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Financial products and practices, excessive risk taking and the liability of decision makers of financial institutions; lessons learned from the financial crisis

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I hereby declare that the work submitted is mine and that where I have made use of another's work, I have attributed the source(s) according to the Regulations set in the Student's Handbook.

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Abstract

The present paper constitutes an analysis of a combination of factors, which have contributed to the global financial crisis of 2007. The writer elaborates on, first, an indicative list of financial products associated with problematic results; second, the excessive risk taking from the part of professionals running major financial institutions; third, the threat imposed by excessive risk taking not only to individual financial institutions but also to the financial system as a whole. With this combination of factors in mind, the aim, at the conclusion of this work, is a proposed approach on both a procedural and a substantial framework for the liability of professionals undertaking excessive financial risk.

Sonia I. Saranti
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"Liberty not only means that the individual has both the opportunity and the burden of choice; it also means that he must bear the consequences of his actions. Liberty and responsibility are inseparable".

Friedrich Hayek (1899-1992)

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Table of Abbreviations

AIG	American International Group (Inc.)
CEO	Chief Executive Officer
CDO	Collateralised Debt Obligation
CDS	Credit Default Swap
FCA	Financial Conduct Authority
FSA	Financial Service Authority
LIF	Life Income Fund
PRA	Prudential Regulatory Authority
n	note
VC	Venture Capital

I. Introduction

It is undisputed that the financial crisis of 2007 onwards did not come out of the blue. This dissertation aims to present, first, the risky financial products and practices introduced in the financial markets; second, the role of those running the financial institutions with regard to those products and practices; third, the interconnection between those two factors and the extent to which they led to or amplified the effects of the crisis of 2007. Those factors are addressed, first, in order to discuss the situation; second, in order to develop a proposed liability mechanism for the decision makers of financial institutions, in case they unreasonably contribute to the cause of financial problems.

It goes without saying that the economic situation of big financial institutions affects the overall economy. With this thought in mind, summarised in the notion of the *interconnection of the world of finance,* the area of study – as described in the first paragraph of this paper – has been chosen for a specific reason: the lessons learned from the financial crisis, with regard to the functions of the stakeholders of the market, can assist with the avoidance of the same mistakes, consequently of the same catastrophic results. The facts need to be underlined, as it can be argued that *markets have no memory*.[1] This is indeed true and this is the reason why, despite the liberal approach flourished within this dissertation, it is sustained that one cannot rely on the market stakeholders' adjustment to the new circumstances, which have arisen due to bad choices. Rather, effective proactive mechanisms are required so that any problems can be avoided.

The writer is going to indicate the way and the reasons why the problematic policies and products were introduced in the market and the reason why the risks associated with them were undertaken in a considerably speculative, if not reckless manner. All those could be fairly summed up with the notion of *'getting rich quick',* as the wrong incentive provided to those running the financial institutions.[2] In fact, the designers, issuers and traders of extremely risky products managed to get great

[1] Brealey R. A. & Myers S. C, *Principles of Corporate Finance* (6th edition, Irwin McGraw-Hill, USA, 2000), p. 368

[2] Persaud Avinash, *Reinventing Financial Regulation; A Blueprint for Overcoming Systemic Risk* (Apress, New York, 2015), p. 162

bonuses,[3] despite any proven malfunctioning or disastrous effects of their initiatives for the financial institutions individually, but also for the global economy overall.

As for the notion of financial institutions, due to the fact that the writer aims at presenting real life examples on how the situation evolved, special reference will be made to specific insurance companies, banks etc. It is underlined, though, that the situation evolved in more or less a similar pattern for the majority of financial institutions that faced difficulties and either recovered or can now be found only in the books of financial history and cases analyses.

As for some necessary terminological clarifications, it is of fundamental importance to underline at the beginning of this work that the terms *day-to-day policymakers* or *decision makers* have been chosen in order to refer to any people running financial institutions, in the sense of being able to make decisions and undertake risks. The aim of this choice is to avoid the restriction in terms, such as executive boards, managers etc., which may reflect the way of decision making in certain jurisdictions, but this is not how the system works everywhere. The idea for the use of this terminology was taken by the Dutch *Regulation Governing Remuneration Policy*,[4] which partially incorporated the *Capital Requirements Directive III, 2010/76/EU* in the Dutch legal framework.[5]

As a final introductory remark, it is stressed that the majority of sources used are contemporary sources, i.e. from 2008 onwards. The reason of this choice is that the issues addressed refer to the very recent financial history. However, when comparisons with policies of the past are made, or when well established for years legal and financial concepts are recalled, relevant long-standing bibliography is as well used.

[3] Chorafas Dimitrios N., *Financial Bloom and Gloom; The Credit and Banking Crisis of 2007-2009 and Beyond* (Palgrave Macmillan, England, 2009), p. 160
[4] Regeling beheerst beloningsbeleid Wft 2011
[5] Kromwijk D. M. & Oostwouder W. J., 'Variable Remuneration and Dutch State Aid: Is a Legal Framework Necessary and/or Wrongful?' (2011) Vol. 8, No. 5 European Company Law, p. 217

II. The Problematic Character of Selected Financial Products

A. Introductory Notes

This section describes, first a selected list of the products and policies misused within the years leading to the financial crisis; second, concrete examples of financial institutions, which suffered severely by the effects of those products and policies and, third, the criticism on the risks inherent in the involvement with highly risky investments, like the products and policies herein analysed. It needs to be stressed that the list of products and, thereafter, financial institutions in trouble examined is indicative and non-exhaustive. The scope of this dissertation is an illustration of the problem, based on the function of some of the circulated products and policies. This illustration indicates the coherence between the role of decision makers and their subsequent liability.

B. Speculative Financial Products & Practices

The reason for choosing to present the following products and practices is that, despite the initial celebration towards their issuing, when their long-term results came up, they were accused of either amplifying or causing the crisis.[6] Indeed, many other products were accused of causing similar results, however, this indicative list enables the identification of the problem.

As for the notion *'speculative'* chosen in this section, it needs to be underlined that the use of those products and practices as such is not necessarily speculative. What made it speculative was the choice of those running the institutions to use them in a way, which, although maximising the short-term financial results of the institutions, was disastrous in the long-term.

1. Identification

a) Securities Lending

One of the most problematic procedures, wherein financial institutions were involved, was the so-called *securities lending transactions.* Within those transactions, one of the parties lends its securities, whereas the borrower deposits collateral –

[6] Johnson S. & Kwak J., 'Is Financial Innovation Good for the Economy?' (2012) Vol. 12, No. 1 Innovation Policy and the Economy, p. 1

primarily cash – with the lender;[7] the title to and ownership of the securities are transferred to the borrower. Institutions get involved in securities lending in order to further develop the yield of their securities portfolios.[8]

Typically, the market value of the securities is lower than the cash provided to the lender. This is called: *overcollateralisation* of the loan provided.[9] This process, and especially the case when overcollateralisation is excessive, causes great concerns for the financial system overall. In fact, it exposes collateral providers to greater risks than they can probably bear, whereas the systemic stability is as well threatened,[10] given the high levels of interconnection of the financial stakeholders. In this context, the relevance of the contagion effect as a key component of systemic risk within the financial market has been a topic of considerable discussion after the recent financial crisis.[11]

