives behind an alternative to private banks was to 1) control transactions and manage credit within the growing public sector, 2) increase the competition in the credit market and reduce undesirable effects of the power of private capitalists. However, the state played a passive role as shareholder and the state. Both the main right-wing and left-wing political parties declared that all banks should operate on strictly commercial basis. Many other state-owned companies at this time were part of regional political programs, but PK-Banken was not, which confirms the arm´s length distance to the state. This market-based view was deepened in the 1980s, when they state lifted most restrictions on the capital market and rule its possibilities to control the banking industry.[25]

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[23] Hagberg, *Bankkrishantering* (2007).
[24] Larsson/Sjögren, 'The Road' (1997), 7.
[25] Larsson, *Staten* (1998), 77, 123-3, 160-76.

In 1990, PK-Banken bought up the smaller Nordbanken, and changed name to Nordbanken. PK-Banken had started a process of privatisation, and the intention from the state was to reduce its ownership. However, in the following crisis, the new Nordbanken experienced substantial liquidity problems and the government decided to intervene, by a capital injection and increasing the ownership to 100 per cent of the voting stock. The financially reconstructed Nordbanken continued to operate, while non-performing loans in the bank were transferred to a so called bad bank – Securum.[26] The government also decided to rescue the private commercial bank Gota Banken, where non-performing loans were placed in the bad bank Retriva. In 1993, even this bank had to be taken over by the state, with the same motive as in the deflation crisis 1920-21, to guarantee financial stability and the deposits of households and firms (no law of deposit insurance at this time)..[27]

The government also supported in the reconstruction of the private bank Första Sparbanken, by giving non-interest bearing loan and providing bailments. All these operations were done within the framework of the Bank Support Authority.[28] The Minister of Finance in the right-wing government, Anne Wibble, argued that holdings and assets taken over by the state should be sold out, but she also stressed that there was no hurry.[29] The dip in the market for properties and the turbulent financial market suggested a slow process of divestment, in order to wait for better prices and subsequently less losses for the state.[30]

Table 2. Number of savings banks and commercial banks selective years 1985–2010.

Evidently, state intervention during bank crises is a tradition in Swedish finance, an institution characterized by strong path dependency. Nevertheless, the rescue operations and public financial support in the 1990s crisis led to a political debate on long-term state intervention and nationalized commercial banks. Since the state-owned bank – Nordbanken – had proven to be one of the worst examples of speculative lending and credit losses, the argument for more extensive state-ownership was less valid, however. Besides, various motives for state

[26] The concept of bad bank did not emanate from earlier Swedish crisis. Rather it was taken from the crisis management in the US
[27] Hagberg, *Bankkrishantering* (2007), 195.
[28] Bergström et. al. *Securum* (2002).
[29] Regeringens skrivelse 1992/93:251.
[30] Swedish Government, *Propositioner (Government Bills),* 1991/92: 153; 1995/96: 172.

ownership in the banking sector that was prevalent in the 1970s became obsolete after the deregulation of the credit market in the 1980s. However, some motives still remained in the 1990s. The former chairman of Nordbanken, Tony Hagström, argued that state-ownership fulfilled a national interest, with the means to prevent that the domestic market would be taken over by foreign banks. Another argument was that a state-owned bank could be used for regional policy interests, but also to satisfy financial needs within housing programs and during periods of structural transformation. The motive was that certain financial transactions and infrastructural investments would never become profitable enough for private banks to consider: even a market economy needs a back-up from a close ally as a state-owned bank for an optimal exploitation of capital. But even these motives, mainly emanating from left-wing representatives of the state, were surmounted in the political rhetoric under the era of market-orientation that directed the policies and strategies in the 1990s.[31]

