Saving Capitalism!

Presentation to the Conference
Too Big to Fail Financial Institutions
by

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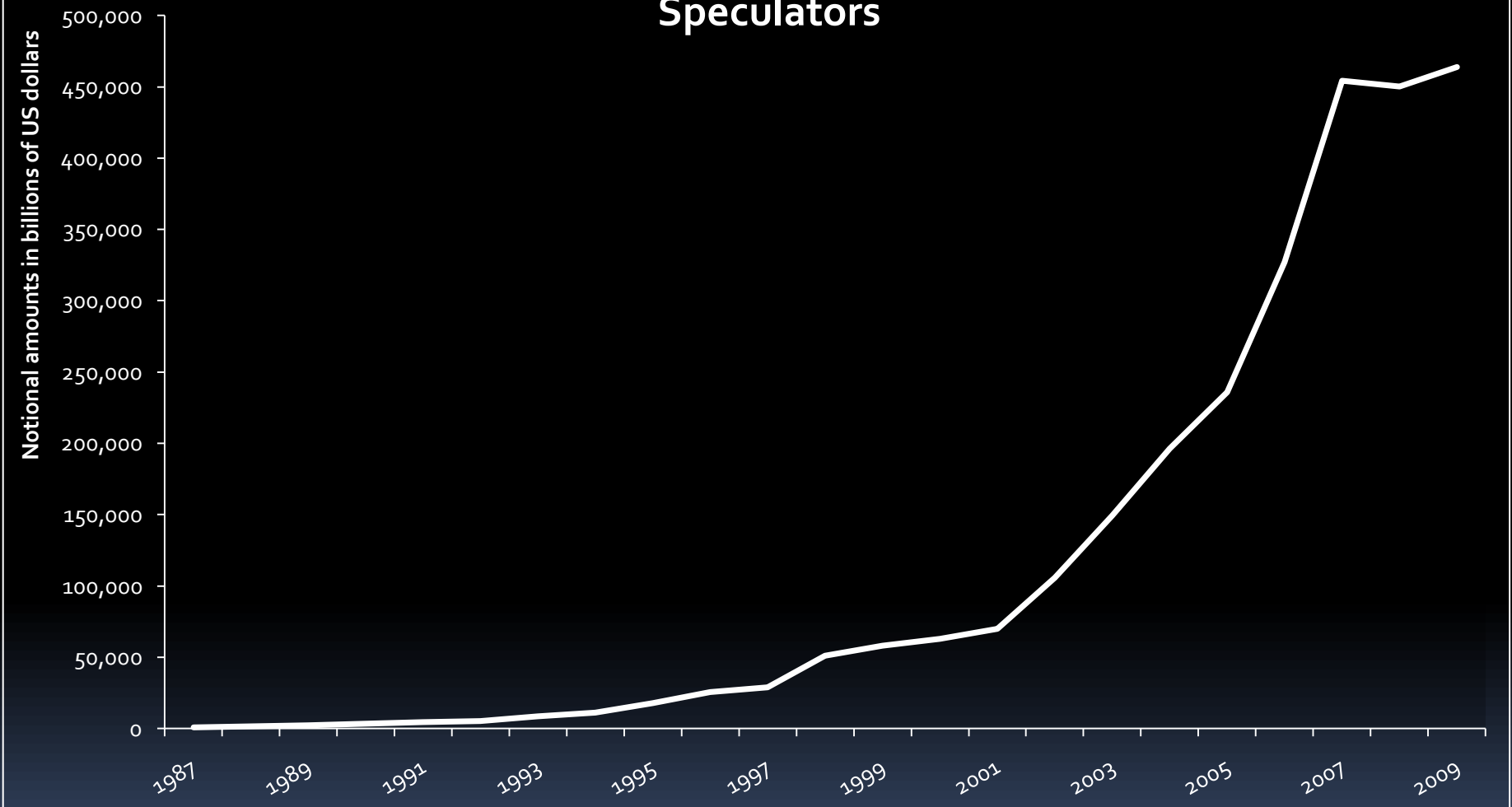
In part from *Black Markets… and Business Blues* by Yvan Allaire and Mihaela Firsirotu (June 2009)

Financial Institutions???

- Regulated Banks
- Investment Banks
- Shadow/Quasi/Crypto-*Banks*
- Hedge Funds of the speculative kind
- Institutional Investors (Pension Funds, Mutual Funds, etc.)
- Brokers and other intermediaries
- Etc.

OTC Derivative Products In Notional US $

The Preferred Tool of Speculators



Source: 2010 by International Swaps and Derivatives Associations, Inc.

The Market Sentinels: not asleep, not bribed?

