



Governance, Executive Compensation, and Excessive Risk in the Financial Services Industry

A research symposium presented by
Friedrich-Ebert-Stiftung and
the Sanford C. Bernstein & Co. Center for Leadership and Ethics

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Acknowledgements

Rapporteur: Mark Lee Hunter

Photography: Leslye Smith
Design: Carolyn Tharp

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Executive Summary

Patrick Bolton, Bruce Kogut, and Werner Puschra

The financial crisis that started in 2007 appears to many as a complex chain of events for which no one is ultimately responsible. This is no doubt true in the aggregate, but false for the causal accounting of responsibility for the collapse of individual banks and financial institutions. For the scores of banks that were saved by federal money under the TARP program and for the many that were permitted to fail, the proverbial “the buck stops here” is suppose to mean that the CEO and the board are accountable for the performance of their institutions. Even if systemic risk is too remote to hang on any one bank, surely top executives and directors are responsible for the fate of their own institutions. For this, CEOs are handsomely paid, with incentives to reward them for good performance. Directors, who are also remunerated for their duties, are chosen from the ranks of experienced and seasoned executives, professionals, and institutional leaders and have the job of managing financial risk. After all, these are financial institutions.

And yet despite these powerful incentives, these financial institutions crashed and burned, shareholders losses were enormous, credit froze, and small firms failed.

There has been academic literature now for over 30 years that states executives should bear risk in order to align their incentives with shareholders and in return their pay should increase when performance is good. A primary way of rewarding executives has been to augment their cash salaries with stock and stock options. Following the deregulation of banking in the 1980s—and the transactions-based compensation system that came in with the securitization that deregulation enabled—pay for performance diffused in the financial industry as well. Volumes of academic studies showed that linking pay to performance improved the risk taking and thus the entrepreneurship of banks.

This financial crisis calls into question this research as well as the now firmly rooted practice of linking compensation to shareholder performance. A few articles following the Internet collapse suggested that pay for performance increased incentives for executives to think more short term, so long as the consequences were disproportionately borne by

subsequent shareholders. However, in general, the academic literature confirmed the common wisdom that increased risk bearing by bank executives aligned incentives.

The crisis did not entirely dispel this belief. The discussions in Washington over executive pay often reiterated that executive compensation should be tied more to performance risk. Some financial institutions tied compensation to the pool of distressed assets, which were already heavily discounted, and then paid out massive compensation in 2009 as these asset prices rose, independent of the actions and performance of managers and executives. Boards of directors and CEOs expressed deep concern over their abilities to attract talent if compensation should be curtailed.

Governance, Executive Compensation, and Excessive Risk in the Financial Services Industry, organized by the Sanford C. Bernstein & Co. Center for Leadership and Ethics and Friedrich-Ebert-Stiftung, gathered leading academic and professional experts from the United States and Europe on the subject of the conference to establish three facts:

1. Did pay for performance practices encourage excessive risk taking?
2. What new practices could both incentivize managers and CEOs and yet discourage excessive risk taking?
3. What are the new responsibilities of boards and regulators in the financial sector?

The organizers of this conference have many thanks to give, especially to the participants who gave of their time and energy to this event. Hamid Mehran of the New York Federal Reserve Board provided intellectual leadership in guiding the thinking behind the conference and the selection of participants. We were also fortunate to have the support of the Bernstein Center staff, especially the co-director Sandra Navalli and Carolyn Tharp, who designed this report, as well as the rapporteur services of Mark Hunter. To Sara Burke of the Friedrich-Ebert-Stiftung, we express our thanks and gratitude for her indefatigable work to attract an excellent cadre of international participants.



Susan Schmidt Bies, former member of the Federal Reserve Board, delivered the opening keynote.

Recommendations

The conference presented many views. We offer our summary of the principal findings and recommendations:

1. Did pay contribute to the financial crisis?

- a. Yes. It would be hard to argue that pay for performance increases incentives for risk when times are good and then argue that such incentives did not lead to too much risk taking given the crisis.
- b. The econometric evidence ranges from no effect to a mild effect (René Stulz) to a significant effect (Balachandran, Kogut, and Harnal; Cheng, Hong, and Scheinkman).
- c. The qualitative evidence shows that four of the top five most remunerated financial executives saw their firms go under or get taken over despite having significant wealth in their companies (Stulz).
- d. The theoretical evidence suggests that managers and stockholders are “too aligned” in the presence of bubbles or in light of implicit government guarantees (Bolton, Mehran, and Shapiro; Bebchuk and Spamann).

2. What should be done?

- a. Compensation should
 - i. Tone down equity-based incentives
 - ii. Tie compensation to measures of excessive risk, such as CDS spreads.
 - iii. Convert debt into equity when riskiness becomes too large (and surely when a financial firm defaults)
 - iv. Postpone incentive pay (with the caveat that many felt that clawbacks would not be effective if managers had outside options)
- b. Governance should be strengthened.
 - i. Boards and top management governance are a blackbox; there needs to be more transparency on the measurement of risk and its credibility within the firm

- c. Regulation should be bold.
 - i. Primary goal should be twofold: to more closely align individual incentives for risk-taking with the longer-term stability of financial institutions while increasing transparency in markets and in measured risk.
 - ii. Increasing competition in markets could be useful in setting industry norms around more conventional compensation levels.

For an incisive perspective on regulation and pay, see “Is There a Case for Regulating Executive Pay in the Financial Services Industry?” by John E. Core and Wayne R. Guay.

Introduction

Two years after the insolvency of Lehman Brothers pitched the global economy into crisis, we are still at “the beginning, not the end” of the process of reforming financial markets, observed Chris Mayer, senior vice dean and Paul Milstein Professor of Real Estate at Columbia Business School. Advancing the process, as Mayer said, “requires collaboration among academics, government, and business.” But that collaboration is missing. There is thus a certain opacity—the making of the US financial reform bill, commented Mayer acidly, was “hard to figure out”—and an underlying absence of consensus as to the causes of the crisis and necessary policy responses.

Meanwhile, the economic crisis continues—and is becoming increasingly political in nature. In the curt phrase of former Federal Reserve governor Susan Schmidt Bies, “These issues are tearing the country apart.” Andreas Botsch, special advisor to the European Trade Union Confederation, said that “workers across Europe believe that the world of finance is waging an undeclared war against them.” Werner Puschra, executive director of the New York office of Friedrich-Ebert-Stiftung, observed that

Governments are now challenged, because of high debts incurred in stimulus and rescue packages.... Last March it seemed the crisis was nearly over; now the feeling is back in full swing.... People around the world who have lost homes, savings, and pensions fear that they will have to pay again, and more, through higher taxes and cuts in services. They not only expect that those who were responsible will help to pay, but they also want governments to rein in the markets.... Stronger regulation is part of the solution—but what about the internal incentive structures? Did they contribute? Are the huge bonuses justified? Should governments regulate pay?

Until the crisis, whether governments should regulate compensation in private firms would have been a very strange question—so strange, in fact, that scholars made hardly any effort to answer it. Nor did many scholars spend a great deal of energy attempting to determine what might constitute inappropriately high compensation, or how compensation might affect the creation or destruction of value.¹

The crisis is making these issues newly pertinent. Five years ago, recalled Lucian Bebchuk, the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance at Harvard Law School, suggestions that compensation schemes were irrational led to the reply: “The system is doing very well.” He continued: “The system is not working greatly in the last five years. So maybe we should be more receptive to this argument that incentives are not working well.”

But even if we assume that certain pay schemes are wrong (and this was hardly agreed upon at the conference), that does not tell us what to do about it. If there is an emerging

¹ In contrast, in the late 1980s and early 1990s investigative journalists closely studied the financiers around Michael Milken and Drexel Burnham Lambert, effectively concluding that they looted a number of companies while destroying them. See Connie Bruck, *The Predators Ball*, and James Stewart, *Den of Thieves*.



Bruce Kogut, the Sanford C. Bernstein & Co. Professor of Leadership and Ethics and director of the Sanford C. Bernstein & Co. Center at Columbia Business School, thanked guests for attending the day's discussion.





Lucian Bebchuk, the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and director of the Program on Corporate Governance at Harvard Law School, spoke with Wayne Guay, the Yageo Associate Professor at Wharton.



Brandon Rees, deputy director of the Office of Investment American Federation of Labor and Congress of Industrial Organizations, spoke about compensation and leverage.

consensus on some points, there remain deep divisions on most.

Part of the consensus is that risk management is a good lever to lift the wreckage of the crisis and see what's under it. Thus there is a focus among researchers on two questions defined by Bruce Kogut, the Sanford C. Bernstein & Co. Professor of Leadership and Ethics at Columbia Business School: "Did governance lead to... an encouragement to take on too much risk and therefore contribute to the crisis? Did compensation encourage excessive risk taking?" Put another way, were managers allowed through lax controls, or pushed through skewed incentives, to gamble?

Less than a decade ago, this issue was supposed to have been definitively settled in the US economy. Sarbanes-Oxley, the Congressional answer to the Wall Street scandals of 2001, instituted rigorous new disclosure, oversight and sanction provisions for the managers and boards of publicly traded companies. At present one might ask if the law's provisions were irrelevant. In at least one way they certainly were, suggested Hamid Mehran, assistant vice president of financial intermediation function at the Federal Reserve Bank of New York: "After 2003, many firms went private to avoid the scrutiny of compensation" mandated by the law.

More important, Sarbanes-Oxley hardly settled the problem of responsible governance. The scope of that failure was implicit in a recurrent theme of the conference, the role played by different monitors at different levels of the economy. Who determines incentives for managers, shaping their behavior? Who monitors their monitors, sanctioning the wisdom or folly of their oversight? Constantly linked to this theme was the issue of power; For example, would our economies really be more wisely managed if shareholders always got their way at big companies? And, assuming that we can define better modes of economic governance, how can we enact them in confrontation with entrenched, potent lobbies?

Part of the answer, said Hamid Mehran, is "to do better to get the best participants and ideas to solve the crisis." He noted that after four decades of intense academic study of governance, "there are more questions than answers." In particular, "most academics have hardly touched financial services. The bulk of work is on industrial concerns."

This conference was thus an exception and a sign that something has changed. Facts and ideas are on the table that would not have been expressed or listened to in 2006. The questions of what evidence matters for solutions to the crisis, and how it matters, are acute. They led to intense debate on May 28. This report follows the debate thematically, because in real time discussion looped repeatedly to unsettled points. Let us be clear: The debate is hardly closed. The evidence to support any given solution remains incomplete and often contested. The conference served to find holes in the evidence, but also to assess the most viable solutions at a moment of extreme urgency.



