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Abstract

Purpose — This paper is pre-occupied with how bank governance can be altered to reduce risk taking and engender greater financial stability.

Design/methodology/approach — Its approach is to review existing bank governance arrangements, contemporary challenges, and alternative reforms.

Findings — It is argued that recent reforms are incomplete. Greater countervailing incentives for bank managers and shareholders are required. This prompts an inquiry into the merits and demerits of four types of reform: changes to executive compensation arrangements; the introduction of a liability standard for directors; the removal of limited liability for bank shareholders; and a criminal offence for managers.

Originality/value — Discussion illumines several problems with the current approach to bank governance and provides insights that can help direct future reform.

Keywords Banking Law, Banking Reform, Banking Regulation, Corporate Governance

Paper type Research paper

1. Introduction

The parlous condition of markets makes protecting financial stability difficult. As regulators continue to disentangle the issues evinced by the financial crisis of 2007, circumstances appear to be outpacing reforms. The Federal Reserve and the Bank of England have commenced a program of rate rises, and global debt, the IMF reports in its Spring meeting (2018), currently stands at 225 per cent of global gross domestic product — 12 percentage points higher than at its previous peak in 2009. As to the future economic outlook, a brexit shaped fog obscures it. Since the financial crisis, much energy has been dispensed reforming structural regulation. Banks were especially pilloried for lacking the capital to absorb losses (Vickers, 2011; Admati, 2014). This helped catalyse adjustments to capital adequacy requirements to make banks more resilient to economic shocks. Another structural upheaval, commonly referred to as "ring-fencing", separates investment activities from core retail banking functions. Efforts have also been made to address the perceived problems in the levels of liquidity and insolvency laws. The overall tenor of the response is a familiar one. In the event of market failure, policymakers often engage in a regulatory arms race predicated on the belief that regulation is the only recourse. Structural regulations loaded with ingots of detail, however, are unlikely to sufficiently moderate market behaviour and improve cultural underpinnings. Indeed, a spate of recent scandals which include mis-selling, LIBOR (Wheatley, 2012), and FOREX aver the collapse of structural regulatory certainties. And in the specific case of ring-fencing, the policy is apt to *increase* the likelihood of failure within one part by concentrating riskier activities and losses. If risk taking is to be reduced and bank culture improved then part of the regulatory puzzle involves figuring out how to alter insider behaviour. This is the gravamen of corporate governance. And, while much ink has been spilled arguing over specific lines of regulation, less has been written about how bank governance should be transformed. This paper seeks to contribute to that particular conversation. It is divided into five principal sections. The first section introduces the conventional model of corporate governance. It shows that applying the model, without alteration, to banks is a grievous mistake. This drives the conclusion that banks are a special case and necessitate a governance approach capable of addressing the problems identified. The four proceeding parts explore areas ripe for reform: i) executive compensation; ii) the introduction of a liability rule for directors; iii) the removal of limited liability for bank shareholders; and iv) the UK criminal offence for reckless management.

2. Carrots and sticks

To understand where the direction of reform ought to be, it is important to begin by tracing where the problems in bank governance lie. Although there is a diversity of institutions of governance and business culture across developed economies, a great convergence has occurred on the basic laws governing the corporate form (Hansmann and Kraakman, 2002). There is, for example, a widespread consensus that managers should act in the economic interests of shareholders. And this shareholder-orientated model is supported by corporate law, international business, government, and elite institutions — with, perhaps, some show of reason. As with other types of firms, the separation of management and ownership in banks poses a classic agency problem. In the absence of effective governance mechanisms, managers are free to pursue their own private agenda, potentially at the expense of the firm's shareholders. Another view holds that managers are risk averse. This is because a bank manager's human capital, reputational capital, private benefits of control, and financial capital are typically highly un-diversified. Accordingly, bank failure could impose significant costs on the bank's management that would not be borne by its shareholders. Whichever view subscribed to the result is the same: managers deviate from shareholder interests. Hence, the importance of executive pay and a market for control. To focus managers on maximising investor wealth, and so that high venture projects with positive net present values are not rejected, managerial pay has been tethered to the performance of the share price. Indeed, prior to the financial crisis, bank executive pay comprised a substantial equity component, in particular stock options. It is easy to understand the pull of this policy: options act as a powerful "carrot" that aligns managerial and shareholder interests and risk preferences. The share price is an observable measure of performance that enables shareholders to hold ineffective managers to account. Maximising the stock price also, under several structured assumptions, enhances social welfare.

