

Corporate Governance in the 2007-08 Financial Crisis: Evidence from Financial Institutions Worldwide

Yale University SOM
November 12, 2010

Comments by

Luc Laeven
(IMF, CEPR, CentER)



The views expressed are my own and should not be attributed to the staff, Management and Board of the IMF

Contribution of this paper

- Literature on corporate governance of banks
 - Banks are special
 - shareholders do not internalize social costs associated with bank failures (excessive risk taking)
 - deposit insurance weakens debtholder discipline
- Paper convincingly shows that corporate governance traits (independent board and ownership concentration) are negatively associated with stock returns, exploiting financial crisis as shock

Specific results

- (Institutional) ownership concentration is associated with greater risk taking and consequently lower stock returns during crisis
 - shareholders do not internalize cost of bank failure
 - cf. Saunders et al; Laeven and Levine
- Independent board is associated with more capital raising during crisis, resulting in lower stock and higher bond returns during crisis
 - Capital issues reduce bankruptcy risks and dilute shareholder value (Myers 1977)

Corporate governance traits

- What is an independent board member?
 - In the paper, every non-executive board member
- Why is institutional ownership associated with negative returns, but a large shareholder is not?
 - Is this about ownership concentration or IO per se?
If latter, what is different about IO?
- Cyclicity of governance
 - Governance traits that destroy shareholder value during bad times may create value during good times
 - Paper only studies bad times, not complete cycle

