

Financial crisis

[Literature](#), [Russian Literature](#)



The latest global financial crisis was exploded in 2008. This was the most serious financial crisis since the economic depression which occurred in 1929 and it severely impacted the global financial market. Lots of corporations collapsed during the 2008 financial recession which was caused by breakage of capital chain. Although some companies did not bankrupt during that period, they also had suffered huge loss. The 2008 global financial crisis began from America. American financial crisis came from the prosperity of real estate.

Before the 2008 global financial crisis, a large number of financial derivatives were generated and financial bubble became more and more serious. Finally, American sub-prime crisis occurred which led to a large number of bank failures. This paper will analyze the reason of American sub-prime crisis and indicate the relevance between Shal's article, agency theory and the 2008 global financial crisis. This essay will argue that agency theory contributes to the 2008 global financial recession.

2 Review of the literature

2. Agency theory

Agency theory has described a relationship between principals and agents. It also can solve this relationship through a contract that 'one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent' Jensen and Meckling, 1976: 308, cited in Lehman and Johnson, 2013).

2.2 Bad theory and human morality and ethics

After the collapse of Enron, Shal (2005) strongly argues that business school does not need to do lots of things.

In contrast, they just need to terminate some old courses which they are teaching for their students. The reason is that the root of the issues in

management practices can be found in the theories of management. Additionally, management practices which are condemned are enhanced by these 'theories and ideas' (Shoal, 2005: 75). Moreover, business school cannot address the issues of moral and ethic. Clansman, Setback and Heckler (1998: 77, cited in Shoal, 2005) claim that management studies is regarded as 'a branch of' the social sciences.

Namely, the issues of business studies can be analyzed and resolved in method of social sciences. However, Ghosted (2005: 77) strongly argues that people use 'scientific' way o explore regulation so that they have ignored the moral and ethics of humans. Because there are some underlying basic diversities between physical sciences and business studies, some theories of physical sciences are not suitable for business studies. Furthermore, the parts of business studies which are related to physical (2005), even though 'scientific methods' (p. 7) exerts some positive influences, the cost is expensive. Therefore, this approach denies the subjective initiative of human. In addition, humans morality and ethic which are neglected by individuals are inevitable in human intentionality. Jensen and Michelin (1976, cited in Shoal, 2005: 75) assert that an idea which 'mangers cannot be trusted' was taught to their students in business school. As a result, when these students graduate, they hardly trust their leaders and do not realize that they should strictly maintain personal integrity.

Additionally, Even though Friedman (1953, cited in Shoal, 2005) acknowledges that the duty of agents is to maximize the profit of shareholders, Shoal discounts this view and argues that compared with

finding a new job by employees, it is easier that shareholder can sell their corporation (Shoal, 2005). Furthermore, shareholder value minimization is the fundamental of the agency theory. However, Shoal (2005: 81) strongly asserts that they are not relevant and points out that these research and analyses are built on incorrect assumption, which meaner they are 'unrealistic'.

Moreover, 'Chicago Agenda' extreme emphasis laws and rules and against human intentionality and indicates that ethic and morals which are only relevant with persons can be removed from socialscience(Shoal, 2005). Nevertheless, Shoal disagrees this view and approves of the stewardship theory, because it can effectively give consideration to he profit of 'customers, employees, shareholders' and their 'communities' (Davis, Chairman and Donaldson, 1997, cited in Shoal, 2005: 81). 2. 3 Background of financial crisis The 2008 global financial recession has been described a 'once in a century credit tsunami' (Earl, 2009: 785).

This is a disastrous blow to global financial community. Ballard (et al, 2009, cited in Huh et at, 2012) points out that many economists regarded the global financial crisis as the most serious globalfinancedisaster since sass. Compared with only 11 banks was bankruptcy during 2003 to 2007, at least 160 American banks went broke in 2008 and 2009 (Fide, 2011, cited in Huh et al, 2012). From this statistics, it is not difficult to know how strong influence brought by this financial crisis. There is a close link between the 2008 global financial crisis and sub-prime crisis.

Bernard (2007, cited in Hellenize and Chaos, 2012) asserts that 'sub-prime mortgages are loans made to borrowers who are perceived to have a high credit risk, often because they lack a strong credit history or have other characteristics that are associated with high probabilities of default'.

Furthermore, during 1990 to 2000, cause of the IT bubble economy, the American government took some steps to prevent economic downturn, such as reducing interest rate, cutting tax, decreasing the cost of sub-prime etc.

Even though there were higher risks that some of sub- prime borrowers cannot repay currency punctually, the sub-prime mortgage had become an extremely phenomenon in that period, because this kind of debits can get more return due to the higher interest rate. In addition, secondary market had Thus mortgagor can easier receive mortgage credit, no matter he or she is the sub- prime borrowers or prime borrowers. As a result, sub-prime mortgage market had developed rapidly.

