Governance and Regulation in Crisis: Addressing the Next One

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Avalanche of New Corporate Governance Proposals

- UK – Financial Reporting Council corporate governance and stewardship codes; Walker report on corporate governance in banks and other financial institutions
- European Commission Green Paper on corporate governance in financial institutions and corporate governance review
- Dodd-Frank proposals on corporate governance, sequel to Sarbanes-Oxley

Cause

- Failure of financial institutions in credit crisis and perceived contribution of poor corporate governance
- In particular, companies took undue risks that jeopardized stability
- Failure to monitor, measure and manage risks

Required Response

- More competence, training, and authority in risk management
- Know risks, justify them, monitor and manage them
- Structure: Board Effectiveness
- Conduct: Accountability, Risk and Remuneration
- Monitoring and Enforcement: Shareholder Relations and Stewardship

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Board Structure and Effectiveness

- Board composition, including gender
- Independence and conflicts of interest
- Nominations and appointment
- Induction
- Time commitment
- Information and servicing of board
- Annual re-election
- Annual evaluation of board performance
- Scrutiny by non-executive directors
- Separate functions of chairman, CEO

Changing Board Composition

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Year	Mean Board Size	Mean % Independent Directors	Average Number of Board Appointments of Outside Directors
2000	15,0	41%	3,6
2001	14,8	44%	3,5
2002	14,4	49%	3,6
2003	12,4	62%	3,0
2004	11,9	66%	2,9
2005	11,7	67%	2,9
2006	11,6	67%	2,9
2007	11,7	65%	2,9
2008	11,7	63%	2,9

Accountability, Risk and Remuneration

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- Audit committee and internal controls
- Risk management committee and CRO
- Relation of pay to performance and risk – “say on pay”, equity, options, golden parachutes, deferred compensation, accounting restatements, executive compensation committee
- Disclosure

Shareholder Engagement and Stewardship

- Two-way communication from and to shareholders
- Shareholder monitoring
- Public engagement – shareholder resolutions, proxy voting, voting policy and behaviour
- Private engagement – meetings with directors
- Collective action
- Relation between pension funds and fund managers

Summary on Reforms

- Structure, conduct and monitoring and enforcement
- Internal procedures have to be clear, enforced and effective
- External relations have to be managed by both sides and be transparent
- Minimum EU wide standards

Problem 1
Which Investors?

Corporate Governance and Performance in the Financial Crisis

- During the financial crisis risk taking was greatest in financial institutions with the best corporate governance
- Institutions with the best corporate governance had the worst share price performance during the crisis

Why?

Shareholder-Creditor Conflict

- Greater risk taking depresses creditor claims and increases shareholder value
- Wealth transfer: Greater risk taking encouraged by stronger governance by shareholders – negative externality promoted
- Underinvestment: Inadequate investment in assets that benefit creditors, including equity capital – positive externality discouraged

Proposition 1

"Good governance" may exacerbate the exposure of creditors

Proposed Solution 1
Capital Requirements

- Miles (2011) - Capital requirements should be doubled
- Admati, DeMarzo, Hellwig, Pfleiderer (2010) – bank equity is not expensive
- In Modigliani-Miller context, cost of equity capital limited to tax subsidy on interest payments
- Increased equity reduces substantial social costs of failures

Optimal Capital Ratios

	Permanent Effects of Crises	No Permanent Effects of Crises
Base cost of capital	19%	17%
Lower cost capital	20%	18%
Higher cost capital	18%	16%

Shareholder-Creditor Conflict

- Equity cost of capital high in context of shareholder-creditor conflict: increased capital is wealth transfer to creditors
- Private benefits: reducing incentives for wealth transfers to shareholders and diminishing underinvestment problem
- Social benefits: diminished subsidy from tax payer for deposit insurance and “too big to fail”

Problem 2
Which Shareholder?

