SECTION III

GOVERNANCE, INCENTIVES and FAIR VALUE ACCOUNTING

Overview

How did we end up in such a mess? Under one view (described in Sections I and II), banks were put in an arena where regulators laid down the rules of the game; subject to the rules, banks competed as well as they could; but the rules were so defective to begin with that mayhem inevitably resulted. But there is another view, one less charitable to bankers and one that makes it harder to rationalize the generous bailout packages they have received, namely that the origins of the crisis lie in the financial institutions themselves, in a collapse of corporate and regulatory governance and the provision of ill-designed incentives.

- It is this second view that is discussed in the two chapters that follow, Chapter 7 – “Corporate Governance in the Modern Financial Sector” and Corporate 8 – “Rethinking Compensation in Financial Firms”. The overarching theme is that it has become increasingly unlikely that regulatory governance – based on supervision and pricing of guarantees – and external corporate governance – based on vigilance of board members – will succeed by themselves in disciplining the risk-taking incentives in large, complex financial institutions (LCFIs). Therefore, and as financial products become ever more complex and opaque, financial firms need to be disciplined through the provision of appropriate incentives rather than through direct control over the products. The chapters in this section provide specific proposals to provide suitable long-term incentives to key profit/risk centers and top management of LCFIs.
- Another important issue not touched in this discussion, but one that has come up repeatedly during the crisis, is the role of fair value or mark-to-market accounting. In particular, should fair value accounting be abandoned during stress times since when assets become illiquid, mark-to-market values cause markdowns on portfolios of healthier institutions too (even though they might not need to sell these assets right away) and these markdowns raise concerns about their solvency when the issue may just be one of illiquidity? This theme is at the centre of discussion in the third chapter to follow: Chapter 9 – “Fair Value Accounting: Policy Issues Raised by the Credit Crunch”.