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Article

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Saving the Banks: The Political Economy of Bailouts

Emiliano Grossman[1] and Cornelia Woll[2]

Abstract

How much leeway did governments have in designing bank bailouts and deciding on the height of intervention during the 2007-2009 financial crisis? By analyzing the variety of bailouts in Europe and North America, we will show that the strategies governments use to cope with the instability of financial markets does not depend on economic conditions alone. Rather, they take root in the institutional and political setting of each country and vary in particular according to the different types of business–government relations banks were able to entertain with public decision makers. Still, "crony capitalism" accounts overstate the role of bank lobbying. With four case studies of the Irish, Danish, British, and French bank bailout, we show that countries with close one-on-one relationships between policy makers and bank management tended to develop unbalanced bailout packages, while countries where banks negotiated collectively developed solutions with a greater burden-sharing from private institutions.

Keywords

financial crisis, banking, lobbying, United Kingdom, Ireland, France, Denmark

Introduction

Bank bailouts leave few people indifferent. Extraordinary amounts of public funding were made available to commercial banks during the financial crisis

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of 2008, dwarfing the budgets of many other policy domains. According to some observers, this massive intervention was necessary to keep the banking sector from collapsing. According to others, it constituted an inacceptable gift to private institutions that will help to sustain unreasonable investment decisions in the future. In essence, the question is how much leeway governments had in designing bank bailouts and deciding on the height of intervention. Were the rescue package simply a response to the gravity of the crisis or did banks lobby policy makers for particular advantages? It is possible that bank rescue packages were influenced by both motivations. The risk of a contagion from failing banks created a public problem that justifies intervention, but it is difficult to know how much and what kind of emergency aid is necessary in a given situation.[1] Designing bank rescue packages therefore resulted from consultation with the banks themselves. How much were they able to influence government policy in their favor during these negotiations?

We propose to study this question by comparing national bank bailout plans across Europe and the United States in the aftermath of the crisis. The recent rescue schemes are particularly instructive, because a number of countries with comparable economies and financial sectors have opted for markedly different bailout strategies (Laeven & Valencia, 2010; Schmitz, Weber, & Posch, 2009). Some countries, such as Ireland, poured more than twice their gross domestic product (GDP) onto the ailing banking sector, which eventually led to country into a sovereign debt crisis. Others, such as Denmark, spent surprisingly little, despite initially committing similar sums. Trying to explain both the magnitude of intervention and the difference between initial commitments and budgets actually spent, we concentrate on the period from 2008-2009 to get a grasp of economic policy making in times of crisis. After a short review of the costs of financial bailouts in most European countries and the United States, we select four exemplary cases—Denmark, France, Ireland, and the United Kingdom—to analyze the context, the specific arrangements, and the conditions of each national scheme.

Using the comparative data and the insights from the case studies, we argue that the magnitude and nature of state intervention cannot be explained by economic indicators alone. We show that there is no linear relationship between the extent of the crisis felt in each country and the public authorities' reaction to it. However, the political influence of the banking sector is also insufficient to account for the costs of the bailouts. In some countries, banks lobbied successfully to shift the burden of banking sector losses on the taxpayer; in others, banks were just as central to devising the policy solutions,

but ended up carrying a substantial part of the rescue package burden. Simplistic accounts of "crony capitalism" or banking sector influence cannot capture this variation. We therefore suggest that it is the political organization of the banking sector that matters. Countries where banks have strong interbank ties and collective negotiation capacity have business–government relations that were much more apt to design a national bailout solution. By contrast, countries with close one-on-one relationships between policy makers and bank management tended to develop unbalanced bailout packages. The nature of burden-sharing between public and private stakeholder, and eventually the costs of bank bailouts, thus result from the political structure of the banking sector, not simply its exposure to the crisis.

The comparison is based on data of bailout expenditures in Europe and the United States between 2008 and 2009, the analysis of policy documents, newspaper accounts and secondary literature, complemented by 20 interviews with administrators and banking sector representatives in France, the United Kingdom, and Brussels.[2] The article is structured in three parts. A first section discusses the literature on bank bailouts and gives an overview of the most relevant hypotheses that will be tested. A second section presents the comparative data on commitment and expenditures and demonstrates that mono-causal explanations based on economic indicators or crony capitalism are insufficient to account for variation between countries. A third section therefore presents four case studies and highlights the importance of the structure of business–government relations for the design of the policy solution. The conclusion discusses the lessons of the case studies and the implications of the study for theoretical debates in political economy.

Understanding Policy Responses to Banking Crises

The comparative literature on financial turmoil has traditionally focused on the extent and origins of the crises, but also lays out the variation in policy responses. While some have studied banking crises across all countries over roughly a century (Honohan & Laeven, 2005; Klingebiel & Laeven, 2002; Laeven & Valencia, 2008, 2010; Reinhart & Rogoff, 2009; Rosas, 2009), others have concentrated in particular on the recent crisis (Schmitz, Weber, & Posch, 2009; Weber & Schmitz, 2011). Although the focus of these studies may vary, it is possible to distinguish explanations based on economic and financial fundamentals and explanations based on the political and institutional context in each country, in particular those focused on the role of business–government relations.

Economic Fundamentals and Financial Stability

Much of the policy literature on banking crisis analyzes bailouts by looking at the extent of the crisis affecting each country (e.g., Faeh et al., 2009). Indeed, we would expect bailouts to be more costly in countries where the banking sector was severely affected. In particular, as the size of the banking sector relative to the rest of the economy increases, the urgency for intervention will become more intense (Laeven & Valencia, 2010). Similarly, the role of the banking sector for the financing of the real economy is likely to play a role. Where small and medium-sized companies depend on funding provided by domestic banks, we should see state intervention to prop up these financial institutions to keep their economies afloat.

According to such economic fundamentals, variation in policy responses might be a function of economic pressures, where the government has little choice but to intervene once the crisis has broken out. Inversely, lack of or little intervention will be the result of a small financial sector, where the collapse of individual banks does not trigger the failure of other banks or send shockwaves through the real economy. Public responses are thus a function of problem pressure, which can be analyzed by looking at the structure of the country's financial industry.

Institutional Explanations

If politicians do have some discretion when designing bailout schemes, we should see variation across countries according to political factors. Bailouts are a form of state intervention into the economy with important redistributive effects, and economists have repeatedly warned against the moral hazard they create and their welfare reducing effects. Rosas (2009, 2006) has labeled these two extremes "bagehot"[3] and "bailout": Governments either uphold market outcomes or intervene in support of failing financial institutions.

