Chapter 6
The Corporate Declaration Versus Corporate Practice: The Financial Crisis Perspective

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Abstract The commencement of the global financial crisis started with the credit crunch on the American sub-prime mortgage market and was followed by the sovereign debt of majority of developed economies which raised a number of questions on its reasons and causes. The scope of the systemic problems as well as the depth of the economic slowdown did post crucial doubts on the regulatory and governance standards on financial markets. This paper proposes an analysis of structural and governance failures which led to the outbreak and development of the credit crunch related to unethical and irresponsible behavior on the part of executives as well as poor corporate governance in listed companies and financial institutions. Pointing at the ethical crisis, it confronts the corporate declaration outlined in the code of conduct/ethics and corporate governance guidelines against the corporate practice. Using the example of investment banks such as Bear Stearns, Lehman Brothers and Goldman Sachs as well as listed companies as AIG and General Motors, the paper traces the most problematic areas of ethics and corporate governance in modern organizations.

6.1 Introduction

The outbreak of the financial crisis which started with the credit crunch on the American sub-prime mortgage market and followed by the sovereign debt of majority of developed economies have exerted significant impact on the economic performance of both countries as well as companies worldwide. The outbreak and

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the course of the crisis raise questions on its reasons and causes. The scope of the systemic problems as well as the depth of the economic slowdown post crucial doubts on the regulatory and governance standards on financial markets. The prime causes of the crisis may seem odd as the review of corporate governance and public policy literature provides wide range of studies and lists the fundamental recommendations for sound operation and good performance of both companies and countries. These recommendations refer to the corporate bylaws and regulations, board structure, its composition and work, the role of independent directors, the efficient structuring of incentive executive compensation/remuneration in order to motivate top managers to increase the shareholder value, the information policy and investor relations, the corporate relations with the media, stakeholders and other market participants. However, the widely recognized and well researched governance best practice, the emphasis put on the role of efficient monitoring and control over stock market and listed companies as well as the corporate governance ranking tracing positive examples and corporate role models did not prevent major control collapses and failures.

This paper proposes an analysis of structural and governance failures which led to the outbreak and development of the credit crunch related to unethical and irresponsible behavior of executives as well as poor corporate governance in public listed companies and financial institutions. Pointing at the ethical crisis, it confronts the corporate declaration outlined in the code of conduct/ethics and corporate governance guidelines against the corporate practice. Using the example of investment banks such as Bear Stearns, Lehman Brothers and Goldman Sachs as well as listed companies as AIG and General Motors, the paper traces the most problematic areas of ethics and corporate governance in modern organizations. The lack of integrity and strong values, the dominant public respect based on the level of consumption and wealth as well as the prime priority for generating short term profits proved to be the key drivers for inefficiencies in corporate governance. The phantom declaration of ethical standpoint and the lack of real compliance with codes of best practice led to trust crisis on the market and resulted in deterioration of economic performance.

The paper is organized as follows. The first section outlines the outbreak, the course it took and the main results of the financial crisis related to credit crunch on the American sub-prime mortgage market and followed by the sovereign debt of majority of developed economies. The second section using the examples of selected companies and investment banks provides the analysis of the corporate declaration versus corporate practice based on the codes of conduct or code of ethics, respectively and corporate governance best practice, where applicable. The discussion of the corporate declaration versus corporate practice with the reference selected corporate governance criteria is presented in section three which identifies the most significant sources of control inefficiencies and ethical failures of analyzed companies. The final remarks and summary of conducted analysis are delivered in the section on conclusion.

6.2 The Crisis

The long term policy of low interest rates, the easy access to cheap credits, the belief in constant increase of the real estate value and the numerous subprime mortgages sold on the American market faced surge in foreclosures and resulted in severe financial problems and dramatic downturn on the stock market (Posner 2010). The liquidity constrains and the evaporating trust amongst listed companies and financial institutions indicated significant systemic problems and led to credit crunch affecting the global market and resulting in economic recession. The financial crisis officially started with the collapse of Lehman Brothers in September 2008 proved to be of global impact due to the internationalization and integration of financial system (Posner 2010, 40–79). More precisely, the engagement in sophisticated financial instruments of many institutions operating worldwide threatened the stability of global financial system as instruments of different levels of financial risks were grouped into one package and overrated by rating agencies to boost sales (Kansas 2009; Clarke and Chanlat 2009; Posner 2010). The implementation of advanced and complicated financial instruments known as collaterized debt obligations, credit default swaps or mortgage backed securities was driven by the shareholder pressure upon investment banks to quest for higher profitability and better financial indicators (McGee 2010). The outbreak and the course of the financial crisis is attributed to the investment banks' and hedge funds' aggressive high leverage strategy which adopted 30 to 1 investment rate (i.e. borrowing $30 for every $1 invested). Although such policy proves to be efficient for profit maximization in the times of prosperity, it causes severe collapse under the condition of economic problems affecting majority of market participants (Kansas 2009; Clarke and Chanlat 2009). Many of these institutions worldwide were widely exposed to toxic subprime mortgages what caused a chain reaction of banks failures and companies collapses. Such a significant impact of the credit crunch is heavily rooted in the increasing phenomenon called as financialization of the global economy, in which financial sector and financial services constitute large proportion of the gross domestic product (Posner 2010).

