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Guest Editorial

Corporate Governance and the 2008–09 Financial Crisis

Martin Conyon, William Q. Judge, and Michael Useem

ABSTRACT

The financial crisis of the late 2000s resulted in enormous costs to the economies of many countries and the fortunes of millions of families, and it challenged a host of our conceptions and theories of corporate governance. The governing boards of many financial-services firms seemed unable to prevent the risky and ill-fated decisions that jeopardized their firms, devastated their investors, and helped precipitate a financial meltdown that morphed into global recession. Company boards were also directly responsible through their compensation committees and consultant advisors for a sharp rise in executive compensation during the 2000s that may have contributed to undue short-term risk-taking among the financial-service companies that helped spark the recession. The macroeconomic environment also changed. Historically low interest rates, and the development of new ways of financing mortgage products led to an irrationally exuberant mind-set of lending and borrowing in the housing market. The quality of some loans was questionable, but home asset prices continued to increase – until they collapsed in 2008. The boom and bust in the housing market was an important contributor – one of many including inadequate corporate governance – to the perfect financial storm of 2008–09.

From a conference with 87 papers on the role of corporate governance in precipitating or exacerbating the financial crisis, and from five articles by governance researchers and three articles by prominent governance participant-observers included in this special issue, it is evident that governance played a contributing role. An article by Muller-Kahle and Lewellyn finds that directors of sub-prime lenders compared with other lenders served on a larger number of other company boards, presumably allowing then less time to monitor the sub-prime lender's risky practices, and they served for fewer years on the sub-prime lender's board, suggesting that they were less experienced in evaluating the financial risks of the sub-prime markets. A second article by Grove, Patelli, Victoravich, and Xu report that the higher the levels of debt held by banks, a policy presumably monitored and approved by directors, the lower bank financial and operating performance during the financial crisis. A third article by Yeh, Liu, and Chung finds that director independence on the auditing and risk management committees affected risk taking behaviors and subsequent performance.

In the pursuit of productive avenues for reform, a fourth article Pirson and Turnbull argue for a network of boards representing multiple constituencies, convened through a "stakeholder congress," that would bring more sources of information to the attention of more actors who could make more effective use of the information in guiding company risk management. A fifth article by Nicholson, Kiel, and Kiel-Chisholm argue for the re-establishment of professional restraints and creation of a new set of more responsible social norms within the financial sector to avoid the next financial meltdown.

Three well-informed participant observers corroborate these findings and direct special attention to both company and country governance issues at they help foster the financial meltdown. Berglöf finds that the absence of both micro and macro protections against excessive and systemic risk may have opened the way for the perfect storm. Feinberg concludes that distortions from economically-rational pay practices – ultimately the responsibility of the board – may have contributed to the financial crisis as executives sought to optimize their pay in ways that were not optimal for the firm nor its investors, customers, or lenders. Johnson places some of the blame for the crisis indirectly on the governance door step – directors who hired and monitored the bankers at center of the crisis had helped foster a culture of short-term greed and narrow self-interest that became toxic when it became systemic and no longer limited to a few aberrant players.

Taken together, the five articles and three commentaries in this issue point to the importance and interplay of both micro and macro governance factors in contributing to the financial crisis of 2008–09 – and to the importance of reforming those factors to help avert another financial crisis in the future.

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INTRODUCTION

The financial crisis of the late 2000s resulted in enormous costs to the economies of many countries and the fortunes of millions of families. Triggered by a real estate bubble, overly leveraged financial products, and failures of AIG, Lehman, Merrill, and other major financial firms, the "Great Recession" of 2008–09 saw America's GDP contract by more than 4 per cent and that of some countries by double digits. US unemployment doubled, international trade plummeted, and by March 2009 the Dow Jones Industrial Average had declined by 54 per cent from its peak just 17 months before, wiping out trillions of dollars of wealth from the stock market. Modest, though unsteady, recovery came to most economies in 2010–11, stimulated in part, by direct government intervention by China, the European Union, the United States, and elsewhere.

