

# research newsletter

## The Governance and Regulation of Financial Institutions: Lessons from the Crisis

### Introduction

Governments have injected or pledged trillions of euros, dollars and pounds to rescue financial institutions. While these institutions are rebuilding their balance sheets and governments are considering exit strategies, international regulatory reform is slowly coming under way. The European Commission has launched consultations on deposit guarantee schemes and an EU framework for cross-border crisis management in the banking sector, covering early intervention, forced restructuring and insolvency (COM(2009) 561 final). Proposals on remuneration in the banking sector have been bundled with the revision of capital rules (SEC(2009) 974 and 975 final).

Under the Spanish EU Presidency this has been followed by a European Commission consultation on the equity corporate governance of banks and internal control. The UK Government has already announced that it will implement the reforms of bank pay and governance proposed by Sir David Walker. Jointly these proposals will have a profound effect on incentives and corporate governance in the banking industry.

In this context, the European Corporate Governance Institute, the Centre for Economic Policy Research (CEPR) and the IESE Business School organised an academic conference in Madrid on 16th June 2010 to bring together the latest academic research on corporate governance and regulation and some of the best researchers to shed light on what went wrong in the corporate governance of banks, in their structure and scope and in their regulation.

The conference built upon three earlier events organised by the ECGI, namely:

- **Corporate Governance Standards and Financial Stability**, a Transatlantic Corporate Governance (TCGD) conference hosted in Brussels by the European Commission in September 2008 (*see [www.ecgi.org/tcgd/2008/programme.php](http://www.ecgi.org/tcgd/2008/programme.php)*)
- **The New Role of Government in Corporate Governance**, a second TCGD conference hosted in Washington D.C. by the Securities and Exchange Commission in September 2009 (*see [www.ecgi.org/tcgd/2009/programme.php](http://www.ecgi.org/tcgd/2009/programme.php) and ECGI's Research Newsletter VOLUME 7 / WINTER 2009*)

- **Beyond the Crisis – New Challenges for Corporate Governance**, a conference hosted in Stockholm under the auspices of the Swedish Presidency of the EU in December 2009 (*see [www.ecgi.org/presidency/programme/2009\\_stockholm\\_programme.php](http://www.ecgi.org/presidency/programme/2009_stockholm_programme.php)*)

This newsletter presents digests of the eight academic papers that were presented and discussed at the Madrid conference. It also features highlights from a keynote conference speech by Clifford Chance Partner, Michael Bray.

For further details on the conference, see [www.ecgi.org/presidency/madrid2010/programme.php](http://www.ecgi.org/presidency/madrid2010/programme.php)


[www.fee.be](http://www.fee.be)

The ECGI is extremely grateful to the Fédération des Experts Comptables Européens (FEE), the representative organisation for the accountancy profession in Europe, for kindly agreeing to sponsor this Research Newsletter in recognition of the valuable work they believe the ECGI is undertaking.

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### Research digest

*Eight research papers presented at the conference in Madrid are reviewed by our contributing editor, Richard Smerdon. This digest pulls out some of the key strands from the papers which can be downloaded from the SSRN website.*

## **Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms**

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*(ECGI Law Working Paper No.130/2009 – download from [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1448118](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1448118))*



*Peter Muelbert*

Poor corporate governance of the banks has increasingly been acknowledged as an important cause of the recent financial crisis despite the stringent prudential regulation of their capital and risk. Because it is felt that the economics and functions of banks differ from those of industrial firms a number of proposals and ideas for improvements of corporate governance in the banking sector are bank specific. But as the issues of risk management and compliance have become important in the general corporate governance debate, it is possible that good corporate governance of banks shows the way forward for good corporate governance in general. This paper examines the diverging usage of the term corporate governance in the context of banks; identifies previous work on banks' corporate governance and describes the extent to which recent turbulence on the financial markets has been attributed to deficient corporate governance practices; outlines what is special about banks compared to a generic firm; explores the consequences flowing from these issues in a principal agent approach; describes supervisors' ideas and concepts for a good corporate governance of banks; presents the results of local studies of the (un) importance of banks' corporate governance for

the financial crisis and outlines the numerous reforms already implemented or underway.

### ***Concepts of corporate governance***

Among several current definitions of corporate governance, the Basel Committee on Banking Supervision Guidance defines corporate governance as *"the manner in which the business and affairs of banks are governed by the board of directors and senior management which, inter alia, affects how they set corporate objectives, operate the bank's business on a day-to-day basis, meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders, align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations and protect the interests of depositors."*

### ***The rising interest in banks' corporate governance***

Even before the current banking crisis there had been a significant increase in research into the corporate governance of banks after the Asian banking crisis in 1997. Notable among the promoters of work on this subject were the Swiss Banking Supervisory Authority, the World Bank Group, the International Finance Corporation and the Basel Committee.

However, apart from the issue of remuneration, the topic of banking corporate governance was not widely discussed during the first year of the banking crisis.

During the second year there was considerably more discussion of banking corporate governance, started by the OECD, taken up by EU Commissioner McCreevy and then in greater detail by Sir David Walker in the UK who was commissioned to write an independent review of banking corporate governance. Theoretical and empirical studies followed.

### ***Banks' corporate governance: Theory***

Banks differ substantially from commercial businesses in several important respects: first, stringent prudential regulation relating to liquidity risk and management; secondly, banks are highly leveraged institutions; thirdly, the balance sheets of banks are considerably more opaque than other commercial organisations. It is therefore difficult to assess the riskiness of banks, and hence Basel II increased the disclosure requirements with a view to promoting market discipline; fourthly, the substantial amount of business done with other banks, a greater degree of interconnectedness, means that competitors are therefore business partners as well and therefore pose a major counterparty risk. Contagion is also highly

important issue; fifthly, the holding of derivatives and embedded options changes sharply the risk profile; sixthly, banks are subject to creditor runs; and finally, banks are heavily regulated and supervised entities simply because of their fundamental importance and their vulnerability.

Accordingly regulators and supervisors have tried to limit the banks risk-adjusted total exposure to an arbitrary multiple of its capital. This can however be manipulated, raising doubts as to the efficiency of the concept.