Despite its wide use, and endorsement in the academic literature (see, Jensen and Murphy, 1990; Nguyen and Kasper Nielsen, 2014), applying this approach to banks is problematic for several reasons. First, banking activities lack transparency. The complexity of financial assets mean that they are difficult to observe. Second, banks are highly levered firms. Banks transform short-term deposit liabilities into long-term illiquid loan assets. Deposit insurance provides a cheap source of debt which can be used to increase the value of put options. An exclusive focus on shareholder maximisation, as Jensen and Meckling (1976) explain, encourages excessive risk taking in highly levered firms. This is because shareholders are protected by limited liability from the full extent of losses, and yet are able to capture the full upside of risks. Therefore, the calculus of investment decisions only takes account of the upside. Another consequence of high levels of debt is that banks lack loss absorbency. This makes banks fragile and increases the possibility of failure. The fourth reason is deeper. When a bank fails, its negative externalities are considerable. These costs are heavily borne by taxpayers, who are unable to accurately price into their contracts with banks the costs the bank's default would impose. Failure disrupts the payment system and the credit allocation process, which can have systemic consequences. They are systemic because the damage is not confined to the financial system; it broadly impacts the economy through its effects on asset values and credit availability. Often, there is correlation between investment strategies which gives rise to the risk of contagion. Therefore, the failure of one firm may also call into question the viability of another invested in the same market. To avoid the costs associated with bank failure, governments during the crisis provided pre-emptive bailouts to the banking sector. This created an expectation that other financial institutions approaching the verge of insolvency could rely on the likelihood of financial assistance from the government. Anticipation of bank bailout further incentivises shareholders and managers to increase leverage and assume greater risk. These exceptional challenges caution the application of traditional governance to banks. The situation is otherwise leadenly skewed in favour of shareholders and managers. What comes through clearly here is the need to offset the incentives generated by the use of stock options—the "carrot"—with some form of contingent downside consequences—the "stick".

Post-crisis, reforms in bank governance have been largely leisurely and peripheral. Many interpreted the financial crisis as evidence that managers were inadequately focused on shareholder value. Guided by this interpretation, policy-makers and regulators, in their obduracy to fundamental change, showed a renewed commitment to the shareholder-orientated model. For example, the Basel Committee on Banking Supervision cites, with approval, in its Principles for Enhancing Corporate Governance (2010) the OECD's statement (2004) that 'Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.' Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010), which apply to any firm listed on a national US exchange, recasts disclosure requirements, introduce a mechanism for claw-backs, and mandates advisory "say-on-pay" votes to be held at least once every three years, as well as independent compensation committees. There are similarities with the reforms in the EU and UK. The EU fourth Capital Requirements Directive (CRD IV), aimed at all staff who hold senior management positions in banks, building societies, and investment firms, also, for instance, establishes clawbacks of variable compensation. Other features of CRD IV include a cap on variable pay, deferrals of variable compensation, and bonus structure requirements. Changes in the UK go further. In addition to the provisions of CRD IV, the UK Remuneration Code extends the deferral time horizon. It also prescribes that variable remuneration be risk-adjusted and employee performance assessed with regard to both financial and non-financial factors. That assessment must be based on the performance of the individual, business unit concerned, and the overall results of the firm. Proposed revisions to the UK Corporate Governance Code (FRC, 2017), which covers all companies with a premium listing of equity shares in the UK, once implemented, will furnish boards with the ability to overrule remuneration outcomes made by management. Remuneration committees will also have an expanded remit, with the new responsibility for oversight of company remuneration and broader workforce policies.

