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Corporate Governance and Financial Stability

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Abstract

The relationship between corporate governance and financial stability is an intermediate one. Firms have no obligation to take financial stability into account except when the law or the applicable regulation imposes it. In several fields this is the case: regulation of auditors or credit rating agencies are motivated by financial stability issues. Shortcomings in the governance of large financial and other groups have indicated that these may trigger systemic risks. The paper mention a few fields where – apart from regulations directly applicable to the firms that triggered the crisis - corporate governance rules should be strengthened to avoid systemic crisis to develop again: management remuneration, the role of the CEO and the composition of the boards, accounting and valuation issues are already on the political agenda. The paper leaves it open whether these provisions have to be introduced by way of hard law, and whether existing systems of soft regulation would suffice.

Corporate governance and financial stability[1]

Eddy Wymeersch

In the context of corporate governance discussions, financial stability has rarely been in the centre of preoccupations. Corporate governance and Financial stability is an odd couple: in a certain sense they seem incompatible, both in terms of objectives and in terms of method. However, there are some interesting complementarities.

1. Antinomy of terms of reference

"Corporate governance" relates to the interests of the stakeholders in a company, and to the functioning of the corporate bodies to serve these interests. Hence the horizon of the corporate governance debate remains constrained to the private interests of the parties involved, and does not include the public good that may be affected by company decisions. The question arises whether the public good should be pursued as part of the governance framework, diverting the corporate governance debate from the pursuit of the shareholders' interests. In the prevailing analysis, this is not the case: so for instance does governance analyse and take account of the creditors' interests, but the wider effects of a company failure on the general economic setting, on the employees or on the local community, is beyond the debate on the companies' governance. One could present this dichotomy as relating to public versus private interests, and to continental lawyers this will be identified in terms of public law versus private law. But we know that this legal division is one of principle, with many exceptions, and is not universally accepted.

There secondly is also a question of method and tools: depending on how one views corporate governance, much of the normative thinking has been set in terms of self-regulation, voluntary codes of conduct or other soft law instruments, with mainly market driven enforcement. Whether the pursuit of the public good, which is alien to the usual pattern of objectives of corporate governance, could take place by means of soft law instruments will be analysed later, but is far from self-explanatory.

2. Financial stability

What constitutes financial stability can best be defined in the terms used within the IMF[2]. In a well known paper, Schinasi, made the following analysis:

"Financial stability is defined in terms of its ability to facilitate and enhance economic processes, manage risks, and absorb shocks. Moreover, financial stability is considered a continuum: changeable over time and consistent with multiple combinations of the constituent elements of finance".

He further identified a small number of key principles that can be identified for developing a working definition of financial stability:

The first principle is that financial stability is a broad concept, encompassing the different aspects of finance (and the financial system)—infrastructure, institutions, and markets. Both

[1] Based on a presentation made at the Transatlantic Corporate Governance Dialogue, September 9, 2008, Brussels, see http://www.ecgi.org/tcgd/2008/presentations.php

[2] Garry J. SCHINASI, Defining financial stability, IMF, Working Paper, WP/04/187 (2004).

private and public persons participate in markets and in vital components of the financial infrastructure (including the legal system and official frameworks for financial regulation, supervision, and surveillance)

A second useful principle is that financial stability not only implies that finance adequately fulfills its role in allocating resources and risks, mobilizing savings, and facilitating wealth accumulation, development, and growth; it should also imply that the systems of payment throughout the economy function smoothly.

A third principle is that the concept of financial stability relates not only to the absence of actual financial crises but also to the ability of the financial system to limit, contain, and deal with the emergence of imbalances before they constitute a threat to itself or economic processes

A fourth important principle is that financial stability be couched in terms of the potential consequences for the real economy

3. Further analysis of the antinomy

The purpose of the present paper raises the question whether private companies should also take into account the general interest, especially as the latter would be likely to affect their own future. Should decisions of company directors only be driven by the interest of the shareholders, or of the "corporate entity" according to some legal systems[3], or should they also take into account the wider consequences of their decisions, on their competitors, on the markets, or on the economic or financial system in general? Should companies abstain from profitable but doubtful or unhealthy market conduct, on the basis that this will undermine confidence in the market in general, but may increase its profits?

When market participants sold short bank shares, eventually bringing down the bank, should they have abstained, not because this might have been qualified as "market abuse" – what it was not necessarily - but because it might have triggered a confidence, and hence a bank crisis? Ultimately, the market supervisors had to step in to avoid systemic difficulties.

