The Governance of Financial Institutions

Paolo Volpin
London Business School

Transatlantic Corporate Governance Dialogue
Brussels, 9 September 2008

London Business School

Introduction

- Until recently, common view was that banks (and other regulated firms) were **not** subject to same agency problems between managers and shareholders of most public companies.
  - Why? Regulation restricted managerial discretion and its scope to adversely affect shareholder wealth.

- However, recent crisis has given rise to a more cynical view of what regulation can achieve by itself.
- Debate is still in early stages, but the outcome will be a call for both greater regulatory scrutiny of banks risk-taking and more effective corporate governance of banks.

Outline of the Talk

- ❑ Introduction ✔
- ❑ The business model of banks (2000-2007)
- ❑ Corporate governance building blocks
- ❑ Lessons from the crisis

Bank Business Model

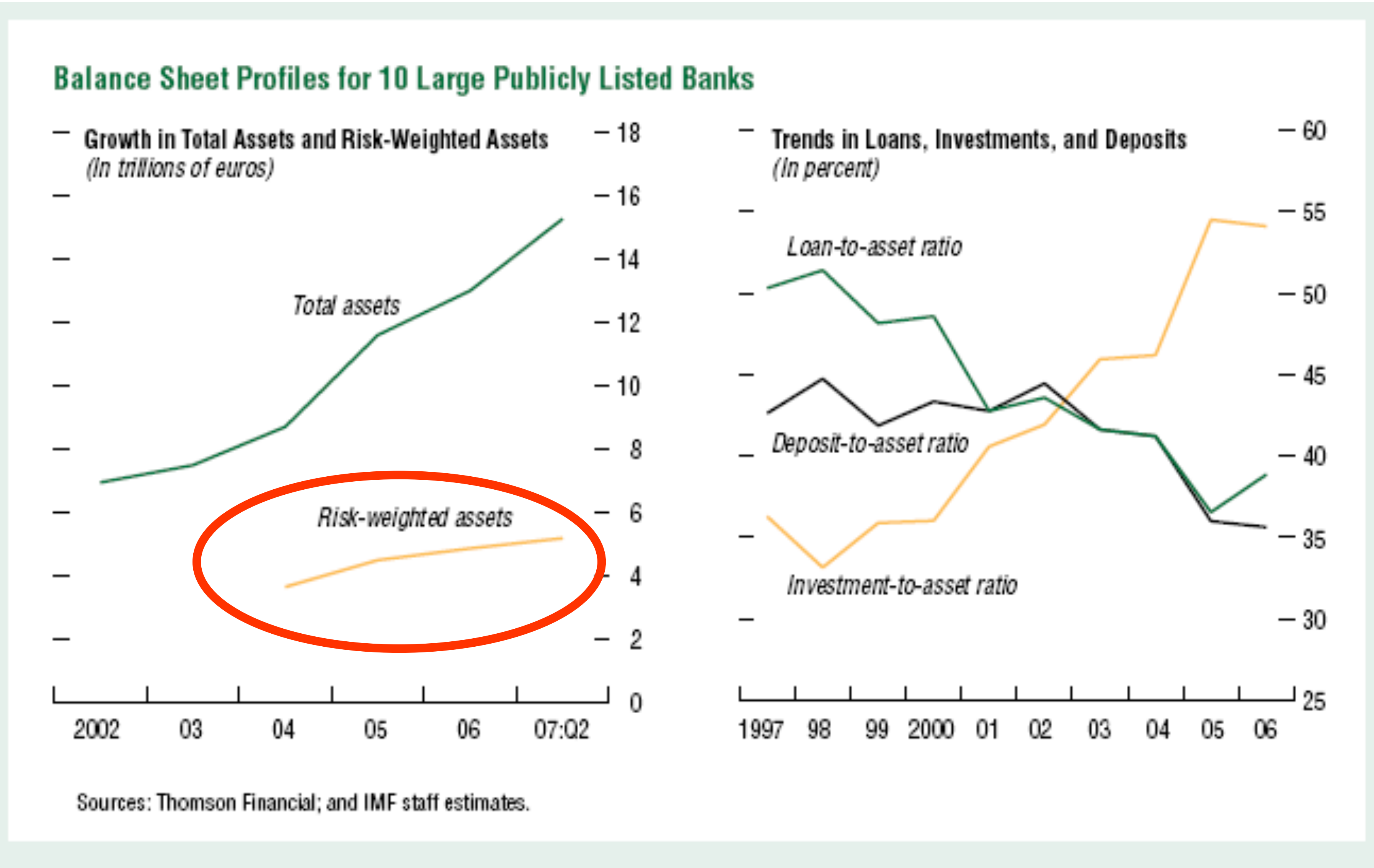
- Banks would pool and securitize the credits they originated to transfer their risk to a myriad of investors.

