Article

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Effective bank corporate governance: observations from the market crash and recommendations for policy
Moorad Choudhry

Abstract
This paper considers the extent to which inadequate corporate governance was a contributory factor to the financial market crash. It examines the experience of selected failed banks, with emphasis on the corporate governance structure in place at each firm, and the background and expertise of the Board and Directors, and draws conclusions for future policy. We find that the nature and composition of Boards was not robust enough to provide independent direction. Their membership possessed insufficient expertise, and was not geared towards a long-term view of the bank’s development. Consequently many banks were drawn into a bull market spiral. The form of management direction contributed to this. Based on our conclusions we recommend that a number of bank governance measures be implemented, if necessary for imposition by regulatory fiat. These measures relate to the composition, structure and expertise of board members and non-executive directors.

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1 Introduction

Banks are the critical infrastructure component in an economy. They provide financing for individuals and corporations, and facilitate the transmission of funds across payment systems. The effective functioning of any economy depends on banks ensuring the supply of credit and liquidity throughout the business cycle and in all market conditions. The importance of banks to human wellbeing and societal development is recognised by the fact that in any every country banking is a regulated industry and protected by taxpayer-funded safety nets. The efficient mobilisation and allocation of funds is dependent on efficient corporate governance at banks. When they are able to undertake this, the cost of capital is lowered for all market participants. This in turn increases capital formation and raises productivity growth. Therefore the management of banks has implications for corporate as well as national prosperity. This in turn highlights the importance, and central function, of bank governance. It is self-evident then, that bank corporate governance must be robust, effective, adaptable to changing circumstances and fit for purpose.

In the banking industry corporate governance refers to the manner in which the business and strategy of the institution are governed by the firm’s board and senior management. An accurate and succinct description of it is given by the BIS [1], which describes the mechanics of bank corporate governance as (i) setting the bank’s objectives, including target rate of return for shareholders (ii) setting the control framework that oversees the daily operations of the bank (iii) protecting customer deposits (iv) setting strategy that accounts for the interests of all stakeholders, including shareholders, employees, customers and suppliers and (v) maintaining the bank as a going concern irrespective of economic conditions and
throughout the business cycle.

A banking crisis highlights the failure of bank corporate governance with dramatic effect. The financial crash and economic recession of 2007-2009 resulted in the demise of a number of banks, of varying size and systemic importance, in the US and Europe. The evidence from the crash is that corporate governance at many banks failed completely, at least with respect to points (iv) and (v) above, and in many cases with respect to all five governance objectives. This was despite the fact that the banking sector is heavily regulated and subject to internationally agreed rules on capital buffers and accounting transparency.

In this article we review the experience of a sample of failed banks in the period leading up to, and during, the crash. We observe the conduct of boards and senior management, as well as the governance infrastructure in place, to determine lessons for policy going forward. The main contribution of this paper is to highlight failures of governance, to identify sources of risk as important determinants of a bank’s corporate governance structure, and to draw on the conclusions arising from the study to formulate recommendations for policy. We outline a more effective framework for governance infrastructure, one that is better suited to managing risk under volatile market conditions.

The remainder of this paper is organised as follows: Literature review; Conventional corporate governance structure; Market observations; Conclusion, and Policy recommendations.

2 Literature

There is a not inconsiderable literature on the subject of bank corporate governance, with the emphasis on the infrastructure of management reporting and board composition. Saunders et al conclude that bank ownership and management structure influence risk taking [2], while Caprio et al look at how these factors
influence bank valuations [3]. Prowse and Macey, and O’Hara suggest mechanisms for the governance infrastructure of banks, [4] [5], and Barth et al consider how regulatory mechanisms influence risk taking. [6].

The BIS study is typical of those from regulatory bodies in proposing a governance outline [1]. It recommends the board to set strategy and establish accountability of senior management. It points out that governance infrastructure varies by jurisdiction, with some country regimes setting a supervisory role and no executive powers for bank boards; other regimes allow for a broader remit that lays down a general framework for management. In other words, there is no universal set of rules on bank corporate governance. This is still the case.

Levine notes the importance of strengthening the ability and incentive of private investors to exert governance control over banks, rather than relying excessively on government regulation [7]. Shareholder education is a vital part of this control. The influence of debt holders is post-facto, and dependent on the legal infrastructure and bankruptcy system in place. This is significant, and implies that debt holders do not exert adequate controlling influence on bank strategy and management until the point where the bank ceases to be a going concern. In a bull market environment, managers and shareholders may prefer this, and the finding of Myers that debt holders are risk averse would support this surmise [8]. However as a form of macroprudential management and control, the influence of debt holders is vital for effective governance. In a notable pointer for future policy, Levine finds that state-owned banks are not a solution to the problem of inadequate governance.[7]

Laeven and Levine is an important contribution to the literature given its date of publication, which preceded the onset of the crisis [9]. They conclude that bank regulations, including capital requirements and supervisory oversight, do not directly influence risk taking. Their study highlights the need to examine how a bank’s ownership and management control structure combines with national
regulatory policy to influence bank risk origination. Amongst their findings the most significant is that traditional regulatory policy does not drive risk aversion; the two key components of Basel II, regulatory capital requirements and supervisory oversight, do not appear to reduce risk taking. They also find that bank shareholders have incentives to increase risk exposure after collecting deposits and debt from investors. This suggests that shareholder presence on the board is not a risk control device, rather the opposite, and also argues for the presence of debt holders.

