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Corporate governance and the new Financial Regulation: Complements or Substitutes?

Introduction

This, the ninth edition of the ECGI Research Newsletter, focuses on *Corporate governance and the new Financial Regulation: Complements or Substitutes?* and draws much of its material from the seventh conference in the Transatlantic Corporate Governance Dialogue (TCGD) series which was held in Brussels in October 2010.

A central theme in the outpouring of analysis on the causes of the global financial crisis is that large financial institutions created substantial amounts of systemic risk, which then was realized and nearly brought down the global financial system. Put in terms of corporate governance, two possibilities emerge. The management of large financial institutions was disloyal to shareholders, the agents taking more risk than their principals desired, perhaps encouraged by highly incentivised compensation schemes. Alternatively, management loyally took on excessive risk, benefitting the shareholders and externalising the costs to the public.

The first possibility suggests a traditional corporate governance response focusing on shareholders rights, in addition to reform of prudential regulation. The second possibility suggests greater emphasis on regulation, but with the possibility that the corporate governance system could be redesigned to internalise more systemic risk and to provide better protection for creditors. In both cases there is a need for a stronger resolution authority. What is the role of corporate governance in financial system reform? Are corporate governance and the new Financial Regulation complements or substitutes? If complements, how do we design their interaction?

Speakers at the TCGD Conference addressed many of these points. Their words are summarised in the conference report which starts below. Those wishing to watch a video of the Conference proceedings or download speaker presentations should go to ***http://www.ecgi.org/tcgd/2010/video/index.php***. This Newsletter concludes with a viewpoint on the topic by Emmanuelle Henniaux and Wendy Reed from PricewaterhouseCoopers

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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.

In this edition

Transatlantic Corporate Governance Dialogue Conference

*The seventh in the Transatlantic Corporate Governance Dialogue series of conferences was held on 25th October 2010 at Bibliotheque Solvay, Brussels. See **www.tcgd.org** for background to this series and details of earlier conferences.*

The banking crisis has moved into a new phase in which it is possible to look back at the origins of the crisis and attempt to analyse some elements of the causes of the crisis and also recent thinking on how mitigate the effects of future crises as well as official thinking on future policy on both sides of the Atlantic especially in relation to the level and nature of any regulation required and the debate on resolution processes.

Under the topic headings of 'Prevention' and 'Early intervention and resolution', the day also included analyses of the nature of governance in and for banks, relevant aspects of the Dodd-Frank Act, the structuring of banking debt instruments pre- and post-crisis and resolution approaches. The keynote speeches provided *insights into the thinking at the highest level on these issues by policy-makers at the EU Commission, the SEC and the Federal Reserve Bank of New York.*

Introductory remarks

ECGI Chairman **Antonio Borges** opened the conference by reminding everyone that the problem left by the banking crisis is still *"huge"*, and we had to ask *"how had we got here?"*, and *"how we can make sure it can't happen again?"* Progress was being made but he felt that we were still at the beginning of the process both of understanding and of trying to avoid a recurrence, and we appeared to be no closer to consensus on these matters. He commented that banks were special institutions. They were both vulnerable but yet central to national economies, and they were also extremely leveraged and interdependent.

Trust was essential as was confidence: if banks collapse, disaster occurs. There was a danger of moral hazard if governments intervened. On the other hand, building in restraints ran the risk of impeding efficiency.

Very big emotional pressures were involved: politicians tended to distrust financial institutions. The question was how to make the banking system more resilient and more robust, without throwing away all the gains in efficiency that had been achieved over the years and which had helped the economy.

We also had to take into account the fact that each country tried to deal with these issues in a different way because there were different banking models.

All these factors meant that it was a challenging time for the work of research groups such as ECGI. *"This very polemic environment is not really ideal for what we do which is cool reflection, serious independent research, in-depth study of what the real issues are, and recommendations. And I must say we're also at a time when there isn't much support for what we do. People are so focussed on the political process; people are so concerned with immediate decision-making and all these conflicts of very serious interests. So the support for long-term thinking, in-depth research, and so forth, is not as abundant as it once was.*

"So we find ourselves contributing with an understanding that perhaps this is really a long-term effort and that, in the end, whatever research we put in place, whatever research outcomes we achieve, will hopefully benefit the process over time, without any certainty that it'll happen right away. But this is why our effort, and in particular this trans-Atlantic effort, is so important. Let's focus on the real issues, let's discuss them with a great deal of independence, let's work for the public good, and let's hope that eventually, one day, this will be the basis for the new legal and regulatory initiatives."

Mr Borges ended his opening remarks by thanking the European Commission and the SEC for their support and expressing gratitude to ECGI's other partners, Columbia University, Columbia Law School, and Brookings Institution, who assured that the intellectual input from the other side of the Atlantic was fundamental. He paid special thanks for the exceptional support given to this conference by PriceWaterhouseCoopers.

Professor Ronald Gilson welcomed delegates to the conference on behalf of co-organisers Columbia University and summed up his own view of the value of conferences under the banner of the Transatlantic Corporate Governance Dialogue: *"We have an enormous amount to learn by talking to each other. We've got an opportunity today to express views, hear other people's views and then adjust our own thinking in light of that. And all of us can speak quietly, rather than in a political context. It is a wonderful opportunity. I'm delighted to welcome you here on behalf of Columbia."*

Session 1- Prevention

This session was moderated by **Claire Bury** from the European Commission, Head of Unit F2, (Company Law, Corporate Governance and Financial Crime) in Directorate F – Free movement of capital, company law and corporate governance. In introducing the three speakers for the session she outlined the issues as follows: *"How can Corporate Governance help prevent future crises? How can we put mechanisms in place to prevent excessive risk-taking and spill-over of risk into the financial system as a whole? Why is bank governance difference? And how can we get the shareholders of financial institutions to take a real, sustained interest in the long-term growth of those financial institutions?"*

Does debt provide "market discipline" for banks?

presented by **Professor Martin Hellwig,** Director of the Max Planck Institute for Research on Collective Goods

Professor Hellwig opened by making the point that the crisis was not just the result of misguided sub-prime lending and misguided investments in subprime–related securities. There must have been something else explaining why the global financial


Professor Martin Hellwig

system was affected, namely that as a consequence of fragility due to a high leverage and very significant maturity transformation, the initial losses in sub prime related securities immediately led to a loss of confidence, a breakdown of inter-bank markets, and a breakdown of refinancing opportunities. There were also what Professor Hellwig described as 'enormous deleveraging multipliers.'

He gave several examples of refinancing operations performed only because no equity was attributed to the assets. For example, UBS Investment Bank where the credit risk in relation to the securitization business was hedged through monoline insurers and with AIG, never thinking about the counter party credit risk on the hedge contracts. In that bank the equity was €40 billion with a balance sheet of €1,600 billion, i.e. equity was 2.5% of the balance sheet.

Two questions were raised : Why didn't risk enter into consideration where, for example, the bank was earning 20 to 30 basis points as it engaged in substantial maturity and liquidity transformation adding to the institution's leverage? Secondly, what investment criteria did these bankers use? Professor Hellwig's conclusion was that the banking industry should be required to have 'a lot more equity' which should be well into the double digit numbers and should not be calibrated to risk.

The industry had been leading 'a fierce war' against attempts to raise equity requirements. One argument had been that higher equity requirements raised banks' funding costs because equity has a higher ROE than debt. But this was fallacious –the higher ROE reflected a risk premium - if there is more equity than the risk per dollar invested the premium must go down.

Professor Hellwig dealt with various arguments against this notion and referred also to the American Squam Lake report on reform of the financial system. The argument of that report was that capital requirements that leaned against short term debt pushed banks towards other forms of financing that might allow managers to be more lax. He rejected that approach saying that it was not supported by analysis. He referred to a 'zoo of models and a zoo of effects each of them studied in isolation.'

"We had no routine for assessing which member or members of the zoo was appropriate for understanding a given real world issue," he opined.