  Issuance of structured credit products grew from $500 billion in 2000 to $2.6 trillion in 2007 (specifically, CDOs grew from $150 million to $1.2 trillion).

- This model benefits:
  - Banks by allowing them to lower their capital requirement and grow,
  - Investors by offering new risk-return opportunities, and
  - Borrowers by increasing the availability of credit.

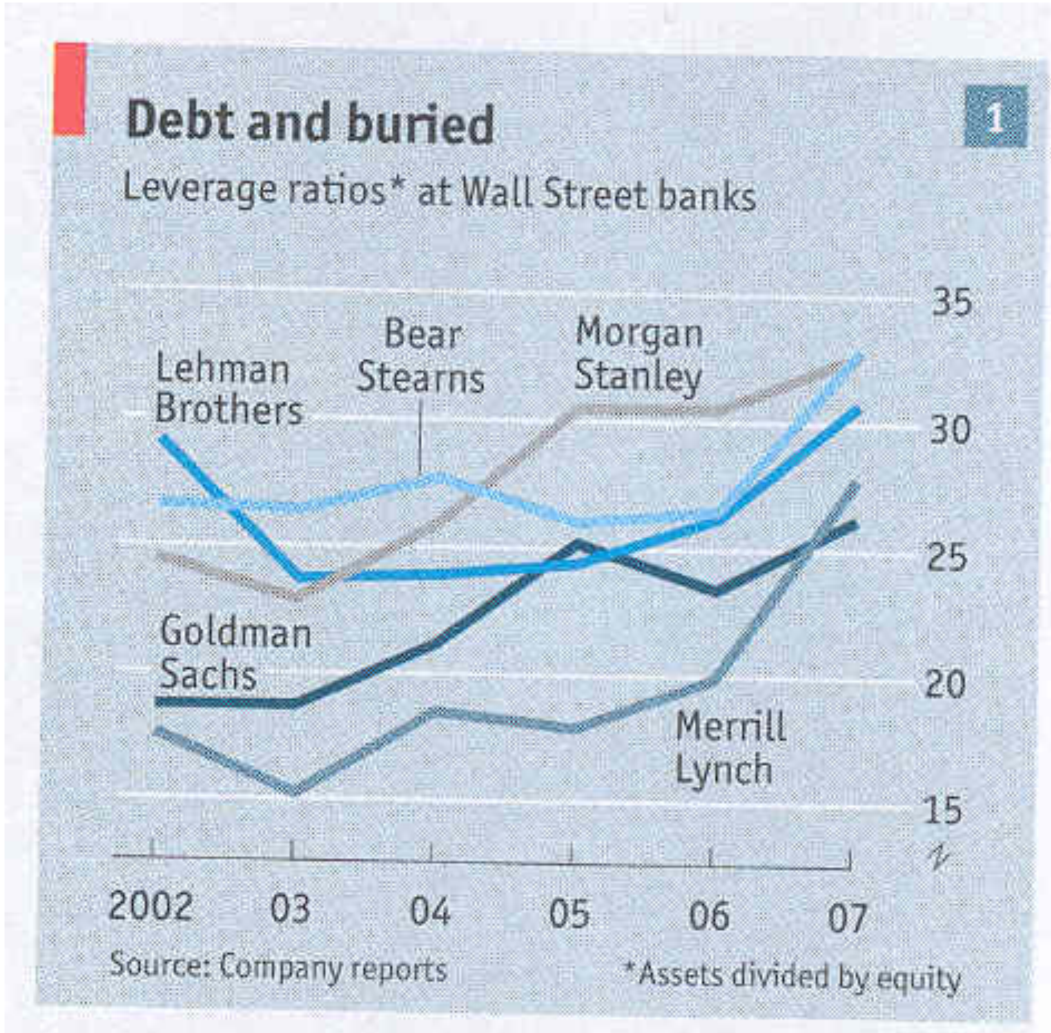
“Credit is now something that is largely bought and sold on the market, rather than held for the long term on the balance sheets of financial intermediaries” (Mario Draghi as cited by Spaventa, 2008)

