THE ROLE OF CORPORATE GOVERNANCE IN THE EVENTS LEADING UP TO THE GLOBAL FINANCIAL CRISIS: ANALYSIS OF AGGRESSIVE RISK-TAKING

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ABSTRACT

This paper seeks to explain how failures in corporate governance contributed to the global financial crisis. More precisely, it studies how the current corporate governance systems failed to safeguard against aggressive risk taking and to provide the control that companies need in order to promote sound business practices. This paper concludes that aggressive risk taking, a corporate governance aspect, was a major cause of the 2007-2008 financial crisis. Inadequate risk management by executives and boards of directors is to be blamed for the credit market collapse and resulting financial crisis. This paper identifies three elements- improper incentive system, rationalization and opportunity- that encouraged managers in financial institutions to engage in aggressive risk taking. This paper contributes directly to understanding what went wrong in the corporate governance system based on a review of the literature. It introduces recommendations to deal with aggressive risk taking behavior in order to avoid future crisis. The outcomes of the study are directly relevant to the corporate decision-makers where the recommendations are tangible and presented in ways that decision-makers could implement.

JEL: G01; G30; G32; G38

KEYWORDS: Financial crisis, corporate governance, risk management

INTRODUCTION

In 2008, the world experienced the biggest economic crisis since the Great Depression (Blundell-Wignall, Atkinson & Lee, 2008; Cheffins, 2009; Ely, 2009; Lang & Jagtiani, 2010). Stock prices dropped further than they had in a single year since the 1930s and major financial institutions were either bailed out or ended up bankrupt (Cheffins, 2009). Lewis, Kay, Kelso, & Larson (2010) argued that bad loans were made at the height of a real estate bubble in the United States. They added that aggressive lenders engaged in extremely high-risk subprime mortgages and most of them violated traditional underwriting standards for the industry. When the overheated real estate market began to cool, it produced a domino effect that caused the collapse of major players in the financial sector.

A remarkable aspect of the financial crisis of 2008, According to Cheffins (2009), is that it occurred despite the strengthening of U.S. corporate governance over the past few years. Corporate scandals at the beginning of the 2000s led to a prompt legislative response in the form of the Sarbanes-Oxley Act of 2002 and new exchange listing requirements at the NYSE and NASDAQ. Those new regulations served as models for governance reform around the world (Adams, 2009). However, many researchers (Cheffins, 2009; Grosse, 2010; Kirkpatrick, 2009) are convinced that the current financial crisis proved current corporate governance arrangements are not adequate to prevent future crisis. A 2009 *Steering Group on Corporate Governance* report, published by the Organization for Economic Cooperation and Development (OECD), concluded that the financial crisis could be attributed to failures and weaknesses in corporate governance system. Similarly, *the Shareholder Bill of Rights Act of 2009*, introduced by the U.S. Senate, found that failure of corporate governance was among the central causes of the financial and economic crises that hit the United States. More precisely, Kirkpatrick (2009) argued that current corporate governance systems fail to safeguard against excessive risk taking and to provide the control that companies need in order to promote sound business practices

This article addresses the issue whether and to what extent corporate governance can be considered a cause of the financial crisis. This is done through analyzing an important aspect of corporate governance - risk management. The major question addressed is: *how might the corporate governance system have contributed to the global financial crisis?* I only study the financial sector because the current crisis proved that the decisions of individual banks could put entire economies at risk. In addition, boards of financial firms face more pressure to satisfy non-shareholder stakeholders than boards of nonfinancial firms.

The paper is organized into four parts. The first part includes a literature review on the fundamentals leading to the financial crisis, and a brief chronology of the phases of the crisis. In this part, I also introduce the corporate governance theory. The second part discusses aggressive risk taking by financial managers before the onset of the crisis. First, I introduce an aggressive risk-taking triangle suggesting three elements behind aggressive risk-taking strategies. Then, I tie the financial crisis to the corporate governance failure. In the third part, I present a series of recommendations based on the review and interpretation of the literature and evaluation on what needs to be done to improve the system. In the final part, I conclude that financial firms failed to implement corporate governance procedures. These procedures consider risk management an obvious oversight duty of the board of directors that would be fulfilled by monitoring the effectiveness of the company's risk strategies and making changes as needed.

