Implications of the Corporate Governance framework during the Credit Crisis on 3 banks

Chandra A. Poojari

Abstract
Financial organizations are extremely critical for a stable economy. Through efficient mobilization and allocation of funds, they lower the cost of capital to firms, boost capital formation, and stimulate productivity growth. The credit crisis revealed the fragility of corporate governance and management within several reputed financial organizations. We discuss the cases of corporate failures of 3 financial institutions, namely Bear Stearns, Lehman Brothers and The Royal Bank of Scotland. We highlight certain intangible governance traits common across the 3 organizations such as charismatic CEOs, inability to comprehend the risk and complexities of the business and delay in providing effective guidance. Further, we analyze the latest filings prior to the credit events and contrast the approach of the 3 institutions against the best practices. We recommend an urgent need for external risk consultants that assist the board in better understanding of the risks, and a regular living will filings that provides a recovery plan (for going concerns) and a resolution plan (for “gone” concerns).

Keywords: Corporate Governance, Investment Banks, Risk Management

*The author is grateful to Dr. Kalyanaram’s and an anonymous referee’s insightful remarks which significantly improved the quality of the paper.
I. Introduction

Several factors contributed with varying degrees of significance towards the buildup of the 2008 credit crisis. (Diamond & Rajan, 2009) highlight three causes: (i) the U.S. financial sector misallocated resources to real estate, financed through the issuance of exotic new financial instruments; (ii) a significant portion of these instruments found their way, directly or indirectly, into commercial and investment bank balance sheets; (iii) these investments were largely financed with short-term debt. Similarly, (Baily & Elliott, 2009) state three possible narratives for the crisis: (i) the government intervention in the housing market - principally through Fannie Mae and Freddie Mac - inflated a housing bubble that triggered the crisis; (ii) the Wall Street bankers’ greed, arrogance and manipulation of the financial system, and misaligned incentives, especially in compensation structures that resulted in inflated balance sheets and mispricing of risks; (iii) “Everyone was at fault” - the government, Wall Street, and wider society adopted a lax attitude towards risk-taking and leverage, creating a bubble across a wide range of investments and countries.

Interestingly, even the 10-member strong Financial Crisis Inquiry Commission (FCIC) created by the U.S. Congress to investigate the causes of the financial crisis could not arrive at a consensus on the causes for the credit crisis. FCIC’s final report, (Angelides, et al., 2011), had two dissenting statements. One dissenting note from 3 members (Bill Thomas, Keith Hennessey and Douglas Holtz-Eakin) was in line with the third narrative of Elliot and Baily, which emphasizes both global economic forces and failures in U.S. policy/supervision to have contributed in equal measure. The other dissenting note by Peter Wallison endorses the first narrative that the crisis was an outcome of the U.S. government’s housing policy, which led to the creation of 27 MM subprime and other risky loans - half of all mortgages in the United States - which defaulted as soon as the massive 1997-2007 housing bubble began to deflate.

![Figure 1: LIBOR Interbank Overnight rates](image)

The turmoil caused investors to reappraise the risks of high-yielding securities which caused sharp increases in the spreads on funds in the InterBank markets (see Figure 1). In order to ease the flow of credit, the U.S. treasury provided liquidity to the markets through the Troubled Asset Relief Program (TARP). TARP made direct investments through the Capital Purchase Program (CPP) to the extent of US$ 204.9 billion in 707 financial institutions in 48 states.

<table>
<thead>
<tr>
<th>Name</th>
<th>Amount ($Bln)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>25.00</td>
</tr>
<tr>
<td>Citigroup Inc.</td>
<td>25.00</td>
</tr>
<tr>
<td>JPMorgan Chase &amp; Co.</td>
<td>25.00</td>
</tr>
<tr>
<td>Wells Fargo &amp; Co.</td>
<td>25.00</td>
</tr>
<tr>
<td>Goldman Sachs Group, Inc.</td>
<td>10.00</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>10.00</td>
</tr>
<tr>
<td>The PNC Financial Services Group, Inc.</td>
<td>7.58</td>
</tr>
<tr>
<td>U.S. Bancorp</td>
<td>6.60</td>
</tr>
<tr>
<td>SunTrust Banks, Inc.</td>
<td>4.85</td>
</tr>
<tr>
<td>Capital One Financial Corp</td>
<td>3.56</td>
</tr>
<tr>
<td>Regions Financial Corporation</td>
<td>3.50</td>
</tr>
<tr>
<td>Fifth Third Bancorp</td>
<td>3.41</td>
</tr>
<tr>
<td>The Hartford Financial Services Group, Inc.</td>
<td>3.40</td>
</tr>
<tr>
<td>American Express Company</td>
<td>3.39</td>
</tr>
<tr>
<td>BBT Corp.</td>
<td>3.13</td>
</tr>
</tbody>
</table>
As of September 30, 2013, the Treasury has recovered almost US$ 225 billion from CPP through repayments, dividends, interest, and other income. Table 1 shows the various entities that received capital north of US$ 1 billion under the TARP program. As for the terms, the Treasury purchased preferred shares in the banks with a 5% annual dividend under the condition that after five years, the rate will increase to 9%. The Treasury also received warrants to purchase stock in the companies at a set price. On the contrary, in the European Union (EU), most of the aid was in the form of a guarantee of the bank's balance sheet by the respective member state. The general consensus in EU was that the banks were not insolvent but short of liquidity. (CEPS, 2010) show that during the crisis, 20 bank debt guarantee and 15 bank recapitalization schemes, and 44 cases of individual bank aid cases were dealt with by the European Commission under the state aid rules. At the height of the crisis, the effectively committed aid amounted to about 13% of the GDP of the EU.

<table>
<thead>
<tr>
<th>Country</th>
<th>Impact on gross public debt and other support</th>
<th>Recovery to date</th>
<th>Impact on public debt and other support after recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>7.4</td>
<td>1.5</td>
<td>5.9</td>
</tr>
<tr>
<td>Cyprus</td>
<td>10</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Germany</td>
<td>12.8</td>
<td>2</td>
<td>10.8</td>
</tr>
<tr>
<td>Greece</td>
<td>19.7</td>
<td>4.3</td>
<td>15.4</td>
</tr>
<tr>
<td>Ireland</td>
<td>40.5</td>
<td>4.4</td>
<td>36.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>14.6</td>
<td>10</td>
<td>4.6</td>
</tr>
<tr>
<td>Spain</td>
<td>7.3</td>
<td>2.9</td>
<td>4.4</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>6.7</td>
<td>1.5</td>
<td>5.2</td>
</tr>
<tr>
<td>United States</td>
<td>4.8</td>
<td>4.2</td>
<td>0.5</td>
</tr>
</tbody>
</table>

The International Monetary Fund in its report, (IMF, 2013), highlighted the fiscal pressure faced by countries as a result of bank recapitalization (see Table 2). In Spain, where financial sector reforms are well underway, four banks were restructured at a fiscal cost of 3% of GDP; further fiscal outlays in 2013 are expected to be small (0.25% of GDP). In the Netherlands, the fourth-largest bank (SNS Reaal) is expected to receive a capital injection - with a cost to the state of 0.6% of GDP - in addition to public loans and guarantees amounting to 1% of GDP. Within a short span, several policy initiatives were undertaken to fix the alternate flaws throughout the financial markets that supposedly caused the crisis. In this paper, we argue about the fact that different banks
operating in the same geography, in the same financial and market environment and under the same regulatory arrangements generated such massively different outcomes can only be explained to a large extent in terms of differences in the way they were run. The role of the corporate governance in the bank was to first set the conditions within which others can manage effectively and second, maintain oversight of the entire firm on behalf of the owners. Fuelled by leverage and the light touch regulation, banks had grown quickly over a very short period following the passage of the Gramm-Leach-Bliley Act in 1999. The scale and the number of the complexities have made the jobs of the board and the manager very difficult at several levels. First, the volume of the transactions have increased manifold. Second, the deals and the underlying structures are getting increasingly sophisticated. And finally, risk management processes that were supposed to provide reality checks have failed miserably when most needed.

(Levin, 2004) argues that banks are generally more opaque than non-financial firms as they have the ability to take on risk very quickly and in a way not immediately apparent to directors or outside investors. The qualities of the loans are not readily observable and can be hidden for long periods. Moreover, banks can alter the risk composition of their assets more quickly than most non-financial industries, and banks can readily hide problems by extending loans to clients that cannot service previous debt obligations. (Becht, Bolton, & Roell, 2011) argue that although depositors and bond holders contribute almost all of a bank’s capital, yet most decisions are taken by managers, boards and shareholders. This is immediately apparent from the fact that bank executives do not take permission from depositors before changing a bank’s risk profile. And, ironically, the compensation package for the CEO promotes further risk taking. While debt and equity would be equally expensive in a Modigliani-Miller world, in the banking world, it is not so. Depositors in a bank with access to the state funded net are more oblivious to the bank risk and therefore, do not seek compensation for the excess risk. Among the worst affected were those that participated directly in the origination and/or distribution of asset-backed securities and derivative products or that held these assets on their book of business. For instance, both Bear Stearns and Lehman rode the U.S. housing boom from 2000 to 2005 as the top two underwriters of new mortgage securities, which totaled US$ 2.4 trillion by the end of 2005 (SIFMA, 2006). Interestingly, Bear Stearns’s co-chief operating officer, Warren Spector, was a former mortgage trader, as were the two heads of the fixed-income division. The unit accounted for 44% of Bear Stearns’ US$ 7.4 billion of revenue in fiscal 2005. On the other hand, Lehman’s COO, Joseph Gregory, previously led the firm’s mortgage group, and CEO, Richard Fuld was an ex-bond trader. Also, many failures were a result of banks growing too fast through acquisitions and in particular, the acquisition of illiquid assets at inflated prices. A classic case was that of RBS (for a brief period, it was the largest Investment Bank) which decided to fund the acquisition of the Dutch bank ABNAMRO primarily with short term debt which increased its reliance on short-term wholesale funding. The wholesale credit markets came to a standstill following the collapse of Lehman Brothers, as banks did not trust each other’s strength of the balance sheet. RBS could access only the overnight markets as market participants were unwilling to fund for a longer term. Figure 1 shows the profile of the overnight inter-bank LIBOR rates in the lead up to and following the bank failures. It is apparent that the overnight funding became difficult to access, and
consequently, RBS became dependent on Bank of England’s Emergency Liquidity Assistance (ELA) on 7 October 2008. (Shleifer & Vishny, 1997) confirm the strong correlation between the ability of a firm to raise finance and its record of Corporate Governance. They argue that a firm is likely to get external finance not only because of the reputation of the capital market and excessive investor optimism, but also due to assurances provided by the corporate governance system.

