

A discussion of the implications for senior management when financial institutions move into the "public domain"¹

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This informal discussion note has been prepared by staff of the World Bank to stimulate discussion on an important topical issue. It is an informal discussion note and does not represent the official view of the World Bank or the Executive Directors

Summary

1. Since the last quarter of 2008, governments across the OECD have stepped in – with varying degrees of alacrity and (un)willingness – to expand the public’s stake in institutions at the commanding heights of international finance. The steps have been breathtaking. The Emergency Economic Stabilization Act in the USA, the UK Government’s credit guarantee scheme, and similar developments elsewhere have turned government into a lender of last resort (and sometimes the effective owner) of banks, brokerages, and even insurance firms.
2. The United States government has nationalized the mortgage guarantors Fannie Mae and Freddie Mac. The Treasury will take preferred equity stakes in the nation's largest banks, including Goldman Sachs, Morgan Stanley, J.P. Morgan, Bank of America, Citigroup, Wells Fargo & Co., Bank of New York Mellon and State Street. Meanwhile, the UK government has nationalized at least two banks and taken majority stakes in three others: Royal Bank of Scotland, Barclays and HSBC Holdings.
3. These issues may be increasingly relevant for Middle Income Countries outside of the OECD. For example, although there have not yet been massive failures in Latin America that have required the governments to take major stakes in private banks, it is expected that the government role will increase. In Brazil, the state-owned banks Banco do Brasil and Caixa Economica Federal (CEF) have been given a broad mandate which will allow them to buy stakes in banks, insurance companies and non-financial firms which need financial support. Credit lines through state banks or entities to support retail, housing, agriculture, and automotive sectors have been set up in a number of countries (Argentina, Chile, Mexico, Brazil, and Peru). New small and medium enterprise credit lines through state entities in Chile, Mexico, and Peru have also been announced.

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4. Some \$500 billion was invested in the financial systems of developed countries by the end of 2008, making governments the largest shareholders in most developed economies' financial industries ("Bank Bail-Outs: Quids Pro-Quo": 2008; "Rescue of Banks Hints at Nationalization": 2009).

5. History suggests that, if maintained for the longer term, such government action is unlikely to improve the performance of financial institutions (Demirgüç-Kunt and Servén: 2008), and this partial nationalization of the financial system is, we are told, only temporary. Still, among the numerous questions raised by these recent government actions, there are concerns regarding the potential disparity between the ethical expectations placed on agents of the private and public sectors. This note primarily considers the impact of public sector ethical traditions for remuneration practices in those organizations that have recently joined the public sector, although it concludes with some broader speculations about the ethical implications for their senior staff.

What does the public look for in public servant behavior?

6. Survey evidence suggests that the values held by staff of the public and private sectors are similar in most regards: incorruptibility, accountability and honesty all appear at the top of a list of the values most widely held in both sectors (van der Wal and Huberts: 2008). The most significant difference, not surprisingly, was that private sector staff saw profitability as a key value in a way that the public sector staff did not. While key values held by staff in the two sectors might be similar, the ethical principles – the rules or standards governing right conduct – are distinctly different in several respects. There are four key ethical principles applied in public sector employment that are not generally found in the private sector.

Principle i. Avoid conflicts of interest

7. All public servants are required to take particular care in relation to financial or personal interests that could bias, or be thought to bias, their decisions. Thus, they are constrained in the financial and economic interests that they can have, whether debts or assets; and they must abide by tight prescriptions on their affiliations with for-profit and non-profit organizations including political and even professional bodies. These restrictions often extend to members of their family or their household.

8. This is not to say that conflict of interest concerns are not found in the private sector - cutting favorable deals for one firm while employed by another is grounds for dismissal or worse. However, for the private sector concern for the best interests of the company and shareholders is the principal responsibility of all employees, while in the context of multiple principals and densely overlapping regulations, conflict of interest situations in the public sector can be distinctively complex, affecting every area of employment. Use of the 'revolving door', with public servants receiving lucrative contracts shortly after their departure from public sector employment is a particular concern.² In the US, action to prevent public servants using the revolving door is somewhat in contrast to the somewhat lax standards that allow rapid changes of roles between lobbyists and the Congress. However, persistent concerns remain, most notably in relation to rapid movement between Pentagon staff and military contractors ("Defense

² See: (OECD: 1998, 2003a, b, 2008a, b)

Contracting: Post-Government Employment of Former DoD Officials Needs Greater Transparency": 2008).³

Principle ii. Be impartial, generally

9. Most public servants are required to set out facts and relevant issues objectively for policy making purposes, and to correct any uncovered errors as soon as possible. This means that information and advice provided to political superiors should be submitted on the basis of the evidence, and must present the options accurately – not ignoring inconvenient facts or relevant considerations when providing advice or making decisions.