This paper is warm to measures such as claw-backs, and the mandating of deferred variable compensation. In particular, the suggestion from the UK Remuneration Code that risk-adjusted profits be used as the basis for bonus decisions is welcome. The general approach to bank governance, however, retains its flaws. To begin with, these reforms make managers more accountable to investors, and serve to prevent managers veering away from shareholder interests. This transmits an under-appreciation of the risk appetite of bank shareholders, who can carry on pressuring and inducing managers to take risks. If the goal is to reduce risk taking and help safeguard financial stability then granting shareholders additional control rights is unlikely to achieve this. Another problem concerns the over-reliance on the stock price as a measure for performance. For example, under CRD IV, at least 50 per cent of variable remuneration must consist of shares. The existence of clawback and deferral provisions do not alter the fact that market prices continue to steer the taking of risks that exploit the State's implicit guarantee. Without altering the performance metrics in executive pay, and the risk appetite of managers *and* shareholders, the situation will remain one-sided: both will seek to enrich their position at the expense of the State. What is more, regulatory prescriptions are not strictly a private corporate governance solution. Their efficacy depends on the ability of the regulator to effectively construct and administer suitable rules. The entrenched reliance on rules is considered a further weakness in the approach post-crisis. Rules need to be properly demarcated in advance, which is particularly difficult to do in this sector given the ambit of systemic externalities. Should the pre-specified scope be under-inclusive, issues of regulatory arbitrage risk becoming exacerbated. Perhaps then a more radical change to the bank governance aspic is required. Instead of opting to decrease the size of the "carrot" — which raises questions of equity and fairness in executive pay, and are outside the scope of this inquiry (see, Villiers, 2010; Kaplan, 2013) — the overarching approach promulgated in this paper is to seek the introduction of a "stick" to discourage excessive risk taking. This is the focus of the next four sections.

3. Executive compensation

As the previous section indicates, executive pay has come increasingly under the regulatory gaze. One of the problems that section identifies is the unflagging reliance on the price of stock, with which performance is judged by. Relatedly, the dominant use of stock options in executive remuneration packages, which shows little signs of relenting, klaxons concern. Acolytes of this approach will likely point to evidence of a positive correlation between performance related pay and shareholder return (Jensen and Murphy, 1990). But this is to miss the point. Compensation arrangements prior to the crisis produced a number of distortions. Managers were incentivised to increase short-term profits even if it created an unduly high risk of future large losses (Bebchuk and Fried, 2010). Much of the short-term growth was predicated on increased leverage, which resulted in greater capital fragility. Distorted compensation practices are moreover contiguous with a dysfunctional culture within a firm. In the case of the UK's PPI mis-selling scandal, the Financial Services Authority (2013, para.22) identify, in written evidence to the Parliamentary Commission on Banking Standards, an over zealous concern with targets and bonuses as a "root cause" of the mis-selling.

Support was signalled, in the preceding section, for the introduction of clawbacks. However, clawbacks, together with other recent measures, cannot adequately remedy the situation. The policy runs into several difficulties. For instance, it is hard to conjure a suitable metric for clawback purposes. Should clawbacks be tethered to the performance of stock then that threatens punitive action based on exogenous factors outside of managerial control. As a result, incentives may become compromised (*see further,* Gordon, 2009).

Equity-linked compensation then should be reduced as a percentage of overall remuneration packages. The proceeding question becomes one of metric selection. Several proposals show promise. One direction might be to use a broader view of firm value when determining compensation. Bebchuk and Spamann (2010) put forward a policy change of this kind. They propound that pay be indexed to a set percentage of the aggregate value of common shares, preferred shares, and all outstanding bonds. The anticipated benefits are two-fold. First, it would, by exposing managers to a greater fraction of the negative consequences of risks taken, lead to a more cautious approach to risk. Second, it would serve to better protect bondholders by obviating the redirection of wealth from bondholders to shareholders. An immediate problem encountered relates back to an earlier point made about the complexity of bank activity. Scores of bank liabilities are not stock-based. And of these, a considerable portion are not traded. It is therefore difficult to identify, with an acute degree of accuracy, the overall value of bank liabilities. How such a policy could adequately be written into regulations is uncertain. As Gordon (2010) highlights, it would require regulators to define the elements of the firm's capital structure that would be included in the compensation formula. This would, in turn, induce managers to vary the capital structure to maximise their compensation. The resulting balance sheet rearrangement may stimulate inefficiencies and fail to reduce systemic risk.