**Outline of the Paper**

The paper, through a case-study framework, highlights the impact of the credit crisis on 3 financial institutions in context of their Corporate Governance framework. The case studies identify the key players, explain the internal workings of the board and thus provide the reader potential rationale for the ultimate outcomes.

The author is of the opinion that such a case study provides a useful way to represent the key points and key messages in the multi-layered and complex nature of the crisis in general and 3 banks in particular. Second, although the credit crisis originated in the sophisticated trading desks of the Wall-Street banks that structured, priced and traded complex products, the implications of the crisis were universal in scope.

People from all walks of life suffered the consequences through job losses, foreclosures, pensioners losing their life-long earnings, and the ‘lost generation’ of unemployed youth. Such disparate audiences are limited in their understanding of the complex and opaque nature of the structure and risk taking in the financial institutions. They can relate far more easily with the case study that sets out the activities of the major players than through an empirical statistical analysis. The author hopes that through the case study, the readers can identify more clearly with the functioning of the financial institutions and appreciate why the events unfolded the way they did.

In Section II, we look at the role of corporate governance within financial institutions and banks in particular. In Section III, we discuss contemporary research in corporate governance following the financial crisis and the ‘credit crunch’. Many of these papers complement the focus of this paper on areas that are central to corporate governance such as competence of the Boards of Directors, executive compensation culture, internal control and risk management. Next, we focus in detail on the corporate governance aspects within 3 large banks that were in the eye of the storm - namely Bear Stearns (Section IV), Lehman Brothers (Section V) and Royal Bank of Scotland (Section VI). We conclude in Section VII with remedial solutions that potentially can avoid similar governance failures in the future.

**II. Corporate Governance within Capital Markets**

![Figure 2: Corporate Governance Structure](image-url)
Figure 2 shows the generic governance structure. The shareholders elect a board of Directors and a chairperson who manages the board’s affairs. The board appoints a Chief Executive Officer (CEO) who is responsible for the day-to-day management of the firm’s business activities. The directors provide an annual report to the shareholders on the firm’s financial performance. The directors’ report is validated by external auditors appointed by the shareholders on the recommendation of the board. There is a formal annual meeting of shareholders during which financial results are presented, directors are elected and auditors are appointed.

Sixty years after it was brought into effect, the Glass-Steagall Act of 1933 was repealed by the Gramm-Leach-Bliley Act of 1999. The barriers among banking companies, securities companies and insurance companies that prohibited any one institution from acting as any combination of an investment bank, a commercial bank, and an insurance company were moved. With the passage of the Gramm-Leach-Bliley Act, commercial banks, investment banks, securities firms, and insurance companies were allowed to consolidate.

There were a series of business scandals in the United Kingdom during the 1980s that resulted in much soul-searching on the lack of control within business houses. The events included siphoning of the organization’s funds by CEOs (Maxwell and Polly Peck), the high salaries and bonuses to some CEOs and directors, often in firms whose status of being a going concern was in doubt. The light touch self-regulation mechanism was found seriously deficient to foresee frauds and the police were too ill-equipped to prosecute the often complicated nature of the crime. To investigate the issues and suggest measures, the Cadbury committee (Cadbury, 1992) was set up in 1991 by the Financial Reporting council, the London Stock Exchange and the accountancy profession. The Cadbury report was one of the first efforts towards best practices in Corporate governance. This code was appended to the listing rules at the London Stock Exchange and listed companies were obliged either to comply with the provisions of the Code or justify their failure to do so.

In the years after Enron (McLean & Elkind, 2004) and WorldCom (Sidak, 2003), the U.S.’ Financial Accounting and Standards Board (FASB) through the Sarbanes-Oxley Act (Romano, 2004) tried to avoid the potential to misuse off-balance sheet entities called Special Purpose Vehicles (the problem resurfaced in the 2008 financial market turmoil). Amongst other things, the act also covered issues such as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure. However, such prudential standards encouraged banks to engage in regulatory arbitrage by taking mortgages and other assets off the balance sheet and to finance them separately in conduits thus simultaneously economizing on regulatory capital and booking transaction fees. In order to make the deal lucrative for investors, the banks further offered a liquidity put that allows the buyer to sell back the asset to the bank at the original price. The Sarbanes Oxley Act required the Boards to be clear about the strategy and risk appetite of the company and respond in a timely manner requiring an efficient reporting system. Accounting methods, however, have been put to the test concerning fair value of assets which either trade in thin markets or in no market at all.

Just as the 2008 credit crisis was unfolding, senior financial supervisors from five countries issued a
report that assesses a range of risk management practices among a sample of 11 major global financial services organizations. The 7 supervisory agencies participating in this project were the French Banking Commission, the German Federal Financial Supervisory Authority, the Swiss Federal Banking Commission, the U.K. Financial Services Authority, and, in the United States, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Federal Reserve. This report from the Institute of International Finance (IIF, 2012) sets out Principles of Conduct, Best Practice Recommendations, and Considerations for the Official Sector in the areas of risk management; compensation policies; liquidity risk, conduit, and securitization issues; valuation issues; credit underwriting, ratings, and investor due diligence in securitization markets; and transparency and disclosure issues. The report also announces the establishment of an industry-based Market Monitoring Group to provide ongoing assessment of global financial market developments for future vulnerabilities. While nearly all the 11 major banks reviewed by the Senior Supervisor’s Group failed to anticipate fully the severity and nature of recent market stress, there was a marked difference in how they were affected determined in a great measure by their senior management structure and the nature of their risk management systems, both of which should have been overseen by the boards.

III. Review of Corporate Governance within banks post the credit crisis

(Blundell, Atkinson, & H, 2008) suggest that there is no simple indicator of good governance linked to independence, compensation, and remuneration. It is likely to be complex and idiosyncratic to the firm. It is not high pay or moderate pay, but whether pay is genuinely linked to bringing long-term value to the bank with funding costs linked to the risks that bank staff take. In the report by the Organization for Economic Co-operation and Development (OECD), (Kirkpatrick, 2009) concludes that the financial crisis can be to a large extent attributed to failures and weaknesses in Corporate Governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies.

(Erkens, Hung, & Matos, 2012) investigate the influence of corporate governance on financial firms’ performance during the 2007-2008 financial crisis. Using a unique dataset of 296 financial firms from 30 countries that were at the center of the crisis, they find that firms with more independent boards and higher institutional ownership experienced worse stock returns during the crisis period. They argue that this is because (1) firms with higher institutional ownership took more risk prior to the crisis, which resulted in larger shareholder losses during the crisis period, and (2) firms with more independent boards raised more equity capital during the crisis, which led to a wealth transfer from existing shareholders to debt holders.

(Altunbas, Manganelli, & Ibanez, 2011) use a large sample of listed banks operating in the European Union and the United States to compute different measures of realized bank risk – namely the likelihood of a bank rescue, systematic risk and the intensity of recourse to central bank liquidity. They analyze how these variables are related to a range of pre-crisis individual bank information obtained from a manually-assembled database. They find that credit expansion, lower dependence on customer deposits, size and weaker capital (especially for undercapitalized banks) in the run up to the crisis accounted for higher ex-post
levels of distress. Other factors, including the amount of market funding and lack of diversification in income sources also contributed to an increase in realized bank risk. Accounting for macroeconomic and institutional factors – including the role of deregulation, economic cycle, competition and asset prices developments – do not change the gist of our results.

The FCIC’s report (Angelides, et al., 2011) states that dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis. The report highlights the obvious lack of management oversight and knee jerk reaction through an example of statements of the Citigroup’s CEO and co-head to the Commission. The CEO of Citigroup told the Commission that a US$ 40 billion position in highly rated mortgage securities would “not in any way have excited my attention,” and the co-head of Citigroup’s investment bank said he spent “a small fraction of 1%” of his time on those securities. It gives further concrete evidences of governance breakdowns and irresponsibility. Take for instance AIG senior management’s ignorance of the terms and risks of the company’s US$79 billion derivatives exposure to mortgage-related securities; Fannie Mae’s quest for bigger market share, profits, and bonuses, which led it to ramp up its exposure to risky loans and securities as the housing market was peaking; and the costly surprise when Merrill Lynch’s top management realized that the company held US$55 billion in “super-senior” and supposedly “super-safe” mortgage-related securities that resulted in billions of dollars in losses.

The 2,300 pages’ Dodd-Frank Act is one of the most far reaching efforts to address the several issues that resulted in the banking crisis of 2008. The Dodd-Frank Act provides prescriptive solutions to issues such as corporate governance, executive compensation and disclosures. For example
- shareholders of U.S. public companies have a non-binding “say on pay” vote for named executive officers, new standards relating to the independence of compensation committees and compensation advisors are mandated, current and former executive officers may be forced to return compensation if a restatement of financial statements triggers a “claw back”;
- brokers’ ability to vote shares for which they do not receive instructions will be further limited; proxy disclosures will be enhanced, the Securities and Exchange Commission (“SEC”) is granted express authority to enact shareholder access to the company proxy;
- smaller reporting companies and non-accelerated filers will be relieved from providing auditor attestation of the effectiveness of internal controls and procedures, whistleblower protections are expanded and the definition of “accredited investor” will be updated.

