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A problematic policy option

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# **Quasi-nationalisation in the UK Banking Crisis: A Problematic Policy Option**

Running Title: Quasi-nationalisation in the UK Banking Crisis

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# Quasi-Nationalisation in the UK Banking Crisis: A Problematic Policy Option

**Abstract:** The systemic banking crisis in 2008 led to the quasi-nationalisation of two UK listed banks: The Royal Bank of Scotland and Lloyds Banking Group (National Audit Office 2010). Using property rights and agency theory as the theoretical frameworks, this paper analyses whether the quasi-nationalisation of these banks has been successful. It is argued that as a rescue mechanism, quasi-nationalisation was a positive development. However, questions arise over its effect as an instrument of banking reform. The State's arm's length approach to management represents a lost opportunity to change the culture of *profitability over people* that contributed to the banking crisis.

Key Words: **Quasi-nationalisation; Banks; Property Rights; Agency Theory; UK**

# **Quasi-Nationalisation in the UK Banking Crisis: A Problematic Policy**

## **Option**

### **Introduction**

In 2008, the systemic distress in the UK banking system led to the quasi-nationalisation of two major banks: the Royal Bank of Scotland and Lloyds Banking Group (National Audit Office, 2010). Alongside significant Government ownership, these banks also continued to have shares traded on the Stock Exchange. The quasi-nationalisation presented uncharted territory for the banks, encompassing additional layers of accountability which are a feature of public ownership (Luke, 2010). Designed as a temporary crisis response, the Government sold a small proportion of the Lloyds Banking Group shareholding at a price in excess of the original investment in September 2013 (UKFI, 2013a) and March 2014 (Lloyds Banking Group 2014). RBS' repatriation to the private sector remains unlikely in the short term (UKFI 2014). This paper considers the policy of quasi-nationalisation in the UK banking sector. Despite efforts to improve accountability, the paper argues that the banks continue to privilege profitability over customer service. The paper contributes to the literature by applying the theoretical understanding of property rights and agency theory to a novel political context. It also contributes to the repeated calls for accounting research into the global financial crisis (Arnold, 2009, British Accounting Review, 2012, CIGAR, 2013).

The paper proceeds as follows. The quasi-nationalisation process is outlined in section one. Section two contrasts the theoretical perspectives of property rights (Alchian, 2008, Alchian & Demsetz, 1973) and agency theory (Fama & Jensen, 1983, Jensen & Meckling, 1976). Section three outlines the status of quasi-nationalisation and the corresponding research

design to analyse it. Section four provides analyses of the Government rescue package under property rights theory (PRT) and agency theory.

The analysis under PRT supports the use of quasi-nationalisation to remedy the immediate crisis. Government ownership benefits from the style of monitoring retained by private sector investors. Nonetheless, markets and auditors failed to anticipate the crisis. The State aims to cushion the economic downturn via bank lending. However, the benefit of influence is eroded in the longer term as commercial ideals prevail. Finally, the PRT analysis considers the diffusing effect of State-driven targets to the wider banking industry, increasing the acknowledgement of banking's responsibility to its customers.

In the second part of the analysis, agency theory challenges the model of quasi-nationalisation as an effective reformatory measure. Market discipline is muted in current conditions, suggesting a need to incentivise bank directors away from share price and profitability measures of success. Scandals occurring at the quasi-nationalised banks, including PPI mis-selling, IT outages and exploitative customer practices represent an opportunity lost for the State to reform banking business as the entities refocus on the UK banking market. Quasi-nationalisation stemmed the solvency crisis of the banks, but stronger State involvement is required to effect substantial cultural change. The context to the UK banking crisis is considered in more detail next.

## **Research Context**

The financial crisis in 2008 led the UK Government to invest over £65bn to prevent the collapse of two major UK banks: RBS and LBG (National Audit Office, 2010). As a result, the

UK Government had an economic stake in RBS of over 84% (RBS, 2009b) <sup>1</sup> and in LBG of 43% (National Audit Office, 2010).

Government ownership was intended to be temporary (Darling, 2008). Both banks retained London Stock Exchange Listings. The banks were to maintain the commercial orientation to their activities, allowing recovery and return to profit (HM Treasury, 2008). HM Treasury created an independent agency, the UKFI, to manage its shareholdings in LBG and RBS (UKFI 2009). The UKFI behaves similarly to an institutional investor (UKFI, 2014a).

