

# Back to the future

## Government, Financial Institutions and the Global Financial Crisis

a PwC Public Sector Research Centre publication



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# Foreword

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## *Different perspectives, shared goals*

Without doubt, the global financial crisis has spurred a level of government involvement in the financial services sector that would have been unimaginable two years ago. Iconic investment banks have disappeared, banking giants hastily merged and others taken into partial or complete state ownership. Even countries not directly impacted by the crisis have had to strengthen deposit guarantee schemes to help address a widespread loss of confidence in the banking system.

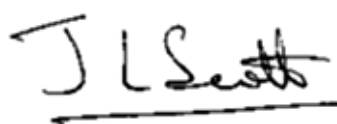
With the world economy now turning a corner, focus has shifted from heading off the risk of a systemic collapse to how the banking system should operate in future. Our previous publication, *The Day After Tomorrow*, looked at the challenges from the perspective of the financial services industry and examined what the banks should do to survive and ultimately thrive in this new environment.



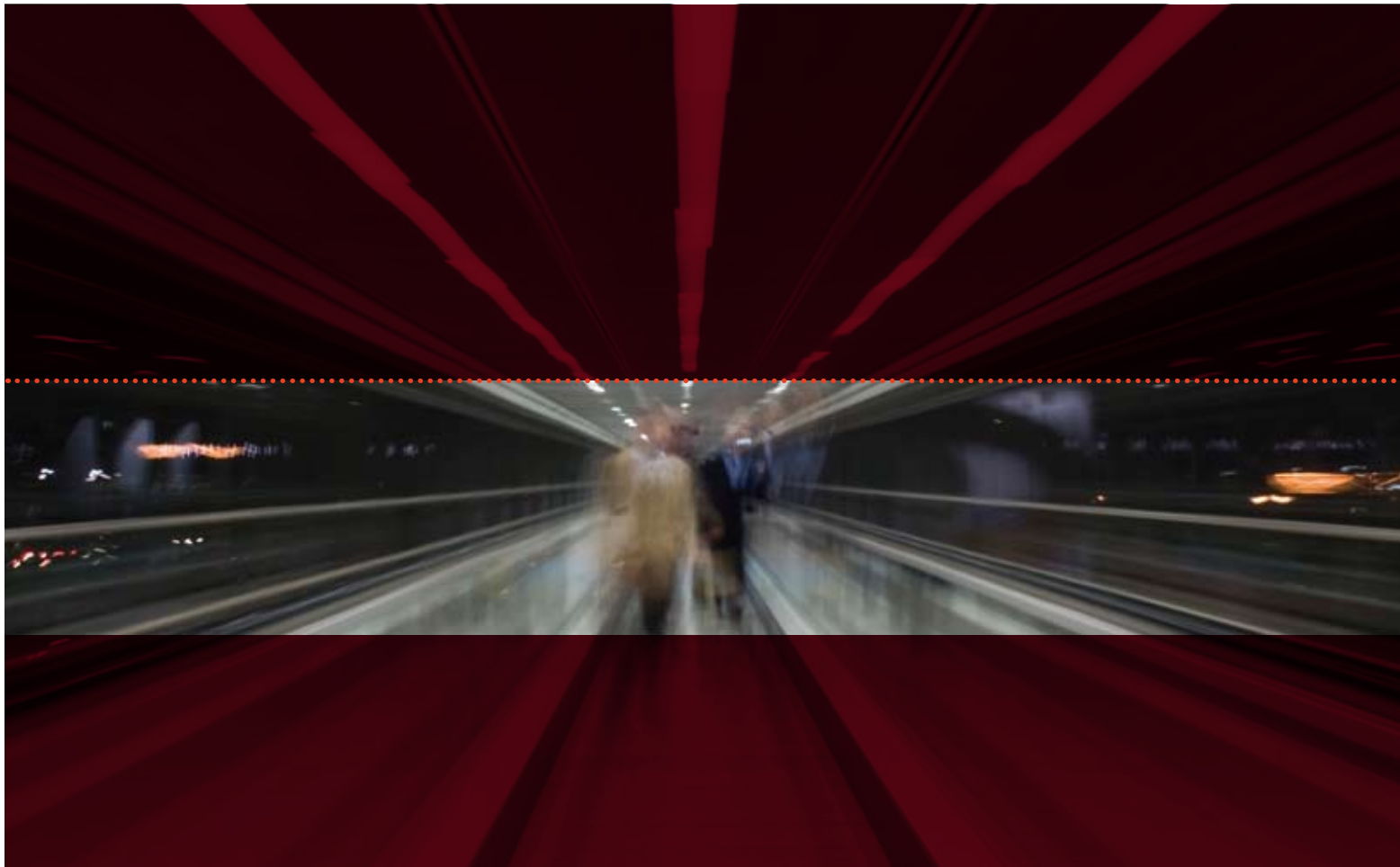
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But with many banks now in state hands, or receiving state support and guarantees, government looks set to be an integral part of the future shape of the financial services industry for some time to come. In *Back to the Future* we therefore turn our attention to government's role. We examine how governments should act as owners, what they can do to help rebuild confidence in the system and how they can deal with the huge debt burden resulting from the bailout.

The two publications therefore present two different perspectives on a common set of challenges. With a wider social and economic agenda, governments may not always see eye-to-eye with the financial services industry and conflicts of interest will inevitably arise along the road to recovery. But the global crisis has shown, once again, the vital importance of a thriving financial system to a modern global economy. Ultimately, governments and the financial services industry share the same goal: to restore the banking system to health and profitability, and need to collaborate if we are to pave the way for a return to sustainable growth.



**Jeremy Scott**  
Global Financial Services Chairman  
PricewaterhouseCoopers LLP



# Executive summary

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**Forced to bail out an industry too strategically important to fail systemically, government is firmly inside the financial services tent where it is set to remain for a considerable time.**

The complexity of individual financial institutions' situations, difficult market conditions and an unattractive disposal environment combine to make the possibility of early government exit from their stakes in the private sector highly unlikely. It will take two to three years to sell major holdings, but five to seven years or more before governments are able to fully divest of their stakes and related guarantees.

