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978-1-107-00187-9 - Corporate Governance and the Global Financial Crisis: International Perspectives

Edited by William Sun, Jim Stewart and David Pollard

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1 *Introduction: rethinking corporate governance – lessons from the global financial crisis*

WILLIAM SUN, JIM STEWART AND DAVID POLLARD

Since the 1980s, worldwide corporate governance issues have attracted much media attention. Issues like corporate fraud, corporate failure and collapse, abuse of management power, excess of executive remuneration, and corporate social and environmental irresponsibility have all been topical in media reports, public forums, academic debates, governmental policy and regulatory agendas. Nevertheless, many of these corporate governance issues would not have been so prominent and exposed, had it not been for the global financial crisis of 2007–10. Many scholars, policy analysts and corporate practitioners have linked the severity and increasingly circular nature of the financial and economic crisis to corporate governance failures, whether systemic, functional or technical (see details in the following sections). Various corporate governance reforms have taken place in Europe and the United States among other countries (several chapters in this volume mention those reforms).

Yet, until now, there has been little research concentrating on an in-depth understanding of what exactly went wrong with corporate governance, how corporate governance failures contributed to the current financial crisis, and how we may reform and improve corporate governance to prevent its future institutional, systemic and moral failures. This volume brings together leading scholars from North America, Europe, Asia-Pacific and the Middle East to explore the systemic failings of corporate governance in relation to the global financial crisis and their underlying theses and approaches, and suggests ways forward for future corporate governance. The volume addresses three general themes that cover the theoretical foundations and dominant approaches of corporate governance, the complex roles of institutional shareholders and boards, and the search for new directions for post-crisis corporate governance research and reforms.

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Generally, this volume takes a critical perspective on corporate governance, aiming at reflecting on corporate governance failures, rethinking what we have believed, accepted or taken for granted in terms of corporate governance perspectives, paradigms, approaches and methodologies, and learning corporate governance lessons from the global financial crisis. The core issues of corporate governance are examined internationally in different societal contexts, yet the international insights are often cross-referencing and reach some similar conclusions, since the current financial crisis is on a global scale and the dominant corporate governance model, like shareholder primacy, has been influential worldwide over decades. This volume is a multidisciplinary research collection contributed by scholars from the disciplinary backgrounds of business and management, economics, law and political science. The contributions are based on multiple methodologies, including conceptual exploration and development, critical review, case study and empirical analysis.

The global financial crisis of 2007–2010

The global financial crisis began with the US subprime mortgage crisis in 2007, triggered by the bursting of a housing bubble in the United States in late 2006. The subprime mortgage crisis was both a real estate and financial crisis, marked by a sharp rise in mortgage delinquencies and foreclosures, dramatic decline in the market value of subprime mortgage backed securities, and a large drop in the capital and liquidity of many banks and financial institutions, as well as widespread tightening credit. In a domino effect, the financial crisis originated in the credit crunch in the United States, spread over quickly to other sectors and countries and caused a series of financial and economic crises such as the collapse of US and European housing markets, collapse of the global stock markets, collapse of the global financial systems, financial markets, and many large banks and financial institutions, the greatest recession of the global economy since the Great Depression and the European sovereign debt crisis. The cost and negative consequences of the financial crisis are immense.

In August 2009 the International Monetary Fund (IMF) calculated that the total cost of the global financial crisis reached \$11.9 trillion, including cash injections into banks, and the cost of purchasing toxic assets, guarantees over debt and liquidity support from central banks. That was equivalent to one-fifth of the entire world's annual economic

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output (Conway, 2009). The Pew Charitable Trusts issued a report stating that between 2008 and 2009 the United States suffered massive losses of income, jobs, wages and wealth, the cost including \$650 billion of GDP income, 5.5 million jobs, \$360 billion in wages, \$3.4 trillion of real estate wealth (July 2008–March 2009), \$7.4 trillion stock wealth (July 2008–March 2009) and \$230 billion fiscal rescue cost. The total cost is equivalent to an average household loss of \$188,250 in the United States alone (Swagel, 2009).

Causes of the global financial crisis were rather complex. On 15 November 2008, leaders of the G20 declared that the financial crisis was caused by (1) ‘market participants [seeking] higher yields without an adequate appreciation of the risks and fail[ing] to exercise proper due diligence’; (2) ‘weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combin[ing] to create vulnerabilities in the system’; and (3) ‘policy-makers, regulators and supervisors, in some advanced countries, not adequately appreciating and addressing the risks building up in financial markets, keeping pace with financial innovation, or considering the systemic ramifications of domestic regulatory actions’.¹ The core theme in the G20 leaders’ declaration of the root causes is particularly linked to financial risks, risks tied up with innovative financial products through ‘securitization’ processes (product risk), vulnerable financial systems (system risk), uncertain and unstable financial markets (market risk), and inadequate policy-making and regulation that might create risks or failed to address risks (policy risk).

