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## **Booms and Busts, Corporate Governance, and Business Acumen**

After three decades of financial crises—and three decades of failed solutions—this White Paper attempts to address three questions:

***How could this happen again?***

***Was Sarbox the solution or the problem?***

***What has been missing from our solutions to financial crises?***

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# ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

## **Table of Contents**

### Part 1: Credit Crisis Reflects Failure of Corporate Governance Reforms



The Sarbanes-Oxley Act was put in place to prevent fraud and abuse, and to increase investor confidence that companies were reducing exposure to risk. Not only did Sarbox not prevent the current enormous financial crisis, but, in fact, **may have caused it** by creating a huge increase in risk exposure through **increased moral hazard**.

### Part 2: The Evolution of Bad Financial Behaviors 1980-2008

This latest crisis is part of a broader trend that has been occurring since, at least, the early 1980s. These crises reflect a **common pattern**: financial innovation leads to an explosion of activity which leads to unforeseen problems. We conclude two things: 1) focusing on prevention hasn't worked and 2) our financial behavior is **getting worse**.



### Part 3: Corporate Governance Reforms - Theory and Practice



There are many examples of how the most recent reforms failed. These examples make it abundantly clear that **Sarbanes-Oxley failed across the board** rather than just in a few limited areas. This highlights a set of fundamental issues that the legislation did not address and which need to be addressed for future crises to be avoided.

### Part 4: Financial Behavior and Business Acumen

Corporate governance must shift from an emphasis on compliance processes, which can only identify and guard against known problems, to an **emphasis on behavior**. If good financial behaviors are developed, then these behaviors can be used to **protect against unforeseen risks** for which compliance processes cannot be preemptively devised.



### Part 5: **Conclusions** – Improving Corporate Governance



If there is a continued **reliance on form and process over behavior**, then whatever risk reduction occurs will still not address systemic risk. In addition, it leads to a **sharp reduction in financial innovation** with its consequent negative impact on **US competitiveness and future wealth**.

## **Corporate Governance and Business Acumen**

### **Credit Crisis Reflects Failure of Corporate Governance Reforms**

#### ***The Enrons Were Not the End***

The US took unprecedented action in the early 2000s to enact major reforms in corporate governance so that the excess and abuses that had occurred at the end of the preceding bust could never occur again. Following the passage of the Sarbanes-Oxley Act of Congress of 2002, US regulators felt that they had solved the problems that led to the failure of companies such as Enron, Tyco and WorldCom in the late 1990s. Now, in 2008, we are feeling the effects of the global economic crisis, which stemmed directly from the US credit crisis. Considering the major corporate governance reforms we have gone through and the expenses we have incurred as a result, why should the credit crisis have occurred in the first place?

*“Considering the major corporate governance reforms we have gone through and the expenses we have incurred as a result, why should the credit crisis have occurred in the first place?”*

The years since 2002 have seen an explosion of corporate governance activity. All US public companies have been to some extent subject to these new reforms and many private companies and other companies around the globe have adopted the basic principles also. Audit, risk management companies, lawyers and accountants have been drafted by most companies to implement significant increases in internal risk reduction activities designed to reduce risk and prevent abuse. Overall expenditures on corporate governance have significantly increased, even for the smallest companies.

In these past six years, we have seen the largest expansion of corporate governance and risk reduction mechanism ever in the history of capitalism. More effort has been expended by companies themselves and their outside advisors including their external auditors, lawyers, accountants, securities advisors and risk management advisors.

This unprecedented expansion of effort occurred in parallel with the expansion of the very financial activities that led to the current crisis. The reforms were implemented during a time when financial innovation led to an unprecedented expansion in new financial products and services.

These products included subprime borrowing and securitization of hitherto un-securitized assets. They also included a huge expansion of untried and untested financial instruments which purported to provide protection for the new products. In retrospect these instruments not only failed to provide protection, but, in the cold light of day, they could never have been expected to provide protection by any rational observer.

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

### ***Where were the Corporate Governance Watchdogs?***

The root cause of the financial problems of the 1990s was risky financial behavior that was covered up by using a variety of techniques such as off-balance sheet entities to disguise the losses. Why then, did the auditors, lawyers, accountants, the SEC and the ratings companies overlook the massive liabilities contained in the Structured Investment Vehicles of institutions such as Citigroup, UBS, Bear Stearns and the like in the current financial crisis of the 2000s?

