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FINANCE, COMPETITION AND GOVERNANCE: STRATEGIES TO PHASE OUT EMERGENCY MEASURES

This paper was prepared for the G20 meeting in London on 2 April 2009. The views expressed herein are those of the OECD secretariat, released under the authority of the Secretary General, and do not necessarily reflect those of any OECD committee or member government.

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Overview

The OECD has been developing a response to the crisis that is holistic, looking at financial market issues, and the wide variety of factors that led to damaging incentive structures, as well as the requirements for broader macro and fiscal policies. The crisis has led to a variety of emergency financial measures such as loans, guarantees, and nationalisations. For financial markets, the focus is on *exit strategies* that are consistent with longer-run goals. OECD Committees, in the framework of the OECD responses to the crisis, agreed to provide strong input into this work through a process of round-tables and new secretariat studies. This report draws on this work to set out the main considerations in terms of timing and policy choices.

The financial markets are looking for credible crisis policies that fit together and are consistent with longer-run economic goals. Crisis measures cannot be divorced from thinking about 'exit' and the sustainability of the strategies undertaken. The more that is done now to deal with the crisis which is consistent with long-run goals (or at least accompanied by a clear strategy and time-line for making it so later on) the more credible will policy measures be seen to be. These long-run goals include: the effective balance between prudential risk control and competition; competitive level playing fields; open investment markets; transparency; and reduced agency problems through better governance. These objectives are concerned with realigning incentive structures to ensure crises of this sort do not recur in the future. However, in the near term they will need to be pursued in a manner that does not exacerbate deleveraging or inhibit lending, which would worsen the impact on the economy. Striking the right balance between the near-term and the longer-run goals is needed to reinforce credibility and instil confidence in financial markets. The appropriate sequencing of actions and choice of positive adjustment measures over alternative policies will therefore be key ingredients in a successful strategy. Some key considerations, for financial markets, competition, corporate governance, pensions, and investment issues are set out below.

1. Introduction

The global financial crisis has three broad elements: the underlying solvency crisis (related to losses that began with securitised low-grade mortgages and insufficient financial institution capital to deal with them); the liquidity crisis related to asymmetric information and uncertainty between buyers and sellers of securities that led to a 'buyers' strike' causing the crisis to spread; and the bank deleveraging of balance sheets leading to severe economic effects.

With respect to solvency, containing the current crisis has already required support for failing or failed financial institutions in many jurisdictions. So long as property prices continue to fall and recession damages the quality of bank assets, new cases requiring support will emerge. Lessons from past experiences indicate three actions for governments to deal with solvency crises[1]:

[1] See Adrian Blundell-Wignall, Paul Atkinson and Se Hoon Lee, "The Current Financial Crisis: Causes and Policy Issues", Financial Market Trends, OECD, Paris, January 2009, pp 16-18.

The three basic lessons of past financial solvency crises

- Expand deposit insurance to prevent runs on banks.

- Separate bad assets from good assets and deal with them, usually by swapping some form of government risk free assets for uncertain risk assets, and dealing with the latter over a long-term horizon.

- Recapitalise asset-cleansed banks and encourage them to operate normally (including by reselling them to the private sector where aspects of nationalisation have occurred).

…and a buyers strike for securities

The liquidity crisis is characterised by a natural buyers strike for many kinds of securities in interbank and long-duration markets; i.e. many wish to sell risky assets but there are few buyers. Central banks have managed the liquidity crisis by extending their operations, including by lending to specific institutions and guaranteeing assets.

2. Responsible crisis management

Sustainability is key

Where possible, it is important to design crisis measures so they minimise future problems. Equally important to consider is that markets will look critically at the 'sustainability' of crisis measures. If the policies are perceived as 'inappropriate', in the sense of not being sustainable, the market will reject them and the crisis will deepen. As policy makers choose emergency measures, they should seek (where possible) actions that are consistent with long-term goals in order to reinforce credibility.

...focusing on long-run goals

Strategies to phase out emergency measures – "exit strategies" – need to be broadly consistent with longer-run economic goals. These goals include: better and more symmetric information flows (transparency) to reduce the risk of liquidity crises; non-distorting regulation; corporate governance and tax regimes that promote incentive structures for better risk control; corporate structures that address contamination risk from affiliates; competitive markets with level playing fields within and between countries; and macroeconomic and social policies that are sustainable and do not '*crowd out'* private activity or worsen longer-run employment and welfare prospects.

3. The timeline for phasing out emergency measures

A time line aligned with reform

The time line for phasing out emergency measures needs to be aligned with progress in financial market reform being undertaken by governments and coordinated by the FSF and IMF, so that the incentive structure in place after the crisis is better and more effective than the one which led to the crisis. It is not too early to consider the issues that will have to be faced once the economic situation stabilises. Among them:

- *Huge budget deficits, perhaps as large as in the 1970s*. These will have to be corrected as economies recover.

- *Seriously deteriorated public debt positions*. This will imply continuing debt servicing obligations over the long term and, for some countries, potential debt management problems.

- *Large amounts of outstanding government and central bank loans*, reflecting the direct support that has been provided to the credit markets. These should be re-intermediated into the financial system.

- *Extensive outstanding guarantees*. Some of these will be equivalent to public debt. Others will be contingent liabilities on balance sheets and will have to be unwound.

