

Governments as Investors of Last Resort Credit Crisis Comparative Case Studies

Law Working Paper N°.187/2012

January 2012

Gerard Hertig
ETH Zurich and ECGI

© Gerard Hertig 2012. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
<http://ssrn.com/abstract=1994557>

www.ecgi.org/wp

ECGI Working Paper Series in Law

Governments as Investors of Last Resort Credit Crisis Comparative Case Studies

Working Paper N° 187/2012

January 2012

Gerard Hertig

Forthcoming in *Theoretical Inquiries in Law*, Volume 13(2), 2012. I thank participants in the 2010 Financial Regulation and Supervision in the New Financial Architecture (Taormina), 2011 American Law & Economics Association (New York) and 2011 Back to the State? Government Investment in Corporations and Regulation (Tel Aviv) conferences for their comments on an earlier draft.

© Gerard Hertig 2012. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

Governments in Europe and the US have recently acquired significant stakes in a number of financial institutions, raising fears that they will use their investments to pursue interventionist goals. The comparative analysis of 16 major bail-outs in Belgium, Germany, France, Ireland, Switzerland, the UK and the US provides evidence to the contrary. Fiscal and political considerations have prompted governments to generally avoid common stock investments, limit direct managerial involvement and favor early exits. While this investment strategy may prove detrimental to other stakeholders, it resembles the approach distressed asset investors would adopt under the circumstances.

Keywords: Bank bail-out, bank governance, government ownership, state aid, resolution, restructuring

JEL Classifications: G28, G32, H81, K22

Gerard Hertig

ETH Zurich

IFW E 49

Haldeneggsteig 4

CH-8092 Zurich

Switzerland

phone: +4144-632-4008, fax: +4144-632-1097

e-mail: hertig@ethz.ch

I. Introduction: What makes the credit crisis special?

It is not unusual for governments to own or invest in firms that are or could be privately financed. They do so for a variety of reasons. To begin with, government investments are especially likely to occur when political parties that favor state intervention into economic affairs get control over the executive branch. Second, governments often become equity or debt holders in times of significant industrial evolution or trade liberalization. The motivation here is to minimize social unrest in the transition phase or to create national champions that are better placed to compete in a globalizing world. Third and more prosaically, governments may also get or keep financial stakes for fiscal reasons. Traditionally, they did so in areas where significant regulatory intervention is required in any event, such as in the energy, telecommunication and banking sectors. In more recent times, governments have reinvested the revenues generated by their control over natural or other resources through sovereign funds, the purpose being to insure revenues for future generations. Fourth, governments' investments can be expected to soar in times of war or significant economic crisis. Here the objective is to overcome public good and collective action problems or to prevent opportunistic behavior.

This paper focuses on the last type of investments and, more specifically, on investments in larger banks during the so-called credit crisis. They differ from other types of governmental investments in that country-specific factors are less relevant. To be sure, ideology and local drivers of government investments still may play a role. For example, while the 1982 French nationalization program was triggered by an economic crisis, its scope and objectives reflected a *Programme Commun* developed in the early 1970s by the communist and socialist parties that took control over the executive in 1981.¹ However, governments in Europe and the US have adopted broadly similar investment strategies during the credit crisis, regardless of the domestic political landscape and regulatory regimes.² They essentially targeted banks, used similar equity and debt instruments, minimized their

¹ See André G. Delion & Michel Durpty, *LES NATIONALISATIONS* (1982).

² For an overview of investments by European governments, see Ana Petrovic & Ralf Tutsch, *National Rescue Measures in Response to the Current Financial Crisis* (ECB Legal Working Paper Series, Paper N°8, July 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430489); by the US government, see SNL Financial, *Government Bailout Reference Guide*, <http://www.snl.com/Sectors/Fig/FailedBanks.aspx>.

involvement in financial institution management and took advantage of profitable exit opportunities.

This common approach reflects the idiosyncrasy of the credit crisis that started in 2007. It caught governments off guard and left them facing a liquidity crisis that jeopardized the funding of banks, ultimately threatening to bring about large scale insolvencies and cause a break-down in the payment system. This situation required immediate and drastic measures. While central banks played their customary lender of last resort role, governments intervened in a more unusual 'investors of last resort' capacity. Functionally, the monetary arsenal was put to use to deal with liquidity issues, whereas fiscal instruments were deployed to address solvency concerns—albeit the difference in measures and objectives became murky as the credit crisis spread out.

The severity of the credit crisis left governments with limited discretion as to how to implement fiscal interventions. To begin with, public finance constraints required governmental investments to be targeted if they were to have any credibility. Second, precedence was given to rescuing those firms with the highest negative externality potential in case of insolvency. This meant giving priority to the bailing-out of banks of systemic importance, as their failure was likely to cause a financial meltdown.

However, anti-bank public sentiment and the perception that deficient financial supervision had contributed to the credit crisis made hands-on governments intervention unpalatable. On the one hand, the risk of voter backlash and the need to get parliamentary or institutional support incentivized governments to market their interventions as short term investments. On the other hand, shortcomings in financial supervision made governments vary of involving bureaucrats in the management of the banks they invested in.

