The so-called global financial crisis has brought to the fore questions about why corporate governance processes, enterprise risk management (ERM) and internal control systems failed to protect financial institutions and economies worldwide from catastrophe.

This time last year I wrote an article for FM analysing the failure of Northern Rock (Study notes, February 2008). In a letter published in the next issue, Malcolm Howard criticised my critique and blamed the bank’s collapse on the regulators instead of its board. “How could [the directors] possibly have predicted that the US sub-prime mortgage crisis would develop and that the money-market tap would be turned off?” he wrote.

The ensuing events in global financial markets serve as a study of why ERM has failed so many organisations – particularly financial institutions subject to the Basel II accord. Much blame has been placed on the credit lending agencies and investment banks, which earned massive fees by developing intricate securitisation packages that few people understood. But rarely has any culpability been admitted by those organisations that unquestioningly accepted easy access to credit and let themselves be carried away by the pursuit of short-term profits and speculative activity that added little or no value, reinforced by inflated executive remuneration packages.

The global financial crisis started in 2007 as a result of falling US house prices and defaults on sub-prime mortgages.
individuals with poor credit histories. These loans allowed US homeowners to borrow up to the full value of their homes, with low initial repayments. But they were unable to refinance when interest rates increased, rendering many homeowners incapable of repaying their mortgages. Foreclosures by lenders and the sale of houses at a loss led to a further decline in the housing market.

The impact of all this on global financial markets largely resulted from the securitisation of such debts. Securitisation involves the pooling of debts, making them available to a wider range of investors, which in turn provides more money for lending. The resulting security often receives a higher credit rating and attracts a lower rate of interest.

Part of the securitisation package was the creation of derivatives known as credit default swaps (CDSs). A CDS is like an insurance policy, under which the buyer makes a payment (a kind of premium) to a seller and receives an amount of money if there is a default in the underlying debt repayment.

Many commentators have argued that it was the use of such derivatives that made the financial system so vulnerable. There has also been criticism of the US Department of the Treasury, the Federal Reserve and the Securities and Exchange Commission for opposing recommendations to strengthen the regulation of derivatives trading.

The portfolios of many financial institutions contained investments with assets derived from bundled home mortgages that had received overly favourable credit ratings. A congressional committee in the US has claimed that the credit ratings agencies were fully aware that their conflicts of interest were giving unduly high scores to risky assets, threatening the stability of the entire system.

The global effects of the sub-prime crisis were an increase in interest rates and a reduction in the availability of credit. In response, governments and central banks announced base-rate cuts, capital injections and lending guarantees to restore liquidity.

In September 2007 Northern Rock experienced a bank run. The UK government provided “lender of last resort” funding and guarantees for depositors. The following year Northern Rock was nationalised.

Bear Stearns, one of the largest US brokers and investment banks, collapsed and was subsequently sold to JP Morgan Chase. The US government intervened by imposing a “conservatorship” to protect mortgage giants Fannie Mae and Freddie Mac from insolvency. Lehman Brothers filed for bankruptcy after the Federal Reserve refused to provide financial support and JP Morgan Chase took over part of its business. Similarly, Merrill Lynch was sold to Bank of America. American Insurance Group (AIG) also suffered a liquidity crisis and had to be supported by the Fed. Washington Mutual, the country’s sixth-largest bank, then went into receivership – the largest banking failure in US history.

In Europe, Fortis was broken up and Hypo Real, Germany’s second-largest mortgage lender, was bailed out by the government. In the UK, Bradford & Bingley also had to be part-nationalised, with Santander picking up the savings part of its business.

Iceland was hit particularly hard because its banks’ debts were six times the size of its annual GDP. Iceland’s three largest commercial banks were taken over by the government and the base rate was increased to 18 per cent under the terms of a loan provided by the International Monetary Fund. The result has been a serious impact on the country’s economy, with sharp falls in the value of its currency and the suspension of its foreign currency exchange market.

Stock markets worldwide have fallen and the global economy faces recession in what many commentators have called the most serious economic crisis since the Great Depression. Many European central banks injected capital into their banking systems and the US government passed the Emergency Economic Stabilisation Act 2008. The government’s “troubled asset relief programme” enabled it to purchase toxic assets from US financial institutions, but in November 2008 the scheme was scrapped, with funds being reallocated to help relieve pressure on consumer credit, including car and student loans. As FM goes to press there are major concerns for the car industry, especially General Motors and Ford, which have called on the US government for help.