- *Partly nationalised banking systems in some countries*, with full public ownership or significant shareholdings that make the government the controlling shareholder. Implicit guarantees in financial markets will be pervasive.

- *Concerns about future pensions as populations age*. Where public pensions are to be tax-financed, long-standing challenges will be aggravated by the large increase in public indebtedness given the claim on tax receipts of larger debt servicing. Assets of private pension schemes have fallen drastically where they have been invested in equities or real estate, leading to funding shortfalls. In addition, support from private employers has come under pressure given weakness of profitability[2]. This will pose actuarial challenges, and public confidence will need reinforcement if people are to remain willing to trust these plans.

- *The impact of the crisis on the insurance industry*. Stable funding methods allow most insurance companies to avoid dependence on short-term wholesale market funding. In addition, while accounting rules require securities to be marked to market if available for sale or trade, the share of assets subject to these requirements is much smaller than for banks. This may have sheltered the industry from having to disclose the extent of its problems. It is notable in this regard that AIG's crisis was triggered by an investment banking division and not by its insurance operations.

- *Competition effects.* Many of the bail-out operations for banks have been firm-specific and adversely affect the competitive environment. Such measures can have negative long-term consequences, even if they are not formally inconsistent with established national and EU competition policies or WTO rules.

- *Demands for support packages* from the auto industry, and risks of state subsidies expanding to other sectors. This can also spur protectionism in trade and possible breaches in international agreements.

4. Roll-back measures in the financial sector

Near-term pre-requisites

As regards the financial sector, a number of key elements must be in place before withdrawing the aspects of public involvement that might be damaging in the longer run. The following are key priorities in the broad sequence in which they might occur.

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2 For example, US companies cutting 401(k) plans in recent months include Federal Express, General Motors, Ford, Motorola, Resorts International, Vail Resorts and Station Casinos.

A. Establishing crisis and failed institution resolution mechanisms

Resolve toxic assets prior to recapitalisation

While governments in the United States, the UK and Europe have made very large commitments of public funds to backstop deposit insurance and support the recapitalisation of banks, the Geithner plan in March 2009 is the first significant initiative to address the second key element of a solution to a solvency crisis (remove bad assets). This is important, for as long as bank portfolios are contaminated by large but uncertain amounts of likely future losses (that will sooner or later have to be recognised), new capital injections will be less effective in resolving bank insolvency problems. A systematic approach to manage the crisis should involve a number of complementary steps.

Bad asset buying mechanism to drain marketable bad assets:

- A government-sponsored *bad-bank-asset* buying mechanism (as in the Geithner plan) is essential. As asset values are hard to determine, it would help reduce risks to taxpayers if the private sector also put up capital to invest (e.g. impaired assets hedge funds and private equity groups). Such buyer funds will need to buy non-performing loans and asset-backed securities (ABS) and mortgage-backed securities (MBS) with conforming structures (single name, rated, absence of exotic derivatives, etc.). Restructuring of collateral and securities may help. Creating a market in this way will incentivise banks with impaired assets and investors to examine the value of underlying collateral such as mortgages etc. and to participate in the pricing process and auctions. Perceptions that products have potential to gain in value will incite private participation in buying—and banks will have to realize the appropriate '*haircuts*' in the process. In time, this process will increase the likelihood that taxpayers profit from the transaction (the government/investor having bought undervalued assets at their earlier deeper discounts). A working market in which the government can demonstrate profitable sales can help facilitate unwinding all government loans, guarantees etc. over the longer run.

A global public input of funds to buy would help

- A first best solution would see a global effort where public funds for the asset buying groups would be augmented with public money from governments of jurisdictions that also hold impaired assets related to subprime.

More public money can be added if the need arises

- Depending on how attractive the process is perceived to be by private investor groups, it is possible that there may not be enough money to deal with the overall size of the assets that need to be 'drained' (particularly on the securities side). If this did prove to be an issue in practice, then more public money initially to get the process started could be a necessary modification to what is otherwise a sensible approach, because: it shares the risks of buying toxic assets between the taxpayers and investors; it creates buyer demand and prevents dumping of assets (as off-balance sheet conduits are consolidated) that would exacerbate the crisis phase.

- With capital injection buffers, many banks will begin to operate more normally. Government divestment of shareholdings could then proceed in line with progress on regulatory and other reforms.

A mechanism to deal with failed firms with complex 'toxic' products

Genuine toxic products can't participate in the market approach?

- Some complex structured products cannot be part of the above government-initiated process of dealing with bad assets. They are too complex and have non-conforming structures involving OTC derivatives. As the buying process for marketable products proceeds, there should be realistic accounting and recognition of losses related to genuinely toxic products, to provide an honest and transparent picture of balance sheets to potential investors, creditors and counterparties. This would occur after the above asset buying program has progressed and had a good opportunity to help banks.

Will there still be banks that can't operate independently?

- In cases where this still results in banks that cannot operate independently, for lack of capital, corrective action can be taken, with regulators either injecting new capital or taking control to protect creditors. This would hopefully be a small part of the banking system.

- For these firms, following the inventory of assets and operations, the bad assets can be separated from the good ones. They, or whatever collateral can be obtained to replace them, should be disposed of over time with a view to recovering as much for taxpayers as possible. The operations of the Resolution Trust Corporation (RTCM) in the United States following the Savings and Loan crisis 20 years ago, and Scandinavian management of banking crises around the same time, provide useful templates for these cases.