The worldwide economic crisis challenged a host of our conceptions and theories of corporate governance. The American governance tradition, fortified by the Sarbanes-Oxley Act of 2002 and the New York Stock Exchange's revised rules of 2003, had emphasized strong outsider-dominated boards with independent audit, compensation, and governance committees. Despite the strengthened regulatory regime in the United States and a comparatively strong focus on shareholder monitoring, the governing boards of many American financial-services firms proved unable to prevent the risky and ill-fated decisions that jeopardized their firms, devastated their investors, and helped precipitate a financial meltdown that morphed into global recession. Company boards were also directly responsible through their compensation committees for a sharp rise in executive compensation during the 2000s. Some critics viewed the growth in compensation as contributing to excessive short-term risk-taking among the financial-service companies, and that in turn helped spark the recession. The precise causes of the global financial crisis will occupy the minds of academics for years to come.

The governance shortcomings that may have contributed to the financial crisis were not uniquely American, however, with companies in many countries evidently adding their own governance deficiencies to the crisis. Iceland's three major commercial banks collapsed, plunging the country into recession. The British government bailed out and effectively nationalized Northern Rock and the Royal Bank of Scotland as their boards' ineffective risk oversight and the banks' exposure to the sub-prime mortgage market led to insolvency. Switzerland's UBS reported a loss of $17 billion in 2008, the largest in Swiss company history, writing down some $50 billion in mortgage assets, losses precipitated in part because of weak governance at the top (UBS, 2009).

Many complex and interdependent forces led to the largest economic crisis since the Great Depression of the 1930s, and corporate governance systems were arguably one of the contributing factors. One issue that many company leaders attending the annual meeting of the World Economic Forum in Davos, Switzerland, in January, 2009, near the peak of the financial crisis, could agree upon was that national corporate governance systems were not working properly (Useem, 2009). While corporate governance may or may not be a root cause of the economic crisis, most informed observers do not hold it blameless. There is little agreement, however, on what precisely was wrong with governance and accordingly what steps are needed to set put matters right.

To help fill that gap, Mauro Guillen, William Judge, and Michael Useem organized a research conference on "Corporate Governance and the Global Financial Crisis" held at the Wharton School on September 24–25, 2010. The conference was co-sponsored by *Corporate Governance: An International Review*, the journal's publisher Wiley-Blackwell, Penn Lauder CIBER of the Lauder Institute of the University of Pennsylvania, and the Wharton Center for Leadership and Change Management. Researchers from around the globe submitted 133 paper summaries for inclusion in the conference, they delivered 87 papers at the conference (authors and titles are available at http://gfc.wharton.upenn.edu/schedule.shtml), and five of the most compelling studies are included in this special issue. The special issue was edited by Martin Conyon, William Judge, and Michael Useem.

The conference papers and issue articles addressed two central and related thematic questions. First, did corporate governance play a contributing role in precipitating or exacerbating the financial crisis in the US and other countries? Second, what public policy and corporate governance reforms are required in light of what we have learned from the financial crisis? Among the specific research issues and policy measures addressed by the papers and the conference were:

- Empowering shareholders to exercise greater influence on corporate boards.
- Instituting new rules and regulations to strengthen risk management.
- Separating the roles of board chair and chief executive.
- Emphasizing stronger norms of director responsibility and self-regulation.
- Preventing financial institutions from becoming "too big to govern."
- Overhauling credit-rating and financial reporting to better signal risk.

While there were clearly breakdowns in "public" governance systems, the five articles included in this issue confirm that specific features of corporate governance did indeed contribute to the financial crisis, and the articles also develop arguments that company directors require better information and improved codes of behavior if they are to help avert excessive risk taking in the future. The articles in this special issue represent important steps in understanding the relation between corporate governance systems and the global financial crisis.

DID CORPORATE GOVERNANCE PLAY A ROLE?