Research references associated with this presentation:

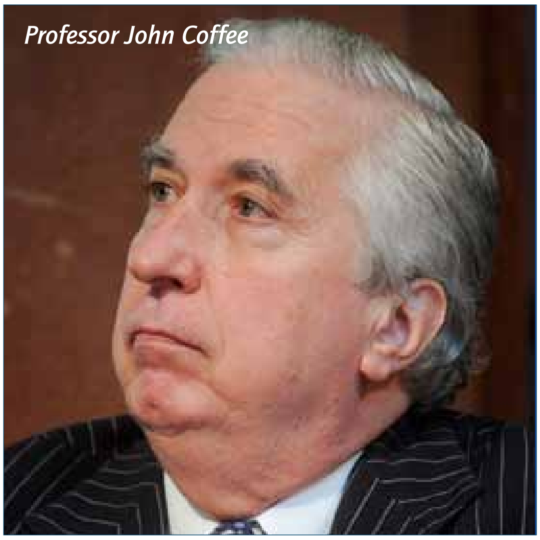
- Admati, P. DeMarzo, M. Hellwig, P. Pfleiderer, ***Fallacies, Irrelevant Facts, and Myths in Capital Regulation: Why Bank Equity is Not Expensive Preprint*** 10-42, Max Planck Institute for Research on Collective Goods, Bonn 2010; The Rock Center for Corporate Governance at Stanford University Working Paper Series No. 86; Stanford GSB Research Paper No. 2063; *http://ssrn.com/abstract=1669704* October 2010
- M. Hellwig, S***ystemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis*** Jelle Zijlstra Lecture 6, Netherlands Institute for Advanced Studies, De Economist 157 (2009), 129 – 208; *http://ssrn.com/abstract=1309442* November 2008
- M. Hellwig, ***Capital Regulation after the Crisis: Business as Usual?*** Preprint 10-31, Max Planck Institute for Research on Collective Goods, Bonn 2010; *http://ssrn.com/abstract=1645224* July 2010

He referred to the alleged advantages or virtues of debt finance though he argued that *"debt induces incentives for excessive risk-taking. Heads I win; tails, the creditors or the tax payers lose."* Banks were different from other corporations. With 95% of their balance sheet and more consisting of debt, there was a real problem.

In the theoretical literature, the mainstay of the notion of short-term debt as a disciplining device is an article by Calomiris and Kahn in the American Economic Review of 1991. On this piece, he commented that the analysis of a bank with multiple financiers was incomplete and, in any case, there was no outside equity. With multiple financiers, the problem was to provide financiers with incentives to monitor the bank rather than free ride on the monitoring of others. In reality monitoring incentives were more readily available for outside shareholders (or analysts) worrying about stock price movements from day to day. As for debt holders, they would have an incentive to free ride on the shareholders' information, being careless on the upswing and getting panicky as stock prices approach zero. This is to precisely what happened in 2005 – 2008, with no discipline at all provided by debt holders in the expansion up to 2007.

In conclusion, Professor Hellwig repeated his call for banks to be required to raise more equity, and made the point that *"reluctance to issuing new shares may itself be a form of excessive risk-taking, if not a form of gambling for resurrection, which we should not really have. Therefore I submit that the argument that higher capital requirements are an interference with optimal contrasting in the markets is just flawed."*

Professor John Coffee



Corporate Governance Provisions of the Dodd-Frank Act

presented by **Professor John Coffee**, Adolf A Berle Professor of Law, Columbia Law School.

Professor Coffee began by commenting that Dodd-Frank was more about the management of systemic risk than corporate governance. He pointed out that in his view, banks were different in that they had a guarantor standing behind them called the taxpayer. The Dodd-Frank Act reflected a lot of taxpayer resistance to the role of a central bank as lender of last resort in this context and he felt that this would cause friction and confusion for the future.

The governance parts of the statute might nevertheless conveniently be divided under four broad headings: corporate governance and shareholder voting; executive compensation; financial institution governance and liability and enforcement rules. Specifically:

- **Corporate governance and shareholder voting: Proxy access** The statute gave the SEC authority to adopt rules which permitted shareholders to submit one or more nominees for inclusion in the corporation's own proxy statement for election by shareholders. Primarily this was directed at the new power given to shareholders to elect up to 25% of the board or, if greater, one director Note, that for most practical purposes non-US companies listed in the United States would not be affected by these rules.

  One important provision of the new rules was that brokers were stopped from voting shares, either on the election of directors or on executive compensation, or on any other significant matter as determined by the SEC. The implication of this change is to restrict the voting power of 'retail shareholder' ownership, while enhancing the power of institutional investors. In turn this would enhance the power of the proxy adviser. Firms such as RiskMetrics or ISS gain considerable influence from the combination of proxy access and the elimination of broker votes.

- **Corporate governance and 'say on pay'**
  Dodd-Frank requires that compensation policy be put to a non-binding shareholder vote. Although the vote is advisory only, the failure by the board to take note of an adverse shareholder vote could result in an activist proxy battle to put activists on the board. The 'say on pay' provisions permitted both a vote on pay and the frequency on which shareholders would have the right to vote on 'say

on pay'. Large institutional investors would be required to disclose how they proposed to vote.

- **Disclosure** Much more disclosure in relation to compensation would now be required in relation to the firm's overall economic performance. This might well lead to further confrontation if the level of compensation rose in inverse proportion to the stock price of the corporation, or if the differential between the pay of the CEO and that of other employees was disproportionately excessive.
- **Compensation clawbacks** The statute mandated a clawback in the event that the earnings on which an incentive payment was based needed to be re-stated. It will be difficult and speculative to try to calculate what would have been paid to a CEO had the earnings been correctly stated.
- **Executive Compensation and financial institution governance** Professor Coffee asserted that in his view Dodd-Frank was premised on the assumption, 'the still debatable assumption', that flaws in executive compensation formulas were responsible in significant part for the 2008 financial crisis.
- **Separation of Chairman and CEO** The United States was still very far short of the British norm, but an explanation was now required as to why the issuer had chosen to have one person serving both roles.
- **Contingent capital standard** Dodd-Frank authorizes the Federal Reserve to mandate the use of 'contingent capital', which might be an intermediate alternative to the calls for more equity in banks. Such a debt security would be designed so that it automatically converted into an equity security at certain predefined trigger points in order to avert a default. Professor Coffee felt that there was a real chance of convergence of thinking on both sides of the Atlantic in relation to contingent capital as a substitute for bankruptcy.
- **Enforcement of litigation remedies and whistleblower bounties** Bounties may change the culture of many large corporations, because whistleblowing can become extremely profitable. If the SEC brought an action and secured disgorgement, restitution, or other kinds of penalties, based on that action, then they must give the whistleblower between 10% and 30% of the total monetary sanctions.
- **Shareholder power** Professor Coffee was not persuaded that enhanced shareholder power reflected in the Dodd-Frank Act would be effective in relation to banks. In the world of banks, giving more power to the shareholders could be problematic because the shareholders' incentives were probably to take greater risk; the easiest way for a bank to increase its profitability is to increase its leverage.
- **Credit rating agencies** Professor Coffee said that these agencies would be 'very affected' by the Act, and would face much more litigation.