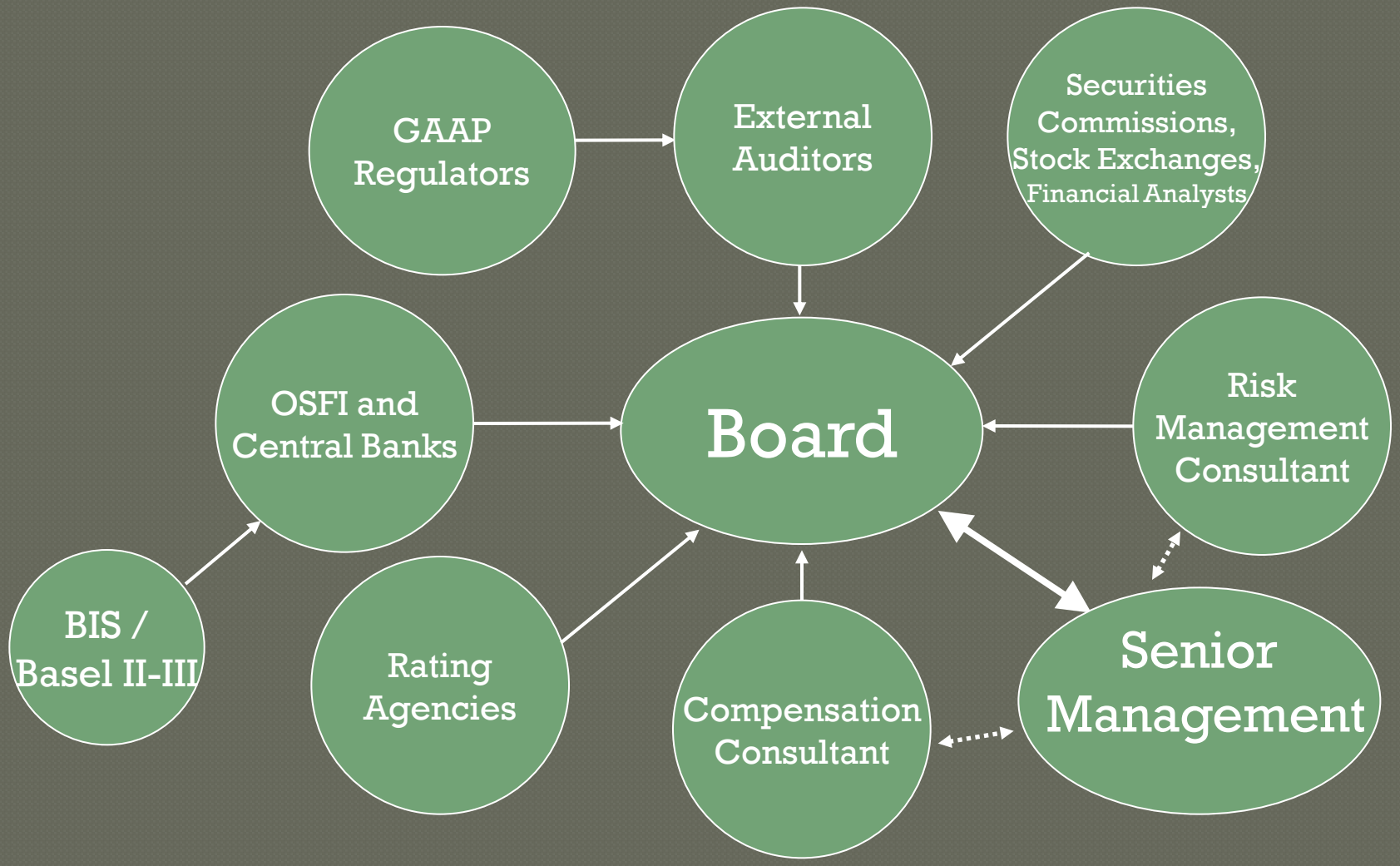
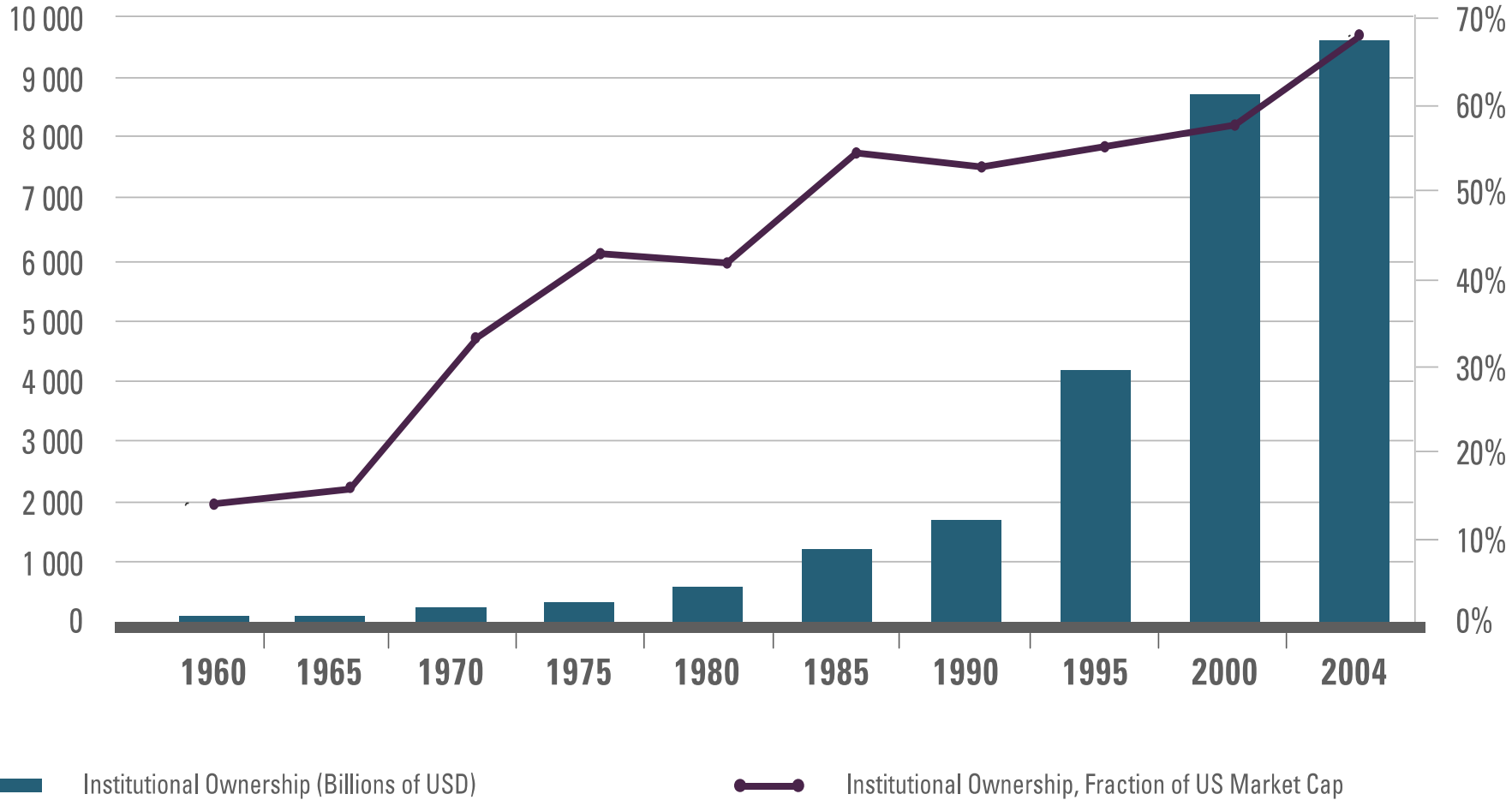


Figure 6

Evolution of Institutional Ownership (U.S.)