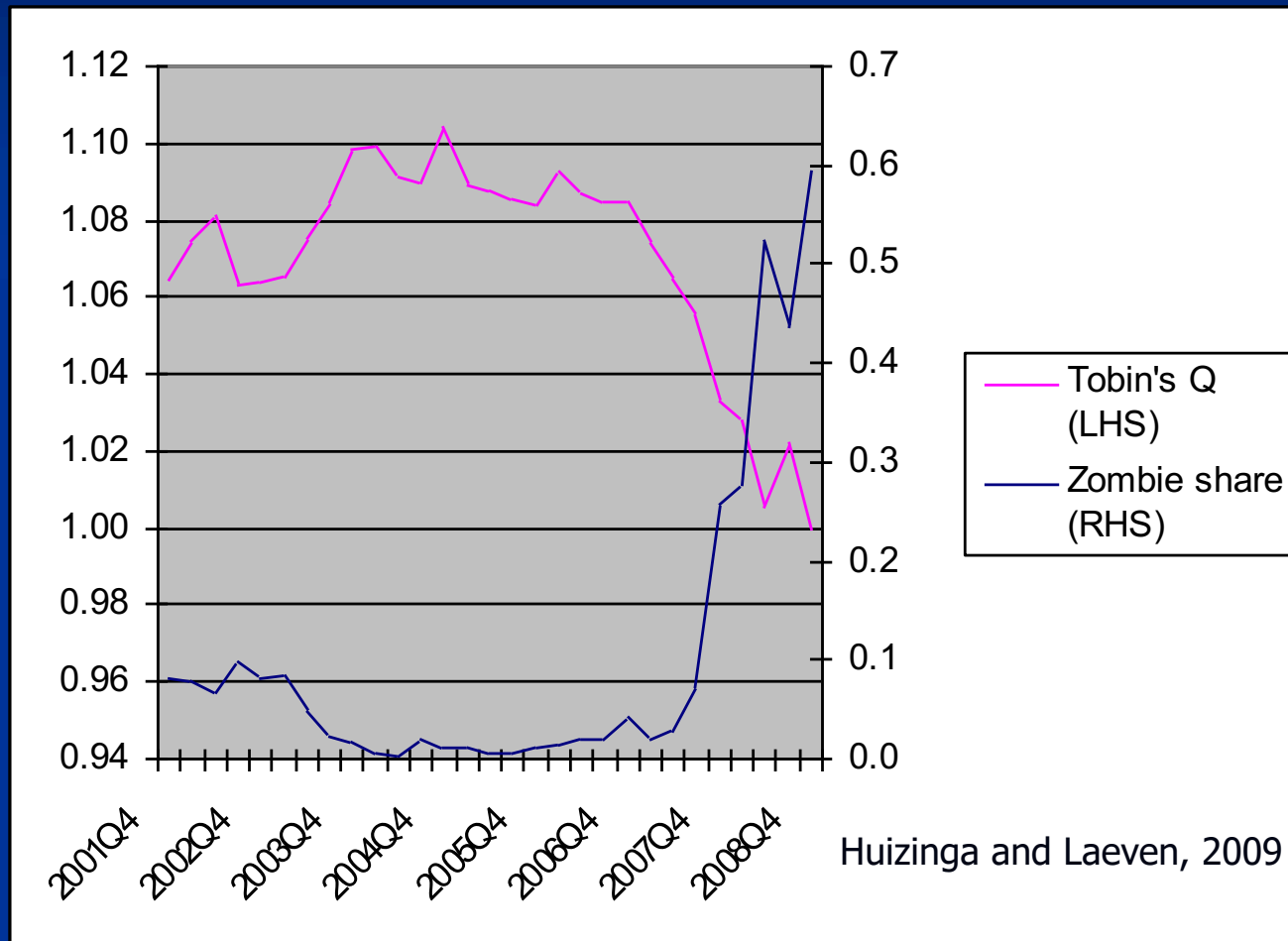
Missing governance traits

- Managerial ownership
 - Owner-managed banks display different risk taking behavior than widely held banks (Saunders; Laeven and Levine)
 - Should control for managerial ownership
- Compensation
 - Many have argued that compensation schemes gave bankers even steeper incentives for excessive and short-sighted risk taking
 - Compensation schemes vary considerably across financial institutions and countries

Bank specific factors

- Why did some banks have more MBS exposure than others? Bad luck? Did governance play a role?
 - Banks with large real estate exposure experienced larger deterioration in market values (Huizinga and Laeven)
 - Coverage in Bloomberg of writedowns by non-US banks incomplete; mostly focuses on US losses
 - Writedowns subject to managerial discretion; distressed firms understated losses (Huizinga and Laeven)
- Flight to quality effect during crisis
 - Control for bank capital and liquidity

