

CORPORATE GOVERNANCE IMPLICATIONS FROM THE 2008 FINANCIAL CRISIS

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Abstract

The importance of structural corporate governance factors identified by the New York Stock Exchange's 2010 Commission on Corporate Governance was reaffirmed here with various empirical and forensic studies. The key, recurring structural factors were all-powerful CEO (the duality factor and related Board independence issues), weak system of management control, focus on short term performance goals (and related executive compensation packages), weak code of ethics, and opaque disclosures. Such weak corporate governance factors were key contributors to both fraudulent financial reporting and excessive risk-taking which facilitated the U.S. financial crisis in 2008. Corporate governance listing requirements by major stock exchanges around the world will help mitigate such problems from recurring in the future.

Keywords: Corporate Governance, Financial Crisis, Banks, Risk-Taking

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Introduction

At the end of January, 2011, the U.S. Financial Crisis Inquiry Commission (Commission 2011) wrote in the report's conclusions: "the greatest tragedy would be to accept the refrain that no one could have seen this coming and thus find nothing could have been done. If we accept this notion, it will happen again." The Commission also concluded that the 2008 financial crisis was an "avoidable" disaster caused by widespread failures in government regulation, corporate mismanagement and heedless risk-taking by Wall Street. It found that the Securities and Exchange Commission (SEC) failed to require big banks to hold more capital to cushion potential losses and to halt risky practices and that the Federal Reserve Bank "neglected its mission by failing to stem the tide of toxic mortgages."

Citing dramatic breakdowns in corporate governance including taking on too much risk, the Commission portrayed incompetence with the following examples. Citigroup executive conceded that they paid little attention to mortgage-related risks. Executives at American International Group were blind to its \$79 billion exposure to credit-default swaps. Merrill Lynch managers were surprised when seemingly secure mortgage investments suddenly suffered huge losses. The banks hid their excessive leverage with derivatives, off-balance-sheet entities and other accounting tricks. Their speculations were

aided by a giant "shadow banking system" in which banks relied heavily on short-term debt. The Commission concluded: "when the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans and the risky assets all came home to roost" (Chan 2011).

In the aftermath of the U.S. financial crisis of 2008, the New York Stock Exchange (NYSE) sponsored a Commission on Corporate Governance which issued the following key corporate governance principles (2010):

- The Board of Directors' fundamental objective should be to build long-term sustainable growth in shareholder value. Thus, policies that promote excessive risk-taking for short-term stock price increases, and compensation policies that do not encourage long-term value creation, are inconsistent with good corporate practices.
- Management has the primary responsibility for creating a culture of performance with integrity. Management's role in corporate governance includes establishing risk management processes and proper internal controls, insisting on high ethical standards, ensuring open internal communications about potential problems, and providing accurate information both to the Board and to shareholders.
- Good corporate governance should be integrated as a core element of a company's business strategy and not be simply viewed as a

compliance obligation with a “check the box” mentality for mandates and best practices.

- Transparency in disclosures is an essential element of corporate governance.
- Independence and objectivity are necessary attributes of a Board of Directors. However, subject to the NYSE’s requirement for a majority of independent directors, there should be a sufficient number of non-independent directors so that there is an appropriate range and mix of expertise, diversity and knowledge on the Board.
- Shareholders have the right, a responsibility and a long-term economic interest to vote their shares in a thoughtful manner. Institutional investors should disclose their corporate governance guidelines and general voting policies (and any potential conflicts of interests, such as managing a company’s retirement plans).

Structural Corporate Governance Issues

Various empirical studies have investigated the impacts of these structural problems of corporate governance upon banks’ risk taking (stock market based measures) and financial performance (return on assets, non-performing assets, etc.). The following corporate governance variables have been found to have a significant, negative impact on risk taking and financial performance (Allemand et. al. 2011, Grove et. al. 2011, Victoravich et. al. 2011):

- CEO duality (the CEO is also the Chairman of the Board of Directors)
- CEO and Board of Directors entrenchment and independence (only staggered re-elections of long-serving Board members versus all Board members re-elected every year)
- Senior Directors (over 70 years of age)
- Short-term compensation mix (cash bonuses and shorter-term stock options (1 to 4 years) versus longer-term stock options, awards, and restricted stock)
- Non-independent and affiliated Directors (larger percentages of such directors versus independent directors)
- Ineffective risk management committees (few or no meetings or no such risk committees)

Also, high leverage (debt to equity) levels were associated with high levels of banks’ risk taking and poor financial performance in these studies. When implementing the \$700 billion bailout of major U.S. banks, the U.S. Treasury did not replace any existing bank Board members but added new Directors to represent taxpayer interests. Many of these original Directors oversaw the big banks and brokerage firms when they were taking huge risks during the real estate boom. A corporate governance specialist concluded: “these boards had no idea about the risks these firms were taking on and relied on management to tell them” (Barr 2008). A senior corporate governance analyst said: “this financial crisis is a

direct result of the compensation practices at these Wall Street firms” (Lohr 2008).

Concerning the lack of disclosure transparency by these banks in not using fair value reporting for their assets, Arthur Levitt and Lynn Turner, former SEC chairman and former SEC chief accountant, respectively, observed (Levitt and Turner 2008):

“There is a direct line from the implosion of Enron to the fall of Lehman Brothers—and that’s an inability for investors to get sound financial information necessary for making sound investment decisions. The only way we can bring sanity back to the credit and stock markets is by restoring public trust. And to do that, we must improve the quality, accuracy, and relevance of our financial reporting. This means resisting any calls to repeal the current mark-to-market standards. And it also means expanding the requirement to disclose the securities positions and loan commitments of all financial institutions. Fair value reporting, when properly complied with and enforced, will simplify the information investors need to make informed decisions, and bring much needed transparency to the market. By reporting assets at what they are worth, not what someone wishes they were worth, investors and regulators can tell how management is performing. This knowledge in turn is fundamental to determining whether or not an institution has sufficient capital and liquidity to justify receiving loans and capital. We should be pointing fingers at those at Lehman Brothers, AIG, Fannie Mae, Freddie Mac, and other institutions which made poor investment and strategic decisions and took on dangerous risks.”