A series of European and US case studies provide evidence that these constraints resulted in governments acting like distressed-assets or 'vulture' investors would have under the circumstances. Vulture investors take stakes in financially distressed firms so as to be able to discipline their managers and influence the restructuring or liquidation process.³ They generally purchase debt instruments so as to take advantage of the control position creditors get in distress situations, but their debt claim is often exchanged for a controlling

³ See also Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401 (1997).

equity stake if the distressed firm can be restructured rather than liquidated. Like controlling stakeholders, distressed-assets investors use their dominant stake to maximize their private benefits. This is often achieved by arranging for a rapid exit through a private sale of the restructured company or an IPO. But private benefits may also take the form of related party transactions, favored distribution following the liquidation of assets ('bondmail') or longer term revenues from the restructured firm's operations (especially in the real estate sector). Note, however, that distressed-assets investor intervention is not necessarily contrary to the interests of other stakeholders. Hence, a recent study has shown that hedge funds investments can contribute to balancing power among bail-out participants and improve the situation of employees and junior creditors.⁴

Our credit case studies show that governments have operated in similar fashion. To begin with, they acquired preferred shares and convertibles bonds/loans rather than common shares. This approach allowed for minimum investments by fostering market confidence—it signaled that banks were not in a desperate capital situation—and preserved existing shareholder loyalty by limiting common equity dilution. At the same time, the provision of guarantees limited the state's direct exposure while increasing its bargaining power. Government control was further enhanced by giving other stakeholders only limited information about the banks' situation and orchestrating the prompt firing of top managers deemed to have mismanaged their firms.

At the same time, business strategies that had been proven to be risky were occasionally continued so as to permit a rapid return to profitability. In addition, variable compensation practices remained prevalent, albeit with an increased reliance on deferred payments. Finally, governments sometimes used their controlling stake to foster transactions that were in their interest, even though they may have had a negative impact for other stakeholders. Hence, various restructurings were facilitated by transfer of impaired assets into government-controlled entities.

The remainder of the paper is organized as follows. The types of investments available to governments are addressed in Section II. Section III deals with cases where governments have already exited and provides preliminary evidence that they acted like distressed-assets

⁴ Wei Jang, Kai Li & Wie Wang, *Hedge Funds and Chapter 11*, J. FIN (forthcoming), http://www.afajof.org/journal/forth_abstract.asp?ref=702.

investors would have under the circumstances. Section VI provides further evidence using cases in which governments have yet to exit. Section V concludes.

II. Types of government investments

It is often more advantageous for governments to deal with crisis-related financial distress by encouraging private rescue operations or relying upon across-the-board stimulus packages than to directly invest in insolvent firms. Unsurprisingly, several banks were rescued through government-induced private rescues in the early days of the credit crisis. But, with the deepening of the crisis, that type of operation became impossible and governments were forced to provide more direct support to banks in financial distress.

In many countries, governments started by providing blanket bank deposit guarantees. However, even combined with the generous provision of liquidity by central banks against increasingly weak collateral, these measures were not sufficient to reduce the likelihood that banks of systemic importance would fail. The only way to prevent this from happening was for governments to engage in bail-outs involving direct state investments.

In such an environment, the design and implementation of these investments is likely to be a function of the government's objective.

Insert Table I about here

If the primary objective is to restore financial stability, the government can be expected to buy super senior debt (to minimize potential losses) and to minimize risk taking by putting in charge work-out experts with primarily fixed compensation packages. To the extent the government engages in related party transactions, they are likely to take the form of preferred reimbursements (again to minimize losses). Finally, governments can be expected to exit as soon as the bank is restructured.

On the other hand, if the primary objective is to increase political clout, the government can be expected to buy instruments with voting rights (to maximize decision-making power) and to insure for a neutral approach towards risk taking by putting in charge civil servants with fixed compensation packages. To the extent related party transactions take place, they are likely to take the form of acquisitions that increase the government's political power. Finally, governments can be expected to keep their investments for as long as the investments suit their political purposes.

Finally, if the government is interested in getting monetary returns, it can be expected to purchase convertible/hybrid instruments (to get control as well as financial options) and to set the stage for risk taking by putting in charge star bankers with primarily variable compensation packages. To the extent related party transactions take place, they are likely to take the form of preferred dividend or interest payments, sale of bank assets or purchase of government-owned bank debt. Finally, governments can be expected to exit as soon as their investment is profitable.

Overall, governments seem to have had limited room to engage in investments aiming at increasing their political power. In the US, Congress made it clear that it would keep a close eye on bail-out activity and oppose interventionist investments.⁵ In the EU, the European Commission signaled that the legitimate interests of competitors had to be preserved and exit incentives imbedded in bail-out agreements.⁶

In short, governments got a license to intervene, but their investments had to be temporary and not used for political purposes. Whether their primary objective was to restore financial stability or insure for the profitability of their investments, like distressed-assets investor would, can only be assessed *ex post*.

III. Exit has occurred

One can consider that exit has occurred when there is no significant capital exposure anymore, following repurchases by the rescued bank or sales to third parties. More specifically, this section will distinguish two types of exits, those occurring within a year or so after entry and those occurring later on.

A. In and out

The most compelling evidence of governments mimicking distressed-assets investors is provided by situations where they fully exited within around a year after entry ('in and out' approach). Let us focus here on three US banks, JP Morgan Chase, Wells Fargo and Goldman Sachs as well as on three French banks, Crédit Agricole, BNP Paribas and Société Générale.

