

# Global Financial Crisis: Unravelling Corporate Governance Failures

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**Abstract:** The global financial crisis of 2007-2008, stemming from the United States subprime mortgage crisis, was a profound and widespread calamity with far-reaching implications for economies, enterprises, and investors worldwide. This essay posits that the root cause of this crisis lies in the failure of corporate governance, asserting that the outbreak unfolded through three stages: the accumulation, amplification, and outbreak of governance risks. Crucially, the first stage reveals a convergence of internal and external governance failures, marking the conjunction of internal governance lapses—specifically in risk management, executive compensation, board operations, and information disclosure—and external governance deficiencies in government regulation, legal requirements, and social accountability. The multifaceted impact of the crisis, leading to the bankruptcy of prominent financial institutions globally and unprecedented government interventions, underscored the urgency of addressing governance issues. Scholars and researchers globally have since dissected the crisis, identifying lessons and recommending reforms. This essay examines the intricate balance between internal and external governance, emphasizing the imperative of effective interaction. Proposals for improvement include enhancing board structures, implementing substantive disclosure rules, fortifying government regulation, and fostering international cooperation. The aftermath of the crisis, while posing challenges, also presents an opportunity for corporate governance reform. The lessons learned highlight the indispensability of robust governance mechanisms in protecting investor and shareholder interests. Effectively navigating the evolving landscape requires staying abreast of contemporary needs and embracing reforms that align with the dynamic nature of global finance. Ultimately, the financial crisis underscores the pivotal role of effective corporate governance in mitigating risks, fostering sustainable development, and safeguarding societal interests.

**Keywords:** Financial crisis, External governance, Government regulation, Internal governance, Legal requirements, Risk management.

## 1. Introduction

The financial landscape is inherently interconnected, with the mobility of financial assets making the international nature of finance particularly significant. The financial crisis of 2007-2008, often regarded as the most severe since the Great Depression, unfolded globally, surpassing the scale of previous region-specific crises. Brunnermeier pointed out that the financial crisis of 2007-2008 is widely considered to be the worst financial crisis since the Great Depression of the 1930s [1]. Moreover, the one-day fall in stock prices was even greater than the 1930s Great Depression [2]. This crisis, originating in the U.S. subprime mortgage market, swiftly spread worldwide, impacting diverse financial institutions and markets. Erkens, Hung, and Matos demonstrated its escalation, pinpointing the collapse of Lehman Brothers in the third quarter of 2008 as a critical juncture [3].

Amidst unprecedented government interventions globally, national bankruptcies, and the collapse of major financial institutions, the crisis underscored the vulnerability of financial systems. Notably, corporate governance failures emerged as a significant contributor, a viewpoint supported by Kirkpatrick [4]. This essay contends that the 2007/2008 financial crisis was primarily rooted in corporate governance shortcomings. The subsequent sections of this essay aim to delve into this perspective comprehensively. Part two will offer an overview of corporate governance and its relation to financial crises, leading into the third part, which examines how corporate governance failures precipitated the crisis. The fourth section will dissect the impact of institutional

deficiencies on corporate governance, addressing risk management, executive remuneration incentives, directorship, and disclosure. Part five will touch upon external governance deficiencies, encompassing government regulation, the legal system, and social accountability. Ultimately, the essay will conclude by summarizing key insights, emphasizing the critical role of effective corporate governance in mitigating financial risks and fostering sustainable development.

## 2. Corporate Governance and the Financial Crisis

### 2.1. Overview of Corporate Governance

The concept of corporate governance was first introduced in the 1930s by the American scholars Bailey and Means. Professor Weian Li first extended corporate governance from internal governance to external governance [5]. This can be interpreted to mean that a company can only achieve the goal of effective corporate governance if both internal and external governance mechanisms work together [6]. In other words, corporate governance requires not only internal operation to complete but also a good external environment to ensure the good operation of internal corporate governance. Internal governance is widely considered to play a direct role in the emergence of the 2007/2008 financial crisis. By having such an impact, internal governance is the focus of this essay.

