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The Role of Leadership and Goverance

JOHN ZINKIN

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Rebuilding Trust in Banks

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Rebuilding Trust in Banks

The Role of Leadership and Governance

JOHN ZINKIN

WILEY

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1 Fusionopolis Walk, #07-01, Solaris South Tower, Singapore 138628

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Library of Congress Cataloging-in-Publication Data

ISBN 978-1-118-55038-0 (Hardcover)
ISBN 978-1-118-55039-7 (ePDF)
ISBN 978-1-118-55041-0 (ePub)

Typeset in 10/12 pt, Sabon LT Std Roman by Aptara India

Printed in Singapore by C.O.S Printers Pte Ltd

10 9 8 7 6 5 4 3 2 1

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Preface

Most books on leadership and governance deal with them as if they are quite distinct and separate. Perhaps this is because writers on leadership typically are historians, successful CEOs, and consultants, or come from the HR discipline, whereas those who focus on governance tend to be lawyers and accountants by training. They therefore tend to see the world through different lenses and focus their thinking accordingly.

I believe leadership is a morally neutral activity, which must be governed lest it go astray with bad results. History is full of effective leaders with followers willing to die to create the conditions their leaders want. Their followers may have been motivated to do good or evil. Which route they chose depended in large part on the moral compass of their leaders. Compare, for example, the appalling behavior of the Nazis during the Second World War or Maoist Red Guards during the Chinese Cultural Revolution with the ANC members' forgiveness in South Africa as a result of Nelson Mandela's extraordinary example. Thus, leadership and governance cannot, must not, be treated separately, because without governance there is nothing to prevent great leaders from becoming great bad leaders. To illustrate this point and how leadership alone is not enough, I use the case of Napoleon in the first chapter, who started so spectacularly, achieved so much for France and Europe, and yet ended up failing. In the second chapter I draw parallels between Napoleon's career and those of four initially very successful bankers who also ended up as failures: Stan O'Neal of Merrill Lynch, Jimmy Cayne of Bear Stearns, Dick Fuld of Lehman Brothers, and Fred Goodwin of the Royal Bank of Scotland.

In business, if we focus only on governance, without recognizing the leadership need to align and energize employees, we may get mediocre performance at best. Quick and decisive action in business has been the justification given in the past for combining the roles of Chairman and CEO in U.S. companies. This creates a form of dictatorship that politicians can only envy. When it works well, it produces great results, as do all benevolent dictatorships. When the incumbent is incompetent, or becomes incompetent, it is disastrous. We need governance to protect us from the follies of the incompetent but powerful leader. The answer is that in both politics and business, we must think of leadership and governance together, if we are to

avoid bad leadership and failures of governance on the one hand; and good governance with mediocre performance on the other.

I hope to show that the recent failures of corporate governance in banking were mainly failures of leadership caused by great bad leaders who were successful leaders originally, but went astray because they were not subjected to the checks and balances of good corporate governance. They had great ideas that they were able to impart to the rest of the organization; they had energy; they were able to energize their subordinates; they were able to execute and they had edge. Yet, these attributes by themselves did not protect them from ultimate failure. I believe this is the result of Lord Acton's famous adage: "Absolute power tends to corrupt absolutely."

Without a system of governance to control the actions of leaders or CEOs, they can end up believing their own propaganda. The more successful they are initially; the greater risks they run and get away with; the greater the temptation to believe they are right and others are wrong; the greater the temptation to continue with a strategy that has gone past its sell-by date. There is no countervailing power, no effective system of checks and balances, to suggest the time may have come for them to reconsider their assumptions or to hold them back from continuing to gamble recklessly with the future of their organizations or taking actions promoting their own interests ahead of those of the organization. To illustrate these points and to draw on the lessons learned from the rise and fall of Napoleon, I look at the cases of Merrill Lynch, Bear Stearns, Lehman Brothers, and the Royal Bank of Scotland in Chapter 2.

It is the role of the banking regulators to ensure that the banking system is stable. It is the role of the securities regulators to ensure that investors are protected and have the information they need to make informed decisions on where to put their money and what to expect in return. Many banking CEOs argue that the regulatory burden resulting from changes in legislation enacted in response to failures of governance is disproportionate. It is my view that such regulation is essential, if we are to have good bank leaders who are held to account for their actions, and that the recent Global Financial Crisis proved beyond doubt that such regulation is needed to protect banks from the actions of great bad leaders.

As Alan Greenspan discovered, his assumptions about how the market worked and how bankers could be relied on to police themselves proved to be wrong. If only he had remembered that the Kondratieff Wave, which deals with the credit cycles in the United States, predicts a boom and bust cycle of 40 to 60 years, he might not have been so surprised at the market's inability to self-regulate. Equally, if he had remembered Peter Drucker's paraphrase of Euripides, "He whom the Gods will destroy, they first give forty years of prosperity," he might have recognized the early warning signals

in time. One only has to compare the superior performance of Canadian and Australian banks during the Global Financial Crisis, with their much tougher regulatory regimes, with that of U.S. or UK banks to realize regulation is in fact a necessary cost of doing business because of the need to protect the system as a whole from market failure.

It is the role of the Board to help the company's management decide on the business the company is in, its beneficiaries, and the difference the company will make to their lives with the return it can expect to earn as a result. It is also the role of the Board to decide the company's values; its risk appetite and risk management; and its succession planning, including appointing and sacking the CEO. In doing this, it is the role of Boards to challenge CEOs' mental models constructively, because as Peter Drucker so perceptively commented, "The biggest cause of corporate failure is the unconscious 'mental models' of the CEO." Yet, as will become clear, the Boards of Merrill Lynch, Bear Stearns, Lehman Brothers, and Royal Bank of Scotland, as well as many others in banking, failed to do this for a variety of reasons, among which the most important was the dominance of the CEO—in effect, leadership without adequate governance.

In the case of banks, Boards have two fiduciary duties to reconcile: first to their shareholders, but second to their depositors. This makes the role of bank Directors that much harder to fulfill.

The key difference between the role of the Board and that of regulators and auditors is that Boards create or destroy value through their role in governance, whereas regulators and auditors contribute to the costs of doing business in the name of disaster prevention. Securities regulators focus in addition on the equitable distribution of the value once it has been created. In making the case why leadership and governance must be considered together, I focus on the performance aspects of corporate governance and how these create or destroy value rather than the regulatory aspects, which are, in the main, the cost of doing business.

AUDIENCE

The primary audience for this book is Directors of banks. It will help them by making the case that they must not allow dynamic and successful CEOs to become overconfident or arrogant so that they persist in strategies that are excessively risky or that have passed their sell-by date. By examining the cases of Napoleon, Stan O'Neal, Jimmy Cayne, Dick Fuld, and Fred Goodwin, they will appreciate the consequences of hubris and the failure to provide an effective counterweight to keep them on track. As a result, it will reinforce their appreciation of why they are responsible for setting the

"tone at the top" and ensuring that their bank is firmly grounded on an ethical foundation. It will also remind them of the importance of their finding the courage to speak truth to power.

It provides them with a working framework to deal with the issues they will inevitably face as they fulfill their responsibilities in the key areas of good governance: setting and reviewing strategy, managing risk, succession planning and talent management, and ensuring organizational integrity by recognizing the importance of culture, compliance, and controls. It does this by exploring what is demanded of Directors, the issues they face, and, where appropriate, provides them with suitable questions to ask management so that they can challenge constructively and thus ensure the long-term value creation of the bank for which they are responsible. In other words, the book attempts to answer the following questions:

- What are Directors responsible for?
- Why does it matter?
- What are the issues?
- How do they trust, but verify?

This allows CEOs room to exercise their remit without being second-guessed. By providing a series of practical questions Directors should ask, this book sets itself apart from others.

The secondary audience is academics, students of governance, and writers on banking, as well as auditors, lawyers, and consulting service providers to bank Boards. This book is also useful for MBAs who are thinking of entering banks.

OVERVIEW OF THE CONTENTS

The book is divided into 10 chapters, 5 of which have supporting appendixes. The chapters are as follows.

Chapter 1: Leadership: A Force for Change argues that effective leaders are able to mobilize their followers to achieve change. However, the act of leadership is morally neutral, as the changes envisioned can be good or bad. The chapter explores the extraordinary career of Napoleon, who achieved more than any single individual in European history because of his unique legacy, both militarily and administratively, and yet failed in the end. It concludes that there are 11 lessons of good and effective leadership and that Napoleon did not meet the criteria of all of them, which is why he ultimately failed.

Chapter 2: Leadership: From Success to Failure explores the phenomenon of "Imperial CEOs" as leaders of banks. It looks briefly at the cases of the CEOs of Merrill Lynch, Bear Stearns, Lehman Brothers, and Royal Bank of Scotland to see whether there are any generalizable lessons that can be drawn from their experiences—in particular, from the ways in which they ultimately failed the 11 tests of good and effective leadership identified in Chapter 1.

Chapter 3: Setting the "Tone at the Top" deals with the role of bank leaders and their Boards in setting the "tone at the top." It explores the interaction between leaders and followers and the importance of the courage to speak truth to power if leaders are to be kept from being corrupted by the power they wield. It is particularly critical in the banking sector, where failures of "tone at the top" may have led to gigantic losses at Société Generale, UBS, and JP Morgan Chase; to the weakness of compliance and controls at HSBC; and to the LIBOR price-fixing scandal. These failures undermine the case for self-regulation of financial services. The chapter makes it clear that the responsibility for setting the "tone at the top" belongs with both the leadership and the Board, with the Board providing the governance to keep leaders honest. It is supplemented by the appendix "Board Questions Regarding the "Tone at the Top."

Chapter 4: Ethics in Finance explores the impact of the four types of integrity: systemic integrity, market integrity, organizational integrity, and personal integrity on ethical decision making. Building on the previous chapter "Setting the Tone at the Top," it looks at ethical dilemmas through four separate, but interdependent lenses to provide people with tools to make ethical business decisions, recognizing that, for individuals, ethical decisions are viewed differently depending on both their cultural backgrounds and where they are in the organization. It uses simple, practical, and easy to understand ethical concepts to guide thinking and is not intended to be a deep discussion of moral philosophy.

Chapter 5: The Role of the Board: Theory and Reality discusses what bank Boards are supposed to do, taking into account the underlying economic and market realities, as they affect the ability of Directors to carry out their function effectively in helping CEOs be "great good" leaders. In doing so, it discusses the role of the Board as a whole, the roles of the Chair, CEO and committees. It concludes by discussing some of the reasons why Boards failed to prevent disaster in banks in the Global Financial Crisis. The chapter is supplemented by the appendix "The Role of Board Committees."

Chapter 6: Leadership, Governance, Strategy, and Risk explores the connection between leadership, strategy, and risk and the resulting need for

governance by the Board. Strategic choices often reflect the desires, ambitions, and personalities of the leaders who decide what the organization's strategy should be. The link between strategy and risk is threefold: first, leaders themselves and their ambitions may pose unforeseen risks; second, the objectives of the strategy may present risks in terms of the acceptability of the organization to the society in which it operates; and third, the risks of poor implementation. This chapter is supplemented by two appendixes: "Board Questions Regarding Strategy" and "Board Questions Regarding Risk."

Chapter 7: Developing Suitable Leaders deals with the difficult topics of succession planning and talent management—an area where many leaders have failed, perhaps because of an unwillingness to recognize they are both mortal and dispensable. It discusses the suitability of talent management and the identification of key skills in which employees must be trained, given the rapidity with which the banking world changes, often rendering business models obsolete. It also explores the need to combine ever-greater specialization (as skills and knowledge become deeper) with the need to remain an effective generalist (able to bridge the gaps between the silos created by technical specialization) and what this means for Boards and CEOs. It discusses the often neglected importance of ensuring that the leadership cadre represents the desired values and culture, as opposed to merely having the desired technical proficiency and skills. Finally, it covers the vexed issue of remuneration, as part of ensuring that the resulting leadership behaviors are suitable. It is supplemented by the appendix "Board Questions to Ensure Suitable People."

Chapter 8: Ensuring Organizational Integrity deals with the need for organizational integrity—a function of culture, compliance, and controls all working together to achieve common behavior. It explores the problematic issues raised when the leadership team is new or not in tune with the culture of the rest of the bank. It examines the role of controls to ensure that there is compliance with appropriate regulations and codes of conduct to preserve the bank's cultural DNA and way of doing business. Finally, it looks at the need for a proper system of controls that reconciles initiative and performance with unthinking obedience and compliance. It is supplemented by the appendix "Creating a Suitable ERM Framework."

Chapter 9: Governance: The Wise Restraints That Set Men Free explores the role of governance as a counterbalance to leadership, to help bank leaders make good decisions for sustainable results. It then examines the three components of good governance—self-discipline, market discipline, and regulatory discipline—and their contribution to good leadership.

It makes the case that self-discipline is by far the most important because of failures in the other two disciplines.

Chapter 10: Leadership with Governance: Rebuilding Trust in Banks concludes the book by drawing the arguments of the preceding chapters together to make the case that good governance is essential for sustainable value creation, and it is needed to prevent great leaders becoming great bad leaders of banks. Without it trust in banks will not be rebuilt.

Acknowledgments

Three women made this book possible.

I must thank Tan Sri Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, for giving me the opportunity in 2011 to run the Financial Institution Directors' Education (FIDE) program, as the Managing Director, Corporate Governance, at the Iclif Leadership and Governance Centre. This allowed me to focus on the problems of governance in financial instiwtutions that has made this book what it is—a book on the importance of reconciling leadership with governance, with specific reference to rebuilding trust in banks.

I must also thank Tan Sri Zarinah Anwar, former Chairman of the Securities Commission Malaysia, for giving me the opportunity to develop training for company directors in corporate governance when I was the CEO of the Securities Industry Development Corporation, the training arm of the Securities Commission.

Most important, I must thank my wife, Lisa, for being so patient with me, since this book has been written in my free time—in the evenings, at weekends and while I was on leave. Without her support and understanding, this book would not have been possible.

I must thank many people for helping me directly with the writing of this book.

Tan Sri Zarinah Anwar, Dato Seri Johan Raslan, formerly executive Chairman of PwC Malaysia, Daud Vicary Abdullah, President of INCEIF, and Ian Buchanan and David Hovenden of Booz & Co have given me invaluable advice on the structure of the book, as well as input on both the arguments and its readability. Kay Luan Tay gave me his perspective as the CEO of the Institute of Bankers Malaysia—the Malaysian banking institute responsible for training bankers. Dato Mustafa Mohamed Ali and Tang Wing Chew gave me feedback on the book from the perspective of independent Directors of Affin Holdings Berhad and Public Bank Berhad respectively, which I incorporated to make the book easier to read. My colleague Youssef Nasr, formerly President and CEO of HSBC USA and North America, helped me understand the banking scandals as they were developing over the past two years and advised me on how to frame the discussion.

Donald Jeganathan, Assistant Governor of Bank Negara Malaysia, gave me his personal feedback on the book to help me appreciate the regulatory perspective, as did Goh Ching Yin of the Securities Commission Malaysia and Angelina Kwan, formerly of the Securities and Futures Commission in Hong Kong. Chris Bennett was influential in developing my thinking regarding the importance of succession planning and talent management.

I am indebted to Professors Didier Cossin and Ulrich Steger of IMD and Nabil El-Hage for the case study materials we have worked on together over the years when teaching Directors about the issues of corporate governance; and to Professor Bob Tricker for his discussions regarding his materials, which are referenced. I am also indebted to the participants of the FIDE programs I have taught and to the many Directors I trained while at SIDC for helping me to appreciate the problems of governance from their point of view.

My ex-colleagues in Iclif gave me great encouragement and feedback as lay readers of the manuscript as it progressed and I thank them for taking the time to read about a subject that was unfamiliar to them.

If I have forgotten to acknowledge people who have helped me or misrepresented their arguments, the fault is entirely mine.

Kuala Lumpur,
September 2013

Rebuilding Trust in Banks

CHAPTER 1

Leadership: A Force for Change

Effective leaders create change and are able to mobilize their followers to achieve such change. However, the act of leadership is morally neutral, as the changes can be good or bad. This chapter explores the extraordinary career of Napoleon, who achieved more than any single individual in European history, both militarily and administratively, and yet failed in the end. It concludes that there are 11 lessons of good and effective leadership and that Napoleon did not satisfy the criteria of all of them, which is why he ultimately failed.

To be a leader one must have followers.

History is full of leaders with followers prepared to die to achieve what their leaders asked of them or ordered them to do. The greatest leaders changed the world they lived in, both for the better and for the worse. Regardless of the outcome, what they had in common was good timing, a strong sense of purpose, and an exceptional ability to communicate their vision and harness the values of their followers to energize them to action.

I believe truly great leaders are remembered because they were able to create major change, or else lasting change, or both. Perhaps the difference between truly great leaders and great bad leaders lies in their legacy and governance. I argue the great leaders of both history and business were able to build or create change that outlasted them, whereas great bad leaders *manipulated* their followers or employees to achieve selfish and self-centered goals, which did not survive their demise or led to catastrophe for their followers or employees during their lifetimes.

Perhaps the best way to assess leaders as a positive force for change is to see how they have passed certain tests:[1]

- Find the energy to create a better future.
- Have a clear purpose at all times.
- Lead with values.
- Encourage courage to speak truth to power.

- Learn from failure and forgive and move on.
- Recruit co-leaders and share authority and responsibility.
- Move from "I" to "We" thinking and create conditions for maximum collective success.
- Create a legacy that lasts.

The best way to illustrate the difference between these different types of leaders, whom I define as "Great Good" leaders and "Great Bad" leaders, is shown in Table 1.1

History is so full of leaders it is difficult to know which ones to choose. To show that what we regard as great historical leadership per se is in fact morally neutral or value free and that limiting the definition of leadership to good leadership only is problematic,[2] I will look briefly at one leader, Napoleon Bonaparte, as a force for change and let you decide whether he was a great good leader or whether he was, in the words of the Earl of Clarendon writing about another great revolutionary leader, Oliver Cromwell, "A brave badd [sic] man."[3]

It is worth noting that some of the greatest leaders of history may not pass all these tests and many more will fail the legacy test. I refer in particular to tests 3, 4, 6, and 7 below. We may find we cannot agree with their values. They did not encourage people to speak truth to power but shot the messenger instead. We may find the real underlying motive was all about satisfying "I" and had little to do with "We"; or the spirit of the times and the style of command did not allow for maximizing collective success,

TABLE 1.1 Leadership Styles Compared

Great Good Leaders	Great Bad Leaders
1. Find the energy to create a better future.	1. Find the energy to create change, though often not for the better.
2. Have a clear purpose at all times.	2. Have a clear purpose at all times.
3. Lead with values and by example.	3. Lead through fear and force.
4. Encourage people to speak truth to power.	4. Shoot the messenger.
5. Learn from failure.	5. Paranoiacs who punish failure.
6. Recruit co-leaders and share authority and responsibility, while retaining accountability.	6. Centralize control and authority becoming bottlenecks in decision making.
7. Move from "I" to "We" thinking and create maximum conditions for collective success.	7. "Après moi le deluge"; regard themselves as indispensable and manipulate followers.
8. Create a lasting legacy.	8. Fail to create a lasting legacy.

depending on how we define collective success. Many are likely to have been dictators, tyrants, or autocrats and, despite this, they were regarded as great leaders, even if their followers had no choice but to follow them. Great good leaders, however, did not have this problem. Their followers chose willingly to be led by them. Even so, as early as Confucius, rulers were advised to be benevolent and virtuous:

> *He who rules by virtue is like the polestar, which remains unmoving in its mansion while all the others revolve respectfully around it.*[4]

When asked what a ruler should do, Confucius replied:

> *Approach them with dignity and they will be respectful. Be yourself a good son and a kind father and they will be loyal. Raise the good and train the incompetent, and they will be zealous.*[5]

Lao Tsu, a Chinese contemporary of Confucius, recognizing there were bad leaders as well as good and great ones, had this to say about leadership:

> *A leader is best when people barely know he exists, not so good when people obey and acclaim him, worst when they despise him. But of a good leader, who talks little, when his work is done, his aim fulfilled, they will say, "We did this ourselves."*[6]

As Barbara Kellerman points out in her book, *Bad Leadership: What It Is, How It Happens, Why It Matters,* this assumption leadership is a form of behavior that gives followers the choice whether to be led or not, is a new idea. It dates back to the work of James McGregor Burns in 1978 when he introduced the concept of transformational leadership[7] and Warren Bennis in 1989 when he introduced the concept of authentic leadership.[8] Both defined leadership as an exercise of power over others based on mutual advantage: "that leaders engage others by creating shared meaning, speaking in a distinctive voice, demonstrating the capacity to adapt and having integrity."[9] Leaders who coerced their followers or, worse still, obliterated them, were not leaders; they were defined as "power wielders" by Burns. "Power wielders may treat people as things; leaders may not."[10]

Yet historians and political scientists throughout history before this reframing of leadership by Burns and Bennis knew about the dark side of leadership and studied it extensively and neutrally;[11] nobody more so than Machiavelli in his book *The Prince*. He accepted the idea of coercive leadership, because in his mind, the only leader who is bad is a weak leader who

cannot make things happen. So much so, that Machiavelli gives advice on how best to coerce followers:

> *Cruelties can be called well used (if it is permissible to speak well of evil) that are done at a stroke, out of the necessity to secure oneself and then are not persisted in but are turned to as much utility for the subjects as one can. Those cruelties are badly used which, though few in the beginning, rather grow with time.*[12]

This brings me to a fundamental issue in the discussion about leadership and its corollary, followership: why leaders lead and followers follow. At its most basic, the answer to this question is self-interest. Leaders and followers engage in a compact designed to protect all against the anxieties caused by disorder and death. In the end, it is this that unites the thinking of Hobbes,[13]Locke,[14] and Rousseau.[15] What differentiates their positions is the emphasis they place on the obligations they believe leaders must take on if they are to maintain legitimacy in the eyes of their followers.

There are many reasons why followers put up with bad leaders.

At the individual level, bad leaders may satisfy a need for certainty, simplicity, and security. From childhood, we have been acculturated into followership—doing what our parents or elders tell us to. "Getting along by going along" is an important social lesson we all learn when we are young. We follow because the cost of not following is often too high. Resistance can create confusion and uncertainty, the very states most of us want to avoid, so resistance is doubly hard. We need leaders to make sense of the world, because as Nassim Taleb and Daniel Kahneman have pointed out, we do not accept the world is random.[16] We need plausible causal explanations, however improbable they might be. It is the way our brains are hardwired to work.[17] Leaders provide the answer to such needs. Finally, in an increasingly uncertain world, leaders are assumed to know what they are doing, even if their followers do not.[18] The angst we experience when we do not understand what is happening makes us all the more likely to turn to a person who gives the appearance of being strong and certain.[19]

At the group level, decision making becomes even more complex. It is relatively easy for 10 people to reach a consensual decision. It is impossible for 10,000, let alone 10 million. That is why we need hierarchies with leaders at the very top of the pyramid who come to represent the whole. Such leaders have to do a great deal of demanding work—engaging stakeholders while understanding different perspectives and time horizons.[20] The outcome of such work is highly uncertain and ambiguous. Most people do not want to have to deal with such ambiguity or with the anxiety caused by the fear of failure. Such people defer to those who have no such qualms, and

they may turn out to be good or bad leaders. This tendency creates what Robert Michels termed the "Iron Law of Oligarchy," which postulates that we naturally divide ourselves into leaders and led.[21] This division of labor or specialization means that leaders get better at tolerating ambiguity and followers demand ever greater certainty, certainty that only the leader can provide.

Even so, bad leaders make a compact with their followers, who in turn mold the behavior of their leaders by allowing them to behave in increasingly arbitrary and autocratic ways over time. To understand this dynamic better, we must divide followers into three groups, as Barbara Kellerman has done. Each group is quite rational in the way it accommodates evil leadership.[22]

First, there is the silent majority, the bystanders. They go along with what is being done because it is too much effort or too risky personally to stand up and be counted, but they do not believe in what is being proposed. They neither take part in nor stop what is being done.

Second come the doers of evil—the people who follow orders because that is what they are supposed to do and take part as efficiently and effectively as they can because they are being measured and rewarded accordingly.

Third, there are the acolytes, the true believers who get behind the leadership—either because they genuinely believe it is the right thing to do, or because they will get so much personal benefit from being seen to be enthusiastically aligned.

In general terms, the issues of leadership are more or less the same whether I look at leadership through the historian's, politician's, or businessman's lens. However, there is one area where the tools business leaders have to affect their followers differ from the tool used by politicians and military leaders. It is the ability to coerce. This is where the leadership challenge in business differs from that of political history, making it even more difficult, because business leaders cannot apply brute force to recalcitrant followers and commercial rivals, whereas political leaders can and do.

What is more, business leaders must embrace change in a way that political leaders may not have to. Business is a continuous process of "creative destruction"[23] because customers demand ever better products and competition springs up to provide them with what they want. Businesses that fail to adapt to the relentless twin needs—to innovate and to compete—will ultimately either be taken over or fail. In short, companies should not in fact assume "business as usual," nor can they revert to rose-tinted past ways of doing business.

Political leaders, on the other hand, often refer to a glorious past when things were better. They also promote the value of order and stability in the name of predictability. They rarely innovate off their own bat because they

are not faced by the twin pressures of changing customer demands and competitive offers to satisfy those demands. Sometimes, on rare occasions, they are faced with sea changes in the political landscape when citizens decide they have had enough of the prevailing form of government: The American, French, and Russian revolutions are good examples, as was the process of decolonization after World War II and perhaps the Arab Spring of 2011.

The need for governments to rethink their "business model" rarely happens, unless they are defeated in war or overthrown in a revolution. Yet business leaders need to reexamine the validity of their business model at least once a year and in some fast-moving industries more often than that.

This is why I deliberately exclude all those great leaders in history who represented the forces of reaction, of conservatism, because their fundamental proposition was either defensive when faced by an existential threat (e.g., Churchill facing Hitler, Elizabeth I defending Protestant England against Philip II's Catholic Spain) or reinstating or defending the status quo (e.g., Tokugawa Ieyasu and the Shoguns who followed him until Japan's Meiji Restoration, or General Charles de Gaulle trying to regain a glorious position in world affairs for France after World War II).

I also exclude religious leaders, however great a force for change they might be, because they are in the business of salvation—a deeply personal matter that defines individual identity. And even if business leaders promote personal and business codes of conduct like Johnson & Johnson's celebrated Credo, they are not in the business of salvation.

From a historical perspective I have chosen[24] to explore briefly the career of Napoleon Bonaparte. I chose him because he was an outsider, a transformational leader who saved the French Revolution, taking France to undreamt of heights of power, whose mere presence on the battlefield was worth 40,000 men[25] according to his nemesis, the Duke of Wellington. And yet he ultimately failed. However, he left behind him an unparalleled legacy, changing the nature of warfare, the political, legal, administrative, and educational systems of France and Continental Europe, as well as the political boundaries of the United States.

In discussing whether leaders are bad or not, I recognize the need to define exactly what is meant by "bad." As Barbara Kellerman points out, there are two quite distinct ways in which leaders can be bad: ineffective and unethical. She goes on to create seven categories that I use to classify leadership into ineffective or unethical bad leadership in Table 1.2.

During the course of the review of both Napoleon's and business leadership as a force for change, I refer back to these ideas in the hope that it will become obvious as a result that we need governance—a system of checks and balances—to overcome the frailties of followers and weaknesses of leaders to keep both on the straight and narrow path that defines good as opposed to effective leadership.

TABLE 1.2 Bad Leadership Types

Ineffective Leadership	Unethical Leadership
1. *Incompetence:* Leaders and followers lack the skill and/or will to sustain effective action.	1. *Callousness:* The leader and some followers are unkind or uncaring, ignoring the needs and wants of most members of the group for which they are responsible.
2. *Rigidity:* Leaders and followers are stiff and unyielding. Although initially competent, they are unable or unwilling to adapt to new ideas and circumstances.	2. *Corruption:* The leader and followers lie, cheat or steal; but above all they put self-interest ahead of public interest and are prepared to cloak their action in self-serving hypocrisy.
3. *Intemperance:* The leader lacks self-control and is abetted by followers who allow self-destructive behavior to continue.	3. *Insularity:* The leader and some followers minimize or disregard the impact of actions of the health and welfare of the "other"—that is, the people outside their organization who are affected by its actions;
	4. *Evil:* The leader and some followers commit atrocities, using pain as an instrument of power, inflicting severe physical and mental harm on people.

Source: Based on Barbara Kellerman, *Bad Leadership: What It Is, How It Happens, Why It Matters* (Boston: Harvard Business School Press, 2004), 40–46.

Obviously these dimensions are not mutually exclusive. Leaders can be both ineffective and unethical and they can combine the seven types of bad leadership to become truly awful, like Kim Jong Il of North Korea, who exhibited all seven dysfunctions.

Let us now look at the case of Napoleon. He was born in the newly acquired Corsica, incorporated into France just in time for him to become the beneficiary of its revolution. He came from a family that experienced hardship as a result of his father dying when he was still young. He chose the army as a career without influential mentors or backers on whose coat-tails he could rise. He endured periods of disgrace in his early career when he was sent away from the centers of political power and came to prominence fighting the Royal Navy at the siege of Toulon in 1793. His mere presence on the battlefield was regarded as being decisive[26] and he saved his France and its ideals from total defeat at the start of his career, though he would later lead it to total military defeat, but not to the defeat of its ideals. He had much wider interests than just war; he was a voracious reader, with insatiable curiosity and a need to learn how things worked.

Napoleon, a Corsican speaking Italian and almost no French, was sent to boarding school in Brienne at the age of nine. There he was taught French, and indoctrinated about the greatness of France and the importance of military service and honor, beliefs that would mark him for life.

His early political readings taught him France needed reform because the power of kings should be constrained. A history of England[27] seems to have influenced his thinking about the nature of kingship, taking him in a radically different direction from the political thinking in continental Europe of 1785, where enlightened despots like Frederick the Great and Catherine the Great were the accepted role models.[28]

The Revolution did not turn out as Napoleon expected; and soon France was not only fighting other European nations who were trying to restore the monarchy, but itself as the south and other parts of France resisted the Terror led by Robespierre. Sickened by the thought of having to kill fellow Frenchmen, Napoleon pleaded to be allowed to fight the enemies of France. His wish was granted with the temporary command of the artillery at Toulon. He formulated a plan to take Toulon from the British fleet supporting British and Spanish troops garrisoned in the fort defending their positions. It succeeded. His commanding officer, Jacques Coquille Dugommier, wrote:

> *I have no words to describe Buonaparte's merit: much technical skill, an equal degree of intelligence and too much gallantry, there you have a poor sketch of this rare officer. . . .*[29]

Napoleon was promoted to brigadier general. His rapid rise and his friendship with Robespierre's brother were to cause him problems when Robespierre was executed and he was falsely accused of spying for the Genoese and placed under house arrest. He was cleared. He was, however, demoted by Aubry, a radical war minister, and had to bide his time until the day he saved the Revolution when asked by Paul Barras, "Will you serve under me? You have three minutes to decide." Napoleon unhesitatingly answered "Yes."

Having saved the Revolution[30] at the age of 26, Napoleon was promoted to full general and assumed command of the Army of the Interior. However, he was to show the world what he was made of when he was given command of the rag-tag Army of Italy:

> *In thirteen months Napoleon had scored a series of victories which outshone all the combined victories in Italy during the past 300 years. With an army of never more than 44,000 Napoleon had defeated forces totalling four times that number: he had won a dozen major battles, he had killed, wounded or taken prisoner 43,000 Austrians, he had captured 170 flags and 1,100 cannon.* [31]

Napoleon achieved this remarkable success by combining six elements that matter in military leadership: discipline; incentives to bravery with recognition of individual and regimental success including commemorating the dead; unity of command allowing him to orchestrate his forces and reassure his troops they would not suffer from divided command; surprise achieved by flanking attacks; speed; and concentration of forces.[32] Finally, as he put it himself in a letter to the Directory: "If I have won successes over forces very much superior to my own . . . it is because, confident that you trusted me, my troops have moved as rapidly as my thoughts."[33]

It has also been argued that four of Napoleon's own personal peculiarities made a difference. He had a rapid metabolism, allowing him to work very fast; he needed little sleep, surviving on half-hour naps; he had an extraordinary feel for the countryside as a result of his upbringing in Corsica, where roads were few, mountains many, and passes critical; and he saw the world through the eyes of a gunner. He used soldiers as if they were artillery, bringing them to bear on a single point and, after taking it, moving them quickly to focus on the next point.[34]

As a battlefield commander, Napoleon was exceptional for a number of reasons. He was always prepared for integrated action[35] and tested himself with different scenarios, always planning for the worst outcome, leaving nothing to chance, recognizing that plans had sell-by dates. He made his troops feel they mattered at both the unit and individual levels and that he entered into a personal contract with them that brought them victories.

Perhaps because he was an artilleryman and was brought up in a family of lawyers, or because of his great skill in mathematics, he realized the importance of detail, accurate firsthand information, and fact-based analysis. Napoleon's ability to see the big picture combined with an almost fanatical emphasis on the little picture and hypothesis testing was exceptional.

His attention to detail meant he rejected executive summaries, asking for the full report instead, with specifics. He even went so far as to read the muster rolls for an hour every day to know exactly where his forces where deployed.[36] Napoleon believed in the importance of good information from all sources,[37] but knew it was important to consider the source carefully.[38] His mathematical skill meant he was always interested in the numbers required to achieve the most effective logistics and deployment of material. He always looked for optimum performance, leading him to abandon conventional thinking about how many men were needed to execute a plan and what the best infantry firing position was. When his experiments demonstrated that the traditional three ranks firing in turn were less effective than two ranks firing at will, he wrote to General Marmont on October 13, 1813: "We believed . . . but experience has shown . . ." and abandoned the practice.[39]

Napoleon held no councils of war because they lead to consensus-based second-best solutions.[40] However, his unwillingness to hold councils of war did not mean that he did not seek other opinions. Quite the reverse; he seems to have understood clearly the dynamics of groupthink—he listened to diverse views in private,[41] he wanted ideas that he could then judge for himself, and was open to ideas regardless of their origin, as was recognized by his archenemy, the Austrian ambassador, Prince von Metternich:

> *Seizing the essential point of subjects, stripping them down of useless accessories, developing his thought and never ceasing to elaborate it till he had made it perfectly clear and conclusive, always finding the fitting word for the thing, or inventing one where the image of language had not created it, Napoleon's conversation was ever full of interest. . . . Yet he did not fail to listen to the remarks and objections which were addressed to him . . . and I have never felt the least difficulty in saying to him what I believed to be the truth, even when it was not likely to please him.*[42]

In the end, what set Napoleon apart from other generals, including Alexander the Great, Hannibal, and Julius Caesar, whom he admired, were the speed,[43] ferocity, and tenacity with which he attacked. Everything was mobile, even artillery,[44] which he kept on the move to support his infantry. The enemy was left bewildered,[45] paralyzed by his unorthodox use of speed and concentration of forces to achieve an overwhelming local advantage, which he turned into battlefield victory.[46] He recognized a defending army always has the advantage, and so one of his cardinal principles was to control the ground on which the battle was to be fought,[47] drawing the enemy out from defensive positions and forcing them to attack him on the ground of his choice.[48]

His most radical innovation was that "he changed the face of warfare from the sport of kings to the nation at arms, with the whole nation being placed on a war footing, conscription, mass production and truly a nation under arms, the beginning of modern 'Total War.'"[49] Napoleon's conscript armies were the French people at war, fighting for the glory of their country.

Napoleon also deserves to be remembered for his success as a reformer. He rationalized routine government activities, reorganizing France into the 98 administrative departments it still has today, each with its own prefect, with delegated powers from Paris to decide what was best for each prefecture, applying the new civil code, or Code Napoleon,[50] as it became known. The Code Napoleon of 1807 is still the law of France, Belgium, and Luxembourg. It has left its imprint on the civil laws of Germany, Holland, Italy, and Switzerland, as well as carrying its ideas of political equality and the importance of strong families as far afield as Bolivia and Japan.

Napoleon also shaped future countries in Europe: Belgium and Holland were the result of his political administration; he resurrected a dismembered Poland by creating the Grand Duchy of Warsaw; he provided the administrative basis for the Italians[51] and Germans to think of themselves as nations rather than petty principalities. In order to put France on a better financial footing and reduce his exposure to attack from the British in the Americas, in 1803, Napoleon sold France's 828,000 square miles of land[52] in North America to Thomas Jefferson for $11.25 million in cash plus $3.7 million in forgiven debts in the Louisiana Purchase. This reconfigured the United States helping it become the leading power in the world.

He increased taxes, but on a rational and fair basis, and subsidized education, revolutionizing France's secondary education system with the introduction of the lycée[53] and the baccalaureat exams.

Centralization and unity were key strands in Napoleon's thinking. The Revolution stressed the importance of centralization, abolished unions, and introduced standardized weights and measures, which suited Napoleon as a benevolent dictator. What is intriguing is the importance he attached to unity. His justification for creating a single Legion d'Honneur rewarding both military and civilian excellence was that doing otherwise would split France into two camps.[54]

This need to preserve the unity of the French nation led Napoleon to grant an armistice to all Royalists, inviting them to return as Frenchmen to serve their country, and some 40,000 took up the offer. More important still was his decision to come to terms with the Pope by means of the Concordat of 1804.

What was left of the French church had been split in two by the Revolution: those priests who swore loyalty to the Revolution and the majority who still remained loyal to the Pope. It was theoretically possible to have two churches side by side; except it went against the idea of centralization and the indivisibility of the nation.

To put an end to this division and to avoid a war of religion across Europe, Napoleon agreed to a deal giving the Pope new power to depose bishops. In return, Napoleon had a clean sweep of bishops. The number of bishops was reduced to 60; they would be appointed by Napoleon, and the Pope would invest them. The State would pay the salaries of bishops and priests and place at their disposal all the unnationalized churches. Under pressure from the Council of State, which regarded the new deal as insufficiently Gallican,[55] 70 "organic articles" were added to the Concordat, including one asserting that the Pope must abide by the decisions of an ecumenical council. In April 1802, Napoleon reopened the churches of France—the most popular act of his rule.[56]

Napoleon used the opportunity to improve the quality of the priesthood and then left the church alone to act as it saw fit. The Concordat remained

in force until 1905 and was the model for 30 similar treaties between the Vatican and foreign governments. As the Pope himself said, "The Concordat was a healing act, Christian and heroic."

Upon achieving a balanced budget for the first time since 1738 through his stiff but egalitarian tax system and thriftiness in government, supported by the establishment of the Bank of France in 1800,[57] Napoleon set about building three great canals,[58] three great ports,[59] and three great roads across the Alps.[60] Within France Napoleon spent 277 million Francs between 1804 and 1813 on roads, lined with trees to protect their users from the sun, changing the look of France forever. He was the first to pave a road in Paris and established its first professional fire brigade. He founded the Bourse (stock exchange), and the Administration des Eaux et Forets to protect the rivers and woods.

Despite the wars, France enjoyed a prosperity she had not known for 130 years: People who were eating meat once a week in 1799 were eating it three times a week in 1805. When times were difficult, as in the winter of 1806–1807, Napoleon personally spent money from his privy purse to keep the silk industry in Lyon going and bought cloth from Rouen; and in 1811 he secretly advanced enough money to the weavers of Amiens to pay their workers.[61] Napoleon never forgot that he had an economic contract with the people of France, and if he failed to deliver, he would be overthrown:

> *I fear insurrection caused by a shortage of bread – more than a battle against 200,000 men.*[62]

As a reformer, Napoleon looked into every area of policy. Initially his republican instincts guided him, though by 1804 after a number of assassination attempts he changed, making himself Emperor of the French, and putting his brothers into positions of power in Italy, Spain, and Holland in an attempt to create a dynasty to replace the exiled Bourbons.

He justified this on three counts:

1. There had been attempts on his life, and so he needed to create a succession mechanism to protect the gains of the Revolution.
2. The monarchs of Europe were unwilling to accept him, and so he needed to build alliances through marriage where possible—hence his marriage to Marie Louise of Austria.
3. Last, his ex-post justification after he was exiled for the second and last time to St. Helena:

> *In establishing a hereditary nobility Napoleon had three aims, (1) to reconcile France with Europe, (2) to reconcile the old France with the new, (3) to wipe out in Europe the remnants of feudalism by associating the idea of nobility with that of public service and disassociating it from any feudal concept.*[63]

It is hard to know whether this is ex-post special pleading. At the start of his career Napoleon had real republican instincts. After the Italian campaign, Napoleon recommended the duchy of Milan and Lombardy should be allowed to become the Cisalpine Republic, modeled on the revised, more moderate French constitution. To help their cause, Napoleon had raised a Lombard regiment that fought with distinction against Austria—the red, white, and green flag he gave them would later become the Italian national flag. The Cisalpine Republic was so appealing that territories that had been part of the Papal States asked to join, as did the Genoese. Napoleon counseled moderation to include the aristocrats who had led Genoa for centuries in his negotiations with the Genoese—supporting his claim that he was interested in reconciling the old and new worlds. He was a supporter of the Swiss Republic and the Batavian Republic. The fact that he created the Legion d'Honneur to combine the idea of nobility with the idea of service gives credence to his third claim.

Clearly, however, he failed in his first aim. The English were implacably opposed to having France as the most powerful nation in Europe—maintaining the balance of power in Europe had been an English policy since 1558. The Austrian monarchy found it hard to forgive the fact the Revolution had caused the death of Marie Antoinette, a family member. Napoleon's attempts to blockade England drove the Russians into the arms of the English, the paymasters of the six coalitions that fought against him. Moreover, the execution in 1804 of the Duc D'Enghien, falsely implicated in the failed assassination attempt in 1803 by Talleyrand, was seen by many in Europe as judicial murder.

Becoming Emperor, even though it was at the request of the French people, was the last straw, alienating many of his previous supporters across Europe, including Beethoven, who changed his dedication to his great third symphony, the *Eroica,* "To the memory of a great man." Perhaps his most serious error was to gamble desperately in 1814 rather than to accept the generous terms initially offered to him by Tsar Alexander II, who remained an admirer of Napoleon to the end. As a result, he faced a revolt by his marshals and was forced to abdicate.

NAPOLEON—LEADERSHIP LESSONS

Earlier I quoted Barbara Kellerman's seven traits of bad leadership and I compared great good and great bad leadership, using eight criteria. I now use these to see how Napoleon fares, shown in Table 1.3.

How Napoleon fares when using the eight tests of great good leadership discussed earlier is shown in Table 1.4.

TABLE 1.3 Napoleon Evaluated against Seven Tests of Bad Leadership

Ineffective Leadership	Napoleon's Leadership
1. ***Incompetence:*** Leaders and followers lack the skill and/or will to sustain effective action.	Napoleon was extraordinarily competent, with a grasp of the big picture and an eye for detail for both the battlefield and people.
2. ***Rigidity:*** Leaders and followers are stiff and unyielding. Although initially competent, they are unable or unwilling to adapt to new ideas and circumstances.	Napoleon innovated both on the battlefield and in developing new administrative solutions; he was willing to listen to all and surrounded himself with leading intellectuals. Most important of all, in agreeing the Concordat with the Pope, he demonstrated a willingness to compromise that saved France and Europe from yet another religious war.
3. ***Intemperance:*** The leader lacks self-control and is abetted by followers who allow self-destructive behavior to continue.	Napoleon does not appear to have lacked self-control; his apparent garrulousness was a carefully practiced art to put informants at ease. His thriftiness was extreme and he was regarded as personally incorruptible.
Unethical Leadership	
1. ***Callousness:*** The leader and some followers are unkind or uncaring, ignoring the needs and wants of most members of the group for which they are responsible.	Although Napoleon was extremely concerned that individual soldiers be recognized and ensured they were properly fed, he does not seem to have worried at all at the number of casualties his campaigns created. However, he was acutely conscious of the need to improve the living standards of the French people and did everything possible to help in times of trouble.
2. ***Corruption:*** The leader and followers lie, cheat, or steal; above all, they put self-interest ahead of public interest and are prepared to cloak their action in self-serving hypocrisy.	Even though Napoleon changed the rules and made himself Emperor of the French, he did not profit personally from his exalted position. Nobody ever accused him of corruption.
3. ***Insularity:*** The leader and some followers minimize or disregard the impact of actions regarding the health and welfare of the "other"—that is, the people who are outside their organization but are affected by its actions;	Napoleon had a global mind-set, though he does not seem to have understood that the English would never make peace with him for both personal reasons and reasons of realpolitik—dismissing them as a "nation of shopkeepers" was to underestimate their staying power.

Unethical Leadership	
4. ***Evil:*** The leader and some followers commit atrocities, using pain as an instrument of power, inflicting severe physical and mental harm on people.	Napoleon's violence and use of terror was carefully calibrated to meet the circumstances in which he found himself (thus passing Machiavelli's test). On several key occasions, he showed great leniency toward his enemies and pardoned two who had betrayed him, following in the footsteps of Roman emperor Augustus, whom he admired.

TABLE 1.4 Napoleon Evaluated against Eight Tests of Great Good Leadership:

Eight Tests of Great Good Leadership	Napoleon's Performance
1. Find the energy to create a better future.	From the outset, Napoleon wanted to change France for the better. This desire stemmed from the way the officials of the Ancien Regime treated his widowed mother with disdain. He believed the monarchy should be made accountable to the people and regarded himself as having an economic and social contract with the people of France. "All my life I have sacrificed everything, tranquility, interest, happiness, to my destiny."[64]
2. Have a clear purpose at all times.	Napoleon put the unity and greatness of France above everything else: "I am destined to change the face of the world; at any rate this is my belief."[65]
3. Lead with values and by example.	Napoleon had moderate habits and made moderation a cardinal principle of his politics.[66] Napoleon believed in cleanliness and clean government—nobody ever approached him to bribe him. He believed in the love of honor and the love of the France. He was a workaholic,[67] meticulous in his attention to detail, and was an attentive listener, open to the ideas of others. As a soldier, he lived with his troops, sharing their conditions.[68] There were, however, two exceptions to his belief in basic equality: He did not believe in the rights of women and he reintroduced slavery into Haiti, provoking a rebellion that he was unable to put down.
4. Know how to manage grief and learn from failure.	There are three areas where it seems Napoleon did not learn from failure: (1) failing to recognize that England was not going to make peace with him and should be taken more seriously; (2) allowing the war in the Iberian Peninsula to continue unabated, leaving him to wage war on two fronts;

TABLE 1.4 *(Continued)*

Eight Tests of Great Good Leadership	Napoleon's Performance
	and (3) not coming to terms with Tsar Alexander when he still had the chance in 1814. He did, however, learn from his failure in Haiti that France could not defend its interests in the Western Hemisphere and sold Louisiana to Jefferson as a result.
5. Forgive and move on.	Napoleon offered generous terms to the Austrians and Italians at the end of the Italian campaign. He forgave two of his most serious enemies. His willingness to settle with the Pope shows an ability to move on when necessary. His sale of Louisiana shows that he sometimes understood the need to cut his losses while he was ahead.
6. Recruit co-leaders and share authority and responsibility, while retaining accountability.	Napoleon was a firm believer in meritocracy in administration and in military matters. He was willing to consult extensively in diplomatic and administrative matters, overseeing dramatic improvements. In military matters, he was not willing to share authority, arguing that it was his job and his alone to ensure the war was prosecuted effectively. Napoleon honed the corps system of army groups so they could function completely independently with their own logistics, scouts, command, and artillery.
7. Move from "I" to "We" thinking and create maximum conditions for collective success.	He wanted to make his generals so successful they would never dishonor their profession.[69] However, his marshals do not seem to have been capable of truly independent thought, still requiring his coordination and vision—leading to defeat in Spain and finally at Waterloo.[70] Initially Napoleon's republican instincts supported collective success. However, once he became Emperor, he gradually became more preoccupied with his personal status and position at the expense of France, ultimately leading to the defection in 1814 of his marshals, who forced him to abdicate.[71]
8. Leave a lasting legacy.	Napoleon changed the nature of war, introducing "Total War." He replaced a corrupt rent-seeking Ancien Regime with a meritocratic system in the military, the church, and the civil service. He created a civil code that was to become the law of France, Belgium, and Holland and influential in Germany and Italy and as far away as Japan and Bolivia.

He put French finances back on a sound footing. He invested in upgrading France's national infrastructure, changing the look of France and incidentally changing how people traveled, from the left to the right side of the road in the countries he conquered.

He decentralized government through the creation of semi-autonomous prefects who "ruled" their departments and unified the educational system by introducing professionally qualified teachers of a centralized curriculum taught across France in lycées, culminating in the Baccalaureat exam.

Finally he laid the administrative and political infrastructure for the creation of Belgium, Netherlands, Poland, Germany, and Italy, as well as the modern United States through the Louisiana Purchase.

CONCLUSION

There are 11 tests of great good leadership. Napoleon did not pass all of them, which is why he ultimately failed. However, he did so well on the tests that he did pass that it is not surprising that Napoleon is regarded as one of the greatest and most effective leaders of all time—the only man in history to have had wars named after him—leaving behind an unparalleled legacy. Whether he qualifies as a great good leader or as a great bad man, I leave to you to decide, based on the evidence in this chapter. What I do believe is that there are important lessons for bank leaders to learn from his experience if they are to rebuild trust in their organizations.

NOTES

1. I am indebted to my colleague Rajeev Peshawaria for the first seven tests, which come from his book, *Too Many Bosses, Too Few Leaders* (New York: Free Press, 2011). They were summarized in an article on August 22, 2011 by Jason Moser in *Motley Fool* entitled "Lessons for Leaders."
2. Redefining leadership as being good leadership creates three major problems:
    1. It is confusing because for most people the word *leader* refers to "any individual who uses power, authority and influence to get others to go along. When we talk of evil political leaders like Hitler, Stalin, and Mao, we still call them 'leaders' and not 'power wielders.'"
    2. It is misleading since "leadership can be considered the exercise of influence, or a power relation, or an instrument of goal achievement, or a differentiated role. The point is that each of these definitions is value-free. It makes

no sense therefore to distinguish between leaders and power-wielders. In fact, to compare them is not to compare apples and oranges, but apples and apples."

3. It does a disservice since we need to learn about good leadership by studying both what makes good leaders and what makes bad leaders so that we can avoid their mistakes.

Barbara Kellerman, *Bad Leadership: What It Is, How It Happens, Why It Matters* (Boston: Harvard Business School Press, 2004), 13.

3. "In a word, as he was guilty of many crimes against which Damnation is denounced, and for which hell-fire is prepared, so he had some good qualities which have caused the memory of some men in all Ages to be celebrated; and he will be look'd upon by posterity as a brave badd man." Edward Hyde, Earl of Clarendon, in *History of the Rebellion*, Macray, W. D., ed. (1888), III, vii, 84, cited in *The Dictionary of Biographical Quotations*.
4. Confucius, *Analects of Confucius* (New York: Norton, 1997), 6.
5. Ibid., 8.
6. www.brainyquote.com/quotes/authors/l/**lao_tzu**.html, accessed on 18 July 2013.
7. James McGregor Burns, *Leadership* (New York: HarperCollins, 1978).
8. Warren Bennis, *On Becoming a Leader* (New York: Basic Books, 1989).
9. Kellerman, *Bad Leadership*, 9.
10. Ibid., 8.
11. "Historically, political theorists have been far more interested in the question of how to control the proclivities of bad leaders than in the question of how to promote the virtues of good ones. Influenced by religious traditions that focused on good and evil, and often personally scarred by war and disorder, the best political thinkers have had a rather jaundiced view of human nature." Kellerman, *Bad Leadership*, 5.
12. Niccolo Machiavelli, *The Prince* (Chicago: University of Chicago Press, 1998), 37, 38.
13. Thomas Hobbes, *Leviathan* (1651).
14. John Locke, *Second Treatise on Civil Government* (1690).
15. Jean-Jacques Rousseau, *The Social Contract, or Principles of Political Right* (1762).
16. Nicholas N. Taleb, *Fooled by Randomness: The Hidden Role of Chance in the Markets and Life* (New York: W. W. Norton, 2001); Nicholas N. Taleb, *The Black Swan: The Impact of the Highly Improbable* (New York: Random House, 2010).
17. Daniel Kahneman, *Thinking, Fast and Slow* (London: Allen Lane, 2011).
18. Stanley Milgram, *Obedience to Authority: An Experimental View* (New York: Harper & Row, 1974).
19. Jean Lipman-Blumen, "Why Do We Tolerate Bad Leaders—Magnificent Uncertitude, Anxiety and Meaning," in *The Future of Leadership,* Warren Bennis et al., eds. (San Francisco: Jossey-Bass, 2001).
20. Elliot Jacques, "In Praise of Hierarchy," *Harvard Business Review,* January 1990.

21. Robert Michels, *Political Parties* (New York: Free Press, 1962), 66.
22. Kellerman, *Bad Leadership*, 25–27.
23. Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (London: George Allen and Unwin, 1943).
24. I could have chosen many other names, such as the first Chinese emperor Qin Shi Huang, Mao Zedong or Deng Xiao Ping from China; Genghis Khan and Kublai Khan from Mongolia; from England, William the Conqueror, Elizabeth l, Oliver Cromwell, and Winston Churchill; from France, Joan of Arc and Louis XIV; from India, the emperors Asoka and Akbar the Great, and Mahatma Gandhi; from Germany, Charlemagne, Charles the Fifth, Frederick the Great, and Adolf Hitler; from Rome, Julius Caesar and the emperors Augustus, Hadrian, Trajan, and Constantine; from Russia, Alexander Nevsky, Ivan the Terrible, Peter the Great, Catherine the Great, and Stalin; from the United States, George Washington, Abraham Lincoln, Franklin Roosevelt, and Martin Luther King; from Vietnam, Ho Chi Minh; from South Africa, Cetewayo and Nelson Mandela; from Turkey, Suleiman the Magnificent and Ataturk; and from Carthage, Hannibal. The fact I did not choose them should not be taken as an adverse comment on their greatness and significance. If you prefer them or others from the huge list of famous people, then I suggest you do a similar exercise of evaluation to the one in this chapter and see for yourself what you discover.
25. Duke of Wellington on Napoleon's death: "I used to say of Napoleon that his presence on the field made the difference of forty thousand men." Elizabeth Knowles, *The Oxford Dictionary of Quotations: Major Edition* (Oxford, England: Oxford University Press, 1999), 809, #19.
26. Ibid.
27. John Barrow, *A New and Impartial History of England from the Invasion of Julius Caesar to the Signing of Preliminaries of Peace, in the Year 1762*.
28. "What was wrong with France, Napoleon decided, was that the power of the King and the King's men had grown excessive; the reform Napoleon wanted—and the point is important in view of his future career—was a constitution which, by setting out the people's rights, would ensure that the King acted in the interest of France as a whole." Vincent Cronin, *Napoleon* (London: Collins, 1979), 48–49.
29. Jacques Coquille Dugommier's dispatch to the minister of War, quoted in Cronin, *Napoleon*, 77.
30. On the 13th Vendemmiare Napoleon had to defend the Tuileries, the seat of government from an expected rebel attack of 30,000 men, while the government only had 5,000 troops and 3,000 militiamen. Guns were to be the deciding factor. Napoleon had eight 8-pounders, which he loaded with grapeshot. Firing accurately into the rebels, Napoleon broke the attack and saved the Revolution. Cronin, *Napoleon*, 85.
31. Cronin, *Napoleon*, 126–127.
32. Cronin, *Napoleon*, 127–128.
33. Cronin, *Napoleon,* 128
34. Cronin, *Napoleon*, 114.

35. *Military Maxim VII*. Accessed February 15, 2013, www.military-info.com/freebies/maximsn.htm.
36. I am indebted to Alan Axelrod for an excellent review of what made Napoleon such an effective leader in his book *Napoleon, CEO* (New York: Sterling, 2011).
37. *Military Maxim LXXVI*. Accessed February 15, 2013, www.military-info.com/freebies/maximsn.htm.
38. *Military Maxim LXIII*. Accessed February 15, 2013, www.military-info.com/freebies/maximsn.htm.
39. "He concluded that, in actual combat, firing at will, rather than in simultaneous mechanical volleys, had become more effective. He also concluded that having the third rank fire over the shoulder of the second rank was hazardous to the second as well as first ranks. It was decided to reduce the firing ranks and to assign the third rank to the task of reloading the weapons of the front two. Napoleon and others "believed" that this would increase the volume of fire, but "experience" soon showed that the second rank fired no more rapidly using this method than it did before, and, furthermore, it fired less accurately. Napoleon therefore decided to do away with the three-rank firing formation altogether." Alan Axelrod, *Napoleon: CEO*, 160.

    At first he (and others) experimented with two ranks, but Napoleon ultimately concluded that the "fire of skirmishers—that is, accurate firing at will against specific targets—is best of all," with the volley fire of a single rank second best, and that of two ranks "still good." He accordingly changed the way large infantry formations fired their shoulder weapons." Alan Axelrod, *Napoleon: CEO*, 161.
40. *Military Maxim LXV*. Accessed February 15, 2013, www.military-info.com/freebies/maximsn.htm.
41. "Never hold a council of war, but listen to the views of each in private." *Letter to Joseph Bonaparte,* January 12, 1806, cited in Axelrod, *Napoleon: CEO*, 110.
42. Prince von Metternich quoted by Felix Markham, *Napoleon* (New York: Penguin Books, 1963), cited in Axelrod, *Napoleon: CEO*, 200.
43. "It is said that the Roman legions marched twenty-four miles a day; our brigades have marched thirty while also fighting." *Letter to the Directory,* January 18, 1797, cited in Axelrod, *Napoleon: CEO*, 188.
44. "Never forget that in war all the artillery must be with the army and not in the park." Letter to General Clarke, January 18, 1814, cited in Axelrod, *Napoleon: CEO*, 84
45. "We no longer understand anything; we are dealing with a young general who is sometimes in front of us, sometimes in our rear, sometimes in our flanks; one never knows how he is going to deploy himself. This kind of warfare is unbearable and violates all customary procedures." *Hungarian officer captured at the Battle of Lodi speaking to Napoleon, whom he did not recognize*. Cited in Axelrod, *Napoleon, CEO*, 145. Also see *Military Maxim XX,* accessed February 15, 2013, www.military info/freebies/maximsn.htm.
46. "There is a moment in every battle at which the least manoeuvre is decisive and gives superiority, as one drop of water causes overflow." Napoleon in St. Helena,

quoted by Felix Markham, *Napoleon* (New York: Penguin Books, 1963), cited by Axelrod, *Napoleon: CEO* 174.