LITERATURE REVIEW

Poole (2010) returned conditions leading to the financial crisis to the stock market peak in 2000 when the Federal Reserve in the United States started to reduce funds rate. Back then, Collateralized Debt Obligations backed by subprime mortgages represented the perfect vehicle for investors seeking high yield investments. As the demand for subprime mortgages increased, underwriting standards decreased. Mortgage brokers lent to the households without adequate income or assets to service the mortgages. Many of the mortgage borrowers were investors anticipating quick resale of the properties they purchased. Low underwriting standards and high home prices rocketed the subprime mortgages in 2005 and 2006 (Scott, 2009). In the same time, the US government encouraged growth of the subprime mortgage market in an attempt to increase the percentage of families owning their own homes. The Bush administration pushed Fannie Mae and Freddie Mac, a government-sponsored enterprise, to accumulate subprime mortgages (Poole, 2010). Fannie Mae and Freddie Mac main business was to expend the secondary mortgage market by securitizing prime mortgages into Mortgage-Backed Securities (MBS) allowing lenders to reinvest their assets into more lending.

Similarly, Lang & Jagtiani (2010) identified three central factors leading up to the financial crisis: the enormous price increase in the housing market, the extensive decline in mortgage underwriting standards, and the tremendous growth of the residential MBS. Lang & Jagtiani (2010) explained that the mortgage market's performance was tied very closely to continued housing price appreciation. When the housing price appreciation began to slow in 2005, the performance of mortgages started to deteriorate, and financial firms that were highly concentrated in the mortgage lending business faced severe financial trouble. "As house prices leveled off in 2006, and adjustable-rate mortgages taken out in the low interest rate environment of 2003-2004 began to adjust up, the music stopped" (Poole, 2010, p. 426).

The sharp collapse in financial markets can be dated to August 9, 2007 when the short-term credit markets froze up after French bank BNP Paribas suspended three large investment funds citing problems in the U.S. subprime mortgage (Lang & Jagtiani, 2010). What was thought to be a subprime problem quickly turned into a financial crisis that drained the credit market and jeopardized the banking system. After so many years of expansion in the U.S. housing market, it was clear that U.S. banks expanded loans to borrowers who were not likely to repay their home loans unless housing prices continued to rise. In addition, it was clear that banks did not apply proper controls to adequately evaluate the risks of their mortgage business.

In 2006, subprime mortgages represented 34 percent of all mortgages issued in the U.S. that year (Scott, 2009). In 2007, 74 percent of all mortgages were securitized and 93 percent of subprime mortgages were securitized. Moreover, about two-third of outstanding subprime mortgages had adjustable rates (ARM). When home prices began to fall and the credit markets tightened, borrowers could not refinance their ARM to reduce payments. In 2006, the rate of delinquencies on subprime mortgages rose sharply to 11 percent posing big credit risks for the banks holding the loans, for the securitization vehicles that sold the loans and for investors in such loans. In mid 2007, credit risk spread in many of the world's major financial markets when the market suddenly cut off funding to several financial entities and the major credit rating agencies announced the first wave of significant downgrades (Scott, 2009; Poole, 2010).

By mid 2008, it was clear that the crisis in the subprime market in the U.S. was having a major impact on financial institutions and banks in many countries. The first major indicator of trouble in 2008 was the failure of Countrywide Financial (Scott, 2009). In mid-March 2008, financial strains intensified as the market cut off funding to Bear Stearns. The bailout of Bear Stearns marked the end of the first phase of the financial crisis (Poole, 2010) and declared the start of the global financial crisis shifting the crisis from the housing market into the mainstream capital markets (Scott, 2009). During the second phase of the crisis, the economy was drifting downward, but not at an alarming pace (Poole, 2010) until the U.S. government had to take Freddy Mac and Fanny Mae into its conservatorship in early September when it appeared that their capital position was weaker than expected. Then, a week later, Lehman Brothers declared bankruptcy (Scott, 2009). Lehman's collapse marked the beginning of phase three of the crisis, when market strains went from serious to calamitous (Poole, 2010). Two days after Lehman's collapse, the giant global insurance company, AIG, was rescued by the U.S. government through a financial infusion of $US 85 billion (Scott, 2009). Finally, in October 2008, the Federal Reserve cut its target funds rate in two steps to 1% and further to near zero in December. By the end of 2008, credit strains were severe and economic activity declined sharply. The financial crisis spread around the world and had become an economic crisis that led the world into a deep recession (Scott, 2009). Bankruptcies in the rest of the world were not as frequent as in the United States; however, there were major failures in Europe and the rest of the world.