The causes of the financial sector inefficiencies revealed to be of dramatic power both for companies and financial institutions as well as countries. In sum, the outbreak and the course of the crisis led to:

- The downturn on the stock market—over the peak crisis period of 2008 and 2009 Dow Jones Industrial Average (DJIA) dropped from its record high of 14,164.53 on October 9, 2007 to 7,278.38 on March 20, 2009 (DJIA history). The S&P 500 index lost ca. 45 % over the same period. The DJIA lost 4.4 % (over 500 points) on September 15, 2008 only, when Lehman Brothers admitted it lost liquidity and announced filling for bankruptcy. It was followed by the consequent DJIA drop by 7 % (777.7 points), S&P500 and NASDAQ plummet

by ca. 9 % over September 2008 as a result of Representative Council rejecting TARP and it constituted the largest indexes decrease within the last 21 years. The downward trend in 2008 was also visible on other stock markets and accounted from 33 % drop for FTSE, 45 % for DAX and CAC to 62 % for Shanghai (Clarke and Chanlat 2009),

- Severe losses of international banks ranging from over $66 billion for Citigroup, over $44 billion for USB, over $16 billion for RBS, over $1 billion for Commerzbank (banks selected randomly from table 1 in Clarke and Chanlat 2009),
- The value loss of assets managed by pension funds estimated at about $2.3 billion,
- The surge of LIBOR interest rate to 10 base points in August 2007 (Taylor 2009),
- The drop of confidence on the financial market amongst financial institutions and other market participants what affected the credit policy and led to the credit crunch indicated by the plummet in credit activity,
- The economic slowdown or economic recession—the fall of US GDP was estimated at 4 % in 2008–2009, the pace not seen since the 1950s. As noted by Pitman and Ivry (2009) US domestic demand remaining "in decline for five straight quarters, [was] still three months shy of the 1974–75 record, but the pace—down 2.6 % per quarter vs. 1.9 % in the earlier period—is a record-breaker already". Bloomberg report of 2009 stated that $14.5 trillion of value of global companies has been erased since the crisis began (Pitman and Ivry 2009),
- The loss of jobs—estimated at 1.53 million in the US alone (Kansas 2009; Isidore 2008),
- The increase of sovereign expenditures for bailout programs—estimated at over $9 trillion in the case of American economy (Kansas 2009; Pitman and Ivry 2009),
- Global consequences of economic recession indicated by the drop of GDP for developed economies by 2.2 % in 2009 and total collapse of banking system in Iceland.

The national policies targeted at bailouts programs using taxpayers money attempted to rescue financial institutions and listed companies known as too big to fail in order to prevent the whole system from collapse (Sorkin 2010). The national policies delivered quick relief and the short term solution to economic problems. The scale and scope of bailout programs estimated worldwide at nearly $11 trillion in 2008 alone (Clarke and Chanlat 2009) translated themselves into sovereign debt crisis characterized by the increase of bond yields, surge in the fiscal deficits and the public debt. The current sovereign debt crisis demands the necessity for significant austerity programs (cut in public spending and tax increases) to assure for balancing of fiscal budgets and providing countries with liquidity.

6.3 The Corporate Declaration Versus Corporate Practice

6.3.1 Methodology

The paper is based on the analysis of case studies referring to the main corporate documents which provide framework for the ethical dimension of their behavior and corporate governance practice. More precisely, for the purpose of the paper the following documents were analyzed:

- The code of ethics or the codes of conduct,
- Corporate governance best practice documents.

The documents were analyzed in the case of companies which revealed severe ethical and governance failures during the crisis such as Lehman Brothers, Bear Stearns, Goldman Sachs, AIG and General Motors. The main goal of this study is to confront the corporate declaration versus corporate practice with the reference to the fundamental guidelines provided by corporate governance best practice. The widely recognized guidelines include high ethical and moral standards, the responsibility for corporate operation in order to assure for long term sustainable value, the accountability to shareholders and stakeholders. More precisely, corporate governance guidelines cover the following aspects (Monks and Minow 2004):

- Efficient board work adopting separation of CEO and Chairman, providing sufficient number of independent directors and specialized board committees (audit, remuneration, nomination etc.),
- Incentive executive compensation,
- Sound information policy, corporate disclosure and investor relations,
- Active participation of shareholders during shareholder meeting (voice execution).

