



BOARDS OUT OF DEPTH IN SUBPRIME?

What bank boards need to avoid lending excesses

By Professor Paul Strebelt (February 2008)

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When the dust settles, the question will have to be asked: Where were the boards of directors when the leading banks and financial firms were loading up on subprime backed CDOs and SIVs? What happened to the risk management procedures laid out in their corporate governance guidelines? How is it possible that some had to take more than ten billion dollars in write-downs, while others like Goldman Sachs and Credit Suisse sensed the risk and were much less exposed?

A meaningful discussion of risk at board level pre-supposes directors with sufficient independence and industry expertise to challenge management about the information they're getting and the appropriate degree of risk to take in the pursuit of value creation. This is more difficult to do when the chairman, who determines the information and sets the board agenda, is the same person who is directly responsible for the executive team, which may have exposed the firm to more than a prudent level of risk. The banks and firms with the biggest losses all had combined Chairmen/CEOs or Executive Chairmen, so it's an open question as to whether their boards saw information about the increasing percentage of CDOs. By contrast, at Credit Suisse, the Chairman is an external director and, at Goldman Sachs, the Chairman/CEO is subject to its partnership culture with two other firm executives on the board (John Plender, FT, Dec.4, 2007).

Even if the increasing holdings of CDOs had been flagged, the boards of the institutions with the biggest losses were out of their depth in terms of expertise for a discussion of CDO sub-prime risk. On these boards with eleven to thirteen members, only a small minority had current experience in financial services that covers the recent era of CDOs and SIVs. On some boards, there was only one external director with financial services expertise. The other board members have impressive CVs, some were previously in financial services, but could hardly be expected to have raised the red flag on CDO risk exposure. Without introduction and coaching by the Chairman, it is difficult to imagine these boards flagging and questioning the risk of CDOs with a triple-A rating.

By contrast, Credit Suisse, having learned from past experience, has a board that is notable for its financial services expertise and independence. Of the thirteen board members, eight are from financial services. One is a previous group executive with the bank. But seven others are external directors: the Chairman is in reinsurance, three others are from banks, and one each from insurance, private equity and auditing services.

On the Goldman Sachs board of twelve members, a majority of seven are from the financial services industry. In addition to the three executives from the firm itself, there are four external directors from merchant banking, private equity, investment management and insurance.

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The moral of the story is that in the financial services industry, boards with Executive Chairmen, or combined CEO/Chairmen, and without sufficient members with current industry expertise are effectively neutered when it comes to risk management; we can't expect them to see and prevent the next lending excess, packaged in the next generation of financial instruments. In an industry that can bring down the whole economy and one with technically complex products, the board should include leadership checks and balances. It should also have a critical mass of industry experts, like at Goldman Sachs and Credit Suisse, who are independent enough to shape management's risk appetite and if necessary tame it by raising the red flag.

This article first appeared in the Financial Times on February 16, 2008.

Professor Strebler is Director of the High Performance Boards program. He also teaches on the International Seminar for Top Executives, the Program for Executive Development, as well as the Mastering Technology Enterprise and Orchestrating Winning Performance programs.

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