FUNDING CORPORATE GOVERNANCE

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Corporate Governance and the Crisis

- The 2001-2002 scandals highlighted a lack of accountability even in the United States, let alone in other countries.
- The reaction of both academics (Homstrom and Kaplan, 2003) and practitioners was that the U.S. corporate governance was good and had become better.
- "No real-world crisis has shown that the current system needs radical revision. Five years after Enron and WorldCom, the capital markets are well into a cycle of unprecedented vigor" (Wachtell et al, 2007).
- In 2008 the real-world crisis came.

Lessons from the Crisis

- There are two main theories of what went wrong in financial institutions:
  1. Shareholders/managers of financial institutions have perverse incentives and took too much risk
     - risk shifting incentives
  2. Boards of financial institutions were
     - uninformed
     - incompetent
     - ineffective

Traditional risk shifting?

- Several papers tried to find this effect and failed.
- The Valukas report does say that Lehman doubled up on risk consciously
- But its managers did not sell any of their shares
- In fact, Dick Fuld lied to the board, not saying he had a term sheet from the Korean Development Bank

My assessment

- Financial crisis highlighted several different corporate governance failures:

1. Failure of debtholders of financial institutions to constrain management
2. Failure of governance systems to uncover bad news
    - The Laocoön Syndrom
3. "Group think" by boards

Failure of debtholders to constrain management

- Most managers are overoptimist about their ability and their chance of success.
- Natural selection
  - Board select more optimist
  - Past successes lead to over confidence
- Board members find difficult to constrain CEO
- Most of the action is done by debt market:
  - Quantity of finance
  - Price
  - Covenants

Why debtholders of financial institutions failed?

- Expectation that they would always be protected by the government.
- Expectation turned out to be right except for
  - Lehman
  - Washington Mutual
- As a result, debt was
  - Too available
  - Too cheap
  - Without covenants

How to Fix it?

- We need system where
  - The regulator has to intervene early (before the systemic cost are large)
  - It has to impose an haircut on the long term debt every time the financial institution is not well capitalized
- See Hart and Zingales (ALER, 2011).

The Laocoön Syndrom

- In any governance system it is crucial to aggregate information
  - To help in the decision process
  - To make reputation work
- Information is diffuse (Hayek, 1957)
- How can we best aggregate it
  - to induce better decision making
  - make reputation work
- In particular, how do we ensure that negative news emerge?
  - Negative payoff to be the bearer of bad news

The Laocoön Syndrom

Why Is So Difficult to Bear Bad News?

1. We are reporting to our judges
    - CEO is afraid to share bad info with the Board (Adams and Ferreira, 2005).
2. Blame the messenger
    - We dislike teachers who criticize our kids
3. Concentrated costs diffuse benefits
    - Speak against an internal appointment
    - Who has the information does not want to reveal it because news affects value of his/own human capital
4. Loyalty vs. honesty
    - Whistle blowers
5. Social pressure
    - Criticism is seen as antagonistic
    - Dissenters are ostracized

Mechanisms to solve this problem:

1) Financial markets
   - A profit reason to spread bad news.
   - This is the reason why so inmpotant
     - Short selling
     - CDS

2) Market for news – the media

3) Entrenchment
   - Watson story

4) A market for Laocoons
   – External auditors
   – Independently appointed board members

Why reputation is not enough?

- Consider external auditors
- Does it pay to blow the whistle?
- Before 2002 auditors who overlooked a fraud were not penalized (Dyck et al, 2010).
- After 2002 yes, why?
- Because SOX forced transferred the right to appoint the auditors to the audit committee formed of independent directors

The Myth of Independent Directors

- Why should they behave any differently?
- Which reputation do they care about:
  - Other CEOs who may hire
  - Shareholders?
- If they care about reputation vis-à-vis shareholders,
  - If they value it reputation more than their position, they should not accept the nomination.
  - If they do accept it, why should they not compromise (at least within limits)?

What Is The Solution?

- Directors not appointed by management
- It is not a guaranty of success, but a hope.
- If directors act in the interest of who appoint them, an alternative source of appointment might change their incentives.
- Approved in Dodd Frank
- Any evidence that this has an effect?
- It is still too early to say

The Italian Experience

- Legge Draghi (1998) introduces the presence of a statutory auditors appointed by “minority” shareholders
- Privatized companies also have a few borad seats reserved for directors appointed by “minority” shareholders
- Legge sul risparmio (2005) extends this to all listed companies

Problems – 1

- Who is a minority shareholder?
  - Risk that this position kidnapped by minority shareholders with a different agenda
  - Risk is particularly intense when international institutional investors do not vote because they are not aware of this concept.
- Limit who can propose the slate of directors
  - What are the incentives?
- Environmental incentives
  - If few of these positions, it does not create an alternative reputational system

Problems – 2

- Risk of Balakanization of boards like little inefficient parliaments.
- Unlike parliaments, corporate boards' primary function is not to redistribute resources but to create them.
- Unlike parliaments, corporate boards have to
  - compete in the marketplace
  - live under the constant monitoring of the stock market,
- The problem in the opposite: social pressure to conform that can lead to what Jarvis (1972) define as groupthink.

Problems 3: Excessive short – termism

- Making directors more accountable to shareholders make them more short-termist
- I do not know of any empirical support for this view.
- Primary reason for a short-term bias is precisely the lack of accountability for corporate boards.
- The role of the board is not to blindly follow stock prices, but to create value for shareholders, exploiting the informational advantage they have.
- In other words, a board that is legitimated can more easily resist the stock market pressure than a board that is not.

Problem 4: Information

- Directors depend on managers for information
- Very risky to create a tension between directors and executives
- Solution is not to ignore it and give all the power to managers

Conclusions

- We need to create the incentives for people to report bad information.
- Besides the stock market, the best way is to create positive career incentives for people who report bad news.
- The most important of such position is the one "minority directors"
- It is not perfect, but it beats the alternatives