Furthermore, at a recent Town Hall discussion, entitled *Does Wall Street Really Run the World?*, Lynn Turner (2011) made the following comments. “There was greater attention to risk management when Wall Street firms were partnerships with individual partner liability twenty years ago versus today as corporations (similar to the evolution of the Big Four accounting firms). Wall Street firms changed from raising money for corporations and serving as investment brokerage firms to a new emphasis on trading for its own sake and for their own shareholders. There was eleven trillion dollar market cap destruction from the economic crisis of 2008. These firms were not really creating value but were selling toxic investments such that a Rolling Stone reporter nicknamed Goldman Sachs the Vampire Squid. Paul Volcker has commented that the last real innovation of Wall Street banks was the ATM thirty years ago, actually by a Nebraska bank.”

Structural Corporate Governance: Bear Stearns and Lehman Brothers Examples

Corporate governance for risk management and company oversight was very weak at both Lehman

Brothers and Bear Stearns per the following red flags which were related to the structural corporate governance factors in the NYSE Commission on Corporate Governance report (Grove and Yale 2011):

- **CEO Duality:** At Bear Stearns, the CEO, James Cayne, had also been the Chairmen of the Board (COB) for the last seven years. At Lehman Brothers, the CEO, Richard Fuld, had also been the COB for the last seventeen years.
- **Board Entrenchment and Independence:** At both banks, there were no staggered board elections as all members were re-elected annually. However, both CEOs had been in their jobs for more than a decade: 26 years for the Bear Stearns CEO and 17 years for the Lehman Brothers CEO. Also, there were majorities of older and long-serving Directors as noted below.
- **Senior Directors:** For Bear Stearns and Lehman Brothers, respectively, the majority of the Directors were over age 60: 85% and 91%, over age 70: 23% and 55%, and over age 80: 15% and 18%. Also, 54% of the Bear Stearns Directors were retired or just “private investors” or in academia. 91% of the Lehman Brothers Directors were retired or “private investors.”
- **Short-term Compensation Mix:** Both companies had large portions of their compensation packages for their top executives in short-term cash (bonus) and stock options,
- **Non-independent, affiliated, and diverse directors:** Long-serving Directors may lose or reduce their independent perspective. For Bear Stearns and Lehman Brothers, respectively, the number of Directors serving since the 1980’s were 38% and 9% and since the 1990’s were 31% and 55% for totals from the 1980’s and 1990’s of 69% and 64%. Also, there were only one woman and one minority on Lehman Brothers’ Board and none on Bear Stearns Board.
- **Ineffective Risk Management Committee:** Bear Stearns’ risk committee only started in January 2007 just 14 months before JP Morgan Chase bailed out the company by taking it over in March 2008. Three of the four members were age 64 and the other was age 60. Lehman Brothers’ risk committee had only two meetings in 2006 and 2007 before it went bankrupt in 2008. The chairman of the risk management committee was age 80 and a retired Salomon Brothers investment banker with banking experience but from a different era. The other members were age 73 (retired chairman of IBM), age 77 (“private investor” and retired Broadway producer), age 60 (retired rear admiral of the Navy), and age 50 (former CEO of a Spanish language TV station). What were the qualifications of these last three members for serving on this risk management committee?!
- **Opaque Disclosures:** Per the SEC chairman and SEC chief accountant, there was a direct line

from the implosion of Enron to the fall of Lehman Brothers which was an inability for investors to get sound financial information necessary for making sound investment decisions. To correct this problem, investors must resist any calls to repeal the current market-to-market standards for financial instruments while also expanding the requirement to disclose the securities positions and loan commitments of all financial institutions. However, there was no fair value reporting at either bank which would have provided the information investors needed to make informed decisions and bring much needed transparency to the market.

The day-to-day management of corporations is generally regulated by state law. Because Delaware generally favors management and directors, many companies choose to incorporate there. Delaware law has a highly rigorous standard for finding officers and directors liable for a company’s mismanagement, “no matter how stupid or self-serving their decisions” (Davidoff 2011). Under Delaware law, only if officers and directors intentionally acted wrongfully or their conduct was so oblivious that it produced essentially the same result, would a Delaware court find them liable.

There may be liability for corporate officers and directors under federal law. Such liability stems mainly from securities fraud cases where such individuals make a misstatement or omission. Such liability has nothing to do with the management or oversight of a company but usually are misstatements about the accounting or financial condition of a company. Personal liability for officers and directors in federal cases are only a little less rare than state cases since the legal standards are high and insurance often covers such cases. There have been only nine cases where an officer or director was held personally and criminally liable for securities fraud in the last quarter century, the most notable were Enron, WorldCom, Tyco, and Qwest. In the Enron shareholder litigation case, there was a \$165 million settlement but the directors personally had to pay only \$13 million as the rest was covered by insurance (Davidoff 2011).

The following conclusions from a forensic accounting report on Bear Stearns emphasized poor corporate governance, especially the lack of key disclosures and possible liability for Bear Stearns executives and directors (Yale and Grove 2011):

In my opinion, the evidence suggests that Bear Stearns inflated the values of its financial instruments that, in turn, inflated Bear Stearns earnings and shareholders’ equity from the quarters ending August 31, 2007 through February 29, 2008. The extraordinary denials on “Black Monday”, March 10, 2008 concealed an important deception apparently agreed upon by senior Bear Stearns executives who did not disclose evidence that the Company was indeed facing the beginnings of a liquidity crisis

brought on by doubts about the value of its assets that, in turn, raised questions about the adequacy of Bear Stearns' equity capital.