Three of the special issue's articles offer direct evidence that governance shortcomings served as contributing if not originating factors in the financial crisis. Taken together, their specific findings confirm that distinct features of governance did make a difference, and they did so in consistent and predictable ways. In that consistency and predictability are implications for company practices and country policies for guarding against undue systemic risks in the future.

In our lead article, Maureen Muller-Kahle and Krista Lewellyn compared American financial firms that engaged in sub-prime mortgage lending with a matched set of financial firms that did not so engage during the period from 1997 to 2005. The contrast is particularly apt for thinking about the financial crisis since we know from other observers that overly risky sub-prime mortgage practices were at the heart of the 2008–09 financial crisis (e.g., Duchin, Ozbas, & Sensoy, 2010). The comparison was made possible by the US Department of Housing Urban Development's practice of identifying sub-prime specialists prior to 2006, defining a specialist as a lender with more than half its portfolio in subprime loans. Muller-Kahle and Lewellyn find that directors of sub-prime lenders served on a larger number of other company boards, presumably allowing them less time to monitor the sub-prime lender's risky practices, and they served for fewer years on the sub-prime lender's board, suggesting that they were less experienced in evaluating the financial risks of the sub-prime markets. These strategic management scholars also discovered that the governing boards of the sub-prime lenders were less diverse in gender, potentially signifying that the sub-prime boards were less likely to challenge the growing wisdom in this period that sub-prime leading was a worthy long-term strategy. The results point to the importance of company practices and public policies that encourage engaged, informed, and diverse dialogue within the boardroom to better protect against unwarranted risk taking behavior.

The second article in this special issue also focused on US financial firms, and it was authored by Hugh Grove, Lorenzo Patelli, Lisa Victoravich, and Pisun (Tracy) Xu. Specifically, these accounting and finance scholars seek to understand if there is a systematic relationship between governance structures and subsequent performance outcomes for a set of 236 publicly-traded American commercial banks prior to and during the financial crisis. In this study, the authors focus on accounting, market, and operational-based performance outcomes. This comprehensive study examines 11 different firm-level governance factors stemming from agency theory to explain performance outcomes in financial firms. Interestingly, only a few governance factors were significant and in the predicted direction. As such, this raises questions about structural causes and solutions to governance problems. However, one of the most robust empirical findings was that the higher levels of debt held by banks, the lower their overall financial and operating performance during the financial crisis. While this finding is counter to standard agency arguments whereby debt holders are incentivized to monitor more closely, it does suggest some very important practical implications for minimum capital requirements and maximum leverage ratios for banks in the aftermath of the financial meltdown.

In the third article on the effect of corporate governance on the crisis within the financial sector, Yin-Hua Yeh, Liang Liu, and Huimin Chung focus on the relationship between banking committee structures and subsequent firm performance of the 20 largest financial institutions from 11 major economies. Using a unique, hand-collected database of multinational firms, these finance scholars find that director independence on the auditing and risk management committees were systematically related to risk taking behaviors and subsequent firm performance. However, director independence on the compensation and nominating committees was not so related, according to this study. Because of their cross-national sample, the authors also explored the influence of national context on the committee independence-firm performance relationship. In sum, this study suggests that additional research at the committee level may be insightful along with study of overall board-level structures and behaviors.

WHAT REFORMS ARE REQUIRED?

The results of these three research articles point to the specific governance reforms that would discourage the excessive risk taking among financial institutions that arguably contributed to the financial crisis if not constituting a root cause of it. These include fostering governing boards whose directors are independent, engaged, informed, and diverse, especially in countries whose regulatory regimes provide weaker protection of shareholder rights.

Two additional articles in the special issue identify reforms that go well beyond a focus on changing the composition or organization of the governing board, the locus of much of the debate to date. The first article investigates the power of information on company risk and the governance failings that are likely in the absence of good information. The second references the power of governance norms and the governance failings that are probable when those norms are misdirected. These two articles explore important and underappreciated features of governance that may have played a subtle but powerful role in precipitating the financial crisis.

