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Chapter 6

Creating Responsible Financial Markets

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A. Introduction

The global financial crisis was a systemic failure. The predominant response from governments and multilateral organizations, predictably, has been a chorus of calls for systemic regulation, particularly around issues of solvency.²

That discussion is important, but incomplete. Any regulator looking at any system must first understand whether the system should be constrained because it is inherently untrustworthy or whether it is able, under the right circumstances, to police itself. So for example, in a maximum security prison the rules are tightly drawn and enforced. On the other hand, some universities take pride in their “honour code,” a peculiar institution where bad practice which could easily be policed (such as cheating in exams) is left to the individual student. The message is clear: any student who attends this university knows that cheating is beyond the pale, and will not need further sanction. They will be trustworthy.

Few systems are at one end of the spectrum or the other. Generally, however, “trustworthy” systems call for self regulation; unstable systems for more intervention. The key as to the optimal mix of regulatory response at any point in time depends critically on two elements: First, the ethos of those whom we seek to regulate (are they trustworthy or not), and, second, the architecture of the system (is it likely to encourage self-regulation and self-correction). Consequences of non-compliance may also be a factor in deciding upon regulatory approaches: A murderer breaking out of prison is a bigger problem than a student cheating on exams. So too can be internal factors, such as concentration and market share: A small bank collapsing may be allowable in trying to establish a trustworthy system even if there are localized problems, whereas the collapse of a major bank that would threaten the world’s financial system through its counterparty relationships. This results in the “too big to fail” and “moral hazard” quandary for regulators. Finally, of course, systems are dynamic over time, moving along the spectrum in response to various developments. Hence regulatory responses need to change over time.

Despite the ability to influence trustworthiness of systems, the majority of regulatory responses to the global financial crisis have been monotonal, emphasizing

¹ Davis, Lukomnik and Pitt-Watson are the authors of “The New Capitalists: How Citizen Investors Are Reshaping the Corporate Agenda,” Harvard Business School Press, 2006. Major portions of this chapter first appeared in “Towards An Accountable Capitalism,” Private Sector Opinion Issue 13, a Global Corporate Governance Forum publication.

² See, generally, Chapter 1 in this publication by Cook and Miller.

constraint. Or perhaps, to be fair, duo-tonal: They dictate either “Thou Shall” (e.g. increase capital reserves) or “Thou Shall Not” (e.g. set limits on executive compensation).

That is not to say that constraining regulation is unnecessary. But what would happen if policing were paired with regulation designed to improve the ethos of the participants and the architecture of the system, thereby enhancing its inherent trustworthiness? We believe the result would be a safer, more self-correcting system. As an analogy, imagine there has been a terrible car crash, caused by bad drivers who, though they had stayed within the regulated speed limit, were unable to stop in time when an emergency situation arose. One response would be to reduce the speed limit. An alternative response would be to retrain all drivers; to encourage them to drive responsibly. In real economic life both need to be done: Set limits *and* create an architecture which makes our financial system inherently more responsible and trustworthy. If the financial system is not trustworthy, no amount of restrictive legislation will make it stable. Unless the inherent trustworthiness of the system improves, regulators will constantly be playing “catch-up” as market participants probe the limits of regulation to find the weak spots. Constraining regulation in such situations is akin to exerting pressure on a filled balloon; the balloon won’t burst at the points of maximum constraint, but the pressure from the inside will probe for other ways out. Increasing the self-resilience of the system will serve to equalize – somewhat – the pressure.

In regulatory terms, what we propose is to increase the attention paid to “market discipline,” in its fullest sense, not just in terms of information and disclosure. This is the third -- and most chronically ignored and ill-defined -- pillar of the Basel II accord.³ Whereas the first two pillars (“minimum capital requirements” and “supervisory review”) are conventional parts of banking regulation, market discipline is often regarded as beyond regulatory reach.⁴ Yet regulation and markets coexist, each affecting the other. Making the third pillar into a real source of support for the banking system will require new thinking not only about the type of market institutions on which a successful modern financial infrastructure depends but, as importantly, on the relationship between each of these institutions. We need to clarify the principles on which any responsible market system depends, and on how these might be applied to banks. We therefore suggest various actions that participants in all markets – regulators, investors, NGOs, bankers – can take to minimize the probability and severity of future financial disasters.

As we argued in *The New Capitalists* (Davis, *et al.*, 2006) a successful economic system is like an effective political system. It has checks and balances, accountabilities and responsibilities, information flows and cultures. Of course regulation is important. But there are five central principles beyond regulation on which a successful financial system depends. These are:

- The entities in it are *responsible* for their actions.
- They will be responsible if they are *accountable*.

³ At a very basic level, the Basel II framework rests on three pillars: minimum capital requirements, supervisory review, and market discipline. See, for example, <http://www.bis.org/publ/bcbs157.htm>.

⁴ While market discipline is Pillar 3 of the Basel II framework, it is generally understood to focus on disclosure by financial institutions, rather than aligning and strengthening market mechanisms so as to encourage real market discipline, particularly in markets wherein banks are public companies or are reliant on issuing large amounts of public debt. See “International Conversion of Capital Measurement and Capital Standards”, Basel Committee on Banking Supervision, June 2006.

