

Gone by the board?

Why the directors of big banks failed to spot credit risks

Governance of global financial groups is being called into question after the market shake-out – but the shortcomings may lie more in the system than among individuals, write **Francesco Guerrera** and **Peter Thal Larsen**

The most immediate human cost of the crisis that has torn through the global financial system is apparent even from a casual walk in the streets of downtown Manhattan and the City of London.

The shorter queues at delicatessens and sandwich shops, the gloom-shrouded watering holes and the number of vacant floors in previously bustling buildings are stark representations of a trend seen in downturns ever since the crash of 1929: in times of crisis, the financial industry eats its own kind.

Over the past few months, as banks, insurers and investment houses felt the squeeze of the credit markets, they have cut their workforces. Financial companies have already fired 83,000 employees since last summer and experts predict that number could more than double over the next 12 months as the crisis shows no signs of abating.

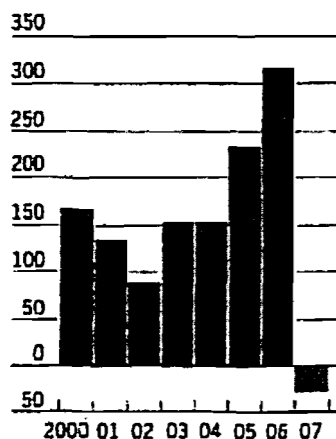
Some of the newly unemployed have famous names, like Chuck Prince, Citigroup's former chief executive; Stan O'Neal, his erstwhile counterpart at Merrill Lynch; and Marcel Ospel of UBS. The vast majority, however, are faceless bankers and analysts whose careers have been cut short, at least for the time being, by the bad bets and risk-taking excesses of the bull market.

Yet amid this purge, one important constituency in the global financial markets has survived virtually unscathed: ordinary board directors. With the exception of board members at companies that imploded, such as Bear Stearns in the US and



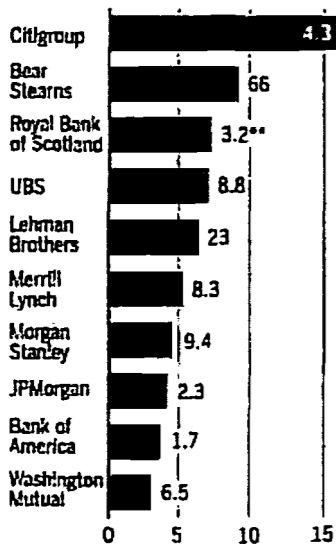
Investment bank pre-tax earnings

Over Wyman Index (1997=100)



Positions cut

Thousands*
Figure at end of bar is % of total workforce



* 10 months to May
** Includes ABN Amro reorganization

Sources: JPMorgan; Bloomberg

Northern Rock in the UK. It is hard to name a director who resigned or otherwise accepted responsibility for the mistakes suffered by the financial institution in his or her care.

"Boards are supposed to be a company's backstop and they completely missed this crisis," says Charles Elson, who sits on several boards and heads the Corporate Governance Centre at the University of Delaware. "Where exactly were they when all this was going on?" The question is beginning to be heard more frequently among shareholders and employees whose investments and job prospects have been hit by the losses and steep plunges in share prices brought about by the crisis.

At the heart of the matter is whether the corporate governance infrastructure, built over the decades to provide checks and balances to ever more powerful chief executives, has been exposed as woefully inadequate by recent events. As one former senior Wall Street executive puts it: "If, as it appears clear, boards were asleep at the switch, then there is something fundamentally wrong with the system of controls we have."

Many board directors dispute this view, maintaining that there is little they could have done to stem the wave of easy debt and risk mispricing that ended up swamping the global financial system. "A board can't be a risk manager," says a director at a large financial group. "What boards can do is monitor the performance of executives and take action when appropriate, which in most cases they did."

The argument is that it is unfair to ask external directors who meet at best once a month to take the blame for the industry's failures when highly paid, full-time executives failed to spot the dangers of such a dramatic deterioration in the markets. "If you had gathered 100 of the wisest men and women before the bursting of the bubble, given them 50 business lines and asked them which one Citigroup or Merrill Lynch should exit, I doubt any of them would have mentioned collateralised debt obligations," says an executive at a large financial group.