Increased discrepancy between market and book values of U.S. banks

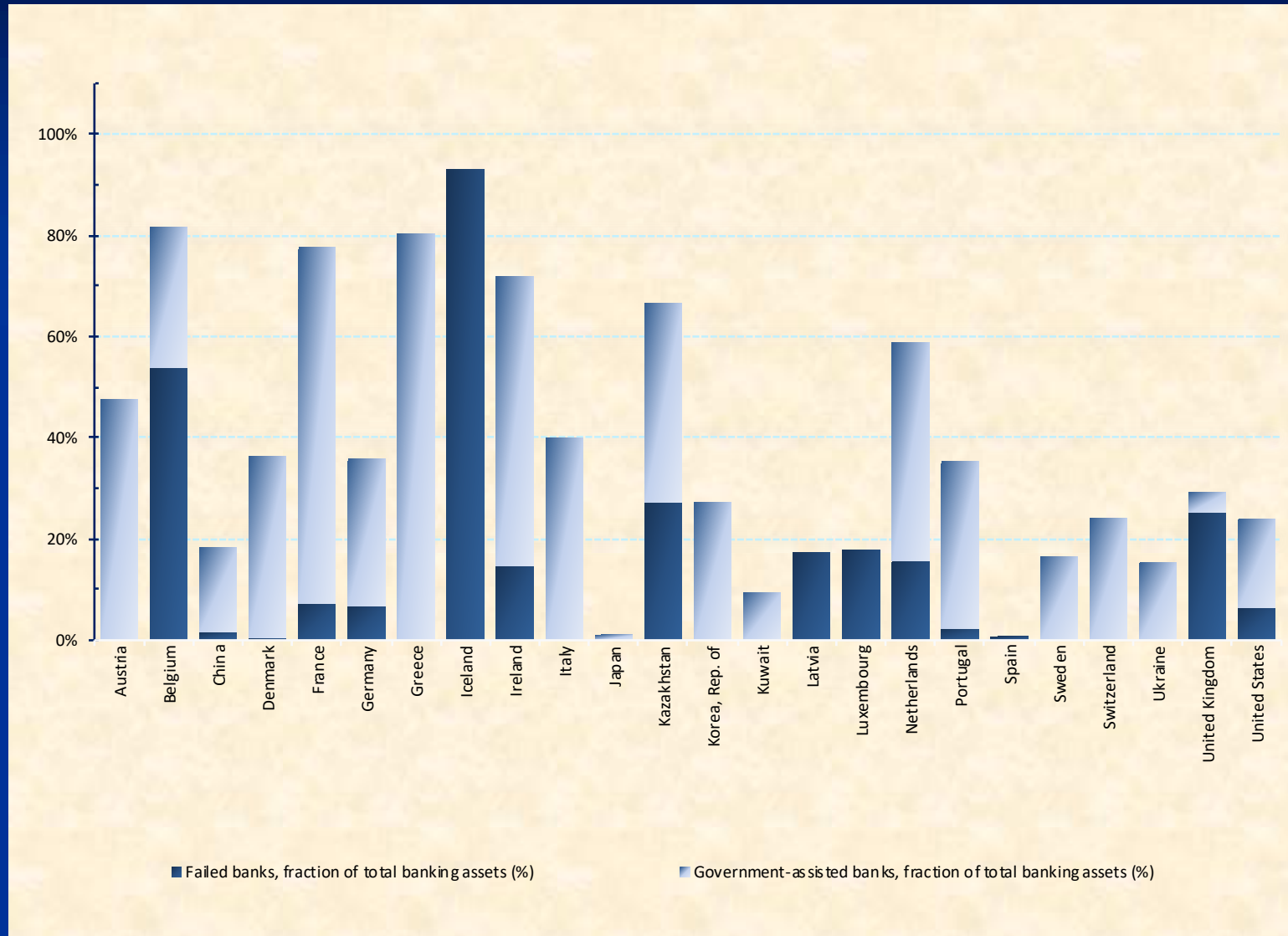


Tobin's Q is the ratio of market value to book value of assets.
Zombie share is the fraction of banks with Tobin's Q less than 1.

