Working Group on Privatisation and Corporate Governance of State Owned Assets

Corporate Governance and Temporary Government Control over Financial Institutions

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I. SUMMARY AND ISSUES FOR DISCUSSION

1. The escalation of the financial crisis in the second half of 2008 has placed pressure on banks’ regulatory capital, caused both by write downs of asset values and outright losses. This has, in turn, led member governments to adopt emergency responses, including both selective and broadly available capitalisation programmes for financial institutions. Many OECD governments have already become, or are in the process of becoming, significant shareholders in private sector financial institutions.

2. Some governments have limited recent experience in owning bank assets. In many cases, the governments are also “reluctant owners” who see their ownership as a transitory arrangement to be progressively unwound as the crisis recedes. As the UK Treasury stated in announcing its financial support package, “…the Government is not a permanent investor in UK banks. Its intention, over time, is to dispose of all the investments it is making as part of this scheme in an orderly way.”1 This raises the question as to the most effective ownership arrangements and the process of re-privatization.

3. The prospect of large scale, but temporary, government ownership involvement in the financial sector gives rise to a range of corporate governance issues, both for the owner governments, for the firms involved and for the remaining investors. For this purpose the principles for government ownership, which are formulated in the OECD Guidelines on Corporate Governance of State Owned Enterprises (the “SOE Guidelines”) may be informative. Particularly, since establishing good corporate governance at firm level is considered a key step in a successful privatisation process. In addition, the Working Group is currently concluding a “best practices” report on effective privatisation, which includes important country experiences with the various steps and actions involved in privatisation [DAF/CA/PRIV(2008)8].

4. In light of the SOE Guidelines, recent developments raises important questions in relation to level playing fields and protection of minority shareholders amid rapid and forced ownership change. Further pertinent issues include: how the separation of ownership and regulatory functions can be best achieved in circumstances where the recapitalisation effort has a largely regulatory element; how should existing ownership entities be involved; to what extent should the temporary shareholdings be integrated into a government’s overarching ownership framework; and what are the implications for the relationship with stakeholders in circumstances where governments want to limit the risks of moral hazard.

5. A number of OECD governments have experiences with recapitalising financial institutions during the credit crises in the 1990s. The banking crises in Finland, Norway and Sweden in the early half of the 1990s and of Japan and Korea in the latter half of that decade all involved state-led recapitalisation efforts. These examples are recent enough to provide relevant lessons to governments in the current situation but also provide a relatively complete picture of how state ownership evolved during the course of the crises, how state holdings were managed and how temporary ownership arrangements were ultimately unwound. Accordingly, these quite diverse experiences could usefully inform governments who are now faced with similar policy choices in managing partially state-owned financial institutions.

Issues for Discussion

- Delegates are invited to share their own experiences on the key corporate governance issues that arise when governments invest in commercial financial institutions in response to financial crises. In particular, the Working Group members are asked to consider:

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1 Treasury statement on financial support to the banking industry, 13 October 2008 (http://www.hm-treasury.gov.uk/press_105_08.htm)
How to resolve the tensions in ensuring an appropriate separation of ownership responsibility for the shareholdings in financial institutions from the regulatory responsibilities, while at the same time maintaining the required level of cross-government co-ordination needed to respond adequately to the financial crisis.

The extent to which the terms of the rescue of individual banks creates “level-playing field” issues with respect to the non-assisted banks and other financial institutions. This issue may be exacerbated by the fact that the terms of the investment often reflect the underlying macro-economic objectives of government’s recapitalisation efforts.

Specific issues that may arise with respect to the equitable treatment of non-government shareholders, in circumstances where government investments have often been structured to achieve the dual interests of minimizing the risk to taxpayer funds and limiting the scope for moral hazard.

To what extent governments are using or will use their ownership role to impose corporate governance reforms on the particular institutions in which they have invested (for example, remuneration), and how those reforms will be reconciled, or coordinated with, corporate governance reforms that apply to the industry or the market more widely.