1000 U.S. Publicly Listed Companies

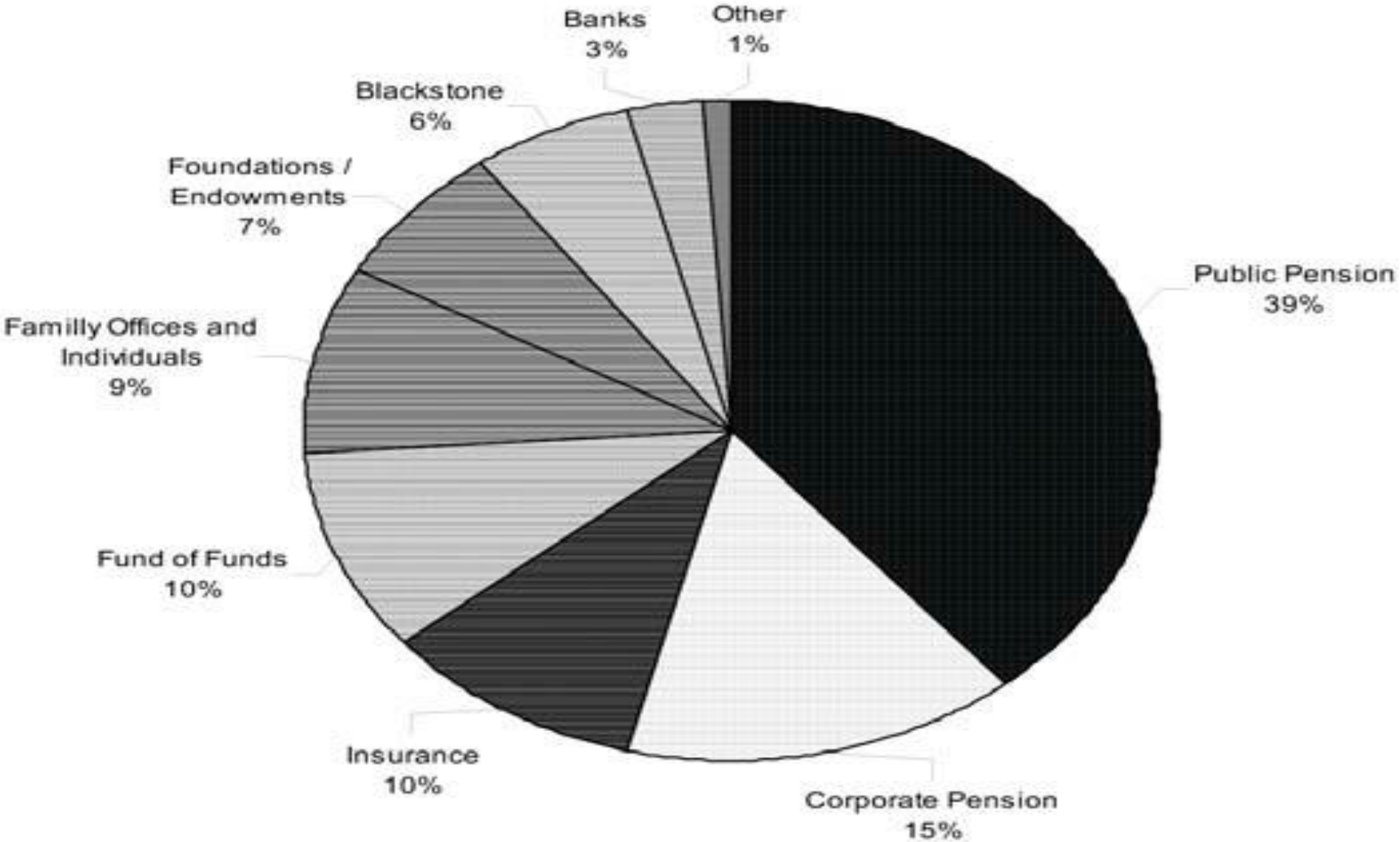
SOURCE: GORDON, J.N. 2006



The Motivations of Institutional Investors: the quest for *alpha*

- Beat the indices;
- Rank in the first quartile or, even better, in the 1st decile;
- Having to give account of their performance over a short-term period, they push for short-term performance even though their obligations may be long-term;
- To perform well compared to other funds, they have become prime suppliers of funds to all speculative funds, private equity funds, etc.

Pension Funds as Source of Funds to…Blackstone



Pension Funds as Sources of Funds to KKR

(source: KKR prospectus, filed with the SEC, July 6th, 2010)

