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Financial Crisis, Corporate Governance, and Bank Capital by Sanjai Bhagat, Cambridge University Press (2017), US$39.99

The global financial crisis (GFC) has brought to the fore the importance of 'corporate governance' and put a question mark on prevailing practices on dealing with stressed 'too big to fail' (TBTF) banks. Though, there were various factors which led to the crisis, excessive risk taking by the top executives in large financial institutions and the lenient government policies for home buyers could be identified as the two prominent ones. While there are several books available now on the GFC, it is difficult at times to differentiate one from the other in terms of the broad content and key findings. The book by Sanjai Bhagat titled *'Financial Crisis, Corporate Governance, and Bank Capital'*, however, lucidly explains some of the intricate aspects of the GFC while offering a unique approach in terms of an empirical analysis of the relationship between corporate governance and capital requirement in banks. The author, professor at the University of Colorado, having experience of working with the US Securities and Exchange Commission, the US government agencies and Fortune 500 companies, provides insightful details of the crisis and also offers remedies to overcome or minimize the effect of such a crisis in the future.

The book highlights the role of public policies relating to home mortgage in the financial crisis. Prior to 1992, the US government sponsored enterprises - Fannie Mae and Freddie Mac-promoted the growth of sub-prime market and dominated the residential mortgage market with their combined share rising from 40 per cent in 1996 to 56 per cent in 2008. This enabled home ownership by those who could not otherwise afford it. In this process financial institutions played a key role by issuing mortgage backed securities (MBSs). MBSs issued by banks, also known as private label securities (PLS), constituted about 50 per cent of the total MBS issued. Total PLS issued during 2005 and 2006 amounts to more than US$ 1 trillion. As the US real estate prices started to decline in 2005-08, home buyers who had no money started defaulting on payments and the default rate increased to 35 per cent, which eventually affected the US financial system.

The author argues that apart from the lenient government policies for home buyers, excessive risk taking decisions by the top executives in large financial institutions was a major cause of the GFC. The book also contests the notion of 'too big to fail' (TBTF): the firm whose size, complexity, interconnectedness, and critical functions make it so important to the overall financial system of a country that, if anything goes wrong, in the larger interest of the economy, the government needs to bail it out. As the TBTF results in uneven playing field for small and big banks, the author proposes a solution which can be implemented only by the intervention of corporate board members and institutional investors in big banks.

The author argues that the pre-crisis compensation packages prevailing in the industry might have led to misaligned incentives. The TBTF bank CEOs were able to realise substantial gains on their common stock sales in the pre-crisis period (2000-07), while during the crisis of 2008 they had to incur large losses. Additionally, stock sales by TBTF bank CEOs were significantly greater than stock sales by other bank CEOs in the pre-crisis period. Finally, different risk-taking measures suggest that TBTF banks were significantly riskier than other banks. The author, based on an empirical analysis of the compensation structure of 100 US financial institutions, provides an alternative to the existing compensation package.

The compensation package proposed by the author is based on simplicity and transparency, and focuses on creating and sustaining long term shareholder value without any need of bailouts. The proposed package, unlike most other executive compensation reform proposals, does not place a ceiling on executive compensation. The author provides four justifications in support of a simple and transparent compensation structure. First, the financial sector is a fast-evolving sector and it is difficult to predict risks that may emerge as products and markets develop. Moreover, in the context of large and interconnected financial institutions and complex financial instruments, banks grapple with 'unknown' and 'unknowable' risks. The more complicated and opaque an incentive package is, the more difficult it will be to anticipate individual responses and predict what risks will or will not materialise. Second, as shareholders are now required to vote on CEO compensation packages, a simple incentive structure is easier for them to understand and evaluate, reducing the need to rely on third-party vendors of proxy voting advice, the value of which has been the subject of considerable controversy. Third, simplicity and transparency in incentive compensation packages mitigate public scepticism towards high pay of executives. Finally, the focus on creating and sustaining long-term shareholder value would channel management's attention to longer term profitability of an investment or trading strategy. Business and legal scholars posit that managers should act in the best long-term interest of shareholders - what could be the better way to do this than tie management's incentive compensation to long-term share price. The author refers to this as the Restricted Equity proposal, as he proposes that the incentive compensation of bank executives should consist only of restricted equity - restricted in the sense that the individuals cannot sell the shares or exercise the options for one to three years after their last day in office.

The proposal only limits the annual cash payouts an executive can receive. The amount of restricted stock and restricted stock options that can be awarded to a bank manager is essentially unlimited as per the proposal; though, in practice, the award amounts should and need to be anchored to the current practices in a particular company. Also, the focus on creating and sustaining long-term shareholder value would minimise the likelihood of a bailout which would reduce the potential burden on the taxpayers.

Equity-based incentive programs, however, may lose effectiveness in motivating managers to reduce excessive risk-taking when a bank's equity value approaches zero. There is a moral hazard or agency cost of debt arising from shareholders' potential preference to take extreme risks when a firm is close to insolvency. This is because the shareholders gain from the upside of a positive outcome, albeit low in probability, while limited liability leaves the losses, should the gamble fail, on creditors. The moral hazard problem when equity value approaches zero may well be more severe for banks, as their creditors have less interest in monitoring against risk-taking activity because the government not only stands behind retail depositors, but also often bails out other creditors. Suitably aligning management's incentives in this context, therefore, calls for focus on the interaction among bank capital structure, bank capital requirements and bank executive incentive compensation whereas, the extant literature analyses compensation reform in isolation.

The book provides an excellent overview of executive compensation policies by banks and highlights how understanding their interactions with other variables like bank size and bank capital can enhance our assessment of risks and improve regulatory aspects. The author emphasises that banks' shareholders and management at present have fairly limited ability to internalise the consequences of risks. Corporate governance principles ensuring clear allocation of authority, responsibilities and accountability for deterioration in financial soundness parameters of a bank are as much important as the emphasis on higher and better quality control to ensure financial stability.

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