Once the crisis management was over, the intention by the state to reduce their ownership in the banking sector was on top of the agenda. In 1995 one third of the stocks were sold out and in a governmental bill the year after, the social democratic finance minister Göran Persson stressed that the parliament has agreed on selling out all shares in Nordbanken. He also put attention to the fact that one of the objectives of the Bank Support Authority was to prepare Nordbanken for a total sale, i.e. to dress the bride before the wedding.[32] However, the selling-out of shares turns out to be a slow process. Between 1997 and 2001 Nordbanken became a part of the new banking concern that was established in Norden: Merita-Nordbanken and later Nordea.[33] In 2007, the right-wing government was repeating the intention to sell out all shares, but in the sub-prime-loan crisis starting in 2008, the state had to activate its role as a lender of last resort once again: the state participate in the new issue of shares by making use of all its subscription rights. In 2011, the Swedish state started to reduce its ownership in Nordea was reduced, and totally left as a shareholder in late 2013.[34]

4. Danish banking crises and government intervention

In contrast to Sweden, Denmark has a limited tradition for state ownership of industrial firms in general and financial institutions in particular. The technological, political and economic

[31] Larsson/Sjögren, *Vägen* (1995), 156-69; Larsson, *Staten* (1998), 216; Anell et al., *Staten* (1992), 163-68.
[32] Swedish Government, 'Propositioner' (1995/96), 45.
[33] Nordea was founded as a result of a merger between the Danish Unibank, the Finnish Merita Bank, the Swedish Nordbanken and the Norwegian Kristiania Bank.
[34] Swedish Ministry of Finance, 'Press release' (2011).

modernization processes in the early Danish capitalism was marked by a relatively weak state. It was characteristic that the imperative introduction of new dairy methods in the agricultural sector in the 1880s resulted from private, decentralized initiatives as did the establishment of new infrastructures such as telecommunication in the 1890s and electrification in the 1900s. The Danish state was also absent in the formal institutional setting concerning the regulatory market formation processes. The initial banking law came as late as 1919 while the earliest competition law came in 1931. The financial sector was thus relatively unregulated from the establishment of the first bank in Copenhagen in 1857 to the 1910s.[35]

The possible need for banking regulation was present in the contemporary economic-political debates – in particular following the banking crisis in 1907-08, caused by a building boom in Copenhagen. The crisis caused state intervention but a legal enforcement of financial rules and regulations was avoided by a coalition of the agrarian and liberalistic political party ”Venstre” and the industrial classes in the right wing conservative political party.[36]

The First World War was followed by a new banking crisis. The government made an intervention providing access to liquidity when the largest Danish Bank, Landmandsbanken in 1922 went bankrupt due to substantial losses mainly related to failed investments in Russia and partly to speculative investment “consortiums”.[37] The reconstruction of Landmandsbanken was a complicated and politically sensitive process and only in 1928 the Danish state did initiate a long term agreement for the continuation of the bank. The influential and wealthy shipowner, A.P. Møller, decided to invest in the bank in the mid-1930s by an ownership of approximately 20 per cent. The shipowner Mr. Møller publicly expressed that the motive was to avoid permanent state-ownership of the bank and consequently political influence on its businesses.[38] A new restrictive banking law followed in 1930 and consequently the limits for banking operations, bank management and bank investments became explicit. A long stable period followed with national-based, restrictive legal framework and only few banking crises. However, in contrast to Sweden, the banking crisis did not lead to long-term state ownership of any Danish bank.

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[35] Iversen/Andersen, ‘Cooperative’ (2008).
[36] Hansen, ‘Bankredninger’ (1997).
[37] Hansen/Mørch, *Den Danske Bank* (1997).
[38] Hornby, *Ved rettidig* (1988).

The deregulation of the Danish banking sector in the 1980s was a gradual process, initiated by the termination of the strict restrictions on lending and interest rates levels in respectively 1980 and 1981. These measures were followed by the implementation of international regulation standards in the early 1990s, particularly the second EU banking directive. As in Sweden, the deregulation of the banking sector caused an increase in the risk taking and lending profile of a number of primarily regional and local banks. Still the Danish banking crisis of the late 1980s and early 1990s was solved by the industry it-self and it was not a systemic crisis.[39] An analysis published by the Danish National Bank pointed at two important reasons which explained the relatively mild Danish banking crisis of the late 1980s and early 1990s.[40] The Danish banks had gradually implemented their growth strategies accordingly to the changing regulatory regime and the national and most important banks kept a sound balance between lending and deposits. Secondly, the Danish crisis was encapsulated by the consolidation of the industry. In 1990 six of the largest Danish banks merged into two major national banks: Den Danske Bank and Unibank, and simultaneously relatively large banks such as Sydbank and Jyske Bank acquired a number of local and regional saving banks and private banks.[41] According to Claus Vadstrup, a third reason was the stable macroeconomic conditions in Denmark in the early 1990s based on a credible fixed exchange rate.[42]

Table 3. Number of commercial banks, foreign banks and bank offices in Denmark 1991–2013.