Given the unique universal harm caused by the crisis, one has to wonder why managers and boards of directors engaged in such risky behaviors and failed to protect themselves and their companies. Before expanding with the role of excessive risk taking in the fall out of the financial crisis, it is important to define the role of corporate governance.

Corporate governance defines the relationship between shareholders and managers. It is a response to the agency problems created by the separation of ownership and control. Today, corporate governance covers all the rules of and constraints on corporate decision-making. Wells (2010) believed that good corporate governance allows for a balance between what managers and what shareholders desire. Good corporate governance assumes that managers have the proper incentives to work on behalf of shareholders and that shareholders are properly informed about the activities of managers. Dragomir (2008) summarized the historical points of corporate governance. Dragomir claimed that Adam Smith was the first one to express the emergence of the corporation. Then the modern corporate governance theory was born with Berle and Means in 1932, followed by the birth of the agency theory with Jensen and Meckling in 1976. In 1984, Freeman discussed the stakeholders' theory. Recently, corporate governance codes were established by the European Union before they were reformed with the Sarbanes-Oxley Act in 2002. Finally, Organization for Economic Cooperation and Development published corporate governance principles that deal with the globalization of corporate governance promoting the responsibility for true and fair reporting.

With the U.S. being the world's dominant economy after World War II, successful corporations grew rapidly and the manager-oriented model of the corporation was superlative. At the beginning, the internal governance of companies was not a high priority; the focus was on building trust among corporate executives and shareholders who only cared about dividends and stock prices of the companies they owned (Howson, 2009).

In summary, the corporate governance theory has long been based on the existence of a board of directors that acts on behalf of the shareholders to supervise and direct the management of the corporation. This theory indicates that profit and return on investment to shareholders are the primary indicators of the success of a business enterprise (Aquila, 2009). Even though the main purpose of strong corporate governance is to increase shareholders' equity and achieve sustainable economic growth, I believe that good corporate governance must serve the interests of all stakeholders by assuring the implementation of adequate internal and external controls over the company's operations.

AGGRESSIVE RISK-TAKING

Scholars agreed that the bubble in the housing prices has triggered the recent financial crisis (Scott, 2009; Yeoh, 2010; Lang & Jagtiani, 2010). Many researchers argued that the most important element of the current financial crisis relates to the credit cycle and blamed the aggressive lending tactics by bankers and credit brokers for what happened (Rotheli, 2010; Pacess, 2010). As Pacces (2010) put it, "Individual mortgage deals were closed as they were pooled together with thousands of similar mortgages, securitized, and sold immediately to investors in different tranches of Mortgage Backed Securities" (p. 3). He added, "Mortgage originators did not have incentives to screen the quality of the credit being provided" because "they did not have sufficient skin in the game" (p. 4). Pacces (2010) concluded that the risk was underestimated and financial institutions were eager to fund the subprime mortgage business by purchasing Mortgage Backed Securities (MBS) that offered great earnings relative to default risk. Similarly, Grosse (2010) agreed that the financial institutions that were involved in creating and distributing MBS did not adequately value the risk of these instruments. Grosse (2010) argued that managers of these financial institutions failed to exercise oversight over their employees who created and sold improperly valued assets.

