

# Problems in the Governance of Financial Companies and whether Current Corporate Regulation Can Prevent the Recurrence of Financial Crises

Yihan Jiang \*

Mathematics Department, University of California, Santa Cruz, CA 95064, United States

\* Corresponding author. Email: ydai42@ucsc.edu

**Abstract.** During the financial crisis of 2008, global economics experienced an immense impact and the majority of the financial firms were affected a lot. In the aftermath of the crisis, experts have analyzed the major problems that emerged in the management of financial companies during the financial crisis, and have solved these problems. However, the outbreak of the financial crisis has a variety of causes, such as war, and disaster. A lot of the blame has been placed on subprime mortgage defaults. But the fact is that the bad loans of the bank existed for a long time. Contrary to common belief, the primary cause of the crisis was not subprime mortgage defaults, but rather a lack of corporate governance, according to the Association of Chartered Certified Accountants. Therefore, this paper analyses one of the reasons is the problems of financial companies in management, and the paper is divided into specific problems, solutions, contrast and conclusion to go over my point of view that the poor management of financial companies led to the 2008 financial crisis.

**Keywords:** Financial crisis, financial companies' management, Global economic.

## 1. Introduction

### 1.1. Background

During the 2008 financial crisis, the global economy took a beating, and most financial institutions were severely harmed. Following the crisis, professionals examined and resolved the major issues that arose in the administration of financial firms during the financial crisis. However, there are several causes for the onset of the financial crisis, such as wars and natural catastrophes. Subprime mortgage failures bore a large share of the blame. Banks, on the other hand, have a lengthy history of making faulty loans. According to the Association of Chartered Certified Accountants [9], contrary to common assumption, the major cause of the crisis was not subprime mortgage defaults, but corporate governance failings. As a result, this paper plans to explore one of the causes, financial company management, and my paper is separated into particular issues, answers, comparisons, and conclusions to discuss my thoughts on financial firms' bad management until the 2008 financial crisis.

### 1.2. Related research

Using a large data sample of non-financial and financial organizations from 1996 to 2007, Adams demonstrates that financial firms have no poorer governance than non-financial enterprises on average. Adams employs a basic governance score and governance index to assess how well-governed bank and non-bank financial organizations appear to be in comparison to non-financial companies. Adams also found that bank directors were paid far less than their non-financial firm counterparts and that banks receiving bailout cash had more independent boards than others. The findings show that existing governance strategies' concentration on governance measures is insufficient to identify governance shortcomings attributed to financial institutions. Furthermore, recent governance improvements may be required to assume some of the responsibilities of financial firm boards [1]. It went had two big economic downturns between 2000 and 2010. The collapse of the Internet bubble, as well as the ensuing bear market from 2000 to 2002, pushed Congress to establish Sarbanes-Oxley, a key component of corporate governance. The housing bubble burst towards the end of the decade, resulting in a severe credit shortage and the worst recession in decades.

As a result, Congress approved the Dodd-Frank Act, which altered a variety of financial rules. Among these modifications are substantial corporate governance improvements. Bainbridge inquired about the modifications in two ways. First and foremost, are they a good notion for improving corporate governance? Second, what do they say about the relative benefits of the federal government against states as providers of corporate governance regulation? Corporate law has traditionally been the province of the states. However, the federal government is now becoming more active in corporate governance regulation. The modifications investigated in this paper present a series of case studies to investigate whether federalization improves results. Bainbridge examines these shifts in the context of corporate governance, CEO remuneration, corporate fraud and transparency, shareholder activism, corporate democracy, and deteriorating competitiveness in the United States' capital markets [2]. Since 2007, financial markets, the banking system, and the real estate, commodities, and energy markets have been more integrated, volatile, and subjected to many shocks. G20 and market authorities must work together more closely [3].

