Can we blame bad corporate governance for failing financial institutions?

Jerry Davis
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Questions for this session

- Could the financial crisis have been prevented if the governance of the major perps had been better?
- Were AIG, Fannie Mae, Lehman Bros, Bear Stearns, or Washington Mutual demonstrably worse than their peers? If so, in what ways?

Prologue: A (very brief) history of corporate governance among financial institutions

- The most troubled players were in highly diverse industries
  - Commercial banking (Citi, Wachovia)
  - Savings and loans (WaMu)
  - Investment banking (Bear, Merrill)
  - Mortgage banking (Countrywide, New Century)
  - Insurance (AIG)
  - GSEs (Fannie, Freddie)
- Corporate governance has very different histories across these industries

Case #1: commercial banks

- Commercial banks in the US were traditional segregated geographically (by state) and industrially (from investment banking and insurance)
- Bank boards were traditionally much larger (2X) and more star-studded than industrial boards
- Money center banks and local banks had distinct governance profiles

Money center banks were largely staffed with CEOs of multinationals

Top executives on bank boards, 1982

Chase Manhattan
- AT&T
- Amoco
- Bethlehem Steel
- Celanese
- Chesebrough
- Continental
- Cummins
- Exxon
- Federated Dept Stores
- General Foods
- Georgia Pacific
- Macy's
- Xerox

Chemical Bank
- American Standard
- AT&T
- Burroughs
- Champion Intl
- Dupont
- Eli Lilly
- Mobil

JP Morgan
- Corning
- Dupont
- Merck
- NL Inds
- Tenneco

Manufacturers Hnvr
- American Home
- Campbell Soup
- Cluett Peabody
- Phelps Dodge
- Revlon
- Texaco
- US Steel

In ~ every major city, local corporate executives staffed the boards of local banks…

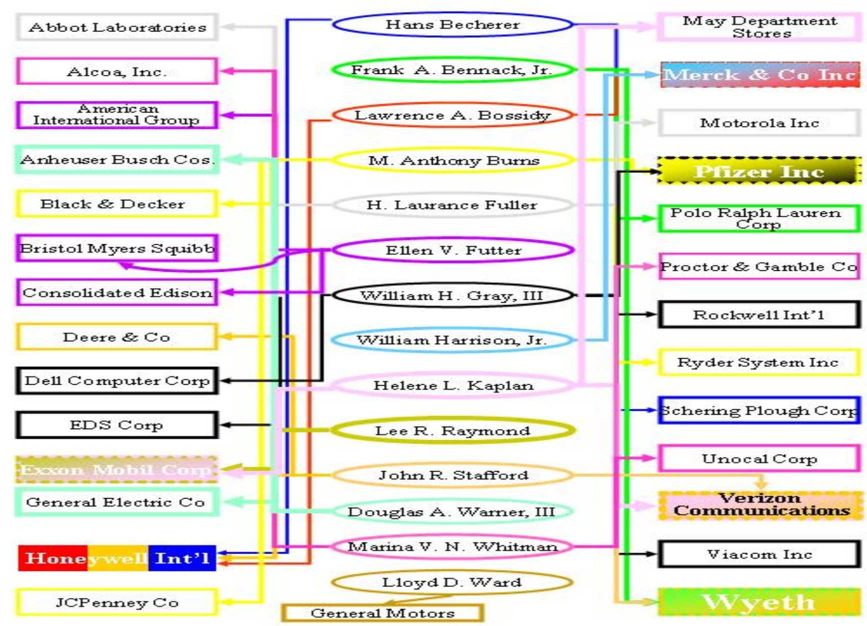
- **Boston: Bank of Boston**
  - Computervision
  - Dennison Manufacturing
  - General Cinema
  - Gillette
  - Prime Computer
  - Raytheon
  - Wyman Gordon
- **Pittsburgh: Mellon Bank**
  - Air Products
  - Allegheny International
  - Alcoa
  - Joy Manufacturing
  - PPG Industries
  - Quaker State Oil
  - Sperry
  - US Steel

Data for 1986 from Davis (1991)