Growth of Assets and (Particularly) “Investments”



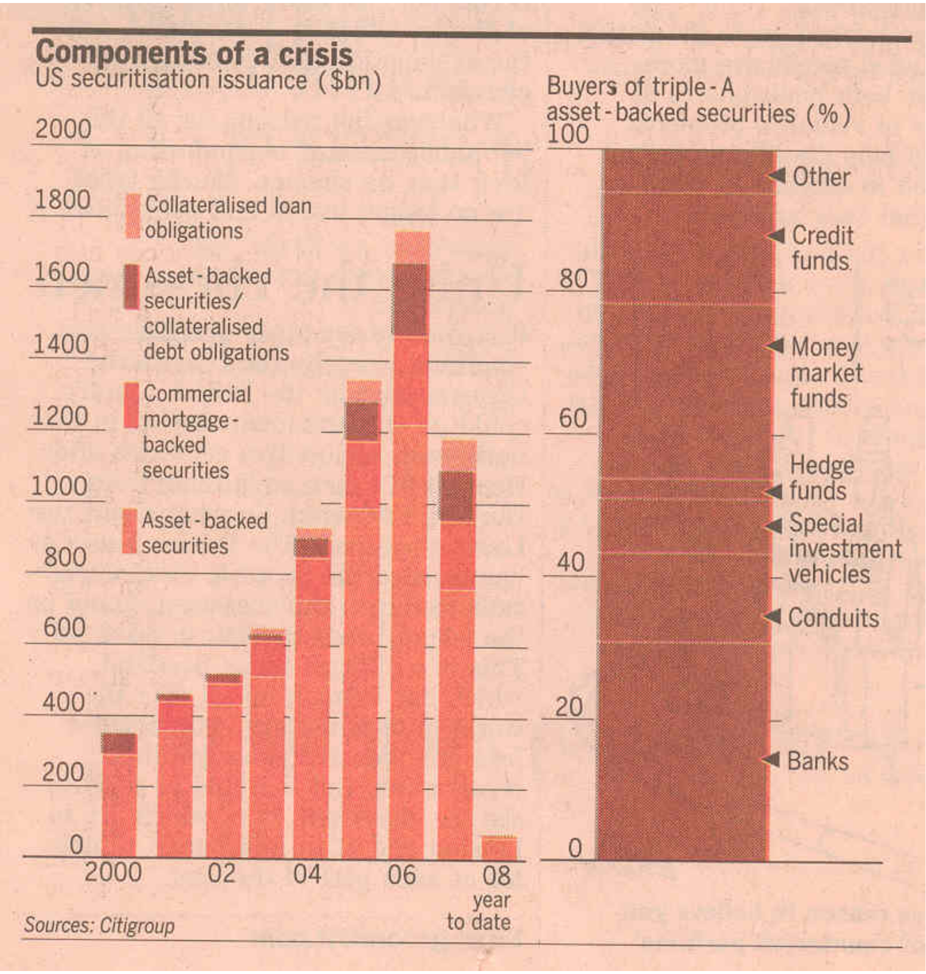
Sources: Thomson Financial; and IMF staff estimates.