I. Defining and measuring the relationship between incentives and risk taking

A. A sense of *déjà vu*

In 1993, a Yale Law Journal article² argued that governance, compensation, and other factors could result in excessive risk taking, especially in the context of complex financial products. The author was Henry Hu, who at this writing is the inaugural director of the Division of Risk, Strategy, and Financial Innovation at the Securities and Exchange Commission and the Allan Shivers Chair in the Law of Banking and Finance at the University of Texas Law School.³ His keynote speech strongly suggested that the crisis was partly rooted in human nature, and that neither human nature nor the ways it responds to financial incentives have changed greatly since 1993:

- Compensation structures can be highly asymmetric. A derivatives specialist might achieve lifetime wealth in a single year, or might lose his or her job. The temptation to take risks, get the money, and run may arise.
- Senior management may not necessarily have the requisite financial sophistication to understand the risks inherent in their firms' products or strategies. Cognitive biases (such as the belief that "housing prices never fall") can cause derivatives specialists to make errors in modeling.⁴ Those specialists may not always be inclined to enlighten executives, and the executives may neither be asking the right questions or listening to the answers.
- Compensation structures may be too short-term, relative to the long-term nature of the risks assumed and to high staff turnover rates. The risks associated with certain products or strategies may not arise or be clear until years later, long after bonuses have been paid.

² Henry T. C. Hu, "The Causes of Informational Failure and the Promise of Regulatory Incrementalism," *Yale Law Journal*, Volume 102, April 1993, pp. 1457-1513.

³ The views Hu expressed were his own and not necessarily those of the SEC, individual Commissioners, or his colleagues on the SEC staff. As to this summary, Hu notes that none of the references to a "consensus" of participants should be deemed to include him; among other things, time constraints precluded him from attending most sessions.

⁴ *Ibid.*, p. 1487-1491.

When Hu made these points in 1993, they were hardly mainstream. Now, they arguably define the ground on which the debate takes place. Observed Bruce Kogut: "Usually, what we decide in business schools is, 'Does pay produce good or bad things?'" The new frame, he said, is "whether governance and compensation policies are responsible for managers taking on too much risk, not just watching risk, and are therefore responsible for the catastrophe we're facing."

B. Does equity-based compensation promote long- or short-term management?

1. The unions: "I want their grandchildren to hold the stock."

Equity-based incentives, which became widespread in the United States before their broad adoption in Europe, came under direct and powerful assault from Brandon Rees, Deputy Director of the Office of Investment at the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). Rees noted that union-sponsored pension plans holds \$480 billion in assets. The AFL-CIO's members take a keen interest in executive pay, said Rees: "It's the most popular section of our website." He made it very clear that they are outraged and worried by current executive compensation practices:

Runaway CEO pay has exacerbated economic inequality—and more importantly, led managers to make very bad decisions that hurt long-term value Stock markets in the last decade declined 24 percent—the collapse of the internet bubble, corporate accounting scandals, and now the financial crisis. Meanwhile, CEO compensation peaked at over 500 times the average worker's pay in 2000.

Executive compensation has a double-whammy effect, argued Rees. On the one hand, "golden parachutes insulate CEOs" from the effects of their mistakes. (That also bothered Lucian Bebchuk: "First, we have to get away from the ways that managers are insulated from long-term losses to shareholders.") On the other hand, equity-based incentive packages "can encourage excessive risk taking to obtain short-term price increases." There are at least two mechanisms



Peter Bofinger, professor of economics at the University of Würzburg and member of the German Council of Economic Experts, discussed excessive risk and compensation.

at work, Rees argued. One is volatility, which can serve to increase prices today as well as to lower them tomorrow. A second is to “overuse individual performance measures to reward executives, without adjusting for risk.”

As an example, Rees pointed to the now-defunct Bear Stearns, whose board “selected just one metric, return on equity,” in determining its CEO’s compensation. “There are two ways to increase ROE—increase net income, or decrease the amount of shareholder equity employed,” he explained. The latter strategy depends on increasing debt financing. Thus “while earnings increased, the debt to equity ratio increased at Bear Stearns, to an astonishing 32 times equity.”

Excess compensation and risk

- Compensation of executives, corrected for size, is correlated with riskiness of firms
 - » Sensitivity to ABX (AAA) returns
 - » Betas
 - » Return volatility

The AFL-CIO’s remedy hinges on making equity-based compensation subject to what Rees called “meaningful stock lockup provisions.” Specifically, he said, “I would like to see their grandchildren obliged to hold the stock.” In practice, however, the union asked companies for a five-year holding requirement, which would hamper managers from speculating on volatility.

This is part of a larger project “to refocus shareholder power around long-term interests,” said Rees, and executive pay is hardly the only driver in the opposing direction. Rees noted that “the typical security today has over 100 percent turnover, due to our market structure and high frequency trading.” That leads to “a market failure to see why people invest in stocks, for retirement and kids’ education,” and a conflict between those shareholders and “the interests of short-term investors.”

Later in the day, European trade unionist Andreas Botsch offered proposals that were similar to Rees’s. The European unions want a systemic reform based on principles that Botsch summarized as “a financial system of five S and one D”:

- smaller in size,
- slower in speed,

- separated functionally,
- simpler (less complex in instruments),
- less short term,
- and thus more stable and democratized.

Like Rees, Botsch wants reform “to restore the fundamental role of a financial system,” though instead of paying for retirement and education he cited “intermediation, allocation, and transfer of capital to productive use.” Both of them would compel managers to act on behalf of stakeholders as well as shareholders; both would limit their freedom to do certain kinds of business in certain ways. Neither believes that the financial industry will reform itself. Said Botsch, “One of the favorite songs of bankers must be ‘Across the Universe’ by the Beatles. They keep singing, ‘Nothing’s gonna change my world.’”

2. How Bear Stearns and Lehman executives cashed out \$2.4 billion in incentives before their firms exploded, and how to avoid a repeat.

Rees’s polemical language was highly singular at this conference; yet his fundamental argument was largely shared by Lucian Bebchuk: “I think we would all accept that it would be good to tie executive compensation to long-term results.” The only issue, he suggested, is how. The current situation involves “a problem we can refer to as a short-term distortion—a divergence of interests between managers and shareholders. They don’t internalize the consequences of risk taking for shareholders.”

Bebchuk noted that there is disagreement about how much of a role “short-term distortion” played in the last crisis. But part of that disagreement is based on a mere legend carried by “various media accounts that assumed that executives of Bear Stearns and Lehman saw their personal wealth wiped out with the firms.” If so, then “flawed incentives could not play a role” in those failures. This conclusion has real-world consequences, as Bebchuk wrote in a recent paper, “Commentators have used this assumed fact as a basis for dismissing both the role of compensation structures in inducing risk taking and the potential value of reforming such structures.”⁵

5 Lucian A. Bebchuk, Alma Cohen, and Holger Spamann, “The Wages Of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008.” Harvard Law School, Discussion Paper No. 657, 12/2009.



(From left) Lucien Bebchuk, the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and director of the Program on Corporate Governance at Harvard Law School; Wayne Guay, the Yageo Associate Professor and associate professor of accounting at Wharton; and Peter Bofinger, professor of economics at the University of Würzburg and member of the German Council of Economic Experts.

In fact, however, “those executives did not see their wealth wiped out together with the firm,” said Bebchuk. “They came out with big money.” The written version of the story notes that compensation packages allowed them “substantial opportunities (of which they made considerable use) to take large amounts of compensation based on short-term gains off the table and retain it *even after the drastic reversal of the two companies’ fortunes.*” There were thus “incentives to seek improvements in short-term results even at the cost of maintaining an excessively elevated risk of an implosion at some point down the road.” Bebchuk acknowledges that this doesn’t prove “that these incentives in fact had an impact on the executives’ decisions.... It does show that concerns that this might have happened should not be dismissed.”⁶

How much money is involved? During 2000–2008, the top five executives of Bear Stearns captured \$1.4 billion in cash bonuses and equity sales. In the same period the top five at Lehman collected another \$1 billion. Even allowing for their initial investments in stock options, said Bebchuk, “Their net payoffs were in the hundreds of millions net positive.” Bebchuk was suggesting, like Rees, that over time such incentives lead executives to assume risks that can turn out disastrously. One could object that these outcomes are freakishly exceptional, both in terms of the wealth that was captured by individuals and the scale of the corporate failures. But that raises the issue of whether market rules should be constructed around average cases—which is what we do when we trust in the market to make things right on its own—or exceptions. Kogut argued that “we have to care about outliers in the context of externalities and systemic risk” in particularly strong terms. “You don’t excuse a criminal because the population on average is honest,” he said.

Assuming this analysis holds, what solutions might exist? A comparison of Bebchuk’s proposals with Rees’s is instructive:

- Like Rees, Bebchuk proposed that lockup provisions will be key to any reform: “We should genuinely separate the point in time when equity incentives vest... from the time when they can be cashed in.”
- Unlike Rees, he would not like to see grandchildren obliged to hold the stock: “We would let executives cash out. Otherwise the rewards aren’t there; they can’t use the money.”

- Nor would he force them to hold the stocks until they retire: “The problem is that this provides perverse incentives to retire. If you have a large portfolio, instead of having retention incentives you have incentives to leave. This would be especially powerful for execs who are successful,” because they could cash in before their successors potentially damage their portfolio’s value.
- Part of the solution, said Bebchuk, should be “aggregate limitations on unwinding, so each year you can unwind only 10–20 percent of your portfolio.”⁷
- In that case, he added; “anti-hedging arrangements become very important,” because delayed unwinding will push executives toward hedging their portfolios.
- Most important, said Bebchuk, “We should strengthen the rights and tools of shareholders, keeping in mind that in the United States the rights of shareholders are weaker than in the United Kingdom or any other common law country. That would prevent or make less likely all those structures that make executives disregard the rights of other stakeholders, by taking money off the table.”

Whatever the solution, Bebchuk warned, there will be gaming. “Imagine everything is tied to long-term results. For whom? If for shareholders, the executives are not taking into account adverse consequences for bondholders and the government, so there will be excessive risk taking.” Thus compensation packages should include a mix of equity, preferred shares, bonds, and the value implied in CDS. The key principle in performance-based compensation, concluded Bebchuk, should thus be “to include not only consequences for equity holders, but also for other investors in the firm.”