47. *Military Maxim XVI*. Accessed February 15, 2013, www.military-info.com/freebies/maximsn.htm.
48. "If the enemy occupies a strong position you must occupy a position that will force him to attack you." Quoted in Luvaas, J., *Napoleon on the Art of War* (1999), cited in Axelrod, *Napoleon, CEO* 163.
49. "Napoleon Bonaparte (1769–1821)," www.historyofwar.org/articles/people_napoleon.html, accessed January 1, 2012.
50. Under the Code all people were declared equal under the law and special privileges for the nobility and the church were abolished, as were feudal rights. Religious freedom was guaranteed, as was trial by jury (though this was later revoked). Parents were given rights over their children for the first time. More contentiously, wives were not allowed to sell or give away their property and could only own property with their husbands' consent in writing and fathers were allowed to imprison their children for up to one month.
51. He succeeded at Campo Formio in getting the Austrians to recognize his fledgling republics, but had to capture Venice and trade it to the Austrians to get them to agree to give up Milan. These actions laid the foundations for the reunification of Italy in 1871.
52. The land that was bought enclosed all of Arkansas, Missouri, Iowa, Oklahoma, Kansas, and Nebraska as well as parts of Minnesota, North Dakota, South Dakota, New Mexico, Texas, Montana, Wyoming, Colorado, and of course Louisiana. The land purchased also included parts of what is now Alberta and Saskatchewan in Canada. The land purchased in the Louisiana Purchase now makes up about 23 percent of the territory of the United States. www.surfnetkids.com/go/66/ten-facts-about-the-louisiana-purchase/, accessed January 3, 2012.
53. The key was the establishment of 30 *lycées*, which provided educational opportunities beyond the secondary schools and replaced the *écoles centrales*. Every appeal court district was to have a *lycée*, and they were to be completely supported, and controlled, by the state. Scholarships were provided, with about one-third going to sons of the military and government, and the rest for the best pupils from the secondary schools. Howard C. Barnard, *Education and the French Revolution* (Cambridge, England: Cambridge University Press, 1969), cited by www.napoleon-series.org/research/society/c_education.html#19, accessed January 3, 2012. The *lycées* had a six-year term of study, building on the work of the secondary schools. The curriculum included languages, modern literature, science, and all other studies necessary for a "liberal" education. Each *lycée* was to have at least eight teachers, as well as three masters (a headmaster, an academic dean, and a bursar). The government provided a fixed salary for teachers, as well as bonuses for successful teachers who also received a pension. Teachers were chosen by Napoleon from a list of recommendations provided by inspectors and the Institute. The inspectors were given overall responsibility for inspecting the schools on a regular basis.
54. "If we make a distinction between military and civil honours we shall be instituting two orders, whereas the nation is one. If we award honours only to

soldiers, that will be worse, for then the nation will cease to exist." Quoted by Cronin, *Napoleon*, 206.

55. Gallicanism tended to restrain the Pope's authority in favor of that of bishops and the people's representatives in the state, or the monarch. These opinions were restricted to France originating in the *Declaration of the Clergy of France* in 1682. A. Degert, cited by C. G. Herbermann et al., ed., "Gallicanism," Catholic Encyclopedia (New York: Robert Appleton Company, 1913).
56. Cronin, *Napoleon*, 216–217.
57. Marjorie Bloy, "The Age of George III," www.historyhome.co.uk/c-eight/france/napfra.htm, accessed January 6, 2012.
58. The Saint-Quentin; the canal from Nantes to Brest; and the canal linking the Rhone to the Rhine, allowing him to ship goods from Amsterdam to Marseille and from Lyon to Brest without their being exposed to the guns of the Royal Navy.
59. Cherbourg, Brest, and Antwerp.
60. Napoleon had roads blasted through the Great St. Bernard, the Little St. Bernard and the Col de Tende. They were so well built that it became possible to travel freely between Italy, France, and Switzerland for the first time, even in winter.
61. Cronin, *Napoleon*, 207–208.
62. Quoted in Felix Markham, *Napoleon* (New York: Penguin Books, 1963), cited in Axelrod, *Napoleon, CEO*, 40.
63. Napoleon's third-person memorandum dictated in St. Helena after 1815, cited in Axelrod, *Napoleon, CEO*, 218.
64. Napoleon to Josephine, March 1807, quoted in Norman Mackenzie, *The Escape from Elba: The Fall and Flight of Napoleon 1814–1815* (Oxford, England: Oxford University Press, 1982), title page.
65. To Joseph Bonaparte, quoted in Markham, *Napoleon*, cited in Axelrod, *Napoleon, CEO*, 39.
66. "Moderation is the basis of morality and a man's most important virtue . . . without it a faction can exist but never a national government." Quoted in Cronin, *Napoleon*, 190.
67. "When his physician told him he was overworking, Napoleon replied, 'The ox has been harnessed; now it must plough.' . . . By those in his administration, this apparently superhuman effort was applauded, by royalists abroad derided. La Chaise remarked, with a touch of adulation, 'God made Bonaparte, and then rested.' To which the émigré Comte de Narbonne retorted: 'God should have rested a little earlier.'" Cronin, *Napoleon*, 194.
68. General Doppet reporting on Napoleon at the 1793 Battle of Toulon, quoted by Robert Asprey, *Rise of Napoleon Bonaparte* (New York: Basic Books, 2001), cited in Axelrod, *Napoleon, CEO*, 180, and letter to Joseph Bonaparte, June 26, 1806, quoted in Axelrod, *Napoleon, CEO*, 154.
69. Letter to Joseph Bonaparte, 1808, quoted by Markham, *Napoleon*, cited in Axelrod, *Napoleon, CEO*, 202.
70. "Napoleon Bonaparte (1769–1821), www.historyofwar.org/articles/people_napoleon.html, visited January 1, 2012.

71. "The need for rest was so universally felt through every class of society, and in the army, that peace at any price had become the ruling passion of the day; and the whole force of this sentiment was levelled at Emperor Napoleon, whom they accused of having rejected peace, of not honestly desiring it even now. As such feelings spread Napoleon's power inevitably crumbled. The men who had been driven so long by his restless will, and bewitched by his sense of destiny, were coming to the last breaking-point, and he could no longer depend on any of them to act for him or to share his magical dreams as they faded in the harsh light of defeat. The most his closest comrades-in-arms could now do for him was to strike the best possible bargain for his life and liberty." N. Mackenzie, *The Escape from Elba: The Fall and Flight of Napoleon 1814–1815* (Oxford, England: Oxford University Press, 1982), 13.

CHAPTER 2

Leadership: From Success to Failure

This chapter explores the phenomenon of "imperial CEOs" as leaders of banks. It looks briefly at the cases of the CEOs of Merrill Lynch, Bear Stearns, Lehman Brothers, and Royal Bank of Scotland to see whether there are any general lessons that can be drawn from their experiences—in particular from how they ultimately failed the 11 tests of good and effective leadership.

In considering why, at times, successful bank CEOs ultimately fail disastrously, I use the tests of leadership and lessons learned from the experience of Napoleon. He was a great success initially, saving France and the Revolution from defeat, then leading it and himself to unrivaled greatness, only to go on to defeat and disaster in Russia. In a sense, his career is not that different from those of the four CEOs reviewed in this chapter. They are Stan O'Neal, formerly CEO of Merrill Lynch; Jimmy Cayne of Bear Stearns; Dick Fuld of Lehman Brothers in the United States; and Fred Goodwin of Royal Bank of Scotland (RBS) in the United Kingdom. Like him, they were outsiders, transformational leaders who changed their organizations, achieved great heights, and ultimately failed. However, unlike Napoleon, they left no legacies behind.

In the early years of the millennium, four American bank CEOs encouraged their companies to take on enormous amounts of short-term debt to invest in mortgage-backed securities. As a result, for a brief time, they became the biggest and most profitable banks in Wall Street. Individually, they made huge amounts of money—in the case of Jimmy Cayne of Bear Stearns and Dick Fuld of Lehman Brothers, because they were such large holders of their company stock. Jimmy Cayne and Dick Fuld borrowed so heavily and bought such inappropriate assets for their institutions that when the inevitable downturn in the property market occurred, their companies collapsed. Bear Stearns was absorbed by JP Morgan Chase and Lehman Brothers went bankrupt. The leaders appear to have chosen

to ignore the warning signs and doubled down on their bets, making collapse inevitable. The other two American CEOs, Stan O'Neal of Merrill Lynch and Chuck Prince of Citi, were late into the market and wanted to prove that they could beat the competition by playing what turned out to be a risky game of catch-up. As a result, they took their firms into the mortgage business, just as it was beginning to go bad:

> *In a few years, Citigroup and Merrill became the largest issuers of the riskiest mortgage securities, surpassing earlier leaders including Bear and Lehman, reaping huge fees in the process, making stars of their CEOs, who were all the while oblivious to the high risks they were taking. Together they ultimately lost as much as $100 billion in mortgage securities, perhaps more.*[1]

As anybody who has read *The Big Short,*[2] *The Age of Greed,*[3] *Bull by the Horns*,[4] or *Too Big to Fail*[5] or watched CNBC's program *House of Cards*[6] will know, the collapse of the subprime mortgage market had been foreseen by those who understood what was really happening to the U.S. property market. The signs had been in the wind since as early as 2004. So it is somewhat surprising that these four CEOs appear to have taken no notice of the omens. Or perhaps rather than ignoring them, maybe they felt, as Dick Fuld of Lehman Brothers felt, that their firms would survive any downturn.[7]

The case of Fred Goodwin of RBS in the United Kingdom is slightly different in that it was only partly related to problems in the United States, but mainly due to following a growth strategy that turned out to be inappropriate. The final straw was the disastrous acquisition of ABN-Amro, which brought RBS to its knees—an acquisition which, in the words of RBS's current chairman, was:

> *With the benefit of hindsight, . . . the wrong price, the wrong way to pay, at the wrong time and the wrong deal.*[8]

However, Goodwin's behavior shared characteristics that were to be found in that of O'Neal, Cayne, and Fuld.

When trying to understand why these highly capable men failed, two things stand out:

1. The first thing that is clear is that none of the four CEOs followed Alfred's Sloan's policy of ensuring they had strong Boards and actively seeking dissent in the Board in order to make better decisions:

> *If we are all in agreement on the decision—then I propose we postpone further discussion of this matter until our next meeting to*

give ourselves time to develop disagreement and perhaps gain some understanding of what the decision is all about.[9]

2. The second is that these four CEOs failed to pass the eight tests of good leadership, even though they may have passed the tests of bad but effective leadership outlined in Chapter 1, shown in Table 2.1.

In the following discussion, I mention briefly the problems created by O'Neal's leadership style because it demonstrates a characteristic that seems to apply to most initially effective, but ultimately bad, leaders. I will then

TABLE 2.1 Tests of Good and Bad Leadership

Tests of Good Leaders	Tests of Bad Leaders
Great good leaders:	Bad but effective leaders:
1. Find the energy to create a better future.	1. Find the energy to create change, though often not for the better.
2. Have a clear purpose at all times.	2. Have a clear purpose at all times.
3. Lead with values.	3. Lead through fear and force.
4. Welcome the courage to speak truth to power.	4. Shoot the messenger.
5. Learn from failure.	5. Are paranoiacs who punish failure.
6. Recruit co-leaders and share authority and responsibility.	6. Centralize control and authority becoming bottlenecks in decision making.
7. Move from "I" to "We" thinking and create conditions for maximum collective success.	7. "Après moi le deluge"; regard themselves as indispensable and manipulate followers.
8. Create a lasting legacy.	8. Fail to create a lasting legacy.
Effective leaders demonstrate:	Bad and ineffective leaders demonstrate:
1. Competence: Leaders have the appropriate skill and will to sustain effective action.	1. Incompetence: Leaders and followers lack the skill and/or will to sustain effective action.
2. Flexibility: Leaders and followers can see that changed circumstances require new strategies and solutions, and that strategies have sell-by dates.	2. Rigidity: Leaders and followers are stiff and unyielding. Although initially competent, they are unable or unwilling to adapt to new ideas and circumstances.
3. Calmness: The leader remains calm and collected and encourages subordinates to pause and reflect before acting, even under stress.	3. Intemperance: The leader lacks self-control and is abetted by followers who allow self-destructive behavior to continue.

look in more detail at Cayne, Fuld, and Goodwin. I will not comment on Chuck Prince's leadership style, because there are few lessons to be drawn from it. He had been promoted to CEO because of his loyalty to Sandy Weill[10] and it has been argued he was being steered by Robert Rubin to take on more risk[11] when that was the wrong thing to do.

STAN O'NEAL

O'Neal had a remarkable career by any standards, and it was all the more remarkable as he was one of the first African-American CEOs in the United States and the first of a storied Wall Street institution. Obviously a talented man, he was ultimately to prove an embarrassment to Merrill Lynch for the following reasons: intolerance of dissent; choosing the wrong strategy; secretiveness; and an inappropriate reaction to the crisis when it began to unfold.

O'Neal succeeded in concentrating more power into his hands than was normal: He was chairman, CEO, and president for the nearly six years he was at Merrill. He also demanded and got such a high degree of loyalty from his key management team that they were nicknamed "The Taliban" and he was called "Mullah Omar."[12] In addition, he had personally handpicked eight of the ten independent Directors on Merrill's Board.[13] Maybe, he was not looking for divergent perspectives or different points of view to help him "to develop disagreement and perhaps gain some understanding of what the decision is all about," in the words of Alfred Sloan.

If he had any reason to distrust people, he would force them out of the company, saying, "Ruthless isn't always that bad."[14] He set about overhauling the company, targeting the performance of Goldman Sachs, by redirecting the firm into riskier and more lucrative lines of business. He also began the practice of proprietary trading, so that in 2006 Merrill made $7.5 billion from trading its own money and that of its clients, compared with only $2.6 billion in 2002. However, he also ramped up the use of leverage and entered the mortgage backed securities market with a vengeance. In 2003, Merrill hardly counted in the collateralized debt obligation (CDO) market; by 2005, it was the largest issuer of CDOs. Even this was not enough. He began buying mortgage servicers and commercial real estate firms, and finally First Franklin, one of the leading subprime mortgage lenders, for $1.3 billion, moving Merrill Lynch out of its traditional areas of expertise and into the systemically flawed subprime market.[15]

In 2006, the market began to change for the worse and the risks being taken on were causing concern to the most able risk manager in

Merrill, Jeffrey Kronthal. Kronthal advised caution, insisting on a $3 billion ceiling on CDOs with subprime tranches in them. This sensible risk management policy constrained O'Neal's ambition to be the leading mortgage lender. In July 2006, at a time when house prices were falling and delinquencies rising, O'Neal replaced Kronthal with a young derivatives trader from the London office with no experience of the U.S. mortgage market. To make matters worse, in 2006, Merrill created $44 billion in CDOs—three times as much as in 2005.

Voices of doubt were stilled by O'Neal's intolerance of dissent and perhaps by the fact that huge bonuses were triggered by the $700 million in fees generated by the creation and trading of CDOs, regardless of whether they had all been sold. O'Neal received $46 million in bonus that year (the young, inexperienced derivatives trader was to take home more than $20 million in bonus).

> *For a while this seemed to work. In a triumphal letter to shareholders in the annual report issued in February 2007, titled "The Real Measure of Success" O'Neal proclaimed 2006 "the most successful year in [the company's] history—financially, operationally and strategically," while pointing out that "a lot of this comes down to leadership." The cocky message ended on a note of pure hubris: "W[e] can and will continue to grow our business, lead this incredible force for global capitalism and validate the tremendous confidence that you, our shareholders have placed in this organization and each of us."*[16]

In 2007, Merrill continued to expand its CDO book with more than $30 billion underwritten in the first seven months—but without proper attention being paid to its risk profile. Risk management did not have an independent voice. As trouble started to develop, the head of the mortgage division left to set up his own hedge fund and the two managers left in charge of the business advised the Board on July 21 that the exposures were nearly fully hedged and that any resulting loss would only amount to $77 million. Not everybody agreed with this assessment and two weeks later a letter was sent to the Directors advising them of the deteriorating position.

During August and September, the value of the portfolio fell like a stone. At the beginning of October, the firm projected an expected loss of $5 billion, not $77 million. By the end of October, the expected loss was $7.9 billion. The final tally was an $8.4 billion write-down on failed investments, which exceeded the net earnings for the whole of supposedly wonderful 2006 and the largest loss in the company's 93 years of existence.

During this difficult time, when the firm needed a calm hand at the helm, O'Neal's reaction was to withdraw, brood, and lose himself in golf, playing on his own, often on weekdays:

> *During August and September 2007, as Merrill was losing more than $100 million a day, O'Neal managed to play at least twenty rounds of golf and lowered his handicap from 10.2 to 9.1.*[17]

Then he made an unauthorized overture to Wachovia about a merger without telling the Board until he had dinner with them, when he casually mentioned he had talked to Wachovia. This would have resulted in a personal payout of $274 million if he left on completion of the deal. The Board got rid of O'Neal two days later. They allowed him to "retire" with an exit package worth $161.5 million on top of the $70 million he had already received during his time as CEO and chairman.[18]

It is truly sad that a man who had started so well and had apparently set Merrill on a stellar path of success for several years should end up with the following being said of his performance as CEO of Merrill by a former coworker, reported in the *New Yorker,* "I wouldn't hire Stan to wash windows. What he did to Merrill Lynch was absolutely criminal."[19]

Sadder still, it could have been avoided had he welcomed dissent from his subordinates and chosen a competent and engaged Board, for they would have prevented him from careering headlong into financial disaster with a strategy that had gone past its sell-by date with no proper assessment of its attendant risks.

JIMMY CAYNE

What exactly happened in the rise and fall of Cayne appears open to interpretation—his and that of Ace Greenberg, his mentor and former CEO. Cayne's version, which was the basis of much of what was written about the collapse of Bear Stearns, naturally paints a more flattering picture.[20] Greenberg's would seem to be more rational, though perhaps not totally unbiased when dealing with some key events before Cayne's elevation to CEO. In the main, my comments are based on Greenberg's narrative in *The Rise and Fall of Bear Stearns*, where he provides a first-hand description of what happened.

As will become clear, Cayne was very different from Greenberg: He appears to have been extravagant and self-indulgent whereas Greenberg had a relentless focus on reducing costs and containing risks. Greenberg embodied frugality and the old-school values from the time when Bear

Stearns was a partnership. Unlike Cayne, who would disappear early on Thursday afternoons for his weekend, Greenberg was available to all and sundry in the company.[21] Whereas it had been difficult to get Cayne to return for even the Board meeting at which the JPMorgan Chase purchase was finally approved, Greenberg was still working at his desk on the trading floor talking to his customers at the time of the demise of the company, even though he was 80 years old.

Whether Cayne believed all the things he claimed to have done or not, is a moot point. He took credit for saving New York City from extinction, though according to Greenberg he had not in fact been involved in the selling of the notes that mattered.[22] He was certainly successful in persuading Charlie Gasparino of CNBC, writing in *Trader Monthly,* to describe him as having "built Bear Stearns from the ground up brick by brick." Cayne was high-energy, clever, and calculating, both in the good and bad sense of the term; he was a good rainmaker and promoter of Bear Stearns.[23] Many attributed Cayne's rapid rise to the fact he played bridge with Greenberg, a claim Greenberg denies, arguing that he was promoted on merit and that his politicking had not yet become an issue.[24] However, it was soon to become one, when combined with his greed:

> *At first, Jimmy's avidity struck me as a mixed blessing—according to the PSD [poor, smart and a deep desire to become rich] principle I wanted our people to be hungry—but over time it increasingly seemed like an unfortunate character trait. As head of private client services, he pushed the retail reps out of competitive instinct and a clear awareness that their success and the consequent rewards would encourage a personal loyalty to him and enhance his stature. No problem with that, in principle. But in Jimmy's case that hunger for money and status, and the gamesmanship that went with it, indicated an insecurity that was no blessing at all. Jimmy was constantly caucusing and forming alliances. I didn't like it and told him so, but I don't think he could help himself.*[25]

Greenberg then allowed Cayne to run the compensation committee, which he later realized was a mistake, as it allowed Cayne to build personal alliances and increase his influence in the firm:

> *"In giving Jimmy that much authority, especially over compensation—a position guaranteed to help him nurture his personal alliances and broaden his influence throughout the firm—I was feeding the beast (without having gauged the beast's full appetite), but at the time I couldn't have cared less. . . . Jimmy's need for*

power and the swaggering bluster that went with it—along with, as we would discover, his need to have the largest profit share at Bear Stearns, the most lucrative compensation package on Wall Street, the biggest whatever—betrayed an insecurity that I had seriously underestimated, I suppose because I'd never experienced anything like it myself. The possibility that humility could enhance one's strength and authority is something I don't think Jimmy ever pondered.[26]

Once Cayne became chairman, he began to ignore Greenberg's advice and became increasingly disconnected from the business. As long as the stock price was fine, Cayne seemed to think the business was fine:

A maddening correlation existed between our share price and Jimmy's behavior. The higher it went, the more negative the effect upon his attitude and temperament. He became more aloof and full of himself. A Wall Street CEO has to make his presence known among his troops and within the community. It's a given that he must fly the flag on the charitable and business social circuits. Jimmy did very little of this. Maybe once in a while he would agree to be an honoree at a charity dinner, but he made no effort to conceal his impatience with these events. He preferred to be home in his pajamas playing bridge on his computer and actually bragged about that.[27]

Cayne did not "walk the walk and talk the talk." He reserved one elevator for himself, ignoring the problems it created for the rest of employees in the morning rush. Greenberg relates a conversation about this that reflects the egocentricity of the man:

"Want to help your image around here Jimmy? Get rid of that elevator thing. Everybody thinks it stinks."

"It's only from eight to nine in the morning," he said.

"Yeah," I said. "Just when everyone needs to use it."[28]

Even though there was a house rule forbidding smoking before it was made illegal in New York, Cayne used to smoke cigars in his office, and continued to do so after it became illegal, as if he was above the rules of the firm. A small matter, no doubt, but a poor example to set nevertheless. Another example of poor role modeling came when the $10.7 billion Hilton financing deal was being discussed. It is alleged Cayne could not be bothered

to attend the conference call from his golf club, because it conflicted with tee time.[29]

Unlike Greenberg, Cayne did not worry too much about liquidity, proposing to spend $1.5 billion in June 2007 to buy back 10 percent of the Bear Stearns stock, to keep the price up.[30]

Cayne's downfall was made inevitable by an article about him in the *Wall Street Journal* on November 1, 2007,[31] which did credit him with the 600 percent rise in the stock price since he had become CEO. It then highlighted his inattention to the real issues threatening Bear Stearns; discussed the fact that he had left a conference call with analysts in the middle of the call; pointed out that he was more likely to be playing golf or bridge and be unavailable during moments of serious difficulty, drawing deeply unfavorable comparisons with the behavior of Jamie Dimon and Lloyd Blankfein in similar circumstances. Perhaps the killer was the part that detailed his extravagances and wasteful use of chartered helicopters to go off and play golf at the weekend and accused him of smoking marijuana and bragging about the $140 Cuban cigars he kept in his office.

Cayne rebutted the charges in an e-mail to the staff of Bear Stearns, saying "I remain, as I have been for many years, intensely focused on our business," and that it was absolutely untrue that he had behaved inappropriately outside the firm. But the damage had been done.

Perhaps Cayne's greatest failure was his refusal to listen to others when he needed their expertise most, treating them as rivals to be removed:

> *Bear was all about Jimmy, his underlings would say. He fired Warren Spector [the head of fixed income], his most threatening rival, when he needed his expertise most. Many felt Cayne wanted no competition. "I really do believe that ironically one of the things that hurt the firm most was that the stock price did so well," said an executive at the firm. "It emboldened Jimmy to stop listening, and that [listening] was the one thing he was really good at."*[32]

DICK FULD

When the crisis that would engulf Lehman swallowed Bear Stearns, Fuld had grounds for believing in his judgment.[33] He had been given the job of reviving Lehman Brothers when it was spun off by American Express and had become independent with too little capital. He cut the head count dramatically to make it profitable and became the public face of the new bank. He had taken a different position from all the other banks, except for Bear Stearns, when

Long Term Capital Management had nearly taken the market down with it in 1998 and Lehman had survived. He had led the company through the tragedy of 9/11 and the ensuing difficulties when they had had to work out of the Sheraton because they had to abandon their offices. He had bought the new headquarters of Lehman Brothers and it had proved to be a good investment. Even though he understood full well the dangers of leverage, he believed he had enough capital to withstand a run and so had continued to take leveraged bets. As he put it, leverage was like "Paving roads with cheap tar. When the weather changes the potholes will be there deeper and uglier."[34]

What Fuld had not done, however, was do more than tweak the culture of Lehman Brothers. Perhaps because of the 10 difficult years that Glucksman (his former boss and mentor), he, and Gregory (his deputy) had experienced when they were part of a dysfunctional Shearson Lehman, the Lehman culture remained paranoid, combative, and tribal. He became the "outside face" of Lehman, relying on Gregory to be the "inside face" of Lehman. However, Gregory's style seems to have been rather brutal and eccentric as far as hiring and promoting people went, so that when the property bubble burst and hit Lehman, very few people in the crucial commercial real estate business actually had any experience of property.

The appointment of Erin Callan as CFO appears to have been another error, as she had no experience of treasury or accounting—key areas if Lehman was to survive the crisis—even though she did well in her first conference call announcing Lehman's results after the collapse of Bear Stearns. Her appointment proved to be the red flag that David Einhorn, an influential hedge fund manager controlling over $6 billion of assets, was looking for. He was unconvinced that she was fully the master of her brief, especially in the area of marking-to-market properties that were overvalued, given her background as a tax lawyer.[35]

Another error in the gradual unraveling of Lehman's credibility was Fuld's intemperate reaction to the article in the *Wall Street Journal* revealing his plans to link up with Korean sources of capital.[36] As a result of this leak, Fuld decreed that nobody was to speak to the *Wall Street Journal* again; perhaps not the most sensible move at a time when PR strategy could hold the key to controlling the climate of opinion in financial circles.[37]

Fuld was by now caught in the trap of many successful, hard-charging, and charismatic leaders. He appears to have been poorly served by key lieutenants on whom he relied and who were out of their depth, making the wrong calls and appointing unsuitable people, as is shown by this excerpt of a conversation between him and Skip McGee, quoted in *Too Big to Fail*:

> *"You've not been served well by your COO. He's in over his head. He's not minding the store. He's made some horrible personnel decisions, and he's not watching your back on risk."*

> *Reminding McGee that, as a member of the executive committee, he was responsible for making key decisions along with everyone else, Fuld said, "The entire executive committee is the risk committee."*
>
> *McGee, realizing that he was not getting his point across, stated carefully, "You are a wonderful leader, but when the books are written, your Achilles' heel will be that you have a blind spot for weak people who are your sycophants."*[38]

A rather less flattering description of Fuld suggests that, once he became head of an independent Lehman, he invested aggressively in mortgage underwriting in order to catch up with Goldman Sachs and Morgan Stanley, and that he did not pay enough attention to the attendant risks of this strategy. In this narrative, his head of risk, Mike Gelband, warned him to reverse his exposure in mortgages in 2005. He was soon gone. So was Madelyn Antonic, Lehman's risk manager, after she had criticized the aggressive risks taken in mortgages.

> *Those who disagreed were thought disloyal and dissent was stifled. In the face of growing risk, Fuld raised the stakes further and earned a $35 million bonus that year. In 2007, he went on a real estate buying spree, buying buildings in the United States and overseas, even as markets were weakening. He kept issuing CDOs as well. As the markets became nervous, he chose to double down.*[39]

In such circumstances, it is supposed to be the role of the Board to protect the CEO from the forcefulness of his or her personality. After all, the CEO is supposed to be the servant of the Board, though this is made extremely difficult in practice when the CEO is also the chairman who has appointed the Directors. Unfortunately, the Lehman Board was one of the weaker Boards in Wall Street and Fuld may have intended it to be that way, reinforcing the truth of Skip McGee's comment.

In a lawsuit filed by the New Jersey Department of Investment alleging that $118 million in losses to the state pension fund were the result of Board and management misrepresentation, the role of the Lehman Board is described as follows:

> *The supine Board that defendant Fuld handpicked provided no backstop to Lehman's executives' zealous approach to the Company's risk profile, real estate portfolio, and their own compensation. The Director Defendants were considered inattentive,*

elderly, and woefully short on relevant structured finance background. The composition of the Board according to a recent filing in the Lehman bankruptcy allowed "Fuld to marginalize the Directors, who tolerated an absence of checks and balances at Lehman." Due to his long tenure and ubiquity at Lehman, defendant Fuld has been able to consolidate his power to a remarkable degree. Defendant Fuld was both the Chairman of the Board and the CEO. . . . The Director Defendants acted as a rubber stamp for the actions of Lehman's senior management. There was little turnover on the Board. By the date of Lehman's collapse, more than half of the Director Defendants had served for twelve or more years.[40]

Table 2.2 shows the makeup of the Lehman Board.

TABLE 2.2 Lehman Board of Directors[41]

Person	Age	Years as Director	Experience
Michael Ainslie	64	12	**Audit Committee member** Real estate, chemicals; CEO National Trust (4 years); CEO Sotheby's (10 years) to retirement in 1994; now private investor
Sir Christopher Gent	59	5	**Audit Committee member** Vodafone CEO (18 years), retired 2005; Non-Executive Chair GSK
Roger Berlind	77	23	**Audit Committee member** Founded brokerage (1960); sold it. Theatrical producer since 1976 and investor
Thomas Cruikshank	76	12	**Audit Committee Chair** Halliburton 39 years; CEO (26 years), retired in 1995
John Akers	73	12	33 years with IBM; CEO (8 years) retired in 1993
Marsha Johnson Evans	60	4	USN Rear Admiral retired, Director Girl Guides (2 years); CEO Red Cross (3 years) to 2005
Jerry Grundhofer	63	<1	CEO US Bancorp (14 years), retired 2007; on the Board for 6 months
Roland Hernandez	50	3	Spanish Media entrepreneur; Retired Chair/ CEO of Telemundo in 2000

Person	Age	Years as Director	Experience
Henry Kaufmann	80	13	Investment banker; Salomon Bros (26 years), retired 1988; consultant since
John Macomber	80	14	Consulting (McKinsey); chemicals (Celanese 15 years); CEO Exim Bank till retirement in 1992
Richard Fuld	61	18	Chair and CEO (39 years with Lehman); as Chair/CEO 15 years

With the exception of Jerry Grundhofer, who had joined the Board too late to save the day, none of the Directors had any experience of structured products, though perhaps Henry Kaufmann could have provided good, but out-of-date advice, given his background in Salomon 20 years earlier.

FRED GOODWIN

Goodwin's remarkable career perhaps comes closest to that of Napoleon. He was not a banker, but a chartered accountant and he did not have a banking qualification. Yet during his career at RBS he was named "Businessman of the Year" by *Forbes*'s global edition in 2002[42] and "European Banker of the Year" in 2003, knighted for his services to banking in 2004, and awarded an honorary doctorate by St. Andrews University as well as an honorary fellowship by the London Business School in 2008.

Yet by the end of 2008, Goodwin was being labeled "the world's worst banker." Daniel Gross makes a compelling case[43] for this on the following counts:

- He used mergers and acquisitions to fuel growth, which became increasingly ill-advised after the initial success of the hostile NatWest takeover for £26.4 billion in 2000. In 2004 he used $10.3 billion of RBS's cash to buy Cleveland-based Charter One Financial to expand RBS's footprint in the U.S. rustbelt. In November 2007 he instigated the biggest banking merger in history, with disastrous results. In the words of the new RBS chairman at the 2009 AGM:

  I don't think there can be any doubt that the key decision that led RBS to its difficulties was the acquisition of ABN AMRO. That is the painful reality that we can now do nothing to change. With

the benefit of hindsight, it can now be seen as the wrong price, the wrong way to pay, at the wrong time and the wrong deal.

- He overcommitted to investment banking, trading in structured products with poor credit controls. The extent to which this was a problem is shown by the following comment:

  Under Goodwin, the bank expanded trading and investment in derivatives, boosting derivatives assets 44 percent to 483 billion pounds in the first half of 2008. That was more than the bank's 443 billion pounds of net deposits.

  Meanwhile, its reserves of Tier 1 capital, a measure of financial strength and the vital reserve set aside to cover losses, was the lowest among its U.K. rivals at the start of 2008.[44]

- He built expensive headquarters in Stamford, Connecticut, costing US$500 million just in time for the collapse. The centerpiece of the 12-story building was the world's largest trading floor, which would prove too large as RBS's activities would shrink as part of its restructuring.
- He told shareholders in February 2008 that no additional capital was needed and then in June raised £12.3 billion at 200p a share. The rights issue was designed to shore up the balance sheet suffering from £6 billion worth of write downs, a third of which were from ABN-AMRO. But it was too late and between June and October RBS lost more than 80 percent of its market capitalization.[45]

Why did Goodwin continue to push for growth by acquisition when his shareholders were already wary, accusing him of being an insatiable empire builder having already made him promise that there would be no more acquisitions after he took a small strategic stake in the Bank of China costing £1.6 billion?[46]

Partly it was a case of "vaulting ambition which overleaps itself, of hubris brought low by the very qualities which led to such stellar success,"[47] but it was also because Goodwin and his predecessor George Mathewson were in a hurry to take a boring local bank and turn it quickly into a regional and then global bank. Goodwin was executing his predecessor's vision, according to Simon Maughan at MF Global Securities, who is quoted as saying:

He [Goodwin] was exactly the right person because he would not suffer fools or listen to detractors, but just pursue the grand aim to take RBS to the top table.[48]

Perhaps this is precisely what went wrong. Where were the people who could challenge him? Where was the Board? The Financial Services Authority in its investigation into why RBS failed makes a number of interesting comments in the rather prosaic language of bureaucracy, suggesting that putting forward a different point of view to Goodwin might have been quite difficult:

> *608. During the period 2003 and 2004, prior to the Review Period, the FSA had identified a risk created by the perceived dominance of RBS's CEO. While it was recognised that CEOs of large firms tend to be assertive, robust individuals, the FSA's view was that, in the case of RBS, the 'challenging management culture led by the CEO' raised particular risks that had to be addressed.*
>
> *609. The risks that can emerge when there is a dominant CEO are not merely ones of difficult relationships between the CEO and the Board, staff, shareholders and regulators. More seriously they can also result in a lack of effective challenge by the board and senior managers to the CEO's proposals, resulting in risks being overlooked and strategic mistakes being made.*[49]

Although Board members, when interviewed by the FSA, did not confirm the media's reports that they had been bullied, but said they were treated professionally and with respect, they did point out that Goodwin came across as "somewhat cold, analytical and unsympathetic"[50]. The RBS Internal Audit report of July 2008 had found the Group Executive Management Committee were not operating as a team, with bilateral conversations, too focused on performance targets, and they often seemed bullying in nature.[51] The fact that Goodwin's direct reports were among the best paid in the industry may have played a "part in discouraging robust and effective challenge of the CEO by his direct reports."[52] In addition, the FSA report raises four issues regarding Goodwin's judgment and behavior:[53]

1. He was overly focused on revenue and profit growth at the expense of giving sufficient attention to balance sheet risk posed by the growth of assets in commercial real estate and structured credit in the period 2004 to 2007.
2. His desire to proceed with the ABN AMRO deal to achieve earnings growth outside the mature UK market and strengthen RBS's competitive position against peers, despite having briefed the Board originally that it was **not** a must-do deal.[54]
3. He had a bias toward optimism, reflected in his response to emerging losses in structured credit, monoline insurance, and leveraged finance

in 2007 and 2008 evidenced by his decisions on whether to hedge and recognize losses in the accounts. In an interview with one of his direct reports, the FSA were told that the CEO "is and was an optimist and he tended to take an optimistic view of what was likely to happen and had often in his life been proved right." Some shareholders are reported as having the view that he did not fully appreciate:

a. The large, single name risks arising from RBS's rapidly growing exposures in syndicated and leveraged loans.
b. The growing accumulation of risks across the group.

These turned out to be important contributors to the collapse in the market confidence in RBS in 2008 and its vulnerability to the market stresses.

Goodwin's personal bias toward optimism was reinforced by information being provided to the Board that emphasized the good news and perhaps deemphasized the bad. The RBS Group Internal Audit Report of July 2008 to the chairman pointed out that they felt executive management had too much control over the information presented to the Board, "too often with 'good news' reporting and decisions presented as a fait accompli."[55] A case in point cited by the internal auditors was a report to the Board regarding the performance of the Citizens business in October 2007, which stated that overall it would meet its budget for that year. Apparently, a number of Directors had taken this as a positive report, whereas the reality was so different that the internal auditors concluded that "making any reassuring statements, at the September Board and in October to the group CEO, would be incautious at best."

4. He had failed to provide the right balance between maintaining his own detailed understanding and oversight of the Global Business Markets (GBM) and in delegating some of the management of that business to others. The suggestion in the FSA report appears to be that he had not overseen this critical part of the business properly nor had he delegated to people of appropriate competence, though not to the point of it becoming appropriate for the FSA to take enforcement action against him. The report concludes with the damning words:

While the Board was entitled to rely on assurances from the CEO that the GBM business was being properly managed, including adequate oversight of risks, and while there was no basis for enforcement action, in retrospect there remains an important question about the quality of the CEO's judgement in his delegation of responsibility for the management and oversight of GBM.

The FSA cites three reasons for the poor quality of the Board's decision making:

1. Excessive confidence in their ability to acquire another bank in a hostile takeover because of "the firm's track record of successful acquisition and integration, particularly of NatWest, and the CEO's personal contribution to it."
2. Insufficient discussion of the risks involved to identify "show-stoppers," given its complexity, scale, and how it was financed. Instead the focus was on identifying scope for synergies and cost cutting. The Board appears to have taken too much comfort from the fact that ABN AMRO was regulated by the DNB (the Dutch banking regulator) and the FSA; filed its records with the U.S. SEC; conformed with Sarbanes-Oxley requirements; from rating agency reports and from the fact that their great rival Barclays was persisting in their bid. This despite the fact that the minutes of the March 28, 2007, Board minutes record that the CEO:

   provided background to the project. . . . A bid for [ABN AMRO] was not seen as a "must do deal." The CEO advised the board that "execution risk would be high" and that "any bid for [ABN AMRO] and subsequent integration would be more difficult than previous transactions."

   However, the Review Team has not found evidence that the Board undertook any penetrating analysis of the risks on an enterprise-wide basis in respect of capital and liquidity.[56]

   The FSA report goes on to note that it is difficult to reconcile the lack of rigorous testing, questioning, and challenge with what they would expect of a Board involved in deal of such strategic importance—reflecting an extraordinary level of groupthink.
3. The third key factor highlighted by the report was the lack of sensitivity to the importance of understanding counterparty risk and the importance of customer and counterparty confidence in the bank.

In their conclusion on the CEO's capability and management style, the FSA review team raised the following issues:[57]

- There was an inadequate focus at Board level on the core banking fundamentals of capital, liquidity, asset quality, and risk—at an aggregate level and by line of business.

- The risk management information was inadequate to help the Board monitor and mitigate aggregated risks across the group and failed to provide adequate early warning.
- The status accorded to the group risk function was insufficient to allow the development of high-quality predictive risk assessment and management.
- The information provided to the Board was incomplete.
- The CEO's optimism, confidence, and focus on revenue growth were a factor in the preceding.

CONCLUSION

We can see in Table 2.3 why four such talented CEOs went from success to failure, when they are assessed against the 11 leadership criteria established at the start of the chapter.

TABLE 2.3 Assessment of O'Neal, Cayne, Fuld, and Goodwin

Bad but effective leaders:	
1. Find the energy to create change, though often not for the better.	1. All four were transformative leaders with the energy to take their companies in new directions, changing the business model, increasing risk and apparent reward.
2. Have a clear purpose at all times.	2. They had a clear purpose at all times: a. O'Neal and Goodwin seemed to be focused on becoming the biggest. b. Fuld and Cayne seemed to be more focused on the share price.
3. Lead through fear and force.	3. All four appear to have led through fear and force.
4. Shoot the messenger.	4. O'Neal, Cayne, and Fuld are recorded as shooting the messenger; there is no direct record of Goodwin doing the same.
5. Paranoiacs who punish failure.	5. Unclear.
6. Centralize control and authority, becoming bottlenecks in decision making.	6. O'Neal certainly centralized control; Cayne was a bottleneck by being absent; Fuld delegated centralized control to Gregory; Goodwin seems to not have controlled GBM properly.
7. "Après moi le deluge"; regard themselves as indispensable and manipulate followers.	7. All four seemed to regard themselves as indispensable, with O'Neal and Cayne appearing the most egocentric and self-centered.

Bad but effective leaders:	
8. Fail to create a lasting legacy.	8. All four failed to create a lasting legacy: Everything they built has been dismantled or is in the process of being dismantled.
Bad and ineffective leaders demonstrate:	
1. *Incompetence*: Leaders and followers lack the skill and/or will to sustain effective action. 2. *Rigidity:* Leaders and followers are stiff and unyielding. Although initially competent, they are unable or unwilling to adapt to new ideas and circumstances. 3. *Intemperance:* The leader lacks self-control and is abetted by followers who allow self-destructive behavior to continue.	1. Although initially competent, as the crises developed all four created problems: a. **O'Neal** failed to appreciate the risks incurred by his CDO strategy and retreated to play golf at the critical moment. b. **Cayne** was unavailable and disengaged and failed to focus on the importance of liquidity and the risks posed by high leverage. c. **Fuld** mishandled the negotiations with the Koreans and by holding out for unrealistic valuations of property assets and too high a share price destroyed any chances of a deal a number of times. Although he understood the risks of leverage, he took them nevertheless and failed to have proper risk management. d. **Goodwin** failed to focus on the banking fundamentals of liquidity, asset quality, and risk. 2. All four displayed rigidity: a. O'Neal, Cayne, and Fuld by persisting in going for leverage and building portfolios in subprime after the market was beginning to turn down—ignoring advice to the contrary. b. Goodwin by sticking with an acquisition that was originally not a "must-do deal" in his own words; even after the key asset for RBS in the ABN AMRO portfolio, the La Salle bank in the United States, had been sold. 3. O'Neal, Cayne, and Fuld all behaved in self-destructive ways.

Finally, if they had followed Alfred Sloan's approach to decision making and actively sought dissent as opposed to stifling it, they might not have gone from success to failure.

NOTES

1. Jeff Madrick, *The Age of Greed* (New York: Alfred Knopf, 2011), 373.
2. Michael Lewis, *The Big Short: Inside the Doomsday Machine* (New York: W.W. Norton, 2010).

3. Madrick, *The Age of Greed.*
4. Sheila Bair, *Bull by the Horns: Fighting to Save Main Street from Wall Street and Wall Street from Itself* (New York: Free Press, 2012).
5. Andrew Ross Sorkin, *Too Big To Fail* (New York: Viking, 2009).
6. David Faber, *The House of Cards* (2009), www.cnbc.com/id/28892719/House_of_Cards.
7. "The previous summer, when housing prices started to plummet and overextended banks cut back sharply on new lending, Fuld had proudly announced: "Do we have some stuff on the books that would be tough to get rid of? Yes. Is it going to kill us? Of course not." The firm seemed impregnable then. For three years Lehman had made so much money that it was being mentioned in the same breath as Goldman Sachs, Wall Street's great profit machine." Sorkin, *Too Big To Fail,* 11.
8. RBS press release, Annual General Meeting, April 3, 2009, cited in Financial Services Authority Report: *The failure of the Royal Bank of Scotland,* December 2011. Accessed January 3, 2013, www.fsa.gov.uk/rbs.
9. www.brainyquote.com/quotes/quotes/a/alfredpsl194029.html#fzMXMKty3pvGPiRW.99, accessed December 21, 2012.
10. Madrick, *The Age of Greed,* 389.
11. Bair, *Bull by the Horns,* 125.
12. Sorkin, *Too Big To Fail,* 144.
13. Jim Gillespie and David Zweig, *Money for Nothing: How the Failure of Corporate Boards is Ruining American Business and Costing Us Trillions* (New York: Free Press, 2010), 6.
14. Sorkin, *Too Big To Fail,* 144.
15. I am indebted to Andrew Ross Sorkin for his analysis of what went wrong at Merrill Lynch in *Too Big To Fail*, 142–147.
16. Gillespie and Zweig, *Money for Nothing,* 7
17. Ibid.
18. Ibid.
19. Sorkin, *Too Big to Fail*, 147.
20. For example, Cayne is quoted as saying that he was enticed by Greenberg to join Bear Stearns with a $70,000 salary and within a couple of years he was earning $900,000 in commissions. The reality, according to Greenberg, was that Cayne's starting salary was $700 per month as he had not yet passed the relevant exams allowing him to sell equities, and that $900,000 was a figment of Cayne's imagination. Ace Greenberg, *The Rise and Fall of Bear Stearns* (New York: Simon & Schuster, 2010), 84–85.
21. Greenberg's remarks to new hires: "If I can help you, I want to. I'm someone who's known for getting things done around here. When my phone rings I answer it myself. If you have a problem and don't call me, it's not my fault." Greenberg, *The Rise and Fall of Bear Stearns,* 79.
22. Ibid., 86.
23. Ibid., 87.
24. Ibid., 89.

25. Ibid., 102–103.
26. Ibid., 110–111.
27. Ibid., 144–145.
28. Ibid., 146.
29. Ibid., 153.
30. Ibid., 150–151.
31. Kate Kelly, "Bear CEO's Handling of Crisis Raises Issues: Cayne on Golf Links, 10-Day Bridge Trip Amid Summer Turmoil," *Wall Street Journal,* November 1, 2007. Accessed January 3, 2013, http://online.wsj.com/article/SB119387369474078336.html.
32. Madrick, *The Age of Greed*, 378–379.
33. Andrew Ross Sorkin, *Too Big To Fail*, 11–28.
34. Ibid., 14.
35. Ibid., 107.
36. Susanne Craig, "Lehman is Seeking Overseas Capital: As Its Stock Declines, Wall Street Firm Expands Search for Cash, May Tap Korea," *Wall Street Journal,* June 4, 2008. Accessed January 3, 2013, http://online.wsj.com/article/SB121253687372943195.html.
37. Ibid., 111.
38. Ibid., 118.
39. Madrick, *The Age of Greed*, 386.
40. Leslie Wayne, "New Jersey Sues Over Its Lehman Losses," *New York Times,* March 17, 2009, and *The Supine Board,* New Jersey complaint, (2009), 111, cited in Gillespie and Zweig, *Money for Nothing*, 16.
41. Dennis K. Berman, "Where was Lehman's Board?" *Wall Street Journal,* September 15, 2008. Accessed December 19, 2012, http://blogs.wsj.com/deals/2008/09/15/where-was-lehmans-board/.
42. "Fred Goodwin, Chief Executive of Royal Bank of Scotland, Has Been selected as Forbes Global's Businessman of the Year in Recognition of the 'Brilliantly Strategised Hostile Takeover' of NatWest Three Years Ago." Helen Dunne, "Royal Bank's Fred 'the Shred' Wins Forbes Accolade," *The Telegraph,* December 28, 2002. Accessed January 5, 2013, www.telegraph.co.uk/finance/2837654/Royal-Banks-Fred-the-Shred-wins-Forbes-accolade.html.
43. Daniel Gross, "Who's the World's Worst Banker?" *Slate,* December 1, 2008. Accessed January 17, 2013, www.slate.com/articles/business/moneybox/2008/12/whos_the_worlds_worst_banker.html.
44. Simon Clark, "Goodwin's $140 Billion Binge May Doom RBS to Nationalization," *Bloomberg,* November 24, 2008. Accessed January 4, 2013, www.bloomberg.com/apps/news?pid=newsarchive&sid=a_6BKzvwAYCY&refer=uk.
45. Arnott, "The Rise and Fall of 'Fred the Shred,'" *Bloomberg Businessweek,* October 14, 2008. Accessed January 4, 2013, www.businessweek.com/stories/2008-10-14/the-rise-and-fall-of-fred-the-shredbusinessweek-business-news-stock-market-and-financial-advice.
46. Ibid.

47. Ibid.
48. Ibid.
49. FSA Board Report, *"The Failure of the Royal Bank of Scotland,"* www.fsa.gov.uk/rbs, December 2011, 233.
50. Ibid.
51. RBS Group Internal Audit Report, July 2008, cited in ibid., 233.
52. FSA Board Report, *"The Failure of the Royal Bank of Scotland,"* www.fsa.gov.uk/rbs, December 2011, 234.
53. Ibid., 234–235.
54. Ibid., 229.
55. RBS Group Internal Audit Report cited in FSA Board Report, "The Failure of the Royal Bank of Scotland," www.fsa.gov.uk/rbs, December 2011, 237.
56. Ibid., 228–229.
57. Ibid., 237–238.

CHAPTER 3

Setting the "Tone at the Top"

This chapter deals with the role of bank CEOs and their Boards in setting the "tone at the top." It explores the interaction between leaders and followers and the importance of instilling the courage to speak truth to power in the organizational culture if leaders are to be kept from being corrupted by the power they wield. It is particularly critical in the banking sector, where failures of "tone at the top" may have led to gigantic losses at Société Générale, UBS, and JPMorgan Chase; to problems of compliance and controls at HSBC; and to the worldwide LIBOR price fixing scandal. These undermine the case for self-regulation of financial services. They make it clear that the responsibility for setting the "tone at the top" belongs to both the executive leadership and the Board, with Boards providing the governance to keep leaders honest.

What is "tone at the top"? Is it just integrity in the top management? Is it the same thing as an ethical culture? Is it ethical behavior that serves as a role model for all employees that puts equal emphasis on means and ends? That is to say, does the top team stress the importance of *how* targets are met while delivering results? Does "tone at the top" require the existence of a clear code of conduct?

I argue that "tone at the top" involves not just the CEO and top management team, but the Board as well and that it covers not just *how* business is done, but also *what* business is done. It is, therefore, a fundamental, but often ignored part of strategy because it requires the bank to decide *what* its values are, *whom* it will do business with, *how* it will do that business, *which* risks it will take, and *how* it will measure performance and reward its people. The failures of governance that led to the Global Financial Crisis were in the end failures of "tone at the top" compounded by failures of "tone in the middle" caused by the wrong "tone at the top."

In answering these questions about strategy, the purpose and values of the top management team must be communicated throughout the organization in terms of desired outcomes and behavior for trust to be restored to banks.

Perhaps the best place to start for setting the "tone at the top" is to answer the following four questions that will define whether the bank has the technical capacity and emotional capability to create a long-term "license to operate"—the permission society as a whole gives to an organization to do business legally and make money doing so:

1. *What do the members of the top management team want to be remembered for when they are working for the bank?* Management must be clear about what it really wants to do—which is primarily a technical, emotional, and ethical set of decisions:
   a. Technical because that determines whether there is a distinctive product or service to offer.
   b. Emotional because that will provide the energy needed to overcome the obstacles on the way to success.
   c. Ethical because that will guarantee the long-term acceptability of the business. In order to establish the economics of what they propose, management must define what business they want to write and who they want to have as clients.

   Satisfactory economic, technical, emotional, and ethical answers to the questions of legacy will provide the emotional and mental energy needed to succeed.
2. *What does society think of what the top management team wants to do?* If society welcomes such activities and provides positive emotional feedback, the energy levels of the employees will be highly charged and they will be excellent ambassadors for the organization—proud to work for it. However, if society disapproves, employees will feel they have to justify to others and themselves why they work at the bank. This creates an emotional drain and source of internal conflict, truly debilitating if, in addition, they are secretly ashamed of their organization.
3. *Is the business worth doing?* Only if the market for the intended products and services is large enough to warrant the investment of time, energy, and money, is it worth doing. If it is, then the bank is on the way to having a sustainable future. But this is true only if the way those products and services are marketed and sold does not misrepresent what the products can do, and if they are offered to people who really need them and are made to understand clearly how they work and what their limitations are. The selling misrepresentation scandals in the United Kingdom and their cost to banks both in fines and damaged reputation reinforce this point.
4. *Does the bank have the necessary resources, skills, and competencies to do the job properly?* A mismatch of skills and competencies can be

almost fatal, as has been proved in the case of UBS and RBS. Not having the right financial resources is fatal as it leads to liquidity crunches, as Bear Sterns, Lehman Brothers, Merrill Lynch, Washington Mutual, Countrywide Financial, RBS, Northern Rock, Fortis, and others discovered to their cost.

Answering these four basic questions allows Boards to then work with the CEO and top management on the four cardinal issues that frame the "tone at the top": the resulting mission, vision, values, and behavior. It is not possible to set the "tone at the top" without taking these four elements into account, because they are its drivers.

Figure 3.1 shows how Boards can help the CEO and top management build coherence and consistency into setting the right "tone at the top" while ensuring that it is reflected throughout the organization regardless of level.

I start with the "Purpose" of the bank: What are its objectives and goals in serving the defined beneficiaries of its existence? This is the challenge Lord Turner set banks when he accused them of creating opaque products that served little or no social purpose.[1] When asked to elaborate what he meant, he gave as an example, tax avoidance products developed by Barclays Structured Capital Markets as socially useless zero-sum products designed to transfer money from the taxpaying generality to individual pockets in his final testimony to the UK Parliamentary Banking Standards Committee.[2]

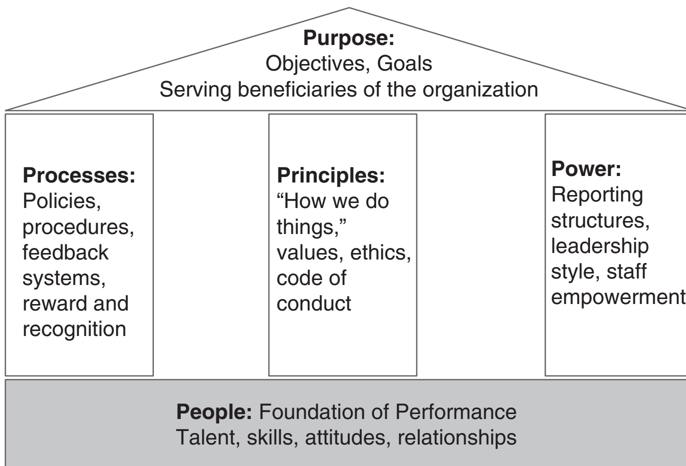

FIGURE 3.1 Setting the "Tone at the Top": Integrating Five Ps
Source: John Zinkin, FIDE program, Ethics in Finance, June 2013.

The fundamental purpose of banks is twofold. It is to:

1. Analyze and underwrite loans—made up of depositors' money—which they then lend to clients. They can either hold these loans and keep them on their books or sell them to third parties as part of their market-making activities. When they do this well, they serve the real economy by channeling savers' surplus funds to investors who can deploy the money productively, creating sustainable wealth.
2. Provide the payment systems that allow everyday activities to continue smoothly. It is this second purpose that is threatened by the failure of a bank, which can then turn into a collapse of the system if liquidity dries up as result of a crisis of confidence.

Unfortunately, these two fundamental purposes delivered relatively low rates of return, whereas selling derivatives and proprietary trading by so-called "casino" banks was much more profitable.[3] Shareholders in banks and senior management became dissatisfied with the returns offered by conventional banking—investors because they were looking for ROE of more than 15 percent and senior managers because they wanted the bonuses offered by "bulge bracket" investment banks.

To satisfy the need for higher returns, bank Boards allowed the addition of a third purpose—the proprietary trading of derivatives. It is this business that is riskier than the other two. Unfortunately, much of it is of no relevance to the real economy. Many "synthetic" structured products are, in effect, bets on a price on a given day without any underlying trade, and are similar to bets on which two raindrops will reach the bottom of a window first in terms of their impact on the real economy. They are designed to be difficult for clients to understand and their opacity makes it extremely hard for the buyer to know what proportion of the price is in fees as opposed to reflecting the risk being run. In the case of credit default swaps (CDS), parties can take out insurance on third parties—a violation of the principle that any insured must have an insurable interest in the item being insured. To make matters worse, there is no limit to the number of parties taking out a CDS on the same exposure. It is as if 50 people can take out insurance on a third person's house and have an active interest in seeing the house burn down. It is hard to see how such products "serve a wider social purpose," to use Lord Turner's phrase.

Another way of looking at the same point is that defining the "Purpose" properly is to ensure that banks will have a long-term sustainable "license to operate" by creating products and services that answer customers' real needs; satisfy them properly; and do not take advantage of the inevitable

information asymmetry that exists in financial products between buyer and seller. Creating this long-term "license to operate" depends on banks deploying the world's savings in investments that pay off by creating wealth in the real economy. It is not about fueling Wall Street's and the City's proprietary trades, designed to enrich hedge fund partners and traders through excessive bonuses.

Without a clearly defined "Purpose" that both solves the client's problems and meets society's needs, a bank has no foundation for its own moral compass. Perhaps the clearest view on banking "Purpose" and what went wrong is that of Stephen Hester, the CEO brought in originally to resurrect RBS:

> *It is possible to look at the many scandals that have hit banking in recent years and see them as individual episodes of bad judgement or wrong behaviours. In fact, I think it's more accurate to say that most of them are related to one big scandal: banks have simply not been good enough servants of their customers in the recent past.*
>
> *The banking industry in the decade preceding the crisis was focused on income; it expanded too fast, prioritised sales over service and failed to properly balance the interests of its customers and shareholders with those of its managers. Hubris set in. Too much of the ethos became selfish—personally and institutionally. Of course market economies rely on self-interest as a key mechanism. But it works best where "enlightened" or "sustainable" self-interest is what's pursued.*
>
> *There is a basic truth about what makes a good company. Really good companies perform well for their owners, regulators, employees and communities if, above all else, they serve their customers well. You can have a number of different goals for your company, but at the core great businesses are driven by their customers' priorities—by their customers' values, goals and needs—and not by their own. . . .*
>
> *Banking needs to unambiguously recognise that its purpose is to serve customers well. And to serve them in the context of their broader communities and the range of impacts that banks, as a huge industry, have on society—culturally and economically.*[4]

The fact that Stephen Hester had to go out of his way to make this point in a speech shows how far banks strayed from recognizing the

importance of serving the real needs of their customers. What reads like a statement of the obvious for any company selling tangible goods and services, is regarded as a brave and almost revolutionary statement when made by the CEO of what was one of the world's largest banks. When bank Boards and the top management teams accept the fundamental validity of these remarks, they will have rediscovered their true purpose and will be well on the way to rebuilding the trust that is so necessary for the industry to thrive.

The central pillar in Figure 3.1, "Principles," deals with the moral compass of a bank: how it does things, captured in its values, ethics, and code of conduct—in short, its culture. Currently this is seen as the weakest part of banking:

> *The culture of the banking industry overall, and that of Barclays within it, needs to evolve. A number of events during and after the financial crisis demonstrated that banks need to revisit fundamentally the basis on which they operate, and how they add value to society. Trust has been decimated and needs to be rebuilt. . . .*
>
> *Culture is generally defined as "the instinctive behaviours and beliefs characteristic of a particular group." Changing a culture, therefore, requires at least three things:*
>
> - *Affirming the key values and operative beliefs that guide the behaviour of everyone in an organisation—these are deep-seated and tend not to change without direct intervention;*
> - *Ensuring that the actual behaviours of those who represent the organisation are consistent with those values (and are so regarded by those who come in contact with the bank); and*
> - *Ensuring that vital reinforcing mechanisms, such as visible leadership examples, formal and informal systems and processes, policies and rewards, are aligned with those values, operative beliefs and behaviours.*[5]

Reading the codes of conduct of major banks would suggest that there should be no problem. Yet this would be inaccurate, as is shown in Table 3.1.

The list in Table 3.1 is not exhaustive by any means, yet the point is clear: Professed practice and reality are far apart. Either the communications departments of these banks live in a different world or they are deluding themselves that published codes of conduct impress readers. Codes of conduct are only as good as the bank's adherence to them.

