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Corporate Governance Practices and Financial Crisis: Literature Review

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Abstract

With the ongoing global financial distress and recession, the issue of governance mechanism has become even more important and is being highly discussed. Starting with distresses caused by misuse of risk controls for dreadful obligations, collateralization of obligation protection and misrepresentation, significant financial foundations in the United States and Europe confronted a credit crisis and a break in financial movement. The crisis quickly formed and spread into a worldwide financial shock, bringing about various European bank disappointments, decreases in different stock records, and extensive declines in the market estimation of values and items. Corporate Governance (CG) aims to reduce the likelihood of deception, malpractices, monetary frauds and delinquency of management (Ubha and Cahill, 2007). This study analyses the impact of failures and weaknesses in corporate governance on the financial crisis. It concludes that the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies. Accounting standards and regulatory requirements have also proved insufficient in some areas. Last but not least, remuneration systems have in a number of cases not been closely related to the strategy and risk appetite of the company and its longer term interests. The article also suggests that the importance of qualified board oversight and robust risk management is not limited to financial institutions. The remuneration of boards and senior management also remains a highly controversial issue in many countries.

Keywords: Corporate Governance (CG), Finance Crisis, Risk Control System, Transparency, Disclosure, Board Oversight.

1. Introduction

With the ongoing global financial distress and recession, the issue of governance mechanism has become even more important and is being highly discussed. More specifically, Corporate Governance (CG) practices of big companies and role of different special committees are being closely reviewed and has gained new focus as a means of improving economic efficiency. Chhaochharia and Grinstein (2007) noted that CG rules have an economically significant impact on firm value. Countries globally were affected, some harder than others, by the change of uncertain lending and extremely leveraged investment approaches by Western financial intermediaries that rapidly surrounded the world in an economic and financial emergency between 2007 and 2009. Besides, the de-utilizing of money related organizations additionally quickened the liquidity emergency and caused a decline in global exchange. It has been contended that if individuals or firms have an adequately solid drive to apply CG, unavoidable outcomes may not happen as a shock. Political and economic uncertainty had subsided by then, which the credit rating organizations distinguished by lifting their ratings, generating an increase in foreign direct investment (FDI) inflows.

The recent financial crisis in 2008 is frequently termed as the maximum serious monetary disaster after the terrific depression of 1930's (Blundell-Wignall et al., 2008; Cheffins, 2009; Kirkpatrick, 2009; Clarke, 2010; Lang and Jagtiani, 2010). Numerous researchers and reports reviewed the reasons of this worldwide monetary disaster (Clarke, 2010; Laeven et al., 2010; Lang and Jagtiani, 2010; Tarraf, 2010; UNTACD, 2010; Yeoh, 2010). Many researchers implicate CG as one of the fundamental reasons for international crisis, at the same time as different factors play most effective a supplementary function (Kirkpatrick, 2009; Yeoh, 2010; Fetisov, 2010).

Several deficiencies in the CG shape and techniques caused the disintegration of many monetary establishments, and triggering the crisis. Many banking and financial institutions did no longer pay due attention to CG before and in the course of the crisis. Hence, the main objective of this study is to critically examine the association between financial crisis and CG and relate it to the sustainability of the listed firms. A brief overview of financial crisis, CG, global financial crisis, contributor to financial crisis, impact of financial crises on large and small business, financial crises in USA, Europe and Asia and its association with CG, learning from the financial crises and major changes in CG have been focused based on literature review and different reports.

2. Financial Crisis

The term financial crisis is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults. Major corporate and accounting scandals of Enron, Tyco International, Adelphia, Peregrine Systems, and WorldCom cost investors billions of dollars when the share prices of affected companies collapsed, and shook public confidence in the US securities markets.

The financial crisis revealed severe shortcomings in CG (OECD, 2008). When most needed, existing standards failed to provide the checks and balances that companies need in order to cultivate sound business practices. Pisano et al. (2012) pointed out that, recent reforms, like the Euro emergency, the financial and economic disaster, spectacular cuts in public budgets etc. seem to advocate that the existing set up of financial markets is no longer sufficient in economic, social, and political stipulations, neither in a short nor in a long-term point of view.

