ROUTLEDGE RESEARCH IN CORPORATE LAW

Rethinking Corporate Governance in Financial Institutions

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Rethinking Corporate Governance in Financial Institutions

There are many deep-seated reasons for the current financial turmoil but a key factor has undoubtedly been the serious failings within the corporate governance practices of financial institutions. There have been shortcomings in the risk management and incentive structures; the boards' supervision was at times weak; disclosure and accounting standards were in some cases inadequate; the institutional investors' engagement with management was at times insufficient and, last but not least, the remuneration policies of many large institutions appeared inappropriate. This book will provide a critical overview and analysis of key corporate governance weaknesses, focusing primarily on three main areas: directors' failure to understand complex company transactions; the poor remuneration practices of financial institutions; and, finally, the failure of institutional investors to sufficiently engage with management. The book, while largely focused on the UK, will also consider EU and Australian developments as well as offering a comparative angle looking at the corporate governance of financial institutions in the US.

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This book is dedicated to my beloved father, Panikos. Your wisdom, strength and love have inspired me to be the best I can be.

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In loving memory of my beloved uncle, Judge Takis Eliades.

Contents

Introduction

'Human behaviour flows from three main sources: desire, emotion and knowledge.'

– *Plato*

The global financial crisis of 2008 was a crisis largely of human making. It was also a corporate governance crisis. Internal imbalances proved just as significant as the other triggers to the financial turmoil and the events that happened sparked a fresh round of deliberation about the most likely deficiencies of corporate governance. Of course the roots of the crisis predominantly lie in the atmosphere that prevailed at the time, of inadequate bank capital, highly leveraged hedge funds, subprime mortgage securities and reckless loans. For years there were low interest rates, weak government enforcement efforts, minimal government interference and deregulation. The collapse of Northern Rock, Lehman Brothers and other banks occurred because the financial risk generated by the US subprime mortgage lending was being directed and reused across the world through shadow banking structures. With hindsight, the credit-rating agencies failed terribly in the performance of their duties, products were so complex and non-transparent that even those who created them were unable to understand what they meant, and in addition too much faith was placed on investors' apparent sophistication. There were profound failures of the economy and policy, and inadequate transparency. These ingredients came together to trigger a financial crisis of astonishing proportions. Still, questions remain. Would things have become so bad if the corporate governance system pushed for greater responsibility and greater ethos? Could a better environment have softened the wounds left by the crisis, even to a degree? Certainly, the question of how far poor corporate governance practices led to the eventual catastrophe has been one of the most controversial since the global crisis' emergence.

A myriad of 'wrongdoers' have been identified and there is now sufficient evidence to preliminarily isolate the key suspects who contributed to the financial disaster: weak regulators, poor management and incompetent managers, greedy investment bankers, unsuitable remuneration structures and levels, and inattentive shareholders. Executives showed a lack of understanding of strategies and products, and weak ethical standards. Rather than carefully evaluating risk, their management style was more akin to gambling. There were misaligned pay arrangements that motivated management to agree to risky paths, and all that within a system that somehow allowed failure to go unpunished. Shareholders appeared unable to scrutinise and monitor company boards; they accorded low priority to governance issues, thereby encouraging the risk-taking that eventually proved fatal for many institutions. This was clearly a period of unquestionable failures of the system of governance. Years later, the picture looks rather different. There is now a renewed interest on the quality and quantity of pay. There is a renewed interest on the accountability and personal responsibility of those who manage firms. There is also a new emphasis on the role of shareholders, particularly on the potential monitoring and supervisory role institutional investors can play.

This book addresses what is regarded as the most difficult question in any corporate governance system: whether confronting the aforementioned issues can help redress the balance in corporate governance. At the very least, they must not be overlooked; the identified deficiencies played a significant role in the hasty assumption of risk that led to the crisis, even if that role was more indirect. The book has been structured to facilitate a better appreciation of different notions and developments in the post-crisis epoch. In doing so, it provides a thorough critique of three fundamental themes: executives' personal and professional accountability, executive remuneration and its role as an incentive mechanism and, finally, shareholders' engagement and activism. It evaluates the developments, often in a comparative perspective, and draws out some of the implications for the broader appreciation of global trends in the area of corporate governance. Despite the focus being on the position in the United Kingdom (with the exception of the last chapter) the issues addressed, and in particular the theoretical rationalisations, conceptions and ideas underlying the three central themes, contribute generally to the ongoing worldwide debate on corporate governance.