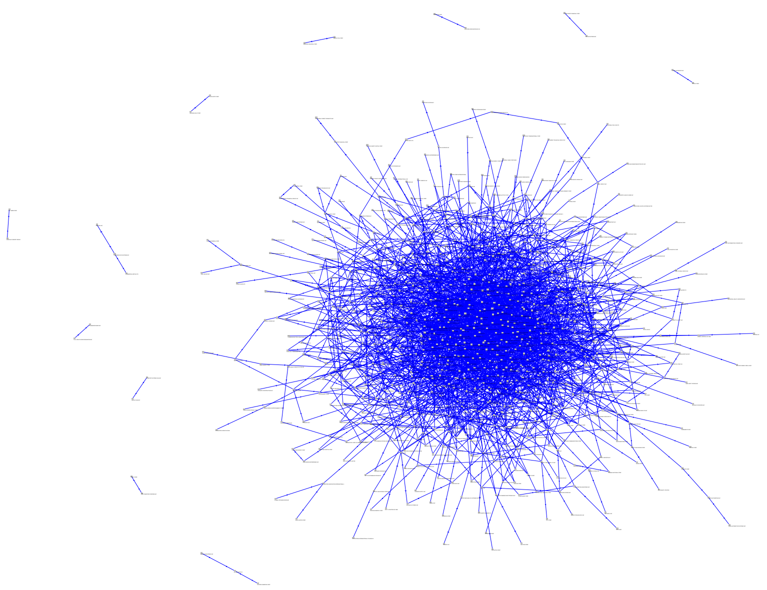
Why? Legitimacy and information

- Impressive boards served a signaling function to reassure potential clients and others of the banks' legitimacy
- Well-connected outside directors provided far-sighted information to broadly guide future investments
- A result of this strategy was that bank boards were highly "central" in the shared director network

JP Morgan Chase board, 2001

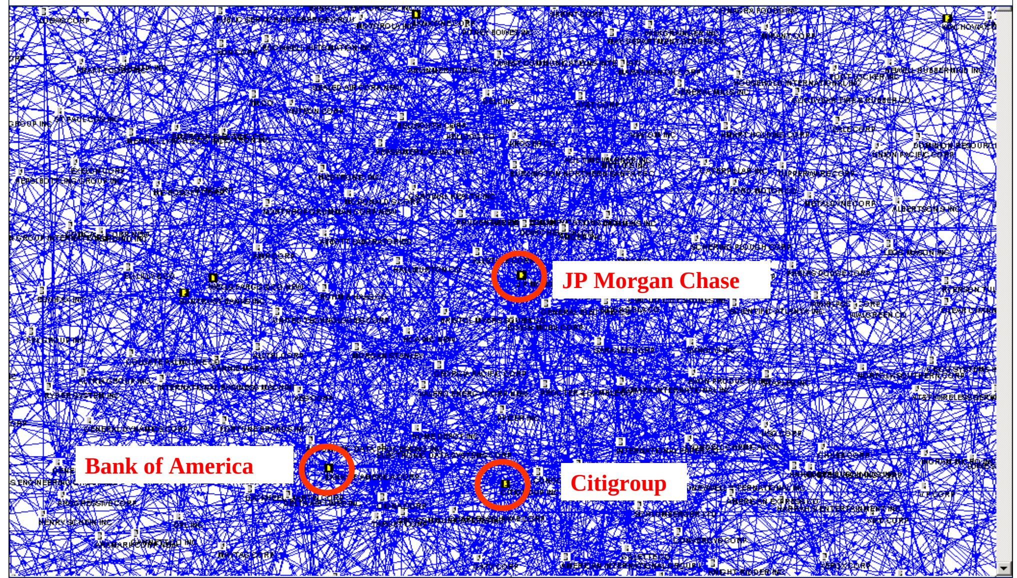


Corporate boards are all connected by shared directors



The *Fortune* 1000 board of directors network

…and banks sit somewhere in the middle of the network

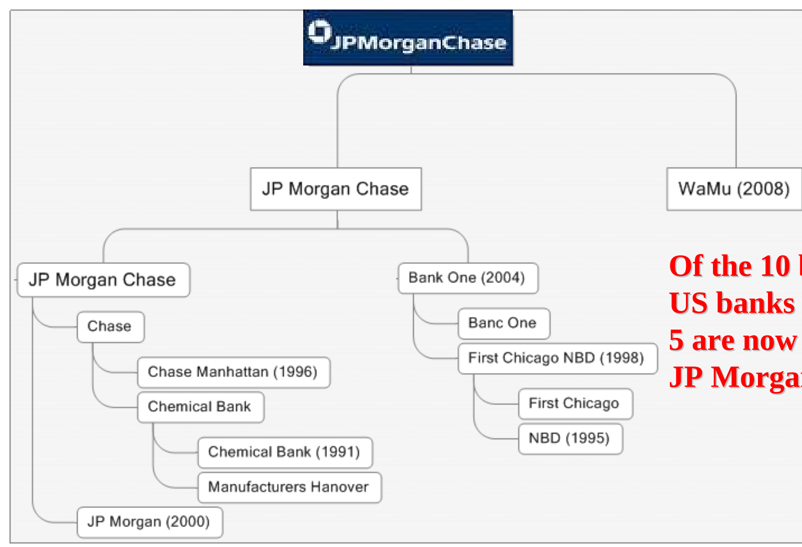


Banking has changed dramatically since the 1980s

- Market-based finance replaced corporate loans, and securitization meant that loans were not held in portfolio
  - → banks shrank their boards and recruited far fewer CEOs and "stars"
- Consolidation meant a few large banks grew into truly national players
  - → bank boards saw increased churn in membership