The United Kingdom House of Commons Treasury Committee makes several observations based on its study of bank governance in the lead-up to the crash [10]. Among its findings are that the system of non-executive director (NED) oversight was flawed, because it had degenerated into a “cosy club”, with insufficient time committed to their role by NEDs who also combined their board responsibilities with full-time employment and directorships at other firms. Critically, NEDs also lacked sufficient relevant expertise. However the finding that bank boards lacked diversity in their NED complement is difficult to justify, given the wide mix of backgrounds of many board members. In anything bank boards were over-diversified, at the expense of financial sector expertise and experience. Treasury Committee concludes with recommendations that (i) the talent pool on the board be enlarged (ii) NEDs be restricted on the number of directorships they accept (iii) the board be supported by a dedicated secretariat and (iv) all board members, both executive and NEDs, demonstrate sufficient expertise before being appointed.

From the viewpoint of corporate governance, the most significant finding in the Treasury Committee report is that bank shareholders do not subject boards to sufficient scrutiny. In fact shareholders have an incentive to increase risk exposure, particularly after a period of increasing returns. This was also observed in Laeven and Levine [9]. The experience of KBC Financial Products, discussed later in this article, is instructive in this regard.
3 The conventional bank corporate governance framework

We noted in the literature review that there is no universal bank corporate governance model. Differences in organisation and infrastructure differ by regulatory jurisdiction and also within them, depending on the type of institution being considered. The Basel Committee, as noted by the BCBS and BIS, [11], [1] suggest the following, inter alia, as elements of strategy and technique that are essential to an effective corporate governance arrangement:

- a coherent and explicit statement of strategy for the business, with stated required return and performance measures;
- clear and transparent outline of responsibilities for the executive management;
- explicit lines of authority and communication, from board downwards and from business lines upwards;
- strong framework of internal control, and accountability, and review procedures and processes for this control (including internal and external audit arrangements and a board audit-risk committee);
- an effective risk management framework that also describes the monitoring and reporting of all risk exposures;
- transparent information flows both internally and externally.

These principles are still required in the current post-crisis environment. In the wake of the crash, it is reasonable to conclude that the above principles were not observed at many banks. However that does not suggest that these principles need to be changed, but rather observed and enforced more adequately and, in a number of key respects, added to.

Irrespective of the regulatory jurisdiction of a bank, at the top level there are five areas of governance over which strong oversight must be established; these are (i) genuine controlling supervision by the board of directors; (ii) supervision by
individuals who do not work within the business lines; (iii) direct executive supervision of each business line; (iv) independent audit and risk management sub-boards, and (v) senior personnel who are sufficiently expert in their jobs. In other words, in the post-crisis era, a “rubber stamp” review board will not be acceptable.

The board should establish a coherent, articulated strategy for the bank. This is stated by the BIS [1], but was not always observed in practice. However strategy objectives must be reviewed on a frequent basis, so that they can be altered as necessary to respond to changes in economic circumstances. Such “macroprudential” oversight is perhaps the most difficult aspect of a board’s responsibilities. Further, board directors must be qualified to perform their role and must be able to access all necessary information, on a timely basis, to enable them to perform their duties. The events during the crash suggest that this was not always the case.

3.1 Board structure and role

The most effective composition of a bank board remains an issue for debate. Heidrick and Struggles define three different forms of board structure that are common in Western Europe and North America [12], which are illustrated in Figure 1.

**Figure 1 Board structures**
The fully unitary system is common in UK banks, as well as in Spain, while the two-tier format is required by law in Germany and also observed in Switzerland and Holland. The mixed system is observed in Belgium. All these countries, with the exception of Germany, suffered a banking crisis of one type or another in 2008, while a number of German landesbanks had to be rescued by the federal government. On anecdotal evidence therefore we conclude that the form of the board itself does not have a bearing on the ability of a bank to survive a capital or liquidity crisis. A checklist of accepted business best-practice operating mechanisms, as contained in Heidrick and Struggles [12], confirms further that simple observation of form for board supervision did not prevent banks from failing to meet the challenges of the crisis. For instance, UK banks are reported as exhibiting the highest rating on corporate governance in the study, yet suffered possibly the most serious banking crisis. A country ranked in the study with a low governance rating, such as Denmark, experienced fewer bank liquidity and capital problems in the crash.

Other metrics reported in the study are also uncorrelated with the experience of banks during the crisis; for instance the average number of board members at European banks is 11.8, however countries above this figure (Belgium, with 12.7 on average) and below it (the United Kingdom, average of 8.5) both suffered banking crises. However the issue of the most effective size of a board remains contentious. Advocates of large boards believe that these allow scope for representation of diverse interests, as well as a wider range of expertise. The experience of banks in the crisis however, suggests that large boards are unwieldy, as well as unable to react quickly enough to fast-moving events.

3.2 Board objectives and senior management

The composition and objectives of the board should be set to prevent a specific interest group from gaining overall control. Levine notes that concentrated
shareholders can act to exert control over diffuse shareholders and debt holders. [7] Thus board objectives must be set with this in mind. Transparency in operation and reporting is a key requirement.

The performance of senior management is as important to corporate governance as that of the board. The same principles of independent supervisory oversight, relevant experience and suitable expertise, are required of management as they are of the board. The BIS noted situations to be avoided by senior management [1], but which were nevertheless evident at certain banks during the crisis, such as (i) senior managers involved in business line decision making (ii) senior managers lacking sufficient expertise and (iii) managers unwilling or unable to maintain control over so-called “star” performers.

