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Corporate Governance: Insider Information, the Bane of Financial Melt-Down? (Pp. 111-121)

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Abstract

Words are not enough to express the global financial melt-down. Is it foreclosure , bad debt, bank failure, tentacles, stock market crash, share nose-diving, investors havoc or suicide or death- trap, government inability, business failure, mortgage failure, Fannie Mae-Freddie Mac phenomenon, bait and switch game, etc; the insider knowledge or information, the scapegoat? This is the problem investigated in this study. Therefore, the hypothesis is that the insider knowledge of the manager does not cause the global financial melt-down. The method is analytical using desk research. The finding is that the insider information possessed by the manager informed the manipulation of firms, securities, risky business, terms, prices, etc, for their benefit to the detriment of investors and therefore caused the financial melt-down. Finally, the major recommendation is that corporate governance needs reforms for tighter control and application of full oversight functions on investment bankers.

Introduction

It is a good thing to develop so that poverty will be minimized, hence, the need for investment. But the investors are at risk of losing their investment or capital on account of mis-management by managers of the investments, the

“Leviathan”. Can the insider knowledge or information possessed by the managers to run the firm, stocks, etc, their own way (risky for quick profits) against the safety of the investors’ funds be the scapegoat? How can it be tamed? For example, the capital monitoring of corporate managers is expected to curb the ugly insider information (Amadasu, 2009a). To what extent do your shares (investor’s) represent a minor fraction of the total shares outstanding? Voting cannot help either because you will be treated with virtual impunity. Moreover, the rules of corporate governance will stack the deck in management’s favour.

If one sues for malfeasance, the business judgment rule gives the board of directors broad legal discretion to use their business judgment for protection from second-guessing of shareholders (Amadasu, 2009b). Selling one’s shares in the open market is at a loss as managers must have driven down the share value. Hiring the best team of lawyers or solicitors to defeat the firm and drag oneself in the mud is not a good option. This is because of the fact that you would have borne all the costs enough to make the firm efficient and the benefit going to other shareholders. Takeover may not even help because of takeover wars (like the 1980’s) and difficulties. The use of debt (as bond holders can ask for higher interest rates or restrictive bond covenants) to curb management and reduce agency costs is another option (Cook and Easterwood 1994). This is because of the ability of bond holders to seize control easily in bankruptcy and force employees out into the labour market. What of the aftermath?

Therefore, the insider knowledge or information is being investigated as the scapegoat for financial melt-down to tame it. The hypothesis is that the insider knowledge of the managers did not cause the global financial melt-down. The analysis using desk research follows after the literature review and thereafter, a concluding part.

Literature review

Corporate governance intractable problem arose from corporate law in the U.S in separation of ownership and control and increased by the institutional rules promulgated by American courts legislators and regulators (Roe 1990, 1993, Grund fest, 1990, Black, 1992, Bhide, 1993). A single investor cannot single-handedly deal with or remove the executive that has erred by committing malfeasance. If the investor wants to play the role of the activist’s by hostile takeover bid or collecting proxies in a proxy fight (Ikenberry and Lakonishok, 1993, Malatesta and Walkling, 1988; Comment

and Schwert, 1995; Cook and Easter wood, 1994) through voting their shares at the annual general meeting, it is a costly move. Even, the “poison pills” recent legislative, defensive innovation, whereby there is a conditional, discounted voting security purchased rights accruing to existing shareholder making a hostile offer, lower the probability of a success.

Also, note that the shareholders elect the board of directors (Jensen and Warrner, 1988; Holderness and Sheehan, 1991; Byrd and Hickman, 1992, Shivdasani, 1993; Brook and Rao; 1994; Pound 1995; Bernstein, 1994; Miller 1994) to hire, monitor and compensate the executives of firms.

These shareholders are atomistic in the sense that each owns less than 1% and one out of them may not be in a position to monitor and discipline management. Agreed that shareholders (the last claimants after creditors and employees to firm’s profits. This is optional and morally defensive) are risk-averse and have well-diversified portfolio with respect to any particular firm and therefore can support long-term, risky, investment of firms (than managers or other stakeholders) which makes for a firm’s future (Fama and Jensen, 1985). But no unilateral action of one shareholder to bear all costs whereas the benefits are widely dispersed to all shareholders (which should have taken part in a collective action), a free ride indeed! Even corporate governance rules will not allow institutional investors to band together to challenge management. This environment is paradoxical but it is the truth. Therefore, one understands the ambitious seizure of effective control by the managers inside the firm (Grossman and Hart, 1986; Harrington and Prokop, 1993) supposed to run the business or invest properly in the best interest of the investors now turn around to do whatever they like through unethical practices to satisfy their whims and caprices (Osiegbu, 2008; Okereke, 2008; Lawal, 2008; Amadasu, 2009b). Finally, such may result in financial melt-down for the investors or backlash after growth (James, 2001; Dodd, 2007).

