

# Financial crises and corporate finance: causes, context and consequences

[Finance](#)



## 1. 0 Introduction – background to financial crash of 2007-8

This essay will examine the background and unfolding of the 2007-2008 financial crisis and its impact on the theory and practice of corporate finance. I will analyse whether changes to the way the financial and non-financial corporate sector operated over recent years contributed to the depth and severity of the crisis. Specifically, financial deregulation in the 1990s in financial markets and the securitisation of the corporate sector (Ball, 2009), have led to claims that the 'solution' to the so-called agency problem of aligning manager and shareholder interests may have actually made the crisis worse. I will argue that the easing of regulations on the mortgage loan sector especially increased the risks of a financial crisis developing by creating the environment for a massive financial asset bubble. Historically low interest rates and 'easy money' policies of the US Federal Reserve under Alan Greenp following the bursting of the technology bubble in 2000 created conditions for the bubble. I will also examine whether the growth in markets for innovative financial products such as CDOs disguised risks and even mispriced assets in the mortgage market by separating the obligation to fund the original loans from the trading of such obligations as collateralised debt. The outcome of the crisis in terms of future corporate financial behaviour and regulatory reforms of the corporate sector will be reviewed.

## 2. 0 Corporate finance models and the financial crisis – the role of CSR

Critics of the corporate sector such as Simms have argued that the narrow focus among publicly listed companies on short-term profits over and above sustainable long-term corporate health, helped cause the financial crisis of

2007-9. The process of selling off traditionally run companies to global multinationals had led to the disappearance of famous companies such as Twinings and Cadbury from the British economy, and the loss of jobs related to these closures. Simms is not alone in claiming that the narrow pursuit of short-term profits as well as excessive pay among senior executives has not served the interests of the wider economy and stakeholders including workers and pension funds. Simms sees the selling off and closure of great British enterprises as the result of the loss of traditional family business ethics and their replacement by financial sector values of high returns to investors. Fernandez-Feijoo Souto (2009) analyses the financial crisis in terms of the opportunities it presents for companies to refocus on corporate social responsibility. CSR is seen as growing in importance as part of the corporate culture although there is difficulty in defining what CSR actually means. Fernandez-Feijoo Souto argues that the financial crisis has provided a new urgency to the need to clarify what defines CSR and how it should be implemented. This includes building a name as a responsible business and relating this to growing revenue, keeping key personnel, understanding consumer's bias toward companies with a good CSR brand; changing relationships through the value chain based on trust and treating customers and suppliers well; improving conditions which in turn reduce employee turnover and raise productivity, and reducing legal conflicts by complying with regulations. Simms argues that companies with a business model that has CSR built into it have been shown to be much better adapted to survive the challenges of the global financial crisis than companies that have followed a short-term profit strategy. He uses the examples of Bear Sterns

and Lehmans, which traded under the saying “ Let’s make nothing but money,” as classic examples of the kind of approach that led to disaster. However for each such example, one can point to a similar company, such as Barclays or Goldman Sachs, that have continued to thrive during the financial crisis despite having the same financial focused ethos. This is reflected in the evidence of numerous studies the result of which show unproven links between CSR and cost, profit and longevity (Fernandez-Feijoo Souto, 2009). There is evidence also of a split between positive economic results and more negative financial results, meaning that potentially short term financial gains may come at the cost of longer term economic performance.

Lipton, Lorsch and Mirvis (2009) state: “ Excessive stockholder power is precisely what caused the short-term fixation that led to the current financial crisis.” They point to money managers focused on short-term financial results who fuelled excessive risk taking. This tendency was favoured by government and regulators failing to impose checks on risk taking. Lipton, Lorsch and Mirvis see a “ direct causal relationship between the financial meltdown and the short-term focus” of stockholders.

### 3. 0 The role of securitisation in the financial crisis

Securitisation of the mortgage and loan market, which developed in the 1990s, is seen by some commentators as central to the development of the financial crisis of 2007-8. Securitisation of asset-backed bonds is the process of creating debt instruments from a package of loan assets, usually home loans, commercial loans and retail loans such as credit card debt or auto

loans. This allows banks to release value from the assets on their balance sheet. The asset-backed market was developed in the United States and grew rapidly from the early 2000s. Banks and other originators of mortgages sold on packages of their loans to an issuer, usually called a special purpose vehicle (SPV). The purpose of the securitisation is to reduce the institution's balance sheet, which allows its return on equity to rise and also releases capital for other purposes. The process of securitisation enables the issuer to achieve enhanced credit ratings, usually up to AAA investment grade (Sundaresan, 1997). The credit rating of the original loan does not affect the rating of the SPV, even if the original mortgage holder defaults on the loan or is declared bankrupt. The securitisation deals are normally rated by credit ratings agencies such as Moody's, Fitch or Standard & Poor's. The investment bank or investor which purchases the SPV securities will often approach an insurer to gold plate the deal by providing a credit default guarantee for the SPV in the event of default (Teasdale, 2003). It has been argued that the complexity of securitisation restricts the ability of investors to assess risk, and that securitisation markets are likely to be subject to serious declines in underwriting standards.

