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# Relations Between Poor Corporate Governance and Financial Crises

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***Abstract:*** The science of examining how corporate authority is distributed is known as corporate governance, when used broadly. Viewed narrowly, it is a branch of science that sits at the level of company ownership, investigates the process of appointing professional managers, and performs regulatory activities regarding the discharge of professional managers' obligations. The "management right level" of enterprise management is based on science and involves the enterprise owner and management right authorization, or management right in the case of authorization, in order to accomplish company goals and utilize all available methods of operation behavior. On the other hand, corporate governance is built at the "ownership level" of the business based on science and deals with professional managers' scientific approval and oversight. This article investigates the role of corporate governance in the financial crisis and why stock prices did not anticipate bad corporate governance, setting the scene for the global financial crisis of 2008. On the basis of existing research, analytical studies were conducted and summarized into conclusions. As shown in this paper, inappropriate corporate governance ultimately leads to an increased risk of economic crisis. Therefore, it is important to adopt the necessary tools to improve corporate governance. Management should formulate appropriate corporate strategies and ensure that they are effectively implemented, ensure that internal controls are effective and develop a good corporate culture, etc. The government should also improve the relevant regulations and ensure their implementation.

***Keywords:*** Corporate Governance, Subprime Mortgage Crises, Financial Crises, Stock Market

## 1. Introduction

The US subprime mortgage crisis served as the impetus for the financial crisis of 2008. The United States has faced economic challenges in the twenty-first century, including the fallout from the September 11 attacks and the collapse of the Internet economy. The Federal Reserve implemented quantitative easing to encourage economic development.

The Federal Reserve (Fed) implemented quantitative easing as a strategy to boost economic development. The benchmark interest rate was lowered by the Federal Reserve thirteen times between 2001 and 2004. Only from 2001 to 2004 did the Federal Reserve reduce interest rates thirteen times, with the benchmark rate falling from 6.5% to 1% in 2004. The sustained low interest rate not only helped to sustain the US economy but also fueled the country's real estate bubble and

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raised the share of debt financing in all bank and financial institution financing. In order to keep the currency stable and rein in inflation, the Federal Reserve then started to boost interest rates. The benchmark interest rate increased from 1% to 5.25% as a result of 17 consecutive rate hikes by the Fed between June 2004 and August 2006 [1]. Interest rates on home loans rose as a direct result of the Federal Reserve's interest rate hikes, placing more pressure on homeowners to make loan repayments.

As the official start of the global financial crisis, Lehman Brothers, the second-biggest investment bank in the US, declared bankruptcy in September 2008 after disclosing massive losses associated with subprime mortgages. Following that, a great deal of panic hit the market, causing a vast number of financial items to lose value and be liquidated. Significant industrialized nations throughout the world also went through successive crises, in addition to a number of significant investment banks in the United States being taken over or going bankrupt [2].

This article starts with the 2008 subprime mortgage crisis, examining the relationship between poor corporate governance and economic crises. The ultimate goal is to uncover the connections between them. Firstly, it seeks to identify the reasons for ineffective corporate governance. Secondly, it explores other factors contributing to financial crises, such as the prevalence of privately backed mortgages at the time. Finally, it proposes recommendations from various perspectives to enhance corporate governance standards and reduce the risk of triggering financial crises.

## 2. Reasons for Poor Corporate Governance

### 2.1. The Key role of the Board of Directors and Shareholders

The first and most important point is the legal obligations and the board of directors' and management's roles in internal corporate governance. The primary cause of the financial crisis's prevalence of risk management failures in companies is that, in Anglo-American nations, corporate governance upholds shareholder supremacy and the company's primary goal is to maximize shareholder value. On the other hand, because listed companies are more likely to be viewed as investment vehicles, investors are primarily focused on stock price. The management wants to keep the share price growing as much as possible to attract additional investors and provide a set level of revenue to shareholders. The management's primary focus appears to be the share price fluctuations; investors should seek the company's short-term profitability because public market investments yield a certain amount of profit in the short term. This helps to ensure that the management can align with shareholders' interests and minimize the agency cost of the business. Additionally, the management works to ensure that shareholders' interests are met by not only lowering the agency cost but also providing high compensation for directors and executives, as well as shares or options allocated to them. Thus, on the one hand, management works to drive up share prices in order to increase the value of their own options or shares [3]. The financial institutions engaged in excessively short-term-focused activity during the financial crisis, disregarded their business operations in the implied, accumulating risks, and shown extreme profit-seeking behavior. The management of Lu's business was formed as a result of their willingness to take on more risk and pay a higher compensation for the deformed situation. This was made possible by the management's generous compensation and increased incentives to engage in high-risk, high-profit business activities brought about by the short-term rise in the company's share price.

