Global Financial Crisis: Corporate Governance Failures and Lessons

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Abstract

The recent financial crisis was truly a global crisis. There were several aspects of failure in this crisis and corporate governance was major one. This paper reviews the literature on corporate governance failure in financial institutions in global financial crisis. Literature highlights that risk management, board practices, remuneration system, transparency and disclosure norms were found lacking in different aspects. The article further draws significant lessons on these deficient areas of corporate governance. The study is critical from the viewpoint that new perspectives of corporate governance reforms emerge from this analysis, which may be generalized for all the firms (not limited only to banks and financial institutions) in different jurisdictions.

Key Words: Financial Crisis, Corporate Governance, Risk Management, Remuneration, Transparency

Introduction

The recent financial crisis is often termed as the most serious financial crisis after the Great Depression of 1930’s (Blundell-Wignall et al., 2008; Cheffins, 2009; Kirkpatrick, 2009; Clarke,
Several researchers and reports reviewed the causes of this global financial crisis (Clarke, 2010; Laeven et al., 2010; Lang and Jagtiani, 2010; Tarraf, 2010; UNTACD, 2010; Yeoh, 2010). Many scholars implicate corporate governance as one of the main reasons for global crisis, while other factors play only a supplementary role (Kirkpatrick, 2009; Yeoh, 2009; Fetisov, 2010). Several deficiencies in the corporate governance structure and processes led to the collapse of many financial institutions, and triggering the crisis. Many banking and financial institutions did not pay due attention to corporate governance before and during the crisis.

The article makes an endeavor to ascertain what the various aspects related to corporate governance failed and the lessons that may be learned in the aftermath of the global financial crisis. It is important to study various aspects of corporate governance lapses during the crises because it will help in figuring out the normative implications for future reforms (Tarraf, 2010).

The structure of paper is as follows. Section two of the paper highlights why the recent crisis is global financial crisis as well as providing a brief taxonomy of the crisis. Section three delivers a literature review related to corporate governance failure during the crisis. Section four of paper 1) lists lessons that can be learned from this crisis, and 2) lists suggestions recommended by the researchers for future reforms. The last section of the paper provides some concluding remarks.

**Global Financial Crisis**

The financial crisis of 2007-08 was a crisis truly global in nature that affected all regions and countries of the world (Clarke, 2010). The scale and reach of this crisis was worrisome, and much bigger than the earlier region specific crises in Asia, Japan and United States, and was only
comparable to the Great Depression. The fall of share prices on a single day was even more than the Great Depression of the 1930s (Cheffins, 2009). The International Monetary Fund (IMF) estimated the potential losses from this crisis were approximately $1400 billion up to the end of October 2008 (Clarke, 2010). The global crisis was initiated in the latter part of 2006 and by the end of 2008 engulfed the entire world. There were several macro- and micro- economics perspectives of this crisis (UNTACD, 2010). A brief overview of how this crisis took place is given by citing the following lines of a UNTACD report (2010, p.1-2):

Expansionary monetary policy with falling interest rates caused asset price booms, particularly in the U.S. housing sector. This was accompanied with a rapid expansion of lending and a corresponding decline in underwriting standards and increase in risk, fuelled in part by the unregulated growth of the so-called ‘shadow banking system.’ This side of the financial system developed between 2000 and 2008 and consists of institutions and legal entities that provide financial intermediation without taking deposits. As such, they are not subject to the same regulatory oversight as institutions that do take deposits. These institutions used short-term credit to invest heavily in sub-prime mortgage-backed securities, which became increasingly risky as housing prices began to fall in the US after mid-2006. In the absence of regulatory oversight, the risk inherent in these assets were not adequately rated, yet had become increasingly dispersed throughout the global financial system. Being highly leveraged and holding what became known as ‘toxic assets’, large financial institutions in the shadow banking system began to fail as default rates began to rise. Global credit markets contracted with the decline in
confidence: the record high interest rates that banks used to lend to each other almost halted inter-bank lending. This caused a global liquidity crisis and a subsequent decline in world trade triggering, through various feedback loops, a recession which has impacted real economies globally.