Phenomenally High Leverage



Source: Economist

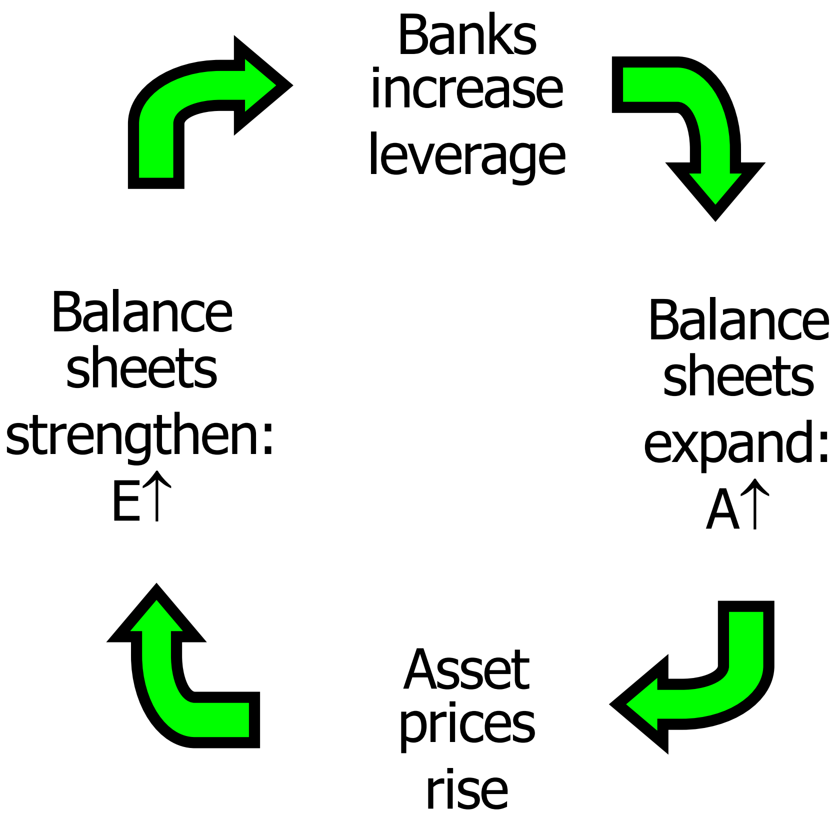
A Lot of Exposure to ABS!



Source: FT

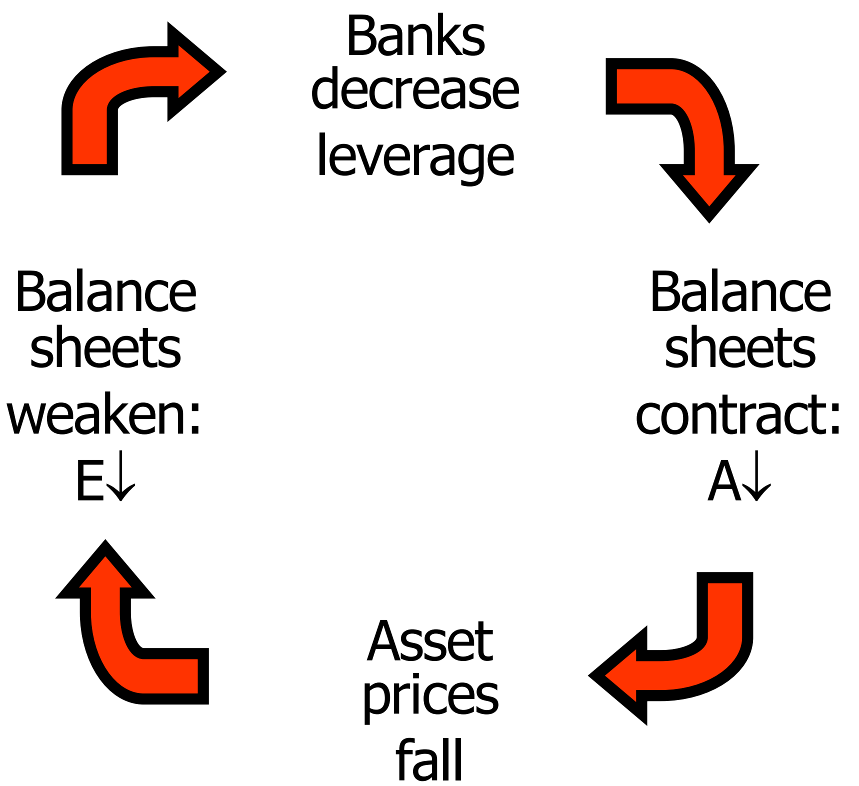
With hindsight … this growth in leverage and investment lead to asset price bubble and great financial instability.

