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A Retrospective Analysis of the Causes and Effect of the 2008 Global Financial Crisis and its Lingering Effect on the Current International Economic Meltdown

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INTRODUCTION

In the last two decades, there has been an explosion in academic and policy research devoted to corporate governance in companies, corporations and certain public establishments. Series of studies on corporation governance are increasingly impacting on a different policy areas such as economic, finance and management[1]. These research findings provides an essential influence on the decision-making process linking a number of other significant regulatory initiatives related to commercial laws and odes of good corporate governance globally [1].

For purposes or clarity, corporate governance is the system by which companies are directed and controlled[2]. It follows therefore that an ffective corporate governance involves among others, mechanisms to ensure that the executive and non-executive members uphold and respect the rights and privileges of company stakeholders as well as making those stakeholders responsible for whatever decisions it takes in the process of generation and distribution of wealth and services invested in the company. Put the other way, corporate governance connote a situation of low companies or establishment should be governed so as to ensure that as a going concern it is run effectively and efficiently [2].

According to the traditional agency theory, the role of corporate governance is basically one of ensuring that the company is run and managed in the interest of the shareholders,

[1] Keasey, Thomason and Wright, 2005
[2] UK Report on the Committee on the Financial Aspect of Governance Available at http:www.routledge.com/textbooks on 9th April, 2012

focusing on accountability in order to reduce the propensity of risk for the benefit of the shareholders. The agency theory with it main concern on the interest of the shoulders is seen as been narrow as it does not consider other stakeholders who may have different interest in the firm. In other words, the roles of the board are overly neglected under this theory. But, in the wake of the global financial crisis of 2008, academic and policy makers in the corporate governance came up with series of reasons for cause of the crisis. While some theorists argued that market oriented approach otherwise referred to as the Anglo-American model which is known for deregulation, self-regulation for corporate control and financial dominance incentives accounts for the collapse of the global financial market in 2008 and 2009 respectively, the internal governance theorists contends that the unchecked corporate decisions-making, poor risk management, inadequate remuneration policies and managerial misbehavior gave rise to internal governance system which largely caused the financial crisis [3].

A. G. Monks pointed out that the cause of the crisis is a function of a deliberate neglect of the shareholders in the decisions making process of the firm thereby divesting them the ownership status. Monks' position is related to the Adam Smith postulation. For according to Smith:

> *Being managers of other people's money than their own, it cannot well be expected that they should be anxiously vigilant with which the partners in a private co-partner frequently wasted over their own ..... Negligence and profession, therefore must always prevail.... in the management of the affairs of a joint stock company[3].*

Smith and Monk emphasizes the active participation of shareholders in the daily management of a firm without which there cannot be an efficient and effective company management.

[3] Adam Smith, "The Wealth of Nation (Smith 1776).

It is trite that opinion varies in attempting to explain the cause(s) of the global financial crisis, and as result, we shall attempt a retrospective analysis of the various views given to explain and ascertain the immediate and remote cause(s) of the global economic crisis of 2008.

OVERVIEW OF THE GLOBAL FINANCIAL CRISIS (GFC)

The global financial crisis which started in January had reached it crescendo in the middle of September, 2007 thereby changing the face of Wall Street business transactions in the United States of America. Financial giants such as Lehman Brothers, AIG, Freddie Marc and Citi Group were either liquidated or bailed through governments' intervention. Strong financial institutions like Morgan Stanley and Goldman Sacks were forced to convert to banking holding companies thereby heralding the end of the era of investment banking system in the United State of America. According to Rothman "*Wednesday is the type of day people will remember in quant-land for a very long time. Events that models only predicted would happen once in 10,000 years happened every day for three days*"[4].

Although at the on-set, the U.S. economy seemed to resist the financial crisis but this was to be for just a short while. The fall started when the Wall Street migrated to the Main Street and towards the end of 2008, like a wild-fire, it had spread to other parts of the major economic hubs of world [5].