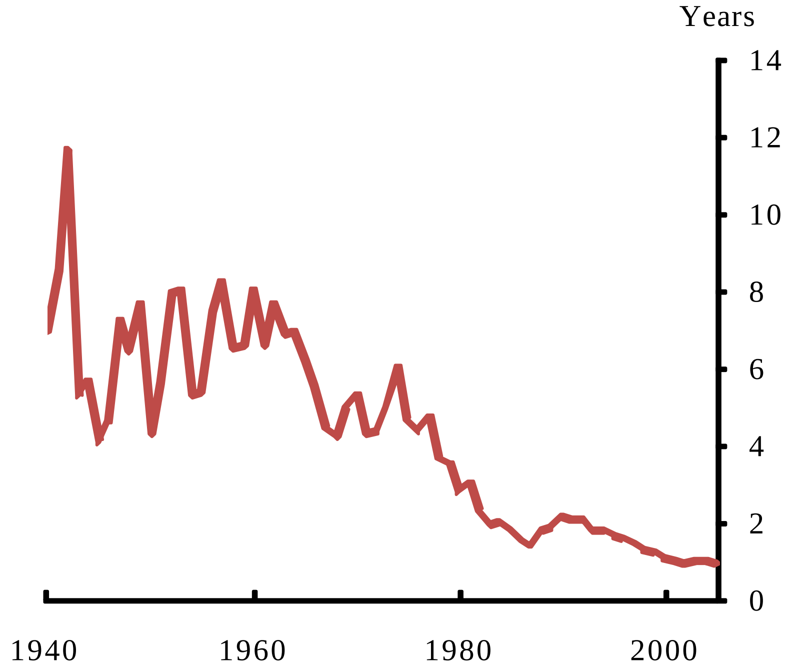
"We need an end to short - termism ... at least until next week."

Which Shareholders? What Time Period?

- Critical role of hedge funds in takeovers
- High frequency trading: 60-70% of equity trades in US and 30-40% in Europe
- Average holding period of shares declined from 3 years in 1990 to less than a year
- Should the firm reflect all shareholder interests equally or mainly long-term?

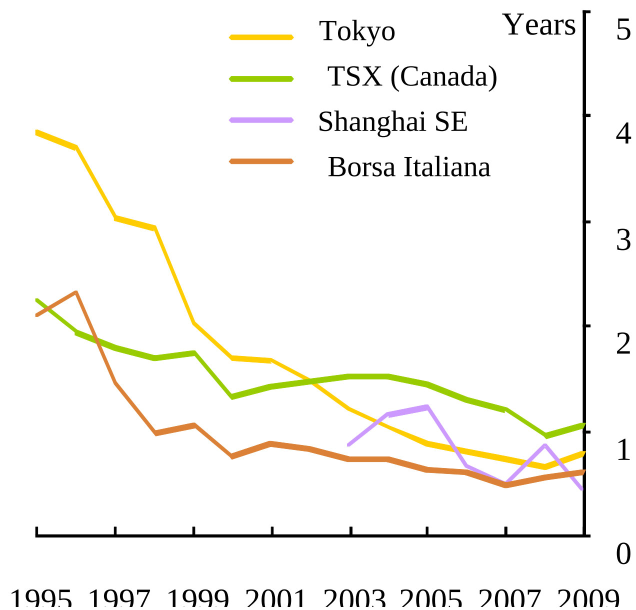
Holding Periods

US



Source: New York Stock Exchange

Other Major Stock Exchanges



Source: World Federation of Exchanges

Proposition 2

Shareholder conflicts arise not only between minority and majority shareholders but also between short and long-term shareholders

Proposed Solution 2: Alternative Incentive Arrangements

- Deferred compensation
- Linking executive compensation to creditor risk, eg CDS spreads
- Loyalty shares, increased voting rights

Problem 3
The Incentives Dilemma

'Your card is fine. I'm just checking that your bank hasn't expired'