In an asset price boom, credit liquidity rises…



... and feeds into further asset price rises.

When asset prices fall, credit liquidity decreases …



... and feeds into further asset price decline.

Write-Downs and (Emergency) Capital Issuances

Bank/FI	Writedowns/losses ($bln)	Total capital raised ($bln)
Citi	40.8	44.1
UBS	38.1	27.7
ML	31.7	16.1
AIG	20	12.5
BoA	14.9	17
RBS	14.9	23.7
MS	12.6	5
HSBC	12.5	2.2
JPM	9.8	7.8
CS	9.6	1.4

Outline of the Talk

- ❑ Introduction ✓
- ❑ The business model of banks (2000-2007) ✓
- ❑ Corporate governance building blocks
- ❑ Lessons from the crisis

Corporate Governance Building Blocks

- Contractual Incentives:
  - Compensation Structure & Inside Ownership
  - Debt (Maturity & Covenants)
- Active Monitoring:
  - Board of Directors
  - Shareholders (Activists and Large Shareholders)
  - Creditors (Banks & Large Lenders)
- External Constraints:
  - Product Market Competition
  - Market for Corporate Control
  - Need for External Capital
  - Regulation

Limits of Pay for Performance

- On 25 March 2008, Bear Stearns' CEO (Jim Cayne) sold his 5,612,992 shares in the company for $10.84.
- His personal wealth had fallen by $425 million in a month!

- It is hard to imagine that a *bigger stake* in the firm would have produced the right incentives to get things right.

- In other words, higher-powered incentives are hardly the solution.

- However, a better design of these compensation schemes (particularly within the organization) may actually help.