⁵ See Krishna Guha, *US Treasury Told to Hold Rescued Banks to Account*, FIN. TIMES (London), Dec. 11, 2008, <http://www.ft.com/cms/s/0/d0ec5ad2-c728-11dd-97a5-000077b07658.html#axzz1apBkYh1f>; id. *Framework Shows Lack of Appetite for State Ownership*, FIN. TIMES (London), Feb. 24, 2009, at 19.

⁶ Communication from the Commission, *The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*, OJ C 270/8, Oct. 25, 2008.

Insert Table II about here

In October 2008, the US Treasury and the French government adopted similar entry strategies. JP Morgan Chase, Wells Fargo and Goldman Sachs issued preferred shares with warrants, whereas Credit Agricole, BNP Paribas and Société Générale sold super-subordinated debt, a functional equivalent of preferred shares. The approach was likely to reassure common shareholders as it signaled that these banks were not in a desperate capital situation and limited equity dilution.⁷

To be sure, the general outlook was gloomy as the credit crisis was in full bloom; moreover, the French government made an additional purchase of preferred shares in BNP Paribas and Société Générale in March 2009. Nevertheless, our six banks were financially solid enough to generate positive returns on equity (ROE) in 2008 and 2009 (when many banks had negative ROE) and to allow for governmental exit within a year of entry. In addition, no chairman or chief executive officer (CEO) was replaced when governmental investments took place or throughout their duration, which is in line with a 'capital is adequate' story.

Obviously, even a bank with adequate capital is likely to benefit from governmental support in times of turmoil, especially when it is perceived as part of a blanket approach aiming at minimizing the stigma effects of governmental support (as in the US) or at signaling governmental commitment to the banking industry (as in France). Interestingly, our banks had to pay a price for these diffuse advantages. To begin with, the US Treasury got a sturdy 5% dividend on its preferred shares whereas the French Government charged a significantly above market 8% (average) interest on its super-subordinated loans. Moreover, the US Treasury was able to cash around \$1bn per bank on warrant sales at exit time. For their part, Credit Agricole, BNP Paribas and Société Générale all had to agree to make loans to finance economic activity when getting equity investments, a commitment that remained in force after the French government got repaid for its investments.

In short, this set of case studies provides unambiguous, albeit retrospective evidence that governments acted like distressed-assets investors would have under the circumstances: bureaucratic interference was kept at a minimum; exit occurred as soon as possible;

⁷ See Augustin Landier & Kenichi Euda, *The Economics of Bank Restructuring: Understanding the Options* (IMF Staff Position Note, June 2009), <http://www.imf.org/external/pubs/ft/spn/2009/spn0912.pdf> (common equity investment are likely to be perceived as reflecting the presence of toxic assets).

investment design allowed for above average interest and dividend returns as well as for an exit premium. Of course, one could deem our six banks not to be representative: the ‘in and out’ approach may only work for banks that did not need governmental investments in the first place. However, even assuming that governments were *ex ante* aware of a selection bias, it remains that they designed their investments like distressed-assets investors would have.

B. Phased exit

For some banks, governments have adopted a ‘phased’ rather than an ‘in and out’ approach. The focus here will be on one US bank, Citigroup, and one Swiss bank, UBS.

Insert Table III about here

Government entry also occurred in Fall 2008, but the invested amounts were significantly higher than for the six banks discussed above. Hence, while the entry strategy adopted for Citicorp was similar to the one followed for JP Morgan Chase, Wells Fargo and Goldman Sachs (issuance of preferred shares and warrants), the US Treasury invested \$45bn. UBS, for its part, not only received CHF 6bn for mandatory convertible notes issued to the Swiss government, but was also allowed to transfer impaired assets valued at \$38.7bn to a StabFund vehicle funded and managed by the Swiss National Bank (UBS keeping a 10% first loss liability). These larger amounts did not only mean that governments had a quantitatively larger exposure. As indicated by the negative returns on equity generated by both banks in 2008 (especially) and 2009, they also took a bigger risk in terms of investment quality.

The increase in riskiness was accompanied by stronger governmental intervention. US authorities are reported to have generally tried to accelerate the pace of Citigroup’s management shake-up.⁸ The Swiss government adopted a similar approach, even though it had stated that it did not want to be represented on the board of UBS or exercise direct influence over the bank’s business strategy.⁹ Hence, Swiss authorities are understood to

⁸ Francesco Guerrera & Joanna Chung, *Regulators Urged Citi to Replace CFO Kelly*, FIN. TIMES (London), Aug. 19, 2009, <http://www.ft.com/intl/cms/s/0/e56b5d48-8c56-11de-b14f-00144feabdc0.html#axzz1apBkYh1f>; Damian Panetta & David Enrich, *FDIC Pushes Purge of Citigroup’s Management*, WALL ST. J. (European ed.), Jun. 8, 2009, at 25.