The financial crisis has had a huge economic impact on the UK. The country emerged from the (first) recession in 2009 with higher public and private debt and higher unemployment (OECD Economic Survey, 2011). Growth in 2012 has been described as flat. The growth since 2008 has been the slowest post-recession recovery in output in the past 100 years (National Institute Economic Review, 2013) . Public Sector net debt is expected to peak at 79.9% in 2015 (Office for Budget Responsibility, 2012). Successive UK Budgets have announced spending cuts, benefit cuts, reduced pension entitlements and public sector pay freezes to contain and manage the huge debt (Office, 2012). These effects have also had significant impacts on the taxpayer and have been related to the collapse in the UK banking sector.

Overall, State investment did not rest exclusively upon financial stability. Equity capital was designed to achieve conflicting objectives - the stability of the banks; protecting consumers; and in assisting the wider economy recover from the crisis (House of Commons Treasury Committee 2009). The State sought to implement economic assistance (HM Treasury, 2009b) and banking remuneration reform through ownership (HM Treasury, 2009a). These are discussed next.

## ***Director Remuneration and Appointment***

The 2008 rescue gave the State the right to appoint directors to the board (RBS 2008; TSB 2008). In addition, the Government conditions imposed limitations on pay and bonus awards to bank staff, using deferred schemes and non-cash payments (RBS 2008; TSB 2008).

The Government commented on the rationale for the bonus restrictions:

“...we are trying to stop irresponsible remuneration, whereby people are encouraged to do something that damages the banks and, therefore, the rest of the financial system. What we are suggesting means that in future the rewards will be tied to the long-term interests of the bank.” (Darling 2008)

Executive remuneration continues to arouse strong public sentiment. Responding to this, the entire banking industry in addition to RBS and LBG undertook that executive pay would be restrained and be linked to the performance of the banks against agreed lending targets (Project Merlin, 2011). Subsequently, the banks have been subject to best practice guidance on bonus payments, the bonus tax and EU caps on bonuses (Europa, 2013, House of Commons Treasury Committee, 2010b). Notwithstanding public scrutiny, the banking industry continues to pay generous remuneration (Goff and Arnold 2014).

## ***Customer Lending***

As well as the changes at executive level, the Government negotiated involvement in lending policies for economic reasons. The banks were committed to maintaining lending at pre-crisis levels and increase these in subsequent years (HM Treasury, 2009a, Lloyds Banking Group, 2009, RBS, 2009a). After three years, the largest banks in the industry took collective responsibility for the lending to the UK economy in 2011 (Project Merlin 2011), thereby seeking to restore public trust in the banking industry.

Since 2011, the customer experience at the quasi-nationalised banks has been subject to much criticism. Customer service has been criticised after scandals in mis-selling of payment protection insurance (PPI) (Lloyds Banking, 2013, RBS, 2013), management of businesses in distress and customer lending (Large, 2013, Tomlinson, 2013). The new Chief Executive of RBS has promised to lead a change in the bank's business practices (RBS, 2014).

The rescue of RBS and LBG by the State was realised through significant equity ownership which makes a theoretically informed analysis based on property rights and agency theory relevant. Whilst PRT deals with impacts at the macro level, agency theory penetrates to individual contracts and incentives. Research using multiple theoretical reference points has been advanced as a rich area for research in public sector settings (Jacobs, 2012, Kurunmaki *et al.*, 2003). PRT and agency theory are discussed in detail next.

## **Property Rights and Agency Theory**

Both property rights theory and agency theory provide important insights into quasi-nationalisation. Property rights theory considers that private ownership is preferable over public or common ownership. Despite Government intentions under temporary ownership, the use of public corporations for social or political objectives is still frequent (Kole and Mulherin 1997). In contrast to PRT, agency theory considers the relationship between principals and agents. Therefore, the economic and political objectives post-intervention can be attributed to interests rather than the nature of the ownership. Agency theory offers a useful counterfoil to analyse the implications of quasi-nationalisation for the banks and underpins the rationale of the State investment (Bank of England, 2009, Darling, 2008, House of Commons Treasury Committee, 2009).



## ***Property Rights Theory***

PRT advocates that the protection and maintenance of private property leads to an increased efficiency of resources and so increases social welfare (Alchian and Demsetz 1973; Demsetz 1967). The classical property rights literature is critical of State ownership as it attenuates property rights of individual citizens (Colombatto, 2004, Geddes, 1997). With State ownership, individuals cannot exercise choice over their property rights nor do they control the agents who manage the entity on their behalf (Eggertsson 1990). Thus, there is limited motivation to monitor the organisation and realise value from it (Eggertsson, 1990, Geddes, 1997).