- Those who call them to account will need *relevant information*.
- Information must be *independently prepared*.
- Finally, just as a healthy political system hinges on the scrutiny of vigilant citizens, a successful financial system will need the oversight of *vigilant market participants*.

Attention to these principles offers a new and constructive agenda to those who wish to create a more sustainable response to the financial crisis and one which will be less expensive for us all.

B. What went wrong?

Before we offer a model for a more accountable and more stable form of capitalism, it's worth reviewing what went wrong with this one. The catalogue of culprits begins with borrowers who were overextended and could not repay their mortgages. The list extends to bankers who are blamed for lending more than was appropriate and who were caught flat-footed when depositors asked for their cash to be returned. Their culture is seen as being greedy and short term. Regulators also come in for criticism. How come they didn't see this was going to happen? After all, they knew what the banks were doing. Why didn't they put a stop to it? And what about all those eminent men and women who sat on the boards of the banks? Surely they knew – or should have known -- the risks that were being taken? What about the accountants who declared these banks to be solvent? And the credit rating agencies (CRAs) that assessed the debt as investment grade -- fit for widows and orphans – when it later turned out to be toxic? Or the investors who demanded returns above that reasonably available?

Finding a litany of miscreants misses the point. It is not one individual or institution which is to blame, it was the entire system. Each of the “players” was seeking to maximize their own interests in ways that were perfectly within the law. If they were asked if this was acceptable behaviour they would have pointed to Adam Smith, who famously observed that “it is not from the beneficence of the butcher the brewer and the baker that we expect our dinner, but from their regard to their own self interest” (Smith, 1776). Except this time, the collision of all these self-interests brought the system to its knees.

At the heart of the problem was the way banks thought about risk. They worked on the previously accepted truth of diversification: If you take many small risks you are less likely to lose all your money than if you take one big risk. So banks began to diversify their risk-taking activities. In the mortgage area, this went to an extreme, as banks and other financial institutions began to sell off parts of their mortgage loans, and to buy loans originated by others. Soon financial engineers repackaged diversified pools of mortgages into structured products, allowing instant diversification with a single purchase.⁵

Compare this to traditional practice. In the old days a local bank might hold many mortgages from people living in its home town. That would be pretty risky because if, for example, the local industry failed, the loans would all come under pressure at once. So it

⁵ The Royal Bank of Canada, for instance, cites this advantage on its website: “Diversification - Structured products allow investors to participate in a portfolio of many securities, which helps spread market risk.” See www.royalbank.com/educationcentre.

needed to monitor those loans closely, intervene to mitigate problems, and hold lots of reserves. In other words, it needed to actively manage its risk beyond the origination process. More recently, however, banks have been able to own a part share in a myriad of mortgages from literally all over the world through the use of structured products. The cost of monitoring and managing the risk of any one loan may not be worthwhile for any individual financial institution owning small pieces of thousands of loans. What this means in the aggregate is that no institution is responsible for managing the risk of any of the loans. Also, since banks diversified their loans, theoretically they had less risk in total, meaning they were able to lend more. Lend they did, with a vengeance. All this was sanctioned by banking regulators acting in accordance with the Basel agreements on banking solvency.

The result has been a huge increase in loans made on an existing capital base coupled with a decline both in the interest rates charged for the loans and in the toughness of lending standards. So for example, it was possible for purchasers to borrow more than the value of their house. This in turn forced up asset prices, such as those of houses, company shares and risky debt. Home owners and investors felt they were on a one-way bet, confident that property prices would continue to rise, so they borrowed and bought more.⁶

Why was there not more widespread criticism of these practices? Why did we not hear the whistles blowing a warning? In fact, some experts had suggested a mounting crisis.

Perhaps the market suffered from what psychologists call the “bystander effect”: Because there were so many bystanders, no-one saw it as their duty to call into question the risk models being used. Or perhaps it was the siren song of short-term profits that blinded shareholders, board members, executives and others. As Charles Prince, the deposed CEO of Citicorp infamously noted, “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. We’re still dancing” (Nakamoto and Wighton, 2007). This was the musical chairs version of capitalism: Pray that when the music stops someone else is left without a chair, not you. What Prince and others failed to consider is that there would be no chairs left for anyone.

So the music continued and the game continued, even as the chairs were being taken away. The bank manager who issued mortgages, who was responsible for making sure they got paid back, and who was accountable they went bad, was eliminated. Instead mortgage brokers originated loans and then sold them on to be packaged with others. Bits of that one loan, and tens of thousands of others, were then sold around the system. In that way everyone took many small bets and, so they thought, reduced their risk. In fact, no one knew what risks they, or the system, were taking. Certainly no one felt it was their responsibility to manage those risks. With each institution acting the same way, spreading the risk became, itself, a systemic risk. With each institution responsible for tiny bits of thousands of mortgages, no one institution or market player was responsible or accountable for any one loan.