The global financial crisis has highlighted corporate governance challenges. The legislative actions required to alter all firms' risk management, CEO compensation, and transparency procedures in order to improve corporate governance are examined [4]. Erkens et al. explore the impact of corporate governance on the performance of financial organizations during the 2007–2008 financial crisis. Using a unique dataset of 296 financial businesses from 30 countries at the epicenter of the crisis, we discover that firms with more independent boards and larger institutional ownership incurred worse stock returns throughout the crisis. Further investigation suggests that this is due to two factors: (1) firms with higher institutional ownership took more risk before the crisis, resulting in larger shareholder losses during the crisis period; and (2) firms with more independent boards raised more equity capital during the crisis, resulting in a wealth transfer from existing shareholders to debtholders. Overall, our findings contribute to the field by investigating the corporate governance drivers of financial company performance during the 2007–2008 financial crisis [5]. The fast emergence of types of cyber governance over the last 20 years has been a phenomenon. The academic community has paid close attention to this style of governance, but no comprehensive theory has been provided, nor has a sufficiently precise and theoretically coherent description arisen. Jones, Hesterly, and Borgatti's purpose are to propose a theory that explains the conditions under which well-defined network governance has a competitive advantage and may thus originate and thrive. The theory combines transaction cost economics with social network theory, and network forms of governance, in general, are reactions to asset specificity, demand uncertainty, task complexity, and frequency. These *quid pro quos* encourage enterprises to structurally embed their transactions, allowing them to leverage social processes to coordinate and safeguard exchanges. When all of these prerequisites are met, forms of network governance outperform hierarchically and market solutions in terms of adapting, coordinating, and securing exchanges [6].

Shann proposes eight causes for people's mistrust of massive, complicated Anglo corporations, as well as methods to eradicate them. The abundance of information about directors, but also the paucity of information independent of management to analyze management and the firm, are two factors. A third factor is that directors lack a systematic approach for determining if their faith in management is misplaced. The fourth and fifth reasons are that directors have complete control over how they handle their own conflicts of interest, and powerful shareholders can participate in related party transactions that unfairly extract wealth. The sixth and seventh factors are the director's drive to avoid reporting to colleagues and the director's inability to operate alone. The eighth argument is that stocks may be manipulated and traded in secret. Four amendments to the articles of incorporation were identified as necessary to resolve these problems. These include the formation of an oversight committee, the implementation of cumulative voting by directors, the formation of a stakeholder group, and the implementation of sunshine stock trading [7]. The bank failed in 2008 because people who knew the risks lacked access to those with the incentive and capacity to take remedial action. The reports of the Lehman Liquidators and the Financial Crisis Inquiry Committee give proof of this problem. Cyber governance may enhance communication and control inside and between banks, their

regulators, and stakeholders. Legislators and/or regulators can implement cyber governance by compelling bank shareholders to alter their corporate bylaws to provide a division of power with checks and balances with stakeholders, who can function as complementary and/or co-regulators. This decentralized regulatory architecture allows basic creatures to live in complex, dynamic, and unexpected settings while avoiding communication mistakes and/or overload. Communication and control Natural Science, as defined by Wiener in 1948, explains why nature lacks centralized management and communication systems. This regulatory system science explains why regulators and huge organizations are unable to manage, control, or consistently govern complexity. The example of significant cyber governance organizations demonstrates that they have gained long-term operational gains across the business cycle. This demonstrates how natural systems may be used to give design requirements for improving the efficiency of company operations, governance, and regulation [8].

In the United States alone, \$10.2 trillion has been lost in the last two years. 45 percent of the world's wealth has been lost in the last year, and the United States has witnessed three of the greatest bankruptcy cases. The catastrophe occurred again, just when most observers felt Enron had learned its lesson. Massive government involvement, the collapse of the financial system, and public indignation over CEO missteps have all revealed the flaws in the mainstream corporate governance structure. According to the Association of Chartered Certified Accountants, corporate governance failings, not subprime mortgage foreclosures, were the primary cause of the crisis. The OECD is developing new rules for corporate governance, while public officials are advocating for more extensive and stringent regulation. How likely are these reforms to help avert future crises? This is unlikely to happen unless Anglo-Saxon corporate governance and regulatory institutions are fundamentally rethought. As a result, Turnbull and Pirson will investigate the systemic faults in Anglo-Saxon corporate governance that originate from a single board's disproportionate authority. Turnbull and Pirson have created an alternative governance paradigm for communication and control based on natural science. Turnbull and Pirson then investigate why a single board of directors cannot successfully oversee large enterprises that affect human existence. Examples of alternative models demonstrate that managers may create governance frameworks that considerably lower the possibility of systemic blind spots and the tremendous wealth loss that they entail [9]. Lehman Brothers Holdings Inc. ("LBHI") and its 22 affiliates (collectively, the "Debtors") filed petitions with the United States Bankruptcy Court for the Southern District of New York on September 15, 2008, seeking protection under Chapter 11 U.S. Bankruptcy Code. Some of Codex's case files [10].