Kirkpatrick (2009) pointed to major failures of risk management systems in main financial institutions due to improper corporate governance procedures. He reported that information about exposures in a number of cases did not reach board of directors. In other cases, boards had approved risk-oversight strategies but failed to monitor their implementation. Kirkpatrick (2009) concluded that in many cases corporate governance deficiencies facilitated or did not prevent poor practices.

Of the explanations of the financial crisis of 2008, Rose (2010) considered the one that link the crisis to managerial aggressive risk-taking is the most pervasive. Risk management is an essential aspect of good corporate governance, and vice versa. It works hand in hand with corporate governance as a means of constraining agency costs and promoting efficient and prudent management.

Erkens, Hunga, & Matos (2009) investigated the role of corporate governance in the financial crisis using data from 296 of the world's largest financial firms across 30 countries. In their empirical study, they found that boards and shareholders have encouraged managers to increase shareholder returns through aggressive risk-taking. And managers have ignored systemic risk leading their companies into liquidity problems and/or bankruptcies. Along the same line, Lewis et al. (2010) accused bankers and fund managers of pocketing enormous bonuses with no thought to the long-term consequences of their actions. The gambling by these bankers and fund managers was fed by the knowledge that if disaster struck, someone else will be blamed. bankers believed that when things go bad, borrowers, investors, taxpayers, governments and other stakeholders would bear the lion's share of the losses.

Corporate governance arrangements require boards of directors to be clear about the strategy and risk appetite of their companies. These arrangements require efficient reporting systems that allow boards to monitor their companies and respond in a timely manner if needed to. Corporate governance makes risk management an oversight duty of the board. The board function is to monitor the effectiveness of the company's management practices and make changes as needed. In its 2004 *Enterprise Risk Management Integrated Framework Report*, The Committee of Sponsoring Organizations of the Treadway Commission **(**COSO) stated that:

> Enterprise Risk Management is a process, affected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives (p. 2).

The Enterprise Risk Management framework includes Risk Assessment tool that allow risk analysis before determining how risk should be managed. After assessing the risk, management should develop a set of actions to align risks with the entity's risk appetite. Finally, policies and procedures should be established and implemented to ensure that risk responses are effectively carried out.

In his review of what worked and what did not within corporate governance mechanism, Kirkpatrick (2009) drew the following conclusion:

> Some firms made strategic decisions to retain large exposures to super senior tranches of collateralized debt obligations that far exceeded the firms understanding of the risks inherent in such instruments, and failed to take appropriate steps to control or mitigate those risks. Some firms had limited understanding and control over their potential balance sheet growth and liquidity needs. They failed to price properly the risk that exposures to certain off-balance sheet vehicles might need to be funded on the balance sheet precisely when it became difficult or expensive to raise such funds externally (p. 8).

Given the unique harm caused by the recent financial crisis, one has to wonder why managers in financial institutions engaged in such risky behaviors and why they failed to protect themselves and their companies. In order to explain why aggressive risk taking was so popular, a aggressive risk-taking triangle is proposed (refer to Figure 1):

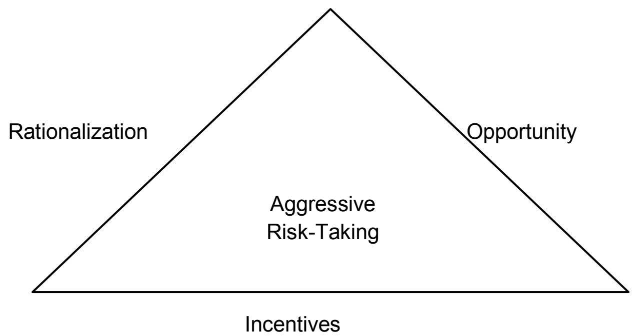
<u>Incentives</u>

Excessive risk taking was encouraged by incentive systems that rewarded high levels of risk taking. Incentive structures have an important impact on corporate strategy and success. The *Remuneration Impact Assessment* published by the European Commission on 2009 stated that badly designed remuneration policy in the financial services industry contributed to short-termism and excessive risk-taking without adequate regard to long-term global performance. The assessment addressed the problem of the mismatch between pay and performance. Executive remuneration normally consists of fixed salary and other incentives. These incentives can affect long-term performance and sustainability of the companies.