⁶ See Greenspan and Kennedy, “Sources and Uses of Equity Extracted From Homes,” Finance and Economic Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, DC, USA, March 2007

Enter the credit rating agencies. These organizations forecast how likely a loan is to default. When the CRAs say something is investment grade, meaning unlikely to default, companies can issue debt to investors widely and therefore less expensively. However, CRAs got it wrong on subprime mortgages. Some might argue that CRAs made an honest mistake. However, the business model of CRAs is itself suspect, because they get paid by those who are issuing debt, not by those who are investing on the basis of the ratings. So, if it wants to get paid, a CRA has the incentive to give positive credit ratings. This is obvious, and not just in hindsight.⁷ The CRAs had already got it wrong in 2001 with Enron and Worldcom. In 2006 we wrote “Credit Rating Agencies harbour a fundamental conflict: they are paid by the companies they rate, not by the investors they are supposed to protect” (Davis, *et al.*, 2006, pp. 141-143). Certainly CRAs were not producing independent information.

When the crisis broke, loans fell precipitously in value, despite those investment-grade ratings. Strong banks now had to mark down their value. When these banks started to look weak depositors began to withdraw funds and put them elsewhere. Government agencies ultimately came to the rescue, but were concerned that they couldn't be seen to save every bank. So they allowed the collapse of Lehman Brothers in September 2008. Investors became nervous. There were runs on banks as depositors took their money out. The contagion was not limited to the US (Bear Stearns, Merrill Lynch, etc.) and the UK (Northern Rock, HBOS, RBS). Around the world the list of banks receiving some type of governmental intervention continued to grow, including such high profile names as Dexia, Fortis, Hypovereinsbank (Real Estate), and, of course, much of the Icelandic banking system. Banks had no way to trust the balance sheets of other banks or even industrial companies and they wanted to conserve their own cash, so lending between banks dried up. This is the lifeblood of the financial system. Companies could no longer assume they had access to cash or credit and so cancelled investments and began to cut costs. The global financial crisis and resultant recession were upon us.

C. The requirements for accountable capitalism

Though largely unnoticed, there now is a burgeoning set of institutions that could help embed accountability into the economic system in the same way that political institutions gird democracy in “civil society”. In hundreds of initiatives, national, supranational and global; voluntary, enterprising and regulatory; people have been trying to create a “civil economy” to replace the uncivil economy of the past. All capital markets, whether equity, credit, currency or whatever, need to conform to the five principles outlined above. Each is reviewed in more detail below.

Accountability. For each player in the market, we need to be able to answer some simple questions. In whose interests do you work? To whom are you accountable? What alignments or misalignments of interests can affect your performance? The governance of each intermediary ought to assist in its alignment to both fulfil its purpose and to be accountable. This means addressing structural conflicts of interest, developing mechanisms to report to those from whom its power is derived, monitoring the functioning

⁷ The potential conflicts were recognized by the United States Securities and Exchange Commission and by various official commentators in a 2003 concept release “Rating Agencies and the use of Credit Ratings under the Federal Securities Laws” [RIN 3235-AH28]. See: <http://www.sec.gov/rules/concept/33-8236.htm>

of these mechanisms, etc. If it isn't so configured, it is a potential danger to the system and needs particular oversight.

When you look at the capital markets, particularly those in the US where the credit crisis began, there are glaring gaps in accountability. US pension plan governing boards do not include representation from the workers who are contributing to the plan. As noted earlier, credit rating agencies are paid by issuers, not the investors who rely on the ratings. The boards of most financial institutions in the US did not feature independent chairmen who could effectively oversee the CEOs. Shareowners could not easily remove directors.

Responsibility. Accountability is the tool that enforces responsibility: Each financial intermediary should actively exercise its rights to optimize the long-term value of its assets on behalf of those for whom it works. For example, institutional shareowners should not only *have* rights to oversee corporate boards and managements, they should use those rights.

In markets with dispersed share ownership (such as the US and UK), big investors, particularly pension funds, have pooled members', depositors' and individuals' savings and become the fractional owners, not only of much of the debt which has turned toxic, but of the companies that originated the debt. With such a vast amount of value at stake, one might have thought that they would have found ways to defend their interests by holding boards and managers to account, thereby protecting the interests of their savers. Yet most institutional investors prefer to try to add value by trading in and out of securities as speculators rather than investing for the long term and engaging with the companies as owners. The average American retail mutual fund turns over more than 100% of its securities every year (Bogle, 2003). Globally, even institutional accounts, supposedly invested on behalf of long-term, sophisticated investors such as pension funds, show a remarkably short-term perspective, with an average turnover of 72% per year (Investment Horizons: Do Managers Do What They Say?, 2010). Another complication is that the ultimate owners of the assets –pension funds and others – may not even realize that the asset managers that they employ are trading short term; some 65% of the accounts examined in a recent study have turnover that exceeds what the portfolio managers predicted to their clients ex-ante (Investment Horizons, 2010).

Such frequent trading is akin to Charles Prince thinking that he can find a chair even when those about him are falling onto the floor. If you always think you can trade out of the way of a disaster at the last minute, you don't put much energy into trying to prevent disasters by being a responsible owner. Lord Myners, the United Kingdom's Financial Services Secretary, noted in a criticism of pension fund executives that "disengaged investors lead to ownerless corporations and the risk of unaccountable executives and boards running amok" (Myners, 2009).