PRT also considers managerial self-interest within corporations. This is more marked in a public organisation where wealth capturing mechanisms, such as share options, are not available as compensation (Valentinov, 2007). Thus, there is little incentive to reduce costs or increase output in State owned enterprise (De Alessi, 1983), causing inefficiency. State ownership may also encompass vaguely defined property rights. The incomplete delineation of property rights has been found to create inefficiency as individuals try to capture and isolate aspects of property in transactions (Eggertsson 1990). Furthermore incomplete delineation may result in interested parties lobbying for further specification of rights (Libecap, 1978).

Property rights research has indicated that the efficiency of state owned enterprises is less than privately owned corporations (Boardman & Vining, 1989, Dewenter & Malatesta, 2001, Karpoff, 2001). However, this is less clear in competitive industries (Caves & Christensen, 1980, Crain & Zardkoohi, 1978) and it has been shown that when Government acts as an

arm's length, temporary shareholder, the efficiency of corporations may be only negligibly different (Kole and Mulherin 1997).

## ***Agency Theory***

Agency theory is designed to consider conflicts of interest which may arise between principal and agent, and how interests are aligned through incentives (Jensen, 1994) In this theory of the firm, the Agents (Directors) act on behalf of the Principals (Shareholders) to run the day to day business operations. The principals receive a share of profits and the agents receive remuneration for their efforts (Jensen and Meckling 1976).

There are two problems associated with agency theory. The first is that the agents are self-interested utility maximisers and will act in their own interests rather than the principal's (Jensen & Meckling, 1976). Agency contracts also cause information asymmetry. To ameliorate this, the principal requests audited financial accounts to help assess how the provided resources have been put to use. In addition, the principal will incentivise the agent in such a way as to align interests, mainly through remuneration (*ibid*).

There are also market mechanisms which help to control for agency costs. Open stock markets allow unsatisfied principals to sell their shares onwards (Fama and Jensen 1983). In addition, the takeovers market will prey upon inefficiently performing organisations whose share price has dropped (*ibid*).

Agency theory is relatively silent over the merits of public or private ownership. There is a recognition that the bureaucratic control may lead to politically motivated interests stifling legitimate goals of disperse principals (Shleifer & Vishny, 1986). However, recent data suggests public ownership in banks results in higher economic growth (Andrianova *et al.*,

2012)→. Public policy initiatives, such as deposit insurance have been found to be an efficient use of State resources (Diamond & Dybvig, 1983, Grove *et al.*, 2011). Moreover, it has been argued that banks are efficient recipients of State Aid to assist in onward welfare (Hainz & Hakenes, 2012). This is an important consideration as these resources could have been used elsewhere if they had not invested in the banks (Bank of England, 2012b).

Yet there may be some concerns with conflicts between principals if one shareholder has substantial ownership. There may be efficiency gains, as the block holder of shares is very motivated to monitor the agent (Grove *et al.* 2011). On the other hand, minority shareholder interests may be stifled by an overbearing block shareholder (*ibid*).

Overall, agency and PRT offer different perspectives on the implications of the quasi-nationalisation the UK banks. The next section discusses the status of these banks as quasi-nationalised and the research design in analysing it.

## **Research Design: Exploring Quasi-Nationalisation**

This section considers the basis under which the banks can be termed ‘quasi-nationalised’. The ensuing public ownership status has implications for the accountability of the banks and this has influenced the research design undertaken.

This paper uses the term ‘quasi-nationalisation’ to acknowledge the political history to the terms of banks ownership whilst representing the fact that private investment is still a critical factor in shaping the banks’ own strategies. Other sources have described the Government intervention as quasi-nationalised (Kerr & Robinson, 2011, Myners & Costello, 2012). The conventional term when discussing the exit of Government from owning the

banks is 'privatisation' (UKFI, 2014b) and has included the UKFI hiring a "Privatisation Strategy Advisor" (UKFI, 2013b).

Public ownership is a complicated matter. It reflects not only on the shareholdings of the companies but also on aspects of control. Under the accounting basis of IFRS 10 and its predecessor IAS 27 (IASB 2009) both banks have been deemed to be public sector by the Office for National Statistics (Lloyds Banking Group 2013b). This was reinforced by the Auditor General, who qualified the Whole of Government Accounts (WGA) produced by the UK Treasury due to the decision to *exclude* RBS and Lloyds from consolidation, saying it did not consistently apply its own policies and did not meet IFRS standards (Office, 2012).