### 2.2. Institutional Deficiencies in U.S. Corporate Governance

The corporate governance structure of the United States financial institutions has been deformed, and the institutional risk caused by the short-term profit-seeking behavior nourished by insider control has even been derived into systemic financial risk. Some scholars also pointed out that in the subprime crisis, the moral risk of Wall Street, which was controlled by managers, was fully exposed, and the

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lack of owner constraints led to the collapse of Wall Street's corporate governance mechanism [4]. In the United States, shareholdings are highly decentralized, with a pattern of "weak shareholders and strong management" insider control [5]. As many as 3/4 of the independent directors of U.S. listed companies do not have professional knowledge, and these uneducated independent directors can easily become the voting machines of the proxy, i.e., the executives of the company. Although the current option incentive and dividend system has strengthened the role of incentives, it lacks a risk constraint mechanism for sustainable development, i.e., there is a lack of an accountability mechanism for major losses suffered by the enterprise and a mechanism for recovering improper income of the senior management in the design of the enterprise system. During the subprime crisis, some financial institutions represented by Wall Street In the subprime crisis, the executives of some financial institutions, represented by Wall Street, carried out the so-called innovation of financial products with a view to maximizing their personal incomes, and over-expanded the risky subprime mortgage business, while those who were controlled by the management were not punished or suffered any losses. business, while those directors who were controlled by management and did not know the business tacitly approved and indulged in these short-sighted behaviors of the executives, neglected to properly assess and effectively control the risks, and even condoned fraud. and effective control of risks, and even condoned fraudulent asset underwriting and business practices, leading to the accumulation of various potential factors capable of triggering the subprime crisis [6].

The reasons why those Wall Street executives did not control the risks arising from their economic activities are complex, and let's take bank executives as an example. First, the moral hazard view maintains that because of explicit and implicit bank guarantees like deposit insurance, central bank liquidity, and government bailouts, it is reasonable for the bank to take excessive risks because of conflicts of interest, or principal-agent issues, between the bank's shareholders, management, and creditors.

Secondly, the behavioral perspective argues that banks overestimate their level of risk-taking because they either believe too much in themselves or fail to consider the possibility of extreme events (tail risks). On the extreme end of this spectrum, banks were over-risking before to the crisis.

Documenting insiders' pre-crisis actions is one empirical method of analyzing these problems. We examined US bank CEOs' trading patterns in a recent research. We test whether the performance of U.S. banks during the 2007–2008 crisis was related to bank insiders selling their own bank stocks before house prices peaked and reversed in the second quarter of 2006. We do this by using executives' trades in their own portfolios as a proxy for their understanding of excessive risk-taking.

Each standard deviation increase in sales for the top five executives resulted in a 13.33 percentage point decline in stock returns during the crisis, which is roughly 32% of the 40% negative returns for banks with above-average real estate exposure.

In sum, given the information content of bank insider trading prior to the overall real estate problem, these results suggest that insiders understood the significant risk-taking of their banks, that they were not simply overly optimistic, and that insiders at riskier banks therefore sold more stock prior to the crisis [7].

## 3. Relations between Poor Corporate Governance and Financial Crises

One of the important reasons why enterprises can choose high-risk and high-yield investment projects is that they can promote the rise of stock prices because of the limited information disclosed by enterprises to the public. The market may not understand how high the risk of the enterprise's investment projects is, but the enterprise can be publicized to exaggerate its own future earnings, which in turn brings the market information that the stock price will rise in the future, which is what we call the theory of information asymmetry. When there is information asymmetry, each party to a transaction possesses unique information [8]. Asymmetry in information arises when certain

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participants in socio-political, economic, and other activities possess information that other participants do not. In market economic operations, different sorts of persons have varying levels of knowledge about pertinent information; those with better information typically have a more favorable position, while those with less information typically have a more unfavorable position. Asymmetric information could cause unfavorable selection. Another reason is that shareholders are more inclined to choose high-risk and high-yield investment projects than creditors. As mentioned above, many listed companies neglected to manage the risks associated with their operations, which also sowed the seeds for the subsequent economic crisis [9].