In the decade from the mid-1990s to mid-2000s the Danish financial sector went through a formative phase marked by aggressive growth based on three fundamental strategies. The large banks mentioned above made a related, national diversification acquiring insurance companies, mortgage institutions and investment banks. In addition, the large banks adopted a strategy of internationalisation. The pan-Nordic bank Nordea was established in year 2000 and Danske Bank internationalized through acquisitions in Scandinavia, Ireland and Northern Ireland - culminating with the acquisition of Finnish Sampo Bank in 2008 – the hitherto largest acquisition in Danish business history. Finally, Danish banks expanded their activities by increasing lending and by introducing new innovative financial products. In 1996 the Danish

[39] Hansen, 'Bankredninger' (1997).
[40] Abildgren/Thomsen, 'En fortælling' (2011).
[41] Abildgren/Thomsen, 'En fortælling' (2011).
[42] Vadstrup, 'How did Denmark' (2009)

Mortage Banks introduced a new flexible loan with a variable interest level based on short term loans. This flexibility was enhanced with a new legislation in 2003 which made it possible to include up to ten years postponement of the repayment.[43] From 2003 to 2006, a number of regional and local banks introduced more aggressive growth strategies congruently with a high growth in the real estate prices, particularly in Copenhagen.

Table 4. Annual growth of total credit volumes in various Danish banks 2003–2007. Percentage.

In 2006 the profitability of Danish banks peaked when the return on equity reached an average of 19 per cent for the 20 largest banks.[44] In the same year total lending of Danish banks grew by 25 per cent, from 1,342 million DKK to 1,691 million DKK, where the latter figure was equivalent to almost 100 per cent of the Danish annual GDP. Deposits on the other hand only grew by 9.4 per cent to 1,290 billion DKK.[45] This misbalance combined with a general high exposure towards property and construction mirrored a rising fragility of the Danish banking sector. From the spring of 2007, the Danish demand for property stagnated while the supply continued to rise. That eventually caused falling real estate prices from the summer of 2007. The falling property prices caused an immediate pressure on some of the most risk-oriented banks as large customers within the property market failed to meet their obligations.

Roskilde Bank, one of the ten largest banks in Denmark, experienced a liquidity pressure in June 2008 and the national bank decided to ensure the short term survival of the bank by issuing a non-limited credit facility. By late August 2008 the Danish national authorities were facing four interrelated issues Firstly, it was clear that Roskilde Bank did not live up to the legal solvency demands. Secondly, no private institutions had showed any interest in acquiring the bank. Thirdly, the situation in Roskilde Bank, with substantially more lending than deposit combined with high exposure towards large costumers in the troubled Danish real estate market, was not unique.[46] At least 5 to 10 local, regional and national banks experienced a similar problem. Finally, a global financial crisis developed week by week and consequently the

[43] Rangvid, *Den finansielle* (2013).
[44] Finansrådet, 'Pengeinstitutter' (2014).
[45] Iversen, *Sidste udvej* (2013).
[46] Jeppesen, *Blændværk* (2009).

troubled bank faced accelerating problems in the daily access to capital, which ensured the necessary solvency degree.