That principle is being applied in Brazil, though not quite as Bebchuk described it. Board members and senior executives of financial institutions share liability in case of catastrophic losses, and may have to pay claimants from their personal resources. According to Otavio Damaso, senior advisor for the deputy governor for financial system regulation and organization of the Banco Central do Brasil, “This reduces the incentive for excessive risk taking.” One can well believe it.

6 Ibid.

7 The lower figure is the one used in Bebchuk’s paper; the higher figure is the one he cited at the conference. He did not explain the discrepancy.



Jose Scheinkmann, the Theodore A. Wells '29 Professor of Economics at Princeton University, spoke on the panel "Compensation and Leverage."



Hamid Mehran, assistant vice president of Financial Intermediation Function at the Federal Reserve Bank of New York, moderated the panel on "Governance in Banks and Bank Holding Companies."

C. In search of "excessive" risk

1. Are managers shareholders at heart?

There is a conceptual hole in the argument that poorly conceived incentives drove executives to pile on excessive risks until disaster struck. Exactly how much risk is "excessive"? Wayne Guay, the Yago Associate Professor at Wharton, half-jokingly answered: "I have 'excessive' in quotations, because of my ignorance of what that means.... We're immediately jumping to the term excessive, without asking what's a normal amount of risk, and then finding deviations." Whatever it means, he suggested, it may not be the underlying issue:

Incentives to focus on the short term is [one] allegation. The story is [executives] pump up the stock, dump the equity, and do it in a way they won't be caught. If true, this points to unresolved agency conflicts. This is something shareholders don't want them to do, and suggests a governance problem. But this isn't *risk taking*—it has more to do with earnings management.

René Stulz, the Everett D. Reese Chair of Banking and Monetary Economics at Ohio State University, dismissed the idea that financial executives consciously piled on risk for greater gain. First, he noted, they were hardly aware of the risk of systemic failure: "The market did not anticipate a one-third fall in real estate prices." Second, the investments whose failure smashed the system "were not viewed as risky by regulators, the public, banks, and raters... It was not like

What Is Excessive Risk Taking?

- Investing in AAA securitization tranches was not excessive risk taking from the perspective of shareholders of an institution
- From the perspective of shareholders, do we really know that there was excessive risk taking? How would we quantify it? Did CEOs have the wrong incentives from the perspective of shareholders?

Figure 1: From the presentation of René Stulz, the Everett D. Reese Chair of Banking and Monetary Economics and director of the Dice Center for Research in Financial Economics at Ohio State University.

in 2006 people knew we were taking excessive risk and did not talk about it." Moreover, he found in a paper written with Rudiger Fahlenbrach that the "sensitivity to risk" of CEOs at major banks prior to the crisis "never comes out negatively, and in some regressions it's positive." In other words, these executives did not miss the real risks because they carelessly or willfully overlooked them.

Stulz then attacked the assumption that equity-based compensation would inevitably lead CEOs to strategies that effectively betray other shareholders. On the contrary, he and Fahlenbrach argue, "Large holdings of equity by CEOs could in fact lead them to focus appropriately on the long run," even at the expense of speculative investors. That, they note, is the outcome predicted by the pre-crisis economic literature, which argued that companies did better when their managers gained and lost in sync with their shareholders. (Noted Patrick Bolton, "The best articulation of the conceptual foundation is in Holmstrom and Tirole (1993).⁸ What do they say? Stock price is a good measure of the long-term fundamental value of the firm, so to maximize it, you want pay to be sensitive to stock price.")

According to Stulz, the correct moment to examine the influence of incentives on executive decisions and risk taking is not 2000–2008, but 2006, a year before the crisis hit. That year, he said, "The firms where CEOs had the large [equity] investments were Bear Stearns, Lehman, Merrill Lynch, and Countrywide." In other words, the banks where CEOs were best aligned with their shareholders had the worst performance during the crisis. In Stulz's lapidary phrase: "The greater the sensitivity of equity ownership, the poorer the performance during the crisis." More precisely, he said, "If you were maxing shareholder wealth before the crisis, it worked out poorly.... If you were a CEO and looked at the stock prices, you could think you were doing well before the crisis."

Was there a mismatch of executive incentives and shareholder interests? Said Stulz, "It does not look like a first order problem before the crisis." He did not say explicitly that CEOs are lately being punished for trying to maximize shareholder wealth as well as their own before 2007. But he made it clear

⁸ Bengt Holmstrom and Jean Tirole, "Market Liquidity and Performance Monitoring". *The Journal of Political Economy*, Vol. 101, No. 4. (Aug., 1993), pp. 678–709.

enough that in his view, there is neither sufficient evidence to condemn them as recklessly greedy nor to demand regulation of pay:

We think regulators should not regulate pay levels... there is a movement to have regulators interfere with compensation across banks. We have to ask if regulators have the incentive, knowledge and ability to do that. You have to understand a lot about risk management, the nature of the work someone is doing. Having that regulated in detail is going to be quite counter-productive. When we talk about regulation of compensation, people have alternatives. People and activities can move to less-regulated sectors. The more we do about regulation of compensation, the more we will see political considerations in banks, which could lead to an allocation of capital that is not the best.

Regulating pay won't be easy work on the front lines, commented a Federal Reserve official: "I wonder about sending an examiner who makes \$150-190,000 annually to look at [J.P. Morgan CEO] Jamie Dimon's compensation. I wonder how I can challenge his pay. Mine is a fraction of what he makes." Lucien Bebchuk responded:

This kind of stuff is much easier for examiners to do than many of the things they do now... It would be applying clear principles that are simple. Not saying to Jamie Dimon, 'You make too much money, sell the mansion! It's saying, 'You can't cash out too many of your equity positions too quickly'... Firms should have clear, meaningful ownership guidelines; your examiners could enforce them.

Wayne Guay, however, strongly supported Stulz's warning that we don't know enough about the causes of the crisis to punish one set of actors.⁹ "I don't mind boards having regulatory guidelines" on compensation, he said. "I feel less good about everyone having the same guidelines." He is even less comfortable with the "pump and dump" narrative that's driving reform. "CEOs allegedly have a tendency to unwind their incentives," he summarized. But the fact is, that is "not a pervasive problem... there's not a lot of selling going on." What, then, asked Guay, "are the incentives to take a 5 percent catastrophic risk, and throw the firm and my career under a bus?"

For most firms, there's evidence that risk-taking incentives from common equity is pretty small. But banks are highly leveraged. Do they have greater incentives? Maybe. But their wealth is tied to one risky asset. To increase the option value, you have to jeopardize the value of that healthy firm. I would like to see somebody measure the option value associated with this common equity. I haven't seen anybody do it for financial firms. I'd like to see somebody do a dollar value. Is it big enough to drive behavior? If so, we'd expect to see more equity volatility, a greater incidence of financial distress in banks than other firms.

In the absence of such evidence, he said, "It doesn't appear to me that the idea that focus on the short term drove excessive

⁹ Guay and John E. Core make these points in greater length and detail in their article, "Is There a Case for Regulating Executive Pay in the Financial Services Industry?" Draft version, Jan. 25, 2010. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1544104.



Henry Hu, director of the Division of Risk, Strategy, and Financial Innovation at the US Securities and Exchange Commission (SEC), delivered the lunchtime keynote.



Tano Santos, the Franklin Pitcher Johnson Jr. Professor of Finance and Economics at Columbia Business School, spoke on the panel "Governance in Banks and Bank Holding Companies."



Sara Burke, policy analyst at Friedrich-Ebert-Stiftung and Arantxa Jarque of the Federal Reserve Bank of Richmond listen to speakers' comments.

risk is empirically supported." Nor does it make sense, he repeated: "Stock options aren't a big enough payoff to drive people to endanger otherwise healthy firms."

Lucian Bebchuk argued that this is not the right way to read the evidence: "It's not in 2006 that CEOs knew the economy would collapse and tried to bail out. Rather, you operate the firm for many years with an elevated risk. Maybe down the road, at an uncertain time, there will be a large loss. Meanwhile, you constantly take some money off the table."

Kogut remarked that the issue can't be reduced to "the incentive property of an extra five or 10 million. When you're talking about such high levels of compensation, you're not talking about motivating people." At those levels, he said, "the standard model of why we compensate people so highly, to get them to work harder, may not be the right one to explain these results." In other words, the people taking those huge sums have reasons beyond simply acquiring more wealth; but in the state of the evidence, economists can only speculate what those reasons might be.

2. The shareholder as a vector of disaster

- Compensation structures are an important determinant of how the financial system performs—and whether financial firms take excessive risks.
- To avoid excessive risk-taking, compensation structures should be reformed to:
 - » Link payoff to long-term results
 - » Define long-term results more broadly than maximizing long-term shareholder value.
- To bring about such reforms:
 - » Shareholder rights need to be strengthened
 - » In addition, monitoring and regulating the compensation of financial executives should be added to the toolkit of financial regulators.

(Presented by Lucian Bebchuk.)

Does the pump and dump story denounced by Guay make better sense with shareholders in the role of villain, instead of CEOs? John Coffee, the Adolf A. Berle Professor of Law at Columbia Law School, raised the possibility:

There is a dominant, prevailing scenario shared by Congress, the public, and academics: reckless managers driven by compensation assumed excessive leverage. Shareholders are assumed to be cautious, prudent, and long term oriented, while managers have shifted to risk-taking through incentives. The first is true, the second is a fairy tale. But it's shaping a good deal of pending legislation.

Jose Scheinkmann, the Theodore A. Wells '29 Professor of Economics at Princeton University, argued that if there were incentives to take unreasonable risks by managing for short-term gains, "it's more likely to have come from shareholder demands than managers' interests." In a study of finance firms in the period 1992–2008, he and his coauthors found that "compensation and risk-taking are not related to governance variables but covary with ownership by institutional investors who tend to have short-termist preferences and the power to influence firm management policies."¹⁰ In other words, big shareholders who want fast returns lean on firms to reward managers who deliver them.

Scheinkmann noted that there is some basis in theory for this view, but that it is better supported by empirical studies and anecdotal evidence. He alluded to a famous quote from Citigroup's Chuck Prince: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." This sad epiphany is iconic: at some point in every Bernstein conference Chuck Prince has been cited as a "leader" whose shareholders would have had his head if he dared to stop dancing on the edge of the volcano. (Another participant added that likewise, "John Mack was getting killed at Morgan Stanley by shareholders for not taking enough risk before the crisis.")