Given that temporary state ownership will stretch into the medium term, governments should not waste this opportunity for reform. They must clearly define their objectives, focus on taking a positive role and navigate three key public policy challenges:

- Government must seek to be 'good owners', focusing on wider social and economic objectives as well as narrow financial goals as shareholders;
- They must rebuild the confidence and trust that are essential for the financial system to function efficiently; and
- They must put in place credible plans to address financial deficits.

## Being a good owner

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As owners governments can take a longer-term approach and adopt the role of an activist investor, thereby focusing not just on the financial return on investment but also on the economic and social returns. They must challenge strategy but avoid politically motivated meddling and be mindful of the market distortions introduced by state ownership. Governments also need to manage carefully the conflicts arising from their distinct roles as owners/shareholders, acting on behalf of taxpayers, and supervisors/regulators, acting on behalf of consumers and businesses.

There is an important distinction, however, between maximising shareholder value within a context that is supportive to wider economic and social goals and using government ownership of the banks as a substitute for more appropriate policy mechanisms to achieve those social objectives.

The need to tackle the problem of toxic assets is a key lesson from previous crises and historically 'bad bank' structures have proved the most effective method of dealing with them. The sheer breadth and scale of the current crisis in comparison to previous more localised periods of turmoil have, however, necessitated a wider range of solutions, some involving retaining assets on balance sheet.

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## Restoring trust

Breaking up the banks is no panacea. Proposed solutions to address market failures by dismantling large and complex financial institutions could generate unnecessary costs and are a distraction from more useful market reforms to diversify risk by encouraging diversity of provision. Similarly, product regulation has limited effectiveness and attraction as a solution and can introduce conflicts of interest with wider public policy objectives.

Restoring the long-term trust and confidence of business and consumers in the financial system will require a combination of regulatory and market driven reforms as well as a return to more conservative approaches to doing business. More could and should be done to strengthen governance through more effective board-level understanding, oversight and accountability. Compensation design needs to be reformed, with remuneration plans focused on the long term. An internationally agreed set of principles on compensation reform is required, which can then be tailored to specific countries.

Whilst many reforms to the regulation of individual institutions are focused at national level, this is necessary but not sufficient. A more international approach to regulation is needed and systemic risks must be addressed over and above the risks in individual institutions. Current reforms are moving in the right direction, but more work is required to develop effective global regulatory mechanisms, which are likely to arise through a collaborative international approach rather than a single regulatory institution.

## Dealing with debt

Many governments have a fiscal mountain to climb as they deal with the combined effects of state bailouts, recession and the consequences of the financial crisis extending beyond banking boundaries, for instance to the insurance and automotive sectors. In the short-term, the focus remains on stimulating economies by maintaining increases in public spending as the global economy turns around and heads towards the recovery ward. But, in the medium term, dealing with debt on such an unprecedented scale and avoiding a long term drag on economic recovery requires credible, sustainable plans to address the fiscal gap and avoid a return to intensive care.

There are steps governments can take to do more with less, starting with operational efficiency improvements. Efficiency savings, however, will not be enough to turn around major fiscal deficits. The role of government must be revisited and all options considered, including service decommissioning.

Even now, governments must not forget the need to plan for the future. A return to growth is essential: the priority for government is to spend on projects with a high social and economic return, which will assist private sector wealth creation. At global, national, regional and local levels, governments need to act as the runway for future growth, navigating their economies through current troubled waters, while charting the way ahead to a better and more sustainable future.

# Introduction

The global financial crisis has spurred unprecedented government intervention in the financial services industry. The contraction in capital, credit and liquidity created a “monetary vacuum” at the centre of the banking system, which governments have helped fill with fresh capital. Government is now firmly “inside the tent”, where it will remain for some time (see [Figure 1](#)).

The result will be a banking system under a new stricter governance model operating in a global economy that will look very different from the pre-crisis world order. In an earlier publication, *The Day After Tomorrow*, we analysed the challenges the financial services industry faces, not just to survive, but also to build a sustainable competitive strategy and thrive in this new environment. In this new complimentary publication we turn the focus onto government. The period of interim state ownership within the banking system presents many challenges, but also an opportunity for reform that should not be wasted.

The impact of the crisis has not been distributed evenly across the world’s economies and in presenting a framework for meeting public policy challenges we may not speak to every country’s

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*The Chinese use two brush strokes to write the word crisis. One brush stroke stands for danger; the other for opportunity. In a crisis be aware of the danger, but recognise the opportunity.*

