

# crisisresponse

PUBLIC POLICY FOR THE PRIVATE SECTOR

## Banks in Crisis

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This is the ninth in a series of policy briefs on the crisis—assessing the policy responses, shedding light on financial reforms currently under debate, and providing insights for emerging-market policy makers.

### When Governments Take Temporary Ownership

**The current financial crisis evolved quickly. In most of the developed countries affected, governments initially improvised solutions that eventually led to substantial investments in systemically important banks. Not all their actions are worth emulating, especially those that undermine normal governance arrangements and the ability of all shareholders to hold the banks' board and management accountable. Lessons from earlier crises show that governments acting as temporary owners can minimize costs to taxpayers by following sound commercial practices and good corporate governance principles. Quickly developing and making public the exit strategy is also important.**

Among the policy measures that governments have adopted in the financial crisis are public investments in debt, equity, and hybrid instruments resulting in their partial or full ownership of financial institutions. Government investments have recapitalized distressed banks that failed to meet legal minimum capital requirements and increased capital in banks that met legal requirements but were nonetheless thought to require more.

In distressed banks, governments generally had a legal basis for intervening in ownership and governance. Such interventions can potentially result in the revocation of the banking license and liquidation. More commonly, however, shareholders' rights were overridden, and the bank (or most of its assets and liabilities) was sold to another bank, sometimes with government financial assistance. This is standard practice for resolving failed banks in the United States.

Notable recent examples include the acquisition of Bear Stearns by JPMorgan Chase with the support of a liquidity line from the Federal Deposit Insurance Corporation (FDIC), and the seizure of Washington Mutual by the FDIC and its subsequent sale to JPMorgan Chase.

In other cases, such as larger banks that could not be readily sold or complex groups in which the legal basis for the intervention was not clear, governments have taken an ownership position, sometimes to the extent of outright nationalization. In the United Kingdom, for example, the government has recapitalized RBS and Lloyds by acquiring stakes of 70 percent and 65 percent, respectively, and has nationalized Northern Rock and Bradford & Bingley by acquiring 100 percent stakes.

Governments have also made capital available to banks that did not contravene capital rules,



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through programs that generally are voluntary and open to large, systemically important banks (as in the United Kingdom) or to all banks (as in the United States). In several countries governments' interventions were initially ad hoc, then formalized under more standardized, industry-wide arrangements (such as the U.S. Troubled Asset Relief Program).

A range of financial instruments have been used. Recapitalizations of deeply distressed banks have typically involved common shares, usually resulting in significant or full direct government ownership. Investments in other banks have usually involved preferred shares and, in some cases, subordinated debt. Recapitalization through preferred shares and subordinated debt more readily allows banks to redeem or retire the new capital, either from future earnings or by raising new capital from the private sector. In some cases these instruments have involved high dividend or interest rates or step-up clauses (specifying a higher cost of redemption after a certain period) intended to provide an incentive for early repayment of support (as in Austria, Ireland, and the United Kingdom). Governments in some cases also obtained warrants to acquire additional shares. These provide upside potential for taxpayers but also allow the government to inject additional capital and to take a larger equity position should it become necessary. In the current crisis, market analysts have placed particular emphasis on banks' Tier 1 capital ratios, and many of the instruments have been declared to qualify as Tier 1 capital.<sup>1</sup>

How governments have intervened in governance as a consequence of their investment varies considerably. Four different means for structuring the ownership function have been used. Some governments have used existing arrangements for state ownership (Austria, Belgium), while others have located the ownership function in a new bank recapitalization entity (the United Kingdom and prospectively the United States) or, less commonly, in the finance ministry (Ireland) or the deposit insurance entity (prospectively in Canada).

In some cases governments have acquired board representation even though they own no common shares (Belgium, Ireland). Governments also have directly preempted board and share-

holder decisions, again often without owning common shares. The most common interventions are limits on executive compensation (France, Germany, Ireland, Italy, Sweden, the United Kingdom, the United States) and restrictions on dividend payments (France, Germany, Greece, Italy, the United Kingdom, the United States). While a stated objective of most investments is to maintain bank lending, few investments involve requirements to maintain specific lending volumes.

### **Objectives of temporary ownership**

The objectives of government investment and temporary ownership need to be agreed on and articulated from the outset. The primary objective tends to be to remove any concerns about the liquidity and capital adequacy of a systemically important bank, so as to maintain confidence in the bank and in the financial system generally and to ensure that the bank can meet its obligations, including to the payments system. A secondary objective may be to restore the bank's capability to provide new credit to the economy. This objective may increase in importance with the size of the share of troubled banks in the system, reflecting social and political concerns about the potential broader economic impact of a systemic contraction in bank lending.