What Scheinkmann and his coauthors did was to look at the total direct compensation of top five executives across a

¹⁰ See Ing-Haw Cheng, Harrison Hong, Jose Scheinkman, "Yesterday's Heroes: Compensation and Creative Risk Taking." Conference paper, available at www.gsb.columbia.edu/leadership/may2010.



Stéphane Jacobzone, senior economist at the Regulatory Policy Division of the OECD, commented during the panel discussion on “Governance in Banks and Bank Holding Companies.”

range of industries, controlling for the sector and the size of the firms. They then sought to correlate these factors with a number of measures of risk, in particular whether the markets considered that the firm had a high risk of default. One innovation in their research was to take account not only of “insider ownership” (i.e., equity compensation) but of every form of compensation—the “residual” amount that the companies gave these people. Equity ownership alone, as Stulz showed, doesn’t predict risk taking. Likewise, Scheinkmann et al. found evidence that executives who own their firm’s stock mitigate their risk taking.

But total compensation, if Scheinkmann and his team are correct, changes the outcomes. Firms that paid their leaders relatively high compensation in 1992–94 continued to do so later, “whether the firms did well or not.” What they rewarded, consciously or not, was managers who took on higher risk: “There is a clear correlation between the compensation and the amount of risk they took.” (Not incidentally, the best-compensated managers, who took the most risks, were not always the ones with the biggest titles: “At AIG the CEO was not the most important person.”) Salary levels weren’t very predictive about how much risk a manager would take, but both bonuses and equity or option compensation were. And higher risk taking and higher compensation were associated with faster stock turnover and higher levels of institutional ownership. The champion here was Lehman, which the markets considered as showing a high probability of default on three occasions during the period studied.

How did it work out? The persistently high-paying, high-risk firms—Bear Stearns, Lehman, Citicorp, Countrywide, and AIG—began this period by performing well. Of course, as Scheinkmann delicately put it, “They later did badly.” (In fact, three of them disappeared.) In this study, big money for executives, big risks, and big, speculative shareholders went together with very big catastrophes.

Is that result an anomaly—because the financial industry is different from others or for another reason? Scheinkmann conceded that a piece of the story is missing: “We don’t know who sets up those [incentive] schemes. I’m on a board... no shareholders call us up to say ‘do this or that.’” Wayne Guay pointed out that “there’s a huge literature that makes the consistent point that managers are risk-avoiding, and if

anything, shareholders need to give them incentives to take more risk than they would otherwise be inclined to take.”

Lucian Bebchuk had argued that stronger shareholder rights were necessary in the United States to restrain executives’ tendency to “take money off the table.” However, he added:

Even when the shareholders have enough power that execs will focus on long-term results, we’ll still have the problem of excessive risk taking from the perspective of society as a whole... shareholders prefer excessive risk taking. So they may have an interest in pay arrangements that encourage risk taking too much.

There is uncertainty here as to causes and dynamics, and it makes regulatory policy choices far harder to design, let alone enact. Scheinkmann proposed two solutions that sidestep the disagreement: “regulating the risk these firms are allowed to take and allocating voting power according to holding horizons, like how much time you have held your stock.” The former solution would constrain both executives and shareholders, and the latter gives more power to non-speculative equity owners. But both situate the governance of the firm in rules made outside and above the firm.

3. The trouble with transactions

The conference opening keynote speaker Susan Schmidt Bies, a former member of the Federal Reserve Board and currently on the board of Bank of America, suggested that not merely the structure of incentives, but the trigger for their disbursement, needs to be looked at:

The model is based on transaction compensation—the aggregators only get paid if they securitize something, the investment banks only get compensated when they market the securities. Everything is transaction-based, so you want to get as many deals done as fast as you can. Old-fashioned good sense lending rules, at good banks, were that there was no compensation to loan officers based on the volume of loans; it was based on the quality of the portfolio of loans. You were paid when the portfolio matured. If it was junk you paid the price, and lost your job. However, said Bies, “I don’t hear much discussion” of the transaction compensation principle. Indeed, she was the



only person who evoked it during the day. That may be unfortunate, because no regulatory changes would be required to stop the practices she denounced.

4. A growing appetite for disclosure

The Federal Reserve's Hamid Mehran agreed with Scheinkmann that stock options aren't the only compensation issue. He noted that in 2007, executive teams in the New York financial industry took billions of dollars in bonuses. The boards of directors that approve such bonuses have proven difficult to constrain, he said. He argued that when "bonuses will be based on how much dividend the firm is paying, if you pay out to make your bonuses, you kill tangible common equity." He recalled that the Fed is applying pressure to stop this practice: "To create an incentive plan to not deplete capital, regulators are proposing that lots of bonuses cannot get paid out... because of the [bailout] subsidy, regulators arguably have the right to control it."

Compared to bonuses, added Mehran, stock options "are the past." The present is bonuses, "and we can't observe them clearly." The implication was that this is going to change before long. Bonuses are a prime target in many ways, observed Bebchuk, not least because their benefit for anyone but their recipients is hard to prove:

If you look for evidence that bonuses raise performance, we don't have it. Even the evidence for options improving performance is not so strong.... It's hard to show those things, but it goes back to the principle of economics: If you have an agent and you give them good incentives, this is the right way to go. We basically have a situation in which people can take a lot of money off the table, and if they do, there is a divergence between them and long term value. Unless you can show me it's not a problem, I am concerned and I would like a better compensation structure, in the same way we have pay for performance.

That will require firms to disclose more fully and intelligibly the compensation of their leaders. That idea is gaining ground even among skeptics of regulation like Wayne Guay, who noted that "in terms of the regulatory focus, transparency seems like a really big issue." It is also another issue that firms can manage without regulators coming through their doors:

A lot of recent proposals on executive pay have been about retirement plans, perquisite consumption, retirement—relatively little focus is on, 'Tell me how the incentive structures really work, [so that] for such and such a percentage increase in stock or equity volatility, this is what it implies for the wealth of the CEO.' We do that for derivatives, I don't see why we can't do it for CEOs.

5. Building risk into pay

Patrick Bolton's task here was "to propose a way of adjusting pay for performance, for risk." He observed that the concept of pay for performance has serious limitations: "It doesn't allow for leverage, or stock options, there's no adjustment for risk, and none for speculative bubbles." Echoing Rees, he suggested that equity options can be an invitation to speculative management:

Once you have a leveraged institution, equity is like a call option. You maximize the value of the option by maximizing volatility. If you're a CEO of a bank and you want to raise debt, the bond market may understand that you may have adverse risk incentives and will price that in. You can say, 'I'm not taking on more risk to minimize the cost of capital.' But the amount of risk you take is hard to observe, so you can't guarantee it. That's one constraint. The other that will make you bad at controlling risk through compensation is you have negative incentives through shareholding. Investors may have misperception of risk.

In a paper with Hamid Mehran and Joel Shapiro,¹¹ Bolton proposed that these constraints can be mitigated by basing compensation not only on stock prices, but on credit default swap spreads (the annual amount a buyer must pay a seller in case a credit instrument defaults). That way the markets, and not shareholders, decide how much risk is excessive: "CDS spreads pick up the markets' perception of how much risk the bank is taking. The market also picks up the incentives to take risk." For example, market beta—the relation of a stock's returns to the market as a whole—is a common risk measure, and it is "very strongly" correlated to pay, said Bolton.

11 "Executive Compensation and Risk Taking", Preliminary draft, May 27, 2010.



Arantxa Jarque of the Federal Reserve Bank of Richmond and Tano Santos, the Franklin Pitcher Johnson, Jr. Professor of Finance and Economics at Columbia Business School spoke during a coffee break.

Through a small events study, Bolton and his colleagues explored new disclosure requirements for executive compensation. He summed up: "The more deferred it is, the more pension compensation there is, the less likely the CEO is to take risk." If risk taking increases with leverage and compensation, he concluded, the solution is to "base pay on CDS spreads." More exactly, as he wrote with Mehran and Shapiro, "A high, and increasing, CDS spread would result in a lower compensation, and vice versa."

In answer to a critic who challenged the assumptions that "higher compensation means more short-term compensation, put in place by shareholder desires," Bolton said, "Nothing tells us we should reward managers for taking on market risk. Right there, that's excessive. The theory says you should do [relative performance evaluation], and it's missing in compensation practice."

The idea of compensating executives with securities that are tied to credit ratings and spreads appealed to Wayne Guay. So did "the idea of deferred compensation that the executive foregoes if the firm gets into distress. Current plans have some of those features. You could limit the ability of these plans to be funded if the firm goes under."

D. The state of the debate on executive pay

Despite holes in the evidence, and disagreement over what the evidence that exists might mean, and strong disagreement over the wisdom of further regulation, there was a certain consensus in the room:

- The proposition that bigger compensation delivers better results for shareholders and stakeholders is not supported by evidence.
- Some compensation, in particular bonuses, is especially hard to justify from the standpoint of shareholder value, and even less acceptable from the standpoint of stakeholder value (as in bonuses at bailed-out banks).
- Firms that push to maximize shareholder value in the short term are more at risk than peer firms that do not.
- Whether because powerful shareholders select them or they select themselves, some executives who take home particularly high rewards assume higher risks.
- Opaque or incomplete disclosure makes it easier for boards to grant such rewards.
- Finally, it is indeed possible to conceive viable mechanisms to correct some excesses, such as adjusting compensation to risk or sustainability. Those mechanisms do not necessarily require more intrusive regulation than is currently the case.



Susan Bies, former member of the Federal Reserve Board, spoke with Monika Mantilla, CEO of Altura Capital, during a conference break.

II. Who will govern the financial system, and how will they govern?

A. Getting past “groundhog day”—reforming the risk culture and competency of boards

In the 1993 film *Groundhog Day*, a reporter must live the same moment over and over because he doesn't grasp its meaning. For Susan Schmidt Bies, that syndrome is “a major issue... I've been in banking since the 1970s, and this is my third major housing mortgage crisis. If you look at the root causes of this one, most were not new—they were well known and understood, but the lessons were forgotten. So what did we forget?”

Bies provided a catalog of practices that led three times to disaster in only four decades:

- “We focused too much on individual loans and underwriting, not enough on the marketplace. The economists clearly saw we were building houses far faster than new household formation... that excess inventory is still with us.”
- “When we saw prices rising, it created its own demand, because speculators came into the market... in some markets 40 percent of new construction went to investors.”