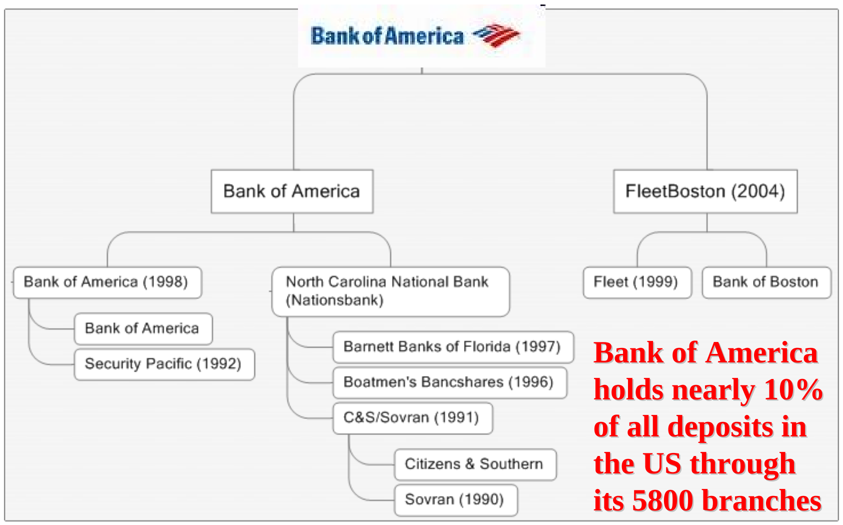
Bank consolidation since 1990:

(Almost) every New York-based commercial bank became JP Morgan Chase

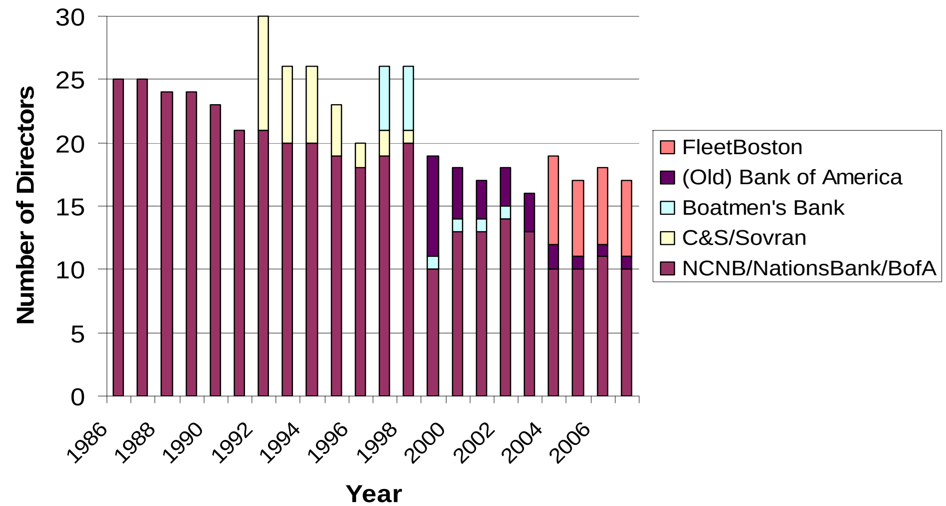


Of the 10 biggest US banks in 1989, 5 are now part of JP Morgan Chase

Bank consolidation since 1990:
North Carolina National Bank bought the biggest banks outside New York



Effects of consolidation: NCNB/NationsBank/Bank of America board composition, 1986-2007



Case #2: investment banks

- Few investment banks were free-standing public corporations prior to the 1990s
- The partnership model was still observed in some notable cases (e.g., Goldman Sachs)
- Among publicly-traded investment banks (Merrill, Morgan Stanley), boards were relatively low-profile: small, and few CEOs

What does good corporate governance look like (according to reformers)?

