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

<table>
<thead>
<tr>
<th>Chase Manhattan</th>
<th>Chemical Bank</th>
<th>JP Morgan</th>
<th>Manufacturers Hnvr</th>
</tr>
</thead>
<tbody>
<tr>
<td>• AT&amp;T</td>
<td>• American Standard</td>
<td>• Corning</td>
<td>• American Home</td>
</tr>
<tr>
<td>• Amoco</td>
<td>• AT&amp;T</td>
<td>• DuPont</td>
<td>• Campbell Soup</td>
</tr>
<tr>
<td>• Bethlehem Steel</td>
<td>• Burroughs</td>
<td>• Merck</td>
<td>• Cluett Peabody</td>
</tr>
<tr>
<td>• Celanese</td>
<td>• Champion Intl</td>
<td>• NL Inds</td>
<td>• Phelps Dodge</td>
</tr>
<tr>
<td>• Chesebrough</td>
<td>• Dupont</td>
<td>• Texaco</td>
<td>• Revlon</td>
</tr>
<tr>
<td>• Continental</td>
<td>• Eli Lilly</td>
<td></td>
<td>• Texaco</td>
</tr>
<tr>
<td>• Cummins</td>
<td>• Mobil</td>
<td></td>
<td>• US Steel</td>
</tr>
</tbody>
</table>

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

- Abbott Laboratories
- Alcoa, Inc.
- American International Group
- American Brands Co.
- Bank of America
- Bristol Myers Squibb
- Consolidated Edison
- Deere & Co.
- Dell Computer Corp.
- EDS Corp.
- Eaton Corp.
- Exxon Mobil Corp.
- General Electric Co.
- Honeywell Int’l
- JCPenny Co.
- Kmart
- May Department Stores
- Merck & Co Inc.
- Motorola Inc.
- Proctor & Gamble Co.
- Polar Saph Lauren Corp.
- Prudential Corp.
- Ryder System Inc.
- Texas Instruments
- UAR Corp.
- Verizon Communications
- Viatel Communications
- Vickers Inc.
- Wyeth
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 shrunk 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

Bank of America holds nearly 10% of all deposits in the US through its 5800 branches


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**

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

**Ownership structure in 2006**

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

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**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!

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**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