The BIS report also suggested more frequent board meetings, and meetings of board sub-committees, than is generally the norm. Of the bank failures observed in this study, no bank conducted board and sub-committee meetings more than once a month, with an average frequency of one meeting every eight weeks. The pace of events in 2008 suggests that such a frequency is insufficient to meet risk management demands. We illustrate the speed at which events occurred with two charts: Figure 2 shows the Chicago Board Options Exchange VIX contract, an indicator of market volatility in the S&P500 equity index, for the period July-October 2008. From a stable level we note the sudden increase in volatility from September, following the collapse of Lehmans, which took markets by surprise (although the funding and capital issues at that firm had already been under scrutiny). Figure 3, the credit default swap price for Morgan Stanley during the same period, shows the same sudden rise in volatility. The administrative support required for board and senior management meetings makes it problematic to hold them at greater frequency, thus a less unwieldy sub-committee structure may be required. This would make senior management better able to respond to changing events.
Effective bank corporate governance…

Figure 2 VIX contract levels Jul-Oct 2008
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Figure 3 Morgan Stanley credit default swap level Jul-Oct 2008
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4 Main Results

In a memorandum to its membership inviting the formulation of a response to the Basel Committee for Banking Supervision proposals, the British Bankers Association notes that “principles are being reviewed in the light of apparent failures in corporate governance that emerged during the credit crisis.” [13] The events of 2007-2009, when the US and certain European banking sectors were saved from bankruptcy only after the infusion of state aid, imply a failure of corporate governance at individual banks that exacerbated the problems created by a falling market. The diverse nature of the banks that failed or required government bailout, from a Wall Street investment bank to a UK building society, suggests that inadequate and incompetent management was also a factor in the crash. The banks observed in this study reflect failures in:

- the role of the board and its approving and overseeing the implementation of the bank's market and risk strategy;
- the board's qualifications, and having relevant knowledge and experience;
- the existence of an independent risk management function, including a chief risk officer or equivalent with sufficient authority and the ability to confront senior line management up to CEO level; and
- the ability to identify, monitor and manage risks on an ongoing firm-wide and individual entity basis.

The observations in this section provide a selection of failure in corporate governance and control at the banks that failed or required government bailout. We concentrate on those issues of governance that can be addressed directly with practical recommendations for improvement.

4.1 United Kingdom banks

The United Kingdom (UK) was the first country to experience difficulties in its banking sector, beginning with Northern Rock plc in 2007, which suffered the first
bank run in the UK for over 140 years, and culminating with the nationalisation of Royal Bank of Scotland, HBOS and Dunfermline Building Society amongst others, by the end of 2008. We examine the failures at these institutions from the corporate governance perspective.

4.1.1 Northern Rock plc

This bank exhibited a classic failure of best-practice corporate governance in two respects: the inability of the board to exercise sufficient checks and balances on a senior director, in this case the chief executive officer (CEO), and insufficient banking expertise within the board itself, principally the chair.

The UK banking sector was characterised by a high level of competition. Banks competed against each other to attract deposits. All else being equal, the bank that is able to pay the highest deposit rate will attract most deposits. This is only sustainable from a bottom-line viewpoint by taking on more risk on the asset side of the balance sheet. This happened with the UK bank Northern Rock plc, and was stated by the Chairman of Dunfermline Building Society as a factor in its demise. In part due to its more aggressive credit portfolio, Northern Rock was able to pay out a higher rate on its clients’ deposit accounts compared to that paid by the big “high street” banks, as noted in Cooper. [14]

The institution began with conservative beginnings, as a building society concentrating solely on regional mortgages and deposits. In 1997 it converted to a bank, and pursued an aggressive policy of growth and geographical expansion. However the deposit base was not extended significantly beyond its regional roots. CEO Adam Applegarth was the driving force behind the growth strategy.

Muradoğlu notes that in the first half of 2007, Northern Rock originated GBP 10.7bln of mortgages, an increase of 47% from one year previously and which represented 19% of all new mortgages during that period, elevating the firm to
market leader. [15] At the time, the bank was ranked the eight largest in the UK, and this share of the mortgage market arose from aggressive marketing and an extension of the risk-reward profile. Northern Rock, for example, was a key supplier of both 100% loan-to-value (LTV) and 125% LTV loans, the central premise behind which was that house prices will never fall. This was not an assumption restricted to Northern Rock; the credit ratings agencies implicitly assumed continuously rising house prices, on a national scale, in the methodology of their rating models for structured finance securities (noted for example, by Landuyt [16]). However unlike credit rating agencies, banks have direct personal experience of their mortgage markets, including in Northern Rock’s case the recession of 1990-91 during which house prices fell. That the CEO and board did not consider this risk, and also assumed continuous rising prices, is a failure of board judgement and the bank’s governance.

By any standards the bank’s growth performance in 2007 was phenomenal, and it reflected a key part of Northern Rock strategy: the desire for increased market share. This concentration on market share, at the expense of the funding side of the balance sheet, was the second failure in governance and the one which caused the bank’s failure. Northern Rock expanded beyond its deposit base, so the expanded volume of assets was funded in the wholesale markets, including the securitisation market. When rumours of the bank’s loan book quality reached the inter-bank market, credit lines were withdrawn in August and September 2007. The shortfall in funding could not be made up without recourse to the central bank, which resulted in the bank’s demise shortly after when it was nationalised by the UK government.