When Merrill Lynch sold part of its portfolio at 20 cents to the dollar, it triggered value adjustments by many of their colleagues and competitors, eventually leading to a collapse of one of them: should Merril have looked only at its own balance sheet, or also have considered the effect on its colleagues?

Usually the answer to both questions will be: as long as there is no violation of the law, the conduct is permissible.

The above-mentioned conflicts occur of course all the time: the firm as a "nexus of conflicting interests" has been analysed by many leading legal academics[4]. Usually the conflict is solved by agreement and negotiation, while on subjects of public interest there will be an express legal provision. The public law holds the economic operators to a certain discipline, imposing it on all market participants, in order to maintain the often mentioned "level playing field". Equal treatment before these externally imposed burdens is essential,

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[3] This is the approach under Dutch law, art. 250, § 2, NBW according to which continuity of the firm belongs to the primary objectives of the firm: see WINTER - VAN SCHILFGAARDE, Van de BV en de NV, nr. 4, p. 11.

[4] Usually this analysis is referred to as the company constituting a "nexus of contracts": see J.M.M. MAIJER, Het belangenconflict in de naamloze vennootschap, 1964 en 25 jaren belangenconflict in de naamloze vennootschap, Kluwer 1989.

and will be maintained by the courts. There can be no doubt that firms have to abide by the rules that are imposed by the legislators and public authorities in the public interest.

A further question arises to what extent firms should be bound by other than these externally imposed legal duties, in other words whether they should abide by "etical" standards, or behave in a socially responsible way. To what extent are firms bound to respect interests that are not directly relevant to them, but may affect them indirectly, whether by loss of reputation, loss of confidence, loss of turnover, or broadening the range of risks, e.g. from litigation on the basis of some general principle. The debate about the corporate social responsibility (CSR) and its impact on corporate governance may be analysed from this angle. With CSR, not the proper interest of the firms is addressed - what still belongs to the regular scope of a board's decision making - but also the interests of affected third parties, of society in general, even those that are in no way connected to the firm's economic interest.

As far as financial stability is concerned, although a financial crisis is likely to be detrimental to the firm's interest[5], there seems to be no justification why firms should voluntarily adapt their behaviour to pursue financial stability or the interest of the economy as a whole. Firms can act egoistically, and usually do. This is the reason why the public authorities should intervene by enacting clear laws, directives, or other commands, and enforce them.

The objective of financial stability is different from other non-economic objectives such as "ethical conduct", "social responsibility", "ecological conduct" and so on[6]. In the latter case, the pursuit of the objective is also directly beneficial to the firm's reputation, its public image, its standing in the local community and therefore its attractiveness to a large segment of its clientele, or its shareholders. Ultimately, self-interest guides this type of action. More generally, should one not also pose the question whether corporate governance codes benefit the firm and enhance the return to shareholders? As is well documented the answer to this question is far from unidimensional: in terms of market returns, bad governance practices would usually result in lower returns, but it is not clear whether good governance practices will increase returns.

The financial stability objective is less elusive than e.g. social corporate responsibility. Essentially different is that there are both national and international institutions that have been put in charge defining the conditions and of analysing the threat to financial stability. They have received instruments to pursue this objective. At the national level, central banks usually are in charge of financial stability, explicitly or implicitly through their ability to act as lender of last resort. On an international basis, the international financial institutions (IFIs) and the international regulators (Basel Committee, IOSCO) have played an important role in identifying financial stability concerns and cooperate in the Financial Stability Forum (FSF) with the regulators' associations[7] and the main central banks. Among the instruments proposed for contributing to financial stability sometimes corporate governance tools are mentioned. This is quite different from CSR, where no clear political authority is exercised, and where the use of corporate governance instruments is based on a largely voluntary

[5] But the rule is not general: some firms are benefiting from the crisis, such as "vulture" funds, or short sellers.
[6] If regulation applies, the question becomes of course entirely different.
[7] The "Financial Stability Forum" (FSF) brings together senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. Among these: the Basel Committee, IOSCO, IAIS.

approach[8]. As to "ethics" the concept is usually too elusive to be considered a usable yardstick, at least in legal terms.

4. Corporate governance as a tool for achieving financial stability

I will here resist the temptation to enumerate the initiatives of the – global or regional - authorities in charge of financial stability, or to analyse the legal value of their decisions or recommendations, and of the instruments used to enforce these policies. The purpose of this paper is more to analyse the impact of the financial stability requirements of these institutions on the corporate governance mechanisms, and how corporate governance rules and regulations have become instruments at the service of financial stability.

