Fresh thinking on the Financial Crisis and Corporate Governance

1. Is it possible at this stage, after so much ink has been spilled about the financial crisis, to come up with fresh original and compelling research and insights?

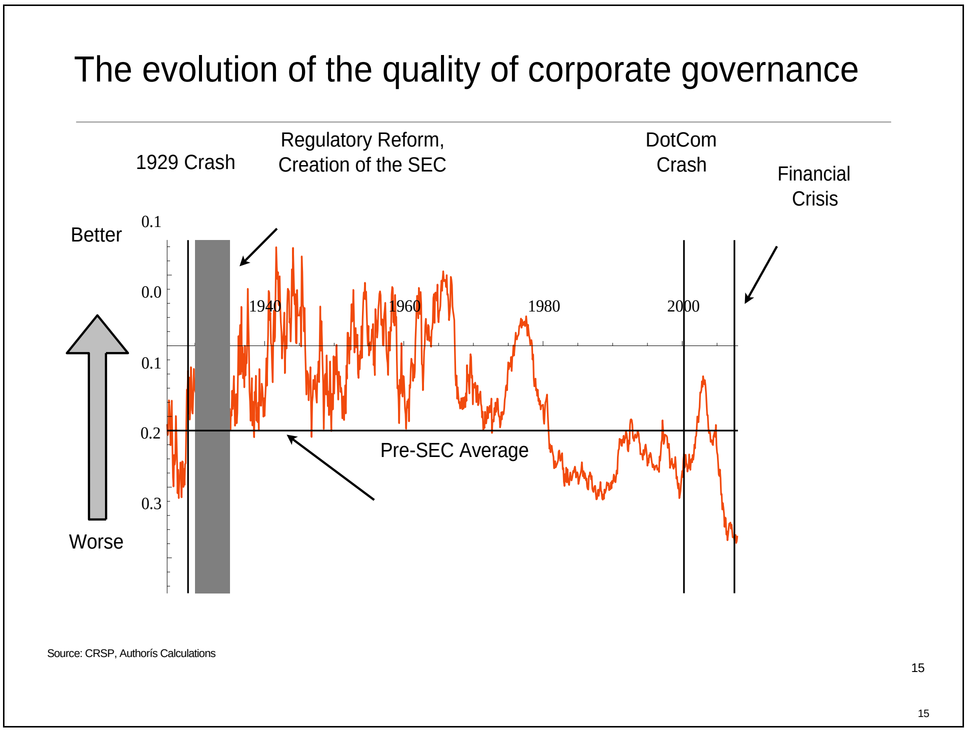
2. **Professor Charles Goodhart's LSE Financial Markets Group** provided a powerful affirmative answer at a conference last week organised by **Kevin James** of the **Bank of England**.

3. I wanted to share with you my impressions from this fascinating occasion by picking up themes on the financial crisis and its interaction with corporate governance – a subject also now high up the policy agenda, especially in the context of **Professor John Kay's review** for the Department of Business, which is now approaching its final stages.

4. In an absolutely gripping paper, which you can see here http://www2.lse.ac.uk/fmg/events/conferences/home.aspx Kevin James develops a compelling theory of diminishing returns to regulatory intervention.

5. Using US data, he designs a measure of the quality of corporate governance, including market transparency and correlates this with recent market crises.

6. Kevin James suggests that changing levels of market transparency have a profound impact upon the quality of corporate governance and the level of transparency can explain the poor quality of corporate governance before the US acted to establish the SEC in the early 1930s; the transition to good governance in the immediate post war period; and a plunge in the quality of corporate governance in recent decades, which coincides with the **dotcom crash of 2000** and the **financial crisis of 2008**.



7. No less stimulating, is **Professor Eugene White's** examination of the weakening of stakeholder incentives which increased risk taking in lending to property markets in the US.

8. Professor White suggests that a series of measures directly linked to corporate governance could have played a major part in **incentives to increased risk taking**.

Weakening of Stakeholder Incentives Increased Risk-Taking

- Double Liability
  - –Adopted in 1864 to incentivize shareholders
  - –Abandoned 1933—seen as ineffectual in halting banking collapse & depositors now have FDIC insurance
  - –1990s switch of investment banks from partnerships to limited liability
- Election and Role of Directors
  - –Decrease in directors oversight of management
  - –Management plays crucial role in nomination of directors
- Liability of Management
  - –Senior management no longer post bonds
  - –Fewer consequences for poor performance
- Supervision
  - –Increase in number of agencies
  - –Clouds accountability and transparency
  - –Less Credibility, More Liable to Capture

9. These include the abolition in the 1930s of **double liability –** under which shareholders were liable to the par value of the shares they held, as a result they were more prudent in lending policy with fewer failures, higher capital ratios and less risk taking than in single liability banks.

10. At the same time directors of these banks held significant **equity stakes**, were obliged to attend frequent meetings and many bank officers were obliged to **post personal bonds** which would become payable in the event of a corporate failure.

11. Professor White notes additionally that the 1990s switch of investment banks from **partnerships to limited liability** may also been a contributing factor to a changed approach of risk taking. As a partnership, he notes that retired partners of Goldman Sachs might not withdraw their capital for ten years and maintained offices on the partner's floor. Having "skin in the game" meant strong incentives to restrain risk taking. Since flotation, only 18% of stock is now held by retired partners reducing the incentives to monitor and diversify.

12. Continuing this corporate governance analysis, Professor White notes a decrease in **directors' oversight of management**, with management playing a crucial role in the nomination of directors; that senior management **no longer post bonds** against liability and have fewer consequences for poor performance.

13. In the US regulatory world there has been an **increase in the number of agencies** which clouds accountability and transparency and makes regulators less credible and more liable to capture.

14. I hope I have given you enough of the flavour of these papers to suggest that they put up a powerful new line of approach. The direct connection between corporate governance and financial crises has not yet come to centre stage in the EU and UK raft of re-regulatory measures which have followed 2008/9. But it would be alarming if the opportunity were missed to explore these connections.

15. The failure of the corporate governance model applying to banks to act as a check, brake or even an early warning system of the financial tsunami was depressing and indicates the importance of searching inquiry to learn lessons.

16. The indications are that, just as very significant increases in capital adequacy reserves now turn out to be essential to the future health of the banking sector, so does a rigorous inquiry into governance structures and the incentives which they foster.

17. The papers at the Financial Markets Group/Bank of England conference on Complements to Basel provide an excellent starting point for such work.

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