The overarching component of Northern Rock strategy was a desire for balance sheet growth, and ever-increasing market share, a strategy put in place shortly after the bank floated on the stock market. This was driven by the CEO, with acquiescence from the board. The board failed to notice signs of overheating in the
housing market, for instance, the large write-down by an HSBC US subsidiary, together with the widening credit spreads in asset-backed security (ABS) markets, at the start of 2007 did not lead the management to revise strategy, as noted by Muradoglu. The Chairman, Matt Ridley, did not have prior banking experience, with a background as a zoologist and science writer.

4.1.2 HBOS plc

The experience of HBOS plc, a UK bank formed by the merger in 2001 of Halifax plc and Bank of Scotland, illustrates the risks inherent in appointing senior management to banks that do not have backgrounds in banking, and more critically lack relevant experience continuously over the business cycle. The CEO of HBOS plc during the time leading to its takeover by Lloyds TSB (to forestall imminent bankruptcy) was Andy Hornby. He had joined Halifax as chief executive of Halifax Retail in 1999, after periods at a consulting company, Blue Circle (a manufacturing company), Asda (a supermarket) and George (a clothing retailer). He was then chief operating officer of the merged HBOS before being appointed CEO in 2006. During his tenure the firm expanded into corporate lending, and it was the corporate loan book that was revealed to have suffered losses of GBP 6.7 bln by the end of 2008, a majority of the total GBP 10 billion losses reported by the end of 2008 (quoted in The Daily Telegraph on 13 February 2009). The key statistic is the rate of growth in this market, which saw the HBOS balance sheet expand from GBP 12bln of corporate loans in 2005 to over GBP 70bln in such assets by the end of 2008, noted in Property Week. [17]

During the entire time that the CEO had been personally working in banking (1999-2008), the business environment had been essentially benign; the dot.com crash and events of 9/11 had not impacted seriously bank liquidity levels, and the economy did not suffer recession. In such an environment, an emphasis was placed on market share and balance sheet growth, with a consequent negative
impact on loan origination standards. Market share, and rate of growth, are key elements of strategy in the retail industry, where they are viewed as a benchmark by ratings agencies and shareholders. A successful background in this sector would, one expects, predispose an individual to apply the same principles in the banking industry. However market share and growth in market share are not natural elements of a banking strategy, which in general incorporates more conservative elements related to loan quality and return on capital. Furthermore, a sustainable strategy would also allow for market slowdown and recessions, knowledge and expertise that a banking professional with experience across the entire business cycle would be expected to possess.

Although technically bankrupt, the government encouraged Lloyds TSB to take over HBOS, which it completed in January 2009, apparently without any due diligence on the extent of its losses. Once these were known, Lloyds TSB was partly nationalised by the government.

4.1.3 **Royal Bank of Scotland**
The failure at RBS reflected a number of factors, the most significant of which was the fallout from the takeover of Dutch bank ABN Amro in 2007. A large and complex organisation such as RBS would present challenges in its management during a stable market; in a recession and liquidity squeeze this would become still more difficult. However the failure at RBS was also a failure in governance. The CEO at the time of the ABN Amro takeover and up to its nationalisation, Fred Goodwin, was a career banker with a strong influence over the board. The board itself was relatively large, with 18 members of diverse backgrounds, including the Chairman Sir Tom McKillop, who was a chemist and former CEO of the pharmaceuticals company AstraZeneca.

At the beginning of 2007 the market downturn was not entirely unexpected. Much bank research output at the time commented on the increasing delinquency rate in
the US mortgage market, and also the falling prices in the ABS market. That RBS continued to pursue the ABN Amro takeover suggests that the board were either unaware of this or chose to ignore it. Either of these is a failure of governance. The issue becomes one of behavioural economics; for example DeBondt et al suggest that in the pursuit of profits the existing regulatory and governance regime is not able to prevent CEOs and boards from undertaking ever more risky ventures. [18] That the board was not able to consider the ABN Amro takeover more critically is one of the factors that led to the bank’s failure.

Further, this experience highlights that bank regulators have a case for reviewing the size and strategy of systemically important banks, particularly in the area of growth through mergers and/or acquisition. When this takes place, regulators must look closely at how the transaction is funded. The experience of both RBS and Fortis, in the aftermath of the ABN Amro takeover, is instructive: the acquiring banks had not put in place a robust funding strategy behind the transaction, and this became evident when interbank markets froze in the aftermath of the Lehman crash, as noted by Landuyt [16]. Of course a smaller bank is also no guarantee of diminished systemic risk; for instance banks with a relatively smaller asset base still impose the risk of a potential run on the banking system, and Northern Rock and Bear Stearns were good examples of this. However the risk exposure for the government and taxpayer is considerably larger with larger banks.

An appreciation by CEOs and boards of banking history, or at least a familiarity with previous crises, would generate more appropriate risk management culture. For example Boyd and Gertler, assessing the US banking crisis of the early 1980s, conclude that liquidity should never be taken for granted and banks must manage the liability side of the balance sheet with sufficient prudence and conservatism to allow for future changes in market circumstances. [19] It is clear that the RBS board, and Andy Hornby at HBOS, were not familiar with the basics of bank liquidity management. We can conclude from this that senior management do not
learn the lessons of earlier failures and market corrections, but also that it is essential for the board and senior management to include sufficient individuals with longstanding experience of banking, so that they retain familiarity with the changes that occur in economic conditions.