Professor Coffee concluded by sounding a cautionary note in relation to the Dodd-Frank Act so far as governance was concerned. The Act changed very little

Research references associated with this presentation:

- John C. Coffee, Jr., ***Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate System Risk*** **-** *http://ssrn.com/abstract=1675015* October 2010
- Lucian Bebchuk and Holger Spamann, ***Regulating Bankers' Pay,*** 98 Geo. L. J. 247 (2010)
- Rudiger Fahlenbrach & Rene M. Stulz, ***Bank CEO Incentives and the Credit Crisis*** *http://ssrn.com/abstract=1439859* July 2009
- Andrea Beltratti & Rene M. Stulz, ***Why Did Some Banks Perform Better During the Credit Crisis?: A Cross-Country Study of the Impact of Governance and Regulation*** *http://ssrn.com/abstract=1433502 July 2009*
- Reint Gropp and Matthias Kohler, ***Bank Owners or Bank Managers: Who Is Keen On Risk?*** *at http://ssrn.com/abstract=1555663 February 2010*
- David Erkens, Mingyi Hung, Pedro Matos, ***Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide*** *http://ssrn.com/abstract=1397685* September 2010

except in relation to executive compensation. The real issue was the approach towards shareholder power, as to which he was sceptical in relation to financial institutions. *"The interesting problem here is that more and more empirical evidence suggests that the more shareholder-friendly the corporate governance regime is at a financial institution, the more that financial institution will ride the rollercoaster of having high earnings in the boom years, and falling earnings and near-bankruptcy in the down years."*

Is bank governance different?

presented by **Professor Patrick Bolton, Barbara and David Zalaznick** Professor of Business, Columbia Business School.

Bank governance was in Professor Bolton's view 'clearly different.' Contrasting governance in banks and non-financial corporations: banks had a very different regulatory oversight, and also much more intensive regulatory oversight. The regulators expected that the Board of Directors and the CEO would try and balance shareholder value maximisation and safety and soundness. The really critical issue was: how much did one delegate to the boards in terms of worrying about safety and soundness? How much did one leave to the regulators? And how did the two interact?

The level of coordination or lack of it between regulators and the board on this issue was still to be worked out. There was a danger that if the regulator became too engaged in, for example stress testing, he would be blamed for any subsequent failures.

Shareholder power took a very different form in banks with limited scope for hostile takeovers and proxy

Professor Patrick Bolton

contests. Board sizes tended to be larger on bank holding companies than in non-financial institutions, and there was some evidence that the larger the size of the board, the weaker the governance. Regulation had tended to require more independence from directors on boards of banks. Maybe this needed to be reconsidered: Professor Bolton asked what 'independence' achieved.

Some recent studies (Ferreira Kirchmeier and Metsker and the Landesbanken case) seemed to show two particular things: The first was that asset write downs and losses, on average, were three times larger for state-owned banks than for privately-owned banks in Germany over the crisis period. Second, what was it about state-owned banks that caused these losses? Almost everything was explained by the financial incompetence of board members in state-owned banks. If one looked at two state-owned banks, one having financial expertise on its board and the other one not, what one found was that the one that did not have financial expertise was more likely to incur losses.

Professor Bolton referred to the recommendation in the Walker report that non-executive directors should have the knowledge and understanding of the business and commented that it was amazing that we had had to wait so long to put that as a recommendation.

Professor Bolton referred to a number of other Walker recommendations:

- establishing a risk committee separately from an audit committee and elevating the role and standing of the CRO;
- the remuneration committee should seek advice from the risk committee on risk adjustment;
- long-term deferral of incentive pay. The evidence seemed to show that pre-crisis the bulk of stock options awarded to CEOs vested within a year. A very large percentage of options was exercised immediately upon vesting.

Professor Bolton also discussed a study which asked the question: *"does CEO compensation lead to excess risk-taking?"* The study looked at the period from 1992 to 2008. The study seemed to demonstrate that there were two very important determinants of pay: one was firm size, measured by market capitalisation; and the other was industry characteristics. However, it was also necessary to look at what Professor Bolton described as 'residual pay', that is to say pay which was not affected either by firm size or by industry characteristics. The question was whether past residual

Research references associated with this presentation:

- Cheng, IH., H. Hong, and J. Scheinkman, **Yesterday's Heroes: Compensation and Creative Risk-Taking** Princeton University Working Paper *http://ssrn.com/abstract=1502762 2009*
- Bolton, Patrick, Mehran, Hamid and Shapiro, Joel D., **Executive Compensation and Risk Taking.** FRB of New York Staff Report No. 456 *http://ssrn.com/abstract=1635349 June 2010*

compensation explained future measures of risk that financial institutions took. The evidence seemed to show that where the residual compensation was highest (Bear Sterns, Lehman etc) it highly correlated with subsequent risk-taking. In other words risk-taking was correlating with compensation.

Moreover, the link between compensation and risk had nothing to do with governance. If anything, one found that companies that complied on all levels on the governance front where there was 'say on pay' one might not get the outcome one wanted. One might actually get more risk-taking.

Professor Bolton referred to a recent paper written by him together with Mehran and Shapiro looking at effective tools providing a 'market measure' of risk for banks, and in particular the CDS spread as a measure of risk. The complications of calculating both deferred pay and clawback under the new rules could in his view be made much easier by basing pay on a CDS spread which would *"make the clawback automatic."*

Session 2 - Conference keynote speeches

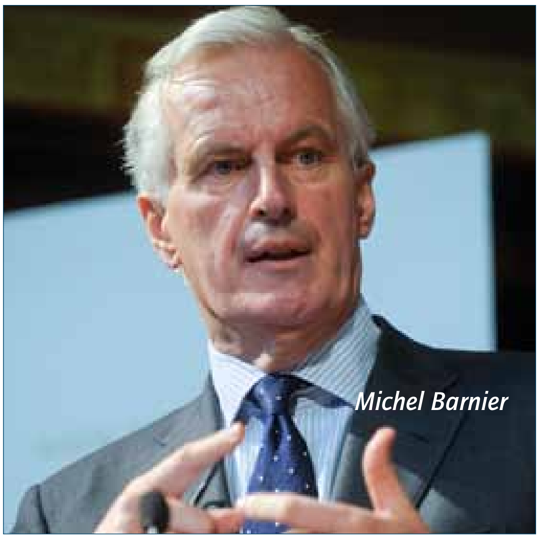
Michel Barnier, Commissioner for Internal Market and Services, European Commission

Commissioner Barnier in opening his address spoke of the support given by the European Commission in facilitating the Transatlantic Dialogue. He affirmed his belief in the necessity for continuing transatlantic dialogue which he had held since he was the French Foreign Minister. He greeted Commissioner Paredes and also Antonio Borges, Ronald Gilson and Marco Becht, and spoke of the high level of activity in the United States in which he was closely involved.

"Ladies and gentlemen you have in front of you a European Commissioner who will make every effort to attain real dialogue, a real convergence with the United States because it is in our common interest to learn the lessons from this crisis together."

The objectives of both United States and Europe were usually the same (the Communication of 2 June could be compared with the Dodd-Frank Act) even if the realisation of those objectives was achieved in different ways. The situation in Europe was sometimes complicated by the fact that each of the 27 Member States had their own identity, differences, culture and budgetary and taxation policies. *"We are building a united Europe not a uniform Europe."* Crisis prevention started within companies. The European Systemic Risk Council had been constituted alongside regulation for banks, insurance and the marketplace. Basel III had to be implemented in order to reform the issue of bank capitalisation, and proposals would be put forward for legislation after consultation in the spring of 2011.

There were two other subjects that concerned companies, namely corporate governance and the prevention and resolution of crisis. He was personally extremely interested in issues of crisis prevention and would be working to develop a culture of prevoyance (oversight/foresight). There had been a lack of risk culture by boards, shareholders and supervisors.



Michel Barnier

This needed to change and a period of serious consultation was under way. He referred in particular to recently presented Commission regulatory texts on the subject of derivatives and the grain trade where consultation had been extended in order to achieve the best results.

In the field of corporate governance, the Commission would act in the same way, and he would be very attentive to the remarks and proposals of the Transatlantic Corporate Governance Dialogue. It was necessary to make sure that a company's board of directors had the right qualifications and experience and time to deal with their obligations. Supervisors should control and implement policies objectively. A risk committee should advise the Board of Directors. There should be separation between the functions of President (Chairman) and General Manager (Chief Executive). In certain cases, the person responsible for risk assessment should carry main board status.

Shareholders also needed to take a longer-term view in addition to the strengthening of their rights under the recent Directive on Shareholders' Rights. Careful evaluation would take place in relation to the responses to the consultation exercise on the financial sector governance which had been launched earlier in the year.