Even more remarkable was that senior Bear Stearns executives knew or should have known that even when the Company conceded to counterparties in collateral value disputes, Bear Stearns continued to use its own traders' higher valuations. In effect, Bear Stearns was knowingly cooking its books. There are indications in the SEC memoranda that Bear Stearns tended to use the traders' more generous valuations for profit and loss purposes, even when Bear Stearns conceded lower valuations to the counterparty for collateral valuation purposes.

These practices apparently resulted in the overstatement of income and capital and inappropriately inflated asset values. Pricing its massive portfolio of mortgage-related and other securities was complicated further because market prices for many of the Company's assets were not available because some securities traded infrequently or were thinly traded at highly distressed prices.

In its 10-Q for the period ending June 30, 2008, JP Morgan Chase reported that the value of Bear Stearns' stockholder equity at May 30, 2008 was slightly less than \$6.1 billion or some \$5.8 billion less than Bear Stearns reported at February 29, 2009 (Sorkin 2011). Apparently, Bear Stearns took massive write-downs and charges during the two-month period, although the nature of the charges was not explained. What was disclosed, however, was that JP Morgan Chase took an additional \$3.5 billion of charges against Bear Stearns' trading assets when it marked them to fair value, further reducing Bear Stearns' stockholders' equity to just \$2.6 billion. Clearly, the loss of value could not have occurred exclusively in this three-month period between February 29 and May 30, 2008. The arbitrariness of such write-downs is illustrated by the current financial accounting for Greek bonds. Two French companies, BNP Paribas and CNP Assurances, took only a 21% write-down on their Greek bond investments but Commerzbank of Germany wrote down the same Greek bonds by 51% and all three firms had the same Big Four audit firm (Turner 2011).

The Florida investor's case against Bear Stearns was settled for a small fraction of his losses although the investor's attorney advised him to continue the legal battle since there was a solid legal basis to continue. However, it appeared that the established legal strategy was again successful here: just outspend the other, smaller side until it gives up! Corporate officers and directors often argue that the potential liability for a company's operations is significant and claim that the risks of serving as an officer or director have become too great. As a result, they contend, it will become more difficult to recruit and retain competent officers and directors. "But the truth is that they have about the same chance of being

held liable for their poor management of a public firm as they have of being struck by lightning" (Davidoff 2011).

Few directors and officers from the financial crisis have yet been found liable under either state or federal laws. Angelo Mozilo, Countrywide CEO, did pay \$22.5 million of a \$73 million fine, the rest being covered by insurance. The Lehman Brothers' CEO and top executives did owe \$90 million in fines that were covered by insurance. Further, many directors from Bear Stearns (six), Lehman Brothers (six), and Enron (seven) continue to serve on other boards. The old boy network on Wall Street is emphasized here as is the decline in importance of reputation on Wall Street. Prior bad conduct simply is not viewed as a problem. Also, the Dodd-Frank financial reform act only involves the "too big to fail" entities. If one fails, the act authorizes the federal government to claw back just two years of compensation from those held responsible for the failure. This is a weak penalty for the failure of a big bank with many billions of assets (Davidoff 2011).

Concerning executive and director compensation as a structural corporate governance problem, the average salary of a CEO at S&P 500 companies was \$10.8 million in 2010 up 27.8% over 2009 and the median salary for a CFO was \$3 million. Outside directors' compensation now averages about \$200,000 for Fortune 500 companies. The upside of serving as an officer or director appears large while the legal liability downside appears very limited. Also, 25 major U.S. corporations paid their CEOs more than they paid to the U.S. government in federal income taxes in 2010, primarily due to transfer pricing with offshore tax havens. Many public U.S. companies spent more on lobbying that on federal income taxes, such as these 25 companies which spent over \$150 million on lobbying and campaign contributions in 2010 (Anderson et.al. 2011).

Risk Management in Corporate Governance

Both financial and non-financial tools for risk management appeared to work well in the analyses of Bear Stearns and Lehman Brothers (Dutta et al 2010). Both companies had similar, very weak financial positions and weak risk management practices as discussed subsequently. The Bear Stearns bailout may have been helped by Wall Street connections, like Henry Paulsen, the U.S. Treasury Secretary who was also the former CEO of Goldman Sachs. However, possibly the federal government later thought that Lehman Brothers was "too big to save" since it was twice the size of Bear Stearns. Then, after the Lehman Brothers bankruptcy ignited the world financial crisis in 2008, the federal government reversed its thinking and bailed out the largest 19 U.S. banks in 2009 with over \$700 billion in funds

since they were now “too big to fail.” This bailout occurred despite the fact that all these banks had received unqualified audit opinions on their financial statements and internal controls in their prior year’s annual reports before the bailout. No “going concern,” explanatory paragraph, audit reports were issued for possible bankruptcies in these banks. Thus, audit reports appear not to be a tool for assessing the risk management of such banks.

Risk management at the major U.S. (bailout) banks was very poor and contributed significantly to the U.S. financial crisis which started with the bankruptcy of Lehman Brothers in September 2008. In March 2010, the SEC started requiring all publicly traded companies in the U.S. to provide disclosures that describe the Board’s role in risk oversight. Such disclosures were required in the annual proxy statements of these firms. In July 2010, the U.S. Federal Financial Reform (Dodd-Frank) Act was signed into law and mandated risk committees for Boards of financial institutions and other entities that the U.S. Federal Reserve Bank oversees.

The following interview with Satyajit Das (2011), an international respected expert on finance with over 30 years of working experience in the industry, provided comments on risk management and corporate governance in the banking industry:

“As banks expanded their mortgage service, they exhausted the pool of people who they could reasonably lend to and, then, they moved onto the others—until they came to people who couldn’t ever really pay them back. So the trick was to hide or get rid of the risk of non-payment---it became a case of NMP (not my problem) or risk transfer. So banks made loans that they shouldn’t and, then, they transferred them to people who probably didn’t quite grasp the risk fully or were incentivised to look the other way. It was a culture of fraud and self-delusion. It’s amazing how much money banks can make just shuffling paper backwards and forwards. Paul Volcker, the former chairman of the Federal Reserve Bank, argued: ‘I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth---one shred of evidence.’”