In particular, the problematic situation with securities lending can arise when the borrower decides to return the securities. In this case, the lender shall return the collateral (cash, in most cases); which, in turn, means that the lender should be able to return that collateral. However, this collateral has been invested and there is the chance that the capital along with the return of the investment of the collateral is not at the hands of the lender; hence the latter cannot give it back to the borrower. This notion is shortly described as “potential liquidity risk exposure”.[12]

Among the main lenders of securities in those transactions are insurance companies.[13] A concrete example of how those transactions and the liquidity risk exposure they entail, had – almost – catastrophic effects for an insurance company, AIG, due to “false forecasts” is submitted below[14]. One of the primary reasons why

[7] McDonald R. & Paulson An., ‘AIG in Hindsight’ (2015) Vol. 29, No. 2 The Journal of Economic Perspectives, p. 84
[8] Adrian Tobias et al. ‘Repo and Securities Lending’, Federal Reserve Bank of New York; Staff Reports, Staff Report No. 529 (December 2011 – Revised February 2013), p. 7
[9] Copeland M. et al., ‘Repo Runs: Evidence from the Tri-Party Repo Market’, Federal Reserve Bank of New York; Staff Reports, Staff Report No. 506 (July 2011 – Revised August 2014), p. 11
[10] Keijser Thomas et al., ‘Financial Collateral: From Private to Regulatory Law Reform’, in Keijser Thomas (ed.), *Transnational Securities Law* (Oxford University Press, USA, 2014), p. 54
[11] *See indicatively* Lastra Rosa M., *International Financial and Monetary Law* (2nd edition, Oxford University Press, USA, 2015), Chapter 4
[12] Adrian Tobias et al. (2013), n 8, p. 7
[13] Ibid., p. 7
[14] Section II.C.1

securities lending led to the negative results known today for institutions such as AIG, was the excessive pure speculation for the cash collateral reinvested by the financial institutions, which led to substantial mismatching between asset and liability.[15] In fact, it should be underlined that the provision of such collateral, either in the form of money or in the form of transferrable securities, constitutes one of the major components for the financial markets – and primarily the wholesale financial markets – to function.[16] However – as a further justification of the notion *"speculative"* – special attention is required when the holder of the collateral uses it to make profit.

A final remark, regarding how the problematic situation with this practice evolved prior to the crisis, refers to the US securities lending market in 2008. In particular, the lenders reduced the amount of securities they were willing to lend for a certain amount of collateral and asked for more compensation for collateral entailing greater risk.[17] This even more underlines the uncertainty realised within excessively risky initiatives the years leading to the financial crisis.

b) Repurchase Agreements (Repos)

Repos is another story of crucial importance within the context under examination, since repos constitute one of the principal means of financing for financial institutions in jurisdictions such as the USA. A repo is a sale of securities, along with the promise that the securities will be repurchased at a specific time in the future and at a certain price. The similarity between repos and securities lending is apparent: in the case of securities lending we have the lending of securities followed by a reverse transaction, whereas in repos, the securities are sold, in order to be repurchased at a specific price and at a later date.[18]

The differentiation between the bilateral and the tri-party repo transactions is of crucial importance in the context of the present work, given that their results within the last financial crisis were considerably different. Their difference lies with the fact

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[15] Adrian Tobias et al. (2013), n 8, p. 10

[16] Keijser Thomas et al. (2014), n 10, p. 28; Ong K. & Yeung E., 'Repos and Securities Lending: The Accounting Arbitrage and their Role in the Global Financial Crisis' (2010) Vol. 6, No. 1 Capital Markets Law Journal, p. 92

[17] Fleming Michael J. et al., 'Repo Market Effects on the Term Securities Lending Facility' (2010) Vol. 100, No. 2 The American Economic Review, Papers and Proceedings of the One Hundred Twenty Second Annual Meeting of the American Economic Association, p. 591

[18] Ong & Yeung (2010), n 16, p. 92

that in the case of bilateral repos, the two trading parties perform all the transactions involved. In tri-party repos, on the other hand, a third party undertakes the settlements and the collateral management.[19] The two kinds of transactions are similar as to the contractual details of the repurchase agreements and companies use both of them in order to furnish their financial needs.[20]

The repo market is one of the markets entailing great risk, as indicated by their recent results, despite that repos are considered as a by definition low risk investment, forming short-term investments with predictable results. It is submitted that – as proven by the modern financial history herein addressed – this market is risky, due to the fact that whether or not it will experience losses depends on multiple factors. Thus, those involved *or those running the companies involved* should be very attentive not only regarding the quality of collateral provided for particular securities, but also, for example, regarding the creditworthiness the securities lenders confer on their counterparties, when, especially, a tri-party – but also to some extent a bilateral party – *repo market* is involved.[21]

In the case of bilateral repo transactions, important losses were experienced in early 2008, due to an increase in the reduction of value *(haircut)* of all or some of the collateral classes. A run was experienced, because a smaller amount of cash could be raised from borrowers holding a particular amount of securities, leading them to de-lever.[22] In fact, the increase of haircuts was the response of the securities' lenders against their fear regarding the value of collateral they received or the creditworthiness of their counterparties.[23]

An asset (securities) class can as well experience a haircut.[24] In the USA, even at the outset of the worst financial crisis in history[25] many hedge funds and shadow banks went bankrupt, due to their exposure to the bilateral *repo market* and their inability to meet margin calls by reason of large asset class haircuts.[26]

[19] Copeland et al. (2014), n 9
[20] Ibid., p. 4
[21] Adrian et al. (2013), n 8, p. 8
[22] Ibid., p. 8
[23] Fleming et al. (2010), n 17, p. 592
[24] Adrian Tobias et al. (2010), n 8, p. 8
[25] Chodorow-Reich G., 'Effects of Unconventional Monetary Policy on Financial Institutions' (2014) Brookings Papers on Economic Activity, Brookings Papers on Economic Activity, p. 156
[26] Adrian et al. (2013), n 8, p. 9

No haircut increase can be problematic as well. This seems to have happened in the case of Lehman Brothers, analysed below[27]. In particular, a financial institution, relying on *repo market* transactions for funding its operations, may be forced into bankruptcy, in case its creditors refuse to continue financing its repos.[28]

Despite these observations, though, it has been sustained that especially the tri-party repos – as compared to and unlike the bilateral – did not contribute to the financial meltdown under examination, since no system-wide run on the tri-party repo market has been identified.[29]

c) Subprime Loans

The lending to *subprime borrowers*, a category of borrowers primarily for home mortgages, was another speculative act focusing only on short-term results. [30] Those borrowers could not meet the requirements to take out a loan, on the basis of the regular requirements set by rational lenders, such as their income, credit history, their payment to income ratio and loan to value ratio.[31] However, they were given loans, since the above-mentioned factors were not observed to the extent necessary. Banks and other lenders considered them as a very profitable market,[32] because they were penalising subprime borrowers' weak creditworthiness by charging higher interest rates. This trend led to a very high interconnection between financial institutions, which were large purchasers of securities backed by *subprime assets.*[33]

Even before the outburst of the financial crisis, the dangers for those investing in those loans or the securities associated with subprime loans were more or less known. In fact, investment in residential mortgage loans entails four main risks: *i)* the credit risk, associated with the default of the home owner; *ii)* the liquidity risk, since mortgage loans tend to be considerably illiquid; *iii)* the price risk, according to the flows in the market of interest rates; and *iv)* the prepayment risk, when borrowers

[27] Section II.C.2
[28] Adrian et al. (2013), n 8, p. 8
[29] Copeland et al. (2014), n 9, p. 2
[30] Arora Anu, 'The corporate governance failings in financial institutions and directors' legal liability' (2011) Vol. 32, No. 1 Company Lawyer (2011), p. 3
[31] Fabozzi Frank J. et al, *Foundations of Financial Markets and Institutions* (3rd edition, Prentice Hall, USA, 2002), p. 427
[32] Schooner H. M. & Taylor M. W., *Global Bank Regulation; Principles and Policies* (Elsevier, USA, 2010), p. 45
[33] Ibid., p. 7

repay the loans earlier than the maturity date, which deprives lenders from their right on the remaining interest rates payments.[34] Based on this multifactorial risk, inherent in investing in this kind of mortgage loans, one cannot but preview the multiplication of those risks when it comes to subprime residential mortgage loans. Hence, any harmful effects, which easily one could have predicted, actually resulted in a contagion result with serious effects for the global economy.

