

The focus of regulatory reforms in Europe after the global financial crisis: from corporate to contract governance

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Every crisis offers opportunities to rethink, reform and renew structures and institutions, as well as rules and standards. The market economy will certainly survive the global financial crisis and may even emerge in better shape, but it must be open to scrutinizing or even reinventing itself.¹ This process of regulatory reform started immediately in the midst of the crisis: advisory boards such as the Issing, the Turner and the Larosière Committees soon developed reform proposals at the national and European level (Issing Committee, 2009; Turner Review, 2009; Larosière Group, 2009). Some of them have already been adopted by law-makers or are about to be drafted as legislative proposals (European Commission, 2009a and 2009b). At the international level, a first outline of a global financial architecture came to be identifiable in the aftermath of the London G20 summit (G-20-Summit, 2009a and 2009b). Further actions to assure a sound and sustainable recovery from the global financial and economic crisis were discussed at the summit in Pittsburgh in September 2009.²

Reforms in periods of crisis, however, tend to embody overreactions.³ Hence the financial crisis is a real challenge for governance research as well: scholars have to face difficult questions of legal policy, namely to identify dangers of over-regulation, advise against them in a timely fashion, and develop principles of smart regulation (Kirchner, 2009, p. 14).⁴ In order to meet this challenge, governance research might well be forced to rethink its own methods and approaches, specifically to widen its research focus. After all, the financial crunch was not only a crisis of corporations. Contracts and markets played an important role too.

Causes of the global financial crisis

The global financial crisis had many different causes. In any event, it did not only emerge due to specific corporate structures, but was also (and perhaps mainly) rooted in the instability of markets. As is well known, subprime loans in the United States were often approved regardless of financial standing and equity contribution (Grundmann *et al.*, 2009, pp. 3 *et seq.*, with further references). Corresponding risks were collateralized with insufficient security because mortgages were not transparent; or they were transferred by virtue of loan insurances (Richardson, 2009; Taylor, 2009, pp. 61–3). Personal claims against real estate credit users were for legal or practical reasons almost impossible. Low and partly variable mortgage rates and the expectation of rising house prices created further incentives to borrow more money than appropriate with respect to personal solvency (Grundmann *et al.*, 2009, pp. 7 *et seq.*; Zandi, 2009, pp. 45–77; comprehensively, Barth, 2009). On the opposite side of the market, there was no incentive for responsible lending either, because through securitization, transfer and bundling credit risks could be transferred almost at will, and without any real chance for the purchasers to evaluate these risks themselves.⁵ Instead, they had to count on the information of rating agencies, who themselves had little incentive to reduce the profitable source of income of the securitization business by poor ratings (Schwintowski, 2009, pp. 45 *et seq.*; Hosp, 2010; see also Levich *et al.*, 2002). More generally, remuneration incentives fostered the dynamics that led to this crisis. These incentives did not only result in remuneration packages of company directors, but also mainly in bonuses of investment bankers and even in commissions of loan and investment advisors: in other words, in compensations that were paid in the operational business.⁶

This short outline demonstrates that the financial crisis had its roots in the allocation of risks and the lack of transparency. However, as opposed to the Asian crisis between 1997 and 1999 or the bankruptcies of Enron and Worldcom, systematic failures of corporate governance were not of key importance (Wymeersch, 2008, p. 1; Mülbart, 2009a and 2009b; see also van den Berghe, 2009). This crisis might have been related to incentives for corporate actors, but incentives for market participants were equally important: ‘The relationship between corporate governance and financial stability is an

indirect one, as the stability of firms and markets are essential elements for maintaining financial stability. Corporate governance tools do contribute to the intermediate objectives at the firm level, but not directly to financial stability' (Wymeersch, 2008, p. 13). Loans were granted, securitized and rated in a legal and social framework that allocated risks and chances in a manner creating incentives for transactions that destabilized the whole system in the long run. Most of the contracts in question were long-term relationships – loan contracts, bond contracts and loan insurance contracts. Such relationships are, by nature, more likely to provide strong and steady incentives than simple spot contracts.⁷ For a thorough understanding of the market instability that was at the heart of the current crisis, it is crucial to analyse the steering effects of all different public, but also social, mechanisms that impacted the autonomous interaction of the various players – central banks, borrowers and private banks, insurance companies and credit rating agencies. It is necessary to understand the entirety of collective, not only hierarchical, influences on a specific social system. This is precisely the task that governance research is all about (Hill and Hupe, 2002, pp. 13 *et seq.*; Köndgen, 2006, p. 514). Yet the social system that was concerned is not only the internal organization of corporations, but also the market.⁸ What governance research has to explore and improve in future is the institutional framework of contractual (in addition to intra-organizational) relations.⁹