The role of government-appointed directors and, in particular, the conflicts that they may face in reconciling the objectives of the government shareholders with the interests of the financial institutions that they represent.

Finally, delegates are invited to consider:

- Establishing a Task Force to gather information and facilitate the exchange of experiences in this area.

- The development of a brief report on practices and experiences for the Working Group’s meeting in April 2009.
II. TEMPORARY GOVERNMENT OWNERSHIP OF FINANCIAL INSTITUTIONS

1. Summary of Recent Government Capital Investments in Financial Institutions

6. In the early stages of the credit crisis, the focus of government action at the broad level was on ensuring financial sector liquidity, rather than solvency. To the extent that individual financial institutions were suffering from deteriorating solvency, in general this was left to the institutions involved to resolve via private sector capital raisings. When governments did become involved, it was on a case-by-case basis and usually involved particular institutions that were considered “too big to fail”. In such cases, the government involved felt the need to execute a rescue of the individual institution to prevent systemic risks from developing. This process began with the UK Government’s takeover of Northern Rock plc in early 2008 and has since involved a number of institutions in various countries. A summary of some major transactions to date is set out in Box 1.

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**Box 1. Selected Capital Injections/Takeovers**

**Northern Rock**

In February 2008, the UK Government put Northern Rock plc into a "period of temporary public ownership". The move followed unsuccessful attempts by the government to seek an acceptable private sector solution to unwind the government loans that were put in place in 2007.

**Fannie Mae and Freddie Mac**

In early September 2008, the US Federal Housing Finance Agency put the US GovernmentSupported Entities (GSEs) Fannie Mae and Freddie Mac into "conservatorship". In concert with this move, the US Treasury "entered into a Senior Preferred Stock Purchase Agreement with each GSE which ensures that each enterprise maintains a positive net worth." Under the terms of the stock purchase agreements, the Treasury committed to $1 billion of senior preferred stock and received warrants representing an ownership stake of 79.9% in each GSE.

**AIG**

On 16 September 2008, the New York Federal Reserve Board agreed to lend up to $85 billion to the American International Group (AIG). The terms of the 2 year loan provided that the "U.S. government will receive a 79.9 percent equity interest in AIG and has the right to veto the payment of dividends to common and preferred shareholders."

**Bradford and Bingley**

In late September, the UK Government announced the nationalization of the building society Bradford and Bingley. As part of the takeover, the government immediately on-sold the deposit taking business to a private operator (Abbey National plc). The nationalized assets essentially comprised the company’s loan books and related funding.

**Fortis**

There have been a series of capital transactions by the Governments of Belgium, Luxembourg and the Netherlands involving the Fortis Group. On 28 September 2008, the three governments partly nationalized Fortis, with a combined investment of €11.2 billion. Then, on 3 October, the Netherlands took 100 per cent ownership of the Dutch components of the group and Luxembourg moved to majority control of Fortis’ Luxembourg banking operations. On 5 October, the Belgian Government took total control of the Belgian banking business and then on-sold 75 per cent to French banking group, BNP Paribas. As a result, the Belgian Government now also has a 12 per cent shareholding in BNP Paribas.

**Dexia**
The Belgian, French and Luxembourg governments invested a combined €6.4 billion in the Dexia banking group in late September. The French investments were split between the Government (€1 billion) and the public sector financial institution, Caisse des Dépots et Consignations (€2 billion), giving it a 25% stake in the bank. The Belgian Government’s investment also resulted in them receiving a 25% ownership interest, while Luxembourg invested in convertible bonds.

**Icelandic banks**

On 29 September 2008 a plan was announced for the bank Glitnir to be nationalized by the Icelandic government with the purchase of a 75 percent stake for €600 million. Subsequently, the Icelandic Financial Supervisory Authority took control of all three major Icelandic banks, Landsbanki, Glitnir and Kaupthing, and appointed receivership committees to oversee the operations of the banks.

