

THE ROLE OF CORPORATE GOVERNANCE AND HOW IT CONTRIBUTED TO THE 2008 GLOBAL FINANCIAL CRISIS

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Submission date: 01-Jul-2023 12:37AM (UTC+0100)

Submission ID: 209690335

File name:

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Word count: 1426

Character count: 9095

THE ROLE ¹² OF CORPORATE GOVERNANCE AND HOW IT CONTRIBUTED TO THE 2008 GLOBAL FINANCIAL CRISIS

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30/06/2023

Introduction

Considered a major economic disruption of our era, the 2008 global financial crisis had far-reaching consequences on economies worldwide. Through this essay, we aim to dissect the pivotal events of this crisis and analyse how they affected Multinational Corporations (MNCs). Moreover, it will discuss the role corporate governance weaknesses played in the failures witnessed during this period. Through a thorough analysis of scholarly sources. This essay will provide insights into the complex interplay between the financial crisis, MNCs, and corporate governance.

Key Events of the 2008 Global Financial Crisis

The collapse of the United States housing market in 2008 served as the primary trigger for the global financial crisis. However, its repercussions soon spread throughout international financial systems. One essential aspect that characterized this crisis was the failure of highly renowned financial institutions coinciding with a substantial drop in global stock markets and a notable escalation in unemployment rates globally.

Notably, the collapse of Lehman Brothers in September 2008 holds immense significance due to its extensive ramifications for the functioning and integrity of the global financial system. Having amassed considerable exposure to subprime mortgages as a leading investment bank Lehman Brothers endured staggering losses during this period. These circumstances eroded overall confidence among investors regarding the reliability of financial institutions and precipitated a halt in credit markets—the very factors that aggravated an already critical situation (Reinhart & Rogoff, 2009).

In addition, it is imperative to highlight yet another noteworthy development which involved the governments' intervention through providing essential aid in the form of bailouts to major financial Institutions such as American International Group (AIG). Subsequently, efforts were undertaken to rescue both Fannie Mae and Freddie Mac. These crucial steps were taken with utmost significance aimed at preventing any further harmful repercussions on the entire financial system whilst attempting to restore much-needed stability (Bryant, 2015).

Amidst the crisis, there was an evident cascade of events whereby global banks confronted liquidity shortages that yielded a detrimental credit crunch. Multinational corporations (MNCs), heavily dependent on external financing for sustaining their global operations and pursuing expansion strategies were profoundly affected by this scenario. The resultant restricted access to credit seriously undermined MNCs' capabilities in meeting financial obligations responsibly, make essential investments towards growth targets, and effectively adapting to fluid market dynamics (Baker & Wurgler, 2013).

Corporate Governance Weaknesses and Failures

Before the onset of the global financial crisis in 2007 corporate governance reforms spanning three decades promoted a management model focused on maximizing shareholder value. This approach lacked extensive historical precedence yet gained traction, nonetheless, despite maintaining some aspects aimed at driving group cooperation within corporations based on their legal structures; these models proved increasingly insufficient when faced with widespread volatility caused by exorbitant liquidity levels within capital and credit markets (Deakin, 2010).

The consequences of this shareholder value norm were noteworthy including an exacerbation of income inequality within Anglo-American economies. Partially offsetting this

inequality was asset price inflation. However, these conditions contributed to the overall environment that precipitated the global financial crisis. It is important to note that poor governance practices alone cannot be solely attributed to the failures of individual financial institutions during this period. Other immediate factors, such as ineffective regulation played significant roles as well. However, the broader trend towards prioritizing shareholder value since the 1980s played a role in fostering a systemic failure within corporate governance - with the banking crisis serving as its most visible outcome. Given these circumstances, it is crucially important that the shareholder value-based approach to governing and managing large corporations, be promptly reevaluated and reassessed (Deakin, 2010).

The failures witnessed during the 2008 global financial crisis were significantly influenced by weaknesses in corporate governance. Inadequate oversight, deficient risk management practices, and flawed incentive structures were prevalent among many multinational corporations (MNCs). Which further amplified the negative impact of this crisis. Notably, numerous financial institutions lacked independent boards of directors who could successfully question management decisions and ensure responsible risk management practices through proper oversight. This absence enabled excessive risk-taking and prioritization of short-term gains over long-term stability. A concrete example is evident in the excessive securitization of subprime mortgages driven by flawed incentive structures. Ultimately leading to the collapse of the housing market and subsequent financial turbulence (Haldane & May, 2011).

Furthermore, ineffective risk management practices within multinational corporations (MNCs) resulted in the underestimation of the risks linked to intricate financial instruments like collateralized debt obligations (CDOs). These instruments were frequently undervalued and retained on corporate balance sheets. Leading to a deceptive perception of safety. Once the true magnitude of these risks came to light. MNCs encountered substantial write-downs and losses (Barth, Caprio Jr. & Levine, 2013).

In addition, it is important to consider the prevailing compensation frameworks in many multinational corporations (MNCs) which have played a significant role in incentivizing reckless risk-taking and favouring short-term gains. Notably, executives are frequently rewarded based on their performance in terms of short-term measures like quarterly profits or increases in stock prices. Regrettably, these assessment criteria often neglect to properly evaluate the sustainability of long-term objectives. Consequently, MNCs may be compelled to engage in hazardous practices and prioritize immediate advantages over enduring stability. (Bebchuk & Spamann, 2010). At the peak of the financial crisis, a number of financial managers voted for themselves some of the highest bonuses in decades to come. Citigroup, for example, a major beneficiary of US government bailout funds, awarded its employees \$5.3 billion (£3.2 billion) in bonuses for the year 2008 (Inman, 2008).

Additionally, a lack of transparency and disclosure also manifested as a corporate governance failure. Many multinational companies did not provide accurate or timely information regarding their involvement with risky assets. This hindered investors' and regulators' ability to accurately assess the true fiscal strength possessed by these entities. Consequently, diminished levels of transparency contributed to waning trust while magnifying turbulence within financial markets (Merino et al., 2020).

In order to tackle these weaknesses. Several nations introduced regulatory reforms after the crisis. The primary goal behind these reforms was to enhance corporate governance practices. Fortify risk management frameworks, and foster transparency and accountability within multinational corporations (MNCs). (Deakin, 2010). The Obama administration was forced to target the bonus culture on Wall Street by appointing Kenneth Feinberg to investigate the firms that had received the biggest bail-out funds (Inman, 2009).

Conclusion

The far-reaching implications of the 2008 global financial crisis have put into perspective the dynamic relationship between economic occurrences, corporate governance deficiencies, and systemic breakdown. In fact, Multinational Corporations (MNCs) experienced the adverse effects of the Lehman Brothers' collapse credit crunch. And the ensuing global economic downturn; all contributing to their hardships when dealing with a volatile setting.

Furthermore, the severity of this crisis on MNCs was aggravated due to corporate governance weaknesses manifesting as inadequate oversight flawed risk management practices and skewed incentive frameworks. To prevent future crises. It is vital for MNCs to make effective corporate governance practices a top priority. The emphasis should be on fostering transparency. Efficient risk management, and sustainable growth. Regulatory reforms and enhanced scrutiny can play a pivotal role in ensuring that MNCs operate responsibly and exhibit resilience while safeguarding their own interests as well as those of their stakeholders.

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