3. Corporate Governance

The modern notion of CG, the two buzz words have been commonly used in the English-speaking world since the 1990s due to the series of failures of big corporate houses in western world as a top concern both for the international business community and financial institutions. The issue of CG arises from the agency theory that clearly defines the possession of a corporate body is alienated from its administration and power (Berle and Means, 1932). CG is the structure of rules, practices and procedures by which an organization is intended for and controlled. Akhigbe and Martin (2008) have demonstrated that measures of financial firms’ short- and long-term risk taking are inversely correlated with their governance structures’ strength. CG fundamentally grips harmonizing the interests of the various stakeholders in an organization - these comprise its shareholders, executives, customers, vendors, financier, government and the community.

A CG structure should defend shareholders' right, such as voting right, right to choose board associate, right to get pertinent information, cooperate and commune with the management, evenhanded treatment of all shareholders (Tricker, 1984). A research has disagreed that an entity is exaggerated by the association among the participants in the structure of governance (Kharouf, 2000). Controlling shareholders can radically influence corporate activities. However, all shareholders should able to obtain effective redress for infringement of their rights and forbids insider trading and obnoxious dealing in their own interests. In contrast, good CG reinforces possessions rights; reduce transaction cost and the cost of capital, and directs to capital market growth (Claessens and Fan, 2002). CG aims to reduce the likelihood of deception, malpractices, monetary frauds and delinquency of management (Ubha and Cahill, 2014).

Lang and Jagtiani (2010) analyzed the roles that CG and risk management played in events just prior to the 2008 crisis. The shocks leading to the crisis were events risk managers would have assessed, so they attributed the crisis to failures in risk management and CG. In their view, most firms failed to appropriately apply fundamental risk management principles, which caused many to fail to appreciate the extent of their mortgage market exposure.

4. Global Financial Crisis

A variety of complex factors created the conditions and culture in which a series of large corporate frauds occurred between years 2000 to 2002. The remarkable, highly publicized frauds at Enron, WorldCom, and Tyco exposed significant problems with conflicts of interest and incentive compensation practices. The analysis of their complex and contentious root causes contributed to the passage of SOX in 2002. Investors had been stung in 2000 by the sharp declines in technology stocks and to a lesser extent, by declines in the overall market. Certain mutual fund managers were alleged to have advocated the purchasing of particular technology stocks, while quietly selling them.

World economic recession is going on from 2007. It is the result of fall of world's financial and capital market. During the financial crisis of 2007–2010, critics blamed Sarbanes–Oxley for the low number of Initial Public Offerings (IPOs) on American stock exchanges during 2008. The main reason of this recession is the crisis of mortgaged loans in the USA. It started in the housing sector. The economists identified two prime reasons for this recession, a) Sub Prime lending, and b) Uncontrolled credit default. A common claim during the first weeks of the financial crisis was that the problem was simply caused by reckless, sub-prime lending. However, the sub-prime mortgages were only part of a far more extensive problem affecting the entire $20 trillion US housing market: the sub-prime sector was simply the first place that the collapse of the bubble affecting the housing market showed up.

The disaster of 2007-08 was a disaster without a doubt international in nature that affected all regions and countries of the world (Clarke, 2010). The size and attain of this crisis become worrisome, and much larger than the sooner location precise crises in Asia, Japan and America, and changed into handiest akin to the splendid melancholy. The fall of share prices on a single day became even extra than the terrific despair of the Nineteen Thirties (Cheffins, 2009). The worldwide monetary fund (IMF) predicted the capability losses from this disaster have been approximately $1400 billion as much as the stop of October 2008 (Clarke, 2010). The global crisis turned into initiated inside the latter a part of 2006 and globally by 2008.

5. Contributor to Financial Crisis

Financial crises are sometimes viewed as a vicious circle in which investors shun some institution or asset because they expect others to do so. Few common contributors identified by many researchers are Leverage, Asset-liability mismatch, Uncertainty and herd behavior, Regulatory failures, Fraud, and Contagion. Many scholars have studied the financial crises from the perspective of CG (Fetisov, 2009; Clarke, 2010; Lang and Jagtiani, 2010; Tarraf, 2010). Numerous lapses in CG association and techniques attributed to the fall apart of monetary institutions main to the economic disaster (Kirkpatrick, 2009; Yeoh, 2010). Clarke (2010) suggests that systematic disaster because of the failure of worldwide monetary market became also the crises of CG and regulation. Before and throughout the disaster, CG problems did get deserved attention that changed into surely required, which cause the fall apart of many economic institutions. United nations convention on trade and development (UNCTAD report, 2010), attributed poor CG practices as a cause of global financial disaster implicated via fragile and the inferior threat management gadget in many failed economic institutions. It also concluded that pervasive chance taking by means of monetary establishments brought on the worldwide financial crisis.