According to the literature in comparative political economy, we would expect countries with a liberal market tradition to refrain from extensive government aid, while more interventionist countries should be more proactive. Moreover, the varieties of capitalism literature have pointed out the importance of socioeconomic traditions for finding collective solutions (e.g., Hall & Soskice, 2001; Siaroff, 1999). Countries with a corporatist tradition should be more likely to find collective solutions, while we would expect countries with a more pluralist tradition to rely on one-on-one relationships, if governments decide to intervene at all. However, the color of government might also make a difference. Traditionally, conservative parties are assumed to have closer ties with the banking sector and financial interests, while left

governments should be concerned about the redistributive effects of bank rescues (cf. Cioffi & Höpner, 2006).

Finally, the number of veto players in a policy process will increase the potential of blockage and might thus reduce the influence of one particular group—the banking sector—over policy outcomes. In such cases, we would expect the size of bailouts to be rather moderate. But others have argued that too many veto players may lead to gridlock and that in that case the only way out may prove to be pork barrel politics (McCubbins & Cox, 2001). According to that vision, then, at least small bailouts may be designed in a way favorable to certain sectors of the economy. At the very least, those sectors may successfully water down strict conditions attached to bail out.

Business–Government Relations

While the list above reflects general political trends, it is also important to concentrate on financial industry lobbying in particular (Braun & Raddatz, 2009; Keefer, 2002). In the wake of the Asian financial crisis, overly tight relationships between banking and politics were colloquially referred to as "crony capitalism." In the 1990s, several authors had alerted the research community to the fact that a variety of forms of "meso-corporatism" were at work in various European Banking policy communities (Coleman, 1993a, 1996a; Moran, 1991a).

First of all, the size and importance of individual banks would seem to matter, as governments can allow individual banks to fail if they do not represent an important part of the national banking sector. Moreover, a concentrated banking sector will have more lobbying resources and is more likely to have access to the government than a very fragmented one.

At a more systematic level, a political-economy literature has outlined that banking systems can be classified into bank-financed economies, where capital access depends on bank credit, and capital market systems (Rajan & Zingales, 2003; Zysman, 1983). In the first category, banks and entrepreneurs maintain club like personal relationships, with close connections to governments; in the second, banks are intermediaries in an "arms-length system" between the entrepreneur and the financier.

Whether one focuses on corruption, lobbying or banking systems, government responses to financial crises are expected to differ according to the connection between bankers and public officials: The tighter their relationship, the more likely are publicly financed bailouts. In the following, we will argue that the relationships between the banking sector and the government do matter for bailout arrangements. However, neither "crony capitalism" nor lobbying per se captures this variation—In fact, financial lobbying is incredibly

well organized in all advanced economies. Rather, what matters is the political organization of the banking sector that is key. Countries, where the banking sector has negotiated collectively, develop very different bailout schemes than the ones where the government interacted bilaterally with individual banks.

The Variety of Bank Bailouts

The financial crisis that started with the bursting of a housing market bubble in the United States in 2007 quickly gained financial markets and led to a series of bank failures, most notably Northern Rock in September 2007 and Bearn Stearns in March 2008, reaching a critical peak after the failure of Lehman Brothers on September 15, 2008. By the end of 2008, the crisis had spread to Europe and Asia, affecting most severely countries such as Iceland, Ireland, Latvia, Spain, Greece, or Latvia, who went into recession or even risked bankruptcy. Between the summer of 2008 and spring 2009, the financial and the real estate sectors in many countries contracted significantly (see Figure 1).

To impede individual bank failures from turning into a general financial crisis, governments responded by issuing state guarantees to reassure depositors, providing liquidity support to banks, recapitalizing them and providing mechanisms to relief financial institutions of impaired or "toxic" assets. Some countries undertook all of these measures, others only some of them. Despite the different policy mixes, the height of expenditures engaged by the different national schemes was remarkable. In the United States, bailout costs passed the US$1 trillion mark in the summer of 2009, in the United Kingdom and Ireland expenditures reached US$718 billion and US$614 billion, respectively. For a country like Ireland, such an amount represented 230% of its GDP. As was the case for Iceland, small countries thus suffered tremendously from the financial crisis, because the financial sector outlays were often much larger than the national economy.[4]

Even a quick glance at Figure 1 shows what is puzzling. There seems to be no clear relationship between the cumulated losses in the banking and real estate sector and the amounts governments committed to save their banks by July 2009, although governments tend to intervene when their sector is hit.[5] Other indicators, such as the relative performance of share indices of banks in the fourth quarter of 2008 (Weber & Schmitz, 2011), confirm that there is a negative relationship between health of the banking sector and the announced size of government intervention, as one should expect, but the relationship is insufficient to explain the degree of variation.