While these objectives may conflict, particularly in the near term, both require quickly restoring the bank to financial health. While governments are involuntary investors, becoming an owner for reasons other than return on investment, they need to act as any professional investor would, with the aim of maximizing the value of their investment whether or not it can be fully recouped.

To help ensure a consistent and comprehensive approach to temporary government ownership, governments need to develop and publicly communicate a credible ownership policy. This policy would articulate the government's objectives in temporary ownership, define the general terms and conditions that will apply to its investment, and describe how it will exercise its ownership as well as what its intentions are for divestment.<sup>2</sup>

To help minimize the long-run costs for taxpayers and facilitate eventual divestment, the

ownership policy needs to be based on a set of guiding principles associated with sound commercial practices, good corporate governance, and competitive neutrality. Sound commercial practices and good corporate governance need to be applied to decisions on the amount, structure, and terms and conditions of the investment and its subsequent handling. Governments would in effect seek to mimic the practices of a private sector owner. Their investment and subsequent actions would be oriented toward returning the bank to profitability, probably after financial and operational restructuring over a short period, and maximizing value.

Similarly, the availability and amount of the investment, its terms and conditions, and the subsequent involvement of government in governance need to be consistent with the principle of competitive neutrality. That means ensuring equal treatment by the supervisory authorities and other arms of government for banks in which the government has a temporary ownership stake. Special forbearance from prudential rules for such banks, for example, is best avoided. In the euro area an action plan adopted at a summit in October 2008 specifies that banks benefiting from government capital support “should be obliged to accept additional restrictions, notably to preclude possible abuse of such arrangements at the expense of non beneficiaries.”<sup>3</sup>

### **Terms and conditions of the investment**

Governments need to approach the investment decision, and structure the terms and conditions of the investment, in a manner consistent with the objectives set out in the previous section.

### **Whom to support?**

For a distressed bank that appears to be solvent, the management and board ideally should be required to make formal application for government recapitalization. The application process would provide the information needed for analysis to support decisions on the capital situation of the bank and on the size, structure, terms and conditions, and other features of the new investment. As part of the application, the management and board would need to present plans for financial and operational restructuring, such as how they intend to handle problem

assets, strengthen controls and risk management, improve efficiency and shed noncore operations, and reduce indebtedness.<sup>4</sup> Debt restructuring involving debt-to-equity conversions might also be required or encouraged by the government as part of this process.

As a general principle, banks that meet legal minimum capital requirements should not be forced to apply for government capital support. Instead, consistent with Pillar 2 of the Basel II capital accord, supervisory procedures can be applied to ensure that management and the board achieve capital levels exceeding the legal minimum given the bank’s risk profile and other relevant characteristics. In a period of widespread crisis and extreme uncertainty, however, preemptive recapitalization of such banks, especially systemically important banks, may be required to maintain or restore confidence in the financial system.

### **How much, what form, and what structure?**

The investment needs to be large enough to restore the bank to financial health. The goal is not only to meet regulatory capital requirements. It is also to ensure that the bank can return to profitability after funding the cost of financial and operational restructuring and absorbing the losses associated with this restructuring.<sup>5</sup>

To achieve this goal, there needs to be reasonable certainty that the bank will be able to generate an adequate (market) rate of return after the investment and required restructuring. A common error, arising from failure to obtain adequate information and undertake sufficient analysis, is to underestimate the size of the investment required, leading to a need for additional recapitalization later. Insufficient recapitalization can undermine management and board incentives, delay a return to normal operations, and impede divestment. Managers operating with insufficient capital have incentives to take inordinate risks (to “bet the bank”) and to delay the recognition of losses, such as those that might be inherent in necessary restructuring.

Structuring the terms and conditions of the investment so that bank managers and owners do not request more new capital than needed is also important. This requires a dynamic process for assessing the bank’s application—one that holds

management and the board to a high standard in information and supporting analysis and that uses outside expertise in assessing and challenging management's plans.

To achieve the goal of restoring the bank to profitability, the investment would best take the form of common stock (ordinary shares). Convertible preferred stock (preference shares, or what the U.S. government calls "contingent common capital") is also an option. The key distinction between the two options is whether the government will have the ownership rights inherent in common stock or whether it will be a passive investor by investing in nonvoting preferred stock.<sup>6</sup> For recapitalization of deeply distressed banks, an investment in common stock is the better option. In such cases taxpayer funds will be at substantial risk, and the government cannot be a passive investor.

The use of preferred stock and subordinated debt is best reserved for banks with good prospects for a near-term private sector solution to the capital deficiency. The intent would be to buy time for a private sector solution to materialize, and to create incentives for the board and management to find such a solution. If no private sector solution should materialize, governments generally have the option to convert preferred stock or subordinated debt to common shares or to exercise warrants and acquire common shares. This has been the approach taken, for example, in the United States, Germany, Switzerland, Belgium (except in the nationalization of Fortis), and Ireland (except in the nationalization of Anglo Irish Bank).