Recapitalising

- Where what remains of the good assets and the liabilities has little (possibly negative) net worth, capital in the form of common equity, which in the first instance may come from explicit funding for deposit insurance or other guarantees, should be injected to bring net worth to zero. It should then be increased to a sufficient positive value that renewed operations in the market place or arms-length disposals to sound institutions are viable. In many cases, conversion of preference shares and subordinated debt into common equity would be a good start to this process.

Upfront capital injections versus ultimate costs for taxpayers

- Such a mechanism, assuming "forbearance" is avoided, would address problems as they arise. The capital injections, i.e. over and above drawings from any available deposit insurance fund, would represent the "up front" cost to taxpayers. Ultimate costs would likely be lower than these since: (i) at least something should be recovered from the separated bad assets; (ii) arms-length disposals should eventually be possible at prices that reflect any financial support beyond what was necessary to bring net worth to zero; and (iii) viable state-owned banks constitute assets with positive value.

B. Establishing a revised public sector liquidity support function

Another exit pre-requisite is the need for a more reliable global liquidity mechanism

A further useful precondition for beginning to phase out government involvement would be substantial progress with best practice and market-based liquidity support mechanisms being designed in forums such as central banks, the BIS and the FSF. This would put in place a liquidity safety net to reinforce confidence and reduce the risk of future liquidity crises. Such a function would:

- Increase the size and composition of its balance sheet in times of strain in a predictable manner.

- Contain international coordination elements that can deal with cross-border issues.

- Seek to minimise moral hazard issues, via coordination with prudential policy reforms, such as (a) countercyclical capital rules; (b) a requirement that institutions to be considered for public support in the future will include only those subject to full prudential supervision.

Improved market infrastructure and reporting

...and better infrastructure…

Better market infrastructure that works in bad times as well as good is also an important prerequisite to exiting from emergency measures. Important elements would be:

- Facilitating a transition process from OTC markets for complex products to more transparent exchange-traded and single name products.

- Improved reporting, credit rating processes and valuation practices.

C. Keeping viable recapitalised banks operating

Exit cannot occur precipitously

The immediate priority is to unfreeze the credit markets, get the money and credit systems functioning normally again and provide support for the real economy. Therefore, every effort should be made to encourage viable banks to keep operating even where they have become dependent on government support. Given government control and commitment to adequate capitalisation, such banks should be able to operate without excessive risk aversion. As conditions return to normal in financial markets, and economic recovery gets underway, the process of withdrawing the various supports and preparing the return of financial institutions to full private ownership and control should begin. <u>However, this should not be done so precipitously as to risk the progress that has been made.</u> An interim option would be to organise any banks under regulators’ control as limited liability companies, so they can operate on a commercial basis in accordance with national laws, as the temporary measures necessitated by the crisis are progressively unwound.

D. Withdrawing emergency liquidity and official lending support

Redistribute funding risk between the public and private balance sheets

It will be important to redistribute the funding risk between the public and private sector balance sheets, as well-functioning financial institutions emerge, and as the ability to tap directly into existing pools of savings (for example sovereign wealth funds (SWFs) and pension funds) increases. Direct lending from central banks and governments as part of liquidity support to banking systems and more generally to support selected non-banks is inconsistent with a good competitive framework, both in financial markets and in the wider economy. These need to be withdrawn as the above mechanisms are put in place:

- Direct official lending to non-banks should be re-intermediated to well-capitalised banks or other private lenders.

- As central bank support for non-banks shrinks, liquidity in the banking system should be reduced.

- Central bank direct support for individual banks will be replaced by the above-mentioned counter-cyclical open market and liquidity support operations process.

Withdrawal of liquidity support can't be rushed

<u>To avoid threatening the economy, it is desirable that current recipients of support move voluntarily from public support to the market rather than face a withdrawal of support that could prove premature.</u> This requires that market support be available, whether in the form of bank credit (including the revised public liquidity function above), or other capital market instruments from appropriate sources of capital. It also calls for the full withdrawal of any subsidy element in official support that makes this preferable to recourse to the markets. The first of these will emerge as progress is made with the whole range of issues discussed elsewhere in this paper. The second cannot go faster than that, and in any case should not be rushed.

Progressively tightening terms can be used later on

If beneficiaries seem slow to respond to opportunities as they become available in the markets, progressively tighter terms and conditions on continued official support -- until they contain a penalty element -- should be persuasive.

E. Unwinding guarantees that distort risk assessment and competition

Guarantees distort competition and risk assessment

Government guarantees backed by taxpayers are less transparent and more difficult to evaluate than official lending support but raise issues similar to those concerning liquidity measures. For bank debt instruments, these guarantees distort competition by increasing the cost of borrowing for debt instruments that are close substitutes for bank debt and for bank debt not meeting eligibility criteria. They also distort the pricing and assessment of risk. A private secondary market is already emerging for this debt. As sunset dates for the guarantees approach, the terms and conditions will move towards those prevailing in the market, giving beneficiaries strong incentives to adjust. Like lending facilities, they should not be precipitously withdrawn. However, the extension issue is almost certain to arise in some cases, and increasingly penal terms and conditions should be built in to give beneficiaries a strong incentive to look for market alternatives. Where beneficiaries are financial institutions, it is essential that any guarantees be aligned with the more general framework regarding deposit insurance, with guarantees explicit and appropriately priced or credibly non-existent.