Agency theory provides a suitable framework for a more detailed analysis of these problems. The author analyses the different types of agents, agency conflicts and solutions to these conflicts in general before taking up the implications for banks in particular. The paper in this context identifies the different perspectives of shareholders, depositors and other debt holders, and supervisors. Under the heading of the supervisors' perspective, the paper examines the financial stability concerns of supervisors and the work of the Basel Committee on Banking Supervision to enhance corporate governance. In summary, it is the board which has to take into account the interests of depositors, not just those of shareholders. The focus of the Basel paper is very much on the duties of the board and individual board members. From the supervisors' perspective, the purpose of banks' corporate governance is therefore less to safeguard the integrity of the promises made by corporations to investors and more to safeguard the promises made to depositors and other debt holders. EU law and banking regulation supports that approach.

A distinction is therefore to be made between 'debt holder governance' and 'equity governance.' Thus, the interests of shareholders and supervisors are not fully aligned.

#### ***Banks' corporate governance after the financial crisis: evidence and reforms***

The empirical evidence so far does not provide strong support for the argument that the banking crisis was essentially a failure in governance. Risk management has attracted most interest in the debate. The board itself may not be the best manager of risk simply because of lack of specialist skills. The key lesson, the paper argues, seems to be for banks to appoint an independent chief risk officer at the highest level of top management who has direct reporting access to the board or to the risk committee or audit committee if such exists. The individual must possess the authority and standing to impress the importance

of sound risk management practice throughout the organisation.

In relation to the board, a high proportion of independent directors does not appear to affect performance. However, the financial industry expertise of the chairman is positively related to bank performance. The Walker review also recommends more stringent qualifications from independent directors in terms of knowledge, expertise, experience and character. It also suggests a more active role for the Financial Services Authority.

It is still 'open to debate' whether remuneration structures of banks were a possible cause of the crisis. Empirical studies do not find any correlation between remuneration structures and risk. However, the existence of highly publicised remuneration packages does not rule out the possibility that decisions of senior executives were in fact influenced by their remuneration packages. The paper identifies and analyses a number of remuneration reform initiatives both before and after the G20 Pittsburgh Summit.

#### ***Dampening banks' risk appetite by corporate law mechanisms?***

In theory, requiring a bank to act in the interests of depositors/other debt-holders, could be achieved in either or both of two ways: incorporating these interests into a bank's corporate objective by law, or stipulating a fiduciary duty of directors to depositors. The evidence so far, in particular from German listed banks, does not suggest that the first of these possibilities will be effective.

As to the second, the paper argues that the use of the 'business judgment rule' reflects the particular problems that face a director taking an entrepreneurial decision on risk and is a better risk management tool than imposing a specific fiduciary duty to depositors.

#### ***Conclusions***

The paper concludes with the tentative view that although governance of both banking and other commercial entities could benefit from improved rules in relation to internal control systems and risk management practices, nevertheless because of the particular characteristics of banks, banks' corporate governance should not provide the generalised way forward for corporate governance.

## Market freedom and the global recession

*Domenico Giannone, Professor, Université Libre de Bruxelles-ECARES and CEPR, Michele Lenza, European Central Bank and Lucrezia Reichlin, London Business School and CEPR*

*(ECGI Finance Working Paper No. 288/2010 - download from [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1623862](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1623862))*



*Domenico Giannone*

The paper analyses in particular the relationship between 'credit market freedom' within the broader indicators of market risk such as governance, political instability and quality of regulation and asks 'Have more liberalized markets fared better in the global recession?'

There are a number of factors which require detailed analysis before it is possible to arrive at an answer to this question. First it is not clear that credit market liberalisation helps shelter countries from cyclical shocks; second, although the presence of 'foreign' banks in a country can be a stabilising force when shocks are global, foreign banks have little advantage over local banks in helping resilience. In addition, liberalisation of credit markets has an 'ambiguous effect' on banks' performance and competitiveness which, in turn, may affect resilience to cyclical shocks.

The authors first study the effect of rating and regulatory quality in the labour, business and credit sectors, using a number of indices. Separately, the study looks at indicators of financial and trade openness, financial development, soundness of the banking sectors and macroeconomic influences. The paper then analyses the joint significance of these

rating variables and controls by using Bayesian Model Averaging. Finally, the paper considers single components of the indicators and provides additional robustness checks.

Having conducted these different analyses the paper concludes:

- liberalisation in credit markets (judged by regulatory quality) appears to have a negative effect on countries' resilience to the recent recession as measured by output growth in 2008 and 2009;
- positive variables linked to resilience are income level, the current account but not other "openness indicators", banks' claims as a percentage of deposits, and various indicators of financial depth as well as labour market regulations;
- other negative variables in relation to resilience are net interest margins and overhead costs in the banking sector;
- it appears that deregulated markets are more vulnerable to volatility, but the mechanisms are not fully understood although the literature appears to suggest that more deregulated markets are more prone to risk-taking behaviour;
- more work now needs to be done to understand the link between financial liberalisation and vulnerability to cyclical shocks.

## Boards of Banks Around the World

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*(download from [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1620551](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1620551))*

This paper undertakes a large sample investigation of the characteristics of boards of banks around the world. Two goals are in mind: the first is to provide the most comprehensive and detailed analysis to date of the determinants of bank board characteristics. The second is to assess the extent to which regulation can affect bank board structure and composition.

The paper analyses four board/director characteristics: director independence, board size, financial expertise, and 'director busyness.' The main variable of interest is board independence which the paper measures by the fraction of directors without significant employment and business relations with the firm and its executives. The authors expected firm characteristics and country

Daniel Ferreira



characteristics to be important determinants of board independence, and, in relation to banks, direct or indirect regulation of board composition is an additional reason for countries to matter for board independence.

The study required a reliable and meaningful measure of board independence. The authors were able to construct a reliable measure because they have data on the employment histories of bank directors, as well as a comprehensive record of fees paid to banks by their corporate clients. Using this self-reported classification as their starting point, the authors construct a new independence variable by adjusting each director's status to take into account both prior work experience within the same firm and client relationships in case the outside director represents a firm that has a significant commercial relationship with the bank. Employee representatives are also considered non-independent.