Other types of conflicts are inherent in markets with controlling shareowners, such as the practice of paying management fees to a controlling shareowner as well as other types of related party transactions. These may have the effect of enriching one particular shareowner while impoverishing others, affording that shareowner little incentive to improve the overall company or system.

Relevant Information. Disclosures should not merely be voluminous, but shaped for real use and addressed directly to value. It is an open question as to whether current accounting procedures, such as “mark-to-market”, may be inadequate.⁸ The relevance of such an accounting principle depends on the circumstances in which it is applied, and the purpose for which it is used. Certainly it is very dangerous to use such accounting for bank regulation because it is pro-cyclical: it rewards the banks when things are going well but puts a squeeze on them when things go wrong.⁹

Another concern is that there are huge areas of financial markets that are opaque, such as the “Credit Default Swap” (CDS) marketplace. A CDS is essentially an insurance policy on whether a company will default on its loan. It is a bit like a life insurance policy on a specific company and, just like a life insurance policy, it has a useful role. However, most people would be concerned if they discovered that someone had been buying a life insurance policy on their life and they didn’t know who it was. Yet many CDSs are bought and sold with no disclosure whatsoever. If you hold a CDS, it is in your interest for the company concerned to go bankrupt. Because there is little transparency about who owned how much CDS written on which companies, we don’t know how much they contributed to the credit crisis. But recent news reports do suggest that they played at least some role (Morgenson and Story, 2010). Similarly, so-called “dark pools” of liquidity mask trading in stocks by institutions. Such opaque trading platforms may help an individual institution buy and sell without disclosing positions. However, by minimizing market impact, they possibly harm the overall system by robbing the rest of us of information and by spreading liquidity from transparent exchanges to hidden computer networks.¹⁰

Independent Information. That markets move on information is well-known. For good reason auditors are now largely prevented from providing consulting services to the companies they audit) and stock analysts are prevented from being compensated for investment banking results in the US following the Enron/Worldcom scandals of the early 2000s, when puffery from investment banks (exaggerating the benefits of a particular investment) was positioned as supposedly objective investment advice, so as to gain underwriting business for those banks.¹¹ Markets need conflict-free intermediaries to serve as a reliable check on corporate information.

CRAAs are certainly conflicted, but so too are remuneration consultants (tempted to build CEO-friendly payouts in hopes of gaining other business); director search firms (leery of recommending feisty board candidates for fear of losing other search contracts); and various distribution channels which take fees from asset managers but claim to be doing due diligence on those same asset managers, as was the case in the Bernard Madoff situation. We wrote in *The New Capitalists* that if the public lost faith in the integrity of

⁸ See, for example, “Why Mark-To-Market Accounting Rules Must Die,” *Forbes*, 24 February 2009; “Reverse Leverage of Mark-To-Market Wrecks Banks,” *Bloomberg*, 13 October 2008; “Former FDIC Chair Blames SEC for Credit Crunch,” *CNBC*, 9 October 2008.

⁹ For a good primer discussion on procyclicality and other issues related to mark-to-market accounting, see, Tanya S. Beder, “Mark-To-Market Accounting: Practices and Implications,” testimony for US House of Representatives, Committee on Financial Services, Sub-Committee on Capital Markets, Insurance and Government-Sponsored Enterprises, 12 March 2009.

¹⁰ For a discussion of dark pools, see Caplan, Cohen, Lenz, and Pullano, “Dark Pools of Liquidity,” *PWC Alternatives*, Vol. 4, No. 2, 2009.

¹¹ This was accomplished through a series of United States Securities and Exchange Commission lawsuits and settlements. See <http://www.globalresearchanalystsettlement.com>.

these agents, “the capital markets would seize up” (Davis, *et al.*, 2006, p. 123). That is exactly what happened

D. Adding vertical regulation

Moving to an accountable, sustainable capitalism requires rethinking the regulation and governance, not just of banks and other entities comprising the financial system, but of the regulatory architecture encompassing them.

Each market participant is a link in many chains. A homeowner borrows to create a mortgage (link 1) from a mortgage originator such as a local bank (link 2) who sells the mortgage to an investment bank for packaging into a mortgage pool (link 3) which is rated by a credit rating agency (link 4) so that it can be sold to a pension fund or other institutional investor (link 5) and so on. That’s oversimplified, of course; there could be all manner of intermediaries, but this would be the basic structure of a mortgage securitization chain.

The cliché that a chain is only as strong as its weakest link is true. But it is also dangerous because it’s not the whole picture. Chains can fail not because there’s a weak link, but because the links don’t work smoothly with each other. If the links don’t work with each other – if they don’t fit together well or they’re rusted or frozen – then what you have is not a chain, but merely a series of elliptical pieces of metal. That’s what happened in the financial market. There was not a weak link in the chain, yet it failed. Borrowers got what they wanted: cheap and plentiful credit. Mortgage originators got what they wanted: lots of fee-generating origination. Banks got what they wanted: unprecedented numbers of individual mortgages to package and sell, reaping billions of US dollars in fees. The credit raters got what they wanted: a lucrative new product area that became their single largest profit source. Institutional investors got what they wanted: securities that yielded more than was available elsewhere in the investment grade bond market.