Another issue is that of data management. A firm of the complexity of RBS is prone to suffering from incomplete management information (MI). This is less of an issue in a stable market, when data that is slightly out-of-date is still of value. However in a dynamic and/or falling market, it hampers effective governance. A legacy of RBS’s growth through acquisition is that there is no one MI system in place; all the constituent parts of the firm such as NatWest, Gartmore, ABN Amro and RBS itself retained their separate accounting and risk management systems. This made presenting an accurate, timely picture of risk exposure difficult. Senior management and the board were hampered in their decision making as a result.

Ultimately the failure at RBS was a failure of management and governance. A firm of the market strength and size of RBS benefits in the first instance from economies of scale and lower-cost funding. To lead the bank to nationalisation, despite the advantages available to it, was an indictment of the board’s lack of credentials to effectively manage a financial institution.

4.1.4 Dunfermline Building Society

Building societies in the UK are retail savings and loans institutions, and therefore inherently conservative in culture and strategy. Dunfermline Building Society (DBS) was located in Scotland only, with no branches and negligible business interests in England or elsewhere in the UK, and would have been expected to have had mortgage exposure only to this geographical region. That it did not was the result of a change in strategy by the board from 2004 onwards, and which resulted in the cessation of the firm as a viable independent entity. The failure of DBS at the height of the financial crisis exposed the poor judgement, risk management ability and leadership credentials of the board. The firm was
nationalised by the government in 2009, and its deposit business taken over by the Nationwide Building Society the same year.

HM Treasury reports that Jim Faulds, Chairman of DBS until March 2009, stated in testimony to parliament that “the responsibility for the plight that Dunfermline found itself in is solely the responsibility of the Board of the society.” [20] He further stated that DBS had “no toxic assets, no sub-prime loans and no USA loans.” It is a fact however that DBS was holding mortgage-backed securities (MBS) during 2007 and 2008, and losses on these assets depleted the capital base of the company to the point where it was no longer solvent.

In 2004 DBS adopted a new strategy that involved diversifying away from the traditional building society business of retail savings and prime loans made against residential property, into the higher risk market of commercial property lending and MBS assets. Testifying to a government committee in 2009, Mr Faulds stated that the board had felt that DBS had to change its structure, its business and its IT system in order to remain competitive [20]. To quote,

“Dunfermline’s systems and its structure were uncompetitive and out of date. We had right on our doorstep giants of retail financial services who were engaged in a price war, we had to compete with Northern Rock who were making offers which we could not understand how they could make (and history has shown how they did it).”

This comment raises an important governance issue, that of the raison d’etre of a banking institution. The owners of DBS (the savers and borrowers, as building societies do not have shareholders) may have believed that the firm existed to provide financial services to its regional community, and nothing more. Expansion for its own sake was not on the members’ agenda. Faulds’ quote also reveals the common mistake of equating absolute size and market presence with genuine shareholder (or membership) added value. The desire to gain market share had
been a factor in Northern Rock’s failure, and it would appear was the case for DBS as well. Furthermore, the comment suggests a short-term strategy of instant growth, in what was seen as a rising market, rather than attempting to follow a coherent policy of long-term value and growth in a sector the firm was expert in.

As part of the new strategy, DBS invested in MBS bonds and lower quality mortgages such as self-certified loans, purchased from two “sub-prime” mortgage providers, GMAC and a subsidiary of Lehman Brothers. These assets suffered write-downs of over 50% of their notional value during 2008. At the same government testimony, when asked whether members were aware of the risks involved in engaging in MBS and commercial lending, Mr Faulds stated, “the members did not know that at the time. We knew that but we believed that we managed those risks reasonably well [sic].” The self-certified loans purchased from GMAC and Lehmans “were performing but not as well as loans we found ourselves.” The DBS chairman stated further, “In retrospect I would rather we had not taken on self-certified loans.” The impression of this series of events is that of a managing board that was drawn into a sector with which it was unfamiliar and inexpert in, and which was outside its core business area.

A further loss, resulting from the failure of an information technology (IT) project, highlights failures in board transparency and communication.

In 2002 DBS set up a subsidiary called Dunfermline Solutions, as part of a strategy to generate fee business from the provision of software solutions and back office services to deposit takers and mortgage lenders. The firm invested GBP 31.4 million in the project, a considerable sum for an institution with a capital base of less than GBP 300 million. The system was not implemented, and DBS wrote off GBP 9.5 million in respect of the IT development costs; this reduced operating profits in 2007 from GBP 11.5 million GBP 2 million. Parliamentary testimony from Chairman Faulds described the project thus:
“We went for a system that we thought would make us extremely competitive. It was too challenging, it took too long, it took too much money and we made a mistake.”

