

Governance and the Crisis

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A financial crisis so shortly after the governance crisis of Enron makes you wonder whether governance had anything to do with the crisis. If it had, then what did we think we solved with the measures taken in the US and the EU after Enron and Parmalat? The US and the EU actually recognized and solved different issues. For the US, the key issue seen as triggered by Enron and its equivalents was

that listed companies failed to disclose appropriate statements to the market. Its key regulatory response through Sarbanes-Oxley was to address failures in the reporting and audit process. In the EU, we identified a broader range of issues, more at the heart of corporate governance, including executive remuneration, the role of independent non-executive directors, and the engagement of shareholders. The key mechanism designed to address these issues were governance codes enforced on the basis of comply or explain. In addition, the Commission addressed issues of executive remuneration and independent non-executives in recommendations sought to enhance shareholder voting through the Shareholder Rights Directive.

Although failed disclosure may not have been the key driver for the financial crisis, the Valukas report on Lehman Brothers' demise nonetheless shows how banks could continue to misrepresent their statements through repo 105 type of transactions, as if the Sarbanes-Oxley Act had never been issued. With respect to executives of financial institutions, we further see that their management of risk was generally flawed, partly because they were not taking risk seriously, partly because they did not understand risk and over relied on quantitative models that somehow failed to match reality. Where Sarbanes-Oxley and related EU Regulation in the amended 8th Directive sought to strengthen both audit and internal control and risk management, risk management for financial institutions never quite made it to the mark. The other issue heavily debated in relation to executives is executive remuneration. Some see it as an important cause for the crisis, others deny this. The recommendations of the EU Commission seek to address design and governance issues related to executive pay systems. In reality, I am afraid executive remuneration through performance-based pay is destined to fail not only

because of design and governance but fundamentally because of who we are. A growing body of academic literature on incentives and motivation reveals that performance-based pay does not work for complex cognitive tasks, crowds out internal incentives to do well, corrupts our behaviour while we still manage to believe that we are honest and that the primary driver for higher remuneration is not at all performance but what others get. Regulation will offer no solution here if we remain unwilling to face who we really are.

The key issue with non-executive directors is that they were largely absent during the financial crisis. Reading popular books on the failures of Bear Stearns and Lehman Brothers and on the tribulations of ABN AMRO shows that non-executive directors did not play a significant role in the events. Apparently, it has been possible to live up to all the legal and code requirements, tick a number of boxes, and still not have a board of non-executives who are truly engaged and understand what is going on. Hau and Thum wrote an excellent paper on the comparative financial expertise of non-executive directors in German public banks and private banks. The conclusion is that German public banks had a relative lower level of financial expertise among their non-executive directors and suffered relatively higher losses. A comforting conclusion, expertise matters, and surely the opposite conclusion would really have been difficult to interpret. However, what does this finding really tell us? Is it just the expertise of the non-executive directors that makes all the difference? My intuition is that the management and staff of German public banks probably is of lower quality than the management and staff of German private banks. That must have had a much bigger impact on the quality of investment decisions and risk management by public and private banks than the quality of the monitoring role the non-executives can exercise. The logical response to the finding of the research seems to be that non-executives need to be educated, and who could be against that? However, we should not have inflated expectations of the value of education. What would we have told non-executive directors of financial institutions five years ago? That a huge crisis is looming, that subprime securitization is madness, and that credit rating agencies are fundamentally unreliable? Not very likely, although precisely what we should have told them. Will we be able to reveal the fallacies that form the basis of the next crisis in time? Not very likely either, particularly when the herd is chasing the fallacies. Ultimately, it boils down to a sense of commitment and responsibility that non-executives should have for the fate of the company. Regulation may have an impact here, although not

necessarily always positive, but the basis of such commitment lies primarily in the personal and social realm, influenced by world views, frames of reference, and past experiences.

Shareholders then. The general observation is that shareholders, in particular institutional investors, were insufficiently engaged in the governance of financial institutions and failed to exercise any meaningful disciplining and monitoring role of management. The regulatory response to this observation is different however. The US and the UK seek to strengthen the role of shareholders in governance, by a renewed attempt to open up the proxy process in the US for shareholders to make director nominations and by advocating a stewardship code for institutional investors in the UK. On the other side of the spectrum, the Netherlands and Germany appear to be focusing on the consequences of institutional investors' absence, which is aggressive shareholder activism. Both countries seek to restrict shareholder rights and impose even more transparency on shareholders in order to mitigate the detrimental effects of activism. I believe neither approach will be successful if we ignore what is going on with the investment behaviour in the capital markets. Most of the trading by now is high-frequency trading, computer-driven trading, and index tracking. None of the parties engaged in these practices have any interest in the governance of companies. The fund management industry and even long-term investors such as pension fund have massively succumbed to one particular investment strategy: diversification of the portfolio. On the belief that diversification reduces risk on any individual investment without a reduction in return and therefore offers a free lunch, the diversification has led to extreme diversified portfolios, Calpers reporting to own over 7,000 equity investments, and large European pension fund managers such as APG and PGGM reporting to own over 5,000 investments. With such portfolios, investors cannot be truly interested to engage in the governance of the companies in which they invest. In fact, they can only compare public information and expectations of companies in which they invest with other companies. As a result, the market as a whole has in all likelihood become myopic, only interested in short-term results. It does not make sense for investors to engage in the governance of companies. They prefer liquidity and immediate return over voting, as their successful resistance against share blocking in the EU and their wide practices of securities lending show.

The real question for shareholders is whether the crisis will have taught them that when everybody diversifies and is interested only in immediate trading results, all will be equally exposed to increased volatility of the market as a whole. Simple economic theory (there is no such thing as a free lunch) should be able to explain this. Some pension funds have indeed indicated to consider concentrating their investment portfolio to a few hundred investments rather than thousands, each of these investments being substantially larger and held for significantly longer periods of time. This may create a sufficient interest to be actively engaged in the governance of the companies they invest in. Concentrating the portfolio in a smaller number of larger investments does increase the risk on any

individual investment. We should therefore expect that such investors will be looking for alternative mechanisms to protect their investments, primarily through more and earlier information and possibly with non-executive board seats or additional dividend and/or voting rights. This raises interesting questions on sharing price-sensitive information with longer term committed institutional investors, equality of shareholders, independence of non-executive directors, and proportionality of voting rights and economic risk. To the extent that Member States are better at facilitating these prerequisites of longer term and more substantial investment by certain institutional investors, they should expect to secure a higher number of these stable and engaged institutional investors for their companies.

Whether this will indeed happen remains to be seen. If it were to happen, we may witness an interesting mix of the dispersed and concentrated ownership models, which will undoubtedly raise new questions for debate and research.

What is clear to me is that none of the governance issues described above lends itself for easy fixes. Policy makers, to the extent concerned with corporate governance, should not fall for the illusion that severe problems require urgent solutions.