Economists’ term for this type of situation - wherein each individual decision seems rational but the resulting whole is problematic or illogical - is a “fallacy of composition”. The links kept on strengthening themselves – gorging on cheap credit, originating more and more mortgages, rating more and more structured products – even while systemic risk was building up, resulting, eventually, in the entire chain freezing up.

Traditional regulation – including the vast majority of the responses to the financial crisis -- tries to insure the health of each link. The theory is that by regulating each link separately, the chain will be strong. In this type of “horizontal” regulation, a regulator focuses on a particular type of institution and issues a set of commands, such as a bank needs to have a specific amount of capital in reserve. The health of the system is, mistakenly, taken for granted if the specific links are healthy.

Horizontal regulation suffers from two inevitable forces which degrade its effectiveness over time. First, markets evolve quicker than regulators can regulate (for instance, credit default swaps were a non-entity a few years ago and there is still not a full regulatory architecture to monitor and control them). Second, such command/control regulation often results in the regulated entities seeking to avoid regulation so as to gain a competitive advantage over competitors similarly regulated. So, for example, we’ve seen banks use devices which allow them to lend more by “gaming the regulator”. Gaming

strategies include, for instance, using 364-day instruments to get better risk-weighted capital treatment than 365-day instruments as well as the extensive use of off balance sheet items and various derivative transactions. Perhaps the most pervasive way credit-originating entities avoided horizontal regulation was by simply by being recognized as banks. This resulted in the rise of the non-bank financial institution in the 1990s and 2000s.

E. A new approach to regulation

We propose a new conceptualization of regulation. Regulation should enhance the robustness of the interaction between market participants, as well as the robustness of the participants themselves. It should address ethos and architecture as well as command and control type rules and regulations. We should enable the various entities within the system to be accountable to each other and to hold each other responsible. This approach might be thought of as ‘vertical regulation’ and is designed to enhance the trustworthiness and self-correcting abilities of the financial markets as a whole, as well as strengthening the individual financial institutions.

Such a regulatory philosophy implicitly recognizes the power of the marketplace, rather than the power of the regulators. Vertical regulation empowers market participants while encouraging them to be responsible and accountable, with requisite independent information and oversight. Below we outline some examples of useful vertical reforms.

- a. Enhance disclosure across the system. Transparency is a condition necessary for accountability. In the US, the focus in this area has been on equities; with the SEC requiring enhanced risk, corporate governance and compensation disclosures by corporations. Those are useful first steps. Here are a few (necessarily technical) examples of where further disclosure could be useful.
 - i. Mandate that for a financial instrument to be tradable or transferable, it must be registered. Various markets have systems for identifying tradable instruments, such as the CUSIP (Committee on Uniform Security Identification Procedures) number in the US or the SEDOL (Stock Exchange Daily Official List) identifier in the UK and Ireland. Requiring every financial instrument to be registered as a condition as a condition of being legally tradable or transferable would mean its basic characteristics are known, it is traceable, and the size of the market is calculable. This would allow the development of new instruments, yet ensure that market participants and regulators are aware of the size, shape and scope of them before they grow to a size that can affect overall financial stability, which is not the case with various derivative instruments today. (To keep this regulation manageable, it could apply only to those credit instruments which exceed a minimum size.)
 - ii. Investors, speculators and traders should have to disclose material positions in a company no matter whether those positions are held in stock, options, or contracts for differences or other derivatives, and should also disclose whether those positions are short or long. This would

mitigate disconnects between economic interests and ownership rights, such as “empty” or “over” voting in merger and acquisition situations.¹²

- iii. Ask all significant investors to make a statement of investment principles that includes a disclosure on whether they are willing to make investments that may damage the system or the real economy as a whole.
- b. Regulate power relationships between market players, not the outcomes of those relationships. In so doing, give some amount of deference to those whose capital is at risk.
 - i. Accelerate the market-by-market trend towards mandating that companies feature a UK-style advisory shareowner vote on pay, and towards allowing shareowners to nominate corporate directors more easily. These reforms do not mandate any specific outcome. They do, however, affect the balance of power between boards of directors, management and shareowners, making boards and executives more accountable.
 - ii. Insist that all the agents in the investment chain declare how they are paid. That includes fund managers, distribution channels, financial engineers, information providers, raters, etc. Encourage the development of agencies that help the ultimate investors to understand whether remuneration is appropriate and whether, over a specified time-frame, it is likely to lead the agent to work in the principle’s best interest.
- c. Focus on the functional purpose of each entity, not its legal status. If market participants are “gaming the regulator”, blow the whistle.
 - i. The requirements around the issuance of a credit instrument – the extension of credit, and, therefore, the creation of counterparty risk - should be the same if you are a bank, insurance company, hedge fund or non-bank financial institution.
 - ii. If an asset is “off balance sheet”, but is managed as though it were “on balance sheet,” it should be treated in the same way. Similarly, banking assets that are held on the banking book and trading book ought to be accounted for in the same way.
- d. Align interests across time frames as well as within and between entities. Make all compensation agreements for executive officers and anyone who can risk balance sheet assets above some minimum threshold subject to claw-backs to