Therefore, the financial crisis had much to do with governance, but not only with *corporate* governance.¹⁰ Most of the early reports, documents and declarations barely mentioned corporate governance. It was addressed neither in the recommendations of the US President's Working Group on Financial Markets, nor in the reports of the Financial Stability Forum and the International Monetary Fund (President's Working Group on Financial Markets, 2008; Financial Stability Forum, 2009; International Monetary Fund, 2008). There was no mention of corporate governance in the Washington or London Declarations of the G20 (G-20-summit, 2008). In the UK, the above-mentioned Turner Review was a bit more fruitful¹¹ and was later complemented by the so-called Walker Review, dealing specifically with bank governance arrangements (Walker Review, 2009). Yet the European Larosière Report called corporate governance 'one of the most important failures of the present crisis' (Larosière Group, 2009,

p. 29). Under this heading, however, the report mainly criticized general incentive mechanisms on markets that promote short-term profit orientation. Only the reform proposals on remuneration and risk management are more specifically related to corporate governance as such. The OECD, the world's leading rule-setter in corporate governance issues (OECD, 2004), called for corresponding reforms as a matter of course and launched an ambitious action plan, but its analysis mainly concentrated on the same two aspects (OECD, 2009a).¹² Moreover, the OECD recommended better implementation and enforcement mechanisms, but did not propose any substantive revision of the current corporate governance principles (OECD, 2009b).

Regulatory reforms in response to the financial crisis

Subsequent to these early reactions, a multitude of regulatory reforms and reform proposals have been tackled in order to respond to the causes of the financial crisis. A short survey of the most important developments at the European and national level, particularly in the UK and Germany, will show that some of these reforms relate very well to the corporate governance framework, mainly with respect to financial institutions. However, the main focus of these crisis-related regulatory reforms centres on the architecture of financial markets rather than on the governance of companies.

General framework of corporate governance

With respect to the general corporate governance framework, only minor modifications have taken place since the financial crisis, and most of the respective developments are not directly related to the crisis and its causes.

At the European level, for example, the effectiveness of monitoring and enforcement systems that Member States have put in place with a view to the national corporate governance codes is currently under review. In November 2009, the European Commission published a corresponding external study in order to provide a basis for the European Corporate Governance Forum's work on this subject (Risk-Metrics Group *et al.*, 2009). While this group's further discussions had a certain emphasis on the causes of the financial crisis, most of its

statements were related to more general issues such as the transparency of derivative positions and empty voting, the protection of minority shareholder rights and the application of corporate governance codes in cross-border situations (European Corporate Governance Forum, 2010). Similarly, most of the amendments that have recently been proposed by the Commission on the German Corporate Governance Code are not directly linked to the financial crisis, but concerned, *inter alia*, incentives for sustainable corporate governance, improvements in the professionalism of supervisory boards by continuing education requirements, and sustainable measures for increasing the proportion of women and international representatives on German supervisory boards (German Corporate Governance Commission, 2010). In the UK, the Financial Reporting Council (FRC) published an updated version of the Corporate Governance Code in May 2010, together with a report summarizing the outcome of its recent consultation process (Financial Reporting Council, 2010). Again, the few significant changes in substance do not respond directly to the financial crisis: directors of FTSE 350 companies are expected to put themselves up for re-election annually, the chairman should hold regular development reviews with each director, and there are new provisions relating to boardroom diversity. Further modifications relate to the disclosure of the business model, the leadership responsibility of the chairman, the time commitments of directors and the role of non-executive directors.

One single topic on the reform agenda is more closely related to the financial crisis: remuneration policies. As this issue attracted much public interest in the aftermath of the crisis, many rule-makers felt the need to take a firm stand in this respect. On the European level, the Commission adopted a recommendation on the regime for the remuneration of directors of listed companies in April 2009 (European Commission, 2009c). The recommendation invites Member States to set a limit on severance pay and to ban severance pay in case of failure; to require a balance between fixed and variable pay and link variable pay to predetermined, measurable performance criteria; and to allow companies to reclaim variable pay paid on the basis of data that proved to be manifestly misstated. With respect to the process of determining directors' remuneration, the said recommendation asks Member States, *inter alia*, to strengthen the role and operation of the remuneration committee through new principles on the composition of such

committees, to oblige committee members to be present at the shareholder meeting where the remuneration policy is discussed to provide explanations to shareholders and to avoid conflicts of remuneration consultants. In a communication accompanying this recommendation, the Commission claims that there was 'broad consensus that compensation schemes based on short-term returns, without adequate consideration for the corresponding risks, contributed to the incentives that led to financial institutions' engagement in overly risky business practices' (European Commission, 2009d, p. 2). Even though this argument seems questionable with respect to compensation schemes outside the financial sector, the Commission observes very accurately whether Member States have acted in order to give effect to these recommendations. A recent report states that most recommendations have so far only been implemented by a minority of the Member States, including Germany and the UK (European Commission, 2010a). In the UK, respective principles are now included in the updated version of the Corporate Governance Code, whereas Germany introduced new legislation on the appropriateness of management board compensation, which came into force in August 2009 (VorstAG, 2009).