In the United kingdom in 2008, Northern Rock was nationalized, RBS, UBS, Bradford and Bingley and Bank of Iceland collapsed by April, 2009. The rate of unemployment had spiraled to 8.9% from its low of 4.4%. The natural consequences of this anomaly is the unprecedented rise in housing market, where prices rose in 2006 and declined sharply in subsequent years[4]. Spurred by the demand pressures during the new economic boom of 1990s, by low interest rates in the 2000s and by ever-loosening lending regime, prices

[4] Congressional Budget Offioce, "A Preliminary Analysis of the Persident's Budget and an update of CBO's Budget an dEconoic Outlook, March 2009.

increased by a factor of about three (3) between the years 1996 and 2006 with an average rate of about 10% per year. Huge economic loss that was last experienced in the late 1930.

In retrospect, economic financial crisis were first noticed in 1930 and in the subsequent intervals of preceding years. The following countries experienced series of financial crises in the 90's: Asia in 1997; Mexico in 1994; Russia in 1998; Brazil in 1999 and Argentina in the year 2002. The effect of all this is the drastic decline in lending from other countries; sweeping collapse of the value of their currencies and stock markets coupled with significant recessions in the economy as a whole [6].

Interestingly, the crisis came to open up the hidden financial impropriety in a number of developed countries which was characterized by an over- dependence on cumulative sources by banking system and asset bonanza in residential properties and businesses. Roughly nine years after, there is still no consensus among academic researchers and policy-makers on the causes of the global economic crises. Although most stakeholders concede that supervision and regulation were lacking, other contend that it was overly accommodative monetary policy beginning from the year 2001 that triggered the economic impasse.

According to Acharya:

> *"It may have been a combination of accommodative monetary policy and growing global imbalances that caused the build-up"*[5].

ANALYSIS OF CORPORATE GOVERNANCE AND FINANCIAL INSTITUTIONS

The trending and unresolved debate whether global economic system will adopt a Common Corporate Anglo-American Governance System or sustain the existing diversity of institutions is one issues facing world economic policy. The reduction in economic growth and the rise in unemployment in Europe in comparison to the Anglo-American economies since the middle of 1990s poses a crisis of confidence in the Europe social model. However,

[5] Acharya and Richardson, 2009.

irrespective of the pressure towards adopting the English-America system of corporate governance, the plurality of policy and corporate governance in the Europe model have resisted any concerted move to set a standard. Rather a plurality of models is adopted, each adapting to local situations and supported by a cluster of social norms and practices in order to enable a balanced economic development.

According to Rebevioux:

> *"Two competing theories form of corporate governance can thus be discerned. In the first case the US model-the predominance of widely held corporations controlled by their owners – is presented as optimal .... The institutional complementarity thesis provides a contrasting perspective on the continuing diversity of capital systems .... The core of this theoretical approach is a rejection of the "one-best-way strategy adopted by the convergence thesis"*[6].

It is trite at this point to reinstate that the diversity of corporate models is valuable and traceable to societal characteristics that together shape the competitiveness of the diverse models. Although it may appear that the shareholder value may be gaining primary ground as a result of the Anglo-Saxon institutional investors, a stakeholder approach is nearer to the European social-economic democracies. Therefore, the outcome of the two competing economic model is highly uncertain. Hannasman in his comment, said that "there is no longer any serious competitor to view that corporations should primarily strive to benefit the interests of shareholders"[7]. On the other hand, A. G. Monks opined that:

> *"A key problem with Anglo-American corporate governance is that shareholders both institutional and individual, do not behave like owners"*[7].

These views shall be analyzed in the light of recent corporate governance failings of financial and other corporate institutions[8].

[6] Amable, 2000

The 2007/2008 global economic crisis has been described as the worst recession for the last seventy years. The degree of damage it costs can be gleaned from the collapse of a number of giant financial institutions, such as the bankruptcy of Lehman Brothers in 2008. In the United Kingdom, the wave of the credit crunch was visible in the failure of Northern Rock Plc (at the time the fifth largest mortgage lender in the UK) [9].

This recent crisis in the financial institution is indicative of the inefficiency and administrative decadence in the existing corporate governance system. As a result, it is pertinent to state, at this point, that the fundamental issue is that the Anglo-American Economic model does not answer to the current financial institutions demand. This submission found support in report released by the United States Financial Crisis Commission which found that: 'the dramatic failure of corporate governance and risk management were a key cause of the crises.[7] For according to Arsalidou, there can be little doubt that Directors management and incompetence were the primary cause of the crisis [10].