### 2.2. Analysis of the Causes of the Financial Crisis

The causes of the 2007/2008 international financial crisis

have been widely discussed by scholars around the world from different perspectives, and a variety of views have been formed. These include the theory of monetary policy failure, the theory of imbalance between the virtual economy and the real economy, the theory of the proliferation of neoliberalism, the theory of the original sin of human greed, the theory of the defective international monetary system, the theory of the original sin of the capitalist system and so on. These hypotheses have explained the causes of the financial crisis at different levels and from different perspectives. However, many scholars argued that corporate governance was one of the main causes of the global crisis, while other factors only played a complementary role [4]. Even though the failure of corporate governance was not the only cause of the 2007/2008 financial crisis, it was an important one [7]. Economic Cooperation & Development (OECD) report pointed out that the financial crisis was largely attributable to the failure and weakness of corporate governance arrangements [8]. Deficiencies in corporate governance eventually caused the collapse of many financial institutions, which led to the crisis. To be specific, corporate governance in many banks and financial institutions was not taken seriously both before and during the crisis. Therefore, this essay will analyse the micro-perspective of corporate governance, concluding that the main cause of the financial crisis was the accumulation of internal and external governance risks in corporate governance, especially in financial institutions.

### **2.3. Corporate Governance Risks at Different Stages of the Financial Crisis**

#### **2.3.1. The Accumulation Stage of Governance Risk**

Firstly, the financial crisis was rooted in the accumulation of corporate governance risks in the first phase. Specifically, the outbreak of the crisis, both in terms of internal and external governance, indicated that there were more serious deficiencies in the US corporate governance mechanism. On the one hand, inadequate board governance, risk management failures, deficient executive compensation systems, and incomplete information disclosure all contributed to the accumulation of internal governance risks. On the other hand, external governance weaknesses such as lack of government regulation, inadequate legal mechanisms, and a serious lack of social responsibility have led to the accumulation of external governance risks (Industrial & Commercial Bank of China [ICBC]) [9]. Thus, the interaction of internal and external governance risks further increases governance risk.

#### **2.3.2. The Amplification Stage of Governance Risk**

Secondly, the governance risks were magnified in the second stage by a combination of corporate governance weaknesses. With the Federal Reserve raising interest rates 17 times in a row, the variable rate lending approach led to a significant increase in interest payments, and many subprime borrowers chose to default as they were overwhelmed by the burden. The fall in home prices then caused those borrowers who were paying their mortgage interest on time to default on their homes. As a result, the price of the house was so reduced that it did not cover the value of the loan [10]. The three-tier chain of financial innovation created by financial institutions through the creation of financial derivatives magnified the risk, meaning that any break in the chain could create serious problems. Furthermore, a more prominent problem is the panic psychology of investors [11]. Under the impact of this psychology, investors sold their shares in droves. It was this

butterfly effect that made the market turmoil increasingly intense. There was a lack of effective stop-loss mechanisms to organize the crisis, which resulted in the actual losses of financial institutions as well as investors being amplified [12].

#### **2.3.3. The Outbreak Stage of Governance Risk**

Eventually, when the governance risks were infinitely magnified, the sub-prime crisis was inevitably triggered in the third stage. However, due to the high degree of liberalization and internationalization of the US securities market, the US securities market had huge investments from governments and investors from all over the world [13]. Consequently, the subprime mortgage crisis spread globally and eventually triggered the international financial crisis. It is clear from the above process that the root cause of the financial crisis lies in the deficiencies of corporate governance. This is because if corporate governance is well established, then the risks of governance could have been resolved in the first stage. Taking J.P. Morgan Chase & Co (JPM) as an example, Wu observed that JPM did not experience any group losses between the onset of the financial crisis and April 2009 [14]. According to Xinhua (2009), this exception occurred because JPM identified the risks accumulated in subprime mortgage securities and other complex institutional financial products a few months before the emergence of the US sub-prime crisis [15]. At the same time, JPM also realized that the US housing market was beginning to head for a bust. JPM then disposed of the risky assets in the second half of 2006 and succeeded in preventing significant losses. Although JPM abandoned a popular Wall Street investment product and lost a small amount of short-term interest, it was able to remain profitable while its peers went bankrupt or waited for government relief. This essay will then focus on the root cause of the financial crisis, i.e., the first stage.