In Europe, the Basel Committee on Banking Supervision has issued 14 sets of principles (Basel-III, 2010) for enhancing sound corporate governance practices at banking organizations. Key areas of particular focus include: (1) the role of the board; (2) the qualifications and composition of the board; (3) the importance of an independent risk management function, including a chief risk officer or equivalent; (4) the importance of monitoring risks on an ongoing firm-wide and individual entity basis, (5) the board’s oversight of the compensation systems; and (6) the board and senior management’s understanding of the bank’s operational structure and risks. The principles
also emphasize the importance of supervisors regularly evaluating the bank’s corporate governance policies and practices as well as its implementation of the Committee’s principles.

**Competence of the board**

The idea that the board is a retirement home for the “great and the good” might be an exaggeration but there is still a grain of truth. The board requires experts who can rationalize the numbers presented and ask insightful questions. Such skill and insight usually comes after years of experience. The obvious solution is to include senior individuals. However, also required are individuals who are not victim of their habits and are willing to spend time to understand, roll-up the sleeves and figure out the details under the bonnet. (Adams & Mehran, 2012) show that the performance of Bank Holding Companies (BHCs) deteriorates when the board has directors who also serve in numerous other boards and thus have their focus dissipated. (Ferreira, Kirchmaier, & Metzger, 2010) have collected detailed biographic data for a sample of 12,240 directors working for 740 publicly-listed banks spanning 9 years (2000-2008) that includes banks from 41 countries. Their data is categorized on four board/director characteristics: director independence, previous banking experience, board size, and director ‘busyness’. Their findings reveal that countries explain more of the cross-sectional variation in bank board independence than bank characteristics do, suggesting that regulation and other institutional features are more important than bank-specific and idiosyncratic factors. In contrast, neither country nor observable bank characteristics explain much of the cross-sectional variation in board experience. While bank-specific characteristics alone explain about 10% of the variation in bank board independence, country dummies alone can explain up to 54% of the observed variation. After controlling for country characteristics, the incremental explanatory power of bank-specific variables is just 3%.

<table>
<thead>
<tr>
<th>Year</th>
<th>Bear Stearns($)</th>
<th>Lehman Brothers($)</th>
<th>RBS($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>5,927,920</td>
<td>4,768,899</td>
<td>825,000</td>
</tr>
<tr>
<td>2002</td>
<td>11,744,609</td>
<td>1,232,352</td>
<td>1,730,000</td>
</tr>
<tr>
<td>2003</td>
<td>12,633,503</td>
<td>7,630,983</td>
<td>990,000</td>
</tr>
<tr>
<td>2004</td>
<td>11,268,364</td>
<td>11,456,939</td>
<td>1,500,000</td>
</tr>
<tr>
<td>2005</td>
<td>13,753,111</td>
<td>14,865,419</td>
<td>1,760,000</td>
</tr>
<tr>
<td>2006</td>
<td>17,878,812</td>
<td>6,545,852</td>
<td>2,760,000</td>
</tr>
<tr>
<td>2007</td>
<td>-</td>
<td>4,327,911</td>
<td>2,860,000</td>
</tr>
</tbody>
</table>

Table 3: CEO Compensation at Bear Stearns, Lehman Brothers and RBS

**Compensation Culture**

There is consensus that remuneration and incentive systems have played a key role influencing financial institutions’ sensitivity to shocks and causing the developments of unsustainable balance sheet positions. The Financial Stability Board (FSB) report, (FSB, 2009), is the most recent pan-global effort towards reforming the remuneration in banks at a global level. Management and Traders are compensated on booking profits. It didn’t take long to figure out that risky activities with significant upside potential resulted in higher bonuses. Greenspan’s “theory” of market discipline creating a moderation in risky behavior proved faulty. (Core, Holthausen, & Larcker, 1999) show that both board-of-director characteristics and ownership structure have a substantive cross-sectional association with the level of CEO compensation, after controlling for standard economic determinants of the level of CEO compensation (e.g., proxies for the firm demand for a high-quality CEO, contemporaneous firm performance, and firm risk). In particular, with respect to the board-of-director variables, they find that CEO compensation is higher when the CEO is also the board
chair, the board is larger, there is a greater percentage of the board composed of outside directors, and the outside directors are appointed by the CEO or are considered “gray” directors. CEO compensation is also higher when outside directors are older and serve on more than three other boards. (Bebchuk, Cohen, & Spamann, 2010) find that the top five executive teams of Bear Stearns and Lehman Brothers cashed out large amounts of performance-based compensation during the 2000-2008 periods (that was not clawed back when the firms collapsed), as well as pocketed significantly from selling shares. Overall, they estimate that the top executive teams of Bear Stearns and Lehman Brothers derived cash flows of about $1.4 billion and $1 billion respectively from cash bonuses and equity sales during 2000-2008.

Control
Risk issues are increasingly becoming too specialist for a meaningful oversight by the whole Board. In theory, the concept that each and every individual should be a risk manager, mitigate and communicate the risks under purview, sounds good. But the concept is utopian at best with no accountability in case things go wrong. The buck should stop with the board. Ideally, the members of the Board should be composed of diverse individuals who complement one another to understand the business strategy from a forward looking perspective, and not just review current risks, issues and audit reports. One of the central themes during the credit crisis was the mispricing and misunderstanding of the risks. Not many understand the limitations of risk management metrics such as Value-At-Risk (VAR), and that simulation results can only be as good as the underlying data and assumptions. Senior-Supervisors-Group (Senior-Supervisors-Group, 2008-2009) studied 11 of the largest banks and securities to identify the funding and liquidity issues central to the crisis and explored critical areas of risk management practice that requires improvement across the financial services industry. Their study found concentration of the risk (on mortgages) and mispricing of the risk. (IIF, 2012) wants international regulatory bodies to engage in a dialogue to prevent the risk for regulatory arbitrage due to fragmented policies that may result in competitive disparities and thus create an unbalanced playing field. One of the centerpieces of the Dodd-Frank is the Volcker rule- a simple concept in which the banks are prohibited from making investment bets with their own money. This rule is an additional attempt to protect the financial system from risk.

IV. Bear Stearns
Founded in 1923, over the years, Bear Stearns has engaged in capital market activities including equities, bond trading and investment banking (80%), wealth management (8%) and global clearing services (2%). By 2008, it had 10 offices in the U.S. and 12 overseas offices in Europe, South Africa and Asia. In total, it had US$ 395 billion in assets and US$ 11 billion in net equity. Bear Stearns had notional contract amounts of approximately US$ 13.40 trillion in derivative financial instruments, of which almost 14% (US$1.85 trillion) were listed futures and option contracts.
The profile of the credit default swaps (derivative securities that pay in the case of a credit event) provides an insightful analysis on the perception of the market during the run-up to the ultimate takeover by JP Morgan. We use the daily time series of Bear Stearns’ 5-year CDS spreads and the daily share prices to provide a narrative during its last one year of existence from March 2007 to March 2008. As seen from the exponential increase in the credit spread of Bear Stearns (see Figure 3), the credit quality came under severe stress but the takeover by JP Morgan prevented any credit events for bond holders.

During the summer of 2007, when two of the Bear Stearns’ hedge funds lost billions during the crisis by making bad bets on securities backed by subprime mortgages and thus (widely believed) to have triggered the credit crisis, both the CEO Cayne and Warren Spector, then Bear’s co-president, were away at a major bridge tournament in Nashville, Tennessee. Shortly thereafter, in August 2007, Cayne fired Spector - in part because Cayne thought Spector should have been at the office in New York dealing with the aftermath of the hedge fund debacle and, many surmise, in part because Spector finished ahead of Cayne in the Nashville tournament. The lack of oversight and attention to details was endemic to scrappy, street fighting ethos of the firm and reflected in the structure and working of the board. Bear Stearns was taken over by JP Morgan at a price of US$10 per share in 2008 (the total price being approximately US$1 billion) in a deal put together by the Fed and the Treasury over the weekend.

IV.1 Board Structure

Mr. James Cayne was CEO of the firm since 1993 and had been chairman of the board since 2001. Although he did step down as CEO following the collapse of Bear’s mortgage-based hedge funds, he continued as the chairman. Since its inception in 1923, Bear’s Board has been run by only men. In 2007, 5 of the 12 directors were also part of the management team (see Table 4) and only 7 directors had banking experience. There were 3 directors who sat on more than four public boards. There was a stark difference between the number of meetings held by the board and that held by the executive committee (see Table 5).
Figure 3: Market reactions to the events affecting Bear Stearns

The profile of the credit default swaps (derivative securities that pay in the case of a credit event) provides an insightful analysis on the perception of the market during the run-up to the ultimate takeover by JP Morgan. We use the daily time series of Bear Stearns' 5-year CDS spreads and the daily share prices to provide a narrative during its last one year of existence from March 2007 to March 2008. As seen from the exponential increase in the credit spread of Bear Stearns (see Figure 3), the credit quality came under severe stress but the takeover by JP Morgan prevented any credit events for bond holders.