Adjustment should be automatic as terms expire… and can be augmented by penal terms at that time…

….gravitating to alignment with the longer-run desired deposit insurance scheme in the exit phase….

Where required, the redesign of deposit insurance will have to be determined in line with prudential reform, including: identification of which institutions will continue to benefit (presumably those subject to full prudential supervision); decisions on the extent to which wholesale depositors are included, and on levels of insurance for depositors (presumably set at levels that are credible in the event of future firm failures).

F. Fostering corporate structures for stability and competition[3]

Financial firms are different, so the interaction with competition and stability is more complex

The financial sector is different from other sectors because of its role in intermediating credit to the real economy – bank failures have negative externalities for firms and individuals due to the strong interconnectedness of finance, and competitors benefit from preventing systemically important bank failures (the Lehman failure demonstrates this). The interface between competition and stability is therefore complex, with the latter taking priority in crises. But as we move through the crisis towards phasing out emergency measures, including divestment of government investments in banks, it will be important to foster corporate structures that enhance both stability and competition. To the extent that this can be accomplished during the crisis phase, the credibility of policy measures will be increased.

Care in the promotion of mergers and design of aid

Mergers of large firms may not be the best solution

Mergers in which financial institutions with stronger balance sheets are combined with weaker financial institutions can be problematic for both stability and competition.[4] Such mergers can create new or larger systemically important institutions that may lead to moral hazard and stability issues later. Positive adjustment strategies that enhance stability with least distortive effects should be supported:

Examples of less distorting choices

- Open market bad asset purchase mechanisms (discussed above) facilitate stability with fewer distortive effects on competition.

...like foreign partners…

- Where mergers are needed, possible preference for a foreign acquisition of a weak domestic bank over a domestic acquisition can mitigate creation of market power.[5]

...selling in pieces…

- Selling segments of failed firms can enhance competition.

…but nationalisations are ambiguous…

- Where feasible, nationalisations may be preferable to mega-mergers, because they create less market power, provide a clearer solvency guarantee and can facilitate a more competitive market structure upon re-privatisation. However, nationalisations are prone to excessive government direction over operational decisions of financial institutions and can burden a government's balance sheet.

Keeping aid to the minimum necessary for stability goals and conditioned on structural reforms is most conducive to better competitive outcomes.[6]

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3 The OECD Competition Committee conducted a series of roundtables on competition and the financial crisis on 17 and 18 February 2009, aimed at examining safeguards to protect competition as emergency measures are implemented for financial stability purposes.

4 Future mega-mergers may occur among non-financial firms in which one is a failing firm.

5 While international mergers raise potentially complex questions over distribution of assets in case of insolvency, they can restrict increases in market power.

Competitive mergers and competition policy

Prompt resolution of the crisis requires an end to the deleveraging phase and continuing impairment of assets. This requires more lending to the real economy now, which will also foster economic and stability objectives. Measures that increase competition can help achieve this objective:

Positive adjustment mergers are worth thinking about

- In countries with a large and diverse banking sector, mergers between unimpaired well-capitalised smaller and regional banks can create players that will take up the lending opportunities not being undertaken by banks in crisis. This will also promote competition with large conglomerates in the future, and possibly reduce the risk that some institutions will achieve market shares that raise systemic concerns.

- Reducing regulatory barriers to entry in banking, both in formal regulation and unnecessary restrictions on competition can foster the above process in a more general way.[7]

- Increasing the availability of fine-grained credit-rating information for SMEs and consumers will facilitate transparency and make available the information needed by existing competitors and new entrants to take up new lending opportunities; and

- Ensuring that switching costs are limited, for example by implementing a regime that reduces the non-pecuniary costs for customers to switch financial institutions (e.g. by implementing "switching packs") can foster the growth of more competitive institutions.

Conglomerate structures that foster transparency, competition and simplify regulatory/supervisory measures

Non-operating holding company structures should be encouraged to protect banking affiliate balance sheets

Non-operating holding company (NOHC) structures which entail legal separation of the parent and affiliates can increase transparency (particularly with respect to capital investments), facilitate simpler regulatory intervention and reduce contagion risk. With respect to the latter, they permit a simple way to protect the commercial banks' balance sheet from affiliates (including securities firm affiliates). These are perfectly feasible structures that have already been put in place voluntarily by holding company groups that contain a bank.[8] The group can still take advantage of synergies and scale economies, including a common technology platform, but without unwanted financial contamination of the banking affiliate balance sheet.

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6 See Commission Communication of 5 December on The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortion of competition (OJ C 10, 15.1.2009 p.2).

7 In order to promote rigor in this review process, governments can use pro-competitive regulatory guidance, such as that contained in the OECD's *Competition Assessment Toolkit* (www.oecd.org/competition/toolkit).

8 For example Macquarie group in Australia which has a banking licence, and a huge securities set of businesses.

- The non-operating parent receives dividends, and it and its affiliates operate as far as possible on terms and conditions that would apply to dealing with outside entities — thereby helping to reduce distortions to competition of affiliates linked to banks (with cheaper internal funding) with outside stand-alone entities, and preventing a misallocation of resources arising from too many resources flowing to affiliates.

- These structures also help to address the 'too big to govern' issue that contributed to failures in risk control—with separate governance in the affiliates.