## **3. Deficiencies in Corporate Internal Governance**

Generally, internal governance is often considered to be the foundation of governance, and its goodness will directly determine the soundness of operations [10]. In this sense, the outbreak of the financial crisis was closely linked to deficiencies in the internal governance of companies. The Action Plan on Corporate Governance and the Financial Crisis (2008) developed by the Organization for OECD concluded that the financial crisis could be largely attributed to the failure of corporate governance and its inherent weaknesses [8]. The study identified four areas of corporate governance weaknesses that were exposed during the financial crisis, namely failures in internal control and risk management, misaligned remuneration systems, inadequate responsibility and functioning of the board of directors, and a lack of shareholder rights [4].

Moreover, the financial crisis was exacerbated by deficiencies specifically within the corporate governance structures of financial institutions. The characteristics of the banking sector, such as high leverage, significant information asymmetry, and substantial social relevance, indicate that the repercussions of corporate governance failure in financial institutions are catastrophic for society. According to the revised principles for strengthening corporate governance in the banking sector by the Basel Committee on Banking Supervision, the principles of corporate governance in the banking sector, namely board conduct, executive management, risk management, and internal control,

remuneration, complex or opaque corporate structures, information disclosure, and transparency. In this case, combining these two perspectives, this essay will discuss the deficiencies in internal governance in four areas: risk management systems, remuneration systems, board of Directors Operations, and information transparency and disclosure [4].

### **3.1. Risk Management System Failure**

First, failing risk management systems are an essential cause of internal governance weaknesses. Lu maintained that the international financial crisis that occurred in 2007/2008 revealed widespread risk management failures in both the banking and non-banking sectors [16]. This phenomenon triggered a profound international rethink. It is obvious that the financial crisis was not a natural disaster; on the contrary, it was caused by human behaviour and could therefore have been avoided (The Financial Crisis Inquiry Commission [FCIC], 2010) [17].

#### **3.1.1. Shortcomings in Risk Management during 2008 Financial Crisis**

Arthur Levitt, former chairman of the US Securities and Exchange Commission (SEC), argued in the early stages of the 2008 financial crisis that the subprime mortgage crisis and the Bear Stearns bankruptcy demonstrated the shortcomings of poor risk management in large financial institutions [18]. There are various overlooked risks in the process of the securitisation chain [12]. It was specifically the continued boom in the property market during the initial years that caused financial institutions to overestimate their risk management capabilities and, therefore, neglect risk management.

Apart from this, there was an over-reliance on the risk assessment models of the time. In fact, the current models have obvious flaws. The commonly used VAR model, although recognised by the new Basel Accord, neglects crisis management. In addition, new technologies such as MBS, CDOs, and CDS have enhanced risk, and these new products, although highly profitable, lack risk transfer and hedging [10].

#### **3.1.2. JPMorgan Chase's Exemplary Risk Management**

As in the case of JPM mentioned above, good risk management awareness and approach was a major reason why JPM performed well during the financial crisis. As a matter of fact, JPMorgan Chase Bank was not in the adjustable-rate mortgage business, nor did it have a structured finance division. At the same time, it tried to avoid getting involved in CDO-related businesses and products. It realised that these businesses lacked transparency and were too risky and unhelpful to consumers. While these decisions affected JPMorgan Chase's short-term profitability, they eventually allowed it to avoid large losses and gain a reputation for integrity in the market [19].

