Government as investor and regulator

Transatlantic Corporate Governance Dialogue

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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

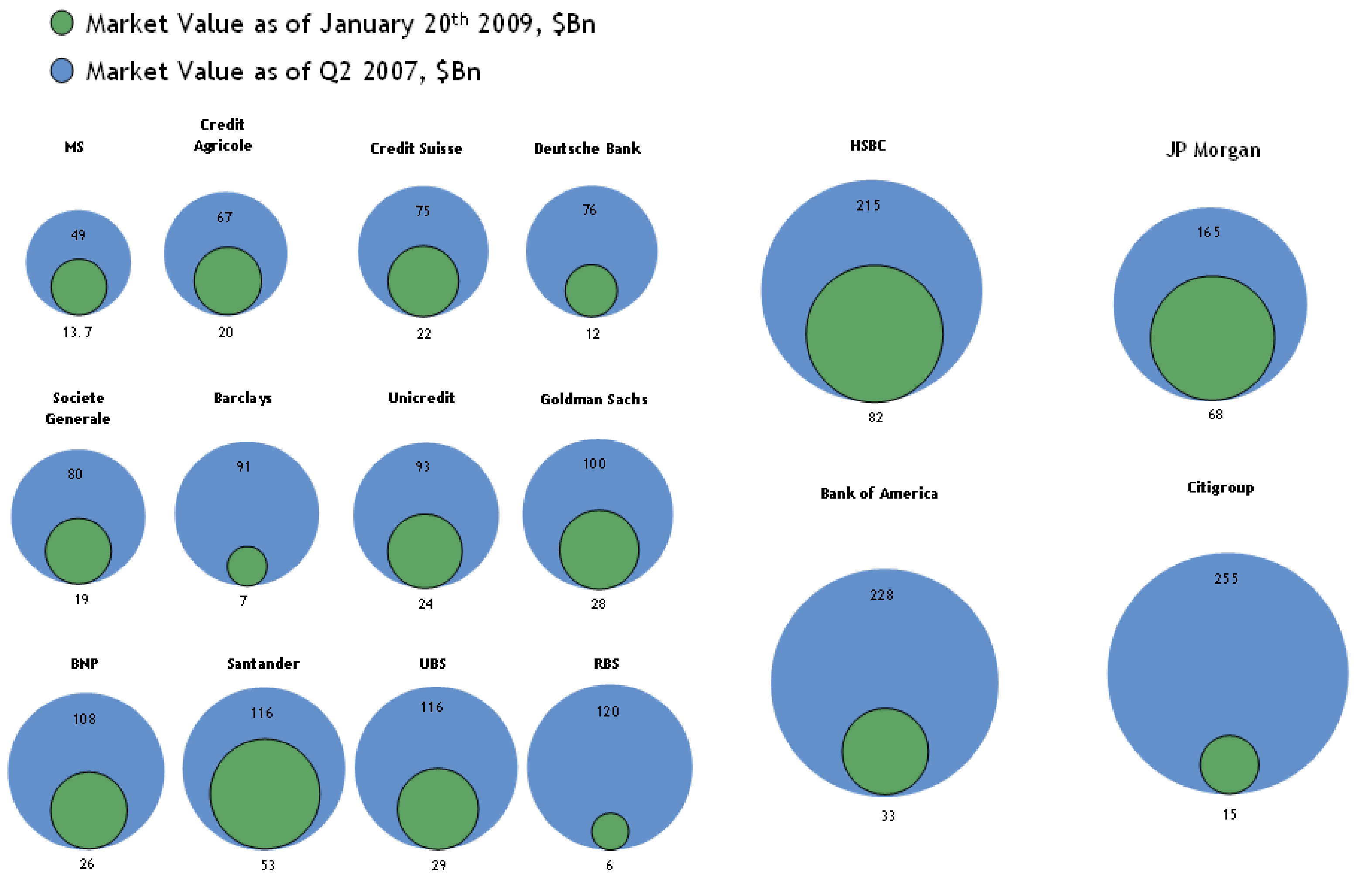
- Banks will have excessive incentives to take risk in the presence of limited liability (for shareholders and managers) and moral hazard (non-observable/opaque risk on asset side).
- This is exacerbated by flat deposit insurance/TBTF and the presence of a social cost of failure
- Problem particularly 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)