An alternative approach, proffered by Gordon (2010), involves awarding managers convertible equity-based pay. Upon certain external triggers, such as a downgrade into a high risk category by regulators or a deterioration in a key financial ratio, such stock-based compensation would turn into subordinated debt. Post the trigger event, managers would effectively work for bond holders. Tying managerial wealth to the firm has the advantage of giving managers an incentive to steer the firm away from financial distress. At least two problems emerge from this proposal. First, managers who near dangerously close to the conversion point may be encouraged to jettison caution and gamble. Second, due to State support, bond holders lack monitoring incentives and therefore cannot be suitably relied on to control risk.

A third option entails including in executive compensation contracts bond performance as well as share prices (Bolton et al, 2015). This approach augurs a closer alignment between managerial and creditor interests. Perhaps, though, too greater a convergence between these interests may transpire. And, as a result, managerial predilection with risk would be insufficient, potentially negatively impacting on the supply of credit. A further problem with this proposal is that usually bond values are much more influenced by market-wide interest rate changes than own-firm credit risk changes, and that an already fragile alternative measure of single-firm credit risk, credit default swap spreads, will be undercut by use as a regulatory device (Armour and Gordon, 2014; Lucas 1976).

The potential for incentive structures to alter behaviour is enormous and should not be under-appreciated. This section has considered different changes to managerial remuneration packages to redress some of the problems identified. While there are problems attached to these modifications, they are likely to produce marked improvements to incentives compared with existing arrangements. Regulators must, however, resist the temptation of belaying bank governance reform there. Such reform has its limits, and if regulatory alteration were to cease with executive compensation other issues would continue to imbue financial firms. The types of reform considered so far, moreover, are vulnerable to being weakened over time through indefatigable lobbying attempts by the affected financial firms (*see further*, Coffee, 2012). Greater deterrents are needed to adequately truncate excessive risk taking. This is what the remainder of the paper will concentrate on.

4. Director liability

Some preliminary remarks on liability are necessary. There exists an anxiety that excessive liability will deter risk taking in its entirety and lead to overly cautious investment strategies. This situation would not be satisfactory either. Economic welfare and an adequate allocation of resources rely on banks to take some risks — it is a matter of degree. The object is to safeguard against socially excessive risk taking not to place an embargo on it altogether. It is critical then to seek balance between liability exposure and rewards for risk taking. This frames the following discussion on proposed changes to liability structures.

Before the reform idea is introduced and its strengths considered, it is helpful to establish the current legal position when it comes to director and officer liability. Directors and officers benefit from the business judgment rule, which is accommodated in multiple jurisdictions. It protects such decision-makers from liability for breach of their duty of care, providing a business decision has been taken in good faith and on the basis of adequate information. The burden is on the plaintiff to present evidence to the contrary. The most commonly cited justification for the rule is to attenuate the problem of managerial reluctance to take risks, as described earlier. Chancellor Allen summarises this well in the case of *Gagliardi v Trifoods International, Inc.* (1996) in the Court of Chancery of Delaware:

> Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.

If this protection were to be removed then the warrant to take welfare enhancing risks reduces significantly. This drives the view that if business risk taking is to be encouraged, it must first be recognised that losses are, to some extent, inevitable. Hence, Chancellor Allen in *Gagliardi* goes on to say:

> If…corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky…their liability would be joint and several for the whole loss…Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on "negligence", "inattention", "waste", etc., could induce a board to avoid authorizing risky investment projects to any extent!