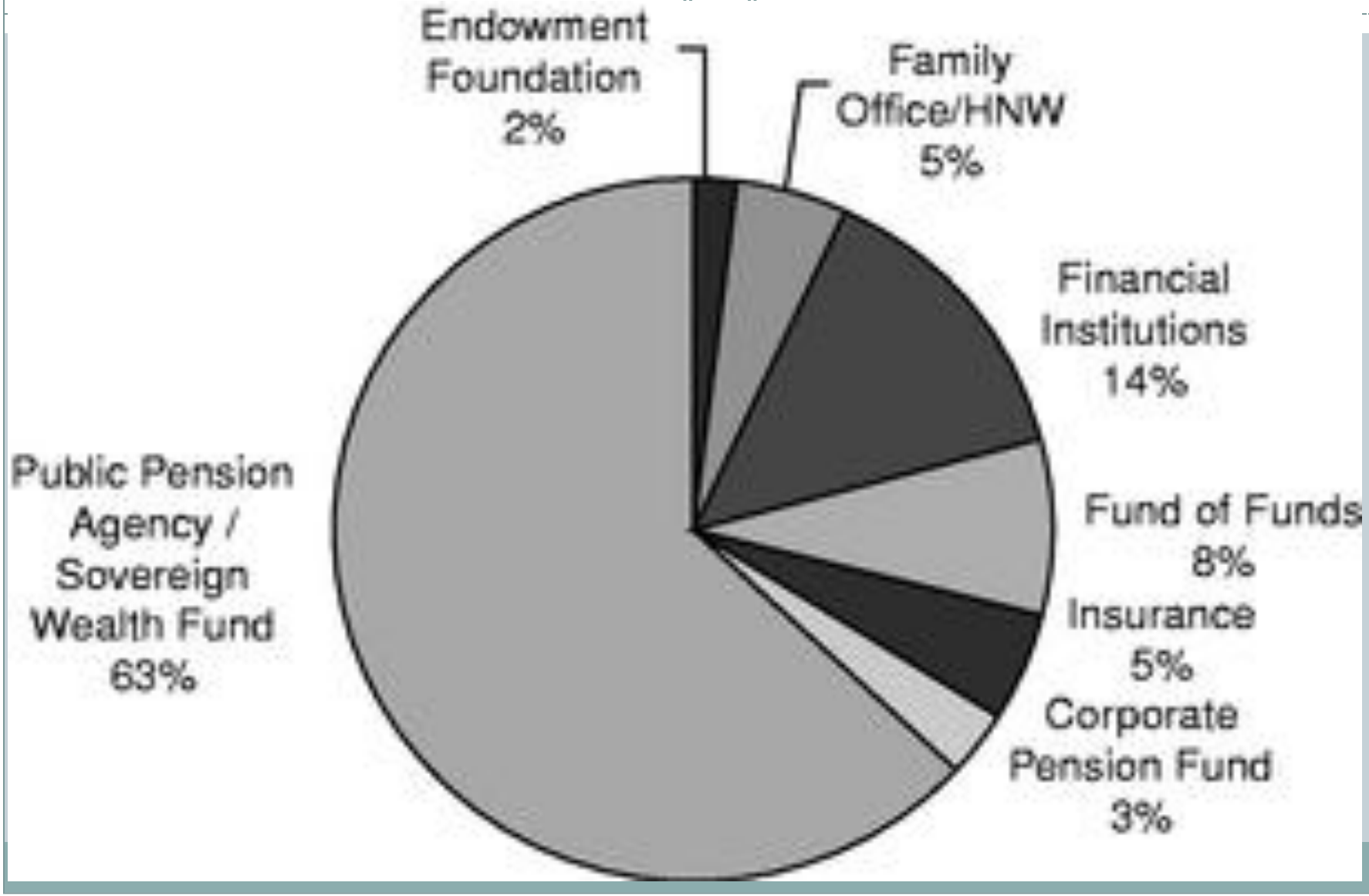


Figure 7

Average stock holding period - NYSE 1920-2008

SOURCE: SG GLOBAL STRATEGY RESEARCH

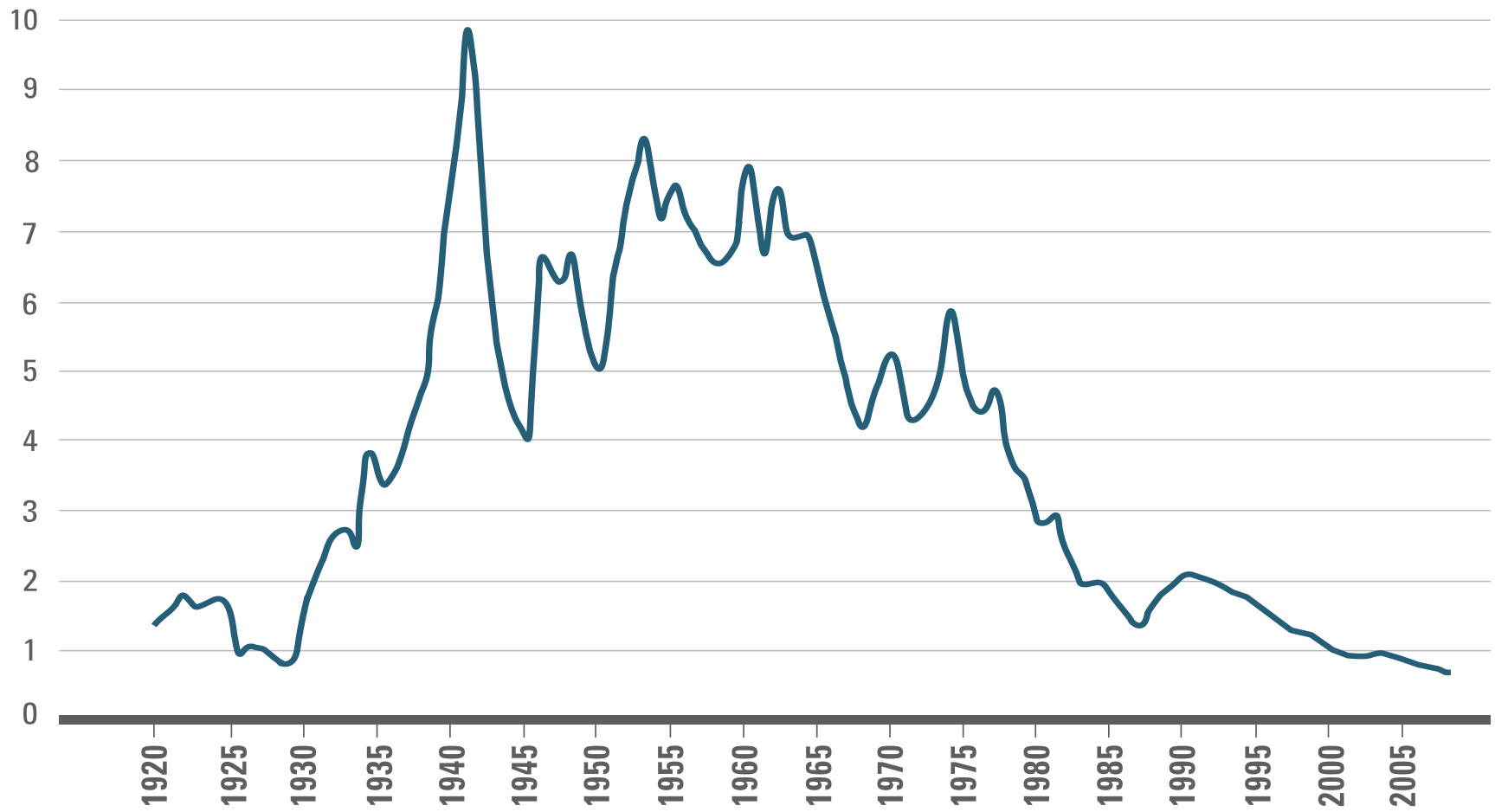
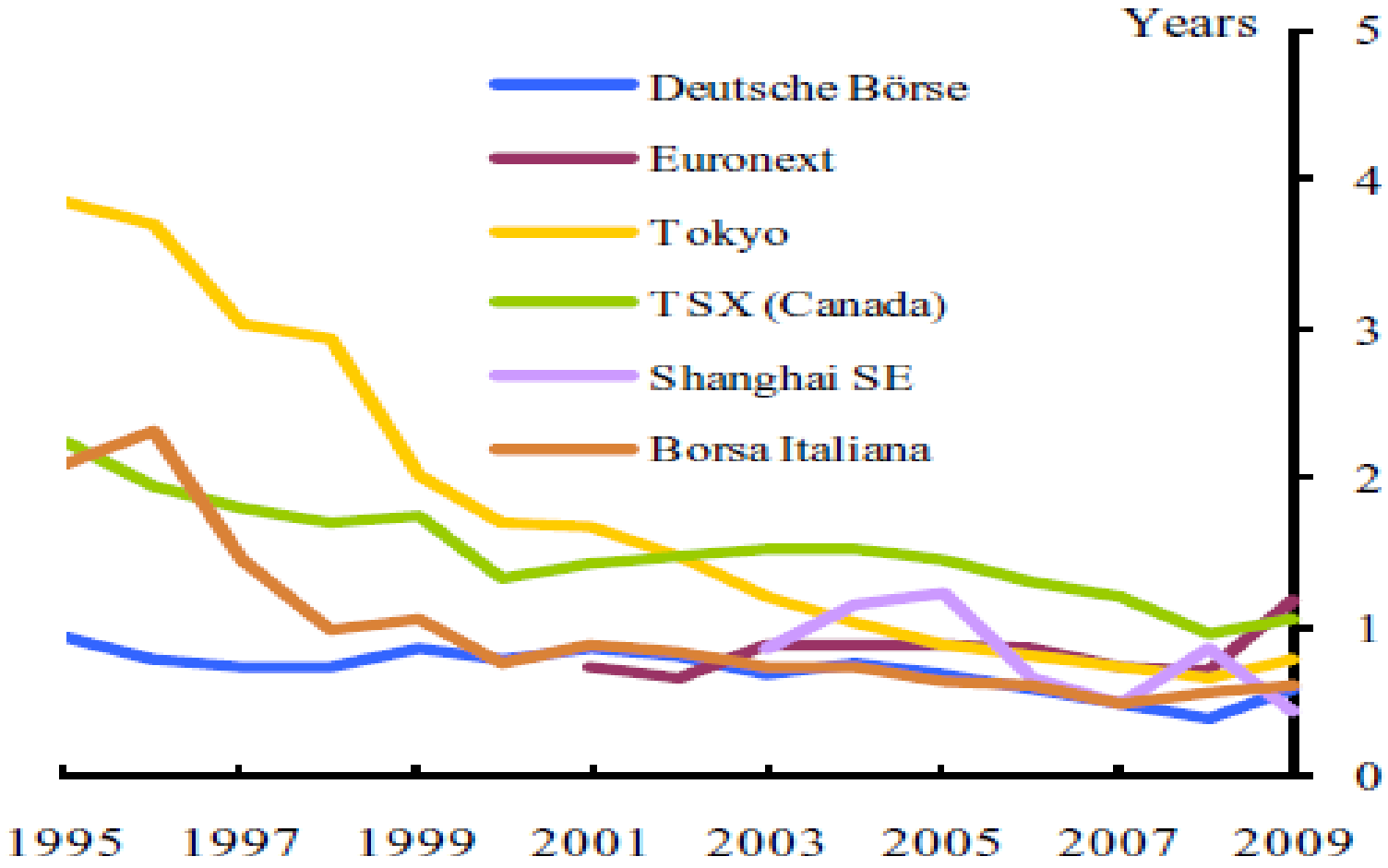


