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Corporate governance and the financial crisis

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Punchlines for this discussion

- Better corporate governance of financial institutions would not have prevented the financial crisis
- Corporate ownership in the US is more concentrated than at any time since WWI
- But: conflicts of interest among financial institutions prevent ownership from mattering the way it could

Financial institutions are highly diverse in their corporate governance

- The most troubled players in the recent crisis were in highly diverse industries
  - Commercial banking (Citi, Wachovia)
  - Savings and loans (WaMu, IndyMac)
  - Investment banking (Bear, Merrill)
  - Mortgage banking (Countrywide, New Century)
  - Insurance (AIG)
  - GSEs (Fannie, Freddie)
- Corporate governance has very different histories across these industries

What does good corporate governance look like (according to reformers)?

- Boards are comprised primarily of truly independent directors
- Outside directors have relevant expertise and resources
- The CEO does not serve as Chairman of the Board
- Directors are elected annually
- Directors' and top executives' wealth is tied to the company via share ownership
- [Optional] The firm has a large institutional blockholder to hold its board accountable

Board composition in 2006

Company	Board size	Indep.	CEOs	"Stars"	Annual?	CEO=Chair?
AIG	15	13	0	6	Yes	No, by charter
Bear Stearns	12	8	0	1	Yes	Yes
Citi	16	13	6	4	Yes	No
Fannie	12	11	0	4	Yes	No, by charter
Goldman	11	9	2	4	Yes	Yes
JP Morgan	14	11	3	4	Yes	No
Lehman Bros	11	9	0	2	No* (2007)	Yes
Merrill Lynch	11	10	1	5	No	Yes
WaMu	13	10	0	3	No* (2007)	Yes
Wells Fargo	14	13	1	1	Yes	Yes

Ownership structure in 2006

Company	Largest shareholders	% inside	Auditor
AIG	CV Starr "group" 15.2%; FMR 6.8%	2.10%	PWC
Bear Stearns	Private Capital Mgt, 6.1%; J. Cayne 6.5%	9%	Deloitte
Citi	No 5% owner; Sandy Weill owns ~ 0.5%	1.10%	KPMG
Fannie	Cap Res 17.2%; Citi 6.3%; AXA 5.4%	0.40%	Deloitte
Goldman	GS "shareholder group," 11.7%	2.90%	PWC
JP Morgan	Barclays 5.1%	1.20%	PWC
Lehman Bros	Smith Barney et al, 5.1%	3.90%	E&Y
Merrill Lynch	State Street (ESOP trustee) ~ 9%	1%	Deloitte
WaMu	Cap Res 10.3%; Barclays 6.2%	1%	Deloitte
Wells Fargo	Berkshire 5.7%	<1%	KPMG

AIG after Greenberg: A model of governance reform

- Substantial turnover among former "Greenberg directors" (7/15) between 2004-2006
- Structural changes:
  - Retained Arthur Levitt to advise on reforms, nominees
  - Director candidates not receiving a majority vote must resign
  - 2/3 of directors must be independent (strictly defined)
  - By-laws require independent (non-executive) Chairman, who is evaluated annually
  - Former AIG CEOs cannot serve as directors
  - Directors limited to 4 other corporate boards
  - All employees must complete formal ethics training
  - Audit committee met 21 times in 2005!