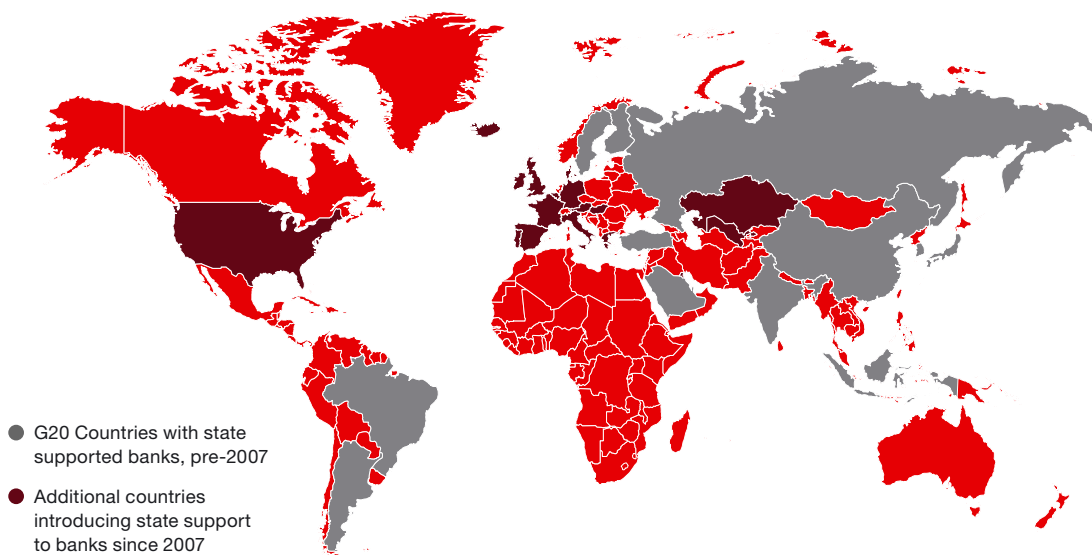
John F. Kennedy

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specific issues. Established financial centres in the developed world have borne the brunt of the fallout and governments have responded with a wide range of support measures – from the provision of credit lines and liability guarantees and the purchase of financial institutions’ debt and toxic assets through to partial or complete equity ownership.

There are lessons from the crisis, however, for all governments. Many countries, even if not directly impacted by the crisis, have still had to strengthen deposit guarantee schemes. The interconnected nature of financial markets, the potential for regulatory arbitrage and the direction of capital flows arising from global macroeconomic imbalances mean that the actions of one government can have far reaching implications for many others. There is, therefore, a need for governments to create a vision for the future of the financial system, rather than undertake piecemeal and possibly conflicting reforms.

**Figure 1:** Map of state involvement in financial institutions



# Challenges for government

# 1

There are many public policy challenges that governments must address to arrive at such a vision. What is clear is that the crisis is not over. Concerns remain that improvements in economic conditions and financial sector performance may not prove durable when, inevitably, government stimulus is withdrawn.

Governments face three critical, interconnected issues. First, many weakened banking systems require continuing state support or guarantees, including in countries where banks were already in government hands. Second, the severe recession induced by the financial crisis has necessitated the extension of state support to other sectors, such as insurance and automotive. Third, governments – particularly in many developed, rather than emerging, economies – face unprecedented fiscal pressure as debt has exploded to cope with the combined effects of state bailouts and the ensuing recession.

More robust financial institutions may seek to free themselves from government involvement as soon as possible. But governments will retain stakes in some financial institutions for a considerable time – perhaps five to seven years or more – and during this period face three key public policy challenges.

They must:

- seek to be “good owners”, focusing on wider social and economic objectives as well as narrow financial goals as shareholders;
- rebuild the confidence and trust that are essential for the financial system to function efficiently; and
- put in place credible plans to address their fiscal deficits.

This will help to re-build financial capital, one of the critical resources which needs to be managed in a holistic way to ensure long-term prosperity.

# Government as a good owner

# 2

## No early exit

The timing of a government's exit from ownership is inherently difficult, since it relies on market conditions. First, the price of assets is difficult to set, particularly for shares and complex financial instruments. It requires a run-in period to market the shares to potential future owners and influence the expectations of institutions and the public. The eventual price must strike a balance between the need to return stock to private hands and the desire to maximise sales proceeds for the taxpayer. Market sensitive decisions also need to be taken on when to sell tranches of shares and through which mechanisms – from trade placings to public offerings.

Second, market volatility can easily upset the best-laid plans of a government looking to divest. The Swedish sale of state telecoms business Telia, for example, was conducted through an IPO, which was heavily subscribed by retail investors, but whose price fell significantly after flotation.

Based on the experience of bailing out banks in countries such as Sweden, Norway and Japan and recent bank privatisations in Central and Eastern Europe, current expectations for early sales of large government stakes are misplaced. The sheer scale of the disposals and the need to clean up balance sheets ahead of sale will necessitate a much slower exit than expected at the start of the crisis. There will be an additional challenge for government during the disposal process to reconcile the need for transparency and accountability, for example to politicians, with the requirement to protect confidentiality and market-sensitive information during what will be very large transactions.

Our view is that for most governments it will take many years to dispose of their stakes in financial institutions. Some banks that have benefited from government support programmes will seek to pay back loans and guarantees as soon as possible. It is not unreasonable, however, to expect that it will take two to three years to sell major stakes and five to seven years or more before governments are able to fully divest of their stakes and any related guarantees. It is important for governments to set appropriate expectations in the market: their ownership, whilst temporary, is likely to stretch into the medium term and they need to consider carefully how best they exercise their shareholding in the interim.

## Facing up to toxic waste

The key lesson from past privatisations is that, to maximise sale proceeds, State Owned Enterprises (SOEs), whether Financial Institutions (FIs) or non-bank firms, need to be 'cleaned' up prior to sale by addressing the issue of non-performing assets on their balance sheets. The experience of bank privatisations in the Czech Republic demonstrates this point clearly: having cleaned up its banks prior to sale, none are currently facing problems associated with the financial crisis.

To date, most of the programmes governments have put in place have not addressed this vital issue – either through the removal of troubled assets from the banks or by the creation of functioning market and pricing mechanisms for these assets.

Historically, 'bad bank' solutions, or similar asset securitisation vehicles, have been the most successful structures deployed in crises to remove troubled assets from FIs<sup>1</sup>. The Swedish government's 1992 intervention in the banking sector, for example, is regarded as tough-minded, pragmatic and decisive and provides a useful illustration of government acting as a good owner.

