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CORPORATE GOVERNANCE ROLE IN TRANSMITTING THE SUBPRIME CRISIS IN THE EUROPEAN COUNTRIES

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Abstract

Corporate governance is at the core of how companies base their long-term economic strategies and is a key element for the stability of any financial system. From this perspective the European financial system was rightly considered different from the American one, many supporting the idea that it's more efficient. However the financial crisis caused by the U.S. subprime loans did not encounter any obstacles and had expanded in Europe with a rapidity that astonished most analysts. This paper proposes an analysis of the role of corporate governance in the expansion of the financial system crisis throughout Europe.

Keywords: corporate governance, financial crisis, financial markets, macroeconomics

1. Introduction

The recent global financial crisis has called into question many of the things considered to be universally true about economics and provoked fierce disputes concerning changing the assumptions on which economic paradigms are based. It is too early to tell how the future global economy will look like, but some ideas are starting to catch consistency and to be agreed and implemented by policy makers around the world. With regard to financial intermediation sector, the essence of these ideas consists in an increase in prudential regulation and supervision of markets, as much as possible without damaging competitiveness. And this is probably a very difficult task for regulators.

The financial system was heavily regulated even before the crisis, people being aware of the systemic risk in the banking sector. Its monitoring was justified by the major impact the incidents concerning financial institutions might have in the balance of the economy's well functioning. Until the beginning of the economic crisis, studies concerning the causes that can lead to banks bankruptcies were almost always focused on quantitative variables

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resulting from the implementation of appropriate accounting standards, standards that, at least in the financial sector, can be very subjective as regards to valuation of assets and financial results.

The banking system was never considered different from the other systems in the fact that corporate governance has a significant influence on its long-term stability. However, most of the times, regulators involved themselves with great restraint in the corporate governance of banks, arguing by stating the benefits of creative destruction and that management compensations are investors private money.

In recent years, several studies were made about the role of banking's corporate governance in the development of the financial crisis and the problems faced by banks lately.

OECD launched in 2008 a very ambitious plan to introduce a number of recommendations regarding corporate governance arguing that this was one of the main causes for the crisis outbreak. In the financial sector, the Financial Stability Board (FSB), created under G20 states, published a set of principles and recommendations regarding corporate governance and especially regarding the senior management compensation of major financial institutions. Also, this board is actively involved in the implementation of these principles in the G20 states.

This paper is divided into five parts. The second part is a brief summary of how the subprime financial crisis that originated in the United States developed to the European continent. The third part of the article is dedicated to the role of corporate governance in importing the crisis in the European Union. Moral hazard, reflected by the greed of managers of the major financial institutions in Europe, proved to have many similarities with what happened in America. Unable to lend money so easily by creating complex derivatives with no real coverage (later called 'toxic assets'), the European banks manage to buy such assets from the U.S. A poor corporate governance remains the main source of moral hazard. The fourth part is a brief analysis of the current measures taken by international institutions to improve corporate governance in the financial system. The authors of this article believe that greater involvement of regulatory authorities is welcome in the corporate governance of the financial system, given the large number of banks needed to be saved with public money. Part Five is dedicated to conclusions.

2. The evolution of the financial crisis: from US to Europe

Many analysts believe that the current financial crisis originated in the U.S. in September 2008 when Lehman Brothers declared bankruptcy. In fact, the problems started long before that date. Since the 2007 BNP Paribas decided to stop three investment funds from trading arguing that it was unable to assess their value in an appropriate manner. Although markets issued early warnings, most signals were not correctly interpreted by any of the direct or indirect participants either borrowers, mortgage securities investors or regulators.

Securitization became a dangerous game due to the way it was put into practice by involving many other participants, institutional control becoming completely isolated.

It is said that the main cause of the U.S. financial crisis was subprime lending. Basically, banks have granted loans way too easy to borrowers whose creditworthiness was at least questionable and these loans were not repaid on time. Of course, these loans were granted under a collateral represented by the mortgages of their owned properties. In turn, these loans were secured by various specialized companies, making the banks to consider themselves safe from possible defaults. Subprime lending was the main source for the sustained growth of housing prices in the U.S. and beyond. Specifically, one could buy a house through a bank loan, to have a grace period of one or two years in which he or she will have to pay only the interest and then refinance the loan through a greater one taking advantage of the housing price appreciation. Speculative bubble was based under the wrong assumption that housing prices will continue to rise and subprime borrowers could refinance their loans. Permanent housing price growth was fuelled by new borrowers who purchased new homes.