TABLE 3.1 Excerpts from Bank Codes of Conduct

Bank	What the Code of Conduct Says	Reality
Goldman Sachs	"It has often been said that one person can cause more harm to Goldman Sachs from a single bad decision than good to the firm over the course of a career. As stewards of the firm's success, our actions each day have a profound impact. No financial incentive or opportunity—regardless of the bottom line—justifies a departure from our values. In fact, loosening our ethical standards in pursuit of business is a betrayal of our duty to clients, shareholders and colleagues and compromises everything we aspire to as a firm."[6] "The scope of our business means that delivering outstanding client service may at times generate real or perceived conflicts for the firm. We are committed to addressing such conflicts with all appropriate disclosure and transparency. If a transaction generates a conflict that cannot be addressed, we would prefer to lose the business than to abandon our principles."[7] "Our clients' interests always come first Our experience shows that if we serve our clients well our own success will follow."[8]	The behavior of Goldman Sachs documented in the Congressional testimony regarding the Abacus and Timberwolf structured products suggests that financial pressures to preserve the bottom line may have meant that Goldman violated their first business principle: namely, that clients' interests always come first.
UBS	"UBS obtains competitive advantage through superior performance rather than by using any unfair business practice. "We deal fairly, honestly and in good faith with clients, business partners, the public, our competitors, third party service providers and each other.	UBS has been fined a total of US$1.5 billion by U.S., UK, and Swiss regulators for fixing LIBOR,[10] using market manipulative practices that may have been in violation of various antitrust laws. Two of its ex-staff face criminal charges.[11]

(*continued*)

TABLE 3.1 (*Continued*)

Bank	What the Code of Conduct Says	Reality
	"We are committed to the principle of the market economy and to complying with relevant laws, rules and regulations, including applicable anti-trust and competition laws. "We do not take unfair advantage of anyone through misrepresentation or omission of facts, manipulation or concealment, or abuse of privileged information "We avoid unethical or unfair competitive practices and use legal and ethical methods when collecting competitive information."[9]	UBS was fined US$160 million by the U.S. Justice Department in 2011 for anti-competitive activities in the U.S. municipal bonds market.[12] UBS paid US$780 million in 2009 for helping U.S. citizens evade taxes to U.S. authorities.[13]
Lloyds-TSB	"Putting Customers First Everything we do begins and ends with customers who trust us to look after their money. If we put customers first, they'll think of us first. By building stronger relationships with customers, they will trust us to meet more of their financial needs and stay with us for longer." "Keeping it Simple A simpler business is more efficient and a more satisfying place to work. It's also good for customers, making us easier to deal with and helping us create simpler and more transparent products."[14]	Lloyds-TSB has had to reserve £5.3 billion for fines for mis-selling payment protection insurance products in the United Kingdom.[15] Clearly this was the not the result of either putting customers first or of respecting the trust they had in their financial advisers. Nor was it the result of creating simpler and more transparent products. It was the result of commission based selling that put volume sold ahead of suitability of product offered.[16]
Citi	"We strive to create the best outcomes for our clients with financial solutions that are simple, creative and responsible. . . . We must put Citi's long-term interests	Citi was a leading player in the subprime market and became the second largest CDO player after Merrill Lynch. It had to be bailed out at least twice during

Bank	What the Code of Conduct Says	Reality
	ahead of short-term gains and provide superior results for our stakeholders. We, as Citi employees or other representatives of Citi, are expected to act in accordance with the highest standards of personal and professional integrity and to comply with all applicable laws, regulations and Citi policies, standards and guidelines."	the crisis of 2008 as the archetypal "too big to fail" bank.[17] "Citi had essentially bought into all the gimmicks to generate short-term profits: poorly underwritten loans, high-risk securities investments, and short-term, unstable liquidity."[18]
Deutsche	"Deutsche Bank promotes honest and ethical conduct in all its business activities. In particular, this means to act responsibly and in good faith and with due care, competence, prudence and diligence, without misrepresenting facts or allowing own judgments and decisions to be subordinated to or guided by extrinsic considerations."[19]	Deutsche was one of the leading providers of structured products in the 2008 crisis and is charged with having misled customers.[20] The U.S. Senate found Deutsche to be a leading player in the subprime crisis along with Goldman Sachs.[21] Deutsche was one of the banks investigated in the LIBOR price-fixing scandal.

The reason for the shortfall between reality and aspiration lies in the left hand pillar, "Processes," of Figure 3.1, capturing the institutionalization of how things are done:

- The policies and procedures and adherence to them.
- The feedback mechanisms and the reward and recognition systems that must all be designed to reinforce the central pillar of "Principles," if codes of conduct are to be adhered to and behaviors are to reflect the values of the business.
- It is also a result of how "Power," is used, as shown in the right-hand pillar.
- The integrity and values of "People," shown as the foundation of the business.

Employees are not fools. They will do what they are paid to do, what they are measured to do, and what they are rewarded for doing. They will

also follow their superiors as role models to get to the top of the organization. That is why "rewarding A while hoping for B"[22] is one of the greatest managerial follies. It is also why walking the walk and talking the talk by the top management team matters so much. These insights mean that Boards must concern themselves with the impact "Processes" have on reinforcing or weakening the "Principles" of the business and therefore the bank's ability to deliver its "Purpose."

It is therefore no accident that Lloyds-TSB, Barclays, HSBC, and RBS in the United Kingdom are reexamining how they incentivize their sales forces. It is also interesting that Martin Wheatley, the newly appointed head of the UK's Financial Conduct Authority (FCA), told banks and insurers in September 2012 to get rid of sales schemes that reward volume ahead of suitability. As a result, banks are incentivizing measures of customer satisfaction and Lloyds is testing a scheme that rewards employees based on customer satisfaction alone.[23] RBS, HSBC, and Barclays have joined them in looking at alternative ways of incentivizing sales forces and Anthony Browne, CEO of the British Bankers Association (BBA), said:

> *Mis-selling is bad for customers, bad for confidence in the industry and bad for banks. There is no excuse for any practices that encourage mis-selling.*[24]

The right-hand pillar, "Power," is perhaps the most problematic of all in ensuring the "tone at the top" stays true to its original intent. "Power" and its use or abuse determines whether leaders of banks (or any other organization, for that matter) stay true to their original purpose. "Power tends to corrupt and absolute power corrupts absolutely."[25] "Power" manifests itself in complex organizations according to the structure of the bank on the one hand and the hierarchies within those structures on the other.

Structural divisions do divide people from each other and often lead to fierce tribal loyalties within silos, undermining the overarching "Purpose" of the bank, as department heads come to regard loyalty to them as individuals as more important than loyalty to the organization for which they all work. Thus, how an organization is structured can reinforce or weaken its unity of "Purpose" and create several competing "tones at the top" to the detriment of customers, employees, and shareholders. The matrix organization is one such organization. It makes perfect sense on paper to have several reporting relationships—functional, geographical, and by line of business. However, it ignores human dynamics and the need for most people to have clarity on who their real superior is—that is, the person who can fire them is the one to whom they will give loyalty, while the other interlocutors are tolerated as "necessary noise in the system."

These problems are exacerbated if there are different cultures operating within the bank, or, worse still, the bank is a hybrid or the result of a merger of different cultures. For example, retail and commercial bankers think differently from traders and investment bankers. Many of the problems commercial banks are experiencing come from their having been taken over by investment bankers and traders who are more high profile, take more risks, and make more money for the bank in good times than the retail bankers, but equally can destroy the bank in bad times. It is a bit like Aesop's fable about the hare and the tortoise, where slow but steady wins the race, except that more often than not the investment banker "hares" have won out instead.

Hierarchies tend to demand deference and obedience from the lower echelons and the higher the "Power Distance" of the culture, the more difficult it is for people lower down in the organization to take initiatives or express an opinion of their own. This is particularly unfortunate because one of the most important traits of good leadership is encouraging subordinates to have the courage to speak truth to power, already mentioned in Chapter 1. Too often subordinates think that loyalty requires them to agree with their superiors, and all too often superiors encourage subordinates to have that belief.

Nobody really likes to have their points of view and deeply held beliefs challenged, particularly if they have been the result of painful personal experiences. Any challenge is often not seen as a challenge to the idea itself, but rather as a challenge to the person who expressed the idea. This unfortunate fact of most human relationships reinforces another dangerous human tendency: groupthink.

In fact, loyalty may really require the willingness by subordinates to challenge and speak up before it is too late for their superiors to do anything different to tackle the impending problems before they create a disaster. This is in the tradition of the great Alfred Sloan,[26] who sent his Directors away after their first board meeting with the instruction that they should come to the next board meeting with the reasons why they did not agree with him:

> *If we are all in agreement on the decision—then I propose we postpone further discussion of this matter until our next meeting to give ourselves time to develop disagreement and perhaps gain some understanding of what the decision is all about.*[27]

Loyalty in this context is the willingness by the Board to ask the difficult questions about "Purpose," "Principles," "Processes," "Power," and "People." These questions are shown in this chapter's Appendix 3A: "Board Questions Regarding 'Tone at the Top.' "

Just as without customers there can be no business, without people there is nobody to create value by transforming inputs into outputs that

customers value to deliver what they expect from the organization. Just as the customer touchpoints that define the quality of the customer experience always involve people, so does the translation of company values into desired behaviors.

Ignoring the foundational importance of "People" puts the "Purpose," "Principles," "Processes," and "Power" at risk and destroys the effect of the right "tone at the top," as the following quote from Walt Disney[28] makes clear:

> *Employees will only complain or make suggestions three times on the average without a response. After that they conclude that if they don't keep quiet they will be thought to be troublemakers or that management doesn't care.*

The reasons why Boards need to consider the impact of the point being made by Walt Disney on their ability to preserve the right "tone at the top" are the following:

- If people conclude there is no point complaining or making suggestions, there are two serious consequences for any bank or business:
  - The drive for continuous improvement disappears.
  - The feedback necessary for error correction and ensuring that codes of conduct are in fact adhered to also disappears.
- The courage to speak truth to power, so essential to stop power corrupting leaders, will not exist. Successful CEOs become over-mighty, believing that their past track records mean they are right and should not be challenged. Yet every strategy has its expiry date, after which what was a recipe for success becomes a recipe for failure.

The other reason why it is important to consider the "People" element of the "tone at the top" is that if the tone is wrong, people will not be proud to come to work. They will secretly be ashamed at what they are being asked to do. Their productivity and efficiency will suffer. Worse, they might become terrorists on the organization's payroll, telling their family and friends what it is really like to work for their bank. Contrast that with a bank where the "tone at the top" is good. People will enjoy their work, be proud of what they do, and become unpaid ambassadors, promoting their bank to their family and friends. It is a point well captured poetically by Khalil Gibran:

> *Work is love made visible.*
>
> *And if you cannot work with love but only with distaste, it is better that you should leave your work and sit at the gate of the temple and take alms of those who work with joy.*

> *For if you bake bread with indifference, you bake a bitter bread that feeds but half man's hunger.*
>
> *And if you grudge the crushing of the grapes, your grudge distils a poison in the wine.*
>
> *And if you sing though as angels, and love not the singing, you muffle man's ears to the voices of the day and the voices of the night.*[29]

The same point is made less poetically by Peter Drucker:

> *But I like to think that a lot of managers and executives trying to solve problems miss the forest for the trees by forgetting to look at their people—not at how much more they can get from their people or how they can more effectively manage their people. I think they need to look a little more closely at what it's like for their people to come to work there every day.*[30]

The right "tone at the top" takes into account people's attitudes and belief systems, allowing employees to internalize the purpose and values of the organization as a whole. This leads to lower absenteeism and staff turnover, higher productivity, maximum spontaneity, and innovation in the service of those goals.[31] The main reason for this is that intrinsic motivators drive performance better than extrinsic motivators, at least in work that does not require mechanical skills. Once the work requires rudimentary cognitive skills, somewhat surprisingly, there is evidence that, beyond a certain point, the more money people are paid, the less well they perform because they are not tapping into their three powerful intrinsic performance motivators:

1. The desire for autonomy—being able to self-direct the work and how to solve problems
2. Learning and self-development as part of achieving mastery and making progress, even if it is slow
3. The desire to make a difference, which requires fitting into a bigger purpose

Admittedly, money has to be "off the table"—in other words, people must feel that they are being paid fairly and that they have enough for their basic needs. Absent that, of course, money does matter.

The other problem with extrinsic motivators appears to be that they over-focus the brain's attention on the immediate, short-term goal, creating a kind of myopic tunnel vision that inhibits creative problem solving and encourages excessive risk taking.[32] So it is clear that any "tone at the top" that ignores the intrinsic drivers of human behavior and that relies too much

on extrinsic motivators that are more appropriate in achieving compliance will create problems of the type that have been evident in banking. Perhaps it is fortunate that UK banks are now reexamining the way they reward their sales forces and that Martin Wheatley of the FCA is telling banks to stop commission schemes that focus on volume rather than suitability and customer satisfaction.

Attitudes and beliefs are obviously vitally important as they create the culture of the organization, but so are talents, skills, and relationships. So again, in setting the "tone at the top," Boards must pay attention to the talents and skills that exist currently and will be needed to deliver the future strategy of the bank. This is dealt with in Chapter 7: "Developing Suitable Leaders."

Finally there is the issue of the "courage to speak truth to power," which raises the questions Boards and top managers must ask as part of keeping the bank and its leadership on track (listed in Appendix 3A).

CONCLUSION

Perhaps if Boards had realized that there is much more to setting the "tone at the top" than merely exhorting CEOs and the leadership of banks to have integrity and behave ethically, we might not have had as many disastrous failures of governance and leadership. Setting the right "tone at the top" is a holistic program of actions covering:

- "***Purpose":*** Banks must satisfy an economic purpose that suits society's requirements; and this means putting their customers' interests first and foremost, and making a profit in so doing, as opposed to taking advantage of their customers because of information asymmetries that exist in so many financial products.
- "***Principles":*** These are central to achieving a sustainable "license to operate" for any organization and it is the Board's responsibility to determine what the guiding principles of their bank will be, and to make it absolutely clear to all concerned that these are non-negotiable. It is only by doing this that Boards can hope to prevent charismatic, successful, and unprincipled CEOs from hijacking the values of the bank to justify a change in direction, strategy, or culture. Any change in strategy that violates the agreed "Principles" should be rejected by the Board, regardless of its apparent short-term profitability, as part of the Board setting and *preserving* the right "tone at the top." To do anything else is to allow the bank to embark on a slippery slope of short-term profit-driven expediency that will destroy the "tone at the top" with tragic consequences.

- "***Processes":*** The Board and top management must ensure that the policies and procedures that constitute the "Processes" of the bank reinforce the agreed "Purpose" and "Principles" rather than expect that they are being implemented as agreed. Boards must be proactive and conduct inspections to ensure that they are being adhered to in practice. Part of the answer is to make risk management answer directly to the Board as opposed to the audit committee, because risk management requires a different set of skills and mind-set from audit. Risk management demands forward-looking "what if" thinking, whereas audit requires "what happened" thinking and is backward looking. Failure to ensure that "Processes" reinforce "Principles" will allow the "tone in the middle" to undermine the "tone at the top," because it is what happens in the middle ranks of the bank that determine whether people think the organization is behaving ethically:

  The leader can make breathless remarks about integrity, values, mission and purpose. . . . I can hear the leader saying that at the state of the company speech; but (as an employee) I am going to judge him or her based on the actions of my manager.[33]

- "***Power":*** Perhaps the most obvious manifestation of "tone at the top" is "Power":
  - How it is used or abused
  - Who reports to whom and on what basis and whether this creates tribal loyalties to silos rather than the bank as a whole
  - How people are promoted and whether there is favoritism and politics
  - Whether there is a culture of fear and shooting the messenger
  - Whether the bank is run on a top-down, need-to-know basis where information is power and hoarded, or on a top-down, bottom-up basis where information is shared and empowering.

  It is the Board's responsibility to prevent over-mighty CEOs dominating the Board and brooking no dissent from management. Failure by the Board to do this may lead to the CEO destroying the bank or its reputation. Failure by Boards to provide suitable checks and balances to abuses of "Power" in leadership contributed to the problems of Bear Stearns, Merrill Lynch, Lehman Brothers, Citi, Countrywide Financial, Fannie Mae, RBS, UBS, and HSBC, to name a few banks.
- "***People":*** The Board's nomination committee is responsible for the quality of the people who work for the bank through succession planning and talent development and management. Too often the criteria used in recruiting, developing, and promoting people are technical. These do not reinforce the ethical behavior of managers in the middle of the business, nor do they reinforce the "tone at the top." Once the

importance of the "tone in the middle" is recognized in underpinning the "tone at the top," Boards must be concerned about recruitment policies at all levels in the bank, not just the top, since what matters most in employee engagement and productivity is the manager to whom the employee reports.[34]

In short, setting the "tone at the top" must be an integrative activity across all parts of the bank and at all levels, not just the top, taking into account "Purpose," "Principles," "Processes," "Power," and "People." It must be done by the Board together with the CEO and top management and cannot be left to the CEO alone. Only in this way can the industry begin to rebuild trust.

APPENDIX 3A

Board Questions Regarding the "Tone at the Top"

Tables 3A.1 through 3A.5 list questions Boards should ask regarding "Purpose," "Principles," "Process," "Power," and "People."

TABLE 3A.1 Questions Regarding "Purpose"

1. ***Current "Purpose"*** (***Why do we exist?***)
   a. Who are the recipients or customers of the organization?
   b. What impact, difference, change, benefit, or outcome to be observed will the company make in the lives of its customers?
   c. What will it cost to deliver such results to customers?
   d. What are the rates of return implied by such activity?
   e. What are the performance standards by which the organization's effectiveness is judged?
   f. Who are our stakeholders and how should we engage them?
2. ***Future "Purpose"*** (***What should we do?***)
   a. What justifies the change in or addition to the original purpose?
   b. Will we have the required skills, competencies, and resources to make the change?
   c. How does the change affect our risk appetite and risk exposure?
      i. Financially
      ii. Reputationally
   d. How will our key stakeholders react to the change and how will it affect our "license to operate"?
      i. How will our customers react?
      ii. How will our employees feel and what will they do?
      iii. How will the regulators view the change?
      iv. How will society regard us?
   e. What changes do we have to make to our processes and policies?
      i. Operationally
      ii. From a compliance perspective

TABLE 3A.1 Questions

- f. How will the change affect our culture, values, and behavior?
  - i. Will it create incompatible cultures?
  - ii. Will it create or be hampered by incompatible legacy effects?
  - iii. What effect will it have on rewards and recognition?
  - iv. What key performance indicators (KPIs)?
- g. How will the change affect our key people?
  - i. Relationships
  - ii. Career paths

TABLE 3A.2 Questions Regarding "Principles"

1. ***Do we have a clear statement of our values?***
   - a. Do our employees understand why these are our values?
   - b. Do our employees understand they are non-negotiable?
   - c. Are they used as an integral part of the recruitment process?
2. ***Do our values translate into observable behaviors***
   - a. Do these translate into measurable KPIs?
   - b. Are they used as part of the performance appraisal system?
     - i. For personal development
     - ii. For promotion
   - c. Is there a clear statement of desired behaviors and unacceptable behaviors?
   - d. How are desired behaviors rewarded and unacceptable behaviors sanctioned?
3. ***Do we have a clear code of conduct?***
   - a. How is it enforced?
     - i. Regardless of rank or business produced?
     - ii. Are exceptions made, and if so under what circumstances?
   - b. How often are employees trained in its use and in resolving any resulting dilemmas?
4. ***Do we have clear role models of desired behavior?***
   - a. How well do we know and understand the personal values and drivers of behavior in the top management team?
     - i. CEO?
     - ii. COO?
     - iii. CFO?
     - iv. CRO?
     - v. CIO?
     - vi. Heads of the lines of business?
   - b. Does the CEO live the values?
   - c. Does the top management team walk the walk and talk the talk?
   - d. Do we provide coaching and mentoring to ensure the values are lived?
   - e. Do we hire and promote on the basis of values?
   - f. Do we fire on the basis of values?
5. ***What procedures do we have to verify compliance?***
   - a. How effective are they?
   - b. Who is involved?

   c. What authority do they have?
   d. Who do they report to?
   e. How often are reviews undertaken?
      i. Internally
      ii. By independent third parties
   f. How can performance be improved?
6. ***How well does the "tone in the middle"[32] reflect the "tone at the top"?***
   a. How do superiors treat their subordinates?
   b. How confident are subordinates in the ethical behavior of their immediate superiors?
   c. How engaged are these subordinates?

TABLE 3A.3 Questions Regarding "Processes"

1. ***Are we staying within our agreed risk appetite?***
   a. Systemic risk?
   b. Business risk?
   c. Market risk?
   d. Operational risk?
   e. Value At Risk (VAR)?
   f. How effective are we at aggregating the risk across the bank and its lines of business?
2. ***If there has been a change in risk appetite, why?***
   a. What are the justifications for the change?
      i. What are the possible scenarios?
      ii. How could they impair the bank?
   b. What are the implications
      i. Short-term
      ii. Long-term
3. ***Do we have an orderly resolution process?***
   a. Under what circumstances would it apply?
   b. How would it work?
   c. How long would it take?
4. ***Are we focusing on the right performance drivers?***
   a. Is there too much emphasis on income and margin growth?
   b. How much attention is paid to the quality of the equity buffer?
   c. Are we meeting regulatory requirements?
      i. Levels of capital adequacy
      ii. Levels of leverage
      iii. Adhering to the "Know Your Customer" requirements
      iv. Adhering to sanctions requirements
      v. Adhering to AMLA and FATF[35] requirements
   d. Do our KPIs create an excessive short-term focus at the expense of the long-term sustainability of the bank?

TABLE 3A.3 (*Continued*)

e. Do our reward and recognition systems promote excessively risky behavior?
f. Do Risk Management and Compliance have enough authority or are they overruled by Sales?

TABLE 3A.4 Questions Regarding "Power"

1. ***Do we have a culture of high "power distance"?***
   a. Are decisions taken top down?
   b. Do subordinates wait to be told what to do?
      i. Do subordinates delegate upward to avoid accountability?
      ii. Is the decision-making bottleneck at the top?
      iii. Are subordinates expected to second-guess their superiors' desires and intentions?
      iv. Are communications on a need-to-know basis?
      v. Is information hoarded or shared?
   c. Is there a fear of failure?
      i. Mistakes are not forgiven or forgotten?
      ii. Is experimentation discouraged?
   d. Is there a culture of shooting the messenger?
2. ***Is unquestioning obedience regarded as a sign of loyalty?***
   a. Is dissent valued?
   b. Are providers of early warnings valued or punished?
   c. Is diversity of experience and opinion valued?
   d. Do people who rock the boat constructively advance in their careers?
3. ***How much do we value***
   a. Honest feedback?
   b. Harmony?
   c. Face-saving at the expense of making the right decision?
   d. Learning from mistakes?
   e. Exploration of alternative outcomes and scenarios?
4. ***Do we have effective early warning systems in place?***
   a. Can we tell whether we are deviating from our "Purpose"?
   b. Can we tell whether we are not true to our "Principles"?
   c. Can we tell whether we are not in compliance with our "Processes"?
   d. Can we tell whether we have problems with our "People"?
      i. Are we recruiting the right people?
      ii. Are we promoting the right people?
      iii. Are we terminating the right people?

TABLE 3A.5 Questions Regarding "People"

1. ***Is integrity a threshold criterion in recruitment?***
2. ***Do we have a robust succession plan for***
   a. CEO?
   b. C-suite?
   c. Other pivotal roles?
3. ***Do we have the right staffing levels to meet our strategic goals?***
   a. Currently
   b. Medium term
   c. Long-term
4. ***How do we know whether we are promoting the right people***
   a. With the right values?
   b. With the right skills?
   c. With the appropriate mix of experience and backgrounds to maximize the value of diversity?
      i. Gender
      ii. Nationality
      iii. Functional background
      iv. Industry background
      v. Lines of business
5. ***Are we promoting people at the right speed and giving them the right personal development plans***
   a. Are we moving people appropriately so that the experiences they acquire fit the needs of the business?
   b. Are we moving them too fast or too slow?
   c. Are they promoted based on merit?
6. ***Do we have a fair and transparent talent management system?***
7. ***Are our people suitably mobile***
   a. For national postings?
   b. For regional postings?
   c. For international postings?
8. ***How well do we know our key people personally?***
   a. How well do we understand what "makes them tick"?
   b. How well do we understand their values?
   c. How well do we understand how they will respond to pressure?
   d. How much do we trust them?
   e. How good are we at predicting how they will behave under different conditions?

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CHAPTER 4

Ethics in Finance

This chapter explores the impact of the four types of integrity: systemic integrity, market integrity, organizational integrity, and personal integrity on ethical decision making. Building on the previous chapter "Setting the 'Tone at the Top'" this chapter looks at ethical dilemmas through four separate, but interdependent lenses to provide people with universal tools to make ethical business decisions. It uses simple, practical, and easy to understand ethical concepts to guide thinking. It is not intended to be a deep discussion of moral philosophy.

Ethics in finance requires a holistic approach when dealing with the issues and dilemmas people in banks face every day. This is true of all businesses, but more so in finance for five reasons:

1. The interconnectedness of financial institutions creates contagion effects that jump from company to company and across borders easily and quickly. This does not happen in the same way in other sectors of the economy because of the uniquely fungible nature of finance and the speed with which financial markets become illiquid when there is a panic. This makes systemic integrity an overriding concern for regulators, as we learned in the Global Financial Crisis (GFC).
2. The importance of market integrity, which is essential if the right signals are to be given and if fair dealing is to be guaranteed.
3. The need for regulatory integrity, if market malpractices and failures are to be dealt with effectively.
4. The need for organizational integrity, built on ensuring there is an appropriate culture in place reinforced by effective compliance and appropriate controls. This is covered in Chapter 8: "Ensuring Organizational Integrity."
5. The importance of personal integrity lest the inevitable asymmetry of information between buyer and seller in financial services becomes the excuse for mis-selling and unfair dealing.

SYSTEMIC INTEGRITY

Before the Global Financial Crisis, it is fair to say that regulators focused mainly on micro-prudential risks—the risks being run by individual banks—rather than on macro-prudential risks—the risks posed by banks behaving collectively in ways that put the system at risk. Regulators assumed, wrongly as it turned out, that the industry could be trusted to look after its own interests.

The structure of the banking industry had changed in some fundamental ways since the last great financial crisis of the Great Depression:

- Investment banks ceased to be partnerships, so investment bankers were now taking risks with other people's money rather than their own and behaving less responsibly as a result.
- With the repeal of Glass-Steagall in the United States and the advent of universal banks developed in Europe, investment bankers had much more money to play with. Proprietary traders could now use the huge balance sheets of retail banks as the basis for leverage;
- Mergers and acquisitions created systemically important financial institutions (SIFIs) that were "too big to fail," and were able to use the implicit resulting taxpayer subsidy to compete unfairly with the smaller community and regional center banks, accelerating the trend toward consolidation.
- Globalization of financial services brought new players into the market, increasing the availability of short-term, volatile wholesale funds to finance the ballooning derivatives and structured products markets, which hardly existed before 2000.
- The rise of unregulated "shadow banking" created an unseen threat to the entire financial system, both by siphoning off funds from the regulated sectors and by undertaking activities that would not have been allowed by regulators, had they been supervising them.
- The increased interdependence of financial institutions (best illustrated by the risk to the entire financial system posed by AIG's difficulties and the knock-on effects of Lehman's bankruptcy), meant counterparty risk had become much more important because so much of the funding was based on wholesale money that could literally dry up overnight.
- The resulting fragmentation of the financial value/supply chain into specialists (assumed to be better value creators in their specific niches than generalist organizations that straddled the whole value creation process), may indeed have led to greater innovation and better value, but at the expense of nobody feeling responsible for the integrity of the value chain as a whole.

These changes would have crucial systemic implications and bring the importance of systemic integrity to the fore:

> *In the wake of what has happened to major companies like Lehman Brothers, AIG and Fortis, we [can] say that the roots of the credit crisis can be traced back to increasingly opaque supply chains that even bankers admitted they no longer understood.*
>
> *Bankrupt financial giants . . .[are] the inevitable results of an economic system that extends around the world and, in the process, ensures that risks are chopped into thin slices and then distributed between the different layers and players in the value chain. The final—if not always intended—consequence is that few people, if anyone, can understand or control the full extent of those risks.*[1]

I believe that the most important of the changes was the fragmentation of the value chain, leaving nobody in charge; nobody responsible for the integrity of the system as whole. Comparing the subprime model with that of the Grameen bank in Bangladesh makes the point forcefully. The success of the Grameen bank microfinance model depends on the following key factors:[2]

- Loans are only made for productive investments rather than for consumption.
- Women were chosen as the target borrowers because they have a much better track record than men in repaying loans they take out. In addition, they also use their profits to benefit the family as a whole.
- The women borrowers are carefully screened by the lenders who are fellow members of the community, who know the borrowers personally and so can vouch for their character. More important, the borrowers know the lenders and understand the social consequences of failing to repay their loans.
- The money raised by depositors stays in the community where it is raised rather than being siphoned off by the head office, to be lent elsewhere to people who have no connection with the depositors.
- Due diligence is baked into every stage of the system and there are serious social sanctions for failing to pay.

Compare the Grameen system just described with the subprime value chain shown in Figure 4.1.

The contrast with the subprime value chain shown in Figure 4.1 could not be starker. Mortgage brokers were incentivized to create mortgages without vouching for their quality. The originating banks did minimal risk management because the resulting mortgage-backed securities would either

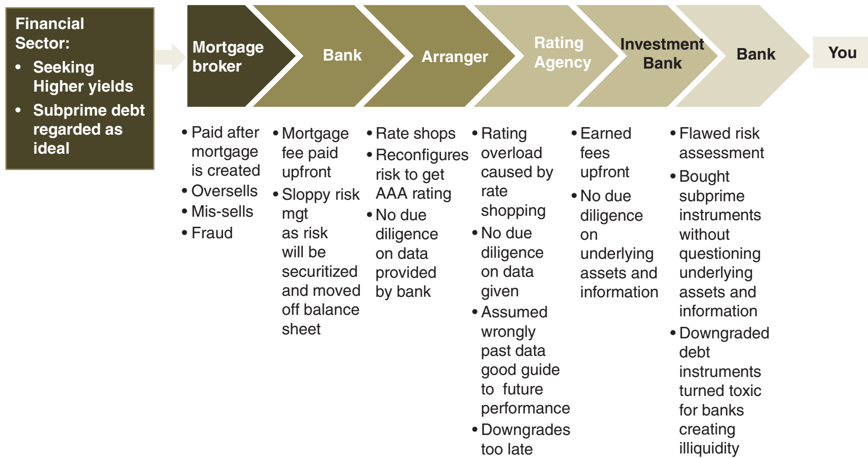

FIGURE 4.1 Failure of Systemic Integrity in the Subprime Value Chain
Source: J Zinkin, FIDE program, Ethics in Finance, June 2013.

be sold to third parties who would bear the consequences or be hidden off balance sheet so the regulators would not ask difficult questions about the asset quality. Arrangers would shop for rates between the credit rating agencies, putting them under pressure to lower their standards and reconfigure the tranches so that they would be converted into AAA. As the subprime boom built, the rating agencies were under increasing pressure to process applications as fast as possible. This pressure was made worse by rate shopping that created extra work and a conflict of interest, as the agencies were pressured to accept securities by issuers who paid them to rate them.

Even assuming the rating agencies resisted the temptation, their models were wrong because they were based on past data; much of the information they received had been structured so that they would achieve the required FICO scores to get past the analysts who were under time pressure. The investment banks were only interested in selling on the high-yielding securities and so did not take the time to do good due diligence, which, given the complexity of some of the CDOs, would have required a great deal of time to understand, let alone verify. The banks trusted the investment bankers and did not verify.

How did this happen?[3] It happened because nobody was responsible for the integrity of the system. The borrowers did not know the lenders, so they did not care whether they did not tell the truth to get the mortgage and then failed to pay. There were no social sanctions for defaulting on mortgage payments. The brokers were only interested in their commissions and were being encouraged by companies like Countrywide Financial and Ameriquest to create more mortgages, so they were happy to pass the responsibility on

to the banks. The banks knew they would be rid of the problem as soon as the arranger repackaged the mortgages into mortgage-backed securities. The arranger got the rating agencies to grant them AAA and then passed the poison pill on to the investment banks, which passed it on to the banks.

The resulting collapse was made much worse because of the nature of the structured products, as Sheila Bair, the then head of the FDIC, explains:

> *Most mortgage securitizations were set up to provide the senior tranche—the triple-A portion of the securitization—with substantial overcollateralization. What that meant was that if a mortgage defaulted, it had no impact whatsoever on the senior tranche—unless the defaulting mortgages exceeded 20 to 30 percent of the mortgage pool. However, here is the catch: because of the way in which many securitization documents were written, if, instead of a foreclosure sale, the loan was modified, the reduced mortgage payments flowed through to all the investors in the securitization pool, meaning that everyone's income was reduced, including that of triple-A investors.*
>
> *So what would you do if you were a triple-A investor? If a loan becomes delinquent and the servicer modifies it with a 30 percent payment reduction, your portion of the payment flows from that mortgage will be reduced along with all the other bond holders. If, however, the servicer simply forecloses on the loan, even if the losses on foreclosure amount to 50 percent, you will still prefer the foreclosure because that entire loss will be absorbed by the lower tranches. From the standpoint of the triple-A bondholders, it makes more sense to foreclose. And the triple-A bondholders were more numerous and more powerful than investors holding the subordinate tranches.*[4]

Actions that made sense at the micro-prudential level were profoundly damaging at the macro-prudential level, creating a near total systemic failure. We learned the hard way that we were after all "our brother's keeper"[5] and that systemic integrity is everyone's business.

MARKET INTEGRITY

Financial market integrity has proved to be somewhat of a mirage. Believers in *unfettered* free markets' ability to make sensible and ethical decisions, like Alan Greenspan, have had to recognize that they were wrong, and markets do in fact need to be regulated. There is an argument that this is the result of turbo-charged capitalism and the fact that finance has become so divorced from the real economy it was supposed to serve. Derivatives trading has

been the driver of much of the growth by creating contracts that were many times larger than the underlying instruments. Whereas, in the past, economists saw this as a benefit by spreading risk, recent thinking concludes the opposite because of the excessive emphasis on short-term results, which synthetic derivatives, by their very nature and duration, promote.

> *Hyperactivity also reverberates through the corporate sector, shortening boards' planning horizons for projects and shareholder value.... The scale of financial activity and the intensity of secondary trading indicate that financial markets are in a state of what might be described as "expanding disequilibrium."*[6]

Two other changes in the course of my lifetime have affected the workings of the market: a change in the level of expected normal returns by investors and the creation of a world where the three fundamental pillars of Protestant capitalism have been eroded.

When I was studying finance at the London Business School in 1969 (in the days before the Capital Asset Pricing Model, the Efficient Markets Hypothesis, and Milton Friedman's article in 1972 arguing that business existed to maximize profits became the received wisdom), the expected rate of return investors were looking for was estimated to be the risk free rate plus three or four percent to cover for the risk of holding equity. This translated at that time into somewhere between 7 and 8 percent per annum. Today, this would presumably translate to somewhere between 4 and 5 percent per annum, given the quantitative easing being carried out by the U.S. Federal Reserve, the Bank of England, the European Central Bank, and now the Bank of Japan. Yet shareholders and pension fund managers have been expecting returns on equity in the high teens and early twenties ever since businessmen were persuaded that the purpose of business was to maximize shareholder returns, rather than creating and maintaining satisfied customers.

This higher expected rate of return has forced businesses and the bankers who serve them to look for higher yield and often people have forgotten that to create higher yields, the financial engineers have to structure products that are inherently riskier to justify those yields. They have done this by creating synthetic derivatives that have become bets on bets. They have moved finance away from the real economy it was supposed to serve into a world of its own that creates little social or economic value for much of what it does. In this rarefied atmosphere of bets, transactions are win-lose deals, as opposed to those that serve the real economy where win-win is a common and desired outcome. As a result, it should not really be a surprise that ethical considerations take a back seat—the trade or doing the deal is all that matters regardless of its impact on people's lives.

The second change is the erosion of the three pillars of Protestant capitalism developed in Geneva in the seventeenth century. These were deferred gratification. mutuality; and trust:

1. *The end of deferred gratification:* The advent of the credit card and the invention of securitization meant that we no longer have to defer gratification, which was the mainspring for investing, as opposed to speculating. Investments were designed to create a better future and people lived according to the maxim that "anything worth having is worth waiting for." However, when NatWest Bank launched its Access credit card in the United Kingdom in the mid-1960s, its tagline was "We take the waiting out of wanting!" Securitization had much the same effect for businesses. This is not to say that these two inventions are bad—just that they changed some of our fundamental behavioral assumptions that reinforced the short-termism of investors. Immediate gratification became acceptable, whereas in the past it had been rather frowned on. The world of 24/7 news and finance made it all seem so natural that nobody questioned a fundamental shift in our assumptions about how to live and what levels of debt were acceptable.
2. *The end of mutuality:* Mutuality is a fundamental tenet in all ethical codes. Christians have "Do unto others as you would have them do unto you."[7] Confucians have "What you do not want done to yourself, do not do to others."[8] So do Hindus, Buddhists, and Taoists. Jews have "Love your neighbor as yourself."[9] Mutuality lies at the heart of Islamic concepts of insurance and also explains why risk sharing is the route chosen in Islamic finance as opposed to the Western concept of risk transfer.

   The concept of mutuality underpins all long-term relationships individuals have with each other. Perhaps still more important, it is essential if systemic integrity is to be preserved. Yet, as the subprime crisis demonstrated only too clearly, there was no mutuality in the way each person in the supply chain behaved. They were not in the slightest interested in the problems they were creating for people down the supply/value chain.[10] They were all involved in a gigantic scheme of musical chairs in which each player passed the problem on to the next player until the music stopped, when the whole house of cards came tumbling down. It was the "Greater Fool Theory" of finance[11] in action with a vengeance.
3. *The Decline in Trust:* When I was growing up in the United Kingdom, bank managers were among the most trusted members of the community. They were like honorary uncles, invited to children's birthday parties; they gave advice; and they often took the view that what their client wanted to do was unwise, and exercised their discretion to

refuse to do business on the grounds it would not be sensible for the client to undertake the transaction. Bank managers might sometimes be snobbish and difficult to get to, but most people believed that most of the time they had their clients' best interests at heart. Yet by 2011, five out six people in the United Kingdom and three out of four in the United States no longer trusted banks "to do the right thing," according to the Edelman Global Trust Barometer's findings.

Part of what has happened is that the sort of person who went into banking has changed. In the "good old days" when banking was boring, respectable and perhaps rather dull, people became bank managers because that is what bank managers were expected to be. However, with the advent of the graduate MBAs who were attracted by the lifestyle depicted in *Liars Poker* or *Bonfire of the Vanities*, perhaps there are now more people in banking "whose intellect trumps their ethical sense" to use Lord Lawson's phrase.[12]

As a result, it may take a long time for the market to recover its integrity because that depends on changing how the market works. This will be caused by changes in the behavior of individuals and organizations, which will be a slow process resulting from stepped-up enforcement and prosecution of market manipulators. It will depend on what type of person banks choose to continue recruiting and promoting; and it will also depend on what the regulators do to make good the ethical shortfalls of underregulated players who did not understand the importance of systemic integrity. As a result, there is a need to think more about regulatory integrity, if we are to preserve systemic integrity.

REGULATORY INTEGRITY

Regulatory integrity depends on several factors:

- Having truly independent regulators who can draft appropriate laws without being constrained by the political lobbyists of the banks.
- Being sufficiently independent that they are able to enforce regulations without fear or favor, including demanding and getting custodial sentences for malfeasance.
- Having adequate levels of sufficiently qualified staff who understand what the market players are trying to do.
- Being able to draft effective regulations that are an appropriate combination of rules-based and principles-based thinking.
- Having the personal integrity to be incorruptible servants of the public at large whom they are supposed to protect from the vagaries of the market and the malpractices of market participants.

TABLE 4.1 Attitudes of Universalists and Particularists Compared

Universalists	Particularists
1. What is good and right can be defined and always applies. 2. No exceptions to the rules. Similar treatment for all in the same category. 3. Level playing field. 4. Use legal proceedings to ensure promises are kept. 5. Rules only apply within categories; exceptions apply outside categories.	1. Attention given to the obligations of relationships and special circumstances. 2. Waivers to rules granted because exceptional circumstances always exist. 3. Handicaps. 4. Personal relationship is the basis for keeping promises. 5. Must sustain, protect, or discount this personal relationship no matter what the rules say.

- Last and not least, having the appropriate regulatory architecture to ensure that there are no overlaps with destructive turf wars as a result of "underlaps" where whole sectors of financial services are unregulated.

It is not my purpose to discuss regulatory issues, as this book's focus is on what Boards and the top management teams of banks can do to regain the trust they have squandered. Consequently, I will say no more on the subject, other than to comment that regulatory integrity is a vital pillar in the system. I will, however, explore briefly some issues with regulation and the merits and demerits of rules-based versus principles-based regulations.

In his work on culture, Fons Trompenaars classified people as being either Universalists or Particularists.[13] Table 4.1 compares and contrasts the attitudes of these two groups to rules and regulations.

Clearly there is a big difference in the worldviews of the two groups that must be reconciled somehow if regulations can be made to apply to both.

This brings me to the issue of which is better: rules-based or principles-based regulation? I believe we need both, because each has its merits and demerits, as shown in Table 4.2.

Regulatory integrity will help build a strong ethical framework for banks, as long as we have a regulatory infrastructure that:

1. Satisfies the criteria of true independence in the formulation of regulations and in their enforcement.
2. Employs suitably qualified, incorruptible staff who understand how the market works and how its players will try to game the system.
3. Takes into account the different reactions to regulation of Universalists and Particularists.
4. Reconciles rules and principles based regulation.

TABLE 4.2 Principles-Based and Rules-Based Regulation Compared

Principles-Based Regulation	Rules-Based Regulation
1. Addresses the "Why" question.	1. Addresses the "What" question.
2. What is permitted is sometimes unclear.	2. What is permitted and what is not is made clear.
3. Substance above form.	3. Risk of form over substance.
4. Requires exercise of judgment above all.	4. Requires checking off boxes rather than exercising judgment.
5. Carries the risk of poor execution because of insufficient detailed direction on How to implement.	5. Carries the risk of "breaking the law legally" to get round the spirit of the law by focusing on the wording.

Source: J Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur, April 2013.

Figure 4.2 shows the interrelationship between these four elements and the importance of integrating them into one coherent ethical framework. Systemic integrity provides the overarching guarantee that the system as a whole will work as expected. It depends on the foundation of personal integrity, in turn flanked on either side by regulatory integrity and organization integrity, and assumes market integrity and the effective workings of regulatory integrity to make good the shortcomings of market and personal integrity to protect systemic integrity.

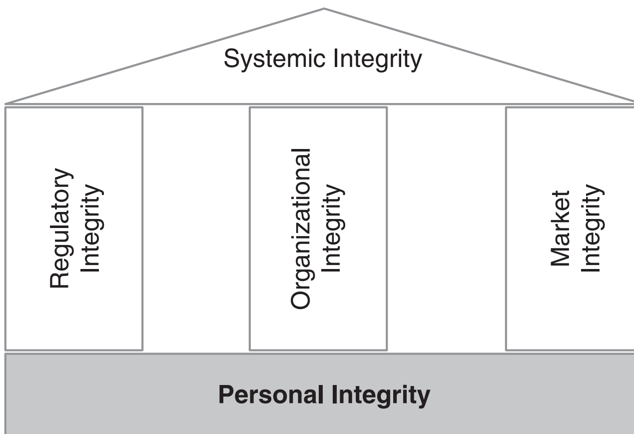

FIGURE 4.2 Ethics in Finance: An Integrated Approach
Source: J Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur, April 2013.

ORGANIZATIONAL INTEGRITY

In the long run, this depends on having an ethical vision and mission that is socially acceptable. It is reinforced by management and the Board, ensuring that there is an appropriate culture, protected by effective systems of compliance and control to prevent inappropriate behavior putting the organization at risk. Chapter 8, "Ensuring Organizational Integrity," covers this in detail.

PERSONAL INTEGRITY

Integrity is about knowing where to draw the line. It is more than honesty, because it requires looking at the bigger picture, as opposed to merely telling the truth and causing pain for no purpose. Integrity requires proactivity, as opposed to merely abstaining from undesirable activity. Integrity requires loyalty and obedience with a clear conscience, which may occasionally entail resignation or disobedience and disloyalty when there is a fundamental disagreement over purpose and values. Consequently, personal integrity requires reconciling a sense of belonging with a sense of moral autonomy, taking into account other people and one's social roles.

Having integrity is not the same as being a "Person of Integrity" who wears integrity as a badge in public, where every challenge to opinions is taken as a moral challenge, implying a lack of integrity in the challenger:

> *The Person of Integrity proclaims principles, to which he or she may be ruthlessly obedient, but the odd thing about principles is the fact that the more general they are, the more they admit interpretation and exceptions. And so, not surprisingly, whatever is in his or her best interest turns out to be the "right" thing to be backed by absolute principle. The Person of Integrity is impossible to argue with, dangerous to disagree with, and as unpredictable as the opportunist or the chameleon. Whereas the opportunist and the chameleon shift with the winds and the situation, the Person of Integrity pretends to be the moral rock around which the rest of the earth revolves, while nevertheless serving only his or her own demands.*
>
> *Integrity requires willingness to negotiate and to compromise as well as conviction and commitment. The idea that integrity means being closed to outside influences and temptations as opposed to open to others is a grotesque and dangerous misunderstanding. . . . Integrity involves openness and affection and flexibility, and not surprisingly, an organization or corporation that has integrity will be one that is composed of open-minded, independent, but cooperative and caring individuals, not rigid, self-righteous clones.*

> *Integrity involves principles and policies, to be sure, but it also involves a pervasive sense of social context. Otherwise it becomes mere self-righteousness, not virtue at all.*[14]

I would agree with the argument that some of the values that form the basis of personal integrity have weakened in the past 60 or so years:

> *Firms whose managers act on the principle that employees are self-interested opportunists who must be forced to do their job will tend to create just that. Conversely a company that functions on the basis of trust and co-operation creates a system in which honest, co-operative people flourish. Self-fulfilling prophecy makes every company a force for either good or ill.*
>
> *Since the 1980s, the assumptions baked into the management model are the pessimistic ones. In the crash of 2008 we can see where the template based on them (incentives, compliance with letter rather than spirit, rejection of ethical considerations) leads. If the 21st century that management makes possible is to end happily, managers will have to absorb its most important lesson from the 20th: what matters most in management is not what you make but what you believe.*[15]

This assessment jives well with the thinking of the late Sumantra Ghoshal, who argued that business schools were responsible for promulgating an entirely wrong set of values[16] so that the initials MBA may have come to stand for "Morally Bankrupt Agent" and business ethics are treated as an oxymoron. It also shows that we still have made little progress in recognizing the fundamental importance of ethics in business, and especially in finance, since 2005, when he wrote his paper criticizing business schools.

Part of this is the result of the tendency of economists and business schools to depersonalize business and finance and lump all companies and sources of capital together as economic abstractions of which *the market* is the biggest and most impersonal. This is to exclude our own free will and the choices we make as individuals every day at work. It is also the problem of the legal basis on which corporations are established. The fact that they are a "legal fiction" defined in terms of obligations to shareholders implies that corporations are not moral agencies or at best have morally ambiguous responsibilities for employees and customers.[17] If we combine this amoral concept of the firm with the aggressive and militaristic metaphors and language used when promoting competitiveness, the other underlying assumption about how firms do business, we are likely to create the wrong "tone at the top" and "tone in the middle."

What has caused this? I agree with Sumantra Ghoshal, Jim Kouzes and Barry Posner,[18] and Daniel Pink[19] that it is in part the result of invalid

assumptions about what motivates people. I believe that businesses need to treat people with respect; to reward and recognize people rather than compensating them for coming to work; to provide people with a "line of sight" so that every job matters; and to recognize that money and bonuses are not everything.[20] I think it is worth quoting Robert Solomon on the impact on behavior of how we think about business:

> *How we do business—and what business does to us—has everything to do with how we think about business, talk about business, conceive of business, practice business. If we think, talk, conceive, and practice business as a ruthless, cutthroat, dog-eat-dog activity, then that, of course, is what it will become. And so, too, it is what we will become, no matter how often (in our off hours and personal lives) we insist otherwise. If, on the other hand, business is conceived—as it often has been conceived—as an enterprise based on trust and mutual benefits, an enterprise for civilized, virtuous people, then that in turn, will be equally self-fulfilling. It will also be much more amiable, secure, enjoyable, and last, but not least, profitable.*[21]

This brings me back to the importance of intrinsic motivators discussed in the previous chapter. Islam, for example, regards work well done as an act of worship (*Ibadah*) and Aristotle wrote thousands of years ago, "Pleasure in the job puts perfection in the work."[22] These ancient insights recognize the value of intrinsic motivators, which seem to have been forgotten in banking as a result of excessive focus on short-term deals or trades and unrealistic expectations of sustainable returns in banking by investors. The aggressive, violent language used on so many trading floors, described in *F.I.A.S.C.O*,[23] has not helped.

Choosing between right and wrong poses little difficulty, if it is an obvious black-and-white choice.

The real problem with ethics and personal integrity lies in the so-called grey areas where we are forced to choose between two rights or two wrongs. And how we make these choices is not so obvious because they depend on two different approaches to ethics, which I will call "duty-based ethics" and "consequential ethics" for simplicity. They are also affected by our cultural norms, beliefs, and values, and where we are in the organization, which makes ethics situational.

Duty-Based Ethics versus Consequential Ethics

Table 4.3 compares, in a simplified way, duty-based ethics with consequential ethics as ways of deciding what to do.

Table 4.4 compares the relative merits of each approach.

TABLE 4.3 Duty-Based and Consequential Ethics Compared

Duty-Based Ethics[24]	Consequential Ethics[25]
1. Do the right thing because it is the right thing to do. 2. Don't do wrong, because it is wrong. 3. Doing right has priority over doing good. 4. If an act is in violation of doing right, it should not be undertaken, regardless of the good it could do.	1. Whether an act is right or wrong depends only on the results of that act. 2. The more good consequences an act produces, the better or more right that act. 3. A person should choose the action that maximizes good consequences. 4. People should maximize good consequences.

Source: John Zinkin, FIDE: "Ethics in Finance" module, Iclif Leadership and Governance Centre, Kuala Lumpur, 2012
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TABLE 4.4 Relative Merits of Each Approach

Duty-Based Ethics[26]	Consequential Ethics[27]
Advantages 1. It is a straightforward system with clear, unambiguous commandments. 2. It applies in all circumstances regardless of: a. Context. b. Outcome. 3. It is fair because it treats all people the same. 4. It is easy to teach. 5. In principle it is easy to apply. 6. What should be done is predictable. Drawbacks 1. It ignores context and outcomes. 2. How can we justify doing right when it leads to a bad outcome? 3. It can create serious cognitive dissonance as a result. 4. It can undermine the very principles it sets out to promote.	Advantages 1. It is flexible. 2. It takes into account context. 3. It allows for exceptions to the rule, based on consequences. 4. It focuses on outcomes and results: the more good outcomes, the better. Drawbacks 1. It is difficult to apply in practice. 2. Every act must be assessed on its merits. 3. We must understand the consequences correctly before we can make a choice. 4. Research required to do this may be costly. 5. Time to make decisions may be too long. 6. May be bad for society as a whole: a. Outcomes are unpredictable. b. May destroy trust because of biased decision-making. c. Who decides how to assess the outcomes? d. Outcomes may be regarded as unfair.

Source: J. Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur, April 2013.
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Ethics Are Situational

How we, as individuals, will reconcile the apparent conflict between duty-based and consequential ethics will depend on four factors:

1. Who is affected by the consequences?

   A simple example of an ethical dilemma makes the point well—it is a variant of the famous "Trolley Case" first proposed by the British philosopher Philippa Foot in 1967.[28]

   Imagine you are standing by the switch on the trolley track and a trolley car comes careering toward you totally out of control. You are in charge of the switch, determining whether the trolley car will go to the left or to the right.

   You must choose. If the trolley car goes to the left, it will kill one person; if it goes to the right, it will kill five people. How do you decide what to do? I would guess you calculate the consequent loss of life and choose to send the trolley car to the left, killing only one person, instead of five. However, supposing that one person is a child with a great future ahead of her and the other five people are very old and sick, would that change your mind? What if the person on the left was your husband, your wife, your child, or one of your parents and the other five people were total strangers? Would you still make the same decision on the grounds that only one life would be lost as opposed to five?

   All religions teach the equal sanctity of life in the eyes of God, so presumably one versus five should win because it is the right thing to do. Yet, based on my experience of teaching this case, I am willing to bet that you would choose to send the trolley to the right and kill five people if the one person on the left hand track was a close relative. You would justify this on the grounds that we have a duty to look after family first; and society and the law would accept that argument.

   Then there is the famous "Heart Transplant Case."[29] Imagine you are the administrator of a hospital and you are responsible for administering the organ donation program. A billionaire who needs an urgent heart transplant approaches you with the following offer: If you allow her to jump to the head of the line and replace an ordinary office worker (with a wife and two children) who has been waiting for the transplant heart that has just arrived, she will donate enough money to finance 50 dialysis machines and pay for 500 hip operations. You know that if you allow the billionaire to jump the line, the office worker will die. What do you do and how do you justify your actions? Would it make a difference if the office worker was unmarried and had no children?

Whenever I have discussed this case, most people will not take the deal because they feel it is wrong to cause the death of the office worker and it creates an unfair society where only money matters, in violation of religious teachings that we are all equal in the eyes of God. Yet there is a substantial minority (15 to 25 percent) who will argue in favor of taking the billionaire's offer on the following grounds:

a. Look at the good the deal does: 500 people will have better lives because of the hip operations and thousands can live nearly normal lives because of the dialysis treatment.
b. The billionaire is obviously more valuable to society than the office worker.
c. You cannot be sure that the office worker will in fact die, as maybe another heart will arrive in time.

Perhaps the problem with their argument is that it turns the hospital administrator into a proxy for God. Also, it is not a big step from thinking like this to deciding that some human beings are less worth looking after than others.

Once we discriminate between different types of people, it is a slippery slope that can all too easily lead to arguing for eugenics and even genocide. That is precisely the value of duty-based ethics—it allows us to draw a line we should not cross.

What about a relative who has made a living will, clearly indicating that if anything really serious happens, she should not be resuscitated but allowed to die with dignity? What do you do when that person for whom you care very much has a serious stroke and the doctors say there is a 50:50 chance of recovery if she is put on life support? Do you listen to the doctors or to the wishes of the patient?

2. What impact has the language used around us had on how we think?

Metaphors matter. They create associations of ideas that go beyond the words we use. And so it is unfortunate that the modern metaphors used in business are so violent and devoid of ethical content. We hear the phrase "It's not personal, it's just business," all the time in gangster movies, as a justification for a grisly act. Using jungles and evolutionary competition as analogies are inappropriate since above all business needs rules and fair dealing if it is to be sustained. Cooperating is more appropriate than "every man for himself" for business success, despite the popularity of reality shows like *The Apprentice*, which glorifies appalling behavior as the way to the top.

"Business is war."[30] If this is really the case it should worry us greatly for three reasons:

a. First, customers are not territory to be conquered, occupied, and plundered. Perhaps one of the reasons why banks appear to have lost

their customer-centricity is that in the battle for market share they forgot what the objective was: not conquest and pillage but customer loyalty, achieved through customer satisfaction as opposed to brute force or capture through "sticky" CRM systems.

b. Military perspectives and military language and thinking are nationalistic, alarmist, pessimistic, conservative, and authoritarian.[31] None of which is good for innovation and creativity. Worse still, they reinforce the win-lose mind-set of traders, justifying extending win-lose thinking from trading to situations that are win-win in regular retail banking, where banks do well when their customers do well.
c. Competition is not only about knocking out the other man, nor is it about winning the whole market for oneself. As Supreme Court Justice Louis Brandeis put it, "Competition consists in trying to do things better than someone else; that is, making or selling a better article at a lesser cost, or otherwise giving better service. It is not a competition to resort to the methods of the prize ring, and simply 'knock the other man out.' That is killing a competitor."[32] As Robert Solomon points out, no business succeeds by simply eliminating competitors. Too often they become unresponsive to changing customer needs or the market has moved on. The bitterest battles in business end up as lose-lose, while the greatest success stories are not war stories at all.

"An Efficient Money-Making Machine" is an even more dehumanizing metaphor than business as war or a jungle. The business world ceases to be a place where human aspirations can thrive and be rewarded and has become a place of interchangeable parts, where trust is a lubricant and people are less reliable than robots or software programs that replace them. This industrial-mechanical approach to business focuses on control—the antithesis of creativity and autonomy, which are such important intrinsic motivators, as discussed in the previous chapter. If we combine this dehumanizing mechanistic terminology with the abstract concepts of game theory and the fact that so much of finance is disembodied and far removed from flesh and blood activities of people at work, it is hardly surprising that many investment managers and traders are unable to appreciate the effects of their speculative activities in synthetic derivatives on the real world and the suffering they can create. It is only natural that they should come to think of finance as a kind of computer game where anything goes, as Lord Turner put it in his final testimony to the UK Parliamentary Committee on Banking Standards.[33]

3. Where we are in the organization:

    Ethical dilemmas look different from the top of the organization and from the middle. This why "tone at the top" must take into account "tone in the middle." The concept of compliance makes perfect sense to people at the top of the organization because it is about protecting the organization from itself to ensure there are no breaches of the law, of the organization's code of conduct. Yet for compliance to work, it is critical that breaches lower down in the organization be escalated upward. While this seems eminently uncontroversial when seen from the top, it may feel quite different lower down.

    Escalating breaches of codes of conduct or reporting malpractices in the lower reaches of the bank means making profoundly difficult personal choices that affect real people with whom one has to work every day. This can lead to being ostracized by your peers; being labeled as troublemaker by your immediate superiors; and is often a career limiting move. How many whistle blowers get promoted or get another job?

    We forget at our peril that in every culture the idea of "snitching" is frowned on. Parents bring their children up not to tell tales. The best case made against snitching is Lieutenant Colonel Frank Slade's impassioned defense (brilliantly enacted by Al Pacino) of Charlie in the 1992 film *Scent of a Woman*.[34] Yet we expect people to be comfortable with the idea of escalating misdemeanors and in effect snitching on the people they work with every day to protect abstract concepts like the ethical reputation of the bank that seem to be only of interest to the top management, every now and again. We should not really be surprised that failures of compliance are so frequent when everybody at lower levels knows what is going on. It makes it all the more important that the Board follows Ronald Reagan's dictum: "Trust but verify," as I argued in the previous chapter.

4. Impact of cultural differences on how we think:

    There are a few global norms we all share regardless of culture, shown in Table 4.5.

    Despite the fact that "when in Rome we should do as the Romans do," a simple test that I call the "Manifesto Test" will show that actually, deep down, we all approve of the behaviors on the left and disapprove of the behaviors on the right in Table 4.5.