In studying the causes of its $18.7 billion loss in subprime mortgages for the year of 2007, the investment bank, UBS, revealed that it faced fundamental failures in incentives (Sahlman, 2009). UBS discovered that its employees had strong incentives to engage in high-yielding MBS. The fee structure at the bank provided special incentives to buy riskier securities. For example, traders received a fee 3 to 4 times as high when they bought risky Collateralized Debt Obligations (CDOs) than when they bought safer ones.

Moreover, UBS gave lots of current cash compensation to individuals engaged in transactions that exposed the company to big risks. UBS awarded bonuses based on gross revenue without consideration of sustainability of those revenues. Finally, UBS charged a very low cost of capital that clearly was not based on the riskiness of the assets being purchased.

Figure 1: Aggressive Risk-Taking Triangle



This triangle explains why managers in the financial institutions engaged in risky businesses jeopardizing their careers and leading their firms to credit crisis and even bankruptcies. The triangle identifies three elements (sides) that led to excessive risk-taking by managers: Incentives – rationalization – opportunity.

It was obvious that remuneration and incentive systems have played a key role in developing the financial crisis. Kirkpatrick (2009) noted that CEO remuneration has not closely followed company performance. The problem was that bankers had the upper hand in setting the structure and the levels of their compensations. Bankers, rewarded through performance contingent bonuses and stock options plans, have an incentive to generate short-term profits regardless of the long-term outcomes.

In addition, researchers have drawn attention also to remuneration problems at the sales and trading function level. Heller (2008) argued that the system of bonuses in investment banking provides incentives for substantial risk taking and do not allow flexibility for banks to reduce costs when they have to. The size of bonuses is unlimited at the upper end while it is limited to zero at the lower end. Losses are borne entirely by the bank and the shareholders and not by the managers.

The Private Sector Report issued by Institute of International Finance in 2008, identified compensation as a serious issue:

> There is strong support for the view that the incentive compensation model should be closely related by deferrals or other means to shareholders' interests and long-term firm-wide profitability. Focus on the longer term implies that compensation programs ought as a general matter to take better into account cost of capital and not just revenues. Consideration should be given to ways through which the financial targets against which compensation is assessed can be measured on a risk-adjusted basis (p. 12).

Broadly speaking, the above-mentioned issues provided strong incentives for managers to engage in risky behavior and insufficient incentives for them to protect their companies. Compensation and other incentives were not well designed to achieve an appropriate balance between risk appetite and risk controls and between short term and longer-term performance.

Rationalization

In explaining the extreme lending policies adopted by banks before the crisis, Rotheli (2010) claimed that the length of the boom period allowed younger and inexperienced managers to be in positions responsible for lending decisions. According to Rotheli, these young managers have not experienced a major economic slowdown during their career and eventually they tend to underestimate risks. During a boom, each bank faces the challenge of strategically positioning itself in the market. Managers had to follow expansionary lending policy to avoid being marginalized by bolder competitors. Therefore, the struggle for survival rationalized the trend towards riskier lending. In order to gain market share, bankers had to offer a compelling product to customers. In the mortgage business, this meant low lending standards and low introductory rates.

> In a hotly competitive business, the marginal price is often set by the lowest common denominator – the firm with the lowest quality, lowest integrity and most aggressive people; the weakest control systems; and, the most aggressive accounting systems. That is exactly what happened in the mortgage industry from 2001 to 2006, as well as in a wide range of other areas like high yield lending (Sahlman, 2009, p. 9).

Another reason that pushed managers to take more risk was that shareholders in financial firms are interested in the current profits, with little regard for the long-term health of the firm itself, and no identifiable interest whatsoever in the entire financial system. Accordingly, the same corporate governance mechanism that holds managers responsible to their shareholders incentivized managers to make risky and irresponsible decisions. Managers who did not follow the crowd stayed behind and might have lost their jobs. Therefore, traditional corporate governance principles rewarded managers for irresponsible risk-taking, higher short-term profitability, and a dynamic stock price, while punishing managers who implemented wisely safe structures designed to ensure long-term profitability and overall market stability.

