The Political Economy of Corporate Governance

Anat Admati

Stanford Graduate School of Business

Center on Democracy, Development, and the Rule of Law (CDDRL)
Stanford University
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"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."

Governance Questions For All Institutions

Is the outcome "socially efficient?"

Corporations: Key Features

Abstract legal entities

Separate from stakeholders

Derive existence and legal rights from governments

- ✓ Property rights
- ✓ “Locked in” capital
- ✓ Limited liability
- ✓ Political speech (?)
- ✓ Religious (?)

Some History

17th -18th centuries

- ✓ Dutch East India (VOC) (inc. 1602), British East India, French Mississippi Company

End of 19th century US

- ✓ Infrastructure projects

Banks were late to become limited liability corporations

Standard View of Corporate Governance

Corporations “owned” by shareholders

Main governance challenge:

✓ Align managers with shareholders

- + Financialized compensation
  - **Stock value**
  - **Accounting profits**
  - **Return on Equity,**
- + Takeovers (“market for control”)
- + Board role
- + Shareholder activism

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The social responsibility of managers is to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.

Milton Friedman, 1970

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In theory, the goal of the firm should be determined by the firm’s owners…. shareholders agree they are better off if managers maximize the value of their shares.

Corporate Finance, Berk and DeMarzo, 2016

”

I fell into the rabbit hole of banking.

Total Liabilities and Equity of Barclays 1992-07

Hyun Song Shin, "Global Banking Glut and Loan Risk Premium," IMF Annual Research Conference, November 10-11, 2011; Figure 22.

$380,000
DEBT
(MORTGAGE)
$20,000
EQUITY

+2.5%
DEBT
(MORTGAGE)
$30,000
$20,000
EQUITY

+5%
DEBT
$40,000
$20,000
EQUITY

+10%
DEBT
$60,000
$20,000
EQUITY

-2.5%
DEBT
$20,000
$10,000
EQUITY

-5%
DEBT
$20,000
$0

-10%
DEBT
$20,000
-$20,000

B.I.G. BANK
DEPOSITS
ATM

B.I.G. BANK
LONG TERM DEBT
OTHER DEBT
SHORT TERM DEBT
DEPOSITS
ATM

B.I.G. BANK
LONG TERM DEBT
OTHER DEBT
SHORT TERM DEBT
DEPOSITS
EQUITY
ATM

B.I.G.
BANK

Google
B.I.G.
BANK

AVERAGE
US
CORP
Google
B.I.G.
BANK

Financial Innovation in Recent Decades

“Shadow Banking” (Partial Picture!)

Pozsar, Adrian, Ashcraft and Boesky, 2010

JP Morgan Chase

Dec. 31, 2011 (in Billions of dollars)

Large Banks are Opaque

"Banking remains too much of a black box... for many investors scarcely an investible proposition."

Andrew Haldane, BoE, Nov 2011

"Investors can't understand the nature and quality of the assets and liabilities... The disclosure obfuscates more than it informs."

Kevin Warsh, Jan. 2013

"The unfathomable nature of banks' public accounts make it impossible to know which are actually risky or sound. Derivatives positions, in particular, are difficult for outside investors to parse."

Paul Singer, Jan. 2014

Regulatory Measures were Uninformative

"Tier 1" capital ratios: What crisis?

Market-based measures

From: Andrew Haldane, "Capital Discipline," January 2011)
(See also "The Law of the Opposite: Illusionary Profits in the Financial Sector," Godron Kerr)

The Mantra in Banking

"Equity is Expensive"

To whom?

Why?

Only in banking?

Zombie (Insolvent) Banks: Opaque and Dysfunctional

Unable to raise equity

"Gamble for resurrection"

Anxious to take cash out

Avoid equity

Sell assets, even at fire-sale prices

Underinvest in worthy "boring" assets

Try to hide insolvency in disclosures

Lobby policymakers for supports

Basel Capital Regulation
(No Science, manipulable measures)

Basel II	Basel III
"Common equity Tier 1 capital" to risk-weighted assets: 2%	"Common Equity Tier 1 Capital" to risk-weighted assets (RWA): **4.5%** » Plus 2.5% conservation buffer » Plus 1.5% "Tier 1" to RWA Leverage Ratio: "Tier 1" to total » Basel III: **3%** » US: **5-6%**
"Tier 2" Loss-absorbing debt	"Tier 2"/TLAC loss-absorbing debt.