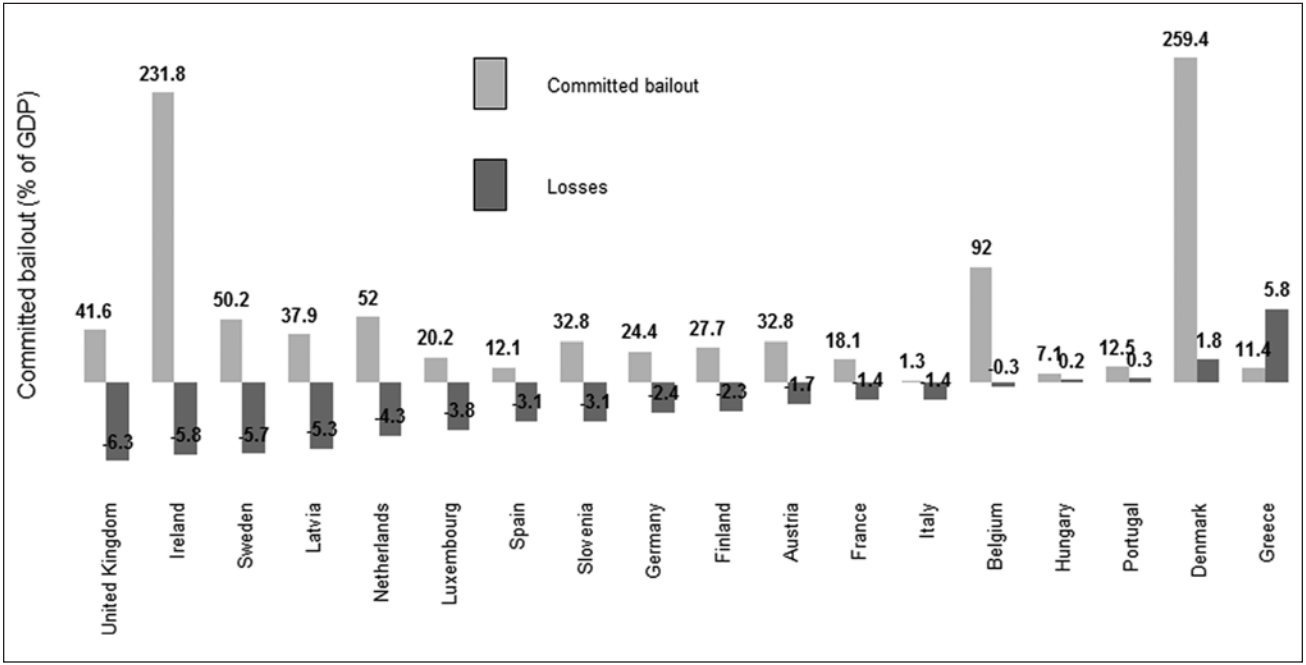

Figure 1. Cumulated losses in the banking sector versus committed bailout expenditures.
Source: Value added of financial and real estate sector from Eurostat; Bailout expenditures from European Commission (2009), Bank for International Settlements (Faeh et al., 2009).
Note. Cumulated losses as a percentage of GDP from 08Q3 to 09Q01. Committed expenditures as percentage of GDP, for all EU countries up to July 2009; figures for non-European countries up to June 2009.

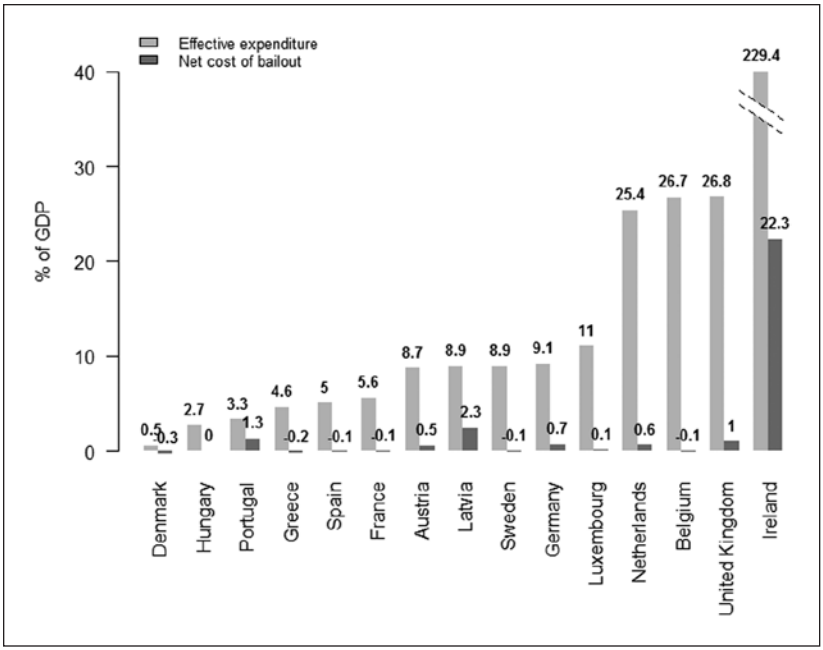

Figure 2. Actual expenditures versus net cost of bailouts by 2011.
Source: Bailout expenditures from European Commission (2009), Bank for International Settlements (Faeh et al., 2009); net costs from Eurostat (European Commission, 2009, 2011).
Note. Actual expenditures for all EU countries up to July 2009; net costs by the end of 2010.

To make matters complicated, money committed to bailing out banks was not always used. Figure 2 therefore considers the actual amounts that were effectively used by the summer of 2009. In most cases, governments committed much higher amounts for guarantees or recapitalization schemes, but those were not necessarily taken up. The United Kingdom or the Netherlands, for example, committed between 40% and 50% of their GDP, but only spent around 25%. Denmark is particularly striking as it committed 259% of its GDP, but actually only spent 0.5% in the 1st year of the crisis.[6]

Moreover, not all of the money spent is actually lost. Governments had the possibility to charge interest for the money they lent and levy fees for public guarantees. Assets they acquired (some toxic, others not) could be sold off after a certain period. In some cases, the write-downs on these assets were or are still going to be important, but not always. Without trying to imply that the policy makers had all the relevant information to know whether their actions procured the government costs or equity, it is

interesting to compare the amount of money different countries actually spent on bailouts and the net costs they appear to have borne by May 2011 (cf. dark column in Figure 2).

Explaining the differences between actual bailout expenditures in 2009 and net costs estimated in 2011 is beyond the scope of this article. It depends in great part on the value of the assets governments held, which varied according to a lot of different factors, both internal to the banks' investment decisions, the evolution of financial markets and the design of the bailout (i.e., reimbursement conditions and costs of bailout participation). It is nonetheless instructive to see that bailouts cannot always be equated to throwing public money into the throats of greedy private institutions. The ways in which bailouts are designed and the costs they impose on the financial industry thus need to be taken into account for a comprehensive discussion.

The question we will focus on in the following is as follows: What explains how much different countries decided to spend on bailing out their banking sector and why do we observe differences in the way these rescue packages were designed? Put more concretely, what distinguishes the countries like Ireland, the United Kingdom, or Germany, where bailout have been particular expensive, from France, Spain, or Denmark?

Explaining Variation

Analyzing these variations in a quantitative manner is difficult. The number of cases is small and the relevant explanatory variables highly aggregate. Explanatory variables such as the concentration of the banking sector are proxies that could give indications about the economic importance of the sector, but also the political organization or the potential influence of the sector's lobby. More importantly, however, figures about costs and government intervention are not always as reliable as one would wish for in a quantitative analysis. First of all, the statistical overviews prepared by organizations such as the European Commission or the International Monetary Fund are subject to extensive bargaining over categorization and accounting methods. Second, the numbers published continue to be updated or corrected. To cite just one anecdote, German finance minister Wolfgang Schäuble discovered in the fall of 2011 that the bailout costs incurred by the German government were actually 55 billion euros less than previously announced! An accounting misinterpretation by the public unwinding company had overstated the liabilities of Hypo Real Estate in 2010 and 2011 (Wiesmann, 2011). While we may expect accounting errors of such staggering proportions to be rare, the event illustrates that one should be cautious not to overestimate the reliability of individual figures.

