Corporate Governance in the Modern Financial Sector

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Summary

Given that the LCFIs are highly levered entities with over 93% leverage, we argue that equity governance mechanisms should be only a part of its optimal governance structure in which debt and regulatory monitoring should be important components. Although we point out some symptoms of weaknesses in equity governance leading up to the financial crisis, the high leverage and failure of risk management are more consistent with even more weakness in debt/regulatory governance. As mechanisms for strengthening debt/regulatory governance we propose that the board of directors of these LCFIs include regulators and prominent subordinated debt holders of the LCFI. We also propose that all independent board members be educated in the operational details and complex products of the LCFI. Given the claim structure of the LCFI, its top-management compensation should induce to maximize the total value of the enterprise and not just the equity value. The existing compensation structures seem too short-term and oriented too much towards equity-value. We propose that LCFIs should use more long term contracts that include deferred compensation features. Restricted stock, claw backs, pool of bonuses tied to long-term profits, ROA (not just ROE) or ROIC, with thresholds set based on business risk (asset beta) as well as financial risk (leverage) would all be features that implement top-management structures that are optimal. Although we do not propose that the regulator mandate specific compensation structures, proper pricing of FDIC as a function of incentive features in compensation structures and preferential tax treatment of some of these desired structures may be a good idea.

What do we mean by corporate governance?

In general, corporate governance mechanisms align the manager with investors. The manager generally holds only a small fraction of the claims in the firm and enjoys a high degree of discretion because of the incompleteness of the contracts that dictate his choices. Corporate governance usually consists of two types of mechanisms: mechanisms that monitor the manager (corporate boards, monitored debt, large block holders) and mechanisms that align the manager with the claim holders (high powered incentives in compensation structures, performance-related dismissals of CEO, hostile
takeovers with replacement of incumbent management). How is corporate governance different in the LCFIs? To understand this, we need to examine how the claim structure of the LCFIs is different from that of a regular non-financial firm. On the liability side, LCFIs are highly levered entities. At least 93% of the claim holders of an LCFI are debt holders (including depositors). Another claimant is the FDIC deposit guarantor who has sold a put to the LCFI. Given this structure of claims, corporate governance mechanisms that align the manager with equity holders, may deviate significantly from that of total firm value maximization. In other words, with 93% debt in the capital structure, the corporate governance in LCFIs have to align the manager also with the interests of the debt holders and the FDIC guarantor. Monitoring by the debt holder and monitoring by the regulator would be important components of corporate governance in LCFIs. See John and John 1993 for details.

How effective would be monitoring by debt holders? This may depend on whether or not the LCFI is a depository institution or not. In a depository institution, the prominent debt holders are the depositors. In most cases, the depositors are small claimants and hence their incentives to monitor are subject to the conventional free-rider problem. In addition, since a large fraction of the deposits are insured, the depositors’ incentives to monitor are further reduced. In other words, it is not practical to assume that the depositors would do any significant amount of monitoring. Of course, the regulator would have to play the monitoring role on behalf of the depositors. The regulator has additional incentives to monitor since she has sold the default put to the LCFI in the form of the FDIC guarantee. For both the reasons the regulator has an extremely important role in the corporate governance in the LCFI. In addition, if the LCFI has subordinated debt, the subordinated debt holders can play a role in monitoring the LCFI. The concrete mechanisms by which the subordinated debt holders are able to monitor the LCFI may be through the enforcement of debt covenants as well as the proper pricing of the subordinated debt.

In order to assess the role of possible governance failures in LCFIs, it would be useful to characterize conceptually the optimal governance system that the LCFI should have. Assuming that the debt and the FDIC insurance is correctly priced, the correct governance system for the LCFI is one that provides managers incentives to maximize the total value of the LCFI (the sum total of the value of all the claims outstanding against the LCFI) and not just the value of the equity of the LCFI. In other words, the equity holder governance that is conventionally thought of as corporate governance is only a part of the optimal governance that an LCFI should have. Moreover, even if the equity governance had worked well in a particular time period, it is possible that the total value of the LCFI was not maximized during this period. If the FDIC insurance was properly priced, the with-guarantee value of the LCFI would be equal to the without-
guarantee value of the LCFI. On the other hand, if the FDIC insurance is not properly priced, then the appropriate objective in structuring corporate governance and managerial incentives would be to maximize the without-guarantee value of the LCFI. Otherwise, the LCFI management would undertake non-value maximizing choices that may game the discrepancy in the pricing of the FDIC insurance. In the above discussion, we had assumed that the positive and the negative externalities caused by the LCFI on the financial system (and the society as a whole) were not significant. In reality, these externalities may be large. If that is the case, the design of the optimal governance for the LCFI and the corresponding managerial incentives should take into account the positive and negative externalities caused by the LCFI. For example, if the risk shifting activities by an LCFI imposes negative externalities on the financial system and the society at large, the governance of the LCFI should be structured to induce more conservative choices by the management compared to those that maximize the total value of the LCFI.