As a response to these challenges, the Danish government, the financial supervisory agency (FSA), the national bank and the organization of private banks (Finansrådet) initiated negotiations on the measures, which could ensure the financial stability of the country. The result was the so-called "stability package" which consisted of two important measures. The Danish state provided an unlimited guarantee on all deposits and other unsecured claims, with an unlimited guarantee for two years. The guarantee was provided to Danish financial institutions that were members of the "Det Private Beredskab" – an organization for sectoral self-insurance in relation to deposit guarantees. Besides, a state-owned organisation was founded by private capital, in order to take over the obligations of troubled banks: Finansiel Stabilitet A/S.[47]

In relation to the actual structure of the intervention, the initial negotiations in September 2008 showed that the Danish state and the private actors of the banking industry agreed that the private sector should solve the crisis itself by paying a "self-insurance" to the state, providing a guarantee which could ensure domestic and international trust in the Danish banking system. During the negotiations it became clear that a number of Danish banks were so economically strained that on the one hand they could not live up to the legal solvency requirements and on the other hand no private banks were willing or able to take over their obligations through mergers and acquisitions. In the by-laws of Finansiel Stabilitet it was stated that primary purpose of the organization was to dismantle its own assets. It was regarded as a temporary organization, which should ensure the Danish financial stability in a transitional and turbulent period. The costs of setting up Finansiel Stabilitet were until October 2010 covered by the private sector, which continued to contribute to the reconstruction of other private banks.

The board of directors of the Finansiel Stabilitet was appointed by the Danish government in November 2008 and the Danish state decided to appoint two private bankers for the chairmanship, as chairman former bank manager in Nordea, Henning Kruse Petersen and as vice-chairman former bank manager in Danske Bank, Jacob Broholm. These two private actors

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[47] "Det Private Beredskab til Afvikling af Nødlidende Banker, Sparekasser og Andelskasser" (Det Private Beredskab) was founded June 13, 2007 by the Danish organization of private banks (Finansrådet). This guarantee was limited to 300,000 DKR or app. 40,000 Euro.

then decided to employ the former manager of the Danish financial supervision agency (FSA), Henrik Bjerre-Nielsen as daily leader of the new institution. The objectives of Finansiel Stabilitet were discussed in a board meeting in mid-December 2008. In the discussion, Mr. Bjerre-Nielsen emphasized that it was "a new company, with an unusual business". The objective of Finansiel Stabilitet was, according to Bjerre-Nielsen, to ensure financial stability by "... fulfilling its obligations under the guarantee scheme as cheaply as possible."[48]

Finansiel Stabilitet was partly a public enterprise under the Economic and Business Ministry and partly a financial holding company. The CEO emphasised that a swift dismantle of assets was desirable but at the same time “it would be appropriate to keep those activities where a quick sale due to a temporary loss of demand can only be done at prices that do not reflect expected future earnings - eg. in real estate.”[49] The objective of Finansiel Stabilitet was thus to define the balance between the desire of swiftly divest activities of the failed banks and on the other hand to maintain assets if there was a legitimate expectation of improvement in the economy and thereby increasing prices.

In February 2009, the Danish government decided upon a second banking legislation “package”, which aimed to support the liquidity of the Danish banks – and thus the general access to credit in the Danish economy. The law was two-fold with a scope of three years. Firstly, it was decided that Danish banks could apply for access to hybrid core capital injections from the Danish state. Secondly, the banks could apply for an individual state guarantee, which could be used in relation to the issuance of bonds. The Danish Ministry of Economy and Commerce should administer the former scheme while the new financial holding company for non-performing loans, Finansiel Stabilitet, should administer the latter.

Finansiel Stabilitet’s activities were thus separated in two important spheres: (1) The take-over, sell off and continuation of troubled banks and (2) the assessment of applications for individual state guarantees including a monitoring process. From the founding in October 2008 to the end of 2012, Finansiel Stabilitet (and thus the Danish state) took over three medium-sized regional Danish banks and six smaller banks:

1. EBH Bank (November 2008)

[48] Finansiel Stabilitet Archives (FS), Board meetings, 16 September 2008.
[49] Iversen, *Sidste udvej* (2013), 68.