6.3.2 Findings

6.3.2.1 The Corporate Declaration

The code of ethics/code of conduct which are formulated in majority of large companies prove to be of fundamental importance for corporate operations. Code of ethics referred also to code of conduct or code of business conduct and ethics declare the major philosophical principles and values in organization and function as policy documents defining responsibilities of organizations to their stakeholders (Stevens 2009). The code may play an essential role for company management in strategy formulations, motivation and communication systems and corporate culture. More importantly, the strong ethical values which provide for integrity and

accountability are the integral components of sound corporate governance and effective leadership. Thus, the code of ethics while implemented and communicated effectively may contribute to company's strengths and its competitive advantages. The review of code of ethics/conduct documents of analyzed companies indicates that these documents emphasize the importance of values such as trust, responsibility and integrity and praise the fundamental roles of strong customer relations and accountability to shareholders and stakeholders. Lehman Brothers in its five page 2004 code of ethics stated that "(..), integrity and ethical behavior are all the more important because of the trust our clients must place in us". The code addressed the basic topics found in most corporate codes such as conflict of interest, retaliation, stealing, use of proprietary information, non-retaliation, and compliance with laws and fairness and emphasized the importance of trust and strong client relations built over the years (Stevens 2009). More importantly, the high ethical standards were required from all employees of the bank as the code was saying that "ethical business practices entail a clear understanding of right and wrong, and a motivation on the part of our directors and employees to act at all times in a manner of which they can be proud". The 2003 code of business conduct and ethics of Bear Stearns was intended to establish standards that the bank deemed necessary to deter wrongdoing and to promote compliance with governmental laws, rules and regulations and honest and ethical conduct divided into eight sections: accountability for adherence to the code, compliance with applicable laws, rules and regulations, conflicts of interest, corporate opportunities, fair dealing, financial reporting and disclosure, protection and proper use of company assets and confidentiality. The code emphasized the personal accountability of employees and senior executives "for ensuring that their conduct adheres to the letter and the spirit of this Code". Additionally, employees and senior executives were expected to promote ethical conduct and compliance with the laws, rules and regulations that govern the activities of the firm having the affirmative obligation to report any known or suspected violation of the code values. The Goldman Sachs 2005 code of business conduct covered similar aspects addressing the importance of the compliance and reporting, personal conflict of interest, public disclosure, compliance with laws, rules and regulations, corporate opportunities and confidentiality saying that "integrity and honesty are at the heart of our business. We expect our people to maintain high ethical standards in everything they do, both in their work of the firm and in their personal lives". The code of General Motors known as Winning with Integrity (only 2011 version is available) offers according to the introductory sentence the values and guidelines of employee conduct and in five sections covered personal integrity, integrity in the workplace, integrity in the marketplace, integrity in society and communities as well as integrity toward the environment. The code addresses global scope of GM operations, emphasized the deep commitment and outlines policies and obligations that guide the business conduct. Complying with the legal obligations and policies described in the GM guidelines is seen as the imperative of company's operations. According to the code General Motors is "committed to maintaining a culture that promotes the prevention, detection and resolution of misconduct. Each

employee has an obligation to report potential misconduct. Examples of misconduct may include fraud, theft, workplace violence, discrimination, harassment, misuse of company resources, conflicts of interest, information breaches, improper accounting controls or purchasing arrangements, and other unethical behaviors". The AIG code of conduct (only the 2010 version is available) presents the core values and principles which reflect on the talents and expertise in order to distinguish AIG on the market. The code is perceived as an integral component of the value proposition brought to customers, employees and all of company's communities. According to the code "AIG expects every employee to collaborate with colleagues throughout the organization, manage risks, comply with all applicable regulations and optimize operational efficiencies". The AIG code consists of six principles covering people (Develop diverse talent. Reward excellence), customer focus (Anticipate their priorities. Exceed their expectations), performance (Be accountable. Manage risks. Deliver AIG's strength), integrity (Work honestly. Enhance AIG's reputation), respect (Value all colleagues. Collaborate with one another) and entrepreneurship (Seize opportunities. Innovate for and with customers).

In sum, the analysis of the key elements of codes of ethics/business conduct (as applicable) in the analyzed companies indicates that the most crucial aspects for corporate operation referring to ethics, responsibility and accountability are covered. It is however important to mention that different studies revealed several systemic or operational shortcomings related to language adopted or communication strategy in place.[1]

Review of the corporate governance guidelines of the analyzed companies reveals declared formal compliance with majority of best practice recommendations addressing the elements crucial from the perspective of efficient monitoring and control. The corporate governance guidelines refer to the board composition and functioning, board director selection, nomination and succession planning, board committee charters, CEO evaluation and board self report, chairman and CEO leadership, executive compensation. The precise breakdown of the corporate governance guidelines of analyzed companies is presented in Table 6.1.