Chart 11: Average holding period in other major stock exchanges



Source: World Federation of Exchanges

Who owns the publicly traded, widely-held corporation?

The basic assumption underlying "corporate democracy" has become questionable:

Are these transient share-flippers, speculators and game-players really the legitimate owners of publicly traded corporations ?

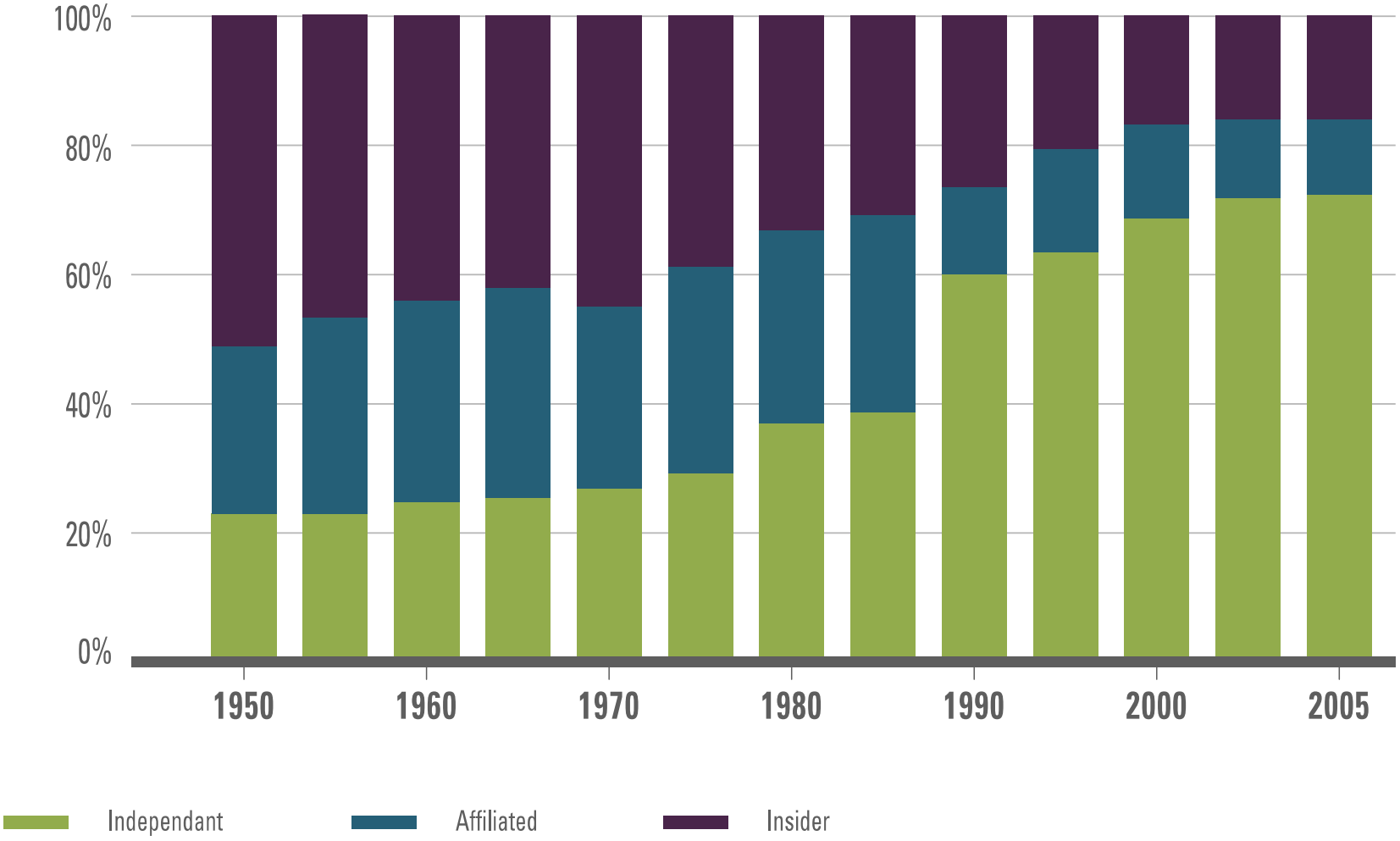
" Tourists don't vote ! "

" Gamblers don't own the casino ! "

Figure 8

Board Composition of U.S. Corporations 1950-2005

SOURCE: ADAPTED FROM GORDON, J.N. 2006



Except for the requirement that board members do not have relationships with the company and its management that would /could influence his/her decisions.....

the concept of board independence is…

"***without interest when measurable, interesting when incommensurable! "***

The actors in the 2008 financial drama: What's common to all (or most) of them?

Sub-Prime Originators	Lending « Banks »	Investment Banks	Sellers of Credit Default Swamp	Investors in Sub-Prime, CDO, MBS and others
Countrywide Financial HSBC Washington Mutual Wells Fargo Home Mortgage First Franklin Financial New Century Financial Etc.	Bank of America Citigroup Wachovia Merrill Lynch Fannie Mae Freddie Mac	Lehman Brothers Bear Stearns Morgan Stanley Merrill Lynch Goldman Sachs	AIG MBIA Ambac FGI Hedge Funds	Investments Banks European Banks American Banks Hedge Funds Pension Funds ***and*** **Credit rating agencies** (Moody's, Standard & Poors)

All, or almost, are typical corporations of the warped sort of capitalism!