2. Roskilde Bank (July 2009, after one year ownership of the National bank),
3. Amagerbanken (February, 2011)
4. Fionia Bank (March 2009)
5. Capinordic (April, 2009)
6. Løkken Sparekasse (June 2009)
7. Eik Banki (January 2010)
8. Fjordbank Mors (June 2011)
9. Max Bank (October 2011)

Despite the administrative division and sale of these banks, Finansiel Stabilitet provided individual state guarantees to 56 Danish banks amounting to 335,7 billion DKK out of which guarantees of 191,7 billion DKK were used to issue bonds on the financial markets. In its annual report of 2011, Finansiel Stabilitet stated a total balance of 54,5 billion DKK and employed approximately 500 people.[50] Despite the Danish tradition for limited state ownership, the Danish state was, two and half year after the acceleration of the financial crisis in the summer of 2008, now deeply involved in the Danish financial sector. In an article on Denmark and the Financial Crisis, it is argued that the development of Finansiel Stabilitet constituted an example of incremental yet significant institutional change. The organisation was established with a political wish of consolidation of the sector.[51] The legal framework of Finansiel Stabilitet was rather open, and the private actors in the management could thus define the means used in order to reach the well-defined aim, namely financial stability through the handling of the distressed banks.

5. The perception of the state – a comparative analysis

A comparison of the political responses to the Swedish banking crisis in the early 1990s and the Danish banking crisis in the late 2000s unveils important similarities and differences. The similarities include the background of the crises, with the pressure on the solvency in a number of banks which in the previous booming years had executed an aggressive growth strategy. Another similarity was the lowering of the price levels on the domestic housing market. At the time of each crisis, the state interfered in a number of ways in order to encapsulate the crisis and ensuring financial stability. In both countries the governments combined all types of banking intervention measures, which illustrates the gravity of the crises.

[50] Iversen, *Sidste udvej* (2013), 204-205.
[51] Carstensen, 'Projecting from a Fiction' (2013), 569.

Another notion is that the financial system of Denmark and Sweden underwent the same process before, during and after the two banking crises, i.e. re-regulation during a long period of boom followed by financial innovations, surplus of liquidity, debt accumulation among firms and households, the burst of the bubble and finally bailout schemes. These similarities confirm the existence of a deterministic cycle of crisis, suggested by Nordic financial historians.[52] This model also predicts an active role played by the state, after the bubble has burst and the banking industry has to be re-structured. Besides, we can´t leave out the possibility that the successful way of banking crisis management in Sweden encouraged and guided the Danish government once the acute problems appeared.

The contagion from the sub-prime loan crisis hit Denmark much harder than the other Nordic countries, while Denmark only experienced a mild crisis in the early 1990s, when the other three economies underwent a deep and lengthy crisis. In the post-crisis period, Finland, Norway and Sweden changed the rules of the economic game, for example by a tax reform that substantially reduced the interest deductibility provisions. In combination with stricter rules and more discipline within the banking industry, the level of debt finance fall substantially. Because of the institutional changes, these three Nordic countries did not take part in the hausse that characterized the many assets markets before the sub-prime-loan crisis. The Danish legislation, however, was more liberal and market-oriented and the banking sector lacked enough discipline. New high-risk financial innovations were introduced, such as flexible loans, and shortly after credit volumes began to increase, followed by a skyrocketing of property prices in 2007. The Danish banking sector became fragile and their customers heavily indebted. As Kluth and Lynggaard have emphasised the Danish mortgage bank sector was even bigger than in Ireland, which was affected severely by the financial crisis due to a relatively large financialization of the economy.[53] Not surprisingly, Denmark suffered most among the Nordic countries during the latest world-wide crisis.

In this comparative analysis, we will focus on the most radical forms of intervention: when government set up a new organization for financial stability and take direct ownership control in one or more insolvent banks. lready at the beginning of each crisis, there were significant national institutional features, which explain the further outcomes. First, one of the troubled

[52] Sjögren/Knutsen, 'Why do' (2009).
[53] Kluth/Lynggaard, 'Danish and Irish' (2013).

Swedish banks, Nordbanken, was owned by the state prior to the crisis, and the financial stability in Sweden was ensured by direct state investments in three troubled banks.. When the Swedish economy recovered from the mid-1990s, marked by lower interest rates, the government start to sell out assets, and the public bank support could close earlier than was expected (mid 1997). The state ownership in Nordbanken, Merita-Nordbanken and later Nordea was reduced gradually from 1995 and onwards.