Moreover, JPMorgan Chase's risk management consciousness also emphasises soundness and prudence. In 2005, JPMorgan Chase Bank sold its only SIV and significantly reduced its subprime-related business in 2006. The corporate hierarchy believed in limiting the actual number of holdings if it could not accurately price the risk of each portion of the portfolio held in the market [12]. All these moves were later considered to be extremely sensible.

In addition, JPMorgan Chase agrees that good risk management creates value. Therefore, the company aligns risk management with the interests of its shareholders and requires all employees of the company to embrace the concept

of risk management [12].

Obviously, these were the key factors that enabled JPMorgan Chase to achieve remarkable results during the crisis [20]. It is true that well-managed risk management mechanisms and corporate governance could even determine the survival of a company during a global financial crisis.

### **3.2. Deficiencies in Executive Compensation Incentive Systems**

In addition to the risk management system, Berrone (2008) and Van Den Berghe (2009) asserted that deficiencies in the remuneration incentive system for executives were one of the main causes of the financial crisis [21-22]. Following the financial crisis, executive compensation in financial institutions became one of the focal points of concern for investors and regulators. Bicksler claimed that the greatest failure of corporate governance in the financial crisis was in CEO compensation [23]. The reason is that it is not the result of any fair negotiation but a product of management power.

#### **3.2.1. Flaws in Executive Compensation Structure**

Management compensation in US companies generally consists of performance-based salaries, data-based financial bonuses, and stock options based on share price performance [24]. Since the 1980s, stock option income has gradually become a major source of management compensation in US companies and has reached spectacular levels. In the case of Richard Fuld, chairman, and CEO of Lehman, for example, he earned a cumulative US\$48.8 million from Lehman in the eight years from 2000 to 2007 through salary, stock dividends, and bonuses; in 2007, his total remuneration was US\$71.9 million, including a base salary of US\$750,000, bonuses of US\$4.25 million, stock gains of US\$40.28 million and other income of US\$26.62 million [12]. However, such compensation systems encourage companies to seek quick and easy financial returns and are prone to be overly optimistic about the market. With the impact of these, the lack of long-term thinking is likely to result in a failure not only to manage corporate risk prudently but also to adequately consider the long-term interests of other stakeholders in the global market [25]. Incentives in the form of stock options cause management to take too many risks in the pursuit of profit.

#### **3.2.2. Misaligned Corporate Law and Short-Term Profit Pursuit**

Steven pointed out that current corporate law allows CEOs to earn high incomes without regard to risk. Since a large part of executive compensation is in the form of dividends linked to short-term profits and share prices, the better the company's earnings, the higher the dividends [26]. This misaligned compensation system has left executives in US companies with little time to focus on the long-term growth of their companies and more time to pursue short-term interests. The executives are overly concerned with the price of the company's stock and even go beyond their ethical boundaries to engage in various arbitrage practices that magnify their interests [4].

#### **3.2.3. Lack of Accountability and Consequences**

Additionally, the management's excessive pursuit of high-risk investment products made it possible for a slight market shock to bankrupt the company. However, instead of being reprimanded by the company for failing to exercise diligence and prudence in risk management, the company pays them well for engaging in high-risk, high-profit activities [12].

Moreover, these executives were not penalized or lost because of the crisis, and many had left with large severance packages before the crisis broke. For example, in 2007, Merrill Lynch lost US\$10 billion, and its share price fell by almost half, while the ousted CEO Michael O'Neill received a retirement payout of US\$161 million [27].

As a result, highly irrational incentives allow potential risks and liabilities to be ignored by executives. They simply do not consider the value of the company from the perspective of shareholders and other stakeholders, which inevitably jeopardizes the long-term value of the company. In other words, an unreasonable remuneration system induces executives to gamble with the future of the company, which ultimately leads to bad consequences.

### **3.3. Deficiencies in Executive Compensation Incentive Systems**

This is followed by the functioning of the Board of Directors. The board of directors is at the core of corporate governance. Thus, when a crisis breaks out, and companies are in trouble, the public will first hold the boards of these companies accountable [28]. However, many directors are unaware of what responsibilities and roles they can play.