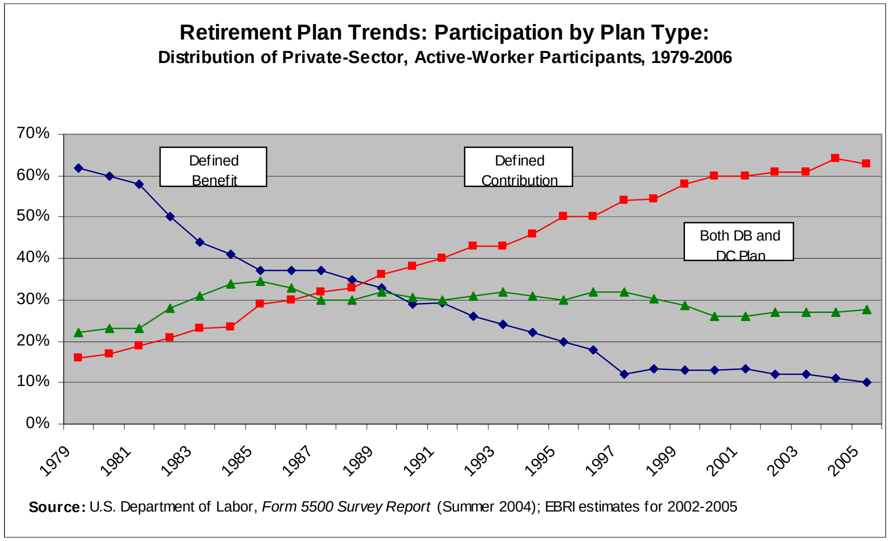
Fannie after Raines: A model of governance reform

- Substantial turnover among former "Raines directors" (7/13) between 2004-2007
- Structural changes:
  - By-law requires separate CEO and Chairman of the Board
  - All directors but one are independent
  - Majority vote required for director election
  - Stock ownership requirements for executives and directors

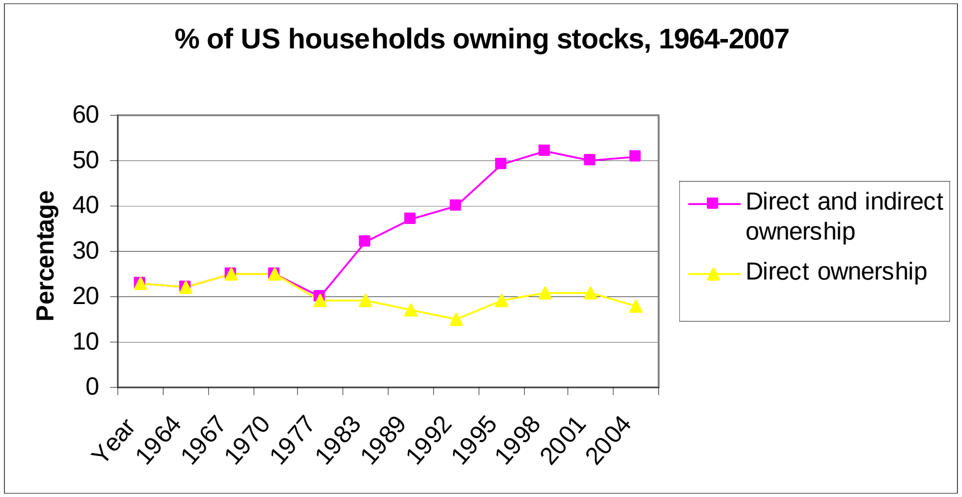
Conclusion I

Even a perfect board, annual director elections, aligned incentives, etc. can't address the internal problems of firms like AIG

American employers moved from DB to DC pensions…

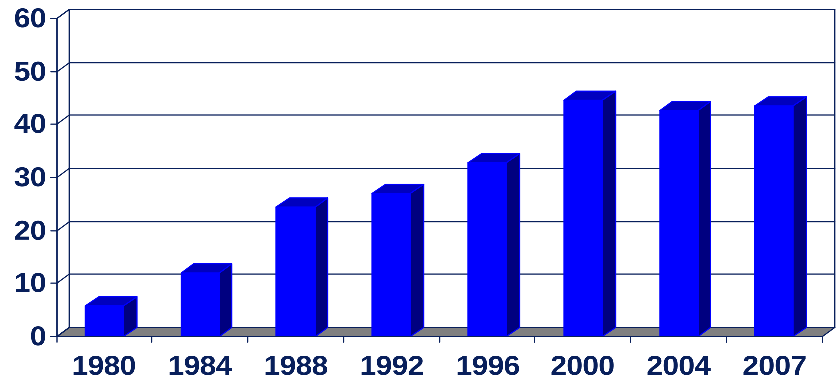


…so households became increasingly invested in the stock market during the 1980s and 1990s



