The role of Governance Failures in the current Financial Crisis

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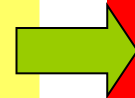
Why should regulation move towards principles?

The turn of the millenium brought a new context to regulation of financial markets:

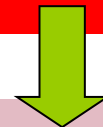
- The dismissal in 1999 of the Glass-Steagall Act has deepen integration of commercial and investment banking.
- In Europe, the development of *bancassurance* has erased limits between banking and insurance.
- New unregulated market segments, in particular, hedge funds
- The consolidation of several financial innovations from securitized products, option pricings, credit default swaps,…



How can regulators face these challenges:

• rules cannot follow the path of dynamism imposed by reality

• need to rely on other complementary private supervisory bodies



Basel 2

Solvency 2

Financial Regulation and Governance

Rules / Principles

A

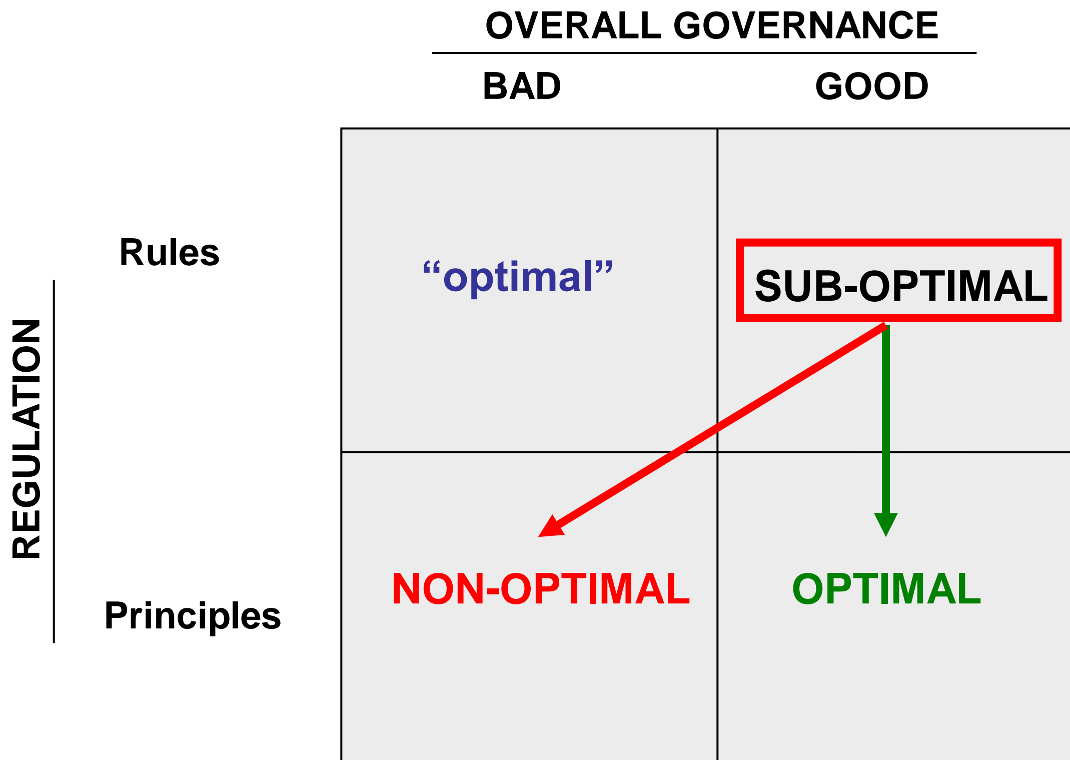
B

Quality of Governance

Auditors, rating agencies, institutional investors, corporations…

The Supervisor

Poor governance and Principles is maybe not a good idea…



Why should we be cautious in moving towards Pples?