Corporate Governance Failure

Many scholars have studied the financial crises from the perspective of corporate governance (Fetisov, 2009; Clarke, 2010; Lang and Jagtiani, 2010; Tarraf, 2010). Various lapses in corporate governance arrangement and procedures attributed to the collapse of financial institutions leading to the financial crisis (Kirkpatrick, 2009; Yeoh, 2010). Clarke (2010) suggests that systematic crisis due to the failure of international financial market was also the crises of corporate governance and regulation. Before and during the financial crisis, corporate governance issues did get deserved attention that was actually required, which lead to the collapse of many financial institutions. United Nations Conference on Trade and Development (UNCTAD) in its analysis report (UNCTAD report, 2010) of corporate governance in the wake of the financial crisis, attributed poor corporate governance practices as a cause of global financial crisis implicated through fragile and the inferior risk management system in many failed financial institutions. OECD report (Kirkpatrick, 2009) observed, “…..financial crisis can be to an important extent attributed to failures and weakness in corporate governance arrangements. When they were put to the test, corporate governance routines did not serve the purpose to safeguard against excessive risk taking in a number of financial services companies” (p. 2). Festiov (2009) believed the decline in corporate governance standards before crisis
evolved, resulted in this global financial crisis. A brief literature review is carried out in the following paragraphs implicating the corporate governance failures during the crisis.

As early as 2008, Blundell-Wignall et. al. (2008, p. 11) by using Union Bank of Switzerland (UBS) as an example concluded that corporate governance played a crucial role in financial crisis. Banks and their boards failed to understand the risk associated with complex financial products. The Boards of investment banks failed in the guiding of strategy and implementing risk control procedures. Further, remuneration incentives allowed managers to invest in poor quality mortgage products. Berrone (2008) and Van Den Berghe (2009) viewed faulty incentive system for executive of financial institutions as one of the main reasons for the financial crisis. Berrone (2008) suggested that stock options and exit packages for top executives were wrongly designed. Stock options allowed the executives to higher risk while exit packages rewarded top executives even for their failures.

Kirkpatrick (2009) suggested that there were certain inherent deficiencies in the system. Deficient corporate governance processes attributed to the failure of risk management systems in many of the failed banks. Boards of failed banks did not take into consideration the risk factors before approving the company strategy. Company's disclosures of about the foreseeable risk factors and about systems for monitoring and managing risk were obviously lacking in many banks. The accounting and regulatory environment was even not efficacious. Again Kirkpatrick (2009) stated that remuneration systems were not aligned to the company's risk appetite, strategy and long-term sustainability of the company. Buiter (2009) pointed out that there was very little transparency on off-balance sheet items of complex financial products and the risk financial institutions were carrying for the shareholders of the company. Further, the author agreed that the remuneration structure of banking professionals allowed them to take extreme risk with focus on
short-term profit. Sahlman (2009) in his study on the financial crisis, concluded that “…many organizations suffered from a lethal combination of powerful, sometimes misguided incentives; inadequate control and risk management systems; misleading accounting; and, low quality human capital in terms of integrity and/or competence, all wrapped in a culture that failed to provide a sensible guide for managerial behavior” (p. 4).

The UNCATD report of 2010 also concludes that pervasive risk taking by financial institutions caused the global financial crisis. The issue of excessive risk in financial institutions is ultimately linked to failure in board oversight of delivering the appropriate strategy and setting risk appetite. The report particularly specified that remuneration structures provided enough incentives for extreme risk taking. While, Clarke (2010) agreed that remuneration policies for managers were designed in ways that give incentives for high-risk taking he concluded that extreme risk taking coupled with faulty remuneration structure in banking and financial institutions led to this crisis. Appropriate risk management system was not placed in financial institutions to deal with complex financial products. Bonuses for executives were based on upfront earnings from business rather than their actual accomplishment. In addition, lack of universal accounting and valuation resulted in lack of transparency and misrepresented disclosure to shareholders.