Financial stability is an overall objective, which can be whether directly mandated, but usually materialises in intermediate objectives at the firm level, which translate at the macro level in a comprehensive financial stability objective. Bankruptcy rules support credit: they are formulated at the firm level, but ultimately serve to protect the confidence of creditors, and to avoid " first come first serve" conflicts among creditors, what would undermine stability.

Financial supervisors take specific action for ensuring the bank's individual stability – e.g. on liquidity -, but with systemic banks this will result in the pursuit of overall financial stability. Financial rescue operations aim not only at avoiding hardship on savers and depositors, but also if not primarily to avoid contagion and systemic collapse.

The same applies to corporate governance measures. Recently a considerable number of new governance requirements have been put forward with reference to financial stability. Each time, financial stability was not the immediate objective, this being the well functioning of the firm, especially for firms of systemic dimension, ultimately and on a collective basis contributing to overall financial stability. However, these requirements are not always proportional to the mere interests of the individual firm, as their justification would rely on wider public interests, in this case the interest of the overall economic and financial system. The question will arise whether boards of directors can be expected to act according to these requirements that are based on financial stability considerations, earmarking company funds for objectives that are only indirectly and remotely benefiting the firm, or may be even detrimental. Conversely, could directors be held liable for refusing to implement these requirements? Although the overall answer may be to the negative, each specific requirement has to be analysed on its own merits, as often the two levels of objectives will be very closely intertwined.

5. Overview of corporate governance measure relevant for financial stability

In this section a number of characteristic cases of corporate governance matters with specific systemic impact will be listed.

[8] Although several measures such as environmental information may have to be mentioned to publish in annual reports, according to the law of some jurisdictions; see Commission Recommendation 2001/453/EC of 30 May 2001 on the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies see e.g. Communication from the Commission implementing the partnership for growth and jobs: Making Europe a Pole of Excellence on Corporate Social Responsibility, 22 March 2006, Com(2006) 136, Final. In many jurisdictions, this type of information is not mandated.

a) The gatekeepers

A first series of measures relates to the "gatekeepers" that play an essential role in our financial system, more specifically the auditors and the credit rating agencies (CRA). In both cases, actions aim at creating trust in players essential for the smooth functioning of the markets. CRAs will certainly object to that analysis[9].

- the credit rating agencies

A series of measures relating to CRAs now tabled, both by IOSCO and by the European Union. The IOSCO approach is per definition a worldwide one, and being based on an agreement among the securities supervisors of the world, it is essentially based on a non-binding regulatory technique. Enforcement would rely on the individual supervisors' action. The EU's one is likely to be of a regulatory nature, being based on a recent proposal for a European directive or regulation.[10] As to substance, both work streams will be largely parallel. Both pursue to improve the reliability of the credit ratings as a core parameter in the investment process, avoiding any deviation from an objective, neutral and data based assessment of the debtor, and establishing its probability of default. Conflicts of interest, assurances as to the quality of the underlying assets, issues of adequate governance and staffing are among the items to be included[11]. By way of a side remark: would explicit regulation of credit ratings not support the reliance of the investing public, increasing the systemic nature of the ratings? And is it convincing to say that investors can use a rating, but should rely on their own risk assessment?

We should be reminded that in 2002 a similar effort was undertaken after the Enron debacle: the Sarbanes Oxley act put the auditing profession under public oversight. Although the population is less numerous and less diversified, a similar approach is likely to be followed for the CRAs. In both cases, imperatives of public policy have urged the legislators to intervene in the business model of these firms, as they had taken advantage of weak or inexistent self regulation to go beyond the boundaries on which public confidence in their profession was established. In each case the motivations was the public interest, aiming ultimately at fully and objectively informing the markets on the financial position of their clients and therefore avoid triggering a confidence crisis that might affect financial stability. In each of these regulations the corporate governance 'toolkit", along with external supervision, were called upon: composition of the board of the CRAs, rules on conflicts of interest, special monitoring by board members, use of soft law instruments in support, etc.[12] Rules and recommendations are enacted with a view of having these firms acting more professionally so that the markets can confidently rely on their judgment. It is only ultimately that financial stability comes into the picture, as being one of the triggers for re- regulating their activities.

- the auditors

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[9] At least before the present crisis they proposed their ratings as mere opinions on the probability of default, with any effect on wider issues.