The analyses draw upon data between October 2008 and March 2014. Data was sourced from State participants, shown in table 1, as well as LBG and RBS. Data was collected concurrently with the events. There were four overarching themes to the collection:

- The relationship between the Banks and the State
- Updates, analyses and responses to the targets set out by the original intervention into RBS and LBG;
- Management communication with markets regarding business performance and State ownership; and
- Remuneration in the banking industry and bonuses in particular.

The theoretical frameworks were utilised in a sequential process to analyse the impact of Government ownership on RBS and LBG. PRT was utilised first under the broad themes of consequences of public ownership; monitoring of managers; targets and negotiation of property rights. These were informed via the analysis of PRT literature. The predictive

nature of the model allowed theoretical insights to be compared against the actual events occurring in the banks. Likewise, key themes from agency theory literature and empirical banking studies were utilised to analyse the data from RBS, LBG and the main State interests in Table 1. The key themes included principals and block ownership; agent behaviour and incentives; and market influences.

Documents were closely read and pertinent items extracted for analysis in Excel. The analysis was an iterative process as events continued to develop and was informed by the literature from the theoretical frameworks, particularly those which considered the banking industry in greater detail. The next section discusses the key findings of the analysis.

**Table 1: The Main State Participants in RBS and LBG Ownership**

BODIES	MAJOR GROUPS/ NATURE OF INTEREST IN THE BANKS	INFLUENTIAL INDIVIDUALS
Government	Labour (to May 2010)	Alistair Darling
	Coalition Cons/ Lib Dem (May 2010 – Sept 2014)	Gordon Brown David Cameron George Osborne Vincent Cable
Opposition	Cons/Lib Dem (to May 2010); Labour (May 2010 – 2012)	As above
Select Committees	Treasury Select Committee: Financial Crisis Inquiry	John McFall MP
Bank of England	Credit Guarantee Scheme	Mervyn King (Governor to July 2013)
	Quantitative Easing	Mark Carney (From July 2013)
	Monetary Policy – Interest Rates	
	Funding for Lending Scheme	
	Customer Charter	
	From April 2013: Prudential Regulation Authority responsible for UK financial stability	
Financial Services Authority/ Financial Conduct Authority (from April 2013)	Ultimate authority to deem banks able to be 'deposit taking institutions'.	
External Auditors	External Audit	
HM Treasury	Investor in the failed banks	
UK Financial Investments Ltd	Independent agency running the State shareholding in the banks	
National Audit Office	Government auditor	

# **Quasi-Nationalisation as a Rescue Mechanism: A Property Rights Analysis**

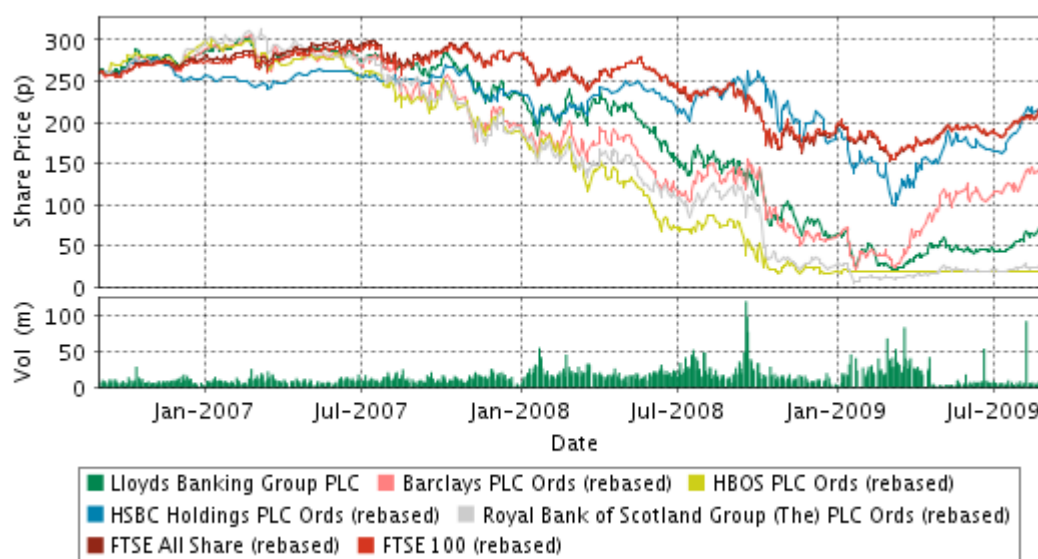
An analysis of quasi-nationalisation using PRT demonstrates its success as an immediate response to systemic distress during 2008. The following in depth analysis is structured as follows. The first part looks at the failure of the supposedly more rigorous checks of the private sector. The next section considers the lending conditions imposed by the State and how these have been interpreted differently over time as property rights are renegotiated. The final section considers the dispersed responsibility for UK economic health to a wider range of banking corporations.