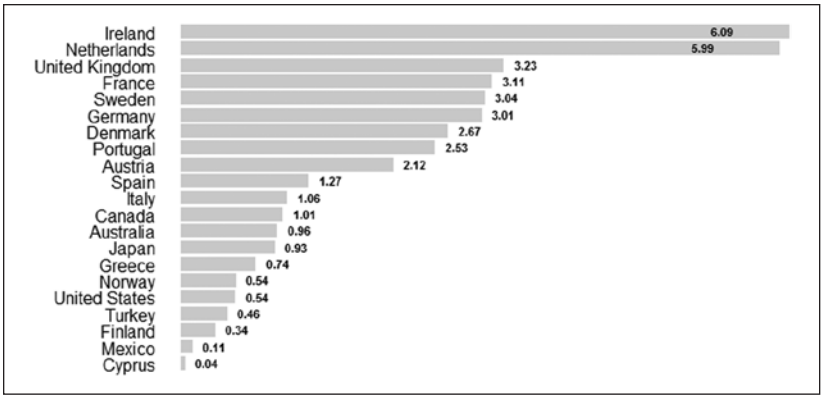

Figure 3. Internationalization of the banking sector.
Source: Bank of International Settlements.

We nonetheless examined a series of indicators highlighted in the theoretical discussion and checked for correlations to help us focus our quantitative study. A correlations table can be found in the appendix. In line with the hypotheses developed in the section on economic and financial indicators, variation may depend on the relative importance of the banking sector in those different countries, as well as its internationalization. Figure 3 presents a common measure of internationalization of the banking sector, that is, the sum of external assets and liabilities over GDP of the banking sector and shows the great variety of situations that can be observed all over Europe.

Note. Internationalization indicates sum of assets and liabilities as a percentage of GDP (cf. Lane & Milesi-Ferretti, 2007).As can be gleaned from the correlation table in the appendix, bank sector size and internationalization are strongly correlated. Yet, only bank sector size correlates with the actual costs or extent of bailout, while internationalization is related to the net costs of the fiscal packages. Countries that have highly internationalized banking sectors are also the ones that have intervened most heavily, with the notable exception of the United States.

Political and institutional factors have become very prominent within the varieties of capitalism research agenda. Using a measure of coordination developed by Hall and Gingerich (2009), one can see that coordination is strongly and significantly correlated with the size of the banking sector and also with the net costs of fiscal packages to stimulate the economy (cf. Table A1 in the appendix). Unfortunately, this indicator is available for a few countries only. It is one of the single most important correlates of crisis management,

but also the extent of the crisis. Other indicators, such as the partisan "color" of governments or the number of veto players, do not have any significant correlation with the extent of the crisis.

To sum up this brief initial overview, we find little systematic evidence in favor of either economic or political-institutional explanations of bailout. To be sure, bank sector size and internationalization have a measurable impact on the total cost of bailout. But we could find few other explanations to account for the great variety of reactions and the different the significantly different levels of financial effort to bail out the national financial sector. As shown above, this effort is not simply a function of the depth of the crisis. While the size of the banking sector accounts for some of this, a lot of variance remains unexplained. To push this analysis further, we therefore present four case studies based on these initial observations to better explore the mechanisms underlying aid decisions.

A Qualitative Comparison

As internationalization and the importance of the banking sector seem to matter for bailouts, we compare two small open economies, Denmark and Ireland, with two larger economies that nonetheless have an important banking industry. All four of these countries are thus likely to commit substantial sums to saving their financial sectors in times of crisis. Although all four did intervene by designing nation-wide rescue plans for the banking sectors, they differ in terms of money committed and in terms of the net costs incurred by the governments.

Denmark and Ireland responded very early on by making quite substantial sums available to the banking sector (259% and 232% of GDP, respectively). However, Denmark ended up spending only 0.5% of GDP. By contrast, Ireland spent almost all of the committed money (229.4%) and quickly slid from a banking crisis into a sovereign debt crisis, requiring the government to request a bailout by the IMF and the European Central Bank.

The United Kingdom and France were able to stomach the banking rescues somewhat more easily than the smaller countries, but nonetheless committed 42% and 18% of GDP, respectively. The British lead becomes even stronger in terms of actual expenditures, which amounted to 26.8% for the United Kingdom and only 5.6% for France. By May 2011, the French bank plan had actually brought a benefit of €2.4 billion to the government budget, thanks to the interest rates and dividends paid for the support, but mainly also to the fact that no French bank ended up going bankrupt. The U.K. plan, by contrast, which entails the nationalization of two banks, led to considerable write offs.

As Figure 2 indicates, Denmark and France are among the most profitable bailout scheme, ranked first and fourth in terms of GDP. In absolute terms, France leads the European countries. On the other end of the scale, Ireland holds the uncomfortable first place among all European Union countries, both in terms of absolute costs and as percentage of GDP. The United Kingdom follows in third position, just after Germany in absolute terms, and fourth in terms of GDP, with a loss of −0.9 percentage points of GDP (European Commission, 2011).

The four cases thus allow comparing two small open economies with two larger ones, which all had important banking sectors but vary along a lot of the dimensions discussed earlier. Most importantly, they also varied in outcomes, which Denmark and France among the most profitable bailouts and Ireland and the United Kingdom still struggling to deal with the consequences.

In the following section, we will try to demonstrate that the variation in government responses can be explained by the organization of the banking sector and their collective action capacity. Where banks maintained close but individualized relationships with the government, they were able to secure aid from the government that was tailored to the immediate needs of the ailing banks, sometimes with considerable costs to the government when these banks ended up failing. Where the banking sector negotiated collectively, by contrast, governments were able to make them carry a more substantial part of the burden of public intervention. Moreover, banks monitored each others' health and refused to engage in long-term assistance.

Negotiating Bailouts in Small Economies: Ireland and Denmark

Ireland and Denmark are small open economies who joined the EU in 1973, but only Ireland adopted the euro. While Denmark is traditionally described as a corporatist country and Ireland as a liberal economy, their banking sectors started to look similar by the mid-1990s, after deregulation in Denmark. By the mid-2000s, the bond market on the Copenhagen Stock Exchange had become huge compared to the size of the Danish economy. Housing finance boomed, creating a considerable bubble on the Danish property market (see Mortensen & Seabrooke, 2008). Like in Ireland, the explosion of mortgage lending was fueled by the access banks had to cheap funding on international wholesale markets (Clarke & Hardiman, 2012; Lane, 2011).