The Policy Framework for Effective and Efficient Financial Regulation

- Reference benchmark, ideal system
- 10 key principles
 - » Precautionary and proactive approach, risk based
 - » Sound incentives (remuneration guidelines)
 - » Comprehensiveness (all participants covered)
 - » Consistency across markets and borders, and competitive neutrality
 - » Use of Better Regulation Tools and ex post review
 - » International coordination and convergence
 - » Open competitive and safe markets

- “Banks were making loans at rates way below the risks inherent in the processes. Same as the 1970s: bankers forgot they needed to know the local market, and lent outside their footprint.”
- “The return of no-documentation loans, where people who were originators wanted to close a loan no matter what. It's a way to speed up closure processes. People didn't want you to talk to competitors.”
- “By moving to a securitization market we focused on collateral value, and forgot the basic rule of credit writing: you have to base lending first and foremost on ability to repay. You only care about the value of the house if the borrower cannot repay from current cash flow earnings... The model didn't look at the capacity of the borrower to pay.”

This was the second time in this series of conferences that institutional forgetfulness has been evoked as a factor in the crisis, while the memory of key leaders has been proposed as a safeguard. Takatoshi Ito, Professor of Economics at the University of Tokyo, recalled in December 2009 that “one Japanese institution that held the toxic assets [of the US subprime crisis] got rid of them in a very early stage. I talked to the guy responsible.... I said, ‘How did you make the decision?’ He said, ‘I remember the non-performing loans problem [in Japan in the early and mid-1990s].”¹² Likewise, at this conference Stéphane Jacobzone, senior economist at the OECD's Regulatory Policy Division, said that banks, as any large organizations, may have an institutional memory. For example, senior management at banks hit by a previous crisis could be more cautious when a new crisis occurs, as was illustrated by Australian examples during the recent Global Financial Crisis.

Bies argued that forgetfulness is not merely or only a matter of individual incentives, but of governance: “How do I make sure that management has learned these lessons, incorporated it into the culture?” (As Tano Santos, the Franklin Pitcher Johnson Jr. Professor of Finance and Economics at Columbia Business School, put it later in the day, “Why do we need regulators to tell us not to do undocumented loans?”) Though she did not use the term “accountability”, her examples

¹² See “The Quantitative Revolution and the Crisis: How Have Quantitative Financial Models Been Used and Misused?” Columbia Business School 2010, p. 19. Available at www.gsb.columbia.edu/leadership/research/dec2009.



Andreas Botsch, special advisor to the European Trade Union Institute/ European Trade Union Confederation and head of the Economics Department of the German Confederation of Trade Unions, spoke on the role of governance.



Otavio Damaso, head of department for the Financial System Regulation and Organization at Banco Central do Brasil spoke on the panel, "Governance in Banks and Bank Holding Companies."

demonstrated that it is a key issue in the breakdown of governance:

We have to look at the tail end [of the crisis]—the foreclosed loans. Servicers, who handle the monthly payments from people whose mortgages were securitized, are hired by the investors. The borrower has no ability to determine who the servicer is. Their mortgage can be sold tomorrow.... Borrowers have no recourse to a servicer when they say they aren't treated well; they're out of the equation when the mortgage is sold... not having a customer relationship after the mortgage closes is a huge issue.

Current reform projects won't solve that issue, she added: "I can't find it in the Senate bill." In general, she said, "I don't believe the prevention side [of the bill] is focusing on root causes."

Even without a reform bill, Bies suggested, firms could hugely improve risk management practices at executive and board levels. In particular, they can address a power mismatch between risk managers and line managers—"an enormous problem within financial institutions," commented Patrick Bolton later, "that [people] haven't even talked about." Said Bies:

It wasn't until the mid-1990s that we thought of risk management in commercial banking. Many of them still don't have a senior enough position in the structure. They report through and under the CFO, sometimes they're aligned with auditing. They have limited access to the structure of the board, unless they create an enterprise risk management committee. They don't have the stature to say 'no' to the line officers, and the line officers make it clear they're the ones who pay your salary.... It should be the job of line management, and the risk managers should make sure there is framing and validation. Risk management by risk managers is a scenario for failure.

The issue of how executive compensation affects a firm's risk profile is almost never discussed at the board level, she said. Bies knows of exactly two companies where the board's compensation committee meets with the risk committee. The

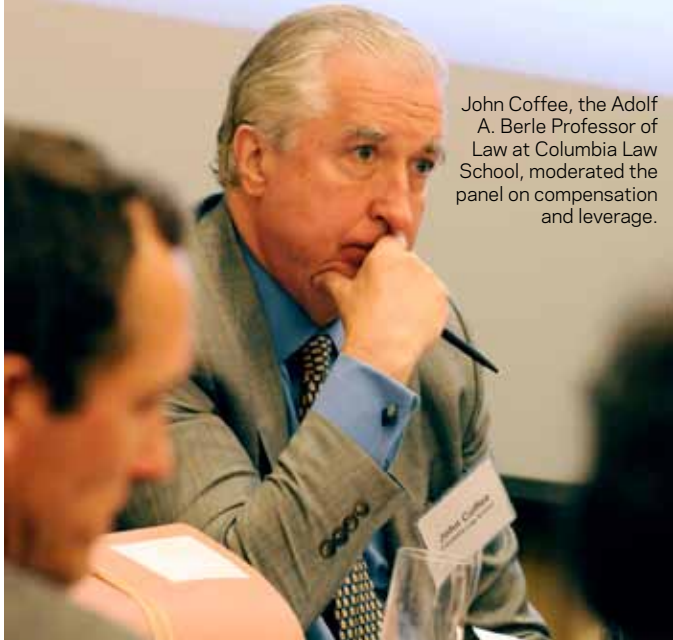
rest, she said, "are too siloed." They have another cultural problem, suggested Patrick Bolton: "Arrogance. That may also be relevant when it comes to the world of financial wizards and engineers."

A question of competence is certainly involved. Bies offered Bank of America's board as an example: "Wonderful people, but the business changed. You didn't have people in critical risk areas sitting on the board." Just as Sarbanes-Oxley made it clear that there must be people with financial expertise on the board's audit committee, the current crisis should make it clear that "people who serve on the risk committee [must be able to] ask the right questions—if you don't understand the nature of the risks you don't know what questions to ask." (Santos agreed: "The knowledge of the people who sit on boards is out of whack with people at the bottom who know the markets and take risks. This is a pervasive problem.")

Through a comparison with the insurance industry, Bies suggested that the financial industry also needs to rethink its vision of risks and how to prepare for them:

The insurance industry has a whole different approach: we don't know when there's the next earthquake or firestorm, but we do know that when it happens we have huge exposures. Their main mission is to manage exposure for those extreme events. In the middle ages and industrial revolution whole cities were wiped out by fires. The insurance agency called to change building codes, hire professional firefighters. They planned for what would come. In the financial services industry we have to stop saying, 'This won't happen.' We have to say, 'It will happen, and this is our immediate reaction when it occurs,' because we know it will occur.

In sum, Bies warned that we can't count on boards to restrain the risk taking of managers if those boards lack appropriate perspective and competency. Empirical support for Bies' observations came from Harald Hau, associate professor of finance at INSEAD. Hau sought to determine whether there was a correlation between the expertise of board members at private and state-owned German banks, and the way the banks performed during the crisis. The state-owned Landesbanken, he found, did far worse than the private banks. Like the private banks, said Hau, "They were pursuing



John Coffee, the Adolf A. Berle Professor of Law at Columbia Law School, moderated the panel on compensation and leverage.



Harald Hau, associate professor of finance at INSEAD, spoke on the panel "Governance in Banks and Bank Holding Companies."

value maximization." But they had numerous civil servants and politicians on their boards. They also showed losses that were an average of 200 percent higher than comparable private banks. The key explanation, said Hau, "was a strong correlation to financial illiteracy [among board members] and underperformance.... Private banks had financially competent boards."

It didn't happen by accident, Hau showed. The private banks made financial skills, and not merely education or general management experience, a criterion for board members. Thus, noted Hau, even "union representatives on boards had more competence in private banks than public banks." The criteria were different at Landesbanken, whose board chairmen "could not control the number of political appointees."

Spain's local and regional savings banks, or *cajas*, partly resolved their financial competency issues through what Tano Santos called "a symbiotic relation with the Bank of Spain. The supervisors are there on a daily basis." That prudential regulation stopped Spanish banks from taking certain risks:

At some point, the Spanish banks said, 'Can we do things off the balance sheets?' The Bank of Spain said, 'We don't get it from a risk capital point of view.' Nothing legally prevented the banks from doing it—the Bank of Spain told them not to. The decision proved wise... People in the Spanish banking industry tell you that the Bank of Spain is a wonderful device to not do certain things.

Bies serves on the board of a major insurance firm, and has been struck by the difference of culture between insurers, who continually "manage exposure for extreme events," and banks, which keep "saying this won't happen." But crises will indeed recur, she said: "We have to say it will happen, and what is our immediate reaction when it

occurs, because we know it will occur." She confessed, "I'm pessimistic."

These discussions brought up a major issue for scholars, summed up by Jose Scheinkmann: "Maybe governance really matters, and we just don't know how to measure it." As Wayne Guay said, "We can measure all kinds of aspects, but not good or bad governance. So a lot of things we measure are, if the CEO is not the chairman, or the board is big or small." He was alluding to Sarbanes-Oxley as well as to debates over whether non-executive and independent board members make better watchdogs in firms. Harald Hau found a measurable criterion that correlated to results in a crisis. But the larger issue of what constitutes good governance and how we measure it remains unsettled, at a moment when new rules of the game are being enacted into law.

