Financial Disaster Recovery

A Private-Sector Agenda for Risk Management

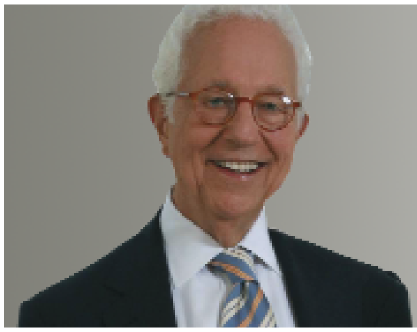
By Ira Millstein and George Vojta

Trust in financial institutions and their advisors has been lost. There will be additional regulation, but regulation alone cannot restore trust. It is necessary for the private sector to act to restore its important role in the financial system. Unlike previous crises, such as the dot.com burst, Asian Crisis, Great Depression, or the Tulip Collapse, the current extraordinary turbulence results from financial institutions wounded, in some cases mortally, by egregious failures in corporate governance and risk management. These weaknesses—inappropriate risk-taking and malfeasance—must be acknowledged with honesty and without reservation, and the requisite remedial action must be defined and rigorously implemented.

The remedy must originate with the boards and managers in charge of our financial institutions. The current state of affairs involving massive government intervention has been chronicled fully by the media. However, we firmly assert that a financial system dominated and controlled by the state is not a solution; it brings its own deficiencies. The market, over the long term, if appropriately regulated, has been found to be the most efficient system for wealth creation; savings must continue to be allocated to their best use. Gross undermining of the market system can be resisted by acknowledging the fault lines in need of repair and voluntarily repairing them ourselves to the extent possible.

Let us consider, for a moment, the world of financial institutions and their impact on the population at large. In the last century, direct or indirect individual shareholdings in public corporations have increased dramatically. In 1952, about 6 percent of U.S. adults had direct or indirect shareholdings. In 1985, the figure was 28 percent; in 2002, it was about 40 percent, or 84 million individuals. Indeed, the beauty—but also the peril —of the evolutionary path of public corporations in the United States since the last century is that they increasingly represent the investment of an ever-wider segment of the population.

Direct ownership is only part of the story. Conceptually, the whole system has now moved away from us—individuals as beneficiaries. Individuals who used to save for retirement or to send their children to college by directly holding stocks in the GEs and GMs of the world—the "forced capitalists," as dubbed by Delaware Chancery Judge Leo Strine, Jr.—now make their investments through financial intermediaries such as pension funds and mutual funds. In 1980, institutional investors held more than 37 percent of the equity markets. Today, they hold about 60 percent of all U.S. stocks, according to The Conference Board. As a result, corporate governance and capital markets' vitality has become a matter of general interest, and corporate crises are even more likely to have detrimental effects on society as a whole.



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Enter the New Investors

Another striking new feature of today's capital markets is the constant proliferation of different types of shareowners within the "institutional" category with increasingly heterogeneous objectives and tactics. For example, Sovereign Wealth Funds, half of which came into being since 2000, managed assets somewhere in the range of \$1.9 to \$2.9 trillion as of June 2008, according to RiskMetrics Group. Private-equity funds engineered deals with an enterprise value of \$1.4 trillion in the boom years of 2006 and 2007. Hedge-fund assets have increased about 3,000 percent since 1990, and accounted for approximately 30 percent of total U.S.

equity trading volume in 2006.

This proliferation of new owners puts the model of shareholder activism, which was envisioned in the 1980s and 1990s, under severe strain. Institutional investors were once presumed to share a common goal when exerting pressure on boards to monitor management and effectively guide firm strategy. That assumed homogeneity now seems long gone, and heterogeneity is ever on the rise. This diversity of shareowners has brought a whole host of agendas, strategies, and values to the table. Some of these owners have limited investment horizons and are only interested in realizing a short-term profit, and others may have hedged or shorted their positions and consequently have a financial interest in the failure of the enterprise.

With this new array of owners came a blizzard of new financial instruments, which are complex, and often incomprehensible, even to the most financially literate; deregulated markets stimulated such innovation. The emergence of new financial instruments and new owners was mutually reinforcing. Hedge funds were one of the main buyers and users of complex financial instruments, which were also used to finance the private-equity boom between 2005 and 2007. The new financial instruments, such as credit default swaps, other derivatives, and CDOs, differ from conventional public stock and debt, as the latter are not subject to similar regulatory requirements. Observers, such as *The New York Times* columnist Floyd Norris, have noted that this problem of "unregulation" was due less to the fact that regulation was scaled back "than to Wall Street's finding ways around it by establishing new products that could work between the cracks."