Furthermore, a large portion of American preferred to buy a house in installment plan before the 2008 global financial crisis and some of them were sub-prime borrowers. Basic and Chine (1996, cited in Change and Chine, 2013: 14) claim that people need 'more than enough' fortune to certify their social status. This is why lots of American purchased a house in installment plan. Because of the higher interest rate, local banks were pleased to borrow currency to these sub- prime borrowers. Goodhearted (2007) claims that in order to assess the default risk, here is no experience that the price of house has declined in the whole of America.

However, the price of house started to fall from the end of 2006 in lots of areas of America (Goodhearted, 2007). Because the value of mortgage is less than the debts and the growing interest rate, increasingly sub-prime borrowers gave up repaying currency to banks. Consequently, even though lenders had sold these mortgages, it cannot cover the loss. In other words, the income gained by selling houses was not enough to offset the values of the credit and interest. As a result, these banks were suffering serious loss and some of them had to close down. 4 The link between Shoal' article, agency theory and financial crisis In recent years, agency theory is widely used in lots of corporation and regarded it as the fundamental theory of corporate governance. Agency theory has played an important role in traditional control systems. Moreover, in this theory, shareholders use the method of supervision and reward to control managers and employees. It is the foundation of agency theory to maximize the value of shareholders. Principals need to supervise agents whether they focus on shareholder' interest when they are operating a corporation.

However, Shoal (2005) strongly points out that this theory does not improve the company's performance, because it is analyzed by physical science and then neglect the moral and ethic of human. Because the different perspectives between shareholders and agents, they can make the diverse decisions. Thus some primary issues should be focused on in agency theory. Firstly, because of the diverse goals between principals and agents, how to 'align' them has become thorny (Lehman and Continue, 2013: 1). Secondly, how to guarantee agents carry out according to principals' ideas. (Lehman and Continue, 2013). Shareholders are interested in long-term strategies

which can sustainably evolve their corporations. In other words, in long-term strategies, shareholders' value, such as stock price and dividends, can be maximized (Klein, 2009). In contrast, agents focus on short-term strategies so that they reject long-term strategies. In this way, they not only can effectively avoid unpredictable emergency which usually occur in long-term strategies, but also can get profit in a short time. It is why leaders just pay attention to currently profit and overlook long-term development.

For example, they may use 'inferior raw material' to manufacture (Lehman and Continue, 2013: 1). As a result, current margin can increase; however, they have overlooked some more corporation. Obviously, the loss of long-term cannot be estimated. This is similar as the sub-prime mortgage.

Lenders prefer to lend currency to sub-prime borrowers, because of the higher interest rate. They can collect more properties in a short time. In addition, if the housing price is higher than the price of mortgages, borrowers will try their best to repay the debt, because they do not want to lose their house.

To assume, if a mortgagor cannot timely repay, house, as a mortgage, will belong to the bank. Namely, when the bank sale this house, it can get extra property immediately. In this case, lending currency to borrowers, even though they are sub-prime borrowers, it is hardly to get damage to lenders. However, loaners have only noticed the short-term profit, therefore, they loaned mortgage to sub-prime borrowers instead of prime borrowers; however, they had neglected sustainable development, especially when the price of house dramatically declined.

In fact, when the housing price decreased, some borrowers preferred to give up the mortgage to lenders, especially the value of house is lower than the loans (Klein, 2009). In other words, banks only can receive these mortgages instead of the loans. As a result, huge loss derived these banks collapse. Furthermore, mortgage lender also can resell these mortgage to investment bank. However, some of them had hid some information in order to a higher price (Klein, 2009). In this way, some drawback of mortgage cannot be known by a new buyer.

What is worse, these shortcomings may be modified to become some advantages to attract others. This fraud and sharp practice had continuing occurred. Namely, there are increasingly investing companies were involved in this event. Nevertheless, because the housing price decreased, these mortgages had devalued, which caused a serious debt crisis. Shoal (2005) points out that business school should open some ethic courses to teach their students more accountable. Obviously, he has predicted this perspective.

Initially, if lenders do not only pay attention to short-time strategies, they did not only pursue the minimization of value in a short time and preferred to lend currency to prime borrowers rather than sub-prime borrowers. Even though the price of house decreased, borrowers are bound to consider their reedit, because they do not want to be classified in sub-prime borrowers. Additionally, they had stable jobs to ensure the possible of repayment. Namely, banks may not consistently suffer such a huge blow.

Furthermore, in order to earn greater profit, some agents had lent more than 20 times cash than the value the company's security assets. Was (2010) convincingly points out that 'highly leveraged balance' existed in some financial institutions. For example, investment banks' liabilities-to-assets ratio was 0.96 at the end of 2006 (Was, 2010). In other words, the majority of assets was borrowed. Even though these agents used insurance to transfer risk, blind pursuit of interests had brought some huge hazard. Sometimes, if an agent is indeed regarded as a selfish man, it will damage the benefit of his or her corporation.

Even though it may be reasonable that agent should some underlying differences between physical science and business studies. In other words, some theories which are correct in physical science cannot be reasonably used in business studies. Eisenhower (1989, cited in Lehman and Continue, 2013: 1) points out that it is a significant issue that if an agent makes a decision, it will be difficult for principals to check whether this decision is beneficial for the company, such as 'creative accounting' which is seriously harmful the profit of corporation.