As shown in Table 6.1 corporate governance guidelines covered most important elements addressing key challenges of board work, executive compensation and its contacts with management. Although the documents differed in length and outline (from basic list of key elements for AIG to fancy presentation for Goldman Sachs) they stressed the needs for accountability, commitment and involvement of directors, board evaluation performance and attempt to tie corporate governance guidelines to code of ethics and business conduct.

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[1] A paragraph on p. 5 about full and fair disclosure is comprised of only three sentences, but the first uses 32 words, the second, 69 words and the third, 56 words (Stevens 2009).

Table 6.1 Areas covered in corporate governance guidelines of analyzed companies

Company	Areas covered in corporate governance guidelines
Lehman Brothers (Based on annual report 2007)	Documents on the website (corporate governance guidelines, code of ethics, charters of audit committee, compensation and benefits committee, nominating and corporate governance committee)
	Board of directors (composition, committees, meetings/sessions, proportion of independent directors, evaluation and report, continuous education, materials from senior management)
	Communicating with the board of directors (information on how to contact the non-management directors, and how to contact the audit committee regarding complaints about accounting, internal accounting controls or auditing matters)
	Certificate of incorporation and by-laws
	Board of directors and committees (composition, voting regulations, directors removal, vacancies in the board, the size of the board)
	CEO and CFO certifications
Bear Stearns	No document available since the company was taken over by JP Morgan. The Annual Report 2006 delivers information on business operation in different market segments and board composition. No data on corporate governance principles is provided
	JP Morgan documents cover widely recognized set corporate governance guidelines.
Goldman Sachs (as of 2011)	Board of directors (independence and oversight, experience & qualifications, engagement and depth of access)
	Director selection and committee structure (accountability, board committees)
	Board oversight (role of the presiding director)
	CEO evaluation
	Succession planning
	Compensation
	Risk management

(continued)

Table 6.1 (continued)

Company	Areas covered in corporate governance guidelines
General motors (as of 2011)	Board mission and responsibilities
	Selection and composition of the board (designation, membership and selection criteria, majority voting in election, director orientation and continuing education)
	Board functioning (selection of the chairman, role of lead director, size, mix of management and independent directors, definition of independence, former CEO board membership, limits on outside board memberships, meeting attendance, retirement age and term limits, board compensation, loans to directors and executives, stock ownership by non-employee directors, assessing board performance, ethics and conflicts of interest, confidentiality)
	Board relationship to senior management (regular attendance of non-directors at board meetings, board access to senior management)
	Meeting procedures (selection of agenda, materials distributed in advance, board presentations)
	Committee matters (committees and their performance evaluation, assignment and rotation of committee members, frequency and length of meetings, agenda)
	Leadership development (formal evaluation of the CEO, succession planning, management development)
AIG (as of 2011)	Roles of board and management
	Board composition (size, skills required, proportion of independent directors)
	The chairman of the board (selection and duties of the chairman)
	Selection of directors (nomination and orientation and continuing education)
	Election, term and retirement of the directors (election and term, voting for directors, director retirement, former CEOs, change in status, board vacancies)
	Board meetings
	The committees of the board (number and types, composition)
	Board responsibilities (business strategy, management succession, evaluating and approving compensation for executives, reviewing and approving significant transactions)
	Expectations of directors (commitment and attendance, participation in meetings, loyalty and ethics, other directorships, contact with management, board interaction with institutional investors and the press, confidentiality)
	Communications with the board of directors
	Evaluating board and committee performance
	Charitable giving
	Political contributions

Source Own compilation based on the materials of analyzed companies

6.4 The Corporate Practice

As presented above all of the analyzed companies formulated code of ethics/ business conducts as well as well corporate governance guidelines. Majority studies on the reasons of the financial crisis indicate the essential role of aggressive market policy and shareholder expectations of quarterly results as well as the pressure for short term profits. However, researchers and practitioners point also at corporate governance inefficiencies and moral failures as issues contributing to the financial crisis. The two of the studied companies – Lehman Brothers and Bear Stearns lost their liquidity due to the extensive involvement in subprime mortgages financial instruments (Posner 2010, 61–69). Bear Stearns was rescued in a take-over transaction by JP Morgan for \$50 billion. Lehman Brothers collapsed after 158 years of history as result of the drop of its share price to less than \$2 after announcing a \$2.8 billion loss in the third quarter of 2008 and declared bankruptcy on September 15, 2008 what is perceived as the date of the outbreak of credit crunch (McDonald 2009). The three remaining companies—Goldman Sachs, AIG and GM—found themselves in severe liquidity problems and were covered by the government (taxpayers) sponsored Trouble Assets Relief Program (TARP) (Kelly 2009). Table 6.2 presents major corporate governance inefficiencies and ethical failures of analyzed companies.