The failure of the global economy in 2007/2008 opened a Pandora's box' to the weakness of the current English-American corporate governance system: it created an avenue to evaluate the current system and its values. As earlier mentioned, a great number of issues has been said to be the immediate and remote cause of the crisis. Such as lack of transparency, recklessness of the practice of the board and self remuneration package practices which invariably encouraged 'short-termism' and high level of risk-taking.

This essay argues that a good corporate governance involves a multi- disciplinary studies, it examines whether the adoption of an all-inclusive model by the financial institutions directors could lead to a more effective, efficient results thereby achieving greater stability within the financial sector and other corporate institutions.

[7] United States of America Financial Crisis Commission, Conclusions of the Financial Crisis Inquiry Commission, (2011) Available at http://c0182732.cdn1.com/fcic_final_report conclusion accessed on 14 April, 2013.

Under the UK Companies Act of 2006, the exercise of powers by the Directors are governed by Sections 171-177. This article provides an examination of section 172 to ascertain whether the enlightened shareholder value adopted under this Act does encourage company Directors to adopt a more inclusive decision-making approach taking into consideration the effects of a course of action on the stakeholders of the company. We argues that considering the essential position of company Directors, they should not be allowed to posses such a narrow focus which basically centers on short-term profits. Rather, the stability of financial institutions should be adopted to guarantee the protection against the economic and social fall-out of recession. Soon as this practice is adopted, it is hoped that a re-occurrence of instability in the financial sector will be nipped on the board.

CORPORATE GOVERNANCE THEORY

The Anglo-American Corporate Governance System is based on the concept that the ownership of a company is widely shared among many stakeholders rather than ownership restricted to or left in the hands of a single individual. For instance, in the top 20 companies in England, no shareholder controls more than 20% of the company's shares]8]. In the study of American corporations, in the wake of the Wall Street crash, Berle and Means noted the emergence of a separation of ownership from control. In that research, it was demonstrated that corporations had undergone an evolution of control, changing through stages from control through complete ownership to majority control, to control by legal devices, to minority control and finally, managerial control[8]. As a result of this evolution of changes, the power to control a company changed from the ownership control to i.e. shareholders, to those who controlled it, i.e. Board Directors and executives since the management control the company with no shareholding interest in it, their self-interest becomes the norm in the company. This is the situation that was painted by Adam Smith that:

[8] Adolf Berle and Gadiner Means, The Modern Corporations and Private Property (Transaction, Publication (1932)

> *"Being managements of other peoples' money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance.....*[9].

In other words, the interests of management would better be protected by making decisions that favours management such as self-rewarding bonuses[9]. This sort of separation of ownership from control invariably diminished the legal rights of shareholders which was initially a proprietary right according to Talbot. The corporation is no longer answerable to the demands of private or individual ownership; rather the company has become a public institution under public corporation. The duties of Directors to shareholders raises the question of whether Directors do not owe it duties to shareholders and of whose interests does the directors serve.

ANGLO-AMERICAN METHOD AND EXECUTIVE REMUNERATION

Academic critics such as Farrar argue that the modern structure of corporate governance which is modeled after the English system following the decision in Salomon Vs. Salomon & Co. Ltd. paved way for the separation of ownership and control. The pendulum has thus shifted and opened a floodgate for insider abuse. Based on the relationship that exists between agency and the principal, corporate governance requires the adaptation of the interest of the agent with those of the principal and reduce the desire of mismanagement and abuse. Based on the separation of ownership and control, the use of obnoxious and self-serving incentive such as high level remuneration, encourages an unregulated bad practices[11].

It is not in doubt that the epicenter of projecting the aims and objectives of the company under the Anglo-American System is the Chief Executive Officer (CEO). The popularity of this position has grown tremendously in public recognition and status globally. As the CEO of Disney World, as a result of his visionary leadership in 1998, he was paid the sum of $576 million as compensation package. This is greater than the combined remuneration

package of all 100 CEOs of FTSE 100 corporation at the time, as well as greater than the combined salaries of similar large groups of CEOs, in giant companies in other parts of the globe.

