Corporations and Society

Anat Admati
George G.C Parker Professor of Finance and Economics, GSB

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Alumni Weekend
October 27, 2017

“Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders.”
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
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
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
ROE
Governance Questions For All Institutions

Who makes decisions on behalf of institutions?

What information and constraints do/should they have?

What are/should be their motivations?

Is the outcome “socially efficient?”
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 well-developed democracies.
Rules: Good or Bad?

Meaningless distinction

Laws “essential”

Regulations “costly”

Proper questions

✓ Are the costs and benefits private or social?

✓ Are rules and their enforcement

  + fair?

  + cost-beneficial?
Rules Need to be Written through a Political Process

Ideally
Un-conflicted experts design rules on behalf of the public

In reality, all too often
- Experts involved are conflicted
- Narrow interests win over broader interest
- “Thin political markets” prevail
  - *(Political Standards, Karthik Rammana)*
- Many forms of “capture”
Rules Need to be Enforced

**Ideally**
Rules are enforced effectively in the public interest

**In reality, all too often**
- Enforcement is ineffective and inconsistent.
- Diffuse responsibility, failed governance, and legal/political frictions allow individuals responsible for corporate misconduct or crimes to remain unaccountable.
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.
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
  + design and enforce effective rules to enable contracts and markets to work
  + promote fairness and justice
Governance-Related Inefficiencies

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

Deception
Tobacco, sugar, financial advisors, “fake news”

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

Monopoly Rents
Pharmaceuticals (US), auditing, rating agencies, tech

Other Law Evasion
Taxes, discrimination, environment

The inefficiencies cause real economic and other harm. They may arise in any organization.
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.
How Delaware Thrives as a Corporate Tax Haven

One Address in Delaware; 285,000 Corporations
General Motors ‘Murdered’ Our Daughter: Pennsylvania Parents Speak After Nationwide $120M Faulty Ignition Settlement

Millions to go to education, investigation & enforcement after GM's 'deceptive' practices with ignition switch safety issues

(Published Thursday, Oct. 19, 2017)
“Facebook’s Ad Scandal Isn’t a ‘Fail,’ It’s a Feature”

New York Times, September 23, 2017
“Equifax Officially Has No Excuse”

_Wired, September 14, 2017_
“Wells Fargo Leaders Reaped Lavish Pay Even as Account Scandal Unfolded”

New York Times, March 16, 2017
“Banks have paid $321 billion in fines since the crisis (but they’ve made almost $1 trillion)”

CNBC, March 17, 2017
How I fell into the rabbit hole
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.
JP Morgan Chase: “Fortress?”
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?
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
Zombie (Insolvent) Borrowers: Opaque and Dysfunctional
Zombie (Insolvent) Borrowers: 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)

<table>
<thead>
<tr>
<th>Basel II</th>
<th>Basel III</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Common equity Tier 1 capital” to risk-weighted assets: 2%</td>
<td>“Common Equity Tier 1 Capital” to risk-weighted assets (RWA): 4.5%</td>
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<tr>
<td></td>
<td>» Plus 2.5% conservation buffer</td>
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<tr>
<td></td>
<td>» Plus 1.5% “Tier 1” to RWA</td>
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<tr>
<td></td>
<td>Leverage Ratio: “Tier 1” to total</td>
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<tr>
<td></td>
<td>» Basel III: 3%</td>
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<tr>
<td></td>
<td>» US: 5-6%</td>
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<tr>
<td>“Tier 2” Loss-absorbing debt</td>
<td>“Tier 2”/TLAC loss-absorbing debt.</td>
</tr>
</tbody>
</table>
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.


*Financial Times*, November 9, 2010.
Bad Regulations Matter

The Awful Case of Greece

Swiss banks retreat

Greek debt restructuring

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)**

<table>
<thead>
<tr>
<th>Country</th>
<th>EU bailout loans</th>
<th>Private banks</th>
<th>Other</th>
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<tbody>
<tr>
<td>Germany</td>
<td>68.2bn</td>
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<tr>
<td>France</td>
<td></td>
<td>43.8bn</td>
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<tr>
<td>Italy</td>
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<td>38.4bn</td>
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<tr>
<td>Spain</td>
<td></td>
<td>25bn</td>
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<tr>
<td>IMF</td>
<td></td>
<td>21.4bn</td>
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<tr>
<td>ECB</td>
<td></td>
<td>18.1bn</td>
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</tr>
<tr>
<td>Netherlands</td>
<td>13.4bn</td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td></td>
<td>11.4bn</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td></td>
<td>10.8bn</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>7.5bn</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Austria</td>
<td>5.9bn</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finland</td>
<td>3.7bn</td>
<td></td>
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</tr>
</tbody>
</table>

Source: Open Europe, BIS, IMF, ECB
US banks forced to hold $68 billion in extra capital.