In the following discussion, we will examine whether the corporate governance in LCFIs has failed and whether managerial compensation design has been optimal. We will make a distinction between equity governance and debt governance in LCFIs. We will examine the accounting principles that go into the design of top-management compensation and capital budgeting. We are also going to examine the incentive effects of the contracts of managers/traders that have become increasingly short term. We close by providing some solutions for strengthening the debt/regulator governance of the LCFIs and the compensation structures of managers and traders of the LCFIs.

Did governance fail?

In this section, we examine whether there was a failure in the equity governance and debt governance in the LCFIs. In the introduction, we argued that an optimal governance structure for LCFIs should balance equity governance with appropriately strong debt/regulator governance. First we examine whether the outcomes were consistent with a failure in equity governance. After that, we will consider whether the same factors which might have weakened equity governance might have damaged debt governance even more.

Let us consider whether the outcomes were consistent with strong equity governance with concurrent weak debt governance. Significant high-powered managerial compensation structures, risk-shifting strategies, involving high-leverage and high scale of operations, and curbing or silencing of risk management were all consistent with a management strongly aligned with equity holders (i.e., with a high level of equity governance). In such an environment, the management would have strong incentives to adopt risk-shifting strategies (strategies that may have increased risk with
lower net present value). Silencing and curbing of risk management by the LCFI board is not inconsistent with an equity-value maximizing corporate board. Similarly, Chuck Prince’s statement that “as long as the music is playing on, we will continue to dance…” is also consistent with effective equity governance. Given that such risky strategies were in place, it is possible that the large losses that we have seen were simply bets gone awry and the realized state was the bad one. Moreover, if regulation was lax during this time period, there are several reasons why an equity value governance system gave rise to risky strategies with the outcomes that we have observed. Gaming of too-big-to-fail, mispriced deposit insurance, coarse capital requirements, etc. would have also led to similar strategies even when the equity governance was effective. The high level of compensation paid to bankers may also be argued as appropriate rewards for talent/skill in a competitive labor market (see Gabaix and Landier, 2008 who show such evidence can explain pay scales in corporate America).

There is also some evidence that certain firm characteristics of the LCFIs may have weakened the conventional mechanisms of equity governance. In particular, we will examine institutional activism, hostile takeovers, corporate boards and market competition. Given the enormous size of the LCFIs, the stake of equity ownership needed for effective monitoring and intervention was simply too large for even large institutions and hedge funds. Typical hedge fund activists consider an ownership of 5-15% of equity appropriate for launching activism. They found it difficult to hold even 1% of the equity of some of the LCFIs. An additional factor that discouraged institutional activism and hostile takeovers was the complexity of these financial institutions. The intricate nature of the financial products and the complexity of the positions that they maintained in derivatives, credit swaps, and other complex instruments made it difficult for these institutions and raiders to exercise external market discipline.

In the absence of external market discipline, the corporate boards could have become more active. However, the same factors of size and complexity made it difficult for the boards to be effective. The board members ownership in these large LCFIs was miniscule. The activities of the LCFIs were increasingly becoming complex and technical. It could be argued that the board members found it difficult to ask the hard questions leading to asymmetric information between the corporate board and the management. The disciplining effect of market competition was also not able to compensate for the weakening of other governance mechanisms. Entry in the banking sector is difficult due to the initial capital requirements in this regulated industry. It is not easy for new smaller banks to compete with an incumbent LCFI due to various fixed costs in setting up large trading desks, trade settlement/clearing, enterprise-wide risk management, etc.
We also argue that all the characteristics of the LCFIs that we mentioned above such as size and complexity also weakened regulatory monitoring. The complexities of the nature of the financial products and the transactions of the LCFIs have also made it impossible for many regulators to ask the relevant hard questions leading to ineffective regulation. In fact, in can be argued that the weakening of the regulatory monitoring was probably a more important factor in the risky strategies implemented by the LCFIs.