It is demonstrated that bank board independence increases over time in the pre-crisis period of 2000 to 2006 with the largest increases occurring around 2002 to 2003 for US banks, and with a one-year delay for banks outside the US. Independent directors now hold an overwhelming majority on the boards of US banks, but independent directors are still in the minority in other parts of the world.

On average, US banks have board independence levels 19 percentage points higher than those of non-US banks. For each country the authors compute its 'independence gap' as the difference between its average bank board independence and those of matching US banks.

Thus countries materially matter for bank board

independence. Why? Laws, regulations and institutions can either complement or substitute for internal governance. In addition, direct and indirect regulation of bank board appointments can explain why bank board independence varies so much across countries. The authors consider three sets of country-specific variables: board regulations, proxies for financial and economic development, and legal-environment variables.

Findings from the data show that banks have less independent boards in countries where courts have the right to remove bank directors. Put another way, bank board independence is higher in countries where courts cannot remove bank directors and in countries that require one-tiered boards. There is also strong evidence that banks in countries with mandatory one-tiered structures have boards that are on average more independent. The authors also find that countries with higher levels of per capita GDP have banks with more independent boards. However financial development and investor protection do not lead to greater board independence.

With regard to the other three board characteristics, firm size is very important; larger banks have larger boards, busier directors, and more directors with banking experience. Secondly, regulation also appears to affect the variables identified above; countries with 'empowered' courts have larger boards and less busy directors. Country characteristics matter relatively less for these variables than they do for board independence.

The paper also analyses the effect of countries on board independence. While countries such as the US and Canada display levels of bank board independence at about 74%, countries such as Spain, Sweden and the UK have independence levels in the 40-50% range. Countries such as Argentina, Denmark and France are in the 10-30% range. It is acknowledged that these numbers are difficult to interpret because country effects cannot be estimated with much precision. Differences in bank characteristics across countries may explain much of the cross-country variation in board independence. The study therefore formulates a matching procedure in which non-US banks are matched with US banks that have similar observable characteristics.

Five bank characteristics are used in the matching procedure: assets, sales growth, market to book, return on assets, and leverage. For each non-US bank, the authors define the matching bank as the US bank whose propensity score is the closest to that of the non-US bank.

The difference between the average of the country independence levels and those in the matching sample is called 'the independence gap'.

By using the matching formula, the differences in board independence between US and non-US banks are reduced. In all but four cases, matching makes non-US bank boards appear relatively more independent. For example, in the case of Italy, Italian banks display average board independence of 33%, which implies an independence gap of 41% if benchmarked against the average of US banks. The matching approach however suggests that Italian banks are more similar to those US banks that have on average 39% of independent directors. Thus, once bank characteristics are taken into account, Italian banks appear to have levels of board independence roughly comparable to those in the US.

The second finding is that, despite the overall reduction in the differences between US and non-US banks, there is still much cross-country variation in bank board independence. Only Canada appears to have a substantial edge over the U.S. In Canada, boards are more independent than those in similar US banks by 41 percentage points. Examples of other countries are given in the paper. A third important finding is that, overall, most countries display an independence deficit with respect to the US. Australia, Canada, India and Puerto Rico are exceptions.

The final lesson from the analysis is the importance of adjusting self-reported board independence levels for misreporting.

To summarise, when estimating the effects of countries on bank board independence, it is important to take bank characteristics into account and to adjust self-reported independence levels for the presence of client-directors and other misclassification problems. Once those issues are considered, the measured independence gap between US and non-US banks falls substantially, but it is still quite large at about 19%.

How is the variation in bank board structure as between countries versus firm characteristics explained? The authors formulate a methodology to address this issue. The results suggest that while bank characteristics can explain little of the observed variation in board independence, country-specific characteristics account for a surprisingly high fraction of that variation.

A question also addressed is whether the same applies to other important characteristics of board structures, namely, board size, the number of directorships held

by outside directors and the percentage of outside directors with banking experience. The results seem to suggest that bank characteristics seem to matter more and countries seem to matter less for board size relative to what is found in board independence regressions. The findings also suggest that bank size is positively associated with board size, while none of the other bank variables display statistically precise relations with board size. Thus, bank size seems to be the most important driver of board size. The authors conclude that countries matter relatively less for other board characteristics than they do for board independence. Board size is mostly determined by bank size. Countries seem to matter more in explaining outside director 'busyness', but not as much as they do for board independence. Neither country characteristics nor observed bank characteristics are good predictors of the level of banking industry experience of outside directors.

The authors also address the question of which country characteristics affect bank board structures. The results suggest that countries have a substantial influence on bank board structure and that their importance is disproportionately higher for independence than they are for other board characteristics. There may be a relationship between board independence and countries with more developed capital markets. Other possible explanations are differences in business practices, and differences in laws and regulations. Models were developed to enable the authors to address and test these issues.

As a result, the authors found no evidence that bank board independence is chosen so that it complements external governance at the national level. In contrast they find direct evidence that bank board independence is related to board regulations that vary across countries. The magnitude of these effects is "substantial". Thus the tentative conclusion is drawn that laws and regulations that are specifically targeted to board structures can partly explain the large 'country effect' on bank board independence.

The paper also concludes that countries matter so much for bank board independence in part because there are some board regulations that vary across countries. These regulations seem to have an important effect on bank board independence, but somewhat relatively less so on board size, director busyness, and director banking expertise. For these latter characteristics, country effects are relatively less important.

If regulation is an important determinant of board independence, one may wonder whether board

composition in banks is set optimally. Although there is no empirical design that can satisfactorily address this issue, it is possible to investigate the link (if any) between bank characteristics and board structures in more detail. The paper formulates a model to address this question.

### **Host's Dilemma: Rethinking EU Banking Regulation in Light of the global crisis**

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*(ECGI Finance Working Paper No 286/2010 - download from [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1631940](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1631940))*



Home country regulation and supervision based on agreed prudential standards has become the core principle in the design of regulatory structures (The 'Basel Concordat'). Under this principle, in the case of financial regulation in the EU, if a financial intermediary that has been duly licensed in one member state offers financial services and establishes branch offices in other member states, no additional regulatory approval is required in the host state. The paper questions the soundness of this principle as the primary means for governing interdependent financial markets. It draws on the lessons from the global financial crisis which has exposed the vulnerability of host countries' financial systems to regulatory abstinence by home countries of transnationally operating financial groups.