Why would good corporate governance overseers pay no heed to the massive risks inherent in the ever-more exotic instruments devised by Wall Street? Wasn't this their job? Wasn't this why they were – and still are – being paid enormous sums by every public company to avoid major risks? Wasn't the good corporate governance movement all about achieving complete transparency so that corporate managers could never hide major risk again from investors and shareholders?

Weren't the consulting and audit companies there to advise us if anything seemed wrong? Isn't there a now-enormous corporate governance industry that was encouraged to form by the Federal Government precisely to ensure that an Enron could never happen again? Weren't there new legal and accounting rules and regulations in place to ensure that this industry had the right guidance and road map to guide the armies of lawyers, accountants and consultants who now oversaw companies and their financial systems? Didn't Congress devise these rules so that we could never be blindsided so totally again?

What is it in the compensation systems of companies that could lead to the managers benefiting at the expense of the shareholders? Why would a compensation system be designed that could lead to shareholders losing while managers made huge sums in compensation? Aren't compensation systems such as these prone to lead to systemic risk?

*“Why would good corporate governance overseers pay no heed to the massive risks inherent in the ever-more exotic instruments devised by Wall Street? Wasn't this their job?”*

Weren't auditors, corporate governance specialists, lawyers and accountants, and the ratings companies supposed to point to such conflicts of interest as part of their responsibility for good corporate governance? What factors could possibly have led them to overlook these risks? Why did the honorable few whistle-blowers get canned and ignored, even by the corporate governance guardians? Wasn't the SEC supposed to be making them all do their job?

### ***Compliance with Process Doesn't Work Either?***

Explanations for past crises before the 90s had always rested on traditional approaches. The major crises, those of a systemic nature, had always developed from mass market speculation followed by a panic and a collapse. The answer to these was government

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

action of a reflationary nature after the vent and expansion of the money supply beforehand. But in a true systemic crisis this can take time as happened in the 1930s and even then it was probably the Second World War that provided the true stimulus.

The crisis of the 1980s culminating in the setting up of the Resolution Trust Corporation to buy back devalued assets led to another model, a formal organization to act as a “bad bank” to hold onto bad assets until they could be sold once the market improved. This worked but it was still an ex post facto solution.

The solution of the 90s went one step further, to try to prevent crises before they even happened. This was the significance of Sarbanes-Oxley. For the first time in capitalist history, the plan would be to set up an institutional arrangement that would prevent systemic crises before it could even occur.

*“Institutional arrangements aimed at prevention, such as Sarbanes-Oxley, have just definitively failed.”*

The lesson to date therefore has not been good. Solutions after the event do not prevent the crises from occurring in the first place. Cheap money before the crisis may actually make it worse, as in the current crisis. Institutional arrangements aimed at prevention, such as Sarbanes-Oxley, have just definitively failed. Where do we go from here?

### **The Evolution of Bad Financial Behaviors 1980-2008**

We cannot look at the events of 2008 without also looking at the evolution of the financial system over the past 30 years. This has seen three explosions of financial innovation which have ended in busts.

The first of these was the leveraged buyout boom of the 1980s which led to a bust at the end of the 80s. The second was the boom in exotic financial strategies and derivatives led by the theories of Nobel prize winners Merton and Scholes (of Black-Scholes fame) which led to the failure of Long-Term Capital Management in 1998 and eventually to the failures of so-called New Age companies such as Enron. The third phase was the boom in mortgage securitization and its extension to the creation of other exotic instruments which led to the mega-bust of 2008.

We show the chronology of these phased in the table below.

**White Paper – Booms and Busts, Corporate Governance, and Business Acumen**

**Table 1 Chronology of Recent Economic Cycles**

<b>PHASE</b>	<b>DATE</b>	<b>EVENT</b>	<b>DOW</b>
<b>LEVERAGED BUYOUT BOOM AND S&amp;L BUST</b>	<b>1980</b>	The invention of high yield bonds	1000
	<b>1980-90</b>	The leveraged buyout boom	3000 peak
	<b>1987</b>	Black Friday – the 1987 Stock market crash	2000
	<b>1990-3</b>	The S&L crisis	3000
<b>TECH BOOM AND BUST</b>	<b>1993</b>	The founding of Long-Term Capital Management (LTCM)	3500
	<b>1997-8</b>	The Asian and Russian economic crisis	9000
	<b>1998</b>	LTCM failure and rescue	8000
	<b>2000</b>	Enron affairs emerges, numerous other companies fail	11500 peak
	<b>2001</b>	Technology boom turns to bust, stock market crashes	10500
	<b>2002</b>	Sarbanes-Oxley Act passed in Congress	9000
<b>MORTGAGE BOOM AND BUST</b>	<b>2002</b>	The onset of widespread mortgage securitization	10000
	<b>2007</b>	Credit crisis begins in US	14000 peak
	<b>2008</b>	Financial crisis goes global, stock market crashes	8000

We must understand this chronology in order to follow the main thesis of this White Paper concerning the importance of behavioral approaches to corporate governance.