In the US, this approach has been formalised in the Delaware General Corporation Law §102(b)(7), which permits the waiver of liability for any breach of directors' duties not in bad faith. The decision of *re Caremark v International Inc. Derivative Litigation* (1996), made clear that directors do, however, have a continuing duty to ensure that "monitoring systems are in place". The case is of enormous interest; for present purposes attention is particularly drawn to two aspects. First, to satisfy this duty, it requires merely a "good faith attempt" to make sure that such monitoring systems are in place. Second, liability will only be faced if directors have, for example, "utterly failed" to implement oversight. In the UK, the Companies Act 2006 s.174 provides an objective duty of care for company directors. It has been observed that, in practice, there is a low probability of enforcement (FSA, Report on the Failure of RBS, 2011). And, imposing regulatory fines against the company is not particularly helpful in the case of banks. Due to the existence of capital requirements and the strenuous demands often made on banks' balance sheets, large financial penalties will impel greater fragility.

The failure to internalise the systemic risks in the financial sector, combined with the limited ways in which existing duties of care apply to directors and officers, has prompted Armour and Gordon (2014) to propose a regime of personal liability for oversight. This would consist of a review framework as well as an oversight framework. The former would create a duty for managers to address the conflicts of interest embedded in high-powered performance incentives through obtaining board-level review of risk taking that may give rise to systemic harms. As to the latter, the board would have oversight responsibility for the level of risk taking by the firm, including risk taking in operations together with strategy. Liability would be owed to the firm, and could be triggered by a shareholder action following the occurrence of significant losses. Their selected standard of liability is negligence-based. And, according to the proposal, courts would begin their assessments by evidencing industry practice, and proceed to consider whether the level of oversight precaution undertaken would be thought desirable by diversified shareholders. The measure of liability would be based on remuneration.

It is a proposal grounded in pre-federal deposit insurance US, where, in the event of insolvency, bank directors faced liability to creditors under, as it was commonly known as, the "trust fund" doctrine. The New York Court of Appeals in the case of *Hun v Cary* (1880), which held bank directors liable on a negligence standard, highlighted the vulnerability of depositors and the higher standard of care required for directors of a bank. But then, in 1933, the inception of federal deposit insurance catalysed the withdrawal of negligence liability for bank officers and directors.

The proposal has several merits. Chief among them is, appropriately structured, such liability should make agents behave less riskily. This is expected to occur, in part, through improved risk oversight. The board level review, tasked with investigating and understanding the level of risk attached to bank activities, promises to also determine appropriate risk parameters. Once established, continual oversight will ensure risk limits are not exceeded, and where necessary, trammel risk taking. The proposal also resolves an issue with deposit insurance. Its capacity to protect against systemic risk from bank failure only extends so far

— a point well made by Armour and Gordon (2014). In the case of the failure of large financial firms, deposit insurance is impotent to the ensuing financial disruption. An expanse of vulnerability thus exists. Out of the financial crisis, several mergers materialised. The financial system is, as a result, even more concentrated. And stability depends on a few financial monoliths perilously perched atop it. Director liability can help fill the space created by the exhausted capacity of deposit insurance to safeguard stability. Something else in the proposal's favour is, because enforcement is in the hands of private plaintiffs rather than regulators, opportunities for lobbying to undermine its efficacy are much reduced.

There is then a compelling *primie facie* case for introducing this sort of director and officer liability. But, probe a little deeper and several problems emerge. First, the imposition of liability gives currency to the concern articulated by Chancellor Allen in *Gagliardi*. Boards may opt to avoid authorising risky investment projects in their entirety. The second problem has two facets. On the one hand, it may produce strong disincentives for highly skilled and experienced individuals to accept director or officerships. And existing directors and officers may re-consider their positions and exit. A loss of talent will possibly hinder the understanding of risk and the future performance of the firm. On the other hand, while the threat of liability should, in theory, mitigate excessive risk taking, it may produce offsetting effects as well. In contrast to the first mentioned problem of risk aversion, individuals who remain in post or pursue such positions may actually have an undesirably *high* propensity for risk. The second tenable effect is that, in the presence of the proposed duties and oversight frameworks, investors and customers become complacent in monitoring and scrutinising the riskiness of the bank themselves. There will also be handicaps in determining, in a given situation, whether sufficient oversight precautions were undertaken — a likely point of fierce contention. While some instances where boards were deficient, such as in the case of loose internal controls that permit risk taking beyond agreed upon risk limits, are easily identified, others are considerably less clear cut. Another of these problems points towards the preserve of bank shareholders. Shareholders remain shielded from losses above their equity holding but favourably positioned to benefit from the up-side of excessive risks. This criticism does not, on its own, collapse the case for extended director liability. But it does show that reform should not stop there, otherwise it would still be incomplete. Something more is needed. And it is to that prospective option that this paper turns to next.