One example is the French giant bank, BNP Paribas. Before the crisis, BNP Paribas implemented highly conservative risk capital and liquidity requirements. Because of its policy, the bank lagged behind its European competitors such as Deutsche Bank and Société Generale that were making unprecedented profits. With the onset of the global financial crisis, both Deutsche Bank and SocGen were laid low along with the global financial sector, while BNP Paribas survived in far better shape. However, BNP Paribas was criticized in the financial press, had a static stock price, and underwent disruptive shareholder efforts to change senior management (Howson, 2009). The real difficulty was that directors and managers were not well situated to think systemically or act in the long-term public interest. Along the same line, Howson (2009) questioned if AIG's managers, for example, should have turned away assured profits for the company's shareholders arising from Credit Default Swaps written virtually non-stop on AAA-rated CDOs because of some tentative fear that the ongoing boom was too good to be true.

One excuse for increasingly investing in securitizations was that banks had to make use of as much funding liquidity as they had access to. Managers wanted to realize short-term profits, which could be shown to shareholders who only care about current results. Managers, accountable to shareholders, cannot convince their shareholders of accepting less profit in the short run with a promise of maximizing long-term values. Even when managers had less optimistic expectations on the future price of Asset-Based Securities, they could not get shareholders to endorse shrinking of the securitization business and commit to the long run results. Rather, shareholders would force a temporarily underperforming management to resign (Pacces, 2010).

To sum up, managers did not have a choice. If they refused to be involved in the innovative business that was booming before 2006 and the easy money it generated, they would be replaced by others willing to do so. To those mangers, being fired for bankruptcy or underperformance was the same.

Opportunity

The third element in the Aggressive Risk-taking Triangle is the availability of opportunities for managers to exercise their risk-taking strategies that led to the financial crisis. Mainly, ineffective board oversight, improper disclosure and accounting standards and the credit rating process paved the road to executives to do what they have done.

Deficiencies in risk management and incentive systems point to deficient board oversight. Organization for Economic Cooperation and Development (OECD) identifies the key functions of the board to include aligning key executive and board remuneration with the longer-term interests of the company and its shareholders. The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization. Internal controls should be set in place to recognize and assess the material risks that could adversely affect the achievement of the company's objectives (Kirkpatrick, 2009).

In a survey based on interviews with European banks, all interviewed banks admitted that risk governance is a key responsibility of bank boards. The banks confirmed that defining the company's risk appetite and indentifying emerging areas of risk are boards' responsibilities. They further indicated that boards must ensure that risk appetite is a coherent reflection of the company's strategic targets. The interesting point was that most of the interviewed banks indicated that their boards were broadly knowledgeable rather than extremely knowledgeable of their company's risk measurement methodology. More importantly, only one third of the banks were confident that their strategy and planning functions had a detailed understanding of their companies' risk measurement methodology. The results of this survey indicated that risk management is not deeply rooted in the organizations. Accordingly, this was a clear corporate governance weakness (Kirkpatrick, 2009). In addition, reports have documented that risk management information was not always available to the board or in a form corresponding to their monitoring of risk. OECD Principles states that: "in order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information" (Kirkpatrick, 2009, p. 20).

Monetary policies formed another opportunity for executives. Lewis et al. (2010) explained that during the current financial crisis, central banks increased liquidity in order to enhance fees, which led to the ill-fated boom in American sub-prime mortgages. This tendency of bankers and financial managers to accept unnecessary risk is stressed by the fact that financial assets grow during booms. By hedging these extra assets as collateral, bankers were able to borrow even more. If financial groups use the borrowed money to buy more of the sorts of securities they lodged as collateral, then the prices of those securities will go up. That, in turn, enables them to accrue even more debt to buy more securities.

Credit Rating Agencies (CRAs) gave another opportunity to financial mangers to continue their risky business. Rom (2009) explained that CRAs deeply misread the risks of the subprime mortgage market due to the CRAs' economic incentives, their ignorance, and that they became overwhelmed. These factors led CRAs to overrate billions in dollars in MBS. Managers depended on the rating of these agencies to buy and hold the securities.