Clarke (2010) agreed that remuneration regulations for managers have been designed in methods that give incentives for high-danger taking he concluded that severe hazard taking coupled with faulty remuneration structure in banking and financial establishments brought about this crisis. Appropriate risk management system changed into no longer located in financial establishments to cope with complicated products. Bonuses for executives have been primarily based on prematurely income from enterprise in preference to their real accomplishment. Further, lack of time-honored accounting and valuation resulted in loss of transparency and misrepresented disclosure to shareholders.

Pirson and Turnbull (2010) suggested that directors and boards of Anglo-American CG structures did not perform their obligations properly. Boards didn't preserve test on risk management device and administrators could not manage the excessive risk taking conduct of control. Yeoh (2010) studied many economic institutions in the course of the financial disaster. He directed attention to intense lapses in transparency and disclosure norms and raised questions on the role of non-government administrators in financial institutions.

5.1 Financial Crisis in Europe

In Europe, a number of major financial institutions failed. Others needed rescuing. In Iceland, where the economy was very dependent on the finance sector, economic problems have hit them hard. The banking system virtually collapsed and the government had to borrow from the IMF and other neighbors to try and rescue the economy. In the end, public dissatisfaction at the way the government was handling the crisis meant the Iceland government fell. A number of European countries have attempted different measures.

5.2 Financial Crisis in USA

Banks and financial institutions that bought security-paper have lost money. In its latest calculations, the IMF reckons that worldwide losses on “toxic assets” originated in America will reach $1.4 trillion. Normally the banks and financial institutions lend and borrow money and the money market works well. During the crisis, money markets ceased to function as investors and banks who ordinarily arrange foreign exchange swaps among themselves for a set time period are nervous about the risk that their counter-party will go bust because of liability of "toxic assets" while the swap is being put into place and so have shied away from such deals. Thus the global money market was closed and a severe credit-crunch was felt across the world. If it were allowed to continue further it would have led to depression.

At the heart of the portfolios of many of these institutions were investments whose assets had been derived from bundled home mortgages. Exposure to these mortgage-backed securities, or to the credit derivatives used to insure them against failure, threatened an increasing number of firms such as Lehman Brothers, AIG, Merrill Lynch, and HBOS. Other firms that came under pressure included Washington Mutual, the largest savings and loan association in the United States, and the remaining large investment firms, Morgan Stanley and Goldman Sachs. At the end of October a currency crisis developed, with investors transferring vast capital resources into stronger currencies such as the yen, the dollar and the Swiss franc, leading many emergent economies to seek aid from the International Monetary Fund (European Debt Crisis, 2011).

The recent financial crisis has raised several questions with respect to the CG of financial institutions (Aebi et al., 2012). By using a sample of up to 372 US banks and focus on the credit crisis of 2007/2008, they investigated whether risk management-related CG mechanisms are associated with a better bank performance during the financial crisis of 2007/2008. They found out that banks, in which the CRO directly reports to the board of directors and not to the CEO (or other corporate entities), exhibit significantly higher (i.e., less negative) stock returns and ROE during the crisis. In contrast, standard CG variables are mostly insignificantly or even negatively related to the banks' performance during the crisis. They also observed that standard CG mechanisms do not improve banks' crisis performance.

5.3 The Most Serious Financial Crisis since the 1929 Wall Street Crash

When viewed in a global context, taking into account the instability generated by speculative trade, the implications of this crisis is far-reaching. The crisis, however, has by no means reached its climax. It could potentially disrupt the very foundations of the international monetary system. The repercussions on people's lives in America and around the world are dramatic. The crisis is not limited to the meltdown of financial markets, the real economy at the national and international levels, its institutions; its productive structures are also in jeopardy. As stock values collapse, lifelong household savings are eroded, not to mention pension funds. The financial meltdown inevitably backlashes on consumer markets, the housing market, and more broadly on the process of investment in the production of goods and services.

6. Impact of Financial Crisis on Businesses

6.1 Impact of Financial Crisis on Large Business

Key CG principles namely: strong board oversight, appropriate remuneration practices tied to performance as well as risk, and transparency, have a significantly effects on how a business is impacted in a financial crisis. Following are the impacts of financial crisis on large businesses.