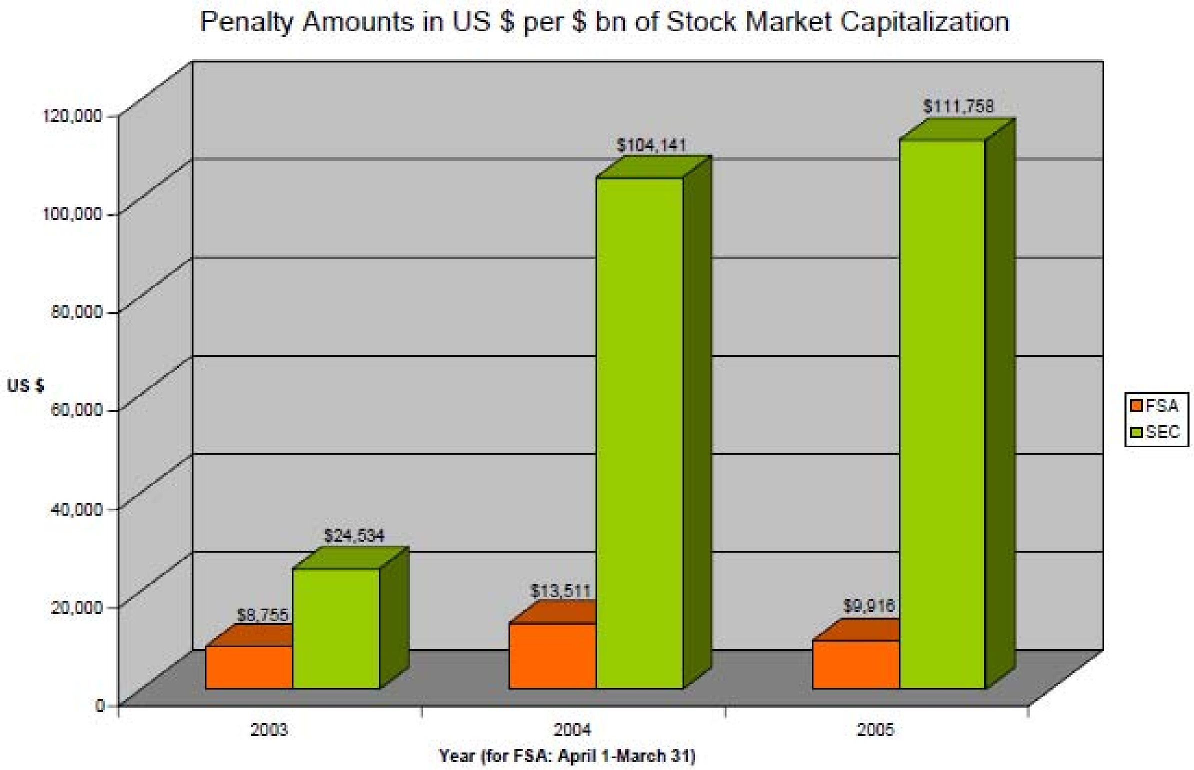
The Impossibility of Correct Incentives

- “It is impossible to establish a compensation mechanism that separates skilled from unskilled managers solely on the basis of their returns histories. In particular, any compensation mechanism that deters unskilled risk-neutral mimics also deters all skilled risk-neutral managers who consistently generate returns in excess of the risk-free rate” – Dean Foster and Peyton Young

Proposition 3

Financial performance based incentive mechanisms cannot resolve governance problems

Proposed Solution 3
Public and Private Enforcement



SEC Enforcement as Trigger for Private Litigation

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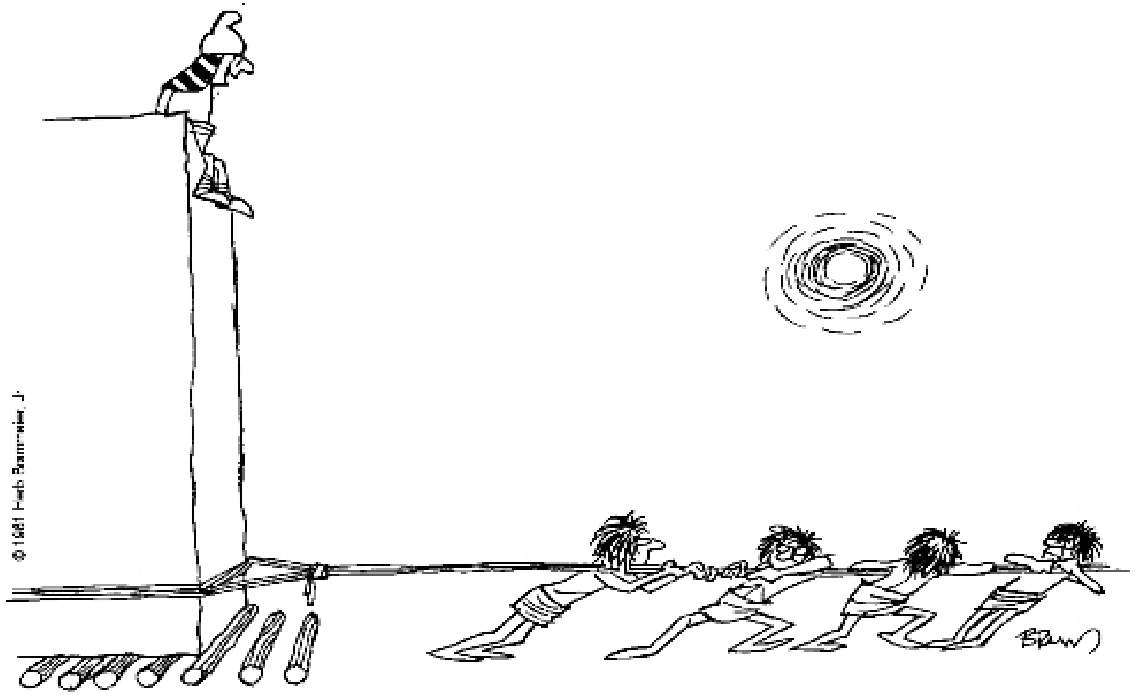
Panel B: Monetary Penalties		
Number of fines imposed on firms	N	47
Penalties ($millions)	Total	5,028.16
	Mean	106.98
	Median	0.89
	Min	0.00
	Max	2,277.00†
Panel C: Class Action/Derivative Lawsuits		
Number of class action/derivative lawsuits	N	231
Payments ($millions)	Total	8,697.07
	Mean	37.65
	Median	0.80
	Min	0.00
	Max	2,830.00††