…firewalls can also be useful in preventing contagion risk…

Regulations can also limit contagion risk between subsidiaries of a financial conglomerate (including NOHC's) while fostering improved competition in the market for financial services. Appropriate firewalls with a key focus on controlling loans to affiliates, loans and guarantees to enhance creditworthiness and marketability of securities underwritten by affiliates, purchases of low quality assets from affiliates, warehousing of affiliates assets, and the buying of affiliate securities reduce contagion risk of the type encountered in the subprime crisis. Structured properly, they also promote level playing fields by limiting cross-subsidisation of affiliates competing with independent competitors.

Credit rating agency market structure

The issuer pays model led to difficulties

Credit rating agencies had some role in the crisis by giving unwarranted ratings to complex and risky products that enhanced their marketability to investors. The issuer-pays model proved not to be conducive to the correct pricing of risk, suggesting the presence of market failure in the form of a captive market. There is a need to examine ways to improve the efficiency of that market by reducing barriers to entry, including possibilities such as:

...so reduce barriers to entry…

- Simplification of registration requirements.

- A reconsideration of official endorsement in regulatory procedures of a few rating firms, and similar endorsements in mandates for public pension funds.

Full applicability of competition policy rules

During the crisis, emergency measures have taken precedence over competition rules. Markets have failed to function and there is a lack of price and granular credit rating information. This has required off-market information sharing with governments and the firms involved to the exclusion of others, creating market distortions and the risk of collusion and price fixing. A prerequisite for government divestment of ownerships stakes, loans and guarantees should address the interface between regulators and competition authorities by:

…transparency…

- Specifying clear transparent rules for when stability policies take precedence over competition policy, and when the latter will apply again.

…and market for financial services and regulatory jurisdiction consistency is needed

- Promoting consistency over time between the market for financial services in a region and regulatory jurisdictions. This may involve greater regulatory coordination or international regulatory forums, such as colleges proposed by the FSF, to address both cross-border regulatory issues and to avoid competitive distortions arising from regulatory action in one region for firms competing in broader markets.[9]

G. Strengthening corporate governance

Financial aid means restrictions on governance

Many firms that have received public funds or are owned by governments are already subject to severe restrictions on governance and remuneration. During such periods, they should be run as close as possible to the OECD guidelines to ensure appropriate governance.[10] Before phasing out emergency measures, it is incumbent upon governments and authorities to improve rules and guidance for the governance of financial firms, both to enhance risk control and to redress other weaknesses that contributed to the present crisis. At the OECD, governments will be examining a range of possible recommendations, including:

Independent and competent directors

Strengthen the fit and proper person test… competence and knowledge of governance

- Strengthening the *fit and proper person test* and extending it to cover more institutions. All too often *fit and proper* has been assessed in terms only of fraud and history of bankruptcy. There is a compelling case for the criteria to be expanded to technical and professional competence, including general governance and risk management skills. The test might also consider the case for independence and objectivity.

- Extending fit and proper powers to a more controversial area: term limit on board membership for directors without a direct stake in the company. Age per se is not the issue here, but rather length of time on the board, especially under the same CEO or chair.[11]

Separate chair and CEO role

- Requiring formal separation of the role of the CEO and the Chair in banks.[12]

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9 In Europe for example there is a single market for goods and services whereas financial regulation is carried out on a national basis.

10 See *OECD Guidelines on Corporate Governance of State Owned Enterprises*, OECD Paris, 2005.

11 Research in the US indicated that the weighted average director tenure at the end of 2007 for financial institutions that disappeared was 11.2 years but 9.2 years for those that survived the first phase of the crisis. The former was associated with long CEO/Chair tenure. In the UK, the code sets a limit of 9 years if the director is to be considered independent while in Netherlands and France it is 8 and 12 years respectively.

12 Indeed, a number of US banks have already moved in this direction. It was already common in a number of other countries. The only question is whether it should be made mandatory by financial market regulation.

Risk officer role

In the post-Enron years it appears that there has been a strong focus on internal controls for the purpose of financial reporting, together with having the internal and external auditors report to the Audit committee. Risk management in financial institutions deserves the same emphasis.

A risk officer with board access…

- All financial firms should require a Chief Risk Officer, responsible for risk management, with direct access to the board (not necessarily a Risk Committee but probably not the Audit Committee).

…with some independence…

- The employment conditions of the chief risk officer may require some built-in protections balancing the need for independence from management and access to information.

...like an ombudsman on risk

- This role would be akin to an 'ombudsman' not replacing the CEO role as risk manager, but drawing the board's attention to issues they should be concerned with.

Fiduciary responsibility of directors

The complexity of some corporate groups (large and complex businesses) has been identified as both governance and risk control issues during the crisis. To the extent that this issue cannot be adequately addressed by policies to separate and simplify the activities of affiliates in complex groups (see above), in some jurisdictions there may be a need to clarify the fiduciary duty of directors.

Clearly defined fiduciary responsibilities

- Some groups might require fiduciary duties of directors to be more closely tied to that board and company.[13]

- These duties will need to strike the right balance between greater involvement with the firm and separation from management and other operational activities.

Remuneration

Fixing governance is a good first step

...and tax incentives need thinking about

It is difficult to be very precise about executive remuneration. Reformed and strengthened boards would improve governance, especially if it was clear that the duties of directors were extended to overseeing sources of risk and the compatibility with the institutions financial strategy. This would make the link between risk management and compensation policies clear and transparent. Where possible, tax incentives could also help to encourage a greater use of compensation linked to longer-run performance.

