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IMPLICATIONS OF THE GLOBAL FINANCIAL CRISIS IN TERMS OF CORPORATE GOVERNANCE: THE CASE OF LEHMAN BROTHERS

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Abstract

The recent global financial crisis (GFC) has introduced many lessons to the business world. The bankruptcy of Lehman Brothers, one of the biggest financial institutions in the world, is one of these lessons. The stockholder governance is the reason of this bankruptcy. This paper will compare stockholder and stakeholder governance perspectives by scrutinizing the bankruptcy of Lehman Brothers. When we search for the reasons of this bankruptcy, greedeness is the main factor. This paper is expected to be enlightining for the ones who want to learn real the reason of Lehman Brothers' bankruptcy and of GFC.
Key Words: Corporate governance, stockholder governance, stakeholder governance

Özet

En son yaşanan global finansal kriz (GFK) iş dünyasına birçok ders vermiştir. Dünyanın en bük finansal kurumlarından biri olan Lehman Brothers'ın batması bu derslerden birisidir. Hissedar yönetişimi bu batışın nedenidir. Bu makale Lehman Brothers'ın batışını derinlemesine inceleyerek hissedar ve paydaş yönetişim perspektiflerini karşılaştıracaktır. Bu batışın nedenlerini incelediğimizde aç gözlülüğün ana neden olduğunu görürüz. Bu makalenin Lehman Brothers'ın batışı ve GFK'nin gerçek nedenini öğrenmek isteyenler için aydınlatıcı olması umulmaktadır.
Anahtar Kelimeler: Kurumsal yönetişim, hissedar yönetişimi, paydaş yönetişimi

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I. Introduction

The recent global financial crisis (GFC) has affected both finance and real sectors of USA. Lehman Brothers was one of the biggest financial institutions in the world with a very high financial rating and reputation in the finance sector. But the failure of this investment bank in a very short period of time suprised each person and financial institution not only in USA but also in the world. The bankruptcy of the Lehman Brothers is closely related with its corporate governance practices (i.e. stockholder governance practices). In order to scrutinize this bankruptcy, corporate governance practices, definitions and comparisons of the related terms will be given in the second, third and fourth sections, theoretical background of corporate governance will be given in the fifth section, performance criteria will be given in the sixth section, and definition of good and bad governance will be given in the seventh section. In the eighth section, the failure of Lehman Brothers will be briefly discussed. Finally, the conclusion will be presented in the nineth section of the paper.

II. A Brief Definition of Corporate Governance and Management

Starting point of this paper should be making clear definitions of corporate governance and management. Management is about running business, and corporate governance is about seeing that the business run properly. Management is to deal with the daily operations of the firm (Huse, 1998), and corporate governance is to exercise power over entities (Tricker, 2000). Managing the relationships with the varied stakeholders on a day to day basis refers to the definition of management, and the exercise of good authoritative judgement (Bird, 2001) or effective director behavior via stakeholder participation (Freeman and Reed, 1983) refers to the definition of governance. Our definition of corporate governance is the effective management of companies via stakeholder dialogue and inclusion, which will create good reputation for the companies and hence make them more durable and stable in the long term and even in a turbulent environment. This definition is especially important for the Turkish companies because a stable environment is unfortunately an acception in Turkey. Therefore, modern startegic management, which is closely related with corporate governance, is a must for Turkish companies rather than traditional strategic management.

III. The Introduction and Definitions of Stakeholder Perspective and Stockholder Perspective

After defining management and corporate governance briefly two important questions are needed to be asked: How can we run our businesses more properly or effectively? Which principles should be on the core of corporate governance? At this point, the meaning of the word principle is needed to be explained because the meaning of this word is very related with the answers to these two important questions. Wood (1991) has made the definition of principle clearly: "*A principle expresses something fundamental that people believe is true, or it is a basic value that motivates people to act.*" There are two dimensions, stakeholder perspective and stockholder perspective, which are based on principles in order to explain corporate governance. These principles are extracted from different theories of organization such as stakeholder theory, agency theory, stakeholder agency theory, resource dependence theory, resource based theory, strategic management theory, corporate social performance theory, economic theory and the theory of the firm. The names of these two dimensions, stakeholder perspective and stockholder perspective, are used by several academics (Freeman and Evan, 1990; Freeman and Reed, 1983; Greenwood, 2001; Mills and Weinstein, 2000).