- Boards are comprised primarily of truly independent directors
- Outside directors have relevant expertise and resources
- The CEO does not serve as Chairman of the Board
- Directors are elected annually
- Directors’ and top executives’ wealth is tied to the company via share ownership
- [Optional] The firm has a large institutional blockholder to hold its board accountable

Board composition in 2006

Company	Board size	Indep.	CEOs	"Stars"	Annual?	CEO=Chair?
AIG	15	13	0	6	Yes	No, by charter
Bear Stearns	12	8	0	1	Yes	Yes
Citi	16	13	6	4	Yes	No
Fannie	12	11	0	4	Yes	No, by charter
Goldman	11	9	2	4	Yes	Yes
JP Morgan	14	11	3	4	Yes	No
Lehman Bros	11	9	0	2	No* (2007)	Yes
Merrill Lynch	11	10	1	5	No	Yes
WaMu	13	10	0	3	No* (2007)	Yes
Wells Fargo	14	13	1	1	Yes	Yes

Ownership structure in 2006

Company	Largest shareholders	% inside	Auditor
AIG	CV Starr "group" 15.2%; FMR 6.8%	2.10%	PWC
Bear Stearns	Private Capital Mgt, 6.1%; J. Cayne 6.5%	9%	Deloitte
Citi	No 5% owner; Sandy Weill owns ~ 0.5%	1.10%	KPMG
Fannie	Cap Res 17.2%; Citi 6.3%; AXA 5.4%	0.40%	Deloitte
Goldman	GS "shareholder group," 11.7%	2.90%	PWC
JP Morgan	Barclays 5.1%	1.20%	PWC
Lehman Bros	Smith Barney et al, 5.1%	3.90%	E&Y
Merrill Lynch	State Street (ESOP trustee) ~ 9%	1%	Deloitte
WaMu	Cap Res 10.3%; Barclays 6.2%	1%	Deloitte
Wells Fargo	Berkshire 5.7%	<1%	KPMG

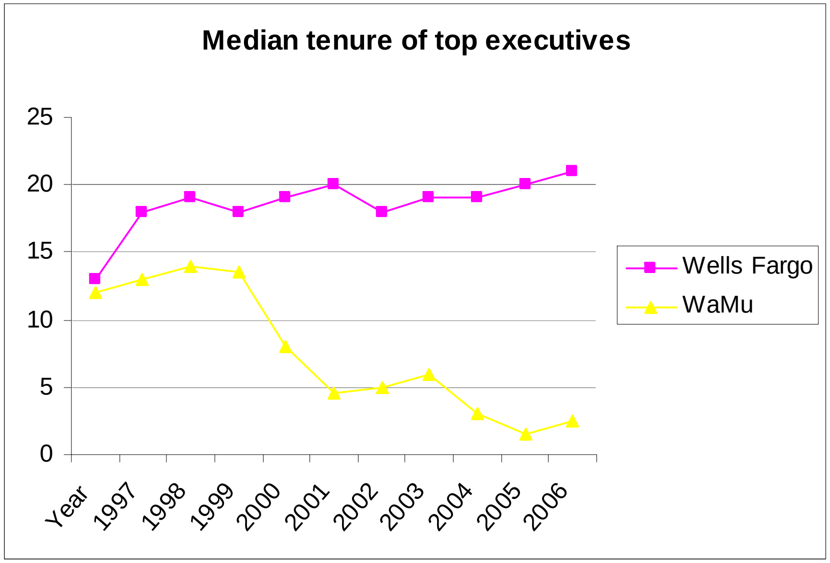
AIG after Greenberg: A model of governance reform

- Substantial turnover among former "Greenberg directors" (7/15) between 2004-2006
- Structural changes:
  - Retained Arthur Levitt to advise on reforms, nominees
  - Director candidates not receiving a majority vote must resign
  - 2/3 of directors must be independent (strictly defined)
  - By-laws require independent (non-executive) Chairman, who is evaluated annually
  - Former AIG CEOs cannot serve as directors
  - Directors limited to 4 other corporate boards
  - All employees must complete formal ethics training
  - Audit committee met 21 times in 2005!

Fannie after Raines: A model of governance reform

- Substantial turnover among former "Raines directors" (7/13) between 2004-2007
- Structural changes:
  - By-law requires separate CEO and Chairman of the Board
  - All directors but one are independent
  - Majority vote required for director election
  - Stock ownership requirements for executives and directors

Is executive churn a warning sign?



Conclusion

- Governance at financial institutions is unlike at other corporations
  - Different roles for boards
  - Changing functions over time
- The “checklist” model of governance reform would not be effective for preventing financial collapse
- More “inside-focused” indicators may be more effective