The role of corporate governance in the financial crisis: the debate

When a number of large and influential banks and financial institutions and other publicly held companies collapsed or were bailed out during the financial crisis, there was a real concern about the appropriate governance of those corporations. Did those collapsed or nearly collapsed corporations in particular, and all corporations in general, have proper corporate governance practices in the United States and other countries before and during the financial crisis? As many banks and financial institutions were the makers of innovative, yet highly risky, financial products (and derivatives) and/or investors and traders of those financial products, they were either risk-creators

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and -distributors or risk-takers. They were at the centre of the financial crisis with questionable governance practices. However, the question of whether and to what extent corporate governance played a significant role in the financial crisis cannot be answered without a debate. Basically there have been three different views and positions in the debate.

The first view is that the financial crisis was unrelated or little related to corporate governance. Scholars have shown that since the 1970s corporate governance in the United States and other developed countries has improved significantly (e.g., Adams, 2009; Cheffins, 2009). For example, in many companies independent directors were introduced, board chairmen and CEOs were separated, corporate audit and risk committees were established, executive pay was increased and incentive-driven to deliver value for shareholders, minority shareholders' rights were protected, and institutional shareholders and hedge funds became more active in monitoring and disciplining corporations.

Since the 1990s, corporate governance codes in many countries, corporate governance principles and guidelines provided by the Organisation for Economic Co-operation and Development (OECD), the World Bank and the IMF, and corporate governance reforms and regulations had intensively channelled corporate behaviours and actions towards accountability and responsibility. The Sarbanes-Oxley Act of 2002, in particular, is believed to have strengthened corporate governance by making mandatory many best practices of corporate governance, such as board independence and audit procedures, with severe penalties for any breach of the legislation. Thus, in 2006 Christopher Cox, Chairman of the Securities and Exchange Commission (SEC), optimistically reported to the US Congress that 'We have come a long way since 2002. Investor confidence has recovered. There is greater corporate accountability. Financial reporting is more reliable and transparent. Auditor oversight is significantly improved' (quoted in Rezaee, 2007, p. 38).

Hence, the logical conclusion is that publicly held corporations were, in general, governed satisfactorily before and during the financial crisis (Cheffins, 2009), with no significant correlation between corporate governance and the financial crisis. Cheffins suggests that the sharp decline of stock markets in 2008 was not necessarily related to corporate governance performance. Based on his empirical study of

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thirty-seven firms removed from the S&P 500 index during 2008, Cheffins concludes that corporate governance in those firms functioned tolerably well and did not fail in the financial crisis. A further empirical study by Adams (2009), using a large sample of data on financial and non-financial firms from 1996 to 2007, shows that the governance of financial firms was on average not worse than that of non-financial firms. She also indicates that boards of banks receiving bailout money were more independent than the boards of other banks, and bank directors received far less compensation than directors in non-financial firms.

The second view in the debate is that the financial crisis was closely associated with the insufficient implementation of corporate governance codes and principles while current corporate governance frameworks are not wrong in general. This position is presented by the OECD. In June 2009, the OECD Steering Group on Corporate Governance issued a report stating that there are four weak areas in corporate governance contributing to the financial crisis, including executive remuneration, risk management, board practices and the exercise of shareholder rights. It asserted that the principles of corporate governance, as agreed standards among the OECD countries many years before the financial crisis, had adequately addressed those key governance concerns and the 'major failures among policy makers and corporations appear to be due to lack of implementation' of the principles (OECD, p. 55).

Thus, for the OECD, an ineffective implementation of existing corporate governance arrangements and principles is the key issue. The OECD is sceptical of the effectiveness of legislation and regulation in implementing corporate governance principles, and emphasizes the role of voluntary codes and corporate initiatives for better implementation. The UK has made a similar claim that there were no major problems with corporate governance codes prior to the financial crisis and the only problem remained with the implementation of the codes. It is believed that 'complying with the Code in itself constitutes good governance' (Financial Reporting Council, 2010, p. 2).