When both housing markets started to experience a downturn in 2006 and 2007, the exposure of both Irish and Danish banks to their own property markets became visible. Although much has been written about the housing markets in Ireland and Spain, the Danish drop in housing prices is even larger

than the other two (OECD, 2009, p. 18). At the same time, Irish and Danish banks experienced difficulties in raising money on international wholesale markets. Bank share prices dropped between mid-2007 and mid-2008 and Denmark saw it first bank failures in late 2007 with bank Trellerborg. By the summer of 2008, the government decided to organize the bailout of Roskilde Bank, to prevent a contagion to the rest of the industry. Meanwhile, the Irish government began considering nationalizing Anglo Irish Bank, which had invested roughly 75% of their loans in the property sector (Honohan, 2010).

On September 30, it became clear to the Irish government that Anglo Irish would not survive another day. Fearing a contagion, the government announced in a dramatic step that all deposits and most liabilities of Irish-owned banks would be backed by a public guarantee. Danske bank, the owner of National Irish bank, which was not covered by the Irish guarantee, experienced a massive withdrawal of Irish deposits. Five days later, the Danish government announced a similar blanket guarantee through the Danish Banking Scheme. In international comparison, both countries are outliers, not only because of the amounts guaranteed but also because the public support covered deposits and existing bank bond debt, and in the Irish case, even interbank deposits and new debt.

The Irish blanket guarantee, announced without consultation with other European countries, was severely criticized for its beggar-thy-neighbor aspects and for covering only Irish-owned banks operating in Ireland, a provision the government later revised (Honohan, 2009). Indeed, the solutions elaborated by the Irish government seem particularly erratic and uncoordinated. For example, after the guarantee decision was taken, the chairs and CEOs of Bank of Ireland and Allied Irish Bank met again with the Irish Taoiseach and Minister of Finance to find a way to save Anglo Irish. Although the solution elaborated was eventually not implemented, it is remarkable to note that nobody thought to involve Anglo Irish representatives in the discussion (Honohan, 2010). Similarly, the hands-off approach of the financial regulator Patrick Neary in the run-up of the crisis has been criticized. Clarke and Hardiman (2012) note that "there was little evidence of the organizational and social distance normally required for effective regulatory enforcement" (p. 33).

Trying to tackle not just liquidity, but also the solvency of their banks, the Irish government decided in late November to make public funds available and announced a recapitalization package of €10 billion on December 14, 2008. Initially, the government proposed that the financing necessary for capitalization were to come from equity funds, including sovereign wealth funds from the Middle East, but Irish banks strongly opposed (Kluth &

Lynggaard, 2013). A privately funded solution was thus abandoned. The level of capital injections were negotiated individually with the banks on terms set unilaterally by the government. Under the plan, the government initially bought preference shares in Bank of Ireland and Allied Irish Bank for €2 billion each and €1.5 billion in Anglo Irish Bank.

The recapitalization measures had little success in restoring market confidence as their announcement was drowned by revelations of a circular loan scandal at Anglo Irish. The scandal led to a series of resignations in the management of Anglo Irish, the Financial Regulator, as well as Irish Life and Permanent and Irish Nationwide, which were found to have made deposits under the government guarantee scheme as exceptional support to Anglo Irish Bank. In the light of these revelations, the government announced the full nationalization of Anglo Irish on January 15, 2009. Shortly after, further capital injections increased the control of the Irish state in Allied Irish and Bank of Ireland, gave it full control over two building societies and made it the largest shareholder in all the major banks.[7]

By then, it had become clear that Ireland needed to find a way of dealing with insolvent banks and a more systematic way of assessing the value of remaining assets. On April 7, 2009, the government announced its intention to set up a National Asset Management Agency (NAMA) by late 2009 for the transfer of toxic assets. NAMA currently covers all six Irish-owned banks, and acts as a bad bank: risky property assets are removed from the banks' books through a special purpose vehicle, which is owned jointly by NAMA (at 49%) and private investors (51%).[8] NAMA finances the purchase of the troubled assets through government bonds and is run as an independent agency with management services provided through the National Treasury Management Agency.[9] In addition, a Prudential Capital Assessment Review was set up in early 2010 to assess each bank's recapitalization needs.

In 2010, the initial guarantees were up for renewal. In the light of continuing deterioration of the situation of the Irish banking sector and soaring public debt, a joint EU-IMF bailout was adopted in November 2010. The €85 billion package aimed to help restructure the remaining private backs and, eventually, sell off the nationalized banks. This took place in the midst of public outcry against the perceived loss of sovereignty.[10] Yet, new stress test results published in March 2003 showed that the most battered banks' situation had deteriorated, making another bailout necessary and potentially using up most of the IMF deal's contingency. At the time of writing (March 2012), new negotiations are taking place between the Irish government and central bank and the EU and the European Financial Security Fund on the other hand. Giving Irish banks—which are all nationalized—direct access to

the European fund would help "europeanizing" the Irish bailout and take pressure off the Irish central bank. It is not certain, however, that the other EU members that pay into this fund—all except Greece—will agree to this solution.

In the Danish case, events were no less dramatic, but the government had several policy instruments to fall back on during the outbreak of the crisis. To begin with, the memory of the financial crisis of the 1990s was still vivid in the Nordic countries in the 2000s, even if one can debate how much previous lessons were heeded (Mayes, 2009). Bank resolution was an important concern and a public guarantee fund for depositors and investors (*Garantifonden for Indskydere og Investorer* [GII]) had been established in 1994 to provide guarantees for distressed financial institutions and help with their unwinding if need be. When the public deposit insurance was judged to be contrary to EU state aid rules, the Danish banking industry collectively established a private alternative in 2007, the Private Contingency Association for distressed banks (*Det Private Beredskab*).[11]

The Roskilde Bank failure was the first test for the Private Contingency Association, who took ownership of the bank jointly with the National bank. However, the size of Roskilde Bank, the seventh largest in Denmark, and its massive losses soon exhausted the Fund and clarified the crucial role for government backing and the Nationalbank leading role (Carstensen, 2013). Still, the Private Contingency Association became the backbone of the Danish bailout plan, the government and the Danish Bankers Association (DBA) began to negotiate as confidence faltered in September 2008.