### **1.3. Objective**

The purpose of this paper is to educate readers on the problems that arose in corporate management during the 2008 financial crisis. The reader of this paper can be anyone as this paper does not use complex financial terms and is not very complicated to read and understand. In addition, the thesis was organized in advance before writing, because the content was not specific enough, so it was revised several times in the draft. The reason why choosing this topic is that this topic is more popular, and the information is easier to find. The confident part of the paper is its overall clear structure, having practiced writing about the problem, comparison, solution, and conclusion before writing this essay. Therefore, the overall structure and logic of this paper are relatively sound.

## **2. Contrast performance between the financial firms and non financial firms**

During the financial crisis, many people believed that it was the financial companies' inadequate management of the company that caused the various problems. However, some people believe that the performance of financial companies in the financial crisis has exceeded that of most non-financial companies, in other words, financial companies have handled the crisis better than non-financial companies [2].

Some people believe that the public perception of financial companies has deteriorated because of the media's arbitrary falsification and misrepresentation, thus blaming financial companies for all the problems. Boards, for example, are being chastised for what appear to be extravagant compensation packages obtained by CEOs of banking institutions even while their firms failed or were bailed out by the government [1]. The paper has summarized several important reasons why corporate governance of financial companies is better than other non-financial companies during the financial crisis.

### **2.1. Board of Directors Establishment**

The first point is that the boards of directors of financial and non-financial companies have the same legal responsibilities, but the boards of directors of financial companies are strictly established in accordance with the listing requirements of the exchange. Therefore, they are well established in terms of various systems and policies, compared to other non-financial companies, whose boards of directors may not be as well established and regulated as financial companies.

### **2.2. Regulator System**

The second point is that financial companies have internal regulatory bodies to supervise different departments, so they have regulations to evaluate compliance in many businesses, forming a mutual check effect. So, financial companies will not have problems in corporate management and behavior regulation to a large extent, but, compared to non-financial companies, the need for regulatory bodies may not be very necessary. So, this may be less of a protection system, for the company's internal supervision is likely to appear as loopholes.

### **2.3. Diversity of Board Members**

Financial corporations perform better than non-financial firms, according to Adams and Renée Birgit's "Governance and the Financial Crisis [1]," which examines the number of board seats, the ratio of males to women, director compensation, and the diversity of board members for financial and non-financial organizations. Banks, on average, have more independent boards, larger boards, fewer outside directorships, attendance concerns, a higher proportion of female directors, and lower director remuneration than non-financial enterprises, according to the findings. As a result, banks do not appear to be worse managed than non-financial enterprises on average, except for director attendance [1].

As a result of these comparisons, financial businesses outperformed non-financial enterprises, and during the financial crisis, financial firms over-relied on their own management systems, contributing to the disaster. How is it feasible that the United States still has governance issues despite robust shareholder protection measures and recent governance reforms [1]?

## **3. Problems of corporate governance**

### **3.1. The specific problems of a unitary board during the financial crisis**

A unitary board is a group of directors that takes strategic decisions for the company [8]. The downfall of numerous financial organizations in 2008 was largely due to the unitary board's issue since it directly led to financial enterprises' corporate governance. In 2008, the unitary board suffered from a systemic lack of hierarchical communication [8].