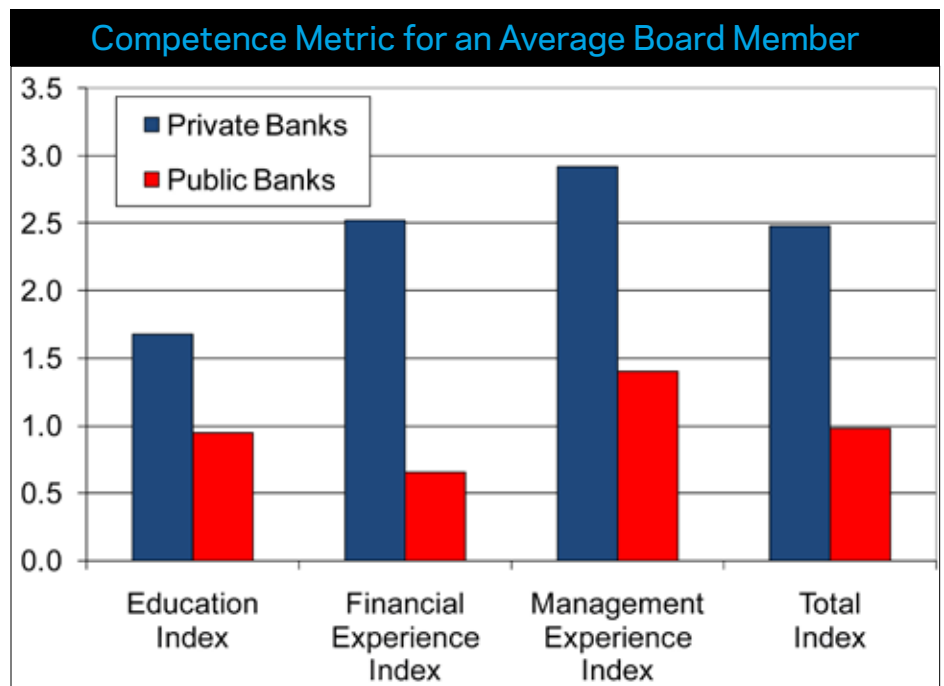


Figure 3: Sum of indicators in each dimension is scaled to a maximum value of 10. (Figure copyright by Harald Hau, INSEAD.)



Henry Hu, director of the Division of Risk, Strategy, and Financial Innovation at the US Securities and Exchange Commission (SEC), and Jeff Gordon, the Alfred W. Bressler Professor of Law at Columbia Law School, respond to questions after Hu's keynote presentation.

B. The 800-pound gorilla: the double problem of political governance

1. The denial of political responsibility in the crisis

The single greatest change running through the Bernstein Center conferences since December 2008 is the growing presence of the state in the conversation. Partly this is due to the fact, as Mehran put it, that “regulators are an arm of governance,” and we are constantly driving toward more regulation of the financial sector. The crisis has weakened a major conceptual obstacle to interventionism, suggested Lucian Bebchuk: “One of the standard objections to government intervention is that regulators are at an information disadvantage. That’s true of other forms of prudential regulation. People on the inside may have more information and be better positioned, but they don’t have the right incentives.” More precisely, they don’t have the right incentives to share information of the type that can help regulators to avoid systemic crises, and they can’t avoid those crises on their own.

So the state steps in. But there is no guarantee that it will act more wisely than the markets. Across conferences, there is visibly growing awareness that irresponsible political forces may further damage the financial system. The spectacular failure of Fannie Mae and Freddie Mac points to “obvious lessons that have nothing to do with private sector compensation and governance,” said Charles Calomiris, the Henry Kaufman Professor of Financial Institutions at Columbia Business School. As he sees it, the lessons have everything to do with how narrow political objectives may override business sense. Those entities assumed risks that their risk managers opposed, and “they got back a message saying we have a political mandate, we have to do it.... The risk manager who stood his ground was fired, and now teaches elementary school.” This is not an isolated case in either the United States or the world, said Calomiris:

“The [German] Landesbanken are driven by political considerations too. European governments don’t like talking about how much they’ve contributed to this problem. It has everything to do with political will. There’s a political equilibrium of risk denial.”

Politics, said Calomiris, is “the 800-pound gorilla” in this discussion. It drives 90 percent of the issue of corporate governance and pay, because “the politicians love this debate. It enables them to beat up on bankers.” (As opposed, that is, to justifying their own roles.) But bankers in general are not a fair target, suggested Calomiris, “If you looked at the banks that were repeatedly involved in alleged criminal or unethical activities, [Merrill Lynch, Citi, and UBS] would come up repeatedly.” Likewise, he noted, only a handful of banks kept pushing on the buy side of the crisis. For the majority, governance or excessive risk taking were not issues of the same magnitude.

Did bad governance explain why financial firms take on too much risk?

Did executive pay lead to excessive risk taking?

Said Calomiris, “The pols want to discuss pay, that’s what gets them votes. They don’t want to hear about these complicated things.” Which is why, said Patrick Bolton, “solutions have to be simple.” In any case, said Calomiris, “we’re not going to fix the political problem, it’s off limits.” And so, he said, “We need to think about fixes in an environment where the political sector doesn’t want to hear about it.”

2. Lobbying and the erosion of trust in finance and government

A second political problem is lobbying power, said the OECD’s Jacobzone: “The issue is to restore trust in governance, and redefine the public interest. [But] governments will not pass good laws and regulations... no reform can be achieved... until they resolve the lobbying issue.” It is not a matter of putting an end to lobbying, but of defining rules to ensure that it complies with ethical requirements. For example, the OECD has defined 10 principles for transparency and integrity in lobbying.

In particular, lobbying power is reflected in and enabled by tremendous variation concerning ethics requirements to work in the public sector. These are seen as more stringent for example in Canada than in some other countries that have been hit harder by the crisis. Stronger ethics criteria for civil servants may have helped. “You have to ensure that people



Peter Bofinger, professor of economics at the University of Würzburg and a member of the German Council of Economic Experts, spoke with a conference attendee.

Some Other Issues

- Do we really want regulators to decide whether the compensation is appropriate at lower levels?
- Do the regulators have the right incentives? Do they have the knowledge? Do they have the ability?
- What about competition?
- Should we worry about politics?

Figure 4: From the presentation of René Stulz, the Everett D. Reese Chair of Banking and Monetary Economics and director of the Dice Center for Research in Financial Economics at Ohio State University.

Tying CEO Compensation to a Measure of Default Risk (CDS Spread)

$$\text{Compensation} = \bar{w} + s_E P_E + s_D (\bar{P} - P_{CDS})$$

- **Empirical evidence:** using a SEC regulation on increasing compensation transparency in 2007, we show that the market (CDS spread) believes tying compensation to debt-like compensation (deferred compensation and pension) leads to lower risk

Figure 5: Proposed by Patrick Bolton, Hamid Mehran, and Joel Shapiro (2009).

are not compromised by past or future financial interest,” said Jacobzone. But the reverse is often the case. Santos observed that Spanish finance is dominated by the Santander bank and the Bank of Spain, and said, “The head of the Santander team was hired by the Bank of Spain. This revolving door is a very serious problem. I see how to solve this by paying supervisors much better. But this is not politically feasible.”

Lobbying is underway to shape the post-crisis playing field in the EU, where the creation of the European Systemic Risk Board at the end of 2009 galvanized players on all sides. Andreas Botsch reported that it became a focus for Europe’s unions: “We managed through the European Parliament to get seats with voting rights for unions and civil society organizations on the board, where before it was concentrated on the financial industry and central bankers.”

A similar process will soon gain traction in the United States, said Coffee, and will be reflected in declining severity of regulation:

Regulators are severe, harsh, and aggressive for a few years after a crash.... Regulatory intensity will wane once we get back into the boom years. You can bet on a compensation formula, dilution constraints, or regulatory supervision. It’s part of the package. But there will be international regulatory arbitrage. The United States will say we’re driving people to the United Kingdom. Or people will say we should have moderate deregulation.

C. Contingent capital: a solution with broad support

One feasible “fix” for the possible insolvency of financial institutions, said Calomiris, resides in “contingent capital.” In its current form (variants have been discussed by academics for decades) the concept is credited to Mark Flannery of the University of Florida.¹³ Since the end of 2009 it has gained repeated public support from present and former members of the Federal Reserve Board, including former chairman Paul Volcker, as well as Canadian Finance Minister Jim Flaherty. But in recent weeks these supporters have backed away.¹⁴ Nonetheless, the idea is simple enough to explain in a political setting, as in this Congressional testimony:

[Flannery’s system] would require large banks to hold debt instruments in the form of Contingent Capital Certificates that would automatically convert to bank equity, if the market value of a large bank’s equity fell below an established threshold. This would eliminate regulatory delays and negotiations when a bank might be in jeopardy. Establishing the threshold as a function of the market value of a bank’s equity would provide a

13 “Stabilizing Large Financial Institutions with Contingent Capital Certificates.” University of Florida, Department of Finance, Insurance, and Real Estate, Gainesville, FL.

14 See Kevin Carmichael, “Flaherty Steps Back from Contingent Capital Idea; Concedes Alternative to Bank Tax Might Not Get a Lot of Support at G20 Summit.” The Globe and Mail (Toronto), June 21 2010, via <http://www.theglobeandmail.com/report-on-business/economy/flaherty-steps-back-from-contingent-capital-idea/article1611599/?cmpid=rss1>.



Charles Calomiris, the Henry Kaufman Professor of Financial Institutions at Columbia Business School, spoke on the panel "Governance in Banks and Bank Holding Companies."

daily valuation about whether the debt certificates would need to be converted to capital."¹⁵

bailout. It would also "change incentives of shareholders as the threshold is approached," predicted Coffee.

What Calomiris likes in Flannery's idea is that "it creates a constituency outside the bank... of debt holders who will keep track of and penalize excessive risk taking. You have to create a constituency that loses from risk.... You bolster bank risk-taking performance by creating that constituency." William Dudley, the president of the Federal Reserve Bank of New York, has argued that this would also be "more efficient... relative to simply raising capital requirements," because the contingent capital turns into equity "only in the bad states of the world."¹⁶ In other words, when a bank is about to fail, holders of contingent capital gain ownership leverage. For example, said John Coffee, "You can convert the capital into a senior preferred stock, or give voting rights to debt holders under other circumstances."

The most important effect on shareholders, he suggested, would target CEOs:

As a firm gets in trouble, and the CEO knows the trouble better than anyone else, to the extent he's got a huge amount of stock, if he sells the firm to somebody else, or if he enters a capital raise that will dilute the shareholder claims, he's wiped out. He may not care about the shareholder in Dubuque, but he cares about his portfolio. If he switches from an equity share to a debt share, he has an incentive to draw more capital into the firm, which he wouldn't if he were thinking only of his shares. So the most important feature lies in the effect on the CEO. It will provide an incentive to bring more capital into the firm.

This strategy, said Coffee, would address an issue raised by Scheinkmann's study among others: "What if shareholders are seen as even a larger part of the problem than executives, because they are risk-indifferent or risk-tolerant?... The broader implications are that aligning manager issues with shareholder interests does not necessarily represent a sound policy from a social standpoint." But that, he warned, is what Congress is pursuing, "trying to increase shareholder control over managers, to make them more responsible." Certainly, he said, "I don't think anyone wants to make banks wholly immune to accountability to their shareholders." But neither would any prudent person wish to leave control of systemically important assets wholly in the control of shareholders.