7. As the crisis has evolved, and banks regulatory capital has become a more wide-ranging concern, governments have shifted their emphasis from one-off injections of capital to more systematic responses to boost bank solvency. Leaving aside the possibility of regulatory forbearance, there are two general approaches being adopted by governments to ensure banks’ are adequately capitalised. Firstly, governments are stabilising banks’ balance sheets making markets for illiquid assets or facilitating the removal of distressed assets off balance sheet (for instance, by the establishment of separate “bad banks”). Secondly, governments are directly recapitalising their banking sectors by establishing pools of capital accessible to a wide range of financial institutions to effect or underwrite improvements in their solvency. It is in this second set of approaches that issues relating to state ownership are more obviously relevant.

8. In early October 2008, the UK established the first broadly available bank recapitalization programme. The government announced that an initial £50 billion pounds would be available to UK incorporated banks and building societies to increase their Tier 1 capital ratios. Subsequently, the UK Treasury announced potential investments totaling £37 billion into three institutions, Royal Bank of Scotland, Lloyds TSB and HBOS. These investments include both preference share issues and support to ordinary equity raisings. In the case of RBS, the government committed to an initial £5 billion subscription of preference shares and agreed to underwrite a further £15 billion rights issue to ordinary shareholders. Depending upon the extent to which the rights are taken up, government will end up with up to 63% ownership of the bank, in which case it has negotiated the right to appoint three independent directors. For Lloyds TSB and HBOS, the government, subject to a merger between the two institutions, would commit £4 billion in preference shares and will underwrite a further £13 billion in ordinary share issues split between the two banks. Under the terms of the offer, government will have the right to appoint two independent directors to the merged entity and the institutions will be unable to pay ordinary dividends until the preference shares are repaid.

9. The UK Treasury also provides details on the administrative arrangements that will be put in place to manage the government’s shareholdings, announcing that “the Government intends to create a new arms length body to manage the Government's shareholdings in recapitalised institutions on a professional and wholly commercial basis, and seek to effectively realise value to the taxpayer. Transparent arrangements will be put in place to ensure that any role for the Government in relation to investment

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2 This improves bank solvency only if the “bad assets” are acquired at concessional prices.

3 To the extent that governments acquire distressed assets via commercially oriented structures, this may also give rise to governments being owners of effectively commercial enterprises.

4 The choice of equity instrument has been constrained by the desire to boost Tier 1 capital in the banks. While the Financial Services Authority allows banks to count non-cumulative, perpetual preference shares as Tier 1 capital, they also require that at least half of core Tier 1 capital be in the form of ordinary shares.

decision-making is clearly defined. A model for such arrangements already exists in the form of the Shareholder Relationship Framework that was established for Northern Rock and outlines the key corporate governance arrangements in relation to board’s structure, authority and composition, and further identifies the specific roles and rights of the shareholder, UK Treasury.

10. Subsequent to the UK plans being announced, the euro area members of the European Union announced a coordinated plan to “make available to financial institutions Tier 1 capital, e.g. by acquiring preferred shares or other instruments including non dilutive ones.” So far, Austria has committed up to €15 billion to provide capital support for banks, France has committed up to €40 billion, Germany has committed up to €80 billion, and the Netherlands has committed up to €20 billion. In late October, the French Government utilized €10.5 billion of the announced funding to invest in subordinated debt instruments (qualifying as Tier 1 capital) in the country’s six largest domestic banks. Similar to the UK, the investments will be made by a separate entity established for the purpose of holding state banking investment, the Société de prises de participations de l’Etat, which will also hold the government’s investment in Dexia. The French Government support is conditional upon limits on executive remuneration and commitments to maintain lending to specified sectors, but is not specific on government appointed representatives on the boards of the recipient institutions.

11. From its committed funds, the Dutch government has announced an investment of €10 billion in ING Group by way of convertible preference shares that qualify as Tier 1 capital. As part of this investment, the Dutch government will to the board, who will be elected at a general meeting of shareholders. The nominees will join ING’s audit committee, remuneration and nomination committee and the corporate governance committee of the Supervisory Board. Further, they will have approval rights for decisions concerning equity issuance or buybacks, strategic transactions with a value equaling more than one quarter of ING’s share capital and reserves.