The author advocates that existing arrangements with their bias in favour of host country regulators and a strong focus on entity based regulation be supplemented with effect-based jurisdiction.

Effect-based jurisdiction would allow countries to regulate financial intermediaries that have a material effect on their domestic financial markets irrespective of their domicile.

The paper discusses the limitations of home-host country regulatory division of labour in the light of the global crisis. It develops the principles of effect based regulation and assesses its likely impact on inter-regulatory cooperation, drawing from experience with other regulatory regimes that accommodate multiple overlapping jurisdictions. It also analyses the scope for effect based jurisdiction within existing EU law and offers some critique of proposals for reforming the EU financial regulatory system currently under discussion.

In the analysis of the limitations of home-host country regulatory regimes, it is suggested, firstly, that the allocation of regulatory jurisdiction that is tied to a particular form of intermediation - banking - is incomplete. It also suggests that host country control over subsidiaries is effectively undermined by the ease with which transnational financial groups can side-step regulatory controls imposed on one vehicle (banks) by channelling capital to other vehicles (leasing companies) or by engaging in direct lending activities to customers in foreign markets. Secondly, it ignores the potential for conflicts of interest between host and home country regulators as their risk exposure to the activities of these banks diverges. In addition, the strategy is oblivious to the fact that in a highly interdependent financial system, contagion can spread from anywhere (i.e. parent or subsidiary, home or host country) throughout the entire system.

The standard solution to these problems is the centralisation of regulatory powers – supra-national regulators that undertake to supervise financial groups operating in more than one country.

The paper analyses the supposed benefits and disadvantages of centralisation. One possible advantage of centralisation is said to be the avoidance of 'a race to the bottom', whereby several host countries in competition with each other seek to attract foreign capital by lowering regulatory standards.

Two conclusions follow from the analysis. First, centralisation does not resolve all conflicting interests between home and host countries, customers and financial service providers etc. Second, the benefits of centralisation do not necessarily outweigh the costs of a decentralised system with partially overlapping jurisdictions that pursue different regulatory goals. While standardisation may reduce the costs for firms

in the initial stages, the total costs of incomplete regulation and bail-out may far exceed the benefits. Moreover centralisation tends to come at the expense of information.

As an alternative to centralised regulation at the global level, the paper offers the alternative of devolving regulatory powers to (multiple) local agents. The paper advocates this solution on grounds of efficacy, not least through recognising the costs of regulatory failure in a financial crisis which are born by three sectors: ordinary people who lose their savings, taxpayers and multilateral organisations such as the IMF.

Risk exposure is determined not merely by the domicile of an entity but by a system's exposure to systemic risk. So, the bias in favour of home country regulation (Basel Concordat as well as the EU regulatory regime) is out dated.

This calls for an effect-based allocation of regulatory responsibilities. A domestic regulator should have jurisdiction over practices of financial intermediaries that have a material effect on the stability of their home markets irrespective of the nature of the entity that undertakes these actions and whether or not the entity is domiciled within their jurisdiction and whether or not the action is taken domestically or abroad. Effect-based jurisdiction should complement, and not replace, entity-based home country regulation.

The paper deals with the objections to this proposition, for instance the imposition of excessive regulatory burdens and undermining rather than fostering cooperation among regulators.

The author also discusses the legality of effect-based regulation in the EU, and finds that the scope for effect-based extraterritorial jurisdiction under existing EU law is limited to financial intermediaries and/or services not covered by directives such as DCI 2006. In fact, the current trend for EU legislation is to embrace increased centralisation, for example the current proposals for the European Banking Authority- "this structure does not bode well for resolving Host's Dilemma."

The paper concludes that the key problem with existing regime is the misallocation of regulatory powers given the distribution of risk and ultimately costs. Unfortunately, current reform proposals further entrench the voice of home country regulators in EU institutions.

### **Bank CEO Incentives and the Credit Crisis**

Rüdiger Fahlenbrach, Ecole Polytechnique Fédérale de Lausanne and René Stulz, Ohio State University, NBER and ECGI Fellow

*(ECGI Finance Working Paper No. 256/2009  
– download from [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1439859](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439859))*



The paper demonstrates, based on the evidence, that the lack of alignment of bank CEO incentives with shareholder interests cannot be blamed for the credit crisis or for the performance of banks during the crisis.

The view commonly adopted during and after the recent banking crisis was that a significant factor in causing the crisis was the method by which chief executives were compensated. It was argued that there was little or no alignment between compensation and long-term performance. And yet, the received view of commentators was that "stock ownership provides the most direct link between shareholder and CEO wealth".

The authors suggest that the results of their research show that there is no evidence that banks with a better alignment of CEOs' interests with those of their shareholders had higher stock returns during the crisis. Indeed there is some evidence that banks led by CEOs with better alignment had worse stock returns and a worse return on equity.

Though options have been blamed for leading to excessive risk-taking, there is no evidence in the sample researched by the authors that greater sensitivity of CEOs to stock volatility led to worst stock returns

during the credit crisis. No evidence was found that bank returns were lower if CEOs had higher cash bonuses.

Criticisms of the incentives to CEOs have been that they concentrated on the short run, they incentivise the taking of more risks than would have been optimal to shareholders. The high leverage of financial institutions implies that CEOs can increase the value of their shares by increasing the volatility of the assets since the shares are effectively options on the value of the assets. The received wisdom has been that large holdings of equity by CEOs would lead to focus on the long run, to avoid some risks that might be profitable to shareholders, and to avoid excessive leverage.

The study found that bank CEOs had substantial wealth invested in their banks. For example, for the median CEO, the value of stock and options in his portfolio was more than 8 times the value of his total compensation in 2006. Consequently, changes in his bank's stock price could easily wipe out all of a CEO's annual compensation. The large holdings of vested unexercised options are striking. They are not consistent with the view that the typical CEO knew that there was a substantial risk of a crash in the stock price of his bank.

The evidence suggests that CEOs took exposures that they felt were profitable for their shareholders ex ante but that these exposures performed very poorly ex post.

The study looked at 54 banks that received TARP funding and found that there is no statistically significant difference in relation between dollar equity incentives and returns in the sub samples of TARP and non-TARP recipients.

