The Corporate Governance of Banks and other Systemically Important Financial Institutions

Jeffrey N. Gordon
Columbia Law School

Transatlantic Corporate Governance Dialogue

December 17, 2012

Summary, 1

Banks/SIFIs are different from non-financial firms

1. Leverage and the capacity to rapidly increase risk makes them more prone to fail and harder to monitor
2. Failure of financial firms has systemic fallout whereas failure of (most) non-financial firms does not
3. Key difference: “excessive” risk-taking, which is not coherent idea for non-financial firm, becomes the governance pivot for the financial firm

Summary, 2

Consequence: the Governance Rx drawn from experience with non-financial firms needs to change as well

-- Post-crisis empirical evidence calls into question much received wisdom about board structure

-- "shareholder empowerment," which has been a lodestar of corporate governance reform, stands on shaky ground for the financial firm

Summary, 3 – New approaches

- Approach one: Focus on modifying the incentives of the SIFI’s agents, through effort to replace “high-powered” employee incentives with “low-powered” incentives
- E.g.: current EU proposal: limit variable pay to small multiple (2 or 3) of fixed pay

Summary, 4

- Alternative approach: new board model that Is focused less on prescription and more on accountability of the board for major losses at the firm.
- Achieve accountability by imposing monetary liability on directors for negligent risk oversight, on occasions of “serious loss”
-     -- no business judgment insulation; uninsurable

  -- but capped in amount

Special Bank Corp Governance Rules?

- **Greater likelihood of bank failure than non-financial firms**
  - High Leverage
  - Can take on risk very quickly (including low visibility ways of increasing leverage through explicit and implicit guarantees of nominally unrelated entities and through products – such as derivatives – that embed leverage)
  - without outsiders observing
  - without insiders observing (rogue traders)

But so what? These risks (even hard to cabin risks) are known ex ante, so creditors can adjust.

--Indeed, repo (secured short term lending) is one way they do adjust

Should Bank CG be different? -- 2

- Bank Governance should be different because the implications of bank failure are different. The consequences of a SIFI failure are "systemic ," the disruptions potentially massive, and it is hard to produce legal rules that will cause banks to internalize systemic risk

Regulation and Governance

- Regulation and governance are complements not substitutes

Faced with "regulation," management has three choices

1. Innovating subject to regulatory constraints of risk-creating activity
2. Arbitraging around (invariably) incomplete regulation
3. Influencing and reducing regulatory constraints despite the risks

- *Governance Will Influence Management Choice of Strategies*
- *Negative synergy* between regulatory incompleteness and high-powered incentives to maximise share price
- **Thus unwise to rely upon regulation alone to control systemic risks**

Shareholders and Risk-Taking: Financial Firms v. Non-Financial Firms

For non-financial firm, shareholders can protect themselves against managerial (or controller) risk-taking through **diversification**

-- Diversified Shareholder measures results through impact on portfolio: failure of one firm does not systematically affect the values of other stocks in the portfolio

-- Indeed, failure of Firm 1 may be improve performance of Firm 2

--- elimination of rival; greater market power, higher profits

Shareholders and Risk-taking, 2

- Thus Diversified Shareholders are said to "risk neutral"
- Implication: Firms should take highest positive present value projects. Despite the inevitable failures, that will increase the value of the shareholder's portfolio overall

Shareholders and Risk-taking, 3

Financial Firm Presents Radically Different Case

-- The diversified shareholder is not protected from risk-taking that leads to failure

-- Failure of a systemically important financial firm will reduces values throughout the investor's entire portfolio

Shareholders and Risk-taking, 4

- Mechanisms of Systemic Harms
- Systemic Effects: trigger *contagion* to other financial firms and *credit contraction* for non-financial firms
- Meaning: Reduced returns throughout the economy, reduced values throughout the investor's portfolio
- Meaning: Perceived increase in "systematic" or "market" risk – for which the diversified investor is compensated for bearing – also reduces portfolio values

Shareholders and Risk-taking, 5

- Thus “excessive risk-taking” is coherent idea in case of financial firm, even for diversified shareholder
- **Produces new corporate governance problem**

---Old problem: how to incent managers to take highest positive present value bets

-- New problem: how to constrain managers from taking certain positive present value bets, even if they are the highest

But Why Isn't this Corporate Governance Problem Self-Solving?