Is all this, as Malcolm Howard wrote in his letter of March 2008, easy to see in hindsight without any attribution of blame to the organisations that benefited from what can only be seen as unsustainable strategies? Or should boards have identified the high level of risk in their business models? Where was the scepticism in their questioning of strategy, reported performance and management decisions? And how is ERM and internal control implicated in what can be seen as a major failure of those processes?

The answer to the first questions can be found in the words of one of the world’s most astute and successful investors. Back in 2003 Warren Buffett, chairman of Berkshire Hathaway, warned that “the rapidly growing trade in derivatives poses a mega-catastrophic risk for the economy. Such highly complex financial instruments are time bombs and financial weapons of mass destruction that...”
could harm not only their buyers and sellers, but the whole economic system.”

So did the companies that invested in sub-prime mortgages really understand the risks involved? Did organisations realise how global credit tightening and increased interest rates would affect them? Did their directors have an adequate understanding of what their staff were doing? The investigation into the collapse of Barings Bank in 1995 as a result of dealings by rogue trader Nick Leeson revealed that boards often have no grasp of the complexities of their trading strategies and have inadequate controls to guard against risky activities.

Why are boards so myopic? Buffett believes that executive remuneration packages have been structured in such a way as to encourage greed and short-termism. In the New York Times on October 16, 2008, he repeated his often-used aphorism: “A simple rule dictates my buying: be fearful when others are greedy and be greedy when others are fearful.”

For the answer to how enterprise risk management (ERM) and internal control is implicated, we need to look at how organisations use it. The problem with ERM is that it can too easily become little more than a box-ticking compliance exercise, as Michael Power, professor of accounting at the London School of Economics, has recently pointed out.

More than 30 years ago Royal Dutch/Shell developed the concept of scenario planning. It listened to analysts’ views on global business conditions and prepared itself for the eventuality – if not the timing – of the subsequent oil crisis.

ERM emphasises the need to stand back from the day-to-day business, question the assumptions behind business models, consider “what if?” scenarios and identify responses that might avoid or mitigate the effects of these events if they do arise.

History shows us that such lessons – eg, the dot-com crash and the US savings and loan crisis – repeat themselves, but are not necessarily learned by organisations.

Research has shown that, although financial institutions use sophisticated financial modelling techniques such as value at risk, they have a poor understanding of “operational risk”, defined by the Basel Committee on Banking Supervision as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events that include poor information systems or risk management procedures.

One commentator recently wrote: “I agree with experts who blame the Alan Greenspan era of deregulation and laissez-faire culture for creating this mess. Free-market culture breeds unbridled capitalism, which in turn creates a business culture driven by short-term profit-taking...

Corporate decision-making power [becomes] completely skewed to favour profit-generating functions. This is against the basic principle of risk management: a strong, independent risk organisation that mandates a firm-wide risk management policy, monitors and controls risk limits, and promotes risk management-aligned business and compensation practices. It is apparent that none of this was happening in most, if not all, of the broker dealers and investment banks. Financial innovation driven by exotic structured products and complex derivatives fuelled an artificial boom where firms resorted to excessive leverage and focused on generating maximum returns on capital and maximum bonuses for revenue-generating functions.

“Having said all that, it’s difficult to blame the investment banks completely, since a regulatory environment that promotes extreme free-market culture does not incentivise executive management to take any long-term decisions sacrificing short-term profits. The very fact that regulatory authorities gave short shrift to the level of enforcement and deadlines associated with applying Basel II norms shows how callous they have been.”

So it may be necessary, but not sufficient, to blame the regulators. The banks can’t afford simply to write off the present financial crisis as unforeseeable and ignore the lessons yet again. Buffett foresaw the dangers and converted his investments to cash before the crash, allowing him to invest now in stocks that he sees as undervalued.

Companies need non-executive directors who think like Buffett. Boards must adopt a wider and longer-term perspective on strategy, performance and risk, taking more consideration of the sustainability of their business models. Assumptions must be continually and critically re-evaluated, not taken for granted. Organisations need to learn from this financial crisis and improve their governance, risk management and internal controls – because after the recovery and the bull market that will follow, another bust will surely come.

References