Normally, in an appropriate financial regulatory system oriented to long-term financial stability, banks would not be able to lend money to so many subprime borrowers considering the simple fact that these loans should result in a high level of provisions. It would have been difficult to maintain a solvency ratio above 8%, as set out in Basel II recommendations (due to the high risk of those assets). However, banks have secured those loans through local insurance companies so they could fit the regulatory requirements imposed by the authorities. This was due to the fact that the insurance market was much less regulated than the banking sector, so they could assume the potential losses of those loans.

Insurers themselves could have sold those securities through financial derivatives. They created the so-called CDO's (Collateralized Debt Obligations) that were very popular until about 2007. These were purchased by everyone from everywhere (including European banks) because of their high profitability. Almost no one knew or was interested to know what lies behind these assets, which were evaluated by reputable rating agencies to grade 'AAA'.

When the bubble grew too much, that is when banks began to have difficulty in finding new potential customers willing to buy houses, house prices ceased to increase and borrowers were unable to refinance or repay their loans drawn and started to enter in default.

In the European Union this type of loans had a considerably smaller size. However, European banks bought enough toxic assets to get into big trouble once the bubble burst. It is quite difficult to estimate the value of the toxic assets that was held by European banks just before the crisis. Deloitte experts appreciated in 2011 that these assets stood at about 1.5 trillion British pounds [H. Wilson, *Europe's banks have £1.5 trillion of toxic assets*, Telegraph, Dec 15, 2011]. However, this evaluation is extremely optimistic given a more recent European Commission document stating that from the beginning of the crisis and until today about 4.5 trillion Euros were spent to bail out banks only in the euro area [European Commission, *A Roadmap towards a Banking Union*, Communication from the Commission to the European Parliament and the Council, Brussels, 2012, 3].

In any case, it is obvious that the top managers of banks in Europe could not refrain to buy those assets that brought them very high yields and consequently higher bonuses for financial performance, similar to those of their colleagues in the U.S. But this was not the real cause of the financial crisis in Europe, rather a trigger.

3. Corporate governance role in transmitting the crisis

Corporate governance underpins how companies base their long-term economic strategies and is the key to the stability of any economic system, including the financial system. In particular, corporate governance refers to how companies are directed and controlled in observing the principles of fairness, transparency and accountability of all stakeholders. It is the result of norms, traditions and behavioural patterns developed and supported by all legal system. This is supported by most economists. From this perspective, the European financial system was rightly considered different from the U.S. one, many claiming it's more effective. However, large sums of money were invested in assets that promised high returns but proved to be extremely damaging once the crisis started. It can be said that the U.S. exported the subprime crisis in EU, but the responsibility of accepting the 'offer' belongs to the importer.

Today, despite many studies on corporate governance, there are still not any clear and fixed criteria to assess the corporate governance. In principle, general corporate governance criteria apply to almost all types of companies, and therefore also to banks.

However, banks represent a special category of companies in that they are, or should be more heavily regulated by the authorities. This is particularly important because of their role in the smooth running of the economy by providing financial intermediation, respectively by transferring funds from those who do not need them temporarily to profitable long-term investment. We must not forget the important role that banks play in creating electronic money, thereby increasing the money supply and, potentially, the inflation. We should also take into account what is called systemic risk. Banks rely heavily on the confidence of those who choose to keep their financial resources to them. When a bank enters into bankruptcy the entire banking system suffers from the general decrease in trust. At least in terms of banking, the Austrian school theory of Joseph Schumpeter about creative destruction should be accepted with caution [1].

Banks are a special case of institutions working almost exclusively with financial assets and whose business consist almost always in dealing with the risk of their investments proving inefficient, so they have whole departments dedicated to risk management.