Furthermore, managers may not want to spend capital on 'long-term research and development', because it can reduce the short-term interest (Lehman and Continue, 2013: 2). Therefore, even though it seems exact that managers should maximize the value of shareholders, Shal discounts this view. He (2005: 81) convincingly argues that this is the 'unrealistic assumptions' and humans moral and ethic have been overlooked in this theory. In fact, shareholders and agents have the diverse goals, which

meaner that shareholders are interested in long-term strategy; oppositely, agents prefer to focus on the short-term strategy.

Because of the unrealistic assumptions, agency problems which contribute to the 2008 global financial crisis are ignored. 3 Implication in article 3. 1

Stewardship can remit financial crisis In Shoal's article, he argues that stewardship theory which can be alliterative to replace the agency theory can remit the problem between principals and agents (Shoal, 2005).

Stewardship theory does not advocate personal interest, but the elective profit. In this theory, collective profit is higher than the personal benefit.

Hernandez (2008) points out that agents' and shareholders' benefit can be aligned in stewardship theory. 'Responsibility' and 'psychological ownership' are combined with the profit of shareholders (Block, 1996; Davis, Chairman, and Donaldson 1997; cited in Spheres et al, 2012: 2). In other words, they have become a collective and the interests of collective have closely linked with personal profits. According to Hernandez (2008), employees can feel more responsible and fulfill their obligations in stewardship theory.

Because the interest has become consistent, the conflicting goals may not exist. Compared with agency theory which monitoring is necessary between shareholders and agents, shareholders and staff can cooperate in a harmonious environment. Furthermore, stewardship is also beneficial for realizing the interactions between sales personnel and consumers (De Router, De Gong and Wetness 2009; Hernandez, 2008, cited in Spheres et al, 2012). Therefore, it is good for a corporation to pay attention to customers, staff and shareholders simultaneously.

Take sub-prime crisis makes an assumption, if the majority of corporation accepted the stewardship theory instead of the agency theory before the 2008 global financial crisis, the credit tsunami might not occur or it was not as heavy as this. Interest among agents', shareholders' and customers' are tightly relevant. In other words, agents and shareholders may not only focus on the short-term profit and ignore long- term. Therefore, they may prefer to lend currency for prime borrowers while limit the amount of loans which is loaned to sub-prime borrowers.

In addition, when lenders resell their mortgage, they may not deliberately hide weak information and may not modify shortcomings in order to resell a higher price. Even though the agency theory has been extensively used in the world, Shal has realized the drawback of it and try to replace it. The agency theory has contributed to the 2008 global financial crisis to a large degree. Namely, Shal has forecasted the issue which has widely existed in the majority of companies. Furthermore, the stewardship theory advocated by Shal can effectively remit the problems between shareholders and agents.

It also can decrease the harm brought by financial crisis to some extent. 4 practice relevance 4. The power of government While it can effectively decrease the probability of financial crisis that using the stewardship theory replaces the agency theory, it is not enough. Therefore, the power of government cannot be overlooked. Because it can cause economic bubble that a government continually slash interest rates or dramatically reduce

interest rates. However, American government had constantly reduced the interest rate thirteen times from 2001 to 2003.

As a result, it caused the boom of American real estate. In addition, the application condition of sub-prime mortgage had decreased. A large number of people preferred to purchase a house in installment plan, which caused the 2008 global financial crisis. Therefore, except for the stewardship theory, government also should pay attention to the frequency and the range of decreasing rate. Excessively fast decline the interest rate or oversize decrease them may cause economic bubble, which can harm for the domestic financial market.

What is worse, it can lead to global economic crisis. Thus improper regulations may indirectly lead to financial crisis. In addition, it is important that government should limit the rate of the sub-prime mortgage in any investment bank. Klein (2009) points out that regulation which can defend financial market should be built by government. In other words, reasonable legislative can effectively prevent financial crisis. Consequently, the effect of government cannot be ignored. It also can effectively protect financial market and prevent huge loss.

While the dominant economic system is free market, governmental macro-control, which is beneficial to the current economic system, is inevitable. 5 Conclusion Agency theory has described the relationship between principals and agents. Even though the foundation of the agency theory is to maximize the value of shareholder, Shoal (2005: 81) convincingly points out that it is incorrectly built on an 'unrealistic crisis. Because sub-prime borrowers have

the lower credit and lower repayment ability, when the value of mortgage was less than the loan, they preferred to give up repaying the debt.

As a result, sub-prime lenders had to sustain the huge loss. However, agents only focused on the short-term profit. They preferred to loan currency to sub-prime borrowers. Therefore, borrowing currency to sub-prime borrowers had become a common phenomenon in that period. Even though Shoal's article was published before the international financial crisis, he was still aware of the problems of agency theory in economic system. While agency theory is accepted by the majority of corporations, it still has some serious problems.