## ***The Failure of Private Sector Scrutiny: Markets and Auditors***

The private sector monitors corporations through financial, audit and market information. PRT advocates that there is little incentive to monitor the efficiency of State owned corporations through these mechanisms because the individual benefits from doing so are negligible. The State is therefore left to monitor publicly owned entities/bodies on behalf of citizens. This is of concern because the efficiency and effectiveness of State monitoring in the UK has been problematic (Ashworth, 1991, Jenkins, 2004, Zahariadis, 1999). Private sector resources, however, are arguably utilised more efficiently due to the more challenging and extensive monitoring system they operate within (Alchian and Demsetz 1973; Alchian 1974). Yet, in the UK, the more regarded private monitoring systems failed to anticipate the banking crisis. The following section considers the share market and the auditors of the big banks.

Figure 1 shows the largest UK FTSE banks' share prices from September 2006 to September 2009. LBG and RBS accepted State Intervention in October 2008. Under the strong form of efficient markets hypothesis (Malkiel & Fama, 1970) all relevant market information would be incorporated into the share price of the banks, including potential crises. Figure 1 shows that UK bank share prices only started to decline after the subprime crisis began in August 2007. The crash pre-dated the major decline in bank share prices, suggesting prices reacted to events in financial markets, rather than anticipating them.

**Figure 1: Banking Industry Share Prices: August 2006 – August 2009**



Source: (Lloyds Banking Group, 2013)

Share price crashes are an enduring feature of economic crises (Kindleberger & Aliber, 2005) and may be responded to with regulatory change (Carnegie & O'Connell, 2014). Whilst this may place crashes in a cycle of banking failures globally and across time (Laeven & Valencia, 2008), it also suggests a persistent flaw in monitoring.



Private property rights may be enhanced by the quality of auditor information received (Iossa & Legros, 2004). Yet auditor information has been unresponsive to the banking crisis. The audit reports did not identify any issues with the going concern of the UK banks prior to 2008. Table 1 below shows the audit report outcomes for the banking industry since 2002.

**Table 1: Audit Report Outcomes for the Largest Listed UK Banks**

Bank/ <sup>2</sup> Years	RBS	LBG/ Lloyds TSB	HBOS <sup>3</sup>	Barclays	HSBC
<b>2002 - 2012</b>	Unqualified	Unqualified	Unqualified	Unqualified	Unqualified
<b>2013<sup>4</sup></b>	Unqualified	Unqualified	Unqualified	Unqualified	Unqualified

The audit reports of the largest UK banks are silent on the subject of the financial crisis. Yet continued support of the State was necessary to retain RBS and LBG as solvent trading entities. A significant uncertainty which may impact on the going concern assumption may often result in an *emphasis of matter* paragraph in the report (Financial Reporting Council, 2013). In this case, the auditors have neither referred to the significant uncertainty nor the need for Government support. The appointed auditors relied on Government representations to assess the going concern for RBS in 2008 (House of Lords Select Committee on Economic Affairs, 2011) and there was a clear absence of professional scepticism within the profession (Banking Standards Inquiry, 2013). It is unknown whether there was regulatory pressure to provide these particular reports (Sikka, 2009). Nonetheless, the validity of this report remains tautological, with the main beneficiary

shareholder, the State, having its own reassurances forming the basis of the clean audit report.

Quasi-nationalisation helps to balance out the failures of the market monitoring preferred by PRT. The State is a beneficiary of private sector monitoring expertise (Alchian 1974). The markets are left to run as before without radical overhaul from the Government. Yet political intervention can still be justified through State ownership.