<sup>1</sup> Further information on bad banks is set out in a companion PwC publication 'Stabilising and reviving the financial system: Employing guarantee structures, "bad banks" and other mechanisms to combat the financial crisis', May 2009

Category	Definition and examples
Guarantees	<b>The guarantee of a financial institution's liabilities</b> E.g. Asset Protection Scheme (UK), "In return for a fee, the government will provide to each participating institution protection against credit losses incurred on one or more portfolios of defined assets to the extent that credit losses exceed a first loss amount to be borne by the institution"
Provision of lines of credit	<b>Providing funds to significant institutions in risk of failure, or to market participants to meet the credit needs of, for example, households and small businesses</b> E.g. Systemically Significant Failing Institutions Programme (US), "The Treasury will provide capital on a case-by-case basis to systematically significant institutions that are at substantial risk of failure"
Purchase of debt	<b>Purchase of debt of financial institutions such as bonds, commercial paper and syndicated loans</b> E.g. Asset Purchase Facility (UK). The Bank of England is authorised to purchase high quality private sector assets
Purchase of equity	<b>Purchase of equity of financial institutions such as common or preference shares</b> E.g. Bank recapitalisation scheme (UK), which allows Tier 1 capital in the form of equity as well as preference shares, and Targeted Investment Programme (US) where the Treasury will consider financial institutions for the purchase of preferred shares and warrants
Purchase of troubled or 'toxic' assets	<b>Purchase of toxic assets from financial institutions</b> E.g. In Russia the World Bank has commenced purchasing toxic assets via its International Finance Corp investment arm, and in Switzerland the Swiss National Bank purchased UBS's toxic assets as part of its support package in October 2008
Nationalisation	<b>Nationalisation of financial institutions – government as 100% shareholder</b> E.g. Northern Rock (UK), Carnegie Bank (Sweden), Fortis and ABN Amro Bank (NL)

To deal with its crisis the Swedish government issued a blanket guarantee for all non-equity claims on the country's banks, set up a stand alone Bank Support Authority to handle its efforts and established 'bad banks' for the institutions that were nationalised. Importantly, the Swedish government forced the banks to write down their losses and issue warrants of ownership to the government where capital needed to be infused.

They also reinforced the principle of moral hazard by ensuring that bank losses were borne first by shareholder capital. Outstanding bad loans were settled favourably and quickly – by 1997 – with assets being sold either individually or in packages. The bad bank scheme also produced a surplus for the government, which exited its positions in the banks through public offers.

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The current crisis differs, however, in both scale and breadth from its more localised predecessors and a wider range of solutions than just ‘bad banks’ have been required. For example, not all problems arise from loan defaults; many are related to the pricing of structured products in markets that have been hit by a lack of confidence. In these instances a more appropriate solution may be to quarantine the assets but continue to hold them on balance sheet, dependent on the pressure to release capital. Where problems of pricing exist, government’s role in restoring trust and confidence in markets may prove as important as setting up specific programmes to remove assets from banks’ balance sheets.

### Managing conflicts of interest

In most cases, governments have multiple aims for state involvement in banks. These range from restoring stability and confidence in the financial system in order to provide a runway to growth, through to returning the banks to health in the private sector while maximising the ultimate proceeds of sales for taxpayers.

Governments that have recently come ‘inside the tent’ need to consider their medium term objectives and must make clear how they will operate in their distinct roles as owners/shareholders, acting on behalf of taxpayers, and supervisors/regulators, acting on behalf of consumers and businesses.

For most governments, these aims are hugely challenging as ownership of banks is a new experience and they lack the necessary in-house skills and experience.

An important distinction also needs to be made between full and partial state ownership of banks. For instance, a government’s aim for banks to lend more to stimulate the economy can conflict both with its own desire as a regulator for banks to repair their capital ratios and with management’s responsibility to other shareholders to maximise returns (and hence value from share sales) by lending less and at a higher cost to re-build margins. Government must ensure that it does not use its position as the largest shareholder in a bank to abuse the rights of minority shareholders.

The presence of government intervention can also create market distortions, for example, by creating differences in banks’ costs of capital, by impacting remuneration structures and by creating unfair competition through state guarantees. Governments need to guard against getting involved in operational decisions and using state supported banks (SSBs) inappropriately as a tool of activist business policy, with the resulting accusations of political meddling and misallocation of capital.

There has been much debate about the moral hazard created by government intervention and its consequences. In our view, however, this crisis has made clear that the state has ultimately to guarantee banking activity, in the same way that the state would have to step in to ensure continuity of supply of any other utility such as electricity or water. The suppliers of money are just too strategically important in modern economies to be allowed to fail systemically.

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## Activism not interference

Government should take the role of an activist investor, acting as a 'critical friend' by engaging and challenging the boards of banks on their strategy and encouraging a longer-term approach to business. They should not, however, interfere in day-to-day operation – SSBs should be run in the same way, with the same attention to best practice, as any other business.

This needs to be done in the context of an appropriate governance structure, which recognises the unique involvement of government and where the roles of all players are clear – Boards, management, government and other shareholders. For example, the UK's Shareholder Executive applies four principles when working with management teams of government-owned businesses: clarity, value, transparency and professionalism. UKFI (UK Financial Investments), which holds the UK government's bank stakes, has a similarly clear remit for its dealings as an activist investor.

Many governments have called for, and several reforms have been aimed at, increasing transparency in the banking system. But this is an issue on which different countries have different views. Countries with a history of state involvement in the banking system, such as China and the Middle East, are often seen by Anglo-Saxon countries as inherently more open to political interference and could, therefore, be made 'safer' by reforms to governance, which increase transparency. These countries, justifiably, can argue that many banks in countries with a greater apparent focus on transparency suffered the worst losses in the crisis.

Progress, however, can and has been made where there is a focus on gaining multilateral agreement on broad principles of transparency, for example, on the need to more closely regulate areas such as tax havens operating outside the system.

## Maximising economic and social returns

The focus for many governments currently appears to be on divestment strategies and the timing of exits, rather than developing and implementing a strategic plan to maximise the return, both financial (to shareholders) and economic/social (to the wider economy and society), from their forced investments.