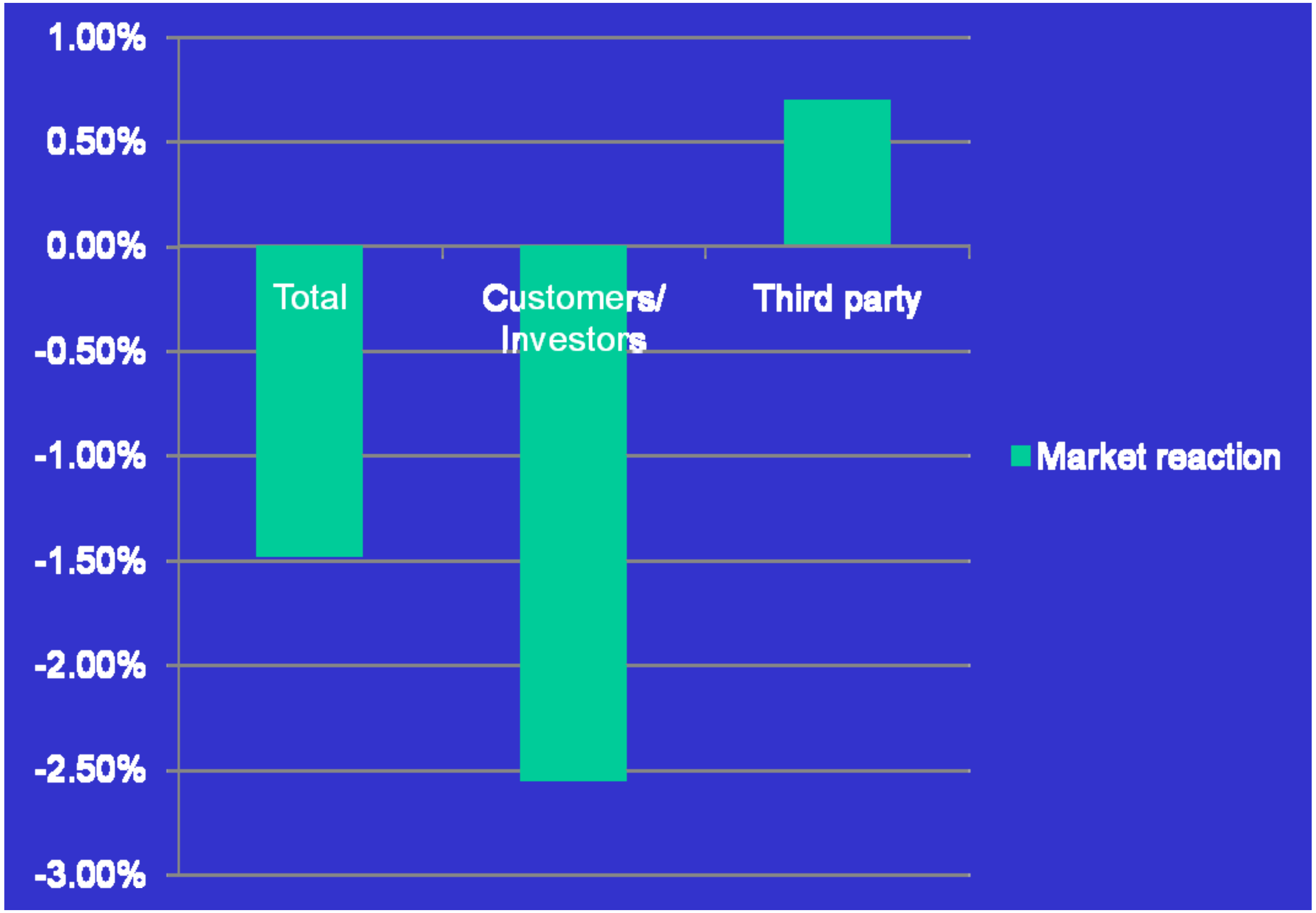
Karpof et al. (2008)