Commissioner Barnier emphasised to 'our American friends' that Europe is not just a free-trade zone. The crisis was giving rise to an increase in protectionism everywhere in Europe, so, he felt that it was a responsibility to create a marketplace in which growth could be achieved for the benefit of every company and every citizen and to put the market at the service of businesses and growth and the citizens of Europe. He referred to the imminent launch of the Single Market Act, an action programme of 50 proposals intended to support this philosophy.

In this context, consideration needed to be given not just to the financial sector but to all listed companies and a particular three aspects of listed companies, namely, the board of directors, shareholders and an evaluation of the principle of 'comply or explain', which, in his view *"does not seem to work correctly everywhere."* As regards the board of directors, non-executive directors have a role to play and during the financial crisis, weaknesses in some Boards of Directors within the financial services sector had appeared. Lessons can also be learned in this respect by other listed companies.

The Commission was working on issues of diversity and specifically the feminisation of boards in order to achieve a wider diversity of professional and social profiles. He was convinced that more diversified boards would attain better results. Accordingly there would be encouragement for the wider diversification of boards. Managers must have enough time to dedicate to their duties and this needed to be verified. The Commission would be working on other ideas including ways of carrying out evaluations and, in particular, external evaluations of directors.

The Commission would look also at the issue of shareholders rights and obligations in order to encourage a degree of activism by shareholders as owners.

Finally, on the third issue of comply or explain, Commissioner Barnier said that the explanations given by companies were often insufficient or unconvincing. The Commission would therefore be raising questions as to whether the voluntary principle of 'comply and explain' should apply and there would be wide consultation on this matter.

Turning to the question of risk management, it was important to avoid risks and bad behaviour, so that the risk should not become a crisis, and that an ill-managed crisis should not become a catastrophe which led to taxpayers having to pay for such mistakes. *"I no longer want taxpayers to be summoned to the front line to pay for mistakes of managers, or due to risks taken by senseless bankers. Banks will have to pay for banks."*

Accordingly the Commission would be putting together a framework or 'toolbox' for approval by the European Council and by the European Parliament for the prevention, prevoyance and resolution of systemic risk. This would need to be established on a transnational basis.

There would be a supervisory committee, a resolution committee and certain guidelines in order to reinforce responsibility at all levels including shareholders and, if necessary, creditors. It was not proposed that banks should be taxed but the system in place in Sweden in his view worked well as did that used in Germany. Commissioner Barnier was favourable to the idea of a fund *"at the bottom of the toolbox."* These proposals would be presented in the spring of 2011.

The European Commission had not got all the answers but it had a role to play and it would take its time in order to thoroughly evaluate the issues. However the crisis *"was no joke"*, and so the idea of *"business as usual"* by management would not be acceptable. No market, no player, no product and no territory would be without sensible regulation and effective supervision. It was important to concentrate on the issues given that we were still within the current crisis, with the risk of a new crisis looming without the tools to prevent it or to limit its effects. *"Markets move faster than democracy."*

There is increasing concern amongst the public which brings with it protectionist and nationalistic attitudes. It was necessary to be aware of this and that is why it was important not to pretend to reform, but actually to reform. He put a lot of faith on the quality and honesty of the transatlantic debate.

He concluded that whilst he felt there were many shared objectives, there might also be aspects of the debate which would give rise to divergences between the American and European point of view. He was thinking particularly of the correct application of Basel, and also about accounting standards which he recognised was a very difficult subject. He would be going to New York the following Thursday for an International Accounting Standards Board meeting.

Troy Paredes, Commissioner, U.S. Securities and Exchange Commission

Commissioner Paredes commented that the question posed in the title of the Conference required us to engage a range of complex questions: *"some of which are marked by tension – for example, the imperative that businesses must take risks for our economy to grow, but our desire that they do so prudently; the desire for executives, directors, lawyers, bankers, accountants, and others to act ethically, but not to be unduly hamstrung by fear of liability; and the need for the government to serve its regulatory mission responsibly, such as by guarding against risks that could threaten the financial system, but without regulating to such an extent that the private sector dynamism and entrepreneurism that drive economic growth are stifled."*

He proposed to deal with three topics: implementation of Dodd-Frank; executive compensation, which was a key determinant of how the CEO and other senior officers behaved; and the role of board directors in corporate decision-making. He explained at this point that his views were his own and did not necessarily reflect those of the SEC or his fellow commissioners.

Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank' or 'the Act'): the Act directed the SEC to undertake detailed rule-making and to conduct a great number of studies, including corporate governance. Since the financial crisis the SEC had undertaken various initiatives including public

Troy Paredes

company compensation and governance disclosures, and the election of board members. He offered the following overarching thought: *"The extent to which the recent wave of federal government regulation in the U.S. already has displaced and distorted private sector decision making in our economy concerns me, and I am troubled by the potential that future regulatory initiatives – notably, the regulations implementing Dodd-Frank – will go too far, unduly burdening the financial system at the expense of economic growth*

"We have to recognize the real-life costs to society if the regulations implementing Dodd-Frank excessively constrain and hamper the U.S. financial system. As we strive to further secure the financial system and protect investors and others from misfortune, we need to be mindful that, as the regulatory regime becomes increasingly restrictive, financing may be more costly for companies and individuals to come by; the ability of businesses and investors to manage their risks appropriately may be compromised; fewer valuable investment opportunities that would create wealth and income for investors may become available; and the commercialization of new ideas may be frustrated."

Mr Paredes said that this required a cautious approach including an assessment of the cumulative impact of new regulatory demands, and including ensuring that the US regulatory regime was appropriately predictable: *"Throughout the financial crisis itself, there was a great deal of uncertainty as to how the law would be applied and as to the nature and extent of the U.S. government's potential intervention."*

He offered three suggestions:

- the solicitation of comprehensive input from those likely to be affected;
- decision-making should be supported by data;
- adopt a more incremental approach to regulatory reform which *"allows for a more efficient and better calibrated regulatory regime to develop over time, having been grounded in the learning of experience and our consideration of the market's adaptations."*

Executive compensation

Mr Paredes ranged over the level of rule-making which would now be required of the SEC in relation to executive compensation: including 'say on pay' shareholder votes, compensation committee independence; consultants and other advisers to compensation committees; clawback in the event of restatement; employee and director hedging of the value of the issuer's stock. He offered three observations in this context:

- the effect of regulations on the incentives of issuers, boards, senior executives and shareholders: some of the effects might be undesirable: might a CEO come to believe that he's underpaid because the multiple of his compensation to that of the median employee is lower for him than for his peers at other companies? Would executives press for higher base pay to compensate them upfront for the risk that incentive compensation may have to be forfeited?
- Executive compensation does not lend itself to 'one-size-fits-all' approach is, but instead demands a 'textured, firm–specific analysis.'
- There was a risk that in attempting to dissuade companies from taking excessive risks, companies might take too few risks.

