Large Bank Governance Reform

Charles Calomiris
Columbia Business School
May 28, 2010
Objectives

• Value maximization of the firm.
• Other objectives relating to other stakeholders?
  – The FDIC?
  – Borrowers?
  – The economy?
• These are aspects that bank regulation (capital regulation, liquidity regulation, etc.) can and should address, but management should stick to its knitting of maximizing firm value.
  – Focus is good
  – Value maximization leads to efficient resource use, assuming that distortions from safety nets, and externalities of insufficient capital can be addressed by regulation. Which they can.
Problem

• Agency problem between manager and stockholders is key friction.
• Temptation in banks of value-destroying short-term risk taking under asymmetric information?
• Large banks are often fragmented, making agency problems more severe.
  – Takeovers are not feasible because of human resource intensity. Good employees will leave if there is a protracted control battle.
  – Private equity investors are also limited by commerce-banking restrictions and suitability rules.
  – Other institutional investors, as with all public firms are limited to small percentage holdings.
• See Bhagat and Bolton (2010) on crucial role of director ownership and corporate governance/performance.
Solutions

• Remove ownership restrictions on institutional investors of all types, and encourage appointment of independent directors with large ownership stakes.

• Regulate pay to create long-term objectives. Restrictions can force long-term focus, albeit at a cost (more pay).

• Regulations that impose and reward market discipline in the debt market (CoCos) would work well to solve agency problem since the main concern – value-destroying risk taking – is something outside stockholders and debtholders can agree on, and concentrated debt holders would have incentive to monitor and punish it. (CoCos have other benefits, too.)

• Long-term equity-based pay, concentrated ownership, and CoCos reinforce each other, since CoCos punish equity holders via dilution effects of either conversion or preemptive offerings.