Problem 4
The Dominance of Reputations

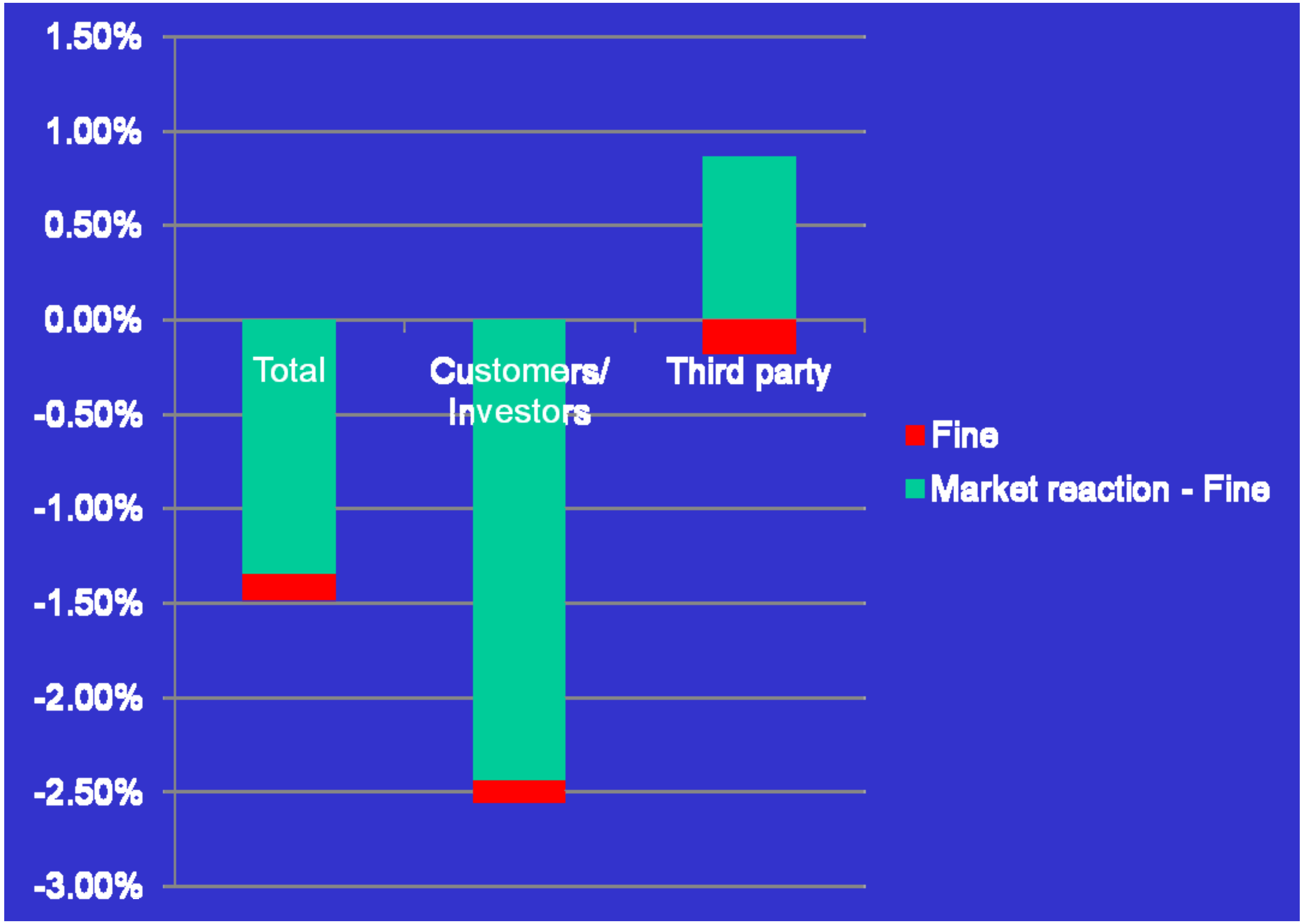


"Believe me, fellows, everyone from the Pharaoh on down is an equally valued member of the team."

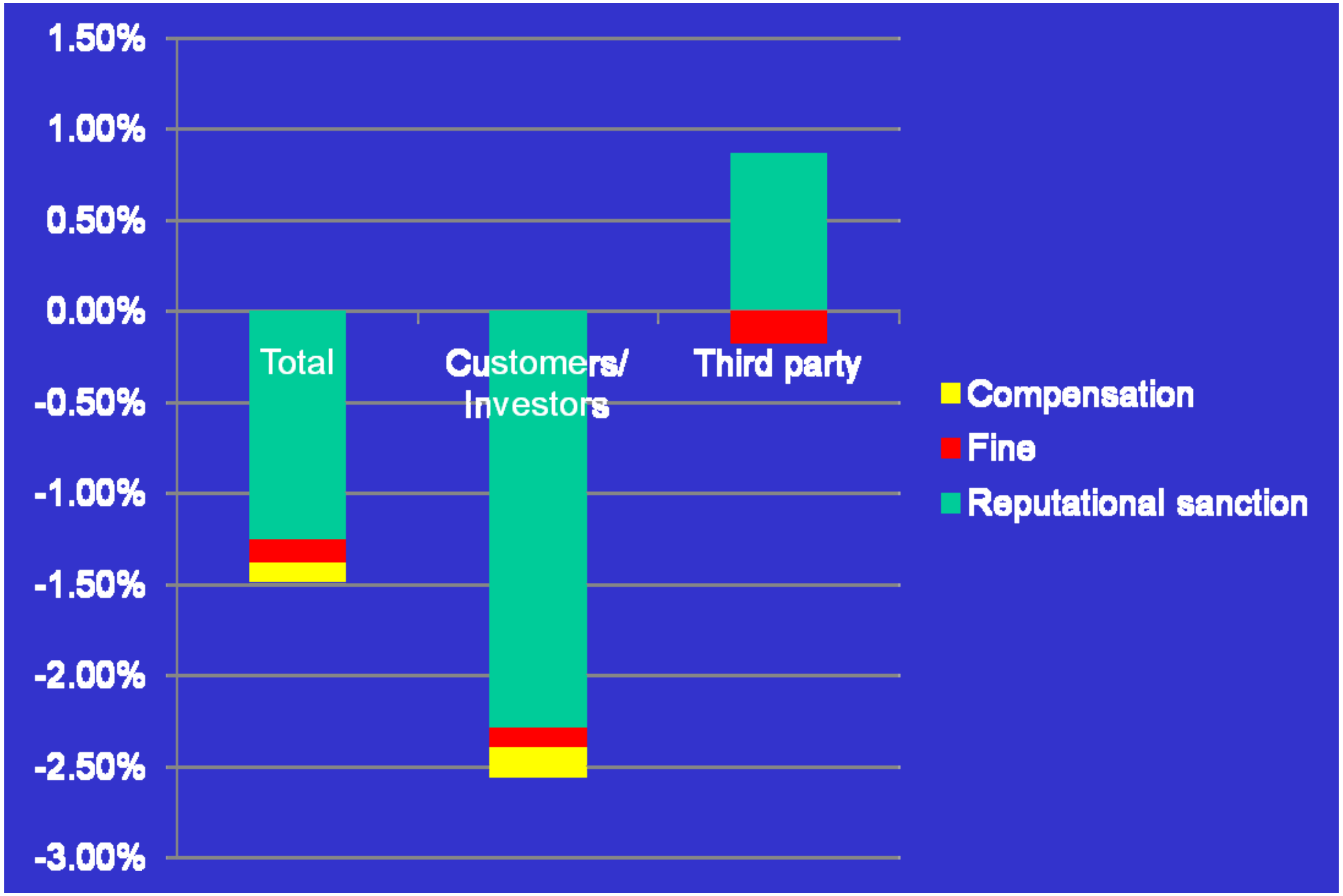
Reputational Damage



Reputations and Fines



Reputations and Compensation



Proposition 4

Capital is neither a

necessary condition for compliance (reputational losses dwarf public and private penalties)