Source: Federal Reserve *Survey of Consumer Finances* (various years)

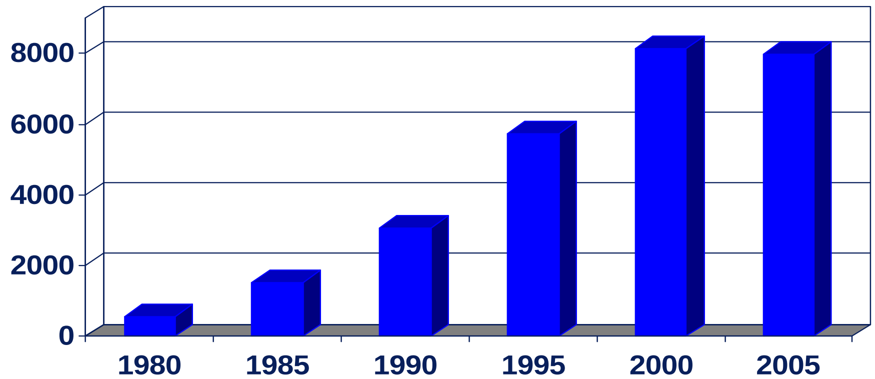
Specifically: investors in mutual funds



Proportion of households allegedly owning mutual funds

Source: Investment Company Institute 2008 *Investment Company Fact Book*

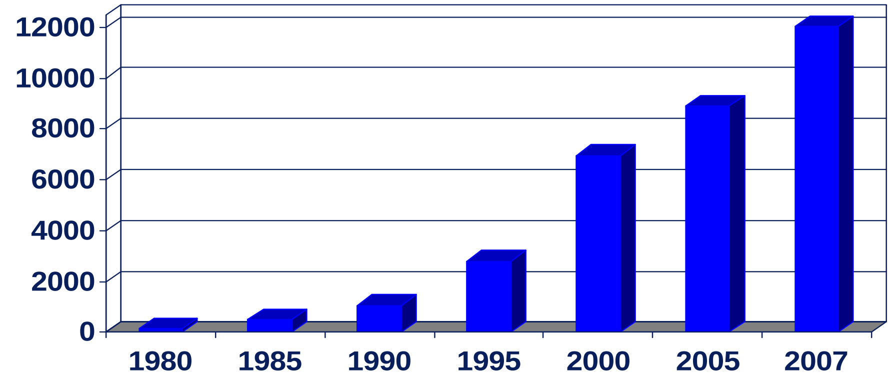
There are many more US mutual funds now



Number of US mutual funds

Source: Investment Company Institute 2008 *Investment Company Fact Book*

And they gathered a lot of assets

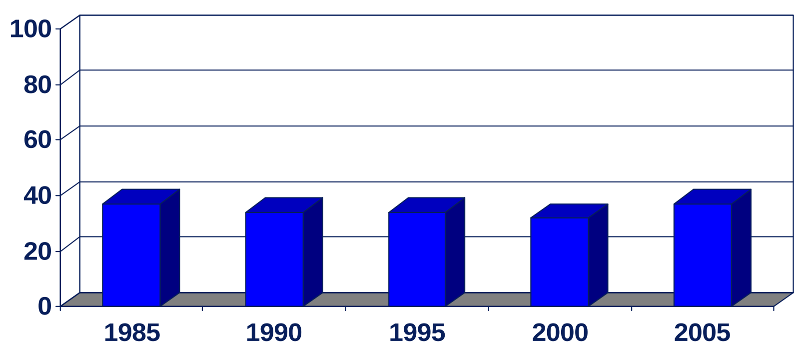


Billions of dollars in assets held by US mutual funds

Source: Investment Company Institute 2008 *Investment Company Fact Book*

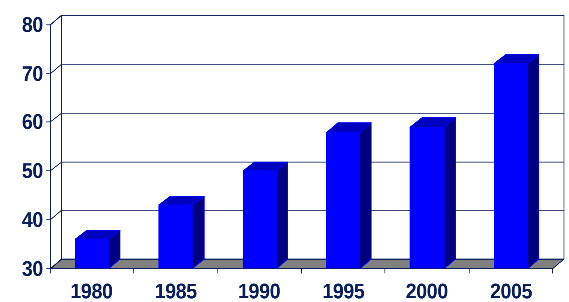
But 'name brand' funds got most of the benefit