.....gradually, slowly ushered in over the last thirty years and spreading to all parts of the economy and all parts of the world:

- *One-share/one-vote publicly listed company "owned" by an array of mostly short-term "investors";*
- *Fastidiously governed by "independent" but quickly overwhelmed directors;*
- *Managed by a mobile executive class "motivated" by stock options to "create (quick) shareholder value";*
- *Surrounded by speculative funds free to play all sorts of lucrative games with the company's shares and debt.*

Figure 1

Median Value of Total Compensation, 1936-2005

Three highest paid executives of the 50 largest U.S. firms

(Constant 2000$)

SOURCE: FRYDMAN AND SAKS, 2007

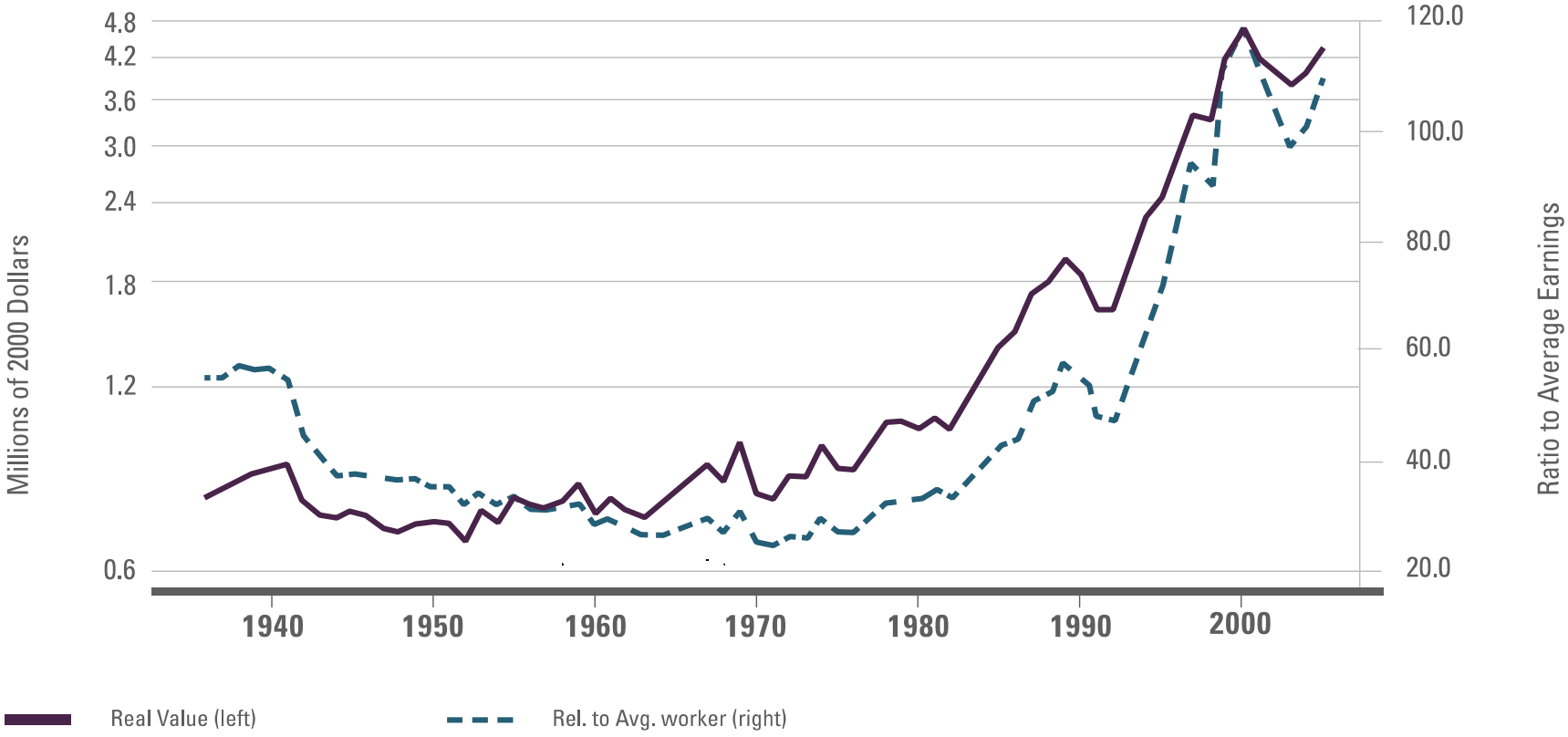
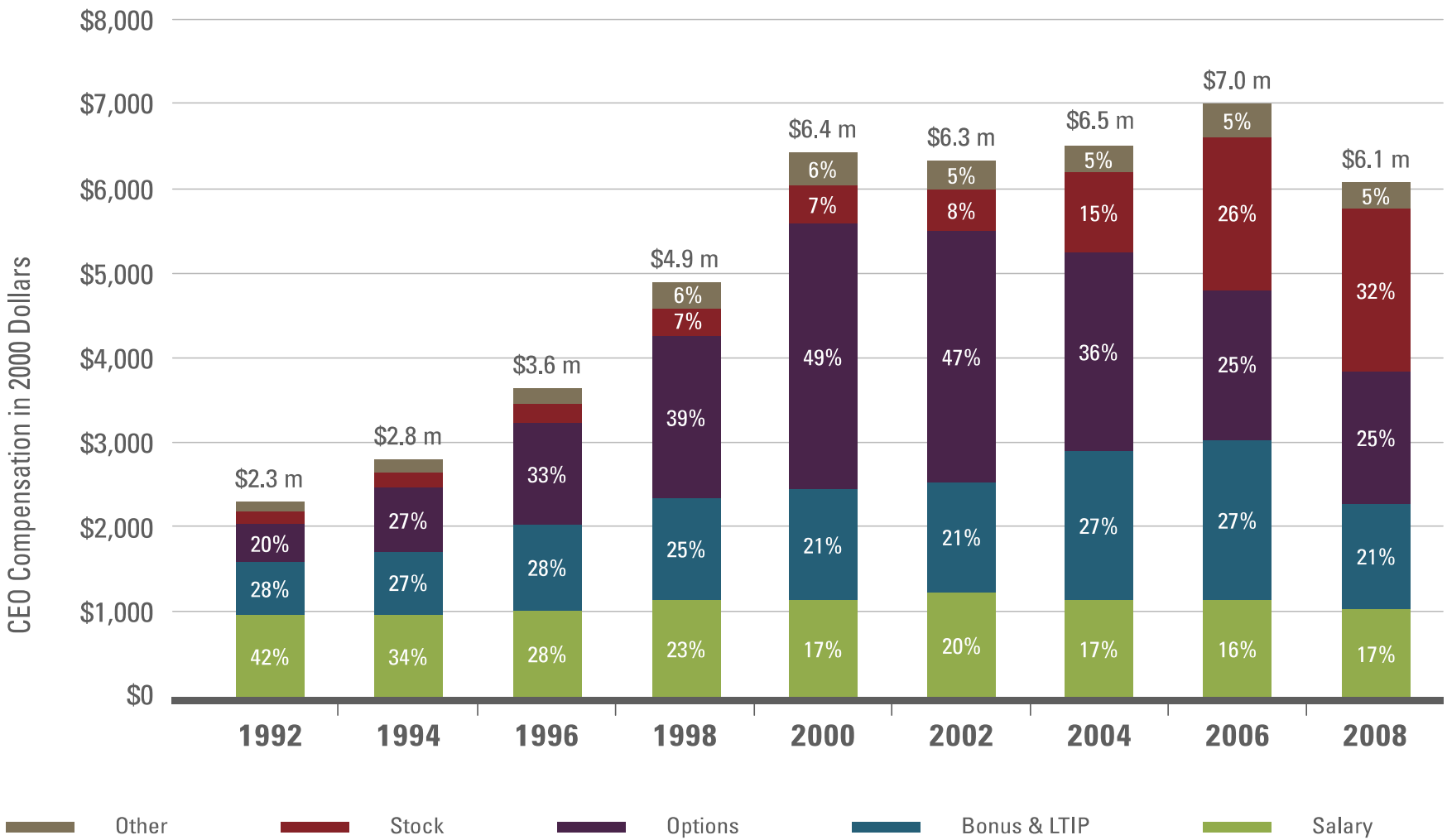