During the summer of 2007, when two of the Bear Stearns' hedge funds lost billions during the crisis by making bad bets on securities backed by subprime mortgages and thus (widely believed) to have triggered the credit crisis, both the CEO Cayne and Warren Spector, then Bear's co-president, were away at a major bridge tournament in Nashville, Tennessee. Shortly thereafter, in August 2007, Cayne fired Spector - in part because Cayne thought Spector should have been at the office in New York dealing with the aftermath of the hedge fund debacle and, many surmise, in part because Spector finished ahead of Cayne in the Nashville tournament. The lack of oversight and attention to details was endemic to the scrappy, street fighting ethos of the firm and reflected in the structure and working of the board. Bear Stearns was taken over by JP Morgan at a price of US$10 per share in 2008 (the total price being approximately US$1 billion) in a deal put together by the Fed and the Treasury over the weekend.

IV.1 Board Structure

Mr. James Cayne was CEO of the firm since 1993 and had been chairman of the board since 2001. Although he did step down as CEO following the collapse of Bear's mortgage-based hedge funds, he continued as the chairman. Since its inception in 1923, Bear's Board has been run by only men. In 2007, 5 of the 12 directors were also part of the management team (see Table 4) and only 7 directors had banking experience. There were 3 directors who sat on more than four public boards. There was a stark difference between the number of meetings held by the board and that held by the executive committee (see Table 5).

Table 4: Board of Bear Stearns in 2007

<table>
<thead>
<tr>
<th>Name</th>
<th>Age</th>
<th>Gender</th>
<th>Title</th>
<th>In Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alan C. Greenberg</td>
<td>79</td>
<td>Male</td>
<td>Chairman of the Executive Committee</td>
<td>1985</td>
</tr>
<tr>
<td>James E. Cayne</td>
<td>72</td>
<td>Male</td>
<td>Chairman of the Board (since 2001); CEO</td>
<td>1993</td>
</tr>
<tr>
<td>Alan D. Schwartz</td>
<td>56</td>
<td>Male</td>
<td>President and Co-Chief COO</td>
<td>1987(Except 1997;1998)</td>
</tr>
<tr>
<td>Henry S. Bienen</td>
<td>67</td>
<td>Male</td>
<td>President of Northwestern University, Independent Director</td>
<td>2004</td>
</tr>
<tr>
<td>Carl D. Glickman</td>
<td>80</td>
<td>Male</td>
<td>Private Investor, Independent Director</td>
<td>1985</td>
</tr>
<tr>
<td>Michael Goldstein</td>
<td>65</td>
<td>Male</td>
<td>Chairman and CEO of ToysRUs, Independent Director</td>
<td>2007</td>
</tr>
<tr>
<td>Donald J. Harrington</td>
<td>61</td>
<td>Male</td>
<td>President of St. John’s University, Independent Director</td>
<td>1993</td>
</tr>
<tr>
<td>Frank T. Nickell</td>
<td>59</td>
<td>Male</td>
<td>President and CEO of Kelso &amp; Company, Independent Director</td>
<td>2006</td>
</tr>
<tr>
<td>Paul A. Novelty</td>
<td>63</td>
<td>Male</td>
<td>Chairman and CEO of Apex Oil, Independent Director</td>
<td>2002</td>
</tr>
<tr>
<td>Frederic V. Salerno</td>
<td>63</td>
<td>Male</td>
<td>Independent Director</td>
<td>1992</td>
</tr>
<tr>
<td>Vincent Tese</td>
<td>63</td>
<td>Male</td>
<td>Chairman of Wireless Cable International Inc., Independent Director</td>
<td>1994</td>
</tr>
<tr>
<td>Wesley S. Williams Jr.</td>
<td>64</td>
<td>Male</td>
<td>Independent Director</td>
<td>2004</td>
</tr>
</tbody>
</table>

Table 5: Executive Committee of Bear Stearns

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alan C. Greenberg</td>
<td>Chairman of the Executive Committee</td>
</tr>
<tr>
<td>James E. Cayne</td>
<td>Chairman of the Board (since 2001); CEO</td>
</tr>
<tr>
<td>Alan D. Schwartz</td>
<td>President and Co-Chief COO</td>
</tr>
<tr>
<td>Samuel L. Molinaro Jr.</td>
<td>Exec. VP; CFO</td>
</tr>
<tr>
<td>Warren J. Spector</td>
<td>President and Co-COO</td>
</tr>
</tbody>
</table>

While the executive committee met on 115 occasions, the full board by contrast met only 6 times. Three directors who were also part of the management team served in the Board for over 20 years. Four of the 9 Independent directors had been in the board for over 14 years. An independent director, Mr. Nickell, (who joined the board in 2006) was the President and Chief Executive Officer of Kelso & Company, which was the manager of various investment partnerships which make investments in portfolio companies. From time to time, Bear Stearns acted as underwriter or sold stock for some of these portfolio companies. In fiscal 2006, Bear Stearns underwrote approximately 9.5 million shares of Endo Pharmaceuticals Holdings Inc. sold by Endo Pharma LLC of which affiliates of Kelso & Company had a beneficial interest in approximately 5.9 million shares. Bear Stearns received fees for this transaction of approximately US$4.1 MM. Also in fiscal 2006, Bear Stearns earned approximately US$250,000 in arranging an add-on to bank financing for Overwatch, a portfolio company of Kelso & Company, and in December 2006, earned approximately US$3 MM for mergers and acquisition advice to Overwatch. Bear Stearns arranged financing for another portfolio...
Table 4 and Table 5 show that the management team dominated and exercised significant control of the corporate governance. The long and unbroken tenure of the management team questions the extent to which the board could have provided the necessary independent thought-leadership. The unfolding events showed that the board’s agenda was strongly influenced by the management. For instance, the lack of a staggered board could have resulted in group-think that prevents uncomfortable questions being raised. There is doubt that based on the extensive P&L generated through Mr. Nickell’s company whether he was independent both in letter and in spirit. The fact that the CEO was also the chairman of the current board raises tremendous conflict of interest.

**Audit Committee**

According to the charter, the purpose of Bear’s Audit Committee was to assist the Board in the Board’s oversight of (1) the integrity of the financial statements of the Corporation, (2) the Corporation’s compliance with legal and regulatory requirements, (3) the qualifications, performance and independence of the Corporation’s independent auditor(s), (4) the performance of the Corporation’s internal audit function and (5) the Corporation’s systems of disclosure controls and procedures, external financial reporting and internal controls over financial reporting. Among the 7-member audit committee (see Table 6), 3 directors held among them 18 board seats on listed companies. Vincent Tese, the audit committee chairman, served on the boards of 5 listed companies in addition to Bear Stearns. Two members of the audit committee, Michael Goldstein and Frederick Salerno, served on the audit committees of 11 public companies between them.

The NYSE Rule 303A.07 requires that if an audit committee member serves on the audit committees of more than 3 public companies, the Board is required to determine that such simultaneous service would not impair the member’s ability to effectively serve on the Audit Committee. However, Bear’s board determined that based upon Mr. Goldstein and Mr. Salerno’s wealth of financial experience, knowledge of the Company and ability to dedicate the necessary time to Board service, their service on the audit committees of five and six public companies, respectively, does not impair their ability to effectively serve on the Company’s Audit Committee and that their service on the Audit Committee is in the best interest of the Company and its stockholders. In the Sarbanes-Oxley era which tightened up the role and duties of audit committees, it is rare, and more than a little troubling, to see boards tolerating that level of concurrent responsibility on the part of audit committee members.
At Bear Stearns, the pay comprised of two elements for executive officers and other key employees - base salary and a performance-based annual bonus, which is payable in both cash and equity-based components.

<table>
<thead>
<tr>
<th>Name</th>
<th>Base Salary ($)</th>
<th>Cash Bonus ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alan C. Greenberg</td>
<td>250,000</td>
<td>9,000,000</td>
</tr>
<tr>
<td>James E. Cayne</td>
<td>250,000</td>
<td>17,070,746</td>
</tr>
<tr>
<td>Alan D. Schwartz</td>
<td>250,000</td>
<td>16,237,150</td>
</tr>
<tr>
<td>Samuel L. Molinaro Jr.</td>
<td>250,000</td>
<td>12,967,500</td>
</tr>
<tr>
<td>Warren J. Spector</td>
<td>250,000</td>
<td>16,194,430</td>
</tr>
</tbody>
</table>

Table 8: Salary and Cash Bonus Compensation paid to the Executive Committee of Bear Stearns

### IV.2 Compensation

The Compensation Committee (see Table 7) was responsible for overseeing the compensation policies, programs, and practices, with particular attention to the compensation of the Company’s executive officers. Three of the four members of the Compensation Committee had been on the board for over 14 years the latest addition in 2006 being Mr. Nickell. However, the profitable relationships between Bear Stearns and Mr. Nickell’s firm could potentially influence his judgment on the compensation.