Bad Regulations Matter
The Awful Case of Greece

BIS (2014), Company Data, EBA (For 2010-11 Greece Exposure Data), German Bankers Association, Morgan Stanley Research

Who Owned Greek Government Debt, July 2015

Leading creditors (in euros)

Source: Open Europe, BIS, IMF, ECB

Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulations: Why Bank Equity is Not Socially Expensive

August 2010

(revised 2013)

The Leverage Ratchet Effect

2013

(Forthcoming, *Journal of Finance*)

Anat Admati, Peter DeMarzo, Martin Hellwig and Paul Pfleiderer

https://www.gsb.stanford.edu/faculty-research/excessive-leverage

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US banks forced to hold $68 billion in extra capital.

Financial Times, April 8, 2014

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“

US banks forced to hold $68 billion in extra cash.

Telegraph., April 8, 2014

”

“

US bank old $68
billic ash

2014

FALSE

”

“

The Lobbying Cry

This rule will keep
billions out of the Economy

Tim Pawlenty, Financial Services Roundtable, July 2015

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Tim Pawlenty, Financial Services Roundtable, July 2015

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From Banking Textbook

Bank capital is costly because, the higher it is, the lower will be the return on equity for a given return on assets.

- Frederic S. Mishkin, 2013, The Economics of Money, Banking and Financial Markets, 3rd Edition, p. 227

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From Banking Textbook

Bank capital is co[illegible]use, the higher it is, the lower will [illegible]on equity for a give[illegible]sets.

FALSE

- Frederic S. Mishki[illegible]conomics of Money, Banking and Financial [illegible]ets, 3rd Edition, p. 227

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Is Basel III “Tough?”

Tripling the previous requirements sounds tough, but only if one fails to realize that tripling almost nothing does not give one very much.

Martin Wolf, *Financial Times*, Sep 13, 2010

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If **at least 15%** of banks’ total, non-risk-weighted, assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any.

Anat R. Admati, Franklin Allen, Richard Brealey, Michael Brennan, Markus K. Brunnermeier, Arnoud Boot, John H. Cochrane, Peter M. DeMarzo, Eugene F. Fama, Michael Fishman, Charles Goodhart , Martin F. Hellwig, Hayne Leland, Stewart C. Myers, Paul Pfleiderer, Jean Charles Rochet, Stephen A. Ross, William F. Sharpe, Chester S. Spatt, Anjan Thakor

Financial Times, November 9, 2010.

”

An open letter to JPMorgan Chase Board of Directors

Anat Admati, Jun 14, 2011

Dividends can wait until banks are stronger

By Anat Admati
Published: January 19 2011 22:59 | Last updated: January 19 2011 22:59

Last updated: February 16, 2011 5:09 pm

Only recapitalised banks should pay dividends

Share Author alerts Print Clip Gift Article

From Prof Anat R. Admati and others.

Fed Runs Scared With Boost to Bank Dividends: Anat R. Admati

By Anat R. Admati - Feb 24, 2011

Why the bank dividends are a bad idea

March 14, 2012 @ 4:35 pm

By Anat Admati

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How much capital? Enough so that it doesn't matter

John Cochrane, *Wall Street Journal*, March 1, 2013

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Because we have substantial self-funding with consumer deposits, we don’t have a lot of debt...

John Stumpf, Wells Fargo Bank CEO, 2013

”

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Because we h substantial self-funding wit er deposits, we don’ ot of debt...

John Stumpf, Wells Fargo Bank CEO, 2013

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It is difficult to get a man
to understand something
when his salary
depends on not understanding it.

Upton Sinclair, author

”

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It is difficult to get a politician
to understand something
when his campaign contribution
depends on not understanding it.

”

“

It is difficult to get a regulator
to understand something
when his future job
depends on not understanding it.

”

“

It is difficult to get a journalist to understand something when his access to news depends on not understanding it.

”

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Just about whatever anyone proposes… the banks will claim that it will restrict credit and harm the economy…. It’s all bullshit

Paul Volcker to Senator Ted Kaufman, 2010

”

Is More “Credit” Always Good for the Economy?