[10] See EU Commission consultation on Rating agencies: ec.europa.eu/internal_market/consultations/2008/securities_agencies_en.htm

[11] For further details see: CESR's advice on Credit rating agencies: The role of credit rating agencies in structured Finance, CESR doc. 08-277, http://www.cesr-eu.org/index.php?page=groups&mac=0&id=43

[12] See the EU Commission's proposal on CRAs: nt. 8. i.a. on conflicts on interest.

Although the argument has been put forward with respect to the CRAs as well, for auditors there is another distinct line in the financial stability analysis, pointing to the detrimental consequences of a default of one of the remaining Big Four[13]. Elaborate studies have been made in this respect proposing different measures to incite the so-called "second league"-auditing firms to access the market for auditing services for the listed or public interest companies. Several approaches have been put forward. Opening up the auditing firms to external financing, changes in their board structure, strengthening the formation of young candidate auditors, or appointment of a joint auditor are among the remedies that have been put on the table. But much of the problem lies not on the offer, but on the demand side. Specific procedures upon appointment of new auditors by public interest firms are likely to contribute the most to these diversification efforts. It is important to note that these considerations are, at least indirectly, based on financial stability concerns: if one of the remaining four firms would fail, about 1/3 to ¼ of the listed companies in more developed economies would have to change auditor, leaving them for an intermediate period without external supervision on their accounts, creating continuity risks, and leading to even stronger concentration. Without analysing here possible scenarios, the disappearance of one of the big audit firms might affect confidence in the markets and lead in turn to negatively influence the valuation of the assets of the audited firms. If this would happen on a massive scale, stability in the markets is likely to be affected[14]. In several jurisdictions measures are being considered to deal with this matter[15].

b) The financial institutions

Financial institutions, mainly banks and investment banks, but increasingly also insurance firms and pension funds are being severely shaken this last year up to the point that systemic issues have urged the financial authorities to intervene in the markets.

In numerous cases, governance weaknesses or even deficiencies governance – some quite usual - have been pointed at as being the direct causes of the dismal performance of these firms: omnipotent CEOs[16], lack of authority of the board, no effective checks and balances, board members belonging to the same social network as the executives and handpicked by the CEO, insufficient banking knowledge in the board or lack, insufficient internal controls or absence of responsiveness of the board to internal warnings, weaknesses in risk assessment, etc., all contribute to explain why some of the largest, most sophisticated banks have so massively fallen in the pitfalls of the subprime crisis Any of aforementioned observations could be annotated by referring to one or more of the recent incidents[17]. The financial turmoil now seems to show sign of degenerating into a much-feared general economic crisis affecting

[13] These understood in terms of auditing firms.
[14] Although in the Enron case and the subsequent disappearance of Arthur Andersen, no systemic consequences have been noticed, the effects might have been different in a bear market.
[15] See Financial reporting Council: Choice in the UK Audit Market: Progress report and Further Consultation, May 2008; US Department of the Treasury, Advisory Committee on the Auditing Profession, May 5, 2008 (Draft report); Oxera Report, Ownership Rules of Audit Firms and their consequences for audit market concentration, October, 2007
[16] L. BEBCHUK, M. CREMERS, U. PEYER, CEO centrality, SSRN, 1030107, 2008 pointing at the negative effects of the presence of an overly strong CEO position.
[17] E.g. on the Northern Rock Affair, see House of Commons: The Run on the Rock, http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/918/918.pdf.
An easy to read summary of the events is found in: A. BRUMMER, The Crunch, The scandal of Northern Rock and the Escalating Credit crisis, 2008. See Also House of Commons Treasury Committee, The Run on the Rock, HMSO, London 2008.

the "real economy". Beyond strict financial stability, overall economic development is now at stake, and special issues relating to the position of creditors arise[18].

Recommendations and suggestions from international organisations abound and repeatedly refer to governance issues, both in establishing the causes of the present crisis, and for proposing remedies for the future.

The April 2008 report of the Financial Stability Forum[19], regrouping the world leading financial regulatory bodies pointed to the need to" maintain sound governance and control practices associated with valuation processes…"[20]. The adequate analysis of the risks at all levels of the firm (audit committee, external auditors, internal risk controls, internal models) are repeatedly stressed. Investors, industry representatives and auditors were invited "to develop principles that should form the basis for useful risk disclosures"[21] The Institute of International Finance[22], regrouping the lading bankers in the world, published an extensive guidance for the banking community clarifying principles like

> "Senior management, in particular the CEO, is responsible for risk management, under the direct oversight of the Board. Both should ensure that the firm has the proper focus on risk, which includes a clear definition of the firm's risk appetite and the constant monitoring of the risk profile in relation to such appetite".