The study also looked to the insider trading of bank CEOs in 2007 to 2008. It found no evidence that CEOs 'traded out' of their positions. They had to bear the losses associated with the poor outcomes of the exposures their banks had at the end of 2006. The evidence of CEO trading of shares in 2007 and 2008 is consistent with the hypothesis that the crisis and its evolution were unexpected by bank top executives and is also inconsistent with the hypothesis that CEOs focused knowingly and suboptimally on the short term.

The literature on this subject shows, amongst other things, that:

- the share of pay in the form of stock and options for bank CEOs is lower than in other industries
- the financial industry has relatively more highly compensated individuals than the non-financial industry

- deregulation has led to greater pay-for-performance sensitivity of CEO pay at banks
- asset volatility is higher for banks that grant more options, but at the same time these banks have less leverage, showing that the effects of option grants on bank policies are complex
- greater pay for performance sensitivity may lead to more systemic risk, indicating that there may be a conflict between shareholder wealth maximisation and financial stability
- there is possibly a moral hazard problem induced by the existence of deposit insurance priced in a way that does not reflect the risks taken on by individual banks
- leverage should reduce the pay-for-performance sensitivity of bank CEOs compared to other CEOs because of monitoring by debt holders: accordingly bank CEOs have lower pay-for-performance sensitivity than other CEOs.
- it is possible to develop a model in which it is optimal for the FDIC (Federal Deposit Insurance Corporation) to set insurance premiums taking into account the compensation contract of the bank's CEO.

Further findings resulting from this research are as follows:

- the relative measure of the importance of equity incentives, the value of total equity portfolio divided by the total annual compensation is much smaller for non-CEO executives than for CEOs. These results suggest that cash bonuses are more important for non-CEO executives
- it is possible to design methods of measuring long-term performance using a mix of stock returns, return on assets and return on equity (defined in the paper) building in selected regressions
- the relation between the executive incentives and the performance of sample banks is driven by the incentives of the CEO
- there is no evidence that incentives in TARP firms had a different effect on the ROA or the ROE than incentives in non-TARP firms.
- in searching for insider deals by CEOs of sample banks the authors do not find a single hedging transaction
- when the search was expanded to all bank insiders between January 2007 and December 2008 less than 10 transactions were found, mostly prepaid variable forward contracts by non-executive directors.

### Conclusions

Whether one looks at depository banks only or at a larger sample that includes investment banks, there is no evidence that banks with CEOs whose incentives were less well aligned with the interests of their shareholders performed worse during the crisis. Evidence was found that banks where CEOs had better incentives in terms of the dollar value of their stake performed significantly worse than banks where CEOs had poorer incentives. Neither cash bonus nor stock options had an adverse effect on bank performance during the crisis.

A possible explanation is that CEOs with better incentives to maximise shareholder wealth took risks that other CEOs did not. These risks looked profitable at the time to shareholders. In fact these risks had unexpected poor outcomes. However these poor outcomes are not evidence of CEOs acting in their own interest at the expense of shareholder wealth. On average CEOs in the sample taken for the purposes of the study lost at least \$30 million and the median CEO loss was more than \$5 million.

### Wages of failure: executive compensation at Bear Stearns and Lehman 2000-2008

Lucian Bebchuk, Harvard Law School, NBER and ECGI Fellow, Alma Cohen, Tel-Aviv University, Harvard Law School and NBER and Holger Spamann, Harvard Law School (*ECGI Finance Working Paper No. 287/2010* – [download from papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1513522](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1513522))



Holger Spamann

*This paper was presented at the Madrid conference by Holger Spamann together with the next paper in this Digest under the combined title of "On Bankers' Pay and Risk-Taking".*

In contrast to what has been commonly assumed thus far in relation to the stories of Lehman Brothers and Bear Stearns, the top executives of those two firms were not financially devastated by their management of the firms during 2000 to 2008. They were able to cash out large amounts of performance-based compensation, both from bonuses and from share sales, during the years preceding the firm's collapse. This cashed out performance-based compensation was large enough to make up the losses on the executives initial holdings at the beginning of the period. As a result, the executives' net payoffs from their leadership of the firms dealing 2000 to 2008 "were decidedly positive."

The authors discuss the implications of this analysis for understanding the possible role that pay arrangements have played in the run-up to the financial crisis and how they should be reformed going forward.

The narrative of the financial disasters of these two houses has led observers to infer that risk-taking decisions made by the firms' top executives (ultimately leading to the firms' demise) must have been due to failure to perceive risks. The paper finds that the standard narrative's assumed fact is incorrect. During the period 2000 to 2008, the top executives were able to pocket large amounts of performance-based compensation (\$1.4 billion Bear Stearns and \$1 billion Lehman Brothers respectively from cash bonuses and equity sales during 2000 to 2008).

The paper introduces the teams of top executives whose compensation is analysed. During the period under review, the composition of the top five executives' team remained largely stable at both houses. The shareholder payoffs these teams produced were indisputably poor since shareholders who held their shares throughout the period lost most of their initial investment.

The paper also discusses the large paper losses on shares suffered by the top teams when their firms collapsed, losses on which the 'standard narrative' focuses. These losses did not tell the full picture. To get the full picture, it is necessary to calculate what they cashed out during these years as well as what they had to begin with.

The paper then examines the cash bonus compensation the top executives took out during the period. Although the financial deterioration in 2007 led Bear Stearns to stop paying bonuses and Lehman to reduce them, the executives had already pocketed in five years large amounts of cash bonus compensation. The firms' pay arrangements allowed the executives to keep all paid bonus compensation.

No amounts were clawed back. Accordingly, the paper examines what the executives obtained from cashing out shares and options during 2000 to 2008. Contrary to the standard narrative, the executives regularly took large amounts of money 'off the table' by offloading shares and options.

The authors say that their analysis does not support the view that executives' losses from the firms' collapse imply that they could not have had incentives to take excessive risks. The fact that the executives chose not to sell all of their holdings indicates that they did not anticipate the firms' 2008 collapse. Even though the executives had incentives to take excessive risks, their decisions might have been driven by a failure to recognise risks, and thus might not have been affected by the incentives. However, given the structure of executives' payoffs, the possibility that risk-taking decisions were influenced by incentives cannot be dismissed, but rather, must be taken seriously.