In the first of the two articles, management and governance specialists Michael Pirson and Shann Turnbull explore the role of information asymmetries within the boardroom in creating unreasonable systemic risk. To help rectify the information deficits that afflict most boards, Pirson and Turnbull call for a more complex governing structure. Specifically, they argue for a network of boards representing multiple constituencies, convened through a "stakeholder congress," that would bring more sources of information to the attention of more actors who could make more effective use of the information in guiding company risk management. If firms are not prepared to voluntarily move from their current unitary structure toward more networked governance, argue the authors, national regulators should step in to require it.

In the second of the two reform articles, Gavin Nicholson, Geoffrey Kiel, and Scott Kiel-Chisholm argue for the re-establishment of professional responsibility within the financial sector to avoid the next financial meltdown. Specifically, they argue that no structural change can adequately avert future financial crises without commensurate attention to the social norms that surround proper financial transactions. Hence, the norm of *caveat emptor* – buyer beware – is problematic when the complexity of financial products becomes too great to readily assess. Similarly, the norm of self-interested behavior needs to be challenged when the entire financial system is put at risk. While Nicholson, Kiel, and Kiel-Chisholm, specialists in accounting, law, and management, acknowledge the difficulty of changing social norms within societies, their arguments are appealing in light of the experience of national economies that weathered the crisis in relatively good fashion, such as those of Canada and Scandinavia, where social norms evidently helped avert the crisis.

MICRO AND MACRO GOVERNANCE

The conference organizers also invited three prominent governance participant-observers to present their own assessments of the role of governance in the financial crisis. Their commentaries, included in this issue, corroborate and reinforce the findings and conclusions of the five articles, but they also go beyond them to emphasize looking at both company and country governance issues at they fostered the financial meltdown.

The three participant-observers bring substantial practical and academic experience in corporate governance to their observations on the crisis:

Erik Berglöf. Chief Economist and Special Adviser to the President at the European Bank for Reconstruction and Development. Served as director of the Stockholm Institute of Transition Economics; professor at the Stockholm School of Economics; senior fellow at the Brookings Institution; founder and president of the Center for Economic and Financial Research, Moscow; board member and research fellow for the European Corporate Governance Institute; advisor to national governments, International Monetary Fund, and World Bank.

Kenneth R. Feinberg. Managing partner of Feinberg Rozen, LLP. Served as US-appointed administrator of the BP Deepwater Horizon Disaster Victim Compensation Fund; Special Master for Executive Compensation for Troubled Asset Relief Program (TARP) companies; Special Master of the Federal September 11th Victim Compensation Fund; Fund Administrator for the Hokie Spirit Memorial Fund following the shootings at Virginia Tech University; adjunct professor at the law schools of University of Pennsylvania, University of Virginia, and Columbia University.

Simon Johnson. Professor of Entrepreneurship at MIT Sloan School of Management, and author of *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (2010); senior fellow at the Peterson Institute for International Economics; member of the Congressional Budget Office's Panel of Economic Advisers; formerly Economic Counselor (chief economist), International Monetary Fund; former member of US Securities and Exchange Commission's Advisory Committee on Market Information.

Drawing on his European experience along with that in the US, Erik Berglöf emphasizes looking at both the "micro" governance system and the "macro" governance framework – governance at the firm level versus governance at the country level. He argues that we should consistently consider their joint impact and the possibility that weaknesses at one level might be compensated at the other level. If not, it may be a prescription for a perfect financial storm.

Focusing first on the micro level, Berglöf observes that governing boards in Europe are more under the influence of founding families and large banks than in the United States, where stockholding by contrast is relatively dispersed among a large number of institutional investors, resulting in what has been termed a "strong manager-weak owner" syndrome (Roe, 1996). Without powerful principals monitoring their firms, and without a strong macro-governance system to make up for this micro-weakness, it is not surprising that the financial crisis originated in the US. The absence of both micro and macro protections – too few vigilant owners and bankers and too little regulatory vigilance of the banks – may have opened the way for the storm.

