Government as investor and regulator

Transatlantic Corporate Governance Dialogue

Xavier Vives
IESE Business School

SEC, Washington
September 14, 2009
Market failures in financial markets

• Externalities:
  – Lack of internalization of social cost of failure/systemic risk
    • Network effects (payment system, interbank markets)
  – Coordination failures/Contagion

• Asymmetric information:
  – Agency problem leading to excessive risk taking (moral hazard, risk-shifting)
  – Adverse selection in credit and financial markets: failure of competition, market breakdown
  – Small investor unprotected
Market failures in financial markets

E.g. Competition may not deliver efficient outcomes:
  • Credit rating agencies: Issuer-pays model and conflicts of interest, entry restrictions, failure of reputation mechanism and race to the bottom?

• Market power
  – Switching costs
  – Asymmetric information

• Bounded rationality
  – Behavioral biases and fads
  – Lack of understanding
  – Management overconfidence
Regulation

• Objectives:
  – Protection of the system because of economy-wide externalities
  – Protection of investor
  – Maintaining competitive markets

• Facilities and policies:
  – Lender of Last Resort, Deposit Insurance
  – “Too Big to Fail”
  – Capital requirements, prudential regulation
  – Supervision
  – Competition policy

• Side effects/distortions
Excessive risk taking

• Banks will have excessive incentives to take risk in the presence of limited liability (for shareholders and managers) and moral hazard (non-observable/opaque risk on asset side).

• This is exacerbated by flat deposit insurance/TBTF and the presence of a social cost of failure

• Problem particularly acute for banks close to insolvency/bankruptcy

• Intense competition may worsen excessive risk taking problem (high profits provide buffer and increase “charter value”)
### Vives (World Bank Research Observer, 2006)

<table>
<thead>
<tr>
<th>Banking regimes</th>
<th>Risk taking incentives</th>
<th>Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free banking (observable risk/ high disclosure)</td>
<td>Liability (Rates)</td>
<td>Asset (Investment)</td>
</tr>
<tr>
<td></td>
<td>medium-low</td>
<td>absent</td>
</tr>
<tr>
<td>Free banking (unobservable risk/ low disclosure)</td>
<td>medium-high</td>
<td>maximal</td>
</tr>
<tr>
<td>Risk-insensitive insurance</td>
<td>high</td>
<td>maximal</td>
</tr>
<tr>
<td>Risk-based insurance</td>
<td>low</td>
<td>absent</td>
</tr>
</tbody>
</table>
The shock
What the banks were worth

Market Value as of January 20th 2009, $Bn

Market Value as of Q2 2007, $Bn

HSBC

Credit Agricole

Credit Suisse

Deutsche Bank

13.7

20

22

12

15

91

93

100

19

7

24

28

100

116

116

120

26

51

29

6

215

102

185

68

229

33

255

15

Source: Bloomberg, Jan 21st 2009

While JPMorgan considers this information to be reliable, we cannot guarantee its accuracy or completeness.
Corporate governance

• “I made a mistake in presuming that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders” (A. Greenspan Oct. 23, 2008)
• Failure of “shareholder value” or of corporate governance controls?
  – Too little or too much alignment of incentives between shareholders and executives given excessive risk taking from limited liability + TBTF?
Consequences of the shock(I)

• Tremendous pressure to stabilize the system
  – Massive bailout
  – Asset purchases, guarantee schemes (deposit insurance, interbank market, mutual funds),
  – Capital injections, nationalization
  – Mergers

• Tremendous distortionary potential
  – Moral hazard
  – Uneven playing field
  – Long term effects in market structure
  – Protection of inefficient incumbents
  – Threat to EU single market, subsidy races/national champions
  – Spillovers to other sectors
Consequences of the shock(II)

• Government as owner: Nationalization
• Government as main creditor: Loans to recapitalize

• Systemic crisis (post LB failure) overrides competition policy concerns
  – State aid distorting competition:
    • Cost of capital
    • Quality (safety, vertical differentiation)
  – Market power concerns on mergers overruled
    • HBOs-Lloyds TBS, …; Abbey-Lloyds was blocked
    • Consolidation in the US and elsewhere
State aid in the EU