Falling Stocks and Slumping Dividends

As declining revenues show up on its quarterly earnings report, the manufacturer's stock price may decline. Dividends may also slump, or disappear entirely. When the manufacturer's stock falls and the dividends decline or stop, institutional investors who hold that stock may sell and reinvest the proceeds into better-performing stocks. This will further depress the company's stock price.

Credit Impairment and Bankruptcy

Accounts Receivable is also impacted by the recession. The customers of the company that owe it money may pay slowly, late, partially or not at all. Then, with reduced revenues, the affected company will pay its own bills more slowly, late, or in smaller increments than the original credit agreement required. Late or delinquent payments will reduce the valuation of the corporation's debt, bonds and ability to obtain financing. The company's ability to service its debt (pay interest on the money it has borrowed) may also be impaired, eventuating in defaults on bonds and other debt, further damaging the firm's credit rating and preventing further borrowing. If the company's debts cannot be serviced and cannot be repaid as agreed upon in the lending contract, then bankruptcy may ensue. The company will then be protected from its creditors as it undergoes reorganization, or it may go out of business completely.

Employee Lay-offs and Benefit Reductions

The business may cut employees, and more work will have to be done by fewer people. Productivity per employee may increase, but morale may suffer as hours become longer, work becomes harder, wage increases are stopped and fear of further layoffs persists.

Cuts to Quality of Goods and Services

Secondary aspects of the goods and services produced by the recession-impacted manufacturer may also suffer. In an attempt to further cut costs to improve its bottom line, the company may compromise the quality, and thus the desirability, of its products. This may manifest itself in a variety of ways and is a common reaction of many big businesses in a steep recession.

Reduced Consumer Access

As firms impacted by the recession spend less money on advertising and marketing, big advertising agencies which bill millions of dollars per year will feel the squeeze. In turn, the decline in advertising expenditures will whittle away at the bottom lines of giant media companies in every division, be it print, broadcast or online. As the effects of a recession ripple through the economy, consumer confidence declines, perpetuating the recession as consumer spending drops.

6.2 Impact of Financial Crisis on Small Businesses

The impact of any financial crisis such as recession on small businesses is similar to large businesses. Small businesses usually lacks in significant liquidity and asset valuation comparative to the large business. Without major cash reserves and large capital assets as collateral, smaller businesses may have a harder time surviving a recession. Bankruptcies among smaller businesses may therefore occur at a higher rate than among larger firms. The bankruptcy or dissolution of a small business that serves a community can create hardships not only for the small business owners, but for residents of the neighborhood. In the wake of such bankruptcies or dissolutions, the entrepreneurial spirit may take a hit, discouraging, at least for a while, any risky business ventures. Too many bankruptcies may also discourage banks, venture capitalists and other lenders from making loans for startups until the economy turns around.

Good CG will certainly help to mitigate the financial crisis on small business though it would be difficult to nullify the impact of financial crisis on small business.

7. Asian Financial Crisis and Corporate Governance

The "Asian Crisis" of 1997–98 affected all the "emerging markets" open to capital flows. Measures of CG, particularly the effectiveness of protection for minority shareholders, explain the extent of exchange rate depreciation and stock market decline well than standard macroeconomic measures. A possible explanation is that in countries with weak CG, worse economic prospects result in more expropriation by managers and thus a larger fall in asset prices. The Asian financial crisis further showed that conventional and alternative CG mechanisms can have limited effectiveness in systems with weak institutions and poor property rights (Claessens and Fan, 2002).

Mitton (2002), in his study, a sample of 398 firms from Indonesia, Korea, Malaysia, the Philippines, and Thailand, and found out that firm-level differences in variables related to CG had a strong impact on firm performance during the East Asian financial crisis of 1997–1998. Significantly better stock price performance is associated with firms that had indicators of higher disclosure quality, with firms that had higher outside ownership concentration, and with firms that were focused rather than diversified.

From a sample of 800 firms in eight East Asian countries to study the effect of ownership structure on value during the region's financial crisis, Lemmon and Lins (2003) found out that the crisis negatively impacted firms' investment opportunities, raising the incentives of controlling shareholders to expropriate minority investors. Crisis period stock returns of firms in which managers have high levels of control rights, but have separated their control and cash flow ownership, are 10–20 percentage points lower than those of other firms. The evidence is consistent with the view that ownership structure plays an important role in determining whether insiders expropriate minority shareholders.