Corporate governance in financial institutions

When regulatory reforms are specifically targeted to the financial services sector, their link to the financial crisis seems intuitively plausible. Indeed, the elaboration of such sector-specific rules can probably be identified as the single most important trend in European corporate governance since the crisis. This trend recently culminated in a Green Paper on corporate governance in financial institutions and remuneration policies, published by the European Commission on 2 June 2010 and announcing a plethora of legislative and non-legislative proposals to be implemented in the near future (European Commission, 2010b). This approach goes far beyond the developments at the national level, particularly in the UK: whereas the extensive Walker Review of Corporate Governance had a specific focus on the banking industry, it largely refrained from proposing additional provisions and instead advocated amplification and better observance (Walker Review, 2009). Accordingly the revised UK Corporate Governance Code does not include any sector-specific provisions (see Financial Reporting Council, 2009 and 2010).

By contrast, the first European step towards sector-specific governance rules had already been taken in April 2009, with respect to remuneration policies. Along with the general remuneration rules mentioned above, the Commission published a more specific recommendation for the financial services sector (European Commission, 2009f). As opposed to the general scope of application of corporate governance rules, these recommendations apply to all undertakings operating in the financial services industry, regardless of their legal status, and regardless of whether their securities are admitted to trading on a regulated market. Compared to the general recommendation on executive remuneration, the Commission proposes more specific mechanisms of internal transparency, control and review as well as allocation of the responsibility for remuneration policies to the board instead of a remuneration committee (European Commission, 2009f, para. 6 and Section III). Above all, the respective rules are not only recommended for company directors, but for 'those categories of staff whose professional activities have a material impact on the risk profile of the financial undertaking' (European Commission, 2009f, para. 1.2 and Recital 13). A recent report of the Commission states, however, that Member States have responded only very cautiously to this sector-specific recommendation. A relatively high number did not initiate any measures or took unsatisfactory ones; and only seven Member States apply relevant measures across the financial services sector. The Commission concludes disappointedly that 'these substantial differences of national implementation on an element as fundamental as the structure of the remuneration policy are worrying' (European Commission, 2010c, p. 11).

However, this experience did not prevent the Commission from proposing additional corporate governance rules specifically for the financial sector. In its recent Green Paper, the Commission justifies this sector-specific approach by the particularities of financial institutions. On the one hand, their potential systemic risks imply that taxpayers are 'inevitably stakeholders in the running of [such] institutions, with the goal of financial stability and long-term economic growth' (European Commission, 2010b, p. 5). On the other hand, depositors and creditors favour a very low level of risk, so that their expectations are potentially at odds with those of financial institutions' shareholders. While none of these arguments is implausible,¹³ the differences to other sectors are arguably in degree rather than in kind. In any event, the question arises

whether they justify the wide range of proposals that the Commission set forth. They are aimed not only at changing remuneration policies in companies in order to discourage excessive risk-taking, but also at improving the functioning and the composition of boards of financial institutions in order to enhance their supervision of senior management, at establishing a risk culture at all levels of financial institutions in order to ensure that long-term interests of the business are taken into account, and finally at enhancing the involvement of shareholders, financial supervisors and external auditors in corporate governance matters. Some specific proposals even touch the very concept of private business organizations by considering, for example, giving supervisory authorities 'the power and duty to check the correct functioning of the board of directors and the risk management function' (European Commission, 2010b, p. 15, para. 4.2). Of course, these proposals constitute only the first step of the legislative process; they will be reconsidered in accordance with the input that the Commission receives during the ongoing consultation process. Nonetheless, the radical nature of some Green Paper proposals is quite astonishing, in particular because the European Commission itself acknowledges that 'corporate governance did not directly cause the crisis' (European Commission, 2010b, p. 2).¹⁴

Governance of financial markets

The Commission's acknowledgement is in accordance with the author's observation that the financial crisis did not primarily emerge due to specific corporate structures, but had its roots in the instability of financial markets. As a consequence, taking stock of respective regulatory reforms must not be confined to corporate governance. Such selective perception would effectively fade out the actual emphasis of European and national rule-makers alike, clearly focusing on ensuring the stability of financial markets. The European Commission explicitly centred its initiatives on the 'governance of international and European financial markets' in order to create responsible and reliable financial markets for the future (European Commission, 2009h, p. 4). The respective legislative and regulatory measures and pending propositions have indeed become so numerous and manifold by now that it is impossible to quote more than some important examples at the national and European level, which are all closely related to the aforementioned causes of the crisis.