**Phase 1: The LBO Boom and Bust – 1980-1991**

The innovation of the 1980s in the financial arena was the invention of high yield bonds, otherwise known as junk bonds, which is widely ascribed to Michael Milliken. This led

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

to an explosion of buyout funds, greenmail, huge increases in corporate valuations and the subsequent bust as over-leveraged companies could not repay their loans as demand conditions turned down.

What originally started as a good idea became widely copied, bowdlerized and then abused, leading to massive frauds by both companies and individuals. The subsequent analysis concluded that LBO activities led to a focus by managers on financial returns over real economic activities that eventually led to the hollowing out of companies and thus their eventual demise.

These pools of capital also were diverted into office building and the subsequent over-investment in commercial property and thence the office space bust leading to the S&L crisis. Money became too cheap and the resulting over-investment, low deal quality and mass defaults to the banks for both corporate and commercial loans led to mass failures of banks and companies.

*“...LBO activities led to a focus by managers on financial returns over real economic activities that eventually led to the hollowing out of companies and thus their eventual demise.”*

The solution to the problem was the Resolution Trust Corporation acquiring failing banks and properties, thus putting a floor under the eventual damage. At the time there was little talk about the increase in moral hazard but it is clear in retrospect that this was the beginning of the approach that argues in favor of limited social and financial damage through reliance on government actions which would, at the same time, also protect both perpetrators and victims.

### ***Phase 2: The Tech Boom and Bust – 1993-2000***

The options pricing revolution of Merton and Scholes led to the widespread practice of providing options to employees, formal pricing mechanisms for them, and the extension of these techniques into stock trading and debt. This led to the ascendance of the quants – usually PhDs from the physical sciences who used their mathematical knowledge to apply these new techniques into the area of making money.

John Meriwether’s founding of Long-Term Capital Management (LTCM) in 1993 was a reflection of a new wave of innovation in financial markets which exploited these techniques and the ability of the quants to extend them into new financial domains. This led to an explosion of new approaches to financial markets and stock trading by numerous other companies and the over-use of debt.

The failure of the emerging markets in 1997, and of Russia’s in 1998, were events not accounted for in these models. This led to the failure of LTCM in 1998 and its bailout by the New York Fed. However this rescue of the system merely encouraged other players to continue using these techniques in the corporate sphere leading to the excesses of

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

companies such as Enron, WorldCom and Tyco which used similar approaches to amass cheap money, thereby funding abuse and fraud and leading to their eventual failure. This in turn led to the tech bust of the early 2000s due to a huge over-supply of cheap money, which led to low deal quality and eventual bust.

Widespread public indignation over the frauds and busts of the tech boom led Congress to take action. In 2002 it passed the Sarbanes-Oxley Act, whose aim was to prevent the abuses of the system exposed by Enron and some of the other notable busts of that period.

### ***Phase 3: The Mortgage Exotics Boom and Bust 2002-2008***

The genesis of the boom and bust of the 2000s was the introduction of two major sets of financial innovation: (1) securitization of new asset classes and (2) the emergence of new ways to apparently guard against default of these instruments.

Mortgage securitization had already commenced in the late 1990s but only became extensive after the end of the tech bust. It quickly spread throughout the US economy leading to the enormous run-up in housing prices and the overleveraging of consumers. This led also to high corporate growth rates, excessive corporate valuations and to high stock prices.

The securitization boom extended into the corporate arena and to another round of innovation with the creation of new types of financial instruments which fueled the boom and led to further overleveraging. The subsequent erosion of credit quality coupled with inevitable demand slowdown led to the subsequent bust which has now stretched into all corners of the world.

*“Again, this is an ex post-facto solution, and one that is fraught with the danger that it will sow the seeds of the next boom and bust cycle. Since the prevention option did not work last time we will have to think of another.”*

We are only just now starting to think of how to address the crisis. So far we have reverted to reflationary action, dramatically expanding the money supply. Again this is an ex post-facto solution, and one that is fraught with the danger that it will sow the seeds of the next boom and bust cycle. Since the prevention option did not work last time we will have to think of another.