    Just ask yourself whether you would vote for a politician who promised to do more of the behaviors on the right. The answer is no, regardless of culture or political system. Then ask yourself the same question regarding a politician who promised to do more of

TABLE 4.5 The Manifesto Test

Positive Behaviors	Negative Behaviors
1. Truth	1. Lying
2. Freedom	2. Cheating
3. Reverence for life	3. Corruption
4. Trust	4. Bribery
5. Loyalty	5. Self-dealing
6. Obeying the law	6. Insider trading
7. Keeping employees out of harm's way	7. Market manipulation
8. Transparent disclosure of financials	

Source: John Zinkin, *FIDE: Ethics in Finance Module,* Iclif Leadership and Governance Centre, Kuala Lumpur, Malaysia, 2012.

the behaviors on the left. Even if you did not believe the promises, I suspect you would vote for that politician. There are many other behaviors I could cite, like "Loving one's parents" on the good side of the ledger and "Molesting children" on the bad side of the ledger, but these seem to me to be the most relevant ones in a book on leadership and governance. However, that does not mean that there are not some genuine grey areas, which make it difficult for individuals at work to determine what is right.

I explore two cases where cultural differences do have an impact on governance-related matters. I examine these cases through the lenses of traditional Confucian concepts and western concepts of corporate governance to pinpoint the ethical dilemmas they create (see Table 4.6 and Table 4.7):

1. Trust
2. Filial conduct

These two examples are not meant to be exhaustive. Their purpose is to show that cultural origins do make a difference to individuals as they try to frame the issue of what is the right or wrong thing to do. They also bring our attention to the fact that benefits of right behavior are long-term, somewhat abstract and diffuse, spread across many people, whereas the harm done to the perpetrators by "doing the right thing" is immediate, direct, and personal. It should therefore not come as a surprise that people lower down in the ranks in banks often find it very difficult to behave in the ways that good corporate governance and banks' codes of conduct demand. What looks and feels right, when seen in general terms from a distance at the top of the

TABLE 4.6 Implications of Trust (Xin)[35]

The Facts of the Case	Is this the right thing to do?
In a tender for the purchase of cables, Chung finds out that senior executives who had been with the company for more than 10 years in the purchasing department regularly released confidential information to favored suppliers over the mahjongg tables when playing socially with them. Chung, who is new, only learns about this practice when he begins lunching with them and is taken into their confidence. He feels very uncomfortable after learning about this practice. Since he is now "one of the boys," he decides not to blow the whistle as it would be betraying the confidence of senior colleagues.	**The Confucian and relational viewpoint:** From a traditional Confucian perspective, Chung is doing the right thing because he is not betraying the trust his new colleagues have placed in him. **The corporate governance perspective:** Chung is doing absolutely the wrong thing by most corporate codes of conduct. However, this needs to be qualified by the fact that every culture disapproves of snitching, so his discomfort and ambivalence is doubly understandable. *The dilemma is between to whom trust should be accorded: the organization or Chung's colleagues? It is made more acute by the fact the good created by reporting the misbehavior is abstract and long-term, whereas the harm to his colleagues is immediate and personal.* *Perhaps considerations of this kind explain why trader misbehavior over LIBOR fixing was not reported upward in Barclays and UBS.*

bank or through regulatory eyes, feels quite different in the middle or the bottom of the bank, when colleagues with whom one works every day are affected directly.

FOUR ETHICAL LENSES

Having recognized that ethical decisions sometimes create difficult dilemmas as competing principles and values color the decision frame, there is nevertheless an approach that can be used to reconcile the various issues to arrive at "Right-Good" decisions. It is a four-stage process, using four different ethical lenses one after the other as follows:

1. Test 1: The Effectiveness Test—does it achieve what we want?
2. Test 2: The Predictability Test—does it violate our values, principles, and policies as an organization?

TABLE 4.7 Implications of Filial Conduct (Xiao)[36]

The Facts of the Case	Is this the right thing to do?
One of the instructions given to Meng by his boss was to "ensure the quarterly business report looks good when presented to the board of directors." Meng had always been on good terms with his boss. He realized his advancement in the company was highly dependent on his boss's evaluation of his performance. In this case, Meng and his boss are aware that inclusion of the latest research-based statistics in the report would definitely cast doubt on the viability and continuity of the joint venture project. After much thought Meng decides to omit the statistics provided by a private consultant, knowing that in so doing, he would be able to present a positive business report.	**The Confucian and relational viewpoint:** From a traditional Confucian perspective, Meng is doing the right thing because he is making his boss look good. In many high "power distance" cultures this might also be regarded as the right thing to do. **The corporate governance perspective:** Meng is doing absolutely the wrong thing by most corporate codes of governance with their emphasis on transparency and full disclosure. It is also bad business practice in that it denies top management the opportunity to put things right before it may be too late. *The dilemma here is between looking after one's immediate boss and one's career as a result; and looking after the long-term interests of the company by ensuring transparency and timely reporting of potential problems. There is also a question of materiality if the problem is not material; perhaps Meng believes the truth can wait one quarter?* *Perhaps considerations of this kind go some way to explaining why Jamie Dimon did not appreciate early enough what was happening in London with the "London Whale" dynamic hedges that finally cost JP Morgan US$6.2 billion in losses, so that he initially dismissed them as "a tempest in a teapot."* [37]

3. Test 3: The Mutuality Test—does society allow it?
4. Test 4: The Self-Image Test—what do you say to your eight-year-old daughter?

Test 1: The Effectiveness Test

This is a variant of Machiavelli's approach to ethics. Essentially the question being asked is "Will we get the results we want by doing this?" It is purely results oriented and if that is all that is asked, it will foster a rotten culture where the ends always justify the means—exactly the kind of culture that is any regulator's nightmare.

However, it is a legitimate starting point. If we will not get the results we desire, why even consider doing it? So it has value as ground zero. Assuming the answer to the question is affirmative, we move to the second test.

Test 2: The Predictability Test

This is a variant of the Kantian rules-based approach to ethics. Having established with the first test that we can expect to achieve the desired outcomes, the next questions to answer will be "Are we violating our values, policies, and procedures as an organization?" If the answer is negative, then it is fine to proceed. If, however, we violate values, policies, and procedures, then we should stop because any organization that is comfortable doing this will be at the mercy of different, contradictory individual interpretations in different situations and over time.

Test 3: The Mutuality Test

This is a variant of Rousseau's Social Contract ethics. Essentially it answers the question "Will this strengthen our long-term "license to operate"?" If society is happy with what we are proposing, then we can go ahead to the last test. If, however, society frowns on what we are proposing, we need to proceed with care. It may still be legal, but our freedom to operate could be severely constrained, as has happened with tobacco companies, and seems to be happening with certain kinds of synthetic derivatives, which have been regarded as undesirable by the regulators, unless they are traded through exchanges rather than over the counter. If society disapproves strongly enough, then we can expect it to be made illegal, as happened in Switzerland on March 3, 2013, when Swiss voters overwhelmingly approved a referendum to curb senior executive pay and to outlaw "golden hellos" and "golden parachutes."[38]

Test 4: The Self-Image Test

This is pure personal ethics—how you feel about what you are proposing to do. Some people call this the "smell test," others the "news headline test"—how would it look if it appeared in tomorrow's papers? Still others ask the question "Could you sleep at night after deciding to so this?" or call it the "Look at yourself in the mirror" test. Personally I prefer the question "What would you tell your-eight-year-old daughter?" because children have an amazing way of cutting to the chase and ignoring the PR and rationalizations that adults find convincing.

Despite the considerable complexities any individual faces when making ethical decisions, I believe the four-stage test will help people arrive at "Right-Good" decisions because it takes into account the need for:

- Results.
- Predictability.
- Social acceptance.
- Being able to sleep at night.

CONCLUSION

Regulators will need to find new ways to make banks consider the systemic implications of actions that make perfect economic sense as individual organizations, but which in aggregate will cause a financial "Tragedy of the Commons."

Unfortunately, market integrity has proved to be problematic. Experience suggests that it will take time to recover market integrity as this will demand changes in laws, regulations, the way banks operate, and who they have as their leaders.

The burden to make good failings in market integrity falls on regulators who must be independent and able to enforce regulations without fear or favor. Regulators will also need to find the right balance to create the right regulations that reconcile rules-based with principles-based regulations in the never-ending struggle to prevent market players from gaming the system.

Finally, personal ethical decisions are never as easy as we think. There are often grey areas to cloud our judgment. As individuals we need to take into account the conflicting guidance of duty-based and consequential ethics. The four-stage set of tests that combine effectiveness, predictability, social acceptance, and personal feelings of what is right provides a good way of getting to "Right-Good" decisions. Personal integrity is at the heart of everything: it informs individual behavior; it is essential for systemic integrity and regulators cannot operate effectively without it.

We need to recognize that rules (regulatory signals), incentives (market signals), and belief systems (personal values) all affect how individuals make decisions. Only when we remember that they each need to be considered, will we have an effective framework for making ethical decisions in banking that takes into account self-discipline, market discipline, and regulatory discipline, as shown in Figure 4.3.

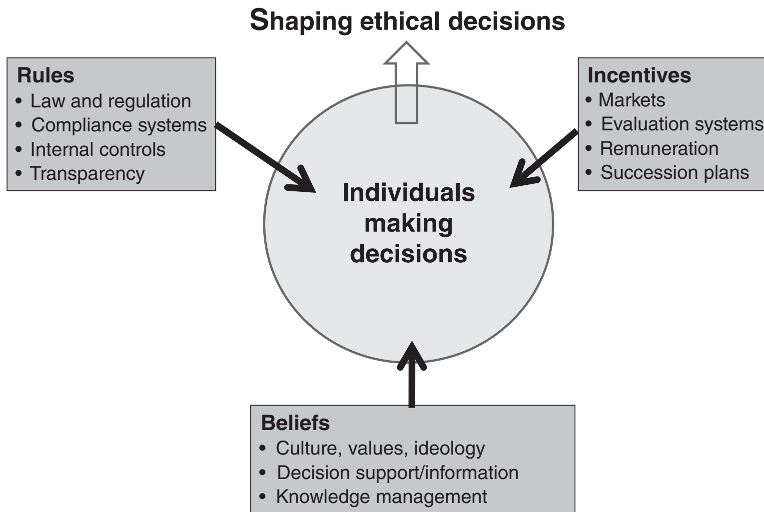

FIGURE 4.3 Integrating Beliefs, Rules, and Incentives
Source: J Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur April 2013 .

NOTES

1. John Elkington, "Time to Tackle Subprime Supply Chains," October 18, 2008. Accessed December 28, 2012, www.sustainability.com/blog/time-to-tackle-subprime-supply-chains#.UNz1_OTqn48.
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CHAPTER 5

The Role of the Board: Theory and Reality

This chapter discusses what bank Boards are supposed to do, taking into account the underlying economic and market realities, as they affect the ability of Directors to carry out their function effectively in helping CEOs be great good leaders. In doing so, it discusses the role of the Board as a whole; the role of the Chair, CEO and committees.[1] It concludes by discussing some of the reasons why Boards failed to prevent disaster in banks in the Global Financial Crisis.

The Board is the ultimate custodian of corporate long-term value creation. In financial institutions, Boards are answerable not just to shareholders, but also to depositors (if banks) and policyholders (if insurers). Boards play a pivotal role as stewards, responsible for the continued success of the financial institution (FI):

> *Boards of Directors play the pivotal role in FI governance through their control of the three factors that ultimately determine the success of the FI:* the choice of strategy; the assessment of risk taking; and the assurance that the necessary talent is in place, starting with the CEO, to implement the agreed strategy. *[Emphasis added]*
>
> *Boards that permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk and talent issues are making a critical mistake.* Above all else, Boards must take every step possible to protect against potentially fatal risks.[2] *[Emphasis added]*

Table 5.1 shows what the *Group of Thirty*[3] expects Boards to do.[4]

The *Group of Thirty* goes on to recommend Boards undertake the following 10 tasks to be effective, shown in Table 5.2.[5]

Doing items 2, 3, 5, and 8 really well, assumes Boards are technically competent to assess the issues facing banks and that they really understand

TABLE 5.1 What the Group of Thirty Expects

Boards Must
1. Recognize that corporate governance (CG) is an ongoing process and not a fixed set of guidelines and procedures.
2. Dig deep selectively, as necessary for understanding, and only agree to proposals once they are very clear they understand what is being proposed and its long-term implications.
3. Provide independent challenge, which “should bring a high quality and value-additive contribution to Board deliberation and is not evidenced by the number of times a Director says no to management.”
4. Remember that smaller Boards requiring greater time commitment are a far better approach than having larger Boards that require only modest time commitment.
5. Recognize that balancing risk, return, and resilience is difficult. “If a risk is too complicated for a well-composed Board to understand, it is too complicated to accept.”
6. Insist on management giving the Board the best means of understanding the issues on which judgment is needed and budget accordingly for the cost of providing such information.
7. Remember that values and culture determine behavior across the organization and effectiveness of its governance arrangements and that as Directors they are the custodian of these values and culture.

what is required for a bank strategy to succeed at a granular level. However, in the case of banks, understanding the issues, products and services and potential alternatives requires a very high degree of technical understanding of how the business works, as well as of the drivers of both risk and profitability. This has become a challenge even for executive Directors, as a result of the:

- Rapidly changing regulatory environment.
- Complexity of the products that financial innovations have created.
- Time horizons over which long-tail risks manifest themselves.
- Existence of “Black Swans” (once in 10,000 year events).

If it is becoming difficult for executive Directors to keep up with the changes, imagine how much harder it is for non-executive Directors to understand enough of what is really happening to be able to challenge constructively and evaluate the validity of the answers they get from management. We need to ask ourselves whether it is just too difficult for talented amateurs to be effective independent Directors of banks. As a result, we also need to consider whether the time has come to create a profession

TABLE 5.2 Ten Tasks of Effective Boards

Effective Boards
1. Fashion the leadership structure to allow the Board to work effectively as a team unified in support of the enterprise.
2. Recruit members with irreproachable independence of thought and action to create Board balance of expertise, skills, experience, and perspectives recognizing that diversity (not just gender diversity) prevents groupthink.
3. Build a nuanced understanding of all matters regarding the organization's strategy, risk appetite, conduct and risks it faces and its resilience.
4. Appoint the CEO and ensure the top team has the required skills, values, attitudes, and energy essential to long-term success.
5. Take a long-term view on strategy and KPIs, focusing on sustainable success.
6. Respect the fact they are responsible for direction, oversight, and control while management runs the business.
7. Reach agreement with management on strategy and champion management once decisions are made.
8. Challenge management vigorously and thoughtfully, discussing all strategic proposals, key risk policies, and major operational issues.
9. Ensure rigorous and robust processes are in place to monitor compliance with agreed strategy, risk appetite, and relevant laws and regulations.
10. Assess Board effectiveness regularly and share the results with the organization's lead supervisor.

for Directors of banks with specific qualifications and continuous education to keep Directors abreast of the regulatory and technical changes banks have to deal with today. The UK's Parliamentary Commission on Banking Standards recently concluded that the time had indeed come to professionalize Directors of banks.[6] Table 5.3 spells out the five primary responsibilities of the Board.[7]

This distinction between governance and management lies at the heart of all codes of corporate governance. Yet there is a blurring of the boundaries in today's environment.

BLURRING OF THE BOUNDARIES

Although most codes, including the new Malaysian Code of Corporate Governance 2012, state there is a clear separation of roles between the Board and management, the law is more ambivalent. In both Malaysia

TABLE 5.3 The Five Primary Board Responsibilities Board

The Board
1. Governs on behalf of the owners, translating their expectations into organizational performance.
2. Is the highest authority in the company, answerable to the owners for everything that happens.
3. Is the initial authority as well as the final authority.
4. Should delegate its authority as much as possible, but without jeopardizing its accountability.
5. Should recognize that **governance and management are not the same; the Board governs, management manages.**

and Australia, the Companies Acts state that Boards "direct and manage," presumably to allow Boards to intervene when a company is in a state of terminal disarray or when the CEO has been terminated and there is no immediate replacement. This ambiguity is useful for politicians and the media because it permits them to shout "Where was the Board?" when things go wrong.

In the court of public opinion, there is no such boundary when things go wrong. Take the case of Marcus Agius, the former non-executive Chairman of Barclays, when he was being cross-examined by the UK Treasury Committee regarding Barclays' LIBOR fixing (July 10, 2012),[8] shown by the following exchange:

> ***Michael Fallon***: "If you were concerned . . . that the bank's funding position should not be misinterpreted, . . . why weren't you involved with Mr. Diamond in telling your staff to get involved with the regulatory authorities as a matter of urgency?"
>
> ***Marcus Agius:*** ". . . because, for the avoidance of doubt—and maybe I should have made the point earlier—there is of course a distinction between what the board does and what the executive does. The executive is there to run the bank. The board does not run the bank. I stayed unusually connected with the senior management because of my concerns, but I did not make any executive decisions. That was not my job."
>
> **Michael Fallon:** "The question is: what does it say about your senior management team that in the end an instruction to manipulate LIBOR was not questioned? . . . You have overall responsibility for the culture of the bank. That is why you have resigned."

As the foregoing testimony made quite clear, regulators and legislators hold the Board accountable for the values and culture of the organization, expecting them to verify that what management tells them is happening regarding values, compliance, and enforcement is really happening. Directors are accountable and are expected to know how management is implementing what they have been authorized to do; they cannot hide behind the separation of roles.

Some Boards might argue that to do this is to get involved in operational detail and therefore crosses the line from directing and governing over into managing the business. While there is undoubtedly some truth in this, the world is changing: Both the public and regulators are increasingly expecting Boards and shareholders to do just that in the areas of values and culture, as can be seen from the following quote:

> *Values and culture should be seen as the ultimate software that determines the behaviors of people throughout the FI and the effectiveness of its governance arrangements. The fact that the quality of embedded values and culture cannot readily be measured does not detract in any way from their critical significance.* Boards, management, supervisors, and shareholders must be continuously and proactively attentive to the maintenance and reinforcement of values and cultures that lead to safe, sound, innovative, ethical, and high performing FIs.[9] *[Emphasis added]*

It is clearly becoming increasingly difficult for Boards to respect the line between governance and management, as a result of changing stakeholder expectations and this makes an already challenging role that much more difficult, as Directors try to reconcile increasingly divergent expectations.

In carrying out its five primary responsibilities, the Board must answer five questions that frame everything the company does, shown in Table 5.4.

TABLE 5.4 The Five Questions Boards Must Answer

The Board should decide *not what a company does, but what it exists for* by answering the following questions:
1. Who are the recipients or customers of the organization?
2. What impact, difference, change, benefit, or outcome to be observed will the company make in the lives of its customers?
3. What will it cost to deliver such results to customers?
4. What are the rates of return implied by such activity?
5. What are the performance standards by which the organization's effectiveness is judged?

Figure 5.1 shows where the boundary lies between the role of the Board in providing direction and that of the executives in managing the business.

This is clear insofar as it goes. However, every corporate governance code makes it clear that Boards do not just have an oversight or supervisory role. Boards are also expected to help formulate strategy; help the CEO plan; set policy and agree on procedures for which they are held accountable in the public domain when there is a breakdown in policies, procedures, and compliance. This has been evident in 2012 in the Barclays LIBOR fixing scandal,[10] the JP Morgan CIO derivatives losses,[11] and HSBC's failure to prevent money laundering.[12] The Board is also accountable for monitoring and supervising the effectiveness with which the management executes. This is shown in Figure 5.2.

The fact that Boards are expected to initiate strategy, formulate policy, act as coach and adviser to the CEO, as well as oversee and audit execution creates an anomaly. From an auditor's perspective there is a potential conflict between the forward-looking and backward-looking roles shown in Figure 5.2. The so-called "Four Eyes" principle stating that a person creating or initiating an expense cannot be the same person authorizing and monitoring it, would suggest Boards are in a conflicted position when they have both a forward-looking and backward-looking responsibility. This does not mean Boards cannot exercise the four roles shown in Figure 5.2—just

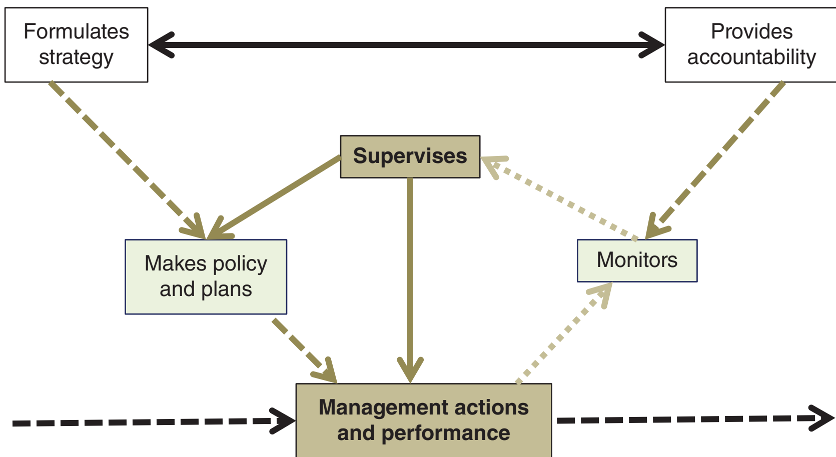


FIGURE 5.1 Boards Govern and Direct; Management Manages
Source: Based on R. I. Tricker, *International Corporate Governance: Text, Readings and Cases* (Singapore: Prentice Hall, 1994), 150.

	Forward looking	Backward looking
Outward looking	Formulates strategy	Provides accountability
Inward looking	Makes policy and plans	Monitors and supervises

FIGURE 5.2 The Four Roles of the Board
Source: Based on R. I. Tricker, *International Corporate Governance: Text, Readings and Cases* (Singapore: Prentice Hall, 1994), 149.

that it requires the exercise of judgment to be sure Boards do not become conflicted when they undertake the four roles expected of them. It is this potential for being conflicted that explains why regulators and corporate governance codes focus so much on the independence of the Board and its non-executive Directors.

Perhaps the best way to illustrate the boundaries between the bank Board and management is shown in Table 5.5.[13]

Potential role conflicts are not the only thing the Board must learn to reconcile and work with when the boundaries between Board and management roles get blurred. There are also operational dilemmas every Board must come to terms with. These can be categorized as stakeholder dilemmas—how best to work as an effective Board and the dilemmas created by the need to have the best people on the Board. These dilemmas are shown in Figure 5.3.

First, what are these two stakeholder dilemmas?

1. Boards must reconcile Milton Friedman's claim that "the purpose of business is to maximize shareholder value"[14] with Peter Drucker's equally emphatic argument that "the purpose of business is to create and maintain satisfied customers."[15]
2. Uniquely in the case of FIs, Boards have two fiduciary duties to reconcile: to their shareholders and depositors if they are bank Boards; to their shareholders and policyholders if they are insurance company Boards. These dual fiduciary duties are new—they are the result of the Global Financial Crisis—and only time will tell how difficult it is for Boards to reconcile these conflicting duties, especially in the duty of loyalty.

TABLE 5.5 Boundaries between a Bank Board and Management

Function	Bank Board's Role	Bank Management's Role
Strategy Setting and Target Setting	1. Guides strategic direction. 2. Challenges assumptions, priorities, and options put forward by management in the strategic plan. 3. Reviews the business plan and budget and sets targets for management.	1. Develops strategic direction and plan for the company based on agreed direction and boundaries. 2. Coordinates the development of business plan and budget across all bank BUs.
Performance Management	1. Reviews, approves, and provides feedback on bank-wide KPIs and targets. 2. Reviews bank results quarterly, discusses material variances, and ensures that corrective actions are taken, if required.	1. Establishes bankwide KPIs. 2. Monitors KPIs monthly with BUs, investigates variances and develops corrective actions if required. 3. Cascades KPIs throughout the bank.
Human Capital Management	1. Selects and proactively plans CEO succession. 2. Reviews the performance management philosophy. 3. Evaluates the CEO. 4. Endorses the development plan of people in pivotal positions. 5. Understands the pool of future leaders. 6. Recognizes the differences in culture and behavior between the investment bank and other parts of the bank.	1. Develops and implements the bank's performance management system. 2. Evaluates leadership performance and potential of all executives. 3. Identifies the top talent pool and closely manages their performance and development plan. 4. Appreciates the difference between trader and banker mentalities.
Risk Management	1. Sets the company's risk parameters. 2. Understands major risk exposures and ensures appropriate risk mitigation approach is in place. 3. Considers the risk factors in all major decisions.	1. Analyzes and quantifies the company's risks. 2. Manages all risks within the boundaries set by the Board. 3. Instills risk management culture throughout the organization. 4. Reviews Value At Risk (VAR) regularly, taking into account "long-tail" risks.

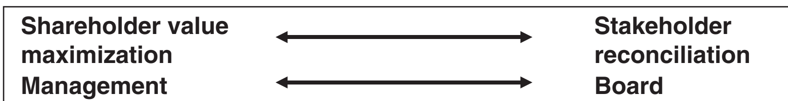
TABLE 5.5 (*Continued*)

Function	Bank Board's Role	Bank Management's Role
Shareholders	1. Ensures all shareholder views are represented and shareholders are treated equally.	1. Understands the needs of shareholders and communicates key decisions in transparent manner. 2. Ensures that all disclosure or any other regulatory or statutory requirements are fulfilled.
Stakeholder Management	1. Balances and manages economic impact of stakeholder interests on shareholder value. 2. Supports management in managing key stakeholders.	1. Manages all stakeholder interests within boundaries agreed with the Board.

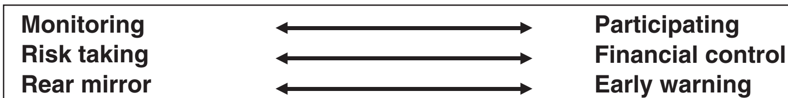
Second, what are the Board's three work dilemmas?

1. How do Boards reconcile monitoring decisions and their implementation and participating in the formulation of those decisions without violating the "Four Eyes" principle?
2. How do Boards strike the right balance between risk taking, without which there can be no reward, and financial control, which, if carried to extremes, stifles the "animal spirits"[16] that are at the heart of capitalism?

Stakeholder dilemmas



Board work



Director qualifications

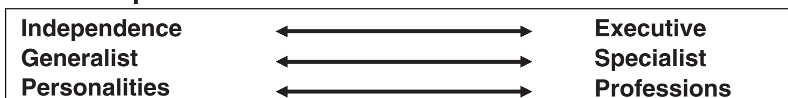


FIGURE 5.3 Boards Must Reconcile Operational Dilemmas
Source: IMD 2008.

3. How much time should Boards spend on looking at the numbers (looking in the rearview mirror), as opposed to looking outward and forward at external factors and trends that could hurt the bank's ability to create sustainable long-term value for shareholders and stakeholders (early warning)?

Third, what are the two dilemmas regarding Director qualifications and the resulting interpersonal dynamics?

1. Typically effective Boards range between 7 and 11 members. This range constrains the number of people Boards can appoint, while taking into account the need to get the right skills mix, the right experience resulting from diversity of background, skills, and personalities. This problem is particularly acute in the case of banks because the business is so much more complex and the risks are so much more difficult to understand than in normal businesses. As a result, there is a greater need to have some members of the Board who really understand banking, sacrificing as a result some of the desired diversity of independent Director experience.
2. These dilemmas have to be reconciled through a combination of effective Chairmanship and appropriate selection of the CEO and the Directors on the Board. This is hard because current leading practice argues against the formation of large Boards created to maximize diversity, but with small executive committees designed to make decision making manageable. They may do that, at the expense of disenfranchising the other members of the Board who are not on the executive committee.

Table 5.6 shows the key elements of role of the Board in its capacity of oversight of the conduct of the bank's business.

The way many codes are written, strategy and risk are separated and it might seem that Boards are only expected to look to managing risk, once they have decided on the strategy the company will follow. That is not the intent, even though it would appear that some Boards have indeed only become engaged with risk management once they have agreed on their strategic direction. The reason this is dangerous is that each strategy has its own unique risk profile that reflects the industry, the type of customers, and the products offered, as well as the inherent counterparty and systemic risks the company will face from its exposure to external and internal sources of risk, culminating in reputation risk, shown in Table 5.7.

Chapter 6: "Leadership, Governance, Strategy, and Risk" deals with the impact of personalities, and strategy on risk management.

TABLE 5.6 The Role of the Board in Overseeing the Conduct of the Business

The Board oversees the conduct of the business and ensures it is aligned with the agreed strategy by:

1. **Agreeing KPIs**
   a. Input
   b. Output
   c. Outcome
2. **Developing a Balanced Scorecard**
   a. Financials—lagging indicators
   b. Others—leading indicators
3. **Overseeing Appropriate Processes**
   a. Capital allocation between projects and between the present and future earning streams
   b. Efficiency, measured via its ability to keep down costs
   c. Record of innovation
   d. Ability to execute
4. **Codifying Shared Values and Behaviors**

Boards are expected to do proper succession planning covering:

- CEO.
- First line.
- Key positions in the company.
- The creation and maintenance of an up-to-date replacement chart.

Chapter 7: "Developing Suitable Leaders" deals with succession planning and talent management.

TABLE 5.7 Sources of Reputation Risk

External Drivers of Risk	Internal Drivers of Risk
■ Politics	■ Cultural and values misalignment
■ Regulation and legislation	■ Problems of communication
■ Technology	■ Inappropriately set KPIs
■ Competition	■ Operations
■ Business mix	■ CEO
■ Macro-economic trends	■ Succession planning
■ Micro-economic trends	
■ Socio-cultural change	
■ Systemic risk	

Finally, Boards must engage with stakeholders and protect their interests. This means Boards must appreciate who their key stakeholders are and why they matter. It also means Boards must know what to communicate and which channels to use. Table 5.8 shows what Boards must consider, if stakeholder interests are to be protected.

Regulators around the world are beginning to recognize that the time needed to fulfill the duty of care is greater than many independent Directors have been prepared to give. As a result they are emphasizing the importance of fostering effective commitment. In Malaysia, for example, the *Malaysian Code on Corporate Governance 2012* (MCCG 2012) requires the Board to make explicit its expectations regarding the amount of time Directors should devote to the company.

In this context, the Board should have protocols for independent Directors accepting Directorships in other companies, as well as ensuring that Directors spend sufficient time to carry out their responsibilities. As a result the MCCG 2012 now caps the number of Directorships in public listed companies at five. This is consistent with the UK's Walker Report recommending that Directors of banks spend between 30 and 36 working days per year per Directorship.[17] In addition to raising the bar for time commitment, the MCCG 2012 also stipulates that Directors must be properly trained, making it clear that Directors should participate in lifelong learning. This is entirely consistent with Bank Negara Malaysia's (the Malaysian Central Bank) requirement that Directors be formally trained through the mandatory Financial Institutions Directors Education (FIDE) program and associated continuous professional development of Directors.

The final complication in Boards carrying out their roles effectively is that there is not one best way of engaging with management and this is recognized by the OECD: "There is no single model of good corporate governance."[18]

TABLE 5.8 Protecting Stakeholder Interests

The Board is responsible for:
1. Preparing and conducting shareholder meetings: AGM and EGM.
2. Selecting and reviewing the external auditor and rotating the external auditor once every five years
3. Approving the amount of and procedure for paying dividends
4. Complying with corporate codes of conduct and ethics
5. Filing lawsuits and claims
6. Approving related party transactions
7. Resolving corporate conflicts
8. Ensuring the company is a good corporate citizen
9. Ensuring alignment with the government's economic objectives

There is "no one size fits all" solution because the correct approach for any given company depends on its unique combination of external and internal conditions combined with its own special combination of "Hard" and "Soft" elements, shown in Figure 5.4.

Figure 5.4 shows how Boards must take into account both external and internal factors and at the same time consider the "Hard" and "Soft" elements that affect the frameworks, structures, policies, and processes they assume exist in the organizations for which they are accountable.

It is clear why there can be no one way of governing an organization. Take the "Hard" elements first:

- *Regulations*: They differ by country and industry. In the case of banking there are different regulators with different agendas that Boards must consider.
  - Prudential regulators who are interested primarily in systemic stability like the Ministry of Finance (or Treasury) and the Central Bank. Their focus is depositor protection and minimizing the risk of economic collapse.
  - Securities regulators who are interested in maximum transparency and who are not averse to volatility and the instability it brings. Their focus is on investor protection and on ensuring the development of an orderly, transparent, and efficient capital market.

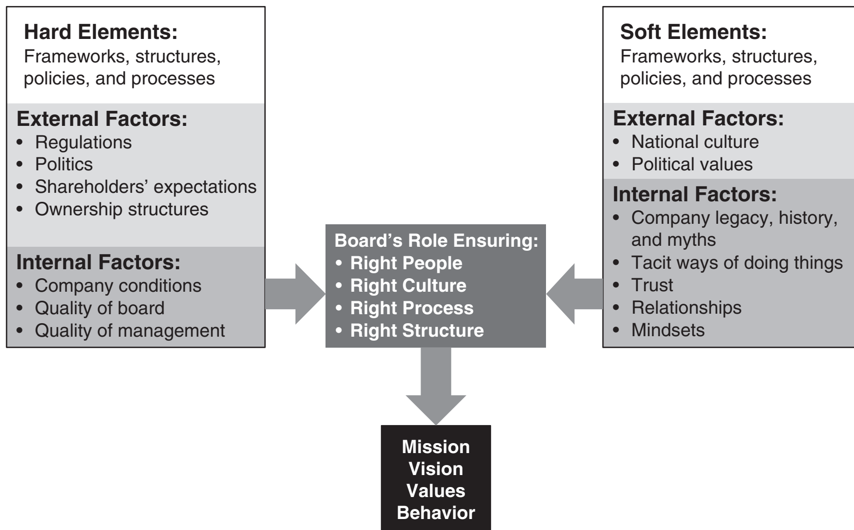


FIGURE 5.4 The Appropriate Governance Model Is Unique to Each Organization
Source: John Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur, April 2013 .

  - Enforcement regulators like New York State's Department of Financial Services (DFS) or Chicago's Commodities Futures Trading Commission (CFTC) or the UK's newly established Financial Conduct Authority (FCA), who are primarily concerned with whether there has been a breach of the law and who are less interested in the concerns of the prudential or securities regulators.[19]
  - How much of the banks' business is shadow banking that may not be regulated at all;
- *Political changes:* Every Board must pay attention to what is happening in the political environment and the impact of changing casts of politicians will differ by company, depending on their relationships with the key players.
- *Economic conditions:* The impact of macroeconomic variables on clients of banks will differ considerably, depending on their exposure to changes in interest rates, inflation, currency, and the microeconomic effects of changes in macroeconomic demand on their clientele.
- *Shareholder expectations:* Although these will be colored by an industry view, they will reflect the unique relationships banks have with their shareholders and how well they conduct their investor relations.
- *Ownership structures:* These will determine both the purpose of the organization and its priorities and governance arrangements. What is suitable for a widely owned bank like HSBC or JP Morgan Chase is unlikely to be appropriate for a government-owned bank with a developmental agenda, or for an Asian family controlled bank like Hong Leong or OCBC that takes a long-term view and is more risk averse as a result of having family "skin in the game."
- *Internal factors:* Company conditions will obviously be unique to each company: their competition, their growth prospects, the strength of their balance sheets; their P&L; their ability to innovate, execute, and improve will depend entirely on the quality of their people and processes, their management, and their Boards. Which kind of Board to have—"VIP," "Scout," "Watchdog," or "Challenger," shown in Figure 5.5—and its interaction with management will depend critically on
  - The quality of the Board itself.
  - The quality of management the Board has to deal with.
  - Where the company is in its life-cycle: a start-up; in a growth phase; in a steady-state phase; or in decline, and if in decline, how rapid?

A start-up bank is best served by a "Scout" Board where there is a great deal of advice and coaching. A company that is in serious difficulties is best served by a "Watchdog" Board that is very hands-on because the Board is forced to take on some executive responsibilities, especially if the CEO has

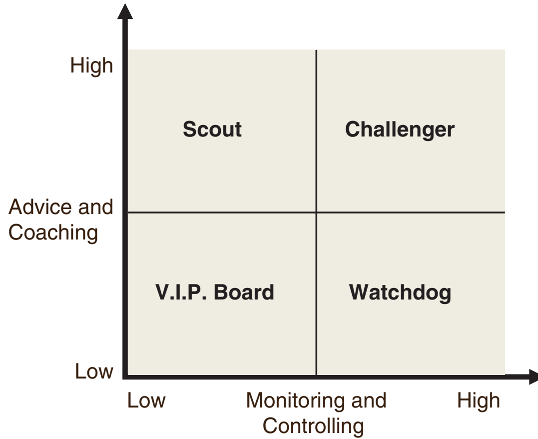


FIGURE 5.5 Boards Must Choose the Right Engagement Model
Source: U. Steger, and W. Amann, W., *Corporate Governance: How to Add Value* (Hoboken, NJ: John Wiley & Sons, 2008), 22.

been terminated (as in the case of Barclays). Many stable companies elect to have "VIP" Boards, and it is the contention of this book that such Boards do not contribute to good governance because they do not have the time or commitment to add value—this is discussed further, later in the chapter. "Challenger" Boards are probably the best, though it is very difficult for the Chair to manage such a Board.

Thus we can see that the "Hard" elements make it inappropriate to try to impose a cookie-cutter governance solution on banks. What is true of the "Hard" elements is even truer of the "Soft" elements:

- *National culture:* Every culture has its own ways of communicating both up and down a hierarchy and in peer-to-peer interactions. What works in Sweden or Germany will not work in China or Malaysia. There are issues of differing "power distance" in the hierarchical relationships that affect what can be said and how it can be said. Equally in cultures that value harmony and saving face, the direct feedback that would be normal in Australia or the Netherlands would cause grave offense. Effective corporate governance depends on quick and transparent communication and so it must take into account what can be communicated and how to do it, which will differ by culture. This problem is made more challenging when a bank operates in more than one culture.
- *Political values:* The weakening of the Anglo-Saxon model of laissez-faire capitalism as a result of the Global Financial Crisis combined with the

resurgence of Asia and the rise of sovereign wealth funds will affect the relationship of government and business and the boundaries between them. It may also affect the value placed on political independence and this will make good governance more challenging, as the temptation to interfere in nominating Board members and even management may become stronger over time. Furthermore, directors who are appointed to a bank Board as a reward for past services may not really understand that their role is about creating a sustainable future for the bank rather than resting on past laurels.

- *Legacy and history:* Boards that ignore a bank's legacy and history run grave risks of destroying the DNA that made the bank what it is. Sometimes it is important to create new DNA and start fresh, but the chances of success are often slimmer than the consultants who propose the change in direction and strategy realize. UBS is an excellent case in point. Legacy and history may often become blockers when innovation is needed, but they should not be ignored because of their emotional power. Harnessing the myths of the organization and its founder is always more effective than trying to overrule them, especially in cultures that respect the past.
- *Tacit knowledge:* One reason for failures of new direction is that Boards may not be fully aware of how much tacit knowledge they are either destroying or ignoring. Knowledge of the "way we do things" is a critical lubricant that raises efficiency. Each bank has its own way of doing things and it is this difference between the different banks' ways of doing things that goes a long way to explaining their different levels of performance.
- *Trust:* Trust is the reverse side of the compliance coin. Trust and culture are inextricably linked through the phrase "Culture is what people do when nobody is looking," made famous by Herb Kelleher when he was Chairman of Southwest airlines and paraphrased by Bob Diamond, who said, "Culture is difficult to define, I think it's even more difficult to mandate—but for me the evidence of culture is how people behave when no-one is watching,"[20] when he was CEO of Barclays. When there is trust, there is less need for expensive compliance mechanisms or consumer protection. However, the levels of trust within organizations and between organizations cannot be generalized.
- *Relationships:* These are by definition unique. Perhaps it is also important to remember that different organizational and national cultures value relationships differently. Americans tend to rely on what is written in the contract, whereas most Asian cultures put the relationship ahead of the contract. This may create problems of governance and compliance because universalistic minded North Americans

and Northern Europeans will say the rules apply regardless, whereas pluralist Asians, Southern Europeans, and Latin Americans will find good reasons why in these particular circumstances the rules do not apply,[21] again making it very difficult to have uniform approaches to governance.

- *Mind-sets:* Finally, as we have learned, different types of financial service have different mind-sets. Traders live in a win-lose world and seem to be motivated by the size of their bonus. Retail bankers used to appreciate the importance of customer-centricity and creating a win-win world where success for the client represented success for the bank. Bank Boards need to ensure that the mind-sets they promote can reconcile the risk-averse deposit-taking mentality with the risk-taking mentality of securities trading to create long-term value.

As Figure 5.5 shows, only when Boards have taken all these points into account can they ensure they have the right people, the right culture, the right processes, and the right structures in place. Once that is done, they can define the desired mission, vision, values, and behavior to create long-term value and rebuild the trust in banks that is so sorely needed.

ROLE OF THE CHAIR

The Chair is the pivotal role in ensuring that the Board functions effectively and, working closely with the company secretary, the Chair is the custodian of the company's corporate governance. Most codes recommend that the roles of Chair and CEO be kept separate.

This is not merely to prevent an excessive concentration of power in the hands of one person, but also reflects the fact that the role of the Chair is different from that of the CEO.

The Chair represents the Board to the shareholders; is responsible for ensuring the effectiveness and integrity of the workings of the Board; and for the relationship between the Board and the CEO.

Table 5.9 shows the responsibilities of the Chair in ensuring the effectiveness of the Board and its governance processes.[22]

The Chair is also responsible for company communications with shareholders, and when the bank is in trouble, with regulators and legislators. On a day-to-day basis the Chair represents the bridge between the shareholders' interests and the Board by providing:

- Coherent leadership while representing the bank to its public and understanding the views and priorities of the shareholders.

TABLE 5.9 Chair's Role in Ensuring an Effective Board

In performing this role, the Chair is responsible for:
1. Leading the Board in setting the values and standards of the company, working with both executive and non-executive Directors to create constructive relations of trust.
2. Promoting the highest standards of corporate governance, probity, and integrity.
3. Setting the Board agenda in consultation with the CEO and Company Secretary.
4. Ensuring a clear structure for the smooth running of the Board.
5. Managing the business of the Board.
6. Ensuring the provision of accurate, timely, and clear information to help Directors make informed decisions.
7. Acting as facilitator by setting the style and tone of meetings to ensure:
a. No member dominates.
b. Full discussion takes place.
c. Diverse opinions are heard to promote constructive debate and informed decision making.
d. Discussion leads to logical and coherent policy to guide the CEO and against which KPIs can be set.
e. There is consensus in the Board, but may, when needed, call for a vote.
8. Taking the lead in identifying and meeting the development needs of Directors.
9. Building an effective Board with the right mix of skills, working with the nomination committee.
10. Arranging the annual performance evaluation of the Board, its committees, and Directors.
11. Ensuring effective implementation of Board decisions.

- Systematic contact with shareholders by writing at least twice a year to them, and at the AGM by using the opportunity to encourage shareholders to ask questions because "such questions give Chairmen a feel for the issues which are on the mind of shareholders and in answering them they have the chance to put forward the company's point of view, persuasively and in a public forum."[23]

The most important responsibility of the Chair, however, is to ensure that there is a close relationship with the CEO, by:

- Providing support and advice when needed, while respecting that executive responsibility lies with the CEO (despite external pressures to the contrary when the company is in crisis).

- Monitoring the performance of the CEO (in conjunction with the nomination committee) to advise regarding any performance shortfalls.
- Finding a replacement if there is a problem, and ensuring the CEO leaves either voluntarily through resignation or involuntarily through termination.
- Ensuring that the CEO is fulfilling his or her obligation to the Board by having a proper succession plan, with adequate bench strength to replace the CEO in the event of an emergency.

If the succession plan fails, it is the Chair's responsibility to find a new CEO[24] (as was demonstrated in the Barclays LIBOR crisis).

Table 5.10 shows the division of roles between the Chair and the CEO.[25]

Table 5.11 lists the desired personal qualities and attributes of the effective Chair.

TABLE 5.10 Division of Roles between Chair and CEO

Roles of the Chair	Potentially Shared Roles	Roles of the CEO
1. Provides Board leadership: a. Plans meetings and agenda b. Ensures Board receives proper information in a timely manner c. Chairs all Board meetings d. Ensures all Directors contribute e. Drives discussion toward consensus and closure 2. Chairs shareholder meetings 3. Acts as company ambassador in the domestic market and abroad	1. External relations, including relations with shareholders 2. Senior leadership development	1. Develops and implements strategy, reflecting long-term objectives and priorities established by the Board 2. Assumes full accountability to the Board for all aspects of company operations and performance 3. Puts adequate operational plans and financial control systems in place 4. Closely monitors operating financial results in accordance with plans and budgets 5. Represents company to major customers, employees, suppliers, and professional associations

TABLE 5.11 Desired Personal Qualities and Attributes of the Chair

Qualities and Attributes of the Chair
1. ***Character and Style***
a. Able to nurture a Boardroom team production culture that is
i. Cohesive.
ii. Creative.
iii. Open and generous—trusting.
iv. Constructively challenging—questioning and independent thinking.
v. Prepared and committed—recognizing that positions are not gifts for past service.
b. Able to motivate and build on the competencies of each Board member.
c. Able to create and maintain collaborative working relationship with the CEO.
d. Constantly developing and improving Board processes.
e. Ensuring appropriate and up-to-date skills.
2. ***Preferably Independent and Non-Executive***
3. ***If not, then there should be a senior lead INED to counterbalance.***

In the event the company has an executive Chair, many codes require the Board to have a majority of independent Directors with a senior Lead Independent Director who takes on the responsibility for good governance, dealing with executive Chair performance problems by acting on behalf of shareholders to:

- Ensure the independent non-executive Directors (INEDs) agree there is a problem.
- Take action by persuading the executive Chair to resign.
- Find a replacement.

ROLE OF THE CEO

The Board's authority is delegated to executive management through the CEO. This means all authority and accountability of executive management is the authority and accountability of the CEO. As a result, the CEO is accountable to the Board for achieving the agreed ends—the agreed goals within the limits set on the CEO by the Board. In a very real sense, the CEO is the servant of the Board, and not its master.

Thus the CEO reports to the Board at every Board meeting in a timely manner on all material issues that affect the company's agreed ends. Table 5.12 shows what the CEO must report.

TABLE 5.12 What the CEO Must Report

CEO is expected to report in a timely manner on:
1. All material matters including potentially strategic or politically significant development prospects.
2. Any underperforming business/activity, with a proposal to rectify the problem.
3. All matters affecting shareholders and the markets in which the shareholders' interests are traded.
4. The organizational structure and systems in place to develop talent and put in place a succession plan.

The CEO also works together with the Board in:

- Setting the direction of the company.
- Articulating and living the values of the company.
- Allocating resources to achieve agreed goals.
- Ensuring effective risk management.
- Cascading goals and KPIs to measure and manage performance across appropriate time horizons:
  - Long term: 5 to 15 years.
  - Medium term: 3 to 5 years.
  - Short term: 1 to 3 years.
- Ensuring the company reputation is enhanced.

ROLE OF COMMITTEES

This section covers the role of committees in general, shown in Table 5.13, with the roles of the audit committee, the nomination and remuneration committee, and the Risk committee (if there is one) covered in Appendix 5A: "The Role of Board Committees."

WHY BOARDS FAILED

The previous sections cover what Boards should do and how to do it in order to provide guidance and help to the CEO. It is clearly not easy to do this for a bank. There are dilemmas to reconcile; there is no one right way of engaging with management and the business is very complex, with risks that are not easy to understand. Even assuming Directors are properly qualified and exercising their fiduciary duty, there is no guarantee of successful outcomes. The dramatic failures of Bear Stearns, Lehman Brothers, Merrill Lynch, RBS; the

TABLE 5.13 Role of Committees in General

What do committees do?
1. Committees aid and extend the capacity of the Board, but do not substitute for it.
2. Their decisions must be referred back to the Board for approval.
3. They should provide the Board with written and verbal reports after each meeting.
4. They must act according to agreed, written Terms of Reference (TOR).
5. They should consist of a majority of independent Directors who have access to executives and professional advisers.
6. Meetings should be formal, with minutes taken, attendance and voting recorded.
7. The Board should evaluate the performance of committees annually and report their activities to shareholders in the annual report.

near failure of UBS; the problems faced by HSBC and Standard Chartered over money laundering; the rogue trader problems at Société Générale, UBS, and JP Morgan Chase, retail product mis-selling in the United Kingdom, and the LIBOR price fixing crisis all point to some common causes leading to Board failure to ensure that the all-important "tone at the top" creates the desired values and behavior, shown in Table 5.14.

TABLE 5.14 Causes of Board Failure

Bank	Inappropriate Board Involvement
Bear Stearns[26]	1. The Board did not challenge the often absent CEO, Jimmy Cayne, because the members were hand-picked friends. 2. The Board did not appear to understand the extent to which the bank was overly leveraged because Board members were not bankers, were not kept in the loop, and did not ask. 3. The Board did not appear to appreciate the extent of the banks' CDO liabilities and the fact that the bank could become illiquid in less than a week because of its wholesale funding strategy. 4. The Board did not apear to appreciate the extent to which the CEO and top management remuneration led to risky behavior as a result of excessive focus on short-term ROE. 5. The Board overpaid the CEO with a package that bore little relationship to performance.

TABLE 5.14 (*Continued*)

Bank	Inappropriate Board Involvement
Lehman Brothers[27]	1. The Board did not challenge Dick Fuld because the members were his hand-picked friends who knew little or nothing about modern investment banking.[28] 2. The Board appears to have allowed the CEO to double down on property bets (Archstone investment) when the market was in decline,[29] perhaps because of his successful contrarian bet during the dotcom meltdown. 3. The Board did not know that the bank's VAR had been raised three times, increasing its exposure to risk of illiquidity.[30] 4. The Board allowed the CEO to mishandle a negotiation with Korea Development Bank that might have saved Lehman.[31]
Merrill Lynch[32]	1. The Board did not challenge Stan O'Neal (Chairman, CEO, and President); they were hand-picked friends with little experience of financial services because the CEO did not want them asking questions. 2. The Board "had absolutely no idea how much of this risky stuff was actually on the books; it multiplied so fast"—rising from $1 billion to $40 billion of exposure in 18 months. 3. The Board allowed O'Neal to initiate merger talks with Wachovia Bank without informing them. The deal would have given O'Neal a $274 million payout. 4. The Board appears to have allowed O'Neal to eliminate any potential successor from within the bank. 5. The Board allowed O'Neal to "retire" with an exit package worth $161.5 million. 6. Independent Directors did not even turn up for the shareholders' meeting that approved the sale to Bank of America.
RBS[33]	1. The Board appears not to have challenged Fred Goodwin because of his past success in acquiring and integrating NatWest; he ran the show. Moreover, he paid inadequate attention to risk posed by expanding the balance sheet and the quality of assets held on it.[34] 2. The Board did not appear to appreciate the risk to the balance sheet posed by the CEO's drive for growth by acquisition, allowing one acquisition too many, in the case of ABN-Amro. 3. The Board did not challenge the CEO on the ABN-Amro price when Lasalle Bank in the United States, the initial reason for RBS's interest in ABN-Amro, was sold by ABN-Amro. 4. The Board did not appear to appreciate the risk the funding strategy chosen to finance the acquisition presented to the RBS balance sheet in case of a liquidity crunch.

(*continued*)

TABLE 5.14 (*Continued*)

Bank	Inappropriate Board Involvement
	5. The Board did not appear to appreciate the risk posed by the CEO going for revenue growth and margin at the expense of equity, which was way below the required level. At the end of 2007, its common equity tier 1 ratio was 1.97% compared to minimum 4.5% under new Basel III standards; and a higher level of 9.5%, with which the Financial Stability Board (FSB) and Basel Committee now agree for the largest systemically important banks. 6. The Board allowed the CEO to be rewarded on ROE, compounding the risk element by encouraging undercapitalization and increased leverage.[35]
UBS[36]	1. The Board did not challenge Marcel Ospel's vision to change the bank into a universal bank by getting into investment banking. 2. The Board allowed itself to be persuaded by management consultants without understanding the change in risk profile involved by getting into investment banking. 3. The Board did not insist on having appropriate risk management systems in place as a result.
HSBC[37]	1. The Board expected adherence to laws and a code of conduct and appears to have failed to ensure proper inspection of behavior in the far-flung field operations in Mexico and the Gulf. There was a failure of communication and follow-through in the initial stages. 2. Head office instructions were not followed, requiring the CEO to visit Mexico personally to get the bad practices stopped. 3. The Board appears not have given sufficient support to the compliance function; it was too tentative in its recommendations and sales overrode it. This was in part the result of cost-cutting measures agreed by the Board.[38] 4. The Board appears to have failed to ensure the "tone at the top" translated into behavior that protected long-term reputation, instead tolerating a culture in which short-term sales targets were met without due consideration for the bigger picture and the bank's license to operate; as a result, HSBC has had to pay fines of US$1.92 billion.[39] 5. The Board appears to have allowed over-mighty country operations, suggesting that a global bank might be not just too big to fail, but too big to manage: "The idea of running a genuinely global network, let alone doing so frugally is on trial."[40]
Standard Chartered[41]	1. The Board appears to have allowed an apparent breakdown in the compliance culture with the general counsel focusing on speedy enabling of transactions by encouraging the use of loopholes that became illegal. As a result, Standard Chartered has had to pay fines totaling US$667 million to the DFS and the U.S. Justice Department.[42]

TABLE 5.14 (*Continued*)

Bank	Inappropriate Board Involvement
Rogue trading at Société Générale,[43] UBS,[44] and JP Morgan Chase[45]	1. Boards and management appear to have allowed hedging to become a source of speculative profit, instead of being a protection against the downside. 2. The resulting tolerance of risky behavior led traders to believe that what they were doing was okay and had been approved by their superiors; UBS had to pay fines totaling US$1.5 billion for possible criminal activity in LIBOR fixing.[46]
Retail product mis-selling by UK banks[47]	1. Boards do not seem to have thought through the behavioral implications of the incentive schemes retail bank sales forces were operating under, allowing commission schemes to drive mis-selling of payment protection insurance to members of the public in the United Kingdom and incurring fines as a result, cumulating to £10.8 billion,[48] with Lloyds-TSB alone facing fines of £5.3 billion.[49]
LIBOR price fixing[50]	1. From the evidence at the Barclays Parliamentary Inquiry, it would seem the Board of Barclays relied on management to follow its own compliance procedures when they were not doing so, and did not think to investigate why there had been a breach of Barclays process that had been aired in the press. 2. Perhaps the Barclays and the UBS Boards took comfort from the fact that neither the U.S. Treasury nor the Bank of England seemed to be too concerned with collusion that was designed to stabilize the system during the height of the 2008 crisis, even though it was illegal, or maybe they simply did not know what was happening. They were therefore unprepared for the CFTC investigations and the resulting fines from U.S., UK, and Swiss regulators that totaled $1.5 billion for UBS[51] and ensuing reputation damage to the industry as a whole.

CONCLUSION

What are the key themes emerging from these sample cases of bank bad behavior, incomplete as they are?

- ***Boards allowed themselves to be dominated by powerful CEOs*** who might have had past success and used that to head off difficult questions by Directors who were not sufficiently well versed in modern banking and investment banking to know what questions to ask without being intimidated by the technical answers given by management.

- ***Boards did not understand the implications of the strategies they agreed to*** in terms of:
  - Risk appetite and increased exposure, especially if liquidity was to become an issue.
  - What could happen when and if things did go wrong.
  - What was actually happening to the balance sheet and how this was undermining not just the stability of their bank, but through counterparty risk, the stability of the system as a whole.
- ***Boards also did not appreciate the risk structured products posed to their banks and to the system as a whole***. In this, they were joined by management and regulators (in particular Alan Greenspan, who believed derivatives spread risk across the system rather than concentrating it).
- ***Boards were found wanting as far as understanding how well the codes of conduct and compliance systems were working in fact.*** "Expecting" rather than "inspecting" proved to be a critical weakness in Board oversight.
- Perhaps most seriously, Boards ***were guilty of allowing a culture of risky short-termism and exploitation of consumers to become the norm***, by ignoring the pernicious effects of the reward and remuneration systems. This was made worse by a creeping change of values from those that had prevailed in retail banks before the creation of universal banks with investment bankers in top positions. Also, investment bankers themselves had behaved differently in the past when they were true partnerships and their own money was at risk. Now that they were risking other people's money, they took greater risks, and carried this attitude over into retail banks they joined. Their focus on bonus, combined with the corrosive effect of commission selling on the ethics and integrity of front-line sales forces, devalued customer-centricity and long-term value creation. Reputation hardly mattered:

  The individualistic, bonus-driven ethos of the trading floor permeated institutions in which the idea of fiduciary obligation to customers was ebbing away.[52]

If Boards are to help CEOs rebuild trust in banks, they will have to do a much better job of:

- Approving and reviewing strategy.
- Understanding the risks they incur as a result.
- Ensuring they engage the right people and develop them appropriately with the right values.
- Ensuring that the right reward and control systems are in place to keep them honest.

The next three chapters deal with these responsibilities.

APPENDIX 5A

The Role of Board Committees

Tables 5A.1 through 5A.4 show the roles of the audit, nomination, remuneration, and risk committees.[53]

TABLE 5A.1 **Role of the Audit Committee**

1. **Working with External Auditors**
   a. ***Appointing and remunerating external auditors***
      i. Reviewing the previous year's performance.
      ii. Discussion the coming year's audit proposal.
      iii. Assessing the audit team's independence and experience.
   b. ***Agreeing to the scope of the external audit***
      i. Understanding the audit plan.
      ii. Understanding the expectations of work from auditors.
      iii. Evaluating how key risk areas are covered during the audit.
   c. ***Ensuring the independence of external auditors***
      i. Updating matters affecting auditor independence, including rotation for the key audit partner.
   d. ***Reviewing external audit findings and recommendations***
      i. Reviewing the audited financial statements.
      ii. Discussing audit findings and any disagreements that have occurred with management.
      iii. Meeting auditors without management present to assess any difficulties encountered during the audit, or other concerns they might have.
      iv. Discussing internal control deficiencies/fraud/illegal acts.
2. **Working with Internal auditors**
   a. ***Appointing and remunerating internal auditors***
      i. Reviewing the previous year's performance.
      ii. Discussing the coming year's audit proposal.
      iii. Assessing the audit team's independence and experience.
   b. ***Approving the scope of the internal audit***
      i. Understanding the audit plan.
      ii. Understanding the expectations of work from auditors.
      iii. Evaluating how key risk areas are covered during the audit.

(*continued*)

TABLE 5A.1 (*Continued*)

c. ***Ensuring the independence of internal auditors***
   i. Updating matters affecting auditor independence, including rotation for the key audit partner.

d. ***Reviewing internal audit findings and recommendations***
   i. Reviewing the audited financial statements.
   ii. Discussing audit findings and any disagreements that have occurred with management.
   iii. Meeting the auditor without management present to assess any difficulties encountered during the audit.
   iv. Discussing internal control deficiencies/fraud/illegal acts.