• Two reference cases
  – Credit Lyonnais in France (cost up to 2.5% of GDP)
  – State guarantees in Germany for Landesbanken and saving banks (to comply with capital requirements)

• EU dealing with many banking aid cases (up to Dec. 2008)
  – 22 decisions in 2008:
    • Mostly approved/without objection (some arguments in Germany and France)
      – guarantee schemes (DK, FI, PT, IRL, NL, SWE, FR, IT)
      – asset purchase schemes (ES)
      – holistic schemes with all of the above (DE, UK, GR)
      – individual recapitalization or guarantees cases
  – 2 cases currently under formal investigation procedure
  – 15 cases under assessment
State ownership is distortionary

- Government is on both sides of the regulatory relationship
- Political objectives/incentives rule
  - Board incompetence (e.g. German public banks: larger losses in the crisis linked to lack of professionalism in boards by Hau and Thum)
- If not disciplined by competition:
  - Less financial stability: Higher risk exposure and more bank losses
  - Soft budget constraint and inefficiency
- Eliminates market for corporate control
- Uneven playing field (implicit guarantees)
- Less competition and lower financial development
Supervisory Board competence

Source: Hau and Thum, 29 largest German banks.
Issues

• How to prevent that the present distortions become permanent and spill over to other sectors?

• What role for government before getting out?
  – Exercise control rights to improve efficiency (nominating independent directors who have financial/management expertise with transparent process)
    • To avoid regulatory forbearance covering losses
    • To restructure
    • To align pay structures with social goals
    • But not to manage banks or direct credit (except in liquidation situation)
  – Exercise cash flow rights to protect taxpayer
    • Limit executive pay packages in helped institutions?
State aid in the EU

• Conditions for state guarantees/recapitalization (Communications Oct.-Dec. 2008):
  – Non-discriminatory access:
    • Level playing fields among institutions and banking sectors
  – Help limited in time and scope (only necessary liabilities)
  – With contribution of private sector and with appropriate market-oriented remuneration for support or recapitalization
  – Behavioral rules for beneficiaries:
    • Commitment to expand or to limit lending?
  – Incentive for State capital to get out eventually
  – Distinction between sound and distressed banks
    • Recapitalization only for fundamentally sound institutions

Xavier Vives
Competition policy (I)

• Competition policy geared towards avoiding anticompetitive effects in individual crisis/failures
• What to do in a systemic crisis?
• Well-designed regulation may alleviate trade-off between competition and stability but is unlikely to eliminate it
  – E.g. capital requirements with allowance for systemic externality
• Aim must be to preserve the long term viability and strength of competition in the financial sector
• In the short term:
  – Restructuring decisions have to be made quickly
    • Issue: How to close inefficient insolvent institutions?
  – Competition has to be restricted/regulated for entities
    • close to insolvency (E.g. S&Ls)
    • and those which have received subsidies and/or TBTF
• Need collaboration of competition authority and regulator to enforce/monitor temporary behavioral commitments
Competition policy (II)

• Banking sector specificity in competition policy should be recognized and exception limited.
  – This would protect competition policy in banking.
  – Help avoiding the extension of bailouts to other sectors

• Role of competition policy
  – To keep markets open, foster integration, weed out inefficient institutions, and remove artificial barriers
  – To check the distortions introduced by rescue packages
  – Crucial to get out of the crisis and save single EU market (1930s)
  – Increased advocacy role in a new long phase of tighter regulation and public control?
    • Financial deepening-innovation and growth
    • Role of entry post-crisis
Some background references

http://webprofesores.iese.edu/xvives/

- "Imperfect Competition, Risk Taking, and Regulation in Banking" (with C. Matutes), *European Economic Review*, 44, 2000, 1-34.
- Coordination Failures and the Lender of Last Resort: Was Bagehot Right After All?” (with J-Ch. Rochet), *Journal of the European Economic Association*, 2, 6, December 2004, 1116-1147.
- "Regulation and Competition Policy in Banking (with E. Carletti), in *Competition Policy in Europe Fifty Years after the Treaty*, Oxford University Press, 2009.