### ***The Lesson – Our Financial Behavior is Getting Worse***

In retrospect it is clear that there is a pattern in each of the cycles we have experienced since the early 80s:

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

- A financial innovation leads to new ways to create credit, drives up the prices of corporate and other assets, credit quality declines to a point where at some point a failure in one part of the financial system has a chain effect throughout the rest of the system.
- The failure leads to the failure of both corporate and consumer borrowing and thus impacts the financial institutions, some of which fail and the rest of whom reduce credit leading to a sharp slowdown in demand.
- The larger the slowdown and the greater the threat both to the economy and to interested players such as financial institutions, the more pressure is exerted on the government to find a solution or to effect some type of bailout
- The government organizes a rescue or a bailout.
- At the same time legislative action is taken to address the problems identified in the last cycle which led to the problems that have been experienced.
- These bailouts tend to condition expectations that in the next cycle, there will be a floor set under any widespread market slowdown set by the willingness of the government to take broad action of either or both an institutional and reflationary type so that financial institutions in particular do not suffer irremediably.
- There is a wide level of confidence that legislative actions taken by the government will reduce the risk of the crisis occurring again.
- The resulting expectation tends to encourage even riskier financial behaviors in the next financial cycle.
- As a result, successive crises become worse since the combination of confidence that there are inbuilt safeguards against failure, coupled with the reaction of moral hazard, ensures that more risks will be taken each time there is a new round of financial innovations.

The lesson is that we tend to fight only the last war in the financial realm. The problems that occur the next time have different causes that most do not recognize when they occur.

Yet in the next economic cycle there tends to be excessive confidence that government actions have reduced the risk of another crisis. So the system rolls into the next crisis with a misplaced confidence that it has shut down the loopholes and with increased confidence that even if something does go wrong, the government will be there to bail out anyone who has gotten into too much trouble. This is the infamous problem of the creation of moral hazard.

### ***And the Move to a Preventative Focus Has Not Worked***

Sarbanes-Oxley did introduce two huge innovations into corporate governance. These were:

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

- It focused on a micro-economic as distinct from a macro-economic solution, the latter having always been favored by government.
- It also focused on preventive action as distinct from an ex post facto solution.

The fact that Sarbanes-Oxley did not work does not detract from the fact that this was the first time in the 1980-2008 period that broad action in response to major financial crises was contemplated at the micro-economic (as distinct from the macro-economic) level for preventative purposes.

But it is clear that although the microeconomic and preventive focus was a major step forward, they still did not work. The problem now is to develop methods and approaches that are microeconomic and have a preventive focus that will actually work in real life.

### **The Theory and Practice of Corporate Governance Reforms**

#### ***Theory Looked Great***

Following the tech crash of 2001, legislators set to work to address the issues identified as causes of the crash. Essentially they identified bad financial behaviors which exhibited themselves in bad or fraudulent accounting, and multiple conflicts of interests involving auditors, analysts and corporate officers. The legislative solution to these problems was the Sarbanes-Oxley Act of 2002, otherwise known as Sarbox or SOX.

The theory behind Sarbox was that:

- Conflicts of interest led auditors to look the other way, and if these conflicts were eliminated, then audit oversight would be more effective
- Inadequate compliance and audit processes exacerbated the problem of misleading statements and would be fixed by mandating formal compliance procedures that, if followed correctly, would ensure that the misleading statements could not be produced
- Conflicts of interests with securities analysts led to them hyping stock, and if these conflicts were addressed, then the hyping would stop and investors would not be misled
- If corporate officers had to sign results personally with jail as a penalty, this would act as a counterweight to them signing off on misleading or false results which they would have an incentive to do because of the personal rewards they would gain through their stock-based compensation.

Sarbox is known legally as the “Company Accounting Reform and Investor Protection Act of 2002”. We should particularly note that its title explicitly states its intention to protect investors.

**White Paper – Booms and Busts, Corporate Governance, and Business Acumen**

The aim of the Act was to prevent bad corporate financial behaviors, particularly those that had as symptoms fraud, which led to investors losing their money through misleading and fraudulent practices by corporate officers. Its aim in doing this was to oblige all those involved in the financial management process to comply with certain oversight processes which, it was felt, would dramatically reduce the potential for fraud.

The outcome would be, the theory went, that the resulting systems and processes would reduce risk and therefore improve business results. As a result the investing public could have much greater confidence in financial statements, and corporate officers themselves would identify compliance and risk problems more rapidly with the new controls in place.