Figure 5

The Structure of CEO Compensation from 1992-2008 – S&P 500

(In Constant 2000$)

SOURCE: FRYDMAN AND JENTER, 2010



Egregious compensation in the financial sector

***The 25 best paid hedge fund managers* earned in 2010 a total of U.S. $22.1 *billion with $350 million the minimum earnings* to get on this list.**

At the head of the class, John Paulson earned $4.9 billion; it would take someone earning a decent income of $100,000 *some 50,000 years* to earn what Paulson earned in a single year.

The collective pay-check of these 25 managers was *larger than the Gross Domestic Product of 75 countries* on the World Bank's list of 178 countries…

… and *three times the total compensation of all CEOs of the S&P 500 companies (themselves under heavy fire for their "excessive" pay packages!).*

The Wages of Failure

Le salaire de la faillite

Source: Lucian A. Bebchuk, Alma Cohen, and Holger Spamann, février 2010

TABLE 4: TOTAL CASH FLOWS FROM BONUSES AND EQUITY SALES 2000-2008

	Bear Stearns		Lehman	
	CEO	Executives 2-5*	CEO	Executives 2-5*
Bonus	$88MM	$239MM	$62MM	$102MM
Sales of shares	$289MM	$817MM	$461MM	$389MM
TOTAL	**$378 MM**	**$1,074MM**	**$523MM**	**$492MM**
Total Top-5	**$1,452MM**		**$1,014MM**	

What is to be done to deal with the immediate causes of the 2008 fiasco?

1. Re-design incentive systems for all financial players;
2. Review the applicability of *mark-to-market* accounting principles;
3. Once the volume of transactions for any type of over-the-counter derivatives reaches a threshold, move them to clearing houses or exchanges;
4. Review the role of credit rating agencies;
5. Certify new financial products;
6. Prohibit ***naked OTC derivative*** products, at least on the credit derivative swaps;
7. Curtail ***naked*** short selling of stocks, re-instate the uptick rule where it was abandoned, and control other forms of short selling;
8. Reassess the investment latitude of pension funds.

What has been done two (soon three) years later!

1. **Re-design variable pay systems for financial institutions**...*Little, except where the U.S. Government has put money; the G20 adopted some proposals to control in some way bonus payments to traders and other finance executives..Commitment to guidelines (directives in the EU) about performance-liked compensation and deferred payment at G20 meeting; Dodd-Frank dumps responsibility on the SEC, stipulates on situations where claw-back of compensation will be obligatory.*
2. **Review the applicability of *mark-to-market* accounting principles..***Under pressure by banks, the accounting boards have modified the rules to relax its application*
3. **Once the volume of transactions for any type of over-the-counter derivatives reaches a threshold, move them to clearing houses or exchanges**; *...some proposal for a reform of this type, is in process; G20 meeting proposes that standardized derivatives be traded on exchanges and clearing houses; non-standard ones be subjected to greater capital requirements;*
4. ***Review the* role of credit rating agencies**...*Not much achieved; still a work in progress; SEC granted oversight in the U.S.; Dodd-Frank calls for more transpoarency and better control of conflicts of interest; removed the obligation for institutional investors to limit their investments to issues rated Investment Grade Rating by these NRSO*
5. Prohibit ***naked OTC derivative*** products, at least on the credit derivative swaps; *almost made it into Dodd-Frank; was pulled out at the last minute;*
6. **Certify new financial products and regulate hedge funds...** *Not much has changed, except for some registration of hedge funds with the SEC;*
7. **Curtail naked short selling of stocks, re-instate the uptick rule where it was abandoned, and control other forms of short selling***; ..no short sale if current price is lower by 10% or more than the closing price on the previous day; not much else..*
8. **Reassess the investment latitude of pension funds**; *Nothing, not even discussed*

How and when the Board of a Financial Institution could play a useful role?

1. Re-design variable pay systems for financial institutions...**YES indeed.**
2. Review the applicability of *mark-to-market* accounting principles **SOMEWHAT-already modified.**
3. *Review the* role of credit rating agencies...***within their institution*** **CERTAINLY.**
4. Certify new financial products...**or set policy on financial product innovation; put the burden of proof on the *innovator.***
5. Reassess the investment latitude of pension funds; ***review the level and type of alternative investments; question the use and compensation of hedge funds and private equity funds.***

How and when the Board of a Financial Institution could play a useful role?

- Make sure the institution has the system and capability to pull together in one place all relevant early-warning information and the ability to connect the dots (i.e. the correlation between seemingly independent phenomena).
- Management should present their overall view of the state of the financial system to the board and its risk committee with appropriate recommendations for action.

How and when the Board could play a useful role?

- **Organizations should not become more complex than what its governance can handle;**
- **Boards of directors should be wary of incremental complexity which may overwhelm their ability to govern;** that is the lesson of the recent failure of American and European banking institutions. Their complexity had become such that it overwhelmed their governance (and too often, their senior management).
- **Organizations dedicated to complex and risky investment strategies must have an ownership structure and governance system appropriate to their mission.**

But the Fundamental Causes of Repeated Financial Crises Have to Be Addressed

What is required is nothing less than a new capitalism, a capitalism ***based on forms of business ownership and management compensation to bring back:***

- *some level of trust and loyalty within and around companies,*
- *a long term perspective in their governance and management*
- *and due consideration of the stakeholders that give companies their legitimacy and purpose.*

What should be done?