5. Shareholder liability

So far, this paper has considered reforms aimed at managers and directors. These, together with existing policy changes, can play a part in modifying their behaviour. However, there is one group yet to be adequately dealt with: shareholders. Recent measures enhance their powers. This is problematic. Currently, losses for shareholders are restricted to the equity held at the time of failure. In the absence of countervailing incentives for shareholders, their socially excessive risk appetite is also kept in a pristine state. Shareholders, as a result, are able to continue apace to pressure managers to take on more risks. For example, managers may be threatened with removal or loss of control if they reject risky projects that would increase the share price. Valorising this account further, Ferreira et al (2013) provide evidence that bank managers who were less insulted from their shareholders took on more risk. They also show that bank managers fully insulated from shareholders are roughly 18 to 26 percentage points less likely to be bailed out.

The above justifies an inquiry into ways of curtailing the risk preferences of bank shareholders. It has been suggested that the rule of limited liability should be removed for shareholders of the bank (Ridyard, 2013). Such a policy change has the benefit of being a market-based solution. Modifications to the liability structure should yield at least two desirable outcomes. First, additional liability exposure acts as a deterrent to excessive risk taking. Bank shareholders are impelled to reduce their risk appetite. If this bears out then they will be able to better monitor and control risk from a social welfare perspective. Second, in the event of failure, internalisation of the costs of failure increases through the additional costs imposed on shareholders.

The policy change takes flight from banking history. Between 1863 and 1935, US banks mostly operated on a system of double liability. Under double liability, shareholders of a failed bank were liable for the initial cost of their shares plus as much as the par value of their shares to cover the bank's losses. Evidence from this era supports the two projected outcomes of removing limited limited liability postulated earlier. Grossman (2001), for example, finds that banks subject to double liability held a lower proportion of risky assets, had higher capital and liquidity ratios, and were less likely to fail. And, in another study, Macey and Miller (1992) reveal that, based on the failures of national banks in the US during the regime of limited liability, depositors were suitably protected from losses: on average, for every $1000 in deposits in a given year, depositors lost just 44 cents.

Throughout the late 19th and early 20th century, the UK imposed additional liability on shareholders by having firms issue partly paid shares for less than their nominal value. Such shares carried contingent liability for the remaining uncalled capital which, at the discretion of managers, shareholders were liable for. In an illuminating work, Grossman and Imai (2013) find that prior to World War I, UK banks operating under stricter liability rules undertook less risk than those operating with lower levels of contingent liability. Put together, there is a strong argument in favour of reverting back to a system of contingent liability. But for this policy change to make sense, the costs and downside consequences must not dwarf its merits. This point will now be considered.