***In Practice Nothing Worked as Planned***

It is demonstrably the case that the corporate governance reforms failed to prevent the excesses that emerged in financial and other companies in the 2002-2008 periods. Undoubtedly there will be many explanations made for this failure in the future. In order to see where and how the failures occurred it is instructive to look at the actual structure of the Sarbox legislation and to make a high-level assessment of how they worked in practice.

There are 11 sections (or titles) in the Sarbox legislation. We have summarized them below in the table. Each title addressed a different problem that had been identified as a cause of the tech bust and provided a solution. We have shown for each title what actually happened. The table shows that each of the broad solutions represented by the 11 titles failed to operate in the way it was supposed to.

**Table 2 Sarbanes-Oxley Law and Outcomes**

<b>Title Number</b>	<b>Content of Law</b>	<b>What actually happened after Sarbox</b>
1	Independent oversight of public accounting firms providing audit services and audit and compliance processes	Auditors signed off on compliance processes at numerous companies where financials masked a true loss position where the financials were technically in compliance with accounting standards but not in their spirit.
2	Auditor independence and prevention of non-audit services	Sarbox increased auditor revenues significantly meaning loss of consulting revenues was not a problem so they still gained revenues by signing off on bad financial behaviors. So long as auditors are being paid by the entity they are

**White Paper – Booms and Busts, Corporate Governance, and Business Acumen**

		auditing, there is a continuing conflict of interest.
3	Corporate responsibility - senior executives take individual responsibility for the accuracy and completeness of corporate financial reports.	Didn't prevent any CEO, CFO or other senior officer signing off on statements that masked the true financial position of their companies eg Lehman Brothers, AIG.
4	Enhanced financial disclosures including off-balance sheet transactions	Most banks still had numerous off-balance sheet vehicles for which they were still responsible which included huge liabilities e.g. Citigroup with its Special Interest Vehicles (SIVs).
5	Analyst conflicts of interest	Didn't stop analysts from mainly issuing buy rather than sell recommendations
6	Commission resources and authority with securities professionals	SEC fairly passive throughout entire period
7	Action against violations including ratings companies	Huge conflicts of interests in ratings companies which analysts, auditors and SEC did not identify or take action on
8	Corporate and criminal fraud accountability and providing certain protections for whistle-blowers	Noted whistle-blowers lost their jobs notwithstanding this section.
9	White collar crime penalty enhancement	Many offenders of the tech bust period were not prosecuted.
10	Corporate tax returns to be signed by CEO	Did not prevent systematic downplaying of risk and most CEOs still got huge compensation even if they were dismissed
11	Corporate fraud accountability records tampering	Too simplistic to deal with highly sophisticated financial instruments and the routine misleading of investors

Of course, for each of the 11 titles set above, the explanation behind the failure is long and complicated. It is likely that there were many cases where Sarbox did work as intended and that in some cases it did prevent abuse and reduce risk.

But overall the outcome is clear; the corporate governance reforms of 2002, even though they were implemented by every public company in the US, did not prevent the spread of the risky financial innovations and their abuse of them.

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

These risky financial innovations spread not only to the financial services companies but to many if not most companies downstream from them. These companies in turn used techniques based on these innovations for numerous other financial purposes such as investments, loans, borrowing, mergers, acquisitions, hedging, speculation, and so on.

### ***Corporate Governance Reforms Focused on Process Not Behavior***

There are multiple problems with the philosophy and approaches behind Sarbox. Some of these are as follows:

**Systemic vs. non-systemic risk:** Sarbox approaches were not designed to address issues of systemic risk. They were designed for the normal range of risks in normally-trading markets where financial behaviors are mostly good, and only a minority is bad.

**Mass market psychology:** Sarbox is designed to address normally trading markets where mass market psychology does not take hold and induce mass ignorance of major risks. Yet this phenomenon occurs in almost every cycle and is worst in the most difficult times.

**Collaborative networks:** Sarbox does not address collaborative networks where organizations cooperate in pernicious ways to support intrinsically bad financial behaviors, such as the conflicts of interest between the ratings companies and the mortgage pools they rated.

**Compensation conflicts:** Sarbox does not address situations where compensation plans could be so remunerative that they give corporate officers and managers an incentive to risk the survival of the company; that is, there is a conflict between compensation incentives and company survival. This occurred extensively and systematically during the last boom period.

**System contagion:** Sarbox does not address the issue of mechanisms, such as securitization, which purport to control risk by passing it to risk takers but fail due to bad forecasting, which can lead to contagion and system-wide impact.