### **3. 1 Credit Default Swaps – analysis of impact of CDS market in the financial crisis**

The huge growth of the credit default swap (CDS) market is considered by many analysts to be one the worst elements of securitisation. The Bank for International Settlements reports that the CDS market increased in size from \$6 trillion in 2004 to \$57 trillion in June 2008 measured by notional principal (Stulz, 2010). The government bailout of AIG brought the CDS market to

global attention, and led some commentators to see the CDS market as the primary cause of the financial crisis. As Stulz (2010) argues, there are two problems with the CDS market. First, the sellers of credit default swaps are not able to bear the risks they took on, so some of the benefit of credit default swaps in terms of hedging are actually unfounded - ultimately leading to the \$80 billion bailout of AIG. Second, because of their inherent leverage of a CDS, they can enable investors to take more risky positions. The availability of these instruments to non-risk-averse investors may lead to risk being under-priced. However, Stulz shows how the CDS market performed remarkably well around the default of Lehman Brothers. The credit default swap market did not cause the subprime mortgage defaults or the disappearance of liquidity. Excessive leverage by financial institutions and the collapse of the housing market was the cause of the crisis. For example, AIG borrowed heavily to acquire home loan-backed securities and it made even bigger losses on its portfolio of home loan-related securities than on its credit default assets.

#### 4.0 Ponzi schemes and failure of investment banks to report criminal behaviour

The crisis also revealed outright criminal activity taking place in the investment sector, most famously in the case of Bernard Madoff, whose wealth management business was exposed as a Ponzi scheme with \$65 billion funds missing from accounts. Madoff was sent to prison for 150 years. JP Morgan acted as banker to Madoff but did not report their suspicions about his activities to the SEC (Ferguson, 2012). Critics have commented that there

have been very few prosecutions of investment bankers for such activities as ‘shorting’ the very stocks that they recommended to their clients (Lewis, 2010). The Securities and Exchange Commission and New York prosecutors have brought very few prosecutions and no one has faced criminal conviction. Ferguson points out that Morgan Stanley’s Howie Hubler began to bet against securities connected to the subprime market in 2004 with management approval (Ferguson, 2012). The title of Ferguson’s film ‘Inside Job’ refers to the pattern of investment bankers and lawyers whose clients are banks then taking senior judicial and political roles in the government and financial authorities. This, it is argued, has caused a disincentive to go after the banks for actions that could be prosecuted.

#### 5. 0 Reform of corporate finance regulations – legislation and limits of reform

Reform of the banking and wider corporate sector has been discussed and enacted in a variety of forms in the US and Europe. Banks have undergone stress tests to see if they could cope with further financial crises. The UK authorities have begun to reform corporate governance to give shareholders greater power to oversee compensation of executives, such as binding votes on executive pay, but this has not yet been implemented. New rules on the levels of reserves that banks must hold in order to ensure they are able to cope with future crises were agreed in November 2010 at the G20 summit in Seoul. G20 Finance Ministers backed the Basel Committee on Banking Supervision’s plans for capital and liquidity requirements for financial institutions. However most of these new reserve requirements have not yet been enforced, partly because the banking sector remains extremely

fragile following the financial crash with high level of debts still threatening the financial system. Following the crisis, there were many calls for the separation of retail and investment banking, or even the breaking up of 'too big to fail' banks, but these have not been acted on by government.

President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law in July 2010. The Act marks the biggest reform of the US financial sector since the Great Depression (Avery, 2011). Section 939A of the Act effectively bans the use of credit rating agencies in an attempt to improve capital requirements for US banks. However implementation is likely to take many years.

In America economists such as Paul Krugman have called for a return of the Glass Steagall Act 1933, which was put in place following the 1929 Wall Street Crash and then removed in the 1990s as part of the liberalisation of the banking sector (Krugman, 2011). Countries with stronger regulation of their banking sector, including Canada, Australia and Germany, did not suffer a banking crisis in the manner of the UK and USA, where regulation was 'light'.

## 6.0 Conclusion: comparison with regulatory response to 1929 Financial Crash

By comparison with the response of authorities to the Great Crash of 1929, it can be argued that through to 2012, five years after the crisis began, major reforms to the banking sector and to corporate governance in the US and UK have not been implemented in the way they were in the 1930s. This may be a result of the fact that governments and securities oversight authorities are



far less independent of the corporate finance sector than they were in the 1930s. The financial services sector has grown in relation to GDP compared to its position in the 1930s, and its political influence is far greater. This means that reform and regulation has been much slower and weaker than it was in the last Great Depression. Calls for reform will not go away, especially as the crisis continues in Europe and North America. Action on corporate governance, and implementation of proposals for financial and banking reform will be required in order to prevent further financial crises occurring in the future.

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