### ***Eroding Influence: Reinterpreting UK Lending Conditions***

PRT helps to explain the relatively weak impact that lending targets have had subsequent to the Government intervention. A key objective of quasi-nationalisation was a focus on customer support and borrowing through the economic downturn by promoting lending targets (National Audit Office 2010). The success of the lending targets is questionable as criticism has centred on the expense of borrowing experienced by SME customers. The banks responded to the poor performance on lending by reinterpreting the rationale for Government targets at the time of the 2008 rescue:

“All of the discussions I was involved in with the Treasury at the time were all about trying to smooth the path of economic adjustment. It was never about lending a particular sum; it was about trying to remove the panic factor of people being starved from credit improperly, which could have happened.” (House of Commons Treasury Committee, 2010a)

The targets are reinterpreted to consider establish the *availability* of credit rather than *lending* a set amount of money. Property rights are specified further to gain advantage (Libecap 1978). As the lending conditions are considered in the aftermath of the crisis, there are political incentives for the State to collaborate with the new interpretations (Riker

& Sened, 1991). Viewed positively, quasi-nationalisation helps the State and the banks to collaborate and change the dynamics of the targets over time conflict. Ultimately, however, the State has not been able to steer economic policy through ownership of RBS and LBG, although its *capacity* to intervene remains. Increased monitoring is necessary to give incentives to act in the interests of the State (Clarkson, 1972). Less pleasant jobs may be neglected when there is no profit incentive to carry them out (*ibid.*).

### ***Diffusing Targets to the Wider Banking Industry***

Whilst the State influence on the quasi-nationalised banks may be weaker than expected, the State intervention has successfully influenced the banking industry collective to assume further societal responsibility. In 2011, the wider banking industry agreed to lending goals for businesses under Project Merlin (2011). In this agreement, the UK banks, including those who have not received any Government capital, agreed to take collective responsibility for the lending targets originally given to RBS and LBG. Project Merlin also has been designed to provide stability for the banks in fulfilling their societal responsibilities (Project Merlin 2011).

From a PRT perspective, Project Merlin creates property rights from the previously common resource of responsible banking and financial stability. Commonly owned resources can result in inefficiency (Alchian and Demsetz 1973). The increasing delineation of aspects of property rights, such as stability, will help to encourage greater efficiency of the implicit support of the Government during all stages of the economic cycle (Barzel, 1997). Moreover, the banks become an efficient recipient of State Aid as responsibility for financial stability is diffused (Hainz & Hakenes, 2012).

Overall, property rights theory does give an important insight into the implications of quasi-nationalisation. Private sector attributes of monitoring and competitive pressures remain with the banks. Shifting dynamics of the banks' relationship to Government are enabled through arm's length management and reinterpretation of lending targets over time. Yet the State retains a capacity to intervene in areas of great public concern. Moreover, quasi-nationalisation has perhaps helped in diffusing societal responsibilities to the wider banking industry. Quasi-nationalisation has thus been an effective rescue instrument for RBS and LBG, but it has failed to enable change through ownership for lending targets and customer service. Agency theory, looked at next, considers this failure to enable further change in more detail.

## **Opportunity Lost? Quasi-Nationalisation as an Instrument of Reform**

Agency requires the existence of conflicts and the alignment of incentives to be considered (Jensen 1994). The first part of the analysis under Agency theory justifies the requirement of the State to monitor the companies closely in the face of market failure. Next the analysis demonstrates that principal and agents' interests are aligned on share price and privatisation. The State should thus be incentivising agents for achieving wider social goals of stability and fairness to customers. This remains problematic in the wake of major scandals.

### ***The Monitoring of the Markets***

The following section considers the unusual situation of quasi-nationalisation from an agency theory perspective. Depressed share prices and the market for takeovers have been

identified as mechanisms which prevent organisational inefficiencies occurring (Fama and Jensen 1983). However, the current market conditions mean that these two disciplinary effects will be suppressed. Agency theory predicts that mass selling of shares is a sign of discontented principals and would therefore be a moderating mechanism on agents' consumption of non-pecuniary benefits (*ibid.*). In this case, the mass sell-off of shares is the ultimate goal and thus the share price will not be a monitoring mechanism to prevent management inefficiency. Secondly, the possibility of takeovers for these banks in the current economic climate is particularly low especially given their large market share and the potential competition issues which could arise (UKFI, 2014a). The market is therefore not a strong regulating force for the quasi-nationalised banks.