12. On 16 October the Swiss Government announced that it developed a set of measures available to its two large banking groups, UBS and Credit Suisse. While Credit Suisse chose not to participate (instead raising funds in the private capital market), UBS issued CHF 6 billion of mandatory convertible notes to the Swiss Government which, when converted, would equate to the Government holding a 9.3 per cent stake in UBS. The terms of the convertible notes do not give the government the right to nominate directors to the Board of UBS.

13. In a similar vein to the moves by European governments, the US Treasury announced that there would be a Capital Purchase Program initiated as part of the Troubled Asset Relief Program (TARP). Under this program, the Treasury would purchase up to $US 250 billion in senior preference shares in US controlled banks and savings institutions. To participate in the scheme, qualifying institutions are

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6 Treasury statement on financial support to the banking industry, 13 October 2008 (http://www.hm-treasury.gov.uk/press_105_08.htm)
7 http://companyinfo.northernrock.co.uk/downloads/nr_shareholder_framework_310308.pdf
8 Summit of the euro area countries: declaration on a concerted European action plan of the euro area countries, 12 October 2008.
9 At the same time, French banking regulators increased the tolerance level for hybrid instruments in Tier 1 capital from 25% to 35%; without such a move the hybrid instruments would not have been effective for banks that are already close to the existing ceiling.
10 Individual banks that choose to participate would be required to subscribe for between 1 and 3 per cent of risk weighted assets up to a maximum of $25 billion per institution. In addition, US Treasury will receive warrants to purchase ordinary shares with a market value equal to 15 percent of the senior preferred investment.
required to submit to strict requirements on executive compensation and to limits on the payments of ordinary dividends. In other respects, the capital instruments have been designed as passive investments; the senior preferred shares that will be issued carry no voting rights and Government has committed that it will also not vote shares that it receives from converting warrants. The senior preferred shares would not entitle the holders (initially US Treasury) to appoint directors, except when dividends on the shares are not paid in full for six dividend periods, whether or not consecutive, in which case the holders would have the right to elect two directors. Nine large US financial institutions agreed to participate at the announcement of the scheme.

2. Past OECD Experience with Government Capitalisation of Financial Institutions

14. In the normal course of events, the above governments would have been unlikely to establish substantial minority (and in some cases majority) holdings in private sector financial institutions. However, using government funds to recapitalise the financial sector in a time of crisis is not without recent precedent. In the 1990s, the responses of authorities to banking crises in Finland, Sweden, Norway, Korea and Japan all, to some extent, involved governments injecting capital into stressed institutions.

15. In Finland’s banking crisis, the first institution to fail was Skopbank, which was a commercial bank that acted as a main backer for the domestic savings banks. The Bank of Finland took control in 1991 after an earlier attempt to raise private capital in 1990 did not have the desired result. The ownership of Skopbank was later transferred to a Government Guarantee Fund that was established in 1992. In March 1992, the Government established a more systematic scheme of capital support available to all banks, regardless of the solvency, in proportion to their risk weighted assets. The funding was provided by way of a non-cumulative convertible preference notes that qualified as Tier 1 capital. This offer was taken up by some 130 banks.

16. The Government of Norway took full ownership of the country’s three largest commercial banks between 1991-1992, writing down the existing owners’ share capital to zero in two of these banks. Two new entities were established to manage the crisis: the Government Bank Insurance Fund and the Government Bank Investment Fund. The first of these was empowered to inject capital into the troubled banks and be a short term owner; the second was designed to be a longer term owner of the shareholdings once the initial crisis had receded. While the management and Boards of Directors were changed as part of the nationalisation, the government chose to preserve the governance structures that were in place and to hold the Fund, the owner of the shares, at arm’s length from government. The Norwegian government ultimately sold its stakes in the number two and three banks. However, it continues to retain a blocking minority stake (34%) in the legacy bank, DnB NOR, whose ownership function has been transferred to the Norwegian Ministry of Trade and Industry.

