Addressing the Financial Crisis: A Corporate Governance Perspective

By Maria Fotaki, Doctoral Candidate

These days the drivers, the consequences and the ways to address the current financial crisis have been the objects of universal debate. The sale of Bear Stearns on March 17th to JP Morgan Chase, the nationalization of Fannie Mae and Freddie Mac on September 8th by the US Treasury, the bankruptcy of Lehman Brothers on September 15th and the bridge loan of $ 85 billions to AIG on September 16th by the Federal Reserve have triggered the worst corporate collapse that we have witnesses since the Wall Street Crash in 1929. The impact for households, investors and banks are tremendous worldwide. Global stock markets are experiencing their worst days with thousands of investors having lost their savings, private consumption is declining, and the automobile industry is falling dramatically while the unemployment rate is escalating with around 500.000 Americans having lost their jobs during the past two months. Nevertheless, a week after the bailout loan to AIG, as the Congressman Elijah E. Cummings pointed out, the company's top executives were 'getting their manicures, their pedicures, massages, their facials for $ 440.000 at a luxurious resort while the American people were paying their bills'.

Currently, everybody is forecasting a recession of the economy with unpredictable depth and duration. Nevertheless, we are all aware of the fact that no one trusts anyone and that no one is willing to lend anyone. Within this context, it becomes evident that the need to restore shareholders' trust in financial markets and firms is more vital than ever. And forgetting Corporate Governance is at the core of what went wrong in this crisis.

This article is written in that spirit. It expands the debate on the causes and consequences of the crisis by using a corporate governance perspective. At first glance, most market participants and CFOs have appointed the crisis to the increased complexity of the new financial instruments, the risk management practices of the financial institutions, the deregulation of the financial services industry, the executive compensation packages as well as to the irresponsible homebuyers in the US. In a closer glance, it was not only these reasons that caused the collapse. Over the past decade, there have been several signs of economic stress. As W. H. Donaldson, the former Chairman of the Securities and Exchange Commission indicated on November 20th, the attack of the 11th of September, the dotcom mania, the overexpansion of the telecommunications industry along with the corporate scandals of Enron and WorldCom have been such economic stress indicators. At the same time, world real economy has been confronting dramatic imbalances: the West was consuming more than it was producing while the East was producing more than it was consuming. Moreover, and in terms of statistics, private savings in US as a percentage of disposal income were equal to zero in 2007 as well as the Interbank Market Liquidity index, issued by the Bank of England in April 2008, which was also hitting zero in April 2007 and has been declining below zero afterwards. Despite the signs, no one did anything to prevent the collapse that was following. Why?

A brief overview of economic history regarding economic crisis patterns could illuminate us at this point. In the 1st phase of a crisis, a new technology is discovered that minimizes risk. In the 2nd phase, this new technology performs really well and wealth is being collected. In the 3rd phase, risk raises and a lot of questionable decisions concerning risk have to be made given the fact that economic agents are driven by opportunism. At the 4th and last stage, the crisis takes place. Within the context of the current crisis, it is the 3rd phase that has not attracted much attention by the market participants and the wider business community. It is the phase which manifests a corporate governance deficit for most of the firms in the following areas:

- *Board of Directors (BoDs)*: apparently, the BoDs did not do follow their mission within the corporation, i.e., they 'did not ask the right questions' regarding the risks that were undertaken by the CEOs. In particular, the BoDs were not supervising the CEOs properly and consequently, they were not stewards of the interests of shareholders, either because they could not understand the risk implied by the new structured products, or because the Chairmen of these boards were at the same time the CEOs of their companies. As the Association of Certified Charter Accountants pointed out on October 17th, 'it appears they did not understand the risks and were using risk assessment with tools which were inappropriate. Boards may not have expended the necessary time and energy, and/or lacked the expertise to ask the right questions.'
- *Remuneration Policy*: the short-term 'hitting the numbers' mentality of most top executives in those banks, which was induced by the stock-options compensation packages, was the underlying motive for many of the bad decisions and management practices as well as for the intentional misreporting of the financial statements of those firms. In his recent article in the New York Times, Nicholas Kristof revealed that the average salary of the CEOs of large listed companies last year was 344 times higher than the average salary of an ordinary worker, while three decades ago it was estimated to be only 30 to 40 times higher.
- *Shareholders' Management:* it is more than obvious that shareholders had no clue of what was really going on. In particular, risk management practices were opaque to C-level executives and shareholders, while at the same time a lot of rating agencies were making a handful of dangerous products appear safer in exchange of large profits. It is worth to mention that according to the Standard & Poor Corporate Governance Score, Fannie May scored a 9 out of 10 in 2003, a score that was indicative of very strong corporate governance practices regarding board structure, board committees, remuneration policy, internal control and risk management etc. However, two years later S&P lowered Fannie Mae's score to 6 and in 2007 it withdrew it.

It is therefore more than evident that firms, even the most prestigious ones worldwide, have not taken Corporate Governance into heart. In fact, the recent crisis has shown that they have just forgotten it. A few years ago, Enron, WorldCom and Parmalat have dynamited a snowball of regulations in order to prevent managers to govern their firms to their own interests. However, improper behaviors are still present and the efficiency of the regulatory framework is under a hot debate. In this respect, and along with the 'trickle-up economic' measures, which are at the top of the reform agenda of national governments to stimulate aggregate demand, a shift of attention to good corporate governance and ethics is of paramount importance. 'Compliance to the letter' of the regulations regarding corporate governance practices is not enough any more. As the International Corporate Governance Network indicated on November 11th 'while corporate governance failings were not the only cause of the present financial crisis, better governance would be integral to an overall solution aimed at restoring confidence to markets and shielding them from future crises'. In their declaration on November 20th, the G-20 manifested that we should 'strengthen financial market transparency, including by enhancing required disclosure on complex financial products and ensuring complete and accurate disclosure by firms of their financial conditions'. As the recent financial crisis has shown, corporate governance based solely on more regulations is not efficient to control decisions that are associated with the control of economic resources. Other mechanisms should be established as alternatives to over-regulation. We have no choice that to build the 'new governance' of firms on ethics, corporate culture and long-term strategy.

References and Bibliography

1. Donaldson, W. H. (2003), Corporate Governance: what has happened and where we need to go, *Business Economics*, vol. 38 (3).
2. Kristof, N. (2008), N*eed a Job? $17,000 an Hour. No Success Required*, New York Times.
3. Stiglitz, J. E. (2008), We Aren't Done Yet: Comments on the Financial Crises and Bailout, *The Economist voice*, The Berkley Electronic Press.
4. *Using the OECD Principles of Corporate Governance: A Boardroom Perspective*, OECD, 2008.

Related web links:

1. The Harvard Law School Corporate Governance Blog, **http://blogs.law.harvard.edu/corpgov/**
2. International Corporate Governance Network, **http://www.icgn.org/**