The Danish bailout scheme became known as "Bank Bailout Package I" and specified that all members of the Private Contingency Association were covered by an unlimited deposit guarantee until September 30, 2010. In return, the combined contribution of private banks to the Fund amounts to 35 billion DKK (approximately €4.7 billion), which divided up into three parts: a collective guarantee scheme of 10 billion DK, payments to the government for the public backing of 15 billion DK and an additional 10 billion DK set aside in case the first pillar was insufficient. The government in turn committed to set aside the money paid by the Fund to cover potential bank losses stemming from bank failures and to guaranteed all deposits beyond the depositor insurance scheme in case the funds of the private scheme was exhausted. In particular, the government established the winding up company Financial Stability (*Finansial Stabilitet A/S*), which could secure the payment of creditor claims to distressed institutions and handle the controlled dismantling of financial institutions that no longer met solvency requirements. The Bank Bailout Package I was passed by the Danish parliament on October 10,

2008, following an agreement between the government, political parties, and the DBA 5 days earlier, and became effective on October 11.

Although the bailout scheme helped to avoid a run on Danish banks and prepare the orderly resolution of troubled institutions, funding difficulties continued throughout the remainder of 2008 and many feared the collapse of even the largest banks, including Danske Bank. To avoid a generalized crisis and credit squeeze, the Danish parliament adopted an additional legislation to address solvency difficulties through recapitalization, Bank Package II on February 3, 2009, for a total of potentially up to 100 billion DK (€14 billion). Moreover, Bank Package II introduced a guarantee scheme for loans until the end of 2013 (Østrup, 2010).

A third package was introduced in March 2010 to extend the previous deposit guarantee scheme set to expire at the end of September 2010 and bring Danish deposit insurance in line with EU legislation. Effective on October 1, 2010, Bank Package III entails a deposit guarantee of 750,000 DK per customer. The agreement also entails a standard set-up for dismantling distressed financial institutions and is financed through a contribution of 3.2 billion DK from the banking industry to the public unwinding company Finansiel Stabilitet S/A. A fourth package became necessary in August 2011 when the failure of two banks proved difficult to manage. Finally, a fifth package completed the Danish scheme in March 2012.

Through the contributions of the private sector, the public expenditures actually used in the Danish case were minimal, compared with the Irish case. In this context, it is important to note that the difference in costs of the bank bailout is not due to the general health of the banking sector. Only a small minority of Danish banks chose not to be covered by and contribute to the unlimited guarantee scheme. Concerning recapitalization, a total of 50 banks and mortgage lenders applied for capital contributions.[12] With 9 bank failures, the Financial Stability Company continued to manage the resolution of 6 banks through subsidiaries (i.e., bad banks) by 2012.

The collectively negotiated bailout packages in Denmark shifted the burden of failing banks to the private sector. In Ireland, the government negotiated with banks in individual consultations, both concerning the conditions they would accept for their own rescue, but also concerning possible public-private bailouts of other Irish banks, as in the case of Anglo Irish. Irish banks only spoke up with one voice when they refused private foreign investors as part of the national recapitalization scheme. They did not, however, have the will or the capacity to organize to propose a comprehensive bailout scheme. In sum, although the type of exposure and the initial responses were very similar in Denmark and Ireland, the negotiations between the financial industry and the government were remarkably different.

The Crises Responses in the United Kingdom and France

Skeptics might argue that the lessons from these two cases should not be extended beyond small countries, where clientelistic relationships and collective problem solving are more common because the networks between economic and political elites are so tight. The Danish public–private arrangement might furthermore be a typical story of Scandinavian corporatism. Extending the comparison to larger countries illustrates that the general pattern holds true there as well. Relationships between bank management and policy makers in the United Kingdom were not as clientelistic and wrought by scandals as in Ireland and the United Kingdom's government managed to propose a much praised nation-wide bailout scheme, which inspired many other countries (Quaglia, 2009). However, the costs of the bailout remained on the shoulders of the government. In the French case, by contrast, a public–private solution was found. Like in Denmark, the French scheme depended on the high organizational capacity in France, which has a long tradition of interbanking ties.

To be sure, the British exposure to the crisis was more intense and started considerably earlier, with the nationalization of Northern Rock in February 2008 after a run on the bank in September 2007. Despite effort to maintain liquidity, the situation deteriorated. The government enabled a takeover of HBOS by Lloyds TBS in September, but failed to find a similar solution for Bradford and Bingley, which was nationalized by the end of September 2008. Simultaneously, the U.K. government was drawn into the Icelandic financial crisis.[13]

To avoid a collapse of the entire banking system, the government developed a comprehensive bailout scheme in meeting between the Prime Minister's Office, the Treasury, and bank representatives on October 2, 2008. When coordination with the EU proved unsuccessful and U.K. stock markets continued to plummet, Prime Minister Gordon Brown and Chancellor of the Exchequer Alistair Darling decided to announce a £500 billion bailout package on October 8. The initial British plan had three pillars: (a) recapitalization through a Bank Recapitalization Fund, for £50 billion; (b) a Credit Guarantee Scheme, a government loan guarantee for new debt issued between British banks for up to £250 billion; and (c) liquidity provision through short-term loans made available through a Special Liquidity Scheme operated by the Bank of England, for £200 billion.

The U.K. bank support plan was voluntary. Banks benefitting from the rescue package had to accept restrictions on executive pay, changes in corporate governance and dividends to existing shareholders. They furthermore committed to offer reasonable credit to homeowners and small businesses.

Although banks such as HSBC Group, Standard Chartered, or Barclays declared their support for the plan, they announced that they will not have recourse to the government recapitalization. Only the Royal Bank of Scotland and Lloyds TSB together with HBOS applied for government funding. Following a series of adjustments and transactions, the capital injections eventually led the British government to acquire 83% of the Royal Bank of Scotland (but only 68% of the voting rights) and 41% of Lloyds (National Audit Office, 2010). Following the nationalizations of Northern Rock, Bradford and Bingley, and the solicitation of the Bank Recapitalization Plan, the government decided to establish United Kingdom Financial Investments in November 2008 as a vehicle for managing public ownership in the banking system.

In France, the crisis arrived only in 2008, in particular when it became clear that Natixis, the investment branch of Banque Populaire and Caisse d'Epargne, was heavily exposed to both the subprime crisis and the Madoff fraud. By the fall of 2008, the value of Natixis' stock dropped by 95%, which led to the resignation of the CEOs of Banque Populaire and Caisse d'Epargne in March 2009. In a deal brokered by the French president Nicolas Sarkozy, the two banks merged (Massoc & Jabko, 2012). The Franco-Belgian public finance bank Dexia also came into trouble in September 2008 due to liquidity difficulties. Dexia was quickly forced to apply for state aid and was bailed out by uniquely coordinated action between the Belgian, the French, and the Luxembourg governments.