Notwithstanding, the fact that the Board Directors of corporations are vested with the powers to take responsibility of the daily affair of the firm, the CEOs are in command and in-charge. In the US, CEOs arrogate of the 20th centuries, thereby marginalizing the role of the board:

> *"Corporate boards, assert legal traditional powers, they are the sovereign of their realms. But until they began to flex their muscles in the 1990s, boards rarely behaved that way, leaving most decisions in the hand of the management[9].*

Both the US Corporation laws and the UK Company Act 2006 which assigns ultimate responsibility for company affairs to the Director authorize them to delegate functions for the running of the company to management. The effect is that Chief Executives exploited the opportunity of such control to appropriate to themselves an increasing share of the wealth of the company through bonuses, inflating salaries and wanton growing stock options.

According to Aguillera:

> *A comparative perspective underscores the immense power, charisma and leadership given in the US corporate governance system to the Chief Executive Officer (CEO), who usually also exercises the role of chairman of the board[10].*

The split of two roles above is often perceived in the US as a sign of weakness for the CEOs. This is the over-centralization of the power of control of companies on the CEO's accounts for the wide margin between the CEO's salary and that of other executives[11].

[9] Lorsch, J. W. and E. Maclover, Pawns or Potentates: The Reality of America's Corporate Boards (Boston: Harvard Business School Press, 1989).

Company CEOs consolidated their power by forming a ring of cartel in the form of 'espirit de corps' which is often encouraged in board towards fostering commitment among board members but this has been abused by some CEOs who often influence the board to forestall any challenge to their exercise of their autonomy. Westphal put it this way:

> *"Among large US corporations there are strong disincentive, rather than incentives, for non-executives or adopt corporate governance reforms that will limit managerial autonomy..... Senior managers and directors of large established corporations have a shared group consciousness as members of a unified corporate leader elite."[11].*

Also the Forbes survey of 500 companies in the US discovered that Non-Executives Directors experience prejudice and social ostracization by their peer directors when ever they are perceived to ask for reforms such as the separation of the position of the CEO and that of the chairman or the creation of an independent nominating committees. In the UK, a similar tradition is practiced: The trend is that Executive Directors are less likely to express policy disagreement with their superiors at the board meetings. As one of the non-executive directors pointed out: "The executive directors of boards have very little awareness of their responsibilities under the company law or any other law, and the reason for that is quite understandable: they owe their jobs, careers, and futures to the Chief Executives who appoints them. If they are going to have an argument with the Chief executive or differences of opinion on policy, which occur all the time, that has to be off board[10].

Managerial theorists argues that although shareholders as owners of the firm, should take the ultimate decision in respect of takeovers but in reality control is ultimately exercised by the top management through proxy voting to ensure their continued rule. In the 1980's in the United States of America, several factors such as the availability of large amounts of loan capital, bonds with low credit ratings and suddenly large corporations that previously thought themselves invulnerable became takeover targets. This renewed wave of market for

corporate control, it was believed, re-established the relationship between ownership and control.

C.E.O.s' MISPLACED GOALS

The measure of the extent of mismanagement which hitherto led to financial crisis can be gleaned from the insidious management entrenched in the US Corporation. There was unconscious and rapid increase of CEO and executive remuneration irrespective of the abnormal performance of the financial market. Granted that equity reward was aimed at aligning executives with shareholders interests, but the explosion of executive stare options suggests that management is out of control of either boards or shareholders. Mr. McDonough observed that there is one issue which demands for urgent action; 20 years ago, Chief Executive Officer of a corporation were paid 42 times more than the average factory worker. This is justified in the sense that based on education and greater dedication, he can be paid as such. Today, the same study suggests that an average CEO takes home emolument of over 400 times the average employee's income. Responding to this gross financial aberration he enthused:

> *"It is hard to find somebody more convinced than I of the superiority of the American Economic System, but I can find nothing in economic theory that justifies this development.*[10]

It is not in doubt that the job of CEO's is nevertheless demanding and requires a rewarding incentives to pool brilliant and talented employees, however this has always been the position over the decades. We argue that essential issue is not the astronomical increase in CEO reward but first and foremost how the appropriation of an increasing share of the wealth of the corporations by the Chief Executives impacts upon the relationships with the owners (shareholders) and the employees and the larger society. Secondly, is the fact that owing to the scramble for largesse of the CEOs certain aims and objectives suffer neglect

[10] McDonough, W. J. "Corporatize Board Elections and Internal Controls, Federal Reserve Bank of New York, 2005.

thereby affecting the success and development of the company. The misplacement of the CEO goals as a result of pursuit of personal interest has been an age-old incident: it occurred in the earlier periods in different forms and in all of this case, the CEOs' ambition and personal aggrandizement was the driving force. Both in the UK and US, in 1970s, and 1980s respectively, a sustained lack of capital investment was partly due to the personal aggrandizement of management.