The organisation of especially large financial groups has received special attention in a Basel Committee statement of Enhancing Corporate Governance for Banking Organisations,[23] dealing with what is often referred to as "Internal Governance". The list of the main recommendations illustrate standard principles of corporate governance

- . the corporate values, codes of conduct and other standards of appropriate behaviour and the system used to ensure compliance with them;
- • a well-articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured;
- • the clear assignment of responsibilities and decision-making authorities, incorporating a hierarchy of required approvals from individuals to the board of directors;
- • establishment of a mechanism for the interaction and cooperation among the board of directors, senior management and the auditors;
- • strong internal control systems, including internal and external audit functions, risk management functions independent of business lines, and other checks and balances;
- • special monitoring of risk exposures where conflicts of interest are likely to be particularly great, including business relationships with borrowers affiliated with the bank, large shareholders, senior management, or key decision-makers within the firm (e.g. traders);
- • the financial and managerial incentives to act in an appropriate manner offered to senior management, business line management and employees in the form of compensation, promotion and other recognition; and

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[18] D. HEREMANS, Corporate Governance Issues for Banks: A Financial Stability Perspective, SSRN, 1024693.
[19] Enhancing market and institutional resilience, 7 April 2008 http://www.fsforum.org/publications/r_0804.pdf
[20] Pt III.7. The Basel Committee is expected to issue guidance on valuation practices and processes and for reinforcing sound practices. The BCBS also recommends the adoption of the Group of Thirty December 2003 report on "enhancing Public Confidence in Financial reporting".
[21] Point III.2.
[22] Principles of Conduct and best Practice Recommendations, Financial Services Industry Response to the market Turmoil of 2007-2008, July 2008, http://www.iif.com/
[23] http://www.bis.org/publ/bcbs122.htm.

➢• appropriate information flows internally and to the public.

Interesting to note is that the statement expects that "The application of corporate governance standards in any jurisdiction will depend on relevant laws, regulations, codes and supervisory expectations". Especially the latter refer to supervisory practice, based on self-assessment and comply or explain. It allows for ample flexibility.

Although this paper does not refer to financial stability issues, it is clear that is also driven by general interest considerations.

Most of these actions are of a non-legal nature, and expect to be implemented at the national level, by the competent authorities, or by the financial institutions themselves. Whether implementation will take the form of hard law, or of recommendations, or other soft law instruments, is a matter of national choice. However, it should be recalled here that soft law instruments may later appear to have more teeth than originally expected, e.g. when in liability lawsuits the standard of conduct that is expected from management is analysed on the basis of a soft law statement. Formal endorsement by the board, or for some provisions even by the general meeting, would confer considerable strength to some of these recommendations.

6. The use of governance tools for alleviating the stability concerns

Can we, from a corporate governance perspective, draw some first lessons from the findings that are made in the numerous recent cases where financial institutions have run into considerable difficulties?

- *the incentives have to be rightly conceived*

A first lesson concerns the incentive structure: incentives are at the core of corporate governance. In the recent crisis, one sees that at all levels, incentives have been geared towards the short term, towards the immediate gain, without looking at the longer-term continuity of the firm. In the subprime crisis, there were many instances of potentially destructive incentives: the brokers, granting the mortgages, cashed their fees without, concern as to the solvency of the mortgage debtors. The originating and distributing banks sold the CDOs on the presumption that it was a true sale, without any further risk to the bank, but disregarding the contingent liabilities based on liquidity lines, or even mere reputation concerns. And the investors bought on the basis of flawed credit ratings, as the markets were very hot, and there was no time for even a semblance of a due diligence. The consequences are known: a major confidence crisis, grave risks to worldwide financial stability. In the absence of specific regulation, a better-balanced incentive structure might have protected both the banks, and the ultimate investors, and even the mortgage debtors who now are confronted with massive repossessions. The governance question could probably not have been solved with regulation. Should this type of monitoring by incentives rather not have been within the remit of the risk committees of the financial institutions involved? Should they not have taken responsibility for the toxic products their firms put on the markets[24]? And rather than the own short term bonuses of brokers, management and boards, should the long term risks not have

[24] One could compare with some type of product liability. It has even been suggested that new financial products – especially the more sophisticated one – should be subject to ex ante scrutiny and approval, as is the case for medical drugs.

been identified and analysed in great detail, and be included in the overall risk profile of the business. The longer terms interest of the banks should have run parallel with those of the markets in general, especially as far as financial stability is concerned.