This in itself is not a failure of corporate governance. What is significant however is the manner in which this event was communicated to members; the statement did not highlight that it was due to management failure; instead, the losses were written off as “excellent progress” in the annual report [21]. The Chairman's statement included the following:

“... made excellent progress last year in many areas of IT by focusing on those areas that deliver the greatest benefits. Over time the technology market changes and our business priorities and requirements also change which is why we made the decision to suspend the development and implementation in some areas of our investment, particularly those relating to the origination and administration of retail mortgages and in systems integration. This has resulted in a requirement to make an exceptional provision of £9.5m against those areas where work has been suspended. This re-focusing of technology investment towards Savings and Investments, management information systems and the mortgage intermediary market means the Society is in a better position to deliver in 2008 those areas of our investment that are of greatest benefit to our members.” (p.4)

The parliamentary commission concluded that the DBS board lost direction, and in allowing the increased costs possibly committed a breach of the duties owed to DBS members. It also described as “disingenuous” the description of the GBP 9.5m loss written off on the IT project in the Members Review as “excellent progress”, as noted by HM Treasury [20].
4.2 UBS AG

The Swiss bank UBS was the recipient of a USD 59 billion government bailout at the end of 2008, after reporting large losses in its structured credit business. This was reported by Bloomberg [22]. The bailout included a USD 5.2 billion capital injection. The experience of UBS mirrored that of other banks that were rescued by their governments, in that the failure of specific business lines was exacerbated by failures in governance. In the case of UBS, the senior directors of the bank did not identify a flaw in the internal funding arrangement in place, which allowed the structured credit business to book artificial profits. This demonstrated a lack of expertise by senior management, as well as an inability to involve itself at a sufficient level of detail in what was an important discipline and control mechanism.

As a key driver of the economic decision-making process, the cost at which funds are lent from central Treasury to a bank’s business lines needs to be set at a rate that reflects the true liquidity risk position of each business line. If this is unrealistic, there is a risk that transactions are entered into that produce an unrealistic profit. This profit will reflect the artificial funding gain, rather than the true economic value-added of the business. Evidence of the damage that can be caused by artificially low transfer pricing can be found in UBS’s own annual shareholder report. Blundell-Wignall and Atkinson discuss the losses at UBS AG in its structured credit business, which originated and invested in collateralised debt obligations (CDO). [23] Quoting the UBS report,

“...internal bid prices were always higher than the relevant London inter-bank bid rate (LIBID) and internal offer prices were always lower than relevant London inter-bank offered rate (LIBOR).” (p.97)

In other words, UBS structured credit business was able to fund itself at prices better than in the market (which is implicitly inter-bank risk), despite the fact that
it was investing in assets of considerably lower liquidity than inter-bank risk. There was no adjustment for tenor mismatch, to better align term funding to liquidity. A more realistic funding model was viewed as a “constraint on the growth strategy”. We observe again the pursuit of growth and market share for its own sake, rather than genuine shareholder added value.

This lack of funding discipline played an important role in the decision making process, because it allowed the desk to report inflated profits based on low funding costs. As a stand-alone business, a CDO investor would not expect to raise funds at sub-Libor, but rather at significantly over Libor. By receiving this artificial low pricing, the desk could report super profits and very high return-on-capital, which encouraged more and more risky investment decisions. A correct transfer pricing mechanism would have enforced greater discipline on the business lines. That senior management was not aware of this flaw in the internal funding process reflects poorly on its expertise in this area (a fundamental ingredient of banking), and on its knowledge of the bank’s core processes.

4.3 KBC Bank NV

Excessive losses during 2008, principally in its KBC Financial Products (FP) derivatives trading arm, resulted in KBC Bank NV receiving an injection of EUR 2.5 billion in euros in October 2008 from the Belgian government. As it is a high-street retail bank in Belgium, the government had been forced to act to prevent the firm’s bankruptcy. A second tranche of EUR 2 billion equity cash was paid by the regional Flemish government in January 2009. Taxpayer support was also extended in the form of government guarantees of up to EUR 20 billion to cover expected losses in the CDO portfolio. The extent of these losses had not been expected at board level, which had been accustomed to excess profits from the FP subsidiary. These profits, generated during 2002-2007, had helped create a culture of complacency at bank senior management.
For instance, at the outbreak of the US sub-prime crisis in 2007, certain members of the board were unaware of a special purpose vehicle named Atomium, which held ABS securities on its balance sheet that included sub-prime mortgage assets. This was a USD 5 billion securitisation structure, and its existence was raised by journalists at a press conference in August 2007; the finance director (CFO) was not able to provide details on it. FP’s CDO business had grown to over EUR 20 billion but the board was unaware of this exposure. It was this business that was the cause of FP’s losses in 2008.

Insufficient shareholder scrutiny was evident, in part the result of a period of five years of return on equity (RoE) exceeding 22%, up until the crash. The implication is that management oversight had become complacent, having observed excess profits during the bull market of 2002-2007. At the FP level, trade and business ideas returning less than 20% were rejected, even if they were potentially sound sustainable business ideas, because they did not match the excess returns of the main business lines. The lack of board scrutiny was reported by Donovan, who noted the departure of both the KBC Bank CEO and the board member responsible for overseeing the FP business, shortly after the government bailout. [24]

FP was another institution that had implemented an inadequate internal funds pricing mechanism. The majority of its liquidity came from the parent, a AA-rated bank at the time, which was lent to the subsidiary at a rate of Libor plus a uniform transfer price. This transfer price was below 20 basis points (noted by Choudhry [25]). However one particular business line at FP, the funds derivative desk, originated assets in partnership with hedge fund of funds. This involved lending to investors in hedge funds via a leveraged structured product. These instruments were illiquid, with maturities of two years or longer. Once dealt, they could not be unwound, thus creating significant liquidity stress for the lender. FP funded this business lines from central Treasury at the standard low transfer price, rolling over
the liabilities on a short term basis. The liquidity problems that resulted became apparent after the fall of Lehmans, when interbank liquidity disappeared.