⁹ See Chris Hughes & Haig Simonian, *Arm’s Length Fix that Looks Long Term*, FIN. TIMES (London), Oct. 17, 2008, <http://www.ft.com/intl/cms/s/0/173d09e4-9be3-11dd-ae76-000077b07658.html#axzz1apBkYh1f>; *Participation sous Conditions*, LE TEMPS, Oct. 17, 2008, <http://letemps.ch/Page/Uuid/da79ef9a-e1a1-11dd-b87c-1c3fffea55dc>.

have played a decisive role when it came to managerial changes, including the replacement of the chairman of the board.¹⁰ Moreover, compensation was subject to more direct and explicit constraints than at the six banks discussed in previous section. At Citicorp, variable compensation had to be deferred, regardless of whether it was paid in cash or equity. Similar restrictions applied to UBS, albeit cash bonuses only had to be deferred if they exceeded CHF 1mio.

Higher risk also meant a higher price for governmental support. Citigroup was required to exchange some of the preferred shares it had issued against common shares, giving the US Treasury 34% of the voting capital. UBS, for its part, had to accept to pay LIBOR plus 250 basis point interest to the Swiss National Bank (SNB) for its funding the StabFund vehicle, to share with the SNB a potential gain resulting from the realization of the transferred assets and to provide the SNB with warrants on 100 million UBS common shares at an exercise price of CHF 0.1 to cover a potential loss on the sale of the transferred assets.

In addition, investment design allowed governments to profitably exit while keeping residual rights. On the one hand, dividends, fees and the sale of shares resulted in the US Treasury cashing in an estimated USD 12bn, whereas the Swiss government made SFR 1.2bn following the conversion of its notes. On the other hand, the FDIC is still holding Citigroup preferred shares valued at USD 3bn, whereas the SNB has indicated that it would not allow UBS to repurchase the assets it had transferred to the StabFund vehicle (thus continuing to benefit from welcome interest payments).¹¹

Here again, the case studies provide unambiguous, albeit retrospective evidence of distressed-assets investor behavior. Governmental interference was more visible, but private investors would have similarly increased their managerial intervention in view of the more risky investments. Exit occurred as soon as possible and investment design allowed for both above average returns and continued benefits. Moreover, the tougher investment environment makes a selection bias argument much harder to make.

¹⁰ See Olivia Kühni, *Die Finma veranlasste Marcel Ospels Rücktritt*, TAGESANZEIGER, Sep. 14, 2009 <http://www.tagesanzeiger.ch/wirtschaft/unternehmen-und-konjunktur/Die-Finma-veranlasste-Marcel-Ospels-Ruecktritt/story/18531380>.

¹¹ See *UBS-Sonderfonds Schönt Jahresabschluss der Nationalbank*, NEUE ZÜRCHER ZEITUNG, Mar. 4, 2011, http://www.nzz.ch/nachrichten/wirtschaft/aktuell/ubs-sonderfonds_schoent_jahresabschluss_der_nationalbank_1.9761468.html.

IV. Equity stakes remain significant

In a quite large number of cases, governments have yet to exit, i.e. still hold significant capital exposure in banks they have invested in during the credit crisis. This section will address two governmental approaches: ‘waiting for a profitable exit’ and ‘fundamental changes’ (new business model, balance-sheet restructuring and/or nationalization).

A. Waiting for a profitable exit

Governments have generally indicated their willingness to exit as soon as possible, but this can amount to mere wishful thinking. The focus here will be on two banks where exit preparation efforts have been both noticeable and credible, Royal Bank of Scotland (RBS) and Lloyds Banking Group.

Insert Table IV about here

Like in France, the US and Switzerland, governmental intervention occurred in Fall 2008. However, entry investments took a new dimension, partly due to Lloyds and RBS reeling from the botched acquisitions of HBOS and ABN AMRO, respectively. Having paid £8.5bn for common and (soon to be converted) preferred shares, the UK government ended up controlling 43% of Lloyds voting capital. For RBS, state control reached an even more impressive level. An original £20bn common share investment, followed by the subscription of £25bn worth of non-voting shares, resulted in the UK government controlling 70% of RBS voting capital.

Getting substantial voting rights obviously led to the government having more of a say. To be sure, like their US and European counterparts, governmental officials have tried not to openly intervene in bank management. Nevertheless, they played a role in top management being replaced at both Lloyds and RBS, as exemplified by the demise of RBS’s chairman and CEO being announced the same day as its rescue by the government.¹² The government also had a heavy hand in compensation matters.¹³ However, governmental intervention generally reflected a profitable exit strategy, in particular by tolerating if not condoning the hiring of top performers and the pursuit of financially or politically risky strategies. For example, Lloyds and RBS offered their new CEOs multi-million pay packages that were in line with

¹² See also Vladimir Guevarry, *Bischoff to Head Lloyds*, WALL ST. J. (European ed.), July 29, 2009, at 31 (Lloyds consulted with the government about the appointment).

¹³ See UK Financial Investments Ltd, Investment Mandate, October 2010 (at 7. Remuneration), http://www.ukfi.co.uk/releases/UKFI_IM_20101001.pdf.

those paid by other major banks.¹⁴ Similarly, government officials have accepted to make the £2'000 cap to cash bonuses toothless by limiting the deferral period to 3 months.¹⁵ Or, to take another example, there seem to have been no objections to aggressive risk pricing by RBS or to lucrative home mortgages practices by both Lloyds and RBS.¹⁶

However, here too governmental support had its price. There was a 12% dividend on the Lloyds preferred shares the government originally owned. More significantly, the asset protection schemes Lloyds and RBS consented to enter into in Spring 2009 called for arguably hefty fees. To insure £282bn of its assets, RBS had to agree to a £700mio fee per year for the first three years, and £500mio fees thereafter. Lloyds balked at finalizing a similar agreement and paid £2.5bn to avoid participation in the scheme.

