

Corporate Governance and Systemic Externalities

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1. The shareholder value norm

The prevailing wisdom

- ‘Shareholder value norm’: *Managers should run the firm so as to maximize the share price*
 - ⇒ Keeps managers *accountable*: responds quickly to events
 - ⇒ Results generally *desirable*: shareholder value \approx social welfare IFF:
 1. Stock market is informationally efficient (\Rightarrow share price is best predictor of firm’s cash flows)
 2. Investors can diversify away risks associated with firm project choice (\Rightarrow maximizing firm’s cash flows maximizes welfare of its diversified shareholders)
 3. Social costs of firm’s activities are impounded into its cashflows by private law and regulation (\Rightarrow maximizing firm’s cash flows maximizes social welfare)

Implications for corporate governance

- “Encourage managerial risk-taking”
 - Managers have undiversified human capital
 - Likely to prefer less risky projects even if lower NPV
- ⇒ Tie managers to stock price
 - ⇒ Give managers equity “upside”: Equity compensation (shares, stock options)
 - ⇒ Avoid liability “downside” for managers: business judgment rule
 - ⇒ Performance assessment based on stock price (independent directors, takeovers, etc use stock price as guide)

Business judgment rule

“If ... corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky!—you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on “negligence”, “inattention”, “waste”, etc., could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.”

Chancellor Allen, *Gagliardi v. Trifoods International, Inc.* 643 A. 2d 1049, 1053 (Del. Ch., 1996)

2. Incomplete internalization of social costs: the case of banks

Social costs: The case of banks

- Systemically important financial institutions ('SIFIs')
 - Bad outcomes in risky ventures => losses for the SIFI
 - Also trigger *contagion* to other financial firms and *credit contraction* for non-financial firms; associated losses are not compensable
 - Bad outcomes are worse for society than for the firm: firm has an incentive to take (socially) “excessive” risks of triggering them

Internalization mechanisms

Mechanism	Scholarly champion	How social cost impounded onto firm's cashflows	Conditions for success
Contract	Coase	Contract price	Contracting costs low enough
Tort	Calabresi	Damages	Damages set to social cost
Regulation	Pigou	Penalties	Penalties set to social cost

Incomplete internalization: Contracts

- Not all parties affected by bank failure are able to contract with the bank
 - Other financial institutions
 - Firms that would wish to borrow money in the future but now cannot
- For those who do have contracts with the bank
 - Lack of transparency makes accurate pricing very difficult
 - Expectation of bailout *ex post* weakens incentives to price risk of bank failure *ex ante*
 - Baker and Mc Arthur (2009): large US banks enjoyed interest rate discount over small banks of 0.29% prior to bailout, rising to 0.78% thereafter

Incomplete internalization: Tort law

- To deter harmful activity, set expected damages = social cost
 - Where harm is probabilistic but affected by level of care, use negligence standard to induce appropriate level of care
- Losses suffered following bank failure are “economic” : no harm to property or persons
- Economic generally not compensable under tort law
 - “Pure economic loss” limitation
- Tort law consequently does not deter bank risk-taking: *liability insufficiency*

Regulation and “shareholder value”

- Controllers can maximize stock price by
 1. Innovating subject to regulatory ‘pricing’ of social cost
 2. Arbitraging around incomplete regulation
 3. Influencing and reducing regulatory ‘pricing’ of social cost
- If 2. and 3. are cheaper than 1., then managers will maximise stock price by pursuing them.
- *Negative synergy* between regulatory incompleteness and high-powered incentives to maximise share price
- Unwise to rely upon regulation alone to control social costs

3. Shareholders and “Shareholder value”

Systemic risk and shareholders

Claim

- In absence of internalization, shareholder value norm encourages managers to take more risk than even diversified shareholders would prefer
 - Social costs of bank failure are borne by diversified shareholders (DS) through their portfolios (but not undiversified managers)
 - Option-based compensation and business judgment rule give managers upside payoffs but no downside costs
 - Specifically, if M causes bank to pursue risky project
 - M's expected returns increase; volatility of M's returns increase
 - DS' expected returns decrease; volatility of DS' expected returns increase
- ⇒ M has incentive to take project so long as benefit of ↑ expected returns exceed cost of ↑ risk on undiversified portfolio (“participation constraint”).