Critics counter that, with financial groups having recorded more than \$400bn (£203bn, €257bn) in losses and having been forced to raise \$300bn-plus in capital at bargain basement prices, boards cannot shirk all responsibility. "Directors get together a few times a year and want a quiet life: that's human nature," says a former director at several financial companies. "But this time around a quiet life meant that they failed to oversee management."

At the same time, one of the main charges levelled at direc-

tors of financial groups is that they do not know enough about the industry their companies are in. Even Wall Street executives admit that, although day-to-day affairs are the realm of management, greater financial literacy could have helped directors challenge management's appetite for risk.

"The vast majority of these people could not tell you how a derivative works. It is very easy for skilled, charismatic managers to persuade them that whatever they were doing was good business," says one.

That impression is reinforced by a look at the boards of eight prominent US financial institutions: Citi, JPMorgan Chase, Bank of America, Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers and the pre-rescue Bear Stearns. According to their biographies on the companies' websites, more than two-thirds of the occupants of those board seats had no significant recent experience in the banking business. Fewer than half had any financial services industry experience at all.

Moreover, many of the directors without a financial background happened to sit on highly technical board committees. At Lehman, for example, Roger Berlind, a theatre impresario and private investor, is on both the board's audit committee and the finance and risk committee. At Citi, John Deutch, a former head of the CIA who is now a physical chemistry professor at the Massachusetts Institute of Technology, sits on the audit and risk management committee. Similarly, Tommy Franks, the retired top US Army general, is on the audit committee of Bank of America.

Although Mr Berlind was unavailable for comment, Lehman said he had considerable managerial experience. In 1960 Mr Berlind co-founded Carter, Berlind, Potoma & Weill, the investment firm that gave Sandy Weill, a future chief executive of Citi, his first big break. Lehman pointed out, Bank of America did not comment. In a statement, Citi said its board was "composed of a group of highly seasoned executives who diligently performed their duties with respect to subprime and other issues".

In the UK, until recently banks did not tend to look for non-executive directors with a background in financial services, opting instead for executives from other industries - or former politicians and civil servants whose government connections could prove useful in a highly regulated industry. "There is a feeling [in financial institutions] that they have plenty of bankers and want people with a different background," says Phillip Marsden, a former banker who is chairman of Ridge-

way Partners, a boutique headhunting firm.

In the current crisis, however, these trends have contributed to the impression that bank boards are hopelessly out of touch with the complexities of the business they oversee. Paul Myners, the former City fund manager who has been non-executive chairman of several large companies, recently called for banks' boards to raise their game, arguing that "most boards of directors resemble "a retirement home for the great and the good".

Bank executives retort that the quest for directors with knowledge of different industries was driven partly by the desire to have a broad set of opinions in the boardroom and partly by reg-

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ulatory requirements. One hurdle faced by banks in both the US and Europe is that it is almost impossible to recruit outside directors: among the ranks of their rivals because of potential conflicts of interest.

For US-registered companies, the issue has been exacerbated by the introduction this decade of the Sarbanes-Oxley corporate governance legislation. By striving to foster more independent boards and end the cronyism that was seen as being prevalent in years gone by, the rules have made it even more difficult for companies, especially larger ones, to hire financial practitioners as directors.

For example, executives at Citi, which is looking for directors with a financial background,

complain that many good candidates cannot be considered because, in the regulators' eyes, they might have conflicts with the company's sprawling business. "One of the unintended consequences of Sarbox is that its emphasis on independence ruled out from board positions a lot of the people who knew about this business," says Ted Dysart, head of the Americas board practice for Heidrick & Struggles, a big headhunter.

Even people reaching the end of their banking career are reluctant to tie their hands by joining the board of any one institution, as this could make it harder for them to take other jobs. "Why would I want to conflict myself out of working for the rest of the industry in return for a non-executive director's fee?" asks one former British banking executive who has been approached about several board vacancies.

For banks, this reluctance compounds the difficulties that all publicly listed companies face in recruiting competent directors. The risk of legal and regulatory penalties has led many capable business people to conclude that the responsibilities of serving as a director outweigh its benefits.

This comes at a time when banks suffering from the credit crisis are seeking to add financial experts to their boards. "People are very nervous about joining bank boards because they feel uncertain about the extent of the sophisticated financial instruments on the balance sheet and what the values are," says one London-based headhunter.