- 1. **Blockholders**. Many firms are blockholder controlled, so can limit management risk-taking
- But: undiversified blockholders in financial firm may have perverse incentives: benefit from the upside of risk-taking; avoid most of the loss from systemic effects of failure
  - -- Thus for sufficiently high expected gains, blockholders will support "excessive" risk-taking

Shareholder problems, 2

- 2. **Diversified shareholder**. Diversified shareholders are majoritarian owners

  But: collective action/ coordination cost problems limit their effective governance power

  And: Market prices may give misleading signals

  - Stock price impounds only information about cashflows of *this* firm
  - Harm to other portfolio firms' expected returns not impounded
  - Stock price of bank may rise even if imposing costs on Diversified Shareholder portfolios

  $\Rightarrow$Shareholder value norm *makes things worse*

Shareholder Problems, 3

Moreover, usually interests of blockholders and diversified shareholder are in sync – not this time

The Wedge:

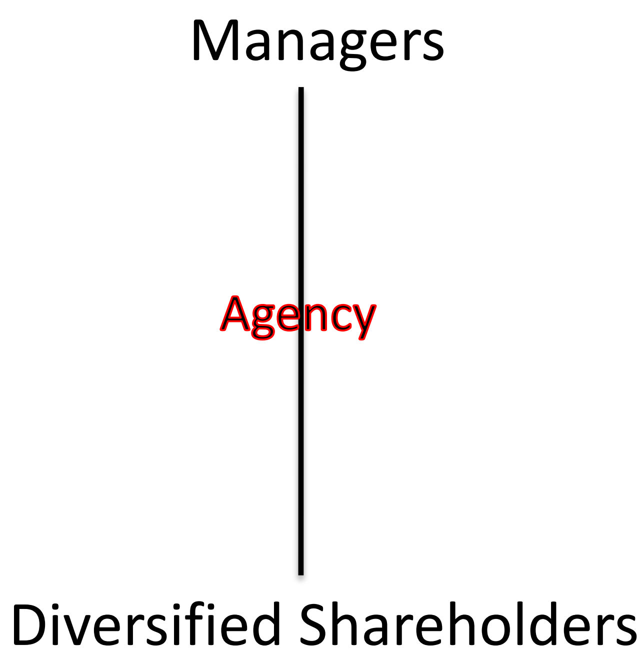
- NOT Managers v. {Blockholders + Diversified Shareholders}
- BUT: {Managers + Blockholders} vs. Diversified Shareholders

Shareholder problems, 4

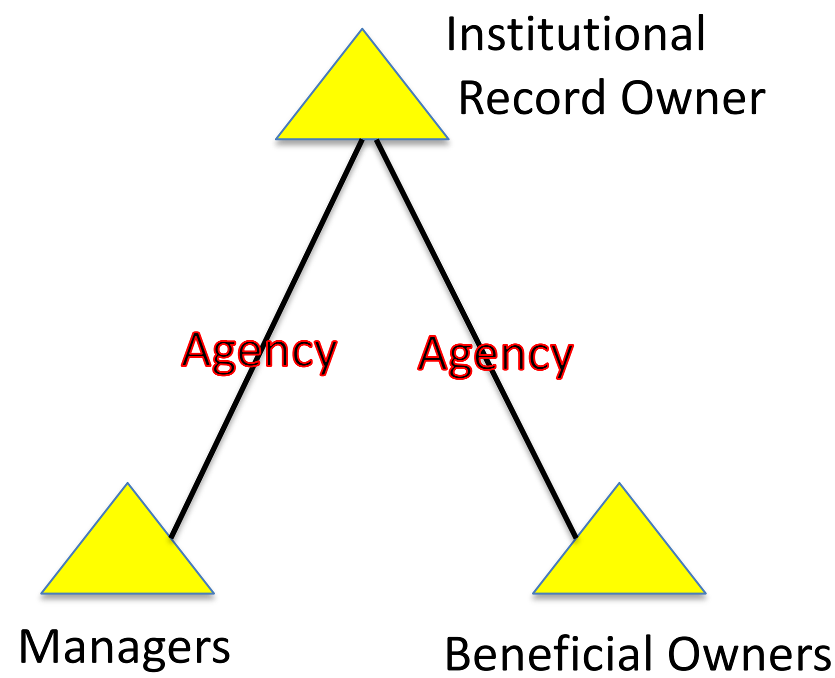
- 3. **Institutional Investors.** Many diversified shareholders own through institutional investors. Many blockholders are institutions.
- But their interest in constraining excessive risk-taking is undercut by the “agency costs of agency capitalism.”