The role of board directors

Mr Paredes referred to what he felt was the 'bottom–line question' that directors and their advisers have to ask: what makes for an effective board of directors? *"What matters most is not how a board is composed or structured or how many meetings are held each year. What matters most is how directors act. As I view U.S. corporations, boards of directors are expected to improve corporate decision making by spurring deliberation. In acting as a body, the promise is that boards will draw on the distinct perspectives, experiences, sensibilities, and expertise that different directors offer. The expectation is that as the group works through a range of ideas and arguments, the decision that is made will be better as a result of the directors' collective efforts. As decision making improves, so should the company's competitiveness and its ultimate performance............directors should be willing to dissent, and disagreement from others should not be discouraged or suppressed. When it leads people to engage rigorously, disagreement helps ensure that the unknown is identified, that potential conflicts are spotted, that information is uncovered, that biases are managed, and that challenges and opportunities are assessed in a more balanced way. Indeed, a board may want to consider designating one or two directors, perhaps on a rotating basis, whose express charge is to be skeptical and to press when needed."*

On the other hand: "disagreement *and spirited deliberation should not give way to hostility. Distrust and disharmony can threaten an enterprise; boards need collegiality and cooperation and a well-functioning relationship with management. Dissent will be most constructive, then, when conflicting viewpoints and pointed resistance do not trigger defensiveness, but instead are encouraged as catalyzing better decisions that benefit the corporation and its stakeholders."*

Mr Paredes concluded by recognizing the cooperative spirit with which policymakers around the globe have committed themselves to addressing the causes and consequences of the turmoil. *"Of the many lessons to learn from the financial crisis, one is particular apt for this gathering: Simply put, the world is extremely interconnected, perhaps to a degree and in ways that were not fully appreciated. Global capital markets with global consequences recommend enhanced global regulatory cooperation. I trust that we can and will build on the new relationships that have been established and the longstanding friendships that have been strengthened as we continue shaping the new financial regulatory regime."*

However: *"a corollary to cooperation is to recognize that we in the United States do not have a monopoly on good ideas. As the SEC continues wrestling with complex matters, we must give due attention to the views of our fellow securities regulators abroad who may have grappled with similar issues and adopted approaches from which we can learn. There is value in looking to other jurisdictions to assess their responses to common regulatory challenges and opportunities.*

"Of course, as regulators cooperate and learn from each other, it must be stressed that even if something works for one country it may not work for another. Given the complexities of crafting a financial regulatory regime, no two countries' regulatory systems will be mirror images. In fact, one would expect diverse countries with

unique economies, political structures, cultures, and histories to approach financial regulation differently, even as we share the common ends of ensuring the integrity of our financial markets, protecting investors, mitigating systemic risk, and facilitating access to capital."

Panel Discussion

Following these two speeches, a panel comprising **Professor Ronald Gilson** *(in the chair)*, **David Devlin**, a partner at PriceWaterhouseCoopers, Dublin, **Peter Montagnon**, Senior Investment Adviser at the Financial Reporting Council and ECGI Chairman **Antonio Borges**, commented on the issues raised by the Commissioners.

Professor Gilson opened the discussion by observing that the speakers had picked up in their addresses the tension implied in the title of the Conference as between regulation and governance. Governance was flexible whereas regulation had dangers of 'petrificatrion'. On the other hand, regulation was politically accountable (e.g. systemic risk).

Peter Montagnon felt that this was not an 'either/or issue', but one of finding the right balance. In addition one should factor into the equation the question of economic growth and structures within corporations which are conducive to growth. 'Comply or explain' had its limitations, as suggested by M. Barnier, but regulation might run the risk of economic damage. Mr Paredes had in his view rightly emphasised the need to avoid unintended consequences arising out of regulation.

David Devlin asked *"why didn't existing regulation work?"* He pointed to the problem of Ireland's banking crisis following years of weak regulation but also incompetence by the banks. So regulation had to be approached with modesty. On the other hand he was optimistic about the role which new EU supervisory authorities could play in future. He endorsed the view of Commissioner Paredes that there was a need for evidence-based regulation. Under the heading of prevention being better than cure, Mr Devlin asked whether there was more that could be done by auditors while not getting away from their main job as agents of shareholders and without being too ambitious.

Antonio Borges offered two further comments: first the Greek and Southern debt crisis in Europe: *"It's not resolved, a huge crisis of devastating consequences."* The current crisis was not like the 2008 crisis, although there were some similarities. Firstly, there was a very serious underestimation of risk and a huge element of moral hazard. It was assumed that countries would be bailed out. The boards of companies that exposed the companies to the southern debt problems did so because of the moral hazard issue. It was a failure of governance and massive failure of regulators. If the regulators had intervened much earlier the current problems would be much less. He commended the recent actions by the UK FSA in becoming much more interventionist. Regulators should work more with the markets, not less. They should use the information they have to keep markets informed and help boards of directors understand what the risks are. His second comment related to the nature of investors – some 'good', some 'bad'. Should long-term investors be rewarded and speculators discouraged? He thought this was dangerous and that both long-term and short-term investors had important roles to play.

Peter Montagnon whilst agreeing with much of Mr Borges' comments felt that the recent withdrawal by Prudential from the acquisition of AIG following intervention by the FSA was more influenced by investors not wishing to see a rerun of the RBS/ABN Amro deal, and not so much as a result of FSA intervention. Governance could not compensate for bad regulation but it could complement and work with good regulation to produce good outcomes.

David Devlin emphasised the need to support ideas of accountability to shareholders and to adopt Walker recommendations in relation to risk management.

Professor Gilson whilst supporting Commissioner Paredes' exhortation to boards of directors to hold vigorous debate, without losing the co-operation of directors or managers, Professor Gilson was sceptical that board conduct would reach that level in practice.

Session 3 - Early Intervention and Resolution

Christine Cumming, First Vice President, Federal Reserve Bank of New York

Christine Cumming gave the keynote speech to introduce the third session. Her topic was the supervision and resolution of financial institutions in danger of failing. First Vice President Cumming made it clear that her views were personal and not necessarily the views of the Federal Reserve Bank of New York. *"In any industry, it is important that unsuccessful firms fail. Business strategies fall short, franchises depreciate, and management loses focus. Large or small, unsuccessful firms need to be cleared from the scene through merger, restructuring or liquidation. This is no less true for the financial industry than for* *any other. And for all firms, society has an interest in ensuring that the process of failure does not destroy more value than necessary. As an economist, I see much innovation in national insolvency practices over time as designed to reduce the cost of insolvency and increase the value preserved in the insolvency process."*

As the Lehman bankruptcy had demonstrated, the issues in resolving large, internationally active financial firms although recognised for some time presented difficult challenges in terms of matters such as different insolvency regimes across countries and untested resolution processes for very large financial firms both at national and international level. The recommendations in March 2010 of the Cross–Border Bank Resolution Group (CBRG) formed by the Basel Committee on Banking Supervision were to be welcomed.

First Vice President Cumming recalled the early 1990's overexpansion of commercial real estate and leveraged buyout lending with the result that many large financial institutions had to be merged into others or unwound. Banking supervisors had responded to the problems by requiring banks with large exposures to implement a three-part program: "*First, the bank comprehensively identified its problem loans and assigned them to workout specialists. Second, the bank developed and executed a capital plan and strengthened its liquidity. Third and essential to raising new capital, the bank developed a new business plan demonstrating its ability to return to profitability.*

"This program worked, in large part because it was applied timely enough. Stylized facts about time's role on the value of a failing firm created urgency in implementing the program. Those stylized facts were: the value of the firm's assets and its business lines tends to decline with time as the firm's financial weakness becomes more apparent and market pricing of its assets takes on a 'fire sale' character; The funding capacity of the firm declines as its troubles become more evident, counterparties cut lines and limit maturities and the quality of counterparties declines; and the value of the firm's franchise decays as customers migrate to other providers.

"This three-part program of identifying all problems, replenishing capital and liquidity and recasting the business plan was designed around loan exposures, but continues to be relevant today. The challenges are to adapt such a program to the many financial institutions strongly oriented toward capital markets activities with the resulting volatile balance sheets and income streams and to apply the program timely."

First Vice President Cumming recalled in that context the changes made in 1991 to enable The Federal Deposit Insurance Corporation (FDIC) to declare a bank insolvent when its tangible equity fell below 2% of assets.

The CBRG had recommended that all systemically important financial institutions should develop recovery plans. *"I believe the development of such plans by healthy institutions and their discussion by a college of the firm's principal regulators constitute important innovations in the supervision of financial institutions. The Cross Border Crisis Management Group has provided momentum and a forum for discussion of progress and challenges as supervisors initiate discussion of recovery plans with firms. The discussions we have held in the United States involve the financial institution, its major U.S. regulators and the regulators of the foreign legal entities containing its principal business operations. Those discussions have included both the development of a global liquidity contingency plan and a plan to reduce the risk profile of or 'de-risk' the financial firm by winding down or selling business operations or financial assets. The intention is to have recovery plans, as well as resolution plans, in place by the end of 2011."*

First Vice President Cumming drew attention to the benefits of recovery planning: it brings about a discussion of the firm's response to severe stress scenarios, a response which should be developed together with supervisors; and it identifies impediments to the firm's recovery.