In other words, this problem is about the lack of a strong system of communication to determine whether a crisis is happening and take appropriate action to stop it. Lack of communication leads to a lack of risk monitoring, which means that no one wants to be a misinformed decision-maker in a business environment, and if one person makes a bad decision that leads to a problem in the overall outcome, then the problem will be more serious in the business environment.

Therefore, in the hierarchy of financial companies, they are very focused on the accuracy of the information in terms of communication, which leads to a reluctance to report to superiors for information that is not certain. This leads to a lack of effective communication between the board and management and increases the probability of a crisis. In the bankruptcy examiner's report on Lehman Brothers Holdings Inc, for example, data was provided on how corporations administered by a single board of directors represent a systemic danger to the company and the financial system [10].

### **3.2. The Company's Reliance on a Single Board of Directors**

The company's reliance on a single board of directors leads to an information overload that prevents board members and the CEO from processing information promptly. The belief held by certain American academics that unitary boards are the natural order of business structure obstructs their research and may lead to subsequent unproductive ideas [8]. In addition, separate boards can create conflicts of interest, especially when it comes to things like compensation and auditing. Even if the board members are all independent directors, there can be conflicts with the auditors regarding their own remuneration. Conflicts of interest arise even when the subcommittee is made up of so-called "independent" directors [4].

## **4. Specific solution to improve governance**

In the aftermath of the financial crisis, the majority of financial firms have reformed their corporate governance, mainly through network governance. A chosen group of persistent and organized autonomous enterprises that engage in the development of products or services based on implicit and open contracts to adapt to environmental variables and to coordinate and secure communication is referred to as network governance [6].

### **4.1. Network Governance Minimizes Communication Risks**

In the previous discussion of the problems that arise in independent boards of directors, there was mention of the ineffectiveness of communication in a hierarchical system, where boards of directors have been complaining about the inability of management to provide effective information, but with network governance, most companies can establish parallel communication channels [3]. This way, board members can cross-check all the information they receive, not only from management but also from sources independent of management.

As a result, the board is ideally positioned to gather useful information from all divisions in order to give strong corporate supervision and management [5]. Many cooperatives have designed their governance systems so that the board listens to staff and consumers regularly. Employee directors are expected to make up half of the supervisory boards of bigger German enterprises. VISA's governance mechanism is organized around the owners and consumers it serves [7].

### **4.2. Increase the Number of Stakeholders Monitoring the Company**

The second advantage of network governance is that it can effectively monitor the company by increasing the number of stakeholders. This means that the board of directors or the management may make mistakes in decision making, but through the supervision of other relevant interest, workers can control and reduce some unnecessary risks. When a common interest arises, most people want to protect this interest. When purchasing stock in a firm, for example, investors must be worried about the company's growth or changes in performance. The investors put their money into the company, so with the drive of common interests, investors will spend a lot of energy monitoring the company. The investors are more concerned than the company's management is about the development of the company. Then in such an environment, even if the company has some problems that the management is not aware of, it is likely that other investors will find out and inform the management of the company. Customers of Raiffeisen Cooperative Bank Switzerland are incorporated into the bank's governance structure, allowing them to submit input to management. Customers expressed their

concerns directly to the members of the control board when hazards that were not known to management surfaced. Many small banks, credit unions, and savings clubs were able to withstand the financial crisis of 2008 by using these methods [8]. This approach was proven in the 2008 financial crisis, when the bank was able to reduce its losses by including its clients in the company's supervisory department, thus allowing them to effectively manage and advise the company.

## 5. Conclusion

The financial crisis in 2008 was a huge blow for financial companies. At the same time, the cause of the financial crisis is not only due to the problems in the management of the company, because the causes of the financial crisis may come from various aspects, may come from society, government, war, natural disasters, but this paper focus on the problems in the management of the company in the financial crisis.

After the financial crisis, many companies introduced network governance in their management. The advantage of this approach is to reduce the ineffectiveness of communication in the original hierarchy and to increase the number of stakeholders to effectively manage and monitor the company. Specifically, since the network governance has already solved the problems of the company from the management during the financial crisis, it is very unlikely that the financial crisis will be triggered by the problems of the management in this case.

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