17. In Sweden, the government’s response to the financial crisis involved a general guarantee to the entire banking system coupled with a facility to invest capital into financial institutions that breached their regulatory capital limits. The government established a separate Bank Support Authority to administer both the guarantee and the capitalisation of weakened institutions. While the Authority administered the scheme, ultimate decision about providing capital support to individual banks were taken by government. In order, to limit moral hazard risks, the government made it a condition of providing solvency support that any losses were first covered by pre-existing shareholders. Two banks were the main recipients of government recapitalisation proceeds: Nordbanken and Gota Bank. The banks were restructured with impaired assets moved to separate entities (i.e. “bad banks”). Gota Bank was ultimately merged into

11 The list of country examples is not exhaustive. For example, there have been banking crises in other OECD countries ranging from Hungary, Mexico, Slovak Republic, Spain and Turkey.
Nordbanken and, in 1995, the Swedish Government sold a proportion of its equity in the combined entity and the bank was relisted on the stock market.

18. After severe asset price inflation in the late 1980s Japan experienced a banking crisis that reached a climax in the mid to late 1990s. The crisis resulted in the government, through the Deposit Insurance Corporation of Japan, injecting significant capital into 25 different banks, mainly via preferred and subordinated bonds or loans. Total capital injected equaled ¥12.4 trillion. Of that amount, the DIC had recouped ¥9.1 trillion as of 31 March 2007, but still held ¥3.3 trillion in capital instruments across 15 different institutions.12

19. In 1997, the Korean Government response to its banking crisis involved the acquisition of Korea First Bank and Seoul Bank with a substantial recapitalization of the insolvent banks by the government and Korean Deposit Insurance Corporation (KDIC). KDIC was the nominal shareholder and entered into Memorandums of Understanding with the nationalized banks. There was change of management, and restructured board representation. Compared to the Japanese experience, the KDIC was particularly aggressive in dealing with corporate abuses, initiating court proceedings against nearly 1,300 people13. The ownership was originally expected to be short term and, to this end, 51 per cent of Korea First Bank was sold in 1999. However, the remaining minority stake was not sold until 2005. Seoul Bank was sold in its entirety to Hana Bank in 2002.

3. Corporate Governance Challenges in Temporary State Ownership of Financial institutions

20. The rapid and unplanned capital injections into financial companies by governments raise a number of specific corporate governance issues. As noted above, the nature of the current crisis has meant that governments have taken ownership interests in banks reluctantly but with significant speed. Furthermore, governments’ objectives in taking an ownership interest in financial institutions are almost entirely “non-commercial” in the strict sense, relating to the macro-economic objectives of restoration of confidence in credit markets through the repair of balance sheets. Where financial objectives have been specified, these are usually expressed in terms of limiting the risk to public finances and are subsidiary to the primary objectives of stabilizing the financial system. The SOE Guidelines provide a broad framework for guiding governments in exercising their ownership responsibilities in these unique circumstances; applying them to the current situation helps to highlight some specific challenges with which governments are faced. The following discussion seeks to draw out some of the key issues that are pertinent to the capitalization actions of recent months.

3.1 Separation of Ownership and Prudential Regulation

21. The government capitalizations that have occurred have been designed to boost financial institutions’ regulatory capital and to limit systemic risks. Depending upon the nature of the institution(s) involved and the legal and administrative frameworks, the decision to invest public funds to boost financial institution solvency have variously involved central banks, financial market supervisors, deposit guarantee bodies and policy agencies. Crisis management has dictated a high degree of coordination between policy makers and regulators that does not, in the long term, fit the ideal of complete separation of ownership and regulatory functions (Guideline 1.A). The Annotations to the SOE Guidelines state that “full administrative separation of responsibilities for ownership and market regulation is therefore a fundamental pre-requisite for creating a level playing field for SOEs and private companies”. This Guideline is more usually associated with market structure regulations that impact on competition; it is less

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12 Deposit Insurance Corporation of Japan, Annual Report 2006
than clear how such a recommendation can be applied to financial sector regulation, particularly in a situation where the .

