THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

THE COMMISSION ON BANKING STANDARDS REPORT AND BANK INCENTIVES: **A MISSED OPPORTUNITY**

Julia Black and David Kershaw

LFMP
Law and Financial Markets Project

Law and Financial Markets Project Briefing 2/13

THE COMMISSION ON BANKING STANDARDS REPORT AND BANK INCENTIVES: **A MISSED OPPORTUNITY**

Julia Black and David Kershaw*

In our submission to the Parliamentary Commission on Banking Standards[1] we argued that there is scope to improve bank conduct and culture by altering the existing structural incentives for banks to put shareholders' interests first. In our view the incentives for bank managers to prioritize shareholder interests are one of the central drivers of the bank failures and scandals of recent years. This is because the incentives of bank shareholders, *including long term shareholders*, are not aligned with our interests as citizens to have a safe and functioning banking system. More precisely, shareholders in banks that benefit from the State's "too-big-to-fail" (TBTF) subsidy have strong incentives to take socially excessive risks. It is well known that shareholders who benefit from limited liability have an incentive to increase the risk profile of the company in which they hold shares. By doing so they increase the value of their shareholdings. In non-financial companies this is not thought to be problematic as debt providers discipline any attempt to increase the risk profile of the company. But in banks which benefit from the TBTF subsidy creditors do not discipline the banks because they assume they will get repaid even if the banks fail. This is because the State provides formal (deposit insurance) and uncosted informal guarantees. It follows, therefore, that for diversified shareholders it is rational to encourage managers to "bet the bank" and rational to encourage managers to game regulation that attempts to prevent them from doing so.

The Banking Commission's Final Report[2] acknowledges these skewed incentives. It observes that "institutional shareholders have incentives to encourage directors to pursue high risk strategies in pursuit of short term returns and ignore warnings about misselling". Evidence which UK banks submitted to the Commission also supports the view that bank shareholders prior to the crisis actively contributed to excessive risk taking by pressuring management to alter the risk profile of bank investments. RBS, for example, observed that: "in some instances investors pressed for what were arguably unsustainable levels of return, creating pressure to increase leverage and take on additional risk". Douglas Flint, Chairman of HSBC, observed that:

> There was a great deal of pressure coming from shareholders who were looking for enhanced returns and were pointing to business models that have, with hindsight, been shown to be flawed and in particular very leveraged business models and saying, "You guys are inefficient. You have a lazy balance sheet. There are people out there that are doing much better than you are", and there was tremendous pressure during 2006/07.

If shareholder pressure to take excessive risk is real, then we would expect to find that banks with strong shareholder rights are more likely to take excessive risks – and therefore more likely to fail – than banks with weak shareholder rights. Quite simply, shareholders with stronger shareholder rights are more likely to get their way. Recent work by Ferreira, Kershaw, Kirchmaier and Schuster[3] provides important empirical support for this claim. Their paper shows that in the United States banks with stronger shareholder rights were more likely to be bailed-out than those with weaker shareholder rights, and more likely to engage in riskier banking activities. In the United States, core corporate law rights – such as rights to remove directors and the right to call a shareholder meeting - are optional. This means that it is possible to identify banks with weaker shareholder rights than UK banks as well as banks with stronger shareholder rights which are more similar to UK governance arrangements. This paper codes the banks with weaker and stronger shareholders rights and then analyses the comparative probability that these different banks will be bailed-out. The paper's finding that banks with strong shareholder rights were more likely to be bailed-out may be subject to different interpretations discussed in the paper, but an important possible explanation is that direct or indirect shareholder pressure supported by strong shareholder rights resulted in riskier investment profiles in these banks than the risk profile of the banks with weaker shareholder rights, where managers were able to resist that pressure.

* j.black@lse.ac.uk; r.d.kershaw@lse.ac.uk

1 Available at: http://www.lse.ac.uk/collections/law/news/Sanctions%20-%20submission%20from%20Black%20and%20Kershaw%2011%20Jan%202013.pdf.

2 Report of the Parliamentary Commission on Banking Standards, Changing Banking Standards for Good (Volume 2) (available at: http://www.parliament.uk/documents/banking-commission/Banking-final-report-vol-ii.pdf).

3 'Shareholder Empowerment and Bank Bail Outs' available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2170392).