TABLE 5A.2 **Role of the Nomination Committee**

1. **Assess Board composition and skills**
   a. Determine suitable size of the Board, allowing for appropriate staffing of committees
   b. Assess the appropriate Board skills mix on a regular basis
   c. Recommend suitable Director training and development
2. **Recommend candidates for key posts, taking into account the views of shareholders, regulators, and the CEO**
   a. Chair
   b. CEO and C-suite
   c. Directors
   d. Key positions
3. **Conduct annual Board performance evaluation**
   a. With the Chair, evaluate the performance of individual Directors and of the Board as a whole
   b. Assess the independence of independent non-executive Directors
   c. Report results in the annual report
   d. Approve senior management appointments
4. **Develop and review a succession plan and talent management pipeline**
   a. Identify the talent pool and ensure that an appropriate development program is in place
   b. Review progress on a replacement chart of key individuals
   c. Review company personnel policies (recruitment, promotion, rotation, termination, and appraisal policies)

TABLE 5A.3 Role of the Remuneration Committee

1. **Recommend Board a suitable remuneration policy to the Board**
   a. ***Packages for executive Directors***
      i. Link reward to individual and corporate performance to encourage high performance standards
      ii. Salary scales drawn up within the scope of general business policy and not dependent on short-term performance, to avoid excessive risk taking
   b. ***Packages for NEDs and independents***
      i. Linked to their level of responsibilities
      ii. Linked to their contribution to the effective functioning of the Board
2. **Evaluate CEO performance**
   a. Assess CEO performance against agreed KPIs
   b. Ensure the right balance between long-term and short-term objectives
3. **Establish and review incentive plans and stock options to achieve shareholder alignment**
   a. Ensure packages that do not reward risky behavior
   b. Ensure equitable distribution of incentives across different grades
   c. Understand determinants of packages under different scenarios to ensure that golden parachutes are not abusive
4. **Ensure that plans are adequate to recruit and retain talent**
   a. Review market conditions with consultants, using appropriate peer comparators
   b. Put in place transparent pay-for-performance programs

TABLE 5A.4 Role of the Risk Committee

1. Ensure the organization has a comprehensive risk management policy
2. Appreciate that risk management is a dynamic process as markets and internal and external forces evolve over time. As a result members of the risk committee must:
   a. Be well read
   b. Keep in touch with market developments
   c. Get independent information rather than just relying on what management gives them
3. Consider the effectiveness of the policy, including IT risks
4. Consider risks posed by relationships with significant vendors and consultants
5. Review management's reports on management's self-assessment of risks and actions taken to mitigate them
6. Understand the scope of internal and external audit reviews of risk management associated with:
   a. Financial reporting
   b. All other processes
7. Obtain reports on findings and recommendations, together with management's responses
8. Hire outside experts and consultants as needed

NOTES

1. Much of this chapter's discussion on the roles of the Chair, CEO and committees is based on *FIDE Handbook on Good Governance, Part 1 Role of the Board,* 4-8, 12-14, 17-23, written by the author for the Iclif Leadership and Governance Centre, self-published by Iclif in 2013. Tables that are not otherwise attributed are sourced from this handbook.
2. Group of Thirty, "Toward Effective Governance of Financial Institutions," 13 (2012), accessed December 14, 2012, www.group30.org/images/PDF/TowardEffGov.pdf.
3. The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It includes governors of leading central banks and the US Treasury Secretary among its members. For more details see http://www.group30.org/.
4. Based on Group of Thirty, "Toward Effective Governance of Financial Institutions," 16.
5. Based on Group of Thirty, "Toward Effective Governance of Financial Institution," 19–20.
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7. Peter Wallace and John Zinkin, *Corporate Governance* (Singapore: John Wiley & Sons, 2005), 44.
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11. Jessica Silver-Greenberg and Susanne Craig, "JP Morgan Trading Loss May Reach $9 Billion," *Dealbook, NY Times,* June 28, 2012. Accessed December 13, 2012, http://dealbook.nytimes.com/2012/06/28/jpmorgan-trading-loss-may-reach-9-billion/.
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13. Putrajaya Committee, *The Green Book: Enhancing Board Performance* (Putrajaya Committee on GLC High Performance, 2006), 24.
14. Milton Friedman, "The Social Responsibility of Business is to Increase its Profits," *New York Times Magazine,* September 13, 1970.
15. Peter Drucker, *The Practice of Management* (Oxford: Butterworth Heinemann, 1955), 35.
16. "Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical

expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities." John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936), 161–162.

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CHAPTER 6

Leadership, Governance, Strategy, and Risk

This chapter explores the connection between leadership, strategy, and risk and the resulting need for governance by the Board. Strategic choices often reflect the desires, ambitions, and personalities of the leaders of the organization who decide what the strategy should be. The link between strategy and risk is threefold: first, leaders themselves and their ambitions may pose unforeseen risks; second, the objectives of the strategy may present risks in terms of the acceptability of the organization to the society in which it operates; and third are the risks of poor implementation.[1]

Writers on leadership often deal mainly with the history, personality, and traits of the leaders who are their subjects, without really examining the strategic choices they made, and whether there might have been better or other alternatives and why they were not chosen. I am also puzzled by the way many codes of corporate governance separate the Board's responsibility for strategy from its responsibility for risk into two different responsibilities, almost suggesting that what companies should do, is to decide on strategy first, and then think about the risks inherent in that strategy and how to manage and mitigate them. This would seem to ignore the fact that not all strategies have the same risk profile and each strategy involves a unique risk appetite for the organization, and it is the Board's responsibility to determine both at the same time.

I find this all the more puzzling when I consider that Booz & Company found that there were three reasons for shareholder value destruction:[2]

1. Strategic: These reasons destroy 60 percent of shareholder value and include issues related to customer demand, competitive pressures, and management ineffectiveness.
2. Operational: These reasons destroy 27 percent of shareholder value and include issues related to cost overruns and M&A integration problems.
3. Compliance: This represents only 13 percent of shareholder value destruction and includes both financial and non-financial compliance.

When I link this to the second finding in the Booz & Company paper regarding the sources of risk and how companies deal with them, it will become clearer how leadership, strategy, and risks are interrelated, as is shown in Figure 6.1.

As I go through these risks briefly, it will become apparent that there are three ways in which the interaction of leadership with strategy creates risks:

1. *The choice of strategy itself*, which so often reflects the personal agenda and ambition of the CEO rather than what is in the best long-term interests of the bank.
2. *The failure by CEOs and senior managers to set the right "tone at the top"* and "tone in the middle" is reflected in "Cultural Risks" and in compliance. While it is clearly the responsibility of management to do this, it is the Board's responsibility to determine what the "tone at the top" should be and therefore what needs to be done by the CEO and the senior management to ensure that it is appropriate and reflected properly in the "tone in the middle."
3. *The failure by CEOs and senior managers to implement effectively* in the areas of "Traditional Risks" and "Earnings Drivers," to use Booz's terminology, where the responsibility lies primarily with management.

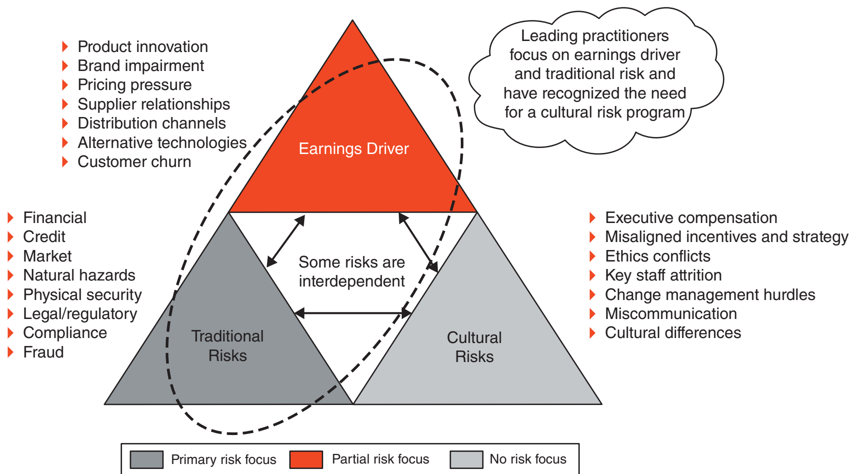

FIGURE 6.1 Enterprise Resilience View of Risk

Source: Booz & Company.

Booz's findings that there has been no focus on the cultural risk elements should not really surprise us, as most of the recent scandals and the banking failures in 2008 are results of this lack of focus.

CHOICE OF STRATEGY

Too often, as we have already seen in the case of Bear Stearns, Merrill Lynch, Lehman Brothers, and RBS, strategy has been determined by the CEO, without adequate understanding of its implications by the Board. This holds true for other financial institution failures, such as MF Global, where the new CEO, Jon Corzine, took a disastrous bet on the Euro[3] without explaining the risks associated with such a bet to his Board.[4] The same applies to the collapse of Northern Rock in the United Kingdom. The Board failed to appreciate the risks posed by a funding strategy that relied so much on short-term wholesale finance to build a business, where there was a fundamental mismatch between the terms of the assets and liabilities.[5]

Recognizing this, Bank Negara Malaysia (the Malaysian Central Bank), for example, makes it very clear that establishing strategic objectives, the attendant risk appetite, risk management capabilities and plans are the responsibility of the Board. It also makes it clear that the Board must set the KPIs by which progress is measured and monitored:

> *An institution should clearly establish its strategic objectives, which take into account the institution's risk appetite and its risk management capabilities, and devise a business strategy and plans for achieving them. The Board should approve these objectives, strategies and business plans, and ensures that performance against plans is regularly reviewed and monitored. The Board should also establish key performance indicators (KPIs) to define, measure and monitor the performance and progress towards achieving organizational goals. The KPIs established should reflect the goals of the Licensed Institution, be measurable and allow for corrective action if things go wrong. KPIs should complement overall business targets, relate to its core activities and be balanced between short and long-term objectives and strategies.*[6]

Put another way, Boards are responsible for:

- Providing the strategic direction.
- Challenging management's strategic plans.
- Reviewing the business plan and budget and setting appropriate targets as a result.

This would suggest that Boards respond to plans brought before them by management. While this is true most of the time, Boards have the authority to initiate as well as approve plans. Thus, Boards are well within their rights to make clear to management what their expectations going forward are and to challenge the most basic assumptions regarding the very existence of the company and its purpose.

Once in a while (perhaps every 5 to 10 years), Boards should reexamine who benefits by the company being in existence by asking who are the stakeholders; who are its customers; what difference in their lives does the company make through the provision of goods and services; what return should the company and its shareholders expect for providing these goods and services; what costs should the company incur; and what long-term value does the company create as a result. Only by asking these fundamental questions can the Board determine whether the company should continue as is, expand, contract, or exit the business. Getting answers to these fundamental questions is the role of the Board, so it can provide direction to management and guidance to the CEO.

Typically most Boards will choose to go for an in-depth offsite session to review where the company has come from: its legacy of successes and failures, as a prelude to deciding where it ought to go. In such an exercise the Board will need to reexamine:

- Purpose or "ends" of the organization.
- Mission, once the purpose has been established.
- Vision.
- Culture and values to see whether the change in purpose, mission, or context requires a change in culture and values.
- Environmental analysis, including organizational alignment to achieve the mission and vision.
- Business model.

One problem Boards need to recognize when going through this process is that the decisions they make and the choices they face affect the risk profile of the company and as a result its risk appetite. This will then require the Board to match the risk appetite of the company with that of its shareholders, with the attendant impact on the cost and structure of financing. The choice of financing may in turn affect the ability to realize the strategy, as RBS discovered to its cost in the ABN AMRO acquisition.[7] As a result, in practice Boards may have to undertake an iterative process where the effect of strategy on risk and cost, and of risk and cost on resources needed to achieve the chosen strategy, must be reconciled.

Revisiting the Company Purpose

The first step in setting strategy is to revisit the purpose of the company. When the Board revisits the purpose of the company, it is important to remember that this is not an exercise in validating or invalidating what the company does. Instead, it is a critical exercise to determine what the company should exist for. Table 6.1 shows the questions that must be asked to do this.

TABLE 6.1 Revisiting the Organizational Purpose

Five Questions to Ask in Deciding What a Company Exists For

1. ***Who are the recipients or customers of the organization?*** Who should they be to ensure a sustainable client base?
2. ***What impact, difference, change, benefit, or outcome is the organization trying to have on the lives of its customers?*** Is this impact sustainable over time or will it become irrelevant as a result of:
   a. Political or regulatory change? Is the company's "license to operate" safe over time?
   b. Economic conditions—both macro and micro-economic—and what is their impact on target countries, industries, and client companies?
   c. Technological change? Will its impact be gradual, giving the organization time to adapt or will it be disruptive, putting the company out of business?
   d. Change in client habits or expectations? What are the megatrends (e.g., demographics, social change, and impact of lifestyle and life stage changes) that can change customer demand and how will they affect the future of the company?
   e. The competitive offers and alternatives to what the company offers, and how they affect the long-term sustainability of the customer value proposition.
   f. The attractiveness of target markets and industries and how effective the barriers to entry are? How high are the barriers to exit? How intense is competition? What is the expected growth rate? How do these affect the available market margin?
3. ***What are the costs of delivering the desired value proposition to existing and prospective customers?*** What needs to be done to get nonbuyers interested in what the company has to offer? Will satisfying noncustomers alienate existing customers?
4. ***What rates of return is the company attempting to achieve as a result?*** Are they realistic? Are they sustainable in the medium and long-term? Do they meet shareholder expectations and match shareholder risk appetites?
5. ***What are the performance standards by which the effectiveness of the organization will be judged?*** How important is financial performance and over what time horizon? What are the leading indicators that matter (typically captured via balanced scorecards) and what relative weight should be given to customer-centric, employee-centric, or shareholder-centric measures? Are there inherent contradictions between different measures and what is the best way of reconciling them?

Almost by definition, answering these questions is not the role of the CEO, other than in his or her role as a member of the Board, for it is the CEO's responsibility to meet the objectives determined by the Board in defining the agreed purpose of the organization. For the CEO to decide what these should be is to create a conflict of interest between the CEO, as the executive answerable to the Board for meeting the performance standards by which he or she and the organization will be measured, and his or her role as a member of the body (the Board) that will review his or her performance.

Revisiting the Company Mission

Closely related to the company purpose, is the company mission. This turns the rather more abstract ideas of the purpose into concrete form by defining who the customers are and what products and services will be offered to them, with some indication of qualitative targets to be achieved in a realistic time frame. It also often includes a statement of company values. The mission serves to define both the business the company is in and, as important, what business it is not in. Thus the Mission answers three questions:

1. Who does the company serve?
2. What products does it offer?
3. How does it provide such products and services?

Table 6.2 shows some examples of bank mission statements.

As part of developing the mission, the Board needs to answer the following seven questions, shown in Table 6.3.

Perhaps one of the more important roles of Boards is to ensure that whatever mission they decide on helps guarantee the company's long-term "license to operate." Considering the sustainability of the long-term "license to operate" is important because it acts as an early warning signal regarding whether the senior management wants to do what has been agreed on the one hand, and whether society will continue to allow the company to continue in its line of business on the other hand.

Figure 6.2 shows the four questions Boards must consider and answer satisfactorily if the long-term "license to operate" is to be protected. The questions need to be addressed in the order in which they have been numbered and Boards need to recognize that two of the questions have a major ethical dimension, while two of them are primarily commercial. The point to note is that Boards ignore the ethical dimensions of the company mission at their peril because behavior that is unethical but legal may become illegal as society turns its back on such activities. They also

TABLE 6.2 Examples of Bank Mission Statements

Bank Mission Statements

- *HSBC*
  "Who we are and what we do
  HSBC is one of the world's largest banking and financial services organizations. With around 7,200 offices in both established and faster-growing markets, we aim to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper and, ultimately, helping people to fulfill their hopes and realize their ambitions."[8]
- *Wells Fargo*
  "Our product: SERVICE. Our value added: FINANCIAL ADVICE. Our competitive advantage: PEOPLE."
- *US Bancorp*
  "Our mission statement captures the simple sentiment that drives our organization—we are working together for our customers and our communities."
- *JP Morgan Chase*
  "At JP Morgan Chase we want to be the best financial services company in the world. Because of our great heritage and excellent platform, we believe this is within our reach."
- *Northern Trust Corp*
  "Northern Trust is a global leader in delivering innovative investment management asset and fund administration, fiduciary and banking solutions to corporations, institutions and affluent individuals. For nearly 120 years we have evolved with the changing needs of our clients and our world."
- *Fifth Third Bancorp*
  "Proudly providing banking services for 5.8 million customers. We understand that earning your trust is key to our financial strength."[9]

TABLE 6.3 Key Questions Regarding the Mission

1. Do we have a clear business focus and is it understood by all?
2. Have we developed a compelling, differentiated mission that sets us apart from the competition?
3. Do we really understand our competition—not just our head-to-head competitors, but all the competitors for market margin (using Michael Porter's Five Forces framework)?
4. What are our ambitions?
   a. Do we want to be technological leaders or followers?
   b. Are we targeting early adopters in the product life cycle?
5. Which market segment do we want to be in?
   a. Prestige.
   b. Premium.
   c. Value for money.

(*continued*)

TABLE 6.3 (*Continued*)

d. Low cost mass market
e. What psychographic grouping do we want to serve?
6. How adaptable is our mission to changes in external conditions?
7. Does the mission protect the company's long-term "license to operate"?

need to reflect on the employee implications of having an unethical but legal mission. They are likely to have to pay more to recruit and retain people because of the ethical stigma around the company's activities and they may in fact not be able attract top talent who are likely to go elsewhere to avoid that stigma. Perhaps the best recent example of this potential conflict between what is commercially acceptable in the short term, but poor businesses in the long run, legally defensible but ethically indefensible, were Goldman Sachs's Abacus and Timberwolf deals, scrutinized by Congress.[10] The damage to Goldman's reputation was considerable. But more important, when Carl Levin was given the answer that what Goldman had done was legal, his reaction was that in that case the law

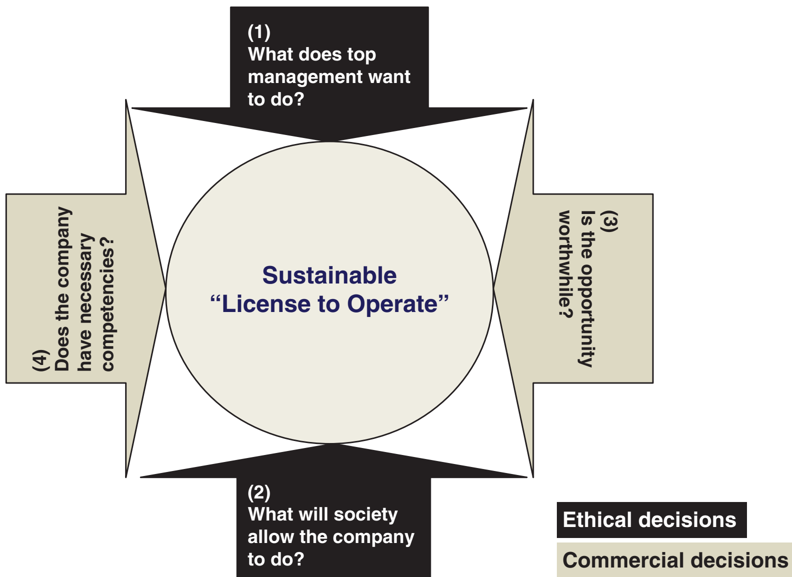

FIGURE 6.2 Four Commercial *and* Ethical Questions Boards Must Answer
Source: J. Zinkin, Iclif Leadership and Governance Centre, 2011.

needed changing. This proved to be an important turning point in the development of Dodd-Frank legislation. Goldman's lawyers helped Goldman win the battle regarding Abacus and Timberwolf, but contributed to losing the war over tougher regulation.

Too often, line management and CEOs are in the thick of battle and cannot see the impact of their actions on the "license to operate." It is the role of the Board to ensure that while management delivers what is promised in the short term, it has not jeopardized the long-term "license to operate" as a result.

Revisiting the Vision

A well-crafted vision:

- Enables people to think about or plan the future with great imagination or wisdom.
- Acts as an energizing call for action to rally the troops.
- Engages both hearts and minds.
- Provides a clear mental picture of what successful execution will feel like.

As a result, there are some basic questions Boards need to consider when deciding on the vision so that it does not degenerate into mere fantasy. These are shown in Table 6.4.

TABLE 6.4 Questions Regarding Vision

1. Is the vision distinctive?
2. Does it engage both hearts and minds?
3. Does it communicate in compelling terms what success will look and feel like?
4. Are people clear about their roles and responsibilities in achieving the vision?
5. Are people clear about "what is in it for them" in achieving the vision?
   a. How it will affect them professionally in terms of career development and reporting relationships?
   b. How it will affect them personally in terms of job satisfaction and work-life balance as well as rewards and recognition?
6. Is it broken down into milestones and targets with due dates, so people know where they stand on their journey toward the ultimate destination described in the vision? Do they understand their responsibilities for making it happen?
7. Do people understand the consequences of failing to achieve the vision for:
   a. The company as a whole?
   b. Their department?
   c. Themselves as individuals?

Once again the custodian of the vision is the Board. The CEO is responsible for guarding the vision in his or her capacity as a member of the Board. However, it is the responsibility of the CEO to ensure that everybody understands "what's in it for them" in achieving the vision, and equally what are the consequences for them and the organization as whole for failing. It is the responsibility of the CEO to operationalize the vision, by ensuring it is broken down into milestones and targets with due dates. Perhaps the most important and often neglected part in this is to ensure that every employee has a clear "line of sight" between achieving the vision and his or her own job.

CEOs who are not wholehearted in their support of the vision can do tremendous damage to what makes it unique, as happened with Hewlett-Packard with the arrival of Carly Fiorina.[11] Equally CEOs and Boards must be very careful when they change the vision of the company that they do not alienate key stakeholders, as happened with UBS, when it decided to become preeminent in investment banking under Marcel Ospel.[12]

Revisiting Culture and Values

Following the Barclays LIBOR fixing scandal and the HSBC money laundering problems in 2012, it is crystal clear (if there ever was any doubt), that Boards are responsible, and will be held responsible by the public, regulators, and politicians for the culture and values of their company.

What is culture? Culture is defined as follows:

> *Culture is the collective programming of the human mind that distinguishes the members of one human group from those of another. Culture in this sense is a system of collectively held values.*—Geert Hofstede[13]
>
> *Culture is the deeper level of basic assumptions and beliefs that are shared by members of an organization, that operate unconsciously and define in a basic 'taken for granted' fashion an organization's view of itself and its environment.*—Edgar Schein[14]

The importance of culture is best illustrated by the following excerpts from an article by Andrew Hill in the *Financial Times:*

> *Mr Diamond himself kept coming back to one lofty concept, directly referred to 50 times during the hearing. . . . The shape and form of companies does contribute to their culture.*[15]

From a Board perspective, recognizing the different factors that contribute to an organizational culture is only the first step. Boards must nurture those unique elements that make a company successful, while at the same time discouraging the bad habits that could jeopardize the long-term success of the organization as the second step. This translates into the Board being accountable for the "tone at the top," ensuring senior management conducts itself in the manner that sets the example for middle management. Boards must also recognize the dangers posed by conflicts between different cultures within the organization. For example, securities traders behave very differently from retail bankers: They value different things; they are rewarded in different ways, which reinforces the differences in their beliefs and values.

What is true within an organization is even truer when two different organizations come together as a result of a merger or takeover. Boards must recognize that conflicts of culture, differences in axioms about how to do business, and incompatible systems (reward systems as well as IT systems) can undo all the synergy benefits of the deal. The Nomura Board does not seem to have given this enough weight when they authorized Shibata-san, Nomura's COO, to acquire Lehman's Asian operations.[16] So it should not have come as a surprise that the acquisition failed.

Culture is delivered through the values the company espouses. It is essential that values are taken seriously, and that no exceptions are made when individuals violate the company values. The more productive the individual, the higher up in the organization, the more important it is that the values apply to that person's behavior, and that violation of the values leads to severe sanctions, even dismissal. When two different organizations with different values have to work together or merge, there can be real problems of mismatched behavior.

For values to work effectively two things are needed:

1. *A code of conduct that is enforced* regardless of the individual's rank or financial contribution to the company. Only in this way can employees be expected to live the values of the company.
2. *Values that can be translated into observable behaviors* that form part of the appraisal, reward, and recognition systems of the company.

To highlight potential problems with culture and values, Boards should ask the following questions, shown in Table 6.5.

Any strategy that violates the organization's values will fail. Any CEO who violates the organization's values will either be rejected by the organization or will create lasting damage. And in a regulated industry like banking, any CEO who does not respect the values demanded by the regulator will lose the regulator's confidence, and be asked to leave as a result.

TABLE 6.5 Questions Regarding Culture and Values

1. *Do we have a distinct culture?*
   a. What is its origin and do the conditions that created it still apply?
   b. Is it a source of competitive advantage or does it hold us back?
   c. If there is a need for change, what needs to change, and how long will it take?
   d. Does our culture make it easy/difficult to
      i. Diversify our activities?
      ii. Acquire, merge, or be merged with another organization?
2. *Within our organization are there different cultures?*
   a. Do they coexist well or do they create silos?
   b. Do the differences lead to incompatibility in
      i. Staffing?
      ii. Reward and recognition?
      iii. Risk appetite?
      iv. Career progression?
3. *Do we have our own way of doing business?*
   a. Do we have a formal code of conduct or statement of business principles to reinforce it?
   b. Does everybody understand it?
   c. Is the code of conduct enforced regardless of rank and position?
   d. Are employees trained in dealing with gray area dilemmas?
4. *Do we have a clear set of values?*
   a Are they understood by all?
   b. Do we live our values?
   c. Do they translate into observable behaviors?
   d. Are they reflected in each job description?
   e. Do they form part of performance appraisal?
5. *Do the reward and recognition systems reinforce our values or do they work against them?*

Environmental Analysis and Organizational Alignment

A key process in deciding what makes a company's offer distinctive and desirable to customers is the environmental analysis. This covers factors outside and inside the firm with a view to reconciling what the external environment has to offer with the company's ability to capture the opportunities provided. Included in this exercise is an internal review of how effectively the organization is aligned to deliver its mission and vision.

A number of tools or frameworks are useful in looking at the company's external environment. The PESTLE framework, SWOT analysis, and Michael Porter's Five Forces are useful as starting points. The PESTLE and SWOT frameworks and the relevant questions Boards should ask when using these frameworks are shown in Appendix 6A, Table A.1 "Board Questions Regarding Strategy."

Table A.1 in Appendix 6A looks at questions that Boards must ask regarding the external factors that affect strategy: the political, economic, social, technological, legal, and environmental (PESTLE) considerations and their impact on the business.

Table A.2 in Appendix 6A shows the questions that need to be asked when working out the strength and weakness part of the SWOT analysis. The key point to note is that the questions are almost identical for both—the answers determine whether the results reveal strengths or weaknesses in the company's ability to compete and create long-term value. Boards must ask these questions and be satisfied with the answers as they decide on the strategy for the company. Boards must also recognize that existing strengths may become future weaknesses. They must be on the lookout for tipping points or inflexions when strength becomes a weakness.[17]

Table A.3 in Appendix 6A shows the questions that need to be asked to assess the opportunities and threats faced by the company before deciding on the appropriate strategy. Boards would also do well to remember Michael Porter's "Five Forces" model. This looks at market margin in a given industry in an attempt to explain why Warren Buffett was right when he said that it is more important to be in a good industry, where even the least effective company can earn a reasonable return, than to be the best competitor in a lousy industry, where nobody makes a good return, and that energy is better spent getting out of that industry rather than trying to improve it:

> *Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks.*[18]
>
> *When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact.*[19]

The last stage of the environmental analysis is a thorough review of the organization's alignment with its mission and vision. How to do this has already been discussed in Chapter 3.

Revisiting the Business Model

Boards need to reexamine the assumptions on which the company business model is based, and the "Business Model Canvass" developed by Osterwalder and Pigneur is a useful framework to help Boards ask the right questions of management.

The Business Model Canvass looks at customer segments, customer relationships, channels, value propositions, key activities, key resources, and

key partners to relate them to revenue streams on the one hand and the cost structure on the other.[20] Table A.4 in Appendix 6A lists the questions Boards should ask regarding the appropriateness of the bank's business model and that of its major clients.

Completing these six steps in setting strategy is most helpful in determining the context and content of any long-range strategy. It is my belief that if the Merrill Lynch, Bear Stearns, Lehman Brothers, RBS, UBS, HSBC, and Barclays Boards had all used the series of questions at each of the six steps listed in appendix A, they would not have been carried away by the force of personality of their CEOs and would have avoided the crises that hit them as a result of wrong strategic choices.

AVOIDING CULTURAL RISK

This relates to what Booz & Company categorized as cultural risk, created by the following seven factors:

1. *Executive Compensation:* As a result of the Global Financial Crisis, executive compensation in banks has become a flashpoint for Boards to consider. Remuneration for CEOs in the United States and the United Kingdom in particular has caused adverse comment regarding the absolute levels bank and investment bank CEOs were getting paid. There does not seem to be any clear link between performance and pay and CEOs have been able to walk away with enormous packages when they have been terminated.[21] This has led to a serious deterioration in the climate of opinion regarding banks, and in the case of Bob Diamond's package before he was asked to resign, to a shareholder revolt and ultimately to the resignation of the Board member chairing Barclays Remuneration Committee.[22]
2. *Misaligned Incentives and Strategy:* Incentives for senior managers and CEOs were seriously misaligned as a result of the desire of shareholders for maximum ROE in an environment of low yields. This led Boards to condone risky behavior and to put in place incentive plans focused on ROE for CEOs, which encouraged CEOs to put the long-term viability of their companies at risk, by adopting strategies that were riskier and ignoring the long-term risks they posed.
3. *Ethics Conflicts:* Values and the ethical standards adhered to by the company are the responsibilities of Boards, the CEO, and senior management who are responsible for both the "tone at the top" and the "tone in the middle." If any Directors or CEOs felt they could hide behind the plea that these are operational issues, they would have been proven wrong by the Senate interrogation of Goldman Sachs senior

management in the Timberwolf and Abacus cases;[23] the Parliamentary Inquiry into the LIBOR-fixing activities of Barclays;[24] and the Congressional inquiry into HSBC's money laundering activities.[25]

4. *Key Staff Attrition:* Ensuring that the company has the right key staff in the right jobs at the right time is the responsibility of the nomination committee and the CEO.
5. *Change Management Hurdles:* These are of special importance to Boards during mergers and acquisitions. Too often Boards agree to mergers and acquisitions proposed by CEOs without really appreciating what can go wrong during the post-merger or acquisition integration process. The disastrous RBS acquisition of ABN AMRO is a case in point.
6. *Miscommunication:* This is a vital operational issue. It is only the Board's responsibility if what is being miscommunicated are the purpose, vision, mission, values, and agreed strategy. It is, however, an essential leadership responsibility to articulate clearly the vision and mission and to live the values. Failure to do so will derail strategy implementation and increase risks to the business dramatically;
7. *Cultural Differences:* Culture is a key Board and leadership responsibility. It incorporates values, codes of conduct, and the essence of "Who we are, what we do and how we do it." Boards must therefore recognize that there will inevitably be cultural differences based on:

   a. Age: Think of the difference in attitude and behavior of Baby Boomers, Gen X and Gen Y, and Millennials.
   b. Nationality: People from Japan or China communicate quite differently from people from the Netherlands or Australia, for example.
   c. Profession: Even within banking there is a huge difference between retail and investment bankers, between branch managers and traders, let alone the difference between accountants and lawyers.
   d. Education: MBAs approach problems quite differently from people who did not go to a university and joined their bank as tellers.
   e. Income: The choices faced by the top 1 percent and the middle class whose real incomes have been stagnant or in decline are totally different.
   f. Organization: Consider the differences in culture of Household and HSBC or of Bear Stearns and JP Morgan Chase and the resulting difficulties when they were acquired.
   g. Division: Trading floors do not behave in the same way as bank branches.
   h. Department: Front offices are different from middle and back offices because of their need to interface with customers.

Each group has its own set of axioms, beliefs, and way of doing things. Boards and bank leaders must therefore ensure that any strategy or change takes these into account so people can work together effectively: taking the same things for granted as well as being able to trust each other and rely on each other to get things done according to the company's agreed values. Failure to recognize that cultural differences exist will, at the minimum, create unnecessary friction as vested interests defend their ways of doing things, and can destroy the synergy benefits that are the basis of so many mergers and acquisitions. Part of HSBC's problems in Mexico over money laundering was a mismatch of culture, values, and behavior. Nomura's failure to integrate effectively the relics of Lehman in Asia was the result of cultural problems. Critics of retail banks that have been in the headlines have argued that this was the result of putting investment bankers with different values in charge.

Thus Boards must question the cultural implications and barriers to effective implementation of any merger, acquisition, or cross-border expansion and be sure management understands the differences and has a convincing plan to deal with them when they arise.

FAILURE OF EFFECTIVE IMPLEMENTATION

Still using the Booz & Company framework, the failure of CEOs and senior management to implement strategy effectively from a risk perspective shows up in:

Traditional risks.

Earnings drivers.

Traditional Risks

Essentially the traditional risks reflect more of an inward looking focus on what can be managed through sensible policies in the first place, mitigated through careful monitoring by management and the Board, with the resulting residual risks being insured.

- *Financial risk and credit risk* concern the company's cash flows and its subsequent ability to finance its operations, which can be readily quantified, as long as the assumptions about the probabilities of occurrence are correct and no "Black Swans" occur.
- *Market risk* represents the risk that the company's portfolio of investments will be affected by changes in market sentiment—whether this

is regarding equities or bonds. These can be mitigated through sensible diversification policies, as long as the assumptions about the lack of correlation between different asset classes hold true. Unfortunately when market liquidity dries up (e.g., in 2008, after the collapse of Lehman Brothers) asset class values tend to become highly correlated, nullifying the assumptions underlying value at risk (VAR), leaving the company exposed to potential disaster.

- *Natural hazards* represent the risk of natural events disrupting either the company supply chain (e.g., the Thai floods of 2011) or damage to the company's own physical assets (as in the Fukushima nuclear plant disaster in Japan). Where and how the company's assets are located is in part a matter of policy, but once the decisions have been made, the company is hostage to fortune, and mitigation and insurance are the only options available.
- *Physical security* represents the risks of all the things that can go wrong in health and safety, and more recently the addition of terrorist events (e.g., 9/11, plane hijacking, and piracy). Making sure that there are good security arrangements to protect offices and other assets is particularly important in failed state environments or where there is civil strife.
- *Legal/Regulatory* risk reflects the possibility that the political climate of opinion will change to the disadvantage of the bank, leading to restrictions on its "license to operate." Currently, this is regarded as one of the most important risks faced by banks in Europe and the United States, as a result of the scandals involving Barclays, JP Morgan, HSBC, Standard Chartered, UBS, and others. It is something Boards can never afford to ignore, lest they lose the support of their regulator.
- *Compliance and fraud* represent a different kind of risk, namely that things inside the company are not working as they ought. In the case of compliance failures, it is the Board's responsibility to ensure that the compliance function has the authority, skills, and power to enforce compliance and to check that policies are in fact being adhered to (the lesson from both the Barclays LIBOR and HSBC money laundering scandals). Fraud is much more difficult to deal with as it involves people acting in deliberately misleading ways.

Earnings Driver Risks

These are the risks affecting margin and the company's ability to remain profitable once strategy has been agreed. There is little Boards can do about these risks, other than to understand their impact on the P&L and encourage management to take corrective or remedial action; failing

which, to be realistic about how to manage the resulting decline in profitability.

- *Product Innovation:* Technological improvements can either enhance the company's margins or create entirely new ways of doing business. Just as they can do this for the company, they can do it for the competition as well. Boards must therefore track this because failure leads to long-term decline and possible extinction of the company as an independent entity.
- *Brand Impairment:* Corporate brands, particularly those of banks, have to consider the impact of brand impairment not just on the margins they can command, but also on the effect impairment has on overall reputation and as a result on market capitalization—and these are directly the responsibility of the Board.
- *Pricing Pressure:* Pricing issues are operational matters best left to management, though Boards need to be aware of any pricing issues as these can affect reputation and brand.
- *Supplier Relationships:* On the whole, supplier relationships are operational matters unless they affect corporate reputation through violations of environmental, health, and safety regulations or create undue NGO and media interest in how they operate. Boards must therefore reassure themselves that no such problem could arise.
- *Distribution Channels:* Typically these risks are operational, unless the business model itself envisages a totally different way of using distribution.
- *Alternative Technologies:* These are the risks that can put a company out of business. Although they are operational in nature, Boards need to be aware of their existence and potential impact on the long-term viability of the company.
- *Customer Churn:* Customer loyalty is now recognized as being more important than customer satisfaction[26] as an indicator of the health of customer relationships. This is an operational matter and only really becomes a cause for Board concern as a leading indicator of problems.

QUESTIONS REGARDING RISK

In Chapter 2 one theme running through the disasters that befell Merrill Lynch, Bear Stearns, Lehman Brothers, and RBS was a lack of understanding of the risks being run by their CEOs and therefore their Boards. Perhaps these could have been avoided if the Boards had been armed with the right

list of questions with which to challenge their CEOs. Specifically these questions relate to:

- Systemic risk.
- Reputation risk.
- Operational risk.

Systemic Risk

Systemic risk is a relatively new area for Boards to consider and has really only become a priority since the Global Financial Crisis began in August 2007 with the closing of two BNP Paribas money market funds on August 9, 2007.[27]

Systemic risk in financial services has been created by six factors:

1. *Unrealistic shareholder expectations:* Before Milton Friedman popularized the idea in 1972 that the purpose of business was to maximize shareholder returns, investors were comfortable with a 3 to 5 percent premium on the so-called risk-free rate represented by U.S. treasury bills or the UK "gilts"—that is, a fair return. This meant that on average the expected ROE was around 8 to 9 percent. The result of investors demanding a maximum return instead in the 24/7 world of finance was twofold:
   a. Pension fund managers and investors were encouraged by asset managers to switch in and out of stocks in the search for maximum returns. As a result, investors gradually ceased to behave as owners of the business in which they were invested, with a long-term view, and became more like speculators interested in maximizing yield through day trading and, later, high-speed algorithmic trading. Boards and management were increasingly pressured to achieve double-digit growth rates and ROE in the high teens.
   b. Responding to these pressures led banks to move into areas whose risks they did not understand fully, and to compound the riskiness of such moves by increasing leverage to get higher levels of ROE.

   Table B.1 in Appendix 6B: "Board Questions Regarding Risk" shows the risk questions Boards should ask regarding shareholder expectations.
2. *Herding behavior:* This has occurred where banks have seen their competitors getting into apparently profitable lines of business that may be inherently much more risky over the long term, though this is not yet apparent. As a result, when analysts and investors put pressure on them to be less conservative and get into the lines of business their competition are in, it is very difficult to resist. The pressure may come from

external consultants who present comparisons of business portfolios without including the differences in the risk profiles of the various businesses, sectors, or products, suggesting as a result to Boards that it is sensible to do what others are doing. Subprime is an excellent example, as was the Lloyds of London LMX disaster in the 1980s in insurance.[28]

Table B.2 in Appendix 6B shows the risk questions Boards should ask regarding herding behavior.

3. *Failure of systemic integrity:* This occurs typically when there is a disaggregation of the value chain, which results in nobody taking responsibility for the integrity of the entire system, preferring instead to pass the problem on to the next participant in the value chain, thus passing the buck to another organization so it becomes their problem. Subprime was a classic example.

   In these circumstances Boards need to be reassured that their dependence on and trust in systemic integrity is not misplaced.

   Table B.3 in Appendix 6B shows the risk questions Boards should ask regarding systemic integrity.
4. *Inappropriate rewards:* The Global Financial Crisis highlighted the problem of inappropriate rewards: from the way mortgage brokers were incentivized; credit rating agencies were paid; investment bankers received bonuses for highly risky short-term behavior that ignored long-tail impacts on the viability of the business; to CEOs being measured on ROE.

   Table B.4 in Appendix 6B shows the risk questions Boards should ask regarding appropriateness of rewards.
5. *Moral hazard:* Does the fact that the organization is deemed to be "too big to fail" or worse still, "too big to jail," encourage unreasonable ambition and systemically dangerous risk taking?

   Table B.5 in Appendix 6B shows the questions Boards should ask regarding moral hazard.
6. *Tragedy of the Commons:* The tragedy of the commons occurs when an action that makes sense for one individual leads to all individuals doing the same and as a result destroying what they have in common. Subprime and the Lloyd's of London LMX death spiral were examples of the tragedy of the commons in financial services. When only a few companies were selling subprime mortgage-backed securities they made a great deal of money, because the system could stand the relatively high-quality risks, but when everybody got into the act, the quality of the risks deteriorated dramatically and the resulting defaults brought the system to its knees. In the case of the LMX death spiral, Lloyds' underwriters sliced and diced risks and reinsured and co-insured them to the point where they no longer knew what the underlying catastrophe risk exposure they faced really was. As a result, they were insuring risks they thought they had laid

off through reinsurance, only to find it had come back on their books (in the same way as banks had subprime risks on theirs).

Table B.6 in Appendix 6B shows the questions Boards should ask regarding the tragedy of the commons.

Reputation Risk

In some ways, reputation risk is the most important risk Boards have to deal with in the normal course of business because it is the consequence of failures in strategy and operations and as a result can be the outcome of systemic risk, when the entire industry is discredited (as has happened with banking); of strategic risk; of business risk and operational risk. Figure 6.3 shows how some of these different risks can combine to create reputation risk.

Even though it is so important, it is surprising how often management and Boards forget to consider the reputation risk of their actions, and had they considered it properly, they would almost certainly not have chosen the path they followed. It is perhaps no coincidence that the new CEOs of Barclays[29] and Deutsche Bank are now placing reputation impact as the most important KPI for their banks.[30] Indeed, the CEO of UBS's investment banking unit told the Parliamentary Committee on Banking Standards on January 9, 2013 that UBS was overhauling its culture and was "serious about putting integrity over profit."[31]

Table B.7 in Appendix 6B shows the questions Boards should ask regarding reputation risk.

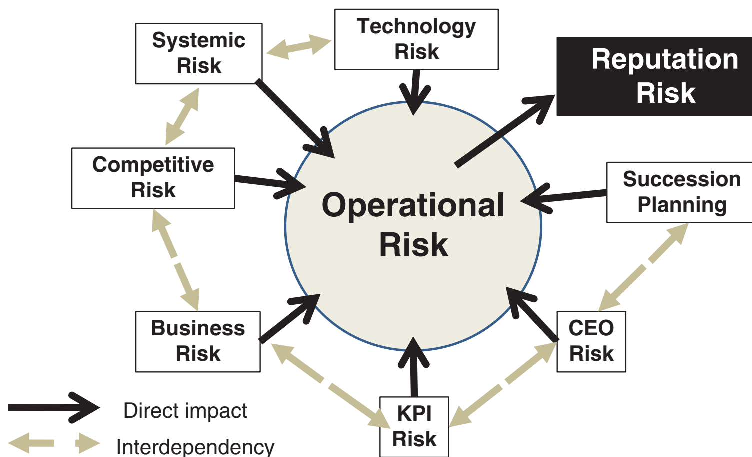

FIGURE 6.3 Reputation Risk Can Be Caused by a Combination of Many Risks
Source: J Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur, April 2013.

Operational Risk

Operational risk covers concentration risk, credit risk, liquidity risk, interest risk, currency risk, and value at risk (VAR):

- *Concentration risk:* The *Business Dictionary* defines this as "probability of loss from heavily lopsided exposure to a particular group of counterparties." It is therefore important for Boards to be aware of the nature of exposures to counterparties—after all, it was precisely because companies did not understand their exposure to counterparties that liquidity evaporated after the collapse of Lehman Brothers, causing the Global Financial Crisis. Boards must reassure themselves that the risks they face are not heavily lopsided.

  Table B.8 in Appendix 6B shows the questions Boards should ask regarding concentration risk.
- *Credit risk:* The *Business Dictionary* defines this as "probability of loss from a debtor's default. In banking, credit risk is a major factor in determination of interest rate on a loan: longer the term of loan, usually higher the interest rate. Also called credit exposure." Credit risk is linked to liquidity risk as well as interest rate risk. Both are affected by the concentration risk represented in the mix of retail and wholesale portfolios that are affected by economic risk at both the macro- and micro-economic levels, as well as by systemic risk and political risk, as is shown in Figure 6.4. The problem is whether the bank is capable of appreciating the interaction of these different elements and therefore of recognizing the value of the aggregated risks adequately.

  Even though it is complicated, Boards need to be able to understand the interactions between the different elements.

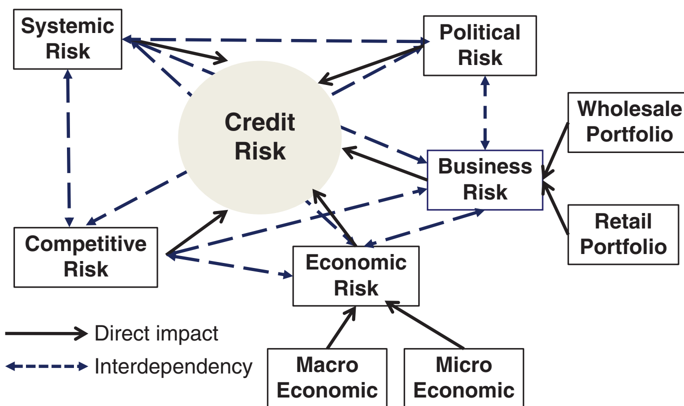

FIGURE 6.4 Drivers of Credit Risk
Source: J Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur, April 2013 .

Table B.9 in Appendix 6B shows the questions Boards should ask regarding concentration risk.

- *Liquidity risk:* The *Business Dictionary* defines this as "probability of loss arising from a situation where (1) there will not be enough cash and/or cash equivalents to meet the needs of depositors and borrowers, (2) sale of illiquid assets will yield less than their fair value, or (3) illiquid assets will not be sold at the desired time due to lack of buyers." The collapse in 2008 of Bear Stearns and Lehman Brothers in the United States and Northern Rock and RBS in the United Kingdom reminds us banks can see their balance sheets disappear almost literally overnight as a result of a crisis of liquidity. Such crises are by their nature rare, and regulators try to make them rarer still.

  Table B.10 in Appendix 6B shows the questions Boards should ask regarding liquidity risk.
- *Interest risk:* The *Business Dictionary* defines this as "Probability that the market interest rates will rise significantly higher than the interest rate earned on investments such as bonds, resulting in their lower market value. This risk is higher on long-term bonds." This was the traditional view of interest risk. However, in today's world of quantitative easing and central banks like the Federal Reserve, Bank of Japan, or the Bank of England adopting policies of financial repression by artificially keeping the long end of the yield curve depressed, there are new risks that the spread is no longer sufficient for banks to cover their operating costs. As a result, Boards need to understand more than just what is happening to the money supply, which affects interest rates directly. They need to understand how economic policies will affect the inflationary or deflationary outlook and the cost of money; and as a result, how exchange rates will affect interest rates.

  Table B.11 in Appendix 6B shows the questions Boards should ask regarding interest risk.
- *Currency risk:* The *Business Dictionary* defines this as "uncertainty about the future value of a currency." In the past, currency movements were explained by balance of payments and relative inflation rates. Countries with balance of payments problems could be expected to devalue their currencies to restore competitiveness. Countries with relatively high rates of inflation could also expect to see their currencies weaken. However, in today's world some of these certainties have disappeared. Some currencies move depending on whether they are "carry trades" or not; and this will be a function not of balance of payments or inflation but of relative interest rates. Other currencies, like the U.S. dollar, Swedish kroner, or Swiss franc may move up as a result of flight to quality as speculators try to exit weakening currencies like the Euro. To complicate matters further, Asian central banks have systematically kept

their currencies at lower exchange rates than equilibrium to keep exports growing and so provide jobs. Boards therefore need to understand a complex set of interrelationships between politics, country growth rates, balance of payments, interest rates, and foreign exchange market sentiments, as well as the relative position of their country's currency with respect to other key currencies. In today's difficult global economic environment this means bearing in mind which currency is regarded as being "the least dirty shirt" in an ugliness parade, as opposed to the best bet in a beauty parade, unlike in the past.

Table B.12 in Appendix 6B shows the questions Boards should ask regarding currency risk.

- *Value at Risk:* The *Business Dictionary* defines this as the "Largest loss likely to be suffered on a portfolio position over a holding period (usually 1 to 10 days) with a given probability (confidence level). VAR is a measure of market risk, and is equal to one standard deviation of the distribution of possible returns on a portfolio of positions." The problem with VAR is that it is based on mathematical modeling assumptions that are sometimes invalidated by the so-called "black swan" events. These events are supposed to happen once in 10,000 years and as a result are outside three standard deviations of the distribution of possible negative returns. The fact they were believed to be so unlikely meant that their potentially devastating impact was ignored.

  We now know better. There are two basic fallacies in the assumptions of VAR: (1) that the bell curve of Gaussian normal distributions was an accurate reflection of reality; (2) that different asset classes had different risk profiles that were not closely correlated as a result. Yet once the "black swan" events materialize, they tend to destroy liquidity in the asset class where they occur, creating a desperate need to realize liquidity in other unrelated asset classes to pay for what happened in the original asset class. In other words, instead of being uncorrelated, in a crisis, they become highly correlated.

  Unfortunately for Boards, these matters are highly technical and therefore asking the right questions is difficult. Making sure the experts are not bamboozling the Board is even harder. Table B.13 in Appendix 6B shows the questions Boards should ask regarding currency risk.

CONCLUSION

The choice of strategy may be based just as much on the personal agenda and ambitions of whoever is leading the organization as on the rational, extrinsic arguments made in the business case. Boards need to recognize

this and make the necessary allowances when thinking about strategy proposed to them by management. In particular, they must think through the risk implications of whatever strategy is chosen and ensure that it does not merely reflect the personal risk appetite or desires of the CEO, but the risk limits and risk appetite agreed by the Board instead, after taking into account the risk appetites of shareholders and other stakeholders.

To do this properly, Boards must adopt a six-step challenge process where they define or revisit the business:

1. Purpose.
2. Mission.
3. Vision.
4. Culture and values.

To make sure that what they decide will be both unique and a source of sustainable competitive advantage, Boards then need to undertake:

5. An environmental analysis to ensure the existence of both the external conditions under which the company will operate and the internal conditions which will determine whether it has the required capabilities and competencies to implement the strategy effectively and within acceptable risk tolerances.
6. A detailed examination of the proposed business model and how it satisfies customers now and in the future, and as a result the resources it requires and the returns it will generate.

Having agreed on a suitable strategy and business with its associated risks, Boards must provide a suitable governance framework to minimize the chances of failure to implement effectively, recognizing what Booz & Company called the "traditional risks" that are basically inward looking and operational, as well as the "earnings driver risks" that affect margin and banks' ability to remain profitable.

To deal with these risks effectively, Boards must also ask constructively challenging questions regarding systemic risks—a new focus resulting from the subprime crisis—as they affect reputation risk. Reputation risk is now perhaps the most critical, as a result of the steady stream of scandals and penalties banks have had to deal with over the years following the GFC.[32]

APPENDIX 6A

Board Questions Regarding Strategy

Appendix 6A covers the questions Boards should ask in relation to using three frameworks for strategy: PESTLE, SWOT, and Business Model. Table A.1 deals with PESTLE, Tables A.2 and A.3 deal with SWOT, and Table A.4 deals with business model assumptions:[33]

TABLE A.1 Questions to Ask When Using the PESTLE Framework

The PESTLE framework consists of the following factors to be considered:
P=Political
E=Economic
S=Social
T=Technological
L=Legislative
E=Environmental

Political Questions

1. Do we understand the political climate and its impact on economic policy? What are the early warning signals of change?
   a. What is the attitude of the government, opposition, and regulators to our industry and our company?
   b. What is the attitude and policy of the government, opposition, and regulators to the drivers of macro-economic performance:
      i. Industrial policy
      ii. Competition policy
      iii. Interest rates and liquidity
      iv. Balance of payments and currency
      v. Employment and productivity
2. Do we know what are the priorities and developmental agenda of the government and how what we do as a company can fit in with them?

TABLE A.1 *(Continued)*

3. Are the connections we have with government appropriate?
   a. Do they help us develop the business?
      i. Short-term
      ii. Medium-term
      iii. Long-term
   b. What happens if the government changes?
      i. Do our past relationships disqualify us within the new conditions?
      ii. Do we understand the priorities and hot buttons of the opposition so that we are not at risk should they take over the government?
   c. Does the government believe in a level playing field or does it favor certain companies? If the latter, what can we do to level the playing field?
4. Do we understand who the key decision makers and influencers are and what matters to them?
   a. Do we understand their priorities?
   b. Do we have an accurate and up-to-date stakeholder engagement mapping process?

Economic Questions

1. How do global macro-economic trends affect the countries and industries in which our clients operate?
   a. What is happening to end-user demand for their products and services in the United States, Europe, Japan, and the BRICs, as well as ASEAN?
   b. What are the impacts of foreign exchange rate movements in these countries on client profitability? Do they offer us opportunities to offer hedging products?
   c. How do changes in the credit environment in these countries affect client liquidity?
   d. What rates of interest do our clients face in each country and do differences offer carry trade and interest rate swaps opportunities?
2. How will changes in macro-economic drivers affect our and our clients' investment decisions?
   a. What are the implications of a rapidly growing GDP on:
      i. Inflation?
      ii. Higher interest rates?
      iii. Rising costs caused by shortage of skills and resource inputs?
      iv. Financing: Should we take on more debt as inflation erodes the cost of principal?
      v. Our product mix to take advantage of new areas of growth?
   b. What are the implications of a stagnant GDP on:
      i. Need to cut costs to improve earnings?
      ii. Need to prepare for signs of downturn?
   c. What are the implications of a declining GDP on:
      i. Deflation?
      ii. Near zero interest rates?
      iii. Liquidity problems?
      iv. Need to cut costs because of weak pricing power?

(*continued*)

TABLE A.1 (*Continued*)

v. Weakened balance sheets?
vi. Financing: Should we deleverage as deflation makes debt expensive?
vii. Whether we can use our balance sheet (if strong) to buy up weakened competitors?
viii. Whether we should sell the company, if our balance sheet is weak, to competition with a strong balance sheet?
ix. What we should do about advertising and marketing investment?
x. Our product mix to recognize the likelihood of clients trading down?
xi. What is happening to our clients and what provisions should we make for NPLs?

d. What is happening to markets and the cost of funds and risk?
i. Equities?
ii. Debt?
iii. Yield and the yield curve?

Social Questions

1. What are the effects of changing demographics: population, life expectancy, life-stage, and lifestyle on:
a. Market segment sizes and relative attractiveness?
b. Products and services offered by us and our clients?
c. Our ability to recruit and retain skilled staff?
d. Our ability to employ the right people at the right cost in the right jobs?
2. What are the effects of changes in education on demand on:
a. Market segment sizes and relative attractiveness?
b. Products and services offered by us and our clients?
c. Our and our clients' long-term "license to operate"?
d. Our ability to recruit and retain skilled staff?
e. Our ability to employ the right people at the right cost in the right jobs?
f. Our reputation risk?
3. What are the effects of changes in disposable income on:
a. Market segment sizes and relative attractiveness?
b. Products and services offered by us and our clients?
c. Our ability to employ the right people at the right cost in the right jobs?
4. What effect does the rise of "civil society" have on our long-term "license to operate"?
a. Changing regulations regarding health, safety, and environmental issues?
b. Acceptability of our business purpose on:
i. Products we offer and the way we offer them (KYC)?
ii. Reward and remuneration for senior management and C-suite?

Social Questions

1. What are the effects of changing demographics: population, life expectancy, life stage and lifestyle on:
a. Market segment sizes and relative attractiveness?
b. Products and services offered by us and our clients?
c. Our ability to recruit and retain skilled staff?
d. Our ability to employ the right people at the right cost in the right jobs?

TABLE A.1 (*Continued*)

2. What are the effects of changes in education on demand on:
   a. Market segment sizes and relative attractiveness?
   b. Products and services offered by us and our clients?
   c. Our and our clients' long-term "licence to operate"?
   d. Our ability to recruit and retain skilled staff?
   e. Our ability to employ the right people at the right cost in the right jobs?
   f. Our reputation risk?
3. What are the effects of changes in disposable income on:
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   c. Our ability to employ the right people at the right cost in the right jobs?
4. What effect does the rise of civil society have on our long-term "license to operate"?
   a. Changing regulations regarding health, safety, and environmental issues
   b. Acceptability of our business purpose on:
      i. Products we offer and the way we offer them (Know Your Customer)?
      ii. Reward and remuneration for senior management and C-suite?

Technological Questions

1. What impact will changes in technology have on our business model?
   a. Do we understand the effect social media will have on:
      i. Marketing?
      ii. Product suitability and usage?
   b. How do changes in technology affect IT risk and IT governance?
   c. What is the right balance between bricks and mortar and "clicks" for product distribution?
   d. What is the right balance between high tech and high touch in the customer experience?
2. Are we technological leaders or followers?
   a. How can we use Internet technology better to market our goods and services?
   b. How can we use IT technology better to mine data and enhance CRM?
   c. How can we use technology to create a climate of continuous improvement?
   d. How can we use technology to manage risk better?

Legal Questions

1. What is our philosophy regarding adherence to the law?
   a. Willingness to break the law and pay resulting fines?
   b. Minimum adherence to the law?
   c. Setting standards of compliance that go beyond the law?
2. Are we adhering to all current laws that relate to our business?
   a. Environment?
   b. Employment?
   c. Consumer protection?
   d. Contract?
   e. Intellectual property?
   f. Listing requirements?
   g. Codes of corporate governance?

(*continued*)

TABLE A.1 (*Continued*)

3. Are we on top of the issues and trends that could affect legislation relating to banking?
    a. Changing public attitudes about banking in general and the bank in particular?
    b. Changes in social acceptance of the bank's business purpose?
    c. Legislative agenda and changes in political priorities?
    d. Industry and competitor wrongdoing?
4. What is the status of litigation involving our company?
    a. What is our philosophy regarding settling in or out of court?
    b. What cases are still outstanding and how much are they likely to cost?
    c. Is there a pattern in the cases that could affect our reputation?
5. What risks are we facing?
    a. Regulatory risk?
    b. Litigation risk?

Environmental Questions

1. What is our environmental footprint and that of our clients?
    a. Waste?
    b. Pollution?
    c. Congestion?
    d. Climate change?
    e. Water use?
2. How can we improve our environmental record?

TABLE A.2 Board Questions for SWOT Analysis: Strengths and Weaknesses

What are our and our clients' strengths and weaknesses in:

1. ***Research and development?***
    a. Basic research
    b. Applied R&D
    c. Time to market
2. ***Technology?***
    a. Product
    b. Process
3. ***Ability to innovate?***
4. ***Purchasing?***
    a. Reliable, stable quality sourcing
    b. Stable supply chain
    c. Quality inputs
    d. Cost
5. ***Production?***
    a. "Lean manufacturing"
    b. Flexibility
    c. Quality
    d. Cost
6. ***Product?***
    a. Low-cost leadership
    b. Differentiation
    c. Service

TABLE A.2 *(Continued)*

7. ***Value proposition?***
    a. Prestige
    b. Premium
    c. Value for Money
    d. Low cost
8. ***People?***
    a. Front line
    b. Back office
    c. After sales service
    d. Diversity
        i) Traders
            a) Forex
            b) Commodities
            c) Fixed income
        ii) Advisory
        iii) Wealth management
        iv) Retail banking
        v) Corporate banking
9. ***Marketing and Brands?***
    a. Product development
    b. Corporate branding
    c. Product branding
    d. Sales?
10. ***Distribution?***
    a. Physical
    b. Virtual
11. ***Risk management?***
    a. Risk appetite
    b. Risk management systems
    c. Compliance
12. ***Systems and processes?***
    a. Aligned with vision and mission
    b. Reinforcing purpose and values
    c. Recruitment, talent development, reward, and recognition
    d. Succession planning
    e. IT
13. ***Culture and values?***
    a. Clarity of purpose
    b. Way of doing things
14. ***Ability to execute?***
    a. Explicit knowledge
    b. Tacit knowledge
15. ***Finance/funding?***
    a. Cost of capital
    b. Liquidity
    c. Leverage

(*continued*)

TABLE A.2 (*Continued*)

16. ***Alliances/partnerships?***
17. ***Aligned shareholder expectations?***

Do the strengths create sustainable competitive advantage?
How unique are they?
When can strengths become weaknesses and vice versa?