The paper concludes by advocating the potential value of reforms that tie executive payoffs to long-term results more effectively and eliminate or curtail executives' ability to benefit from short-term results.

### **Regulating Bankers' Pay**

Lucian A. Bebchuk, Harvard University - Harvard Law School; National Bureau of Economic Research (NBER) and ECGI Fellow and Holger Spamann, Lecturer on Law and Executive Director, Program on Corporate Governance, Harvard Law School

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*This paper was presented at the Madrid conference by Holger Spamann together with the previous paper in this Digest under the combined title of "On Bankers' Pay and Risk-Taking".*

There is widespread concern that executive compensation arrangements could have encouraged excessive risk-taking, and that fixing these arrangements will be important in preventing such excesses in future. The paper asks what has been wrong with bank executives pay, how should it be fixed, and is there a reason for government intervention.

The paper offers three contributions. First, key features of executive compensation arrangements that have provided the bank executives with excessive risk-taking are identified. Enabling executives to cash a large amount of equity-based and bonus compensation before the long-term consequences of decisions are realised has resulted in executives with incentives to focus excessively on short-term results and to give insufficient weight to the consequences that risk-

taking would have for long-term shareholder value. The paper however identifies a distinct and separate problem: executive pay has been tied to highly levered bets on the value of bank's assets, giving executives little incentive to take into account the losses that the risk-taking could impose on preferred shareholders, bondholders, depositors and tax payers.

The second contribution of the paper is to show the limits of corporate governance reforms for eliminating excessive risk taking incentives. Concerns about excessive risk-taking in banks have led legislators and regulators to adopt, or propose, various corporate governance measures aimed at improving pay setting processes and better aligning pay arrangements with the interests of shareholders. Although such measures can discourage some inefficient risk-taking that is undesirable from shareholders perspectives, they cannot be relied on to eliminate the incentives for excessive risk-taking that the paper identifies and analyses. Shareholders in financial firms do not have an incentive to take into account the losses that risks can impose on preferred shareholders, bondholders, depositors, taxpayers, underwriting government guarantees of deposits, and the economy.

The third contribution is to develop a 'normative' foundation and a framework of analysis for making regulation of executive pay in banks and important element of financial regulation. Governments around the world are now seriously considering such pay regulation, for example the FSA in the UK. The authors put forward a case for such regulations and provide a conceptual framework for developing them. The paper discusses what such regulations should include and how they can best complement and reinforce the traditional forms of financial regulation.

### **Yesterday's Heroes: Compensation and Creative Risk-Taking**

Ing-Haw Cheng, University of Michigan (Ross), Harrison Hong, Princeton University and NBER and Jose Scheinkman, Princeton University and NBER

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Although the paper specifically emphasises the lack of causal statements in the analysis, it appears that there is important dissimilarity ('heterogeneity') across financial firms in risk-taking, and that this is correlated with persistent compensation practices.

The recent banking crisis has given rise to critical observations by politicians and commentators to the effect that creative risk-taking contributed in some

institutions to the vulnerability of financial firms. As a consequence, reforms have been suggested to tie pay to long-term performance and increase the say of shareholders in approving compensation and electing directors on compensation committees.



Implicit in these reforms is the view that commercial firms' short-termist incentives reflect mis-governance or entrenchment and a misalignment with shareholder interest.

There is a large amount of literature on the contrasting perspectives of the source of short-termism and risk-taking in markets. The paper draws a few hypotheses from this literature. The first relates to the 'familiar' view of mis-governance and entrenchment; the second draws a parallel between banks like Bear Stearns and dot-com stocks and growth options (in which overconfident investors incentivise otherwise long-run value maximising managers to make investments and take risks in subprime derivatives built from financial engineering). The third is the 'cowboy culture' story in which Bear Stearns has risk-taking in its genes and shareholders who like such firms select to be their shareholders. These three hypotheses yield different predictions.

The data is taken from financial firm executive compensation and risk-taking from 1992 to 2008. The measure of 'short-termism' taken by the paper is the residual of total annual firm compensation (payouts to top executives) controlling for firm size and finance sub-industry specifications. This measure differs from the more traditional measure of incentives, namely, inside ownership. Recent work indicates that inside ownership does not have much predictive power for risk-taking and that executives of finance firms tend

to have high values of ownership stakes to begin with. The authors take the view that the measure chosen by them has more explanatory power for risk-taking.

The empirical design splits the sample into two periods, an early period defined as from 1992 up to 2000, which marks the end of the dot.com era, and a late period from 2001 to 2008 which marks the beginning and end of the housing boom. After that, various risk-taking measures are calculated for the early and late periods respectively, comprising firstly, a price based on measures including firm Beta and return volatility; and the late period computation of the sensitivity of the firm's stock price to be the ABX subprime index, and secondly, consisting of accounting-based measures including the average holdings of mortgage-backed securities not backed by one of the government-sponsored entities and book leverage. The baseline analysis is to regress the risk-taking measures on the lagged residual CEO compensation (1992 to 1994) measure along with other firm characteristics. Similarly risk-taking measures are calculated for the period of 2001 to 2008 and then regressed on the residual compensation measures constructed from 1998 to 2000.

The findings were as follows:

- There is substantial cross-sectional dissimilarity ('heterogeneity') in the permanent component of residual executive compensation. For example, Bear Stearns, Lehman and AIG have persistently high residual compensation. JP Morgan, Goldman Sachs and Wells Fargo have low or moderate residual compensation. The authors interpret heterogeneity of their residual compensation measure as being due to permanent cross-firm differences.
- The residual compensation measure is strongly correlated in both sub-samples with the stated price-based measures of subsequent risk taking. The data suggests there is a lot of "measurement error" in the risk measures to begin with. Firms with high residual compensation are more likely to be in the tails of performance, with extremely good performance in the early period when the market did well and extremely poor performance in the late period when the market did poorly.

The authors ask whether their results are due to mis-governance or entrenchment as opposed to heterogeneity among investors who want to invest in high risk-taking firms and hence need to set compensation appropriately to induce such behaviour. Standard governance measures and measures of

entrenchment, as well as board independence, are not correlated with the results of the paper. If anything, the worst governance score firms are associated with less risk-taking. There is no evidence of mis-governance using these standard metrics for misalignment of interest between shareholders and management.

