

## Will financial reforms really help prevent another financial crisis?

**The financial crisis of 2007-2008 prompted many reforms, but their effectiveness is still under debate. Miguel Duro and Gaizka Ormazábal review the evidence to discover whether — and how — corporate governance reforms are working out in the financial sector.**



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A decade has passed since the crisis exposed some poor governance practices in the financial sector. Many reforms have since been introduced to prevent past problems from repeating. Are they working?

IESE professors [Miguel Duro](#) and [Gaizka Ormazábal](#) compile and analyze a large body of evidence regarding the impact and effectiveness of the reforms, which they have grouped into three categories: (1) internal governance mechanisms, (2) market discipline and (3) regulatory intervention.

## **1. INTERNAL GOVERNANCE MECHANISMS**

### **Executive Compensation**

Empirical evidence suggests that when bank CEOs' pay was more closely aligned with shareholders' interests, the banks performed worse during the crisis. What's more, having greater risk-taking incentives for CEOs led to higher volatility that was not associated with better performance. In this area, reform measures have included an advisory vote on executive compensation (known as say on pay) and regulations that limit or defer the payment of executive bonuses.

Research offers mixed results for these regulations so far. One say-on-pay study on the United States shows that, before votes became mandatory for public firms, shareholder approvals of pay packages were associated with positive stock market returns. However, a subsequent study suggests that companies then made suboptimal changes to pay in anticipation of expanded say-on-pay requirements.

Meanwhile, in Europe, bonus caps for executives, introduced as European Directive CRD IV in 2013, were poorly received by investors, according to one study. This was in line with the results of another study of CRD III, which had come into force three years earlier.

But in the case of the United Kingdom, the announcement of its Remuneration Code — which requires certain bonus payments to be deferred to reduce short-termism — elicited a positive response from the market, according to research. As intended, the code's implementation seems to have reduced the level of U.K. bank risk, although it may have also raised CEO turnover rates compared to other European and U.S. banks.

At the same time, two other studies show that linking CEOs' incentives, at least in part, to a measure of default risk appears to successfully lower risk-taking.

### **Monitoring the Board of Directors**

In terms of boards' governance practices, the post-crisis debate has focused on limiting their size, increasing the proportion of independent directors and boosting the financial expertise

of members.

Banks tend to have large boards of directors. Outside the financial sector, some research has suggested that larger boards may introduce inefficiencies. However, recent research has found no evidence that this applies to the financial sector, as banks tend to be large and complex. Quite the contrary seems to be true, in fact.

As for the proportion of independent directors, the empirical evidence is not conclusive. There are studies of international banks that show a positive relationship between the proportion of independents and the performance of banks. But similar research conducted on U.S. banks calls those findings into question, even suggesting that banks with more independent directors suffered greater losses during the crisis.

Regarding the financial expertise of board members, the impact seems to vary according to the country or geographical area analyzed. Research on U.S. banks found no evidence that more financial experience on boards led banks to fare better during the crisis. In contrast, research on European banks may suggest the opposite. Using a sample of large German banks, research found the financial experience of board members to be negatively correlated with losses during the crisis. And, in the case of the Spanish savings banks (*cajas*), chairpersons without previous banking experience (or postgraduate education) performed worse at the peak of the crisis.

### **Internal Control Systems**

Introducing internal control systems that reinforce supervision and risk management seem to be effective, evidence shows. Notably, creating board-level risk or audit committees and adding a chief risk officer (CRO) seem to yield positive results, as indicated by various academic studies.

In the United States, for example, it was observed that banks with stronger controls in place experienced less volatility during the crisis. In addition, others have documented that loans issued by banks with more powerful CROs had lower default rates.

On the other side of the Atlantic, a study of banks in 20 EU countries from 2008 to 2010 showed that the banks with audit committees that met more frequently were able to provide higher-quality information on operational risks.

## **2. MARKET DISCIPLINE**

### **Competition**

In banking, market competition may increase the amount of risk assumed by financial institutions and affect their stability. Historically, corrective measures have included separating commercial banking from investment banking, and limiting banks from engaging in certain activities that are considered risky. However, a study on the effectiveness of this type of measure in the United States has not yielded clear results.

### **Mergers & Acquisitions Market**

For most companies, the threat of a hostile takeover bid can be a powerful mechanism for controlling corporate governance, as it can reduce managerial opportunism and encourage the maximization of shareholder value. For one thing, a hostile takeover, if successful, usually involves replacing the top management of the acquired company.

However, in the financial sector, hostile takeovers are rare, since there are legal restrictions and financial ones that impede them. As a result, it's doubtful that the threat of a takeover could act as an effective governance mechanism here, as the research indicates.

### **Shareholder Monitoring**

Institutional investors can be important players in the oversight and monitoring of corporate governance, since they can denounce, reprimand or even force the departure of executives and directors. However, shareholder activism in the financial sector faces various challenges. First, there's the difficulty of obtaining an equity stake that's large enough to influence the governance of banks. That's not only due to the cost, but also the industry's legal restrictions on ownership. On top of that, the complexity of financial operations and products makes it hard for outsiders to effectively monitor the business.

As for the empirical evidence in this area, the jury is still out. Some researchers have found higher institutional ownership to be associated with greater risk-taking in banks. In a similar vein, another study focused on the United States during the crisis found a higher concentration of ownership to be associated with higher risk taking, perhaps because of the U.S. government's implicit "too big to fail" guarantee. In Europe, other researchers suggest that commercial banks with highly concentrated ownership were more likely to use discretionary loan-loss provisions to embellish their income statements and hide risks.

## **3. REGULATORY INTERVENTION**

### **Capital Requirements**

Evidence from various studies suggests that capital requirements (e.g., Basel rules) for banks can curb risk-taking incentives. However, there is also evidence that meeting these requirements doesn't necessarily reduce a bank's risk. For example, some authors observed that a large part of the capital raised during the financial crisis came from hybrid capital instruments, such as preferred stock and subordinated debt, and that banks continued to pay dividends in the early phase of the crisis. Consequently, the exposure to future potential crises may have increased, as further explored by other authors.

### **Regulatory Supervision**

Most agree there is a need for regulatory supervision in banking that goes beyond capital requirements. But there's a debate here about the supervisors' interests, which may deviate from the interests of the taxpayers or the society in general. This potential incentive-alignment problem may be compounded by incomplete information and accountability issues.

In particular, the following three issues are unsettled: (1) whether there should be one or multiple supervisors who compete with each other; (2) the supervisory role of the central bank; and (3) the scope of the supervision. One study validates these concerns by suggesting that, in the United States, federal and state supervisory agencies apply their rules inconsistently due to differences in their institutional designs and incentives, leaving some confusion in their wake.

### **Methodology, Very Briefly**

The authors reviewed a large body of academic literature for empirical evidence regarding the role of corporate governance and the effectiveness of the reforms introduced in the financial sector following the 2007-2008 crisis.

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