¹² Empty voting refers to an investor voting shares in a company despite having no economic interest (or potentially even a negative economic interest) in that company. Over voting refers to an investor voting more shares than his economic interest would normally warrant. Both conditions are enabled by the use of derivatives such as options or contracts for differences. For more information, see Hu and Black, “The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership,” *Southern California Law Review*, Vol. 79, No. 4, 2006. See also Hu and Black, “Equity and Debt Decoupling and Empty Voting II: Importance and Extensions”, *University of Pennsylvania Law Review*, January 2008.

allow recouping of payment in the event of later restatements or financial distress after the pay period has passed.¹³

- e. Do not allow intermediaries to influence accountability between other entities if they have nothing, or too little, at risk. Often, in markets with family-controlled companies, holding companies and pyramid structures dilute the voice of shareowners with real capital at risk. While it is true that these intermediary structures have some risk, they dilute real accountability by featuring disproportionate control.
- f. Where known misalignments of interest persist, set up monitoring strategies. It will not be possible to eliminate all conflicts of interest, but where they exist, they should be under particular scrutiny.
 - i. Corporate-sponsored retirement savings schemes in some markets are nearly all controlled by the issuing company; members typically have no say in defining the nature of the plan or the choices available. This can and does allow funds to shun active engagement with portfolio companies, even where such strategies might align with the interests of beneficiaries. One key regulatory antidote would be to require each such scheme to feature member-selected trustees alongside issuer representatives in an oversight board chaired by an independent outsider.
 - ii. Credit ratings affect which instruments various institutional investors may buy. Yet the credit rating agencies are paid by the issuers of the debt, not the purchasers. As we noted in 2006, and as the world unfortunately discovered in 2007 and 2008, this creates an incentive for ratings inflation. Proposed remedies abound. As an example, Stanford Professors and Joseph Grundfest and Evgenyia Hochenberg suggest having an agency owned by institutional investors that makes parallel ratings (Grundfest and Hochenberg, 2009).

Calls for new types of regulation often lead to a discussion of whether such regulation is excessive. The question of “too much” or “too little” is not addressed in this chapter, though it is possible, and perhaps desirable, that combining vertical regulation with horizontal regulation could lead to a more resilient and self-correcting financial system, thereby allowing the elimination of some entity-level command-and-control rules. Ideally, vertical regulation will enhance the robustness of the interactions between market participants, rather than the robustness of any particular set of market participants. Regulation should strengthen the game, not determine the winners.

¹³ For a full discussion of how to ensure compensation is aligned and earnings manipulation and non-economic risk-taking discouraged, see Bebchuk and Fried, “Paying for Long-Term Performance,” Harvard Law and Economics Discussion Paper 658, December 2009. Accessible at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1535355.

F. Beyond regulation: vigilance in the capital markets

Regulation alone, however, is not sufficient. Regulation is the societal codification of the rules of the game. Many rules are subject to interpretation. Outside enforcement agencies are often the wrong entities to interpret subtleties for a number of reasons, not the least of which is that regulators often have binary options – something is or is not allowed.

Limiting the discussion to regulation would be akin to saying the only thing that matters in civil society are laws, police and courts, while ignoring the press, culture, religious institutions, the role of technology and a host of other influences. Accountable capitalism needs multiple civil economy institutions to craft the ethos of the system.

Market-based solutions can promote responsibility. For instance, the Centre for Fiduciary Excellence (CEFEX) in Canada has created a certification program to promote best practice in the investment management industry.¹⁴ More than 50 independent firms have received certifications in the two years since it was established. Two UK money managers, Hermes¹⁵ and Governance for Owners, have created services that pool institutional investor resources so as to efficiently engage with managers of corporations; another example of a market-based solution.

Multilateral institutions and NGOs can play an important role in building the civil economy, just as they do in the political arena. The Financial Markets Recovery Project of the Global Corporate Governance Forum is developing a program to build capacity to train bank directors in emerging markets, with a specific emphasis on risk management skills. This UNCTAD publication may be viewed as an initiative by a multilateral institution helping to explore the behavioural norms and desired architecture of the financial system post-global financial crisis. The Royal Society of Arts in the United Kingdom is promoting new institutions and citizen awareness of investment choices. The IRRC Institute in New York sponsors research into issues of corporate responsibility and the informational needs of investors. The Yale School of Management's Millstein Center researches and educates corporate managements, boards of directors, shareholders, and stakeholders on how to create long-term corporate and shareholder value while at the same time meeting societal expectations.¹⁶

Industry groups can also drive change towards a more accountable capitalism. The International Corporate Governance Network (ICGN) has historically drawn its strength from institutional investors and has represented them in calling upon corporations to act responsibly. But more recently the ICGN has put increasing resources behind making sure that its members themselves act responsibly, both towards those to whom they are accountable (the individuals whose savings those institutions invest) and towards those they would seek to hold accountable (public corporations). This culminated in the ICGN's "Statement of Principles on Institutional Shareholder Responsibilities" (ICGN, 2007). The UK's Institutional Shareholder Committee devised similar guidance and the Financial

¹⁴ Jon Lukomnik serves on the CEFEX advisory board.

¹⁵ David Pitt-Watson serves as a senior advisor to Hermes Equity Owner Services and Stephen Davis as a non-executive director.