TABLE A.3 Board Questions for SWOT Analysis: Opportunities and Threats

Opportunities	Threats
1. ***Positive market trends***	1. ***Adverse market trends***
a. Demographics?	a. Demographics?
b. Country economics?	b. Country economics?
c. Industry economics?	c. Industry economics?
2. ***Organic growth***	2. ***Competition***
a. Enhanced portfolio	a. New entrants?
i. New market?	b. New products?
ii. New product?	c. New processes?
iii. Extend range?	3. ***Cost of finance***
b New process?	a. Debt?
c. New region?	b. Covenant cover?
d. New country?	4. ***Hostile takeover***
3. ***Growth via merger/acquisition***	5. ***Weakness in supply chain***
a. Vertical diversification?	6. ***Legacy effects***
i. Upstream?	7. ***Culture***
ii. Downstream?	8. ***Attrition of key people***
b. Horizontal diversification?	9. ***Affect license to operate?***
c. Remove competitor?	a. Legislative?
i. Consolidate supply?	b. Regulatory?
d. Enhancing supply chain?	c. Civil Society?
i. Outsourcing?	10. ***How big are they?***
ii. Offshoring?	a. Existential?
iii. Insourcing?	b. Manageable?
iv. Onshoring?	11. ***How immediate?***
e. Technology	a. Immediate?
i. Continuous improvement?	b. Within the next 12 months?
ii. Disruptive change?	c. Within 3–5 years?
iii. Improved IT systems?	d. Within more than 5 years?
4. ***How big are they?***	12. ***What can we do to mitigate them?***
a. Quantum jump?	
b. Incremental impact?	
c. No change, but prevent decline?	
5. ***How immediate?***	
a. Within the next 12 months?	
b. Within 3–5 years?	
c. Within more than 5 years?	

TABLE A.4 Board Questions Regarding Business Model Appropriateness

Revenue Streams

1. For what value are our customers willing to pay?
2. For what do they currently pay?
3. How are they currently paying?
4. How would they prefer to pay?
5. How much does each revenue stream contribute to the total?

Customer Segments

1. For whom are we creating value?
2. Who are our most important customers?
3. Which customers are profitable/ unprofitable?
   a. Mass market?
   b. Niche market?
   c. Segmented?
   d. Diversified?

Customer Relationships

1. What type of relationships do our customer segments expect of us?
   a. Personal assistance?
   b. Dedicated personal assistance?
   c. Self-service?
   d. Automated service?
   e. Communities?
   f. Co-creations?
2. Which ones have we established?
3. How are they integrated with the rest of our business model?
4. How much do they cost?

Value Propositions

1. What value do we deliver to the customer?
2. Which one of our customer's problems are we helping to solve?
3. What bundles of products and services are we offering to each customer?
4. Which customer needs are we satisfying?
   a. Innovation?
   b. Performance?
   c. Customization?
   d. "Getting the Job Done?"
   e. Design?
   f. Brand/Status?
   g. Price?
   h. Cost reduction?
   i. Risk reduction?
   j. Accessibility?
   k. Convenience/ease of use?

Key Activities

1. What key activities do our value propositions require?
2. How do we distribute our products?

(*continued*)

TABLE A.4 (*Continued*)

3. What are our customer relationships?
4. Where do our revenue streams come from?

Key Partners

1. Who are our key partners?
2. Who are our key suppliers?
3. Which key resources are we acquiring from our partners/suppliers?
4. Which key activities do our partners/suppliers perform?

Key Resources

1. What key resources do our value propositions need?
2. What key resources do our channels need?
3. What key resources do our customer relationships need?
4. What key resources do our revenue streams need?
   a. Physical?
   b. Human?
   c. Financial?
   d. IP?
   e. IT?

Channels

1. Which channels do our customers want to use?
2. How are we reaching them now?
3. How are our channels integrated?
4. Which ones work best?
5. Which ones are most cost effective?
6. How do they fit with our customer routines?
   a. How do we raise customer awareness of our products and services?
   b. How do we help customers evaluate our customer value proposition?
   c. How do we help customers buy?
   d. How do we deliver our value proposition to the customer?
   e. How do we provide after-sales support?

Cost Structure

1. What are the most important costs inherent in the company's business model?
2. Which key features are most expensive?
3. Which key activities are most expensive?
4. Is the business more cost driven or value driven?
5. How important are the economies of scale/scope?

APPENDIX 6B

Board Questions Regarding Risk

Appendix 6B covers the questions Boards should ask in relation to systemic risk (Tables B.1 through B.6), reputation risk (Table B.7), and operational risk (Tables B.8 through B.13).[34]

TABLE B.1 Systemic Risk Questions Regarding Shareholder Expectations

1. Are the rates of return demanded by our shareholders realistic?
2. Are they sustainable over the medium and long term?
3. Does meeting these rates of return require us to take on risks, whose impact and likely frequency we do not understand?
4. What role does leverage play in us achieving these ROEs?
5. How risky has our level of leverage become and by how much would our asset valuations have to change before the balance sheet was wiped out?
6. How should we deal with unreasonable shareholder expectations?

TABLE B.2 Systemic Risk Questions Regarding Herding Behavior

1. Why are we following the herd?
2. What are the advantages of following the herd?
3. How will we be different from other companies in terms of our offer?
4. How can we be sure this is not another bubble?
5. Why should we not adopt a contrarian position?
6. How long can we last in a contrarian position? How much holding power do we have?
7. How much risk is posed by the fact that so many companies are doing the same thing?
8. What red flags do we need to watch out for?

TABLE B.3 Systemic Risk Questions Regarding Systemic Integrity

1. How can we be sure that all our partners and counterparties are actually performing as we expect them to?
2. What red flags are there to give us early warning of impending failure?
3. How serious would a failure of systemic integrity be:
   a. Financially?
      i. Business interruption
      ii. Regulatory penalties
      iii. Costs of litigation
      iv. Market capitalization
   b. Reputation impact?
4. How long would it take us to recover?
5. What measures do we have in place to ensure such an event does not happen?
6. How well protected are we legally against such an event?
7. How good is our insurance cover and how long would it take for claims to be settled?
8. What redress do we have?

TABLE B.4 Systemic Risk Questions Regarding Appropriateness of Rewards

1. How well aligned are the incentives with our values?
2. How likely are they to reward unethical behavior?
3. What time horizons do they reflect and reward?
4. How likely are they to promote risky behavior?
   a. Noncompliance with policies and codes of conduct
   b. Create regulatory sanctions
   c. Reduce the long-term viability of the organization
   d. Fraud
5. How well do the KPIs promote long-term interests of the company?
6. How likely are our KPIs to promote actions that:
   a. Violate trust of customers, partners, and suppliers?
   b. Promote free rider behavior?
   c. Damage systemic integrity of the value chain?
7. What are the unintended consequences of making cost centers profit centers?
   a. Treasury
   b. Legal
8. What redress do we have against employees who violate our code of conduct?
9. What redress do we have against senior management who put the company in jeopardy?
   a. Termination without payoff?
   b. Claw backs?

TABLE B.5 Systemic Risk Questions Regarding Moral Hazard

1. How systemically risky is what we are doing?
2. What would be the reaction of the regulators to what we are doing?
   a. What penalties would we face in the event of a failure?
   b. How likely are we to be bailed out?
   c. What are the likely terms of a bailout?
3. What resolution actions will the regulators take?
4. How well prepared are we to implement the "living will"?
5. What will happen to the Board and the top management team?
6. What will happen to the company and its employees?
7. How much are we personally at risk in the event of a systemic failure?
8. What will our personal reputations be like?

TABLE B.6 Systemic Risk Questions Regarding Tragedy of the Commons

1. How many of our competitors are doing the same thing we are?
2. How well spread are the risks, or have they become concentrated without our realizing it?
3. What are the counterparty implications of what they are doing?
   a. If somebody defaults
   b. If mark-to-market causes losses that require further asset sales, create a death spiral?
   c. If credit ratings are changed?
4. What is the impact of a "black swan" event on
   a. Liquidity?
   b. Profits?
   c. Balance sheet?
   d. VAR?

TABLE B.7 Questions Regarding Reputation Risk

1. How does our choice of business purpose affect our reputation?
2. What impact on our reputation will this decision have?
3. Why did we risk our reputation?
4. Who was involved in making this decision?
   a. Sales?
   b. Marketing?
   c. Risk?
   d. Compliance?
5. How senior?
6. What factors were considered?
7. How much damage can non-compliance do to our reputation?

TABLE B.7 (*Continued*)

8. What will be the effect of reputation damage on:
   a. Market capitalization and share price?
   b. Ability to recruit and retain key staff?
   c. Ability to win contracts?
   d. Regulatory risks?
   e. "License to operate"?
9. How can we repair the damage?
10. How long will it take?
11. How much will it cost?

TABLE B.8 Questions Regarding Concentration Risk

1. How much of our business is in one country?
2. How much of our business is in one industry?
3. How much of our business is in one group of clients?
4. How much of our business is with one client?
5. How likely is it that our clients could get into difficulties at the same time?
6. How can we diversify our client portfolio?
7. How can we reduce our dependency on the industry without spoiling the opportunity it represents?
8. How can we reduce our dependency on the group of businesses without allowing our competition to gain at our expense?
9. How can we reduce our dependency on the client without weakening the relationship?

TABLE B.9 Questions Regarding Credit Risk

1. What is happening to the economy as a whole (macro risk) and how will it affect the industries with which we are involved (micro risk)?
2. What impact will this have on our clients?
   a. Wholesale?
   b. Retail?
3. How will competition affect:
   a. Our clients?
   b. Our products?
4. What are the chances of the economic and political risks creating systemic risks that erode the creditworthiness of:
   a. Countries?
   b. Sectors?
   c. Clients?
   d. Ourselves?

TABLE B.10 Questions Regarding Liquidity Risk

1. What could happen to cause a liquidity crisis?
2. What would we do in the event of such a crisis?
    a. Dealing with depositors?
    b. Dealing with counterparties?
        i. Banks?
        ii. Clients?
    c. Dealing with analysts?
    d. Dealing with regulators?
3. What will the central bank do?
4. What is our crisis plan?
    a. Getting cash to branches to stop a run on the bank?
    b. Communications plan?
        i. Who is the spokesperson?
        ii. What is the story?
        iii. How well trained in dealing with media and other stakeholders?

TABLE B.11 Questions Regarding Interest Rate Risk

1. What is the Central Bank's monetary policy?
2. How will monetary policy affect interest rates?
    a. Short end of the yield curve?
    b. Long end of the yield curve?
3. What risks are there of inflation?
4. What risks are there of deflation?
5. What is happening to exchange rates and how will this affect interest rates?
6. What impact will changes in interest rates have on:
    a. Yield?
    b. Capital projects?
    c. Infrastructure investments?
    d. Equities?
    e. Bonds?

TABLE B.12 Questions Regarding Currency Risks

1. What is government policy regarding the level of the exchange rate?
    a. What level of employment is the government seeking?
    b. What is the state of the balance of payments?
    c. What is happening to the country's terms of trade?
    d. What level of relative inflation is the government prepared to accept?
    e. Is the government prepared to allow the currency to be a "carry trade" currency?

(*continued*)

TABLE B.12 (*Continued*)

2. What is the rate at which government will allow the currency to:
   a. Appreciate?
   b. Depreciate?
3. What is the exchange rate set by purchasing parity?
4. What is the impact of interest rate differentials on the exchange rate?
5. What is the relative economic outlook?
   a. Faster growth than trading partners?
   b. Slower growth than trading partners?
6. How is the country perceived in terms of "flight to quality"?
   a. Political stability?
   b. Economic stability?

TABLE B.13 Questions Regarding VAR

1. What is the value of the organization's VAR?
2. How often has it changed in the last 12 months?
3. What are the inbuilt assumptions?
   a. Are the risks normally distributed?
   b. How big are the long-tail/fat-tail risks?
   c. What assumptions have been made about correlation?
      i. Are these assumptions still valid?
      ii. When could they become incorrect?
4. What other risk models are we using?
5. What would be the impact of different stress-testing assumptions?
6. What happens if they are wrong in the event of a "black swan"?
7. How vulnerable are we to the downside should it happen?
8. What can we do to prevent catastrophe if a "black swan" occurs?

NOTES

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already in the distribution pipeline needed to be sold before they could launch the latest technology. Dell's model had no such problems. Because customers ordered the latest technology and paid for it before Dell assembled it, there was no added working capital in the Dell system; there was no middleman margin to recover; and most important, Dell could offer the latest technology immediately because there was no obsolete stock clogging the distribution pipeline.

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CHAPTER 7

Developing Suitable Leaders

This chapter deals with the difficult topics of succession planning and talent management—an area where many leaders have failed, perhaps because of an unwillingness to recognize they are not indispensable and they are mortal. It discusses the suitability of talent management and the identification of key skills in which employees must be trained, given the rapidity with which the banking world changes, often rendering business models obsolete. It also explores the need to combine ever-greater specialization as skills and knowledge become deeper, with the need to remain an effective generalist, able to bridge the gaps between the silos created by technical specialization and what this means for Boards and CEOs. It discusses the often neglected importance of ensuring that the leadership cadre represents the desired values and culture, as opposed to just having the desired technical proficiency and skills, if the leadership is to direct the bank as required by the Board and the regulators. Finally, it covers the vexed issue of remuneration as part of ensuring that the resulting leadership behaviors are suitable.

This chapter is divided into three main topics.

1. Succession planning.[1]
2. Talent management.[2]
3. The impact of remuneration and reward on the suitability of leaders.

SUCCESSION PLANNING

This section deals with succession planning for both the company's top management team and the Board, and how to recruit and evaluate Directors.

Succession Planning for the Company

The objective of succession planning for the company is to identify specific roles and key positions and to then make sure that there are identified

individuals who are able and ready to step into those positions when the need arises.

Such people may or may not be high fliers or high potentials, but high performers in their specific roles. Typically they are understudies who can move up into the position of the person immediately above them, and often there are two or three candidates for one position. Under these circumstances moves are upward only, as opposed to horizontal where additional diverse experience forms part of the individual's career development.

The Board's remit in these circumstances is to look at candidates for the position of CEO and at the top management positions reporting to the CEO: chief financial officer (CFO), chief risk officer (CRO), chief internal auditor (CIA), chief investment officer (CIO), general counsel, head of HR, and head of IT. This is to ensure there are several internal candidates for immediate promotion to the level above in the event of a need for immediate action. This recognizes that key positions may suddenly become vacant as a result of promotion, departure, illness, or termination, and that it is the responsibility of the Board to ensure that the CEO is building bench strength and depth in the positions reporting to him or her and in the positions one level below.

Doing this properly requires that, at a minimum, the Directors who are on the nominating committee know the candidates personally, as opposed to just knowing their file. It is essential they understand what makes these candidates "tick," their past experience, their attitudes, ambitions, and above all, their values to ensure there is alignment between the values and purpose of these individuals and the values and purpose of the organization. Only in this way can the members of the nomination committee (NC) be reassured that they are recommending people the Board can trust to do what is expected of them in the way the company's values, culture, and code of conduct demand.

If there are no suitable internal candidates, the Board will have to find candidates from outside. It is a good idea to have external candidates as part of the evaluation process to make sure the company is promoting the best people for the job. However, once the Board looks at external candidates there are a number of issues it must deal with. What signals are they giving to internal candidates if they promote people from outside? How well will outsiders fit in with the culture and values of the organization? Will they be able to work well with people who have been passed over? Will they understand the tacit processes and ways of doing things that contribute to what makes the bank successful? Perhaps if bank Boards had thought harder about these issues they might not have chosen investment bankers, with their different cultures, to lead commercial banks.

Nevertheless, it may still make sense to look outside for new leaders when culture change or new ideas are needed because the operating environment has changed significantly. Too often companies become complacent and suffer from groupthink (for example, Toyota with its quality problems in 2010) and a fresh pair of eyes may see sacred cows for what they are—anachronisms.

Finally when Boards are trying to reconcile what they know about insiders and outsiders, they need to remember that they know the strengths and weaknesses of insiders, but will only be told about the strengths of outsiders and will have to wait to discover their weaknesses. This can put insiders at a disadvantage. Either way, Boards must be sure that the outsiders they introduce into the organization will be accepted and strengthen it, rather than be rejected and weaken it as a result of the conflicts they create. Boards should remember that many companies have come to regret their choice of external candidates.[3] This is true at all senior levels, and never more so than when appointing the CEO.

The detailed questions regarding succession plans in general that Boards must ask to minimize the likelihood of regret are shown in Table A.1 in the appendix to this chapter. Broadly speaking, these questions come under the following headings:

- *Who are the internal candidates?* What are their qualifications, track records, ambitions, and values?
- *How well does the NC really know them*?
- *What skills do they have?* Can they lead change? How good are they at communicating and connecting the dots? How good are they with people and do they develop people?
- *What type of leaders are they and do they meet the company's needs*?
- *How well can they work with the Board*?

The NC's role in CEO succession planning divides into four tasks: recruiting the CEO; evaluating the CEO; rewarding the CEO; and replacing the CEO.

Recruiting the CEO

When recruiting a CEO from outside, there are a number of additional considerations, too often forgotten by NCs and their headhunters. Often Boards have succumbed to the temptation to recruit superstar CEOs because they are featured in the media and are great at promoting themselves, without asking themselves whether people are really as good as their PR makes them out to be; whether their performance is the result of the ecosystem in which they work and therefore not easily transferable to a different working environment; or whether they share the values and beliefs of the organization.

The detailed questions the members of the NC need to ask when recruiting a CEO are shown in Table A.2 in the appendix to this chapter. Broadly speaking, they fall under the following headings:

- What role should headhunters play in the recruitment process and how should the NC select them?
- What kind of experience should the NC look for: What type of company background, functional skills, exposure, and stakeholder engagement experience should the candidate have?
- To what extent is the candidate's success the result of the ecosystem rather than candidate quality?
- How will the chosen candidate be received: what will be the reaction of staff; what will be the reaction of the media, and the regulators?
- What are the values the NC should look for and how can an outside hire be brought on-Board without causing disruption?
- What package should be offered? What should the basis of the package be; what KPIs; what effect will it have on risk and time horizons; what impact will the package have on other people in the company and on the company image if things go wrong?

Evaluating the CEO

It is the role of the Chair and/or Lead Independent Director, if there is one, working with the NC to evaluate the performance of the CEO.

As far as financial KPIs are concerned, the CEO's performance and progress against targets is evaluated at every Board meeting. However, two questions need to be considered:

1. What are the impacts of decisions taken, designed to meet KPIs within the duration of the CEO's contract, on the company after the contract is ended?
2. How is the Board evaluating the CEO on the non financial early warning indicators of performance that feature in balanced scorecards?

As a result, the Board, through the Chairman and the NC, needs to ask an additional set of questions relating to achievement of budget and actuals and what corrective actions will be taken to get back on track. These detailed, additional questions are shown in Table A.3 in the chapter appendix. Broadly speaking, they fall under the following headings:

- How well has the Board spelled out its performance expectations?
- What are the long-term impacts of the decisions: beyond the contract period; on reputation and "tone at the top"; on customers; on employee effectiveness; on investor interests; and on regulatory relationships?
- How well does the CEO work with the Board?

Rewarding the CEO

Rewarding the CEO has become a flashpoint for many Boards, particularly in financial services. Increasingly there have been "Say On Pay" revolts by institutional shareholders in the United States, the United Kingdom and Continental Europe, though they have been taken most seriously in Switzerland. This is because there seems to be a growing disconnect between the performance of the company and the pay accorded to the CEO. This has become a particularly acute problem in the United States, as a result of the change in terms of employment of CEOs; according to Michael Jensen, firing a CEO for cause has become almost impossible, as can be seen in Table 7.1.[4]

In the United Kingdom there have been revolts over the pay of Aviva's CEO,[5] which led to the CEO resigning,[6] or to Alison Carnwath, head of Barclays' Compensation Committee, responsible for recommending Bob Diamond's (former CEO of Barclays) pay package[7] resigning after Bob Diamond was asked to leave as a result of Barclays role in the LIBOR scandal. In the United States there was a revolt over the US$15 million pay awarded to Vikram Pandit (CEO of Citigroup).[8] Roger Barker, head of corporate governance at the UK's Institute of Directors, told the BBC's *Today* program:

> *Executive pay.... It's now at the wrong level, it's become very opaque, very complex and we really I think need to get it on a much more sustainable level.*[9]

The investor unhappiness continues to spread with a shareholder revolt over Sir Martin Sorrell's package as CEO of WPP.[10] Even staid Switzerland saw a shareholder revolt over the lavish "golden hello" of SFR 2 million in cash and 200,000 UBS shares, blocked for a year, but worth more than

TABLE 7.1 Percentage of CEOs Who Cannot Be Fired

Reason for Being Fired	Percentage Who *Cannot* Be Fired
Breach of fiduciary duty	96
Unsatisfactory performance	94
Malfeasance	91
Willful or gross misconduct or breach of contract	65
Willful failure or refusal to perform duties	46
Dishonesty, fraud, or embezzlement	44

Source: Based on Michael Jensen, "Do Markets Need Integrity," *Yale Insights,* October 2007.

SFR 2 million at the time of the deal, offered to the new Chairman of UBS.[11] This issue led to a referendum in 2013, where 68 percent of the public voted to limit the freedom of Boards to offer packages to recruit, reward, or terminate CEOs, including banning golden hellos and golden parachutes.[12] The issue is not yet critical in Asia because CEO pay has not been so out of line with performance as in the United States or the United Kingdom. However, the climate of opinion among investors is changing and they are now beginning to feel they ought to have more of a say on pay:

> *Increasingly, we are seeing that the investment community at large wants to have the levers to hold executive leadership accountable for performance and corporate practices.*[13]

Clearly as a result of the changing context, Boards need to ask more detailed questions regarding CEO pay, shown in Table 7.2.

Replacing the CEO

If CEO pay is the source of unwanted attention and embarrassment for the Board, how CEOs depart can be more embarrassing still, even when they have performed well, as is shown in Table 7.3.[14]

TABLE 7.2 Questions Regarding CEO Pay

1. *How does the Board define performance?*
    a. Return on Equity (ROE)?
    b. Total Shareholder Return (TSR)?
    c. Economic Value Added (EVA)?
    d. Earnings per Share (EPS)?
2. *How tightly linked to actual performance is the package?*
    a. Does it make proper allowance for market movements that are independent of CEO actions?
    b. What happens when performance targets are missed?
        i. Does the CEO share in downside as well as upside?
        ii. Does the CEO only share in upside?
    c. How do we reconcile financial with non financial metrics?
        i. What weight do we give to the financials?
        ii. What weight do we give to the non financials?
        iii. How do we reward
            1. Promoting values?
            2. “Tone at the top”?
3. *What are the chances that the package will encourage risky behavior to the long-term detriment of the company?*
    a. How does the package reconcile long-term and short-term objectives?

   b. Are we using the right performance measures?
      i. Are profit-based measures appropriate when profit can be manipulated so easily?
      ii. Is ROE appropriate or too risky in a banking context?
4. *How will the package be perceived by*
   a. Employees?
   b. Regulators?
   c. Legislators?
   d. Media?
   e. Investors?
5. *What, if anything, is appropriate for a golden hello and/or golden parachute?*

The problem with these packages is that they seem to have deviated from their original purpose, which was to protect CEOs from financial harm when they were taking decisions that would benefit the company and its shareholders, even though they might cost them personally. In the cases of Stan O'Neal and Bob Nardelli, both CEOs had presided over shareholder value destruction during their tenures, making it much harder to defend their payouts:

> *Too many golden parachutes and too many retirement packages are of a size that clearly seems only in the interest of the departing executive. . . . It would seem that compensation committees have lost sight of the original principles, resulting in little or no value for shareholders despite excessive compensation.*[15]

TABLE 7.3 Some Examples of Departing U.S. CEO Compensation

Company	CEO	Tenure	Total Payout
General Electric	John F. Welch Jr.	1981–2001	$417,361,902
Exxon Mobil Corp.	Lee R. Raymond	1993–2005	$320,599,861
IBM	Louis V. Gerstner	1993–2002	$189,352,324
Home Depot	Robert L. Nardelli	2000–2007	$223,290,123
North Fork Bank	John A, Kanas	1997–2006	$214,300,000
Merrill Lynch	E. Stanley O'Neal	2002–2007	$161,500,000
U.S. Bancorp	Jerry A. Grundhofer	2001–2006	$159,064,090
Wachovia/South Trust	Wallace D. Malone Jr.	1981–2004	$125,292,818

Source: Paul Hodgson, "Twenty-One U.S. CEOs with Golden Parachutes of More Than $100 Million," *GMI*, January 2012.

> *Directors who approve such awards for an incoming CEO or allow them to continue in place for existing CEOs may be held accountable when CEOs receive tens of millions after a short or unproductive tenure*. (They may also be held accountable if CEOs are paid twice for their successes.)[16] *[Emphasis added]*

To minimize the problems posed by CEO departures, voluntary or not, Boards should ask questions shown in Table 7.4.

TABLE 7.4 Questions Regarding CEO Departure

CEO Leaves of Own Volition

1. *How unexpected is the departure?*
2. *What difference will the departure make to the share price?*
3. *How disruptive to the company will this departure be?*
    a. Strategic continuity?
    b. Cultural continuity?
    c. People?
        i. First line reports?
        ii. Employees as a whole?
4. *What is the succession plan?*
    a. How will succession be handled?
        i. Internal promotion?
        ii. External search?
    b. How will we deal with those who are not chosen?
        i. How many key people are likely to leave as a result?
        ii. How do we prevent jockeying for position and power?

CEO Is Asked to Leave

1. *Questions 1 through 4 as in the case of voluntary departure.*
2. *What actions has the Board taken to get the CEO back on track?*
    a. Articulated the performance gap?
    b. Agreed on a program of corrective action?
    c. How has the CEO responded?
3. *What separation package has been agreed to?*
    a. How fair is it?
    b. How will it be perceived by
        i. Employees?
        ii. Investors?
        iii. Regulators?
        iv. Media?
4. *What impact will departure have on the share price?*
5. *What legal actions are likely to arise?*
    a. CEO against the company?
    b. Class actions by shareholders against the company?

Succession Planning for the Board

Given the generally agreed view that Boards should not be larger than 11 or smaller than 7 to be effective, ensuring that the Board has the right mix of skills, backgrounds, and personalities is difficult. It is made harder by the fact that regulators in many jurisdictions have imposed term limits of nine years on independent Directors, which means they need to be replaced every nine years. In Singapore and Hong Kong it is even harder, given the term limits are six years. Boards need to ask the questions shown in Table 7.5.

TABLE 7.5 Questions Regarding Board Diversity and Composition

1. *How do we ensure independence of mind in Directors?*
2. *How do we balance between company specific experience and other experience?*
   a. How critical is company specific experience in understanding
      i. The business model?
      ii. Drivers of profitability?
      iii. Drivers of risk?
   b. How valuable are insights from other industries in preventing groupthink?
3. *How do we balance between local and global experience?*
4. *How do we balance between specialists and generalists?*
5. *How do we balance between professions and personalities?*
6. *What diversity is needed?*
   a. What educational background?
   b. What business experience?
   c. Which functions: HR, finance, marketing, engineering, operations, communications, law, accounting?
   d. What technical skills: finance, asset valuation, risk assessment, IT, planning, real estate, M&A, government relations, public policy?
   e. What levels of seniority?
   f. Representing which controlling shareholders?
   g. Representing which stakeholders?
   h. What experience of public life?
      1. Civil service
      2. Military
      3. Diplomatic corps
   i. Age?
   j. Which nationality?
   k. Gender?
7. *How do we prioritize diverse experience?*
8. *How well does how we pay Directors reflect*
   a. Complexity?
   b. Opportunity cost?
   c. Roles and responsibilities?
   d. Time needed?
   e. Experience?
9. *How do we source?*

Recruiting Directors

The actual process of recruiting Directors for bank Boards can be tricky and time-consuming. Whoever is chosen must first of all pass the regulators' fitness and appropriateness tests and be approved by the regulator and central bank before they can be appointed. In considering whom to recruit, the NC needs to take into account several factors, some of which might be contradictory, requiring a delicate exercise of judgment. These are shown in Table 7.6.

Evaluating Directors

The NC and the Chair need to carry out the annual Board evaluation and report it in the Annual Report. There are some key questions the Chair and NC must ask during the process of evaluation. These are shown in Table 7.7.

TABLE 7.6 Questions When Recruiting Directors

1. *What skills and experience are we looking for, given the current Board composition?*
2. *How long will the required skills and experience we are looking for remain relevant?*
3. *How can we compare and contrast candidates most effectively?*
   a. Do we have a matrix of the desired skills and competencies?
   b. Do we have a schedule of the desired backgrounds and experience?
   c. Have the headhunters plotted the candidates on the matrix and schedule to make it easy for us to review and compare candidates?
   d. Are we sure we are comparing like with like?
   e. How do we evaluate candidates with very different profiles?
4. *How do we assess the likely interpersonal dynamics of candidates, once they are on the Board?*
   a. With the CEO?
   b. With the Chair?
   c. With fellow Directors?
5. *How do we exclude candidates suggested by the CEO or other Directors who may not be sufficiently independent in spirit?*
6. *How do we ensure that candidates will have the right level of commitment?*
   a. How do we exclude candidates who are proposed as a reward for past services, rather than because they are passionate about the company?
   b. How do we turn away political appointees who may not be suitable?
7. *How do we save face for candidates who are not selected?*
8. *How do we ensure we make progress toward target percentages of women Board members while maintaining quality?*
9. *Which headhunters should we use?*
10. *How long should we take?*

TABLE 7.7 Questions for Evaluating Directors

Interactive skills of the Director

1. *How collegial?*
   a. Open to the ideas of others?
   b. Respectful, while challenging constructively?
2. *How much active participation in discussion?*
   a. Active listening?
   b. Building on others' ideas?
   c. Relevant and to the point?
3. *How emotionally intelligent?*

Knowledge of the Director

1. *Understands the company's business and strategy?*
2. *Provides valuable insights/input?*
   a. Able to connect the dots?
   b. Ideas are current and relevant?
   c. Uses diversity of background to bring a different perspective to discussions?
3. *Understands the financials and accounts?*
4. *Offers solutions to problems?*

Carrying out the Director's duties

1. *Integrity: Does the Director do what is right for the organization and shareholders?*
2. *Candor: How willing is the Director to push back when necessary?*
3. *Independence: How objective and willing to challenge constructively the views of the CEO and Chair?*
4. *Care: How well does the Director exercise the fiduciary duty of care?*
5. *Commitment: How well does the Director exercise the fiduciary duty of commitment?*
   a. Interest in the business?
   b. Time spent on the business?
   c. Serving on and contributing to committees?
   d. Attendance?
      i. Normally?
      ii. Available when needed?
6. *How effective as a member of the Board?*
   a. Understands industry trends and how they could affect the company?
   b. Shows good judgment?
   c. Has business acumen?
   d. Appropriately detailed?
   e. Appropriately decisive?
   f. Prepared for meetings?

TALENT MANAGEMENT

Regulators do not specifically mention talent management, only mentioning succession planning. This is because talent management covers all levels of the organization, whereas the presumption is that Boards need only concern themselves with the senior positions, given the limited amount of time Boards can give to the subject. In a sense, regulators view talent management as an operational matter best left to executive management.

Even so, Boards have a responsibility for talent management in the following manner shown in Table 7.8.

Figure 7.1 shows how talent management begins with business strategy and in turn affects it through feedback mechanisms, so that for example, if the talent is not available, the strategy must be changed.

Table 7.9 shows the relationship of roles and responsibilities of the Board, the CEO, and HR respectively in making sure that the process shown in Figure 7.1 is adhered to.

Monitoring and Evaluating Performance

In order to ensure the Board exercises its responsibilities and evaluates performance appropriately there are a number of questions to be answered about how the talent management strategy is developed, shown in Table 7.10.

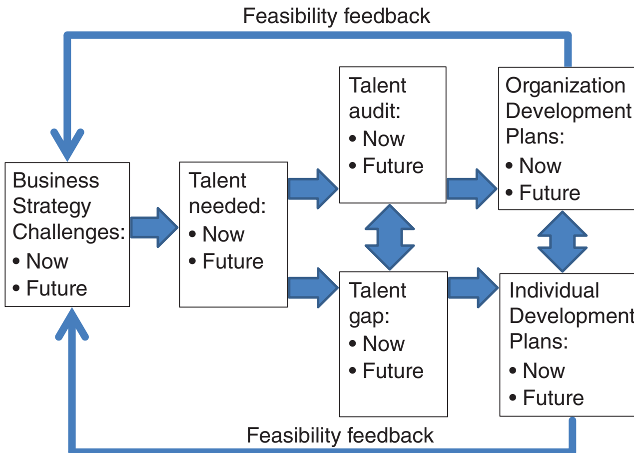

FIGURE 7.1 Talent Management Starts with Business Strategy
Source: J Zinkin 2013

TABLE 7.8 Board's Responsibility for Talent Management

Board Responsibilities

1. *Ensuring management develops a pool of high potentials, placing them in key roles to meet the demands of the organization's strategy:*
   a. Ensuring the relevant roles are created to meet the needs of the strategy.
   b. Ensuring the appropriate portfolio of skills and competencies have been identified:
      i. Relevance.
      ii. Currency—this is increasingly difficult to do given the rapid changes companies undergo as a result of technology, competition, and globalization.
   c. Ensuring a suitable supply of candidates.
2. *Recognizing developing high potentials is determined by:*
   a. The number of capable people in the pipeline.
   b. High potentials may not be identified specifically to fill a given post.
   c. Career progression that requires horizontal as well as vertical moves (unlike succession planning, which is vertical).
3. *Recognizing high potentials are not the same as high performers.*
4. *Recognizing that any talent management process has downsides as well as upsides:*
   a. What does the organization do to keep those that are not identified as high potentials motivated?
   b. How does the organization ensure identified potential/competencies are still relevant three or four years later?
5. *Agreeing on the talent strategy and talent definition:*
   a. Choosing the talent strategy aligned with the company business objectives.
   b. Defining talent based on
      i. Performance ratings
      ii. Potential
      ii. Attitude and motivation
6. *Agreeing on critical positions and competency requirements:*
   a. Determining pivotal positions in the organization
   b. Defining the current competencies and future competencies
   c. Establishing the competency gaps
   d. Determining actions to fill the gaps
7. *Identifying the high potential candidates for the talent pool:*
   a. Identifying high potentials for:
      i. Managerial ladder
      ii. Technical ladder
   b. Developing high potentials to step into leadership positions on the managerial ladder via:
      i. Training
      ii. Coaching
      iii. Mentoring
8. *Monitoring and evaluating the process.*

TABLE 7.9 Talent Management Process

Steps in the Process	Role of the Board	Role of the CEO	Role of HR
Step 1: Develop Talent Strategy and Definition	Ensure talent strategy reflects agreed business strategy, vision, values, and desired culture. Challenge identified strategy and definition presented by management to the Board. Determine which talent management philosophy best suits the needs of the company.	Agree with Board implications of business strategy on talent needs. Align talent strategy to satisfy business strategy, vision, values, and desired culture. Identify current and future needs. Ensure talent strategy is future focused. Involve the senior management team in the definition of talent and the strategy. Ensure the talent management strategy is implemented.	Develop future focused talent strategy with the CEO. Identify future products and services and their talent requirements with the CEO.
Step 2: Identify Pivotal Positions and Competency Needs	Determine and approve the pivotal positions identified by the CEO. Ensure the competency models and their assumptions will deliver the business strategy, vision, values, and culture, and agree them.	Determine the number of pivotal positions. Determine key attributes needed to meet the needs of the business strategy, values, and culture. Determine current and future competencies required.	Identify future pivotal positions. Update competency models to reflect future business needs. Identify competency gaps.
Step 3: Identify and Develop Talent Pool	Get to know each potential candidate personally. Assess external options for leadership in case internal pipeline is inadequate.	Decide who should be in the talent pool based on HR data and appraisals. Provide career enhancing, fast track opportunities for high potential candidates. Review and agree on individual talent development plans. Provide performance feedback and progress reviews to identified talent.	Develop training needs analysis and leadership training. Reflect the talent strategy in recruiting. Recruit and develop external talent when needed. Develop and approve a replacement chart with the CEO and top management team.

TABLE 7.9 (*Continued*)

Steps in the Process	Role of the Board	Role of the CEO	Role of HR
Step 4: Monitor and Evaluate	Ensure succession planning, talent management, and competency modeling are part of the regular Board agenda. Decide on the frequency of reporting on progress. Require high potential candidates to present to Board meetings.	Monitor and assess effectiveness of talent management and leadership development activities. Report regularly to the Board on progress. Take part in the talent review Board evaluating individuals' progress.	Review and update talent management, leadership development, and the succession planning program annually. Assess effectiveness in terms of outcome. Review potentials. Discuss readiness of pool members to move to new positions. Report on the status of the program and individuals' progress.

Boards need to remember strategies are only as good as their implementation. These are some questions Boards must ask regarding how a strategy is being implemented, shown in Table 7.11.

Finally Boards must evaluate the effectiveness of the process over which they have oversight. Table 7.12 shows questions to help Boards assess the effectiveness of the systems that are in place:

Boards must ensure that succession planning, talent management, and career management are driven by the strategic needs of the business and the only effective way to do this is to approach the three tasks as an integrated whole, so that:

1. The needs of the organization and the needs of individuals can be reconciled.
2. Individuals can see where they are and where they are going through career management.
3. Managers can see what human resources they have at their disposal currently and are likely to have in the future, reducing the likelihood of hoarding scarce talent for selfish departmental objectives at the expense of the company as a whole.
4. Succession plans reflect talent pipelines and leadership development programs.

TABLE 7.10 Developing Talent Management Strategy

1. *How well does the existing/proposed talent management strategy reflect our current and future business strategy?*
   a. What are the current competencies to meet our current strategic objectives?
   b. What are the future competencies to meet our evolving strategic objectives?
   c. How big is the competency gap between current and future requirements?
   d. What can we do to fill the gap?
      i. Internally?
      ii. Externally?
   e. How long will it take?
2. *How well does the existing/proposed talent management strategy reflect our current and future values*
   a. What are the attitudes and values we need for the current strategy?
   b. What changes in attitude and values do we expect to meet the objectives of the future strategy?
   c. How do we ensure the people we recruit have our values?
   d. How do we ensure the people we promote live our values?
   e. How do we ensure the people at the top are examples of our values in action?
   f. What do we do with people who do not live our values?
      i. Corrective counseling?
      ii. Separation?
3. *How well does the existing/proposed talent management strategy reflect the kind of culture we need?*
   a. How do we ensure the people we recruit will fit well with the culture we aspire to create?
   b. How do we ensure the people we promote reflect the culture we aspire to create?
   c. When we acquire companies how do we ensure we create a unified culture?
   d. What do we do about divisive cultural behavior?
4. *How adaptive is our talent management strategy to meet changes in:*
   a. Business strategy?
   b. Organizational design?
   c. Priorities?
   d. Technology?
   e. Desired competencies?
5. *Who is responsible for developing the talent management strategy?*
   a. What experience do they have?
   b. What authority do they have?
   c. What frameworks and philosophies do they use?
6. *How often do we review our talent management strategy?*
7. *How do we define talent?*
   a. High fliers (BBC)?
   b. Top 10% (HSBC, GE)?
   c. “Everyone has talent” (Air Asia)?
   d. Leaders of change (Philips)?

TABLE 7.11 Talent Management Strategy Implementation

1. *How do we identify and evaluate the competency needs of the organization?*
   a. How do we create the competency dictionary?
   b. How often do we review the competency dictionary?
   c. Do we differentiate between technical skills and soft skills?
   d. Do we need two development ladders?
      i. Managerial ladder?
      ii. Technical ladder?
2. *How do we identify candidates for the talent pool?*
   a. How many levels of promotability?
   b. Are all bands considered?
   c. Who provides the names?
   d. How do we differentiate between "high performance" and "high potential"?
   e. How do we vet candidates?
      i. Who is involved?
      ii. How well trained are they in assessing people?
      iii. What criteria are used?
3. *How do we communicate the selection criteria to employees?*
   a. Do we coach the candidates before they enter the pool?
   b. Are the selection criteria clear, transparent, and fair?
   c. Do the candidates understand what is expected of them?
4. *How do individuals know they have been identified as talent?*
   a. Are they informed by their coach?
   b. Are they advised by their immediate superiors?
   c. What are they told?
   d. Is it the same regardless of who does the briefing?
5. *What plans do we have in place to develop the talent?*
   a. Have they been reviewed and agreed by the CEO?
   b. Are they updated regularly to ensure they still meet the needs of the business strategy?
6. *How do we give feedback to identified talent?*
   a. Are feedback sessions conducted between candidates, their immediate supervisors, and HR representatives?
   b. Do these sessions cover
      i. Work done by the individuals?
      ii. Assessment of the individual's strengths and weaknesses?
      iii. Suggestions for improvement?
      iv. Recommendations for training and development needed to allow the individual to achieve his/her potential?
7. *What do we do with people who cease to be talent?*
8. *What do we do with poor performers?*

TABLE 7.12 Assessing the Effectiveness of Talent Management Strategy[17]

1. *What criteria do we use to evaluate the talent management process?*
   a. Mobility?
   b. Demographics?
   c. Bench strength and depth?
   d. Speed at which talent is moving up the organization?
   e. Diversity?
2. *How do we define success?*
   a. Percentage of pivotal positions filled
      i. Internally?
      ii. Externally?
      iii. By new hires?
   b. Percentage in pivotal positions eligible for retirement or rotation
      i. Within a year?
      ii. Within five years?
   c. Staff turnover by job category and band?
      i. Voluntary turnover rate?
      ii. Involuntary turnover rate?
   d. Time taken to fill the positions?
   e. Percentage of employees trained by category
   f. Cost:
      i. Per hire?
      ii. Development per employee?
      iii. Training hours per employee?
      iv. Salary per employee compared with competitors?
      v. Incentives compared with the market?
3. *How do we ensure we are spending the right amount of time developing employees for existing and future positions?*
   a. Analysis of proportion of candidates appointed to leadership positions:
      i. Internally?
      ii. Externally?
   b. If more external hires are appointed to leadership positions than internal, does the development process need reviewing?
   c. Retention rates of key employees?
   d. Employee engagement metrics?
   e. Employee productivity:
      i. Output per employee cost?
      ii. Profit per employee cost?
      iii. Value creating suggestions per employee?
      iv. Employee downtime
4. *Who is accountable for the effectiveness of the talent management process?*
   a. CEO supported by HR?
   b. Oversight provided by the Board?

5. *How do we monitor the leadership development processes?*
   a. What technology do we use to support data collection and analysis?
   b. What knowledge management software do we have to identify:
      i. Pivotal jobs?
         - How many?
         - How vulnerable?
      ii. Skills and behaviors needed to perform the jobs effectively?
      iii. Update competency dictionaries?
      iv. Match positions with candidates?
      v. Update the replacement charts?
      vi. Time taken to fill vacancies?

THE IMPACT OF REMUNERATION AND REWARD ON THE SUITABILITY OF LEADERS

The primary focus of most succession planning and talent management is on the technical capabilities of employees. It is a weakness of much recruiting and personal development that, sometimes, too little emphasis is placed on values and the effect that remuneration and reward systems can have to erode the moral foundations of a bank.

If frontline leaders are rewarded for selling volume almost regardless of whether it is what the customer needs, it should come as no surprise that banks are being forced to pay gigantic fines for mis-selling. Equally, if Boards promote investment bankers to top positions because of their undoubted skill at making short-term profits, without due regard for the long-term risk and reputation impact of the actions being taken, Boards should not be surprised if banks get into the kind of trouble UBS and Barclays have found themselves in over LIBOR.

If it is almost impossible to fire a CEO for cause without him or her walking away with more money than could have been earned if the contract had been fulfilled, we should not be surprised that CEOs take risks that destroy the reputation of their bank, and perhaps even destroy the bank, because it really does not matter to them what happens after they leave.

CEOs who start out with good practices and sensible risk taking often end up being pressured by their peers, the analysts, and investors into doing things they know are risky and, often, downright wrong. The gradual change in Angelo Mozilo's behavior from running Countrywide Financial as a respectable provider of mortgage finance into a promoter of the worst excesses of subprime[18] is the result of the "broken windows" syndrome, which applies to financial crime in exactly the same way as it applies to neighborhoods.[19]

Once one bank starts to misbehave and gains share at the expense of ones that stick to good practice, and once the market condones this misbehavior, and investors reward it by pushing up the share price rewarding the bad behavior of the senior management and the CEO who allowed bad practices to flourish, other senior managers and CEOs may begin to follow suit. Finally everybody is "on the dance floor,"[20] to use Chuck Prince's excuse for nearly bankrupting Citi through its exposure to subprime, merely because other people were doing it.

It is therefore vitally important that when Boards look at talent and plan the succession for their top management team they place as much emphasis on the values as they do on the competencies of the individuals in key positions at the top and in the middle of the organization, so that the "tone at the top" is appropriate and is reinforced by and reinforces the "tone in the middle." To do this, Boards must also ensure that only people with the right values are promoted; and that the reward and remuneration systems they have put in place do not undermine good behavior and promote bad behavior. The challenge in reinforcing good behavior in banks is considerable, as evidenced by a Labaton and Sucharow survey of 500 senior managers in Wall Street and London carried out in 2012,[21] which found that:

- Thirty-nine percent believed their competitors had behaved unethically or illegally.
- Twenty-six percent said they had first-hand experience of unethical or illegal behavior.
- Twenty-four percent believed they had to be unethical to succeed in financial services.
- Sixteen percent would engage in insider trading if they thought they could get away with it.
- Thirty percent said that this was because of remuneration.

This survey proves the wisdom of Steve Kerr's article "On the folly of rewarding A, while hoping for B."[22] It reinforces the point that reward and recognition are integral to ensuring that talent management and succession planning do not just provide the bank with skills and competencies, but reinforce the ethical behavior essential to rebuilding trust.

CONCLUSION

Boards are responsible for ensuring that there are qualified and ethical successors for the CEO and the C-suite. Succession planning has, in the past, focused too often on the technical competencies and skills of prospective

candidates without giving sufficient weight to their values—what they actually are and how well they fit with those of the company—and to placing integrity at least on a level with the ability to make profits.

The NC must get to know all candidates personally and have a good idea of how they will react under pressure; whether they will cut corners in order to make the results. In thinking about the fit for the role, the NC will need to consider not just those key positions at the top, but also appreciate the interaction between these positions and the critical ones lower down in the organization.

This is not easy, when candidates come from within the organization; it is even harder when candidates come from outside. Internal candidates suffer from having both their strengths and weaknesses well understood, whereas external candidates benefit from the fact that their strengths will be well marketed and their weaknesses glossed over. In addition, external candidates are like vaccines or an organ transplant—administered well, they strengthen the host; poorly done, they kill it or cause massive tissue rejection.

Boards are responsible for evaluating and rewarding CEOs. It is clear that as a result of changes in the employment contracts of CEOs in the United States, the remuneration, reward, and sanctions mechanisms available to Boards have mutated to benefit CEOs totally disproportionately. This will have to change, if trust in banks is to be rebuilt. In evaluating the performance of CEOs, Boards will have to find ways of reestablishing the importance of long-term metrics and of reputation versus the current short-term focus on ROE. Boards will also have to find ways of limiting the scope for CEO payoffs that actively encourage nonperformance, if capitalism is to regain its moral footing.

As far as talent management is concerned, Boards must recognize that it must reflect the strategic needs of the business, rather than some dewy-eyed view that everyone has talent and it is the company's job to nurture talent, regardless of its relevance to the organization because that will create an environment where employees are more engaged.

Boards must review the effectiveness of the talent management processes, taking into account:

- The effectiveness with which the right people are placed in the right jobs at the right time.
- The cultural fit of these people—so that, for example, traders with their short-term win-lose backgrounds are not running departments that have long-term objectives working together with clients to build win-win outcomes.
- The need to integrate succession planning with career management and talent management so that people have a clear line of sight between

their current role and the direction of the bank and can see how career moves help both their development and the company.

- Finally, Boards must take into account the effects of reward and remuneration systems on the behavior of people and ensure that they reinforce ethical behavior rather than encouraging bad behavior.

APPENDIX **7A**

Board Questions to Ensure Suitable People

This appendix covers the questions Boards should ask regarding succession planning (Table A.1)[23] and then questions relating to overseeing the CEO (Tables A.2 and A.3)[24].

TABLE A.1 Questions Regarding Succession Plans In General

Internal candidates

1. *Who are the internal candidates to succeed the CEO?*
2. *What are their qualifications?*
   a. Educational?
   b. Professional?
   c. Functional?
   d. Cross-cultural
3. *What is their track record?*
   a. What are their successes?
   b. What are their failures?
   c. What did they do specifically in each case?
   d. Why?
   e. How did they get their way?
   f. What obstacles did they have to overcome personally?
4. *What are their ambitions?*
   a. For the business?
   b. For their careers?
   c. For their work-life balance?
5. *What are their values and how well do they fit with the organizational purpose and culture?*
6. *How well do we know them and what evidence do we have for our judgment?*
   a. How long have we known them?
   b. Why do we think we can trust them?
   c. How they will respond under pressure?
   d. How they reconcile short-term and long-term objectives?
   e. How they will behave once they are promoted toward
      i. Stakeholders?
      ii. Previous colleagues who are now subordinates?

(*continued*)

TABLE A.1 (*Continued*)

7. *How capable are they of leading change, if that is what is needed?*
    a. How well can they reconcile our legacy with the need to innovate?
    b. How well can they persuade others of the need to change?
8. *How effective are they at communicating?*
    a. How passionate are they about their work?
    b. How enthusiastic are they?
    c. How good are they at transmitting their passion, purpose, and energy?
9. *How curious are they?*
10. *How good are they at connecting the dots?*
    a. Appreciating global megatrends and their impact on the business?
    b. Identifying industry trends and game changing events?
    c. Understanding the value drivers of the business?
    d. Business acumen?
    e. Seeing the big picture?
    f. Zooming in, when needed, to master the detail
11. *How tolerant are they of ambiguity?*
12. *How well have they developed people?*
    a. Subordinates?
    b. Other team members?
    c. Created co-leaders?
    d. What are their 360s like, if they had them?
13. *How emotionally intelligent are they?*
14. *What type of leadership characteristics do they demonstrate?*
    a. How effective are they as situational leaders?
    b. How well would they lead a start-up?
    c. How well would they lead organic growth?
    d. How well would they lead growth through acquisition?
    e. How well would they lead a consolidation or retrenchment?
15. *Which type of leadership do we need?*
    a. Immediate?
    b. Over the next 3–5 years?
16. *How well can they work with the Board?*

External candidates

1. *How do they compare with internal candidates on questions 1 through 16 above?*
2. *How can we cross-check the references and what the headhunters have told us?*
3. *How can we be sure they will fit in and strengthen the team?*
4. *How easily do we think they will fit into the organization?*
    a. Credibility?
    b. Skills?
    c. Knowledge?
5. *How well do their values and beliefs fit with ours?*
    a. What do we know about their values and beliefs?
    b. How can we be sure they will responds appropriately under pressure?
6. *What are they passionate about?*

TABLE A.2 CEO Recruitment

1. *What role should a headhunter play in the assignment?*
    a. None?
    b. Normal search role?
        i. Advise on the brief being given?
        ii. Screen long list of names for a candidate short list?
        iii. Do psychometric testing?
        iv. Arrange interview round?
        v. Determine remuneration?
            1. Check market rate for the job?
            2. Ensure it is an appropriate comparison?
            3. Structure the package?
            4. Mediate?
    c. How long are we prepared to take to find the right person?
    d. What do we do if we are not satisfied with external candidates and choose an internal candidate instead?
2. *How do we choose the headhunter for the assignment?*
    a. Track record in CEO search?
        i. In general?
        ii. In our industry?
        iii. At our price point?
    b. Specific understanding of our industry?
    c. Specific understanding of our company needs?
3. *What kind of experience are we looking for?*
    a. Stage of company life cycle:
        i. Start-up?
        ii. Steady-state organic growth?
        iii. Growth by acquisition?
        iv. Turnaround?
        v. Divestiture?
        vi. Exit?
    b. Functional skills:
        i. Marketing?
        ii. Sales?
        iii. Trading?
        iv. Research and development?
        v. Accountancy?
        vi. Legal?
        vii. Risk management?
        viii. Corporate finance?
        ix. Change management?
        x. Cross-cultural management?
        xi. Human capital management?
    c. Exposure:
        i. Diverse industry experience?
        ii. Experience in our industry?

(*continued*)

TABLE A.2 (*Continued*)

iii. Multifunctional experience?
iv. Government experience?
v. Regulatory experience?
vi. International?
1. South Asian?
2. Southeast Asian?
3. North Asian
4. Middle East?
5. European?
a. Northern Europe?
b. Southern Europe?
6. North American?
vii. Stakeholder engagement experience:
1. Investor relations?
2. Controlling shareholders:
a. Family?
b. Government?
3. Handling NGOs and community issues?
4. Handling regulators?

4. *How can we determine the extent to which the track record of the candidate is the result of:*
a. Candidate quality?
b. Support systems enjoyed by the candidate in his/her present position?
c. Quality of the team working with the candidate?
d. How transferable are the support systems and/or team to our organization?
i. If good, how do we transfer them?
ii. If not, do we have equivalents?
iii. If not, and we don't have equivalents, how likely is it the candidate will fail?

5. *How will our choice of candidate be received?*
a. Internally:
i. Employees as a whole?
ii. Direct reports to the CEO?
1. Who will stay?
2. Who will leave?
b. Externally:
i. Regulators?
ii. Analysts?
iii. Investors?
iv. Media?
v. Competitors?
vi. Prospective hires?

6. *How will we ensure minimum tension and maximum acceptance of the new CEO?*
a. What on-boarding program is needed for the CEO?
i. Industry briefing?

TABLE A.2 (*Continued*)

ii. Company briefing?
1. Legacy issues?
2. Need for change?
3. Value drivers of the business?
4. Key customer issues?
iii. Technical briefing?
iv. People briefing?
1. Key players and what to watch out for?
2. Internal stakeholder mapping?
3. Legacy/loyalty issues?
4. Industrial relations issues?
5. HR issues?
b. Who will mentor the CEO?
7. *What package should we offer?*
a. How much?
b. Split how?
i. Base?
ii. Variable element?
iii. Cash?
iv. Options?
c. Based on what KPIs?
i. Financial KPIs?
1. ROE?
2. ROA?
3. TSR?
4. Benchmarked against the competition?
5. Set absolutely?
ii. Nonfinancial KPIs?
1. What time horizon?
2. How do we ensure they reflect and reinforce our values?
d. What impact will it have on other people's remuneration?
e. What impact will it have on risk?
f. What penalties are built in for failure to perform?
i. Options "underwater"?
ii. Nonpayment of bonus?
iii. Deferred stage payments?
iv. Claw backs?
g. How transparent and easy to understand?
i. For the CEO?
ii. For analysts and investors in the annual report?
h. How fair?
i. What differential between the CEO and first line reports?
ii. What recognition of first-line team performance versus CEO's individual performance?

(*continued*)

TABLE A.2 (*Continued*)

- iii. Size of Golden Hello?
- iv. Size of separation package?
- i. Have we modeled different scenarios to ensure the package does not create adverse comments by politicians, media, and investors?
  - i. Exceeding KPI targets?
  - ii. Meeting KPI targets?
  - iii. Failing to meet KPI targets?
  - iv. Separation?

TABLE A.3 Additional Questions for Evaluating the CEO

1. *How well has the Board spelled out its expectations to the CEO?*
   - a. What is required of the CEO?
   - b. What authorities the CEO has?
   - c. What priorities have been agreed?
   - d. What time frame the CEO is working to?
2. *What are the long-term impacts of decisions being taken?*
   - a. Beyond the budget time frame?
   - b. Beyond the CEO's contract time frame?
3. *How well does the CEO act as the custodian of corporate reputation?*
   - a. How well does the CEO set the right "tone at the top"?
   - b. How well does the CEO live the values?
4. *How will decisions taken affect customers?*
   - a. Penetration?
   - b. Loyalty?
   - c. Profitability?
   - d. Market share?
5. *How well does the CEO consider employee effectiveness?*
   - a. Talent development and management?
   - b. Development of suitable skills?
   - c. Effectiveness of recruitment policies:
     - i. Fit with business strategy?
     - ii. Cost of recruiting?
     - iii. Diversity and inclusion?
   - d. Effectiveness of career development:
     - i. Retention?
     - ii. Attrition?
     - iii. Percentage internally promoted?
   - e. Productivity?
   - f. Employee engagement?
6. *How well does the CEO consider investor interests?*
   - a. Who owns our shares?
   - b. How long for?
   - c. Market valuation?
   - d. Reconciling different shareholder interests and time horizons?

TABLE A.3 (*Continued*)

7. *How effectively does the CEO deal with regulatory issues?*
   a. How good is the CEO relationship with the regulators?
   b. Does the CEO have the confidence of the regulators?
   c. What plans does the CEO have to improve relations with the regulators?
8. *How well does the CEO interface with the Board?*
   a. How does the CEO work with the Board?
   b. Quality of information provided to the Board.

NOTES

1. The succession planning discussion is based on *FIDE Good Governance Handbook, Part 5: Planning Succession*, written by the author for the Iclif Leadership and Governance Centre, self-published by Iclif in 2013.
2. The talent management discussion is based on *FIDE Good Governance Handbook, Part 6: Managing Talent*, written by the author for the Iclif Leadership and Governance Centre, self-published by Iclif in 2013.
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23. The succession planning table is based on *FIDE Good Governance Handbook, Part 5: Planning Succession*, written by the author for the Iclif Leadership and Governance Centre, self-published by Iclif in 2013, 5–15.
24. The talent management tables are from *FIDE Good Governance Handbook Part 6: Managing Talent*, written by the author for the Iclif Leadership and Governance Centre, self-published by Iclif in 2013, 10–15.

CHAPTER 8

Ensuring Organizational Integrity

This chapter deals with the need for organizational integrity—a function of culture, compliance, and controls all working together to achieve common behavior. It explores the problematic issues raised when the leadership team is new or not in tune with the culture of the rest of the bank. It examines the role of controls to ensure that there is compliance with appropriate regulations and codes of conduct to preserve the bank's cultural DNA and way of doing business. Finally, it looks at the need for a proper system of controls that reconciles initiative and performance with unthinking obedience and compliance.