Harald Hau asked a question about the current debate, especially in Europe, over raising capital requirements for banks: "Can you show that the contingent capital idea produces better results than just increasing equity requirements?" Coffee replied, but not directly: "It's not a market solution, it's a regulatory solution to avoid the costs of insolvency." A US Treasury official in the room called it "an alternative to ex ante bank lending, which creates moral hazard" through drawing on a government's general revenues, "whereas contingent capital stays inside the firm's structure."

Contingent capital would avoid that danger, said Coffee. For example, suppose that "any significant financial institution had to be half-financed by contingent capital, and half of that would be converted to capital by a new block of voting shareholders. The other half might convert only on default." That would prevent the institution from going bankrupt, and avoid a

Avinash Persaud, a member of the Network for Sustainable Financial Markets and Chairman of Intelligence Capital Limited, pointed to "a fundamental problem" with contingent capital proposals:

No one's behaving optimally when the stock prices reach a low threshold. You'll decide either to convert or not convert. When you impose mandatory conversion, it's distributed between the equity holder and the converted capital holder.... You'll have a potential problem of manipulation. You have to be very careful in thinking of mandatory conversion.

15 David A. Walker, the John A. Largay Professor at the McDonough School of Business at Georgetown University, "The End of Excess (Part I): Testimony in front of the House Financial Services Oversight And Investigations Subcommittee." May 6, 2010.

16 Emmanuel Olaoye, "Fed's Dudley Eyes New 'Contingent Capital' Regulations for Banks." www.complinet.com/global/news/news/article.html?ref=125643, Oct 14 2009.

Coffee conceded that "this solution is imperfect. But it does not bet on existing shareholders as the champions of public



Avinash Persaud, a member of the Network for Sustainable Financial Markets and chairman of Intelligence Capital Limited, spoke about governance.



Katharina Pistor, the Michael I. Sovern Professor of Law at Columbia Law School, moderated the discussion on "Governance of Multinational Bank Holding Companies and the role of the Financial Stability Board?"

interest or financial stability. They will not save us in times of crisis." (He did not say, or need to say, that they didn't last time.)

As Coffee explained it, contingent capital sounds like a simple, elegant solution. But Patrick Bolton warned that it "is more complicated to implement than it appears." Calomiris said, "I'm all in favor of this, but there's a big design and political issue." One key issue raised by Susan Schmidt Bies is how to make contingent capital (or some other form of subdebt) a real disciplinary force. That means it has to be linked to other measures, Calomiris acknowledged: "It isn't enough just to require it, you also have to say 'no bailouts,' and not allow implicit bailouts, make it a binding constraint." There is no such binding constraint in the financial reform bill passed by Congress, though the possibility for future bailouts by the Federal Reserve has been limited.¹⁷

D. Limiting the inter-connections among financial institutions

Peter Bofinger, professor of economics at the University of Würzburg and a member of the German Council of Economic Experts, worries that massive bailouts "convinced everybody that if you invest money in a large bank it will be safe." He said:

This is one of the negative incentive effects of the crisis—you can feel more secure than before. If banks are too big to fail, investors have no incentive to monitor the bank, they can take on bigger risks, and thereby are more likely to fail.

The "too big to fail" issue remains to be solved, and banks clearly cannot or will not solve it themselves. Bofinger ran through the extant proposals: the International Monetary Fund advocates higher capital requirements, Congress has discussed size limitations on banks, Paul Volcker argued for the renewed separation of investment and commercial banks,

¹⁷ For an interesting comment on this measure from a political standpoint, see Eli Lehrer, "Five Reasons to Cheer the Financial Reform Bill," posted July 13, 2010, on the Frum Forum at www.frumforum.com/five-reasons-to-cheer-the-wall-street-reform-bill. Lehrer is a research fellow at the conservative Competitive Enterprise Institute, and in April conservatives savagely attacked the reform bill as an open door to bailouts. Lehrer concludes that the bill makes bailouts much less likely.

Reduction of interbank connectedness would lead to a new financial landscape

- Reduction of speculative transactions between banks
- Diminished role of wholesale banks
- Diversification rule would have also applied to pension funds and insurance companies
- Increasing importance of mutual funds for the investments of pension funds and smaller banks (Kotlikoff's limited purpose banking proposal)

Figure 6: From the presentation of Peter Bofinger, professor of economics at the University of Würzburg and a member of the German Council of Economic Experts.

and in Germany, taxes have been proposed on "systemically relevant banks." None of these measures, said Bofinger, will address "the root of the problem":

In the recent crisis the main cause was that the insolvency of one bank leads to the insolvency of others, a domino effect. Banks have a very high exposure vis-à-vis other banks... the main problem is that they are too interconnected to fail.

From that perspective, the size of a financial institution matters far less than the nature of its linkages to other banks: "You can have a large bank that has no systemic problem if its investors are diversified; a smaller bank with [non-diversified] investors can be a systemic risk." The reason is that if it fails, so may its investors; if they, too, are banks, to which other banks are likewise exposed, then contagion sweeps through the system. The obvious and simple solution, said Bofinger, is to "limit inter-bank exposures to ten percent of a bank's [total] exposure. Then one or two big banks can fail without posing a systemic risk." That would also render government intervention through size restrictions or punitive taxes unnecessary.

This solution has already been partially enacted through the European Capital Requirements Directive. As amended on September 16, 2009, its Article 111 clearly declares: "A credit institution shall not incur an exposure... to a client or group of connected clients the value of which exceeds 25 percent of its own funds." However, no less than six other



articles provide loopholes to this rule.¹⁸ To be effective, Bofinger argued, the rule must be far more strict and far less avoidable. But that will clearly impact established interests:

If you want to reduce [bank interconnectedness] this will lead to a new financial landscape—less speculative transactions between banks, fewer wholesale banks, a stronger relevance of mutual funds. You would no longer use banks as intermediaries.

There was no disagreement on Bofinger's insight that interconnectedness trumps size in systemic failures. Erik Berglof of the European Bank for Reconstruction and Development specifically cited interconnectedness as a key factor in the disaster that overtook Eastern Europe. As another participant put it:

Crises occur after booms, when there's de-leveraging. In a de-leveraging crisis every bank is connected to every other. Take Northern Rock, interconnected by its funding model, not by borrowing or lending to other banks. [This is why] even a small bank going bankrupt in Spain has a huge psychological impact on European markets.

The issue that was raised was whether or not bankers will like a rule that remodels the financial landscape, and in the process dis-intermediates them from numerous transactions. As Calomiris ironically commented, like proposals to create incentives for uninsured debt, Bofinger's proposal "assume[s] the bank is well-governed and the CEO is smart." The problem is that "in this crisis the banks who were not well-managed and where the CEO was not smart played a role." Put another way, people may seek outcomes that visibly undermine their long term interests. Like the speakers who preceded him, Bofinger led the conversation to the point that it is not enough to have a viable, simple solution. There must also be a constituency for it that can oppose other constituencies. The loopholes that sapped the power of Article 111 to restrain inter-bank exposures surely became law because powerful stakeholders fought for them.

¹⁸ See "Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009, amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management." Official Journal of the European Union, 17/11/2009, L302/97-119. Via eur-lex.europa.eu.

III. Is global financial governance a myth, or a necessity?

A. Why the global crisis is good for national regulators

"When the crisis hit, global leaders swung into action, the G20 was forged out of the fires, and everyone was full of talk of global harmony and cooperation," recalled Avinash Persaud of the Network for Sustainable Financial Markets. The catchphrase of the moment was that "banking is a global business, and needs to be globally regulated." But this, too, is a fallacy, said Persaud. "Despite the global talk, an increasing amount of action is local."

The fallacy of global governance operates on two levels, he said. At the G20, "leaders tend to talk the same vocabulary... but in different regions they mean different things. They think global regulation means other people are doing what they're doing." At the operational level, we are witnessing "a shift in regulation away from the notions of 'home country' regulators following global rules to the 'host country' regulator. It's happening whether we like it or not." For example, "By saying that all activity [of a foreign financial institution] has to take place through local subsidiaries, regulated locally, capital and assets are ring-fenced locally." And that is appropriate, said Persaud, "The locus of regulation should be local."

On the one hand, an opportunity has been lost: "We could've had a single rulebook of financial regulation, banning nasty products." On the other, said Persaud, "I'm not so disappointed. It's inevitable that we'll see a swing away from global regulation toward host country regulators with host country rules. That disappoints my liberal international friends, not me."

Globalism doesn't look the same from the viewpoint of the BRIC countries, he pointed out, "There's an unholy alliance between big banks and liberal internationalists to want global regulation. This is highly efficient from their perspective. They'll say if you don't have it, it's bad for development, [that] if there are no global rules there'll be no end of regulatory arbitrage." (Trade unionist Andreas Botsch gave a precise current example: when the EU sought to regulate the footprint of all funds not domiciled there, and that are used for tax or



Erik Berglof, chief economist and special adviser to the President at the European Bank for Reconstruction and Development (EBRD), spoke on the panel, "Governance of Multinational Bank Holding Companies and the role of the Financial Stability Board?"



René Stulz, the Everett D. Reese Chair of Banking and Monetary Economics and director of the Dice Center for Research in Financial Economics at Ohio State University, discussed regulation.

arbitrage reasons, "We noticed the considerable protests of funds out side the EU, in particular the US and UK offshore funds.") The alliance paints a scary picture, but in fact, said Persaud, "There are stronger arguments the other way." He said:

It's increasingly obvious: there isn't one set of global rules that's appropriate for the world. An Indian financial regulator has a totally different view from a regulator in Beijing or the United States. They have different priorities[.] There is not one set of rules appropriate for these different states of development and priorities.

Nor is it true that host country regulation will lead to more regulatory arbitrage than global regulation, "Having a global set of rules enforced differently across different countries is a substantial source of regulatory arbitrage," he said. In either case, local regulators view themselves as global champions for their home financial industries. "London was so proud of light touch regulation," said Persaud with heavy irony.

Is there no place, then, for global regulation? Persaud answered that unspoken question: "We need counter-cyclical regulations." He said:

Financial crashes are not random, they follow booms. Booms are caused by some collective belief that something has occurred, risks have fallen, they can lend more and borrow more. I think one thing we can do to reduce the next boom, its amplitude and frequency, is to have counter-cyclical regulation. I favor market solutions, but crashes are the consequences of a market failure.