The capital market's external supervisory function has not been properly utilized in the process of financial risk buildup in the United States. The operating performance of a company can be reflected in the stock market, but the financial information of the company can readily impact the stock price. The management of many American corporations attempts to alter the company's financial statements in an attempt to conceal their business performance, raising the stock price and reaping large profits. Investors have little incentive to investigate the dangers associated with management's behavioral choices because they also receive investment rewards from this process. The stock market's representation of the company's value is likewise warped during this process. In a positive economic environment, the value of an enterprise is often overestimated.

Looking at the performance of American financial institutions before and after the financial crisis, it can be seen that the American corporate governance mechanism has indeed lost the ability to monitor risk. Although the corporate governance structure of the United States has formulated the corresponding check and balance mechanism according to the national cultural factors, the role of the system is still very weak. In general, the defects of American corporate governance mechanisms can be summarized into the following three points: Mechanism design is not coordinated with macro supervision. The corporate governance mechanism is to coordinate the rights, responsibilities, and interests of the three parties, but does not stipulate the relationship between the company and the regulatory agency, and the company's behavior often tries to break through the principle of macro supervision. In order to maintain macroeconomic stability, regulators in the United States strive to establish a complete regulatory system, but in the implementation of policies, companies often try to evade supervision. This is particularly evident in the financial field. Before the crisis, the amount of funds operated by "shadow banks" in the United States showed an increasing trend year by year.

Mechanism design is disconnected from mechanism execution. From the above introduction to the failure of corporate governance mechanisms in the United States, we can see that we need both good institutional design and strict institutional implementation. After the long-term stable economic development, the American public gradually relaxed the risk inspection, and financial institutions implemented more aggressive business strategies, injecting a large number of high-risk financial products into the market. In addition, risk supervision and management institutions such as credit rating agencies, credit enhancement agencies, and accounting firms have also lost their vigilance and lowered their professional standards in order to seek profits, which has encouraged risk-taking behaviors in the market [10].

## 4. Discussions and Proposals

According to the arguments mentioned above, this paper suggests that the government is supposed to accelerate the innovation of governance mechanisms and improve risk management and remuneration incentive mechanisms. To guarantee that the Board of Directors can efficiently carry out its obligations, make clear the roles and authority of the Supervisory Committee, the Board of Directors, and other committees. You should also provide efficient routes for information sharing across various departments and levels. The Board of Directors can carry out its responsibilities with effectiveness. These duties include supervising and directing the company's major operating, risk

management, and corporate strategies; they also entail evaluating the efficiency of the enterprise's financial and reporting systems and guaranteeing their integrity.

Apart from the Board of Directors, there are still other methods that we can enforce to improve corporate governance.

First of all, enterprises need to formulate a clear development strategy. A clear development strategy can make enterprises more clear about their goals and directions, and can make the various business and management activities more coordinated. In formulating the development strategy, enterprises need to consider the changes in the market, the development trend of the industry, and their own actual situation to ensure the feasibility and effectiveness of the strategy. At the same time, enterprises also need to constantly adjust and optimize their development strategy to adapt to market changes and their own development needs [11].

Secondly, enterprises need to strengthen team building. An excellent team can not only make the enterprise more competitive and dynamic, but it can also make the enterprise's various business and management activities more efficient and orderly.

Third, enterprises need to optimize the management system. A perfect management system can make all business and management activities more standardized and efficient.

Fourth, enterprises need to focus on corporate culture. A good corporate culture can make the enterprise more cohesive and centripetal force, but also can make the enterprise's various business and management activities more orderly and efficient.

Finally, enterprises need to strengthen execution. A strong executive force can make the enterprise's various business and management activities more efficient and orderly.

## 5. Conclusion

The Board is responsible for overseeing and directing the enterprise's strategy, key operating policies, and risk management policies; ensuring the integrity and effectiveness of the enterprise's financial and reporting systems and exercising appropriate controls over them. Furthermore, as mentioned above, if enterprises neglect to manage the risks associated with their operations, it will increase the possibility of sowing the seeds for a financial crisis. In short, to improve the level of enterprise management needs enterprises to develop a clear development strategy, strengthen team building, optimize the management system, focus on corporate culture, and strengthen the implementation of efforts. Through the implementation of these five steps, enterprises can effectively improve the management level and lay a solid foundation for the long-term development of the enterprise. This paper lacks the calculation of a mathematical model or analysis. Future research will increase this aspect of the study.

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