The first dimension is named *Stockholder Perspective* and the second is named *Stakeholder Perspective*. A good corporate governance is related with the latter. Corporate governance is a conundrum because managers practice the principles of both dimensions (Clarke, 1998), which creates a paradox in the management of businesses. This paradox explains the reason of huge companies' entropy in U.S.A. and even in continental Europe and Japan recently.

IV. The Comparison of Stakeholder Perspective (Good Governace) v.s. Stockholder Perspective (Bad Governance)

Stakeholder perspective (good governance) is related with the companies which give importance to all of their stakeholders such as emploees, customers, suppliers, stockholders, government, and environment rather than only to their stockholders. Principles under stakeholder perspective are extracted from different theories of organization such as normative stakeholder theory, strategic management theory, resource based theory, corporate social performance theory, and the theory of the firm.

On the other hand, stockholder perspective (bad governance) is related with the companies which give importance to only to their stockholders rather than to their stakeholders. Principles under stockholder perspective is extracted from different theories such as instrumental stakeholder theory, agency theory, stakeholder agency theory, resource dependence theory, economic theory, and the theory of the firm.

Especially most important scholars in finance, management, and economics tried to solve the corporate governance conundrum via stockholder perspective (Demsetz, 1983; Fama, 1980; Fama and Jensen, 1983a; Fama and Jensen, 1983b; Jensen and Meckling, 1976; Williamson, 1985) but recent bankruptcies of several giant companies in U.S.A such as Lehman Brothers and financial distress of General Motors showed that the philosophy of agency theory or stockholder perspective is not adequate to solve corporate governance conundrum. On the other hand, other scholars pointed to the right direction, stakeholder perspective, two decades ago (Freeman and Reed, 1983) and recently also (Clarke, 1998; Greenwood, 2001; MacMillan and Downing, 1999; Mills andWeinstein, 2000; O'Higgins, 2001). Stakeholder perspective is expected to prevail over stockholder perspective in the 21. century because agency theory, stewardship theory and other theories related with stockholder perspective could not solve the corporate governance problem via pure rationality assumption. The bankruptcy of the very large corporations is the proof of the fallacy of stockholder perspective. Therefore, the purpose of this paper is to make a contribution on good corporate governance, which is based on stakeholder perspective.

In order to explain why stakeholder perspective is more related with good corporate governance than stockholder perspective (as it is generally named lassez-faire capitalist economic theory) the most important question is needed to be asked: Who or what is more important to our businesses and to our society?: Money or people? If the former is chosen there is no way to run our businesses properly or effectively and make better contributions to our society in terms of wealth creation. In other words, if we do not emphasize the importance of people in our businesses there is no way to solve the corporate governance conundrum. The rationale behind this answer to this important question is hidden in the meaning of the word principle. Principle is a basic value that motivates people to act. In our contemporary age, where the communication is very rapid and easy, if businesses cannot motivate their stakeholders to continue their exchange relationships with them, they will not able to survive or achieve a sustainable growth in the long run.

If managers continue to use the principles of both dimensions, by emhasizing the importance stockholder perspective or especially being near to this dimension as it is seen in U.S., may be they will be able to achieve high profitability by the help of high financial leverage in good times but this phenomena will be only valid in the short run (Clarke, 1998; MacMillan and Downing, 1999; Mills and Weinstein, 2000). In other words, firms, which have a stakeholder perspective, will able to achieve a sustainable growth in the long run and even survive in turbulent environments. This is especially important for Turkish industrial firms because severity and duration of turbulent environment in Turkish economy is much more than the ones in developed countries.