22. Government actions in bailing out individual firms will involve distortions of the “level playing field” in financial markets, either because the rescue efforts are provided to selective institutions (for instance, excluding non-domestic institutions), or to selected sectors, as in markets where non-bank financial institutions compete with banks. While this is essentially unavoidable in the short run, an important issue will be how the associated corporate governance issues are best managed in the longer term. Depending upon how the crisis unfolds, there is the possibility of continued high level co-ordination between the bodies that act as shareholders and those that hold regulatory functions and powers. For example, in a situation where asset markets deteriorate further, regulators may require the banks with state ownership to raise additional capital. This will place the government in a position where, in exercising its regulatory functions it will mandate the investment of additional capital and on the other hand, in exercising its ownership responsibilities will be required to determine whether it will facilitate or support such a capital raising. Regulators may need to consider how the institutional arrangements are best structure to ensure that regulators are afforded appropriate independence while allowing for a considered and coordinated response to addressing bank capitalisation.

23. The institutions that have participated in the recapitalization programmes will be keen to ensure that ownership functions are ultimately quarantined from regulatory responsibility, since it could be a prerequisite to an orderly unwinding of the governments’ ownership interests. Ownership has been used as part of a solution to regulatory solvency concerns in the short run, but if governments are keen to divest holdings relatively quickly, then long term regulatory solutions may have to be developed in isolation from government ownership. This implies that regulators and institutions’ management should ideally have a relationship that is independent of the agencies with ownership responsibility. Regulatory separation will be of the utmost importance to those financial institutions that have not participated in the recapitalization programmes, or have been excluded. These institutions will be concerned to ensure that they receive no adverse regulatory treatment by virtue of their not being within the scope of the governments’ rescue packages.

3.2 Ownership Objectives

24. Apart from pure financial market regulation, the question arises as to what extent governments will use their ownership to pursue macro-economic objectives and how this is best managed. The current investments of government funds to boost solvency of financial institutions are motivated by quasi-regulatory objectives, including promoting confidence in credit markets, preventing systemic risks from emerging and stabilizing individual financial institutions. In announcing their rescue package, the UK Treasury explicitly acknowledge a range of conditions for their investments, including maintaining lending levels to homeowners and small to medium enterprises; and supporting people struggling with mortgage payments (refer Box 2). Similarly, the French Government’s investments in France’s six largest banking institutions were on condition that the participating institutions agreed to lending targets for a range of customer classes.

25. The use of state ownership to pursue wider economic policy objectives is not unique to the current situation and the SOE Guidelines clearly contemplate that “in some cases SOEs are expected to fulfill special responsibilities and obligations for social and public policy purposes [which] may go beyond the generally accepted norm for commercial activities” (Guideline I.C). Where this occurs, the SOE Guidelines highlight that it is important that non-commercial objectives are “clearly identified, disclosed and adequately compensated.” What is different in the current situation is that the pursuit of non-financial objectives has motivated the initial investment and so is quite different to a situation where governments impose operating conditions on a long-held SOE. The initial conditions for Government investment, such
as those identified for the UK and France above, appear uncomplicated since the arrangements are transparent, specific and the funding is inextricably related to the initial investment of government capital. From a corporate governance perspective, what is more interesting for these conditions is how governments will seek to enforce them and, if government objectives evolve over time (or governments seek to make any current implicit objectives more explicit), what processes will be suitable to vary or elaborate existing agreements.

**Box 2. UK Ownership Arrangements for Financially Supported Banks**

As part of its investment, the Government has agreed with the banks supported by the recapitalisation scheme a range of commitments covering:

- maintaining, over the next three years, the availability and active marketing of competitively-priced lending to homeowners and to small businesses at 2007 levels;
- support for schemes to help people struggling with mortgage payments to stay in their homes, and to support the expansion of financial capability initiatives;
- remuneration of senior executives - both for 2008 (when the Government expects no cash bonuses to be paid to board members) and for remuneration policy going forward (where incentive schemes will be reviewed and linked to long-term value creation, taking account of risk; and restricting the potential for “rewards for failure”);
- the right for the Government to agree with boards the appointment of new independent non-executive directors; and
- dividend policy.