Management and directors of financial institutions cannot really understand what is going on---it’s simply not practical. They cannot be across all the products. Non-executives are even further removed. Upon joining the Salomon Brothers Board, Henry Kaufman found that most non-executive directors had little experience or understanding of banking. They relied on Board reports that were neither comprehensive nor detailed enough about the diversity and complexity of the bank’s operations. They were reliant on the veracity and competency of senior managers, who in turn were beholden to the veracity of middle managers, who are themselves motivated to take risks through a variety of profits compensation formulas.”

Also, the Board of AIG included several heavyweight diplomats and admirals, even though Richard Breeden, former head of the SEC, told a reporter: “AIG, as far as I know, didn’t own any aircraft carriers and didn’t have a seat in the United Nations” Such poor risk management at banks has recently occurred again as it was reported that UBS lost over \$2 billion through the manipulations of a UBS rogue trader, just like the Barings Bank rogue trader which bankrupted that bank in the 1990’s. Un-hedged trades by the UBS rogue trader had been going on since the 2008 financial crisis, despite the clean opinions given by a Big Four auditor on the internal controls of UBS (Craig et al 2011).

It’s silly to think that everybody in finance is evil or engaged in fraud. Most people involved are very smart, diligent, hardworking and passionate about what they do. It’s groupthink. They have ways of thinking about the world. They think it’s the right way so they keep trying it again and again. At least until there is a horrendous disruption and then they go: “Oh dear? There’s a problem.” Take Alan Greenspan. He thought deregulated markets were the solution. He thought that any problem could be fixed by flooding the system with money. He was wrong, but even today he doesn’t really see that his world view is erroneous. These people are very good at rationalization and don’t tolerate dissent. As for responsibility, they are doing what is accepted practice---they think they are doing the best for their stakeholders. As long as you follow convention, you are unlikely to be successfully prosecuted or made liable. Ultimately that may be the only real purpose of corporate governance---to ensure that by following a set of accepted practices, you make yourself and your organization litigation proof (Davidoff 2011).

In response to an email about this issue of why Bear Stearns was saved and Lehman Brothers let go into bankruptcy, Lynn Turner (2011) replied: “Both were highly risky with very, very arrogant CEOs and chairmen. Neither had a great board but Bear Stearns may have had better connections on their board and in this instance, Lehman Brothers being second was fatal. Both depended way too much on very short term financing, including overnight commercial paper or daily repurchase agreements---a very ill advised and highly risky strategy for any company let alone one with very little capital.”

Structural Corporate Governance Factors: Evidence from U.S. Commercial Banks

In the wake of recent financial crisis, corporate governance practices in the banking industry have received heightened attention. Anecdotal evidence has suggested that corporate governance at banks was ineffective at preventing detrimental lending practices, leading to an extremely vulnerable financial system. The global economic impact of the

financial crisis and the alleged role played by corporate governance have signified the need for more empirical research on the role of corporate governance at banks. Empirical questions have arisen regarding current corporate governance structure in the banking industry. These questions included whether corporate governance practices promoted in the non-regulated and non-financial industries can also effectively enhance the governance of banking firms and the role of these corporate governance mechanisms in shaping bank performance during the financial crisis period.

Structural corporate governance factors were analysed in U.S. bank performance during the period leading up to the financial crisis (Grove et al 2011). The factor structure by Larcker et al (2007) was extended to measure multiple dimensions of corporate governance for 236 public commercial banks. Findings revealed that structural corporate governance factors helped explain banks' financial performance. Also, strong support was found for a negative association between higher leverage and financial performance measures (in terms of return on assets and excess stock returns) as well as loan quality (in terms of non-performing assets). Such findings indicated excessive risk-taking by banks. The structural corporate governance factor of CEO duality was also negatively associated with financial performance.

The extent of executive incentive pay was positively associated with financial performance but exhibited a negative association with loan quality in the long-run. There was a concave (increasing then decreasing) relationship between financial performance and both board size and average director age. There was also weak evidence of an association of anti-takeover devices, board meeting frequency, and affiliated nature of committees with financial performance. Agency theory was applied to the banking industry with the expectation that the structural corporate governance-performance linkage might differ, due to the unique regulatory and business environment. Results extended Larcker et al (2007), especially regarding the concave relationship between board size and performance and the role of leverage. However, given the general lack of support for agency theory predictions here, alternative theories may be needed to understand the performance implications of corporate governance at banks. Findings were relevant for regulators, especially concerning the ongoing financial reforms of capital requirements and executive compensation. Specifically, there was a consistent negative association between leverage and performance which supports the current debate on increasing the appropriate level of tier I capital for banks.

Such evidence has emphasized how regulation significantly influences the effectiveness of corporate governance. Hagedoff et al (2010) argue that there is a complementary association between regulation and

some governance mechanisms and that they should be developed in synchrony. Thus, effective regulation of banks and synchronous effective corporate governance mechanisms are very important, given the significant role that these institutions play in the financial markets. This conclusion is especially important when negative repercussions, such as the 2008 financial crisis, are experienced from risk-taking of banks not being properly managed and regulated, such as high bank leverage without minimum capital requirements.