Market discipline is further stifled by Government backing of the financial system. Deposit insurance schemes have previously been cited as raising moral hazard as the managers do not bear the consequences of the risk that they bear (Houston & James, 1995). Empirically, the effects of deposit insurance has been to decrease the impact of bank runs (Angkinand, 2009, Dell'Ariccia *et al.*, 2008) but it does also make them more likely to occur. In the UK, moral hazard is increased further by the use of State support designed to keep the banks solvent. Until State guarantees can be removed by regulation, moral hazard remains high (Banking Standards Inquiry 2013b).

Agency contracts demonstrate that there are risks of self interest in quasi-nationalisation. This is exacerbated by the muted market disciplines of takeovers and share prices which are available for other corporations.

## ***Interests Aligned on Share Price and Privatisation***

Agency theory points to the importance of the satisfactory share price and impending privatisation as the main motivator for both banks and the UK State. But the motivations for the top executives running LBG and RBS go beyond profit maximisation (Jensen and Meckling 1976) to the opportunity to significantly enhance their reputations (Fama, 1980) by overhauling the failed institutions. Success in this regard can be demonstrated by the sale of Government equity back to private investors. Moreover, share price is a pivotal measure of market confidence. Overall, then the share price of the company will be an area of keen interest for the banks' management.

For the principal, the UKFI is also looking to share price performance by seeking to 'implement an agenda to maximise value of shareholders' and to implement a strategy of disposing of its market investments (UKFI 2014). Again, this will be achieved through the shares in the bank being suitably attractive to investors.

The UK Government has sold a third of its original shareholding in LBG since 2013, at a price in excess of its original investment (HM Treasury 2014). However, RBS' immediate results horizon means that it remains unattractive to private investors (Banking Standards Inquiry, 2013). Nonetheless, there is an alignment of interests of share price and privatisation.

The findings of agency theory in this regard would thus point to the opportunity for the UKFI to incentivise the UK bank executives in other ways, since privatisation is already an aligned interest. Under the wider conditions of customer lending, service and remuneration, agency theory demonstrates that Government intervention has resulted in unintended consequences, which are explored further next.

## ***Incentives – Awarding and Refusing Bonuses***

At the heart of agency theory is the desire to align the interests of the agent with the principal (Jensen & Meckling, 1976). A large part of aligning interests is through the use of managerial incentives such as remuneration (Jensen, 1994). For the UK banking crisis, the nature and extent of bonuses has been a central topic of political debate. The coalition Government has continued to express their concerns about pay and remuneration (HM Treasury & Department for Business Innovation and Skills, 2012). However, the monitoring of the State may be self-serving, as there are no associated cash incentives with bureaucratic oversight (Shleifer & Vishny, 1997).

Yet this pro-active approach could be viewed as strength of monitoring for the banks formerly employed in excessive risk taking. For in a weakness of the separation of ownership and control, the shareholder is unable to monitor the *process* of remuneration and can only disagree with the remuneration proposals presented at the AGM (Broadbent, Dietrich, and Laughlin 1996). The UKFI has required RBS and LBG to lead the way in reforming remuneration policies, whilst at the same time being subject to established private sector scrutiny mechanisms (UKFI 2014). At RBS and LBG, bonuses were awarded to the top management executives within the confines of the new bonus regulations. However, ensuing media criticism meant that bonuses were waived by the CEOs. The RBS Board stated:

“ Stephen Hester subsequently decided to waive his bonus because the attention it received had become a damaging distraction for him and the Group...A balance is always required between minimising compensation costs, and so maximising profits in the current year, and protecting the

business from which future profits can flow. We have sought to strike this balance fairly while erring on the side of restraint, reflecting the nature of our ownership.” (RBS, 2012)

There are two interpretations of this bonus waiver under agency theory. If in the long term the managers are expecting greater rewards from constraint today (Fama, 1980) agency theory may explain the willingness of the CEOs in waiving their bonuses for the year. In other words, they will recoup the short term losses through more lucrative contracts in future years, with enhanced reputations for their work and high integrity.

An alternative mechanism for considering the bonus waiver under agency theory is offered through political constraints of pay (Jensen & Murphy, 1990). The large public pressure to constrain top level management pay is offered as an explanation for a lack of sensitivity between pay and performance of CEOs. It has been contended that the free market should determine pay to allow good performance to be rewarded, which also in turn pay for poor performance to be adjusted accordingly.