The book consists of four chapters. Chapter 1 provides a critical evaluation of bankers' personal responsibility for the events leading up to the financial crisis of 2008. A key dilemma in any corporate governance system is how to make corporate executives accountable while still allowing those same executives the autonomy, the motivation and the power they need to create tough and solid institutions. The attention here is on the restoration of personal accountability primarily through law. The focus is on the failure of banks, and therefore the discussion predominantly talks about bankers' accountability.[1] Significantly, the approach taken is designed to address recklessness rather than fraud; this is because this latest crisis period is one characterised by reckless business decisions and lack of understanding of consequences – characteristics that have proven disastrous for the UK and global economy. The general consensus is that precisely this type of behaviour pushed many institutions, particularly banks, to the brink

1 Other terms, such as 'directors' or 'executives', are also used in this chapter. For a further explanation of the different terms, see fn 2 below.

of collapse. Even though the damage done cannot be overturned, the sharpening of bankers' accountability can make less likely the occurrence of episodes that can cause serious externalities. Personal liability is imperative, primarily due to the conflicting enticements promoted through limited liability and the phenomenon of 'moral hazard'. Yet, despite the crisis and the subsequent regulatory response, some of this behaviour remains. Although there are robust new liquidity standards and personal liability measures, more can be done to tackle mismanagement, incompetence and reckless risk-taking. Inconsistencies in law and regulation need to be eradicated. For instance, while it is possible to disqualify the directors for unfitness, or make them personally liable to contribute financially to their institutions' liabilities, the director of a company brought to the brink of insolvency but rescued by nationalisation or another form of government protection cannot be disqualified or held accountable for the debts of the failing institutions. This is so irrespective of the level of wrongful or reckless trading they have engaged in. Certainly this is a serious deficiency of the current system of accountability, made worse by the fact that directors are generally confident that the system will not allow large institutions to fail.

But why do bankers behave the way they do? The chapter deliberates on the key reasons people take uncalculated, reckless risks. Of course, understanding with greater precision why people opt for risky paths that they might come to later regret, is a real challenge. The discussion of incentives for irresponsibility provides two potential perspectives on their behaviour. First, behavioural explanations are possible candidates. Behavioural science maintains that cognitive biases can influence one's behaviour and can create different dynamics within corporations. Studies of the 'behavioural' move appear to suggest that economic actors frequently make decisions that are not in agreement with the rational choice model. Bankers are prone to cognitive errors involving biases towards their own prior beliefs. This is due to a host of irrationalities that exist in economic settings. There are cognitive biases and information asymmetries that make people vulnerable to a number of behavioural actions, influencing their ability to act rationally. Prospect theory also explains their tendency to be risk-seeking; this is a behavioural economic theory that suggests that decision-makers irrationally seek risk despite the fact that the particular circumstances should lead them to the opposite direction. Subsequently, this part of the chapter considers another intriguing perspective into this kind of behaviour: directors frequently appear unable to comprehend the density of their institutions' activities. What we learn is that due to the complexities of financial models, directors frequently lack the knowledge to make good decisions and manage risk. The recent crisis is indicative of this: many of those who were involved with the production of complex products such as highly leveraged hedge funds and subprime mortgage securities had not really grasped the meaning of those products. But institutions can and do suffer when those who manage them are unable to appreciate fully the multifaceted operations their institutions are participating in; the crisis that started in the summer of 2007 showed a collective wisdom of individual ignorance, and ultimately many appeared out of their comfort zone. The weakness of executives to properly calculate and stick to a degree of risk suitable to their particular circumstances leads them to place excessive reliance on internal advice, as shown by the events of Lehman Brothers and Northern Rock. Crucially, this reinforces the need to have appropriate behavioural incentives in place that can potentially diminish their cognitive limitations, at least to a degree.