- Too much or too little in boom, bust, crises
- Wasteful investments in boom
- Credit booms are main predictors of bust and crises
- Debt overhangs in busts exacerbates recession

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Lobbying Cry Continues

This rule will keep
billions out of the Economy

Tim Pawlenty, Financial Services Roundtable, July 2015

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Lobby[illegible]ies

billi[illegible]nomy

NONSENSE

Tim Pawlenty, Financi[illegible]oundtable, July 2015

”

Where is the Courage to Act on the Banks?

Anat Admati, October 12, 2015
Bloomberg View

National Institute Economic Review No. 235 February 2016

THE MISSED OPPORTUNITY AND CHALLENGE OF CAPITAL REGULATION

Anat R. Admati*

The Bank of England must think again on systemic risk

FEBRUARY 14, 2016
by: John Vickers

Sir John Vickers: ‘Bank of England stress tests not tough enough’

10 January, 2017

“

Key Person on Economic Policy
(ex Goldman Sachs COO)

Banks are forced to hoard money because they are forced to hoard capital and they can’t take any risks.. Dodd Frank prohibits them from lending.

Gary Cohn, Director of National Economic Council, February 3, 2017

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Key Person on Economic Policy
(ex Go[illegible]s COO)

Banks are for[illegible]ey because they are fo[illegible]pital and they can’t take a[illegible] Frank prohibits them fr[illegible]ending.

Gary Cohn, Director of National Economic Council, February 3, 2017

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Alternative Facts”

Politics of Banking

Symbiosis and “bargains” banks-governments

- “Banks are where the money is”
- “National champions”
- Guarantees appear free, invisible social cost, willful blindness
- Central banks support governments and private banks
- Banks seem sources of funding, not risk

Banks get away with inefficient recklessness.

“

Banks are still the most powerful lobby on Capitol Hill. And they frankly own the place.

Senator Richard Durbin (D-Ill), 2009

”

Willful blindness
Many enablers
Misleading narratives

“It Takes a Village to Maintain a Dangerous Financial System,”
Anat Admati, in *Just Financial Markets: Finance in Just Society*, Lisa Herzog (ed.) OUP, 2017

Corporate Governance and Political Governance

Who are shareholders? what do they want?

Individuals or institutions?

What are their other investments?

Also employees or customers?

Ultimately citizens and taxpayers?

The Standard Approach to Corporate Governance…

Assumes

- ✓ All markets are “free and competitive”
- ✓ Contracts, “rules of society” and ethics protect non-shareholders
  - + Employees
  - + Customers
  - + Creditors
  - + The public

Ignores

- ✓ The messy process of writing and enforcing contracts and rules
- ✓ The role of corporations in shaping rules and enforcement
- ✓ Diffuse corporate responsibility
- ✓ Governance problems in government institutions, even in democracies.

Governance-Related Inefficiencies

Fraud

Volkswagen, Enron, Tyco, WorldCom, KPMG, Madoff, Wells Fargo

Endangerment

GM, Takata, Japanese nuclear industry, children's products (US), banking, Equifax

Other Law Evasion

Taxes, discrimination, environment

Monopoly Rents

Pharmaceuticals (US), auditing, rating agencies, tech

Deception

Tobacco, sugar, financial advisors, "fake news"

The inefficiencies cause real economic and other harm.

GM and the Flint Water Crisis

Grenfell Fire, London, June 14, 2017

Crisis was avoidable

Widespread failures in financial regulation

Breakdown in corporate governance

Explosive and excessive borrowing, lack of transparency

Government ill-prepared; responded inconsistently

Widespread breaches in accountability at all levels.

The New York Times

Wells Fargo Leaders Reaped Lavish Pay Even as Account Scandal Unfolded

By STACY COWLEY MARCH 16, 2017

CNBC

Banks have paid $321 billion in fines since the crisis (but they've made almost $1 trillion)

Jeff Cox | @JeffCoxCNBCcom

Published 8:27 AM ET Fri, 3 March 2017 | Updated 6:31 PM ET Fri, 3 March 2017

Political Discourse

Meaningless distinction

Laws

"essential"

Regulations

"costly"

Proper questions

Are cost and benefits private or social?

Are rules and their enforcement

- fair?
- cost-beneficial?

"

Those pontificating CEOs will bring back the iron fist of government bureaucrats.

Milton Friedman, 1970

"

Governments “vs” Markets?