Parallel to these individual measures, the government developed a comprehensive bailout scheme together with the six main French banks. Announced on October 12, 2008, the French plan was put into place by law 4 days later. It consists of two *ad hoc* institutions: The *Société de Financement de l'Economie Française* (SFEF), set up to raise capital on financial markets and provide liquidity to ailing financial institutions, and the *Société de Prise de Pariticipation de l'Etat* (SPPE), through which the government would buy equities from the French banks and thus help to recapitalize them. In the European landscape, the SFEF is a unique arrangement as it is jointly owned by the six big banks and the governments, which hold 66% and 34%, respectively. Seven other financial institutions also signed the SFEF agreement to benefit from the liquidity provided through the state-backed mechanism (Cour des Comptes, 2009).[14] Interestingly, HSBC France did not sign the agreement, but was a shareholder of the SFEF. The government agreed to guarantee bank bonds issued by the SFEF up to €360 billion for a maximum maturity of 5 years.[15]

At the same time, the SPPE would invest €10.5 billion in the recapitalization of French banks by January 2009.

Because of the systemic risk they represented, the six main French banks were the beneficiaries of the SFEF and the SPPE. To avoid stigmatizing any one particular bank, all six agreed to be recapitalized simultaneously through the SPPE. Put differently, the government struck a deal with the six main institutions, which effectively constrained them to accept capital and increase domestic lending. In 2009, the government agreed to expand recapitalization through the SPPE to an additional €10.25 billion. Whereas all six banks had participated in the first tranche by issuing deeply subordinated debt securities to the SPPE, the rational for participating in the second tranche was less evident for banks that were not in obvious financial difficulties. Crédit Agricole and Crédit Mutuel therefore decided not to participate in the second phase of SPPE intervention. The two *ad hoc* institutions were created for a limited amount of time and ended their programs according to schedule.

In the British case, more than just additional funds were needed. As banks continued requiring government help, the costs imposed on the government continued to grow and the government developed new legislation to regulate banks further and be able to intervene in a preventive manner in the future. Through new rules established by the Banking Act in February 2009, the FSA and the Bank of England obtained powers to determine the viability of British financial institutions and to exercise stabilization measures, including the sale of all or parts of the business to a private sector purchaser or a transfer to a "bridge bank" to organize the orderly dismantling. Moreover, the Treasury retains the right to take a bank into public ownership. The Banking Act 2009 thus granted considerable powers to force the resolution of a bank esteemed to pose a risk for national financial stability. But none of these changes and of the additional instruments agreed on in the course of 2009 were able to alleviate the costs the massive bank failures imposed on the government. As a result, the most important consequence of the financial crisis in the United Kingdom was the reorganization of regulatory oversight. In particular, the role of the FSA was severely criticized for failing to intervene early on and have ceded too much to self-confident bank management. A decade after Gordon Brown's financial service market reform and the creation of the FSA, powers are currently moved back to the Bank of England and the Treasury has established itself as a key player in banking regulation (House of Commons, 2008). Although the United Kingdom is generally cited as a liberal market economy with little intervention, this is no longer true for banking.

The British bailout plan is said to have inspired many policy makers abroad and even led to a change of the U.S. Troubled Asset Relief Plan (Quaglia, 2009). Similarly, the reform of banking regulation in 2009 was quite comprehensive and went further than in several other European countries. According to several commentators, the costs imposed on banks receiving government aid in the United Kingdom were also particularly constraining. It is thus fair to say that the British government bailout was a well-designed government policy and not a gift to the banking industry, as some might argue for the case of Ireland. The government nonetheless bore the costs of the failing institutions, which weighted heavily on the public budget. Despite attempts to broker private mergers for failing banks, the British bailout did not force the private sector to participate in preventing an overall collapse.

In France, the public–private partnership was possible because interbanking ties were traditionally strong and easily activated. To be sure, some of the conditions of the bailout were favorable to the banking industry. The French Court of Audit, the *Cour des Comptes*, for example, argued that revenue might have been higher had the conditions granted to banks been somewhat more ambitious.[16] Moreover, all government revenue consists of interest payments and dividends, while the government had not demanded a share of the capital gain of the supported banks (Zimmer et al., 2011). The Court of Audit also criticized the second tranche of SPPE financing, arguing that it might not have been necessary, as banks could have raised capital on financial markets (Cour des Comptes, 2010). Still, the SFEF arrangement was generally esteemed to have worked well, because its centralized issuance of state-backed bonds allowed the SFEF to provide an important volume and offer a very low price for their bonds.[17] The collective action capacity of the French banking industry is thus responsible for the upsides and the downsides of the bailout. Massoc and Jabko (2012) have criticized the workings of the "informal consortium," which steered the French financial industry through the tumultuous period. But the downsides do not weight heavily when a bailout actually provides new revenue to the government budget.

Conclusion

The Danish–Irish comparison illustrates that similar types of exposure to the financial crisis can nonetheless lead to very different bank bailouts. In both countries, bank representatives and governments worked closely together. But only in Denmark did the private sector agree to be part of a collective

Table 1. Country Characteristics.

	Ireland	Denmark	United Kingdom	France
Size	Small open	Small open	Big	Big
Crisis	Considerable exposure	Considerable exposure	Considerable exposure	Moderate exposure
Socioeconomic order	Liberal	Corporatist	Liberal	Statist
Business–government	One-on-one relationships	Collective	One-on-one relationships	Collective
Initial commitment	High	High	High	Moderate
Outcome	Sovereign debt crisis	Positive, despite nine bank failures	Probably large write-offs	Positive

solution, which ultimately helped to ring-fence the failing banks and use only a minimal amount of tax payers' money. The collective negotiation capacity is not a purely Danish phenomenon or characteristic of small open economies. This is demonstrated through the French example, where the government also relied on public–private coordination with the French banking sector. Other larger countries did not have a banking industry that was sufficiently homogeneous and interconnected to speak collectively and to be willing to share the burden of a bailout. The government therefore needed to impose the conditions in a top down manner, which often implied higher costs. In the British case, the government tried to rely on private takeovers in the initial period, but was eventually obliged to nationalize several banks, which imposed considerable costs due to large write-offs. In countries where private institutions participated in the design of the bailout and shared the costs, they monitored the evolution and pushed for a disengagement of the aid once it was no longer considered necessary. Table 1 summarizes the characteristics of the comparison.

