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The Indirect Relation between Corporate Governance and Financial Stability

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Abstract

In the wake of last crises, there is an increased awareness regarding the role of a sound corporate governance framework for enhancing the financial stability. We believe, however, that the relationship between corporate governance and financial stability is an indirect one; companies are not obliged to pursue financial stability unless specific legislation or regulations require it. Interestingly, having such targets, large firms, especially those operating in the financial system, can lead to systemic risks, supporting financial contagion. Classical problems of corporate governance such as top management compensation, board composition, and independence of the director, agent theory or the correct valuation are problems envisaged to be analyzed when assessing how they affect financial stability.

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1. Introduction

After the financial crisis, both academics and practitioners have started to give heed to corporate governance issues, as financial stabilizer or source of instability. Some companies, especially those listed on stock exchanges, reacted at the stakeholders' restraint and decided to re-analysed and recast their principles of corporate governance,

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according attention to financial and also non-financial risks, given that different activity sectors, companies with different size, and state-owned companies or private ones may need different approaches.

Nor only financial crisis, but also other systemic threats that are not properly approached and may have large negative impacts on shareholders and stakeholders, can reflect the failure of corporate governance. If the shareholders are hit first, and usually are the first who react at bad news, the impact of awkward corporate governance is transmitted to the whole economy.

The role of multinational companies is more influential nowadays, as they are spreading around the world, homogenizing the corporate governance best practices. On the international level, institutions like Organisation for Economic Cooperation and Development and World Bank tried to promote standard rules for the principles of good corporate governance, but their understanding and implementation is different apprehended.

While the issue of good corporate governance and adequate codes came into sight quite recently, in the early nineties, the idea of a high standard for proper and quality decisions process is rather old and reappeared after every financial crisis.

In this paper we intend to unfold the relationship between corporate governance and financial stability, an indirect one in our opinion. Inasmuch as companies are not obliged to pursue financial stability unless specific legislation or regulations require it, especially companies operating in the financial system can lead to systemic risks, supporting financial contagion.

2. Financial stability from the "being of well-functioning" (as mentioned in Wymeersch, 2008) to a forthright objective

Financial stability, or more often in these latter days, financial instability is the topic of many discussions and scientific papers. Usually, financial stability is the primary objective of national banks at the national levels (before the crisis, only 2/3 of the central banks had an explicit mandate for financial stability – Caruana, 2014), and, at the international level, international regulators such as Basel Committee or international financial institution make all possible endeavours to encounter the endangering of instability.

After the crisis is installed, the list of beneficent and efficient tools the authorities may use is shortening. This is why the preventive policies are needed and valuable. The role of macro-prudential policies was increased, being created new institutions and accommodated special arrangements between central banks, governments and other agencies, taking into account the diversity of economic and political frameworks, with a special touch of cultural elements.

After the recent crisis, it is recognized that financial stability has a magnitude that cannot be neglected. A frowning impairment of the financial market may unpredictable prejudice the real economy. As evidenced in the literature, emerging markets were more prepared to strive against appeared endangering and imbalances and appreciated to approach the financial system as a whole.

As mention in the ECB (2010) document, the origins of financial instability are usually identical: "balance sheet mismatches, high leverage and very rapid growth of financial institutions". Somehow, all these elements are interlinked with corporate governance.

3. Financial stability at micro and macro levels

Financial stability is divergent from other economic goals. It is similar with a "public good" that is useful for everybody and the lack of it can harm anyone, but nobody is obliged to act in order to keep it well; every action is volunteer. Similarly, there is no imponent for firms to choose the interest of the whole economy like in the case of choosing financial stability as its objective.

While a financial stability framework can help most companies to operate in normal conditions, for others the instability can be a source of profit. Voluntary adoption is valid for corporate governance too, unless some legal restrictions apply. The firm's decision can be selfish, looking for its own interest and not the general interest, for the entire economy.

Different situations can be observed for local or multinational companies when facing the threats to financial stability.