Source: Treasury statement on financial support to the banking industry, 13 October 2008 (http://www.hm-treasury.gov.uk/press_105_08.htm)

### 3.3 Ownership Entities

26. The SOE Guidelines propose that the ownership function should be clearly identified with some degree of coordination or centralization (Guideline II.D). Where governments already have in place a centralised ownership function, one option would be to integrate bank shareholdings with other state shareholdings. However, there are features of the current crisis management that may mitigate against such a treatment. Many governments involved in the recapitalization process have limited recent experience in owning banks and, again, see their ownership positions as temporary arrangements. In some cases, the capital injections have been structured in such a way as to create significant incentives for the recipient institutions to repay government provides capital as soon as practicable. Finally, the holdings are in a large number of cases minority holdings that don’t afford governments' significant control. In such circumstances, integrating the ownership responsibility with an existing body that is more designed to manage significant and long term stakes may not be an optimum solution. Such decisions are likely to be determined by a range of factors including the expertise of the governments’ existing ownership entities, the nature of their relationships to the agencies involved in managing the credit crisis and the size and expected duration of the governments’ investments in financial institutions.

27. The expected short-term nature of the holdings and the extent, to which specialized skills are required to be an informed owner of bank shares in a time of crisis, would tend to the view that it would be preferable to hold the shares separate from other holdings. In past crises, Governments have set up special funds (as in the case of Finland and Sweden) to hold the shares or used existing Deposit Insurance
Corporations that had led the rescue process and were considered most qualified to act as owners (Korea and Japan).

28. In the current environment, the choice of ownership entity, in the short term at least, may in part be dictated by the way in which the crisis has evolved; individual bailouts have resulted in ownership split between different government entities, depending upon the legal and constitutional frameworks and the allocation of administrative responsibility among various institutions. For example, in the case of Fannie Mae and Freddie Mac the stock purchase agreement is in place with US Treasury, but for AIG the lending arrangement is with the New York Federal Reserve. In the Dexia transaction, the French investments are split between the government and the public investment body, Caisse des Depots et Consignations. While in their short run responses, governments may have constraints on how they can effectively provide the capital injections, this does not preclude the adoption of alternative ownership structures, once more stable conditions persist. This split approach is also not unknown to past crises; in the early 1990’s, the Norwegian Government established two separate funds, a Government Bank Insurance Fund and a Government Bank Investment Fund. The first fund was used to make short term investments in financial institutions, while the second fund was designed to hold stakes in the medium to long term. When the government decided to hold stakes that were acquired as part of the crisis management exercise for a longer period these were transferred from the short term fund to the long term fund.

3.4 Equitable Treatment of Shareholders

29. Ensuring the equitable treatment of shareholders during the recapitalization of financial institutions is notoriously difficult, accentuated by the fact that the structure of the capitalization transactions have been driven by the dual interests of preserving taxpayer funds and limiting the scope for moral hazard. The issue is qualitatively different from the usual challenges governments face, arising as a result of acquiring stakes in companies rather than the more usual situation where governments are the incumbent owners of SOEs who have admitted private shareholders.

30. Governments have tried to guard against moral hazard risks by structuring the funding arrangements to limit the capacity of existing shareholders to undeservedly benefit from the terms of the rescue. For example, in announcing the stock purchase arrangements for Fannie Mae and Freddie Mac, the Secretary to the US Treasury stated that “market discipline is best served when shareholders bear both the risk and the reward of their investment. While conservatorship does not eliminate the common stock, it does place common shareholders last in terms of claims on the assets of the enterprise.”\(^{14}\) The structures adopted to achieve these goals have taken different forms, including the use of high interest bearing hybrid facilities, issuing preference shares with a high coupon and using equity warrants to dilute existing shareholders. The resulting commercial relationship and ownership structure has often placed governments in a strong position vis-a-vis the remaining shareholders.