Lang and Jagtiani (2010) further suggest that there was a basic failure of the risk control system in many financial institutions. “Financial firms lacked effective internal controls, accurate and timely financial and risk reporting to the right management level, and a corporate-wide view of risk or an enterprise-wide risk management program” (Lang and Jagtiani, 2010 p. 21). Boards of financial institutions failed to ensure that appropriate risk management system is in place to
address risk exposures to financial toxic products. The authors concluded that the compensation system of banks promoted excessive risk taking by managers, which motivated managers to increase profitability of the business rather focusing on the risk position of the enterprise. Complex financial products like CDOs and MBS were the ideal choice for executives, which generated huge revenue upfront without disclosing the risk position. Laeven et al. (2010) pointed out that complex financial products, like CDOs and MBS, increased opacity in financial reporting to shareholders. In addition, the bank incentive structure focused on short-term scenarios resulting excessive risk taking by their executives. Pirson and Turnbull (2010) suggested that directors and boards of Anglo-American corporate governance systems did not perform their responsibilities well. Boards failed to keep check on risk management system and directors could not control the excessive risk taking behavior of management. Non-executive and independent directors did not raise any questions on remuneration and incentive system of executives.

Yeoh (2010) studied many financial institutions during the financial crisis. He directed attention to severe lapses in transparency and disclosure norms and raised questions about the role of non-executive directors in financial institutions. Both Bear Sterns and Lehman Brothers were engaged in opaque financial reporting and lacked transparency in communication with shareholders. Yeoh (2010) also suggested that non-executive directors of financial institutions lacked sufficient time, knowledge and expertise to deal with complex financial products.

**Corporate Governance – Lessons from Crisis**

The extant literatures on corporate governance failure during the global crisis give several insights where lessons learnt from the crisis may be utilized to design new policy guidelines. The
highlighted areas of corporate governance concerns in the financial crisis were risk management, remuneration systems, the board and director’s role, transparency and disclosure, and protection of shareholder rights. Various academicians, researchers and regulators in their analysis have suggested key lessons for future corporate governance reforms.

The OECD report (Key Findings and Main Message, 2009) identified four areas for corporate governance reforms. OECD in an earlier analysis (Kirkpatrick, 2009) ascertained the areas of weakness to be in the remuneration system, risk management, board practices and shareholder rights; and then made recommendations for reforms and best practices related to those areas. The Group of Twenty (G20), in their November 15, 2008 meeting, deliberated on the issue of corporate failure in the financial crisis and identified four key areas for future reforms (Moody’s, 2008). These included better guidance to strengthen a bank’s risk management practices; reassessment of risk management models to guard against unforeseen circumstances; a compensation structure to avoid excessive risk or short-term returns; and effective risk management over structured products.

Several academicians and researchers identified remuneration system deficiencies as the key lesson from the crisis and suggested suitable measures for correcting the deficiencies (Bruner, 2010; Laeven et al., 2010; Fetisov, 2009; Lang Jagtiani, 2010; Van Den Berghe, 2009). The remuneration system promoted extreme risk taking with an unwarranted focus on short-term revenue and even rewarded managers for their failures. Scholars have suggested linking the remuneration structure of executives with company long-term performance with appropriate adjustment for risk (Laeven et al., 2010). Lang and Jagtiani (2010) in their analysis implicated that the remuneration structure should be linked to risk appetite and it should be within the boundaries of internal control and risk management system of the firm. Both Fetisov (2009) and
Van Den Berghe (2009) suggested that it is necessary to link the compensation of executives with performance assessments of actual income earned over the years. Sharfman, Toll and Szydlowski (2009) suggested using clawback policy for executive remuneration with an aim to control extreme risk taking behavior. This policy for top executives of a corporation will make them more accountable towards shareholder and investors’ wealth, and will also discourage board approval of magnanimous executive remuneration and unrealistic compensation policies (Sharfman, Toll & Szydlowski, 2009). Clawback policy on remuneration will make executives to bear financial liability for the losses incurred by the companies for their mistakes, by granting shareholders right to claw back a variable fraction of their remuneration (Fetisov, 2009). The European Commission (2009) lessons for improving the remuneration system, identified four areas of improvements: 1) structure of director remuneration, 2) severance pay, 3) balance between fixed and variable pay, and 4) linking compensation with performance.