The overwhelming majority of studies on how banks can get bankrupt are based only on quantitative analyses of data that usually results from the interpretation of the relevant accounting standards by specialists. With the increasing diversification of financial instruments, bank accounting became slightly subjective in the way that it depends very much on the interpretation of management if a bank is profitable or not (for example provisioning using advanced models based on projections/forecasts of the default risk). Nor could it be otherwise. But this only increases the role of corporate governance is the sustainability of the banking system. Unfortunately, until the financial crisis there have not been so many studies on the role of corporate governance in banking.

Eventually, as stated by Stiglitz in his book entitled *Free fall*, the reason of market failures is related with the incentives and motivations of their actors [2]. Most studies on corporate governance analyses how the top managers in banks are compensated.

In a recently published study entitled ‘The Roles of Corporate Governance in Bank Failures During the Recent Financial Crisis’ Allen Berger examines the influence of corporate governance on the profitability of U.S. banking system [Working paper available at SSRN: http://ssrn.com/abstract=2021799, 2013, 28]. The main variable used to describe and differentiate the corporate governance features is the proportion of shares held by managers of banks in the total shares. The main conclusion of this study is that as middle managers hold more shares in the banks where they work, the chances of those banks to fail are bigger. Proposed explanation are related to the occurrence of moral hazard, bank managers are tempted to engage in more risky activities to get more material benefits. Same is not true for top managers, in their case there is no direct link between the holding of shares and guarding the long-term performance of their institutions.

Another study, entitled *Corporate Governance in the European banking,* and published as a working paper in 2011 analyses the corporate governance in the major European countries as opposed to the U.S. through the organization of management and the average length of board tenure (Table 1) [F. Arnaboldi and B. Casu, Working paper available at SSRN: http://ssrn.com/abstract=1763134, 2011, 20].

Table 1. Banking board size and specifications - by country.

Country	**Size (avg)**	**1 tier board**	**2 tier board**	**Average board length of tenure (year)**
EU	15.2	44%	56%	4.5
US	12.9	89%	11%	8.2

From the above table we can see that in US it is preferred the 1 tier system of management in the banking system in 89% of cases as compared to 44% in the European Union. The 2 tier board system implies the existence of a Board of Directors consisting of executive directors in the bank and the Supervisory Board with members that have no executive powers – their role only consists in appointing the board of directors, appointing the president of that board and monitoring/evaluating the business executives. In theory the dual system should ensure an effective process of decision making within the firm. The theory recommends the adoption of such organizational forms for companies with many shareholders holding fewer shares and therefore not very much interested and involved in the management of such businesses. However, the single tier system from U.S. failed to prevent the emergence and development of such a large-scale crisis as well as the dual system from Europe failed to stop importing the crisis. Also, it can be seen that in the U.S. the average duration of tenure boards is almost double of that in the EU. A bigger tenure should lead to the existence of a long-term vision of leadership and therefore greater attention to risk taking. Practice seems to contradict this theory.

Although there have been many studies showing the existence of major differences related to corporate governance in the two continents, these differences were not found to be very important in terms of how management structures of banks acted, both showing great difficulty in thinking on a long run. Corporate governance should have prevented top managers from European banks to buy something they do not understand entirely, just based on favourable reports from credit rating agencies that also bear their share of the blame. The authors believe that regulation has played a very important role in this regard by encouraging banks to use credit rating agencies in assessing their assets against their own judgments.

4. What is changing?

In response to the financial crisis, the OECD launched in 2008 a very ambitious plan to promote a series of recommendations regarding corporate governance being aware of its role in the behaviour of large corporations taking risks in the markets they operate. According to the analysis of the organization, the major causes that favoured the emergence and development of this crisis are related to corporate governance, respectively: issues with remuneration, risk management, board practices and the exercise of shareholder rights [OECD, *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles*, OECD Steering Group on Corporate Governance, 2010, 3].

However, corporate governance principles were defined by the OECD since 1999 and were revised in 2004 [OECD, *The OECD Principles of Corporate Governance*, 2004, 2]. These principles, although correct in nature and assumed by most countries, were too general to have a major influence on the behaviour of large corporations and managers of these corporations. Stakes were simply too high and the principles too interpretable for having more of a binding. The idea that shareholders should define their own corporate governance principles and ensure that they are observed by management prevailed. Under these conditions, before the crisis, regulators and prudential supervisors of the financial sector were much less involved in corporate governance, limited in most cases only to collect statistical information about these things.