Rise of Agency Capitalism

B & M



Agency Capitalism



Agency Capitalism Undervalues Governance Rights

- Business Model of Institutional Investor gives rise to characteristic agency cost
  - Model: to deliver risk-adjusted superior performance (net of costs), metered in relative terms, not absolute terms
  - -- Model: increase profits through exploiting scale economies of a larger fund
  - Even if the institutional investor has engaged in research that identifies excessive risk-taking, its incentives are to exploit the information through trading rather than engage in the costly exercise of governance rights

Agency Capitalism Undervalues Governance Rights, 2

- Institutional investors have no private incentives to proactively address performance or governance issues, including but not limited to systemic risk concerns
- Concern: this agency cost in relationship between institutional investor and beneficiary may lock in agency costs in the portfolio company.
- Thus: Agency costs beget agency costs.

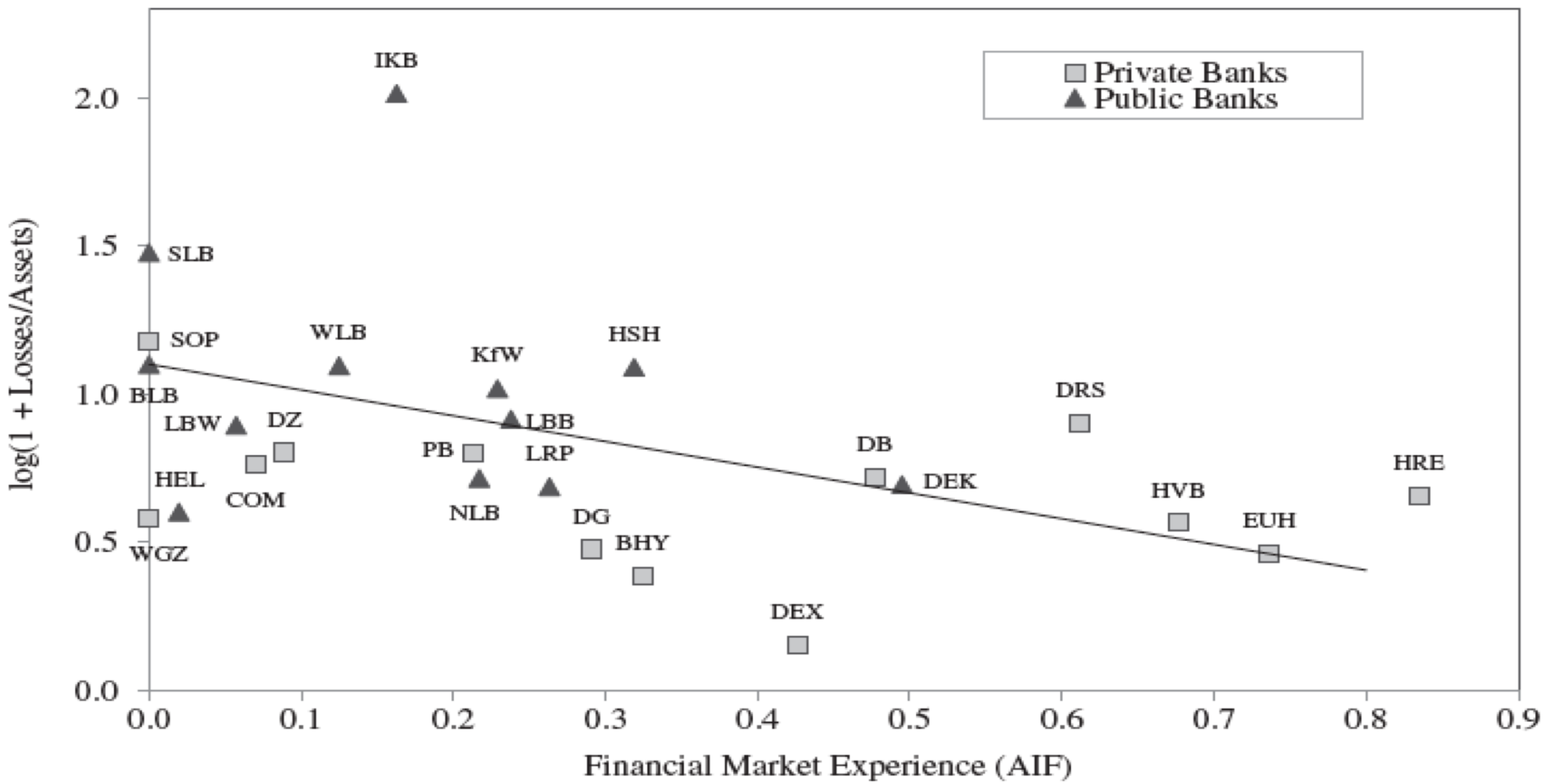
What to do?