**Only addresses common and foreseen risks:** Sarbox addresses known and common risks. It probably protects quite well against these. However it cannot address risks which are unforeseen. Unforeseen risks are the very essence of financial innovation. Thus by its very nature, corporate governance cannot adduce processes which mitigate against such risk since they are the essence of innovation. This is another way of saying that, in a system where financial innovations are important, normal corporate governance processes cannot protect against many if not most of the risk they create.

**Addresses compliance with process not behavior:** The fundamental premise of Sarbox is that if the right processes are followed then risk will be reduced. Sarbox does not

## **White Paper – Booms and Busts, Corporate Governance, and Business Acumen**

attempt to change underlying behaviors, just the way people act in particular situations. There is no attempt to provide an underlying set of good and productive financial behaviors that will be followed even if the processes do not exist or are not mandated to address a particular problem. The underlying premise of Sarbox is that if it is not prohibited, then it is legal and appropriate to undertake such behavior.

### **“Good” Corporate Governance Increases Moral Hazard?**

There is an even deeper problem with any corporate governance process that has far-reaching macro-economic ramifications.

1. The knowledge that there are systems in place to protect against systemic risk provides confidence for those who want to increase risk in order to get higher returns. They believe they will have a safety net preventing these risks from getting out of hand. This leads to even greater risk taking. When profits go down, this leads to even more risky behavior because everyone believes that the risks are ultimately contained.
2. This risky behavior results in reduced moral hazard since corporate managers believe that they have systems in place that will protect them if things go wrong, which is, they believe, very unlikely. Investors similarly become more confident that with apparently sophisticated corporate governance systems in place, they cannot get burned so they increase the riskiness of their investments and bets.
3. Compensation systems reward those who take the biggest risks, since there is a tacit understanding that even if the company has a problem, the employees, including the CEO, will still make out big.
4. In short, the perception that there is a corporate safety net in place because of the existence of extensive corporate governance oversight encourages even more risky behavior. The safety net encourages companies to develop compensation systems which increase systemic risk. These processes lead to reduced moral hazard in turn increasing risky behavior even further.

*“We have just seen the ultimate in the law of unintended consequences. The very laws and regulations that were supposed to reduce risk in fact increased it systemically and into the bargain increased moral hazard...”*

Sarbox created a key prop for increasing moral hazard. If everyone thinks that corporate governance systems lead to low risks of default and problems, they undertake more risky behavior.

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

We have just seen the ultimate in the law of unintended consequences. The very laws and regulations that were supposed to reduce risk in fact increased it systemically and into the bargain increased moral hazard to the point where no-one had any concern about danger. Compensation systems designed on top of Sarbox extended that risky behavior leading to individual employees profiting even if the company went under.

### ***The Dilemma – Risk Reduction vs. Innovation***

Corporate governance reform throws up a central dilemma. Excessive or inappropriate controls can significantly or even totally reduce risk, if they are severe or even draconian. However in this case they will squeeze out all or most innovation.

A low level of control may not reduce risk sufficiently, as has occurred so far, but they do not prevent a high level of innovation. The risk is that the severity of the current crisis moves us to a societal consensus where the desire for risk reduction overwhelms the desire for innovation.

How do we achieve the optimum level of risk reduction at which we significantly reduce the risk of severe financial crises but still maintain the edge in financial innovation at which we still maintain the US' competitive edge and still create financial innovations which can add to overall social wealth?

*“Behavioral disciplines ... teach that people may act in a totally different way, i.e. irrationally. That is, if you reduce risk in one area, they may well act to increase it in others...”*

As we will show below, the key move must be to stress more sophisticated methods of risk reduction which focus on behavioral, rather than merely compliance, approaches. With the right balance between these two types of approaches we can achieve an appropriate balance between risk reduction and innovation. If this is not achieved, the overwhelming probability is that we will achieve better risk reduction at the significant expense of innovation.

## **Financial Behavior and Business Acumen**

### ***Corporate Governance Reforms Miss Key Behavioral Finance Factors***

Over the last few years we have seen the emergence of the new disciplines of behavioral economics and behavioral finance. These discard or relax the assumption of traditional economics and finance that consumers and investors are totally rational. Instead they proceed on the assumption that, at best, they make decisions based on a model of mixed rationality.

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

Sarbox and the good corporate governance movement are based on the assumption that if you reduce risks, then people will act less riskily. Behavioral disciplines instead teach that people may act in a totally different way, i.e. irrationally. That is, if you reduce risk in one area, they may well act to increase it in others.