Analysis

The hypothesis is that the insider knowledge of the manager did not cause the global financial melt-down. Looking at it critically, the researcher believes that it is the gargantuan investment somewhere or all over the place that can no longer be supported and had to crash-land that caused the global financial melt-down. The sub-primes or sub- prime loans or sub-prime mortgages were not the mainstream but related events of the holocaust. Again, the time for this was not suddenly around August 2001 in the United States of America but before then and the tentacles were already brewing. When it happened its

tentacles spread globally, even to Nigeria. What was the role of insider information or management or managers of funds, businesses, etc? Certainly, they (the managers) were not mute, watching helplessly the tumbling down. They can be said to have pulled the trigger and released the first bullet. All these do not support the hypothesis exempting the insider knowledge of the manager. The sudden change in the mortgage terms and price/value of the mortgages, unfavourably and downward cannot but be initiated by them for brisk business, high profits fraught with high risks. One understands therefore, the inability of the mortgage owners or debtors and even creditors and their properties or assets, nose-diving resulting in foreclosures, toxic assets, job losses, inaccessible loans, banks' insolvency threats across the world and all that. Turmoil indeed!

The trail of the financial melt-down is on and on, it is a phenomenon requiring oversight function, regulation, something beyond financial governance, and involving environment, health and trade degradations. Look at it again, bank crises spill over to a number of things namely: equity market, stock market, firms/business reducing their values and stability: obligations, contracts with default or breach: governments and financial houses/systems with instability shocks: consumers with reduced demand from reduced purchasing power of money and job losses: the environment with degradation of health hazards from increased demand on it. Apparently, the environment or the real sector is the saving or grace to turn to but there is the need to use finance to exploit it and reconstruct the damages too. The financial managers with their insider knowledge cannot pass the buck as they were in the mainstream in managing of these unfolding events. They knew from their insider information backed by their over-ambition, limited liability status, board of directors' business judgment, shareholders' atomistic characteristic of ineffectiveness, bankruptcy rule, business judgment, tax havens and other terms applying which may not be explicit in insurance and other business. The question that remains is how to tame this "Leviathan".

Since 0.06% additional increase in troubled, unpaid loans or sub-prime mortgages can cause global financial melt-down like the present global economic situation, the singular action of underwriters in changing prices and terms of investment (term structure) cannot be over-emphasized. The insider knowledge of the managers in this regard was underscored by void tighter corporate governance and lukewarm oversight functions. The riskiest mortgage or security goes to highest yield-seeking over-leveraged hedge funds or buyers. The mortgage or security offers or collects collateralized

debt and credit derivatives. Why going for the riskiest business? If the motivation is for highest yield, how reliable is this in the macroeconomic policy imperfection and ineffectiveness in developing countries and the protectionism of the developed countries? Certainly, the action of the insider or manager's expression of his knowledge is to the detriment of the fund owners or households or shareholders. The capital involved in such a business vanishes on account of reduced price or value in an attempt to quickly recover on the part of buyer or seller. This further adds to the lock jam or problem as nobody wants toxic assets. Such tentacles happen because of lukewarm oversight functions and lack of tighter corporate governance that should have challenged the stubborn managers to retreat to lower or safer level of profits/ambition.

Overinvestment or enormous amount of funding was not checked either. Over-saturated investment/area to give way to the underinvested area is another problem. Look at Fannie Mae (Federal National Mortgage Association or Government Corporation created by Roosevelt Administration in U.S in 1938) providing fresh capital and liquidity to the market and bearing the market risk, credit risk and liquidity risk of the originators of the mortgage loans (bank and savings and loan Associations) by buying the mortgages which in effect returned the lodgments to these institutions. Its over-borrowed funds to finance the mortgage purchase were a big portion of the U.S debt. Moving this off the U.S operating budget informed the 1968 Johnson Administration creation of Ginnea Mae (Government National Mortgage Association) to handle government guaranteed mortgages and privatised others (known as Fannie Mae) retaining some government obligators for low income housing. It also developed the mortgage- backed security to shift the market risk off the government to investors. 1970 saw the creation of Federal National Mortgage Corporation (Freddie Mac) to securitize conventional mortgages and enable competition on the privatized Fannie Mae.

Now the Fannie Mae and Freddie Mac converged through time responsible for the gargantuan funding of U.S mortgages in purchasing, holding and converting home loans into mortgage backed securities. The question is was there any strong oversight function or tighter corporate governance checkmating such huge financial giant all through to the present global financial melt-down? The insider management cum over-ambition must have been rearing its ugly head of mismanagement before the present debate of the melt-down. For example, by 2003 through 2006 Fannie Mae and Freddie

Mac by pre 2003 government faulting them on new accounting rules were also challenged (making them lesser issue) by privately labelled securities issued by some wall Street Firms (Wells Fargo, Lehman Brothers, Bear Stearns, JP Morgan, Goldman Sachs, Bank of America) and high-risk lenders like Indy Mac, WAMU and Countrywide. The rise of these sub- prime mortgage origination and securitisation, being low-rated debt securities became a problem. Institutional investors by their rules should not go for low-grade mortgages or sub-prime. Only \$685 billion out of the \$1.1 trillion sub-prime debt are sellable. Where are the new investors for the rest? The collateralized debt obligation (securitized) must be paid back by their different levels of risk and returns. The highest risk or low-rated debt suffers losses most. The research avers that the insider knowledge of managers allowing for uncontrolled or unbridled manipulations during the recent markets turbulence with stops in the home mortgage journey from original issuer to the ultimate buyer is the bane of corporate governance. This does not support the hypothesis that the managers are not the cause of the failure.