Destitute CG of banks can compel the market to lose self-confidence in the aptitude of a bank then it leads to financial crisis in a country and persuade systemic risk (Marco & Fernández, 2008). Kirkpatrick (2009) concluded that the financial crisis can be to an important extent attributed to failures and weaknesses in CG arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies.

To find whether corporate financial distress is identified with these corporate administration attributes, Lee and Yeh (2004) received three factors to intermediary for corporate administration chance, to be specific, the level of executives involved by the controlling investor, the rate the controlling investors shareholding promised for bank advances (vow proportion), and the deviation in control far from the income rights in light of Taiwanese listed firms, portrayed by a high level of possession fixation, like that in many nations. The confirmation proposed that the three factors are decidedly identified with the hazard for financial grief in the following year. They additionally watched that organizations with weak CG are vulnerable to economic downturns and the probability of falling into financial distress increases.

During the 1997 Korean financial crisis, firms with higher ownership concentration by unaffiliated foreign investors experienced a smaller reduction in their share value (Baek et al., 2004). Firms that had higher disclosure quality and alternative sources of external financing also suffered less. In contrast, firms with concentrated ownership by controlling family shareholders experienced a larger drop in the value of their equity. Firms in which the controlling shareholders' voting rights exceeded cash flow rights and those who borrowed more from the main banks also had lower returns. Thus, they suggested that change in firm value during a crisis is a function of firm-level differences in CG measures.

8. CG – Lessons from Crisis

The highlighted areas of CG concerns within the financial crisis had been risk management, remuneration structures, the board and director's role, transparency and disclosure, and protection of shareholder rights. Arping and

Sautner (2010) analyzed whether SOX enhanced corporate transparency. Corporate transparency is measured based on the dispersion and accuracy of analyst earnings forecasts. Donelson et al. (2017) indicated that firms with reported material weaknesses have significantly higher fraud.

Diverse academicians, researchers and regulators of their analysis have counseled key lessons for future CG reforms. The OECD report (Key Findings and major Message, 2009) diagnosed four regions (governance of remuneration, risk management, board practices, shareholders rights) for CG reforms. OECD in an in advance evaluation (Kirkpatrick, 2009) ascertained the regions of weak point to be inside the remuneration system, risk control, board practices and shareholder rights; and then made tips for reforms and high-quality practices related to the ones areas. The European Commission (2009) lessons for improving the remuneration system, identified four areas of improvements: 1) structure of director remuneration, 2) severance pay, 3) balance between fixed and variable pay, and 4) liking compensation with performance. Pirson and Turnbull (2010) with a concern for improving risk control and oversight suggested and proposed a network corporate system that would help a board get feedback on different risk factors from various stakeholders in the early stages. Adams (2009) stated to reduce risk taking behavior, directors must be adequately paid to meet the difficulties and bear the responsibilities of their position. Laeven et. al. (2010) emphasized collection of information and disclosure of that information to the shareholders for better transparency. He further suggested addressing the issue of volatility by using fair value accounting and transparency on off balance sheet items.

9. Conclusion

The financial crisis became truly an international crisis in terms of effect. It affected nearly all the economies of the sector and losses incurred through shareholders and traders have been extremely good. The whole world is going through global financial crisis specially the develop countries such as USA, EU, Japan, Australia affected by financial crisis. There are lot of financial organization was collapsed.

The global economic crisis that erupted in 2008 challenges current theories of effective CG (Tarraf and Majeske, 2011). The literature assessment carried out on this paper showed numerous elements of CG that failed at some point of the global crisis in monetary establishments: risk control system, transparency and disclosure, board oversight practices, and remuneration system. Various academicians and researchers have drawn considerable lessons that relate to poor factors of CG highlighted by the effects of the disaster. To overcome this situation, act like Sarbanes-Oxley was developed and US govt. & EU authority has taken some good steps, such as bailout problem financial assistance.

The report has provided a review of regulatory developments in the wake of the financial crisis and the implications for corporate governance disclosure and notes that corporate governance failures have been implicated in almost every national and international analysis of the causes of the global financial crisis. Measures put in place in financial institutions through government regulation are now established as best practice in corporate governance. Measures that appear to be common to many of the corporate governance reforms that were undertaken in various jurisdictions over the past year include: Structure of director remuneration, Severance pay, Balance between fixed and Variable pay, and liking compensation with performance. Policy makers may wish to use this report as a guide to developments that has occurred in the wake of the financial crisis.

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