Sarbox and the corporate governance movement have tripped on this phenomenon. Their assumption of rationality has proved not to be valid. Thus they have actually increased the level of irrationality in the system, leading to more irrational behavior. In the new post-Sarbox model, traders and managers can take more risk because they believe that there is less risk in the system so they can take up the slack to earn higher profits.

In the traditional economic and finance model, more financial literacy leads to greater system knowledge and therefore reduced system risk. However in an environment where many managers are not acting as per the classic model of rationality, increased financial literacy is given precedence over business acumen which leads again to increased system risk.

In such an environment, the quants, who have ultra-high financial literacy, but relatively low business acumen, are given their head. They and their models do not take account of nonlinearities that lead to systemic risk.

However corporate governance assumes that the processes in place will protect against this. Good corporate governance's over-reliance on form leads to misplaced confidence in high academic qualifications and credentials and thus increases overall risk by handing power and responsibility to people who have no more ability to assess risk than anyone else.

### ***Good Financial Behaviors Create Capital***

There is a fundamental definitional point to be made. This is that:

***“Good financial behaviors (the ones desired by corporate governance) create capital over the long term”***

The reverse of this principle is that:

***“Bad financial behaviors (the ones that corporate governance tries to prevent) inappropriately consume capital over the long term”***

The intent of the corporate governance reforms of 2002 was to ensure compliance with processes that would reduce the risk of capital being inappropriately consumed. These reforms did not work and a vast amount of capital has been consumed worldwide.

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

Instead of encouraging good financial behaviors, the corporate governance reforms tolerated bad financial behaviors. Moreover, these behaviors may have even been encouraged, through the unintended consequences of managers and investors, who incorrectly believed that these reforms had reduced overall systemic financial risks.

Good financial behaviors create capital. Good financial behaviors derive either from innate business acumen or learned business acumen. Business acumen is a set of behaviors that are difficult to enshrine in formal processes that ensure that, no matter what the circumstances, capital is created or, at least, not inappropriately consumed.

*“Sarbox focuses on compliance with defined processes, not on creating good behaviors and not on business acumen.”*

Sarbox focuses on compliance with defined processes, not on creating good behaviors and not on business acumen. If something is not formally prohibited, it is probably legal, unless it is egregiously false or abusive.

Yet as we have seen the driver behind the failures of the corporate governance reforms is financial innovations that lead to unforeseen risks for which processes cannot be defined in advance. So the only way to address these unforeseen issues is to focus on good financial behaviors, or the development of business acumen.

These good behaviors that create capital or do not inappropriately consume it, are the ones that will offer the best defense against unforeseen risks. In other words, the only long-term solution to systemic crises and reducing risks, particularly systemic, is to focus on behavior, not process. This is true because higher levels of business acumen:

- Create the flexibility to anticipate unforeseen and systemic risks
- Is not simply a set of rules that can be learned through financial literacy
- Is about understanding your innate, unconscious behaviors and their impact on financial outcomes; then adjusting those behaviors to optimize financial outcome
- Is not about avoiding risk, but controlling risk
- Is about creating sustainable competitive advantage

This is in sharp contra-distinction to legislative solutions and corporate governance frameworks which are about focusing on or avoiding risk.

Seen in this light the task of corporate governance is to focus on building good financial behaviors rather than building legally-based compliance frameworks which cannot address unforeseen risks. The key issue is to develop and encourage higher levels of business acumen which will be able to tackle any type of risk, foreseen or unforeseen.

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

Building business acumen can be seen as an analogy to building in good quality in the production of goods and services in corporations. Quality procedures can be defined and measured and must be followed.

However if the workers and managers do not understand the objectives of quality procedures and processes, and if they do not develop good underlying quality behaviors (such as quality circles which allow quality issues to be collegially discussed) then the quality process will degenerate into totally preplanned and rigid frameworks which will not be able to address new and unforeseen quality issues.

### ***The Solution – Behavioral Transparency***

Good, long-term solutions will take creativity and time to develop. The solutions developed by the Fed are short-term only, because they do not address the fundamental issues of behavior and risk. Unless this is done we can expect systemic crises to get progressively worse. Or, in the event that Congress and the Feds clamp down on innovation in financial services, then we can expect lower risk but a progressive decline of the US economy in relation to its peers.

*“... transparency in form rather than substance does not do any good either. If we have transparency in legal and accounting forms, but not behavioral transparency... then we cannot reform the overall financial system.”*

But one of the key lessons is that we cannot rely on good corporate governance as it is currently defined. If anything we need to throttle back and have less Sarbox in order to reduce moral hazard which will change behavior the hard (and effective) way.