In Denmark, the liberal-conservative government coalition proclaimed already at the end of 2008 that it was not the ambition of the state to become an owner of the banks. There were two guiding principles in the crisis legislation. It was stated that the assets taken over by the state should be divested as soon as it would be economically viable. Any possible advantage of long-term state ownership was not considered in the legislation, the by-laws, the strategy discussion or even the political debate in the Danish parliament in September and October 2008 when the legal framework for "Finansiel Stabilitet" was decided upon.[54] The second guiding principle was "self-payment". It meant that the private sector in principle should cover the expenses of the state intervention. During the negotiations between the Danish government, the Danish financial supervisory agency (FSA), the national bank and the bankers association, the liberal-conservative minister of commerce, Lene Espersen, presented the funding solution as an "insurance-system"..[55] At the end of September 2010 the self-payment proved a surplus of 2.5 billion DKK, which was transferred to Finansiel Stabilitet in order to finance the following cases of disrupted banks. The combination of divestment and self-payment as guiding principles suggests that the crisis violated the Danish liberal tradition of solely private ownership, and forced the state and private sectors to find solutions without state ownership in the banking sector.

The ministries in both Denmark and Sweden declared the intention to sell out assets that have been taken over in the bailouts as soon as possible. However, in Denmark this policy was put forward more explicit and implemented as an immediate response to the crisis in the fall of 2008. In the Danish case there was no tradition for state-ownership of banks when the financial

[54] Iversen, *Sidste Udvej,* (2013), p. 35-46.

[55] It meant that the private sector should pay an insurance fee of 15 billion DKK for the state guarantee, plus an additional 10 billion DKK, which covered the running costs of dissolved banks over two years. On top of these 25 billion DKK could follow an additional 10 billion DKK to be supplemented if the funding was required. Totally, the private sector would supply up to 35 billion DKK equivalent to more two per cent of the Danish annual GDP. The possible costs above 35 billion DKK would be covered by the Danish state. That proved not to be necessary as Finansiel Stabilitets guaranties went up to 22 billion DKK (Iversen, *Sidste Udvej,* (2013), p. 205.

crisis started in the late 2008. The perception of the state as a possible owner of financial institutions was not the same in in Denmark as in Sweden. In Denmark, a relatively more private-oriented perception had direct consequences for the banking crisis in at least two ways: for the very state interventionand for the public discussion. The debate in Denmark in 2010 and 2011 did not questioning the two mentioned guiding principles. On the other hand, it was questioned to which extent Finansiel Stabilitet had been efficient enough in securing the interests of the state. The most important performance criterion of Finansiel Stabilitet was thus the highest possible level of divestment under the lowest possible level of overhead.

Both the actual structure of the Danish interventions and the following public debate mirrored a Danish perception of the relationship between the state and the private banks which was different that the perception of the perceived role of the state in the Swedish case of the 1990s. We know that institutional change is a deliberate process shaped by "the perceptions of the actors about the consequences of their actions", and that these perceptions partly result from the cultural heritage.[56] Thus, even perceptions concerning state intervention in the banking sector is a result of actors trying to explain and interpret the world around them. Both banking crises caused formal institutional changes in terms of new regulations and laws, but also informal institutional changes in terms of less risky and less growth oriented banking practices.

The Danish and Swedish cultural heritage was different in terms of traditions for state ownership of banks. The Swedish intervention in the early 1990s followed on a tradition of government intervention and state ownership, while the Danish solutions to the accelerating crisis in the fall of 2008 built upon a deeply rooted aversion against state ownership, which was shared between private and public actors. The collective risk sharing for bank failures mirrors the Danish corporatist history and the characteristics of a negotiated economy. According to Pedersen a negotiated economy, "…entails political and economic processes and relations that are neither strictly public nor private but are situated between public authority and private autonomy."[57] This description constitutes the institutionalized legacies of Finansiel Stabilitet in Denmark, in which the execution of the public interests of stability was given to a number of private actors in a state-owned organisation.

[56] North, *Institutions* (2005), 22-23.
[57] Pedersen, 'Corporatism' (2006), 246.