<table>
<thead>
<tr>
<th>Name</th>
<th>In Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carl D. Glickman</td>
<td>1985</td>
</tr>
<tr>
<td>Donald J. Harrington</td>
<td>1993</td>
</tr>
<tr>
<td>Frank T. Nickell</td>
<td>2006</td>
</tr>
<tr>
<td>Vincent Tese</td>
<td>1994</td>
</tr>
</tbody>
</table>

Table 7: Compensation Committee of Bear Stearns

---

**Table 6: Audit Committee of Bear Stearns**

<table>
<thead>
<tr>
<th>Name</th>
<th>Committees</th>
<th>Other Boards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Henry S. Bienen</td>
<td>Audit</td>
<td></td>
</tr>
<tr>
<td>Carl D. Glickman</td>
<td>Audit and Qualified Legal Compliance Committees and Chairman of the Compensation Committee</td>
<td>Presiding Trustee and Chairman of the Executive Committee of the Lexington Corporate Properties Trust</td>
</tr>
<tr>
<td>Michael Goldstein</td>
<td>Audit</td>
<td>4Kids Entertainment Inc.; Martha Stewart Living Omnimedia Inc.; Medco Health Solutions Inc.; Pacific Sunwear of California Inc.; and United Retail Group Inc.</td>
</tr>
<tr>
<td>Paul A. Novelty</td>
<td>Audit; Corporate Governance and Nominating; and Qualified Legal Compliance Committees and Chairman of the Finance and Risk Committee</td>
<td>Chairman of the Board and Chief Executive Officer of Apex Oil Company; Board of Boss holdings</td>
</tr>
<tr>
<td>Frederic V. Salerno</td>
<td>Audit; Finance and Risk; and Qualified Legal Compliance Committees and Chairman of the Corporate Governance and Nominating Committee</td>
<td>Popular Inc.; Viacom Inc.; Consolidated Edison Inc.; Akamai Technologies Inc.; and Intercontinental Exchange Inc.</td>
</tr>
<tr>
<td>Vincent Tese</td>
<td>Compensation; Corporate Governance and Nominating; and Finance and Risk Committees and is the Chairman of the Audit Committee and the Qualified Legal Compliance Committee</td>
<td>Bowne and Co.; Cablevision Systems Corporation; Mack-Cali Realty Corporation; Intercontinental Exchange Group; and GAMCO Investors</td>
</tr>
<tr>
<td>Wesley S. Williams Jr.</td>
<td>Audit and Qualified Legal Compliance Committees</td>
<td></td>
</tr>
</tbody>
</table>

**Table 8: Salary and Cash Bonus Compensation paid to the Executive Committee of Bear Stearns**
The objectives of the compensation program were to have the base salaries to represent a minimal portion of total compensation and ensure that almost all pay received is based on performance. For the last fiscal of its existence, the base salary for all executive officers was US$ 250,000. The Performance Compensation Plan was segregated into two separate bonus pools. The first pool covered the annual compensation for members of the Executive Committee. The second pool covered certain other members of senior management who were not members of the Executive Committee. The bonus compensation for the Executive committee was determined within 90 days after the beginning of each fiscal year based on a formula. The formula was a function 9 criteria, and the Compensation Committee could base its decision on one or more of the 9 criteria, individually or in combination, adjusted in such manner as it deems fit. The Executive Committee received 51% of their performance-based bonus in cash, 44% in company shares, and 5% in stock options. In 2007, less than 5 months before its two leading hedge funds collapsed, the compensation committee was of the opinion that the Executive committee had done good jobs and merited cumulative bonus of US$140MM.

Table 8 shows the remuneration of the Executive committee. So blind was the committee to any notion of excessive risk that was being taken, it simply copied and pasted many of its statements of praise and satisfaction from one proxy statement to the next. “Therefore, the compensation paid to the Company’s executive officers reflects the Company’s strong absolute and relative performance.” Close ties and over-familiarity may also have been a problem with Bear’s compensation committee. At the very least, the compensation committee’s culture, structure and decisions raise unsettling questions about whether its products are more the reflection of a cozy club mentality of close connections than the result of vigorous market forces and heavy negotiation.

IV.3 Risk Control
Bear did not create a finance and risk committee (see Table 9) until 10 January 2007, just a year before its failure. According to the charter of the Risk Committee, the purpose was to provide the Board oversight of the Company’s: (1) credit, market and operational risk management; (2) funding, liquidity and liquidity risk management practices; (3) balance sheet and capital management; and (4) insurance programs and related risk issues and mitigation. To achieve these objectives, the Finance and Risk committee was supposed to work with the (already unfocussed) Audit Committee on the Company’s policies and procedures regarding the assessment and management of the Company’s trading and investment risks, counterparty credit risks, operational risks and significant risk exposures and trends. The Committee was also responsible for reviewing the Company’s framework for balance sheet management, including categories of assets and liabilities, and levels of unfunded committed funding obligations.

<table>
<thead>
<tr>
<th>Name</th>
<th>Roles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frank T. Nickell</td>
<td>Compensation; Corporate Governance; Nominating; Finance and Risk</td>
</tr>
<tr>
<td>Paul A. Novelty</td>
<td>Audit; Corporate Governance and Nominating; and Qualified Legal Compliance Committees and Chairman of the Finance and Risk Committee</td>
</tr>
<tr>
<td>Frederic V. Salerno</td>
<td>Audit; Finance and Risk; and Qualified Legal Compliance Committees and Chairman of the Corporate Governance and Nominating Committee</td>
</tr>
<tr>
<td>Vincent Tese</td>
<td>Compensation; Corporate Governance and Nominating; and Finance and Risk Committees and Chairman of the Audit Committee and the Qualified Legal Compliance Committee</td>
</tr>
</tbody>
</table>

Table 9: Financial and Risk Committee of Bear Stearns
Within two months, on March 2007, the head of model validation resigned due to difficulty in communicating with senior managers in a productive manner the need to reduce the risk in the traders’ positions. The Board failed to recognize this critical turnover within risk management precisely at the moment when the subprime crisis was beginning to hit and the first large write-downs were being taken. Moreover, for some financial instruments such as distressed debt, non-performing mortgage-related assets, certain mortgage-backed securities and residual interests, Chapter 13 and other credit card receivables from individuals, and complex and exotic derivative structures, the fair value could only be determined based upon Bear Stearns’ internally developed models or methodologies utilizing significant inputs that are generally less readily observable from objective sources. In essence, should the determined values for such items prove substantially inaccurate, there could be significant unexpected losses. The lax risk management control permitted incomplete and deficient pricing models, which was a material weakness that ultimately resulted in the overstatement of the fair value of its financial instruments as well as reported revenues and earnings. As a result, the management’s reports on internal control over financial reporting required by Rule 302 of the Sarbanes-Oxley Act, were materially false and misleading because Bear Stearns’ internal controls were ineffective.

V. Lehman Brothers

Lehman Brothers was founded in 1840 as a small goods and dry fruit store, and later moved to buying and selling of cotton. In 1870, it formed the New York cotton exchange- the first commodities future company in U.S. Thereafter, it was instrumental in organizing coffee and petroleum exchanges. After the civil war, Lehman Brothers helped the state of Alabama issue first bond underwriting of the former confederate state. Over the years, it expanded its business to include selling and trading securities, and in 1887, joined NYSE culminating the evolution of Lehman Brothers from a commodities business to a merchant-banking firm. It filed for bankruptcy on October 2008 in New York and had total assets of US$ 639 billion which was equivalent to the GDP of Argentina. In contrast to Bear Stearns, the Lehman Brothers’ CDS wound up paying US$ 91.375 for every US$ 100 of par value insured following their bankruptcy.

The CEO, Richard Fuld was well known for his autocratic style of functioning which served him well to unite the company and during the years following 1994, Lehman did increasingly well under him (Sewer, 2006). Mr. Fuld’s dominating personality was instrumental in generating a culture that assigned him a special or even unique status, surrounded by admiring, often sycophantic colleagues. As seen from the structure of alternate committees, the ultimate power within Lehman rested with him and he was not answerable to anyone. His almost omnipotent feeling led Mr. Fuld to ignore the several opportunities that came his way to save Lehman from bankruptcy through sale to Korea Development Bank, Bank of America, China Investment Company, and Barclays Bank.

Unlike Bear Stearns, Lehman Brothers was unable to either convince the U.S. Treasury for support or obtain a buyer. Both Bank of America and Barclays Bank, though initially interested in purchasing the firm, were dissuaded because much of Lehman’s assets (consisting mainly of Collateral Debt Obligations...
(CDOs)) were considered “toxic” and worthless. On September 2008, Lehman filed for Chapter 11 bankruptcy protection following the massive exodus of its clients, drastic fall in its stock price, and devaluation of its assets by credit rating agencies.

V.1 Board Structure
Lehman Brothers’ board of directors (see Table 10) was composed of 11 members with the Chairman and CEO being Mr. Richard Fuld. Although the board included 10 independent directors, 9 out of ten directors were retired. The average age of the board was 68.4 years with 4 of them over 75 years. One was a theatre producer, another, a former navy admiral. Only 2 of them had direct experience in the financial services industry and only one of them had current financial sector knowledge. The board of directors held 8 meetings and acted by unanimous written consent two times during Fiscal 2007. The longest serving member of the board was then CEO- Mr. Fuld.

<table>
<thead>
<tr>
<th>Name</th>
<th>Age</th>
<th>Gender</th>
<th>Title</th>
<th>In Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>Michael L. Ainslie</td>
<td>64</td>
<td>Male</td>
<td>Independent Director; Private Investor; Former President and Chief Executive Officer of Sotheby's Holdings</td>
<td>1996</td>
</tr>
<tr>
<td>John F. Akers</td>
<td>73</td>
<td>Male</td>
<td>Independent Director; Former Chairman IBM</td>
<td>1996</td>
</tr>
<tr>
<td>Roger S. Berlind</td>
<td>77</td>
<td>Male</td>
<td>Independent Director; Theatrical Producer</td>
<td>1985</td>
</tr>
<tr>
<td>Thomas H. Cruikshank</td>
<td>76</td>
<td>Male</td>
<td>Independent Director; Chairman and CEO of Halliburton</td>
<td>1996</td>
</tr>
<tr>
<td>Marsha Johnson Evans</td>
<td>60</td>
<td>Female</td>
<td>Independent Director; Retired Rear Admiral (US Navy)</td>
<td>2004</td>
</tr>
<tr>
<td>Richard S. Fuld</td>
<td>61</td>
<td>Male</td>
<td>CEO</td>
<td>1990</td>
</tr>
<tr>
<td>Christopher Gent</td>
<td>59</td>
<td>Male</td>
<td>Independent Director</td>
<td>2003</td>
</tr>
<tr>
<td>Jerry A. Grundhofer</td>
<td>63</td>
<td>Male</td>
<td>Independent Director; Former Chairman and CEO US Bancorp</td>
<td>2003</td>
</tr>
<tr>
<td>Roland A. Hernandez</td>
<td>50</td>
<td>Male</td>
<td>Independent Director; Former Chairman and CEO Telemundo</td>
<td>2005</td>
</tr>
<tr>
<td>Henry Kaufman</td>
<td>80</td>
<td>Male</td>
<td>Independent Director</td>
<td>1995</td>
</tr>
<tr>
<td>John D. Macomber</td>
<td>80</td>
<td>Male</td>
<td>Independent Director; Principal of JDM Investment Group</td>
<td>1994</td>
</tr>
</tbody>
</table>

Table 10: Board of Lehman Brothers in 2008

Similar to Bear Stearns, the board was oblivious to the magnitude and implications of the outsized subprime position in very risky tranches at the bottom end of the securitization chain. In (Valukas, 2010)- a report composed by court-appointed investigator of bankruptcy of Lehman Brothers- further stipulates that there is evidence that top officers of Lehman Brothers Company violated their duties by exposing the company to potential liability by filing misleading reports and financial statements.
This was particularly conducted in the form of the “Repo105” through which the company could remove billions of liabilities off the balance sheet.