V. Normative Stakeholder Theory v.s. Instrumental Stakeholder Theory

At this point another important question comes to mind: How will we see the stakeholders of our businesses? As an end (which is the perspective of normative stakeholder theory) or as a mean (which is the perspective of instrumental stakeholder theory). Donaldson and Preston (1995), Donaldson (1999), and Jones and Wicks (1999), tried to answer this question by converging normative and instrumental stakeholder theories. Freeman (1999) on the other hand, stated that normative stakeholder theory and instrumental stakeholder theory are divergent and cannot be converged.

Instrumental stakeholder theory is critisized because according to this theory managers should perceive the stakeholders of the company as a mean rather than as an end. Therefore, instrumental stakeholder theory can be renamed as stockholder perspective or bad governance because managers of the companies, who are the reflections of owners, perceive the stakeholders of the company as a mean and profit as an end. The main reason under this perception, as it is seen in Table 1 is private cupidity and self interest. These two principles, private cupidity and self-interest, also led to the emergence of agency theory and game theory.

On the other hand, normative stakeholder theory is critisized by some scholars (Donald and Preston, 1995) because there is no way to show that counting on ethical principles really work in terms of profitability. This is a very normal result because the performance measure, short-term profit maximization, is related with stockholder perspective but not stakeholder perspective. Therefore, a different but a meaningful measure has to be offered for the normative stakeholder theory or stakeholder governance: long-term value maximization of the firm.

VI. Comparison of Short-term Profit Maximization and Long-term Value Maximization as Performance Criteria

In fact, the answer of the question in section five lies on the core of capitalist economic theory: short-term profit maximization. Is short-term profit maximization an adequate criterion for measuring the performance of businesses? It depends. Short-term profit maximization is a sufficient measure for companies which have a stockholder perspective but it is not sufficient for the companies which have a stakeholder perspective. If the purpose of the managers, who are the reflections of the owners, of the company is to maximize the profits, then it will be more likely that they will perceive their stakeholders as a mean rather than as an end. If the purpose the managers, who are the reflections of the owners, is to make a contribution to the long-term value of the firm, which requires a balanced distribution of the wealth created by a firm to its to the stakehoders, and form good relationships with the stakeholders in the long term, then it will be more likely that these managers will perceive their stakeholders as an end rather than as a mean. These companies, which have a stakeholder perspective, will have an unique competitive advantage (MacMillan and Downing, 1999), and hence they are expected to have a sustainable growth (Clarke, 1998) and survive even in the turbulent and uncertain environments (O'Shannassy, 2001; Post, Preston andSachs, 2002).

VII. Good Corporate Governance v.s. Bad Corporate Governance

The final but a very important question that should be asked at this point is this: How can we motivate and create valuable relationships with our stakeholders which would lead to an unique competitive advantage, help our businesses achieve a sustainable growth, and survive even in the turbulent environments? The answer to this question is related with two opposite perspectives: A good corporate governance is related with the principles of stakeholder perspective. A bad corporate governance is related with the principles of stockholder perspective. Since the focus of our paper is on the distinctive features of firms which have good or bad corporate governance practices, the definition that is made above is very important in this respect.

VIII. The Case of Lehman Brothers

The reasons for the bankruptcy of Lehman Brothers, which is a 158 years old firm and one of the biggest investment banks in USA, will be discussed by the academics for a long period of time. The main reason for this bankruptcy is the greedeness of its CEO, Richard Fuld. On October 6, 2008, CEO Richard Fuld testified before US Congress. Representative Waxman alleged that Fuld had made nearly 500 million dollars since 2000, while guiding Lehman to bankruptcy. Waxman asked to Fuld, "My question is a simple one. Is this fair?" (http://en.wikipedia.org/wiki/Lehman_Brothers). Although GFC is shown as the reason for bankruptcy of this investment bank, greedeness is the underlying reason for this failure. Since greedeness, which is reflected as the self-interest principle, is the main driver of stockholder governance perspective, than it would not be wrong to argue that it is the corporate governance practices at the micro level that have led to the GFC at the macro level. As a result, it would not be wrong to argue that these kinds of bankruptcies such as Lehman Brothers in the world is the reason of GFC and opposite of this argument is not true (i.e. GFC is the reason of Lehman Brothers' bankruptcy and other financial institutions is not a right argument).