Despite the benefits of having financial help on a Wall Street or City board, however, recent experience suggests that banking expertise is not in itself enough to navigate the current storm. The board of Northern Rock, the mortgage lender nationalised by the British government this year, included Derek Wanless, the former chief executive of Nat-

West (now part of Royal Bank of Scotland); Nichola Pease, chief executive of JO Hambro Capital Management and one of the UK's most respected fund managers; and Sir Ian Gibson, an industrialist who spent several years on the governing body of the Bank of England.

Yet none of these people spotted the risks inherent in Northern Rock's business model, which relied heavily on being able to issue mortgage-backed securities, or were able to rein in the bank's aggressive growth.

At Bear Stearns, rescued from near-bankruptcy by the Federal Reserve and acquired by JPMorgan for a cut price, seven out of 13 directors had a banking background. That is why many corporate governance experts maintain that the biggest deficiency among financial directors during the crisis has been one of attitude and effort rather than knowledge or experience.

"These boards had fabulous individuals on them," says Jeffrey Sonnenfeld, senior associate dean at Yale School of Management. "Intellectual pound for intellectual pound, you could not do better than the Citigroup board [which boasts seven serving and past chief executives] but collectively something went wrong. Boards did not ask the tough questions and did not have the stomach and the interest in working with the CEO to reinvent the business and challenge the status quo," he adds.

Once again, Sarbox stands accused of neutering directors' efficacy. Its critics argue that, by increasing the burden of financial and regulatory compliance, the legislation took directors away from the bread-and-butter work of monitoring the chief executive's performance and the company's strategy. "Sarbox led boards to focus on what was measurable instead of what mattered. What mattered in this case was challenging the risk assumptions made by the CEO and other executives," says a former board director at a US financial firm. "Boards went through the motions and there was no time left for substance."

But even if Sarbox contributed to what one executive calls CYA ("cover your arse") compliance, it cannot fully account for boards' inability to act in the run-up to the crisis. Present and former directors say the main problem is management's overwhelming influence on boards' inner workings.

By controlling the type of information flowing to and from the board and directing the interaction with directors - down to details such as the time and frequency of meetings, their agendas and even the seating plans - executives have powerful weap-

ons to shape the board's thinking. "CEOs call it 'care and feeding of the board,'" says a consultant who has worked with several boards. "Top executives are, by nature, control freaks and want to carefully stage-manage their dealings with directors so as to avoid awkward questions."

The issue is particularly pronounced when, as with most US companies, the chairman and chief executive are one and the same person. "There is a fine line between micro-management and proper information flow. In a number of cases boards [of financial groups] were not given complete information," says Richard Koppes, a former general counsel to California Public Employees' Retirement System (Calpers), the giant pension fund.

"It raises the issue of a strong independent lead director or an independent chair: when someone has absolute power it's more difficult for others to ask for the right information and focus on the right topics," adds Mr Koppes, who is a director of two US pharmaceutical companies.

One Wall Street executive admits that it would not be too difficult for him to present financial information to its board "in such a complex way that people would be prevented from asking whether the emperor is naked, for fear of looking stupid".

With the financial crisis continuing to take its toll on financial groups and their shareholders, there is a real possibility that directors' failure to spot management's strategic and tactical nakedness could come back to haunt them. The litigious nature of the US could prompt some enterprising lawyers to try and prove that many financial companies' directors swapped judgment and curiosity for box-ticking and passivity, thus neglecting their fiduciary duty to protect shareholders' interests.

Alternatively, shareholders could decide to attack underperforming boards by voting against individual directors at companies' annual meetings. Some dissatisfaction has already surfaced in this year's shareholder meetings but, with many of the chief executives seen as responsible for the problems gone, directors could find themselves even more in the firing line in 2009.

In the next few months, board members will have to show investors and capital markets that their ability to oversee companies that are striving to come out of the credit squeeze is better than the stewardship displayed before the crisis hit. Failure to do that may well lead them to face the kind of brutal justice that Wall Street and the City have already meted out to thousands of other employees.

Additional reporting by Daniel Pimlott



Roger Berlind, a Lehman director, with actress Donna Murphy Getty