Interestingly, the government has yet to exit even though both banks' share price has come close (for RBS) or exceeded (for Lloyds) the average price paid by the government. One explanation for the government keeping its investment is that it did not deem the bank to have reached the financial stability required for a divestiture. This would be in line with some official declarations, but not easy to reconcile with governments in France, Switzerland and the US having deemed their banks to be robust enough to cope with an exit. Another explanation is that the government wanted to wait for a more profitable exit. The latter view is supported by Lloyds and RBS having enjoyed positive returns on equity and by efforts to sell the government's investment being a function of share price evolution.¹⁷

In short, while governmental intervention has been heavier handed than in the previously discussed case studies, the general approach has been quite similar. The main difference is a more cautious attitude towards exit, which may partly reflect financial stability considerations. However, the available evidence points towards the latter having played a rather ancillary role (even though they may appear justified in retrospect). The government's attitude towards risk-taking and compensation, its dividend and fee appetite, as well as its

¹⁴ See Marietta Cauchi, *New Lloyds CEO Cashes In*, WALL ST. J. (European ed.), Mar. 21, 2011, at 26.

¹⁵ See Sara Schaeffer Muñoz & David Enrich, *U.K. Bonus Cap Has a Major Loophole*, WALL ST. J. (European ed.), Mar. 4, 2011, <http://online.wsj.com/article/SB10001424052748703752404576178640623894246.html>.

¹⁶ See Dana Camilluca & Sara Schaeffer Muñoz, *RBS's Risk-Taking Raises Eyebrows*, WALL ST. J. (European ed.), Mar. 14-16, 2010, at 21; *id.*, *Bank's Profits on Mortgages Spur Criticism*, WALL ST. J. (European ed.), Sep. 21, 2011, at 24.

¹⁷ See Sara Schaeffer Muñoz, David Enrich & Dana Camilluca, *RBS, Lloyds start Touting U.K.'s Shares*, WALL ST. J. (European ed.), Jan. 11, 2011, at 1, 24.

acceptance of exit preparation efforts bear all the characteristics of distressed-assets investor behavior.

B. Fundamental change

The last set of case studies addresses situations where exit is unlikely to occur in the near future due to the scale of the required deleveraging/divestiture measures or simply because the bank is being wound down. The focus will be six banks subject to fundamental change along a continuum going from new business model to balance-sheet restructuring to nationalization—one approach not being to the exclusion of others. These six banks are Commerzbank (Germany), Dexia (Belgium), Allied Irish, Bank of Ireland and Anglo-Irish (Ireland), and Northern Rock (UK).

Insert Table V about here

Dexia and Northern Rock stand out not only for being among the first banks to be bailed out, but also for entry having occurred through the purchase of common equity. Belgium and French authorities invested €3bn to acquire 17.2% of Dexia's common share, whereas the British government injected £3bn to get full control over Northern Rock. It was rapidly clear that Northern Rock would have to be liquidated under a 'bad bank/good bank' scheme. On the other hand, early governmental exit seemed originally likely for Dexia. Whereas the nationalization of Northern Rock, a mortgage lender, was prompted by the failure of its high risk loan/short term funding policy,¹⁸ Dexia's difficulties reflected a departure from its established business model, making loans to local communities, to engage into lending to banks or communities in Iceland, Ireland, Turkey and the US. However, the attempt to switch back to the original business model failed in Fall 2011, prompting the nationalization of the bank's Belgian banking unit and the transfer of €95bn assets to a special vehicle.¹⁹

For Commerzbank, governmental entry also occurred early and in the wake of business model issues, in particular commercial property lending in Spain and the US. An initial €6.2bn 'silent participation' investment by SoFFin, the German stabilization fund, was soon

¹⁸ See Hyun Song Shin, *Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis*, 23 J. ECON. PERSP. 101 (2009).

¹⁹ See Matthew Dalton & David Gauthier-Villars, *Belgium to Nationalize Dexia's Local Operation*, WALL ST. J. (European ed.), Oct. 10, 2011, at 23.

followed by the acquisition of 25% blocking minority voting stake.²⁰ Here too, the idea was to provide breathing room to allow for a rapid return to Commerzbank's traditional retail and corporate banking business model. However, exit targets have been repeatedly missed while additional governmental investments may still be required.²¹

The Irish government had not much to lose from investing into its troubled banks, as it had already provided blanket guarantee for all banks debts in view of the scale of their property related losses. Political considerations made the Irish government adopt a complex and multi-step bail-out approach, but Anglo-Irish Bank, the hardest hit institution, already ended up being fully nationalized in January 2009 and Allied Irish Banks has been 99.8% state-owned since July 2011. Anglo-Irish is currently being liquidated whereas part of Allied Irish should be privatized under a 'Pillar Bank' scheme. Entry into Bank of Ireland, the strongest of the three banks, has been more limited, with governmental common share ownership currently standing at 15% after having originally amounted to 36%.