Share prices never tell the full value story: in our view, an activist government's exit strategy should aim to achieve an economic and social return on investment (SROI) as well as a financial one. For example, by increasing lending levels to maintain economic activity at a higher level than would otherwise be the case. This applies equally where there is a heritage of long-term state ownership of financial institutions. SROI, however, should not be used as a cover for politically expedient sales of shares at a low price or indeed state support of companies doomed to fail. There is an important distinction between maximising shareholder value within a context that is supportive to wider economic and social goals and mistakenly using government ownership of the banks as a substitute for more appropriate policy mechanisms to achieve specific social objectives.

# Restoring trust

# 3

Regulatory reform is being driven by the desire to minimise the risk that the crisis will be repeated – the ‘never again’ mantra – and by the need to restore the long-term trust and confidence of businesses and consumers in the financial system. Restoring this trust requires a combination of regulatory and market driven reforms as well as a return to more conservative approaches to doing business.

## Balancing product and prudential regulation

Some commentators have called for product regulation to be used more widely as a tool for prudential objectives in addition to consumer protection, drawing on the experience of countries such as Canada where loan-to-value restrictions limited risky lending activity in the years leading up to the financial crisis. On the other hand, product regulation tends to reduce innovation. It can be ineffective, or even counter-productive, if it encourages complex and overly risky forms of product innovation to avoid regulation e.g. in off balance sheet vehicles to avoid capital ratios.

A combination of better consumer education and more active supervision of products and selling practices is therefore required. An approach that focuses on capital, rather than products, is likely to lead to fewer inefficiencies than one in which governments impose blanket restrictions on financial products.

In achieving a balance between product and prudential regulation, government must take account of the potential conflicts of interest and unintended consequences that new regulation can introduce. The US, for example, is likely to move from a suitability standard in product regulation to a tougher fiduciary standard, with greater emphasis on what is best for the customer. But efforts to protect consumers from getting into too much debt can conflict with the objective of encouraging lending growth to re-start consumer spending.

The newly established US Unfair & Deceptive Acts & Practices legislation is a case in point. The aim is to protect consumers and yet, by reducing the ability of credit card companies to mitigate risk, the legislation may either stop certain customer segments from borrowing or push them towards costlier, and more risky, sources of finance.

## Beefing up governance

The capability of regulators has been justly criticised and there is scope for improvement. The private sector, however, will always have a competitive advantage in recruiting talent and it is prudent to assume that a capability gap will remain between regulators and regulated institutions.

At an institutional level, therefore, we support stronger corporate governance and risk management enabled by more effective board-level understanding, oversight and accountability – a key problem has been the downgrading of the risk management function. The position of investors versus management must be significantly strengthened via more effective boards.

Regulators need boards to demonstrate that they are more actively aware of risk management controls and that they are independent of management in assessing those practices. Regulators must ensure that boards have the information necessary, as well as the time and capability, to address overall concerns around risk and return and challenge management's plans constructively. The UK's Walker Review, for example, proposes greater time input from non-executives and chairmen as well as a Board Committee on risk.

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## Look outward, not inward

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We are concerned, however, that reforms to both the regulation of individual institutions (micro-prudential regulation) and the financial system (macro-prudential) are focused too much at a national level, which is necessary but not sufficient. One important realisation from the crisis is the need to address systemic risks over and above the risks in individual institutions or countries. The crisis has exposed the need for approaches to deal with the global nature of the financial system: effective global leadership and international resolution mechanisms have been lacking, with different views taken by different supervisors based on their own national interest.

Sovereign states will always act in their national interests during a crisis and the fundamental importance of banking to economies means that ceding power has serious implications for national government. National regulators will also remain in charge because sovereign governments and central banks are the lenders of last resort and have to bear the cost of bailouts, as the current crisis has shown.

Current G20 and European proposals to develop international frameworks are moving in the right direction, but more work is required to build a collaborative approach to international regulation and clear accountability to address future global risks and opportunities. Governments must establish real-time, virtual processes to enable effective collaboration. They must create a new strategic arena for stakeholders globally to collaborate, both formally and informally, to address systemic risks and re-build trust through a more networked approach.

We therefore support mechanisms to improve collaboration, including supervisory colleges, and reform of international institutions such as the IMF and World Bank. Given the important role these multilateral organisations must embrace, their sources of funding must be strengthened, particularly in light of the significant pressure on the national finances of many of the countries that finance them and the increasing demand on the resources of such institutions. Change to these institutions is needed to clarify their roles, both in the oversight of the international financial system and in ensuring the greater consistency and transparency associated with an international rule book – including accounting rules – to reduce regulatory arbitrage. It will be important, however, to balance the legitimate concerns of many governments concerning certain elements of IFRS with the broader objective of preventing the politicisation of accounting standards reform.

An important key will be improving cross-border coordination between the US and EU bodies. Our view is that there will not be a single international regulatory institution outside the EU, but the direction of reform most likely to be successful is improved coordination between national regulators.

## A prospectus for compensation reform

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Bonus payments and excessive reward have come to symbolise what is wrong with the culture of financial services. There is widespread agreement that there are serious problems with the current approach to compensation in the most highly remunerated areas of financial services – particularly the investment banks and a few universal banks – and we support a focus on long-term remuneration plans.

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While a one-size-fits-all approach to compensation design is clearly not appropriate, in our view there are seven main principles for aligning remuneration with longer-term performance<sup>2</sup>:

- Incentive payments should be based on performance measures that adequately account for the risk taken in producing profits.
- Bonus pools should not be struck below the level at which cost and risk can be allocated.
- Rewards should be aligned with the risk profile borne by the firm.
- Deferrals should be linked to the realised profitability of the business on which the bonus was based.
- Managers should have a significant proportion of remuneration based on divisional or group-based bonuses.
- Compensation design should be considered a key business competence and resourced as such.
- Compensation design should be viewed in conjunction with wider people management practices in order to support a consistent approach to achieving the desired culture.

We believe it is vital to align incentives with what is good for long-term bank profitability i.e. the long-term risk-weighted return. Improving incentive structures, however, will not be sufficient without other reforms. Compensation did not cause the credit crisis and nor can it be used to solve the ensuing problems. Among the investment banks, for example, Lehman Brothers and Bear Stearns had the most long-term reward structures. Reform in compensation needs to be combined with a consistent approach to risk management culture, management of performance and the development of talent.