Short-term profit maximization, which is the performance criteria in the stockholder governance perspective, is closely related with the greedeness of the governors such as Richard Fuld. There are two financial decisions that reflect his motivation for the short-term profit maximization. First, he borrowed short-term funds from the money market and invested these funds as long term assets (e.g. subprime mortgage). In other words, he ignored the golden rule of banking: the mismatch of the maturities of the assets and liabilities. Since subprime loans have a higher yield than the other assets (e.g. prime mortgages or t-bills), the CEO of Lehman Brothers prefered to invest more to the risky assets (i.e. subprime mortgages). Second, he preffered to borrow most of the funds from the money market rather than capital markets due to the lower borrowing costs of money markets in terms of LIBOR (London Inter Bank Offer Rate). Thus, as the spread from the interest income based on the assets and interest expense based on the LIBOR (i.e. net interest magrin) increased so did the profitability of Lehman Brothers. The more Richard Fuld has taken risks the more the short-term profitability of the firm has increased, and the more his bonus based on the profitability of the firm increased also. Since stockholder governance perspective is based on this relationship, there was nothing wrong with these risky financial behaviors.

When the subprime mortgage crisis began in 2007, the value of the bank's mortgage backed securities (MBS) began to drop. In the second fiscal quarter, Lehman reported losses of $2.8 billion and was forced to sell off $6 billion in assets (Anderson and Dash, 2008). Besides, the cost of borrowing in terms of LIBOR increased approximately four times on September 2008 due to the credit crunch. Besides, it was not possible to find new funds from the bond market during the financial crisis On one side the assets were melting very fast and on the other side the liabilities were increasing due to high interest rates in the money markets to borrow and to finance the short-term debt. As a result of these developments in the financial markets, the equity of Lehman Brothers diminished each day. Finally, the company has bankrupted on October 2008.

IX. Conclusion

Short-term profit maximization is the main principle in the stockholder governance. Richard Fuld and all the shareholders of Lehman Brothers believed to the same principle. Unfortunately, it is this principle that enabled the CEO of the firm to take risky financial decisions in order to increase the short-term profitability of Lehman Brothers. Since shareholders of Lehman Brothers were residual risk takers, they had the right to enable the CEO to enhance the value of their shares in the short-term by basing the bonus of the CEO on the short-term profitability of the firm (i.e. emphasis on stockholder governance). But it was not only shareholders who lost something valuable as Lehman Brothers failed. Thousands of employees have lost their jobs. Moreover, investors and millions of households lost their trust to the financial system.

If corporate governance system of Lehman Brothers was based on stakeholder governance, the performance criteria for the company would be long-term firm value maximization. Thus, Richard Fuld would not take risky financial decisions to enhance the short-term profitability of the firm. As a result, Lehman Brothers would not fail due to stockholder governance. The failure of Lehman Brothers has led to the financial distress of the American International Group, which is one of the biggest insurance companies in the world. Thus, American government acquired the firm in order to prevent a catasphore in the financial markets and economy. The GFC has ended due to the rescue packages of governments and now there is the risk of global economic crisis in the coming years. GFC has shown us that if companies can implement the principles of stakeholder governance rather than stockholder governance then there will be no more GFCs in the 21st century. Anglo-Saxon world believe to the stockholder perspective for centuries or since the control and management of big companies seperated from each other. Thus, it will take some time to perceive the reality or overcome the bounded rationality about the fallacy of stockholder governance and to see the implementation of stakeholder governance perspective at the level of organizations and society in the Anglo-Saxon world.

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