10. There is a wrinkle here concerning political advisors, whose essential purpose often is to present one side of a case. In OECD countries the number of such positions is relatively small.

Principle iii. Make your working life available for public scrutiny

11. In the public sector, the higher the position, the more transparency is called for. Declarations of personal and family assets are increasingly sought from senior public servants (either to identify and resolve potential conflicts of interest or as a means to deter illicit enrichment in public office). For obvious reasons these asset declarations are required most commonly in sensitive sectors such as tax and custom administrations.

Principle iv. Above all, recognize that your behavior should provide an ethical example to others

12. In general, public servants are held to a higher ethical standard than most private sector employees. Public servants are expected not only to obey the law, but also to avoid even the appearance of impropriety.

How are standards of public service conduct enforced?

13. The public service of OECD countries is more varied than it was just a few years ago, with different managerial approaches and incentives, and differing rates of pay in different agencies. In response to a fear of an erosion of public sector ethics in this more disaggregated government service, there has been an attempt to replace or reinforce the historically unwritten rules with explicit codes of ethics and conduct. The result is that now almost all OECD countries have produced a document that states the standards of behavior expected of public servants. More than two-thirds of OECD countries have underpinned these standards with a legal framework; and many have supplementary guidelines for specific groups or professions in addition to the general standards applicable to all public servants. All OECD countries sanction corrupt behavior by public officials. The second most frequently criminalized type of misconduct committed by public officials is partiality in official decision-making and abuse of office or public trust. Disclosure of income and assets is increasingly common (OECD: 2000).

14. As it is impossible for statutes and codes to anticipate every eventuality, in Anglo-Commonwealth countries such as the U.K., Australia, New Zealand and Canada there has been some movement further upstream towards articulating preferred core values for public office

³ Under current US law, government officials who make contracting decisions must either wait a year before joining a military contractor or, if they want to switch immediately, must start in an affiliate or division unrelated to their government work.

holders in what has become known as a "principles-based approach". Rules and procedures play a complementary role.

15. To encourage compliance with ethical standards in virtually all OECD countries, there is some legislative branch review of public service activities. Other forms of scrutiny range from external independent investigation by an Ombudsman or Inspector General, to specific judicial or ethics reviews. Reporting misconduct is required or encouraged by law in the majority of OECD countries, and this has driven an array of whistle-blowing arrangements, providing safeguards such as legal protection and anonymity. Citizen complaint procedures are, similarly, being beefed up.

How is public servant pay impacted by these ethical standards?

16. Translating the ethical principles into practice has three implications for public service pay, and compensation more broadly.⁴ First, public servants are generally not involved individually in their own pay determination. Compensation levels are seen as something that should be driven by standard rules concerning the level of responsibility of the post and, increasingly, the quality of performance. Individual negotiations generally have no part to play in such dispassionate and rule-based approaches, except perhaps for some marginal "negotiation" within an established pay band.

17. Second, pay in the public sector is not just a question of what is right or fair for the individual. Compensation levels are a key aspect of public confidence in government. Put starkly, if the public thinks that public service pay is significantly too high, then, generally speaking, it is. The public's view on this is very often shaped by the perceived comparability between different economic sectors.⁵

18. Third, there is a greater degree of pay transparency expected (or demanded) of the public sector. This is certainly not the same as placing the full compensation details of all public servants on a public website. (Such a move caused outrage across Italy in May 2008 when the outgoing government published details of all its citizens' declared earnings and tax contributions on the internet.) However, pressure to increase pay transparency is mounting in many countries, not least as a consequence of various forms of legislation that seek to monitor and avoid public sector discrimination based on gender, disability, or race etc. The usual compromise is that while individual pay is not published, there is public reporting of the pay scales available for public servant positions, and the potential room for maneuver in terms of performance and other bonuses.

19. One particular implication of the transparency requirement is that there tends to be little connection between the pay of senior managers and government officials serving on boards of public corporations and the performance of these corporations. This is likely because introducing a significant performance element would introduce uncertainty, and hence some opacity, into the pay-setting arrangements. For public servants on such boards, remuneration and promotion

⁴ These principles were, broadly, endorsed by an informal on-line survey of 30 senior public servants and academics undertaken by the World Bank and CAPAM in March and April 2009 (see <http://go.worldbank.org/1O8DA7J0H0>). The first and third principles were very strongly supported, with more caveats expressed concerning the second.