While agreement on the need for compensation reform is widespread, the impact of remuneration restrictions on the competitive position of a financial centre will hinder the efforts of any individual country. Remuneration is high on the political agenda, but agreement on an international set of common principles along the lines we propose, while desirable, may be difficult to achieve.

### Back to basics

A shift back to a more conservative approach to banking, with more attention to managing risk than chasing yield, may also help. It is noticeable that those countries which have suffered less as a result of the financial crisis, such as Australia and Canada, tend to have a more conservative approach to banking, which is more cultural than regulatory. Some countries have simpler products with less securitisation, for example in the Middle East (particularly in Islamic banks) or simpler systems with less dependency on loans and complex financial products, for example, Brazil and Argentina. Other jurisdictions have requirements for more collateral and lower loan-to-value (LTV) multiples, for example, the Czech Republic (which has one of the lowest loan-to-value ratios in the EU) and Canada.

Indeed, the Canadian banking system combines an inherently conservative business culture with higher capital requirements and lower leverage ratios than its US counterparts. Coming into the crisis, sub-prime lending accounted for just 5 per cent of the mortgage market and only a quarter of mortgages were securitised. Canada also successfully avoided excessive exposure to the securitised products created by the less conservative lending practices of its US neighbour. As a result none of the major Canadian banks have required government investment. Those countries that have suffered most should take note.

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<sup>2</sup> 'Reward: A new paradigm? PwC, September 2008

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## Market-driven reforms: Glass-Steagall is not the answer

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In our view market failures will not be addressed by breaking up large and complex financial institutions. A return to Glass-Steagall is too simplistic a solution. There is no conclusive evidence that universal banks are more or less risky and hence likely to fail. For example, Canada has five universal banks none of which failed; the UK's Northern Rock failed but was a 'narrow' bank. Indeed, retail banks need to operate in wholesale markets. In practice it would be very difficult to draw the line between commercial and investment banking and would require international agreement to avoid competitiveness issues.

We favour recommendations, such as those in the UK's Turner Report, on higher capital requirements and complementary leverage ratios for institutions with complex, risky, highly leveraged operations – if banks then want to reduce their capital requirements they need to divest non-core, risky operations.

In our view, however, most important is the need to increase capital requirements for universal and wholesale banks engaging in more risky proprietary trading.

## Too big to fail or to save?

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Similarly, 'too big to fail' is a nice sound-bite but is too simplistic. There is no apparent correlation between size, concentration and likelihood of failure. Indeed, the more important issue may be 'too big to save'. All retail banks are too 'systemically important' to fail in a political sense, and other financial institutions are often either too complex or too interconnected to fail. Large institutions might be too big for one country to save, as the collapse of the Icelandic banks illustrated.

While in hindsight the crisis has identified which institutions have proved to be systemically important, less has been learned about how to identify where future problems may lie. Given that a number of different types of institution could turn out in future to be systemically significant, there is a need to prepare for orderly failures where institutions cannot be saved or are allowed to fail – so-called living wills.

Breaking up large and complex financial institutions could generate unnecessary costs and is a distraction from more useful market reforms to diversify market risk by encouraging diversity of provision through lowering entry barriers or putting in place constraints on further concentration.

Market diversity is important for the long-term competitiveness of most sectors and banking is no different. Although the trend is to scale in this market, governments should encourage diversity in their banking provision, for example, by fostering mutuals, credit unions, community banks and the entry of new players such as retailers using internet banking. Even in countries hit by the crisis, such diversity can help to maintain some form of stability. For example, in Switzerland the Cantonal banks have contributed to restoring stability despite the impact of the crisis on its largest two banks.

# Dealing with debt

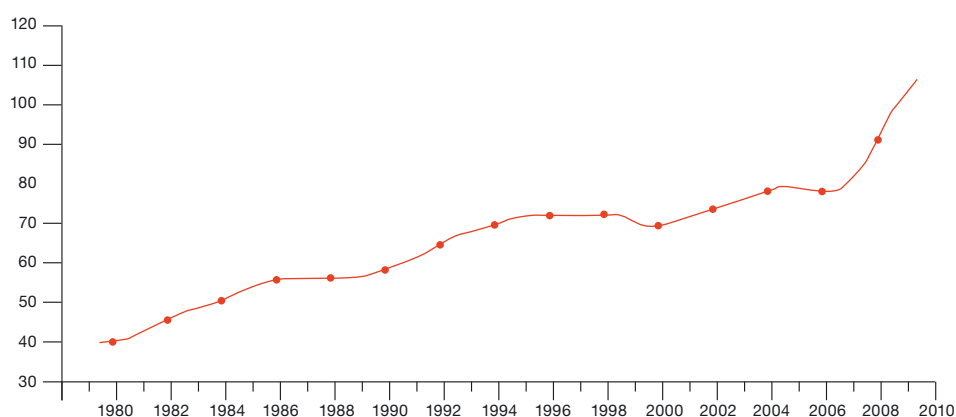
# 4

Alongside restoring trust in financial markets, dealing with debt is becoming a central pre-occupation for many governments, as can be seen from the trajectory of debt in [Figure 2](#), particularly for those which did not build up reserves in the boom years. This applies at state, local and city as well as national levels. In the short-term, the focus remains on stimulating economies by maintaining public spending.

But, in the medium term, dealing with debt on such an unprecedented scale and avoiding both a long term drag on economic recovery and reduced freedom and discretion over future policy requires credible, sustainable plans to address the fiscal gap. The need for action is most urgent for G20 countries where debt is already greater than GDP (Japan and Italy) or is forecast to approach or exceed this level in the next few years (US, UK, France and Germany)<sup>3</sup>.

