Changing course

Bank of America's shareholders get tough—sort of

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KEN LEWIS, the boss of Bank of America (BofA), famously said he had had as much fun as he could stand in investment banking in the autumn of 2007. How on earth must he feel now? Mr Lewis's decision to buy Merrill Lynch in September has cost him his reputation, his independence and, on April 29th, one of his many titles. At the bank's annual general meeting shareholders re-elected Mr Lewis to the board, but voted to split the role of chairman and chief executive. Walter Massey, a board veteran, replaced him as chairman. Mr Lewis can count himself lucky. True, there was strong logic in buying Merrill Lynch, with its coveted retail brokerage, and Countrywide, a sickly mortgage lender, before that. True too, that the government resisted his belated attempts to get out of the Merrill deal in December, as losses at the bank rapidly worsened.

But these are figleaves. The Merrill deal was stitched together too quickly. Mr Lewis agreed on a price (in shares, to give him some credit) that looked inflated even before Merrill posted losses of more than $15 billion in the fourth quarter. "As a group, they are not disciplined buyers," says Jonathan Finger, a disgruntled shareholder. Claims that Merrill paid out lavish bonuses to employees without BofA's say-so, and that Mr Lewis was forbidden by officials to disclose details of Merrill's losses to shareholders (both disputed), make BofA's managers look impotent at best and contemptuous of shareholders at worst. Hostile investors argue that Merrill was already burning money when they voted on the deal on December 5th, before Mr Lewis crossed swords with the government.

The bank's share price has lost more than three-quarters of its value since September. Things could yet get worse. Leaks about the results of the stress tests that have been conducted on America's largest banks suggest that BofA, which has already received $45 billion from the government, needs yet more capital (it would probably not be the only supplicant). This could well mean that the government's preferred shares are converted into common equity. If other investors do not want to get rid of Mr Lewis, the government may do it for them.

For bank shareholders in America, the ground is slowly shifting. Managers and boards will find it much harder in future to argue that they know best after the pasting they have given investors. Chuck Schumer, a Democratic senator, is reportedly planning a bill requiring non-binding "say on pay" votes, independent chairmen and annual elections for boards of directors. The Securities and Exchange Commission is also expected to enact two reforms. One would make it easier for shareholders to nominate their own candidates to the board. The other would stop retail brokers from casting votes, almost always in favour of management, on behalf of investors who have not given instructions on how to vote. These broker votes accounted for roughly a quarter of the BofA ballots.

Working out what effect enhanced shareholder rights would have on banks is harder. Governance activists in America typically laud the shareholder regime in Britain, yet the British

banks fouled up just as badly as everyone else. Take RBS, where the shareholders merrily voted to buy ABN AMRO—the deal that sank the bank—after the credit crunch had struck.

The sympathetic explanation is that shareholders face a difficult job of holding banks to account. Banks are opaque and complex firms. Working out the risks they were taking on was apparently beyond most managers, let alone shareholders. Banks are heavily regulated, which created an unhealthy reliance on supervisors, who were also incapable of understanding the risks. And banks are fragile, which makes shareholders think twice about flexing their muscles when confidence is shaky. “There isn’t a halfway house to register effective dissent without risk of nuclear war,” says Peter Montagnon of the Association of British Insurers.

That worry still preoccupies some BofA shareholders. The bank argues that Mr Lewis and his team are skilled at integrating acquisitions; now that Merrill and Countrywide have been bought, in other words, shareholders would cut off their own noses by getting rid of them. That is a bit like saying BofA managers are experts in getting out of holes they have dug for themselves. But the judgments are finer for other banks. Take Barclays, which riled shareholders with a dilative capital-raising in October but has avoided taking government cash. On April 23rd an unusual number of shareholders opposed the re-election of Marcus Agius, Barclays’ chairman, but nowhere near enough to threaten his appointment. That seems supine to some, pragmatic to others.

Even when shareholders raise objections, it is apparently too easy for executives to ignore them. The boss of Legal & General, a large institutional shareholder, has described the way British banks ignored its advice during the crisis as “sobering”. Some think the role of lead independent directors needs to be beefed up. Another idea is for a committee of the most powerful shareholders to dig deeper into the composition of the board. Increased public scrutiny will also make it harder for executives to brush off criticism. Daniel Bouton announced his intention to resign as chairman of Société Générale on April 29th, citing personal attacks since a rogue-trading scandal forced him out of the chief executive’s job a year ago.

There is another, more sinister explanation for the failure of shareholders to discipline their managers—they do not want to. Shareholders accrue all the gains from risk-taking, but their losses are capped by the amount of equity they hold. Once capital is wiped out, any further losses are borne by creditors. A forthcoming paper by Shams Pathan of Australia’s Bond University finds that bank boards that are more aligned with shareholders’ interests are more likely to take risk than those that are under the thumb of the chief executive.

When banks have only thin slices of equity, or when share prices have dropped precipitously, shareholders’ propensity to gamble goes up even more. A new paper from Lucian Bebchuk and Holger Spamann of Harvard Law School suggests that bankers’ pay be tied not just to equity but to other bits of the bank’s capital structure, such as preferred shares and bonds. Giving shareholders more control makes sense, but like every other solution to this wretched crisis, it creates problems of its own.