Such research has offered important implications for the ongoing debate about capital requirements for banks. In June 2011, the Basel Committee on Bank Supervision announced it would add an additional capital charge of 1% to 2.5% of risk-adjusted assets on the largest banks as protection against huge bank losses that could spark another financial meltdown. As a consequence, the world's systemically important banks must hold as much as 2.5% more capital than the 7% core Tier 1 capital already required. Such research results, which consistently show a negative association between level of debt in a bank's capital structure and bank performance, have supported the need for such a surcharge in capital requirements, which in turn may alleviate concerns about the potential negative effects on lending and economic recovery. Indeed, high-leveraged banks have been shown to under-perform low-leveraged banks on financial performance and loan quality indicators.

Further, this research contributed to the debate on another aspect of structural corporate governance, namely executive compensation. Regulators, shareholders, and compensation committees may find motivation here for a reform of executive compensation packages, such as requiring long-term ownership of stock acquired through options or restricted stock. Using a study of U.S. community banks, Spong and Sullivan (2007) reported that an ownership stake for hired managers improved bank performance and boards of directors were likely to have a more positive effect on community bank performance when directors also had a significant financial interest in such banks. Furthermore, as suggested by Paul Hodgson, a senior analyst at the Corporate Library, a governance research group, one way to reshape executive pay is to employ very long-term payouts, up to ten years out (Barr, 2008). Lastly, such research may capture the consequences of the mismatch between incentive systems and risk management with a lack of risk adjusted financial targets in executive compensation (Kirkpatrick, 2009).

Structural Corporate Governance Factor of Bank Executive Compensation

The recent financial crisis has drawn much attention to the equity incentives used to compensate

executives in the banking industry. For example, the chief executive officer (CEO) of bankrupt Countrywide Financial, Angelo Mozilo, cashed out options that he received as a performance incentive worth \$414 million between 2004 and 2008. In light of this anecdotal evidence, the amount and structure of executive compensation packages in the banking industry have been hypothesized by the financial press as a cause of excessive risk-taking behavior. Unsurprisingly, subsequent to the bailout period, the SEC issued new disclosure rules effective for proxies filed after February 28, 2010 to report employee compensation policies and practices that create risks that are reasonably likely to have a material adverse effect on the company. The rules also changed the value reported for restricted stock and option rewards. Directors and shareholders need to understand a company's broader compensation policies and analyze whether these policies appropriately consider both risk and long-term firm growth.

A few studies have examined the relationship between executive compensation and bank risk taking. Houston and James (1995) reported that bank CEOs received less cash and option compensation and equity-based incentives which do not promote risk taking. Chen et al (2006) reported more current, contradictory findings that banks were progressively using more option-based compensation and this form of compensation is linked with risk taking. Ang et al (2002) also found that bank CEOs were paid more and have more equity-based pay in their compensation structure than CEOs in non-banking firms. DeYoung et al (2010) reported that in response to deregulation, bank boards designed compensation to include more stock options aimed at encouraging CEOs to take on new risky business opportunities.

Another key factor influencing bank risk individually or when coupled with high levels of equity incentives was CEO power. For example, Wachovia's board of directors asked its CEO, Ken Thompson, to leave in May, 2008 and subsequently split his role as the Chairman of the Board (COB) and the CEO, due to reports that Thompson was running the company without proper controls (Mildenberg and Son 2008). Also, he has been blamed for taking the lead role in the \$24 billion acquisition of Golden West Financial (GWF) which brought aboard rising loan defaults, due to GWF's riskier, "pick-a-payment" mortgage portfolio (Foust 2008). In May of 2008, Washington Mutual announced that their CEO, Kerry Killinger, would step down from the role of chairman in order to strengthen corporate governance and reduce CEO power. He was blamed for leading the company into \$19.7 billion of asset backed, adjustable rate mortgages and subprime mortgages which was more than any other lender nationwide (Task 2008).

Promotion of unethical behaviour by equity-based compensation may be more present at banks, given that large banks are often considered to be "too

large to fail" from a regulatory perspective and the expectation that more government bailout funds will be received to offset potential bank failure, i.e., the "moral hazard" problem. This situation may increase executives' tendency to engage in risky behaviour (Kane, 2000). Such risky behaviour may enable bank executives to increase their short-term compensation by maximizing short-term performance at the expense of the bank's long-term performance. On the other hand, in the face of longer-term equity incentives, it makes economic sense for a CEO to focus on long-term performance since focusing on short-term performance might be costly with lower stock prices in the long-term.

This research (Victoravich et al 2011) investigated whether CEO power affects the relationship between equity incentives and risk-taking at banks. CEO power was examined on the basis that it is a key corporate governance factor which enables a CEO to pursue his or her own agenda. Previous literature has shown that CEO power in the form of a more entrenched CEO can have adverse effects on management behavior and incentives (Bebchuk 2002). Thus, over-powerful CEOs were expected to be more able to influence the firm's decision making to their own benefit which is likely a function of their level and type of personal wealth which is tied to their firm's stock price performance, i.e., short-term vs. long-term focus. CEO power was measured with an index comprised of five underlying variables: CEO duality (the CEO is also the COB), a staggered board of directors, the proportion of insiders who sit on the board, the proportion of affiliated board members who also sit on the board, and whether the CEO is the founder. Equity incentives were measured in terms of equity compensation (stock options and restricted stock) and CEO wealth (value of exercisable and un-exercisable options). These measures were employed to capture incentives related to both short-term and long-term firm performance. Risk taking was estimated with both firm specific and market based measures in terms of total, idiosyncratic and systemic risk.