The paper attempts to distinguish between the 'quant bubble' and 'cowboy culture' alternatives. The quant bubble 'story' predicts that Bear Stearns with high residual compensation is like a dot.com stock and hence should have high valuations as say measured by market-to-book. But this is qualified by the observation that standard metrics like market-to-book are typically poor measures of finance firm valuations.

The author's findings suggest that certain firms have more of a culture of high-powered incentives and risk-taking and that investors with heterogeneous preferences invest into these different firms. Dismissal pressure for failure to meet quarterly targets seems to be a more powerful motivator than other incentives.

### Conclusions

The paper's analysis suggests a beginning at least in terms of being able to quantify the issue of risk-taking and compensation. It also suggests that deeper research into the nature of implicit incentives, peer effects and organizational structure might bear fruit in so far as understanding risk-taking by finance firms. One indication coming out of the paper's analysis is the vital role of competition among finance firms and the extent to which competition led to excessive risk taking. *"Further work along these lines is likely to yield considerable insights."*

## An historical perspective and the way ahead

*Edited highlights from the keynote speech delivered at the conference by Michael Bray, a Partner at Clifford Chance, London.*

Michael Bray is a Partner in the London office of leading international law firm, Clifford Chance. He addressed the academic delegates to the conference from the perspective of a banking lawyer of nearly 40 years experience. In this capacity, he had seen London develop into a very significant international financial market and he had acted for some of the world's largest banks. He acknowledged to his audience that in relation to the banking crisis, there had not been much meaningful communication between the academic and the practitioner.

Six months ago, together with his colleague from the Frankfurt office of Clifford Chance, Daniela Weber-Rey, he was charged by his firm to undertake



thought-leadership on governance and regulatory reform in the financial sector. Describing three round table meetings that he has hosted in Frankfurt, Zurich and London: *"They have been attended by high-level practitioners - CEOs from major international banks, very senior chief risk officers (CROs), senior non-executive directors, macro-economists and regulators. There were, of course, a few lawyers as well!"*

His aim in his address to the conference was to share some of the concerns that were raised at these meetings. *"The fundamental issue is how do we reform financial markets in a way which is both going to restore confidence and support sustainable economic growth, with all the financing and liquidity that that requires? It is not about punishing banks and bankers. It's not about preventing a recurrence of the last crisis."* He reminded his audience what J.K. Galbraith said back in 1954, writing about the '29 crash. *"There will surely be another crisis. It will be different, and whatever regulation we put in place today, it isn't going to stop it."*

He felt that in the three years since the crisis started and almost two years since the infamous 'Lehmann weekend', there had been very little apparent progress. At the outset politicians worked well with banks and regulators and put in place unprecedented emergency measures involving trillions of taxpayers' money. *"The system was stabilised and disaster was averted, but co-operation didn't really last that long."*

He believed that politicians on both sides of the Atlantic are taking an increasingly parochial approach and are paying too little attention to the global and borderless way in which financial markets operate. *"The line has become blurred between the real causes of financial crisis and the myths that have grown up and become associated with it. The public has become accustomed to the financial sector being accused of encouraging a culture of greed and irresponsibility. Descriptions such as casino banking, and banks too big to fail conjure up images of reckless executives making 'win or lose all' bets."*

With all of that taxpayers' money being thrown at the problem, the reaction of the public is understandable *"but we have to move on,"* he asserted. Of course, banks are in part the authors of their own failure, and there has been no collective acknowledgement of responsibility on their part. But the truth is really much more complex. Most people now recognise that the crisis was actually due to a collective intellectual failure on the part of a huge number of people.

The responsibility for the crisis has its roots among a whole range of issues, not least the macro-economic policies which are set by the politicians to drive the direction of the markets. If macro-economic policy encourages everybody to own their own home, markets being incredibly efficient will find ways to try to channel cash to those who want to buy their houses.

Crucial to the success of any programme of reform is the need to understand the real causes of the crisis, to address the systemic causes and to recognise the need for a progressive international process to restore confidence in the markets and to strengthen infrastructure. *"The global economy needs a financial system that is predicated on encouraging prudent risk. That's what it's there to do. Banks are there to take risk but it has got to be managed prudently, and there's got to be effective governance. Above all, we have to restore society's confidence in the banks."*

In order to do this, there needs to be a change of collective mindset. There needs to be a constructive and a more collaborative forward-looking approach if markets are to sustain economic growth. *"The attitude that prevails now is somewhat confrontational, backward-looking and increasingly parochial. It ignores the global nature of the financial markets."*

Michael believes that two of the key roles in the financial sector are the provision of liquidity in the form of medium and long-term finance which growing economies need a lot of, and the facilitation

of recycling of the financial surpluses that have built up because of the continuing transfer of wealth. *"A lot of this is tied up to the transfer of wealth from West to East. Trade imbalances are a fact of economic life. Markets depend on the surpluses being put back into circulation. In a global market where foreign exchange barriers have been virtually eliminated, market efficiency will naturally identify where the cash is needed, and it will find a way to channel it there, subject to restraints and preferences of macro-economic policy."*

Taking an historical perspective, he reminded the audience that in the 1970s, Middle East oil producing states chose to place their petrodollar surpluses on a short-term deposit with international banks. Around 200 banks flocked into London, largely to win some of this business. It was left to the banks to convert those short-term deposits into medium-term loans to the developing world. These loans were usually then made to sovereign states or to companies with the benefit of state guarantee, in the belief of course, that a sovereign state could not become insolvent. *"However we know that that belief was somewhat mistaken, and the loans duly gave rise to a sovereign debt crisis and that led to multiple defaults and debt restructuring. If the accounting policies of that time had required the loans to be marked to market, many of the world's leading banks would have faced a solvency crisis that would have been no less extreme than the one that occurred in 2008."*

*"As it was, co-ordinated action by central banks resulted in the development of a risk matrix which allowed the banks to incur their loans on the basis of a level playing field. In time, they were able to rebuild their capital base. Basel I came about as a direct consequence of that crisis. The Basel Committee introduced the 8% capital requirement for banks, and the direct consequence of that was that it constrained the amount of on-balance-sheet lending the banks could undertake. And it increased the cost of it to the borrowing community."*

As the world emerged from recession in the 90s, an increased appetite for loans to the developed and developing world, coupled with a natural aversion by governments to issue more state guarantees, placed a lot of new pressure on the financial system. This led to the search for a model that would allow banks to originate loans to meet that demand, and then to distribute those loans and their related risk, within the financial sector, to capital markets and to communities of investors, who were comfortable with the risk and return ratio. The benefit of this process,

known as the Originate-to-Distribute Model, was that it freed up bank balance sheets for further lending.