In fact, the losses of this category's loan portfolios exceeded massively any assumptions made by both the creators of those loans' securities, as well as of the credit rating agencies. Consequently, as the loans backing the securities started to go bad, the value of those securities declined sharply.[35] As the securities for those loans almost disappeared, the assets were valued at a very large discount compared to their face value.[36]

d) Credit Default Swaps (CDSs)

In simple terms, *CDSs* (or as Warren Buffet called them *'the financial weapons of mass destruction'*[37]) constitute an insurance of a loan in case of default of the borrower.[38] These derivatives provide for the ability of banks to be protected against the non-payment of a loan by the conclusion of the contract that reimburses them in case of failure of the borrower to meet his obligations – this is the reason why the term insurance is used.

It is sustained that these financial products were among the major factors having contributed to the contagion of the financial crisis and, in this sense, it is crucial that they were provided in the context of very lightly regulated parts of the financial market.[39] By lightly regulated markets, the reference is primarily made to Over-The-Counter (OTC) Markets, where the products are traded through a dealer network and not through a centralised exchange, where stricter rules apply.

The importance of those instruments becomes even more apparent on the basis of the fact that, within a system of financial institutions being *too big to fail*, as in the

[34] Fabozzi et al. (2002), n 31, p. 440
[35] Schooner & Taylor (2010), n 32, p. 46
[36] Ibid., p. 46
[37] Alloway Tracy, 'Why Would Anyone Want to Restart the Credit Default Swaps Market; Saving single-name credit default swaps?' (May 11, 2015), Bloomberg Business
[38] Johnson & Kwak (2012), n 6, p. 5
[39] Schooner & Taylor (2010), n 32, p. 47

case of AIG below[40], CDSs were used as means for the achievement of better ratings for subprime backed securities.[41] In fact, when the value of the mortgage-related securities started to deteriorate, the investors having written CDS protection on those securities found themselves responsible to pay hundreds of millions for the CDS contracts they had sold;[42] the most illustrative example is AIG. Investors – including AIG – were, in most of the cases, not fully able to assess the risks inherent, due to the structure of the contracts and misleading ratings. In fact, the CDSs were priced on models, based on data for risk assessment when the default rate was considerably low.[43]

C. Effects of the Products – Concrete Examples

The aim of this subsection is to provide concrete examples of financial institutions having been highly exposed to speculative financial products or policies, as the ones discussed under Section II.B of this paper. The results of this exposure are illustrative of how bad decisions led to the financial meltdown. Those institutions are examples of how the problem evolved, however, there are many similar institutions that could indicate and substantiate the same argument: exposure to excessive risk and high leverage caused a complete financial mess.

1. American International Group (AIG)

The rescue of the insurance colossus AIG constitutes a landmark incident for the history of the US Treasury. The procedure of this rescue officially started on September 16, 2008 and lasted for years.[44] This paper presents the most serious part of this story, which refers to the roots of the problem, i.e. why this huge company with $1 trillion in assets was in need of assistance so as not to go bankrupt.

In broad terms, it is sustained that two activities were the main reasons why the company was led almost to its closure: first, its securities lending business and second, its CDS business.[45] Both caused losses of similar magnitude.

[40] Section II.C.1
[41] Schooner & Taylor (2010), n 32, p. 47
[42] Alloway (2015), n 37
[43] Johnson S. & Kwak J. (2012), n 6, p. 5
[44] REUTERS, 'TIMELINE-The government's rescue and sale of AIG' (September 9, 2012), reuters.com
[45] McDonald & Paulson (2015), n 7, p. 81

To begin with the problem associated with the securities lending, the situation unfolded as follows. Before the financial crisis, the cash collateral of AIG was invested in long-term and illiquid assets.[46] Hence, the exposure of the institution to a potential liquidity stress was of a large scale. This tactic had led to positive results in the beginning. However, when the crisis came up and the borrowers of its securities asked to return the securities to the institution and hence to get their collateral back, the need to liquidate some of the companies assets in order to return the cash of the borrowers led the company to considerable losses.[47]

As far as AIG's exposure to CDSs is concerned, the following remarks sum up the problem. The executives of AIG sustained that their investments related with the real estate – i.e. the insurances they provided to mortgage related securities through CDSs – would initially experience a downfall in their market value, but their recovery would pay off the investment.[48] In 2008, though, AIG suffered huge losses, primarily in the Financial Services and Life Insurance divisions, those losses deriving from their involvement on real estate financial products and from the company's securities lending policy, respectively.[49]

It is sustained that AIG reflects a broader trend, since the financial crisis affected the sector of life insurances in its entirety. Pursuant to relevant evidence provided in the literature,[50] life insurers hold hardly one third of their general account assets in securities backed by mortgages or straight held mortgages, whose value deterioration within 2008-2009 led some life insurers to their solvency borderline.

2. Lehman Brothers

Lehman had a large exposure to almost all the financial products analysed in Section II.B.1, in their speculative aspect of use – as illustrated by the results. It is widely sustained that Lehman Brothers' losses from its derivatives – i.e. financial products including the CDSs – transactions, were one of the major reasons contributing to the liquidation of the institution.[51]

[46] Adrian Tobias et al. (2013), n 8, p. 10
[47] Ibid., p. 11
[48] McDonald & Paulson (2015), n 7, p. 82
[49] Ibid., p. 83
[50] Chodorow-Reich (2014), n 25, p. 170
[51] Schooner & Taylor (2010), n 32, p. 47

Tobias et al. suggest that the problem with Lehman Brothers was that its creditors refused to extend financing for the institution's repos, due to the rumoured non-creditworthiness of the institution, when Lehman relied on its *repo market* transactions.[52] The problem for the creditors was not the quality of the collateral, which logically should have been, as the collateral is the object of the particular transaction, but the creditworthiness of Lehman Brothers. This absence of trust stemmed from rumours regarding the institutions' exposure to junk financial products.

One of the issues causing concerns in the case of Lehman Brothers is that, despite that the tri-party repo market in general did not suffer large haircuts – unlike the bilateral party, as above[53] indicated – this institution did suffer the consequences of such losses.[54] Lehman Brothers displayed special malfunctioning in the tri-party repo market, which has been attributed to its use of repos as a means of '*accounting arbitrage* and *manipulation of balance sheet results'*.[55] When this information became public, the creditors of Lehman started questioning its creditworthiness and acted accordingly.

It is, as well, sustained that Lehman Brothers suffered huge losses from their involvement with the subprime linked securities,[56] above[57] analysed.