### Executive Committee

The Executive Committee consisted of only two individuals (see Table 12), namely Mr. Fuld and Mr. Macomber.

<table>
<thead>
<tr>
<th>Name</th>
<th>In Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>Richard S. Fuld</td>
<td>1990</td>
</tr>
<tr>
<td>John D. Macomber</td>
<td>1994</td>
</tr>
</tbody>
</table>

The Executive Committee had tremendous authority vested in it. For instance, in the intervals between meetings of the board of directors, it could exercise all the authority of the board of directors, except for those matters that the Delaware General Corporation Law or the Company’s Restated Certificate of Incorporation reserves to the full board of directors. The Executive Committee acted by unanimous written consent 16 times during the fiscal year ended November 30, 2007.

### Audit Committee

The Audit Committee (see Table 13) which was responsible for assisting the board of directors in fulfilling its oversight of the quality and integrity of the Company’s financial statements and the Company’s compliance with legal and regulatory requirements had no members with financial expertise. The Audit Committee held 11 meetings during Fiscal 2007.
V.2 Compensation

The Compensation Committee (see Table 14) engaged Johnson Associates, a compensation consulting firm specializing in the financial services industry, to advise on matters relating to the compensation of the Chief Executive Officer and other executive officers, and to consult on executive and director compensation practices.

Johnson Associates reported directly to the Compensation Committee and attended Compensation Committee meetings as requested by the Compensation Committee. In addition, the Compensation Committee reviewed and approved transactions in which the firm was a participant and in which an executive officer of the firm or any immediate family member of any executive officer of the firm had a direct or indirect material interest, in accordance with the Company’s policy regarding transactions with related persons. The Compensation Committee held 7 meetings and acted by unanimous written consent 2 times during fiscal year 2007.

Lehman’s growth strategy resulted in a dramatic growth of its balance sheet. Its net assets increased by almost US$128 billion or 48% in a little over a year - from the fourth quarter of 2006 through the first quarter of 2008 (see Figure 5).

The management obviously, used these figures to justify the increase in its remuneration. The weightings of cash and equity were determined collaboratively by Mr. Fuld, Mr. Gregory and the Compensation Committee. The weightings were subjective in nature, but were balanced to align the interests of the executive officers with the Company’s goals and objectives. Table 15 shows the amount paid to the Executive Officers (see Table 11). The CFO, Ms. Erin, was compelled to resign in 2007 and therefore, was not reflected amongst those receiving the bonus in Table 15.
not reflected amongst those receiving the bonus in Table 15.

The Los Angeles Times (LATimes, 2012) revealed Lehman Brothers paid its top 50 employees a total of around US$ 700 million in compensation in 2007 - the year before the investment bank collapsed. The lowest salary among the top 50 was US$ 8.2 MM. The board members too, were handsomely compensated; the range was from US$ 325,000 to US$ 397,000 plus very high annual bonuses. The CEO, Mr. Fuld, too, rewarded himself with nearly US$ 0.5 billion between 1993 and 2007. Table 15 shows the compensation packet for the executive officers.

<table>
<thead>
<tr>
<th>Name</th>
<th>Base Salary ($)</th>
<th>Cash Bonus($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Richard S. Fuld</td>
<td>750,000</td>
<td>4,250,000</td>
</tr>
<tr>
<td>Scott J. Freidheim</td>
<td>450,000</td>
<td>4,550,000</td>
</tr>
<tr>
<td>Joseph M. Gregory</td>
<td>450,000</td>
<td>4,550,000</td>
</tr>
<tr>
<td>Iam T. Lowitt</td>
<td>200,000</td>
<td>2,650,000</td>
</tr>
<tr>
<td>Thomas A. Russo</td>
<td>200,000</td>
<td>2,650,000</td>
</tr>
</tbody>
</table>

Table 15: Cash and Bonus paid to Lehman Brothers’ Executive Officers in 2007

The Valukas report also shows that Lehman’s board had little foresight of the looming collapse and followed the beggar-thy-neighbor approach. In a section discussing the board’s recommendations about compensation, the company said it was lowering its revenue expectations but believed the firm’s competitors “have sustained large losses, weakening their competitive position.” The firm noted that senior management changes at rivals were causing turmoil and that a “significant pool of talent will become available as many of our competitors’ top performers become disillusioned.”

Lehman’s management decided to exceed risk limits with respect to Lehman’s principal investments, namely, the “concentration limits” on Lehman’s leveraged loan and commercial real estate businesses, including the “single transaction limits” on the leveraged loans. These limits were designed to ensure that Lehman’s investments were properly limited and diversified by business line and by counterparty. Lehman’s highly concentrated risk in two business lines was further stressed due to the market conditions. Ultimately, it exceeded the risk limits by margins of 70% on the commercial real estate and by 100% on leveraged loans. Lehman’s management excluded certain risky principal investments from its

V.3 Risk Control

The policy manual of quantitative risk management within Lehman Brothers states that the Risk Committee (which consisted of the company’s Executive Committee, the CRO and CFO) should meet weekly to discuss all potential threats and risk taking activities. Further, the manual mandates the company’s 2-member Executive Committee to set the overall risk limits and risk management policies. The Finance and Risk Committee (see Table 16) was required to review and advise the Board of Directors on the financial policies and practices of the Company, including risk management. The Finance Committee held only two meetings during Fiscal 2007.

<table>
<thead>
<tr>
<th>Name</th>
<th>In Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>John F. Akers</td>
<td>1996</td>
</tr>
<tr>
<td>Roger S. Berlind</td>
<td>1985</td>
</tr>
<tr>
<td>Marsha Johnson Evans</td>
<td>2004</td>
</tr>
<tr>
<td>Roland A. Hernandez</td>
<td>2005</td>
</tr>
<tr>
<td>Henry Kaufman</td>
<td>1995</td>
</tr>
</tbody>
</table>

Table 16: Finance and Risk Committee of Lehman Brothers
stress tests. Although Lehman conducted stress tests on a monthly basis and reported the results of these stress tests periodically to regulators and to its board of directors, the stress tests excluded Lehman’s commercial real estate investments, its private equity investments, and, for a time, its leveraged loan commitments. Thus, Lehman’s management did not have a regular and systematic means of analyzing the amount of catastrophic loss that the firm could suffer from these increasingly large and illiquid investments. Lehman did not strictly apply its balance sheet limits, which were designed to contain the overall risk of the firm and maintain the firm’s leverage ratio within the range required by the credit rating agencies, but instead decided to exceed those limits. Lehman’s management decided to treat primary firm-wide risk limit - the risk appetite limit - as a “soft” guideline, notwithstanding Lehman’s representations to the Securities Exchange Commission and the board that the risk appetite limit was a meaningful constraint on Lehman’s risk-taking. Lehman management’s decision not to enforce the risk appetite limit was apparent in several ways. For instance, between December 2006 and December 2007, Lehman raised its firm-wide risk appetite limit 3 times, going from US$2.3 to US$4.0 billion; between May and August 2007, Lehman omitted some of its largest risks from its risk usage calculation.

The primary omitted risk was a US$ 2.3 billion bridge equity position in the Archstone-Smith Real Estate Investment Trust (“Archstone” or “Archstone REIT”) real estate transaction, an extraordinarily large and risky commitment. If Lehman’s management promptly included that risk in its usage calculation, it would have been immediately apparent that Lehman was over its risk limits. Even after including the Archstone risk in the firm’s risk appetite usage, Lehman continued to exceed the limit for several more months. And rather than aggressively reduce the balance sheet in response to these indicators of excessive risk-taking, Lehman raised its firm-wide risk limit again.

VI. Royal Bank of Scotland

The Royal Bank of Scotland (RBS) was in a mission to become a global bank as quickly as possible (see Table 17). At the end of 2008, with total assets of over £2.4 trillion/US$3.5 trillion, RBS was the largest bank in the world by assets and the fifth largest by market capitalization. Among the most striking was the decision in this regard to go ahead with the ABN AMRO acquisition. That acquisition played a significant role in RBS’ failure. The irony was that the board decided to go ahead with the ABN AMRO acquisition on the basis of inadequate due diligence relative to the risks it entailed. The information made available to RBS by ABN AMRO in April 2007 amounted to two lever arch folders and a CD.