*"The Originate-to-Distribute Model relied heavily on securitisation techniques and we certainly need the securitisation market to come back. An appetite for risk, or the lack of it, was and it still continues to be, an essential liquidity factor. For example, if you take a company in China sitting on a large dollar surplus, it is unlikely that it would want to use those funds to make loans directly to, say, an infrastructure company in Peru. The financial markets have to find ways to access the cash, and direct it to where it's needed by a route and a series of transactions, not least derivative transactions, that allow the risks to reside with the different communities of risk takers and investors who are most comfortable with it."*

During the same period, there was the historical divide between commercial banking and securities activity under the provisions of the Glass-Steagall Act. This was only dismantled after a lot of debate. The arguments put forward then for the removal of these artificial barriers are still relevant in today's world where the financial system is no longer defined by geographic barriers. There are only these pools of liquidity that have built up in different parts of the world, and the search for a model that allows these pools of liquidity to join up and circulate with the risks and returns split among different communities of investors is entirely logical.

*"What happened was entirely logical and actually was essential for the smooth running of the global economy. And I still think that financing economic growth is a powerful argument in favour of global banks with the power to originate and to underwrite securities, and the maturity to understand how to manage risk effectively. The challenge therefore, in my view, is how we continue to refine the model, rather than re-impose a series of Glass-Steagall barriers that limit excessively the ability of the banks to take on the risks in the first place."*

*"We know that the Originate-to-Distribute Model was flawed in several ways. It was flawed at the point of origination. It was flawed at the point of structuring the financial products which were offered to the market, because they were over-complex. And it was flawed at the point of distribution because of the use of SIVs and other off-balance-sheet vehicles which ultimately had to be brought back on-balance-sheet. But it doesn't mean that the model was itself fundamentally misconceived. It is unfortunate that it has been demonised by its association with casino banking. It would in my view, be a mistake to give up*

*on it, despite all its flaws. The goal should be to revise the model without sacrificing the benefits."*

This is the real problem that requires dispassionate analysis and a refusal to succumb to knee-jerk reactions. How does one go about rebuilding the model? In truth, markets can generally be trusted to deliver efficiency. The global economy needs strong and dynamic markets. That means strong and dynamic banks. The basic proposition that a wide dispersal of risk across the market is healthy and should reduce the impact of systemic shock remains very true.

*"The problem is that the increased capital and liquidity requirements with which the banks will have to comply as part of the prevailing response to the crisis are much more far-reaching than Basel I, and rightly so. But they will inevitably constrain the amount of on-balance-sheet lending which they can make available. They're going to drive the banks to revisit their business models and, in time, push the market back to some form of Originate-to-Distribute Model. This presents a lot of challenges for policy makers and for regulators."*

*"We expect politicians to set direction. That's what they're there for. They are accountable to the public. But they then need to stand back a bit, and let the regulators and the banks craft the detailed changes that are required to correct the flaws in the model. Policy makers should focus on getting the macro-economic policies right and putting in place a system of regulation at the macro level."*

*"Based on my experience as a practitioner, it is crucial to safeguard the entire programme of reform from being undermined by the threat of regulatory arbitrage. The chance of securing international consensus is a huge challenge in itself, as the G20 process has illustrated. Basel I and Basel II took an enormous amount of time to negotiate and put in place. The changes we now need to rebuild confidence are much more ambitious and more difficult to implement. For now I think, any new regulation has to focus on further improving the corporate governance and the risk management regimes in the financial sector."*

The conclusion he drew from the three round tables was that there was much activity within banks to overhaul risk management systems and to give the chief risk officer the appropriate status and accountability to the Board. Banks were also implementing many of the recommendations in the Walker report.

Looking ahead, he suggested that there was still a need for better rules to address the capital liquidity requirements. Greater transparency was needed. Standardisation and a central clearing derivatives market were essential.

Disclosure requirements, restricting proprietary trading, improving rating processes and the use of off-balance-sheet vehicles – there was a huge amount to be done. *“But unless the details are worked out in a measured and a collaborative way, the consequences could well be regulatory overkill, and a big shortage of market liquidity.”*

He ended his speech by addressing the issue of regulation and regulators. *“There is an awful lot of*

*talk about layers of regulation and the possibility of overbearing regulation. Regulation is only as good as the regulators we have. The challenge is to put in place a system with regulators who have the necessary quality to look for and see what is actually happening and who will intervene at the right level. But to get the right sort of people for the job, we are going to have to pay them a great deal of money and then train them in a different mindset.”*



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**C L I F F O R D  
C H A N C E**



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## EU Presidency conferences on European Company Law and Corporate Governance

The conference series 'European Company Law and Corporate Governance Conferences' was launched at a full-day public conference in The Hague in 2004 during the Dutch EU Presidency. In subsequent years, conferences have been held in several countries during their respective EU Presidencies. Information about these conferences, if still available, can be found on various websites. The ECGI has collated documents into a single repository for the first time for the convenience of scholars, practitioners and policy-makers alike – see [www.ecgi.org/presidency/index.php](http://www.ecgi.org/presidency/index.php)

The conferences in this series so far have been:

- the Inaugural Conference in The Hague on 18 October 2004;
- the 2nd Conference in Luxembourg on 28 June 2005;
- the 3rd Conference in London on 14 November 2005;
- the 4th Conference in Helsinki on 5 October 2006;
- the 5th Conference in Berlin on 27-28 June 2007;
- the 6th Conference in Lisbon on 17 October 2007;
- the 7th Conference in Paris on 16-17 October 2008;
- the 8th Conference in Stockholm on 2-3 December 2009.

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