But such regulation cannot be international and uniform. In economic terms, "the United States is in a totally different place in its cycle than Greece, Italy, China, or Brazil." Thus nations or regions must establish their own counter-cyclical regulations. Moreover, nothing else will be politically feasible. "It's going to be very hard for local taxpayers to say, 'I trust someone else's regulation,'" warned Persaud.

It will be even harder for local politicians, he implied: "[US Treasury Secretary] Timothy Geithner said, 'We need global regulation.' Then he told Congress, 'No one's gonna tell us how to regulate our banks.'" Andreas Botsch, special adviser to

the European Trade Union Confederation, commented that German Chancellor Angela Merkel "has done the same thing as Geithner—she declared to a congress of trade unionists in Berlin that she was unhappy with the decision of the European Parliament to go for European regulation, she wants to keep it at a national level." Erik Berglof, the chief economist and special adviser to the president of the European Bank for Reconstruction and Development (EBRD), agreed that national politicians "can't defend not being able to control the instruments of regulation."

But Berglof agreed only in part with Persaud. Yes, he said, "we must be careful not to introduce FSB measures where countries are still in recession." Certainly, he said, there is "a refusal of countries to be at the receiving end of these cycles." He also agreed with Persaud that "the overwhelming trend is toward host country regulation and supervision." But Berglof made it very clear that in his experience, this is hardly the best architecture to deal with a global crisis.

B. Lessons of the crises in Europe

1. The failure of host country regulation in 2008-09

In December 2008, Erik Berglof appeared at the Bernstein Center's conference on "Preventing the Next Financial Crisis" to warn that Eastern Europe was imploding. At the time there was little financial regulation and supervision and no meaningful crisis coordination at the level of the European Union. There was also a serious risk that the national bailouts of banks in the European Union would be structured so as to deny help to their subsidiaries in the East. Berglof said the time in between then and now the EBRD had been part of an effort "trying to plug a hole in the global architecture." He asked:

What are the incentives that an international financial institution faces, how can we think about the design of these institutions to make them more useful in these situations? We had one region, most affected by the crisis, where we [the EBRD] had one third of our portfolio in the financial sector and one third in equity. So we had strong incentives to deal with the situation.



At the time the crucial issue was whether bailout packages within the EU could be used for foreign subsidiaries. If not, said Berglof, “what the host countries would have done was ring fencing, nationalization.” That would entail “a decline of this whole system. There were a dozen or so banks that really mattered. As a commercial bank, you knew there would be de-leveraging, and you would want to be the first to leave. But for the banks as a collective you wanted a more gradual adjustment.” Coordination was highly desirable, but there was “an institutional vacuum...there were very weak powers at the EU level to deal with the EU countries,” Berglof said. Outside the EU, there were no coverage and institutions to deal with subsidiaries.”

The vacuum was filled, recounted Berglof (who did not refer to his own driving role in filling it):

In November and December 2008, the Vienna Initiative started as a conversation among banks and international financial institutions (IFI). In January 2009 we had a first meeting in Vienna and in March a first meeting with the banks and home countries. We got investments and bank commitments to stay engaged. The main component was the commitment of banks, and that over time we would try to lower exposure requirements. Now it’s become a standard meeting, using it as a framework to address vulnerabilities, like foreign exchange mismatches on bank balance sheets. There are more than a dozen banks around the table.

There were “strong incentives for banks to stay engaged, partly through EU support and coordinated IFI investments.” The subsidies carried conditions: “CEOs had to sign public documents committing themselves” to maintain exposure levels. Meanwhile, EU countries were persuaded to allow their banks to use bailout packages in Eastern Europe too. The result was that “a large number of local banks failed, but no foreign subsidiaries.... The initiative did contribute to building market confidence. Eastern Europe had the lowest capital outflows [during the crisis], despite the biggest output shock. These coordination efforts seemed to help in stemming these capital outflows.”

Host or home country authorities proved incapable of resolving these issues on their own: “The easiest case, where

this coordination should have worked, was the Baltics.” There were few banks, and few foreign subsidiaries. But this, said Berglof, “was the part of the world most negatively affected by the crisis.” The reasons included “a fragmented regulatory and supervisory framework, and poor coordination that when the crisis hit came to nothing.” Despite massive support to the Nordic banks, credit contracted sharply and GDP dropped one-fifth in 2009. These countries are now undergoing very harsh austerity programs.

Looking back at the crisis, policymakers throughout the region are drawing the conclusion that they must never again be put in the position they were in the financial crisis. Home country rule, i.e., that the home authorities of the cross-border banks should have the sole responsibility for regulation and supervision, “failed miserably.” Host countries will attempt to reassert control over subsidiaries and branches, but this may lead to fragmentation of the global financial system. “There are also serious issues of effectiveness. Host authorities have limited capacity and they are politically much weaker.”



Figure 7: Presented by Erik Berglof, chief economist and special adviser to the president at the European Bank for Reconstruction and Development (EBRD).



Jose Scheinkman, the Theodore A Wells '29 Professor of Economics at Princeton University, spoke with conference guests during a break.

Global regulation is likely to reinforce this fragmentation through the imposition of capital and liquidity buffers in subsidiaries of the international banks. “Undoubtedly, this will lead to changes in business models of banks.” Given the risk of fragmentation harmonization of regulation across countries is critical to prevent further loss in efficiency and effectiveness of the global financial system. Harmonization also has costs since the impact of regulation differs depending on the structure and functioning of the national banking systems, but the potential benefits should outweigh these costs.

2. The levers of harmonization

What will be the lever of these changes? Discussion centered on the Financial Stability Board (FSB), created by the G20 in the spring of 2009. The FSB says its role is “to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory, and other financial sector policies”.¹⁹ Like Article 111, that is a very clear statement with plentiful potential loopholes. It does not say what levels (global or national) those policies will be designed for, or by whom, and who will actually implement them, as opposed to “promoting” their implementation.

So far as Persaud is concerned, the FSB is and should remain powerless: “There are many things it can do in a world with host country regulation. We talk about transparency and information.... All that could be collected and analyzed by the FSB.” He hinted that the FSB’s lack of democratic “legitimacy”—the public has no voice concerning its membership, a major part of the world is not represented in any way, and the financial industry has a disproportionate voice—would hamper its influence. Andreas Botsch agreed: “It’s been hard for us [unions] to get in touch with them and talk with them; they prefer to keep the shop closed and stay among themselves”

Berglof sees a larger role for the FSB, but whatever happens there, he said, “We’ll have a world that will be much more complex—a fragmentation of the financial system.” The answer to that situation cannot simply be home or host country rule, he warned: “We need to find other structures.” A “purely

sovereign” approach, “dealing with these flows as a matter of individual fiscal balances, will not help. We have a long-term restructuring problem, and private sector restructuring is essential.” It cannot be accomplished only at national levels.

The consensus of the conference on this point was expressed by Katharina Pistor, the Michael I. Sovern Professor of Law at Columbia Law School: “We need coordination among different regulators when push comes to shove.” Jacobzone offered a specific example of how coordination might work:

Impact on other countries is a negative externality of any regulation. There is a negative impact in environment, where US regulations impact Canada. I think it would be best if foreign national regulators could comment on these processes; it’s happening in the environmental sector. The other thing is to force regulators to take into account global and external effects in their impact statements.

3. The Greek and Spanish crises: Is more or less coordination the solution?

The Greek and Spanish crises have led to more harmonization of regulatory regimes in the EU “than anyone would have thought possible” before, said Berglof, “What came out of it is various forms of fiscal federalism. We’ve broken through several taboos in terms of burden sharing.”

But for Botsch, this is hardly enough. “The Greek crisis has accelerated the EU regulatory agenda,” he said. “[But] the stability and growth pact will not work—it will provoke one stabilization pact after another over the next decade.” The unions and their allies in the European Parliament see the solution as “a truly European system of regulation, with executive power given to European institutions.”

Persaud warned that this would be a mistake. In a reference to the current crises in Spain and Greece, he argued that “the way to strengthen Europe is to put more instruments in the hands of [national] policy makers...the resistance to host country regulation will undermine the resilience of Europe.” One way or another, the European Union’s current crises will set a new benchmark for the emerging division of power and responsibility between national and supra-national agencies.

¹⁹ See www.financialstabilityboard.org/about/overview.htm.



Patrick Bolton, the Barbara and David Zalaznick Professor of Business at Columbia Business School, spoke on the panel "Compensation and Leverage."



IV. Summing up: Is there a consensus on compensation and governance?

As Patrick Bolton saw it, the conference agreed that there exists "a need for some kind of intervention... a need for regulation and better governance." Specifically, "there are gaps in compensation policy." As Calomiris highlighted, "It's also about politics." But there is no agreement, said Bolton, "about which is more important." That argument misses the point, he said: "We need everything—regulatory response, governance, politics, compensation. At every step of the way we can work on all these fronts, improve the stability of the financial system."

How? Bolton identified one obvious pressure point: "In economist jargon, we have an incentive problem in banks. We can focus on inputs or on outputs. In a complex system with innovation, focusing on inputs is getting harder. So we have to focus on outputs."

Is there, he asked, sufficient evidence of "excessive risk taking"? In retrospect, the crisis itself seems like pretty good evidence to Bolton:

Before the crisis, what did we hear about? Rational, efficient financial markets. The central banks had everything under control, knew how to manage macro shocks and instability. We had reached a new era of moderation. People were missing the fact that a lot of risk was being taken by highly leveraged financial institutions.

He asked rhetorically: "What is a precedent in history for where we are today?" He explained:

1910 may not be so bad. We were living in a world that had reached a peak of global sophistication... There was a lot financial innovation. The City of London was a major financial center. We emerged from a major financial crisis in the United States in 1906. We had everything under control. Things looked pretty good through the rest of the century. People would not have forecast World War I, the Great Depression, World War II, the enormous changes.

He concluded, "What can we expect for the 21st century? Few people ask. For me that's evidence of short-termism." In other words, the challenge for economists and regulators isn't merely to get through this long, dreadful crisis. It's to do a better job of foreseeing the changes that will follow, than the world could manage in 1910, and designing a system that's prepared for them.

Conclusions
<ul style="list-style-type: none"> ▪ Risk taking increases when it is less observable and there is more leverage ▪ Shareholders may not have the incentive to correct for risk taking due to: renegotiation, deposit insurance, and naive bondholders ▪ Basing compensation on CDS spreads can decrease risk taking ▪ Empirical evidence seems to suggest this will work

Figure 8: Presented by Patrick Bolton, the Barbara and David Zalaznick Professor of Business at Columbia Business School.

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