[13] Such as has been introduced in Australia and South Africa.

H. Privatising recapitalised banks

Speed is less important than getting it right

The long-term goal should be to return institutions that have been recapitalised to private ownership. Especially where levels of public ownership or similar involvement are high, the long-term health of the financial system will depend on the way this is done. The readiness of individual firms in terms of viability will differ. Government involvement may promote a strong desire for exit due to expensive fees and dividends to the government and restrictions on executive compensation. However allowing the process to be driven by individual firms will make it more difficult to avoid competitive distortions. Speed is less important than getting it right[14]. Some priorities include the following.

Pools of long-term capital for equity

Don't lose sight of the less leverage goal in selling government stakes

OECD countries should aim for much higher equity bases and less leverage in the financial system than have been typical of the years that led up to the current crisis. This requires tapping pools of saving rather than investments based on increased leverage. Investors of accumulated saving pools include pension funds, university endowments, sovereign wealth funds, some private equity finds, and even private individuals[15]. Existing banks should be avoided, as sales to banks provide no new capital to the system as a whole. Enterprises likely to be users of bank credit should also be regarded with caution.

Where privatisation programmes are large, experience suggests that they can put strains on available sources of equity capital. Efforts to move quickly can lead to the use of leverage to augment what is available. This is dangerous as equity that is financed by borrowing is only an apparent increase in equity for the system. In the event of financial strains, the structure can be very fragile. A test for potential credible long-term owners is that their own leverage should be modest at most.

A good competitive environment.

Where large parts of the system must be privatised, the process will be a major determinant of market structure and the competitive environment once it is complete. As noted earlier, banks should be reorganised or restructured before privatisation to minimise dominant market positions and encourage effective competition, and mega-mergers can lead to particular systemic difficulties. A clear framework to assure a level competitive framework should be in place and all privatisations should be guided by it.

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14 Some best practices are summarised in OECD, "Privatisation in the 21st Century: Recent Experiences in OECD Countries", a report by the *OECD Working Group on Privatisation and Corporate Governance of State-Owned Assets*, forthcoming.

15 In many instances, these pools of long term capital can only be channelled into equity through international capital flows. This underscores the importance of open markets for international investment during the exit 'phase'.

Aligning deposit insurance regime, no too-big-to-fail.

Many types of financial institutions may ultimately require public support and, when returned to a market environment, they may be subject to different regimes. At privatisation, their status vis-à-vis deposit insurance and guarantee systems should be clear and credible. Either they should be explicitly covered by schemes that are transparently priced, as described above, or *caveat emptor*, with creditors assuming full risks, should apply. To avoid the problem of implicit guarantees, any financial business not covered by explicit schemes should be small enough that the possibility of allowing them to fail will be credible.

5. Getting privatisation right[16]

There is a need to draw lessons from past privatisation episodes

When the crisis has passed, many governments will hold partial or controlling stakes in financial firms, most or all of which should be divested. In many cases these may consist of minor holdings, which can easily be disposed of in an IPO, using pre-emption rights of existing shareholders, or simply sold in organised stock markets. But in others, the amounts may be large enough to warrant some strategic thinking about how to proceed. The large wave of privatisations of state-owned enterprises, which took place during the 1990s and early years of this century, has provided valuable experience of different approaches.

Sequencing and size factors

Governments contemplating the re-privatisation of financial institutions face an important choice at the beginning of the process. They may hive these activities quickly off the public balance sheets by selling them in their entirety to existing financial institutions (i.e. a trade sale). Or they may continue operating them on a commercial basis through a period of sequenced or partial privatisation. Their choice will be guided by market conditions, including the appropriate sequencing if many institutions or countries are involved. An important second consideration is the size of the entities concerned and the government's ownership share.

Governance pre-requisite for trade sales

Government owners need to decide whether and to what extent to reform the governance of financial institutions prior to the sell-off. If a trade sale to other banks or financial institutions is the preferred privatisation method, the government holds a controlling stake, and disposal is expected to be quick, then the need for new governance mechanisms may be limited. In terms of restructuring, the best course of action is for the government to limit it to issues where it holds a demonstrated comparative advantage. If the sale process is competitive, the price mechanism should identify the private buyer best suited to undertake necessary changes after privatisation.

[16] The recommendations in this section are based on OECD (2009), "Privatisation in the 21st Century: Recent Experiences in OECD Countries", a best practice report released by the Working Group on Privatisation and Corporate Governance of State-Owned Assets.

Government role in governance needs care during ownership phase

If governments choose to retain ownership in the financial institutions for a period, while letting them continue to operate in the market, then they need to change corporate governance arrangements in accordance with the best practices laid down in the OECD Guidelines on Corporate Governance of State-Owned Enterprises and the OECD Principles of Corporate Governance. The actual act of changing corporate governance arrangements is in most cases best performed by one agency operating with a necessary degree of autonomy within the central administration.

Divestments of affiliates?

In the recent experience of bank privatisations three priority areas for governance measures generally stand out: putting in place new risk control systems, new management and new boards. To facilitate the privatisation process itself, it may also sometimes be necessary to divest the SOE of some of its subsidiaries or other corporate assets.