<table>
<thead>
<tr>
<th>Year</th>
<th>Assets (£)</th>
<th>Equity (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>583,000</td>
<td>27,300</td>
</tr>
<tr>
<td>2005</td>
<td>776,820</td>
<td>35,000</td>
</tr>
<tr>
<td>2006</td>
<td>871,440</td>
<td>40,200</td>
</tr>
<tr>
<td>2007</td>
<td>1,900,000</td>
<td>53,000</td>
</tr>
<tr>
<td>2008</td>
<td>2,400,000</td>
<td>58,900</td>
</tr>
<tr>
<td>2009</td>
<td>1,696,486</td>
<td>77,736</td>
</tr>
<tr>
<td>2010</td>
<td>1,453,576</td>
<td>75,132</td>
</tr>
<tr>
<td>2011</td>
<td>1,506,867</td>
<td>74,819</td>
</tr>
<tr>
<td>2012</td>
<td>1,312,295</td>
<td>68,130</td>
</tr>
</tbody>
</table>

Table 17: Growth in Assets and Equity of RBS in MM
RBS was largely unsuccessful in its attempts to obtain further non-publicly available information. The decision to fund the acquisition primarily with debt, the majority of which was short-term, rather than equity, eroded RBS’ capital adequacy and increased its reliance on short-term wholesale funding. After the collapse of Lehman Brothers, the credit markets froze, and for the most part, RBS could access only the overnight markets as market participants were unwilling to fund longer term. Even overnight funding became difficult to access, and RBS became dependent on Bank of England Emergency Liquidity Assistance (ELA) on 7 October 2008. The failure of RBS gave rise to what UK’s Treasury has described as “the biggest bailout in history”. The Government injected £ 45.5 billion of equity capital and £ 282 billion of taxpayers’ money was exposed via the United Kingdom government’s Asset Protection Scheme. The British Government, through the ELA, took a 58% stake in RBS ordinary shares alongside a tranche of preference shares in November 2008. This was equivalent to £ 37 billion or £ 617 per citizen of the UK. In April 2009, the preference shares were converted into ordinary shares and the Government’s ordinary shareholding in RBS now stands at 64%. Including the Government’s acquisition of B shares in December 2009, the total economic ownership of the UK Government is currently 80% of the RBS Group. The UK Government formed UK Financial Investments Ltd (UKFI) to manage its investments in financial institutions including RBS. UKFI has been given a clear mandate by the Government with an overarching objective to dispose of the Government’s shareholdings in an orderly and active way, with due regard to financial stability and the promotion of competition. Following the bailout, a report by the Financial Services Authority, (FSA, 2012) identified several errors of commercial judgment within RBS but none stringent enough to warrant legal proceedings.

Some of the causes of RBS’ failure were systemic - common to many banks or the consequence of unstable features of the entire financial system and a deficient global framework for bank capital regulation, together with a Financial Services Authority (FSA) supervisory approach which assigned a relatively low priority to liquidity, created conditions in which some form of systemic crisis was more likely to occur. But on hindsight, it is clear that poor decisions by RBS’ management and board during 2006 and 2007 were crucial to RBS’ failure.

The CEO, Mr. Goodwin - a chartered accountant by training- was more well-known for his ability to spot the minutiae. In a recent book on RBS’ bailout, (Martin, 2013), high- lights that the job of chief executive wasn’t really done by him in the normal sense of someone trying to strategize properly and seeing the dangers and opportunities ahead. Mr. Goodwin was apparently obsessed by all sorts of small details and measuring things and all sorts of minutiae and insignificant details in certain parts of the business. For instance, hours would be spent in meetings discussing the things such as colors for advertising campaigns, computer systems and targets. This narcissistic tendency to control everything and failure to recognize personal limitation was not conducive to successful leadership of the company. The FSA’s report FSA (2012) lists a combination of six key factors that led to RBS’ failure:

1. Significant weaknesses in RBS’ capital position during the review period as a result of management decisions and permitted by an inadequate regulatory capital framework;
2. Over-reliance on risky short-term wholesale
funding.
3. Concerns and uncertainties about RBS’ underlying asset quality, which in turn, was subject to little fundamental analysis by the regulator FSA.
4. Substantial losses in credit trading activities, which eroded market confidence. Further both RBS’ strategy and the FSA’s supervisory approach underestimated the magnitude of the bad losses associated with structured credit.
5. Inadequate due-diligence and mispricing of the risks in the ABN AMRO acquisition.
6. An overall systemic crisis in which the banks in worse relative positions were extremely vulnerable to failure.

The FSA’s report adds that the multiple poor decisions at RBS highlight underlying deficiencies in RBS’ management, governance and culture and, therefore considers whether such underlying deficiencies should be treated as a seventh key factor in explaining RBS’ failure.

VI.1 Board Structure

On paper, RBS’ board (see Table 18) composition and formal processes met acceptable standards and looked strong. It included members with relevant experience and skills and successful track records in other fields. On becoming Chairman in April 2006, Tom McKillop took steps to familiarize himself with RBS’ business and conducted the business of the board and its committees in accordance with relevant corporate governance guidelines. He took care to allow all board members to put forward their views and participate in discussions, and provided opportunities for board members to challenge the executive. The board’s minutes suggest that the discussions covered a range of issues and the board made formal decisions on issues for which it was legally responsible. The Chairman’s Committee (see Table 19) - a body created to improve transparency, facilitate rapid convening and which de facto included all board members - was appropriately constituted and followed formal processes.
3. Concerns and uncertainties about RBS' underlying asset quality, which in turn, was subject to little fundamental analysis by the regulator FSA.

4. Substantial losses in credit trading activities, which eroded market confidence. Further both RBS' strategy and the FSA's supervisory approach underestimated the magnitude of the bad losses associated with structured credit.

5. Inadequate due-diligence and mispricing of the risks in the ABN AMRO acquisition.

VI.1 Board Structure

On paper, RBS' board (see Table 18) composition and formal processes met acceptable standards and looked strong. It included members with relevant experience and skills and successful track records in other fields. On becoming Chairman in April 2006, Tom McKillop took steps to familiarize himself with RBS' business and conducted the business of the board and its committees in accordance with relevant corporate governance guidelines. He took care to allow all board members to put forward their views and participate in discussions, and provided opportunities for board members to challenge the executive. The board's minutes suggest that the discussions covered a range of issues and the board made formal decisions on issues for which it was legally responsible. The Chairman's Committee (see Table 19) - a body created to improve transparency, facilitate rapid convening and which de facto included all board members - was appropriately constituted and followed formal processes.

The board and Chairman’s Committee met frequently to discuss the ABN AMRO acquisition throughout the process and board members were fully aware of the limited extent of due diligence which had been conducted, and the fact that the decision to acquire ABN AMRO was taken against the background of the firm’s track record of successful acquisition and integration, particularly of NatWest, and the CEO’s personal contribution to it. While this sense of confidence in past achievement may have been justified, it may also have led the board to have a false sense of security and underestimate the challenge of new proposals. There was an element of ‘group-think’ in the board’s decision with respect to the deal.

Despite the relevant skills and experience of individual members of the board, it seems to collectively lack a critical mass of members with deep experience in both core banking and investment banking trading activities (for example, structured credit) sufficient to provide a regular, informed challenge to executive assumptions, explanations and proposals. The board seems to have followed Corporate Governance in letter but not in spirit. It failed to challenge the management’s focus on increasing revenue, assets and earnings per share.
(EPS) and failed to ensure that adequate attention was
given to the core banking fundamentals of capital,
liquidity and asset quality. There was no tangible
evidence of the board reigning in or indulging in
significant discussions on major issues. The board, too,
in their assessment of the ABN AMRO deal, seems to
have been overly influenced by a desire to make RBS a
leading global bank (for example, by acquiring a global
payments business) and were therefore, too willing to
proceed with this very large and complex acquisition
on the basis of an inadequate risk assessment,
exacerbated by limited due diligence. There is no
record of the warning signs on the ABN AMRO deal
being deliberated in depth. These signs include:

1. Magnitude and complexity of the transaction.
2. The fact that the bid comprised primarily debt
rather than shares, and RBS’ decision to raise most
of that debt on the short-term wholesale markets
increased its reliance on short-term wholesale
funding and its consequent vulnerability as the
financial crisis developed.
3. There was considerable uncertainty in the market
arising from the consortium structure, under
which RBS would consolidate the whole of ABN
AMRO on its balance sheet before the transfer of
assets to other consortium partners.
4. The extremely limited due diligence conducted for
the deal.

VI.2 Compensation
The CEO, Mr. Fred Goodwin, earned in total around £
20 MM cumulatively during 2001 to 2008 through
salaries and bonuses. The board had designed a CEO
remuneration package heavily influenced by operating
profit, EPS growth and return on equity, as distinct
from return on assets. There were no serious
discrepancies in RBS’ compensation structure prior to
the bailout. Immediately following the bailout, there
was much public disquiet at the continuation of bonus
payments to staff. Ironically, although RBS made losses
of over £ 24 billion in 2008, some of the traders were
paid cash bonuses. There were two main reasons for
bonus payments. The first was the contractual
obligations (often called the ‘inheritance problem’) which oblige banks to continue to make bonus
payments to employees where bonus payments have
been written into their employment contract. The
second was to recruit and retain talented staff and that
the introduction of a bonus ban would lead to an
exodus of highly skilled staff to the detriment of the
taxpayer as shareholders. Another aspect that was in
the limelight was RBS’ pension compensation for its
former CEO that resulted in widespread public anger
and media scrutiny. Mr. Goodwin was originally
awarded £703,000 per year and after widespread
resentment including that from the Prime Minister,
settled for £ 342,500 a year and a £ 2.8 MM lump sum
on which RBS paid the tax.

VI.3 Control
Although in the pre-crisis period, RBS did not have a
formal Board Risk Committee (Walker, 2009), risk
issues were the responsibility of the Group Audit
Committee. Therefore, there is no evidence of a
procedural failure of governance at RBS’ board level. It
is doubtful whether risk management information
enabled the board adequately to monitor and mitigate
the aggregation of risks across the group, and whether
it was sufficiently forward-looking to give early
warning of emerging risks.