Financial Times, April 8, 2014
US banks forced to hold $68 billion in extra cash.

Telegraph, April 8, 2014
US banks forced to hold $68 billion in extra capital. 

Financial Times, April 8, 2014

Telegraph.
The Lobbying Cry

Every dollar of capital is one less dollar working in the economy.

Steve Bartlett, Financial Services Roundtable, Sept 2010
The Lobbying Cry

Every dollar of capital is one less dollar working in the economy.

Steve Bartlett, Financial Services Roundtable, Sept 2010
Bank capital is costly because, the higher it is, the lower will be the return on equity for a given return on assets.

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

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

John Stumpf, Wells Fargo Bank CEO, 2013
Because we’re substantial self-funding with deposits, we don’t need a lot of debt...

John Stumpf, Wells Fargo Bank CEO, 2013
The Lobbying Cry

This rule will keep billions out of the Economy

Tim Pawlenty, Financial Services Roundtable, July 2015
The lobbying cry will keep billions out of the economy.

Tim Pawlenty, Financial Services Roundtable, July 2015
It is difficult to get a man to understand something when his salary depends on not understanding it.

Upton Sinclair, author
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.
Key Person on Economic Policy
(ex Goldman Sachs COO)

Banks are forced to hoard money because they are force 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
Key Person on Economic Policy (ex Goldman Sachs COO)

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Gary Cohn, Director of National Economic Council, February 3, 2017
Banks are still the most powerful lobby on Capitol Hill. And they frankly own the place.

Senator Richard Durbin (D-III), 2009
Politics of Banking
Symbiosis and “bargains” banks-governments

“Banks are where the money is”

Guarantees appear free, invisible social cost, willful blindness

Banks seem sources of funding, not risk

“National champions”

Central banks support governments and private banks

Banks get away with inefficient recklessness.
Willful blindness
Many enablers
Misleading narratives
Moral disengagement

“It Takes a Village to Maintain a Dangerous Financial System,”
Effective whistleblower programs

Early intervention to prevent endangerment
  ✓ Analog of traffic rules

Ensure competition

Better accountability laws and enforcement

Public awareness and understanding

Political accountability to prevent abuse of power in all institutions
FLIGHT RECORDER

TEST

NORMAL
GSB Mission: “Change the world”

On whose behalf?

✓ Business corporations?
✓ “Society”?
✓ What if there is a conflict?

How?

✓ Individual action?
✓ As an institution:
  + CSI, SEED, non-profit exec
An open letter to JPMorgan Chase Board of Directors

Jun 14 2011  Anat Admati
Dividends can wait until banks are stronger

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

Only recapitalised banks should pay dividends

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
THE BANKERS’ NEW CLOTHES

What’s Wrong with Banking and What to Do About It

ANAT ADMATI & MARTIN HELWIG
We’re All Still Hostages to the Big Banks

By ANAT R. ADMATI  AUG. 25, 2013

Where's the Courage to Act on Banks?

By Anat R. Admati

Harvard Law School Forum on Corporate Governance and Financial Regulation

Why Financialized Corporate Governance Works Poorly

Posted by Anat R. Admati, Stanford University, on Wednesday, August 9, 2017
Cross-Disciplinary Education: GSB F332 (Finance and Society)
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.
Deutsche Bank: Show of strength or a fiction?

Three former employees tell US regulators that trades were valued in a way that hid billions in losses.

Deutsche whistleblower Ben Artzi moves on after spurning award

Former risk officer who exposed false accounting at bank hopes others will follow his example.
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
Finance and Society 2016-17 Visitors

Frank Partnoy
Sarah Bloom Raskin
Sir John Vickers

Jesse Eisinger
Judge Jed Rakoff
Corporations and Society 2017-18 Visitors

- Kara Stein
- Bethany McLean
- Fiona Scott Morton
- Franklin Foer
- Peter Georgescu
- Lee Drutman
- Jerry Davis
- Luigi Zingales
A Collective Action Problem: What Will You Do (if anything)?