Finally, U.S. Regulators such as the Federal Reserve, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Controller of the Currency did not identify the risks that were looming with the investment banks' and other intermediaries' activity in securitizing and distributing the debt obligations.

RECOMMENDATIONS

Based on the interpretations of literatures, the following insights are recommended to enhance organizations' risk management:

Existing corporate governance requirements that deal with boards' risk-oversight responsibilities need new interpretations to ensure boards have more engagement in discussing risk-management policies. In addition, current corporate governance frameworks should be implemented.

COSO's *Enterprise Risk Management – Integrated Framework* report highlights four areas of risk-oversight management. According to COSO's framework, boards must understand the entity's risk philosophy, know the extent to which management has established effective enterprise risk management of the organization, review the entity's portfolio of risk in consideration with the entity's risk appetite and determine whether management is responding appropriately to any identified problem.

Moreover, the Institute of International Finance (IIF) noted the need to reemphasize the respective roles of the board in the risk management process in many firms. In its 2008 *Final Report on Market Best Practices,* the IIF made suggestions for strengthening board oversight of risk issues. The report stated that the boards need to be educated on risk issues and to be given the means to understand risk appetite and the firm's performance against it. In addition, the report suggested having individuals with technical financial sophistication in risk disciplines as members of the risk committee.

Finally, while management develops appropriate procedures to identify, manage and mitigate risks, board of directors should satisfy themselves that the risk management processes designed and implemented by management are adapted to and integrated with the board's corporate strategy and are functioning as directed, and that necessary steps are taken to foster a culture of risk adjusted decision-making throughout the organization.

The financial crisis proved that remuneration systems were not well designed to achieve an appropriate balance between risk appetite and risk controls and between short term and longer-term performance. These systems should be adjusted to ensure that managers would not earn more merely by taking on a greater risk. I suggest retaining a part of executives' compensations and paying it out only after several years to ensure that executives emphasize the long-term profitability of their companies.

Suggestions for addressing the remuneration issues are already emerging. The U.S. Treasury Department is considering regulatory reforms that would require compensation committees of public financial institutions to review and disclose strategies for aligning compensation with sound risk-management. In addition, in its *Remuneration Impact Assessment,* the European Commission recommends improving shareholders' oversight of remuneration policies, strengthening the role and accountability of remuneration committees and ensuring independence for remuneration consultants. More importantly, the Commission recommends these measures not only for company directors, but also for staff whose professional activities have a material impact on the risk profile of the companies (Moslein, 2009).

Finally, *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations*, issued by Institute of International Finance in 2008, proposed seven principles of conduct for compensation policies which could act as a solution for the remuneration problem (Table -1).

Table 1: Proposed Principles of Conduct for Compensation Policies

I.	Compensation incentives should be based on performance and should be aligned with shareholder interests and long term, firm-wide profitability, taking into accounts overall risk and the cost of capital.
II.	Compensation incentives should not induce risk-taking in excess of the firms risk appetite.
III.	Payout of compensation incentives should be based on risk-adjusted and cost of capital adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit.
IV.	Incentive compensation should have a component reflecting the impact of business unit's returns on the overall value of related business groups and the organization as a whole.
V.	Incentive compensation should have a component reflecting the firm's overall results and achievement of risk management and other goals.
VI.	Severance pay should take into account, realized performance for shareholders over time.
VII.	The approach, principles and objectives of compensation incentives should be transparent to stakeholders.

Source: Institute of International Finance (2008b), Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, Washington, D.C. Table 1 includes seven principles of conduct for compensation policies that could act as a solution for the remuneration problem.

Direct and timely communications among board members, board committees, and management is one of the most important elements in effective risk-oversight management. Management must communicate to the boards sufficient information to enable them to understand the company's risk profile, the specific material risk exposures affecting the company's current and future operations, how risks are assessed and prioritized by the management team, risk response strategies, implementation of risk management procedures and infrastructure, and the strength and weaknesses of the overall system.