Therefore, as the current law has not proven to be an effective constraint against reckless behaviour, part 3 of the chapter considers a variety of legal and regulatory strategies that might help eradicate the aforementioned weaknesses. Reinstating and reinforcing personal and professional responsibility in the financial sector will require a blend of different strategies; for instance, the promotion of ethos through the medium of education can be a cost-effective way to push for more responsibility in decision-making. But the key focus of this part falls upon the examination of two types of personal liability: monetary and non-monetary, including disqualification, wrongful trading, criminal and strict liability. These are considered as means to better the current accountability regime. The monetary liability of executives, promoted through the wrongful trading provisions of the Insolvency Act 1986, is considered in depth, as well as the role the Banking Act 2009 can play in the sharpening of bankers' accountability. Refining this area will enable the loophole that currently exists in law, whereby directors of nearly failed banks can escape liability, to be filled, at least to a degree. In addition, another proposal is considered here: whether the imposition of strict liability for those earning above a certain amount can help strengthen executive accountability. In relation to non-monetary liability, the effectiveness of disqualification, promoted through the Company Directors Disqualification Act 1986, is deliberated at length, as well as the new criminal sanctions proposed by the government to tackle the kind of managerial misconduct witnessed during the past few years.

Of all the controversies in the post-crisis era, one has proven most enduring: the matter of executive pay in the financial sector. Chapter 2 is dedicated to this thorny issue. Outrage over pay is not new; it sporadically appears from time to time, and when it does, it is normally followed by a number of regulatory changes in the context of corporate governance. Yet, despite its powerful reappearance following the latest crisis, the levels of pay do not seem to have been affected to a notable degree (if at all); in fact, directors have continued to reward themselves rather excessively. Therefore, the question that arises over and over again is: are the current levels of executive pay justified? This is an area of legal scholarship heavily dominated by analyses from a law and economics perspective, and also principally by authors from the United States, and for this reason a new critical analysis of regulatory developments in a UK context is essential. This is certainly a good time to consider this issue, and to question whether the corrective measures that have been adopted so far are strong enough to deal with the tricky aspects of executive pay. Will the changes suffice for now, or is fresh regulation warranted in the United Kingdom? Following a discussion of the controversies of executive remuneration and its surrounding debate, part 3 of the chapter considers the relevant history, structure and current laws related to pay. In the context of concern about remuneration, the comparative analysis is especially useful, particularly since Europe and Australia have introduced measures that go further than the United Kingdom. Therefore, part 4 evaluates key reforms in the European Union and Australia, and reflects upon the latest developments in order to understand whether measures adopted in other systems can help improve the remuneration provisions in the United Kingdom. Are these other systems better in evaluating remuneration problems? Essentially, Australia can add a lot to this debate. The Australian system has been rather proactive in its approach to executive pay; having measured the US and UK experience, it appears to have taken a more realistic approach to this question. Europe, on the other hand, presents a different picture. Although the European framework appears strong, in that it can potentially mitigate the impact of excessive risk-taking, some of its recent steps might eventually prove detrimental. The criticisms predominantly concern the measures related to the caps on bonuses that have the potential to disturb competition, especially since their cross-Atlantic counterparts in the United States have not followed suit.

Part 5 of the chapter examines the theoretical foundations and incentive components of executive remuneration. In the economic literature the agency theory, which supports the shareholder primacy model, has long been the dominant theoretical framework used to validate executive pay. This theory reinforces executive pay and views it as an efficient mechanism for proper behaviour by company executives. Pay for performance, a by-product of the incentives idea, is another valuable mechanism for motivating management to boost performance; it is generally viewed as an effective solution to the alignment problem. The question addressed is whether the current incentive mechanisms remain appropriate for rationalising pay. Are they still suitable or do they primarily create pay packages that result in fresh kinds of conflicts of interest by motivating directors to pursue short-term goals? This part examines the key principles of the agency theory, followed by a critical assessment of the theory's effectiveness: is it efficient in improving the corporate practices of executives? Does it motivate them to act with a long-term focus as opposed to a short-term view? While the agency theory forms the basis of the corporate governance debate, the catastrophic events of recent years doubt whether it is still sensible to use it to rationalise the current levels of executive remuneration. This part also considers pay for performance as an incentive method and questions whether it is right to assume that it can motivate executives to do the right thing. The key problem is that performance targets can narrow one's focus, motivating executives to take reckless risks instead. Does pay for performance as an incentive plan actually work? Significantly, regulation will never be realistic if we fail to consider the problematic nature of this type of pay from the perspective of psychology. Since key financial incentives are arguably ineffective and counter-productive too, this part explores the psychology angle of the most dominant incentive methods.