Basically, the shareholders had responsibility for corporate governance of financial institutions. But in both the United States and the European Union in the mid-twentieth century a phenomenon began to develop represented by a diminishing involvement of the shareholders/owners in their big business decisions and long-term strategies [3]. This has been fuelled by the increasing number of shareholders and the decreasing number of shares held by each and also the possibility for immediate sale of these shares on major stock exchanges. Thus, shareholders of large companies have ceased to be long-term investors of the economy turning into mere speculators. This phenomenon has occurred mostly in the financial sector.

Based on the recommendations of the OECD and G20 forum, the Financial Stability Board - FSB has drawn up a series of nine specific principles regarding corporate governance with special emphasis on how to reward the senior management of financial institutions.

These principles are divided into three categories [FSB, *Principles for Sound Compensation Practices: Implementation Standards*, 2009, 46]:

1. Effective governance of compensation:
   - Preventing the situations in which the Executive Director establishes its own salary and recommends the creation of a special committee under for the leadership of major financial companies;
   - The managers involved in risk management as well as other employees with similar responsibilities should be rewarded regardless of the financial performance of their respective companies.
2. Effective alignment of compensation with prudent risk-taking:
   - Income should be adjusted according to the risks assumed;
   - Revenues must be sensitive to the time horizon for which risks were assumed - for example part of the bonuses can be paid at the time of selling the financial products, but most of the bonuses have to be paid after a period of time and only if everything went well (minimum recommended: 3 years).
   - There must be a balance based on employee role in risk taking between cash and equity compensation.
3. Effective supervisory oversight and engagement by stakeholders:
   - FSB is actively involved in the implementation of these principles in the G20 states, coordinating the relevant supervisory and regulatory authorities and compiling periodic reports on the status of their implementation.

The world seems to have understood that, at least in financial intermediation, it is necessary for the authorities to be more involved in corporate governance through its inclusion in the regulatory systems. The best argument for this idea is the immense amounts of public money used to rescue banks. This is a natural effect brought by the introduction of the concept ‘too big to fail’.

5. Conclusions

It is said that any crisis is unlike any other. Perhaps no future crises will look like this. The recent financial crisis, which seems to be never-ending, was caused largely due to market failures in the behaviour of big corporations whose business is in financial intermediation. The crisis came amid stunningly rapid technological advances that have enabled the development of more and more complicated financial instruments.

In theory these financial instruments should have led to a more effective financial risk management and eventually to long-term financial stability. At least that was how they were promoted by lobbyists. However practice has shown otherwise. These tools not only didn’t improve the stability of the financial systems but they have done major damage to them, requiring large amounts of money from the authorities to save their economies from a terrible and imminent disaster.

Authorities failed in their role to constantly adapt to market changes. In addition to the emergence of new financial instruments, major changes have occurred in the corporate governance of world financial systems and perhaps other systems also. Corporate governance in financial institutions has become a place where market mechanisms fail to provide economic stability in the long run. Under these conditions, the intervention of authorities was and still is perfectly justified.

This article shows that although there were important differences in the corporate governance between the financial systems of Europe and U.S., financial crisis developed and grew freely in both places. As U.S. banks lend subprime borrowers, banks in Europe bought the related financial instruments.

Besides public authorities, economics science itself has its own fault. There have been many studies related to corporate governance and its role in the success or failure of businesses. There have also been many studies about the causes of bank failures. However little or no studies have link these two phenomena before the crisis, bank failures generally being explained by analysing their accounting data. A big problem in terms of corporate governance study is the lack of a centralized source of the data on it. Most current studies of corporate governance of banking systems are based on data collected "manually" from private sources (for example annual reports of banks statements posted on the websites of their corresponding stock exchanges offices).

The authors of this article believe that scientific research on the role of corporate governance in the performance and stability of banking systems is still in the beginning. Progress in this field is also ensured by the fact that public institutions involved in shaping the long-term economic policies begin to pay more importance to this matter.

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