At the same time, however, seeking to create an incentive for a private sector solution by using preferred stock with a high cumulative dividend requirement, or subordinated debt at above-market interest rates, runs counter to the fundamental objective of restoring the earnings capacity of the bank and is best avoided. In the United Kingdom, for example, the government originally recapitalized RBS and Lloyds with preferred stock with a 12 percent dividend yield. There was no way for the banks to deploy such funds profitably, and because they could not meet the dividend requirement, the government had to convert the preferred stock to common shares.

### What resulting ownership interest?

So that existing shareholders bear the cost of past mistakes, their ownership interest in the bank should be diluted, perhaps substantially. The government should acquire an ownership interest commensurate with the amount of its investment. The information and analysis undertaken in the application process would be the main basis for determining what proportion of ownership should accrue to the government as a consequence of its investment. The decision would also be the subject of extensive negotiations between the government and the bank's board and management. These negotiations might also involve other parties, such as unsecured creditors whose debt might be subject to debt-to-equity conversions and who thus might also acquire an ownership interest in the bank.

### Governance arrangements

In principle, when a government becomes an owner of common shares, it gains the same rights and obligations as other shareholders, exercised mainly through voting at the annual general meeting of shareholders. During the current crisis, however, even some governments that have not acquired common stock have made board representation a condition of investment and have directly intervened in matters that under normal circumstances are the purview of the board and common shareholders (such as executive remuneration). While these extraordinary interventions in governance may be explained by the emergency nature of the investments and the public outcry over perceived abuses in executive compensation, they undermine the ability of government and other shareholders to hold the board and management accountable. This section therefore offers guidance on addressing governance issues without resorting to such extraordinary interventions.<sup>7</sup>

### Separating ownership and regulation

To separate the handling of temporary ownership from the policy and regulatory functions of government, a specialized ownership unit can be established. This unit would be responsible for implementing the ownership policy, exercising ownership and governance responsibilities, and carrying out the exit strategy. The unit could be,

for example, the government entity responsible for the ownership function in all state-owned entities or a special team or separate body subject to executive or legislative oversight. Whatever form the unit takes, it needs to be adequately staffed and led by a person with at least as much influence and authority as the bank's chairperson and chief executive officer.<sup>8</sup>

The ownership unit needs the expertise to apply good corporate governance practices, ensure that operations follow commercial principles, and maximize the value of the investment. If these skills are not readily found in government, the ownership unit can rely on outside advisers with backgrounds in such areas as finance and investment banking, corporate governance, corporate restructuring, corporate and bankruptcy law, and information technology. Contracting for such expertise will require access to funding. But the cost is likely to be small relative to the size of the investment and would be recouped by the higher value ultimately realized on the investment.

To ensure public accountability for its actions and performance, the ownership unit needs to operate transparently. The unit should publicly disclose its intentions, its decisions and actions, the basis for these, and its performance in discharging its responsibilities.

### Handling the board

The temptation to put government officials on the bank's board should be resisted. The board needs to be composed of individuals with the collective knowledge, skills, and experience (such as in banking, finance, corporate law, and accounting and auditing) to effectively oversee management. Government officials may lack the qualifications or the time to function effectively as board members. Moreover, putting government officials on the board could undermine its balanced functioning if they are perceived as having extraordinary authority relative to other board members.<sup>9</sup>

A professional board needs to be formed through a transparent process organized by the ownership unit. For example, the unit could create an investors' committee responsible for selecting appropriate board members. When the government is sole owner, half the members of the committee could be individuals active in

the private sector who can help recruit board members. When there are other owners as well, the ownership unit could appoint less than half the committee. To find board candidates with appropriate skills and experience, the committee could use private recruitment firms. The ownership unit needs to follow the recommendations of the committee at the shareholders' meeting when the board members are elected.

The board's mission would be twofold: to ensure that the bank is restructured and managed with the objective of restoring profitability and financial strength, and to facilitate the government's divestment on favorable terms. This mission would require the board members, especially the chairperson, to maintain a continual dialogue with the ownership unit. The chairperson would be responsible for ensuring that the ownership unit is adequately informed about the bank's performance, its strategy for achieving restructuring and other goals, and other issues of importance to the owner. At the same time, the board members need to act in the interest of all shareholders. In countries with long-standing deficiencies in bank governance arrangements, the government could leverage its temporary investment to upgrade the board's governance policies and procedures.<sup>10</sup>

The ownership unit and other government officials need to refrain from interfering in decisions on the bank's day-to-day operations and avoid making decisions that are appropriately the responsibility of the board and for which the board should be held accountable. Nor should the ownership unit seek to influence individual credit decisions. To achieve a government objective of providing new credit to the economy, quantitative credit targets should be avoided. Instead, the focus should be on promoting rapid restructuring, establishing a rate-of-return target that cannot be met by investing solely in government paper, and engaging in a dialogue with the chairperson to ensure that the board and management take into account the views of the government (as shareholder) in this respect.