The third view in the debate is that the financial crisis was at least in part caused by a systemic failure of corporate governance. Perhaps few people would disagree with the OECD's identification of the areas of corporate governance failure, however many people have started to think that the failure of corporate governance may not be purely an

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implementation issue, but more a fundamental systemic failure of institutional arrangements underpinned by several increasingly popular paradoxical assumptions, such as shareholder primacy, profit maximization, effective incentive system, rational self-interest human behaviour, universal agency problems, efficient market for corporate control, etc. As Heineman Jr posits, ‘These board failures [in the financial crisis] represent, in turn, a signal failure of the broad governance movement that gained momentum at the beginning of this decade’ (Heineman Jr, 2008). Using the similar words of Julian Birkinshaw, co-founder of the London Business School’s Management Labs, Caulkin (2009) highlights that the financial crisis is both a failure of the invisible hand of market and a failure of the visible hand of management (including boards and management teams). As the crisis was created by people, the management of financial firms is spotlighted at centre stage. Yet Caulkin makes it clear that ‘management was hijacked by ideology’.

The origins of today’s events can be traced back to the 1970s and the backlash against the cosy corporatism of the 1960s, which would become ‘Reagonomics’. The concern then was that after two decades of post-war easy pickings, the Western economies had gone soft. Faced with formidable competition from Japan and newly emerging Asian economies, bloated Anglo-American conglomerates needed cutting down to size, with managers obliged to focus on shareholders’ rather than their own concerns. (Caulkin, 2009)

The corporate governance framework since the 1980s has largely been shaped by ‘Reagonomics’ – a version of market fundamentalism influenced by neoclassical economics. Caulkin vividly describes such a corporate governance framework:

The company’s job was to make money for shareholders; the individual’s job was to pursue self-interest, allowing the invisible hand to work its magic; and the job of governance was to align ‘agents’ (managers) with ‘principals’ (shareholders) by incentives and sanctions. The carrot was pay linked to stock price, often in the form of stock options. The stick: high levels of debt and a vigorous market for corporate control, which ensured that underperforming assets could readily pass into the hands of sharper managers at hungrier companies. (Caulkin, 2009)

Ultimately, it is the Anglo-American corporate governance paradigm and underlying assumptions that have troubled the finance industry and the whole economy. For example, Visser (2010) argues

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that we have been facing multifacets of greed permitted or encouraged by governmental policies, institutional arrangements, ideologies and cultures. Self-interest and incentive systems led to executive greed, leveraging and risk transfer led to banking greed, deregulation and speculation led to financial market greed, self-regulation and short-term profit maximization led to corporate greed, and shareholder capitalism led to capitalist greed. Clarke (2009) further criticizes the Anglo-American model of corporate governance and states that this model, in its US manifestation, has enabled, permitted or tolerated excess power and wealth at the hands of CEOs, and incentivized investment bank executives to pursue vast securitization and high leveraging to enrich themselves greedily at the severe cost of shareholders, investors and other stakeholders. While the Anglo-American model of capitalism had been paradigmatically promoted to the rest of the world, it evidently induced the collapse of the financial institutions worldwide.

Generally, we take the third view in the above debate. We may agree that corporate governance reforms in developed countries in recent years have generated some fruitful outcomes, such as independent boards, shareholder activism and widely accepted codes and principles as best practices. However, if we also agree that corporate governance not only failed to prevent the financial crisis, but actually encouraged and permitted corporations to create and take excessive financial and business risks for short-term profit maximization, we may see that the problem with corporate governance is not just some technical or implementation issues. The problem is systemic and fundamental, involving models, paradigms, approaches and the orientation of corporate governance systems. Now that the Anglo-American corporate governance model has gained momentum globally since the 1990s through the globalization movement and global capital flows, the unprecedented and greatest global financial crisis since the Great Depression has taught us to rethink whether the failure of corporate governance resides in the model and paradigm itself, in its underlying theses and associated approaches.

The systemic failure of corporate governance

To understand the systemic issues of corporate governance, we should return to the basic question: what is corporate governance? Both the Cadbury Code and the OECD provided the same definition of

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corporate governance: ‘Corporate governance is the system by which business corporations are directed and controlled’ (Cadbury, 1992, p. 15; OECD, 1999). However, as Monks and Minow (2001) and Clarke (2007) among others note, the common understanding of corporate governance is often narrowly confined to the structure and functioning of the board or the rights of shareholders in corporate decision-making. For example, in the UK Corporate Governance Code corporate governance is defined as being ‘about what the board of a company does and how it sets the values of the company’ (Financial Reporting Council, 2010). Yet, Margaret Blair takes a much broader view of corporate governance and refers corporate governance to ‘the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated (Blair, 1995, p. 19).