Although regulators have tended in the past to look at compliance and controls as the most important factors in delivering sustainable performance, there has been recognition that culture matters as well. In fact, it is a central contention of this book that compliance is not as important as many people think—evidenced by Booz & Company's finding that failures of compliance represent only 13 percent of shareholder value destruction[1]—and that culture, values, and self-discipline are the keys to ensuring organizational integrity and the drivers of sustainable performance. Market discipline can help, but sometimes the market provides the wrong signals and, as a result, rewards short-term risky behavior that contains within it the seeds of future failure. Regulatory discipline tries to make good the shortcomings in self-discipline and market discipline, but often creates its own problems as a result of unintended consequences created by smart people gaming the system or the failure to enforce good rules.

Ensuring organizational integrity depends on three things: creating a compatible culture; minimizing problems of compliance; and instituting appropriate controls.

CREATING A COMPATIBLE CULTURE

On January 10, 2013, three former UBS Investment Bank CEOs and Dr. Marcel Rohner, the former UBS Group CEO, testified and proclaimed

that the culture of their organization must change if the problems caused by the Global Financial Crisis are to be avoided in the future.[2] Yet it is not that easy to create compatibility of culture, compliance, and controls—that is precisely why Glass-Steagall was introduced in reaction to the Crash of 1929. Lawmakers recognized then that investment banking, stockbroking, and deposit taking banking needed to be kept separate. Passed in 1933, the Glass-Steagall Act[3] was designed to reduce the excessive financial power of J.D. Rockefeller and J.P. Morgan (foresighted recognition of the importance of "too big to fail"), and to prevent deposit-taking banks from being investment banks and speculating in securities. It worked well and the United States had very few banking failures as long as Glass-Steagall was in force. However, on November 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act—repealing Glass-Steagall and opening the doors to the abuses that led directly to the Global Financial Crisis. This was the result of the need to legalize the creation of Citigroup—the merger of Citicorp with Travelers in 1998, which had been done in violation of Glass-Steagall[4]—and Clinton was persuaded by intensive lobbying by Wall Street, Alan Greenspan, and the Treasury Secretary, Robert Rubin.[5] The repeal of Glass-Steagall has been blamed by some for causing a replay of the run-up to the 1929 crash in 2008:

> *The financial crisis might not have happened . . . but for the 1999 repeal of Glass-Steagall. . . . Without a return to something like Glass-Steagall, another greater catastrophe is just a matter of time.*[6]

Sadly, Paul Volcker, the then Chairman of the US Federal Reserve, in 1987 had correctly foreseen the likely result of easing Glass-Steagall, but was outvoted 3–2. Citicorp, J.P. Morgan, and Bankers Trust advocated allowing banks to handle several underwriting lines of business including commercial paper, municipal revenue bonds, and mortgage-backed securities. Their argument was that there were three independent checks on the types of commercial misbehavior that had emerged since 1933: the SEC, sophisticated investors, and very sophisticated rating agencies. How wrong they were! The SEC did not regulate shadow banks; sophisticated investors were less sophisticated than assumed, and the rating agencies were conflicted, overworked and their modelling assumptions were wrong. Paul Volcker was unconvinced and expressed his fear that lenders would recklessly lower loan standards in pursuit of lucrative securities and market bad loans to the public.[7] How right he was!

The repeal of Glass-Steagall may have been justified on the grounds that it could create the best of both worlds (BOBW), given the supposedly strong independent checks on misbehavior, but it completely ignored the

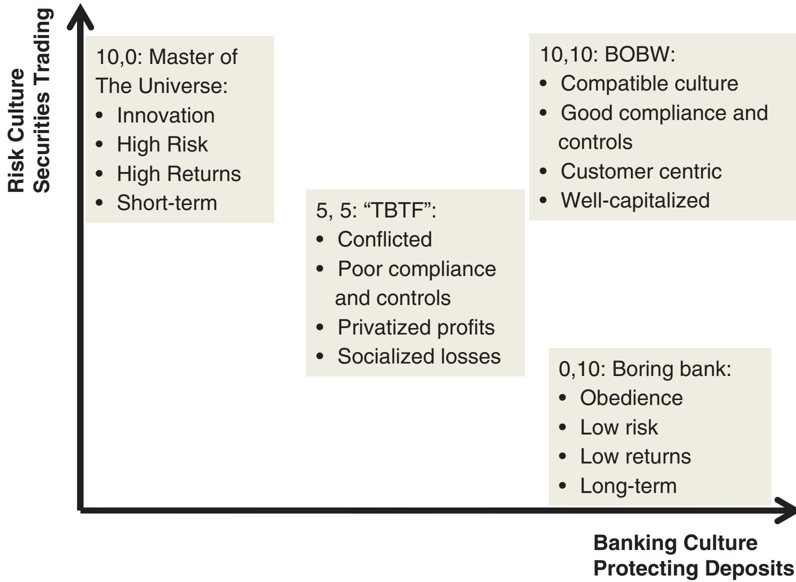

FIGURE 8.1 Failure to Reconcile the Cultural Dilemma
Source: J Zinkin, Corporate Governance program for EPF held in Hong Kong, June 2013.

importance of culture and the resulting problems mixing incompatible cultures would create within banks:

> *It boiled down to the issue of two different cultures—culture of risk which was the securities business, and culture of protection of deposits which was the culture of banking.*[8]

Figure 8.1 shows the cultural dilemma and the result of the failed reconciliation of the two cultures—the creation of "too big to fail" (TBTF) banks, which did not achieve the best of both worlds, but once again put the system at mortal risk instead, ushering in the greatest economic downturn since the Great Depression.

Figure 8.1 shows the high risk taking culture of the investment bankers with their belief that they were masters of the universe. This is the world of shadow banking that was lightly regulated, where financial innovation to create greater opacity and higher fees[9] was the order of the day. Once investment banks ceased to be partnerships and started playing with other people's money, their risk appetite rose dramatically with levels of leverage up to 40 times (when 25 times in the case of LCTM[10] was regarded as

unsustainable in retrospect by Myron Scholes[11]). Rewards focused on ROE, increasing the high-risk-high-return mentality.

At the opposite end of the spectrum are "boring banks" with their focus on deposit taking and protecting depositors. At the extreme, these require a culture of compliance almost verging on obedience, adhering to regulatory constraints providing low returns because they are low risk, with an emphasis on capital protection. Their levels of leverage would typically be the level provided by the fractional reserve banking rules provided by the central bank and they would be nothing like 25 times.

The ambition and justification for repealing Glass-Steagall was to create a BOBW bank with sustainable high returns, by combining the innovative thinking of investment banks with the ability to leverage the huge and low-cost deposit bases of the boring banks, thus achieving the best of both worlds. This is shown in the top right of Figure 8.1.

The reality, however, proved to be very different—a fudged and failed compromise in the middle of Figure 8.1, the TBTF banks. They created:

- Conflicts of interest (despite supposedly being held at bay by internal Chinese walls, policies and procedures).
- Conflicted cultures where traders and investment bankers had to work with retail bankers, leading to:
  - Inappropriate role models.[12]
  - Failures of compliance.
- Complex entities with products the people in the banks did not understand.[13]
- Risk exposures that were wrongly aggregated because different parts of the bank were unaware of what other departments were doing.

More seriously for the system as a whole, TBTF banks could hold governments to ransom,[14] thereby privatizing profits, socializing losses, and neutralizing market discipline.

For the banks themselves, TBTF seems to have become TBTM—too big to manage, as is evidenced by the compliance and control problems experienced in 2012 by HSBC in its money laundering case[15] and JP Morgan Chase's "London Whale" trading losses.[16] Indeed, Dr. Marcel Rohner, when asked by Lord Lawson whether UBS's problems were unique to UBS or a symptom of an industrywide problem, answered that he believed the size and complexity of investment banking had made it too difficult to manage; and that was why UBS had decided to exit large parts of investment banking. He went further to say that they had also concluded that using the cheap funds from the rest of the UBS Group to fund risky investment banking lines of business was also a mistake, as it led to mispricing and misallocation of funds.[17]

It is ironic that Sandy Weill, the principal architect of the demise of Glass-Steagall, with hands-on experience of running a TBTF bank, as the former chairman and chief executive of Citigroup, now has a different view:

> *"What we should probably do is . . . split investment banking from banking, have banks be deposit takers, . . . have banks do something . . . that's not too big to fail."*[18]

PROBLEMS OF COMPLIANCE

This section deals with what can go wrong, even when there are apparently no issues of broader cultural incompatibility. Three factors can conspire to create breakdowns in compliance: failures of judgment and biases; management overrides; and collusion. Of these, the most frequent are failures of judgment and biases, though as we will see management overrides can prove to be disastrous. Collusion can be both active and passive, and unfortunately the results are the same, so it is critical that the "tone at the top" minimizes the tendencies for passive collusion; and that the ethical foundations of the bank's values make active collusion rare, if not impossible to contemplate.

Judgment Traps and Biases

There are six threats to good judgment:[19]

1. *Rush to solve:* This is the tendency to want to find an immediate solution without investing enough in steps 1 and 2 of the judgment process shown in Figure 8.2.

   Too often, the solution is to select the first apparently workable alternative without considering carefully enough what the problem to be

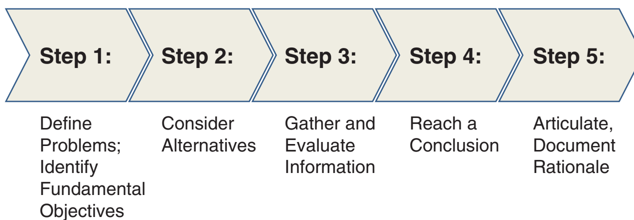

FIGURE 8.2 Professional Judgment Process
Source: J Zinkin.
© Zinkin Ettinger Sdn Bhd.

solved really is and what the objectives should be. As a result decision makers sometimes:

a. Solve the wrong problem.
b. Settle for a suboptimal outcome.

Even though ERM systems highlight this problem, we do not give this the cautionary weight it truly deserves because of the way our brains work and our resulting need for norms and causality,[20] even when none exists because events were truly random.[21]

2. *Judgment triggers:* Every judgment has a trigger that initiates the process of making a judgment. This trigger can lead to skipping the early steps of the judgment process. Triggers often appear as an alternative masquerading as a problem definition. As a result people can:

   a. Take action without a complete understanding of the problem.
   b. Set themselves inappropriate objectives.
   c. Fail to consider all possible alternatives.

   This is often the result of "framing effects," which are the consequence of different ways of presenting the same information. For example,

   The statement that "the odds of survival one month after surgery are 90%" is more reassuring than the equivalent statement that "mortality within one month of surgery is 10%."[22]

3. *Availability bias:* The "availability tendency" limits the alternatives considered or information gathered to the alternatives or information that come readily to mind. This can cause problems for steps 1 and 2 of the judgment process shown in Figure 8.2. This is also known as "What you see is all there is" (WYSIATI).[23] WYSIATI makes it easier to create coherence and for us to accept a statement as true. It allows us to decide on partial information in a fast-moving world and prevents analysis paralysis. Much of the time it is a good enough heuristic to support reasonable actions, but it also makes us jump to conclusions too quickly.

   Many disastrous decisions have been taken on the basis of statements like "In the time available and/or with the information we had available. . . ." Perhaps the best known example of this is the U.S. invasion of Iraq to clear it of weapons of mass destruction it did not possess.

4. *Overconfidence bias:* Overconfidence is part of the human condition and leads to suboptimal behavior in every step of the judgment process. It can lead to underinvestment in:

   a. Defining the problem in the first place.
   b. Identifying fundamental objectives correctly.

c. Consideration of sufficient alternatives.
d. Searching thoroughly for enough information.

How can we explain the origins of overconfidence?

Overconfidence: As the WYSIATI rule implies, neither the quantity nor the quality of the evidence counts for much in subjective confidence. The confidence that individuals have in their beliefs depends mostly on the quality of the story they can tell about what they see, even if they see little. We often fail to allow for the possibility that evidence that should be critical to our judgment is missing—what we see is all there is. Furthermore our associative system tends to settle on a coherent pattern of activation and suppresses doubt and ambiguity.[24]

5. *Confirmation bias:* The "confirmation tendency" affects steps 3 and 4 of the judgment process shown in Figure 8.2. Human beings seek and give excessive credence to confirming information in the information gathering and evaluation steps and to then favor conclusions that are consistent with initial prejudices:

   Contrary to the rules of philosophers of science, who advise testing hypotheses by trying to refute them, people (and scientists quite often) seek data that are likely to be compatible with the beliefs they currently hold. The confirmatory bias of [the unconscious mind] favors uncritical acceptance of suggestions and exaggerates the likelihood of extreme and improbable events.[25]

   Lehman Brothers' disastrous decision to double down on subprime mortgages in 2007[26] was probably the result of confirmation bias (they had successfully run a contrarian strategy in 2001) and of overconfidence based on WYSIATI, given their lack of appreciation that the market really was unsustainable.
6. *Anchoring bias:* The "anchoring tendency" and related potential judgment bias affect step 3 of the judgment process shown in Figure 8.2. In gathering and evaluating information, the tendency is to anchor on an initial value and stay too close to it when attempting to adjust away from it while making the final assessments.

   This is particularly critical when doing due diligence in an acquisition; and even more important in a hostile acquisition like that of ABN AMRO. The anchoring effect of Barclays's bid for ABN AMRO and of the rating agency reports must have helped the RBS Board feel they

were paying the right price for ABN AMRO when in fact they had no real information to justify it, and so were guilty of both anchoring and WYSIATI.

Table 8.1 summarizes the effect of the unconscious mind on our ability to make sound decisions and also indicates that it is not always good for making sound decisions.[27]

It is precisely because of the ability of the ever-active Unconscious Mind to short-circuit the rational processes of the Conscious Mind that it is so important to follow Alfred Sloan's approach to decision making mentioned in earlier chapters:

If we are all in agreement on the decision—then I propose we postpone further discussion of this matter until our next meeting to

TABLE 8.1 The Role of the Unconscious Mind in Decision Making

The Unconscious Mind does the following automatically and fast.

1. Generates impressions, feeling, and inclinations, which become beliefs, attitudes, and intention when endorsed by the Conscious Mind.
2. Is programmed by the Conscious Mind to mobilize attention when a pattern is observed.
3. Executes skilled responses and generates skilled intuitions after adequate training.
4. Creates a pattern of activated ideas in the associative memory.
5. Links a sense of easy mental processing (cognitive ease) to illusions of truth and pleasant feelings, and lowers vigilance.
6. Distinguishes the surprising from the normal.
7. Infers and invents causes and intentions.
8. Neglects ambiguity and suppresses doubt.
9. Is biased to believe and confirm.
10. Exaggerates emotional consistency through the horns and halo effect.
11. Focuses on existing evidence and ignores absent evidence (WYSIATI).
12. Generates a limited set of basic assessments and options.
13. Represents sets by norms and prototypes and does not integrate.
14. Computes more than intended (mental shotgun).
15. Substitutes on occasion an easier question to answer than the correct, but harder one.
16. Is more sensitive to changes in states than to states themselves (prospect theory).
17. Overweights low probability events.
18. Responds more strongly to loss than gain (between 1.5 and 2.5 times more[28]).
19. Frames decision problems narrowly, in isolation from one another.

> *give ourselves time to develop disagreement and perhaps gain some understanding of what the decision is all about.*[29]

Management Overrides

Any control system is only as good as the people who are responsible for making sure it works as intended. Table 8.2 shows why the system can fail because of breakdowns.

These reasons for nonperformance are quite different from problems caused by management override. Management override describes behavior designed to undermine the integrity of the internal controls for illegitimate purposes. These could be to:

- Obtain personal gain.
- Make the organization look better than it is
  - Financially.
  - In terms of compliance.

In the case of Lehman Brothers, both applied:

- Lehman ignored its VAR limits and systematically exceeded its own internal risk limits and controls,[30] as is shown in Table 8.3.
- Lehman did not disclose to the U.S. government, the rating agencies, its investors, or even to its own Board that it had made use of a balance sheet adjustment called "Repo 105" to artificially improve its balance sheet in 2008.

  It chose not to do so because it was trying to mislead the market regarding the strength of its balance sheet by proclaiming that it had reduced its net leverage to below 12.5 to cushion the reputational damage of having to announce a quarterly loss of $2.8 billion in the second quarter of 2008. The use of Repo 105 allowed Lehman to remove $50 billion of assets from its balance sheet temporarily at the end of the

TABLE 8.2 Systemic Breakdowns

1. Instructions are misunderstood.*
2. Mistakes of judgment are made.
3. People are careless.
4. Distracted people are overworked.
5. Temporary personnel are inadequately trained.
6. Changes in system processes are not properly understood.

*When watching their respective testimonies to the UK Parliamentary Committee investigating LIBOR price fixing, it seemed to me that there was a profound misunderstanding between Paul Tucker of the Bank of England, Bob Diamond, and Jerry Del Missier regarding the acceptability of low-balling LIBOR in the Barclays LIBOR fixing scandal.

TABLE 8.3 Lehman Brothers' Excess over Risk Limits

Month	Excess over Approved Limits ($ million)
July 2007	41
August	62
September	608
October	670
November	508
December	562
January 2008	708
	578

first and second quarters of 2008 and declare the cash received as sales rather than financing. As a result, Lehman was able to report that its net leverage was 12.1 at the end of the second quarter, as opposed to the true figure of 13.9. Lehman's global financial controller confirmed that "the only purpose or motive for [Repo 105] transaction was reduction in the balance sheet" and that "there was *no substance* to the transactions."[31] "The justification for doing this was that rather than sell assets at a loss, a Repo 105 increase would help avoid this without negatively impacting our leverage ratios."[32]

Table 8.4 shows some of the typical reasons for management override.

Collusion

Finally, for management overrides to work people need to collude actively:

> *Individuals acting collectively to perpetrate and conceal an action from detection often can alter financial data or other management information so that it cannot be identified by the control system.*[33]

TABLE 8.4 Reasons for Management Override

Using false documents (e.g., purchase orders, sales invoices) management may want to:

1. Increase reported revenue to hide an unexpected drop in market share
2. Enhance reported earnings to meet unrealistic budgets
3. Boost the value of the company prior to an IPO
4. Bolster personal bonus that is linked to unattainable targets
5. Hide violations of debt covenants
6. Hide lack of compliance with legal requirements

However, there is also the passive collusion that occurs when people know that behavior is not compliant, but they either turn a blind eye or condone it because of the lack of ethics in the organizational culture; or they are afraid to blow the whistle because there are inadequate whistleblower mechanisms in place. It may even arise from the thoughtlessness that comes from abrogating individual moral judgment, because there is no empathy for the people who suffer the consequences: They are too far away; they are unknown; they are outsiders. The risks they face as borrowers or investors are simply regarded as "externalities for which no one would be held accountable."[34]

Perhaps the only effective way to prevent passive collusion is to have very clear controls that are rigorously enforced to ensure that there is a strong sense of departmental and organizational discipline as a unifying behavior, regardless of the culture and background of the different parts of the bank. In a sense this is no different from the "no broken windows" policy[35] of crime prevention and reduction applied so effectively by the New York police department under Commissioner William Bratton.[36] The military understand this well and use clearly articulated common objectives and goals reinforced by a harsh "no broken windows" approach to obedience and compliance to weld together disparate units, with different cultures and myths unified into an effective fighting force. Clearly this has yet to happen in much of banking where the differing backgrounds and cultures have allowed broken windows to proliferate in different departments, undermining compliance and good behavior.[37]

INSTITUTING APPROPRIATE CONTROLS

This section deals with managing risks and the effective internal controls needed to create a "no broken windows" environment to create a healthy culture.

Managing Risks

Managing risk is about getting the balance between acceptable levels of risks and reward right. It is perhaps worth quoting the Group of Thirty:

> *Those accountable for key risk policies in FIs, on the Board and within management, must be sufficiently empowered to put the brakes on the firm's risk taking, but they also must enable the firm to conduct well-managed, profitable risk-taking activities that support the firm's long-term sustainable success.*[38]

In order to ensure there is proper governance of the risk management process the Group of Thirty recommends the following eight actions.[39] Boards should:

1. Establish Board-level risk committees to support the Board in approving the FI's risk appetite and to oversee the FI's risk professionals and infrastructure.
2. Ensure there is an independent Chief Risk Officer (CRO) with stature and unfettered access to Board risk committee, with authority to strike the right balance between constraining and supporting risk-taking.
3. Determine clearly articulated risk appetite properly linked to strategy, embedded across the firm, enabling risk-taking.
4. Actively assess and manage the risk culture so it supports the FI's risk appetite.
5. Ensure Directors have access to the right level of risk information so they see and fully understand major risks.
6. Maintain robust risk IT systems generating timely, comprehensive cross-geography, cross-product information on exposures.
7. Focus on emerging risks by having aggregated view of all major risks, strategy and product creep, excess complexity, and areas of over-performance.
8. Strengthen FI's resilience to exogenous shocks, recognizing financial stresses cannot be avoided when they come.

Table 8.5 shows three sets of questions Boards should ask when thinking about how best to manage risk.[40]

Once Directors are satisfied with the answers to these three sets of questions, there are then questions that must be answered concerning the 10 steps in effective risk management, shown in Table 8.6.[41]

Effective Internal Controls

Internal controls are a process put in place by the Board, management, and other personnel to provide reasonable assurance regarding the company's ability to ensure effective and efficient operations, reliable financial reports, and compliance with all relevant laws and regulations:

> *An organization establishes a mission, sets strategies, establishes the objectives it wants to achieve, and formulates plans for*

TABLE 8.5 Questions Regarding Risk Management

How can we be sure we take the right risks?	How can we be sure we take the right amount of risk?	How can be sure we have the right processes to manage risks?
1. How are the risks we take related to our objectives and strategies? 2. Do we know the significant risks we are taking? 3. Do the risks we take give us competitive advantage? 4. How are the risks we take related to the activities that create value? 5. Do we recognize that business is about taking risks and do we make conscious choices concerning these risks?	1. Are we getting a return that is consistent with our overall level of risk? 2. Does our organizational culture promote or discourage the right level of risk taking? 3. Do we have a well-defined organizational risk appetite? 4. Has our risk appetite been quantified in aggregate and per occurrence? 5. Is our actual risk level consistent with our risk appetite?	1. Is our risk management process aligned with our decision-making process and existing performance measures? 2. Is our risk management process coordinated and consistent across the entire enterprise? Does everyone use the same definition of risk? 3. Do we have gaps and/or overlaps in our risk coverage? 4. Is our risk management process cost-effective?

Source: John Zinkin, *Challenges in Implementing Corporate Governance* (John Wiley & Sons 2010), 158.

> *achieving them. Objectives may be set for an entity as a whole, or be targeted to specific activities within the entity. Though many objectives are specific to a particular entity, some are widely shared. For example, objectives common to most entities are sustaining organizational success, providing reliable reporting to stakeholders, recruiting and retaining motivated and competent employees, achieving and maintaining a positive reputation within the business and consumer communities, and complying with laws and regulations.*[42]

Figure 8.3 shows in three dimensions the way the elements of effective internal control are spread across the business units and activities of organization.

TABLE 8.6 Checklist Questions for Ten Steps in Effective Risk Management

Ten Steps	Checklist Questions
1. How do we ensure right levels of authority?	1. Do risk professionals have appropriate authority? 2. Will issues affecting reputation be raised to the right level? 3. Does the company strike the right balance between authority for risk management and making profit?
2. How do we ensure we lead managing risk from the top?	1. Is the "tone at the top" right? 2. Are there relevant independent committees responsible for overall risk management? 3. Is there an individual with overall responsibility for risk management? 4. Should the organization recruit a chief risk officer?
3. How do we ensure right levels of risk expertise?	1. Does senior management understand the risks facing the organization and their potential impact? 2. Does the executive team come from a diverse background? 3. Is the top management team at risk of misunderstanding the nature and level of risk because of information filtering lower down the hierarchy?
4. How do we ensure data are reliable?	1. What are the sources of information used to gain an understanding of risk? 2. How reliable are these sources and are they tested against other sources? 3. Does the organization only rely on historical data? 4. Is the organization using the right mix of quantitative and qualitative risk inputs? 5. Does the organization consider "black swans"?
5. How do we ensure stress testing and scenario planning take place?	1. Does senior management set aside time to discuss different scenarios and their likely impact? 2. To what extent are different scenarios considered when setting long-term strategy? 3. Does senior management seek a range of views and perspectives to test assumptions? Does it allow for "black swans"?
6. How do we ensure incentives reward long-term stability, not short-term profit?	1. Are CG processes robust enough to ensure remuneration will not cause reputation risk? 2. Is there a qualified remuneration committee in place to review and approve policies?

	3. What is the link between performance and reward? 4. Are incentive programs designed to motivate and reward, without encouraging behavior that creates organizational or systemic risk?
7. How do we consolidate risk factors across lines of business and the organization?	1. Does the company understand the interaction between different risk categories and how an event in one part of the business can have a knock-on effect elsewhere? 2. Is there a common language of risk to ensure clarity and understanding across the organization? 3. Do the data and IT infrastructure support aggregation and communication of risk information?
8. How do we avoid excessive reliance on external data providers?	1. To what extent does the organization rely on external sources of information? 2. How robust is this and how often is it cross-checked? 3. Does the organization really understand the methodology used by external providers? Are the limitations understood?
9. How do we achieve balance between centralized and decentralized risk?	1. What is the standing of risk management in the organization? 2. Is risk management seen as a support function and cost center or as a protector of long-term profit? 3. Does it form part of the strategic considerations? 4. Are risks identified and aggregated centrally and subject to an enterprise-wide review?
10. How do we ensure risk management is adaptive?	1. How frequently does the organization review and update its risk assumptions? 2. Is it often enough to take into account changed external circumstances? 3. How is information about changes in the risk environment and risk profile communicated to senior management? 4. To what extent do changes in the risk environment lead to changes in risk management priorities or processes?

Source: John Zinkin, *Challenges in Implementing Corporate Governance* (John Wiley & Sons 2010), 158-160.

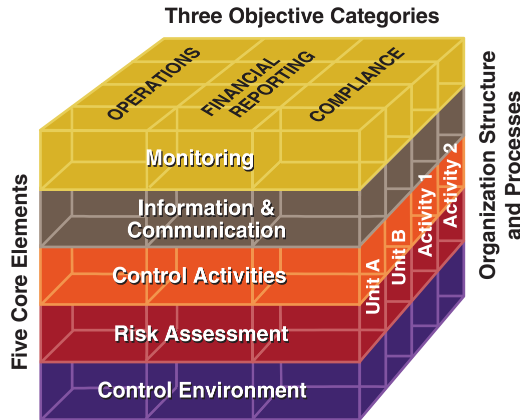

FIGURE 8.3 The COSO Cube
Source: Internal Control-Integrated Framework (2011), 5.

The five core elements must be properly integrated so the three objective categories can be achieved when an organization has its internal controls in place across its business units and activities. The three objectives are defined as follows:

1. *Operations objectives:* These cover an entity's basic business objectives: why it exists, its mission, and the performance criteria by which it will be judged. Typical operations objectives, which apply across the organization as a whole, as well as to its business units and activities, are:
   a. Improving quality.
   b. Reducing costs and production time.
   c. Improving innovation.
   d. Increasing market share.
   e. Improving customer loyalty and satisfaction measured in terms of:
      i. Number of cross-sold products.
      ii. Customer "stickiness."
   f. Improving employee engagement and loyalty.
   g. Improving productivity per employee measured in terms of:
      i. Revenues per person.
      ii. Margins per person.
      iii. Profit per person.
   h. Improving profitability.

2. *Reporting objectives:* These cover financial and nonfinancial reporting, as well as internal and external reporting. Internal or management reporting is determined by the needs of management to make decisions. External or financial reporting tends to be driven by regulators and/or standards established by accounting bodies and other standard-setting organizations:
   a. *External financial reporting objectives*: Reliable financial statements are:
      i. Essential, if banks want to be on good terms with their regulators.
      ii. Essential, if the bank wishes to access capital markets.
      iii. Often critical in winning business.
      iv. Helpful in dealing with suppliers.
      v. Essential for investors and analysts, when they are deciding on where to invest money and how to assess comparative performance.
      vi. Useful in dealing with creditors who look at the state of finances when assessing how much credit to give.
   b. *External non-financial reporting objectives:* Management may be obliged to report such information in accordance with regulations, standards, or frameworks, including reporting on internal control and operating processes—for example the different ISO frameworks for quality management, environmental protection, corporate social responsibility, and so on.
3. *Compliance objectives:* Banks must operate within the framework of regulations and laws affecting their lines of business and are required to report on their compliance. Generally, the regulations that apply to banks and their lines of business are clear. However, there may be confusion or even contradiction between standards set by different regulators and in different jurisdictions when banks operate in more than one country. And some lines of business are not regulated, such as OTC derivatives and dark pools.

The COSO framework sets out five components of internal control. Taking each of the components in turn, we start with the control environment:

> *The control environment is the foundation for all other components of internal control. The Board and senior management establish the tone from the top regarding the importance of internal control and expected standards of code. The control environment provides discipline, process, and structure.*[43]

The five principles relating to the control environment are:

1. Commitment to integrity and ethical values.[44]
2. Board independence in overseeing and developing performance of internal control.[45]
3. Appropriate structures, reporting lines, and authorities and responsibilities in the pursuit of objectives.[46]
4. Commitment to attract, develop, and retain competent individuals in line with objectives.[47]
5. Accountability of individuals for their internal control responsibilities in pursuit of objectives.[48]

The component elements of each of the five principles related to control environment are shown in detail in Table A.1 in Appendix 8A. Table A.2 in Appendix 8A lists the detailed questions Boards should ask regarding the control environment.

Risk assessment follows the control environment in the COSO framework. The four principles are:

1. Objectives are specified with sufficient clarity to allow the identification and assessment of risks relating to the objectives.[49]
2. Risks are identified across the entity and analyzed to determine how the risks should be managed.[50]
3. Potential for fraud in assessing risks to achieving objectives is recognized.[51]
4. Changes that could significantly impact the system of internal control are identified and assessed.[52]

The details of the four principles relating to risk assessments and their attributes are shown in Table A.3 in Appendix 8A. Table A.4 in Appendix 8A lists the detailed questions Boards should ask regarding risk assessment.

The third level in the COSO Cube to be considered by the Board deals with control activities, and here there are three principles for the third level:

1. "The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels."[53]
2. "The organization selects and develops general activities over technology to support achievement of objectives."[54]
3. "The organization deploys control activities as manifested in policies that establish what is expected and in relevant procedures to effect the policies."[55]

The detail of the three principles relating to control activities and their attributes are shown in Table A.5 in Appendix 8A. Table A.6 in Appendix 8A lists the detailed questions Boards should ask regarding control activities.

The fourth level of the COSO Cube deals with information and communication. The three principles relating to information and communication[56] are:

1. The organization obtains, generates, or uses relevant, quality information to support effective internal control.
2. The organization communicates information *internally* regarding objectives and responsibilities for internal control to support the functioning of other components of internal control.
3. The organization communicates *externally* regarding matters affecting the functioning of other components of internal control.

The detail of the three principles relating to information and communication and their attributes are shown in Table A.7 in Appendix 8A. Table A.8 in Appendix 8A lists the detailed questions Boards should ask regarding information and communication. Table A.9 shows the detailed questions Boards must ask regarding information system controls.

The fifth level of the COSO Cube deals with monitoring activities. The two principles relating to monitoring activities[57] are:

1. The organization conducts ongoing and/or separate evaluations.
2. The organization evaluates and communicates deficiencies.

The detail of the two principles relating to monitoring activities and their attributes are shown in Table A.10 in Appendix 8A. Table A.11 in Appendix 8A lists the detailed questions Boards should ask regarding monitoring activities. Table A.12 in Appendix 8A lists the eight factors that contribute to fraudulent financial reporting.[58]

CONCLUSION

There is a belated recognition that culture matters and that some of the problems experienced in banks have been caused by the failure to integrate the culture of securities trading in investment banks with the culture of protecting deposits in commercial banks. Time and again in the cross-examination of bankers by the UK Parliamentary Committee on Banking Standards, the issue of culture has come up. It has been questioned in Barclays and UBS regarding the behavior of traders in fixing LIBOR; it has been questioned in terms of who

is suitable to head a bank and whether investment bankers are the right people because of their culture and backgrounds, not just by the media, but also by the regulators.[59] Glass-Steagall was designed to keep the two cultures separate. Its repeal was designed to commingle the two in the hope of creating a financial institution that would be the best of both worlds (BOBW). Yet instead of creating a BOBW financial institution, the result was a hybrid TBTF monster that put the system at risk, holding governments to ransom as a result. Although initially very surprising, it is perhaps no accident that Sandy Weill, the architect of the demise of Glass-Steagall, has come to the view that it should not have been repealed because the problems of cultural incompatibility are just too great. In an interview with the Financial Times, John Reed, fellow architect of the repeal of Glass Steagall concluded it was a mistake for the same reason.[60]

Ensuring compliance has posed its own problems because of the natural human predisposition to make serious errors of judgment resulting from the six biases we all have (rush to solve, judgment triggers, availability, overconfidence, confirmation, and anchoring biases) as a result of the way the unconscious brain operates. This is made worse when somebody in management decides to override the systems put in place to ensure adherence to policies, evidenced in the catastrophic consequences of Lehman Brothers violating its own risk management policies or in the losses suffered by JP Morgan Chase in the "London Whale" trades. Finally, there is the corrosive effect of passive collusion, which encourages wrongdoing by tolerating its existence, which can be mitigated so effectively through the adoption of a "no broken windows" policy to all forms of noncompliance, however minor.

Regulators have been guilty of adopting a kid gloves approach[61] to banking wrongdoing that directly contradicts the "no broken windows" policy that has worked so effectively in dealing with other forms of crime:

> *The world economy was broken by the banks' cavalier attitude to risk and rules. When authorities suspect outright wrongdoing, a final finding for or against guilty conduct must be sought.*[62]

Maybe, therefore, we can only really expect changed behavior when two things happen: Individuals rather than organizations are penalized for breaches of regulations and regulators adopt a "no broken windows" policy regarding white-collar crime.

Perhaps the best way for regulators to overcome their concerns that trying to prove certain individuals guilty is extremely difficult, or that taking banks to court could destabilize the system if they are found guilty of criminal behavior, is for regulators to set the quantum of the fine and insist it be paid from the bonus pool. This then links the malefactors to the penalties directly, hitting them in their pocketbooks. Regulators can

then leave it to the bank remuneration committee to establish who did what, and when, and divide the fine among the members of the bonus pool. It is then the bank's responsibility to get the facts, and regulators do not have to spend great amounts of time and taxpayers' money taking banks to court.

Such an approach would ensure that Boards become more intimately involved in verifying that the control systems instituted in their banks are effective and work as they are supposed to. It is quite clear, from the way senior executives and Board members have been cross-examined by the various legislative committees looking into banking standards and scandals on both sides of the Atlantic, that Boards are expected not just to trust, but to verify that the right controls are in place and working. The only way Boards can do this without being accused of usurping the role of management is to ask challenging questions using the COSO risk management framework along the lines discussed in this chapter.

APPENDIX 8A

Creating a Suitable ERM Framework[64]

This appendix covers the approach adopted by COSO to establish a sound ERM framework. This is done by looking separately at the principles relating to the control environment, risk assessment, control activities, information and communication, and monitoring activities:

- Five principles relating to the control environment and associated questions.
- Four principles relating to risk assessment and associated questions.
- Three principles relating to control activities and associated questions.
- Three principles relating to information and communication and associated questions.
- Two principles relating to monitoring activities and associated questions.

TABLE A.1 Five Principles Relating to the Control Environment

1. *Commitment to integrity and ethical values:*
   a. "Tone at the top"
   b. Mission and values statements
   c. Standards or codes of conduct
      i. Establishing what is right and wrong
      ii. Providing guidance for navigating what lies in between
      iii. Considering governing laws, regulations, other standards, and CSR
   d. Systematic evaluation of individual and team adherence to standards of conduct, based on:
      i. A defined set of indicators to identify issues and trends related to standards of conduct for both the organization and its outsourced providers. These should be periodically reviewed and revised
      ii. Continually and periodically established compliance procedures to confirm expectations are being met both in-house and outside
      iii. Identification, analysis, and reporting of business conduct issues and trends to senior management and the Board; analysis often requires setting up cross-functional teams to determine root causes and what corrective action is needed
      iv. Evaluation of the leadership as an example in demonstrating integrity and ethical values as part of the performance appraisal reward, and promotion processes
   e. Assesses deviations from the code of conduct or standards via:
      i. Centrally compiled allegations that are evaluated by individuals who are independent of the allegations
      ii. Investigations that are conducted and documented based on defined investigation protocols
      iii. Timely and consistent follow-through with corrective actions
   f. Policies and practices
   g. Operating principles
   h. Directives, guidelines, and other supporting communications
   i. Actions and decisions by management at all levels, including the Board
   j. Attitudes and responses to deviations from expected standards of conduct
   k. Informal and routine actions and communications of leaders at all levels
2. *Board independence in overseeing development and performance of internal control. This includes appropriate committees with suitable charters to:*
   a. Establish Board oversight responsibilities
   b. Delegate Board responsibilities
      i. Nomination committee is responsible for:
         - Leading the selection of the CEO
         - Leading the selection of Directors
         - Evaluating the Board
         - Evaluating the performance of the top management team
         - Ensuring there is a proper succession plan in place for

(*continued*)

TABLE A.1 (*Continued*)

        - CEO
        - C-Suite
        - Mission-critical positions
      - Ensuring there is an appropriate talent management strategy
    ii. Remuneration (compensation) committee is responsible for:
      - Overseeing reward and recognition policies for top management
        - Motivating desired behaviors
        - Balancing incentives between short- and long-term performance
        - Linking performance to strategic objectives
        - Reconciling risk with reward
      - Ensuring that the policy is cost effective
      - Overseeing reward and recognition policies for Directors
      - Ensuring there is the right Board balance and skills mix
        - Market and company knowledge
        - Financial expertise
        - Legal and regulatory expertise
        - Social and environmental expertise
    iii. Audit committee is responsible for:
      - Overseeing management integrity and transparency in external reporting
      - The overall reliability of financial reports
      - Working effectively with
        - External audit
        - Internal audit
      - Whistle-blowing arrangements
  d. Provide oversight of:
    i. Control environment
    ii. Risk assessment
    iii. Control activities
    iv. Information and communication
    v. Monitoring activities
3. *Appropriate structures, reporting lines, and authorities and responsibilities in the pursuit of objectives:*
  a. Board and senior management establish organizational design needed to:
    i. Plan
    ii. Execute
    iii. Control
    iv. Evaluate organization's performance
  b. Board considers factors they need to consider in developing the organizational design:
    i. Size and nature of the business
    ii. Risks associated with the objectives and business processes
    iii. Nature of the authority and responsibility assigned to
      - Top management
      - Operating management

TABLE A.1 (*Continued*)

- Functional management
- Geographic management

c. Board defines, assigns, and limits authorities and responsibilities:

i. Responsibility's three lines of defense

- Front line management provides first line of defense
  - Day-to-day internal control
  - They are rewarded based on performance in relation to all objectives.
- Support functions provide second line of defense
  - Offering guidance on internal control needs
  - Evaluating adherence to standards
  - They are rewarded indirectly for performance of the area in which they are expert
- Internal audit provides the third line of defense
  - Assessing and reporting on internal control
  - Recommending corrective action or enhancements
  - They are rewarded independently of the business areas they review.

ii. Authorities and responsibilities

- Board delegates authority and assigns responsibility to senior management so that:
  - Board stays informed
  - Board challenges senior management
- Senior management does the same at the overall entity and its business units
- Senior management including the CEO is responsible to the Board and other stakeholders for establishing:
  - Directives
  - Guidance
  - Control
- Management executes senior management directives
- Employees are expected to understand the company's
  - Standards of conduct
  - Objectives
  - Risks
  - Related controls
  - Feedback and information flows for monitoring

iii. Limits of authority:

- Delegation occurs to the extent needed to achieve objectives
- Decision making is based on sound practices for assessing risks
- Duties are segregated to reduce the risk of inappropriate behavior
- Technology is used as appropriate to track the workflow's responsibilities and risks
- Third-party service providers understand the extent of their decision-making authority

4. *Commitment to attract, develop, and retain competent individuals in line with objectives*

a. Establishes HR policies and practices, defining what competencies are needed

(*continued*)

TABLE A.1 (*Continued*)

- i. Requirement and rationale
  - Implication of laws and regulations
  - Impact of standards
- i. Knowledge
- ii. Skills
- iii. Experience
- iv. Judgment
- v. Empowerment versus need for supervision

b. Attracts, develops, and retains individuals
- i. Recruits to fit organizational needs
- ii. Trains them to acquire appropriate competencies
- iii. Mentors them on organizational purpose and values
- iv. Evaluates performance
- v. Retains people as appropriate

c. Evaluates competencies and addresses shortcomings

d. Plans and prepares for succession

5. *Accountability of Individuals for their internal control responsibilities in pursuit of objectives*

a. Enforces accountability through
- i. Structures
- ii. Authorities: CEO held accountable for entity internal control
- iii. Responsibilities
  - CEO and senior management design, implement, conduct, and periodically evaluate whether the structures and authorities in fact work as expected
  - Setting "tone at the top"
    - CEO and senior management are responsible for the clarity of expectations regarding ethics, conflicts of interest, illegal or improper activities.
    - Management philosophy, values, and operating style
  - Control and information flow
  - Upward communications and other feedback channels for employees and outsourced service providers

b. Establishes performance measures, incentives, and rewards
- i. Reconciling short- and long-term objectives
- ii. Objectives clearly stated
- i. Implications defined
- iii. Meaningful metrics
- iv. Adjusted to reflect changed circumstances

c. Evaluates performance measures, incentives, and rewards for appropriateness

d. Considers sources of excessive pressure:
- i. Unrealistic short-term performance targets
- ii. Conflicting objectives of different stakeholders
- iii. Imbalance between rewards for meeting short-term objectives at the expense of long-term stakeholder objectives

e. Evaluates individual performance

TABLE A.2 Questions Regarding the Control Environment

1. *Integrity and Ethics*
   a. How do we ensure the "tone at the top" is right?
      i. Are the values clearly articulated?
      ii. Does the top management set an example by living the values?
      iii. How are the values integrated into performance reviews?
      iv. Do reward and recognition systems reinforce the values?
   b. Is there a clearly communicated code of conduct?
      i. Does it spell out desired behaviors?
      ii. Does it specify undesirable behaviors?
   c. Do all levels of the organization understand the code of conduct?
      i. Do employees know what to do?
      ii. Do employees know what is forbidden?
      iii. Have they been trained in dealing with the gray areas in between?
   d. Are deviations identified in a timely manner?
      i. Are employees informed of past incidents violating the code of conduct?
      ii. Are there effective whistleblower policies?
   e. What processes exist to remediate bad behavior?
      i. Sanctions?
      ii. Training?
   f. What policies are in place to provide direction on ethical behavior when dealing with:
      i. Employees?
      ii. Customers?
      iii. Suppliers?
      iv. Regulators?
      v. Other stakeholders?
2. *Board independence and effective oversight:*
   a. How effectively does the Board provide direction?
   b. How does the Board ensure the standards of conduct are aligned with stakeholder expectations?
   c. How well does the Board guide the definition of standards of conduct, competence, and performance for the organization?
   d. How effectively does the Board direct the implementation of oversight?
   e. How well does the Board exercise its fiduciary duties?
   f. How effectively does the Board challenge senior management and follow up?
   g. How do the Board and top management stay in touch with geographically dispersed operations?
   h. How does the Board ensure that the people responsible for compliance can be trusted?
      i. What does the Board expect?
      ii. What does the Board inspect?
      iii. How often does the Board inspect?

(*continued*)

TABLE A.2 (*Continued*)

3. *Appropriate bank organizational design, authorities and responsibilities:*
   a. How does bank structure affect authorities and responsibilities?
      i. Business unit?
      ii. Geography?
      iii. Function?
      iv. Matrix?
      v. Level?
   b. How does the structure facilitate information flows?
      i. Upstream?
      ii. Downstream?
      iii. Across business units?
   c. How are individual authority and responsibility determined?
      i. Job responsibilities?
      ii. Knowledge?
      iii. Skills?
      iv. Experience?
      v. Seniority?
   d. How often are authority limits reviewed?
   e. What are the escalation procedures?
      i. At operational level?
      ii. To senior management?
      iii. To the Board?
   f. How many people are involved?
      i. Are there enough people?
      ii. Do they have enough time?
   g. What documentation exists?
      i. Board minutes?
      ii. Written standard operating policies and procedures?
4. *Commitment to competence and ethical standards*
   a. How do HR policies and practices promote competence and ethical standards?
      i. What weight is given to competence?
      ii. What weight is given to ethical behavior?
   b. How does management reconcile financial performance with non financials?
   c. What weight does management give to reputation impact?
5. *Individual accountability*
   a. How does management empower people?
   b. Do job descriptions make clear what individuals will be held accountable for?
   c. How does management hold individuals accountable?
      i. Regular performance appraisals?
         - Standards?
         - Targets?
         - Actuals compared with target?
      ii. Establishing performance goals for the following year?

TABLE A.3 Four Principles Relating to Risk Assessment

1. *Objectives are specified with sufficient clarity to allow the identification and assessment of risks relating to the objectives:*
   a. Operations objectives:
      i. Consider tolerance for risk
      ii. Reflect management choices
      iii. Include operations and financial performance goals
      iv. Form basis for committing resources
   b. External financial reporting objectives:
      i. Consider materiality
      ii. Comply with applicable accounting standards
      iii. Reflect entity activities
   c. External non financial reporting objectives:
      i. Consider required level of precision
      ii. Comply with externally established standards and frameworks
      iii. Reflect entity activities
   d. Internal reporting objectives:
      i. Consider required level of precision
      ii. Reflect management's choices
      iii. Reflect entity activities
   e. Compliance Objectives:
      i. Consider risk tolerance
      ii. Reflect external laws and regulations
2. *Risks are identified across the bank and analyzed to determine how the risks should be managed:*
   a. Involve appropriate levels of management
   b. Include the following levels
      i. Entity
      ii. Subsidiary
      iii. Division
      iv. Operating unit
      v. Function
   c. Analyze internal and external factors
   d. Estimate significance of identified risks
   e. Determine how to respond to risks
      i. Accept
      ii. Avoid
      iii. Reduce
      iv. Share
3. *Potential for fraud in assessing risks to achieving objectives recognized:*
   a. Consider the ways fraud can occur
      i. Possible loss of assets
      ii. Fraudulent reporting
      iii. Corruption
   b. Consider risk factors

(*continued*)

TABLE A.3 (*Continued*)

- c. Assess incentives and pressures
- d. Assess opportunities for fraud
  - i. Unauthorized acquisition
  - ii. Unauthorized use of assets
  - iii. Unauthorized disposal of assets
  - iv. Altering records
- e. Assess attitudes about and rationalizations of fraud

4. *Changes that could significantly impact the system of internal control are identified and assessed:*
   - a. Assess changes in the external environment
     - i. Political risk
     - ii. Economic risk
     - iii. Competitive risk
     - iv. Technology risk
     - v. Strategic risk
     - vi. Systemic risk
     - vii. Legal and regulatory risk
     - viii. Environmental risk
   - b. Assess changes in the business model
     - i. Acquisitions
     - ii. Divestitures
     - iii. Supply chain
     - iv. Technology
     - v. Physical environment
   - c. Assess changes in leadership
     - i. Values
     - ii. Philosophies
     - iii. Attitudes

TABLE A.4 Questions Regarding Risk Assessment

1. *How clearly are bankwide objectives defined for:*
   - a. Operations?
   - b. Financial reporting?
   - c. Compliance?
2. *How appropriate are they?*
   - a. How were they set?
   - b. When were they last reviewed?
   - c. Do they need updating?
3. *How well are the bank-wide objectives being met?*
   - a. How do actuals compare with planned performance?
   - b. Has management identified the resources needed to perform?
   - c. Do plans exist for resourcing appropriately?
   - d. Does a comprehensive entity-level risk assessment exist that covers all risks?

TABLE A.4 (*Continued*)

- e. How thorough and relevant is the risk assessment?
- f. What policies and procedures are in place to help management meet their objectives?

4. *How are activity level objectives set for each part of the business process?*
   - a. Has management determined appropriate objectives to support achieving the objectives?
     - i. Specific?
     - ii. Measurable?
     - iii. Achievable?
     - iv. Realistic?
     - v. Time-bound?
   - a. Are they consistent across units and activities?
   - b. Do they take into account the big picture as well as the little picture?
   - c. How were they set?
   - d. When were they last reviewed?
   - e. Do they need updating?
5. *What mechanisms are there to manage change?*
   - a. Does the business planning process include consideration of change?
     - i. Periodic meetings where major potential changes are discussed?
     - ii. Action plans as a result?
     - iii. Follow up?
     - iv. Establishment of new controls?
   - b. What assumptions are used?
     - i. Industry trends?
     - ii. Competition?
     - iii. Regulations?
     - iv. Customers?
   - c. How often are budgets and forecasts updated?
   - d. What scenarios are envisaged?
   - e. What impact could they have?

TABLE A.5 Three Principles Relating to Control Activities

1. *Selects and develops control activities:* "The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels."
   - a. Integrates with risk assessment
   - b. Determines relevant business processes
   - c. Considers entity-specific factors
   - d. Evaluates a mix of control activities
   - e. Considers the level at which activities are applied
   - f. Deals with segregation of duties
2. *Selects and develops general controls over technology:* "The organization selects and develops general activities over technology to support achievement of objectives."

(*continued*)

TABLE A.5 (*Continued*)

- a. Determines dependency between the use of technology in business processes and technology controls
- b. Establishes appropriate technology infrastructure control activities designed and implemented to help ensure:
  - i. Completeness
  - ii. Accuracy
  - iii. Availability of technology processing
- c. Establishes appropriate security management process control activities designed to:
  - i. Restrict technology access rights to authorized users according to their job responsibilities
  - ii. Protect the entity's assets from external threats
- d. Establishes appropriate technology and infrastructure acquisition, development, and maintenance process control activities over:
  - i. Acquisition
  - ii. Development
  - iii. Maintenance

3. *Deploys through policies and procedures:* "The organization deploys control activities as manifested in policies that establish what is expected and in relevant procedures to effect the policies."[62]
   - a. Establishes policies and procedures to support deployment of management directives
   - b. Establishes responsibility and accountability for executing policies and procedures
   - c. Performs:
     - i. Using competent people
     - ii. In a timely manner
   - d. Takes corrective action
   - e. Reassesses policies and procedures

TABLE A.6 Questions Relating to Control Activities

1. *Are appropriate controls being applied on a timely basis?*
2. *What actions are taken on deviations or exceptions?*
   - a. Are follow-up actions taken on a timely basis?
   - b. What sanctions exist for breaches?
3. *How are policies and procedures developed for:*
   - a. Data center controls?
   - b. System software?
   - c. Access security?
   - d. Application development and maintenance?
4. *What arrangements exist to ensure appropriate segregation of responsibilities?*
5. *How is access to financial files and databases restricted?*
6. *How is online access to information and data files controlled?*

TABLE A.6 (*Continued*)

7. *What protection arrangements are there against physical destruction of financial records?*
8. *What contingency plans are there to deal with service interruptions?*
9. *What periodic testing takes place of:*
   - Contingency plans?
   - Disaster recovery plans?
10. *What controls are there to ensure that interfaces between critical systems work effectively?*

TABLE A.7 Three Principles Relating to Information and Communication

1. *The bank obtains, generates or uses relevant, quality information to support effective internal control.*
   a. Identifies information needs
   b. Captures internal and external sources of data
   c. Processes relevant data into information
   d. Maintains quality throughout data processing
      i. Produces information that is:
         - Timely
         - Current
         - Accurate
         - Complete
         - Accessible
         - Protected
         - Verifiable
         - Retained
      ii. Information is reviewed to assess relevance in supporting internal control
   e. Considers costs and benefits
2. *The bank communicates information internally regarding objectives and responsibilities for internal control to support the functioning of other components of internal control.*
   a. Communicates internal control information with employees so all understand their roles
   b. Communicates with the Board
   c. Provides separate lines of communication
   d. Selects relevant methods of communication
3. *The bank communicates externally regarding matters affecting the functioning of other components of internal control.*
   a. Communicates to external parties:
      i. Shareholders
      ii. Partners
      iii. Owners
      iv. Regulators

(*continued*)

TABLE A.7 (*Continued*)

        v. Customers
        vi. Suppliers
        vii. Analysts
    b. Enables inbound communication
    c. Provides separate lines of communication
        i. Whistleblower hotline
        ii. Confidential communication channels
    d. Communicates external information to the Board
    e. Selects appropriate methods of communication considering:
        i. Timing
        ii. Audience
        iii. Nature of the communication
        iv. Legal, regulatory, and fiduciary requirements

TABLE A.8 Questions Regarding Information and Communications

1. *How does the bank obtain, generate, or use relevant, quality information to support effective internal control?*
    a. How well does it identify information needs?
    b. How well does it capture internal and external sources of data?
    c. How well does it process relevant data into information?
    d. How well does it maintain quality throughout data processing?
        i. Does it produce information that is:
            - Timely?
            - Current?
            - Accurate?
            - Complete?
            - Accessible?
            - Protected?
            - Verifiable?
            - Retained?
        ii. How often is information reviewed to assess relevance in supporting internal control?
    e. How well does it consider costs and benefits?
2. *How well does the bank communicate information internally regarding objectives and responsibilities for internal control to support the functioning of other components of internal control?*
    a. Does it communicate internal control information with employees so all understand their roles?
    b. How well and often does it communicate with the Board?
    c. Does it provide separate lines of communication?
    d. How does it select relevant methods of communication?
3. *How and how well does the bank communicate externally regarding matters affecting the functioning of other components of internal control?*

TABLE A.8 (*Continued*)

a. How well and how often does it communicate to external parties:
  i. Shareholders?
  ii. Partners?
  iii. Owners?
  iv. Regulators?
  v. Customers?
  vi. Suppliers?
  vii. Analysts?
c. How and how well does it enable inbound communication?
d. Does it provide separate lines of communication:
  i. Whistleblower hotline?
  ii. Confidential communication channels?
d. How and how well does it communicate external information to the Board?
e. How does it select appropriate methods of communication considering:
  i. Timing?
  ii. Audience?
  iii. Nature of the communication?
  iv. Legal, regulatory, and fiduciary requirements?

TABLE A.9 Questions Regarding Information System Controls

1. *How does the bank ensure there is quality information?*
  a. Is detailed information provided to the right people at the right time?
  b. Is it summarized appropriately, turning data into information?
  c. Does the analytical data help managers:
    i. Make informed decisions?
    ii. Act in a timely manner?
  d. How does the bank access relevant external information on:
    i. Market trends?
    ii. Competition?
    iii. Legislative and regulatory development?
    iv. Economic trends?
    v. Industry trends?
  e. How does the bank assess emerging information needs?
    i. How often?
    ii. Who is involved?
2. *How does the bank report suspected improprieties?*
  a. Is there a whistleblower process?
    i. Does it include a confidential communication plan?
    ii. Are reported problems dealt with promptly?
    iii. Is disciplinary action taken when necessary?
3. *How does the bank deal with employee suggestions?*
  a. Is there a process in place?

(*continued*)

TABLE A.9 (*Continued*)

b. Does management acknowledge and reward/recognize suggestions for improvements?

4. *How effectively are employees' control responsibilities communicated?*
   a. Do employees know the objectives of their activities?
   b. Do they understand how their duties contribute to achieving their objectives?
   c. Do they understand how they affect the duties of others and are affected by the duties of others?
5. *How good are the feedback mechanisms on changing customer needs?*

TABLE A.10 Two Principles Relating to Monitoring Activities

1. *The bank conducts on-going and/or separate evaluations:*
   a. Considers a mix of on-going and separate evaluations
   b. Establishes baseline understanding for evaluations
   c. Considers rate of change
   d. Uses experts
   d. Integrates evaluations with business processes
   f. Evaluates objectively
   g. Adjusts scope and frequency of evaluations depending on risk
2. *The bank evaluates and communicates deficiencies:*
   a. Assesses results
   b. Communicates deficiencies to management
   c. Escalates deficiencies to senior management and Board
   d. Monitors corrective actions

TABLE A.11 Questions Regarding Monitoring Activities

1. *How does the bank ensure the reports used for monitoring are reliable and accurate?*
   a. How does the Board detect inconsistencies in related financial documents?
   b. Who is expected to identify inconsistencies or inaccuracies?
   c. Who is responsible for reconciling operational reports with financial reports?
   d. How well does management integrate non financial reports with financial ones?
   e. How well does management reconcile management accounts with financial accounts?
   f. How well does management reconcile leading and lagging indicators?
2. *How is feedback communicated/escalated to senior management?*
   a. How are training session findings communicated to senior management?
   b. What follow-up ensues?
3. *How appropriate is the internal control evaluation process?*
   a. How logical is the evaluation process?
   b. Does it include checklists and other tools?
   c. Are policy manuals and procedures used in evaluating?
   d. Is the evaluation properly documented?

TABLE A.11 (*Continued*)

4. *How suitable are the reporting protocols?*
   a. Are findings reported to people who:
      i. Own the process?
      ii. Can take corrective action?
   b. Are the findings escalated to at least one level above the process owner?
   c. Do employees understand what types of problems need to be reported to the Board?
5. *How effectively do we follow up?*
   a. Are root causes investigated appropriately?
   b. Are corrective actions put in place promptly?
      i. What are they?
      ii. Who is responsible?
      iii. What did we learn?

TABLE A.12 Eight Factors Contributing to Fraudulent Financial Reporting

Incentives
1. Pressure to meet unrealistic targets, particularly short-term ones
2. High performance-dependent rewards
3. Upper and lower cutoff points on bonus plans

Temptations
4. Nonexistent or ineffective controls (e.g., poor segregation of duties)
5. Excessive decentralization blinding top management to wrongdoing lower down
6. Weak internal audit
7. Ineffective Board failing to oversee top management
8. Inappropriately weak penalties/sanctions that do not deter

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CHAPTER 9

Governance: The Wise Restraints That Set Men Free

This chapter explores the role of governance as a counterbalance to leadership, to help bank leaders make good decisions for sustainable results. It then examines the three components of good governance: self-discipline, market discipline, and regulatory discipline and their contribution to good leadership. It makes the case that self-discipline is by far the most important because of failures in the other two disciplines.

Why do we need to bother with corporate governance, when surely what matters is great and effective leadership? Is it not yet another irritating cost of doing business imposed by regulators who do not appreciate how difficult it is to make money running a bank?

WHY CORPORATE GOVERNANCE MATTERS

There are four reasons why we must take corporate governance seriously:

1. It has a major role to play in creating long-term value for shareholders and society by helping reconcile the interests of principals and their agents.
2. It is critical in keeping the CEOs of banks who are often powerful personalities on the straight and narrow by providing a system of checks and balances to protect them from getting carried away by their past track records of successes.
3. Failures of corporate governance in financial services have proved to be incredibly expensive and harmful to society as a whole.
4. It is important in ensuring that companies comply with laws and distribute the value they create fairly.