These more significant investments have gone hand in hand with governmental intervention being more significant than in all cases discussed in previous sections. Top management has undergone major changes at all banks except Commerzbank (where the chairman and the CEO were replaced shortly before entry) and governmental representatives sit (*de facto* or even *de jure*)²² on all boards.

It is more difficult to evaluate whether amplified intervention goes hand in hand with an increase in the price paid for governmental support. This could be the case for Commerzbank Bank, where compensation for supervisory and management board members is capped at €500'000 and 9% is theoretically charged on the silent participation, and for Bank of Ireland, where the dividend for preferred shares is theoretically set at 8% to 10.5% and the government has received more than €2bn for its warrants, guarantees and common shares.

What is striking, however, is that states generally do not oversee fundamental changes like benevolent owners would. Major workforce reductions are the rule, not the exception.

²⁰ See Marcus Walker and Mike Esterl, *Germany Gets Commerzbank Stake*, WALL ST. J. (European ed.), January 9-11, 2009 at 2.

²¹ See Patrick Jenkins, *Banks Contemplate Shrunken Future, Commerzbank*, FIN. TIMES (London), Oct. 14, 2011, at 17.

²² See, e.g., Waller & Mike Esterl, *Germany Gets Commerzbank Stake*, WALL ST. J. (European ed.), January 9-11, 2009, at 2.

Junior bondholders have to swallow 75% to 90% haircuts. Transfers to 'bad asset' entities take place at a very significant discount. Admittedly, these are good reorganization practices and, in addition, the tough approach may bring political benefits as it is likely to please most voters. Nevertheless, one cannot fail to observe that what is being done is very similar to what distressed-assets investors would do under the circumstances.

V. Conclusion

Governments' investments in banks facing financial distress due to the credit crisis were certainly motivated by public good considerations. However, from an *ex post* perspective, their strategies and behavior are very similar to what distressed-assets investors would have done.

To be sure, governments are more likely to avoid direct involvement in bank management than distressed-assets investors, especially when exit looks feasible in the short term. In some countries, this could be due to the privatization wave of the 1990s reducing civil servant experience in firm management. More generally, such arm's length management allows for plausible deniability should financial distress deepen or result in formal insolvency. This is especially important in the credit crisis context. On the one hand, with supervisory failures often considered to be one of its causes, governments rather prefer avoiding further banking involvement. On the other hand, banking fiasco-related citizen anger has prompted parliaments to signal minimal tolerance for state managerial participation.

However, governments have shown no reluctance in adopting tactics aiming at increasing the chances of a favorable exit or minimizing the risk of a negative outcome. On the transparency front, other stakeholders have often been denied full information about the banks' financial situation, in particular regarding bad loans. On the business side, practices that had been proven risky, but likely to produce significant revenues have been tolerated by governments, if not encouraged.²³

Similarly, governments have adopted a rather light touch approach to compensation. There was significant political posturing as far as limiting excessive bonuses and golden parachutes were concerned. Compensation packages were also often subject to governmental approval.

²³ See note 16 above; Sharlene Goff, *Northern Rock to Offer 90% Mortgages*, FIN. TIMES (London), Feb. 28, 2011, at 1.

But governments realized that they could not afford to have talented or simply knowledgeable employees resigning in such crucial times. As a result, there is often a significant gap between the public discourse and the private handling of compensation disputes.

There is also evidence of governments getting ‘advances’ on exit returns by engaging in self-dealing or fostering transactions that are in their interest but detrimental to other stakeholders, in particular minority shareholders. There have been complaints about the remuneration paid to the UK and US governments for their capital investments.²⁴ It has been pointed out that the Swiss government has extracted high interest payment for its UBS investments.²⁵ Germany is said to have imposed unattractive financial conditions, earning fat fees on its credit guarantees.²⁶ There are even instances of minority shareholders formally challenging the fairness of an investment, for example when the German government squeezed them out in the Hypo Real Estate case,²⁷ or when the Belgium government’s acquisition of Fortis Bank Belgium resulted in the price of Fortis Holding shares dropping from €5 to €1.²⁸

In short, our cases studies provide clear evidence of governments acting like distressed-assets investors would have under the circumstances. This does not prove, however, that governments made the returns that distressed-assets investors would require. To begin with, governments acted as investors of last resort, making comparisons difficult. In addition, it is not easy to determine whether the investments made by a given government have been profitable and, if so, to what extent. A good example is provided by state guarantees. Their return does not merely include the interest paid by the guaranteed bank, but also the positive tax effect resulting from the guarantee generating significant cost

²⁴ See Deborah Solomon and Robin Sidel, *Banks Push US on Warrants*, WALL ST. J. (European ed.), July 13, 2009, at 24; Chris Hughes & Haig Simonian, *Arm’s-Length Fix that Looks Long Term*, FIN. TIMES (London), Oct. 17, 2008, <http://www.ft.com/cms/s/0/94ad7534-9be4-11dd-ae76-000077b07658.html#axzz1axAdcZ97>.

²⁵ See Manuel Ammann, Ralf Seiz & David Oesch, *Zu Welchem Preis Hilft der Bund der UBS*, NEUE ZÜRCHER ZEITUNG, Nov. 21, 2008, at 31.