- *Ownership and compensation matter!*
- *Institutional investors must behave!*
- *Management must behave!*
- *Governments must set a level-playing field.*

Ownership and compensation do matter!

Ownership of Canada's Largest 100 Companies (based on Revenues for 2008)

Source: data from Financial Post, compiled by author

State-owned corporations	13
Privately owned	11
Subsidiaries of foreign cies.	13
Cooperatives	3
Publicly traded with control through a class of shares with superior voting rights	12
Publicly traded with a controlling shareholder	7
Publicly traded and widely held	41

Ownership matters!
For Canadian Champions

The Conference Board of Canada identified ***some 43 Canadian companies in 2005 as "industrial champions"***

..with a significant position in their respective international markets and revenues in excess of $1 billion.

- Of these 43 companies:

  *T**hree** have already passed under foreign control.*

- Of the **forty** remaining "champions"

  - *Half are privately owned (6) or are controlled by a single (or related) shareholder (14).*

  - *Of these fourteen companies, nine (9) are controlled through a superior voting class of shares.*

What about the widely held corporation?

Fostering a more stable "ownership" by rewarding "loyal" shareholders:

- *One-year holding period before acquiring the right to vote;*
- *Rate increase for dividends after a given holding period;*
- *Decreasing capital tax rate as a function of holding period;*
- *An excise tax on stock transactions.*

(Some issues with « equality of treatment» clause of CBCA…)

Compensation matters!

Cutting the Gordian knot of compensation

- **Eliminate all tax benefits (personal and corporate) which favor stock options as a means of compensation.**

- **A more radical recommendation: eliminate all stock options as a form of compensation. We will get there eventually…**

(At the very least, stock-related incentives should play a decreasing role in the overall compensation of senior management)

- **Have boards of directors set a cap on the ratio of the CEO's total compensation to that of the median earnings within the firm.**

In setting this ratio, the board should be sensitive to the social, cultural and industrial circumstances within which the company operates.

If capitalisms are to be successful in the 21st century they are likely to be quite different from the models we are familiar with.

Hyman Minsky, 1992

In a global free market there is a variation on Gresham's law: bad capitalism tends to drive out good capitalism.

John Gray, *False Dawn, 1998*

Capitalism can give us the best of all possible worlds, but it does so only on a playing field where the government sets the rules and acts as referee.

George A. Akerlof and Robert J. Shiller,

Animal Spirits (2008)

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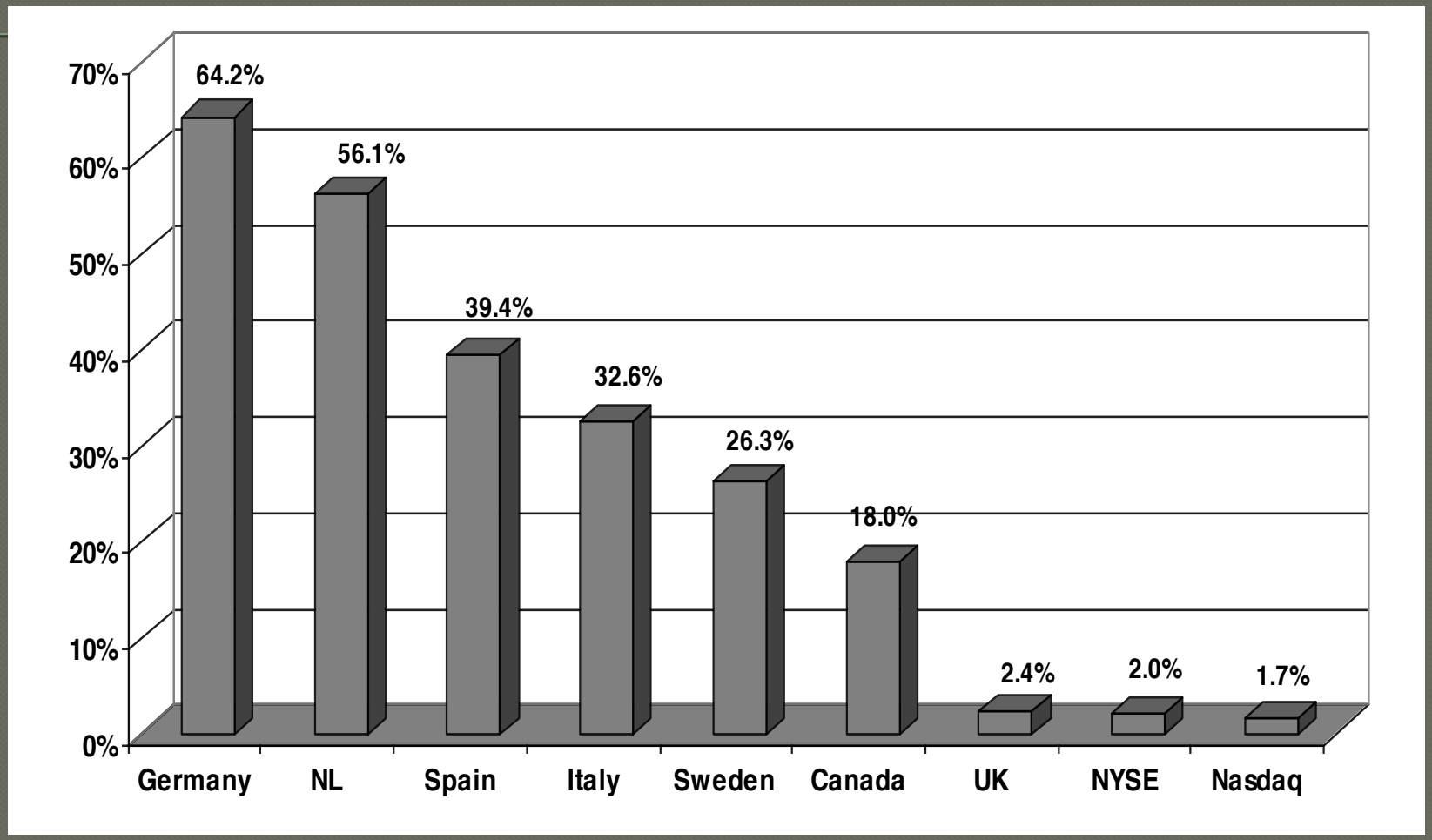
The independence of board members is not the philosopher's stone of "good" governance…

The real challenge : ensure that board members are *legitimate* and *credible.*

Allaire and Firsirotu, 2003, 2009

Importance of "controlled corporations in various societies



Sources : Barca and Becht (2001), The Control of Corporate Europe, OUP and Allaire (2008) for Canada (S&P/TSX).