This research then empirically tested these allegations that weak governance in the form of CEO power and equity incentives (two key structural corporate governance factors) is related to bank risk taking during the period when the financial crisis unravelled. This research examined whether bank risk was a factor influenced by chief executive officer (CEO) power, equity incentives, and the interaction between these factors during 2005 through 2009, which marked the unravelling of the financial crisis. Bank specific risk decreased with CEO power and CEO equity-based incentives (newly granted stock options and restricted stock and accumulated exercisable and un-exercisable stock options). These findings suggested that when CEOs have more power, they can influence the board's decision-making to their benefit in reducing risk. Further,

when their personal wealth was more tied to firm value, they were less likely to take on high risk projects as these projects could be detrimental to their personal wealth. However, CEOs with more power did take on higher levels of firm risk when they had greater levels of future personal wealth in the form of un-exercisable options. These results suggested that powerful CEOs are more likely to take on risk when their personal wealth is tied to long-term firm value, as opposed to short-term firm value. However, results from a supplementary analysis indicated that just cash compensation (total salary plus bonuses) was linked to higher bank risk which may be responsible in part for the risky, short-term practices that led to the financial crisis. This finding suggested that CEOs may have been focusing on maxing out current year bonuses and salary increases by taking on additional risk. Bonus compensation is more certain due to comfort associated with predicting earnings and related metrics, i.e., earnings per share, return on assets, etc., versus the ability to predict the firms' stock price.

This study contributed to the literature with a new perspective on how CEO power and equity incentives shape managerial risk-taking behavior at banks in the recent period of the unraveling financial crisis. The findings contradicted the contention that equity incentives and an over-powerful CEO lead to increased risk-taking at banks. This evidence should be of interest to boards, especially the members of the compensation and nominating committees, who need to evaluate the costs and benefits of equity incentives and the proportion of truly independent directors that sit on the board. The evidence will also help boards understand how equity and cash incentives affect CEO's decision making related to risk taking.

These findings were also relevant to compensation committee members at banking firms. Given the nature of the banking industry and the ability to maximize short-term profitability by taking on risky loans and engaging in risky hedging activities, special attention should be taken when creating compensation packages of top executives at banking firms. Compensation of banking executives should be comprised of long-term equity incentives, primarily in the form of restricted stock in order to reduce risk taking. As well, short-term cash based compensation should be minimized to curb excess risk taking. This conclusion is especially important, due to the moral hazard problem present at banks which is a result of the assurance provided by deposit insurance and taxpayers' bailout funds as well as the complex nature of banking transactions, which decreases the transparency of executive actions.

The findings were also relevant regarding executive compensation in the form of restricted stock and future CEO wealth in the form of un-exercisable and exercisable stock options deserves more attention by academic researchers. The preponderance of the literature on equity incentives

focuses on stock options which is only one part of executive equity compensation mix. Thus, restricted stock and accumulated options in the form of both exercisable and un-exercisable options appeared to have a more profound impact on risk taking than just stock options at banking firms.

Corporate Governance Listing Requirements: Investor Protection From Fraudulent Financial Reporting

A major lesson from recent financial reporting frauds and the U.S. 2008 financial crisis was that effective reform of corporate governance is needed now more than ever. Thus, corporate governance listing requirements of major stock exchanges were analyzed to assess the level of investor protection from such investment disasters (Grove et al 2009). This issue was especially critical to emerging stock exchanges, like in the United Arab Emirates (U.A.E.) and Russia, where these countries are trying to attract foreign investors. The corporate governance listing requirements of the well-established stock exchanges in the United States (both the New York Stock Exchange or NYSE and the over-the-counter-stock-exchange or NASDAQ), United Kingdom (London), and Singapore, were compared to listing requirements of the emerging stock exchanges in the U.A.E. and Russia. The effectiveness of these corporate governance listing requirements for protecting investors were assessed by determining how they address the structural corporate governance factors identified by the NYSE Corporate Governance Commission previously listed at the beginning of this paper.

As an example of such listing corporate governance requirements, the U.A.E. state owned, Borse Dubai stock exchange's listing requirements of 2010 have drawn from both (U.S) and U.K. listing requirements. Since the UAE Borse Dubai stock exchange's goal was to become another major stock exchange by filling the "24/7" continuous, world trading gap between the U.K. and Singapore, their listing requirements for corporate governance are important considerations for many investors. Also, the Sarbanes-Oxley Act (SOX) requirements in the U.S. (Felo and Solieri 2003) have been analyzed as they were written in part to address structural corporate governance factors. The emerging Russian or RTS Stock Exchange listing requirements have focused upon the rules needed for major Russian companies to be included on its leading or most exclusive "List A", as opposed to the less prestigious "List B" (Derisheva 2007).

Common corporate governance structural problems have been identified in fraudulent financial reporting research dating back to the early 1980's (Grove et al 1982) and have continued to the present (Basilico and Grove 2008). These structural factors appeared to be adequately covered by the various

stock exchanges' listing requirements for corporate governance as follows: all-powerful CEO, weak system of management control, focus on short term performance goals, weak or non-existent code of ethics, and questionable business strategies with opaque disclosures. Various behavioral corporate governance factors did not appear to be adequately covered by these same listing requirements: senior management turnover, insider stock sales, CEO uncomfortable with criticism, independence problems with external auditors, and independence problems with investment bankers.

One way to assess the effectiveness of the corporate governance listing requirements of major stock exchanges and related SOX regulations was to look at current trends in financial statement restatements by publicly-held companies. For example, approximately ten years after Enron, WorldCom, Tyco and Qwest, corporate America still has many accounting errors. 1,172 U.S. companies filed financial restatements in 2007, down 15% from 2006 which was up 6.5% from 2005. In 2004 and 2003 there were only 600 and 500 such restatements, respectively. However, the pattern has been changing as the SOX requirements are fixing U.S. financial reporting for many investors. For the first time in a decade, companies of all sizes filed fewer restatements to correct accounting errors in 2007 than they did the previous year in 2006. Also, restatements at large U.S. companies (with market capitalization over \$750 million) dropped from 2005 to 2006 by 26%. Similarly, midsize U.S. companies (with market capitalization between \$75 million to \$750 million) also dropped 13%. However, an increase in restatements (up 45%) from 2005 to 2006 came from the small or "microcap" companies (with market capitalization less than \$75 million) which tend to be less regulated in the U.S. by the SEC and SOX (Glass Lewis & Co. 2008). The SEC typically has investigated just large or mid-size companies for earnings management and fraud in its Accounting and Auditing Enforcement Releases (AAERs) which have leveled off at about 50 per year since their peak of 77 in 2003 following the major U.S. financial reporting scandals.