Governments face the dilemma that reining in fiscal deficits will require taxes to be increased and/or spending to be cut, which could hamper growth. Yet a return to growth is fundamental because it is the primary source of government revenue through personal and corporate income taxes. The priority for government, therefore, is to spend on projects with a high social and economic return, which will assist private sector wealth creation. This includes infrastructure projects, support for Small and Medium-sized Enterprises (SMEs) and strategic sectors as well as addressing longer-term policy challenges such as healthcare, education, ageing populations and the desire for low carbon economies.

Figure 2: Rising tide of G20 Government Debt



Source: Fiscal implications of the Global Economic and Financial Crisis, IMF Staff Position Note June 2009

<sup>3</sup> Fiscal implications of the Global Economic and Financial Crisis, IMF Staff Position Note June 2009

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There are also important steps that government can take to do more with less. An obvious starting point is to focus on improving operational efficiency. The most politically attractive areas are in the back office, through reducing duplication, sharing services and re-deploying resources to the front-line. The UK's Operational Efficiency Programme (OEP) is an example of this approach where the government is seeking efficiency savings in five areas: back office and IT, collaborative procurement, asset management, property and through local incentives and empowerment. An experienced external business-person has analysed each of these five areas for government and quantified the level of efficiency savings that the government could achieve if their recommendations were implemented in full. The potential savings total an additional £15 billion a year on top of existing initiatives.

### Right-sizing government

A focus on efficiency, however, is rarely enough to turn around major fiscal deficits and governments should heed the lessons provided by historical precedents. In 1994, for example, Canada's debt was 69% of GDP and the budget deficit peaked at 9.2% of GDP. The Prime Minister was a strong champion for change and a public campaign formed a consensus within Canada that the debt had to be eliminated. A Programme Review was instigated, which started from the premise of "what is the Government's role?" rather than "what shall we cut from the budget?"

The government recognised the need to act quickly and that setting a firm, short-term deadline could help build confidence that the policy would be successful. There were no targets. Programmes were put through a common Programme Review Test, and those that failed were marked for abandonment or transfers. The biggest savings by far were from "stopping doing things" – efficiency measures just did not make enough of a difference. As a result public sector employment fell by 23% (c. 47,000 jobs) in three years, the budget returned to surplus within a decade and debt is now 28% of GDP.

The Netherlands also experienced a period of successive budget deficits in the 1980s and early 1990s. The Study Group on the Budget Margin proposed reforms including a medium-term framework and an agreement process for establishing policy and budget priorities for the duration of the parliamentary term. After implementing these reforms, net debt was reduced by 50% between 1995 and 2009.

More recently, faced with rising deficits in November 2008 the Irish government established a Special Group on Public Service Numbers and Expenditure Programmes to make recommendations for a return to 'sustainable public finances'. The Group, comprising public and private sector representatives, reviewed each government department's spend as well as cross-cutting issues and themes and asked whether services were needed and, if so, whether the public or private sector should provide them. The Special Group recently reported, identifying €5.3 billion of savings i.e. 9.3% of relevant public spending.

The lessons for governments elsewhere are that there is a need to revisit the role of government and that all options should be considered, including service decommissioning. Without political will and ownership at the highest level, nothing will change. Public support and understanding of the issues and the challenge are also vital and any measures to reduce costs or re-priorities services must be a coherent package, so that the 'pain' is shared.

Governments should also draw on best practice from the private sector. Public sector organisations need to look beyond traditional approaches to cost reduction and encourage new ideas and practices that will transform service delivery. Private sector companies that emerge from the downturn as winners will be those who proactively undertake a strategic, financial and operational review, while positively maintaining 'business as usual' and managing their varying stakeholders' agendas. We believe that these core principles are equally applicable in helping public sector organisations to work through the current economic downturn.

## The runway to growth

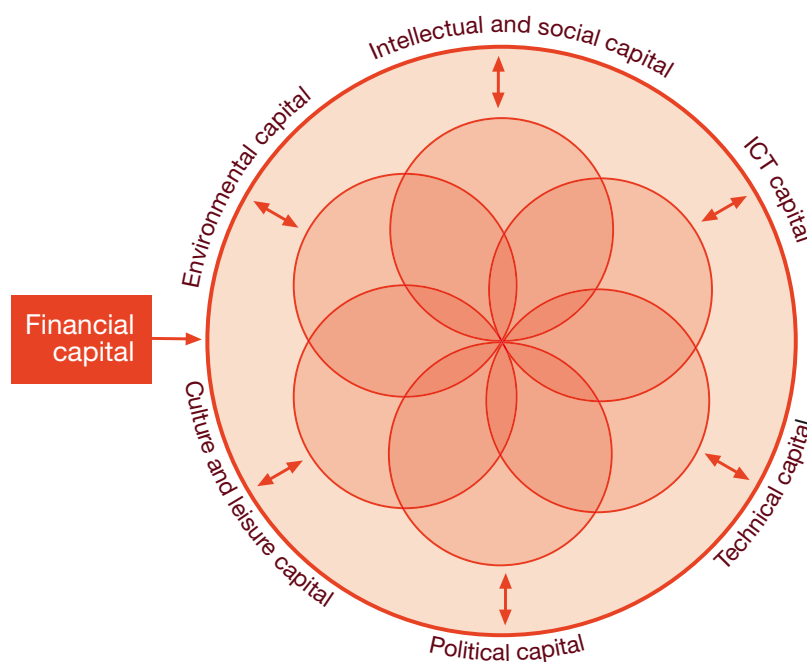
As we emerge from the global recession governments at global, national, regional and local levels need to act as the runway for future growth, navigating their economies through current troubled waters, while charting the way ahead to a better future.