3. Northern Rock

When the UK Financial Services Authority (FSA) – now split into two separate regulatory authorities, the FCA and the PRA – started to issue warnings for excessive risk taking and the problems that could arise out of it, Northern Rock announced that it was aware of the warnings. However, it did not make any effort to raise its liquidity so as to be able to respond in case of abnormal circumstances.[58] The consequence? In September 2007 an old-fashioned bank run – the last previous in Britain took place in 1866[59] – with massive consequences – which was not intercepted as quickly as

[52] Adrian Tobias et al. (2013), n 8, p. 8
[53] Section II.B.1.b
[54] Adrian Tobias et al. (2013), n 8, p. 9
[55] Ong & Yeung (2010), n 16, p. 93
[56] Schooner & Taylor (2010), n 32, p. 47
[57] Section II.B.1.c
[58] Arora (2011), n 30, p. 10
[59] Tomasic Roman, 'Corporate Rescue, Governance and Risk-Taking in Northern Rock: Part 1' (2008) Vol. 29, No. 10 Company Lawyer, p. 297

required by the competent authorities – was experienced, after depositors became aware of Northern Rock's application for a loan facility at the Bank of England and the announcement of the latter that it would at last provide the liquidity assistance.[60] As in the case of AIG, which without the US Treasury's assistant would have gone bust, the same applied for Northern Rock; the company would not have survived without the Bank of England's rescue.

The problem with this bank was founded on the fact that a very small amount of its liabilities stemmed from retail deposits, whereas the vast majority of funding constituted from short-term borrowing in the capital markets and securitised notes, along with some other long-term borrowing.[61] In fact, despite that Northern Rock was not directly exposed to mortgage backed securities, it was indirectly exposed, since it was borrowing from 'financial pools', which included those problematic products.[62] This entailed the involvement of a company based on a tax haven called *Granite*, which Northern Rock used as its special purpose vehicle (SPV), in order to onsell repackaged or securitised mortgages.[63] As indicated above[64], those securities and the mortgage loans themselves were combined with other products of similar or other kind and composed pools of funding in the capital markets. Hence, it was difficult to assess the exact risks entailed and to value them accordingly.

In this context, it needs to be underlined that the House of Commons Treasury Committee expressly blamed the management of the institution for *reckless* business tactics.[65]

D. Criticism on the Risks Undertaken

Excessive leverage. It is submitted, in brief, that the main characteristic of the products so far examined and of the problems they caused to financial institutions is leverage. In particular, the circulation of the above products and policies indicates the high amount of credit used within the market, i.e. the fact that the market and,

[60] Shin Hyun Song, 'Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis' (2009) Vol. 23, No. 1 The Journal of Economic Perspectives, p. 102
[61] Ibid.
[62] Ibid., p. 102; Tomasic Roman, 'Corporate Rescue, Governance and Risk-Taking in Northern Rock: Part 1' (2008) Vol. 29, No. 11 Company Lawyer, p. 330
[63] Tomasic (2008), n 62, p. 331
[64] Section II.B.1.c
[65] Tomasic (2011), n 62, p. 330

subsequently, all the stakeholders involved were exposed to high amounts of leverage, either being leveraged themselves or being exposed to highly leveraged counterparties. In fact, Schularick and Taylor have proven that a *'credit boom'* indicates a high risk of financial crisis.[66]

It is sustained that in order for the effects, side effects and, at last, possible disastrous effects of the above-analysed products and policies to be identified *ex ante*, one needs to approach their scope and mechanism from a disaggregating perspective, i.e. to split them into their components and analyse those relevant to the problem. For example, in the case of *repos* and *securities lending*, there are six key elements that need to be particularly examined so that the risk-exposure can be mitigated, i.e. to be predicted and addressed timely. Those elements are the maturity, the principal, the interest rate, the nature of the collateral, the counterparty and the haircut.[67] In fact, the maturity of repos and securities lending, when their cash collateral is being reinvested, is one of the factors requiring particular attention.[68] The position submitted is that, although maturity transformation, i.e. the transformation of long-term illiquid assets into liquid assets,[69] is one of the key functions of financial institutions as intermediaries, history shows that it needs to be pursued with more attendance as to the effects of possible mismatches in case of abnormal circumstances. Maturity transformation took many forms in the years preceding the financial crisis, to name but a few: reinvestment of cash collateral to be returned on demand, investment in the extremely risky subprime lending policies, etc. In a system where financial institutions are interconnected, which holds true in most of the cases, the speculative approach of the results of the financial products, taken the form so far described, needs to be restricted *ex ante.*

Overall, it is clear that the undertaking of risks is inherent in the functioning of financial institutions, given that through risk free or low risk products, such as government securities, they cannot make the profits necessary for their sustainability. In fact, it is fairly submitted that the width of ability of a financial system to make

[66] Schularick & Taylor (2012), p. 1045
[67] Adrian Tobias et al. (2013), n 8, p. 12
[68] Ibid., p. 11
[69] Lowe Phillip, 'The transformation in Maturity Transformation', Address by Mr Philip Lowe, Deputy Governor of the Reserve Bank of Australia, to Thomson Reuters' 3rd Australian Regulatory Summit, Sydney, 27 May 2015, p. 1

funds available for the running of risky projects is strongly associated with the proper functioning of the economy.[70] This, however, does not preclude the fact that the risk undertaken should not excessively surpass the so-called *risk tolerance*[71] of each institution. Thus, financial innovation, in the form of the products above analysed is overall positive, however, it cannot be upheld without an at least careful way as to addressing risk only where it can be tolerated.[72] It is at least wrong to claim that a new introduction in the financial market is good or bad, or destructive, based on the mere fact that there exists a market for it.[73]

In the same vein, it has been sustained that the risks being and having been undertaken lie within the normal activities undertaken by those running the day-to-day business of an institution, including high exposure to credit. This, though, with the thought that people relying on the proper functioning of financial institutions, such as depositors, shareholders, investors etc., should themselves undertake to monitor this functioning. This argument is turned down – among others – by the so-called as *free riders approach.* According to this approach, it is a very expensive task for those benefiting from the activities of financial institutions, to spend the time and money to monitor decision making, for which they do not even carry the necessary specialised knowledge. Due to this, those benefiting – for example the depositors in case of a bank – will try to benefit from any monitoring exercised by another depositor and *free ride*, so that only the other spends money and makes effort. Most probably, though, all the depositors would think this way and omit monitoring on the basis of the *free ride approach,* i.e. someone else is going to do it for me and I will not to bear the cost of it.[74] The result would be the absence of monitoring at all. Hence, a formula providing for the participation of each stakeholder, taking into account the amount of time and the costs tolerable for each of them, could balance the situation. This is the approach followed in this work and presented in the relevant section[75].