RBS decided to make a bid for ABN AMRO on the basis
of due diligence which was inadequate in scope and
depth, and hence, was inappropriate in light of the
nature and scale of the acquisition and the major risks
involved. The board did not adequately encourage the executives to re-examine the assumptions lying behind aspects of their strategy, especially in light of developments in global markets such as the downturn in the U.S. sub-prime market in late 2006 and early 2007 and the severe stresses in funding markets in the summer of 2007. The deal-

1. Greatly increased RBS’ exposure to risky trading assets and, in particular, to those categories of assets - including structured credit and leveraged finance assets - and monoline exposures where large losses were incurred.
2. The board and management decision to finance the acquisition primarily with debt rather than equity, and for most of that debt to be short-term, both reduced an already low capital ratio and increased potential funding strains. RBS’ total payment comprised Euro 4.3 billion in RBS shares and Euro 22.6 billion cash consideration to ABN AMRO investors. Of the Euro 22.6 billion, the majority was funded by debt of which Euro 12.3 billion had a term of one year or less. The decision to finance a major acquisition primarily with debt, of which the majority was short-term, was a risky financing strategy.
3. RBS did not anticipate the impact on its ability to meet its regulatory capital requirements if ABN AMRO was not to receive approval for its Basel II credit risk models. The resulting higher capital requirements placed additional strain on RBS’ capital resources and contributed to RBS’ apparent fall below individual capital guidance as at end-March 2008.
4. The fact that the board decided that RBS should act as the consortium leader for the ABN AMRO acquisition, which meant consolidating the whole of ABN AMRO onto its balance sheet before the transfer of assets to the other consortium partners, introduced vulnerabilities and uncertainties that were important to market confidence.

VII. Conclusion

Although the aftershocks of the crisis are felt even till date, the regulatory authorities have so far struggled to charge senior individuals over the excesses and/or misrepresentation. For instance, in Oct 2012, Mr. Dimon, in an event organized by the Council on Foreign Relations, revealed that “We’ve lost $ 8 billion to $10 billion on various things related to Bear Stearns now. And, yes, I put it in the unfair category.” In essence, had Mr. Dimon known in detail the balance sheet of Bear earlier, he would not have made the same offer or be compelled to raise the initial offer of $2 per share. There is an important lesson from Mr. Dimon’s statement that we often see being repeated, that in the world of finance, big deals are done on the basis of scant data, poor risk management and the downside is realized much later into the future. On the other hand, closeness and over-familiarity resulted in group-think at the board which had a corollary effect on the board’s decision being oblivious to the resulting risks. For example, in RBS, some of the longest-standing members of the board presided over as many as 24 acquisitions during the eight years in which the ousted CEO Mr. Fred Goodwin was at the helm.

Policy makers and business leaders are widely perceived to be struggling to cope with the unprecedented, rapidly changing landscapes and had called upon deeper prognosis within the several areas of the current economic model. The crisis did not even spare one of the richest monarchs, the Queen of England; she asked academics at The London School of Economics: “Why did nobody notice it?” Of course, she
received a polite letter of response duly signed by the experts. Globally, numerous committees have been setup and several reports written to prevent the repeat of the past events. Jury is still out on the best way to come out of the credit crisis.

The analyses of the Corporate Governance of the 3 financial institutions reveal the need for several common underlying themes which; these include inability to comprehend the complex risk models, skewed incentive structures and clique of ‘old-boys-network’. We suggest potential best-practices for Corporate Governance- some of which are applicable to the banks whereas the others could be applied more broadly.

1. **Risk Management:** The risk management systems have failed in many cases due to Corporate Governance procedures rather than the inadequacy of computer models alone: information about exposures in a number of cases did not reach the board and even senior levels of management. In the case of Lehman Brothers, not only were the risk limits increased repeatedly but even the data used to calculate the risk exposure was inaccurate and under-estimated the risk. Most Board members, indeed, most bankers have no training or experience in risk management. At the moment, the board depends for its risk assessment, on the quality of the risk managers hired by the CEO/CFO. The reality is that risk managers are few and far between, and their quality varies massively. Moreover, with increasing sophistication of the trades and the models, and the complex nature of the technologies used, it is not feasible for an external auditor to sign-off on the robustness of the risk management practice. A typical auditor does not have the training or the background required to keep up-to-date on the progress made in the area of risk modeling and model validation. For example, the Value-at-Risk (VAR) considered the de-facto standard has several limitations as pointed out by (Embrechts, McNeil, & Straumann, 2002) and there has been significant progress in creating a more sophisticated decision making model (see (Rockafellar & Uryasev, 2002), (Poojari & Varghese, 2008)). We would recommend that the auditors need to be complemented with independent risk consultants who have an ability to analyze risk for the board on a live basis and not ex post facto for the annual report. These risk specialists would assist the board for a limited period of time, and the board would commit to change them every 3 or 4 years (in fact, best corporate governance for auditors is the same!). Such experts would perform detailed forensic analyses of the robustness of the internal risk practices that includes data validation, robustness of the internal risk models, methods used in model calibrations. Additionally, they would query the risk management team from within the bank on behalf of the board, not least to ensure that the board asks the correct questions to the management. The risk consultant’s report(s) should provide a narrative for the alternate future scenarios that the bank needs to consider. These scenarios would be a function of the current business model and balance sheet exposure, coupled with the alternate market forces. Such firm-wide scenario analyses of uncertainties, quantification of risk, sharing of quantitative and qualitative information would help in more effective dialogue and advanced forewarnings. This would also mean a better understanding of the correlation among the alternate business lines and their cumulative
impact on the firm. Such approach would put the
results of the stress-testing and scenario analyses
in a proper context in contrast to the tick-box
approach conducted purely for regulatory
purposes. Moreover, the narratives and the
supporting results facilitate the dialogue between
board and the senior management. The board
should then follow up with questions to the
management on how those risks are being
addressed and managed. For example, since many
banks still hold long dated illiquid assets that are
often ‘mark-to-model’, senior managers should be
called upon to elaborate how they valued its
holdings of complex or potentially illiquid
securities during a period of market turmoil.

2. **Living Will**: Section 165 of the Dodd-Frank Act
requires all systemically important financial
institutions to create “living wills” to facilitate
rapid and orderly resolution, in the event of
material financial distress or failure. The living will,
in addition to the details on the assets, liabilities,
and contractual obligations, must also contain the
decision-making process of the management and
the emergency power to the board in the event of
an Armageddon scenario. By its very nature, the
living will needs to be regularly updated based on
the nature of the balance sheet exposures. When
an entity has the potential to be a going concern,
recovery plans should describe the actions that
would be taken to maintain sufficient capital and
liquidity levels. On the other hand, if there is doubt
of bankruptcy, then plans should set out about
how the collateral impact could be minimized.
Also, the board should have the flexibility to
include additional resources at the time of crises.

3. **Diversity and Cohesion**: Well-organized boards
should have directors representing a diversity of
cultural backgrounds, from different industries
(and experiences within those industries), from
both genders. It is obvious that all the 3 boards
were under-represented by women (see Table
4, Table 10, and Table 18). They should not be close
associates and friends, and any potential conflict
of interest with the CEO and/or other board
members should be disclosed to the shareholders.
Due to the nature of business of the bank, the
boards in particular need significantly more
industry-specific expertise than is typically
considered necessary for boards in other sectors of
the economy. Therefore, for banks, the board
members should be brought because the board
perceives they have expertise and a background
that could be beneficial. An ideal board member
needs to be generous with time, intellect and
experience and not be distracted with too many
external commitments. As stated before, there is
evidence that the governance suffers when board
members are stretched for time due to other
commitments. It is important that the chair-
person should command the respect of the team
members such that the board, under the
leadership of the chair-person, works as a cohesive
unit. There should a blueprint of a board Will that
specifies the authority that the chair-person could
have in situation of emergencies. These measures,
for instance, could include an immediate
re-arranging of the board with members of specific
skill sets in times of urgent need.

4. **Communication**: The effective functioning of a
board requires both the discipline of appropriate
formal processes and the facilitation of critical
interactive exchange among board members
ahead of taking decisions, especially in relation to the strategy to be followed. These two ingredients of formal process and exchange among board members are complementary, but both are required. Process alone may involve little more than a box-ticking affirmation that the formal structures required for discussion and decision-taking exist. For instance, RBS’ board (see Table 18) was very large and as (FSA, 2012) pointed out, “made it less manageable and more difficult for individual directors to contribute, hence reducing overall effectiveness.” Without sufficient room for discourse and deliberation, appropriate risk evaluation seems impossible. The critical interactive exchange, while vital, is unlikely to be constructive unless harnessed into an appropriate decision-taking structure and definite actions. By and large, the existence and adequacy of a board’s formal processes can be identified and assessed after the event by reviewing the minutes of board and committee meetings. By contrast, assessing the quality of critical interactive discussion among board members is more difficult. This is because the extent and nature of any differences of view are not typically or dependably captured in minutes. Furthermore, the take-away impressions of board members, both at the time and later, about a particular discussion may differ and may be subconsciously colored by their knowledge of subsequent events.

References

• CEPS. (2010). Bank state aid in the financial crisis fragmentation or level playing field.


Dr. Chandra Poojari has been both an academician and an industry practitioner with a 10-year successful track record in scientific research, asset management, capital raising, leading projects and developing sophisticated technology. He was one of the youngest academicians to get tenure at Brunel University (London) in the Centre for Risk(www.carisma.ac.uk). Within the first two years, he obtained research grants of over US $ 1 MM from the European Union, Engineering Physical Sciences Research Council(UK). As a hedge fund manager, he has traded biometric assets, structured transactions, and advised leading private equity, hedge funds, investment banks and high net worth clients on investment decisions. He can be reached at chandra.poojari@nmims.edu