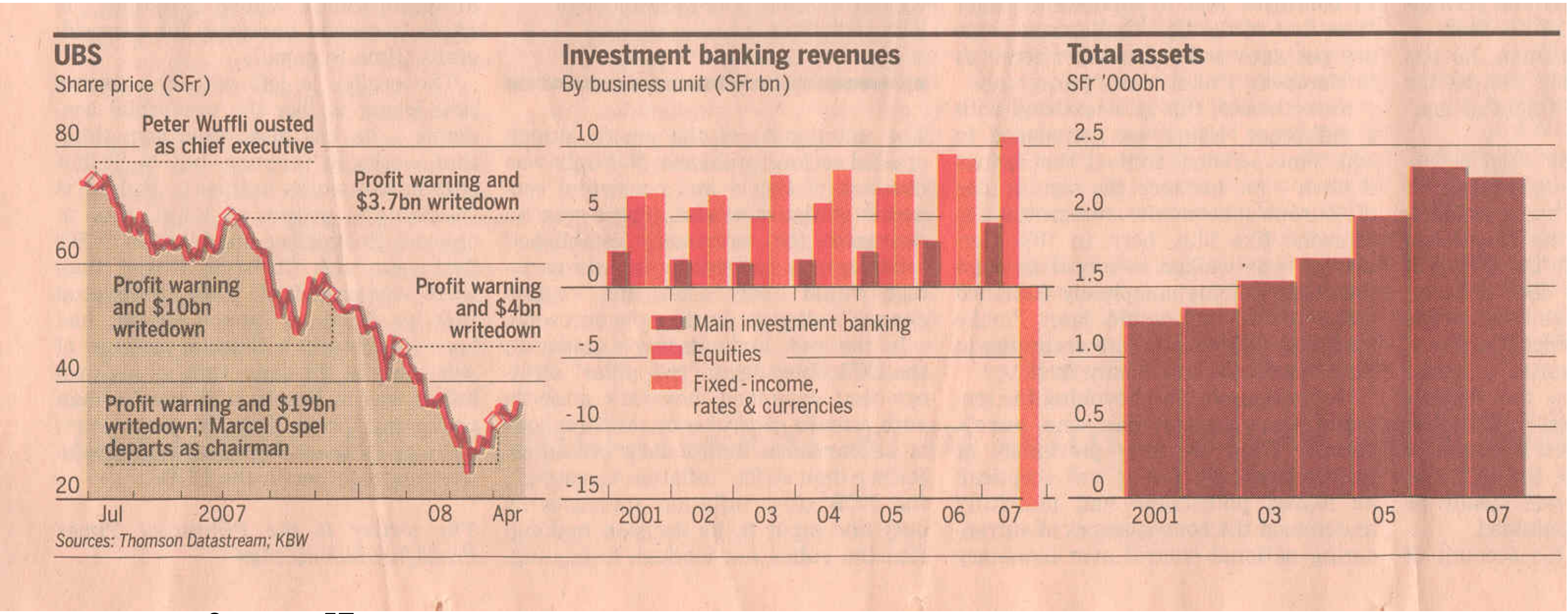
Short Term Perspective

- Emphasis on stock price performance may induce CEOs to take on excessive risk
- Chuck Prince, Citigroup Chairman: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." (FT, 9 July 2007)

- *"If banks feel they must keep on dancing while the music is playing and that at the end of the party the central bank will make sure everyone gets home safely, then over time the parties will become wilder and wilder. … That might not matter were the consequences limited to the partygoers. But they are not. When the party ends, some innocent bystanders may lose their homes altogether."* (Mervyn King, FT, 11 June 2008)