Crony capitalism and bank lobbying have been made responsible for many failures of government intervention in times of economic crisis. As we have seen, bank influence can indeed introduce important biases and led to misjudgment and flawed intervention, with sometimes catastrophic outcomes for the taxpayer. However, the most successful bailouts also implied a substantial participation of the banking industry in finding the most appropriate policy solution. In the cases studied, the industry acted in a collective manner and the government was thus able to engage them in a way that would allow a burden-sharing solution. Bailouts are thus a consequence of the political economy of each country, and not just the problem pressure of the financial crisis.

Appendix

Table A1. Correlations.

	Net costs 2008-2010	Actual expenditures	Ratio effective/ approved	Outstanding loans, claims	Internationalization (finance)	Stock market size to GDP	Bank sector size to GDP (2007)	Leverage	Coordination Index	Quality of government	No. of veto players
Total cost of bailout	0.16										
Ratio effective/approved	−0.12	−0.07									
Outstanding loans, claims	−0.26	−0.21	0.85***								
Internationalization (finance)	0.64**	0.34	0.03	−0.06							
Stock market size to GDP	0.17	0.14	0.17	−0.21	0.70***						
Bank sector size to GDP (2007)	0.46	0.75***	0.17	−0.04	0.69**	0.37					
Leverage	0.06	−0.34	−0.06	−0.06	−0.61*	−0.07	−0.51*				
Coordination Index	−0.62*	−0.28	0.09	0.25	−0.03	−0.41	−0.68**	−0.10			
Quality of government	−0.03	0.17	0.41*	0.17	0.27	0.55***	0.44	−0.07	−0.24		
No of veto players	0.10	0.31	0.23	0.08	−0.15	−0.15	0.28	−0.09	−0.08	0.11	
Right wing governments	0.05	−0.17	0.24	0.17	−0.38	−0.07	0.04	0.15	0.22	0.00	−0.21

Note. The *Ns* vary for each correlation, due to the availability of indicators and the variety of different sources. Sources: Net costs 2008-2010: net fiscal costs of fiscal packages to stimulate the economy, compiled by the authors, adding three successive years, see Figure 2 for details. Actual expenditures: See Figure 2 for details. Ratio effective/approved: See Figures 1 and 2 for details. Outstanding loans, claims: Bank for International Settlements Internationalization: sum of external assets and liabilities of financial institutions over GDP, BIS. Stock Market Size and Bank Sector Size: OECD. Leverage: taken from Weber and Schmitz (2011) Coordination Index: taken from Hall and Gingerich (2009). Quality of government: taken from the International Country Risk Guide, produced by Political Risk Services. No. of veto players: taken from the work of George Tsebelis (2002), regularly updated on his personal website. Right wing governments: database of Political Institutions of the World Bank.

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Notes

1. Several economists have theoretically derived propositions for the optimal bailout strategies (e.g., Aghion, Bolton, & Fries, 1999; Farhi & Tirole, 2009).
2. Since it is difficult to obtain interviews with the actors most central to the negotiation of bank bailouts—heads of government and their central banks, as well as the CEOs of the most important banks—the nature of these interviews is merely exploratory and helped to construct the inquiry and the comparison.
3. Sir Walter Bagehot set out guidelines on a last resort lending that insisted on the necessity of good collateral to justify lending to illiquid institutions. Without good collateral, ailing institutions should be considered insolvent.
4. The costs of the Icelandic banking bailout were not available for the comparative analysis, but one may simply note that the loans made to the Icelandic government in 2008 amounted to US$11,45 billion, which is equal to 65% of Iceland's GDP (US$17.55 billion in 2008).
5. One may note that countries currently experiencing difficulties such as Greece, Italy, or Portugal do not figure either among those having recorded high levels of losses. This illustrates that the current sovereign debt crisis is only imperfectly related to the banking crisis of 2008.
6. To be sure, it is difficult to consider take-up rates as a measure of successful or unsuccessful government schemes and/or of effective aid granted. In some cases,

take-up will be low, because the government plan is inappropriate or highly conditional and thus unattractive for banks, in others, it can reflect the fact that the actual health of banks was better than expected or that the program succeeded in coordinating bank rescues without public expenditures via private investment. Across countries, it appears that the average uptake on capital injections (49%) is higher than for debt guarantees (18%), where some countries such as Canada or Italy have seen zero participation (Faeh et al., 2009).

7. The only bank to refuse government participation was Irish Life and Permanent.
8. The private investors are the pension fund managers Irish Life Investment Managers, New Ireland Assurance, and Clients of Allied Irish Banks Investment Managers, which are part of Irish Life Permanent, Bank of Ireland, and Allied Irish Banks, respectively. Because all three had been under government control and guarantee by 2011, the debt of NAMA is considered as government debt entirely (European Commission, 2011).
9. For further information, see www.nama.ie.
10. In a much-quoted editorial comment, the Irish Times said: "There is the shame of it all. Having obtained our political independence from Britain to be the masters of our own affairs, we have now surrendered our sovereignty to the European Commission, the European Central Bank, and the International Monetary Fund." *Irish Times*, "Was it all for this?" November 18, 2010, p. 17.
11. *Det Private Beredskab* is also sometimes translated as "Private Reserve Fund."
12. See www.philip.dk/en/news/bank-bailout-packages-i-and-ii.html.
13. Two of the failing Icelandic banks—Landsbanki and Kaupthing—had U.K.-based business and a large U.K. depositor base. To protect the assets of U.K. depositors, the government issued a freezing order on 8 October 2008, relying on antiterrorism rules, which greatly angered the Icelandic government.
14. These institutions were mainly housing and consumer credit institution, often the financial activity branches of large industrial groups: PSA Finance (PSA-Peugeot-Citroën), General Electric, Crédit Immobilier, Laser Cofinoga, RCI Banque (Groupe Renault), S2Pass (Groupe Carrefour), and VFS Finance (Volvo). GMAC had originally signed the SFEF agreement but did not request liquidity support.
15. This amount also included the guarantees granted to Dexia.
16. Similar regrets were expressed by public officials in the French administration. Interview, April 15, 2011, Paris.
17. Interview with a representative of the German Bundesbank, Francfort, February 22, 2011.

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