Table 6.2 Corporate governance inefficiencies and ethical failures of analyzed companies

Company	Key problems referring to ethics and corporate governance
Lehman Brothers	Poor risk management, extensive involvement in credit derivates based on subprime mortgages
	Insufficient board work, lack of derivatives experts on board
	Excessive executive compensation not tied to corporate performance
	Executives lacking responsibility for the company and its shareholders, self over confidence
	Fraud and misrepresentation
Bear Stearns	Poor risk management, extensive involvement in credit derivates based on subprime mortgages
	Insufficient board work, lack of derivatives experts on board
	Executives lacking responsibility for the company and its shareholders, self over confidence
Goldman Sachs	Excessive executive compensation not tied to corporate performance
	Limited discosure
	Controversies on the board composition
	Unethical practices of consulting services for Greek government as well as ABACUS fund
General Motors	Poor risk management
	Ineffective and irresponsible board
AIG	Poor risk management, extensive involvement in subprime mortgages insurance
	Ineffective and irresponsible board

Source Own compilation based on the materials of analyzed companies

As studies attribute the outbreak of the financial crisis to the corporate governance inefficiencies, the major criticism of control practice in Bear Stearns refers mostly to the poor risk management and the insider dominated board. The poor risk management refers to the excessive involvement in credit derivatives based on subprime mortgage (White Paper 2008). The analysis of the Bear Stearns board reveals that four of the 13 directors were insiders and performed this function for over two decades—James Cayne and Alan Greenberg (both since 1985), Alan Schwartz and Warren Spector (both since 1987). As study shows most of the nine outside directors have been on the board for more than a decade including: Glickman (1985), Harrington and Nickell (both since 1993), Tese (1994), Novelly and Salerno (both since 2002). Only three directors—Williams and Bienen (since 2004) and Goldstein (since 2007) have been on the board for less than five years (Brown 2008). Thus, most of the directors have been together for more than a decade which affected their independence and objectivity as "friendships that arise out of board longevity" led to severe 'structural bias' (Brown 2008; Kelly 2009). Other corporate governance problem referred to the director removal procedure—as put on the corporate website "non management directors are required to submit a letter of resignation to the nominating committee in the event of any significant change in their primary job responsibilities. The nominating committee shall review the director's continuation on the board in light of all circumstances and recommend to the board whether the board should accept such proposed resignation or request that the director continue to serve on the board". Such regulation was interpreted as the possibility of the board to "change a director's duties, force a resignation, and effectively remove them immediately" (Brown 2008). Additional corporate governance shortcoming was rooted in the executive compensation, both excessive in size and inefficient in structure. In 2006 only James Cayne, the CEO and Chairman, received compensation of $33 million, of which $17 million was a cash bonus and a year later he was awarded $38 million while the bank went almost bankrupt and was taken over by JP Morgan. Alan Schwartz, who was then the president, received around $35 million, of which $16 million was a cash bonus. Moreover, executives took home additional pays generated from investment opportunities and limited partnership around the bank (e.g. A. Schwartz earned almost $3 million) (Brown 2008).

The main corporate governance inefficiencies indicated in the case of Lehman Brothers refer to the poor board work heavily rooted in its inadequate composition. As noted by Larcker and Tayan (2010) Lehman Brothers board of directors revealed good practice from a structural standpoint as it had 10 directors, of average age of 68 years old (versus 61 years at the average large corporations). The board complied with the independence requirements (8 directors met the independence standards of the New York Stock Exchange) and revealed sufficient diversity of professional background, including a mix of current and former executives and decent outside board affiliations. The director compensation was based on a mix of pay including a portion of equity (such as restricted stock units and options). However, the board revealed severe shortcomings in terms of composition as none of directors had expertise in financial services or current

business experience. Moreover, there were no current CEOs of major public corporations on the board as the former CEOs were into retirement for 12 years on average (Larcker and Tayan 2010). Such a board might have problems in understanding the increasing complexity of financial markets and risk management. The presence of directors with experience in nonprofit organization as well as the membership of a theatrical producer (Roger Berlind) and a former actress who was on the board for 18 years (Dina Merrill) proved not to be very useful in the demanding market conditions. The risk committee which included the mentioned directors with no expertise in risk management and finance (R. Berlindand, D. Merrill) met twice a year and five of its directors were in their 70s and 80s (Gross 2010). The poor performance and inadequate skills of directors resulted in the perception of the board as being a joke' (Gross 2010). The leadership style of the confident CEO was perceived as an additional corporate governance challenge. In 2007 Richard Fuld, the Lehman Brothers CEO, received $34 million ($450 milllion over 10 years) while the bank recorded losses of $10 million with the share price falling down by 95 %. The Lehman collapse was attributed to the fraud and misrepresentation of the factual leverage. The size of assets engaged in credit derivatives based on subprime mortgages was reported with the adoption of the so called repo 105 transaction. The repo 105 transactions which doubled between 2006 and 2008 were conducted at the quarter end at the amounts of $50 billion and were targeted at lowering its leverage (lowering the assets to equity from 13.9 times to 12.1 times) solely for the reporting purposes (Bris-May 2010).

