

# For a new financial architecture



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CORPORATE governance seemed to be settling down. After the scandals at the beginning of the decade involving Enron, Parmalat, WorldCom and others, corporate governance rules were tightened, in particular in the form of the Sarbanes-Oxley Act in the United States. But the lull has proved to be short-lived. With the collapse of financial institutions in the US, UK and Continental Europe, the Madoff scandal in the US and Satyam in India, corporate governance is once again at the forefront of the policy debate. What's gone wrong?

The answer is that the standard tools of corporate governance have not proved up to the job. Those tools are essentially the board of directors, auditors, analysts, investors and legislation. None of them has succeeded in preventing the extraordinary destruction of shareholder wealth that has occurred in the financial sector over the past year. Why?

It is instructive to look at the evidence on what makes for good corporate governance. One of the best measures of this is how well it functions when it is faced with a failure. Everything can appear to be working smoothly during boom times but it is when companies fail that corporate governance is really tested.

A particularly interesting question in that regard is what happens when there is evidence that companies are underperforming. How quickly are problems corrected, who takes action and how effective is the action that they take?

Typically, it is a combination of the external members of a board, the chairman of the board, the auditors, the analysts and the investors, in particular the institutional investors, to whom attention turns. How well do they do?

The evidence on the role of boards in failing firms is quite limited. While in principle non-executives could intervene and replace poor management, they rarely do. The role of boards in poorly performing

firms is far more modest than their central function in corporate governance would suggest.

Even independent chairmen appear to play a limited role. While separation of chief executives and chairmen of boards is widely advocated, there is not much evidence that it is associated with markedly greater intervention in underperforming firms.

Attention recently has shifted from directors to investors. Institutional investors in particular have been exhorted to take a more active role in the governance of firms. Shareholder activism has been trumpeted as a solution to otherwise passive investor engagement.

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There have been some examples of funds being specifically created to undertake shareholder activism. They have done exactly what other investors have failed to do, namely target underperforming companies, take shares in those firms, engage actively with the board of directors and replace management where necessary. The returns to such activity appear significant but it is only now with a substantial downturn that their performance in bear markets is being tested and it is unclear how well they will fare in these conditions.

When do directors get fired? The answer is quite clear cut. It is primarily when firms get into financial

difficulty that changes occur. Board turnover is appreciably higher not only when firms are underperforming but in particular when they face financial shortfalls. The reason is straightforward. Faced with a need to raise external finance, investors can impose conditions on additional funding being provided. One of those conditions relates to changes in control of firms.

This control that investors can exert in the presence of funding requirements applies as much to equity funding from shareholders as it does to credit from banks and bondholders. One of the conditions that shareholders frequently impose on companies requiring additional finance is that it will only be made available if there are changes in management.

Unfortunately, this cuts two ways because the other response that we know financial distress promotes is fraud. Much fraud did not set out to be as such. Many people created firms with good intentions but faced with financial distress, instead of owning up, revert to fraud as a way of supporting their activities.

The implication is that we are going to observe corporate restructuring on a massive scale over the next few years, as investors are called upon to bail out failing firms and some revert to illegal activities to avoid this. Since corporate governance and financial institutions are so closely related, good governance rests critically on a well performing financial system. The failure of financial institutions, therefore, not only undermines the funding of new investment and new companies but the governance of our well-established corporations as well.

When reflecting on how to restructure financial institutions in response to the recent crisis, policymakers would, therefore, do well to think beyond the confines of what makes for good savings and investment but also how the new financial order will affect the governance of firms. Over the last few decades, we have experimented with many forms of governance, from the closely integrated banking and corporate systems of Japan to the much more arm's-length relations of the UK and US. Both have been shown to have their defects and the search is now on for a new financial and corporate governance architecture that will remedy these deficiencies and be fit for the 21st century.

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