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

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

Ownership structure in 2006

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

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

Specifically: investors in mutual funds
There are many more US mutual funds now

And they gathered a lot of assets

But ‘name brand’ funds got most of the benefit

Leaving US corporate ownership largely ‘intermediated’ by a few mutual funds
Fidelity is now the largest shareholder of one in ten US corporations

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

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: