Governance and Regulation in Crisis: Addressing the Next One

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and ECGI
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
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

<table>
<thead>
<tr>
<th>Year</th>
<th>Mean Board Size</th>
<th>Mean % Independent Directors</th>
<th>Average Number of Board Appointments of Outside Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>15,0</td>
<td>41%</td>
<td>3,6</td>
</tr>
<tr>
<td>2001</td>
<td>14,8</td>
<td>44%</td>
<td>3,5</td>
</tr>
<tr>
<td>2002</td>
<td>14,4</td>
<td>49%</td>
<td>3,6</td>
</tr>
<tr>
<td>2003</td>
<td>12,4</td>
<td>62%</td>
<td>3,0</td>
</tr>
<tr>
<td>2004</td>
<td>11,9</td>
<td>66%</td>
<td>2,9</td>
</tr>
<tr>
<td>2005</td>
<td>11,7</td>
<td>67%</td>
<td>2,9</td>
</tr>
<tr>
<td>2006</td>
<td>11,6</td>
<td>67%</td>
<td>2,9</td>
</tr>
<tr>
<td>2007</td>
<td>11,7</td>
<td>65%</td>
<td>2,9</td>
</tr>
<tr>
<td>2008</td>
<td>11,7</td>
<td>63%</td>
<td>2,9</td>
</tr>
</tbody>
</table>
Accountability, Risk and Remuneration

- 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

<table>
<thead>
<tr>
<th></th>
<th>Permanent Effects of Crises</th>
<th>No Permanent Effects of Crises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base cost of capital</td>
<td>19%</td>
<td>17%</td>
</tr>
<tr>
<td>Lower cost capital</td>
<td>20%</td>
<td>18%</td>
</tr>
<tr>
<td>Higher cost capital</td>
<td>18%</td>
<td>16%</td>
</tr>
</tbody>
</table>
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."
• 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

Other Major Stock Exchanges

Source: New York Stock Exchange

Source: World Federation of Exchanges
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

Traditionally, UK regulators relied far less on formal sanctions than did their US counterparts. But the FSA has recently signalled a significant increase in formal penalties (FSA, 2010). Where do reputational sanctions fit in?

Coffee, 2007
<table>
<thead>
<tr>
<th>Panel B: Monetary Penalties</th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Number of fines imposed on firms</td>
<td>N</td>
<td>47</td>
<td></td>
</tr>
<tr>
<td>Penalties ($millions)</td>
<td>Total</td>
<td>5,028.16</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Mean</td>
<td>106.98</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Median</td>
<td>0.89</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Min</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Max</td>
<td>2,277.00†</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel C: Class Action/Derivative Lawsuits</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of class action/derivative lawsuits</td>
<td>N</td>
<td>231</td>
<td></td>
</tr>
<tr>
<td>Payments ($millions)</td>
<td>Total</td>
<td>8,697.07</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Mean</td>
<td>37.65</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Median</td>
<td>0.80</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Min</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Max</td>
<td>2,830.00‡‡</td>
<td></td>
</tr>
</tbody>
</table>

Karpof et al. (2008)
"Believe me, fellows, everyone from the Pharaoh on down is an equally valued member of the team."
Reputational Damage

- Time window: (-1,1)
Reputations and Fines

![Bar chart showing market reaction to fines and reputations for total, customers/investors, and third party.](chart.png)
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

Poor chap. Lent his legs to a hedge fund for short selling....
The Fragility of Banks

- 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?

CAPITALISM WORKS BEST WHEN LEFT ALONE

THREE MILE ISLAND

LOVE CANAL

HOUSING BUBBLE

ASIAN SWEATSHOPS

A.I.G.

FORD PINTO
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
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.
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?
• 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