With respect to consumer loans, for instance, the European Commission undertook to propose further measures at the EU level regarding responsible lending and borrowing, including a reliable framework on credit intermediation (European Commission, 2009h, p. 7; for the results of the relevant public consultation, see European Commission, 2009j). In order to restore market confidence and provide for sound information about the creditworthiness of companies, governments and sophisticated financial products, the European Parliament and the Council adopted a directly applicable regulation that puts in place a common regulatory regime for the issuance of credit ratings.¹⁵ With respect to banking, insurance and securities markets, various initiatives aim at enhancing competition in order to respond to systemic risks and in particular to the phenomenon that banks become 'too big to fail'. Current proposals include a specific merger control or even a decartelization of banks (Zimmer and Rengier, 2010). Further noteworthy initiatives aimed at reducing this systemic risk effectively propose levies, taxes or capital requirements, the level of which rises with the systemic relevance of an institution (Doluca *et al.*, 2010; Weber, 2010). In a similar vein, the Commission launched an intensive discussion on further possible changes to the Capital Requirements Directive, aimed at strengthening risk coverage, mitigating pro-cyclicality and discouraging leverage, as well as strengthening liquidity risk requirements and forward-looking provisioning for credit losses (European Commission, 2010e). The ultimate goal of the proposal is to prevent market transactions with a potential to jeopardize market stability. The same is true for the proposed Directive on Alternative Investment Fund Managers, considered to be a crucial part of the European Commission's response to the financial crisis. Again, the purpose is to extend regulation and oversight to all actors and activities that embed significant risks for financial market participants and for the stability of the underlying markets (European Commission, 2009k, p. 2 (Explanatory Memorandum)). The same market-oriented focus is even more obvious with respect to the Commission's initiatives on derivatives. Having adopted two different communications on 'Ensuring efficient, safe and sound derivatives markets' in July and October 2009, the Commission launched a public consultation on derivatives and market infrastructures, and is now in the process of finalizing its draft legislative proposals, again with a clear focus on risk mitigation (European Commission, 2009g and 2009i).¹⁶ Various initiatives at national level point in a very similar direction.¹⁷

Implications for future governance research

'This time is different',¹⁸ at least in one respect: whereas previous crises originated in non-transparent corporate structures, the recent turmoil had its roots also in the instability of markets. Accordingly, most regulatory reforms in response to the financial crisis focused on improving the stability and transparency of markets, not companies. All this should be reflected in future governance research. Oliver Williamson once defined governance as 'an effort to implement the "study of good order and workable arrangements"', where good order includes both spontaneous order in the market . . . and intentional order' (Williamson, 2005, p. 1). Henceforward the study of good order and workable arrangements should take markets and contractual relationships into greater consideration, and develop a research area of contract governance.

The nature of contract governance

The notion of contract governance has thus far only been used rather sporadically, usually with a view to worker participation agreements in corporations, that is, in terms of corporate governance on a contractual basis (Windbichler, 2004, pp. 195 *et seq.*; Windbichler, 2005, pp. 529 and 533 *et seq.*; similarly Eidenmüller, 2007, p. 493). Yet contract governance has a wider scope. It aims at improving the proper functioning of markets by providing a research approach that deals with the institutional framework of contractual relations on markets. Contract governance research examines whether their legal, social, cultural or otherwise agreed conditions generate coordinating or steering effects for market participants (in detail, Möslein and Riesenhuber, 2009). For instance, default rules of contract law provide an auxiliary infrastructure with a potential impact on market behaviour (Windbichler, 1998, p. 271; Bachmann, 2003, pp. 20 *et seq.*; Grundmann, 2007b, p. 143; with respect to company law, Fleischer, 2004, p. 707; similarly from the perspective of institutional economics ('facilitative law') Clark, 1985, pp. 60–72; Furubotn and Richter, 2005, pp. 12 *et seq.*). Moreover, information and transparency obligations can serve similar goals as mandatory substantive regulations. Similarly as with respect to corporate structures, the institutional framework of market transactions is therefore by no means restricted

to supervisory regulation, but can also be composed of default rules, soft law mechanisms or codes of conduct. Such alternative mechanisms might even turn out to function more effectively, for they give guidelines on good conduct, while not prohibiting certain market behaviour. Contract governance research takes these alternative mechanisms into account as well. Such an approach can help to avoid, for instance, counter-reactions and circumventions. As compared with the actual regulatory reforms, contract governance might therefore offer alternative ways to foster long-term market stability, while allowing market players as much contractual freedom as possible (in a similar direction, already prior to the present crisis: Alexander *et al.*, 2006).