Proposals to improve debt/regulatory governance

While there may be some symptoms of a failure in equity governance, it is our view that the failure in regulatory/debt governance was probably the more important factor that lead to the risky strategies implemented by the LCFIs. The solutions, therefore, involve strengthening the regulatory monitoring. Similar in spirit to the Sarbanes-Oxley requirement of an independent audit committee, we propose that the board of directors of the LCFI should include a prominent debt holder and a regulator. All board members (including the regulator member) should be provided with basic but important information/training in the important operational details of the LCFI and its complex financial products. Such information may include aspects of capital budgeting in multi-divisional firms, capital budgeting that accounts in hurdle rates for business and financial risk, capital budgeting that appreciates the difference between costs of capital in good times and bad times, pros and cons of different accounting principles (ROA or ROIC vs ROE), valuation metrics, and different leverage and funding roots (Loan to assets, deposits to assets, tangible equity to tangible assets, etc), risk management principles, and terms and measures

Flawed CEO Compensation Design?

Similar to our argument regarding the optimal corporate governance structure for an LCFI, the optimal CEO compensation should be designed to induce the CEO to make investment choices that maximize the total value of the LCFI (as adjusted for the externalities that the LCFI would cause on the financial system and society). Such an optimal compensation system would not simply align the CEO incentives with that of equity value maximization. Did we have an optimally designed top-management compensation structure? There are important symptoms of flawed top management compensation in LCFIs. Given that the debt holder governance was weak, a management compensation that aligned the manager to firm value maximization would have included the manager holding an important component of inside debt or deferred compensation, features that would have made the manager more conservative that a manager totally aligned with equity value. However, in practice, the managers and traders of the LCFIs seem to be rewarded increasingly through short-term compensation, based on accounting measures that reward excessive risk-taking (e.g.,
ROE instead of ROA or ROIC). There seems to be a greater reliance on cash bonuses rather than on gradually vesting, deferred compensation. Almost all LCFIs rely on ROE and most employ thresholds that are independent of business risk and financial leverage (see attached Acharya and Franks, 2008, report). Such a compensation structures induced high leverage choices and risk-taking on the part of the managers and traders.

**Proposals for improving top-management compensation design**

An optimally designed top-management compensation structure should include the CEO holding an appropriate amount of debt-like securities such as deferred compensation, inside debt, or even subordinated debt. (See John, Saunders, and Senbet (RFS 2000) for details of the argument. To counteract the high degree of short-termism in their investment choices, LCFIs should use more long term contracts that include deferred compensation features. Restricted stock, claw backs, pool of bonuses tied to long-term profits, ROA (not just ROE) or ROIC, with thresholds set based on business risk (asset beta) as well as financial risk (leverage), may all be features that can induce value-maximizing strategies on the part of the CEO. See, for example, details of recent UBS revamping of pay structure and bonuses (FT, 18 Nov 2008). Also see pay structure for Goldman Sachs. Also, in an optimally designed compensation scheme, the CEOs should be made to hold on to the LCFI stock even after they leave the firm for a period of time. An argument against direct regulation of compensation structures is that the value of top managerial talent at LCFIs is very high and the market for this talent is extremely competitive.

We are not in favor of the regulator (social planner) mandating specific contracts for LCFIs which are after all private firms. We believe that a infrastructure of light regulation can be created in which the pricing of FDIC and preferential tax treatment of desirable compensation features can be created in which individual firms can optimize the design of their CEO compensation based on firm-specifics trade-offs.

For example, if FDIC insurance is rationally priced anticipating the investment policy that would be implemented, such pricing would naturally be a function of the incentive features included in the compensation structure. A high-powered incentive structure would have a higher premium because such compensation structure would induce riskier investment choices compared to one that includes deferred compensation (and inside debt holding) by the manager. In other words, rational pricing of the FDIC premium in itself would give LCFIs incentives to design for their top management, compensation structures that would induce them to implement investment choices that maximize the total firm value. For details, see John, Saunders and Senbet, RFS 2000.
In addition to the put that has been sold by the regulator, the regulator has additional claims in the LCFI in the form of implicit guarantees to bail out the firm in some future states of the world. One possibility is for the regulator to impose some constraints on compensation structures of the LCFIs. In the current FDICIA regulation, there are restrictions imposed on the levels of compensation and the option component in the top-management compensation of severely undercapitalized banks. Our own view is that there should only be minimal regulation of compensation structures of individual LCFIs. For the LCFIs in good standing, we propose preferential tax treatment for certain features such as deferred compensation and long-term compensation. Under this tax treatment, LCFIs would still be able to design their compensation structures optimally. Since all LCFIs face similar tax environment, they can compete for talent on an even playing field. There is precedent for such preferential tax treatment of specific compensation features, e.g., section 162(m) of the IRC, a tax law enacted in 1994 that gave preferential treatment for incentive compensation.

Even with an optimally designed compensation structure that induces better actions, the ability of the regulator to monitor the firm and directly limit risk taking through fully enforced leverage constraints or capital requirements or position limits may have to be imposed on the LCFIs.

References