²⁶ See Bertrand Benoit, *Bail-out Earns €300m for Berlin*, FIN. TIMES (London), Aug. 24, 2009, <http://www.ft.com/intl/cms/s/0/f93d57e8-9045-11de-bc59-00144feabdc0.html#axzz1axAdcZ97>.

²⁷ See Klaus J. Hopt, Christoph Kumpan & Felix Steffek, *Preventing Bank Insolvencies in the Financial Crisis: The German Financial Market Stabilization Acts*, 10 EUR. BUS. ORG. L. REV. 515 (2010).

²⁸ See Matthew Dalton, *Europe Seeks Solutions for Troubled Banks*, WALL ST. J. (European ed.), Jul. 15, 2009 at 17.

savings.²⁹ More generally, it is unclear whether contributions paid to governments will result in overall gains or losses. For example, as shown by our case studies, the US government has earned billions on its investments. At the same time, a recent study concludes that these bailouts have proven costly for taxpayers.³⁰ Finally, even if the conclusion is that a government has benefited from its investments, this does not necessarily mean that the investments are profitable on a risk-adjusted basis.

The difficulties in determining whether or not governments have made a risk-adjusted profit on their investments should not come as a surprise. This problem is inherent to government investments in general. For example, it has yet to be established whether privatizations have positive or negative consequences for shareholders.³¹ On the other hand, there is no reason to believe that profitability estimates are impossible to make. Many banks in many countries have not benefited from state bailout, providing benchmarks that can be used to that end.

²⁹ See Mark Gongloff, *US Guarantee Will Save Firms \$24 Billion in Debt Costs*, WALL ST. J. (European ed.), Jul. 27, 2009 at 20.

³⁰ See, for the US, Pietro Veronesi & Luigi Zingales, *Paulson's Gift*, 97 J. FIN. ECON. 339 (2010).

³¹ See William L. Megginson and Jeffrey M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LIT. 321 (2001).

Tables

Table I : Ideal Type Objectives and Implementation			
Objectives Implementation	Restore Financial Stability	Increase Political Power	‘Vulture Investment’
Entry	Super Senior Debt	Voting rights	Convertible/Hybrid Instrument
Top Managers	Work-out Experts	Civil Servants	Star Bankers
Compensation	Fixed > Variable	Fixed	Fixed < > Variable
Bank Risk Taking	Low	Neutral	High
Related Party Transactions	Preferred Reimbursements	Strategic M&A	Preferred Dividends/Interests Asset Sale/Debt Repurchase
Exit	Restructured	Indeterminate	Profitable

Table II: In and Out						
	JPMorgan Chase	Wells Fargo	Goldman Sachs	Crédit Agricole	BNP Paribas	Société Générale
Entry	\$25bn for preferred SH Warrant for 88mio common SH	\$25bn for preferred SH Warrant for 110mio common SH	\$10bn for preferred SH Warrant for 12mio common SH	€3bn for super subordinated loan	€2.55bn for super subordinated loan €2.55bn for preferred SH	€1.7bn for super subordinated loan €1.7bn for preferred SH
Top Managers	Remain in place					
Compensation	Variable > Fixed					
Return on Equity	4% (2008) 6% (2009)	4.8% (2008) 9.9% (2009)	4.9% (2008) 22.5% (2009)	2.6 % (2008) 2.6% (2009)	6.6 % (2008) 10.8% (2009)	6.6 % (2008) 9% (2009)
Related Party Transactions	5% dividend Warrant →\$0.95bn	5% dividend Warrant →\$0.84bn	5% dividend 426mio dividend Warrant →\$1.1bn	8.33% interest	7.75/7.65% interest	8.18% interest
Exit	< 12 months	< 15 months	< 12 months	< 12 months	< 12 months	< 12 months
Sources: Annual Reports, Press releases, Regulatory Filings, Financial Times, Wall Street Journal						

Table III : Phased Exit		
	Citigroup	UBS
Entry	\$25bn + \$20bn for preferred SH 7bn for preferred loss sharing SH Warrant for 465mio common SH	SFR6bn for mandatory convertible notes \$38.7bn collateralized loan via stabilization fund + Warrant for 100mio common SH
Top Managers	New chairman Board → Banking experience	New chairman Board → Banking experience New CEO + CFO + COO
Compensation	Variable must be deferred	\$1mio cap on cash bonus
Return on Equity	-20.9% (2008), -1.1% (2009), 6.85% (2010)	-57.9% (2008), -7.8% (2009), 16.7% (2010)
Related Party Transactions	5% (5 years), then 9% dividend on \$25bn 8% dividend on \$20bn Preferred SH exchanged for voting SH Warrant → \$312mio	LIBOR + 250bp interest on loan 50% on ↑ in bad asset value Warrant → not yet excised
Exit	Sale of SH, dividends and fees → 12.3bn profit (1/2011) FDIC still owns \$3bn trust preferred SH	Notes conversion → SFR 1.2bn profit Interest on loan: 8 years or all bad assets sold
Sources: Annual Reports, Press releases, Regulatory Filings, Financial Times, Neue Zürcher Zeitung, Wall Street Journal		