Since the advent of SOX requirements in the U.S., initial public offerings (IPOs) have increased in the U.K., primarily from Russian and Chinese companies, while IPOs have decreased in the U.S. A possibly related event was that fraudulent financial reporting has increased in the U.K. while recently decreasing in the U.S. Also, many new Chinese companies have avoided the IPO process in the U.S. by doing reverse mergers with existing U.S. publicly-traded companies. Also, a growing body of economic research has shown that the cost of equity capital varies with the regulatory and disclosure environment. When a foreign company has cross-listed on a U.S. exchange, it has incurred a significant reduction in its cost of capital and also has been given

a valuation premium (often 30 per cent or more) over non-cross-listed companies from its home country. Conversely, when a foreign company has cross-listed on the London Stock Exchange, there has been no valuation premium nor has a reduction in the cost of capital occurred. These patterns have continued for over 15 years. The obvious explanation was that stricter enforcement in the U.S. has caused investors to view cross-listed company's financial results with greater trust and assign a higher valuation, i.e. deterrence works. Also, criminal enforcement of securities offences has been virtually unknown in the U.K. and civil insider trading cases have remained rare. Given the hidden costs of insider trading, the time may have come for the U.K. to do more enforcement (Coffee 2008).

In 2005, National Ratings of Corporate Governance were established by the Russian Institute of Directors for 150 Russian companies, i.e. the majority of companies whose securities were traded on the Russian stock exchange. For the first half of 2004, only one company received a Class A rating for a high level of corporate governance while most companies (116) received a medium level of risk with a Class B rating for a positive level of corporate governance. However, the corporate governance of these companies has been improving. At the end of January 2005, a second set of ratings was done. The number of companies receiving a Class A rating increased to five and the number of companies receiving a Class B also increased versus companies with Class C or D ratings (low or unsatisfactory levels of corporate governance, respectively).

In 2007, the Asian Corporate Governance Association produced its fourth survey of corporate governance in Asia in collaboration with an Asian brokerage firm. 582 listed companies in eleven Asian-Pacific markets were rated on a corporate governance scale of one to 100 and, then, summarized by countries' stock exchanges using this scale. The derivatives trading scandal at China Aviation Oil, the Chinese state-owned jet fuel importer, and accounting frauds at several smaller Singapore-listed companies reduced that city-state's score, placing it a level with Hong Kong as the ongoing number one and two rated stock exchanges. India was third and China was ninth. These surveys have raised awareness of good corporate governance practices in this region. For example, many Singapore companies have improved corporate governance practices, especially in promoting greater independence of boards and better communication with shareholders. Also, regional financial reporting and disclosures have improved while the independence of audit committees and political influence on regulatory action are still problematic. These corporate governance improvements have helped offset the reluctance of equity investors to invest in listed companies in the region. Also, private equity investors have helped to improve corporate

governance in listed companies since they had the patience and skill to work closely with management in order to improve their investment exit strategies.

The corporate governance listing requirements of major stock exchanges in the world have enhanced investor protection against common corporate governance factors that facilitated fraudulent financial reporting and the financial crisis in the U.S. Investors have appeared to be protected by the corporate governance listing requirements of each major stock exchange concerning the structural factors cited in the report of the NYSE Corporate Governance Commission as follows: all-powerful CEO (duality factor and lack of Board independence), weak system of management control, focus on short-term performance goals, weak code of ethics, and opaque disclosures. Conversely, investors have appeared to be unprotected by behavioural factors related to corporate governance as follows: CEO uncomfortable with criticism, senior management turnover, insider stock sales, independence problems with external auditors and independence problems with investment bankers (Grove et al 2009).

Using a benchmarking approach where best practices of corporate governance were taken from various entities, the U.A.E. approach drew from both U.S. and the U.K. listing requirements in constructing its own listing requirements for structural corporate governance problems. A similar approach could be used here as specific listing requirements or statutory laws in various countries could be used as benchmarks by other countries to strengthen investor protection. Accordingly, excerpts from major stock exchanges' listing requirements for corporate governance and related SOX requirements were elaborated as guidelines to protect against each of the unprotected behavioural corporate governance factors as follows.

Concerning the factor, CEO uncomfortable with criticism, the London Stock Exchange listing requirements could be used to bolster investor protection. Rule E1 stated that institutional investors should enter into a dialogue with companies based on the mutual understanding of objectives and Rule E2 stated that institutional investors should avoid a box-ticking approach to assessing a company's corporate governance. Thus, if institutional investors asked tough questions of a company's management, particularly the CEO, then, he/she should be more comfortable with criticism and additional tough questions from financial analysts, hedge fund managers, and other investors in conference calls and other meetings with investors. Also, assistance may come from the U.A.E. Article 12.2b which stated that shareholder rights shall include the opportunity to efficiently participate and vote at General Assembly meetings and the right to discuss the matters listed on the agenda and to ask questions of the Directors and external auditor, who shall answer them to the extent that shall not be in any prejudice of the Company's

interest. More independent Board of Directors, as required by all the stock exchanges, should help in this area as well.

Concerning the factor, senior management turnover, a statutory requirement, similar to the SOX requirement on insider trading, could be used here to increase investor protection. Senior management turnover would have to be disclosed on a company's website within two days and reported to the SEC in the same time. Another aid would be the NYSE and NASDAQ requirements strengthening a company's nominating committee with all independent directors. Also, a version of the U.A.E. requirement for directors could be applied here. ARTICLE 3.4 stated that a director shall stay in office until he is succeeded, or he resigns, or he is dismissed via a Board of Directors' decision.