Evidence

- Fortin, Goldberg and Roth (2010): more performance-related CEO pay associated with greater risk taking in banks
- Laeven and Levine (2009): banks with controlling blockholders took more risks than those without
- Beltratti and Stulz (2010); Erkins, Hung and Matos (2010): banks with more independent directors took greater risks and suffered greater losses

Bank failure externalities and “shareholder value”

- Why don't diversified shareholders fix incentives?
 - Shareholder rights: coordination costs
 - Market based mechanisms (compensation, takeovers, independent directors, governance activism etc)
 - Stock price impounds only information about cashflows of *this* firm
 - Harm to other portfolio firms' expected returns regardless of whether they hold bank stock or not
 - Stock price of bank may rise even if imposing costs on DS' portfolios
- ⇒ Shareholder value norm *makes things worse*

4. A proposed solution

Liability strategies (1)

- Liability of whom?
 - Firm? *Likely bankrupt anyway*
 - Shareholders? *Diversified shareholders suffer indirect losses through their portfolios anyway*
 - ⇒ Managers, controlling shareholders
- Liability under what circumstances?
 - Failure to take reasonable care to implement systems to *monitor* risk-taking
 - What is “reasonable” should vary with quantum of expected loss and monitoring costs
 - Should be assessed independently of “industry practice” (cf. FSA Report on RBS, 2011)

Liability strategies (2)

- Liability to whom?
 - Liability to the firm? (~ its shareholders, or creditors, if insolvent)
 - Liability to regulator?
- After failure, both groups have strong incentives to enforce

Liability strategies (3)

- Liability in what quantum?
 - (1) Loss-based measure
 - How to quantify / demonstrate indirect loss?
 - Problems with causation in relation to omissions
 - Possible solution: liability for losses *to firm* + deemed causation if risk management inadequate
 - (2) Gain-based measure
 - Require repayment of all cashflows (compensation, dividends, etc) from firm during period of inadequate oversight
 - Avoids quantification and causation problems

Liability strategies (4)

- Historical
 - US: negligence-based liability of bank directors to depositors (*Litwin v Allen*)
 - Wiped out, seemingly without consideration, by Delaware's § 102(b)(7) in 1986.
- Implementation
 - US: requires repeal of DGCL §102(b)(7) and extension of *Caremark* duty
 - UK: substantive duty is already there (*Barings*); but no shareholder litigation is brought (Armour et al 2009). Public enforcement process is there but no ability to impose fines on *directors* (disqualification of directors or fine on failed bank: see FSA Final Notice on HBOS, 2012).

Liability strategies (5)

- How strong is the claim?
- This would not guarantee avoidance of financial crises
- But would be a step in the right direction

4. Refinements and Objections

What about other governance reforms?

- Constraints on option-based compensation
 - Clearly make sense
- Increasing shareholder rights?
 - Likely to favour undiversified blockholders
- Altering board structure (e.g. co-determination)
 - Unclear whether prescriptive solutions will lead to appropriate structures
 - Liability rule likely to stimulate structural reform of boards
- Altering ownership structure
 - E.g. German *hausbank*, or Japanese-style *keiretsu* model? Chinese-style state control?
 - Liability for controlling shareholders might also stimulate changes in ownership structure

Over-deterrence?

- Effects
 - ↓ supply of qualified directors
 - ↑ compensation for directors
- Reform could be calibrated by cap on liability
 - E.g. amount of compensation / dividends taken out of the firm
 - Gain-based measure does this automatically

Insurance and Derivatives

- For incentives to be modified, necessary to prohibit
 - D&O insurance against liability
 - Managers hedging their position using derivatives

5. Does the problem generalise
beyond financial firms?

Two heuristic (and salient) case studies

- Deep sea oil drilling: BP's charge for *Deepwater Horizon* disaster in 2010 Annual Report : \$40.9 bn
- Nuclear power: Estimated costs of Fukushima disaster to Japanese economy ~ \$50-130 bn
- Tort law
 - Special liability regimes impose liability caps (e.g. \$75m under US Oil Pollution Act 1990, \$470m under Vienna Convention on Civil Liability for Nuclear Damage)
- Regulation
 - Apparently compromised in both cases

Are banks different?

- Compensation arrangements?
- Role of government
 - For banks, bankruptcy triggers disaster costs
 - Government can help avoid bankruptcy (bailout) *ex post*: makes incentive problem worse *ex ante*
 - For others, costs from disaster (may) trigger bankruptcy
 - Government can make firm's costs *greater* (e.g. threat to withdraw licences from BP) forcing firm to internalize more losses

6. Conclusion

Systemic Externalities and Corporate Governance

- Financial crisis forces us to re-think governance of banks
 - Market-based mechanisms based on “shareholder value” push banks in the wrong direction
 - Crisis also casts doubt on efficacy of regulation when faced with agents with strong incentives to focus solely on private returns (ie share price)
 - We propose a re-introduction of old-style liability rules
- The ‘problem’ with systemic externalities probably extends beyond just financial institutions, but they seem the most extreme case