Another area of improvement and reform identified in the aftermath of the financial crisis was risk management (Tarraf, 2010). The crisis has much to do with the monitoring of the risk appetite of a firm by the board and development of an effective risk management system for the same. Muelbert (2009) concluded that the key lesson for banks in this crisis was to have a separate broad risk management control under the authority of a chief risk officer. The individual filling this position should be a knowledgeable person, be under control of the board, and should have complete authority to implement a risk management system. Lang and Jagtiani (2010, p. 23) called for similar reforms with the emphasis on the development of an effective internal control and risk management system with proactive oversight. Pirson and Turnbull (2010) with a concern for improving risk control and oversight, suggested and proposed a network corporate
system that would help a board get feedback on different risk factors from various stakeholders in the early stages.

A third area of concern in the global crisis was board composition and practices. Many researchers called upon changes in the board composition and director’s competence based on the learning gathered from the crisis. Muelbert (2009) suggested boards to have individuals with financial knowledge or some related expertise to deal with risk control and management of the firm. Adams (2009) also suggested directors of financial firms need to have sufficient financial knowledge and expertise. This may be done giving directors sufficient training and education support or hiring new directors that possess these qualities. Muelbert (2009) further called for defining the role and qualifications of non-executive directors so that they could better question the management. Buiter (2009) suggested a better gender balance on boards and members of board of financial institution to pass a given test for becoming the director. Adams (2009) stated to reduce risk taking behavior directors must be adequately paid to meet the difficulties and bear the responsibilities of their position.

Lastly, certain lessons need to be arrived at on the reforming of the accounting standards and transparency and disclosure norms. Laeven et. al. (2010) emphasized collection of information and disclosure of that information to the shareholders for better transparency. The companies must analyze the risk disclosure based cost benefit analysis and its extent in affecting the companies existence. Laeven et al. (2010) further suggested addressing the issue of volatility by using fair value accounting and transparency on off balance sheet items. Clarke (2010) suggested a universal accounting and valuation method to ensure fair reporting to shareholder and investors. Kirkpatrick (2009) in deriving a lesson from this crisis suggested the need for a new risk disclosure policy and some guidelines on risk management accounting.
Conclusions

The recent financial crisis was really a global crisis in terms of its reach and scale of impact. It affected almost all the economies of the world and losses incurred by shareholders and investors were great. Corporate governance failure was one of main reasons for this crisis. The literature review carried out in this paper showed several aspects of corporate governance that failed during the global crisis in financial institutions: risk management system, transparency and disclosure, board oversight practices, and remuneration system. Various academicians and researchers have drawn significant lessons that relate to deficient aspects of corporate governance highlighted by the results of the crisis.

The study is significant from the perspective of regulators and policy makers. Lessons from the failure of corporate governance in banking and financial institutions may be generalized for the development of new policy guidelines not only for the financial sector, but also for non-financial companies. The implications and lessons drawn from this crisis can trigger a new era of corporate governance reforms and new best practices may evolve that may be applied to different jurisdictions. It is an appropriate time for regulators of corporate governance to keep abreast with contemporary scenarios and raise the standard of corporate governance in order to protect the wealth of millions of shareholders.

References