Due to a reconceptualisation of the theoretical assumptions of executive pay, the regulation of executive pay requires rethinking. In re-emphasising that the corporation, rather than the shareholder, is the principal in the typical agent–principal relationship, and that directors are autonomous fiduciaries, ways to reformulate the regulation of pay need to be considered. Therefore, in part 6, a number of reforms to remuneration are put forward. Policy makers in search of solutions to this issue may find that the best approach is to tackle this from two distinct angles: before and after the failure of a company. Hard law provisions are mainly valuable in coping with the aftermath when the company faces the prospect of insolvency or is insolvent, whereas soft law can be used to promote good remuneration practices throughout the life of a company. Therefore, this part considers the role of both hard law and soft law as ex-ante mechanisms, followed by the role of hard law as an ex-post tool applicable when a company's collapse appears inevitable. In considering the strategies that can form part of the soft law mechanisms, four key issues are identified: the issue of disclosure and transparency, the increase of investors' voice on matters of pay, the introduction of caps on bonuses and, finally, the make-up of remuneration committees. In relation to hard law, a number of issues are considered, one of which is the idea of treating bonus payments like dividends for the purpose of distribution rules under capital maintenance law. Other issues considered include extending the role of the Financial Services and Markets Act 2000 (relevant to financial companies) which could be used more effectively to control excessive pay, and, last but not least, the question of whether the government should use its powers as a majority shareholder in certain banking institutions to seek remedies on behalf of the taxpayers, such as blocking payments that could be considered unreasonable.

While the headline-grabbing question of remuneration has attracted the attention of many, Chapter 3 of the book concentrates on the 'bigger picture' facing companies and investors: shareholder stewardship and engagement. The question whether shareholders are capable of defending and promoting company interests has tended to arise particularly in relation to institutional investors. To this effect, there have been some initiatives in recent years aimed at improving the quality of shareholder stewardship and engagement in the United Kingdom. The most significant of these is the UK Stewardship Code, a Code that has turned the UK into a model for stewardship guidelines around the world. Revised in 2012 it is gradually being imitated in continental Europe and elsewhere. The conventional view is that shareholder stewardship is appropriate because as company members they have the necessary tools to act: they are perfectly able to participate in corporate governance due to their expertise, their (natural) incentive to understand and manage risk and their ability to choose and supervise complicated investment routes. But there is another view, the one that says treating shareholders as the ideal management monitors is wrong; rather, it is nothing but an idealistic aspiration, far removed from the reality that governance and shareholders in large companies exist separately. The promotion of a more systematic relationship between institutional investors and management is an expensive use of company resources and by restraining investors from evaluating most board decisions, the separation between ownership and control has a valid efficiency justification. The chapter begins with a general examination of shareholder activism; it considers the shareholders' role, responsibilities and powers as well as their rights in corporate governance. Then, the focus turns to Europe. The European Commission has been active in confronting shareholders' lack of engagement and excessive short-termism. Similar concerns to the ones raised elsewhere in the world were also raised at European level and there have been a series of notable developments, some fairly courageous and some particularly controversial. Thus, part 3 considers the main legal and regulatory developments at EU level that might impact on the ability of shareholders to engage with boards. This is followed by an analysis of the 'shareholder spring' of 2012, a period viewed by many as the exception to the rule that investors are apathetic in matters of governance.