Four important impediments had surfaced in discussions with US institutions:

Christine Cumming

1. The availability of sufficient financial information by the legal entity. For example, most firms in distress found it difficult to answer a crucial question: 'what market participants are most exposed to me and how will they react to my difficulties?'
2. The complexity of unwinding certain books of business, where the business is originated in one location, recorded in another and risk managed in a third. Derivative transactions are a prime example.
3. The use of intra group guarantees. These guarantees can distort the pricing and economics of the subsidiaries business activities and make the subsidiary more valuable to the current owner than to a potential buyer. Such guarantees may allow counterparties to terminate contracts on default.
4. The need to preserve global payment operations.

"The four impediments are all related to institutional complexity. A financial firm organized as a single legal entity would certainly face many complexities, but far fewer than organizations today. This clearly raises the issue of whether the extraordinary organizational complexity of financial firms today imposes social costs that are too burdensome, especially in resolution, relative to its benefits. The economists Dick Herring and Jacopo Carmassi earlier this year documented the reasons for the vast number of subsidiaries at large financial firms, reasons such as regulatory requirements, regulatory arbitrage and tax avoidance.

"If such organizational complexity imposes a high social cost by impeding recovery plans and resolution, providing incentives to reduce complexity may be warranted."

First Vice President Cumming noted that the CBRG report contained recommendations addressing these four impediments. She also suggested that a final benefit of recovery planning was that it was *"a prod to concrete action in the near term, when the institution is healthy and provides a ready – made menu of options when the firm is distressed."*

Resolution Planning:

"The desire to improve the resolution process for cross-border financial firms is widely shared, but how we should we judge progress? The success of private and public sector actions, such as those recommended by the CBRG, to improve the resolution of systemically important firms can perhaps be gauged by the extent to which resolution costs are reduced. We might further gauge progress against additional expectations, such as the absence of taxpayer support of the resolution process, the efficiency of the process (to the extent it is not captured in resolution costs) and the equitable and consistent treatment of stakeholders."

First Vice President Cumming noted the CBRG's recommendations to improve the resolution process: National authorities must have appropriate tools to deal with all types of financial institutions, for example, bridging financial institutions, transfer of assets and resolve claims. The FDIC had these powers as well as experience and her impression was that many countries were considering or had adopted legislation giving the financial resolution authorities similar powers. *"The U.S. Dodd-Frank Act passed in the summer broadens the scope of the FDIC's resolution powers, although in a carefully circumscribed manner. The Dodd-Frank Act allows the FDIC to resolve not only a bank, but a financial holding company of a banking organization or a nonbank financial institution, if the requisite recommendations and conditions are present, among them, that the failure is a threat to financial stability. When the FDIC is appointed receiver, it has available its full set of resolution powers, including the ability to create a bridge company for a nonbank financial institution.*

"The Dodd-Frank Act also strengthens the supervisory regime for systemically important financial firms. It empowers the newly formed Financial Stability Oversight Council (FSOC) to designate bank and nonbank firms as systemically important.

"The CBRG recommendations provide useful building blocks toward a stronger cross jurisdiction national process: resolution tools, national coordination across jurisdictions, recovery planning, setting aside of impediments to recovery and resolution and simplification of organizational complexity. The CBRG also recommends that national authorities seek international convergence of resolution tools and measures."

First Vice President Cumming then, expressing strictly her own views, set out how the CBRG recommendations might evolve: *"Let's focus on a single systemically important financial institution. The healthy dialogue among regulators and resolution authorities in the principal jurisdictions for a given firm and the firm-specific recovery and resolution plans developed could provide the basis for strong cooperation when the institution crosses from healthy to troubled. On the basis of that cooperation, the lead supervisor, with the participation of the resolution authority in the home country jurisdiction, could coordinate a program of early supervisory intervention encouraging a private* *restructuring utilizing the recovery plan. At the same time, the resolution authority in the home country, working with the home country lead supervisor, could begin taking the necessary steps to prepare for a possible resolution as a contingency. If the supervisory intervention does not produce a successful private restructuring and recovery, the home country resolution authority leads a coordinated resolution process."*

First Vice President Cumming expressed the view that economists could be invaluable in helping the authorities understand more fully where coordinated actions. In addition, resolution authority is needed to decide whether there were entities within a given organisation which should not be placed into insolvency proceedings (for example, the Lehman broker dealer).

First Vice President Cumming then addressed the issue of the 'bail–in' mechanism. She felt it had considerable potential as an intermediate position before insolvency, but reflected that it was not yet a well defined concept in the international policy discussion. She suggested areas which needed clarification and development, such as, the nature of the trigger (not, in her view, a 'one minute to midnight 'event), the desired capital structure beforehand and the market capacity to purchase bail-in eligible instruments. She also pointed out that it would be necessary for supervisors in other countries not to treat the triggering of bail-in in as an insolvency event and to coordinate with the home country in the administration of a bail-in. *"If I interpret a bail-in mechanism against the three-part supervisory program for troubled firms that I described at the beginning, conversion of debt to equity stakes is a mechanism to replenish capital, a critical element, but just one of the three key elements. The comparison suggests that the conversion of debt to equity by itself may not be sufficient and a fully developed proposal for a bail-in mechanism will need to include thorough identification and workout of problem assets and positions, as well as a revamped business plan that demonstrates the ability of the financial firm to return to profitability."*

First Vice President Cumming concluded by returning to the issue of time. It would not always be possible for the timing of the resolution process to be optimum and therefore there was a need to develop quickly meaningful recovery and resolution planning for systemically important firms and to continue to build a strong international resolution process. *"Recovery planning by firms helps to increase the margin of time available for firms by shortening reaction time when distress occurs and reducing the impediments to recovery and resolution when firms are healthy. Similarly, resolution planning gives financial authorities a better starting position and more ability to move swiftly and decisively in a financial firm failure. Taken together, augmented resolution powers, recovery and resolution planning and better identification of systemic risks can move us substantially forward in dealing with failing systemically important institutions."*

Panel Discussion

Banking Resolution:
Lessons from economic theory

presented by Professor **Xavier Freixas**, Professor at Universitat Pompeu Fabra, Barcelona

The bankruptcy of banks had a high social cost for society. Citing with approval the speech by First Vice President Cumming earlier he agreed that a different bankruptcy procedure for banks was needed. It was important to preserve 'the payment system' and to avoid disruption of transactions in the economy. Rules for bank bankruptcy were changing where conceivably bond holders in banks who had hitherto been encouraged by governments to believe that the bond would be safe, might lose. *"This is obviously great transparency for the system."*

One problem with bank bankruptcy was that although the regulatory authorities of a country had a mandate to preserve financial stability-the mandate was to preserve stability in that country. So in the UK the FSA was to promote London as a financial centre. Every country wanted to see a growing financial sector, encouraging credit institutions like Freddie Mae and Freddie Mac., but these developments carried the risk


Professor Xavier Freixas

of a new crisis. It was necessary to design rules on how and how early to intervene: there was a natural conflict between governments which wanted matters resolved quickly and shareholders who were prepared to litigate in order to preserve their rights.

Building early intervention into the bankruptcy procedure was highly desirable. Professor Freixas called the deterioration of a bank in distress a self-fulfilling prophesy: once a bank was thought to be insolvent it became insolvent. A bank resolution was different because avoiding contagion implied the process had to be speedy in order to restore the confidence not only of the creditors of the bank itself but also of all the creditors of all other banks. On the one hand certainty and promptness was required whilst on the other hand protection of shareholders' rights made reference to the courts necessary, thus taking time.

Professor Freixas welcomed the EC Communication published on the previous Wednesday which had issued a framework for a crisis management for financial institutions as a special law specific to banks. Thus it appeared that we now had the means to design efficient restructuring for banks and efficient bankruptcies, but we lacked a legal structure that allows for a speedy, renegotiation free, legally certain way of doing this.