Reform of regulations completed

Governments should not privatise in the absence of an adequate regulatory framework. This includes anti-trust regulation to ensure a healthy degree of competition wherever economically feasible and specialised regulation where an element of monopoly is likely to persist. Importantly, these regulatory functions need to be separated from the state's ownership role. An independent competition regulator has an important role to prevent the formation of excessively large financial conglomerates, even at the expense of lower sales proceeds.

In the context of bank re-privatisation a case has been made for targeting privatisation at preferred groups of "long-term investors" or "friendly investors". If such "targeted" strategies are pursued, then it is often more efficient to work through pre-qualification followed by bidding among the selected candidates than allowing the targeting to interfere with the selection of individual buyers. Full disclosure should be made of the criteria according to which a preference for certain shareholders is developed and the objectives they are expected to pursue following privatisation.

Reforms to post-privatisation governance in place

Timely attention should be given to the issue of post-privatisation corporate governance – especially in the case of a gradual privatisation process. Of crucial importance is safeguarding board independence so as to enable directors to protect minority shareholders, including against further privatisation measures that might be at the expense of their interests (e.g. dilution by directly introducing new large shareholders).

Some governments may wish to retain a degree of control over re-privatised banks. The OECD Principles of Corporate Governance do not discourage mechanisms of disproportionate control, provided the non-state shareholders are fully informed of its nature and scope. However, careful consideration must be given to the choice of instruments. Veto rights such as "golden shares" are generally not recommended. They are inherently less transparent than fully disclosed shareholder agreements or voting right differentiation established through corporate bylaws.

6. Maximising recovery from bad assets

Deal with genuine toxic assets over a long horizon

Where governments have moved to separate bad assets from good ones on financial firms' balance sheets, they will face the problem of dealing with the bad assets or whatever collateral was available to support them. Their objective should be to recover as much as possible to offset the costs of managing the crisis. Governments are in a position to approach the task with a medium to longer-term timeframe, avoiding fire-sales that involve large discounts in illiquid markets. Experience suggests that a professional approach to this task often yield returns that are significantly better than appear likely in the midst of the crisis.

To the degree that non-performing assets are predominantly mortgages, governments' longer time horizons would put them in a better position to explore the scope for restructuring products and selling them to more natural holders off the public balance sheet, than banks facing an immediate need to rebuild capital. Where this promises a better eventual outcome than foreclosure and sale, it will be in everyone's interest to proceed in this way. This holds out the promise of breaking the vicious cycle of foreclosure, forced sale by borrower or bank, more downward pressure on prices and further deterioration in bank asset quality.

7. Reinforcing pension arrangements

Pension arrangements, already a major long-term policy concern in many countries with ageing populations, are suffering serious damage during the current turmoil. They will require serious attention once the economic situation has stabilised[17].

20% decline in assets hit

Assets in private pension plans, which have become an important component of diversified retirement systems in many OECD countries, fell by about 23%, or around $5.4 trillion, between the end of 2007 and December 2008. They have likely fallen further since then.

Defined benefit issues

Where these assets fund defined benefit plans, in which benefits are linked to individual wages, or annuities, this decline adversely affects the adequacy of plans' funding. This puts financial pressure on the sponsors of the plan. In some cases, where the sponsor of the plan faces retrenchment or bankruptcy, it can impinge on the plans' solvency.

Defined contribution issues

Where older workers or retirees have defined contribution plans, in which pensions depend on asset values in individual accounts, this decline may imply important losses in permanent income. Younger workers with defined contribution plans may suffer less damage. They have many years to wait for recovery, and most of their contributions to the plans lie in the future and are not affected by recent losses. However, their plans often depend on employer contributions as well as their own, both of which may be adversely affected by the widespread distress that economies are now experiencing. Furthermore, confidence in plans that leave people so exposed to market developments is likely to be hurt.

[17] For in-depth discussion, see OECD, *OECD Private Pensions Outlook 2008*, Paris, 2009.

Public pension benefits, generally taxpayer funded on a pay-as-you-go basis, are not directly affected in the sense that political commitments to them remain intact. However, the fiscal challenges that these commitments pose as populations age will be made more daunting if public indebtedness and future debt servicing rise as a consequence of the crisis. Furthermore, to the extent that private pensions are impaired, public pensions must bear more weight in diversified retirement systems. This may affect the political context in which the fiscal challenges are addressed. It is notable, in this regard, that in countries where substantial reliance is placed on private pension arrangements, public pensions replace relatively low shares of pre-retirement incomes.

…more saving will be needed…but other polices are needed too…

The core of any long-term strategy to assure retirement incomes in ageing populations will be more saving, at both public and private levels. But other measures may be required, especially given the damage to pension funds caused by the current turmoil. Priorities include the following:

Don't dip into reserve funds

- *Avoid funding crisis management initiatives through Public Pension Reserve Funds.* Where such funds are not ring-fenced with governance structures independent of government, there is a political temptation to fund crisis measures from these pools to inject capital into banks and to support fiscal spending programs. This would exacerbate pressure on future funding of liabilities and undermine confidence in pension arrangements. Such policies may reinforce the incentive to save privately, with little net benefits for crisis management.

Need for a long-term view

- *Strengthen confidence in private pension systems.* Concern about market risk may lead to retreat from private systems and arrangements and to pressure to compensate by making public pensions more generous. The best approach over the longer term is to rely on a diversified system, with both public and private sources of income and a mix of pay-as-you-go and asset backed funding. Governments should articulate the case for avoiding panic and taking a long-term view.