As compared to Bear Stearns and Lehman Brothers the case of Goldman Sachs reveals mostly major shortcomings referring to the limited corporate disclosure, controversial practice of executive compensation and unethical attitude towards clients, shareholders and other market participants (Doria et al. 2010). The analysis of the Goldman Sachs strategy shows that its largest problems affecting the company's reputation as well as performance relate to unethical behavior. The bank not only got involved in hiding Greek debt significantly contributing to the sovereign debt crisis in the euro zone. Goldman Sachs helped the Greek government to borrow billions of dollars in 2001 in order to lower their public debt temporarily solely for reporting purposes in order to meet Maastricht criteria and join the euro zone. Additionally, Goldman Sachs has been recently penalized with the largest in stock market history fine of $500 million for misrepresentation of its CDO related products offered in 2008 (Stempel and Eder 2010; SEC 2010). More precisely, Goldman offered its clients financial products based on subprime mortgages targeted for decline of the market performance (ABACUS scheme) causing losses to clients and business partners (IKB Deutsche Industriebank AG). In effect, the bank was making money on products which were of high risk of default by selling these instruments to its clients without providing full information and disclosing the company own investment strategies. Selling these products the bank itself was interested in the default of the subprime mortgage market and it bet against them. The questioned corporate governance practices at Goldman Sachs also refer to the bank's remuneration policy (Posner 2010, 147–150). In 2007 when Goldman earned a net profit of $11.4 billion, its top 5 executives split

$322 million, while the CEO Lloyd Blankfein took home $70.3 million. In 2008 with the net profit of $2.3 billion, executives resigned from their bonuses, while the CEO pay accounted for $1.1million (owing however still shares worth $570 million). In 2009 the bank earned the net profit of $13.2 billion, while paying out bonuses for its employees of $16.2 billion (Cohan 2011).

The identified problems of AIG which led to severe liquidity problems were also believed to be rooted in corporate governance inefficiencies. Unlike the previous cases the main failure was attributed to poor risk management what led to the extensive involvement in subprime mortgages insurance (Foley 2009). More precisely, according the final report by the government's Financial Crisis Inquiry Commission (FCIC 2011) "**AIG failed and was rescued by the government primarily because its enormous sales of credit default swaps were made without putting up initial collateral, setting aside capital reserves, or hedging its exposure—a profound failure in corporate governance, particularly its risk management practices**". As studies reveal the company continued to make risky investments to boost its short term growth. As a result, it sold insurance (credit default swaps, CDOs) worth billions of dollars based on debt securities backed by wide range of obligations from corporate loans to subprime mortgages to auto loans to credit-card receivables. AIG promised the swaps buyers to pay loses in the case of the debt securities default. Due to the complex nature of CDOs their performance depended on thousands of various loans whose value was hard to determine and difficult to predict (Lenzner 2008). The AIG exaggerated exposure to CDSs stared to be problematic as the sub prime mortgage crisis drove the real estate prices to fall and significantly increased defaults that AIG was supposed to compensate for. The company was accused of misrepresentation of its unreported losses and inflation of profits as "these investments were risks aimed solely at improving the balance sheet and were in complete conflict with the long-term success of the company and investor's money" (Financial Crisis Inquiry Commission 2011). In result, AIG announced a loss of $61.7 billion dollars in the fourth quarter of 2008 and since it was perceived as too big to fail (its collapse would have threaten the stability of the financial system), it was covered by TARP bailout scheme. The public opinion was disappointed by the lack of ethical standpoint of the board of directors whose members joint for a $444,000 spa visit after company participated by the $170 billion dollar bailout. Additionally, AIG paid out $165 million in bonuses to its executives in 2008 alone. Therefore, AIG governance structure and corporate culture is referred to those of Enron and Arthur Andersen.

The corporate governance shortcomings identified in the case of General Motors appeared to have lesser impact on the global economy as compared with the analyzed banks and the largest American insurance company. Yet, the company was nationalized by the US and Canadian governments and joined the bailout program. It turned out that although being the manufacturer of one of the most popular cars in the US and worldwide, the company went bankrupt. The main reasons were rooted in the poor strategic analysis and ignoring the market changes. The GM board of directors did not notice the increasing interests for smaller and

more efficient cars (Hill 2009). The studies point at poor strategic performance and structural shortcomings of the board of directors (Finlay 2009). Despite good qualifications of the 13 “independent” directors on the board, eight of them have served with Rick Wagoner, the GM CEO, since 2003 (Macey 2008). The studies on GM board which shocked public opinion debating over the purchase of the new corporate jets fleet while being literally bankrupt was perceived as the poor monitoring passively reacting to executives intensions and strategic directions (Gross 2010). Additionally, observers identified inefficiencies in structuring the executive compensation packages. In 2007 the CEO was rewarded a compensation of almost $16 million (i.e. 64 % increase as compared to 2006) when the company was reporting billion dollar loses of $10.4 billion in 2005, $2 billion in 2006 and $38.7 billion in 2007 (Macey 2008).