As to the implementation of contingent liability, in the US, courts co-operated with administrative agencies and legislatures to craft radiantly clear and easily applied rules to govern the administration of the system (Macey and Miller, 1992). Problems were, to all appearances, satisfactorily resolved. For example, the courts tackled opportunistic transfers to insolvent parties with relative ease, as can be seen in the case of National Bank v Case (1878). This is not to say it was a costless exercise. It was not. Substantial resources were necessary to detect and deal with evasion techniques, and penurious shareholders unable to meet assessments impacted on recovery rates and generated costs. How might recovery work today? The significant increase in the number of multi-national banks suggests enforcement will be more difficult. As Goodhart (2013) explains, so long as most banks only had a few wealthy owners, the system of double liability worked well; but once shareholding became widely distributed, both the quantum and timing of such extra funding became doubtful. There are also sophisticated means available to investors to obfuscate the recovery process, such as specialised holding structures. An approach similar to the one adopted in the US has been proffered (Ridyard, 2013) comprising legislative action and judicial decisions to establish enforcement mechanisms. Courts, as part of that proposal, are to have the authority to declare any efforts to evade additional liability within the corporate form invalid. Concerns over arbitraging the scope of recovery are therefore mitigated since standards will be developed by the courts *ex post*. Given the added complexities of addressing evasion and recovery, costs will inevitably swell. Sufficiently resourced, and such a framework becomes workable.

Changes to the liability structure produces a further concern: the cost of equity. In a regime of contingent liability, the marketability of shares will plausibly be adversely impacted. This may lead to a rise in the cost of equity. Conti-Brown (2011) rebuts this criticism by claiming that the cost of equity will more accurately reflect and internalise risk. Understand, market efficiency is a public good (Directive 2003/71/EC; US National Securities Market Improvement Act 1996). Currently, the extent of risk is arguably not fully impounded in the price. Rather, it mirrors the one-sided situation described earlier. Priced more accurately, the calculus to determine investment projects should include the wider social costs.

There is also a problem of political aesthetics. An instructive example is the case of the City of Glasgow bank. In October 1878, as one of the UK's largest banks, it collapsed leaving a chasm between its assets and liabilities (Acheson and Turner, 2008). That shortfall was met entirely by its shareholders, who, like many other British bank shareholders at the time, were subject to joint and several unlimited liability. The regime was effective in protecting the bank's depositors from loss: no depositor befell a loss. Shareholders, on the other hand, fared much worse with only 254 of its 1819 solvent after the bank's liquidation. This was seized upon by limited liability laity, such as *The Economist*, who, with dogged intensity called for an end to extended liability. Politicians too, helped transform public opinion on limited companies from one of hostility to one of acceptance (Acheson and Turner, 2008; Jefferys, 1977). And so, with an afflatus and the sweep of the legislative pen, the Companies Act 1879 was passed, which facilitated the conversion of banks to limited liability. In the recent financial crisis, governments prolapsed under pressure to financially backstop the banking sector. Contingent liability will only work if banks are shorn of the expectation of bailout. Governments must allow banks to fail and be willing to incur some of the costs of failure. Due to the special economic properties of banks, this forecast is not entirely certain. Nevertheless, the winds of change give reason for some degree of optimism. Recent rhetoric has signalled a commitment to ending bank bailouts. Mark Carney (2016) describes the Minimum Requirement for own funds and Eligible Liabilities (MREL), which is a requirement under the EU Bank Recovery and Resolution Directive, as a significant milestone on the journey to end Too Big To Fail in the UK. Similarly, in the US, House

Speaker Paul Ryan (2017) claims that the Financial Choice Act ends the era of taxpayer-funded bailouts and too big to fail.

Of course, resistance to this proposal will be considerable, and implementation costly. Investiture in the sacred status of limited liability, however, is misplaced. Contingent liability could be effective in deterring risk-taking and providing a cushion against losses, reducing State exposure.

6. Criminalisation

The dynamic in the post-crisis contaminated environment was public disapprobation: something must be done to change the culture of banks. The dearth of criminal prosecutions of bankers produced a perception of unfairness. Criminal law seemed to target small scale misconduct but disclaimed an interest in those responsible for the economic turmoil caused by the financial crisis. In the UK, the Parliamentary Commission on Banking Standards (PCBS) agreed, concluding in its report (June, 2013) that there is a strong case in principle for a new criminal offence of reckless misconduct in the management of a bank. Perhaps, in part to sate the public's appetite for retribution, the offence was introduced by section 34 of the Financial Service (Banking Reform) Act 2013. The UK Treasury eulogised the act, describing it as the 'biggest reform to the UK banking sector in a generation'. Four possible standards of liability for the offence were considered: recklessness, strict liability, incompetence, and negligence. Accordingly, a recklessness standard was deemed most appropriate. The offence applies only to senior managers — for the purposes of the act both executive and non-executive board members are viewed as "senior managers". It carries a maximum sentence following conviction of seven years imprisonment.