In recent years, large traditional financial institutions followed the risk-taking example of hedge funds and private equity in pursuit of their double-digit returns. They hired mathematicians and scientists who dominated the innovation function, and developed esoteric market strategies and financial instruments.

We assert that the current crisis is due in no small part to this surge in risk-taking behavior by financial institutions, coupled with lapses in good corporate governance.

Significant cultural change occurred in the most established institutions and with it came a diminished overall commitment to good management practices and service to constituents and society. One reason, perhaps, was the fear of losing the best and brightest to the new hedge and private-equity groups. There was a new attitude of profit seeking for the institutions' own benefit, rather than fiduciary duties to you and me. This phenomenon was reinforced by the primacy of "doing deals" as opposed to serving clients/constituents. Revenue from trading and principal risk activities became dominant.

Other factors also contributed to and reinforced the deterioration of sound management and governance practices in financial institutions. The first was the contravention of the check-and-balance role of independent gatekeepers—lawyers, accountants, and rating agencies, as John Coffee, Columbia Law professor, has noted. Among the most egregious examples was the case of Arthur Andersen and Enron, and more recently, the flawed rating methodologies for the new complex securities instruments.

The Regulatory Gaps

Deficiencies in regulatory oversight also contributed to this dysfunctional condition in financial institutions. The Gramm-Leach-Bliley Act, enacted in 1999, allowed commercial and investment banks to merge, thereby enabling intermediaries to compete in all segments of the financial market. However, it was envisioned that all diversified institutions would become financial holding companies under Federal Reserve supervision. Regrettably, large investment banks chose to avoid supervision by the Federal Reserve through use of specialized charters, off balance-sheet activities, holding companies, and other means, while insurance companies formed thrift holding companies under the Office of Thrift Supervision (OTS). The Securities and Exchange Commission remained the primary investment bank regulator, but failed to create credible competencies or carry out supervisory activities at this level to any meaningful degree, and oversight by the OTS was deficient. This enormous gap in regulatory oversight allowed

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excesses in risk-taking to occur in these two sectors. The extravagant incentive and compensation policies in financial institutions rewarded short-term profit at any cost and completed this disastrous picture.

Greed prevailed throughout the entire financial "industry," and without proper oversight, was allowed to flourish. The full panoply of abuses included "illegal parking" and tax avoidance; tainted equity research; illegal backdating of options; fraudulent conveyance of securities and conduct of auctions; abusive sales practices; excessive short-selling and leverage; gamed rating of leveraged and subprime securities; leaks of inside information; deficient settlement processes for derivatives; little or no regulation of hedge funds, rating agencies, private-equity firms, and over-the-counter derivatives; opaque, deceptive consumer marketing; and just plain criminal fraud.

We are now experiencing the full thrust of public resentment of the excesses fueling this misconduct: a lack of trust in the capital market and institutions, and anger over the assertions of general corruption of the financial sector as a whole.

The Governance Remedy

The implementation of strong corporate governance practices is essential to the long-term success of our corporations. And with the long-term success of corporations, the overall health of our economy and the welfare of society as a whole follows. Strong corporate governance practices are here understood as an effective system of checks and balances inside each corporation (management accountability to boards and board accountability to shareholders and stakeholders), clarification of the rights and responsibilities of all constituents of the corporate enterprise, and a clear understanding that the role of the corporation in society is to benefit shareholders and stakeholders.

We now have a unique opportunity to use self-help to revamp governance structures. The first priority is for boards to change their focus from profit for the benefit of themselves and management to a renewed commitment to managing society's savings (ours) for the benefit of their shareholders and stakeholders (us). Boards must re-establish and enforce the standard that risks are to be undertaken for the benefit of their constituents, not for the personal gain of management. Second, directors need to be far more competent and engaged, have the courage and expertise to validate and oversee the strategy and risk profile of the enterprise as beneficial to all stakeholders. Third, shareholders must exercise their responsibility to elect directors who are qualified to discharge these responsibilities. Governments which become shareholders have the same obligation.

That leaves the question of whether boards of this nature can effectively oversee complex institutions to assure that the risks undertaken are appropriate and contribute to the long-running integrity of the enterprise.