Funding needs to be resumed as quickly as possible

- *Any forbearance over funding should be temporary.* Losses on investments in pension plans may force many companies to increase their contributions. Since contribution levels are often already high following the losses of 2000-2002, this will add to the stress many companies are facing as the economic situation deteriorates. Some countries (e.g. Canada, Ireland and the Netherlands) have already provided relief by allowing various means of deferring the return to adequate funding levels. It is important that any such forbearance be temporary, as otherwise the security of pension benefits will be impaired. Since confidence in private pension schemes is likely to be influenced by their funding levels, this forbearance should be withdrawn as rapidly as is feasible.

Reconsider statutory performance rules

- *Reconsider statutory performance requirements.* In some countries (e.g. Belgium and Switzerland) pension funds must guarantee minimum returns. In the current environment, such requirements could encourage imprudent portfolio management designed to achieve unrealistic goals. Countries should make these requirements more flexible during difficult market conditions or, even better, replace them with market-based benchmarks.

And strengthen governance

- *Strengthen pension fund governance.* Reform has been warranted since before the current crisis, but is all the more important now given the funding and confidence issues that pension arrangements are likely to face. More effective monitoring of investment risks, performance and balance sheets is needed. Pension boards should have greater expertise and knowledge of financial management issues and they should include more independent experts.

Consolidate small funds

- *Consolidate small pension funds.* Small pension funds often have weak governance arrangements, and they are expensive to manage and supervise. In some cases, consolidation would help to achieve a more coherent scale.

Eliminate rules that aggravate the economic cycle via forced selling

- *Reconsider regulations that aggravate the economic cycle.* In some countries (Denmark, Sweden, Finland, Netherlands) regulations designed to protect participants of designed benefit plans force asset sales on falling markets. These regulations lock in losses and drive prices down further. Mark-to-market accounting and the practice of linking minimum funding levels to investment risk may have reinforced this effect. As with capital adequacy requirements for banks, ways should be sought to introduce funding regulations that are more counter-cyclical in their impact.

Hybrid systems to reduce risk

- *Promote hybrid pension arrangements to reduce risk.* Wider funding gaps and higher contribution requirements are likely to reinforce the existing trend to closure of defined benefit plans. Insolvency guarantee funds will also be active in taking over pension funds sponsored by bankrupt companies. The extent to which regulation reinforces these trends should be reviewed, and ways to promote hybrid arrangements that retain a component of defined benefit features should be sought in order to better spread risk. For example: indexation features where solvency positions permit; altering target returns for defined contribution schemes to the lifetime of individuals rather than current year returns, etc.

Reform mandatory default arrangements

- *Reform mandatory and default arrangements in defined contribution systems*. Defined contribution plans should be designed to integrate accumulation and retirement stages in a coherent way. Often, default arrangements for asset allocation or requirements to convert accumulated capital into an annuity are built in. As regards allocation default options, which usually involve reduced exposure to equities as a person approaches retirement, their design should take account of the extent of choice in the payout stage, the generosity of the public pension system and the level of contributions. As regards conversion, a key issue is how to minimise the "timing risk" of the purchase of an annuity. Making the conversion mandatory may make sense where public pensions are low. But forced conversion is inconsistent with principles of free choice and can impose a heavy penalty in poor market conditions such as are now prevailing.

Education role

- Strengthen financial education programs for pensions (see below).

8. Strengthening financial education programmes and consumer protection

Risks have been transferred to households….they need better education to deal with it…

Financial risks have been increasingly transferred to individuals in recent decades. Not only do defined contribution pension plans transfer longevity and investment risks to individuals, but the crisis has exposed an array of vulnerabilities where poorly informed households facilitated the sale of products that played a key role in the crisis including: adjustable mortgages with reset provisions or interest only loans in the US; the use of foreign currency loans (including some small emerging European countries); and the sale of complex structured products to pension funds with trustees that did not understand the risks. To better equip individuals to deal with a more complex world, financial education needs to be a priority, complementing regulatory reform.

…in pensions…

The rapid growth of defined contribution plans in many countries means that individuals face more of the risk in, and assume more of the responsibility for, assuring their own long-term financial well-being. They are likely to make better decisions, and contribute to better overall functioning of financial markets, if they are well educated and informed about issues relating to management of personal finances.

….to help align product suited to consumers' (new) circumstances…

Consumers are now facing greater financial insecurity, including unemployment, asset repossessions and healthcare issues, at a time when governments are trying to stimulate demand and stimulate credit flows. It is important that these policies are accompanied by rational household decision making, in order to avoid future crises. Effective financial education and awareness campaigns help individuals to understand financial risks and products and thus take decisions better adapted to their personal circumstances. They help them understand the need for policy action and reform. Financial education also contributes to more efficient, transparent and competitive practices by financial institutions. Better educated citizens can also help in monitoring markets, and thus complement prudential supervision.

And consumer protection needs to be strengthened

Governments will also need to improve consumer protection with respect to financial products. The crisis has shown that innovations in the credit markets and mis-selling led to the development and distribution of inappropriate financial products to vulnerable retail consumers. Further, the transfer of financial risks to households has opened gaps in consumer protection that need to be addressed by market conduct regulations. Consumer protection regimes need to be reviewed with an emphasis on advertising and selling strategies of financial service providers, proper disclosure provisions and consumers' access to, and the effectiveness of redress mechanisms in case of abuse or dispute.