Part 4, the heaviest section of this chapter, examines the key hurdles faced by shareholders (particularly institutional investors) that prevent them from acting as effective stewards. This is important, because even if we assume that stewardship can potentially have a positive influence on company performance and should therefore be encouraged, there are numerous obstacles to this. While it is not possible to provide a complete catalogue of the barriers to shareholder engagement, this part deliberates upon the most crucial ones. It is divided into two subsections. The first part addresses key obstacles to the effective monitoring by institutional investors and focuses on four general areas, namely, incentive problems and structural limitations, the problem of short-termism, the complicated relationship between investors and management, the modern portfolio theory and the promotion of diversification, and two matters that relate specifically to the UK Stewardship Code – the 'comply or explain' model of the Code as well as the Codes' domestic focus. The second part considers the behavioural angle. The predominant idea in the debate about investor participation is that the operation of the market is deemed to be the result of rational investor decisions. But according to the findings of a major subfield of economics – behavioural economics – such an assumption is neither reasonable nor a fair representation of reality. Behavioural science doubts the ability of investors to act as stewards. It perceives people as routinely behaving in a way that is distinctively unlike the behaviour normally predicted by models of rationality. Therefore, behavioural economics attempts to understand the reasons why certain decisions do not seem to match the neoclassical economic theory that accepts as true the proposition that individuals are able to make rational decisions. While not a particularly well-defined subject, this 'academic subspecialty' of behavioural finance is becoming more and more popular: researchers have used behavioural analysis for some time now as an instrument for research explicitly directed at corporate governance. Crucially, legal and economic researchers have been increasingly willing to reassess the traditional assumptions of rationality in the context of human behaviour. This certainly empowers scholars to build connections of precise use to the analysis of corporate law-related issues.

Part 5 contemplates possible solutions. In appreciating that current vehicles for shareholder stewardship are problematic, an array of proposals for empowering shareholders are put forward. Alternative reform options are considered, particularly for institutional investors who are committed to a systematic approach to corporate governance. The proposals are divided into five key issues: the training of board members of large institutions, the increase use of shareholder remedies, the deployment of tools provided by the revised UK Corporate Governance

Code, the imposition of fiduciary duties on certain types of shareholders and finally, the adoption of a two-tier share ownership system. This last issue is particularly interesting; a type of two-tier ownership system could succeed better in countering short-termism; it can potentially sanction the granting of preferential treatment, such as enhanced voting rights and higher dividends to those shareholders viewed as 'long-term' shareholders. Additional rewards for good stewardship might motivate investors to agree to participate as 'stewardship investors', thereby promoting the type of long-term thinking the devotees of shareholder engagement enthusiastically support. Crucially it might appeal to foreign investors who are traditionally apathetic in matters of governance; such investors tend to avoid engaging with firms mainly due to the significant costs involved. Finally, the chapter talks about the need to enhance our understanding of behavioural sciences. More research into this field can help the regulator perfect the design of shareholder stewardship. At present behavioural psychology is not an exact science and therefore does not possess the ability to be an accurate forecasting device. More research is required into this field that will enable us to calculate and contemplate questions of shareholders' behaviour better.

Chapter 4 contributes to the discussion so far undertaken by exploring the reform of US corporate governance in the examined fields. Despite the range of opinion regarding the various roots and causes of the global economic crisis, we certainly have the United States to 'thank' for this event; that is where it all started. The chapter brings together the key issues addressed previously in the book and evaluates their implications for the US system. In line with the previous discussion of the book, it examines whether engagement by investors can help improve the regulatory framework of executive remuneration in the United States. Within the triggers of the crisis lie the pay structures dominant in that country; therefore, we revisit the problematic issue of executive pay (examined in Chapter 2) and respond by presenting the US position. The intensity of the debate over the proper reaction points to the necessity for change within the country's system and, from this perspective, the 'say-on-pay' mechanism and its impact on executive pay requires particular attention therefore. In addition to shareholders' increased voice, the chapter also considers other strategies aimed at controlling pay, such as clawback and increased disclosure.

In the context of concern about pay, there are many implications to be drawn; certainly, US executive pay has gone through a makeover in recent years in order to give it a more shareholder-friendly appearance. But given the obstacles to shareholder stewardship (discussed in Chapter 3), increasing significantly the powers of shareholders to interfere is not an ideal strategy. Evidently, the rules promulgated under the Dodd-Frank Act of 2012 empower the residual claimants by rewarding them with tools, some stronger than others, to exercise engagement. In addition to including a plethora of performance metrics, the proxy statements have become more transparent and easier to understand. Importantly, shareholders have been given the 'voice' tool and this is possibly the most crucial innovation of the Dodd-Frank Act. If widely adopted, the new governance model can have a significant impact on the US system. The chapter proceeds in