#### **3.3.1. Inefficiency of Boards**

Undoubtedly, the causes of every corporate scandal and failure could be found in the ineffective functioning of the board. The 2008 financial crisis exposed the inefficiency of many institutional boards, which were unable to provide even independent and objective guidance and judgment. In boom periods, a positive economic environment masks corporate risks and makes it difficult to distinguish corporate governance. When the economic environment turns negative, differences in the level of corporate governance caused by the board of directors start to emerge [16].

#### **3.3.2. Failure of Board Responsibility for Executive Compensation and Risk Management**

Since executive compensation and excessive risk are within the responsibility of directors, the board is indirectly responsible for the failure of companies to adequately manage their own risks [24]. Pirson and Turnbull (2010) stated that directors and boards of directors in the UK and US corporate governance systems do not perform their roles well [29]. Not only do boards fail to oversee risk management systems, but directors are also unable to control excessive risk-taking by management. The non-executive and independent directors did not raise any issues with the remuneration and incentive systems of executives.

Despite the maturity of board governance in the US, the financial crisis revealed serious deficiencies in this area in financial institutions, as represented by the US banking sector. Some boards have given management a free hand to maximise short-term profits at the expense of properly assessing and effectively controlling risks. The board of Citigroup, for example, was seen as lacking objectivity and independence. The fundamental role of the board should be to provide oversight, guidance, and control and to challenge when necessary. However, in many companies, the board does not play such a role [30].

#### **3.3.3. Failures in Board Oversight**

Further, the failures in board operations revealed by the financial crisis are not only reflected in the outcomes of corporate governance (e.g., risk management failures, distorted remuneration systems) but also in the oversight of

boards themselves. According to the survey "Board Risk Oversight - State of the Art Report," most directors continue to indicate that their boards do not routinely implement mature and well-developed risk oversight processes. Resistance to board oversight of risk comes mainly from a lack of board member buy-in to Enterprise Resource Planning (ERM). Board members consistently felt that they did not see the benefits of implementing an ERM process. They believed that the business had other more pressing needs. In terms of corporate governance practices, the board of directors does not put into practice the normative approach. The risk oversight function of the board of directors is not really in place in either financial or non-financial institutions.

### **3.4. Non-Transparent Information Disclosure**

Finally, insufficiently transparent disclosure was seen as an important cause of the crisis. The lack of transparency in the issuance of subprime bonds was a major cause of the crisis.

#### **3.4.1. Importance of Transparent Disclosure in Crisis Prevention**

With adequate information disclosure, investors would be able to objectively position their risk preferences and improve risk management, and financial regulators would enhance effective regulation. Conversely, information asymmetry reduces corporate governance [11]. Therefore, the importance of information disclosure is obvious. Because US companies follow a cosmetic rather than a substantive disclosure rule, it means that mere formal compliance is sufficient. The inadequacy of the current disclosure system has allowed some financial institutions to provide incomplete or even false information to the market with impunity [10].

#### **3.4.2. Inadequacy of Disclosure System for Financial Derivatives**

For a long time, financial institutions have been very poor at disclosing financial derivatives related to subprime mortgages. As a result, some financial institutions have taken advantage of the inadequacy of the business disclosure system and created SIVs to circumvent disclosure. Moreover, as the disclosure system for derivatives has not kept pace with financial innovation, derivative risks cannot be fully disclosed and are not accounted for in the financial statements as necessary [11].

With this impact, neither investors nor regulators can identify problems in a timely manner if they simply look at business returns and expenses.

## **4. Deficiencies in Corporate External Governance**

Lu & Dang contended that corporate governance requires both internal and external governance [12]. The interaction of internal and external governance is necessary to achieve good governance. As an essential part of the process, the financial crisis has exposed the shortcomings of external governance. This essay will only give a brief overview of external governance.