- Conflicting, sometimes counter-intuitive empirical evidence on strategies developed for non-financial firms.
- E.g., Studies assessing the performance of independence directors indicate that banks with more independent directors took greater risks and suffered greater losses

  Beltratti and Stulz (2010); Erkins, Hung and Matos (2010):

Enhancing Director Qualifications

- We know that banks with unqualified directors performed poorly in the crisis
- (Hau & Thum, 2009), showing losses at German Landebanken; Cunat & Garicano (2010), showing similar for the *Cajas*



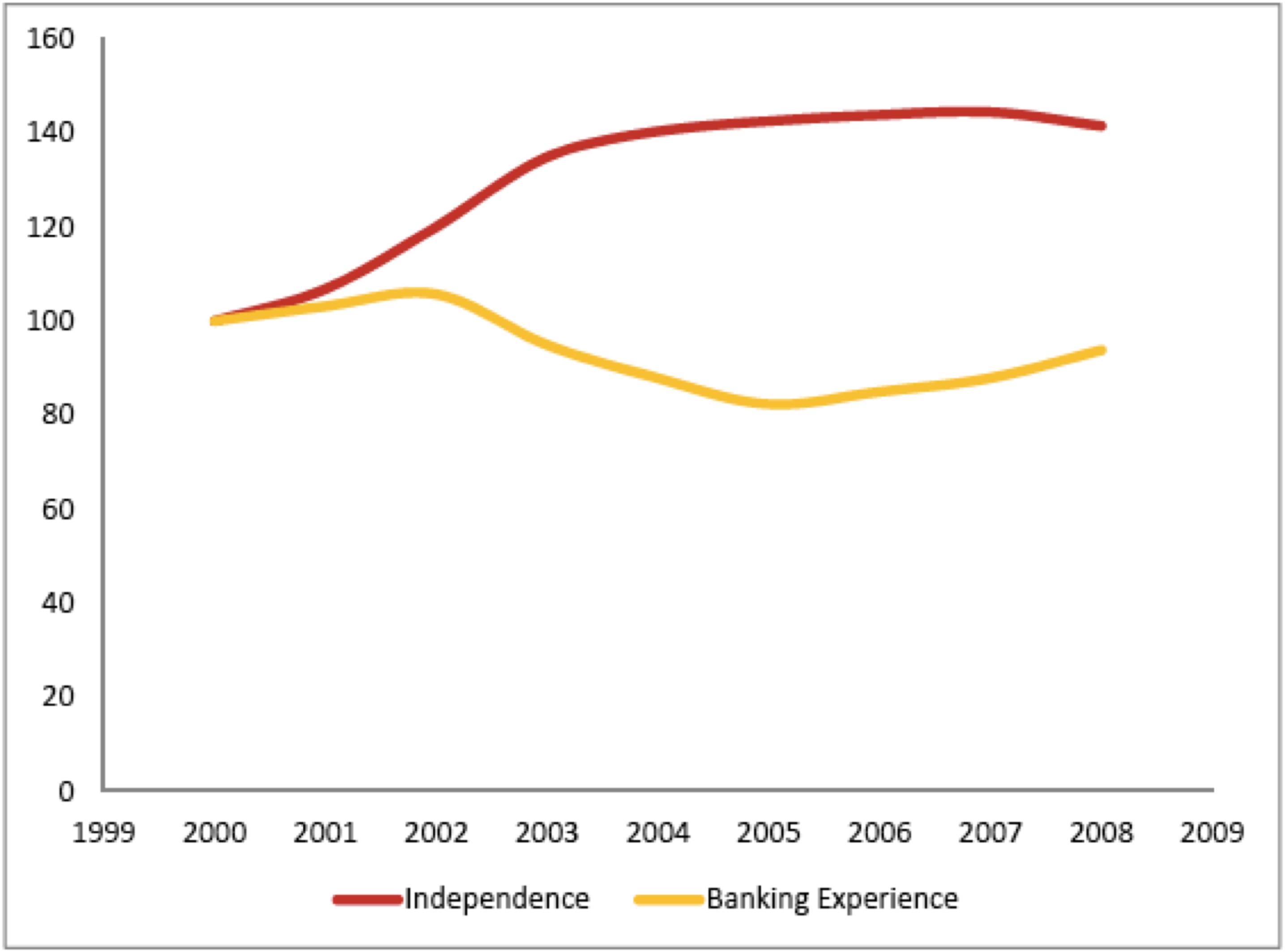
Notes: BHY: Berlin-Hannoversche Hypothekenbank; BLB: Bayern LB; COM: Commerzbank; DB: Deutsche Bank; DEK: Dekabank; DEX: Dexia Kommunalbank Deutschland; DG: Deutsche Genossenschafts-Hypothekenbank; DRS: Dresdner Bank; DZ: DZ Bank; EUH: Eurohypo; HEL: Helaba; HRE: Hypos Real Estate; HSH: HSH Nordbank; HVB: HVB Group; KfW: KfW Bankengruppe; LBB: Landesbank Berlin; LBW: LBBW; LRP: LRPLandesbank Rheinland-Pfalz; NLB: Nord LB; PB: Postbank; SLB: Sachsen LB; SOP: Sal. Oppenheim Jr & Cie; WGZ: WGZ Bank AG Westdeutsche Genossenschafts-Zentralbank; WLB: WestLB.
Source: Hau and Thum (2009).

Director qualification

- And there is some evidence that US banks may have sacrificed expertise for independence, observing the increasing level of board independence since 2000 but the decline in the board's level of financial expertise, as the banking business was becoming ever more complex

Figure 5: Time Trends in Board Characteristics – 2000-2008, US banks only

This figure shows average board independence and banking experience for all US banks in the sample. Board independence is measured as a fraction of board size while banking experience is measured as a fraction of the number of independent directors. All values are expressed as a percentage of their 2000 levels (year 2000 = 100).



Director Qualifications

- But: another important study indicates that the financial expertise of independent directors was *negatively* related to important performance measures during the crisis and was positively related to measures of increased risk-taking in the run-up to the crisis. Perhaps the "sophisticated" directors knew less than they thought and encouraged risk-taking. Or perhaps already risk-taking firms recruited such directors.
- Minton,Taillard, & Williamson (2011):

Board structure – Risk Management

- One interesting piece is evidence is that internal risk management matters. Various indicators of a robust internal risk management process correlate with less risk taking and lower losses during the crisis.
- Ellul & Yerramilli (2010)