Many banks (including UBS, noted earlier) operated on a similar model, with a fixed internal funding rate of Libor plus a few basis points for all business lines, and for any tenor. But such an approach did not take into account the differing liquidity profiles of the businesses. This resulted in excessive risk taking heavily influenced by an artificial funding gain at the business line level. Senior management was unaware, or unable to understand, the risks inherent in an inadequate transfer price mechanism.

The failure of KBC Bank, which would have moved into administration without state intervention, was a failure of governance. The board did not possess the expertise and knowledge necessary to effectively supervise its derivatives subsidiary, and was not aware of the extent of its risk exposure. Furthermore the years prior to the crash, which had seen FP report excess profits, had created a complacent attitude that further eroded adequate board oversight.

### 4.4 Lehman Brothers

The failure of the US investment bank Lehman Brothers is abundantly covered in the existing literature. From the corporate governance viewpoint, what is instructive is the cult of personality of the CEO, Dick Fuld, and the negative impact this had on the firm’s management. In this respect, it provides lessons for regulators and policymakers.

The remuneration structure at Lehman’s placed significant emphasis on employee share ownership. The annual bonus of all staff was paid partly in the form of stock options, vested over a period of two, three or five years and not realisable if the individual left the firm’s employment. The performance and risk-taking culture of the company suggests then that a personal stake in the company at agent level (the
senior management), did not reduce the desire to originate risk. In the case of Lehman’s therefore, it is difficult to conclude that the compensation and bonus culture was a factor in the firm’s demise. It appears instead that the dominance of certain “eccentric personalities” at senior management was the prime factor. This is evident from reading the findings of Sorkin, and McDonald and Robinson [26] [27]. The authors suggest that the CEO and his President, Joe Gregory did not fully understand the risks involved in the new investment banking environment in place from the 1990s onwards.

In the two references noted above, the words “remote” and “denial” appear frequently when describing the personality of the two Lehman executives. What is implied is that these shortcomings were due to megalomania, ego and envy. An example of this is given by McDonald and Robinson, describing the way Dick Fuld dealt with the success of the private equity firm Blackstone [27]. This firm was managed by two ex-Lehman managing directors, Peter Peterson and Stephen Schwarz, who it appears were not on speaking terms with the Lehman CEO. Rather than focus on the core business, as advised by the senior investment banking team (Larry McCarthy, Mike Gelband and Alex Kirk), which had warned about the growing risks in private equity and high-risk leveraged finance, the authors suggest that Mr. Fuld was driven by frustration and envy to start investing in hedge funds, energy companies, commodities and leveraged mortgages, apparently not only to match the success of Blackstone, but also because of a desire to top the league tables published on Wall Street. This obsession arose to such irrational levels that at certain times when high-risk strategic acquisitions were being discussed at the executive committee, the head of risk management was asked to leave the room. Clearly, if we accept this as story as fact, it is not only worrying but also dangerous for any firm.

The example of Lehman is another one of failed corporate governance, and again resulting from the drive and excessive influence of one particular individual. Like
Northern Rock, it has implications for how bank boards can improve their policies and procedures so that they are not at risk from this type of behaviour in future.

5 Conclusion

The sample of failed firms in this study, all of whom required taxpayer support or in the case of Lehman's was allowed to go bankrupt, is notable for its diversity. The size, culture, market participation and strategy of these banks differed considerably; what the firms appear to have exhibited in common was a failure of corporate governance. The senior management of these firms acted in a way that suggests that their firm’s failure would follow inevitably in the event of market correction.

A critical component of effective corporate governance is transparency. The existence of large volumes of off-balance sheet exposures, whether direct or via third-party liquidity backing arrangements, was an issue during 2007-2008. Muradoglu notes the opacity of balance sheets to reflect accurately the extent of assets such as securitisations and other complex transactions was a major factor behind the crisis [15]. This is a lesson for bank boards, to be able to understand better the actual risk exposures of the bank, and the reality of the reported management information. An incorrect assessment of risk by senior management is a behavioural issue; we noted the impact of personalities in the observation of Lehman Brothers. Muradoglu states,

“...herding and underestimation of low probability high impact events are all parts of human nature. Human nature will not change. Thus, we need better regulations.” (p.13)

In other words, regulation and governance needs to be enforced by fiat to take account of weaknesses caused by human nature. We noted earlier the lack of transparency in the corporate governance of DBS, and the personality cult at
Lehman’s that made effective board oversight of company direction difficult. De Bondt et al suggest that in the pursuit of short-term super profits, current regulations and governance culture were not sufficient to prevent bank management from “bending financial reports in their favour.” [18] These examples lead to a conclusion that bank governance needs to be organised formally with stronger, more effective controls and oversight regulation, at the risk of further failure due to behavioural factors at the time of the next crash.

The behavioural issues we have identified in the case studies are a factor because of the nature of financial markets. The paradox of financial assets is that their price behaviour is different to other assets, in that rising prices leads to rising demand. Other assets, goods and services, as well as commodities (but excepting gold), all experience a fall in demand if their prices rise, all else being equal. This leads to short-term behaviour amongst investors as well as bank management. It is also a principal reason why “market share”, while a perfectly acceptable corporate key performance indicator in industries such as clothing retail and air travel, is an inappropriate such measure for banks. Increasing market share is simply a strategy for higher losses at the point when financial markets experience a correction. The influence of management consultants, and their emphasis on market share, is clear here; it is notable that the CEOs of two failed UK banks, HBOS plc, and also Bradford & Bingley plc, both had backgrounds in the consulting industry. The experience of the crash also suggests that it is not best practice to appoint CEOs with a background in retail, where market share is an important KPI.