Further to Blair’s definition, we think that corporate governance mainly involves four-level legal, cultural and institutional arrangements, including regulatory governance, market governance, stakeholder governance and internal (or shareholder) governance. Thus in a broad sense, ‘corporate governance system’ refers to the whole set of regulatory, market, stakeholder and internal governance. Regulatory governance means the public order and control over corporations by state statutes, governmental and professional bodies’ regulations, and government policies. Market governance is the use of various market mechanisms (such as supply and demand, price signal, free competition, market entrance and exit, market contract and market bid) to control and discipline corporate behaviour and action. Stakeholder governance is the direct and indirect control or influence over corporate business, decision-making and corporate behaviour by key stakeholder groups who have direct or indirect interests in the corporation. Typical stakeholders may include investors, banks, suppliers, customers, employees, government and local communities. Internal corporate governance is the institutional arrangement of checks and balances among the shareholder general meeting, the board of directors and management within the corporation, prescribed by corporate laws.² While the board may be at the centre stage of internal governance, as many people believe, the shareholder general meeting and management are equally important in the checks and balances.

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However, many people tend to neglect the close triple relationship in internal governance and mistakenly regard shareholders and their representatives on the board as ‘outsiders’ rather than ‘insiders’ in the internal corporate governance structure.³ Indeed, it is contradictory to see shareholders as ‘owners’ and members, yet ‘outsiders’, of the corporation.

What does a systemic failure of corporate governance mean for the financial crisis? First of all, there was a regulatory failure in governing financial companies before the financial crisis, manifested in substantial deregulation and lack of regulation in the finance industry. In this volume, Thomas Clarke (Chapter 2), Roman Tomasic (Chapter 3) and Roland Pérez (Chapter 6) address the regulatory problems (deregulation, regulatory gap and self-regulation) as a key source of the weak corporate governance system that contributed to the financial crisis. In 1933, in his inaugural address, the US President Franklin D. Roosevelt declared that ‘There must be a strict supervision of all banking and credits and investments; there must be an end to speculation with other people’s money’ (Rosenman, 1938, p. 14). However, the strict supervisory rules over the finance industry in response to the Great Depression had been gradually abandoned from the 1980s onwards when neo-liberal ideology became prevalent and dominant all over the world.

The typical example is the Gramm-Leach-Bliley Act passed in the US Congress in 1999, which repealed the Glass-Steagall Act of 1933 separating commercial banks from investment banks. While commercial banks were allowed to use ordinary people’s savings to speculate in financial markets with excessive risks taken, this new enactment symbolized ‘The Death of Gentlemanly Capitalism’ (Augar, 2001) and the new era of ‘Casino Capitalism’ (Strange, 1997). In 2000, the US Congress passed the Commodity Futures Modernization Act, which allowed the self-regulation of futures and derivatives, declaring that all attempts to regulate the derivatives market are illegal (Mason, 2009). Derivatives, what Warren Buffet referred to as ‘financial weapons of mass destruction’ in 2003, were then astonishingly traded. In 2007, the world GDP was around \$65 trillion in total, the total value of the companies listed in the world stock markets was at its all time peak of \$63 trillion, but the total value of derivatives was \$596 trillion – more than eight times the size of the real economy (Mason, 2009).

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Other significant regulatory failures may include the permission of investment banks to substantially increase their debt level and leverage; the permission of depository banks to move massive amounts of assets and liabilities off balance sheets into structured investment vehicles and conduits to hide their debts, insufficient capital and high risks taken; and the lack of regulation over the shadow banking system, consisting of non-depository bank financial institutions to lend businesses money or invest in 'toxic assets' (such as subprime mortgage backed securities) with a significant high level of financial leverage.

The advocacy of deregulation and self-regulation came with the idea that the market is the most efficient and rational way of allocating resources, monitoring corporations and disciplining corporate underperformance and misbehaviour. For neoclassical economists, pressure from the market for corporate control, the capital market and the managerial labour market are the most powerful force to align the interests of managers with the interests of shareholders. Market governance is seen as the best alternative to institutional deficiencies and hierarchical governance failures (for more details and references, see Sun, 2009, pp. 21–6). However, the key assumption of market efficiency and rationality has long been criticized as too simplistic and counter-experiencing (e.g., Rescher, 1988; Fligstein, 1990; Hampden-Turner and Trompenaars, 1994; Roy, 1997), as the assumption is based on purely calculative and deterministic economic conditions outside social interactive and interrelated processes and individually multiple and complex experiences, which are not simply and straightforwardly rational and efficient. The efficient market hypothesis depends on an even flow of information through to the market. Hence, disclosure and transparency are prerequisites for market efficiency.

However, Steven L. Schwarcz (Chapter 5) points out that although most of the risks were disclosed in the financial market as required by the US federal regulations, the disclosure was still ineffective. Apart from the problem of information asymmetry, there is a problem of information failure inherently embedded in a 'complex system' of financial markets where price volatility and liquidity were nonlinear functions of patterns arising from the interactive behaviour of many independent and constantly adapting market participants. Not only can this produce cognizant complexity (i.e., too complex to