[70] Committee to Review the Functioning of Financial Institutions, *Report (Vol. 1); Presented to Parliament by the Prime Minister by Command of her Majesty – June 1980* (first printed 1980, Her Majesty's Stationery Office, London 1983), p. 23
[71] Larcker D. F. et al., 'Follow the Money: Compensation, Risk and the Financial Crisis' (2014), Stanford Closer Look Series, p. 1
[72] Johnson S. & Kwak J. (2012), n 6, p. 1
[73] Ibid., p. 3
[74] Schooner & Taylor (2010), n 32, p. 32
[75] Section IV

III. The Freedoms of the Decision Makers in Association with their Contribution to the Problem

A. The Role of Those Running Financial Institutions Towards a Financial Meltdown

It has been widely sustained – and actually admitted – that Wall Street bankers were those who caused, or at least substantially contributed to, the financial crisis.[76] Those bankers upheld highly leveraged bets on mortgage loans, as above analysed. They gave wrong incentives with regard to risk undertaking and its association with their remuneration; in fact, those two – risk undertaking and remuneration policies – separately or in combination are coherently cited as among the primary reasons setting the foundation of the crisis.[77]

The counter argument on this is that the one to blame is the regulatory system and the fact that it has failed to sufficiently capture any risks inherent in the activities undertaken.[78] Or, in other words, those responsible for decision-making were not prevented from undertaking any excessively risky activities. However, couldn't it be argued that they are or should have been *ex officio* responsible or even liable for any of their decisions with predictable harmful effects? To the view of the writer, it is invalid to argue that the correct assessment of the risks was impossible, due to the fact that the products and policies in circulation were highly rated. In fact, the products and policies were intentionally combined and traded in such a way, so as their defects to be hidden.[79]

There are indicators of whether an institution operates in a proper manner or not. One of them is the ability of the institution to renew its long-term funding; if not, then there is a potentially problematic situation, which needs particular attention so as to

[76] For a thorough elaboration on the argument, see Santoro M. A. & Strauss R. J., *Wall Street Values* (Cambridge University Press, USA, 2012), Chapter 2 (pp. 27-58).

[77] Larcker et al. (2014), n 71, p. 1; Caywood Steven C., 'Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation' (2010) Vol. 109, No. 1 Michigan Law Review, p. 115; Arora (2011), n 30, p. 3

[78] Pooran Priya Nandita, 'Macro-prudential supervision – a panacea for the global financial crisis?' (2009) Vol. 3, No. 6 Law and the Financial Markets Review, p. 534

[79] The trading of Collateralised Debt Obligations (CDOs), i.e. structured financial products combined by a pool of low to very highly risky loans, however rated on average, inflicted huge losses for financial institutions trading them. They were accused of triggering the subprime mortgages crisis.

be reversed or so that the institution can unwind in an orderly manner, without causing the side effects to those interconnected.[80] This predictability and subsequent action taking lie within the capacity of those running the institutions. However, a substantial problem with those people's presence in those institutions is the fact that it is temporary. In this context, the notion of their moral hazard comes into play.

Especially as far as banks are concerned, one also needs to take into consideration the fact that they fund their investments, and thus make money, by putting other people's money, i.e. the money of their depositors, at risk. Therefore, any sort of financial innovation, such as that in the form of the above-analysed products, should be pursued by means of an economically productive – and not just speculative – use of the savings.[81] It is sustained that the restricted liability of banks' shareholders for the liabilities upheld and their short-term presence in each institution – since their shares are traded, provide for incentives to decision makers to undertake excessive risks. This observation is made on the basis that shareholders normally benefit from risk taking with short-term effects, unlike, of course, the depositors who are – most of the times – to pay the bill in case of an accident, bank runs, extensive loan losses etc.[82] On the other hand, though, even the shareholders do not benefit only from the short-term effects of such initiatives, because when they retain their shares for a longer time, they are exposed as well to the dangers of speculative investments, as the value of their shares fluctuates, shrinks or disappears in case of uncontrollable accidents. In fact, excessive exposure to risks by short-termism and excessive leverage leads on the one hand, to a risk of illiquidity, due to the maturity/transformation gap, and, on the other hand, to a risk of insolvency, given that financial institutions' balance sheets are highly leveraged.

B. Remuneration Policies

Some specific observations, regarding the remuneration of those running financial institutions, facilitate a better understanding of the reason why such speculative risks were undertaken.

[80] Adrian Tobias et al. (2013), n 8, p. 11
[81] Johnson & Kwak (2012), n 6, p. 3
[82] Schooner & Taylor (2010), n 32, p. 22

In January 2008, the five biggest investment banks of Wall Street announced that they were paying $39 billion in bonuses for 2007. Year 2007, though, was a year of substantial losses with many of the losses to be covered by shareholders.[83] It is sustained that the huge salaries of those running financial institutions were not questioned, despite the fact that they were obviously not coherent with what business morality and individual performance results indicate. Contrariwise, in 2008 – when the effects of false and speculative tactics were becoming obvious – institutions retained the belief that they would soon recover into business.[84]

In this sense, financial instability and huge losses within financial institutions were – to a very large extent – connected to, first, the non-reasonable excessive risk taking; second, the incentives of those undertaking the risks;[85] third the absence of interconnection of those two with the results for financial institutions in the long- or short-term. In fact, the years leading to the financial crisis, banks, or more precisely their decision makers, were allowed to resort to excessive risks, much larger than their balance sheets could bear. All the more, all those have been approved by the regulators, in view of the enlargement of banks.[86]

It needs to be underlined that in the vast majority of cases the decision makers are those deciding for their own remunerations; in this context, they value their initiatives on their own and in most of the cases they do not need to account at all for the remuneration they receive for their services. Even in cases where the remunerations are voted upon, thus they are supposedly examined at a certain extent, the applicable system is not effective. The latter given that the remuneration committees are too often composed from non-executive directors, who serve the interests of those being highly remunerated.[87]

C. Longevity of the Institution: Are Their Decision Makers Concerned?

Extremities in salaries being non-justifiable on the basis of the *pay-for-performance* approach lie among the roots of major past financial scandals, such as

[83] Chorafas (2009), n 3, p. 157
[84] Ibid., p. 158
[85] Larcker et al. (2014), n 71, p. 1
[86] Johnson & Kwak (2012), n 6, p. 9
[87] Arora (2011), n 30, p. 7

those of Enron, Adelphia and Tyco.[88] After those cases, the situation with regard to issues such as transparency changed considerably. Remuneration of and the overall estimation towards decision makers of major institutions shrank, with a subsequent shrinking of their so long empowered responsibilities.[89] This reversion, though, did not last for too long, since they managed to restore their 'superpowers'.

As for the decision makers of financial institutions of nowadays – and of the years leading to the financial crisis – and whether they should be particularly concerned for the long-term results of their policies, it is sustained that they are actually provided with incentives to cater for the opposite. In fact, Chorafas writes that the major participants of the financial world are getting away with any adverse effects against other people's money, caused by the risks they undertake; they get compensated with extravagant numbers, even when the companies employing them may have lost billions.[90]

Johnson and Kwak's phrase summarises in the best way the interest of executives, directors and any of those managing the risky products and distributing them to the market: *'By the time risks materialise, the decision makers in question may be long gone'*.[91]

After the results of the financial crisis became apparent, the notion of macro-prudential supervision came into the forefront, thus depicting in the most illustrative way possible that short-termism so far was the adopted practice for the business plans of the financial institutions. In fact, macro-prudential supervision introduces a new pre-emptive approach to supervision: it aims at preventing risks not only for individual institutions, but also for the whole system, so as to deter systemic risks and the subsequent possible financial booms.[92] In this regard, it should be stressed that systemic risks and their subsequent contagion effects are strongly underlined by leading authorities as a field that requires special attention and more prudent regulation.[93]

[88] Chorafas (2009), n 3, p. 159
[89] Ibid., p. 161
[90] Ibid., p. 161
[91] Johnson & Kwak (2012), n 6, p. 7
[92] Pooran (2009), n 78, p. 535
[93] Goodhart C.A.E, 'The regulatory response to the financial crisis' (2008) Volume 4, Issue 4 Journal of Financial Stability, p. 356; Lastra Rosa M., *International Financial and Monetary Law* (second

IV. Notions on the Current Status of Liability of Decision Makers

A. Is There Any Noticeable Realisation of the Individual Fault?

An account conducted in 2009 revealed that the losses in the assets of life insurance companies, due to their involvement with subprime loans reached $180 billions, followed by their subsequent substantial degradation by rating agencies.[94] This obviously affected severely the shareholders, but not the CEOs or other decision makers, who, on the contrary – and as above indicated – received huge bonuses and remunerations for their services.