⁵ The distinctive naivety of the CEOs of the auto companies in using corporate jets to fly to Congressional hearings in Washington in November 2008 seeking a bailout was rather striking to public servants who are more tightly wired to public opinion.

depend on the assessment of their superiors in the administration, which may at best be very weakly correlated with their performance as board members (Robinett: 2006).

Who are public servants?

20. While this might seem a fairly simple, straightforward question, the answer generally proves to be quite tricky in practice. The rise of more complex forms of service delivery in recent years has made the boundaries of the public sector harder to pin down. Over the last three decades there has been a trend to introduce market mechanisms into the public sector, particularly in the provision of services in social sectors. A key driving force behind this phenomenon is the need for governments to secure improved cost efficiency in their operations. But this trend has been promoted by both sides, as the private sector has also sought to work more closely with the public sector. Meanwhile, in some cases, services that were traditionally offered by the private sector have been taken over by the public sector.⁶

21. There are some rather obvious components of the public sector – ministries and departments in central government, for example – and it is not hard to see that schools and hospitals that are largely funded and controlled by central government should be considered as part of the public sector, even if they are not legally owned by government. But what about other private sector bodies and activities that are publicly funded to some degree? And even more perplexingly, what about private bodies that have a distinctive and legally protected market position, and thus whose revenues rest squarely on the favoritism that is shown to them by the state?

22. In the midst of this complexity lies a wide and deep “messy middle” between the polar extremes of fully government-financed programs administered through hierarchical government departments and pure private sector provision of services to the public. The full “*public domain*” is not really determined by simple measures of ownership or funding – although they constitute key questions (OECD: 2006). Institutions are in the public domain if they meet any of the following criteria which demonstrate their significance to public policy:

- They are effectively controlled by government regardless of funding; or
- Their public funding (however indirect) comprises more than 50 percent of their total revenue; or
- They have a distinctive and statutorily privileged market position.

23. In practice, these criteria delimit all the bodies whose contingent liabilities government will cover and, in the event of major operational failure, whose debts they will underwrite. The public domain comprises the organizations, or parts of organizations, whose activities are underpinned by an implicit guarantee from the government. The workers in the public domain are, under this broad definition, public servants. This group has expanded significantly in the recent expansion of the public domain as governments have responded to the international financial crisis.

⁶ In the area of service provision, the key instruments include outsourcing (contracting out), public-private partnerships (PPPs), and vouchers. Some examples of the new entrants to the public sector include, in Germany, private providers of training who are funded by public sector vouchers, issued by public caseworkers to job-seekers. In many countries, apparently fully private hospitals have also joined the new public sector since they are, in reality, funded almost entirely through social security funding. In the UK, the private operators of prisons are providing services that are fully funded by government and would undoubtedly be underwritten in the event of a major operational failure. In Sweden, the majority of publicly-funded residential care facilities for children are now in private institutions.

Implications for the financial institutions that have entered the public domain

24. The farthest reaches of the "public domain" are arguably not as fully covered by the ethical and other principles outlined above as the traditional core civil service ministries and departments.⁷ However, state-owned enterprises (SOEs) as hybrid public-private institutions have existed for many years and provide some evidence that if an organization is in the public domain, then public sector ethical principles must apply. While SOE board members have traditionally been held accountable for the enterprise's performance such as generating profits, avoid generating losses or expanding service coverage, they and their staff have also been held to the same ethical standards as public servants. Literature on corporate governance of SOEs indicates that the ethical expectations for their board members and staff should aim to combine both the private and public worlds – linking the principles outlined above with the ethical standards required in any private sector firm to make it credible and trustworthy in its day-to-day operations and in relation to its long-term commitments. Many comment that SOE boards require stronger ethical standards because of the pressure they may face given the interactions of business considerations with political and public policy ones (OECD: 2005; Robinett: 2006).

25. The impact of these public sector ethical standards on SOEs can be seen most starkly when the constraint that they provide is lifted. Chief executives in the UK's 12 regional electricity distribution companies (SOEs) were increased by 200% in the two years following privatization in 1990. The increases were not attributable to improvements in managerial talent as privatization brought few changes in senior staff. Equally, the salary increases did not correlate with changes in the size of the companies or their stock-market returns or other measures of performance. The increases were, however, highly correlated with the companies' potential profits (Wolfram: 1998).

26. Other heterogeneous public sector entities like regulatory bodies or autonomous agencies that have more in common with the private sector labor market have also observed the ethical expectations set by the core public sector (Manning and Shepherd: 2009).

27. For the new entrants to the public domain, both lawmakers and citizens recognize that there are several ethical areas that need urgent attention, most notably compensation. The issue of pay in these entities, particularly for senior staff, has become a significant political issue, with public anger over excessive executive pay drawing attention to the issue of equitable pay in the new public domain.