31. To protect taxpayer funds, in many cases the instruments used for the recapitalization are of a hybrid nature that does not immediately establish government as an ordinary shareholder with ordinary shareholder rights, but are instead convertible to ordinary shares or have share warrants attached. Nevertheless, the effect of the agreements is to give governments substantial power over matters such as the appointment of independent directors, the determination of dividend policies, and establish the respective rights of ordinary shareholders and governments during the period of the governments’ investments. The imposition of such conditions is not unexpected in the circumstances, but gives rise to questions about how governments will interact with non-government shareholders after the immediate crisis has passed.

\(^{14}\) *Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers September 7, 2008* (http://www.ustreas.gov/press/releases/hp1129.htm)
32. In previous crises the treatment of non-government shareholders also turned out to be a particularly difficult issue. In the case of Norway, the issue was contentious enough for the Government to establish an inquiry into the “zeroing” of existing shareholders capital when the government took control of the three largest commercial banks.\textsuperscript{15} Perhaps reflecting this sensitivity, the Belgian government has sought to establish arrangements to recompense small shareholders who suffer as a result of the Fortis takeover. Under a proposal announced on October 12, the Belgian government announced that the profits enjoyed by its Fortis takeover (and subsequent receipt of BNP Paribas shares) would be put in a special fund, which will pay out in 2014. Beneficiaries would be limited to natural persons, who are EU-citizens, or residents of Belgium, who held shares on October 3.

4. Interaction of Ownership with Broader Corporate Governance Reforms for Financial Institutions

33. To the extent that corporate governance failures have contributed to the current problems, there are clearly going to be a number of corporate governance policy changes that will be canvassed as a result of the current crisis. Examples that have already been widely canvassed include the roles and composition of Boards of Directors and the quantum and structure of executive pay. The question arises to what extent governments will seek to use their ownership holdings pro-actively to resolve these corporate governance deficiencies. The tying of capital injections to reform on executive pay (as has happened in the most of the broad based capitalization programmes, such as in the US – refer Box 3) would suggest that governments may seek to use their ownership leverage to implement at least some corporate governance changes.

\begin{boxedtext}
\textbf{Box 3. Executive Compensation Rules Under US Treasury's Capital Purchase Program}

Companies participating in the program must adopt the Treasury Department's standards for executive compensation and corporate governance, for the period during which Treasury holds equity issued under this program. These standards generally apply to the chief executive officer, chief financial officer, plus the next three most highly compensated executive officers.

The financial institution must meet certain standards, including: (1) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (2) required clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (3) prohibition on the financial institution from making any golden parachute payment to a senior executive based on the Internal Revenue Code provision; and (4) agreement not to deduct for tax purposes executive compensation in excess of $500,000 for each senior executive. Treasury has issued interim final rules for these executive compensation standards.

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34. To some extent it will be inevitable that government ownership will bring some corporate governance changes, since this is likely to comprise a cornerstone of the restructuring process and so will be a fundamental prerequisite to governments exiting their holdings. However, there is clearly a balance needed between using the ownership role to pursue corporate governance reforms, and how these measures will be tied in with more general corporate governance reforms that will apply to the sector(s) as a whole. At a purely practical level, trying to simultaneously develop or edify an ownership architecture so that government can act as an informed shareholder for financial institutions and at the same trying to use that ownership structure to drive corporate governance reforms may prove difficult.

35. There is a risk that, while using ownership leverage will be an effective and immediate measure, it will not promote general solutions and will avoid the rigour of government regulatory processes such as Regulatory Impact Assessments that would apply to more holistic formalized responses. In addition, there are risks that reforms pursued through ownership will create an uneven playing field; for example, limitations on executive compensation that are not applied broadly may place the assisted institutions at a disadvantage to their peers. These tensions will likely require some management to ensure that there is an appropriate dividing line between, respectively, corporate governance reforms that are pursued through active ownership and those pursued through more general means.