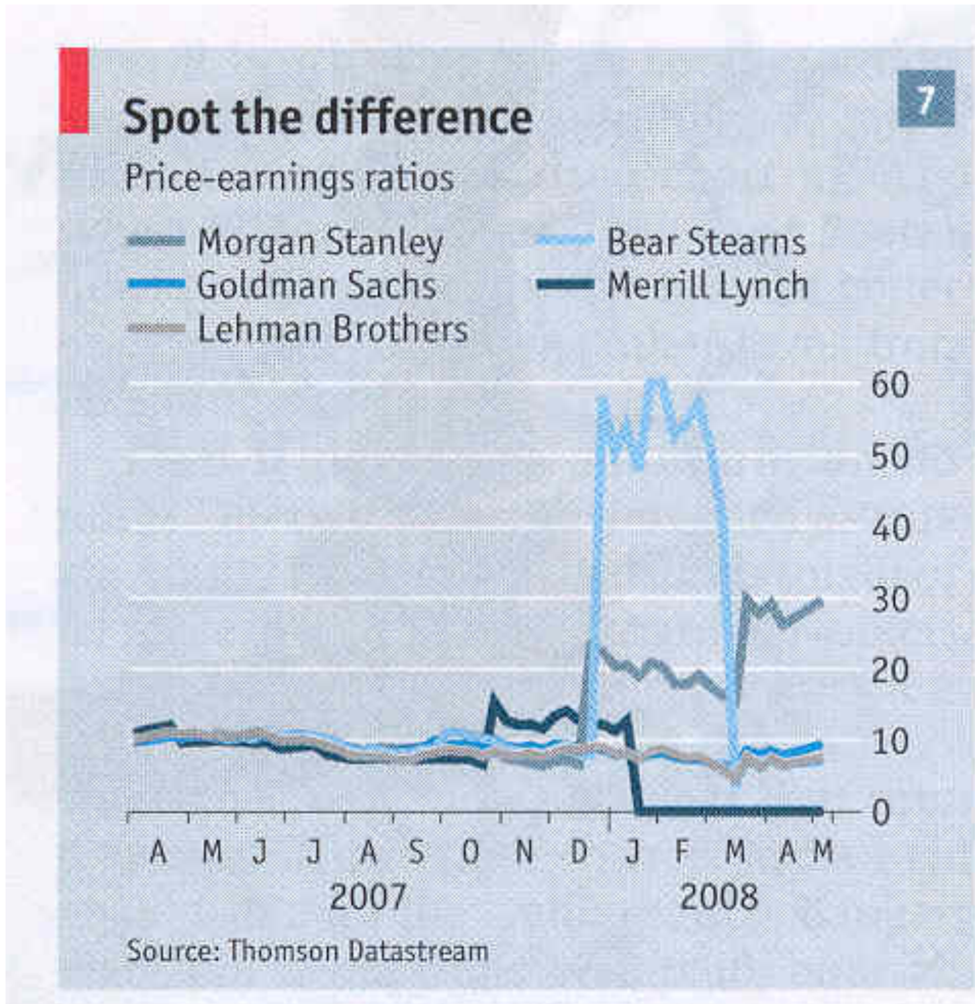
Perverse Incentives

- At UBS, AAA-rated mortgage-backed securities (MBS) were charged very low funding costs. Traders holding these securities were allowed to count any spread in excess of this low hurdle rate as income, which was reflected into their bonus.
  - Outcome: By summer 2007, UBS had a $75 bn exposure to MBS.