Country specific factors

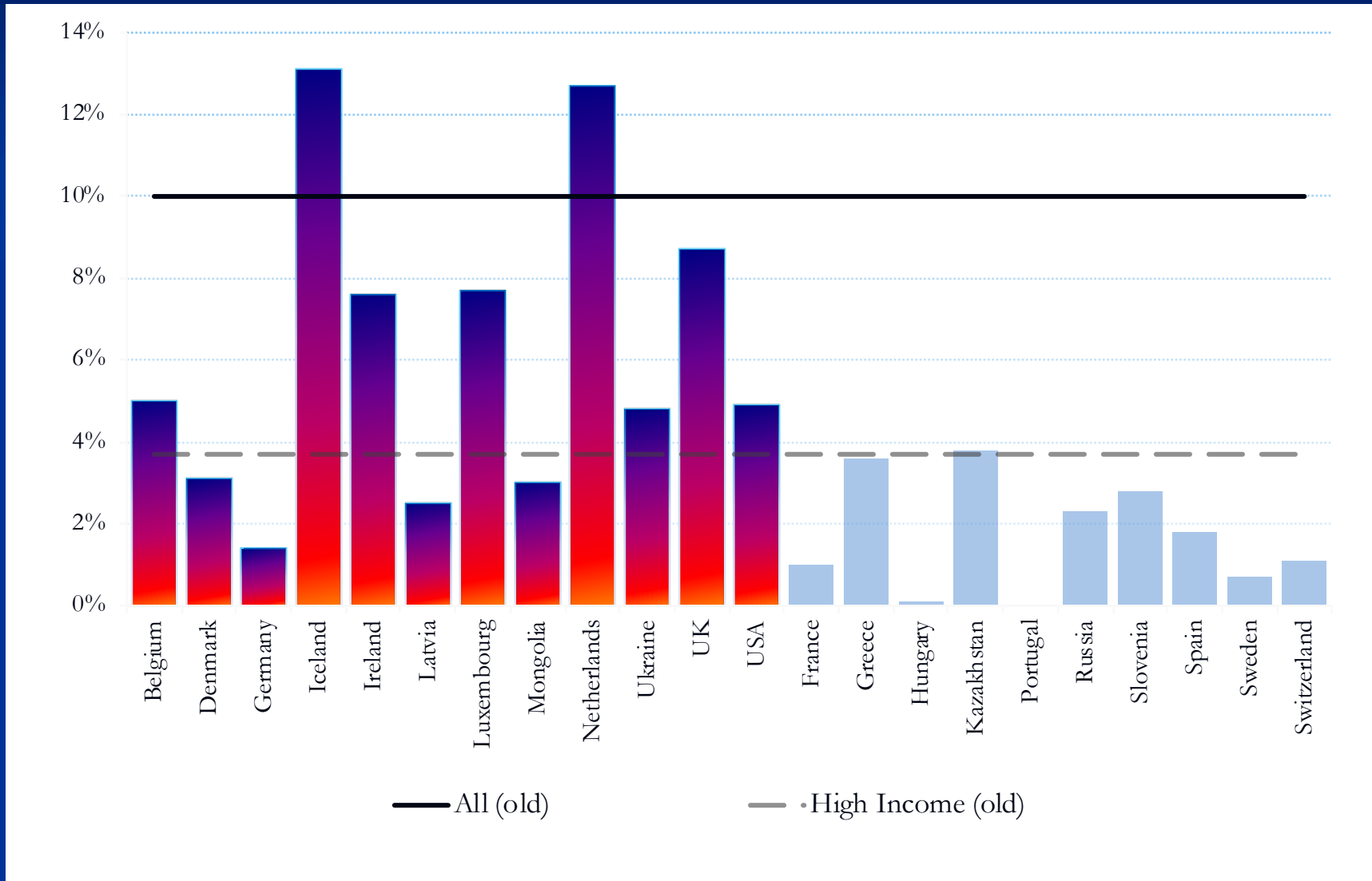
- Sample period includes third quarter of 2008
- Problematic because following collapse of Lehman in mid-Sep 2008, governments announced large-scale intervention packages (including recapitalization measures) that influenced the value of banks
- These country-specific announcements of government interventions interact with bank specific factors (e.g. real estate exposure) to influence market values of banks, and are not controlled for using country fixed effects

Bank Interventions in Selected Countries, 2008-09



Source: Laeven and Valencia (2010)