The financial crash of 2008 exposed the weakness of bank corporate governance. The failure of the banking sector, which required government bailout in the US and Europe, was a failure of governance. Our observations of a sample of failed firms, and the way in which decision making was taken within them, suggests that the nature and composition of bank boards was not robust enough to provide adequate supervisory oversight of management strategy, nor sufficiently
independent direction. Board members were not geared towards a long-term view of the bank’s development, and in some cases lacked sufficient expertise to carry out the function they were entrusted with. An emphasis on peer-level comparisons of market share was allowed to shape strategy, an approach that places low emphasis on shareholder added-value and the firm’s core strengths.

Policy Recommendations

From its observation of a number of failed banks, this study concludes that current bank corporate governance culture and legislation is insufficient to deal with the risk of failure when markets crash. We recommend a number of measures designed to strengthen the infrastructure of corporate governance, and to increase the effectiveness of boards when dealing with dynamic and volatile market environments. If necessary, these measures should be imposed by regulatory fiat:

- **Correct board representation.** At none of the failed firms was a representative of the major debt holders placed on the board. Market observations suggested that risk behaviour is related to the type of representative on the board, and insofar as they represent any stakeholder, NEDs usually represent the shareholders. Increased scrutiny of company earnings has forced listed companies to report their results on a quarterly basis; the short-term focus on corporate results makes boards focus overmuch on share price and peer comparison. A board membership representing solely the management and shareholders, and concentrating on such performance parameters, will be pre-disposed to lower risk discipline in a rising market. Furthermore, Levine suggests that shareholders “have incentives to raise the bank’s risk profile [7]. Debt holders, however, do not enjoy any upside potential from risk-taking but do on the downside if the bank cannot service its debts.” Rarely however, if ever, are bondholders represented on the board. If they were, the accent on policies and strategies would be more risk averse. Therefore we recommend
that bank boards be required to appoint at least one member who is a representative of the major debt holders in the company.

- **Expert knowledge of board members**: In our observation of the events at KBC Bank, we noted that board members were not familiar with securitisation techniques and structured credit products, and with specific structures within their own group. For board membership, financial services expertise is a prerequisite. Non-executive directors must have financial services expertise, and executive directors – including CEOs – must have direct relevant experience. We noted that Bradford & Bingley and HBOS, two failed UK banks, appointed CEOs from the retail sector, and the Chairman of RBS had previously managed a charity. We recommend therefore that the regulator approve only suitably qualified persons for board membership. The expertise of board members must be reviewed annually by bank regulators.

- **Management understanding of core strategy**: A frequent refrain in risk management principles is to know one’s risk. This maxim is also relevant for senior management from a governance point of view. We observed that a board that has no clear understanding of the bank’s direction, beyond a simple one of growth in absolute size and market share, can be easily influenced into higher risk business. This was the case at Northern Rock and DBS. We recommend that boards articulate a clear, coherent definition of strategy and raison d’etre that explicitly outlines the areas of business competence the bank should engage in.

- **Size of board**: We observed that direction and risk management can easily stray into higher risk and inappropriate business sectors without effective checks and balances on management. Bank boards would be more effective with fewer but more committed members. Large-size boards diminish a sense of personal responsibility, with each board member taking refuge in the collective position. This makes it harder to restrain management and the cult
Effective bank corporate governance

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of personality. As long as there are sufficient checks-and-balances to ensure business lines cannot force their own agenda, we recommend that a board of 6-10 persons rather than the norm of 12-20 would make for more effective supervision and control.

- **Frequency of board meetings:** The frequency of board meetings was not able to meet the challenge of a dynamic market environment, of the kind observed in 2008. However it is frequently administratively impossible for a full board to meet more frequently than once every 4-6 weeks. We recommend that a smaller sub-group of the board, an “alpha-team” of key executive directors (the CEO, CFO, 1 business line head, Treasury head and 1 or 2 non-executive directors) meeting more often – say 2 or 3 days every month rather than 6-12 days every year – would provide more solid direction and awareness of bank business, especially during times of crisis or negative sentiment when markets are fast-moving.

- **Expertise of board sub-committees:** It is common practice for boards to appoint an independent risk committee of non-executive directors, for example the Board Audit & Risk committee. However while such committees have an important function, they are ineffective unless the membership is composed of market experts able to understand the nature of the bank’s risk exposures. Otherwise, the role is more effectively undertaken by an internal board sub-committee. We recommend therefore that such board sub-committees consist only of those with proven bank experience and expertise gained over the business cycle.

- **Transparency:** We observed that frequently senior management did not issue transparent notices of strategy, intent and risk exposure to shareholders. In the case of DBS, the description of events in the annual report was kept opaque. We recommend that regulators enforce a requirement, reviewed annually, that
management communicate to shareholders in precise and clear fashion the extent of the bank’s risk and losses.

At many banks the performance of senior management and boards during the crisis of 2008 was unsatisfactory. It is apparent that current corporate governance infrastructure is not sufficiently robust to handle market corrections. We have outlined a range of recommendations that should, if implemented by banks and enforced by regulators, assist management to better handle events during the next crash.

References


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