Market share of top 5 fund families



Source: Investment Company Institute 2008 *Investment Company Fact Book*

Leaving US corporate ownership largely 'intermediated' by a few mutual funds



Corporate ownership by mutual funds

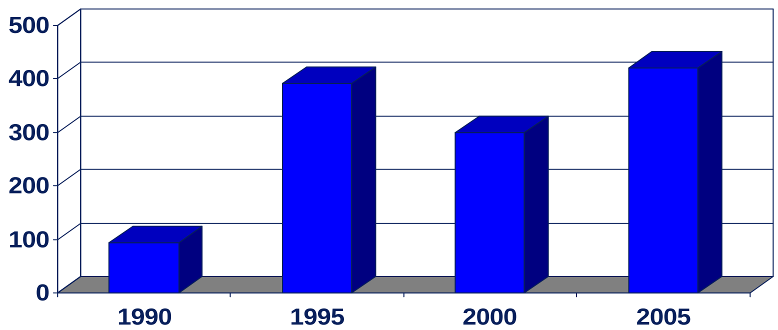
- 1950: 3%
- 1990: 8%
- 2005: 28%

Mean ownership by institutional investors of 1000 largest corporations

Source: Spectrum 13F database, various years

Fidelity is now the largest shareholder of one in ten US corporations

Number of US-listed firms in which Fidelity is largest shareholder



	1990	1995	2000	2005
# of listed firms in US	3833	5187	5828	4423

Source: *Spectrum* 13F and 13G databases, various years

Conclusion II

Ownership in US corporations is more concentrated than at any time since the days of JP Morgan and *Other Peoples' Money*

Mutual funds' support for governance reform is almost perfectly (-) correlated with their pension business

	All Six	Independent Board Chair	Allow Cumulative Voting	Declassify Board	Expense Options	Vote on Parachute	Require Vote on Pill
Clients	-0.545	-1.221	-0.847	-0.31	-1.122	-0.299	-0.159
	(-4.28)	(-3.07)	(-1.76)	(-0.84)	(-2.26)	(-1.39)	(-1.99)
Size	-0.097	0.1679	0.134	0.093	0.252	-0.027	0.017
	(-1.52)	(1.39)	(0.67)	(0.46)	(1.03)	(-0.24)	(0.4)
Finance parent	-12.021	7.2906	-50.016	-9.889	13.432	-9.803	3.473
	(-1.41)	(0.36)	(-1.85)	(-0.40)	(0.45)	(-0.64)	(0.62)
Chair	-66.836						
	(-4.86)						
Cumulative	-68.465						
	(-4.93)						
Declassify	33.042						
	(2.15)						
Expense	-13.470						
	(-0.97)						
Parachute	-33.409						
	(-2.49)						
Constant	113.787	47.0849	65.721	135.058	102.875	80.624	91.921
	(10.23)	(2.97)	(3.29)	(5.62)	(4.28)	(6.69)	(20.87)
LR Chi 2	80.18	10.93	7.98	1.08	6.42	5.45	5.87

n=138 in first model; 23 in all others

Conclusion III

Mutual funds have the potential clout to fix corporate governance, but conflicts of interest limit their enthusiasm

And now, a word from our sponsor

- Papers documenting much of this stuff are available at www.managedbythemarkets.com
- See in particular:
  - Gerald F. Davis, 2009. “The rise and fall of finance and the end of the society of organizations.” *Academy of Management Perspectives* **23**(3): 27-44.
  - Gerald F. Davis, 2008. “A new finance capitalism? Mutual funds and ownership re-concentration in the United States.” *European Management Review* **5**(1): 11-21.
  - Gerald F. Davis and E. Han Kim, 2007. “Business ties and proxy voting by mutual funds.” *Journal of Financial Economics* **85**: 552-570.