6.5 Discussion

The outbreak of financial crisis is attributed to corporate governance failures including inefficiencies of board of directors, inefficiencies in executive compensation packages, inadequate risk management procedures and policies and inefficiencies at the intermediaries and sell side (Kirkpatrick 2009; Isaksson 2009). The main corporate governance shortcomings are presented in Table 6.3.

As presented in Table 6.3 the main shortcomings of corporate governance identified in various studies were also detected in the five analyzed companies. One of the most striking observations derived from the case studies refers to the presence of both corporate governance best practice and code of ethics in all analyzed companies. Therefore, corporate governance failures were not attributed to the lack of know-how and the insufficient access to empirical materials. The control and monitoring inefficiencies related mostly to short term orientation for profit maximization and the lack of fundamental responsibility of executives towards companies and shareholders. The formulation of codes of ethics in the analyzed companies did not lead to implementation of the ethical values in the everyday operation and corporate practice. The norms and values were internalized neither by executives nor by employees. Thus, the codes of conduct and corporate governance documents served simply as phantom declaration which allow for box ticking and the illusory compliance with standards of corporate behavior. The confrontation of corporate declaration and practice demonstrate severe, dramatic gap between that what companies declare for publicity purpose and that what they do pursue in practical dimensions of their activity. The divergence between corporate declaration and practice illustrates the hypocrisy of business and the severe lack of fundamental understanding and needs for ethical and responsible behavior. The messages included in the codes of ethics and the declaration of responsibility and integrity expressed by Bear Stearns, Lehman Brothers and Goldman Sachs proved to be empty declarations formulated solely for the purpose of formal compliance to satisfy shareholders and stakeholders

Table 6.3 Main corporate governance shortcomings

Corporate governance area	Main shortcomings
Board of directors (Gillespie and Zweig 2010)	Lack of sufficient information
	Powerful position of CEO, inefficient leadership
	Drop of trust, negative social perception
	Inadequate board composition—lack of derivative experts, insufficient financial expertise
Executive compensation (Johnson et al. 2009; Kirkpatrick 2009; Bebchuk and Fred 2004; Rost and Osterloh 2009; Clarke and Chanlat 2009)	The lack of incentive function of executive compensation—researchers observed fundamental weaknesses referring to the lack of motivation function (intrinsic vs. extrinsic motivation), maximizing total payoff as the main managerial drive, stock options
	Compensation packages motivated to high risk operations as large portion was paid in cash and structured for short term results
	Growing gap between average CEO compensation (estimated at $18.8 million) and average worker pay from 280 times in 2004 to as much as 520 times in 2008
	Poor work of the board and remuneration committee
	Poor efficiency of independent directors on remuneration committee
Risk management (Kirkpatrick 2009; Clarke and Chanlat 2009; Isaksson 2009)	Inefficient procedures adopted by boards, audit committee and the company management system
	Inefficient procedures referring to operational activity as well as financing policy (value at risk)
	Information asymmetry due to the poor quality of data/materials/documents
Intermediaries and buy side (Kansas 2009; Clapman 2007; Boerner 2008; Clarke and Chanlat 2009)	Wrong practices of rating agencies, financial, analysts and investment funds
	Problematic relationships, conflict of interest, pressure from companies

Source Own compilation based on quoted literature

expectations. Similarly the guidelines provided by corporate governance best practice remained to large extend the phantom declaration as the analysis shows the lack of skilled and experienced board directors, the lack of risk management in place and the lack of efficient executive compensation. The oversight and decision making failure of board of directors is viewed as one of the most problematic and inefficient element of corporate governance system. Board of directors failed not only with the reference to its structural requirements but also and foremost with the reference of theoretical attitude of its directors showing the fundamental lack

of responsibility, accountability and integrity (Gillespie and Zweig 2010). The abuse of corporate governance principles affected the quality of control and monitoring over the analyzed companies and eventually led to companies' collapse. In sum, the analysis allows to depict a severe gap between corporate declaration and corporate practice. The declaration not verified by stakeholders or shareholders was (is) not translated into corporate operations. This study may lead to a conclusion that there is a high probability that such patterns are adopted by other companies and refer to other aspects of their activities. The pressure on companies towards compliance with certain guidelines and recommendation results in them undertaking shortcuts – companies formulate declaration, the recommended values are not however implemented in the practical dimensions.