As already indicated, it is the excessive risk that constitutes the cause of the problem that is the degradation of the financial status of financial institutions. However, undertaking risks is an inherent function of decision makers' position in a financial institution, otherwise they do not make profits and, thus, they shrink. This being said, one could argue that the crucial point to be determined is the borderline between the acceptable risk and the excessive risk. However, how could one distinguish between those two?

Larcker et al. argue that one helpful indicator is the risk leading to the maximum downside that an institution can bear.[95] In the same vein, they sustain that a way through which the undertaken risk could be restricted is by an initiative of the regulators to restrict the amount of leverage that a financial institution can raise.[96] Additionally, the restriction of the incentives provided to decision makers to take up risks constitutes another efficient measure.[97]

Regarding the products described in Section II.B.1 and the problems they caused to the global financial system, it has been sustained that those to blame are the investors and not the issuers and the traders. However, one needs to underline that those products were to such an extent risky, that if investors – rational investors at least – were able to assess the risks inherent, probably they would not have invested

edition, Oxford University Press, USA, 2015), p. 181; Lastra Rosa M., 'Do We Need a World Financial Organisation' (2014) Vol. 17 Journal of International Economic Law, p. 789

[94] Chodorow-Reich (2014), n 25, p. 170

[95] Larcker et al. (2014), n 71, p. 3

[96] Ibid, p. 4

[97] Ibid., p. 4

in them.[98] The market, including the financial institutions, was at a certain extent misled when dealing with the products above examined, given that – among others – they were misleadingly rated, which rendered their evaluation very difficult.

The international financial community seems to have at least underlined the problem, but are there any substantial efforts to deal with it?

B. Initiatives Undertaken

The presentation of the initiatives undertaken so far in the context of restricting any possible destructive effects of any speculative initiatives is indicative. Hence, the present work deals with the relevant framework of two jurisdictions and more particularly with a couple of practices adopted to deal with the problem.

An initial comment stemming from the analysis below is that there is no established liability framework in case of excessive and destructive risk taking on the part of decision makers of financial institutions. There exist only some mere efforts towards the minimisation of any future problems, which, to the view presented in this paper, cannot sufficiently mitigate wrong incentives and initiatives. An indicative presentation of them is made in order to illustrate how the framework now stands.

1. United States of America

Executives' high compensations were called into question even at the end of the years of the Great Depression in 1941.[99] Hence, the fact that complete freedom with regard to the decision makers' remuneration could lead to disastrous side effects did not come out of the blue within the financial history.

After the recent crisis has evolved and its severe effects for the US and for the global economy became more than apparent, the *Obama Administration* decided to undertake initiatives. Thus, in 2010, the so-called as *Dodd-Frank legislation* came into being. Despite the need for further elaboration by the regulators, it is submitted that this legislation constitutes the most comprehensive and biggest financial regulatory reform since the *Great Depression*.[100] As for the further elaboration and

[98] Johnson & Kwak (2012), n 6, p. 5

[99] Caywood (2010), n 77, p. 112

[100] Morrison & Foerster, 'The Dodd-Frank Act: A Cheat Sheet', Morrison & Foerster (2010), p. 2; Parker Edm. & Gupta M., 'Too Much Regulation Creates Bank Brain Grain' (October 18, 2015), Financial Times

specialisation required, the legislation provides for necessary studies and significant rulemaking by commissions, such as the *Commodity Futures Trading Commission* ("CFTC"), the *Securities and Exchange Commission* ("SEC") and by various Federal-banking regulators.[101] This legislation includes regulations specifically oriented to financial institutions, but it also consists of provisions regarding *risk taking* and *executive compensation practices.*

As far as the provisions regarding risk taking are concerned, the legislation introduces provisions and proposals for further initiatives, such as obligatory risk retention by the securitiser *(Section 941)* and special committees for auditing *(Section 989G)* that the financial institutions abide by the established framework. Disclosure requirements are getting more demanding and thorough as well. As far as those issuing the products entailing risk are concerned, *due diligence* obligations are also introduced. More directed, though, to the notion of liability is Title VII of the *Dodd-Frank Act*, known as *Wall Street Transparency and Accountability Act of 2010*, which establishes a decisive framework regarding derivatives and market participants.[102]

As for the pre-existent framework in the US, it is sustained that there was traditionally a mechanism through which, the shareholders of a corporation – this notion including financial institutions as well – can raise the so-called as *"waste claim"*, on the basis of the *corporate waste doctrine.* This doctrine introduces that a shareholder can claim against the board of directors of a company, on the basis of wasting company assets.[103] In this context, Caywood writes that a *waste* is identified in case there is no concrete correspondence among the bonus payment and the results of the service provided.[104] However, this action has only rarely been evoked.

In the same context, the *Dodd Frank Act (Section 957)* legislation endorses the *say-on-pay* principle in the sense of a non-binding vote from the shareholders for their executives' compensation.[105] Within the US and after the rise and effects of the recent financial crisis, the notion of the *say-on-pay* has as well been established in the *Corporate and Financial Institution Compensation Fairness Act* of 2009 (hereinafter

[101] Morrison & Foerster (2010), n 100, p. 10
[102] Ibid.
[103] Caywood (2010), n 77, p. 114
[104] Ibid., p. 117
[105] Morrison & Foerster (2010), n 100, p. 23

2009 Act). In the same way as in the *Dodd Frank Act,* what causes the inefficiency of the 2009 Act is that even there the *say-on-pay* is not binding for the directors, but only advisory; this, however does not mean that it does not constitute a step at all, since it provides the shareholders with the ability to undertake some action.[106] Hemphill and Lillevik argue that the *say-on-pay* policy can function properly as a means of substantial control exercised by the shareholders, if the effective *proxy access* is enabled as well.[107] With this thought in mind, it is submitted that a more multiple-sided approach is required for the system to reach the required results.

2. United Kingdom

It is sustained that the first legislation addressing the issues of accountability, transparency, and performance linkage was established in the UK in 2002 under the title '*The Directors' Remuneration Report Regulations*'. [108] According to this legislation, the shareholders should non-bindingly vote on the directors' previous and next year remuneration, when it comes to publicly traded companies, including financial institutions. Hence, a form of the *say-on-pay* policy is provided in the UK.