nor a sufficient condition for addressing a substantial class of corporate abuses (reputational responses may offset capital at risk)

Capital Market Failures

- None of good governance, incentives, public or private enforcement ensure that banks uphold the public interest
- Capital markets do not achieve efficiency in banking

Proposed Solution 4
Competition

- Product market rather than capital market competition promotes efficient allocation of resources
- Encourages allocative and productive efficiency
- Promotes innovation and entry

Problem 5
Competition

The Fragility of Banks

- Diamond and Dybvig (1984) – banks borrow short-term liquid deposits and invest in long-term illiquid assets
- They are therefore exposed to premature withdrawal of deposits provoking runs
- The greater the degree of competition the greater the fragility of banks

Proposition 5

There is a trade-off between competition promoting efficiency and stability of banking

Proposed Solution 5
Regulatory Rings

- Force banks to invest in safe assets – narrow banking
- Separate commercial and investment banking – Glass-Steagall
- Prevent proprietary trading – Volcker rule
- Ring fence bank subsidiaries – Vickers UK Banking Commission

Problem 6
What are Banks Supposed To Do?

The Misconception

- Diamond and Dybvig (1984) – banks borrow short-term liquid deposits and invest in long-term illiquid assets
- No they don't
- They borrowed money market funds and invested in short-term speculative assets
- Even investments in housing were passed on through securitization
- No owners in Diamond-Dybvig, therefore no decisions on what they do. They just do what they are presumed to do

The Problem

None of:

- Corporate governance
- Incentives
- Public enforcement
- Competition

ensure that banks act in the public interest in the way in which they do in other sectors

- Narrow-banking and separation of commercial and investment banking potentially exacerbate the problem by restricting the function of banks

The Public Subsidy

- Banks receive a substantial subsidy, not just through deposit insurance and too big to fail
- They raise funds through monetary assets
- They pay well below market interest rates because of the transaction benefits of holding money

Defining the Public Purpose

- What is the public benefit of the subsidy?
- Is it restricted to bank liabilities
- Is it just about protecting monetary system?
- If so, there is much easier way of achieving this


EQUITY
AGENT
yu CASH
TELLER COUNTERS/ATM

Mobile Banking

- Pure exchange of cash for book entry money; pure custodianship
- No fractional banking; no investment
- No required reserves or prudential regulation
- Cheaper monetary transmission
- Real issue is not whether we can have safe deposits or transmission
- Should there be a quid pro quo on the asset side?
- What is the purpose of banks?

Financing Capital Market Failures

- Commercial banking should be about solving “capital market failures”
- Lending to start-ups, SMEs, education and training, environmental projects, long-term investments
- If these (once again) defined “commercial” banking then they would transform practice and perceptions of banks, bankers and executive remuneration

Achieving Public Purpose

- Regulation alone will not achieve it.
- Ring fencing provides opportunity of defining purpose of banks and focusing it on capital market failures as part of licence conditions
- Requires a fundamental refocusing of governance not just away from shareholders to creditors or from short-term to long-term investors but to the goals we want banks to fulfil

Bank Governance

- What is best form of governance?
- 1980's – Japan
- 1990's – US
- 2000's – UK
- Now ?

Proposition 6

Commercial banks should be ring fenced, well-capitalized and have a purpose implemented through a diverse range of governance arrangements

Harmonization can create the systemic risks that regulation and corporate governance are designed to avoid

Summary

- Prescriptive corporate governance proposals
- Solutions of governance, incentives, enforcement and competition not adequate
- Neither capital markets nor product markets ensure that banks fulfil their purpose
- Identify purpose of banks
- Suggested that this should be focused on “capital market failures”
- Encourage experimentation and competition not harmonization in governance