Professor Freixas also referred to academic studies relating to how to deal with debt overhang and the criteria of market confidence plus ideas for debt buy backs/debt/equity swap, and the use of preferred debt and warrants. He referred to the 'trade off' between moral hazard on the one hand and bail out on the other hand and the need to design processes which recognized that trade off as part of the resolution process.

Professor Freixas talked also of the problems of cross border banking and the dangers of branch offices and the Iceland experience

A paper from the Duisenberg Business School had referred to a financial 'trilemma' in cross border banking there are three things one could not have at the same time: financial integration, financial stability and supervisory and regulatory authority. It might be 'an impossible mission' to make that work, and 'something in between' might need to be found.

Professor Freixas repeated that he considered the recent EC Communication 'the perfect instrument' to go in the right direction, and recommended deposit insurance for Europe along the lines of the FDIC in the United States.

"Let me conclude by saying again that if you want to have an efficient banking industry we should go to the basic source of the problem, and the basic problem is that a bank bankruptcy is costly to society. And therefore we should have the right legal environment and we should also be realistic about the bargaining game with the regulatory authorities and the liability holders so as to design the right way to intervene."

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- Dirk Schoenmaker, **The Financial Trilemma** mimeo Duisenberg School of Finance *http://papers.ssrn.com/abstract_id=1340395 Dec 2010*

Core Resolution approaches

presented by **Professor Jeffrey Gordon,** Alfred W Bressler Professor of Law at Columbia Law School

Professor Gordon began by expressing his sense of concern that the events of the Fall of 2008 might have put at risk *"the world we had successfully put together in the post-war era."* There was an urgent need, therefore, to address the failure of systemically important financial institutions. In the United States the Dodd Frank Act was an attempt to do just that. However he felt that there were problems with that Act. He also noted the recent European Communication of 20th October on banking insolvency which left open a number of issues. Both the Act and the EC Communication focused on how to resolve a failing firm but not a financial crisis. Secondly, Dodd–Frank stripped the FDIC of pre-existing emergency authorities which were critical to restoring stability.


Professor Jeffrey Gordon

The Communication did not address a general financial crisis where the issues were transatlantic or more global. Dodd-Frank did not deal with trans-national issues, for example, Lehman and Lehman UK. Under Dodd–Frank the FDIC would only have had powers to avoid the failure of Lehman UK by borrowing from the US taxpayer sufficient to pay off all the Lehman UK counterparties. He urged the European commission to think about the issue of multi-jurisdictional issues outside the EU.

Professor Gordon suggested that there might be five possibilities in relation to cross-border resolutions:

- international uniformity of insolvency regimes for financial institutions (sceptical);
- ring fencing of assets within the national subsidiary (also sceptical);
- develop an 'extra tight regime' with highly capitalised balance sheets and constraints on activities and size (doubts as to whether this would last);
- the development of bail-out/in mechanisms along the lines already discussed by First Vice President Cumming earlier in the conference (appealing);
- a network of supervisors from the national oversight authorities who would work together in normal times on recovery plans and thereby set up informal systems that would enable non-disruptive cross-border resolution of failing systemically important financial firms. (intriguing).

Professor Gordon referred to the merger 'solution' in the case of Bear Stearns and the recapitalisation in the case of AIG, neither of which were ideal solutions. An impression of 'bail out' had been given which was extremely unpopular in terms of public opinion. Dodd Frank focuses on the orderly liquidation of the failed firm "*that's at least the rhetoric of its model*." In particular, the act insists that the losses be imposed on creditors.

Professor Gordon outlined some of the particulars of the Dodd-Frank resolution strategy. In broad-brush, in the case of a systemically important non-bank financial firm, Dodd-Frank replaces bankruptcy with an FDIC receivership modeled on its authority in the case of a failing bank. Despite the Act's emphasis on 'liquidation' and creditor loss-bearing, the FDIC retained considerable capacity to preserve the franchise value of the failed institution, including, for example, by establishing a 'bridge bank' that would remain in business until it could be sold and by discriminating among particular categories of

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- Basel Committee on Banking Supervision, **Report and Recommendations of the Cross-border Bank Resolution Group** *http://www.bis.org/publ/bcbs169.htm* March 2010

unsecured creditors. He also drew attention to what seemed to him conceptual confusion in some of the provisions of Dodd-Frank in relation to resolution: as he put it, one person's resolution was another person's bail-out, and some of the provisions seemed that they could result in what looked like taxpayer bail-outs.

Prof. Gordon called attention to the 'dangers' of Dodd-Frank. If financial distress was systemic, he said, then a firm-by-firm approach – serial receiverships – would only exacerbate the distress. Secondly, Dodd Frank and other legislation had withdrawn 'prior emergency authorities.' For example, Treasury could no longer guarantee money market funds and the FDIC could no longer guarantee bank obligations outside of receivership.. Tougher collateral requirements would make it harder for the Fed to provide liquidity to financial market participants. These changes would increase the chance that a period of financial instability could slide into major financial distress, he concluded. Dodd-Frank also provides limited capacity to address cross-border resolution issues.

Professor Gordon looked at the difference in 'trigger events' between the Dodd Frank approach and the EC Communication. He also drew attention to the different functions of the US banking system and of the EU banking system, specifically that EU banks play much larger role in credit provision that US banks These differences he said, will *"predictably lead to a different EU response in support of the banking system; more willingness to contemplate emergency support."*

Session 4 - Summing up, Assessment and the Way Ahead

Jonathan Faull, Director-General for Internal Market and Services at the European Commission, pointed out that the conference had demonstrated agreement on the two most promising methods of trying to avoid future crises, namely, corporate governance and effective resolution processes, but there was inevitably a difference between the American and European approach on implementation of these methods. He cited the example of remuneration where Europe favours a strict framework for the structure of remuneration in financial institutions against what appeared to be greater latitude in the United States in choosing how to provide incentives to their staff.

He also talked about shareholder apathy and lack of interest in corporate governance matters particularly in relation to financial institutions linked to a certain short-termist tendency in the capital markets. Part of


Jonathan Faull

the problem was that asset managers benefited from turning over portfolios which might not serve the long-term interest of their principals. He agreed that regulation was not desirable to deal with this, but ordering behaviour was an important priority.

"I would therefore suggest that we need to carry on this work exemplified by this meeting here today, this need for dialogue between the EU and the US on these issues. The markets we're talking about are global after all, and the crisis has told us that if nothing else. So, anything we can do to help each other understand the way investors behave, why they do the things they do, what public authorities should, can do in that context, is absolutely necessary for us all to make progress on this issue."

On the subject of early intervention resolution, there were again differences of approach between the EU and the US. He summarised the US approach (with due humility) as ensuring that failing institutions could be taken into receivership by the Federal Deposit Insurance Corporation which would then oversee a transfer, winding down and ultimately liquidation. The EU approach would also put banks into an orderly resolution process and try to preserve their essential services as long as possible, the failing institution itself being ultimately wound down. The EU was also considering equipping authorities with additional tools to allow a troubled bank to continue as a going concern to a write down of its debt so that its important economic functions could continue, and in order to buy time for the authorities to sell or wind down its business in the orderly manner. Any moral hazard, he argued, was small by comparison to the current moral hazard which seems to assume that the taxpayer would ultimately step in. The position in Europe was further characterised by the need to ensure that state aid rules, which are part of the competition policy, were strictly observed.

In the United States, the money to deal with orderly resolution envisaged ex– post financing from other financial institutions following failure. In Europe the authorities were trying to design a system of ex–ante financing which would require all banks to contribute to national resolution funds. It would be a levy rather than a tax.