The problem was not only the high cost and mobility of capital. The problem was also the willingness of many top managers of industrial corporations to take advantage of the permissive financial environment to appropriate huge levels of compensation for themselves while neglecting to build organizational capabilities in the companies they were supposed to be lead.[11] Outrageous and mind-boggling executive reward in large US corporations is not an isolated case. It is endemic, and it has been happening because the executives take control of their emolument and fringe benefits structures. The pervasive role of managerial control can be explained for much of the contemporary landscape of executive reward such as obnoxious financial explanation. The overwhelming influence of management pay structure has given rise to distortions in the schemes, resulting to a huge cost to investors and the economy alike. Furthermore, the influence led to compensation structures that reduces managers' incentives in order to increase the company's value and even to establish incentives to take actions that reduce long-term value. However, the problems is not as a result of oversights or lapse of judgment that board is expected to address on their own volition; instead they have arisen from institutional defect in the company governance structure that permits executives to exercise considerable influence over their boards.

It is therefore opposite to say that much as the recent reforms is landed, since it seeks to increase the independence of the boards, they will not be sufficient to make the boards

[11] Lazonick, W, "Controlling the Market for Corporate Control: The Historical Significance of Managerial Capitalism Industrial and Corporate 1 (3) 1992.

responsible and if holders treating them as also owners of the corporation. The mind-blowing elevation in executive reward that took place in the 1990s in the United States has little to do with the output or productive efforts of the management executives themselves. Thus, the unprecedented rise in stock share prize within this period was a by-product of institutional savings and investment coupled with the falling interest rate. Thus corporate governance in the 1990s existed against the high rising prices of shares; the stock market was not a disciplined institution but a promoter of painless enrichment of a few through rising stock share prices. In the thick of these global economic quagmire and the confusing state of what management could do, the CEOs were rather posing as heroes. Ironically, most of the CEOs in the US at the time profited personally from using economic rhetoric's of value creation to cover-up for the practice of value market of 2001/2002 brought to bear on the endemic problems in the corporate governance system thereby raising serious questions with respect to the performance and compensation of corporate executives but most outrageous executive emoluments were retried without questions.

Interestingly, on the occasion when some executives were dismissed for non-performance and incompetence, it was discovered that they had 'gilt-edged' pension compensation entitlements that granted them massively for their incompetence and failure. As a result, the UK department for trade and industry published its communiqué entitled; rewards for failure on Directors remuneration, performance, contract and severance and instructed stakeholders to always carry out a background check on executives' contracts.

According to reports that reviewed the executive contract by compensation, committees in big corporations found that a great number of them used peer group benchmark to arrive at pay and set compensation at or above the requisite fifty percent of the peer group. Such act is in consonance with a clear case of a board who do not strive to get the best deal for their shareholders, rather are happen to go along with whatever can be justified with existing prices [12].

In the last two decades there has been an on-going reform in the corporate governance regime. Although there has been a recorded success in this reforms, it nevertheless could not prevent the economic crisis of 2007.

According to Clarke[12], the corporate governance system has encouraged companies to manipulate stock share prices, abuse the accounting practices in order to embark on excessive short-term financial risk of profit maximization. It is generally observed that the cardinal issue with corporate governance are as just some technical or implementation problems but more of paradigm issues, governing approaches and the orientation of corporate governance systems, which are tied to Anglo-American financial system.

On the issue of corporate governance failure, there is still an on-going debate in the finance industry on the cause of the global financial crisis of 2007/2008. Several issues have been identified as contributing to the crisis: such as the culture of short-termism, outrageous bonuses for CEOs and senior managers and banks regularly exploiting their millions of customers etc. However, in the face of this obvious calamity, not every one agreed to the argument that governance of banks and other financial institutions have malfunctioned as result of corporate governance failure. There three popular views on this current debates: the first school is of the view that corporate governance is not related or remotely related to the global financial crisis of 2007/2008. In historical perspective, they argued that since the 1970, corporate governance in the US and other developed economy has improved tremendously. They contend that publicly held corporations were administered satisfactorily before and during the financial crisis without any direct link between corporate governance and the financial crisis.[13] Based on his research result, Cheffins[12]. observed that corporate governance in firms under study operated and functioned efficiently and did not fail during the financial crisis. Adams in similar way contends that

[12] Clarke T., A Critique of Anglo-American Model of Corporate Governance", CLPE Research Paper 15/2009, 5(3) Available at http://ssm.com.abstarct access on 14 April, 2013.