The incentive structure of bank managers has been the subject of intense political debate in several EU member states. Often managers were incentivised on the basis of production, without regard to the quality of the products they delivered. It affects all echelons in the banks, up to the final salesperson. Managers have been severely criticized for excessive bonuses, especially those based on short term returns, or for "rewards for failure": remuneration committees composed of independent directors, who felt no strong responsibility if not indirectly interested in their own firm, relied on so-called experts, and let badly conceived incentive systems develop in the firms. Reliance on the wisdom of these committees may have been justified, but not their analysis of the effects of the incentives introduced. Incentives based remuneration, aligning the interests of managers and owners, looks very attractive in theory, but is destructive if it is linked to short term results of the firm. Some European states have taken action to limits the mode of calculation of severance payments[25]. The pressure from the public opinion is considerable: confidence in the leaders of financial institutions, and sometimes in the institutions themselves has been undermined. Politically, this situation is rather destabilising: one should not be astonished that in the eyes of the average politician, the legitimacy of bank management is damaged: causing a financial crisis every five to seven years – and this obviously at an accelerating pace - while grossly profiting from the good years but without suffering in the meagre years, constitutes such an imbalance that legislative initiatives will not surprise. A simple answer my be to require bonuses and similar forms of remuneration to be geared to long term returns, and e.g. that no rights will accrue unless five or so years after having been granted. Individual disclosure on the other hand was not the best idea: it merely leads to upwards competition.

Incentives issues are pervasive throughout the system: salespersons sell financial products on the basis, not of the needs of the investors, but on the basis of the fee to be earned. Conflicts of interest rules may in part help to deal with these cases: Mifid contains specific rules on conflicts at the level of the advisory function, and on inducements, both aimed at protecting the investor. But here again, fees should run parallel with achievements, and not be paid frond end.

In corporate governance terms: remuneration committees obviously have not found the right balance between long-term objectives of the firm and the remuneration of the managers. Most corporate governance codes do not contain sufficiently specific messages about the reasonableness of remunerations: among the exceptions one can mention the Tabaksblat Code, which in its revised form states:

- "a description of the specified and objectively quantifiable performance criteria on which the performance-related part of the variable remuneration is dependent;
- an account of the relationship between the chosen performance criteria and the strategic objectives applied;"

But here also, fees could be granted based on the short term results of the firm, creating the

[25] See France, art. 225-22-1, Code de commerce. In the Netherlands on a self regulatory basis in the Tabaksblat code, the remuneration upon dismissal is limited to one year salary. Disclosure on the remuneration would be considerably increased according to the 2008 proposed amendments. In Belgium, it is proposed to reduce the same item to 1,5 year. Other European states are preparing or have considered taking initiatives this field.

well known perverse bias.

New instruments will have to be devised to insure an acceptable balance, e.g. to ensure that incentives relate to the managers' long term achievements, and do not drive short term results, while there should not be rewards for failure.

- board composition

The composition of boards deserves analysis: board in general have not performed well during the present crisis. There might be a question about the composition of the board, a matter that in the past has focused too much on conflicts of interest, fiduciary duties and similar monitoring ideas but concentrated its intention too little on the business[26], and especially in banks on the risks involved in the transactions. Independent directors should not only be independent but first and foremost be knowledgeable: often their knowledge was not firm specific, their commitment too distant, their action non-committal. Boards have to be better balanced between executive and non-executive members, so that a fruitful exchange of ideas can take place between not one but several executives and the non-executives. Fully independent boards have insufficient feeling with the business, and may even be dangerous. The presence of the former CEO in the board – often criticized for understandable reasons of conflict of interest – in certain cases can be justified as he is the only non-executive to have intimate knowledge of the bank's activities. And non-executive directors should have a sufficient feeling for the social, political and legal environment in which the firm is functioning. More insiders on the board might also contribute to better performance, as empirical evidence related to private equity illustrates[27].

- The CEO

The issue of the all-powerful CEO has so many times been denounced in literature: examples of value-destructive CEOs abound and not only in the financial sector. The monitoring board, often composed of members handpicked by the CEO, has been insufficient to keep overactive CEOs in check. In the upturn, directors became somnolent as the results improved from quarter to quarter, but these are the times when the foundations are laid for future disaster. Often directors have no sufficient understanding of the luring pitfalls, and merely applaud the expanding CEO. If they obtain options, or bonuses in whatever form their position is tainted with a serious conflict of interest. The remuneration of directors therefore also deserves attention. The role of the CEO is a matter of checks and balances: too powerful CEOs, or chairs are a potential danger to the firm, and directors should be urged look for instruments for better balancing the board's composition and functioning.

