

Chapter 7: Executive Summary

Corporate Governance in the Modern Financial Sector

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Background

The large, complex financial institutions (LCFIs) are highly levered entities with over 90% leverage. This highly-levered nature makes them prone to excessive leverage- and risk-taking tendencies. By and large, LCFIs also have explicit deposit insurance protection and almost always an implicit too-big-to-fail guarantee. The presence of such guarantees – often unpriced and at best mispriced – has blunted the edge of the debt monitoring that would otherwise exert an important market discipline on risk-taking by these firms. Although there is mounting evidence pointing to weaknesses in equity governance of these firms, the high leverage they have undertaken and the failure of their internal risk management practices also suggest weakness and failure of regulatory governance.

Perhaps even more important, the ever-increasing complexity of LCFIs has rendered weak, if not impotent, the role of governance from existing shareholders and non-executive board members. For LCFIs, the traditional board model used for industrial firms—characterized by infrequent meetings and a landscape that is not likely to undergo fast and dramatic changes—is not entirely suitable. Thus it has become increasingly difficult for LCFI boards to fully grasp the swiftness and forms by which the risk profiles of these institutions can be altered by traders and securities desks.

The Issues

Can the regulatory governance of LCFIs be altered in some robust way that reins in their risk-taking to efficient levels?

- Can boards and regulators who do not interact with the relevant profit centers of LCFIs on a daily basis ever be expected to achieve desirable outcomes based purely on monitoring and questioning? We believe not. Can they, however, ensure that *internal governance* in the form of judicious design of incentives and compensation is set up correctly to achieve this objective?

Policy Recommendations

1. On the regulatory front, our most important policy recommendation is that, to the extent feasible, regulators should price the guarantees right – that is,

commensurate with the level of risk of these institutions – and on a continual basis.

2. With respect to boards, a potential mechanism for strengthening regulatory governance may be to require that the board of directors of these LCFIs include a regulator and one or more prominent subordinated debt holders. Since there are several impediments – political as well as practical – to implementing our recommendation uniformly at all banks, an alternative proposal is that all independent board members be educated in the operational details and complex products of the LCFIs.
3. On the internal governance front, we recommend that regulators and boards pay special attention to, and help improve, capital budgeting practices and performance assessment standards for both top management and traders. We do not propose, however, that the regulators mandate compensation structures at micro levels. Rather, we suggest that they seek relatively un-intrusive ways of helping the industry coordinate its efforts in this area. Given that financial firms seem to be caught up in a bad equilibrium where a firm attempting to implement a more efficient long-term compensation plan fears that it will lose its employees to other firms that do not, perhaps this may be the best service regulators can provide. On this front, we have several concrete proposals:
 - a. Compensation structures should induce management to maximize the total value of the enterprise (for example, return on assets – ROA) and not just the equity value (return on equity – ROE) as is common practice. Maximizing the latter when debt is not fairly or continuously priced induces excessive leverage- and risk-taking incentives.
 - b. Return on assets should be benchmarked against a cost of capital that reflects not just the cost in good times when guarantees render the cost of debt essentially flat and invariant to risk, but also in bad times, when these firms are forced to make shareholder-value diluting equity or subordinated debt issuances. An extension of this practice would be to adjust the cost of debt to the “true” (or without guarantee) cost so that management and traders are not creating value *only* through regulatory arbitrage.
 - c. Existing compensation structures seem too short-term oriented, which induces perverse risk-taking and, to an extent, regulatory arbitrage incentives. We propose that LCFIs should use more long-term contracts that include deferred compensation features. Restricted stock, claw backs, and bonus pools tied to long-term profits would all be features that implement optimal top-management structures.

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