All UK banks are governed by a set of powerful shareholder rights. Even the most empowered shareholders in the United States are not as empowered as UK shareholders are in all UK banks. In the UK, for example, directors can be removed without cause at any time by a simple majority of the votes cast at general meeting, which may in practice be significantly lower than a majority of the issued share. This is typically viewed by UK regulators, commentators and investors as regulatory best practice. We take no position on whether this is correct in relation to non-financial companies, however, for banks these shareholder rights provide a recipe for the excessive risk taking that has wrought such chaos and destruction in both our financial and real economies.

In this regard is it also important to note that UK company law provides other complementary rules that support this pro-shareholder position and the accompanying risk-taking incentives. Most importantly in this regard is the company law rule which provides that directors should prioritize the interests of shareholders when decisions are made.[4] If shareholder incentives are not aligned with the interests of society then in effect this rule instructs bank managers to act in ways that are detrimental to society. It seems likely that pre-crisis shareholders who reminded their directors that their bank's balance sheet was "lazy" and "inefficient" also reminded them of this legal obligation. For these reasons we recommended to the Commission that:

> There is a need to consider whether directors of regulated financial institutions, or a sub-sector of them, should be required to give equal weighting to the interests of all corporate constituencies when they act.

The Commission's report acknowledges this "corporate purpose" conflict by recommending that the Government consult on a proposal "to amend section 172 of the Companies Act 2006 to remove shareholder primacy in respect of banks". This is a valuable step forward but, as we also argued in our submission, changing the corporate purpose of banks is not enough. Even if Parliament were to alter section 172 for banks it would not on its own be sufficient to address the powerful shareholder value / risk- taking incentives as these incentives are the product of the UK's system of corporate governance, not merely of the corporate purpose rule.

So what more needs to be done? In our submission to the Commission we observed that the Commission should "consider whether it would be appropriate to weaken shareholder rights in financial institutions". More precisely we would propose that directors of ring-fenced banks should have traditional three year staggered terms and should ignore the UK Corporate Code's post-crisis recommendation of annual terms. Furthermore, we would propose a minor weakening of shareholder rights to provide that directors of ring-fenced banks whose three year staggered terms have not expired can only be removed at annual general meetings and only then with the votes of a simple majority of the issued shares rather than a simple majority of the votes cast. Ring-fenced banks subject to such governance arrangements would allow managers to resist shareholder pressure to take socially excessive risks.

The post Commission debate has focused extensively on the proposed introduction of a criminal offence for reckless banking which we address in *Financial and Corporate Policy Briefing* 1/13. Yet, these incentive problems, and how to address them, are of a much higher magnitude of importance. It is unfortunate that they remain inadequately addressed by the Commission's Report and unnoticed in the financial media's post-Report coverage.

4 Section 172 Companies Act 2006 (Duty to promote the success of the company).

The Law and Financial Markets Project is based in the LSE's Law Department. The project provides a framework for a research group of LSE faculty and associated participants from outside academia to explore the interactions of law, regulation, financial markets and financial institutions, principally within the EU and the UK.

LFMP

Law and Financial Markets Project

PROJECT MEMBERS

Prof Julia Black, Project Director
Dr Jo Braithwaite
Prof Michael Bridge
Dr Carsten Gerner-Beuerle
Prof David Kershaw
Dr Eva Micheler
Prof Niamh Moloney
Dr Philipp Paech
Dr Edmund Schuster

POSTDOCTORAL RESEARCHER

Dr Guiliano Castellano

VISITING PROFESSORS

Jonathan Fisher QC
Prof Christos Hadjiemmanuil
Roger McCormick

Julia Black is a Professor of Law at the London School of Economics and a research associate of the Centre for Analysis of Risk and Regulation (CARR) and a co-investigator of the ESRC Centre for Systemic Risk.

David Kershaw is a Professor of Law at the London School of Economics and a Senior Researcher of LSE's Financial Markets Group (FMG) and a co-organiser of the FMG's Corporate Governance at LSE.

For further updates and contact details visit the Project's website:
http://www.lse.ac.uk/collections/law/projects/lfm.htm

LSE

Department of Law
The London School of Economics
and Political Science
Houghton Street
London WC2A 2AE