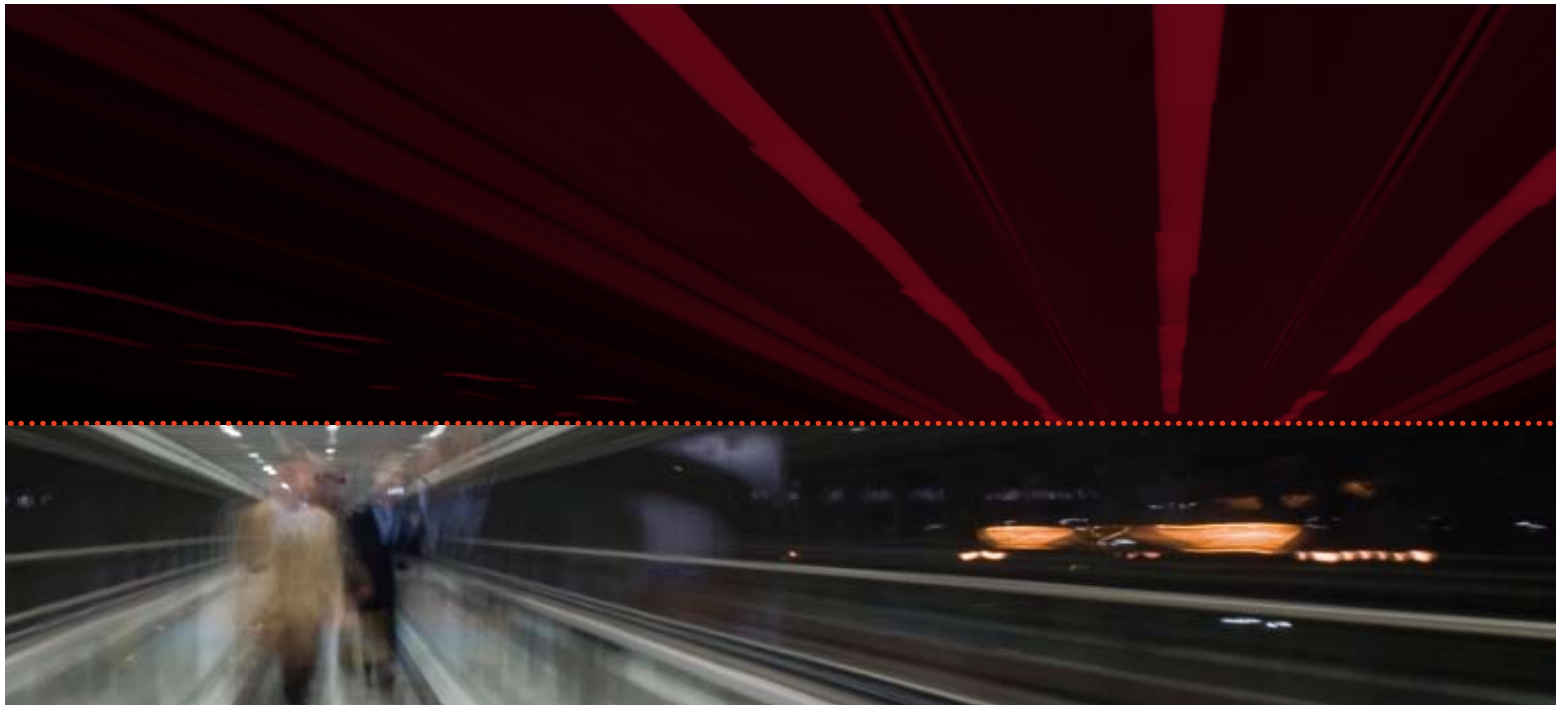
This can be achieved by taking a holistic approach to strategic resource management (see Figure 3). In this 'new capitalism' governments invest in, and strategically manage, the 'capitals' needed by any society for long-term prosperity – financial, intellectual, social, environmental, technical and political capital.

And of course this must be done in a sustainable way. There is no doubt that much stronger global governance is needed to safeguard the fundamentals of the world economy, particularly human and financial capital and natural resources.

New investment plans must be developed, both financial and non-financial, to enhance the 'new capitalism' and sustain entrepreneurship. Risk needs to be balanced with opportunity management and government should not be a captive in the "risk prison". Government must instil confidence and public trust and reduce uncertainty through leadership and vision based on positive ambition, not fear.

Figure 3: A Holistic Approach to Strategic Resource Management: The 'new capitalism'





# Conclusions

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The financial crisis has highlighted the central role of government in addressing global and systemic risks. We remain in a crisis situation with weakened banking systems, economies emerging slowly from a severe recession and faced with an explosion of government debt. The aim must be to return the financial system to health, with trust restored, credit flowing normally again and capital more efficiently allocated, whilst government stakes return to private hands having generated an acceptable return to the taxpayer.

That process, however, will not be swift. Governments will retain a stake in FIs for some time – five to seven years or more – and the period of interim state ownership should not be wasted. Governments need to act as a good steward and focus on economic and social return on investment rather than merely divestment. This applies equally where there is a heritage of long-term state ownership of financial institutions. A combination of regulatory and market-driven reforms is needed to restore trust and confidence in the financial system and governments must also put in place credible plans to deal with public sector debt where this has grown to unsustainable levels.

In our view, early decisions are needed on value creation and exit strategies for businesses which have been backed by governments during the current crisis, but which ultimately must stand alone. While FI stakes remain in government hands, more effective public sector governance is required, as well as tougher, better and smarter regulation. Stronger mechanisms for mitigating global systemic risks are needed, including reform of institutions such as the IMF and World Bank and a greater role for the G20 as a real-time decision-making forum.

Governments need to understand and manage the impact of state supported banks on the wider market. But the learning process works in both directions; FIs need to understand the ‘new normal’ with the emergence of SSBs. They need to prepare for a long period with government inside the tent during which they must communicate with government to inform the development of a pro-competitive policy.

Business wants government to take the lead by creating policies and mechanisms for collaboration that are appropriate for today’s global flows of capital. Governments must seize the opportunity to chart a way ahead, investing in the future and creating a runway to growth.

# Contacts

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