The basis of the framework, though, regarding how decisions shall be taken within the financial institutions in the UK is enshrined in Section 172 of the *Companies Act 2006*. This provision sets out the duty of directors to promote the success of their institutions, in the form of the duty to act in good faith when performing their duties. The measure of success is not addressed in the Act, but it is sustained that the reference is made for the long-term amelioration in the value of the shares of the company.[109]

As for the initiatives undertaken in the UK after the financial crisis, the *Walker Report* (November 2009)*,* introduced by Sir David Walker, is considered as one of the most concrete steps towards a change of the corporate governance as to the elimination of undertaking excessive risks. The report proposes board level risk and remuneration committees. [110] Overall, it is sustained that this piece of work

[106] Caywood (2010), n 77, p. 123

[107] Hemphill Th. A. & Lillevik W., 'US "say-on-pay" legislation: is it corporate governance overreach?' (2009) Vol. 51, No. 2 International Journal of Law Management, p. 105

[108] Ibid., p. 109

[109] Arora (2011), n 30, p. 8

[110] Telegraph Staff, 'Walker Review: The Main Points' (July 16, 2009), telegraph.co.uk

acknowledges the importance of the effective communication and interaction among the companies – thus entailing financial institutions as well – and their shareholders.[111]

Along with the above, the *FSA Principles for Businesses* (2009) apply. After the split of the FSA, the Prudential Regulation Authority administers those principles. All regulated firms are obliged to abide by those rules. In this context, Principle 3 writes that *'A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems'*.[112] Arguably, the wording of this principle does not impose any particular obligation that could be rendered effective so as to eliminate any risk taking. Anyone can evoke that he has applied a vaguely prudential policy, based on his point of view on making business. Such provisions constitute mere euphemisms, absent specific obligations on risk measurement, along with a mechanism that could evaluate the measure of risk, specifying who carries the burden for any decision. The fact that the FSA has fined *Citigroup Global Markets* on the basis of this principle, evoking a trading strategy that has manipulated the trading in the bond market[113] does not offer too much towards the elimination of speculative practices. The reason is that this decision did not offer a measure for the decision makers so that they are aware of when they will possibly be fined. This could either lead to indifference towards the principle, or to possible restricted risk undertaking to an extent harmful for the welfare of companies.

V. The Proposal

A. Introductory Notes

To begin with, it should be recalled that the overall viewpoint enshrined in this paper regarding the proper functioning of the market and, in the same vein, the options provided to the market's stakeholders – including financial institutions – is a liberal one. In this regard, there is no intention to make any submissions for moralities, equality within the society and resources' distribution. However, it is

[111] Arora (2011), n 30, p. 6

[112] Prudential Regulation Authority, 'Principles for Businesses; The Principles' (06.06.2014), fsahandbook.info

[113] Arora (2011), n 30, p. 15

sustained that the current stagnant situation, where there is no automatic adjustment to changes and senior executives are able to disrespect the need for proper and long-term functioning of the market and undertake destructive risks, is absolutely outside the notion of liberalism and the way it should be functioning. As Goodhart recently argued, some changes with regard to remunerations of those running the financial institutions should be made, so as failure to become more 'painful'.[114] In any event, regulatory changes are necessary towards the incentives provided for decision makers to take up risks.[115]

It is suggested that the institutions' decision makers could be considered acting as 'freelancers' providing their services, since they undertake different positions every now and then. In fact, the huge bonuses and salaries under examination were provided, on the basis of the fear of institutions – such as *Goldman Sachs* and Morgan *Stanley*, who were paying the lion's shares – not to lose their traders and investment bankers to other competitors to whom they would easily move.[116] Those decision makers should carry the burden of their freedom of expensive initiatives, when those initiatives are not prudent. It is submitted that this burden should take the form of liability for civil wrong.

A proactive approach amounting to a procedure before any liability claim can be raised against a decision maker is favoured here. To the writer's view, this approach could function very much in favour of prudent decision makers of financial institutions. In fact, vague rules regarding issues associated with liability could detrimentally affect those acting reasonably, unlike a more specific framework. This framework summarises as follows: on the one hand, it aims at mitigating any negative financial results as many issues could be prevented by alarming those involved; on the other hand, the aim is the protection of prudent decision makers, in the sense that if they follow any well formulated system, they do not need to be afraid of reputation and financial damage, due to claims stemming out of nowhere. It needs to be underlined that this dissertation proposes both a substantial and a procedural framework to lead to decision makers' liability.

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[114] Goodhart C.A.E, 'The parlous state of macroeconomics and the optimal financial structure' (2014) Vol. 36 International Review of Financial Analysis, p. 83

[115] Persaud (2015), n 2, p. 153

[116] Chorafas (2009), n 3, p. 160

B. The Substantial Framework

Regarding the substantial requirement, it is recalled that there is the need for a proactive approach with regard to the incentives provided for decision makers to undertake any risks in view of the longevity of financial institutions. A tighter connection with the long-term effects of their *"financial creations or tools"* should be established. However, this proactive approach should not pose them in a restrictive framework of tight regulation and auditing, due to potential adverse effects for their efficiency. It is illustrative, that even when the last words of this paper were being drafted, the press highlighted an increasing tendency of highly experienced individuals moving from large institutions to areas were lighter regulation applies, such as investment funds.[117]

One could evoke, in this sense, that the evaluation of long-term results should not be the only focus, given that some of those products have short-term effects of considerable value, which cannot be ignored. However, their interconnection with other products (for example the interconnection between CDSs and asset-backed securities backed by subprime loans) can in the long-term result in disastrous and easily predictable effects for financial institutions or the global economy as a whole. This is the context, wherein the Basel Committee or any other forum able to create impact and lead states to decisive initiatives should establish a framework with global effects, without the worldwide lobbies' influence and on the basic thought that the global finances are unbreakably linked.

But apart from numerical barriers and weights set as regulatory standards which, first, can be manipulated – given, among others, the growing innovation in the financial world – and, second, cannot control situations where the results of bad policies are only identified in the long-term, the notion of *reckless behaviour* has been introduced and cited in juridical decisions. This notion is supported in this dissertation as it provides a basis to furnish the discussion and the decisions needed, so as to tackle *reckless* risk taking. According to the relevant case law, a reckless person is the one performing within*'(i) a circumstance when he is aware of a risk that exists or will exist; (ii) a result when he is aware of a risk that it will occur; and it is, in the*

[117] Parker & Gupta (2015), n 100

circumstances known to him, unreasonable to take the risk'.[118] It is submitted that – as already stated – it is not reasonable to blame those responsible for the day-to-day businesses of an institution for any shortfall. However, in case the above criteria of recklessness apply, then this could act as a core component towards any accusation against them. However, it is very difficult to capture the cases where those characteristics can indeed be identified. Specific procedures complementing the notion of *recklessness* should be established to substantiate a liability claim, especially given the particular character of the initiatives financial institutions' decision makers undertake, i.e. the ongoing outline of the products they are dealing with. A proposal for those procedures is described in the following section.

C. The Procedural Framework

As already inferred, those running a financial institution should be obliged to underline the dangers enshrined in whatever they introduce in the market, so that those paying the bill are able to decide on the new product-entries or their blockage from the global market.