Shareholder Empowerment

- A recent paper tantalizing suggests that shareholder power “may have led to more bank bailouts during the recent financial crisis.” The authors devised a “management insulation index” – the ease with which directors could be removed – and found lower insulation scores were associated with the higher likelihood of receiving TARP money.
- Some of the prior discussion may make it seem less counter-intuitive.
- Ferreira, Keershaw, Kirchmaier, & Schuster (2012)

Turn To: Agent-focused strategies

- The problem:
- High-powered compensation structures may give managers high upside payoffs that encourage risk-taking, but because manager will not internalize social costs of SIFI failure, Manager may face insufficient downside losses to self-constrain risk-taking

- Thus Managers may knowingly in engage in “excessive risk taking” so long as benefits of increased expected returns exceed costs of greater risks on the Manager’s undiversified portfolio

Compensation strategies: Change the “power,”1

1. Tie senior management compensation to “enterprise value”: debt + equity

- Practical elements: what parts of capital structure would be tied to comp?
- -- In setting comp, how to use the ratio of share price appreciation/ debt price deterioration?
- -- provide incentives to vary capital structure to maximize comp (see “risk weighting”)
- -- valuation of liabilities that do not often trade (pro-cyclicality of “mark to market”)

Compensation strategies: tie to enterprise value

- Debt prices will impound market beliefs about likelihood of rescue (ie, credible resolution regime will impose losses on creditors)
- In run up to crisis, as risks building, liabilities were not decreasing in value. By the time liability values were significantly deteriorating (and CDS spreads were widening), much of the harm was already baked in.

Compensation strategies: Change the "Power," 2

- 2. Regulatory approaches: Reduce High-Powered Incentives to Low-Powered Incentives
- -- EU: highly prescriptive: maximum variable pay to be a low-multiple of base pay
- -- Will produce higher base pay; reduce pay-for-performance link
- -- Will produce exodus of much investment banking activity and trading from the major banks (More effective than Volcker Rule or Liikanen in producing SIFI restructuring!)

Compensation Strategies: Change the "Power," 3

- US – Proposed Rules

  -- General admonition against setting up or maintaining an incentive compensation schemes "that encourage inappropriate risks by the covered financial institution that could lead to **material financial loss"**

  -- deferral of a portion of incentive-based compensation for executive officers of larger covered financial institutions

Alternative agent-focused approach: director liability

- Potential Director liability in cases of for "serious losses" at SIFI
- -- Imposition of Monetary penalty for:
  - Failure to take reasonable care to implement systems to *monitor* risk-taking
  - What is "reasonable" should vary with quantum of expected loss and monitoring costs
  - Should be assessed independently of "industry practice"

Standard: negligence, no business judgment rule protection.

Liability strategy, 2

- Could calibrate the Reform by cap on liability
- To address problems of director recruitment and over-deterrence
  - "Clawback" could be limited to specific number of years
- For incentives to be modified, necessary to prohibit
  - D&O insurance against liability
  - Managers hedging their position using derivatives

Liability Strategy, 3

- Why “serious losses” and not “failure”?

-- US law now permits the FDIC seek damages and clawback from responsible officers and directors of failed financial firm

-- Point is to avoid SIFI failures. No reason to test resolution procedures. “Serious Loss” is warning sign of excessive risk-taking (or poor execution within reasonable risk parameters).

Agent-focused liability

- As discussed above, evidence on corporate governance tools is conflicting
- Problem with many corporate governance prescriptions is lack of firm-specific tailoring
- Board facing liability risk will have strong incentives to devise a risk oversight structure that is matched to the firm
  – Gives board incentives to assess qualifications of directors and structuring of reporting relationships rather than check the box.

- Drawn from current work
- Gordon, **Corporate Governance and Executive Compensation in Financial Firms** (Columbia Business Law Review 2013).
- Gilson & Gordon, **The Agency Costs of Agency Capitalism: Activist Investors and The Revaluation of Governance Rights** (forthcoming, Columbia Law Review 2013).
- Armour & Gordon**, Corporate Governance and Systemic Externalities** (forthcoming 2013).