Quasi-nationalisation may help explain the award and waiver of bonuses. The banks continue to look willing to pay by fulfilling contractual promises and to retain a commercial orientation in their activities. Public pressure, however, can then punish the well paid CEOs, as representatives for the banking industry generally, forcing them to concede earned pay. Restraint on pay can be used to demonstrate austerity within the publicly owned banks. Ultimately, agency theory may offer an explanation for the incentive payments made by the quasi-nationalised banks, but the results of State intention regarding annual pay are disappointing. Despite the platitude of regulations, guidelines and public pressure, pay remains high in selected areas of banking (Arnold 2014).



## ***Opportunity Lost: Valuing Customers***

Private sector information asymmetry is increased in the banking industry because the businesses are so complex (Grove et al. 2011). The original rationale for Government investment in RBS and LBG was to enable liquidity in the real economy as well as maintain financial stability. Banks were encouraged to lend to individuals and small businesses but over time, lending to SMEs has been criticised. ~~Evidence points to restricted~~Bank of England data implies there have been restricted credit conditions for this consumer segment (Bank of England, 2011, Bank of England, 2012a, Bank of England, 2013). Further lending initiatives were implemented to stimulate lending, resting on the availability of cheaper credit from the central bank (Bank of England, 2012c). Under agency theory, this is an incentive for agents to pursue the policy of keeping credit affordable for smaller clients (Jensen 1994). It is the additional lending schemes which are cited as the contributory factor for credit spreads tightening for small corporations for the first time since 2004 (Bank of England, 2013). In contrast, the medium and large sectors spreads had fallen significantly over the same period (*ibid*, p5). Even with a direct financial impact on the banks, the large clients are being favoured over the smaller enterprises, as commercial imperatives are prioritised with State sanction to help increase share prices.

There are other indications that the banks have failed to prioritise customers. This is encapsulated in scandals such as LIBOR rigging (Financial Services Authority, 2013) and payment protection insurance (PPI). PPI was a highly profitable product, helping to subsidise the low or loss making margins being made on cheap credit but the PPI mis-selling scandal has ultimately required large scale provisions in LBG (Lloyds Banking, 2010, Lloyds Banking, 2011, Lloyds Banking, 2012).

An agency analysis finds that quasi-nationalisation of the banks has had relatively little effect as reformatory policy. The scale of equity ownership would have allowed the State to develop changes in business culture and practices of RBS and LBG. However, RBS assessed that there had been a focus on the de-risking of the bank in the immediate aftermath of the crisis and that the cultural attitudes of the bank took a back seat (Banking Standards Inquiry, 2013) . However, incentives remain largely focused on share price and profitability, and customers once again may experience unsatisfactory banking practices.

## **Concluding Remarks**

Using property rights and agency theory as analytical frameworks, quasi-nationalisation can viewed positively as a crisis response mechanism. It has achieved financial stability and increased social responsibility among the banking industry. However, quasi-nationalisation also represents a lost opportunity as the desire to promote lending in the economy and encourage better services for customers has not produced substantial results. There have been a number of difficult issues regarding customer service in terms of LIBOR; debt management and PPI. Further, there remains pressure to be an attractive commercial investment.

PRT generally revealed some advantages to quasi-nationalisation as a rescue mechanism. Where private monitoring in the banks was potentially deficient, the incentives to monitor a private corporation still apply in quasi-nationalisation. The audit reports of the key banks affected by the crisis were unchanged throughout the turbulence of failure and quasi-nationalisation. Property rights also gave some consideration to how the targets agreed at

upon intervention developed over time. Quasi-nationalisation allowed the State to respond to changing economic circumstances.

The analysis under agency theory challenged quasi-nationalisation as an effective instrument of reform. Market discipline was muted by the economic conditions post crisis and the monitoring of the banks' management would therefore be critical. Although there have been developments in both pay and lending requirements, banking pay remains high and access to affordable credit remains problematic. It therefore highlights the potential conflicts that the banks have had to manage, as quasi-nationalisation makes them accountable to the competing obligations of profitability and Government.

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<sup>1</sup> The Government entered a commitment not to exceed a proportion of 75% of ordinary listed shares. The investment exceeding this proportion is contained within alternative share classes and agreements. In total, the economic interest of the Government in the bank was 84%.

<sup>2</sup> Group Annual Report Opinions for UK Listing Purposes Only

<sup>3</sup> HBOS was delisted from the stock exchange following the LBG takeover in 2008. Subsequent audit reports are for the old HBOS group and have not been required to meet listing rules.

<sup>4</sup> There have been changes to the audit report for the banks in the year ended December 2013. Nonetheless, the opinion remains unqualified where information was available.