A first tool to efficiently deter decision makers from recklessly taking decisions – in the sense that their rewards will be judged – is the proper functioning of the *say-on-pay* principle. Shareholders should be able to approve or dismiss the proposed managers' compensations before their distribution. This principle is also inherent in the *Dodd Frank Act* (Section 951) legislation above[119] analysed and – in some sense – in the relevant UK legislation. It has also been suggested that decision makers should not have a say at all on their remunerations.[120] As already argued, though, this choice is problematic in the sense that a higher burden is imposed on shareholders, who may hold only a small amount of shares, given the regular partition of share and who most probably do not carry the necessary expertise. The proper formula for *say-on-pay* would require representatives of groups of shareholders according to the type of shares held, so that the relevant interests to be represented efficiently. It is sustained that, even though the point of view of the shareholders will be addressed, it will not

[118] Regina v G and another [2004] 1 AC 1034, para 41; Roberts T. A. & Wilkins A. *and* The Financial Conduct Authority [2015] UKUT 0408 (TCC), para 48
[119] Section IV.B.1
[120] Hillier David et al., *Financial Markets and Corporate Governance* (2nd European edition, McGraw-Hill Education, Berkshire UK, 2012), p. 589

be decisive. Shareholders normally have neither the necessary qualifications nor the financial means to assess properly the policies and, consequently, the remunerations based on policies' performance. However, most executives know that if shareholders disapprove of remunerations, the remunerations and/or the policies of the institution should change, which provides a motive for higher performances.[121]

Clawback provisions constitute a second tool with potential to restrict speculative initiatives within financial institutions. Those provisions are included in directors' contracts and provide for the recovering of benefits granted to them, under the circumstances specified in their contracts. They can be agreed upon either prospectively or retrospectively to the decision makers' harmful decisions.[122] It should be argued, though, that the choice of a retrospective (to the reckless behaviour) instead of prospective clawback provision is not efficient. The reason is that, if retrospective clawback provisions applied, decision makers would have been unaware of the fact that such clauses are going to be agreed upon; hence, they would not change their practices, before they undertake the excessively risky initiatives. As a consequence, the problematic results would not have been deterred. On the other hand, when clawback provisions are agreed upon before any problematic decision-making (prospective clawback provisions), directors are more attentive on what they do, in view of the effects they may suffer on their remuneration.[123] It should be underlined that any recoveries based on clawback provisions most of the times do not suffice to compensate the whole damages caused to institutions. However, the aim of these provisions is primarily the avoidance of the damage, and secondarily – but importantly as well – the return of the remuneration provided for the harmful initiatives.

Clawback provisions should be introduced, because, first, they embody the proactive approach to be established as a lesson learned from the financial crisis and its roots. Second, it is suggested that prospective clawback provisions can serve as one of the bases upon which a waste claim could be raised. In fact, they could be established as an indicator for the decision makers that their decisions will be reviewed, if proven faulty. Caywood submits that it is unlikely that waste claims can

[121] Hudgson Paul, 'Surpise surprise: Say on Pay appears to be working' (July 8, 2015), FORTUNE
[122] Caywood (2010), n 77, p. 125
[123] Ibid., p. 126

be raised and accepted, when prospective clawback provisions exist, because they prevent the intentional waste.[124] It is argued that this is not correct. A clawback provision *per se* cannot deter managers with intention to act recklessly; it can only warn them for the consequences of any harm they cause.

Based on the arguments already introduced, it is submitted that *say-on-pay* and clawback provisions may provide 'early warnings' to policy makers, which may give substance to waste claims and make it easier to exercise them with success. This corresponds not only to the need for some proactive provisions and procedures, so as directors to be deterred from undertaking destructive speculative initiatives, but also to the liberal approach, on the basis of which the market participants should be allowed to undertake the risks they consider profitable, without this leading to their total immunity from the results of their actions. In this sense, it is sustained that what is required is the introduction of a mechanism to be adjusted to the separate jurisdictions, according to their legal culture. The *say-on-pay* vote of the shareholders should remain non-decisive for the decision makers of the institutions. The reason is that indeed the decision makers are those able to assess the risks they undertake and need to be able to undertake any risk they consider as profitable, to the extent they consider them profitable. However, in case shareholders have expressed their state of mind against the risk to be undertaken, then they need to be provided with the ability to raise a *waste claim*, substantiated first on the basis of a reckless behaviour and, second, on the fact that decision makers have been warned by either a negative *say-on-pay* or a clawback provision in decision makers' contracts.

As already mentioned, the substantial requirement for raising those claims is the reckless behaviour of the decision makers. However, this recklessness could in practice be established on any expressed negative opinion by the shareholders, in the context of their *say-on-pay*. This does not mean that a waste claim could be raised only if there was any *say-on-pay* or clawback provisions in decision makers' contracts. However, if these prerequisites hold, it is much easier for waste claims to be substantiated and thrive.

One could argue that one problematic factor is that when the final results of the speculative initiatives of directors will come up, some of the directors will most

[124] Caywood (2010), n 77, p. 126

probably have been away. This being said, the writer sustains that in order for the various national or regional frameworks on the subject to be efficient, it shall be provided that this shareholders' right can be exercised within certain time frames after the reckless behaviour has taken place, no matter whether the decision makers responsible still run the institution or not. The same should also apply to the clawback provisions, in the sense that the shareholders or any other person having legal interest should be able to raise waste claims, based on clawback provisions, even when decision makers are out of a specific institution, when the results of his activities come out.

Some further notions upon which the liability of decision makers could be established, refer to two main ideas: first, the disclosure of financial investments, especially – but not exclusively – when they admittedly entail higher risks[125] – a notion to be elaborated in decision makers' contracts and, second, the firm establishment of the due diligence approach.[126] It is sustained that the notion of *due diligence* is in a sense inherent in or the *other side of the same coin* of the notion of recklessness. As for disclosure requirements, it is underlined that some of the most severe problems in the financial system were caused because of lack of proper international disclosure of information to supervisory authorities. AIG constitutes one of the most characteristic examples. In fact, the one who at last undertook AIG's rescue was the US Federal Government. However, the British and not the US regulatory authorities mainly regulated AIG's financial products' exposure, even though the burden of an AIG being too big to fail was carried in the US.[127]

Finally, regarding the observation that a tighter procedural framework could make it more difficult for waste claims to be raised, it is submitted that, first, the proposal in this paper aims to a better structured, rather than tighter framework. Second, the proposed framework suggests that when specific prerequisites hold, then the waste claim could be easier substantiated.

[125] Johnson S. & Kwak J. (2012), n 6, p. 7

[126] Fox Merritt B., 'Civil Liability and Mandatory Disclosure' (2009) Vol. 109, No. 2 Columbia Law Review

[127] Garicano L. & Lastra R. M., 'Towards A New Architecture For Financial Stability: Seven Principles' (2010) Vol. 13, No. 3 Journal of International Economic Law, p. 607

VI. Conclusions

This thesis submits that there is a coherence between speculative initiatives inherent in the issuance and circulation of some financial products and policies, the incentives provided to directors of financial institutions for excessive risk taking and the liability of the financial institutions' decision makers. This liability could be founded upon the harm caused by excessive risk. In a properly organised legal system, when there is loss caused by a harmful behaviour and not by accident, somebody should be held liable.

This paper provides for a presentation of how both in substantial, as well as in procedural terms the liability of those decision makers for the harm they cause could be established. There is currently a tendency towards more prescriptive rules, rather than general principles, when it comes to the regulatory framework of financial institutions. However, despite any regulatory limits and barriers to risk, reckless behaviour still threatens the system. The necessity of mechanisms such as a broad acceptance and adjustment of the notion of recklessness in the context examined, the proper establishment of the *say-on-pay* principle and the clawback provisions along with an outline of how those mechanisms could operate combined are dealt with in this thesis. In fact, as argued in Section V of the present, *say-on-pay* principle and clawback provisions can serve as precautions of reckless behaviour for decision makers. If this reckless behaviour is at last identified, then the mechanism of waste claims can be triggered, so as that decision makers are held liable for their damaging initiatives.

It is submitted that future in-depth analysis should be conducted regarding the interconnection of the key players in the world of finance and regarding the role liability issues could play in the prevention of speculative risk within the financial market. An association with the principal agent problem, so as to involve all the stakeholders in the solution of the problem could also be addressed.

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