Another thing we need to learn is that transparency in form rather than substance does not do any good either. If we have transparency in legal and accounting forms, but not behavioral transparency in the sorts of people these companies hire and the compensation systems that they are under, then we cannot reform the overall financial system.

We must understand that the major risks to the system are not only opaque processes but opaque behaviors. Ultimately there must be behavioral transparency for corporate governance to really work as it was designed to originally. Otherwise we will get more Kerviels (as in BNP Paribas) and Leasons (as in Barings). Who knows how many other time bombs are out there ticking away right at this very moment?

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

### ***Recommendations to Improve Business Acumen and Good Financial Behaviors***

#### **a) Assess financial behaviors and show people how to compensate for bad behaviors**

Companies and organizations need to develop ways to assess the financial behaviors of individuals and show people how to compensate for them at the level of the individual. Most people are unaware of how they will react and respond in various financial situations. By showing how they will respond and the principles to follow in responding, it will provide them with the financial and ethical basis for guiding their own behavior in a constructive manner even in situations which are not foreseen.

#### **b) Do at individual, team and company level**

It is important that these assessments and development programs be completed not just at the level of the individual but also at the level of the team, division and company. Behavioral understanding can only be extended by holding programs at the level of the collectives so that teams can collectively address and develop solutions for issues which they can address as a team.

#### **c) Show importance of behaviors over process**

Corporate governance reforms and company internal programs must focus on behaviors at least as much as on process. This is not to say that process should be disregarded. It is a vital front also. But people must be made aware of the unintended consequences of innovation and prepared to handle unforeseen events and situations where it is not possible to formulate processes to follow.

#### **d) Do business acumen training**

Companies and organizations should make business acumen training at all levels a formal part of the corporate governance program. This program should be guided by trainers with an understanding of behavioral finance rather than legal, accounting, audit or legislative experts.

#### **e) Go beyond technical financial, legal and compliance approaches**

One key part of Sarbanes-Oxley has been to implement training in technical disciplines which would expand the knowledge to be able to implement the provision of the legislation and the compliance approach. The training includes accounting, training in the technical provision of the Act, legal issues and also some of the financial concepts underlying compliance. While some of these may have value, it has to be recognized that such approaches will normally only be of value in identifying foreseen and known compliance issues. They will not identify the types of control issues which are

## ***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

unforeseen, for example those that derive from financial innovation. Only behavioral approaches can identify these types of problems although technical approaches may help to elucidate them once the problem has been identified through other methods.

### **f) Training in how to break the system – test to destruction –behavioral failure analysis**

Corporate governance needs to incorporate destructive testing – testing to deliberately try to break financial systems and behaviors to see what the limits of the system are, how easy they are to reach, and what behavioral changes occur under system destruction. In this approach it is important to not use practitioners to test the system, so that there is no conflict of interest with practitioners who have a stake in seeing the system work. Also testers should be given monetary incentives to break the system.

### **g) Enshrine behavioral approaches in corporate governance processes**

Corporate governance approaches must incorporate behavioral change as well as process compliance. By doing this they will enhance the ability of corporate governance to respond constructively to unforeseen situations. The behavioral change must be aimed at bringing about good financial behaviors in the sense laid out in this White Paper.

### **h) Get behavioral finance experts involved, not just lawyers and accountants**

As part of the behavioral focus being introduced into corporate governance approaches, behavioral finance and training professionals must be introduced to help this change in focus. Corporate governance must move its focus away from purely legal, audit and accounting approaches to a broader behavioral focus.

### **i) Make outcome more important than process**

Corporate governance must make good financial outcomes more important than process so that purely legal and formalistic approaches are relegated to a less important role.

## **Conclusions – Improving Corporate Governance**

There are a number of conclusions that we can reach based on this White Paper:

- The corporate governance reforms have embodied two lasting innovations – they focused on the microeconomic level and they were designed to be preventive i.e to prevent problems rather than to cure them after the event.
- However these reforms have not worked and indeed may even have made the problem worse by increasing moral hazard
- The reforms did not work because they emphasize form over substance and compliance process over behavior

***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

In order to make corporate governance more effective we must redress the balance. The key issue is to focus on developing good behaviors and business acumen through training and behavioral change. In this way we will be able to address the unforeseen risks which come from financial innovation and avoid the danger that we may clamp down innovation through an over-reliance on process-based risk reduction approaches.

***White Paper – Booms and Busts, Corporate Governance, and Business Acumen***

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