- The crisis has shown two problems of "nature":
  - Nature of "homo oeconomicus": the rationality argument faces limits and most of regulatory thinking is based on it. New findings on behavioural finance
    - Corporate governance: self control
    - Qualified investors: bounded rationality
  - Nature of the regulatory process: regulation is not the pure outcome of a well intentioned *fonctionnaire*. Need to consider the impact of politicians, industrial interests, other stakeholders, lobbyists:
    - Autonomy of supervisor or international bodies
    - Accountability
    - New focus: (industry based – solo – twin peaks) & (national or state)
- Unresolved conflicts of interests (since Enron) diminish governance effectiveness
  - Auditors: audit vis-à-vis taxation, legal advice and others services
  - Rating Agencies: financial dependence on issuers pay

Governance failures, Risk Management and Compensation Schemes

- By and large, *corporate governance* issues have taken place in firms with dispersed ownership structure. It is there where there was
  - Poor risk management
  - Excessive and ill-designed compensation schemes
- The **principal-agent problem** is alive. Measures previously considered to be efficient to deal with this, have proven insufficient, at least.
- One natural hedge against P-A problem is **more ownership concentration**. There the corporate governance problem is avoiding minority shareholder expropriation. This model, however, cannot prevent the owner going mad and taking excessive risks.
- I will concentrate on two solutions proposed to solve the P-A problem:
  - Independent directors
  - Institutional investors

Governance failures, Risk Management and Compensation Schemes

- Institutional Investors (qualified investors)
  - QI are current or potential Principals as they are or could become shareholders.
  - Regulation normally assumes that QI have smaller information asymmetries: they manage more information, they are more skilled, ie., they are "rational". They can use "political rights" to choose independent directors.
  - If they were such, they could oversee what *agents* do and, hence, vote with the feet: they would sell if they perceive the *agent* is
    - (a) poorly managing risks and
    - (b) being too generous or irrational at compensation
    - (c) several other abuses
  - That is: stock prices should reflect the value of corporate governance
  - Why didn't this happen? What to do about it?

Controlling rights and rationality

The regulator's challenge consists on identifying psychological biases induced by these heuristics.

PSYCHOLOGICAL HEURISTIC	EFFECT	REGULATORY DECISION
Overconfidence, optimism representativeness and anchoring	Myopic assessment of the likelihood of loosing prestige or being caught incurring in bad governance practices. Underestimation of risk and risk measurement Bad corporate governance worked in the past, it might still work in the future.	Information disclosure. Rules are more effective than principles.
Excessive subservience	Bad corporate governance seconded by the CEO's own staff and perhaps also directors.	Enforcement.

Governance failures, Risk Management and Compensation Schemes

- Independent Directors
- An independent director should be free of any conflict of interest -affecting his or her free judgment- jeopardizing the interest of shareholders and stakeholders of the company
- Minimum requirements for “good” independent directors
  - Proper Competence-Qualifications. Knowledge, Judgment, Experience?
  - To devote sufficient time to their duties. Limitation on the number of directorships?
    - » NEW APPROACH TO REGULATION

Governance failures, Risk Management and Compensation Schemes

- Responsabilities of independent directors
  - Prepare themselves thoroughly for the meetings.
  - Continuously seek information to understand the latest developments of the company.
  - Get advice from outside experts if required.
- Specific tasks: participation in risk and audit committees
  - Monitoring accuracy and disclosure of financial statements of the company.
  - Review of adequacy of internal control systems.
  - Overseeing internal models and risk taking behavior.
  - Evaluating performance of senior management and compensation mechanisms.

Governance failures, Risk Management and Compensation Schemes

- How can regulators do?
  - Setting a better legal framework for
    - independent directors
    - qualified investors
  - Enforcement of corporate governance codes.
    - Disclosure of votes of independent directors
    - Mandatory manual of good corporate governance practices.
  - Peer reviewing of good practices
    - Blind workshop of independent directors (e.g. case studies, best practices)
    - Blind accountability events for institutional investors

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