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Research Article

Financial systems and corporate governance: A review of the international evidence

PhD Albert Lusha
University College of Business, Albania

PhD Xhelal Mziu
Agricultural University of Tirana, Albania

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Abstract

This paper reviews international evidence on the interaction between financial systems and corporate governance structures. It examines how different financial architectures—bank-based versus market-based systems shape governance mechanisms and corporate performance across countries. By analyzing comparative institutional frameworks, investor protection laws, and firm-level practices, the paper highlights how financial systems influence ownership concentration, board structures, and managerial accountability. The review also explores the ongoing convergence in governance standards due to globalization, regulatory harmonization, and capital mobility. While no one-size fits all model, strong legal enforcement, transparency, and adaptive governance remain critical across contexts. The paper concludes with implications for emerging markets and policy reforms aimed at fostering sustainable financial development and corporate accountability.

Keywords: financial systems, corporate governance, corporate performance, sustainable finance.

1. Introduction

The connection between financial systems and corporate governance has emerged as a central topic in finance and institutional economics. Financial systems play a critical role in allocating resources, facilitating investment, and enforcing corporate discipline. Corporate governance, on the other hand, deals with the mechanisms through which shareholders exert control and influence over management. The two are deeply intertwined, with each shaping the other's structure and efficacy. Across the globe, countries exhibit stark differences in how financial systems are organized and how corporate control is exerted. These variations are influenced by historical, legal, and cultural factors. By reviewing the international evidence, this paper aims to explore how different financial systems shape governance outcomes and what lessons can be drawn for policy-making, especially in emerging economies.

Corporate governance represents "the system by which companies are directed and controlled" (Cadbury Report, 1992). It is "the distribution of rights and responsibilities among the different participants in the organization, such as the board, managers, shareholders and stakeholders, and lays down the rules and procedures for decision-making" (OECD, 2004). Corporate governance has become a popular topic of discussion in the international scene and a number of factors have contributed to increase the focus on this subject: the collapse of a number of corporations, the hostile takeovers, the antisocial behavior of some companies. The widespread belief that corporate governance is able to affect firm performance and increase shareholders protection has therefore led to increasing global attention. The principles of corporate governance, including in regard to finance, build trust and integrity in the relationship between a corporation and its stakeholders. Requirements of transparency and disclosure call on companies to share openly and accurately all relevant financial and operational information. This guarantees that stakeholders, including investors, employees and the public, have access to the data they need to make informed decisions. In a culture of accountability and responsibility, people in governance and leadership roles are answerable for their actions. Directors and managers are responsible for their decisions and the performance of the company. They're required to make sure the company follows legal and ethical standards. Accountability mechanisms include regular audits, reporting and a clear division of roles and responsibilities so that decisions are made in the best interest of all stakeholders.

2. Literature review

The academic world has been shown to be interested in corporate governance, even before the recent scandals. Frequently, the research is focused on one or a few dimensions of corporate governance and examines the relationship between them and some variables that can represent the performance of the company. However, in recent years, a growing interest is devoted to the analysis of the effects of corporate governance on firm performance through the observation of multiple factors and creation of an index, in an attempt to grasp the growing complexity (Gompers et al., 2003; Bebchuk-Cohen-Ferrell, 2004; Aboav et al., 2010). Corporate governance involves the mechanisms by which companies are directed and controlled. It encompasses the relationships among the board, management, shareholders, and other stakeholders, aiming to ensure firm accountability and long-term value creation. Literature has it that, the adoption of International Financial Reporting Standards (IFRS) guarantees financial reporting by increasing the dependability and consistency of financial information worldwide (Abdollahi et al., 2020). In today's global economy, financial markets are more interconnected than ever. The standard of corporate governance and financial reporting can have broader implications on investment flows and economic stability.

Financial systems are typically categorized into:

- Bank-based systems (e.g., Germany, Japan): where banks play a central role in financing and monitoring firms.
- Market-based systems (e.g., US, UK): where capital markets are the primary source of corporate finance

3. Types of Financial Systems

Bank-Based Systems Bank-based systems, prevalent in countries such as Germany and Japan, rely heavily on banks for the provision of finance. These banks often maintain close, long-term relationships with firms, sometimes even holding equity stakes or board positions. This proximity facilitates monitoring but may also lead to reduced competitive pressures.