### **4.1. Lack of Government Regulation**

Firstly, there is a lack of government regulation. One of the root causes of the crisis as the lack of government regulation. The US government has failed to function well as an important external governor [28]. The current financial regulation is far from perfect. In addition, the current regulatory system and regulatory philosophy reveal many

weaknesses. Regulatory authorities put too much faith in the market and adopt a laissez-faire regulatory philosophy. At the same time, in financial institutions, financial regulation is lagging far behind financial innovation, which will certainly have many negative effects. For example, financial derivatives have created a significant information asymmetry between financial institutions and regulatory authorities. However, the knowledge of the relevant regulators is not up to date with the pace of financial innovation, and they are not professional in this area [10].

## 4.2. Inadequate legal Regime

Second, the legal regime was inadequate. On the one hand, the US has introduced several laws over the last three decades that have gradually deregulated finance. In 2000, many protective regimes in the US financial sector were withdrawn, laying the groundwork for the outbreak of a crisis [31]. On the other hand, the enforcement of existing laws was not strict enough. In fact, the US had laws in place to protect consumer credit rights, such as the Equal Credit Opportunity Act. Unfortunately, these laws have not been strictly enforced. In some respects, the law itself is flawed. For example, the Community Reinvestment Act has led to credit institutions in the US being forced to hold some portfolios of non-performing loans [10].

## 4.3. Lack of Social Responsibility

In the final analysis, there is a lack of social responsibility. The outbreak of the financial crisis was primarily caused by a lack of social responsibility on the part of companies, especially in the banking-led financial sector. The behaviour of the companies involved in the financial crisis chain reveals that too many financial institutions have too little sense of social responsibility. During the decade-long economic boom in the US, investment banks gradually lost their original sound, conservative and client-oriented business philosophy. In the pursuit of short-term profits, these financial institutions were willing to harm the interests of investors and consumers. They launched subprime loans in pursuit of high profits while selling them off to avoid risk [32]. These investment banks ignored their social responsibility and inadequacies in financial innovation, leading to an accumulation of negative impacts that led to a crisis in their own operations. In the end, this led to a global financial crisis.

## 5. Conclusion

To sum up everything that has been stated, the financial crisis of 2007/2008 was, in fact, a global crisis in terms of its scope and scale of impact. It affected almost every economy in the world, and shareholders and investors in all countries suffered huge losses. Following the financial crisis, many studies have reflected on the causes of the crisis from different perspectives. Among these, the failure of corporate governance has been identified as an inherent root cause of the crisis. The discussion conducted in this essay demonstrates that the financial crisis was caused by corporate governance. The outbreak of the financial crisis can be divided into three stages: the accumulation of governance risks, the amplification of governance risks, and the outbreak of governance risks. The most important of these stages is the first. To be precise, the first stage shows that the financial crisis occurred because of a combination of internal governance failures and external governance failures. It was the combination of internal and external governance risks in

the company that led to the outbreak of this financial crisis. In the 2007/2008 financial crisis, internal governance failed in four areas: risk management systems, executive compensation systems, board operations, and information disclosure and transparency. Furthermore, the achievement of corporate governance objectives is neither entirely dependent on being addressed in internal governance nor entirely dependent on external governance. It is also a hard balance to strike between the respective roles of internal and external, while at the same time achieving effective interaction. In terms of external governance, there were deficiencies in government regulation, legal requirements, and social accountability.

While the international financial crisis has brought serious impacts, it has also brought opportunities for adjustment. Scholars and researchers in various countries have learned significant lessons from the results of the crisis and have made various recommendations for improvements in response to the deficiencies in corporate governance. For example, improving the internal structure of boards of directors, establishing substantive disclosure rules, strengthening government regulation, and enhancing international cooperation. The impact of the crisis and the lessons learned could trigger a new era of corporate governance reform. Only by keeping up with the times will corporate governance be effectively improved to protect the interests of investors and shareholders around the world. Taking all these into consideration, the lessons of the financial crisis show that poor corporate governance inevitably leads to losses for companies and thus affects society. Therefore, effective corporate governance mechanisms are vital to the development of companies and the avoidance of risks.

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