Just as the ownership unit needs to operate transparently, it also needs to promote a high level of transparency in the operations and performance of the bank. Transparency will support eventual divestment by better enabling potential new investors to evaluate the bank's prospects.

### Exiting the investment

To avoid market distortions and reduce uncertainty, the government needs to divest as soon as this can be done on good terms. All developed country governments that have taken ownership stakes in banks during the current crisis have emphasized the temporary nature of their investments, and most have expressed an intent to divest promptly.

To prepare the way for prompt divestment, the ownership unit needs to start developing alternative exit strategies as soon as the investment is made. The criteria for divestment are commercially sensitive issues, but general guidelines need to be publicly disclosed to give the market and other potential investors an idea about when the unit will start to consider a sale. Such criteria would concern both the bank and the overall banking system. For the bank, the criteria would focus mainly on the achievement of enough progress in restructuring so that the probable impact on the ultimate balance sheet structure and future earnings becomes clear. For the banking system, the criteria would include measures indicating that the system has stabilized (such as conditions in the interbank market, spreads, and bank equity market valuations) and is returning to normal operations (such as rate of credit expansion).

The ownership unit should be responsible for executing the divestment. The unit would therefore need to keep itself informed about the bank's performance and market developments and continually evaluate the proper time and method for exit. One or more investment banking firms with international and local experience could help in developing the divestment strategy. A process for selecting such an investment bank should be initiated at an early stage.

The government's stake can be divested through sale to strategic or portfolio investors, through public sale or flotation, or through a combination of these. In deciding on the method of divestment, the impact on the future governance of the bank needs to be taken into consideration.

### Conclusion

Authorities in economies not immediately affected by the crisis can prepare now for the possibility of

temporary ownership of financial institutions as a last resort. As the preceding discussion makes clear, this would entail clarifying up front the objectives of temporary government ownership and the conditions under which it might be appropriate, making preparations to have the information and analytical capacity necessary to structure any possible government investment, determining how to organize and staff the temporary ownership function, and having the capacity to quickly identify and appoint new qualified board members. Governments can formulate in advance a statement of objectives and principles to guide any future investment and subsequent governance or ownership as well as a plan to communicate this information to the public. They can also identify and prepare for the legal requirements involved in the entire process, from initial intervention to eventual divestment.

### Notes

This policy brief is based on the author's experience in organizing support to the government of the Republic of Korea during the Asian financial crisis as well as subsequent work on the corporate governance and performance of state-owned financial institutions. Arne Berggren, an independent consultant to the World Bank and a former official of the Swedish Ministry of Finance and the Swedish Bank Support Authority, provided substantial inputs, drawing on his experience in the response to the Swedish banking crisis of the early 1990s. Valuable comments were provided by Laura Ard, Alex Berg, Katia D'Hulster, Heinz Rudolph, and Constantinos Stephanou.

1. Whether these instruments qualify as Tier 1 capital under the Basel II capital accord is open to question. The standard setters may take a relaxed attitude toward these discrepancies, however, since the source of the capital is the government, which might reasonably be relied on to convert such instruments to common equity if necessary.
2. A good example is the United Kingdom's *Shareholder Relationship Framework Document* (UK Financial Investments Ltd. 2009).
3. Declaration of a Concerted European Action Plan of the Euro Area Countries, final version, October 12, 2008 ([http://ec.europa.eu/economy\\_finance/publications/publication13260\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication13260_en.pdf)).

4. The application and information gathering process, or postinvestment analysis, may reveal that the bank is insolvent. In such cases, if the bank cannot be closed or resolved through other established means, the bank should be nationalized as a last resort, with the government taking full or nearly full ownership.
5. Restructuring can give rise to losses in a number of ways. The most common is the write-down of the book value of assets. Losses can also be incurred in restructuring certain liabilities, and there can be costs associated with exiting certain business lines and reducing the number of staff.
6. In practice, as noted, the conditions imposed by some governments represent the de facto exercise of ownership rights even when the government holds no common shares. But doing so undermines established corporate governance arrangements and, as is argued, is best avoided.
7. This section is consistent, for example, with the OECD *Guidelines on Corporate Governance of State-Owned Enterprises* (2005).
8. UK Financial Investments Ltd., set up by the U.K. government and subject to a framework document governing its relationship with the Treasury, is one such example.
9. Although the U.K. government initially placed government officials on the board of Northern

Rock, this decision was later reversed. In future the directors of this nationalized bank will be chosen by the specialized ownership unit, UK Financial Investments Ltd.

10. For these purposes reference can be made to OECD guidelines on corporate governance, including the corporate governance of state-owned enterprises (see OECD 2004, 2005).

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