28. The US Congress tried to tackle the pay issue for the new members of the public domain in September 2008 in the bill that authorized a financial industry rescue.⁸ But corporate governance experts reported that the bill's pay provisions, which focus primarily on golden parachutes that executives often pocket upon a change in corporate control, are too weak and too narrow in scope to significantly change pay practices. The Treasury Department, which received broad authority from Congress to dictate the terms of assistance granted to financial firms under the emergency rescue plan, forced American International Group to freeze the size of its bonus

⁷ For instance, pay transparency among the government-contracted private sector providers of prisons in the UK is far less developed than in the public sector. However, pressure is growing and it appears highly probable that the degree of transparency will soon grow.

⁸ See ("Treasury Announces Executive Compensation Rules under the Emergency Economic Stabilization Act": 2008)

pool for 70 senior executives as a condition of a \$40 billion capital infusion.⁹ At the same time, AIG was planning to pay \$503 million in deferred compensation to some senior employees, warning they might otherwise leave the firm (thus demonstrating the thorny nature of this particular problem and the many loopholes that still exist).¹⁰ Johnson Associates, a compensation consulting firm, predicts annual incentive pay for senior executives will have fallen at least 60 percent in 2008 at investment banks, and by 55 percent or more at commercial banks (Landy: 2008).¹¹

29. Most recently, the Obama Administration proposed on February 4 new compensation rules for financial executives. The rules limit annual executive salary to \$500,000 per year and require companies to disclose executive compensation goals, prohibit “golden parachute” awards, and instruct corporate boards to approve expenses for non-essential services. Similar measures are being discussed in the UK for the Royal Bank of Scotland, with state shareholding of 70 percent. The European Commission, which has approved billions in state aid for European Banks since last summer, welcomed Obama's decision although it announced that it remains up to individual countries to decide on limits to bankers' pay. While in France and Norway the governments prohibited bonuses for employees of the banks receiving aid, in Germany, Denmark, Ireland, the Netherlands and Spain banks themselves are moving to limit rewards.¹²

30. As the significance of the changes to the financial sector becomes clear, it is possible that three key developments in relation to remuneration for senior members of staff of these new entrants to the public domain will emerge. First, a more dispassionate process for pay determination for senior staff – one in which they demonstrably have little personal part to play is a distinct possibility. Second, there will very probably be some movement towards levels of pay that the public find acceptable. Third, the underlying basis for individual pay decisions (the scales and the comparators that were used) are very likely to be made more public.¹³

31. Recent developments might also catalyze the emergence of codes of ethics and of conduct that deter conflicts of interest, not least in rotating in and out of public sector employment; an emphasis on impartiality and facts rather than narrow performance pay-enhancing decisions or politically influenced granting of credits; new forms of scrutiny including declarations of personal and family assets and a dramatic reduction in vendor perks and other gifts; and, maybe in our lifetime, some recognition that they too must act as an ethical example to other, less fortunate sectors of the economy that do not have the blessing of a government guarantee to their operations.

⁹ AIG is currently receiving loans, not a capital infusion - although at the time of writing there was informed discussion of converting the loans to equity purchases if necessary.

¹⁰ The Treasury Department has not taken significant action to curb pay at the banks being bailed out, not wanting to discourage healthier firms from accepting bailout money. However, the Department has barred financial firms that receive capital infusions from deducting from their taxes any executive compensation exceeding \$500,000 per individual. However, companies that are losing money will, of course, not be paying taxes anyway.

¹¹ (Demirgüç-Kunt et al: 2008), drawing on (Honohan: 2009) suggests that banks in receipt of public funding should suspend all dividend payments and restrict the compensation plans for their senior managers until the government is fully “bought out.”

¹² See (Hannon: 2009; Macdonald and Muñoz: 2009; Saltmarsh: 2009)

¹³ A recent on-line survey of senior public servants and academics (see footnote 4) confirmed a strong feeling amongst this group that the principles applying to core public sector staff should also apply to the wider public domain.

32. One frontier issue that remains to be scrutinized in depth concerns lobbying practices in the pursuit of enhanced budgets. Lobbying by public servants to maximize their budgets is hardly unknown¹⁴ – and thus even the imposition of core public sector ethical standards on the recently nationalized or bailed out financial institutions is unlikely to provide a simple remedy to the much maligned practice of using public funds to hire lobbyists to get more.

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¹⁴ This reality is recognized by most public servants – even if it is somewhat overstated by the public choice literature. See (Goldfarb: 2008) for recent discussion of this.

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