Eight Factors Necessary to Restore Faith and Accountability

What are the elements of a sound enterprise risk system? The gravity of the current situation calls for emphasis to be placed on the following eight factors:

- A risk officer at the senior-management level and risk-management groups independent of business lines with real authority for approvals of all risks.
- A risk-adjusted capital discipline that addresses firm-wide core business and transaction-level capital requirements.
- A new-product approval process (especially for complex instruments and risk models), independent of business lines, at the senior-management level. A robust process may have made many of these initiatives unprofitable.
- Fully transparent and comprehensive internal and external reporting, which implies no "conduits," other off balance-sheet vehicles or risks, and no illicit "parking activity."
- Extensive training and certification of competence in risk management for board members, and self-assessments of board performance by peers.
- Timely, comprehensive risk reports for credit, market, operating, liquidity, and other risks deemed appropriate for the individual firms utilizing XBRL, or comparable IT technologies. These reports should be regularly reviewed by senior management and the board.
- Full disclosure of risk-management processes in filings, annual reports, and analyst presentations.
- Regular reviews by the board audit committee, internal control officers and external auditors, rating agencies, and regulators of the risk-management system for adequacy, compliance with policy, and appropriate disclosure.

We believe the answer is "yes."

Our perspective is derived from long experience with more than 80 boards, from experience in the financial sector, and from being early advocates and supporters of the governance movement, long before governance was incorporated into mainstream thinking and mandated by legislation.

Prescription for Improvement

Effective oversight of risk by strong and competent independent boards must be re-acknowledged as a basic element of good corporate governance. This begins with splitting the offices of chairman of the board and chief executive officer. Splitting these roles solves the inherent conflict of self-oversight and permits the CEO to focus on running the enterprise, while allowing the non-executive chairman to manage the board and recruit board members with requisite technical expertise and time commitment to provide adequate oversight. A case could also be made for more internal directors on the board to facilitate availability of proper information for board oversight decisions.

Available technologies, such as XBRL, allow the reporting of risk in as much, or as little, detail as wanted or needed. These technologies can produce for the board sufficient and digestible reports, which are different from, and more effective than, the largely unintelligible mass of information based on detailed financials and footnotes.

In addition, individual institutions should conduct an annual comprehensive review of their risk profile, and eliminate activities that do not stand up to rigorous capital, liquidity, ethical and suitability standards. The results of this review should be validated by external auditors, rating agencies, and regulators, and these validations should be disclosured. The SEC should promote such a process by requiring significantly more disclosure about risk exposure, board actions in monitoring and managing such risks, and assuring that the disclosure standards are updated as required.

We are heading for reform of regulatory agencies that most likely will establish umbrella supervision, probably by the Federal Reserve, over the entire financial system, that should, and will, focus on corporate governance, risk management, capital standards, and liquidity. Supervising organizations must insist, strongly and consistently, that firms establish, maintain, and execute world-class governance and enterprise risk-management programs. Equally important, supervising institutions should levy sanctions on these who fail to meet this standard. All carrot and no stick does not provide sufficient incentive.

A multitude of risk models have been proven to be flawed and require a comprehensive review in individual firms. Client suitability policies and ethical conduct standards must also be reassessed and reissued; the board should mandate termination of all employees guilty of conduct that violates suitability and ethical policies. Gatekeeper relationships must also be placed on an arm's-length basis.

Compensation systems need to be redesigned to moderate rewards, penalize poor performance and unethical conduct, encourage effective service to stakeholders and society, and deemphasize short-term profit in favor of long-term corporate value. Conducting more intensive training of staff and board members emphasizing their fiduciary obligations to stakeholders and society is necessary, and certified board members should be evaluated annually. As part of this course of action, an active stakeholder accountability process should be established for shareholders, creditors, clients, staff, competitors, suppliers, society, and the environment.

The Time is Now

The implementation of formal and substantive governance improvements around risk management with the recruitment of the right type of directors will go a long way in restoring trust in financial markets. And this is the ideal occasion to do so. Not only are financial institutions desperately in need of rebuilding trust, but the recent wave of government intervention in the sector is likely to lead to stringent corporate governance requirements if such improvements are not made voluntarily. The government now has skin in the game.

The Millstein Center for Corporate Governance and Performance at the Yale School of Management, an active partner of the OECD and the International Corporate Governance Network, is currently launching a major project titled "Reconstructing Trust: A Private Sector Agenda" to research, describe, and advocate for the necessary reforms discussed above. It is but one of the flowers that should grow as we find new ways of restoring trust.

All of us, authors included, who have labored in the financial sector must accept degrees of responsibility and accountability for what has happened. But now is the time to begin serious work to deal with the problems and restore the system to health.

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1 Robert C. Clark, Major Changes Lead us Back to Basics, 31 J. Corp. L. 591, 594 (2006).

2 See U.S. Senate, Committee on Banking, Housing, and Urban Affairs, Testimony Concerning the Regulation of Hedge Funds by Chairman Christopher Cox, U.S. Securities and Exchange Commission (July 25, 2006).