¹⁶ Pitt-Watson is an advisor to the Royal Society; Lukomnik is program director of the IRRC Institute and lead consultant on the GCGF's financial markets recovery project; Davis is Executive Director of the Millstein Center at Yale.

Reporting Council is now conducting a consultation on those “stewardship principles” (FRC, 2010). Globally, institutes of directors and similar bodies such as the Indonesian Institute for Corporate Directorship and the Brazilian Institute of Corporate Governance, are focusing on the issues of governance and responsibility, as are banking associations such as the Union of Arab Banks and the Swiss Bankers Association, both of which attended the Global Corporate Governance Forum’s Financial Crisis Response Consultation in June 2009. This initiative helped determine the need and scope for the GCGF’s program to build capacity to train bank directors in emerging markets.

Put simply, the ethics of business are fundamental to economic success. If, when the crisis is over, all we have is a financial system constrained by command and control regulations, where market participants fail to recognize any broader responsibilities for their actions, we will not only stifle innovation, but what innovation there is will be directed at subverting the regulation we have passed. We will just have drawn the contours for the next crisis.

Expert Comment 6.1

Beyond Rules and Regulations: Board-Level Business Ethics is Key to Better Functioning Capital Markets

Philip Armstrong, Head, Global Corporate Governance Forum

Politicians, policymakers, regulators, business leaders, and others have made considerable efforts to remedy the circumstances that led to the global financial crisis. These efforts have relied largely on the implementation of more regulations and more revisions to corporate governance standards.

Absent from the reform discussions is the role that ethics should have played in how boards reached critical decisions that had a calamitous impact on the world’s financial markets. Perhaps the closest has been the Walker Report in the United Kingdom, which explored concerns around the behavioural conduct of bank boards in its enquiry into the meltdown of the UK banking sector.

The challenge for the global business community is to seize the moment now (while institutional and investor support for reform remains strong) and build broader, more assertive adherence to corporate governance best practices.

Chief among boards’ priorities is their need to recommit to high ethical standards, especially since many were compromised over the past two decades to the point that public trust and confidence in business is very low, especially in the banking sector. Ethics should not be an issue that applies only to corporate boards, either. There is much blame to pass around for the financial crisis, including investors and regulators; they, too, should re-examine their ethical standards and decision processes.

Value systems in business have been shaken; in some instances, they appear to have collapsed, none more so than in the banking sector it would appear. In hindsight, too much effort has seemingly been spent on checking the boxes in support of compliance with rules and regulations. Too many directors sidelined ethical issues that could have better informed the fundamental business decisions they made, decisions that had a profound effect on the global economy. In some cases, difficult decisions essential to abiding by the *spirit* of codes of conduct and regulations were conveniently avoided or simply ignored.^a

The extent to which senior management, with their boards' approval, enriched themselves at the expense of their investors' long-term interests is but one example among many that underscores why the moral compass of business leaders needs to be recalibrated. Regulators, under political pressure, should well heed this point, too, as should those investors who gleefully rode the wave of superior profits to the disregard of their own stewardship responsibilities. Too many investors disregarded obvious signals that should have alerted them to problems, especially poor selection of board directors.

How can ethics be re-introduced as part of the moral compass for boards and other institutions critical to the stability and welfare of our financial markets and global economy?

First, this re-introduction surely can't be about rules alone. Boards must play a leadership role in promoting an ethical business culture, with the chairman and CEO setting the "tone at the top." This must be demonstrated – in practice and conduct – to ensure that the right decisions are made and ethical standards are rigorously observed without exception.

More time must also be devoted to board induction and director development, particularly in such complex sectors as banks and financial institutions. This effort should not only cover relevant laws, regulations and codes that govern the business; it should also include a comprehensive understanding of the financial structure of the business and such key performance issues as market environment, strategies, and major risks.

At the Global Corporate Governance Forum, we are helping to address this need by developing board instruction on bank risk governance, drawing on lessons from the financial crisis, which focuses on the special features of banks and the role of directors. This module, an extension of our globally acclaimed *Corporate Governance Board Leadership Training Resources*, follows the journey of a newly appointed bank director as he or she acquires the understanding, skills and insights required for handling the particular challenges posed by financial markets and banking, despite his or her extensive experience as a board director in industry.

Mandatory rules have a role, too, with needed reforms to ensure that boards and senior management are more closely aligned with investor and shareholder interests. Granted, there are limits to what laws and regulations can do to halt the opportunistic behaviour of individual decision-makers. A good example is the enactment of the Sarbanes-Oxley law in the United States. This put into place major reforms in securities laws that toughened audit and disclosure requirements. Yet, these laws did not avert the problems that have taken place in investment banks and other financial institutions, including excessive leverage and other reckless governance practices.

Tougher requirements can inform boards' ethical responsibilities for compensation-setting, risk management, investment strategy and accounting practices. The advent of a Stewardship Code for institutional investors in the United Kingdom shows us that governance responsibilities extend beyond companies and their boards. The various elements of our financial markets should seek to address a number of serious structural deficiencies and perverse incentives highlighted by the global financial crisis, otherwise we run the risk of simply getting back to business-as-usual all too soon and set ourselves up for another crisis in the not too distant future.