As a research perspective, contract governance changes the traditional legal approach in a threefold sense. In the first place, the perspective on contractual and legal rules changes from the usual *ex post* to an *ex ante* perspective: contract governance understands rules not primarily as an instrument of dispute resolution, but as a mechanism for steering and coordinating human behaviour (Möslin and Riesenhuber, 2009, p. 257). Legal scholars have examined the steering effects of private law rules before, but not systematically (in detail, on the legitimacy of preventive and regulatory functions of private law, Wagner, 2006; criticizing, for instance, Honsell, 2008, pp. 626 *et seq.*). Contract governance can help to analyse incentive effects, for example, to better understand the impact of contractual bonus or malus arrangements on individual behaviour. As legal scholarship itself lacks a specific model of human behaviour, such analysis requires a more intensive dialogue with other disciplines – not just economics, but social sciences more generally, in particular sciences of human behaviour, including neurobiology.¹⁹ Experience shows that governance provides a common language which greatly facilitates this dialogue, and may henceforth also do so for contract law (Schuppert, 1999; Hoffmann-Riem, 2004, p. 11). Secondly, contract governance widens the perspective. The contractual relationship between two persons, the bilateral ‘privity of contract’, represents the focus of classical contract law scholarship (Trebilcock, 1993, pp. 58–77). Contract governance has a wider scope, as it focuses on markets, not only on individual contracts.²⁰ Individual needs of protection may often appear less relevant once not only the bilateral contractual relationship, but also alternatives on markets, are taken into account (Möslin and

Riesenhuber, 2009, p. 259). Like corporate governance, contract governance therefore includes an internal and an external dimension, thereby linking contract and competition law considerations more closely together (Möslin and Riesenhuber, 2009, pp. 270 and 288). Thirdly, the broader, results-oriented perspective of contract governance can contribute to a contract law theory of rule-making, thus going beyond the mere application of rules (Eidenmüller, 2007, pp. 490 *et seq.*). Strategic advice for legislators, especially with respect to techniques and intensity of regulation, becomes particularly important in times in which uniform statute books are increasingly supplemented and substituted by various regulatory instruments at different regulatory levels (Calliess, 2006; Michaels and Jansen, 2006, pp. 868 *et seq.*; Calliess *et al.*, 2008).

Similarities and differences between contract governance and corporate governance

Contract governance and corporate governance follow very similar patterns. They both help to provide a wider variety of regulatory tools to rule-makers. Moreover, both mechanisms supplement each other. They are indeed closely linked together and interact in a variety of ways. Exchange and cooperation are of course fundamentally different mechanisms, but they are nonetheless often equally suitable to reach specific goals. This idea is the actual starting point of governance research in Williamson’s seminal article; it also defines a key decision problem in economic theory (path-breaking, Coase, 1937; cf., furthermore, Williamson, 1985, pp. 32–4, 60–2 and *passim*; for a recent survey, Eidenmüller, 2001, p. 1042). The most important difference between contract and organization is that contracts are typically concluded *pari passu* on markets, whereas business organizations are characterized by a hierarchical order (Möslin and Riesenhuber, 2009, p. 258). Decision-making power and risk-bearing can diverge in instances of majority and management decisions (Behrens, 1986, pp. 110–277). It is mainly because of this divergence that a corporate governance framework is required that makes decision-making procedures transparent and provides incentives for decision-makers to act in the best interest of the corporate organization.²¹