But Berglöf remains agnostic on whether corporate governance shortcomings were a root cause of the calamity, noting that the crisis had hit banks in several countries with considerably differing systems of micro and macro governance. Moreover, some of the what are often taken to be good micro-governance practices – such as ensuring that directors and executives are riveted on creating shareholder value and meeting the demands of investors – may (ironically) have actually contributed to the crisis as some banks were inadvertently driven by their investors and directors to take unwarranted risks in the home mortgage market in the name of increasing near-term shareholder returns.

There are even indications, Berglöf notes, that purportedly good macro-governance practices – such as regulators' influence over director nominations to banking boards – may have inadvertently resulted in the placement of less qualified directors on the boards of banks. Also ironic is the fact that financial institutions in the emerging markets such as China and India weathered the crisis better than firms in the developed markets where corporate governance in both micro and macro forms is often viewed as better designed and implemented.

On reviewing these disparate and sometimes contradictory strands of evidence, Berglöf concludes that there is too little evidence at the moment to conclude that corporate governance practices alone constituted a consistent and significant cross-national cause of the financial meltdown.

For his assessment of the financial crisis, Kenneth Feinberg draws on his direct experience as the US Special Master for Executive Compensation under the Troubled Asset Relief Program provisions that mandated government review of the 25 highest paid executives of the seven companies that received the largest amount of taxpayer assistance – AIG, Bank of America, Chrysler, Chrysler Financial, Citigroup, General Motors, and GMAC. In reviewing and then setting compensation for the 175 executives of these companies, Feinberg learned that executive demand for very high levels of pay was very strong, even though in his assessment and that of his compensation consultants, the executives' performance did not merit the millions of dollars they were demanding.

To more closely connect pay to performance, Feinberg established a set of six principles to guide the seven companies' compensation practices, including the requirement of payouts over several years and prohibiting special perquisites, golden parachutes, and retirement packages. In other words, he found that he had to impose on companies what good governance practices would generally suggest – primarily tying executive rewards to long-term company performance – despite company pressures to the contrary. His "prescriptions," he reported "did not go unchallenged," with "strong arguments" coming from the companies that his such provisions would be "counterproductive."

Feinberg's direct immersion in the world of executive compensation thus points to company distortions from economically-rational pay practices – ultimately the responsibility of the board – that may have contributed to the financial crisis as executives sought to optimize their pay in ways that were not optimal for the firm nor its investors, customers, or lenders. Feinberg, like Berglöf, remained unsure if company pay practices contributed significantly to the crisis, but based on his close and unprecedented look at the pay practices of a set of large companies and the norms that supported the practices, he became convinced that there is a "connection." By implication, the prevailing norms of the governing board regarding executive pay is one area ripe for research and reform to discourage though not necessarily prevent future financial crises.

From his extensive policy and research experience, Simon Johnson reaches a pessimistic assessment regarding the capacity of governance reforms to help avert future financial crises. He argues that that we still do not know what factors, including corporate governance, really caused or exacerbated the crisis of 2008–09. And as a result, the next crisis may well be worse than that of 2008–09 because the financial institutions from which it emanated are becoming bigger than ever and thus more vulnerable to systemic risks. We may be moving from a policy-intervention era of "too big to fail" to a policy-impervious era of "too big to save." And this despite alleged modest regulatory reforms, some touching on corporate governance, in the Dodd-Franks act of 2010. We had, Johnson argues, "weakened the levies" in earlier years by "dismantling" banking regulations, thereby reducing oversight of banking in ways that allow for abuses of customers and short-term advantages that impose longer-term systemic risks, and these macro governance shortcomings remain unaddressed."