Of course, none of this will work unless the financial markets and those responsible for their effective functioning (such as policy-makers, regulators, and market participants) demonstrate that good corporate governance practices are determined by the ethical exercise of significant authority and responsibilities on which society's welfare depends.

^a Knowledge@Wharton, " 'A Race to the Bottom': Assigning Responsibility for the Financial Crisis." December 9, 2009. Available at: <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2397>

G. One world, many markets

One final dimension related to building a desirable global financial infrastructure needs to be mentioned. In our globalised economy banks operate, and securities are traded, around the globe. A large Chilean company may well be financed by a bank from Japan, or a pension fund from the Netherlands.¹⁷ Banks receive capital from sovereign wealth funds in Asia and the Gulf Region.¹⁸ Depositors around the world had their money in Icelandic banks and it is generally agreed that the precipitating cause of the global financial crisis was exposure to US sub-prime mortgages. So if a new accountable capitalism is to arise, it must do so on a global basis. If it does not, institutions based in one country could continue to practice destructive short-term strategies in another country.

Historically, each regulator has focused narrowly on its particular domain or jurisdiction, without having a panoramic vision of the whole system. The main regulators up to now have been the Basel Committee for Banks, the International Organization of Securities Commissions (IOSCO) for securities, the International Association of Insurance Supervisors (IAIS) for insurance, the International Forum of Independent Audit Regulators (IFIAR) for audit, and the International Accounting Standards Board (IASB) for global reporting standards. No global regulator claims jurisdiction over credit rating agencies, or over institutional investors acting as fiduciaries for others.

However, as a result of the G20 action in London, in April 2009, the newly constituted Financial Stability Board (FSB) has a clear mandate: "To maintain financial stability". Realistically, the FSB cannot become a new unified global regulator. This is both impractical and politically impossible. Around the world, regulatory structures and even the nature of the law differ.

However, an international body such as the FSB, with its overarching mandate, can agree to principles. The Organization for Economic Co-operation and Development (OECD) took that approach in its much-praised Principles of Corporate Governance, which have been widely adopted. A principles-based international entity can be rigorous, not in writing regulations, but in investigating whether internationally-agreed principles are applied in individual countries.

¹⁷ ABP, the Euro 200 billion Dutch pension fund, has invested nearly Euro 2 billion in banks which make loans in Chile and elsewhere. See: http://www.abp.nl/abp/abp/images/01%200002%2008C_top100ENG%20%28def%20versie%29_tcm108-59128.pdf

¹⁸ Some examples include multi-billion dollar infusions of capital to UBS from the Government of Singapore Investment Corp., to Citicorp from the Abu Dhabi Investment Authority and to Morgan Stanley from the China Investment Corp.

The new FSB could surely agree that:

- all actors in the financial system have responsibility for the tasks they undertake;
- they are in turn accountable, and those to whom they are accountable must be qualified and take their responsibility seriously;
- those who make them accountable need to be provided with relevant information
- information ought to be provided by independent agents;
- all banks, and other financial institutions, need to be “stress tested”, not only for solvency, but also for liquidity; and
- civil society, regulatory institutions, and central banking authorities should have powers and rights that give practical meaning to the above.

Such principles have corollaries that imply specific practices: A preference for transparency in all transactions, clear lines of authority, coordination amongst regulators, an end to opaque trading in derivatives, and a concern about OTC markets.

New institutions would be required to ensure that these practices are implemented. One possibility would be a lender of last resort, perhaps with an expanded role for the International Monetary Fund (IMF).

An inspector charged with judging whether the financial markets of the world in 2006 had met those principles would have concluded that many did not. Perhaps, had there been some such inspectorate invested with the authority of the world’s economic powers to tenaciously ensure that these principles were applied, the irresponsible and unaccountable behaviour which was allowed to thrive until 2007-8 would have been put in check.

Thankfully, the FSB has begun to act along these lines. It has already specified twelve sets of standards it believes to be crucial to global financial stability, including the OECD corporate governance standards.¹⁹ What is missing, however, is a comprehensive program to investigate whether markets have mechanisms to implement and enforce localized versions of these standards and to disclose of findings to the financial markets. Still, the FSB seems to recognize the issue, stating “It is critical that economies have in place an effective legal framework and infrastructure for enforcement.”²⁰

It is also time to realize the third of the Basle pillars – market discipline – in its fullest sense. Market discipline, the ethos and architecture of our financial markets, needs as much attention as do capital requirements and supervisory oversight. To be sure, no amount of regulation of any type can anticipate or prevent all future crises. But in this chapter, several examples of where current practice does not meet the principles of accountability have been identified. If the international regulatory focus for the next few years were to be on improving the trustworthiness of the global financial system through reforming these practices, then the stability of the financial system could be improved. That would promote the emergence of self-correcting mechanisms. That, in turn, should both mitigate the seriousness of the next crisis and allow all market participants –

¹⁹ See Financial Stability Board: 12 Key Standards for Sound Financial Systems.

http://www.financialstabilityboard.org/cos/key_standards.htm

²⁰ See <http://www.financialstabilityboard.org/cos/wasi.htm>

including regulators – to respond more quickly and more precisely. No matter what form it takes.

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