The impact of the financial crisis boosted state intervention, changes in regulation and companies' policies. Newly adopted regulations (e.g. US Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010) and recommendations (e.g. UK Code, EU Green Paper on Corporate Governance) are targeted at improving corporate governance standards and increasing transparency to eliminate severe pathologies. For instance the Dodd-Frank aims at significant reform of executive compensation (e.g. providing for clawbacks, say on pay) and at increasing shareholders participation and exerting of their rights. Another significant result of problems of the divergence of corporate declaration and practice refers to the recent revisions of the code of conduct and updates of corporate governance best practice at GM, AIG and Goldman Sachs. For instance, the Goldman Sachs code of 2011 emphasizes that "No financial incentive or opportunity—regardless of the bottom line—justifies a departure from our values. In fact, loosening our ethical standards in pursuit of business is a betrayal of our duty to clients, shareholders and colleagues and compromises everything we aspire to as a firm". This message seem to address the case of the unethical practice of ABACUS investment scheme as well as trading derivatives by the bank and its hedge funds which proved to be significantly profitable for Goldman Sachs though remaining highly controversial (Wall Street Journal 2010). However, it is too soon to praise for these changes and relate the shift of market regulation and (again) corporate declaration to factual reforms of their practice.

6.6 Conclusion

The outbreak and course of financial crisis are often related to the systemic inefficiencies of the whole financial sector such as practice of rating agencies, the US government housing policy and the Federal Reserve Bank long term policy of low interest rates. Many studies claim that the reasons of the financial crisis are rooted in changes in regulatory regimes which include the introduction of Gramm-Leach-Bliley Act of 1999 to replace Glass-Steagall Act if 1933 (Kansas 2009; Bris-May 2010; Halloran 2010). However, many studies view the crucial role of poor corporate governance in the understanding of the scope and scale of

the financial crisis (Larcker and Tayan 2010; White Paper 2008; Stevens 2009; Bris-May 2010). Thus, the outbreak of the financial crisis is attributed to three main systemic shortcomings of corporate governance including institutional failure represented by irresponsible housing policy from the state and banking system, intellectual failure which related to the poor monitoring from the board despite highly recognized directors on board and the moral failure comprising the acceptance of risk taking policy and structuring compensation attached to turnover.

The prime causes of the crisis may seem contradicting the experience and know- how of corporate governance and public policy as the literature provides a wide range of recommendations for sound operation and guidelines for performance of both companies and countries. These recommendations refer to the corporate bylaws and regulations, board structure, its composition and work, the role of independent directors, the efficient structuring of incentive executive compensation in order to motivate top managers for the shareholder value increase, the information policy and investor relations, the corporate relations with media, other market participants and stakeholders. The commonly shared corporate governance best practice, the emphasis put on the role of efficient monitoring and control as well as the expressed requirements for high ethical standards both for financial institutions and listed companies (Boatright 2008) did not prevent from major control failures. What is worse, stock market and corporate governance seem not to have learned from previous ethics failures (McBarnet 2006:35) and frauds indicating a long lasting severe ethical crisis in corporations and financial institutions (Glasbeek 2002; Mitchell 2001; Stewart 1991). Despite efficient law enforcement, compliance with corporate governance best practice and codes of conduct in place, main failures which caused the financial crisis relate to unethical and irresponsible attitude of both public listed companies and financial institutions. The irresponsible behavior of a few exerted severe impact on the global community and global markets. The lack of integrity and strong values, the dominant public respect based on the level of consumption and wealth as well as the prime priority for short term profits prove to be the key drivers for inefficiencies in corporate governance. The phantom declaration of ethical attitude and the lack of true compliance with codes of best practice led to trust crisis on the market and resulted in deterioration of economic performance.

Analyzing the identified corporate governance shortcomings from a wider perspective one may question whether there are any solutions related to business practice or regulation potential which may help improve the control and monitoring standards. Although it is relatively easy to list the required reforms of corporate governance and the need higher ethical standards as well as both for companies as well as for financial institutions, the problem may lay much deeper and refer to the fundamental assumption of market economy and shareholder capitalism. The investor expectations pushing for constant quarter profits and leading to the increase of firm value seem to be at the cornerstone of the crisis. The expectations of higher profits (share price, dividend payout) and demands for increased consumption constitute the fundamentals of shareholder capitalism.

Such a shareholder pressure combined with liberalization on the financial market created new frameworks for structuring executive compensation and aggressive sale policy. At the same time the level of personal wealth and the size of consumption generated at any price was valued more than ethical behavior, integrity and high morale. As long as there is no essential change in value hierarchy and recognized and respected behavior, none of code of ethics declaration or corporate governance guidelines provide significant improvement of corporate behaviors and monitoring standards.

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