The past year has been a bad year for them, creating the need for instant succession: but planning was often inexistent.

- board and management

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[26] When board of Northern Rock was criticized for not having been more critical the answer as: "the successful CEO should not be stopped". The increase in the volume of its business was exponential: see Run on the Rock, nt. 17, nrs. 18-19.

[27] Association of British Insurers, Governance and performance I Great Britain, Febr. 2008; HERMES, Corporate Governance & Performance, The Missing Links, Oct. 2007; KIM, W., BLACK, B., JANG, H. and 2006, Does corporate governance and affect firms' market values? Evidence from Korea, Journal of Law, Economics and Organization, 22, 366-413, SSRN 311275; GOMPERS, P., ISHII, J., and METRICK, A., Corporate governance and equity prices, Quarterly Journal of Economics 2003, 118, 107-155. SSRN, 278290.

The relationship between the board and the management should be analysed: boards necessarily have to rely on management for information and strategic insights, and it is the latter's duty to objectively inform the board. Although direct access to the different layers of the management may be divisive, separate meetings of the board with the top managers are necessary.

In some cases, managers are reported to have tried to call the board's attention to risky developments, and were not heard. They then opted for early retirement, of sick leave ! Whistle blowing mechanisms, as now exist in many companies, should not be restricted to the lower echelons, but board members should pay careful attention to signals from the leading managers with whom they not always have sufficient contacts, signals that are not always adequately transmitted by the CEO. As evidenced i.a. from the Northern Rock saga, these managers often point to concerns that go beyond the direct interest of the firm.

- Transparency

The call for banks and other financial institutions to be more transparent about their portfolios and about the valuations applied have been inspired, not by shareholder interests but by the wish of the financial regulators to restore confidence in the markets and put an end to the liquidity crisis. This reasoning was already present in the pillar III of the Basel II framework. It is now further rolled out by the banking supervisors within the Committee of Banking Supervisors (CEBS).

- accounting and valuation rules

The IFRS, being based on "fair value" have considerable effect on the financial statements of the financial institutions, and hence on their stability. In the recent crisis, some have argued that the accounting rules have in part to be held responsible for the successive downgrading of the bank's assets, especially as the existing rules did not provide a very convincing answer for the valuation of illiquid assets. The regulators have tried to alleviate some of these concerns staying within the IFRS "fair value" perspective: The Committee of European Banking Supervisors (CEBS) has identified a number of good practices disclosures on the business model, risk management and accounting and valuation policies. CEBS has provided clear guidance on these observed "good reporting practices". But the answer has to come from the IASB: IASB has created an advisory panel on the issue[28] and announced to take further action. Both SEC[29], the FASB and IASB[30] have declared that they will allow more flexibility. The European accounting rule was already stricter than the American one[31] and many financial institution plead for more flexibility in the application of fair value rules for the valuation of illiquid assets.

[28] See IASB.
[29] FASB, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, 9 October 2008, http://www.fasb.org/pdf/fsp_fas157-3.pdf; the SEC announced a widely framed "Study of Mark to Market Accounting" October 8, 2008.
[30] IASB, Next steps in response to the credit crisis 3 October 2008 and 9 October 2009: Trustees support Accelerated steps on the crisis. Both deals i.a. with reclassification under IAS 39. http://www.iasb.org/News/Press+Releases/IASB+announces+next+steps+in+response+to+credit+crisis.htm.
[31] E.g. on the reclassification of assets held "available for sale". The Commission has announced that, pursuing the decision of the Council, it will come forward with changes allowing more flexibility in some of the rules, without leaving the fundamental hypothesis of "fair value".

In actual practice, the approval of the annual accounts and hence of the accounting rules as effectively applied is a competence of the board, acting on the opinion of the auditor. It is not clear that boards always have a good understanding of the hypothesis on which the valuations have been based and hence fully understand the issues involved. A recommendation that a certain number of board members should have a good understanding of valuation and accounting issues, and if not, that members should undertake additional formation, seems therefore more than necessary.

Probably linked to the former subject is the work on pro-cyclicality, and hence whether financial institutions could take measure to counteract the effect of the economic cycle. Fine-tuning within the financial institution may have to be reviewed as part of the Pillar II of the CRD. Although being of considerable interest from a systemic point of view, anticyclical measures would also contribute to the stability of the individual firm[32].