"This dialogue," he concluded *"has become a very important platform for us; it brings together the real corporate governance experts from Europe and from the United States. I am grateful to all the speakers and panellists, the European Corporate Governance Institute, the Brookings Institution and Columbia Law School for having made possible an instructive and fruitful exchange of views and practices. We are at a crucial moment. This is not, if it ever was, a subject for specialists or for a small group of committed theorists. It is essential to the way in which our economies are governed and the confidence in which the public on both sides of the Atlantic holds them in the current crisis and on our way out of it. And what we do in the next year or so in this field, will be to put the structures in place for when a future crisis occurs, as it inevitably will."*

Ethiopis Tafara, Director of the Office of International Affairs at the SEC, emphasised that what he intended to say reflecting his views and not necessarily those of the SEC or its staff. He also paid tribute to the organisers of the dialogue and in particular to ECGI Executive Director Marco Becht.

He reflected that there was a third issue which deserved attention in addition to the two other issues which had caused regulatory concern during the day, namely, the 'too big to fail' quandary and its 'intersection with prudential regulation.' That issue related to the inherent nature of risk in the capital markets which had led to regulation in those markets very different from that found in the banking industry. In the banking industry risk is measured and mitigated, capital reserves carefully monitored. Over the years more investment institutions looked and behaved like banks. The question was, where more and more market participants pose bank – like systemic risks and therefore have had to face increased prudential rather than market regulation, who was then going to assume the investment risks needed to fund for example the riskiest technological ventures. Formulating the right plan to avoid overregulation or unintended consequences would be a challenge.

"In illustration I'd like to address a subject that may appear to be a bit of a digression, cheese. Clotaire Rapaille, a French-born American cultural anthropologist and author, has devoted himself to uncovering the meaning and decoding the thoughts that lie at the heart of different cultures. He describes his work as 'psychoanalysing a culture'. Rapaille has observed that in France cheese is alive, by which he means that you can buy cheese that is young, mature or old. In France you have to read the age of the cheese when you go to buy it, you smell it, you touch it, you poke it. If you need cheese for today you buy a mature cheese. If you need cheese for next week you buy a young cheese. And when you buy a young cheese you never ever put the cheese in the refrigerator, for the same reason that you don't put your cat in the refrigerator. Cheese like the cat is very much alive. By way of contrast, Rapaille has observed that in America cheese is dead. Because the cheese is pasteurised, it is legally and scientifically dead. In America you buy cheese wrapped in a little plastic body bag and you take it home and you put in the refrigerator, which Rapaille claims is like putting the cheese into a cheese morgue. The smell matters much less in American than it does in France. The most important thing is that the cheese is safe. Americans want safety before taste, and the French want taste before safety.

"I think what I find most interesting about Rapaille's work is that it shows that even when we're talking about something as commonplace as cheese, we bring to the conversation an unvoiced set of assumptions, experiences and preferences. My point is that as we look to reform the regulatory framework, we must be mindful of differences in regulatory context. And in this light

Ethiopis Tafara

we must come to agreement on how the new regulatory framework is to address the issue of increased systemic risk while not suppressing risk taking per se.

"This is crucial if we are to address problems yet not undermine economic innovation. To sustain the experimentation and innovation needed to drive modern growing economies, financial capital must afford to take risks. As a corollary we need a regulatory framework that provides prudential regulation for those financial intermediaries that are too big to fail. Surely the essence of our financial system is to let people take chances with their money and to enjoy most of the benefits, and to endure most of the pain, associated with taking those risks. However, if we're in a world where financial entities are too big, too indebted or too inter-connected to fail; we know that those entities will have an incentive to take on excessive risk at the ultimate expense of the public. From a policy perspective in the interest of financial innovation and financing innovation, we have to end up in a world where in fact we can afford to let financial firms fail if they make bad decisions."

Conclusions

Drawing the conference to a close, Professor Gilson said that the last two speakers had framed an issue that seems to be the one that we should walk away with. *"There are failures associated with short-termism and there are failures associated with long-termism when we fail to adjust old institutions that are no longer providing what society expects from them. The focus on the systemic risk associated with the financial crisis that we've just experienced ought not to shield our concern from a different kind of systemic risk which comes from lack of growth and lack of jobs. The real difficulty is that they are both concerns and getting the trade off right is extremely difficult.*

"I hope for all of us," he concluded, *"that we will be in a position where next year the Transatlantic Corporate Governance Dialogue will be able to focus on corporate governance and growth."*

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A practitioner viewpoint

What sets the governance of banks apart from the governance of other organisations?

by **Emmanuelle Henniaux**, Partner, Regulatory Compliance Advisory Services, PwC Luxembourg *(left)* and **Wendy Reed**, Director, Pan-European Financial Services Regulatory Advisory Services, PwC Belgium *(right)*

Although much debated beforehand, the financial crisis has shown conclusively that the complexities of moral hazard in the context of the financial system are a major differentiator. Regulators and academics have long explored the dangers of 'too big to fail', and the collapse of Lehman Brothers realised the threat of 'too interconnected to fail'. A combination of the two can clearly make institutions 'too complex to manage'. Approaches to corporate governance in many other industries do not need to address such concerns: the governance of financial institutions, and particularly banks, is a case apart.

The regulatory reaction to the crisis has been predictable: increasing focus on the quality of regulatory capital; addressing the issues of liquidity which had not been thoroughly dealt with an international level previously; looking to change incentive structures through altering remuneration practices; and more attention to risk management.

But the new regulatory approaches are moving beyond micro-prudential approaches - the 'fallacy of composition' which looked almost exclusively at the stability of individual financial institutions - to macro-prudential measures designed to reduce instability in the system as a whole. These steps are to be complemented by attention paid to the systemic risk inherent in certain financial products, particularly derivatives; to increasing stability within financial market infrastructures; and in bringing increased transparency to many areas of the financial markets. Combined, this creates significant challenges for bank management and boards for the coming years.

Perhaps more incisive than all of these new regulatory demands will be the change in attitude required in order to focus continuously on bank resolution, particularly when operating internationally. The rationale is to remove as much moral hazard as possible from the system by institutionalising the possibility of bank failure. This is obviously a highly complex issue when considered internationally and the specific regulatory requirements are likely to take some time to clarify. But simply by considering it as seriously as they are currently doing, regulators are shifting the goalposts of market behaviour through the realisation that there will be no safe harbours in the future.

What does this mean for boards and bank management? In the short term, the first challenge - that is already being addressed in some EU countries - is the development of 'living wills': working out how, in a crisis, the bank could be wound up with minimal impact on the financial system as a whole. The final configuration of these 'living wills' will take into account the staggered supervisory intervention that is currently being conceived, but essentially, the maintenance of a 'living will' going forward means that every decision must be subject to objective challenge, questioning what impact any new business venture, or product, may have on ongoing viability of the 'will'.

This challenge will need to come, primarily, from the board. The ability to play 'devil's advocate' on a perpetual basis, questioning not only the significant new business ventures but also scrutinising and critiquing the evolution of existing business will place significant demands on boards. Boards need diversity in order to ensure such challenge and to avoid 'group-think'. However, in order to be effective, this challenge needs to be based on sound knowledge of the business of the organisation and of the changing markets in which it operates. Boards will need to invest more time, on an ongoing basis, in understanding the business and educating themselves about the implications of market developments.

But there will always be the risk that 'accepted wisdom' and 'market practices' – what you might call 'passive herd behaviour'- may hold sway against any challenge and limit the options available to the organisation. Similarly, constant 'second-guessing' can also petrify progress and innovation.

The change in perspective now evident amongst the regulatory community in developing their capabilities in relation to macro-prudential supervision, not least in obtaining and analysing wider and different datasets to assess potential risks to the financial system, should provide better intelligence for boards when presenting such challenge. However, macro-prudential surveillance will be much more art than science, and, particularly in the short-term, exercised against a backdrop of significant political intervention. This may exacerbate the difficulties as politics is quintessentially 'short-term'. We also have to remember that no group of individuals – even regulators – are immune to 'group-thinking'.

As a result, there is a substantial need for ongoing, focussed academic research and study, providing empirical data and analysis, to balance the ongoing efforts of regulators and the industry to improve risk management. This is where organisations such as the European Corporate Governance Institute have such a vital role to play, and why PwC is proud to support its efforts.

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