The prime motive to set up the organisations for financial stability was the same in both Denmark and Sweden, namely to help banks to help themselves. Thus, there was a striking similarity in reaction to the liquidity problems. Besides, the public-private arrangement set up were the same type of hybrid organization, formed as a state guarantee for banks to help themselves, i.e. Järnvägshypoteksfonden in 1878/79, AB Kreditkassan in 1922, Bankstödsnämnden with Securum and Retriva in Sweden, and Finansiel Stabilitet in Denmark. Thus, the government interventions in the latest Swedish and Danish crises suggest a common solution in Scandinavia for managing banking crises, regardless if banks are state-owned or not. The difference that remains between the Danish and Swedish bailout schemes was that the Swedish state played at least two roles, where the action to preserve state-ownership in the banking sector was subordinated the target to guarantee the stability of the financial system.

6. Conclusion

Since governmental interventions in the banking sector have not always come uncompelled, we need to analyse motives behind the public policies during and after banking crises. In this article we analyze objectives that might justify public bailout and subsequently state-ownership of banks. Especially, we follow intrinsic principles and perceptions, and explain them in historical and a contextual manner. Our empirics come from the latest banking crises in Sweden and Denmark.

Our study shows that bank crises are major issues for each government to tackle, since the consequences of bank failures could be disastrous for the whole economy. This consideration lead to a pragmatic view on government intervention in the banking sector: from an economic and democratic point of view the alternative to bailouts might be even worse. The perceptions and the argumentation from ministers reflect previous national experiences. The Danish government insisted to avoid permanent state ownership within the banking sector and the legal framework for "Finansiel Stabilitet" was based upon an insurance self-financing principle. The Danish and Swedish economy history is quite different in terms of traditions for state ownership of banks. Thus, the Danish government has been reluctant to accept state-ownership, while the operations made by the right-wing government in Sweden in the 1990s followed on a tradition of state involvement. However, we have also shown that the arrangements set up to guarantee financial stability, make capital injections and reconstructions have been the same in Denmark and Sweden. Even in Finland and Norway around 1990, an organisation for crisis management was set up, administratively separated from the central bank and the financial supervision

authority. As in Denmark and Sweden, it revealed the Ministry of Finance from front-line duties and helped to play down conflicts within the banking industry. Finland, Denmark and Sweden introduced state-controlled banks for non-performing loans, while in Norway some of the banks internally set up their bad banks.[58]

In a European perspective this notion is interesting, since it implies that contemporary ideology and party-colour means less. The way the crises have been managed illustrates a high degree of path-dependency in relation to the state interference, regarding the choice of measures and the implementation in terms of either taking further control of existing troubled bank. The banking crisis of the 1920s led to state ownership of Jordbrukarbanken in Sweden, while Landmandsbanken in Denmark was taken over by private investors. On the other hand, both countries shared a long historical tradition for government intervention, through the take-over of non-performing loans. Already in the early 19th century, this had proven to be an effective method for financially distressed actors in Germany, and both German and Swedish economists around 1850s propagated for this solution.[59]

Our results suggest that the argumentation for state intervention has to be massive, resolute and rapid. The reason for that is that all types of state intervention affects market incentives and tax payers in the long run. Thus, for an intervention to be economically effective and democratically accepted, the public argumentation has to be explicit, especially if it causes a break to what historically is viewed as a norm. The policy implication is that government intervention is an effective way to stabilize the financial system. In fact, the institutional arrangement set up internationally to handle crises has been inspired by the treatment of the Danish and the Swedish banking crises. With an explicit target - to reach the highest possible level of divestment under the lowest possible level of overhead – the governmental operations have a chance of being successful, not being a financial burden for the taxpayers. However, for this to happen there have to be strong institutions in terms of law enforcement, bankruptcy rules and policy transparency. Consequently, if the economy is overwhelmed by nepotism, corruption major political disputes, the chances for an effective crisis management is much hampered. This explains why the Nordic crises have been relatively short.[60]

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[58] Honkapohja, ‘Financial Crises’ (2014), 200.
[59] Hagberg, *Bankkrishantering* (2007), 197.
[60] Jonung/Kiander/Vartia (eds) *The Great Financial Crisis* (2009), 320.

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