While shareholders cannot run their companies because they might lack adequate understanding of business opportunities and the related risks, they should be more involved in corporate decisions. I believe it is important to ensure that the shareholders become aware of the risks assumed by management. This could be done through making more and better information available to the shareholders.

Many boards of directors delegate risk-oversight responsibilities to the audit committee. To enhance risk monitoring, Sahlman (2009) promoted the idea of creating a new kind of external monitor that could provide helpful insight and advice to managers and regulators. This new external monitor could be achieved by creating risk committee. The risk committee will be responsible of identifying key risk areas and will report to the board of directors and to management as well.

It is worth mentioning that legislation has been introduced in Congress that would mandate the creation of board risk committees. The board committee should meet directly with the executives primarily responsible for risk management. In addition, the committee should create an environment in which managers and executives could notify the committee of extraordinary risk issues and developments that need immediate attention.

Corporate governance agency theory should be modified to make managers accountable to all stakeholders and not only to the company's shareholders. De Graaf & Williams (2009) addressed the effect of such modification on the agency theory and suggested that the stakeholder perspective of a company supplements the agency theory, since no one disagrees that shareholders are a stakeholder of the firm. Along the same line of De Graaf & Williams, Afrasine (2009) called for greater involvement of civil society as solutions for a better approach regarding risk management at international levels.

CONCLUSION

Aggressive risk taking was an important contributor to the recent financial crisis. Inadequate risk management by executives and boards of directors is to be blamed for the credit market collapse and resulting financial crisis. Companies' boards of directors were expected to take a leading role in overseeing risk management structures and policies and to implement current corporate governance procedures and guidelines. It is understood that there is no way to eliminate risk and, consequently, boards of directors are not required to attempt to do so. However, it is important for directors to take steps to be well informed of their companies' risk profile, to discuss and evaluate risk scenarios and to satisfy themselves on an ongoing basis as to the adequacy of management's efforts to address material risks.

Corporate governance arrangements require boards to clearly understand the strategy and risk appetite of the company and to establish efficient reporting systems that allow them to respond in a timely manner. Risk management is an obvious oversight duty of the board that would be fulfilled by monitoring the effectiveness of the company's risk strategies and making changes as needed. In addition, boards need to develop and disclose a remuneration policy statement covering board members, key executives and managers. Such policy statements must specify the relationship between remuneration and performance and include measurable standards that emphasize the long-run interests of the company over short-term considerations. Guided by the agency theory, corporate governance mechanisms have been designed to increase shareholders' profits. The recent global financial crisis proved deficiency of these mechanisms. It is not acceptable anymore that corporate governance serves the shareholders' interest only, effective corporate governance must serve the interests of all stakeholders.

The same corporate governance mechanism that holds managers responsible to their shareholders incentivized managers to make risky and irresponsible decisions. Managers who did not follow the crowd stayed behind and might have lost their jobs. Traditional corporate governance principles rewarded managers for irresponsible risk-taking, higher short-term profitability, and a dynamic stock price, while punishing managers who implemented wisely crafted prudential structures designed to ensure long-term firm and overall market stability and health. In this paper, I identified three elements that fueled aggressive risk taking. First, remuneration system among other factors provided strong incentives for managers to engage in risky behavior and insufficient incentives for them to protect their companies. Second, the struggle for survival rationalized the trend towards riskier lending. Managers had to adopt risky trends to show profit to their shareholders who are interested in the current profits, with little regard for the long-term health of the firm itself, and no identifiable interest whatsoever in the entire financial system. Third, ineffective board oversight, improper disclosure and accounting standards and the credit rating process paved the road to executives to do what they have done.

Finally, the credit crisis has focused a great deal of scrutiny on failures in corporate governance, in particular lax board oversight of risk management and executive compensation practices that encouraged excessive risk-taking. Lots of research has discussed risk management or corporate governance independently. However, empirical studies that discuss the relationships between corporate governance and risk control are limited. In addition, further research providing empirical evidence of best practice in corporate governance and risk management is needed.

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