

State-Controlled Banks: The Challenges Ahead

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Why are Governments Investing in Bank Equity?

- Provide additional core tier 1 capital
 - strengthens bank's resources
 - enables bank to absorb expected losses
 - permits bank to restructure its finances
- Beneficiaries (apart from the bank)
 - depositors
 - other creditors (bondholders etc.)
 - borrowers in the real economy (homeowners; undertakings)
- *"The Government must be prepared to hold whatever proportion of equity capital is necessary"* (Mervyn King, Bank of England)
- UK: LloydsHBOS, RBS, Bradford & Bingley, Northern Rock, more?



How the UK Government Manages its Bank Shareholdings

- UK Financial Investments Limited (UKFI): wholly government-owned
- Board of directors drawn from private sector and government
- *“Banks will continue to have their own independent boards and management teams, determining their own strategies”* (HMT Announcement 114/08)
- Information barriers within UKFI separating each bank team



UKFI Operational Involvement in State-controlled Banks (HM Treasury Announcement 114/08)

- UKFI “will work with” banks’ boards to strengthen them via new appointments, but bank’s board will have the final say
- UKFI “will support” reform of pay and bonus schemes
- UKFI “will oversee” bank’s “active marketing” of “competitively priced” lending to homeowners and SMEs, for three years, “at 2007 levels” (per recap deal)
- NB Additional level of controls under Asset Protection Scheme
- Will UKFI thereby have common control of commercial policy across all UKFI-controlled banks?
- What principles will govern how UKFI discharges its role as an activist shareholder?
- Why do these questions matter?



Safeguarding/Promoting a Competitive Banking Sector

- Government's mixed incentives as shareholder and public body
- Ensuring fairness to the remaining private sector banks
- Government approach to structural issues
 - EC-mandated Restructuring Plans (State aid regime)
 - *"Some banks may be too big to fail; but they are not too big to restructure"* (Neelie Kroes)
 - Extent of required restructuring?
 - Mergers of Government-controlled bank assets
- Government role in setting banks' commercial policies
 - risk-taking (amount and quality of lending)
 - different commercial strategies for different banks?



The challenges ahead

- What can we learn from international experience of nationalised banks?
- Intuition: policy-maker, regulator and shareholders are best kept separate
- Yet overriding importance of delivering short term policy goals
- Early government shareholder exit highly desirable – but how to factor in need for investment return for the taxpayer?



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