Market-Based Systems Market-based systems, found in countries like the United States and the United Kingdom, depend on well-developed capital markets for financing. Shareholders are typically dispersed, and investor protection is enforced through legal mechanisms and market discipline. Transparency and disclosure are key components of this model. Each system has its advantages and limitations. Bank-based systems offer stability and long-term financing, while market-based systems encourage innovation and external oversight. Corporate Governance Structures Across Countries Corporate governance involves a variety of mechanisms, including ownership structure, board composition, managerial incentives, and legal protections. Ownership Concentration in bank-based systems tends to be more concentrated, with families, banks, or the state holding significant stakes. This can lead to effective monitoring but may also result in expropriation of minority shareholders. In contrast, market-based systems feature dispersed ownership, requiring stronger legal protections and active capital markets to ensure managerial accountability. Board Composition and Role Boards in market-based systems are often composed of a majority of independent directors, ensuring objective oversight. In bank-based systems, boards may be dominated by insiders or stakeholders with direct financial ties to the firm. Legal Framework and Enforcement Legal origins influence governance practices significantly. Common law countries typically provide stronger shareholder protections compared to civil law countries. Enforcement, however, is equally important as the laws themselves. International Empirical Evidence Numerous studies have compared governance outcomes across different financial systems (La Porta et al., 1997). These seminal works show that legal protections for investors are strongly correlated with the development of capital markets and the dispersion of ownership. Countries with weak legal enforcement tend to have more concentrated ownership and underdeveloped markets. Allen and Gale (2000) argue that both systems can perform well under the right institutional settings. Bank-based systems may be better suited for countries with underdeveloped legal systems, while market-based systems thrive in environments with strong institutions. Demirgüç-

Kunt and Levine (2001) analysis indicates that financial structure matters less than overall financial development. Countries that improve access to finance, regardless of the dominant system, tend to grow faster and more equitably. Convergence Trends and Globalization In recent decades, globalization has increased the integration of financial markets and led to convergence in corporate governance standards. Harmonization of Standards International bodies like the OECD and the World Bank have promoted principles of good governance that transcend national systems. These include transparency, accountability, and shareholder rights.

4. Role of institutional investors

Global institutional investors are pushing firms toward adopting international governance practices. This has led to the emergence of hybrid systems, combining features of both bank- and market-based models. Challenges to convergence despite these trends, deep-rooted institutional and cultural differences limit full convergence. For example, relationship-based governance still dominates in East Asia, even as these countries integrate into global markets. Implications for emerging markets, the challenge lies in building governance structures that are credible, efficient, and adaptable. Legal and institutional development reforms should focus on strengthening judicial independence, improving contract enforcement, and protecting minority shareholders. Developing robust financial infrastructure, including regulatory bodies and disclosure systems, is essential to support capital markets. Balancing global and Local Practices while adopting global best practices, governance models must also reflect domestic institutional realities. A one-size-fits-all approach is unlikely to succeed. There is growing interest in how emerging technologies, such as blockchain and AI, may affect governance and financial intermediation.

5. Discussion

First of all, the results of the study confirmed that specific variables of corporate governance including board skills and expertise diversity and independent audit committees, positively impact IFRS compliance. These findings align well with both agency theory and empirical evidence indicating that effective governance directly improves financial reporting quality. The agency theory indicates that aligning the interests of managers and shareholders is one of the ways used to mitigate conflicts and improve financial reporting quality. This alignment according to the findings of this study is facilitated by corporate governance mechanisms such as board independence and audit committees (Jensen & Meckling, 1976). Businesses must follow several major finance regulations and compliance standards as part of their corporate governance practices. After the Enron fiasco and several other corporate scandals, the United States Congress passed the Sarbanes-Oxley Act (SOX), which was designed to protect investors by improving the accuracy and reliability of corporate disclosures. SOX mandates strict rules for financial disclosures to prevent accounting fraud. It also holds top management and auditors accountable for compliance. The IFRS provide a common language so a company's finances are understandable and comparable across international boundaries. This standardization helps investors and other stakeholders make informed economic decisions, promoting transparency and efficiency in the global markets.

6. Conclusion

The relationship between financial systems and corporate governance is multifaceted and context-dependent. While market-based and bank-based systems offer different strengths, the key lies in building strong legal frameworks, ensuring transparency, and enabling investor voice.
Global trends are pushing toward convergence, but national differences will persist. For policymakers, the goal should be to design adaptive, inclusive, and resilient governance systems that can support sustainable economic development.

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