Table IV : Waiting for a Profitable Exit		
	RBS	Lloyds
Entry	70.3% → 68% common SH (£20bn) Average buy-in price: 50.2p/SH	43% → 40.5% common SH (£8.5) Average buy-in price: 50.2 p/SH
Top Managers	New chairman Smaller board → Bankers New CEO	New chairman Board → Bankers New CEO
Compensation	Variable must be deferred	Variable must be deferred
Return on Equity	-28% (2008), 13% (2009), 13% 2010	7% (2008), 8.8% (2009), -0.7% (2010)
Related Party Transactions	£25.5bn non-voting SH, convertible in common SH £282bn asset protection scheme, £700 annual fee for 2009-2011, £500 thereafter or termination fee	12% dividend on £4bn preferred SH, replaced by common SH in June 2009 £2.5bn fee to exit asset protection scheme
Exit	Highest 2011 SH price: 49.45 pence/SH (Feb 18)	Highest 2011 SH price: 68.98 pence/SH (Feb 18)
Sources: Annual Reports, Press releases, Regulatory Filings, LSE		

Table V: Fundamental Change						
New Business Model → Balance-Sheet Restructuring → Full Nationalization						
	Commerzbank	Dexia	Bank of Ireland	Allied Irish	Anglo Irish	Northern Rock
Entry	25 % common SH (€1.8bn) €8.2bn + €8.2bn 'silent capital' (non-voting but convertible)	17.2% common SH (€3bn) €376mio convertible bond	36% → 15.1% common SH (€1.7bn – €1.1bn) €3.5bn preferred SH Warrant for 25% common SH	49.9% → 92.8% → 99.8% common SH (€3.5bn+€3.7bn+€5b) €1.6bn contingent capital notes €6bn without consideration Warrant for 25% common SH	100% common SH (€4bn) €8.3bn + €17bn promissory note	100% common SH (€3bn) €27bn senior loan
Top Managers	Remain in place 2 government rep	New chairmen Board → Banker, New CEO	New chairman Board → Bankers 2 government rep New CEO + CRO	New chairmen Board → Bankers 3 government rep New CEO + CFO + CRO	New chairman New < board New CEO + CFO + CRO	New chairman Board → Bankers New CEOs + CFO + CRO
Compensation	€500'00 cap for directors/top managers (if no interest paid on convertible)	Fixed > Variable	Fixed, no variable	Fixed, no variable	Fixed, no variable	Variable > Fixed
Return on Equity	0% (2008) -16.5% (2009) 4.7% (2010)	-22.6% (2008) 5.6% (2009) 3.8% (2010)	27.9% (2008) 0.9% (2009) -8.7% (2010)	8.2% (2008) -24.8% (2009) -22.5% (2010)	16% (2008) -24.8% (2009) n. a. (2010)	Not available
Related Party Transactions	9% on silent participation (but only €2mio paid) €221mio converted to maintain 25% SH 0.95% on €15bn guarantee	Belgium pays €4bn for Dexia Belgium 0.5% on €150bn guarantee (below market)	8%-10.25% dividend on preferred SH Warrant → €491mio 9.4bn asset transfer for 5.2bn 80-90% discount on junior debt → €2bn €724mio for guarantee	8% dividend 10% on contingent capital Warrant → €52.5mio €19.8bn asset transfer paid €8.9bn Squeezing junior bondholders 75%-90% discount on junior debt → €5bn €533mio for guarantee	€33.9bn asset transfer paid €12.3bn €7.1bn deposit + €12.2bn senior bonds transfer to Allied Irish 80% discount on junior debt €316mio for guarantee	55bn asset transfer paid 16bn (bad bank) 80% discount on junior debt No remuneration on guarantee
Exit	Guarantee reduced to €5bn Deleveraging Exit repeatedly reported	Nationalization Legacy assets transferred to special vehicle	Common SH → €1.1bn Deleveraging Remaining assets → New bank	Major workforce reduction Deleveraging Remaining assets → New bank	Major workforce reduction Orderly work out of assets	Major workforce reduction Good bank → Sold £947mio + £80mio resale option + no job cuts for 3 years
Sources: Annual Reports, Regulatory Filings, Press releases, European Commission						

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities*.

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

ECGI Working Paper Series in Law

Editorial Board

Editor Eilis Ferran, Professor of Company and Securities Law,
University of Cambridge Law Faculty and Centre for Corporate
and Commercial Law (3CL) & ECGI

Consulting Editors Theodor Baums, Director of the Institute for Banking Law,
Johann Wolfgang Goethe University, Frankfurt & ECGI
Paul Davies, University of Oxford & ECGI
Henry B Hansmann, Augustus E. Lines Professor of Law, Yale
Law School & ECGI
Klaus J. Hopt, Director, Max Planck Institute for Foreign Private
and Private International Law & ECGI
Roberta Romano, Oscar M. Ruebhausen Professor of Law and
Director, Yale Law School Center for the Study of Corporate
Law, Yale Law School & ECGI
Eddy Wymeersch, Chairman, CESR & ECGI

Editorial Assistant : Ayse Terzi, Tilburg University
Malik Curuk, Tilburg University

Financial assistance for the services of the editorial assistant of these series is provided by the European Commission through its RTN Programme on European Corporate Governance Training Network (Contract no. MRTN-CT-2004-504799).

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.org/wp) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
-----------------------------	---

Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html
-------------------------	---