Still, Johnson places some of the proximate blame for the financial crisis indirectly on the governance door step. Just 13 top bankers were, in his view, "largely, but not completely, responsible for what had happened." And behind them, or above them, the directors who had hired and supervised those bankers had an indirect hand in creating a culture of short-term greed and narrow self-interest that became toxic when it became systemic and no longer limited to a few aberrant players. No banker's employment contract had required them, for instance, to "be responsible for the financial stability in the United States." As a result, Johnson observed, for bankers the "incentive is to get in, make money, take risk, perhaps to misunderstand risk, perhaps to misrepresent risk, perhaps to work with other people who do not understand risk." And since executive compensation and excessive risk are the province of directors, the board is indirectly to blame for the failure of financial institutions to adequately govern their own risks. Johnson implicitly places his bets more on the macro than micro side of the aisle, choosing to call for more national regulation than board reform. With more of the first – such as higher capital requirements for banks – more of the second should follow.

CONCLUSION

The commentaries of the three informed observers who were directly involved with the crisis reinforce the findings of the five research-based articles included in this issue. They collectively point to the importance and interplay of both micro and macro governance factors in contributing to the financial crisis and to the importance of reforming them to help avert a future financial crisis.

While this conference and special issue was not intended to settle the issue of whether corporate governance played a major or minor role in this record-breaking crisis, the thoughtful commentaries and careful studies suggest that company boards at least failed to avert or limit the systemic damage and should thus be seen as a potential target for reforms to prevent future financial crises. This conclusion is not to imply that political systems and public governance should be viewed as blameless, and attention to their reform is certainly in order as well.

The precise causes of the global financial crisis will be hotly debated for decades. Many experts point to "regulatory capture" of Washington by Wall Street as the underlying cause of the crisis (e.g., Foster & Magdoff, 2009; Johnson & Kwak, 2010; Krugman, 2009). Others single out the pernicious role of greed and compensation practices that ignored the excessive risks incurred (e.g., Lewis, 2010; Rajan, 2010; Sorkin, 2009). Still others stress cultural, network, and social factors (Davis, 2009; Loungsbury & Hirsch, 2010). Regardless of the root causes, corporate governance mechanisms external to and within financial institutions failed to avoid and adequately cope with the crisis as it unfolded.

An emerging consensus suggests that many other factors contributed to the risk-taking that led to the financial crisis. These include implicit government guarantees that helped create a too-big-to-fail culture, questionable monetary policies, and ill-advised financial innovations and products such as mortgage securitizations and collateralized debt obligations. With post-crisis analysis, it now appears that the 2008–09 calamity emerged from the conditions of a perfect storm, a rare combination of a host of contributing forces, none of which was enough to cause the crisis, but together were enough to generate the crisis.

One of those many contributing factors, for example, was the emergence of an overly exuberant mind-set within the home-mortgage banking community. In a study of mortgage lending from 2001 to 2006, Demyanyk and Van Hemert (2011) found that issuers increasingly provided low-quality mortgages and that mortgage loan-to-value ratios increased while loan documentation decreased. As more home loans were given to buyers with poor credit ratings, buyers proved far less able to meet their obligations and their delinquency rates sharply rose. In short, as the home-mortgage market became increasingly willing to offer high-risk loans and as delinquency-prone individuals became more willing to accept them, a classic boom and bust cycle emerged, creating a housing bubble that proved an important factor –

though one of many including inadequate corporate governance – that ultimately coalesced into the perfect financial storm of 2008–09.

Going forward, a more complete understanding of the multiple causes of the financial crisis at the firm level requires further research and analysis of the relations among governance practices, risk management, loan policies, and capital structures. At the macro level, it requires further study of how regulatory frameworks in an array of countries can help better ensure that directors and executives of financial-service firms take risks that that are neither excessive nor systemic. In this regard it is essential to amass further empirical evidence. This will enable policy makers assign weights to which factors were most salient in triggering the financial crisis. We hope that the articles in this special issue helps contribute to that understanding, and we encourage further scholarly study of the distinctive role of governance in the global financial crisis of 2008–09 to help ensure that we both move beyond the calamity and prevent its recurrence.

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