- the shareholders

The shareholders have been the major corporate victims of the present crisis: apart from a heavy loss of market value, strong dilution has been their fate. Evidently, shareholders are expected to bear the brunt of any crisis. But they should be treated fairly: information has often been scant to inexistent, and driven by the urgency of action, boards have neglected to take measures to avoid dilution. Markets have reacted negatively, contributing to a further loss in value and in confidence. Boards' fiduciary duties towards shareholders also include keeping them correctly informed and allowing them to take part in crucial corporate decision making.

To add insult to injury, in the rescue operations shareholders have been badly hurt by governments deciding on the disposition of the banks in difficulties.

-Wider corporate governance issues

In these cases of banks in difficulties, the relationship with the subject of corporate governance relates to the general obligations of financial institutions, of the boards to ensure the adequate applications of the rules and put in place the necessary instruments and procedures to achieve full and timely application. It is up to the internal governance of a financial institution to ensure these objectives to be met. This obligation is not substantially different from any other obligation imposed by the law, or by the public authorities. Different would be the follow up which is closely monitored and reviewed, while financial stability concerns lead to dramatic intervention of the state as guarantor of financial stability. The absence of any legal framework within which these intervention take place, and their relationship to the corporate governance and company law rules, should be remedied.

A somewhat different topic relates to the regulations applicable to other financial institutions that might have a systemic impact: hedge funds are to be especially mentioned under this heading, although other investment vehicles may, depending on their volume or their activity, trigger similar shocks and endanger financial stability: the LTCM affair reminds us of these concerns. Most of these funds are unregulated, being organised according to private law rules. They cannot be directly addressed by existing regulations. The governance and management of the funds are essentially matters agreed between the partners in the funds, and remain

[32] A working group of the EU Council has been created on this issue.

largely unknown to the outside world. However, as the importance of these funds have significantly increased, it was necessary to drawn up a series of self-regulatory provisions. The Hedge Fund Working Group published a series of standards in January 2008[33]. It is interesting to mention that the report accompanying the standards repeatedly refer to financial stability as one of the concerns in drawing up the standards. Taking into account the particular position of size and influence, and accordingly of concentration, the report calls attention to the concentration of risks and the potential for such concentration to be unwound in periods of stress. In the absence of disclosed information, it is essential to be able to locate and measure the position of firms and in aggregation, moreover as these positions can be quickly transferred. The funds consider that the supervisors should rather have confidence in the robustness of risk frameworks, and understand how the funds thinks about these risks, how they measure them and control or manage them. The report emphasizes that the "framework of risk management is also important for the broader public interest."

These provisions will not always suffice to bring hedge funds or similar vehicles to behave in a sense that is compatible with financial stability. Therefore government action will be necessary: this was the case when the market supervisors first in the US and in the UK, and then all over Europe, imposed restrictions to prevent fund managers to short shares of a certain number of financial institutions[34]. By shorting these shares, so went the reasoning, the shares plunged, undermining the confidence in the bank. Not only shareholders, but creditors as well have been scared out of the bank, leading to a systemic issue. These measures has been heavily criticised, but contributed to at least reduce some short term alleviating of the downward pressure on the share price.

Conclusion

The relationship between corporate governance and financial stability is an indirect one, as the stability of firms and markets are essential elements for maintaining financial stability. Corporate governance tools do contribute to the intermediate objectives at the firm level, but not directly to financial stability.
Reforms are being considered that are directly driven by stability concerns: these relate to the auditors and the credit rating agencies, both crucial gatekeepers in the financial system.
More generally however, the present crisis has brought to light several weaknesses in the governance mechanisms. A rethinking is necessary resulting in a thorough adaptation of the corporate governance provisions.

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[33] Hedge Fund Standards, Final report, January 2008 http://www.mondovisione.com/pdf/HFWG%20FINAL%20REPORT[1].pdf

[34] See for the US, statement of October 1, 2008, listing the different measures taken, http://www.sec.gov/news/press/2008/2008-235.htm; and for the UK: http://www.fsa.gov.uk/pubs/handbook/instrument2_2008_50.pdf. Similar measures have been taken by most of the EU regulators: e.g. France: Ventes à découvert: Interdiction des transactions non sécurisées et transparence des positions courtes sur titres du secteur financier, 19 September 2008, http://www.amf-france.org/documents/general/8421_1.pdf

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