Even in contractual relationships, however, not all relevant questions are decided by mutual consent. Particularly in long-term contracts and

contractual networks we can also track 'hierarchical' decision-making mechanisms (in detail Behrens, 1986, pp. 493 *et seq.*). Moreover, the market mechanism does not always provide for equitable solutions (*Richtigkeitsgewähr*).²² In such cases, alternative governance structures may be required, which are contractual in nature, but feature, depending on their specific design, more or less similarity to corporate governance.²³ This smooth transition between contract and corporate governance corresponds with the insight of business administrations that corporate boundaries are not in every respect fixed. The choice between corporate and contractual structures is rather one of the central challenges for management that has to optimally allocate the various areas of entrepreneurial activity. Due to the advancements of information technologies, outsourcing has gained much importance in recent years so that management experts aptly speak of an 'expansion of corporate boundaries' (Wigand *et al.*, 1997). Corporate boundaries are blurred in many directions, also with respect to financing, where creditors are often granted a similar degree of influence as shareholders by means of contractual covenants (Servatius, 2008; also McCahery and Vermeulen, 2008, pp. 189 *et seq.*). The outsourcing of risks on special-purpose entities or by securitization can be conceptualized as a similar development in the banking business (as a step to banks without boundaries, so to speak; cf. Obay, 2000). Due to this blurring of corporate boundaries the often-cited 'nexus of contracts' is not only a law-and-economics metaphor for the corporate entities,²⁴ but becomes business reality in a very literal sense. If governance research really wants to take a look at social systems as a whole, it cannot focus exclusively on the single corporate entity but needs to analyse the whole contractual network in which corporations are embedded (similarly, Deffains and Demougin, 2006, p. 7). In other words: 'contracting for control' needs to be taken into account (Baker *et al.*, 2006; in a similar vein Hart and Moore, 2008; Fehr *et al.*, 2009).

Linkages between contract and corporate governance

Not only are corporate governance and contract governance two alternatives with certain similarities, however, but these two mechanisms are closely interwoven. Two major linkages between contract and corporate governance were already indicated in the Larosière Report and the action plan of the OECD, and have subsequently induced

intense regulatory activity. The first linkage concerns employment contracts that bind decision-makers to the company. Their incentive structures, especially their remuneration schemes, are of a contractual nature, but they also have an impact on corporate strategy and success (comprehensively, Bebchuk and Fried, 2004). Indeed, there is a general consensus that the design of remuneration schemes had a crucial impact on the financial crisis.²⁵ Remuneration schemes at the executive level and below are rooted in contractual arrangements between companies and their employees; they often comprise not only a fixed salary, but also variable elements such as annual bonuses, long-term cash incentives or stock options, and possibly even severance payments. Contractual structures therefore create incentives that have an impact on management actions and can, as the Commission states, 'affect the long-term performance and sustainability of the companies and therefore also affect investor confidence, employment, competitiveness and long-term economic growth' (European Commission, 2009e, p. 7). On the other hand, the design of these contractual structures depends on the procedural setting within the corporation, more specifically on the question of which corporate body is competent and accountable to decide on such arrangements (for a comparative survey, see Möslin, 2007, pp. 101 *et seq.*). The importance of appropriate corporate governance structures and adequate disclosure rules for the contract governance of remuneration agreements has triggered corresponding legislative reforms.²⁶ Given that remuneration incentives in the operational business of investment banks were relevant for the current crisis,²⁷ remuneration policy is not only a question of corporate governance, but also, and maybe primarily, of contract governance.²⁸

A second linkage between contract governance and corporate governance concerns corporate risk management, in other words the systematic identification, assessment and prioritization of risks (Hubbard, 2009, p. 46; comprehensively, Chew, 2008; Merna and Al-Thani, 2008). Since the financial crisis, the focus has been mainly on so-called external risks, on market risks that originate in contractual arrangements (see, for instance, Senior Supervisors Group, 2008, pp. 12 *et seq.*; OECD, 2009a, pp. 8 *et seq.*). Again, the linkage is twofold in nature. On the one hand, contractual risks and incentive structures can have a crucial impact on corporate strategy and corporate success, as the financial crisis has dramatically shown.²⁹

On the other hand, the ranking of risk management in the internal corporate governance structure may well have an impact on the structure and design of these contractual relationships, thereby affecting contract governance. Accordingly, the Larosière Report and the Basel Committee on Banking Supervision propose independent risk management at senior management level with direct access to the board (Basel Committee on Banking Supervision 2009; Larosière Group, 2009, pp. 32 *et seq.*). The above-mentioned OECD Paper goes even further and emphasizes the importance of future-oriented stress tests in a very general manner, not only with respect to the financial sector: 'Stress testing must form an integral part of the management culture so that results have a meaningful impact on business decisions' (OECD, 2009b, p. 10; with potential impact on future corporate governance standards: OECD 2009a, pp. 33–40). In other words, contract governance, the forward-looking assessment of long-term contractual relationships, is meant to become a key management responsibility for corporate boards in general.