Concerning the factor, insider stock sales, various SOX requirements could be used by all the stock exchanges to enhance investor protection. SOX Section 403 required executive stock trades be reported electronically within two days and also posted on the company's website. SOX Section 304 required forfeiture of bonuses and profits from equity sales by the CEO and CFO when firms restate financial statements from material non-compliance with financial reporting requirements as a result of misconduct. Also, a Russian stock exchange requirement could be used here. RULE 8 stated that an issuer's Board of Directors shall pass a document on the use of confidential information about the issuer's activities, securities issued by this company, and transactions, which involve the above securities, since its disclosures can considerably influence the market price of the issuer's securities. Also, U.A.E. ARTICLE 14 (Appendix, Section 2) stated that the required Governance Report shall state the transactions of the Directors and their Relatives in the Company's securities during the period of the Report.

Concerning the factor, independence problems with external auditors, various SOX sections could be used by all the stock exchanges to help protect investors. SOX Section 508 required that lead audit partners be rotated off an audit engagement every five years and no audit team member be hired by a company during the one year preceding an audit. An Italian law was much stronger in requiring that the entire lead audit firm, not just the lead audit partner, be rotated off an audit engagement every five years. SOX Section 508 also prohibited audit firms from designing and implementing financial information systems, providing internal audit services, and providing valuation and appraisal services to audit clients. SOX Section 802 required that external auditors retain audit working papers for at least seven years. All the non-U.S. stock exchanges have rules establishing audit committees that need to review the independence of external auditors. For example, the Singapore Stock Exchange RULE 11 stated that the Board should establish an Audit Committee,

consisting of three non-executive, independent directors, and having written terms of reference which clearly set out its authority and duties, including the review of independence and objectivity of external auditors. However, none of these stock exchanges' listing requirements, including the U.S. ones, specifically defined auditor independence like the SOX Section 508 or required auditor working paper retention like Section 802.

Concerning the last factor, independence problems with investment bankers, SOX Section 501 enabled the SEC to create rules governing research analyst conflicts of interest and the SEC has been acting with a professional financial analysts' group (FINRA) to establish and enforce the independence of financial analysts. However, none of these major stock exchanges have any corporate governance rules in this area to help protect investors. One suggestion would be similar to the SOX Section 508 prohibiting auditors from performing non-audit services other than tax. A similar rule here would prohibit investment banking firms from providing investment research recommendations on client companies, like the FINRA Rule 2711. Thus, all these "sell-side" financial analysts who work for the investment banking firms would be prohibited from providing such research and from going on road shows to promote client security offerings. In essence, the investment research on these client companies would be performed by the "buy-side" financial analysts who do independent research primarily for institutional investors, similar to the New York Attorney General's settlement with the largest investment banks in the U.S.

Thus, there is potential of corporate governance listing requirements for both structural and behavioural factors from various stock exchanges around the world for preventing fraudulent financial reporting and, thus, for protecting investors. Managers, board members, internal and external auditors, and government regulators should apply these corporate governance listing requirements and related recommendations to help reduce financial reporting fraud and excessive risk-taking from the financial crisis in the U.S.

A related strategy to help detect and prevent financial reporting fraud and financial crisis investment disasters was to strengthen risk management guidelines for companies, as summarized by Hilb (2004): The task of the board and top management is to define an integrated, future-oriented risk management concept. It should be integrated with the existing planning and leadership processes but not constrain entrepreneurial freedom. Such a risk management concept should give management the assurance to cope with daily risk and it should keep the responsibility for directing and controlling within the board. Boards should report annually to owners about their risk assessment and decision-making processes. At the board level,

risk management deals with the process of early detection, prevention, and management of dangers, as well as identification and effective realization of entrepreneurial opportunities. Thus, there must be the conscious exploration of risks where opportunities can be realized and in the prevention or reduction of risk, where the anticipated risk outweighs the expected gains. Risk management deals primarily with higher assurance in planning and a higher probability that company objectives are achieved.

These corporate governance factors should be controlled for improved risk management and individual high-risk areas need to be monitored closely. For example, the SEC has reported that over 50% of the financial reporting frauds and earnings management cases that it detected involved revenue recognition practices. As another example, such risk management guidelines could be summarized for investors in the Governance Report required by the corporate governance listing requirements of the U.A.E. stock exchange (ARTICLE 14): The Governance Report is an annual report of Corporate Governance practices signed by the Chairman of the Board of Directors and submitted to the Stock Exchange Authority on an annual basis or on request during the accounting period covered by the Report. The Governance Report shall be inclusive of all such information as set out in the required Authority approved form, including in particular: 1) requirements, principles, and application methods as necessary for Corporate Governance, 2) violations as committed during the financial year together with the reasons and the method to remedy and avoid the same in the future, and 3) composition of the Board of Directors, according to the categories and terms of office of its members, determining the remunerations of General Manager, Executive Manager or CEO as appointed by the Board of Directors. This Governance Report required by the U.A.E. Authority has six approved sections: governance practices, transactions of directors in securities, composition of the Board of Directors, external auditor's fees, audit committee, and general information. The governance practices section could be expanded to require a summary of how a company's risk management strategy dealt with these structural and behavioural factors of corporate governance, concerning violations and corrective actions to protect investors.

Conclusions

The importance of the structural corporate governance factors identified by the New York Stock Exchange's 2010 Commission on Corporate Governance was reaffirmed here with various empirical and forensic studies. The key, recurring structural factors were all-powerful CEO (the duality factor and related Board independence issues), weak system of management control, focus on short term performance goals (and related executive

compensation packages), weak code of ethics, and opaque disclosures. Such weak corporate governance factors were key contributors to both fraudulent financial reporting and excessive risk-taking which facilitated the U.S. financial crisis in 2008. Corporate governance listing requirements by major stock exchanges around the world will help mitigate such problems from recurring in the future.

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