The following events also, do not support the fact that the insider information did not cause the global financial melt-down:-

- i. Collateralized debt obligations and credit derivatives (unlike publicly traded securities and futures contracts) are not traded in exchanges but in OTC (no transparent price discounting, prices/volumes not disclosed, no surveillance of the market to check vulnerable positions strictly between customers and dealers, no institutionalised markets-markers/dealers to ensure liquidity).
- ii. Under-capitalised, unregulated finance companies, originators of mortgage loans made through banks, cannot sell their loans or get fresh capital or funds as bankers withdrew their support. Then their market will seize. The issuer of collateralized debt obligations could not issue more as they cannot sell their inventory of mortgages to repay the loans.
- iii. Sub-prime mortgage originators could not sell their loans made through the banks.
- iv. Hedge funds with \$100 million capital can have leverage of 500% or borrow \$500 million then add to \$100 million capital to invest \$600 million in equity.

- v. Privately labelled mortgage-backed security issuers and originators (Finance Companies) can move about \$3 billion (\$2.4 billion for investment-grade senior debt securities for institutional investors) and \$600 million high-yield junk through the sub-prime mortgage market.
- vi. Major Banks, broker-dealers gave guaranteed credit lines to structured investment vehicles (SIVs) and conduits, the issuers of commercial papers. This is to get the sub-prime assets off their books to avoid capital requirements. This failed.
- vii. About 3% jump in delinquency rate in US mortgages threw \$57 trillion US financial system into shudders.
- viii. Hedge funds (mortgage originators) have no capital requirements (unregulated in this regard) and serving as highly leveraged should not have handled such mortgages being unstable foundation for organising capital market.
- ix. There was cross-border spread of the market rupture as emerging market equities were sold to meet margin calls (or recover losses), so equity market fell World-Wide with their currencies. Northern Rock Bank in UK, many Germany Banks with US sub-prime mortgages, asset-backed commercial paper in Canada (business not supported by bank credit), etc, suffered.
- x. The Nigerian banking sector unethical practices namely, theft, duplication of check books, suppression, substitution and payment against un-cleared effects, defalcations, computer frauds, forgeries, unauthorised lending, lending to global borrowers, kite flying and cross-firing, foreign exchange malpractices impersonation, over-invoicing, manipulation of vouchers, unofficial, borrowing, fictitious contracts, fictitious accounts, and over-valuation of status report.
- xi. The G-20 U.K meeting 2009 emphasis on tax havens, money laundering, managers mismanagement of investors' funds/mortgages, over-investment/saturation, huge unpaid loans/debts, lack of oversight functions, lack of tighter corporate control, etc. in the cause of the recent global financial melt-down.

- xii. First Bank (Nigeria) PLC share price plummeted by more than 50% during the Nigeria stock market crash because of the insider information possessed by the managers to borrow for short and lend for long so that they and their customers can buy shares cheap and sell dear later. But the Central Bank of Nigeria ordered them to return such money and this led to sudden selling (bearish market) and prices falling. Many banks were in the same boat.
- xiii. The Iceland bank was so bankrupt that it could not pay customers their deposits to make their daily living.

Conclusion

The study is on corporate governance, the insider information the bane of financial melt-down. The hypothesis is that the insider information or knowledge of the manager did not cause the global financial melt-down. Analytical method was used with desk research to prove the hypothesis wrong. For the Leviathan, the insider information or knowledge to be tamed, it is recommended that:

- i. Apply industry standards to securities transactions.
- ii. Check collateral (margin) use in OTC derivative and hedge fund borrowing.
- iii. For CDO (collateralised debt obligation). Policy makers to set new reporting standards in OTC and hedge funds securities.
- iv. Dealers must be market makers.
- v. There should be prudential regulations and such firms to be treated as financial institutions.
- vi. Checking corporate governance rule.
- vii. Changing global governance from traditional, elitist grouping to cross-boarder grouping to reduce over-investment in one area.
- viii. Increasing investment in needy or poor areas.
- ix. There should be no form of saturated investment in any one area.
- x. Tighter control, tax havens reduction, oversight function resurgence and market-still- free business environment.

- xi. Government (without a Red-tape) to take a seat in the investment banking.
- xii. Change bankruptcy, limited status, director's business judgement, shareholders' status, to check managers' 'failure' or risky manipulation of investors' funds.

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