Future research

Contract governance will only be able to provide new solutions for preventing future systemic crises if such a research approach can indeed offer a useful tool for present challenges. Most governance structures in which we find the causes of the financial crisis were contractual relationships (subprime loans, securitization; the assignment of rating firms and so forth). Problems of credit rating, systemic financial risks, the moral hazard of risk transfer and interlocking contracts therefore need to be tackled from the perspective of contract governance. This observation, however, only adds impetus to a research approach that would be interesting in its own right; research on the stability and constitution of contractually organized mass transactions and on transactions that typically are of a long duration. A governance perspective on these phenomena is important because contract law research, specifically in Europe, has not yet followed the shift from an industrial to a service- and knowledge-based society. The sales contract, in thinking and in codification endeavours, still forms the sole starting point, the paradigm. Reality, however, is different: long-term relationships, contractual relationships of cooperation,

relationships of trust with an ongoing and intensive exchange of information and of inputs and with a high amount of cross-decision powers between the parties and mutual positions of influence form largely undiscovered territory, but at the same time one large part of the challenge for today's contract law. Moreover, the multiplicity of contract partners, especially in networks of contracts, but also in the case of parallel behaviour, is a phenomenon which is paramount in real life but still rarely discussed in contract law (see, however, Teubner, 2002; Grundmann, 2007a; Grundmann, 2008; also Cafaggi, 2008). The phenomenon of herd behaviour, in turn, was of utmost importance in the financial crisis. Networks of contracts are dominating all supply relationships, all distribution relationships, thus virtually the whole production chain, but also payment systems as well as many forms of financing. Even less developed – and indeed virtually unexplored – is the theory of herd behaviour in contractual situations. All this points towards a much wider issue: the relationship between contract governance and free market mechanisms.

The concept of 'contract governance' would seem to describe well the panorama of these topics. This term points to other governance discussions, among them most prominently the corporate governance discussion and its breathtaking development. It is of course true that when discussing governance one has to distinguish the original and rather narrow meaning, that is governance of the process of formation of contract and of the phase of performance by the parties (Williamson, 1979), from a governance regime coming from outside, i.e., governance devices in the market order set for mass transactions. However, both the arrangements adopted by the parties and the governance regime set by market organization are interlinked to such an extent that they should not be discussed separately, i.e., governance of a contractual relationship should not be discussed without taking into account market organization. This is particularly evident in situations where parties themselves can change the governance regime set by states, namely in the case of default rules or of 'comply or explain' regimes (Möslein, 2010). In such situations, the governance regime which is finally in place is the result of a combination of both private parties' action and state regime. Governance in contractual relationships, mainly in long-term relationships, in network relationships or in mass transactions that occur in parallel, is the main (although not the exclusive) focus of contract

governance research: primarily governance via private arrangement, but also market organization, especially in national or supranational laws, considering as well that the most important players are corporations.

If the research area is called 'contract governance', this obviously implies that research can learn from how the discussion in 'corporate governance' has developed. Corporate governance discussion was also prompted by important crises, and yet it was much more than a mere answer to a crisis. It encompassed the problems raised by these crises but also reached much further. It was all about fundamental research, the need for which had become even more evident against the background of the crises. Moreover, not all problems and concepts that were discussed in a corporate governance perspective concerned fundamentally new questions. Yet that discussion contained a good deal of novelty, at least in style and approach to research, and to a certain extent really new substantive questions were brought up too. The same would seem to be possible for contract governance where similar developments, to a large extent, are yet to happen.

Notes

- 1 For an extensive account of examples illustrating that good design of a market is crucial to its success, that a market develops over time by trial and error, and that government plays an indispensable role in providing public goods and acting as rule-setter and referee, see MacMillan, 2002.
- 2 Further information available at www.pittsburghsummit.gov/, last accessed 16 August 2010.
- 3 For instance, Klaus Hopt warned strongly against 'the danger of over-regulation, a plethora of standards and a new protectionist wave', see Hopt, 2009.
- 4 The term and concept have been developed in a different area: Gunningham and Grabosky, 1998.
- 5 Despite early warnings: see, for instance, Center for Responsible Lending, 2006. At a glance on the merits: Grundmann *et al.*, 2009, pp. 8–12.
- 6 For an extensive account of (non-executive) remuneration practices in the City of London before the crisis, see House of Commons – Treasury Committee, 2009, pp. 10–17.
- 7 This is one of the central arguments of Williamson, 1979, pp. 247–54; see also Williamson, 1996, pp. 145–70.