[13] Cheffins, B. R., Did Corporate Governance "fail" during the 2008 stock market melt down? The case of the S & P500, available at http://ssrn.com/abstarct, last accessed 20, March 2013.

governance of corporate firms was on the average not worse than that of other non-financial corporations. And that boards of financial institution that accessed bailout funds were more independent than boards of other institutions. More so, that boards of directors of banks received lesser compensation than directors of non-financial institutions. The second view argues that the cause of global economic financial crisis was as a result of non-implementation of codes on corporate governance. The OECD who is a part of this school identified four weak areas in corporate governance that contributed to the global economic crisis. They are executive remuneration, short-term risk management board practices and the exercise of shareholders right. Irrespective of these weakness, it argues that the tenets of corporate governance had sufficiently addressed those core governance issues and that the main failure among board members and decision-makers are due to lack of implementation of those codes and principles. The UK Financial Reporting Council belongs to this school of thought to the effect that there were no major pitfalls with corporate governance codes prior to the global economic crisis. It further observed that the core problems remained the sore issue of implementation of the codes and principles.[14]

CONCLUSION

Towards the end of the twentieth century, it was believed that the Anglo-American system of corporate administration was the perfect models of running a corporation. However, owing to the recent events, there is no gain-saying that the perennial cases of global financial crisis has put a question mark on the viability of the Anglo-American corporate governance model.

In this essay, we have demonstrated that the Anglo-American Corporate Governance model is fundamentally sound. However, it partway over regulatory response still require much to be done. We have also discovered that owing to various kinds of scandals and fraud among corporate executives demonstrate the fundamental elements of the weakness inherent in

[14] Financial Reporting Council, The UK Corporate Governance Code, 28 May 2010. Available at http://www.frc.org.UK accessed 16 June, 2010.

the Anglo-American model which cannot be remedied by the existing company laws i.e. UK Company Act and the Sarbanes-Oxley Act respectively. So far, we have seen that if the US had thought that a hastily-prepared reactionary law such as the Sarbanes – Oxley Act will nip on the bud the issue of scandals in corporate governance was miscalculated as 'even the relatively non-contentions measure regarding audit regulation appears to have been unsuccessful than may have been anticipated'. Similarly, the American model corporate governance method, which have attracted heavy criticism for the high cost it imposed on the US public corporations, betray a lack of thought on the vexed issue of the structure of the boards and shareholders right. What is not very clear, however, is the appropriate solution to be applied in this circumstance. As a result, the plausible way out is that the Anglo-American Corporate governance policy-maker have to have a rethink of the current regulatory system and consider some more flexible regulatory strategies that is seen to be employed by the EU model.

The collapse of the Anglo-American System of corporate governance in financial institutions, and the urgent need for reform has been widely emphasized. Considering the significance of corporate governance in the world economy, the restoration of confidence and stability of the financial sector cannot be over flogged. The question therefore is, what are the possible actions being adopted to achieve long term stability? Rather than point accusing fingers on a particular course as the cause of the global financial crises such as Robert A. G. Monks believes, this essay establish that in enforcing a change of ideology from the age-old view of the enlightened shareholder value, to a pluralist approach, we observes that certain numbers of changes need will be necessary in addressing the lacuna created in the law governing directors duties. It is pointless entitling stakeholders with rights that cannot be enforced. Therefore, we submit that company stakeholders should be empowered under the law to hold board directors accountable. The South African corporate governance may be a veritable precedence in this regard.

As a result, there should be a rethink in what we have believed, accepted or taken for granted in terms of corporate governance perspective, paradigm, approaches and methodologies and learning corporate governance lessons from the global financial crisis. We therefore conclude that a good corporate governance system can only be entrenched by undertaking a holistic and multi-disciplinary studies of the system.

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