The offence reflects a more Hobbesian way of achieving norm compliance by using punitive repercussions. And the more ubiquitous the monitoring, so the theory runs, the likelier it is moral transgressions will be detected and punishment meted. The effectiveness of the sanction relies on the extent to which the deterrent is a *credible* one. If it is credible then the measure has latent behaviour-altering potential. But, this is where the question mark is finely poised. There are several factors that limit the efficacy of the offence. The first is a resource issue. Effective monitoring and supervision, as Black and Kershaw (2013) observe, need significant resources. Inevitably, there are asymmetries of knowledge, expertise, and resources between regulators and the regulated. Regulators, as a result, are put at a structural disadvantage. Resource constraints may also impact on enforcement. Regulators have finite resources and therefore have to prioritise, with great care, where those resources should be allocated. The cost barriers to enforcement are far from trivial, especially if the firm defends the individual. Plausibly, there will be instances, should resources be insufficient, when bringing an action is prohibitively expensive. With Brexit lurking, the pressures on regulator budgets are worsening. The FCA, for instance, in their 2018/19 annual business plan indicate that it has to make, 'difficult and challenging decisions about our priority activities across all business areas that are not related to work on EU withdrawal, including limiting the number of new initiatives we've taken on.' But, even if the coffers are full, the prospects of successful prosecution seem remote. This is because establishing liability for an individual is replete with difficulties. First, causation must be made out. Recall, banks are opaque and their activities complex. A myriad of reasons can often explain a bank failure. Isolating a senior manager's decision that *directly* resulted in firm failure is possibly an insurmountable task. Second, a related point, it is also necessary to prove that the senior manager was aware of the risk that the implementation of a decision may lead to bank failure. On this, delegated authority provides potential for avoidance. An additional limitation is also worth mentioning: for any investigation to commence a bank must first be allowed to "fail". In much the same way as the previous policy change, this involves removing the expectation of bank bailout. It remains to be seen whether, as a bank teeters on the brink of failure, government is able to resist the atavism to intervene with financial assistance.

Suppose convictions do become par for the course. This brings a different set of concerns to the fore. Conceivably, high conviction rates will render experienced and highly competent individuals reluctant to pursue, or continue to hold, senior management positions. It also threatens the adoption of an overly risk averse culture, which may vitiate the appeal of the UK's financial industry and impact on regulator behaviour.

The momentum for reform has not been entirely squandered. Other jurisdictions would do well to propagate a criminal offence of this kind. Despite the noted limitations, the criminal sanction, provided by the 2013 Act, transmits a message of closer regulatory scrutiny of the responsibilities of individuals. And, as the PCBS suggest in its report, it ought to 'give pause for thought to the senior officers of UK banks'. Punishment enthusiasts should not be too sanguine with their expectations, though. If John Coffee's regulatory sine curve (2012) plays out, and an upturn in the economy combines with a decline in public pressure, then there is a danger that the turmoil of the crisis becomes evanescent and a "light touch" approach returns.

7. Conclusion

This paper has shown that the current approach to bank governance is deficient in at least two ways. First, there is a preserved over-dependency on equity-linked metrics of performance. This is apt to induce excessive risk taking, particularly when stock options form a large part of managerial compensation packages. The second deficiency lies in the scant recognition of the unbridled risk hunger of bank shareholders. Bank shareholders are not yet a good proxy for societal interests, and therefore cannot be relied on to effectively monitor and control risks. This paper has attempted to remedy these deficiencies by exploring four types of reform that introduce various kinds of "sticks", with contingent downside consequences. The countervailing incentives produced suggest that such policy changes could compliment existing measures in discouraging excessive risk taking and helping to safeguard financial stability.

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