	Risk taking incentives		Regulation
Banking regimes	**Liability (Rates)**	**Asset (Investment)**	**(With low charter value & high social failure cost)**
Free banking (observable risk/ high disclosure)	medium-low	absent	Capital requirements
Free banking (unobservable risk/ low disclosure)	medium-high	maximal	Capital requirements + Asset restrictions
Risk-insensitive insurance	high	maximal	
Risk-based insurance	low	absent	Capital requirements

The shock

What the banks were worth



J.P.Morgan

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Source: Bloomberg, Jan 21th 2009

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

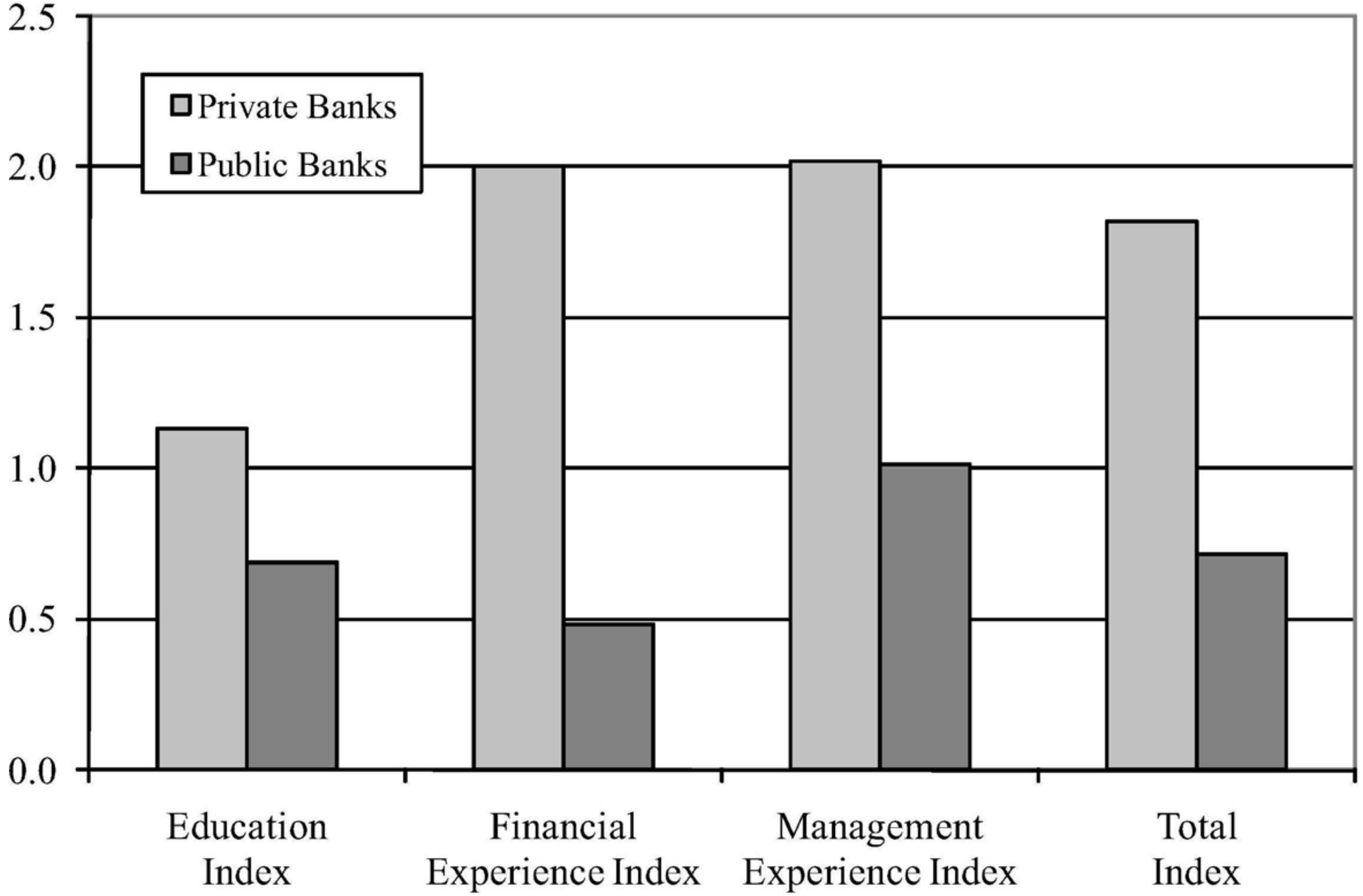
State aid in the EU

- 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

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/

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