

The truly toxic combination

Ivan Png

993 words

7 October 2008

Straits Times

MORAL hazard in banking is nothing new. In the 1980s, Citibank and other major banks were saddled with mountains of bad Latin American loans. The story of how that occurred was essentially the same as that underlying the recent sub-prime explosion: lend and get bonuses now; worry about risks later.

Even the most famous financial institutions do not seem to learn from their past mistakes. Why? The fundamental problem is moral hazard coupled with imperfect corporate governance.

Investment banks and commercial banks need huge amounts of capital. They draw investments from many sources: institutional investors - such as pension funds, mutual funds and sovereign wealth funds - as well as individual investors like you and me.

Every investor in Merrill Lynch, say - whether it is Temasek Holdings or you - is part-owner of the institution. However, most shareholders, owning relatively small numbers of shares, would not participate actively in the management of the business. So there is inevitably a separation of ownership from management. Indeed, that is the essence of the modern corporation.

What bridges that separation? The solution in corporate law is the board of directors. The board is elected by and represents shareholders to oversee and direct the management. But academic studies have shown repeatedly that corporate boards are ineffective.

Consider, for example, Lehman Brothers. What did its board do as it veered towards collapse over the last 12 months? Earlier, while the bank was piling up leverage and derivatives, where was the board?

Lehman's board, before it filed for bankruptcy, consisted of 10 persons, including chief executive officer (CEO) Richard Fuld, who doubled as chairman. Two were over 80 years old, and three were between 74 and 77, including Broadway producer Roger Berlind. Another director had headed the Red Cross, and prior to that, the Girl Scouts. Neither Broadway nor the Girl Scouts are obvious training grounds to learn about managing leverage or CDOs (collateralised debt obligations) and CDSs (credit default swaps).

It is that combination of moral hazard with ineffective corporate governance

that is truly toxic - more so than the CDOs, CDSs and other derivatives themselves.

To earn their commissions, bonuses, profit shares and so on, management must bring in more business and more profit. But, surely, more business and more profit imply more risks? There are the risks of not being able to renew funding and of the additional customers not being creditworthy.

The incentive of managers is to downplay the risk, so that their bosses would approve the additional business. This same incentive to downplay risks spirals upward, all the way up to the CEOs. If the board of directors is not effectively overseeing the CEO, then the buck - literally - passes to the shareholders.

If the board of directors is not effectively overseeing the management of a financial institution, who is? There are two possible answers. One is rating agencies and the other is regulators.

Investors, lenders and other stakeholders look to the ratings agencies - Moody's, Standard and Poor's and Fitch - for objective and independent information about financial institutions and the securities that they issue. As their names suggest, ratings agencies assess financial institutions and securities and make an assessment of the likelihood of default. They assign a rating accordingly.

However, the ratings process is beset with moral hazard. It is the financial institutions that issue the securities who pay the ratings agencies to rate the securities. Recall the saying: 'He who pays the piper calls the tune.'

Financial institutions are known to negotiate with ratings agencies to optimise their ratings. They would try to squeeze through the riskiest (hence, most profitable) loans and derivatives without affecting their credit ratings.

Furthermore, ratings agencies are slow to react. In a recent study, the US Securities and Exchange Commission (SEC) concluded that ratings agencies were less effective in follow-up monitoring than during the issuance period. This reinforces the incentive of financial institutions to hide the bad news until later, while taking commissions and bonuses now.

The other possible overseer of management is regulators. But investment banks such as Bear Stearns and Lehman Brothers were investment banks precisely so as to avoid the tough regulation meted out to commercial banks. Notably, in April 2004, the SEC decided to exempt the five largest investment banks - Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley from a rule limiting their leverage.

The American International Group (AIG) was an even stranger beast. It was not even an investment bank. Yet it built up businesses in credit default swaps and

other derivatives that were so big that the US government had to rescue it with public funds. Indeed, it was too big to fail.

This leads to the most serious moral hazard: If the government continues to rescue big corporations or investment banks that over-leverage, then they will be encouraged to take on more risk, not less.

Indeed, cynics remarked that Lehman CEO Fuld's big mistake was not that he had taken on too much risk. Rather, it was that he had not taken on enough. If Lehman's involvement in CDOs, CDSs, and other derivatives had resembled AIG's in scale and complexity, US Treasury Secretary Henry Paulson would have been forced to rescue Lehman as he did AIG.

Mr Fuld reportedly received almost US\$500 million (S\$730 million) in total compensation between 1993 and 2007. He has lost his job at Lehman, but he is far from being down and out.

Heads, I win; tails, you lose.

The writer is the Lim Kim San Professor of Business Policy, and Professor of Information Systems and Economics at the National University of Singapore. This is the third of ten articles in the ST-NUS Business School series on the financial crisis.

Even the most famous financial institutions do not seem to learn from their past mistakes. Why? The fundamental problem is moral hazard coupled with imperfect corporate governance.