Friedman’s False Contrast

Market

Government

Proper questions

- ✓ Which activities are best done by private sector vs public sector?
- ✓ How do we ensure that governments
  - +enable productive markets forces
  - +address market failures
  - +design and enforce effective rules
  - + promote fairness and justice

THE SHADOW LOBBYING COMPLEX

On paper; influence peddling has declined. In reality, it's just gone underground.

Official 2013 spending on lobbying: $3.2 billion.
The real total: an estimated $9 billion,
including unregistered lobbying.

The Nation.

Public Relations
Companies hire outside PR firms to influence policy.

Law Media Group represents the Aerospace Industries Alliance, which paid $1.3 million to stop defense cuts.

Glover Park Group received $2.9 million for advocacy work on behalf of the natural gas lobby.

Law Firms
Law firms lobby for changes in federal policy on behalf of clients.

SKDKnickerbocker represents TransCanada (seeking approval of the Keystone XL pipeline) and food marketers (seeking to curb Michelle Obama's anti-obesity initiative). **Key staff:** former White House communications director **Anita Dunn**. Salary: $1 million between 2008 and 2009

DLA Piper—the largest and most lucrative law firm in nation, earning $2.44 billion in 2012—represents major healthcare industry firms. **Key staff:** former senator **Tom Daschle**. Salary: unknown

In-House/Corporate PR
Companies frequently press their Washington agendas through in-house public affairs departments.

Deborah Lee James earned $1 million at SAIC, a major defense contractor, before being named secretary of the Air Force in 2013.

Catherine Ann Novelli earned $7.5 million at Apple before becoming under secretary of state for economic growth, energy and the environment in 2013.

Trade Associations
Groups that represent major industries spend millions per year on lobbying.

Biotechnology Industry Organization represents seed giant Monsanto and has spent millions to defeat GMO-labeling legislation nationwide. **CEO:** former representative **James C. Greenwood**. Salary: $1.48 million in 2010

Motion Picture Association of America pushes for legislation favorable to Hollywood, such as the failed 2012 SOPA-PIPA bills. **CEO:** former senator **Chris Dodd**. Salary: $3.3 million in 2012

Financial Services Roundtable lobbies on behalf of 100 of the largest financial services companies; worked to kill and then limit the impact of Dodd-Frank. **CEO:** former Minnesota governor **Tim Pawlenty**. Salary: $1.8 million in 2013

Astroturf/Policy Advocacy
Companies enlist groups that appear to be independent to push for policy changes.

Edelman hasn't registered as a lobbying firm since 2006. Clients include the American Petroleum Institute, which paid $52 million for websites and online advertising to promote the Keystone XL pipeline, tax breaks for the oil industry, and expanded access for drilling on public lands.

Bonner & Associates has clients that include the American Coalition for Clean Coal Electricity (ACCCE), which paid Bonner $43,500 to build grassroots opposition to the American Clean Energy and Security Act. It was later revealed that Bonner forged constituent letters to members of Congress. (In all, ACCCE spent $28 million on lobbying, only $2.2 million of which was reported as such.)

dhya Nagarajan for the Investigative Fund at The Nation Institute

Improving (Corporate) Governance: The Challenge

Create independent sources of information, effective whistleblower programs, etc.

Laws and enforcement tools for more individual accountability

Early intervention to prevent endangerment

- ✓ Analog of traffic rules

Public awareness and understanding

Ensure competition

- ✓ Market power means rent extraction and recklessness

Political accountability to prevent abuse of power in all institutions

Confusions and Politics: The Toxic Mix

I can't Afford to be HERE
99%
THE BEGINNING IS NEAR
Billions FOR Bombs + BANKS
Cuts
STOP Corporate GREED

Cross-Disciplinary Education: GSB Finance 332

A version for undergraduates (cross listed with four departments)

This interdisciplinary course explores how market and non-market forces shape the financial system and, through this system, affect the broad economy and society.

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Breaking Down Academic Silos: Stanford GSB Launches Corporations and Society Interdisciplinary Visitors Program

What do an adman and an investigative reporter have to teach faculty about corporations and society? Visiting experts challenge assumptions.

October 6, 2017

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Helen Chang
Associate Director of Communications
+1 (650) 723-3358
Email

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A Collective Action Problem

Role for Stanford?

- ✓ … through individual constituents?
- ✓ … as an institution?
- ✓ "Corporation and Society" proposal to university
  - + Break disciplinary silos in law, business, social sciences
  - + Enhance research and teaching on governance issues