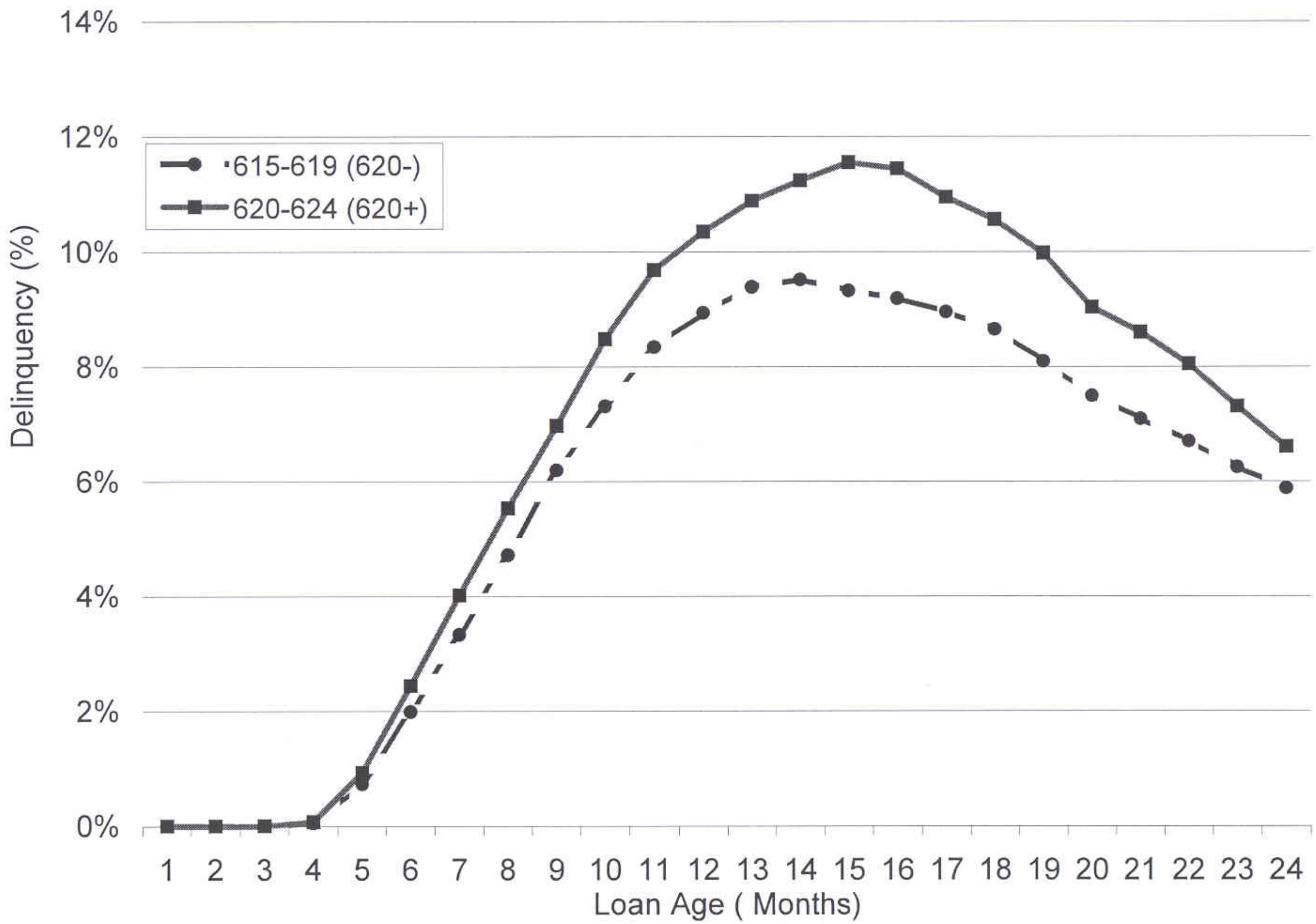
Source: FT

Opaque Banks



Source: Economist

Hidden Cost of Securitization



Source: Keys, Mukherjee, Seru and Vig (2008)

Flawed Risk Assessment Models

- Statistical models used by banks (rating agencies and investors) were based **overly optimistic forecasts** about structured mortgage products:
  - They were based on historically low mortgage default and delinquency rates, coming from a time with much tighter credit standards.
  - They assumed large geographical diversification in the housing market: the US had never experienced a nationwide house price slowdown (Brunnermeier, 2008).

Monitoring

- Lesson from the crisis:
  "Too little too late"

- Limited shareholder activism: Chuck Prince (Citigroup's CEO & Chairman) was ousted in November 2007.

- Passive boards of directors: Historically, banks have always had large boards playing mainly an advisory role. Example: Marcel Ospel (UBS Chairman)'s retirement came 9 months after the first announcement of losses.

Market for Corporate Control

- Does M&A in banking sector create value?
  - Cumulative abnormal returns (CARs) for targets are large and positive; CARs for acquirers are small and negative.
  - Combined returns are not significantly different from 0: the gains in cost efficiency are offset by greater bureaucratic costs.
  - Financial conglomerates trade at a significant discount to some of parts (Laeven and Levine, 2007).
  - Interdependence makes fire-sales very painful: in a crisis, more likely buyers are themselves in trouble (Bear Stearns).
  - Friendly attitude of banking mergers (MOE) makes disciplinary takeovers very rare.

Way Forward

- Compensation structure:

1. Develop and use better models for the valuation of risk within banks.
2. Change incentive structure within banks: Compensation as a function of properly risk-adjusted performance.
3. Enforce greater *transparency standards*. This will help stock price to be more informative.

- Monitoring:

1. More shareholder activism in banks: large shareholders (hedge funds & private equity) will take an active monitoring role.
2. Empower board of directors: Boards will be taking a greater monitoring role. SOX requirements on independent directors will extend to banks.

- Market for corporate control:

  Not clear that market for corporate control works as a solution to agency problems. It seems more often a symptom of poor governance.

References

- Adrian, Tobias and Hyun Song Shin (2008), “Liquidity, Monetary Policy, and Financial Cycles”, Current Issues in Economics and Finance 14, Federal Reserve of New York.
- Brunnermeier, Markus (2008), “Deciphering the 2007-2008 Liquidity and Credit Crunch,” Journal of Economic Perspectives, forthcoming.
- Kashyap, Anil, Raghuram Rajan, and Jeremy Stein (2008), “Rethinking Capital Regulation,” unpublished working paper.
- Keys, Benjamin, Tamnoy Mukherjee, Amit Seru, and Vikrant Vig (2008), “Did Securitization Lead to Lax Screening? Evidence From Subprime Loans,” unpublished working paper.
- Laeven, Luc and Ross Levine (2007), “Is There a Diversification Discount in Financial Conglomerates?” Journal of Financial Economics 85, 331-367.
- Spaventa, Luigi (2008), “Avoiding Disorderly Deleveraging,” Euro50 Group, April, unpublished manuscript.