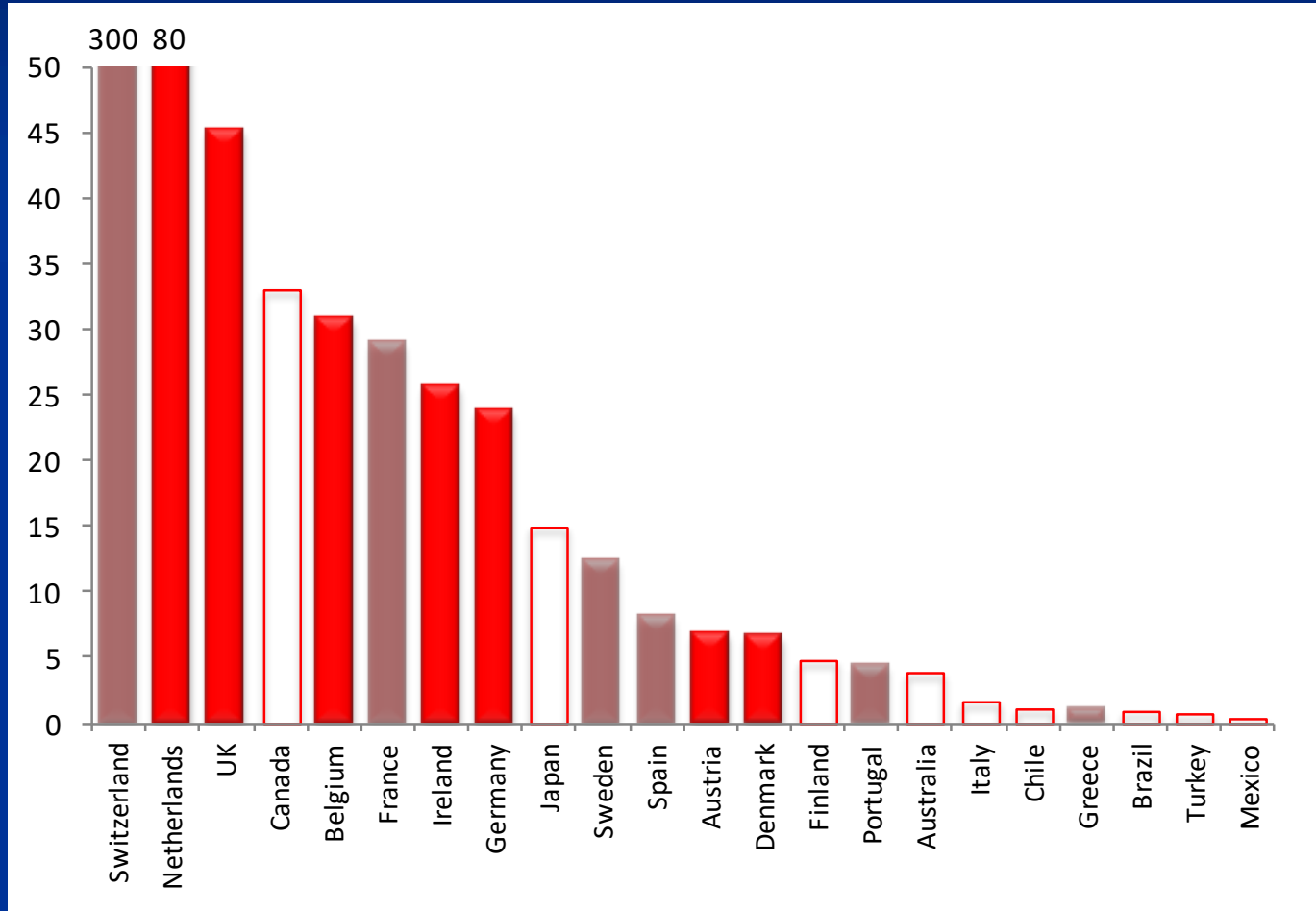
Fiscal Costs associated with Bank Interventions (% of GDP, over 2007-09)



Exploit country variation

- Analysis is done in a cross-country setting
- Yet, little is done to exploit this variation (other than controlling for some country traits)
 - There are large cross-country differences in governance systems and bank characteristics, including exposure to US
 - Sample splits or interaction effects
 - Is effect more pronounced in US (Anglo-Saxon/pro-shareholder countries) ?

Foreign Claims on U.S. by Bank Nationality (end-2006, % of GDP)



Source: BIS

Interpretation of results and policy implications?

- Paper concludes that independent boards are ineffective because they destroy shareholder value during crises (by getting banks to issue new capital)
- Shareholder value creation is not the right metric here
 - Control of insolvent banks should be transferred to debtholders
 - Independent boards are found to increase CDS returns, i.e., they reduce probability of bank failure and create debtholder value during crises, so could be welfare enhancing (especially in a world of regulatory forbearance)