- 8 This fits with the concept of governance as defined, for instance, by Williamson, 2005, pp. 1 *et seq.*
- 9 For a very similar approach, yet from a purely economic perspective, see the research programme of the Collaborative Research Centre (*Sonderforschungsbereich*) Transregio 15, *Governance and the Efficiency of Economic Systems* (coordinated by Urs Schweizer), available at www.sfbtr15.de, last accessed 16 August 2010.
- 10 Similarly, Mülbart, 2009a, p. 411: 'After the beginning of the financial turbulences in summer 2007, the issue of banks' corporate governance, with the notable exception of remuneration, went out of focus for some time.' See, however, Isaksson and Kirkpatrick, 2009, p. 11: 'If there is one major lesson to draw from the financial crisis, it is that corporate governance matters.'
- 11 Turner Review, 2009, p. 78 ('Regulation can and should address issues relating to the proper governance and conduct of rating agencies and the management of conflict of interest'), and p. 93 ('Achieving high standards of risk management and governance in all banks is therefore essential').
- 12 Two additional, but closely related, aspects are the performance of boards and the exercise of shareholder rights.
- 13 More extensively, the Walker Review, 2009, pp. 24 *et seq.*
- 14 In a similar vein, European Commission, 2010f, p. 3: 'Corporate governance weaknesses in financial institutions were not *per se* the main causes of the financial crisis.'
- 15 European Commission, 2009l. In June 2010, the Commission proposed some amendments in order to improve supervision: European Commission, 2010d.
- 16 An update on the consultation process is available at http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm, last accessed 16 August 2010.
- 17 See, for instance, the German proposal for banning certain securities transactions: Deutscher Bundestag, 2010.
- 18 Reinhart and Rogoff, 2009, drawing sweeping parallels between financial crises, across times and continents.
- 19 As contract governance concerns the behaviour of market actors, behavioural law and economics appears as an indispensable complementary discipline. Seminally: Kahneman and Tversky, 1979; further, Camerer *et al.*, 2004.
- 20 Similar to the traditional approach of economic law; very much to the point Hopt, 1972, p. 1019 ('Nicht das einzelne Rädchen, das Räderwerk ist gemeint'). Similarly, for instance, Schwark, 1979, pp. 64–6; and earlier Böhm, 1933, p. 189 (economic law as an aggregate of rules

- 'serving social order and the steering of the collective economic process', author's translation).
- 21 On this divergence cf. again Williamson, 1979; on other mechanisms of coordination (such as clans, federations, networks), see the survey of Mayntz, 2006, p. 14 with further references.
 - 22 German legal scholars tend to speak, more cautiously, of *Richtigkeitschance* instead of *Richtigkeitsgewähr*: a chance rather than a guarantee of just solutions inherent in the contract mechanism; cf. Schmidt-Rimpler, 1941; Schmidt-Rimpler, 1974; recently, Canaris, 1993, p. 883; Singer, 1995, pp. 9–12; Canaris, 1997, pp. 48–51.
 - 23 One example is so-called 'cooperative governance', increasingly studied by economists. See various contributions in Theurl, 2005; Theurl and Schweinsberg, 2004; in a broader framework subject of a recent congress of the prestigious 'Verein für Socialpolitik' (under the heading 'Governance in economic policy').
 - 24 Seminally, Jensen and Meckling, 1976, p. 311 ('The private firm is simply a form of legal fiction which serves as a nexus for contracting relationships'); see also Easterbrook and Fischel, 1989; Eisenberg, 1989.
 - 25 See, for instance, European Commission, 2009e, p. 3: 'badly designed [remuneration] policy and schemes at all levels in the financial services industry contributed to "short-termism" and excessive risk-taking without adequate regard to long-term global performance . . . The problem addressed is not how much directors are paid, but the mismatch between pay and performance.'
 - 26 In Germany, for instance: VorstAG, 2009. For a recent analysis of the regulatory framework and remuneration practices in Europe, see Ferrarini *et al.*, 2009.
 - 27 Larosière Group, 2009, p. 31 (Recommendation 11: '[. . .] the same principles should apply to proprietary traders and asset managers'); OECD, 2009a, p. 14 ('Remuneration problems also exist at the sales and trading function level'). This concern was also shared by the Financial Stability Forum, 2009, p. 20.
 - 28 Quite explicitly OECD, 2009a, p. 17: incentives at lower levels beyond 'the usual focus of corporate governance debates'.
 - 29 While most major banks failed to anticipate the development of the housing market, there was a marked difference in how intensively they were affected, depending on their exposure to certain financial instruments: Senior Supervisors Group, 2008, pp. 3 *et seq.* and *passim*; cf. also OECD, 2009b, p. 7 *et seq.* For an empirical study of the twenty-five largest European banks, see Ladipo and Nestor, 2009.

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International Perspectives

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