Reconciling Competing Interests

In 1976 Michael Jensen and William Meckling published a path-breaking paper introducing the concept of the "Principal-Agency Conflict." This has framed the way we look at business ever since, laying the foundations for the concept of modern corporate governance.[1]

Their basic proposition was that managers could not be trusted to do what the owners wanted because they had their own vested interests to protect. This was a new idea undermining the foundations of managerial capitalism—a concept developed by Peter Drucker in the mid-1940s when he studied General Motors.[2]

Put simply, the principal-agent conflict goes like this: Owners (principals) expect the maximum return for the minimum resources provided by them in the form of equity, whereas managers (agents) demand the maximum resources for the minimum return they can get away with. This is illustrated in Figure 9.1.

Negotiation forces owners and managers to compromise about where they should be on the risk-adjusted conflict continuum in Figure 9.1. However, they may find it difficult to agree where they should end up for three reasons:

1. They may be looking at the problem through win-lose lenses.

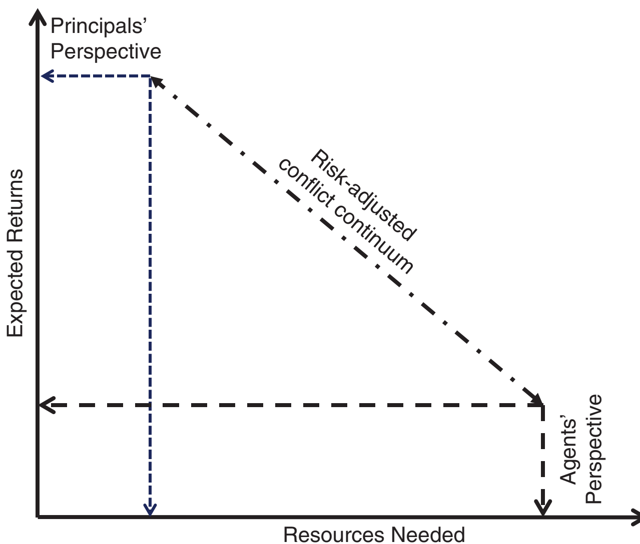

FIGURE 9.1 Principal-Agent Conflict
Source: J Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur, April 2013.

2. They each may have different perspectives of risk that make it difficult for them to decide what is a reasonable return for a given amount of risk.
3. They may have different time horizons as well.

It is not just that owners and managers may not be able to agree what is the right risk profile for a given portfolio of businesses, or that they may not be able to agree on the time horizons over which the agreed returns are to be earned. There is also the problem that different classes of owner do not have the same expectations. There are:

- Shareholders who want immediate returns (day traders).
- Others who are interested in quarterly results (hedge funds and analysts).
- Others who are looking at annual returns.
- Still others who take a long-term view (buy and hold investors, pension funds, and insurance companies)—often extending beyond the tenure of the existing managers.

Thus, there is a real problem with arguing that the purpose of business is to maximize shareholder returns: Which shareholders should be given priority if they do not all have the same objectives, risk appetites, and time horizons?

Past attempts to align the interests of managers and owners had two components:

1. Granting management stock options on the grounds that getting and keeping the stock price high is a good proxy for maximizing returns to shareholders.
2. Maximizing the amount of debt and minimizing the amount of equity so that shareholders get a higher return on the equity they do provide through the effects of leverage.

Each component created its own problems. Stock options did not in fact work out the way they were supposed to.[3] They often became one-way bets for management (discussed in Chapter 7). Moreover, keeping the share price high by artificially boosting it through share buybacks rewarded management for doing nothing to create long-term value. There is another unintended consequence of stock options and the associated need for management to keep the short-term stock price up: Management may not invest in the R&D or technology essential to the long-term future of the firm if it means missing quarterly results expected by analysts.

Research done by Duke University in the United States[4] makes the point powerfully:

- Seventy-eight percent of managers were prepared to sacrifice shareholder value to smooth earnings.
- Eighty percent would decrease discretionary spending on R&D or advertising and maintenance to meet an earnings target.
- Fifty-five percent would not embark on an obviously profitable project if it meant missing the consensus earning target in the current quarter.

The second component—increasing leverage—was particularly dangerous for banks. Anything that reduces the equity base of the business makes the bank more vulnerable to liquidity crunches where the balance sheet can literally disappear overnight, as happened in the United States to Bear Stearns and Lehman Brothers in 2008 and Long Term Capital Management in 1998 and in the United Kingdom to Royal Bank of Scotland in 2008 and Northern Rock in 2007.

Stock options incentivize management to maximize the return on equity (ROE) as this pushes up the share price. Maximizing ROE can be achieved in one of two ways: increase the returns numerator or reduce the equity denominator. Consequently stock options could have the perverse effect of causing management to destroy long-term value by reducing a bank's ability to withstand liquidity crunches as a result of reducing the equity denominator to increase ROE.

The problem can be resolved if we redefine the issue as reconciling the needs of the owners and management by creating sustainable value. By thinking in terms of how to create sustainable value together, instead of arguing about where they should stand on the risk-adjusted continuum, both parties can actually produce a solution of greater value for both parties. This is shown in Figure 9.2 where both parties are able to move outwards and upwards on the diagram beyond the boundary set by the risk-adjusted conflict continuum to create value that is both greater and sustainable.

Keeping Great Leaders Great

It is always difficult to tell a leader who has proved to be successful time and again, against the odds, that perhaps, this time, he or she is wrong. It is almost impossible, if there are no formal systems of checks and balances designed to ensure there is a process of constructive challenge of decisions being taken, before it is too late. It is even more difficult because both the leader and followers come to believe in the leader's superior wisdom or

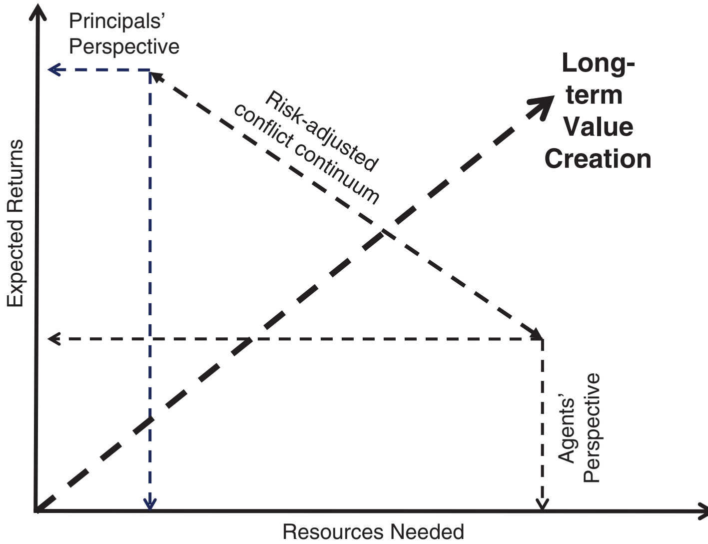

FIGURE 9.2 Reconciling the Principal-Agent Conflict to Create Sustainable Value
Source: J Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur, April 2013.

genius. It may then become dangerous or even career-threatening to query the judgment of such a leader, who:

- Is used to being right.
- Has a track record to prove it.
- Demands loyalty and obedience from his or her followers.

In Chapter 2, I discussed how apparently great leaders of banks ended up destroying value because there were insufficient checks and balances to protect them from themselves. The role of corporate governance is to provide effective checks and balances on "imperial CEOs." How this is achieved is dealt with later in the chapter when I discuss the roles of the three components of good governance.

Failures of Governance Are Expensive

Failures of corporate governance in banks matter because they are very expensive and have the potential to trigger financial crises that damage entire economies and societies. They really matter, which is why we need to find the right governance solutions to try to reduce the likelihood of them happening again.

It is worthwhile putting the cost of corporate governance failures into some kind of context by comparing them with the greatest natural disasters of recent years. What is surprising is that our ability to destroy value through failures of governance far exceeds the ability of nature to do the same, as can be seen in Table 9.1.

As can be seen from Table 9.1, the failure of Lehman Brothers alone destroyed more value than the five worst natural disasters in history combined! Moreover, the loss of value shown in Table 9.1 does not include the value lost on the additional US$1.2 trillion lent secretly by the Federal Reserve at a less than third of the interest charged by the banks to support the top-tier banks after the Lehman collapse.[5] Clearly we can no longer argue that good governance is too expensive and that we should seek to cut the costs of governance. Corporate governance is like insurance: We pay a premium to protect us from the downside; we do not seek to profit from it.

Distributing Wealth Creation Equitably

A key regulatory concern of good governance is how equitably the wealth created by the business is distributed to shareholders. As a result, much of the focus of governance regulation is on how to deal with the money once it has been made. The regulations pay attention to accuracy of reporting, its timeliness and frequency in an attempt to maximize transparency so that the minority, or "outsider," shareholders are not at a disadvantage when compared with majority or controlling insider shareholders. Every attempt is

TABLE 9.1 Ability to Destroy Value Compared

Failures of Corporate Governance	Cost $billions	Natural Disasters	Cost $billions
Lehman Brothers	691.1	Tohoku Earthquake (Japan)	210
Washington Mutual	328.9	Sichuan Earthquake (China)	147
AIG*	170.0	Hurricane Katrina (U.S.)	144
WorldCom	103.9	Northridge Earthquake (U.S.)	43
Enron	63.4	Hurricane Andrew (U.S.)	41
Total	1,357.3	Total	585

*US$ 170 billion was injected into AIG to prevent it going bankrupt. From Brian Wingfield, "Bankruptcy for AIG" (2009). Accessed November 24, 2012, www.forbes.com/2009/03/19/aig-bankruptcy-business-washington-aig.html.

Source: BankruptcyData.com, based on Securities and Exchange Commission filings, quoted by PwC in Non-Executive Directors Development training programs, entitled "Is It Worth the Risk," held in Kuala Lumpur, Malaysia, over the period 2008–2010; www.huffingtonpost.com/2012/03/10/japan-disaster-cost_n_1335250.html.

made to create a level playing field between the different types of shareholder on the basis of "One Share, One Vote." Thus the OECD Principles which are the foundations of codes around the world make it quite clear that equitable treatment must be the basis on which ownership rights are allocated:[6]

- Within any class of shares all owners have equal rights.
- Minority shareholders must be protected from abusive actions.
- Votes should be cast by nominees or custodians in the way agreed with the beneficial owners.
- Cross-border voting should be facilitated.
- Vote casting at AGMs should be made easy and allow all shareholders to be treated equally.
- Insider trading and self-dealing are not allowed.
- Board members and key executives must disclose any conflicts of interest they have as a result of any relationships they have with third parties.

THREE COMPONENTS OF GOOD GOVERNANCE

Good governance is achieved by the interaction of self-discipline, market discipline, and regulatory discipline, where the role of regulatory discipline is to make good any shortfalls in the first two disciplines. Of the three, by far the most important is self-discipline. In theory, market discipline was supposed to be the next most important, but market failures to prevent lapses of governance in financial services in the recent financial crisis have undermined its significance, leaving regulatory discipline to take up the slack—hence the push for new regulation of financial services around the world.

Self-Discipline

What is meant by self-discipline in a bank? It covers the following.

- *An ethical foundation to the business:*
  - What businesses the bank chooses to lend to and the types of business it is not prepared to do matter greatly. Banks have come under consistent attack since 2009 for forgetting that they have a wider economic function than just maximizing shareholder returns.[7] Bank Boards and CEOs must remember that banks are a public good as well as being private entities and therefore cannot be treated as private property in the way vested interests in Wall Street and London have tried to argue. This is even truer if they are "too big to fail." If they are "too big to fail," everybody has an interest in their success

and survival. They should therefore be treated as regulated utilities in which the government has a legitimate interest, as opposed to private entities designed to maximize shareholder value.

- *How the bank conducts its business:*

  Going forward, bank Boards must recognize that they need to change quite drastically how they do business, if they are to regain the trust of people: "Trust in banks and bankers has eroded. Three factors explain that collapse: people have come to doubt the economic benefits of financial liberalisation and of much banking activity; they doubt banks' values; and they doubt whether banks have their interests at heart."[8]

  But it is not just that people are affected by the three factors just mentioned. It is also the fact that commentators are beginning to seriously question whether the model itself is the problem, as is shown by the following quotation from the *Financial Times* when commenting on UBS's announcement that it was cutting 10,000 jobs and getting out of investment banking:[9] "It is telling that news of UBS's withdrawal [from investment banking] precipitated a strong rally in its shares."

  While this may well be true, what the article did not mention is that it does not just require a "real change of heart and expectation" in bankers, but also in their shareholders and their demands of bank Boards in terms of expected returns. As James Gorman, CEO of Morgan Stanley put it so well in his interview with the *Financial Times,* the expected returns have changed dramatically as a result of deleveraging investment banks: "The first test is do you believe an institution can get back to its cost of capital. We're generating 5 per cent. Can we get back to 10 per cent?"[10]

- *A good system of governance* defined as a system of stewardship and control to guide the bank in fulfilling its long-term economic, moral, and social obligations toward its stakeholders. It is a system of direction and control using rules, performance standards, and guidelines. The Board and senior management are responsible for ensuring that the leadership "tone at the top" focuses on reconciling long-term customer satisfaction and protection of depositors or policyholders with shareholder value to the benefit of all stakeholders.

  As Lord Turner points out,[11] the failure in the "tone at the top" in dealing rooms is not new. It is, however, more marked because of the sheer size of the financial services sector, which is new; and so much of the sector is about trading in derivatives and other opaque products that actually do not serve the economy as a whole. The public was sold the argument that a vibrant finance sector many times larger than the needs of

the real economy was good for everybody. They discovered that this was not true, so the manifest failures of "tone at the top" created a furious backlash, at least in the United Kingdom, where it followed a long period of egregious mis-selling of products to customers that they did not need.

So the collapse of trust in bankers which led to the 'Banksters' headline [in The Economist] is the product of three factors.

- *A story of beneficial economic impact which turned out to be untrue.*
- *Poor values and malpractice able to operate on an increasing scale.*
- *And direct consumer experience of exploitative product sales.*[12]

It is therefore essential that the "tone at the top" and the resulting culture in banks be changed if trust is to be restored. It is not surprising then that so much of the critical commentary following the Barclays LIBOR scandal in 2012 should focus on the values of the CEO and issues of inappropriate culture from an investment banking background contaminating the more staid and responsible cultures of retail and commercial banks.[13]

Boards must ensure that they are effective custodians of the bank's values and culture:

Values and culture should be seen as the ultimate software that determines the behaviors of people throughout the FI and the effectiveness of its governance arrangements. The fact that the quality of embedded values and culture cannot readily be measured does not detract in any way from their critical significance. Boards, management, supervisors, and shareholders must be continuously and proactively attentive to the maintenance and reinforcement of values and cultures that lead to safe, sound, innovative, ethical, and high performing FIs.[14]

- Management works within agreed limits set by the Board through the operational self-discipline agreed by the Board with the CEO, shown in Table 9.2.[15]

When considering revising the Malaysian Code on Corporate Governance in 2011 following the Global Financial Crisis, the Malaysian Securities Commission working party realized that problems of governance could be resolved if the right people with the right skills and right ethical standards were chosen as Directors of Boards, CEOs, and Chairmen.[16] When the revised code came out in March 2012, a key recommendation

was to mandate the establishment of nomination committees on all Boards of public listed companies.[17] The right ethical standards would ensure:

- The company's business purpose would be socially responsible.
- The company would have an ethical code of conduct, ensuring that it did not promote unethical behavior and at a minimum complied with all applicable laws.

TABLE 9.2 CEO Self-Discipline Agreed by the Board

CEO Self-Discipline Overall
"The CEO must not let the company and its representatives act in illegal or risky ways, or violate commonly accepted business and professional ethics."

CEO Self-Discipline Regarding:

1. *Treatment of Customers*
   "The CEO cannot allow the company to operate in ways that are unsafe, undignified, unnecessarily intrusive, or that fail to provide appropriate confidentiality or privacy when dealing with customers."
2. *Treatment of Employees*
   "The CEO cannot allow employees to work in conditions that are unfair, undignified, or dangerous."
3. *Financial Planning and Budgeting*
   "Annual financial planning or updates within the year must not differ materially from the Board's priorities regarding the agreed business purpose; must not risk financial failure; or fail to form part of a multiyear plan."
4. *Company Financial Condition and Activities*
   "The CEO must not allow the risk of financial jeopardy or a material deviation of actual expenditures from established Board priorities regarding the company's agreed business purpose."
5. *Emergency Succession Planning*
   "The CEO must have no fewer than two other executives familiar with Board and CEO issues and processes to protect the Board from the sudden and unexpected loss of CEO services."
6. *Asset Protection*
   "The CEO must not allow the tangible and intangible assets to be unprotected, poorly maintained, or needlessly risked."
7. *Compensation and Benefits*
   "The CEO must not allow the financial integrity or reputation of the company to be jeopardized as a result of terms of employment, compensation and benefits to employees, consultants, contract workers, and volunteers."
8. *Communication and Support to the Board*
   "The CEO shall not permit the Board to be uninformed or unsupported in its work."

This need for making ethical behavior the foundation for how Boards look at what banks do, is all the greater because of the unique characteristics of financial services: their greater ability to indulge in pure rent-seeking activities, to exploit customer trust and ignorance, combined with the fact that money seems to have become the only measure of worth in banking.[18]

In most areas of business, people take pride in the quality of the product or service they offer, in having satisfied customers, or in the quality of the relationship they have with their clients. This is in part because in most business activities there really is a win-win answer to reconciling customer and shareholder value. But it is also because it is usually obvious fairly quickly whether a product or service lives up to its promise, whereas in financial services often it is not.

The temptation to exploit the resulting information asymmetry is made greater by the fact that in many cases the originators of products have no direct contact with the buyers or end-users of the products they create. Perhaps the best known example of this was Fabrice Tourre of Goldman Sachs, who sent the following e-mail to his girlfriend, cited in the Congressional hearings investigating Goldman Sachs's Timberwolf and Abacus deals in 2010:

> *When I think that I had some input into the creation of this product (which by the way is a product of pure intellectual masturbation, the type of thing which you invent telling yourself: "Well, what if we created a 'thing,' which has no purpose, which is absolutely conceptual and highly theoretical and which nobody knows how to price?" It sickens the heart to see it shot down in mid-flight, . . .*[19]

Clearly in Fabrice Tourre's case, the products he felt he was creating provided no social benefit and no economic value, either, reinforcing the argument that, in financial services, innovation only created greater opacity and higher fees, unlike other industries where innovation leads to better products at lower prices.[20]

In these circumstances, it becomes critical for Boards to ensure that the culture for which they are responsible does not encourage unethical behavior, because the normal constraints that exist outside financial services do not exist to the same extent in banks. In turn that means a change in the way Boards and senior management respond to apparent success, as Lord Turner points out:

> *What does that mean concretely? Well, the only way to make it concrete is to give specific examples. So let me pose the following questions:*
>
> - *If the top management and board of a retail bank observes that it is making huge profit margins on an ancillary product sold by a*

commission-incentivised sales force: what does it do? Congratulate the sales teams and increase the targets, or ask searching questions about whether the product is truly in consumers' interest, and whether the controls in place to ensure appropriate sales are sufficient to offset the dangers of bias introduced by high margins and commission incentives? If it is serious about values and culture, it has to do the latter: but that's not what happened in most UK retail banks in the case of payment protection insurance.

- *And in an investment bank, if a fancy new product design will enable a corporate or a country to conceal from the market the scale of its indebtedness, or if a trading desk manages to offload a problematic position onto an unsuspecting customer, does the top management and the board say "Congratulations, take a bonus" or does it say, "That's not what we do?"*[21]

The case of Kweku Adoboli, the rogue trader at UBS, reinforces the point. At the age of 26, he was left unsupervised in charge of an ETF desk and its US$50 billion book. In his defense at his trial, he argued that even though there had been an internal memo warning of the fate of Jérome Kerviel, the rogue trader at Société Générale, UBS management asked him to bring in higher profits. This was apparently the result of a push by Oswald Gruebel, who became CEO in 2009 and who said in November 2009, "I'd actually like to see us put more risk on the table." Accordingly risk limits at the ETF desk were increased; punishment for taking excessive risk was weak (Adoboli only was warned about exceeding his limits in January 2011); and his trades verification mechanism was switched off until the activities were exposed. As the article in *The Economist* concluded:

> *Take a smart . . . person, give him billions to play with, push him to make as much money as he can . . . do away with adult supervision . . . a recipe for financial disaster."*[22]

Market Discipline

Believers in free markets have argued that the market will discipline banks that underperform or take unreasonable risks by either selling their shares and thus punishing management whose options would fall in value or by taking over underperforming stocks and terminating the management. Equally, if management performs well, the market will reward managers by buying shares, thus making their options more valuable.

The problem with this approach is that it did not work out as expected for a number of reasons:

- Markets overshoot and undershoot as a result of the herd instinct of market participants motivated by mass greed and mass fear. This means that stocks are likely to rise in a bull market regardless of the effectiveness of the managers; and they fall regardless of how well management tries to counteract the impact of a bear market.
- Investors and analysts often put pressure on management to adopt me-too strategies in their demands that banks should maximize market share and revenue growth by entering market segments for which they are not suited—for example, UBS's entry into investment banking for which they were unprepared and whose risk profile they did not appreciate.[23] Equally, Chuck Prince's justification for exposing Citibank to mortgage-backed securities, whose risks he did not fully understand, was that everyone else was doing it.[24] Even more damaging was the transformation of Countrywide Financial from being a responsible, reputable prime mortgage broker into a subprime broker as a result of the loss of market share to Ameriquest, which was accepting business that Countrywide had turned down as toxic.[25] This was a clear case of the market rewarding bad behavior by Ameriquest and other subprime brokers who were employing unscrupulous methods, funded by Wall Street investors, at Countrywide's expense, signaling to Angelo Mozilo that he had to follow suit, which he then did with devastating results, as he too adopted the deceptive practices he had warned against.[26]
- Forcing good banks to take over banks that were performing badly (e.g., JP Morgan Chase taking over Bear Stearns in the United States[27] or Lloyds Bank taking over HBOS in the United Kingdom) had two unintended consequences:
  - It transferred legacy problems from the failing bank to the successful bank so that JP Morgan Chase is now being sued for mistakes made by Bear Stearns management,[28] or Bank of America after taking over Countrywide.[29] In the case of the United Kingdom, Lloyds was encouraged by Gordon Brown, then the British Prime Minister, to merge with the failing HBOS, creating a crippled bank that had to be partly nationalized to be shored up.[30]
  - It increased further the level of concentration in an industry with too many banks that were deemed "too big to fail." In fact, the very concept of "too big to fail" is an explicit repudiation of the market's ability to discipline bad behavior by management through the creation of a new form of moral hazard on the one hand, and a taxpayer-based

subsidy to the systemically important financial institutions (SIFIs) on the other that creates unfair competition.

Ironically the person most responsible for market failure was the person who believed in free markets most strongly, namely, Alan Greenspan, the chairman of the U.S. Federal Reserve. His, and Ben Bernanke's, policies of keeping interest rates low in order to prevent a stock market driven recession created an asset bubble and forced savers and investors to hunt for yield, pushing banks and financial institutions to take ever bigger risks based on artificially low-priced leverage.

Taking on more leverage improved reported ROE, making CEOs and management look better to investors than they really were. The misleading cosmetic effect of leverage can be seen in Table 9.3. In the case of Banco Santander, had there been no increased leverage, the improvement would have been 90 basis points; in the case of UBS, the improvement would have been 70 basis points; in the case of HSBC, it would have declined slightly; and in the case of Barclays, ROE would have declined by 440 basis points between 2003 and 2006 though they were reporting 23.0 percent ROE. Clearly the safer banks were the ones reporting lower ROE, as was proved to be the case when the crisis hit in 2008. Yet the management would be better rewarded by the shareholders of UBS and Barclays because of the higher ROE, achieved by putting at risk the long-term existence of the banks.

In effect, the market signaled to CEOs that short-term ROE was what mattered; this was reinforced by the fact that CEOs were rewarded on that basis, creating perverse incentives to go for reckless growth, shown in Figure 9.3.

Perhaps it was the short-termism of many shareholders, combined with unrealistic expectations of growth in revenue and earnings that led to investors totally ignoring the importance of systemic stability that regulators and depositors required. The average time for holding a stock on the New York Stock Exchange has fallen from eight years in the 1960s to

TABLE 9.3 Cosmetic Effect of Leverage

Bank	Reported ROE 2003	Deleveraged ROE 2006	Leverage effect 2006	Reported ROE 2006
Santander	10.4	11.3	2.6	13.9
UBS	18.0	18.7	4.4	23.1
HSBC	11.8	11.7	2.8	14.5
Barclays	16.7	12.3	10.7	23.0

Source: Nestor Advisors, "Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks" (2009).

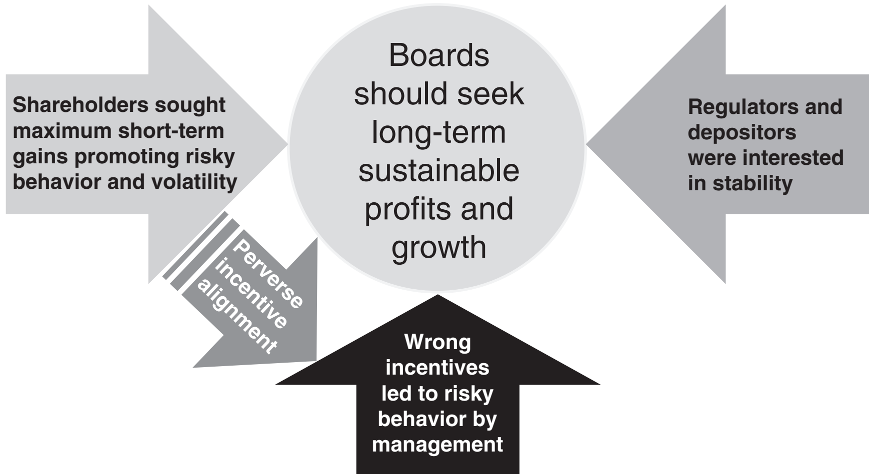

FIGURE 9.3 Bank Boards Chose Reckless Growth Based on Misaligned Incentives
Source: J Zinkin, Corporate Governance program for the Islamic Development Bank in Kuala Lumpur, April 2013.

four months in 2010,[31] so it is hardly surprising that many bank CEOs have focused so much on the short term at the expense of the long-term impact on reputation and systemic stability.

This is particularly unfortunate, as there is some evidence from non-bank stocks that investors are willing to take a long-term view, provided Boards engage with them in the right way. Air Liquide, IBM, L'Oreal, Unilever, and Warren Buffett all now refuse to give earnings guidance to investors or to publish quarterly results, and Google, LinkedIn, and Zynga as well as other tech companies have dual-class voting structures to resist the pressures of short-termism.[32] So perhaps banks could have done the same and avoided creating a house of cards built on unsustainable levels of leverage.

Alan Greenspan, who believed most strongly in the power of free markets, so weakened the price signals that markets are supposed to give that he contributed to the Global Financial Crisis and destroyed his legacy. By exercising the so-called "Greenspan put" after Black Monday in 1987, and again after the bursting of the dotcom bubble and 9/11 in 2001, he prevented an orderly and gradual correction in asset values:

> *The real impact, for investors and for the economy [of Greenspan's action], is to substantially lessen and obscure the price signals that the economy and markets should normally generate.*

> *Crashes, while destructive, tell us things, like, in the case of the housing crash, to stop lending people money they had no hope of paying back to buy houses they could not afford. . . .*
>
> *An economy without feedback from price signals is like a body which can't feel pain, the little things bother you less but the big things may very well kill you.*[33]

As a result, the second pillar of corporate governance, market discipline, failed to reinforce self-discipline, leaving too much responsibility to the third pillar, regulatory discipline, which proved in the event to be a broken reed.

Regulatory Discipline

After 40 years of thinking otherwise, Alan Greenspan was forced to admit that markets do not self-correct and regulation is in fact needed:

> *"I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms," Greenspan said.*
>
> *Referring to his free-market ideology, Greenspan added: "I have found a flaw. . . .*
>
> *"You know, that's precisely the reason I was shocked, because I have been going for 40 years or more with very considerable evidence that it was working exceptionally well."*[34]

Although regulation is clearly essential, there are some very real problems, which must be resolved before it can play the role expected of it. These are caused by:

- Overlaps, underlaps,[35] and turf wars between regulators within given jurisdictions.
- Regulatory arbitrage between jurisdictions—often the result of principles based versus rules based approaches to regulation.
- Inadequate sanctions and penalties for malfeasance destroying shareholder value.

OVERLAPS, UNDERLAPS, AND TURF WARS

In both the United States and the United Kingdom problems have been caused by the financial services industry being regulated by more than one body; by the rise of shadow banking that was not regulated at all; and destructive turf wars between regulators.

In the United Kingdom, for example, there was a dangerous institutional "underlap" between an inflation-targeting central bank (Bank of England) and a rules-driven regulator (FSA), with no one responsible for assessing the big picture risks, or equipped with tools to address them.[36] The failure of Northern Rock in 2007 has been largely attributed to a slow reaction by the Bank of England and weak oversight by the FSA[37] as a result of an inappropriate regulatory architecture, restricting the Bank of England's role to promoting financial stability and leaving bank regulation to the FSA, so that there was no effective mechanism for dealing quickly with a banking collapse, where time is of the essence.[38]

In the United States in 2009, the problem of turf wars and philosophical disagreements between the FDIC and Treasury[39] as well as the FDIC, the Fed, and the OCC[40] was made more serious by the fact that not merely were there different regulators at the federal level with different perspectives of the crisis because they had different constituencies to protect,[41] but there were issues of federal versus state responsibility for regulation, too. Added to this toxic brew was the fact that the shadow banking system was not regulated, and yet this was where the problems of excessive leverage and the resulting liquidity crunch originated. Fuel was added to the flames by new types of unregulated mortgage lending that allowed subprime to spiral out of control.[42]

The final straw was the uncoordinated response of the UK and U.S. regulators to the collapse of Lehman Brothers, where different laws regarding bankruptcy led to the UK regulators seizing Lehman Brothers' UK assets once the bankruptcy was announced, paralyzing the market globally as banks no longer knew what their counterparty exposures were.[43]

REGULATORY ARBITRAGE BASED ON DIFFERENT PHILOSOPHIES OF REGULATION

It has been argued that the financial crisis occurred in part because of regulatory arbitrage between London and New York, after the introduction of Sarbanes-Oxley made it too expensive to list in New York, with the suggestion that the "light touch principles-based regulation" practiced in London was at the heart of the bad practices.[44] Yet the opposite case has also been made regarding the problems with rules-based regulation:

> *The greater the number of laws, rules and regulations, the more people ignore the ethical consequences and focus on compliance only. . . .The legalistic culture of the US gives people a strong motive to shuffle off responsibility to others and cover their back.*[45]

Support for this view comes from Sheila Bair, the former FDIC Chair who argues as follows against rules-based regulations:

> *Other types of regulation—those that seek to define the kinds of activity that are allowed and not allowed among market participants—are also important but less effective in my view,… The more regulators try to answer these questions, the more prescriptive the rules become, adding complexity, new opportunities for gaming, and unnecessary constraints on beneficial product innovation. But tell a mortgage lender that whatever lending standard it uses, it will be on the hook for 5 to 10 percent of the losses if the borrower can't afford his adjusted payments, the lender will have economic incentives to resolve these issues on his own in a way that reduces the likelihood that the borrower will default.*[46]

INADEQUATE SANCTIONS AND PENALTIES

Perhaps the most serious weakness in the regulatory architecture in almost every country is that the "punishment does not fit the crime."[47]

White collar crime is difficult to prove, and often seems victimless, though it is not. It is therefore very hard for law enforcement officers to get guilty verdicts. As a result, the U.S. Justice Department and its equivalents in other jurisdictions either go for civil trials, where the burden of proof is less rigorous than in criminal ones, or the regulators settle cases with companies that have misbehaved by fining them, getting them to agree to change their practices, but without admitting guilt or liability. The fines help the regulators finance themselves, but do not protect society or the investors from repeated malfeasance, as the perpetrators do not pay the fines out of their own pockets; the companies pay them. This adds insult to injury in that shareholders pay twice: once for the consequences of the malpractice in a fall in the share price; and again in the fine paid with money that rightfully belongs to them.[48]

In addition, CEOs of banks who have destroyed shareholder value seem to be able to walk away from their failures with enormous payoffs that are almost retirement plans in their own right, reducing their incentive to make sure they do not blow up the bank on their watch. Not merely are they not penalized financially, but they are not sanctioned socially, either. Perhaps the only exception is Fred Goodwin, formerly Sir Fred Goodwin, stripped of his knighthood for having destroyed the venerable Royal Bank of Scotland. But even he was able to keep a pension that was many times greater than

he would have deserved if the bank had not been bailed out by the British government:[49]

Given there are still so few real penalties and sanctions, maybe the best approach is the one advocated by Sheila Bair:

> *Resolution authority, higher capital requirements, risk retention—all are examples of regulatory initiatives that are designed to create the certainty of financial loss if an institution's financial risk taking goes awry. Understanding that they—not taxpayers or consumers—will take losses resulting from their imprudent financial behavior, financial institutions and those who invest in them will have better incentives to curb their risk taking. . . .*
>
> *Risk retention requires securitizers to absorb some percentage of the loss each time a loan they securitized goes bad. Knowing that they will be responsible for future losses, the securitizers will exercise more care in the quality of the loans they securitize.*[50]

THE WAY FORWARD

A great deal of effort has been expended in both the United States and the United Kingdom in correcting these problems, with the United Kingdom perhaps making the most progress, given that the details of Dodd-Frank are still being worked out; and that there is more disagreement about the Volcker Rule in the United States[51] than with the equivalent Vickers Report conclusions in the United Kingdom.[52] The FDIC and the Bank of England are proposing a joint approach to resolving (winding down) globally significant financial institutions (GSFIs) to prevent a repeat of the Lehman Brothers debacle.[53] At least the common elements of the way forward have been agreed as follows:[54]

- The new standards set by Basel III and their increased liquidity requirements.
- Work is now being done to ensure that banks can be resolved and debt that can be bailed in[55] will be a central part of the resolution process.
- The reconfigured UK regulators (following in the footsteps of their Canadian and Australian counterparts who had a good crisis, and the Asian regulators who learned the hard way in the Asian Financial Crisis) have changed their approach to one that focuses on the essentials of leverage, capital and its quality, and liquidity.
- In addition, regulators have come to recognize that even in the wholesale markets their past reliance on *caveat emptor* needs to be

adjusted. Buyers in the wholesale markets have proved to be less sophisticated than assumed, and therefore more prone to unscrupulous sales exploitation. In addition, it must be remembered that there are retail buyers at the end of the financial supply/value chain who need to be protected more than ever as financial innovation leads to greater complexity and opacity.

- Recognition that macro-prudential policies must be in place to counteract the pro-cyclicality of the micro-prudential policies adopted in the past, where measures taken to save only one bank, if applied to all the banks at the same time, would only make the crisis worse.
- The introduction of higher capital buffers, tighter controls on the use of leverage, and setting aside much higher capital against proprietary trading, combined with the reduction in the scope to do proprietary trading (as a result of the Volcker rule in the United States, the Vickers and Liikanen[56] recommendations to ring-fence commercial bank deposits in the United Kingdom and the European Union respectively) will "reduce the scope for malpractice in complex wholesale finance, simply as a by-product of limiting the potential for unnecessary and risky activity overall."[57]
- The ring-fencing solutions being proposed will increase the range of resolution options open to regulators when things go wrong. This has three potential benefits:
  1. Authorities will be able to save the ring-fenced entity and let the rest of the bank fail. This will strengthen market discipline by removing the too-big-to-fail assumptions that allowed banks like Citi to require government intervention time and again to bail them out.[58] This will in turn simplify the structures that have proliferated making such banks too-big-to-manage.
  2. It may protect lending to SMEs if the majority of the loans are within the ring-fenced part of the bank. This could help preserve economic activity in a downswing because the damaging deleveraging would take place in the non-ring-fenced part of the bank.
  3. By splitting the banks into separate operations it will allow management to focus better on providing service excellence to the retail public and thus help with rebuilding trust.

CONCLUSION

The Global Financial Crisis highlighted the essential importance of self-discipline both at a personal level and at a bank level. Markets have been found wanting as an effective form of discipline; as a result, regulatory

discipline has been forced to assume a more prominent role in an attempt to make good the shortfalls in self-discipline and market discipline.

The crisis could have been prevented if the key ingredients of self-discipline had been in place: ethical role modeling by the leaders of banks; personal values and an organizational culture that celebrated customers and long-term sustainable success, as opposed to short-term risk taking and the devil-take-the-hindmost attitude exhibited during subprime; reinforced by systems of compliance reflecting the spirit of regulations rather than by having lawyers advise on how to find ways around them without breaking the law.

Market discipline has been shown not to work, because the signals provided by the market were so distorted by unrealistic investor expectations and the effect of the "Greenspan put" that unsustainably risky behavior was rewarded, regardless of the long-term impact of such actions. This was made worse by leaders of banks appearing to walk away scot free after destroying unparalleled shareholder value, and by the fact that penalties were imposed on the banks' shareholders rather than on the individuals who had caused the harm. Admittedly this may start to change, as a result of Barclays looking to use the bonus pool to pay the fines levied for fixing LIBOR and mis-selling PPI products.[59]

Regulation was also found seriously wanting. A great deal of work has gone into making good the defects of regulation, but unless banking rediscovers the importance of self-discipline both at the individual and organizational level, regulators will still be forced to clean up expensive messes after the fact. Regulatory discipline will only work as "the wise restraints that set men free" to create long-term value, and for this to happen, bank leaders must be willing to recognize the wisdom of the restraints imposed on them and on markets, instead of fighting them.

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"Even in the good times, many corporate executives were not content to float upwards with the rising tide [as markets rose taking share prices up with them]. They found ways to boost their earning—through sham transactions which allowed them to book revenues even if they didn't really have them, or by moving expenses off their books, or by using one-time write-offs (time and again), to try to give the appearance of robust normal profits. Their objective was to create the appearance of alluring success—or, at least of alluring promise—and cash out before the world discovered the truth. Thus did one form of deception give rise to many others." From Joseph Stiglitz, *The Roaring Nineties: Why We're Paying the Price for the Greediest Decade in History* (London: Penguin, 2003), 126.

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CHAPTER 10

Leadership with Governance: Rebuilding Trust in Banks

This chapter summarizes why leadership alone is not enough and what went wrong with governance. It then goes on to suggest what can be done to have the right governance needed to rebuild trust in banks.

To be successful, when relying on others to implement one's ideas and vision, one must be a leader. Napoleon had quite extraordinary leadership skills, and yet his successes did not keep him from failing. The cases of Stan O'Neal, Jimmy Cayne, Dick Fuld, and Fred Goodwin, who all went from great success to total failure, have parallels with the experience of Napoleon. The lesson, from the similarities in the careers of four bankers at the start of the twenty-first century with that of the greatest soldier-administrator of all time 200 years earlier, is that leadership alone is not enough.

LEADERSHIP ALONE IS NOT ENOUGH

Perhaps the biggest challenge in dealing with effective and successful leaders, who start off well, is how to prevent them from becoming great bad leaders and from losing their moral compass. As I showed in Chapters 1 and 2, just five characteristics differentiate great good leaders from great bad leaders:

1. Great good leaders lead through values, whereas great bad leaders lead through fear.
2. This difference allows great good leaders to learn from failure, whereas great bad leaders punish it.
3. To create an environment where people learn from failure, great good leaders welcome the courage to speak truth to power, whereas great bad leaders shoot the messenger.
4. Great good leaders recognize that they must develop co-leaders to multiply the impact of their vision and values by harnessing the energy of

interdependent teams, whereas great bad leaders centralize power and exercise control, becoming bottlenecks for decision making, keeping their subordinates in permanent states of dependence.
5. These differences in approach allow great good leaders to maximize the conditions for long-term collective success, whereas great bad leaders regard themselves as indispensable, treating talented subordinates as competition to be eliminated in their attempt to maximize control.

Three additional characteristics turn great bad leaders (i.e., people who are effective nonetheless) into total failures. These are:

1. *Incompetence:* where leaders and followers lack the skill and/or will to sustain effective action.
2. *Rigidity:* where leaders and followers are stiff and unyielding. Although initially competent, they are unable or unwilling to adapt to new ideas and circumstances and therefore are unable to recognize that their previously successful strategies will lead to failure.
3. *Intemperance:* where the leader lacks self-control and is abetted by followers who allow self-destructive behavior to continue.

GOVERNANCE FAILED

In an ideal world, regulatory discipline should be less important than self-discipline and market discipline. That is the basis of the argument that less regulation is better than more. Unfortunately, the last 25 years have shown that we cannot, in fact, rely on the financial markets to self-regulate, as Alan Greenspan himself admitted in his testimony to Congress.[1] There are two reasons: the failure of both self-discipline and market discipline. Regulatory failures made matters worse.

Why Self-Discipline Failed

By self-discipline, I mean both the self-control of individuals and the system of controls and compliance within each bank, which must be designed to deal with its choice of strategy and attendant portfolio of risks, its business model, and unique culture.

At the Individual Level

There were several reasons for the failure of self-discipline at the individual level.

First, the merger of investment banks with retail banks appears to have allowed the aggressive and narcissistic[2] *investment banking and trading culture to overwhelm the more empathetic and reserved retail banking cultures in institutions where both lines of business existed*. In particular, what seems to have been lost, as a result of the repeal of Glass-Steagall, was empathy: Individuals no longer seemed to care about the consequences of their bonus-driven actions on other people, least of all on their clients.

Second, bonus and rewards are in part to blame, but it also seems that there may have been adverse selection. As Lord Turner pointed out, investment bankers and traders have misbehaved in the past[3] and books like *F.I.A.S.C.O.*[4] and *Liar's Poker*[5] support his view. Indeed, when Michael Lewis wrote *Liar's Poker*, he intended it to be a cautionary tale about Wall Street bad practices. Instead, to his dismay, it became an advertisement for Wall Street, attracting graduates who wanted to enjoy its life-style, regardless of its ethics.[6] Dr. Marcel Rohner, former Group CEO of UBS, gave credence to this view when he termed many of the people in UBS as "mercenaries" in his testimony on LIBOR fixing.[7]

At the Organizational Level

The failure of organizational self-discipline was the result of several factors.

First, there was the failure of Boards to challenge effectively. The Boards of Bear Stearns, Merrill Lynch, Lehman Brothers, UBS, and RBS failed to challenge their CEOs effectively when they were embarking on disastrous strategies. In part, this was because they were beholden to the CEOs who had chosen them. In part, it was because they did not have sufficient knowledge and understanding of the businesses they oversaw to appreciate the risks and recognize the red flags. As the cases of Barclays over LIBOR fixing and HSBC over money laundering demonstrated, it also was a failure by their Boards to inspect the compliance processes that they were reassured were in place. They trusted, but failed to verify. They failed to ensure the right "tone at the top" and reinforce it through appropriate controls for the "tone in the middle." Standard Chartered's Chairman, Sir John Peace, was called to Washington to apologize publicly for calling their money laundering offenses mere "clerical errors."[8]

Second, the global institutions seem to have become too complex to control. What became apparent was that some of the systemically important institutions were not just "too big to fail," but had become too complex to understand and manage. The problems experienced by Barclays,[9] UBS,[10] and HSBC[11] and most recently by JP Morgan Chase[12] all stemmed from failures of internal controls, which allowed people to misbehave or take risks that went badly wrong. This was in large part the result of the repeal of

Glass-Steagall. As my friend and colleague, Youssef Nasr, put it in an e-mail to me:

> *Twenty or thirty years ago a qualified banker was most suited to run a bank. The financial world was much simpler then and the demarcation lines between different types of players were clearer.*
>
> *Then deregulation and globalization [created] a number of huge financial conglomerates.*
>
> *To run such complex entities required top teams equally versed in traditional banking, accounting, legal and deal-making skills among many others (IT and Marketing probably foremost). Since hardly anyone in this world possesses all these skills, the role of Boards and CEOs should have been to ensure equal representation of, and effectiveness of these skills. Trouble came when either Boards shirked their responsibilities, or you had an imperial CEO who did not properly engage his top team to plug gaps in his own understanding of a very complex business.*[13]

Third, maybe the Boards of the global banks did believe unconsciously that they were "too big to jail." The reaction of the big banks to unprecedentedly huge fines was to announce almost immediately after their imposition that they were immaterial, as far as the results were concerned. This is not the behavior of contrite organizations.

Why Market Discipline Failed

As for market discipline, it was found seriously wanting for a number of reasons.

First and foremost, there was a failure in the pricing of risk, resulting from the "Greenspan put." Low interest rates reinforced the desire for yield without signaling strongly enough that higher yield achieved through increased leverage is dangerous—both at the individual bank level and at the systemic level. They also led to serious misallocation of resources, with too much money going into non productive resources, like housing or household consumption. One of the lessons UBS took out of their debacle was that it was a serious strategic error to use low-cost funds from their banking business to grow their investment banking business and that they would not continue doing so.[14]

Second, as a result of investors seeking yield, the signals given to Boards and CEOs was that short-term ROE was of paramount importance. This, combined with the fact the market paid CEOs on their ability to raise ROE, led CEOs to leverage their balance sheets to levels

that were bound to lead to systemic failure, once confidence in the financial house of cards weakened. This was particularly true of some investment banks, once they ceased to be partnerships. The restraint on the risks they took was lifted once they were risking other people's money in their proprietary trades.

Third, following the disaggregation of the financial services value chain, the market rewarded performance of individual parts of the value chain, without considering the impact of that behavior on the value chain as a whole. For example, Countrywide Financial initially resisted financing subprime mortgages, but ended up following Ameriquest and others, who were rewarded by analysts and investors for building market share and short-term profits at Countrywide's expense. As a result it became extremely difficult for Boards and CEOs to avoid herding behavior and the tragedy of the commons that followed.

Fourth, markets are irrational: They overshoot on the way up and on the way down. On the way up in a bubble, they promote greed and destroy one of the values on which capitalism is based: deferred gratification. On the way down, they destroy the other two: mutuality and trust, as everybody rushes for the exit. What the Global Financial Crisis reminds us is that society cannot allow market forces alone to dictate how we live and what we value; markets serve society, not the other way around.

Why Regulatory Discipline Failed

Regulatory discipline failed for several reasons.

First, the market deregulated because of invalid assumptions about the motivations of individuals within banks and the role of the market in controlling risky behavior. Regulators, like Alan Greenspan, believed that bankers could be relied on to do the right thing. As he admitted, he was wrong.

Second, the scope for mistakes and uncontrolled risky behavior was much greater once Glass-Steagall was repealed. Its repeal was designed to create best of both worlds banks by marrying the cultures of investment banking and traditional banking. It failed, creating "too big to fail," "too big to manage," or "too big to jail"[15] banks instead. In large part this was the result of cultural incompatibility (hinted at by Lord Lawson during his cross-examination of the UBS Investment Bank CEOs[16]), manifested in the people who rose to the top and the resulting clash of values.

Third, and most worrying, is the TBTJ phenomenon—a term coined by Neil Barofsky—also known as the Geithner Doctrine, which appears to condone bad behavior if criminal prosecution were to create a systemic risk.[17] This new form of moral hazard has been recognized by Eric Holder,

the U.S. Attorney General, in his testimony to the U.S. Senate Judiciary Committee:

> *"I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute—if we do bring a criminal charge—it will have a negative impact on the national economy, perhaps even the world economy."*[18]

Fourth, regulatory discipline also failed because of turf wars between regulators within the United States and between jurisdictions. If there had been proper coordination between the U.S. and the UK regulators, the catastrophic disruption caused by the failure of Lehman Brothers might have been avoided.

Fifth and most important of all, it failed because much of shadow banking was not regulated at all. Regulators failed to appreciate the risk of contagion from the shadow banking sector to the banking sector—in particular, the risk posed by AIG's Financial Services Group Credit Default Swap business.

WHAT IS NEEDED TO REBUILD TRUST

The challenge posed by the need to rebuild trust is greater than ever. This is not because people have suddenly started to misbehave, whereas they never did before. It is greater because of two things:

1. The sheer size of the modern financial services industry and its ability to do systemic harm.
2. The public no longer believes the claims made for the value provided to society as a whole by many of its innovations, which were used to justify excessive pay.[19]

As a result, the anger directed at financial services is unlikely to disappear until the public is convinced that there has been real change in individual, personal self-discipline.

For this to happen, there has to be a change in organizational self-discipline, with enhanced compliance, enforced codes of conduct with a "no broken windows" approach to failures to adhere to them. However, to prevent the culture from becoming so rigid it cannot change because of a "no broken windows" approach to compliance, leaders must be able to step back and promote the diversity of thinking that fosters experimentation

and innovation. The difficulty then is to reconcile experimentation and the resulting mistakes with a culture of "no broken windows"—so often interpreted as meaning getting it right first time only. It is the role of the Board to help management reconcile these two apparently conflicting perspectives. This can only be achieved if we have effective Boards that are able to challenge management constructively.

Boards Must Challenge Management Constructively

Although it is the role of the Board to encourage diverse perspectives, this often proves to be more difficult than expected because of personalities, group dynamics, and sheer lack of appropriate expertise in the Board. Alfred Sloan solved the problem in part by challenging his Board to think of reasons why they disagreed with decisions they had already approved.

Perhaps the first challenge that is needed in today's environment is for Directors to revisit the basic purpose of the banks on whose Boards they sit. This requires them to:

- Ensure an ethical foundation for doing business, which energizes employees and creates a social acceptance of a values-based business purpose, thereby safeguarding the bank's long-term "license to operate." One of the major criticisms of banking in the twenty-first century has been that many of the products created serve little useful social purpose.[20] Added to this criticism is a further criticism about the kind of people who entered banking. They have been accused of being overly self-centered and narcissistic,[21] allowing them to become too far removed from the world of the people they are supposed to be serving, which helps explain why they ignored systemic integrity and created the subprime crisis.

  If more Boards had challenged their management by asking them what difference they wanted to make in the lives of their clients, and had thought about the value they were creating for their customers and for society as a whole, instead of focusing on short-term commission and bonus, banks might not be facing the reputational challenge they have today.

  Building an ethical foundation to the business requires Boards and the top management to focus on:
  - "Purpose": Boards must be able to answer the questions about why the bank exists, what difference it is trying to make in the lives of its beneficiaries, and how much value it can create for them. As part of answering these questions, Boards must also consider whether society,

as a whole, approves of what is being proposed, not just now, but in the future, lest the bank's "license to operate" be jeopardized. The role of banks in our society needs to be reexamined. This is a point made by both Lord Turner[22] and by Stephen Hester, the outgoing CEO of RBS,[23] in their different ways.

Boards must ensure banks rediscover the importance of the customer and of serving the customer well by creating fit-for-purpose products and services that reflect real customer needs rather than being an excuse for maximizing information asymmetry and opacity in the name of financial innovation.

Mark Carney, the new Governor of the Bank of England makes the same point more forcefully in an interview with BBC Radio 4, and as Governor of the Bank of England there is some hope, his view will make a difference:

"I think finance can absolutely play a socially useful and an economically useful function but what it needs in order to do so, the focus has to be, of the financier, the people working in the banking system, has to be on the real economy, what it does for businesses making investment, what ultimately it means for jobs in the economy.

And it's the loss of that focus, it's finance that becomes disconnected from the economy, from society, finance that only talks to itself and deals with each other, that becomes socially useless."[24]

- "Principles": It is above all the responsibility of Boards, working with CEOs, to establish the mission, vision, and values of their bank. This is an exercise that determines what business the bank will do and what business it will avoid. It defines how the bank will operate and how its people will behave toward each other and toward all stakeholders, though most particularly with its customers, without whom there can be no long-term future.

  Done right, defining the "Principles" by which the bank will be run provides the raison d'être of the bank; the line of sight between the bank's mission and every employee's job; the values that engage hearts as well as minds; and makes coming to work an act of empowerment rather than an expression of unwilling drudgery. Adherence to, and personal belief in the bank's "Principles" should be the basis on which employees are recruited, developed, retained, and promoted or terminated.

  There is no one right way to do this, as the bank's mission ought to reflect its unique business opportunities and conditions; its competitive set; its unique risk appetite; its unique historical legacy, including who its stakeholders are; and the demands of public policy on what business it does and how it does it.

Boards need to recognize that whenever a bank acquires a team of producers, acquires branches, or merges with another bank, it is putting its "Principles" at risk, and consequently may be jeopardizing the DNA on which it has depended for its past success.

Part of the reason why the ambition to create banks that were the best of both worlds has failed has been the inadequate recognition by Boards of the threat to the "Principles" that form the cornerstone of what makes a bank unique—who it is and how it does business. Too much attention has been paid to the hard financial benefits (which often fail to materialize) of mergers and acquisitions and not enough to the cultural and people aspects that are shaped by a bank's founding principles. Directors of bank Boards often have longer tenure than the CEOs they oversee; and their independence is valuable precisely because it allows them to step back from the pressures of daily business to ensure that the bank's "Principles" are sound and the source of sustainable success.

- "Processes": Boards must ensure the right processes are in place and being adhered to. Employees are not fools; they follow the examples of the people at the top; and they do what they are paid to do. In other words, the "tone in the middle" reflects the "tone at the top" and often vice versa. Boards, under pressure from shareholders, allowed KPIs to be focused on short-term risk taking, and so, management, quite rationally, took more short-term risks without paying attention to the long-term consequences of their actions. They were not paid to think about the long-term, and, as "mercenaries,"[25] they might not even be in the organization when the longer-term risks materialized, having moved on to another bank for better pay.

Fortunately, some of these points have now been recognized both by Boards and by regulators, including the fact that traders do not make money on their own; they need the backing of the entire bank and its systems and people to work on their behalf.[26]

Rewards therefore should take into account the long-term reputation impact of actions to the point of putting reputation, integrity, and customer satisfaction ahead of profit.[27] More radical still, is the proposal that the fines paid by Barclays should come out of the bonus pool[28] linking directly for the first time malfeasance to the take-home pay of the individuals who had transgressed. This is an approach being considered by RBS as well.

Perhaps, regulators could make such an approach mandatory, leaving it to the banks in question to work out who should contribute toward paying the fines, based on what they had done wrong and

how badly they had violated the code of conduct, "tone at the top," and "tone in the middle." To Dr. Marcel Rohner's point,[29] it would reflect more accurately the organizational and team support needed for individual success.

In addition to changing how penalties are administered, a significant change in how bankers are paid is necessary. There are encouraging signs that this has been recognized through the actions being taken:

> *Deferment and clawback of bonuses helps rein in the natural risk-taking appetite of traders. . . . A lower compensation ratio will allow them to reward shareholders while strengthening capital by retaining earnings.*[30]

In some banks, CEOs have been able to destroy their company franchises and walk away richer than if they had done their jobs properly. Somehow, Boards must find a way of avoiding signaling that such failure is rewarded, which is a challenge remuneration committees must face.

- "Power": Boards must ensure that the organizational dynamics and the distribution of "Power" sets the right "tone at the top," which reinforces and is reinforced by the "tone in the middle." This must give the Board and top management an alternative frame of reference to short-term profit maximization—a way of checking that neither the organization nor the individuals who work for it are being asked to behave in ways that are unethical, illegal, or too risky.

  Clearly the failures of compliance that have been highlighted in the testimonies of Barclays,[31] HSBC,[32] and UBS[33] suggest that the nature of "Power" in banking hierarchies is such that it has been very difficult for people lower down the organization to escalate malpractices and malfeasance before they become a serious threat to the reputation of the bank. The dramatic resignation of David Bagley, HSBC's chief compliance officer, during testimony to Congress[34] served to highlight the relative powerlessness of the compliance function in the past. If people lower down the organization are to feel unafraid of escalating bad behavior, there must be a shift in the "Power" in the bank from revenue generation to compliance.

  It would appear that HSBC and Barclays, at least, have recognized this past powerlessness and are taking steps to rectify the situation by recruiting very senior players from the Office of Foreign Assets Control (OFAC)[35] and the FSA respectively,[36] who have been given the remit to make good any defects they find. In the case of HSBC, not only have

they hired Robert Werner from OFAC to oversee prevention of financial crime, which has been separated from the rest of compliance,[37] but they have also replaced David Bagley with Ruth Horgan from KPMG, who will be responsible for regulatory compliance. They have also hired Sir Jonathan Evans, ex-head of M.I.5, as a non-executive Director and a member of its Financial System Vulnerabilities Committee to prevent further financial malfeasance.[38] In the case of Barclays, the new CEO has made it clear that protecting the bank's reputation is the most important KPI, giving added to power to Hector Sants formerly Chief Executive of the FSA, his newly hired chief compliance officer.

- "People": Boards must pay more attention to the motivational drivers of people in banks and not just to technical competence. There would appear to be a consensus that traders and investment bankers are quite different people, with different drives, time horizons, and perhaps moral compasses from traditional retail and commercial bankers. Boards need to pay more attention to the people down the organization, as well as to the people at the top—the traditional focus of nomination committees. This is to ensure that the "tone in the middle" does not overwhelm the "tone at the top," especially if new senior management is brought in to clean up a dysfunctional culture.

  When asked, by the UK Parliamentary Banking Standards Committee investigating UBS, what should be done to rebuild confidence in the banking industry,[39] Dr. Marcel Rohner focused on the issue of culture and the problems posed by over-rapid growth through acquisition: The teams who joined tended to be mercenaries, implying they had no real moral compass. As Lord Lawson pointed out, each production team brought with it its own culture, behaviors, and bad habits, which made creating a core culture more difficult especially when running a global bank from the center. Their discussion highlighted the importance of people, their belief systems, and their associated behaviors, not just at the top of the bank, but at all levels.

- Having a professional Board that fulfills its role dutifully, by challenging management constructively, recognizing that no one individual has all the requisite skills to lead a bank in today's world and CEOs have always been fallible. It is therefore the duty of the Board to make good these two imperfections in any CEO.

  For this to happen, bank Directors can no longer treat their positions as sinecures and must be professional in their approach, as opposed to acting as talented amateurs. As the UK's Walker Report[40] made clear, Directors of bank Boards need to spend between 30 and 36 days minimum per directorship in order to spend sufficient time to master the detail needed to be able to challenge constructively.

Directors, however, need to do more than just spend enough time on a bank Board to perform their duty professionally. In Malaysia, for example, which has a tough regulatory regime enforced by Bank Negara Malaysia, as a result, in part, of the lessons learned during the 1998 Asian Financial Crisis, *Directors are expected to undergo a unique program of mandatory training under the aegis of the central bank supervisors, who are able to check whether the training is effective or not as a result of their access to Board minutes and their supervisory engagements with Board members*. The aim of the Financial Institution Directors Education (FIDE) program is not to turn Directors into chief compliance officers, but rather to give them the tools and confidence to challenge management constructively, and so avoid a repeat of the failures of the Lehman or RBS Boards.

In order to ensure there is an adequate pool of professional Directors who are qualified to challenge management constructively, prospective Directors will be expected to undergo between six and eight days training before they are appointed to bank Boards. The topics to be covered include, inter alia, an introduction to corporate governance in banking; ethics in finance; the Director's legal toolkit; and how to read a bank financial statement as a prerequisite to joining a bank Board. Once appointed, Directors are expected to undergo a further eight days of core training in governance and risk management with a requirement to attend additional electives totaling four days of training. These electives are divided into specialist committee electives for members of the various Board committees covering the topics that are of interest to the committees in question. In addition, there is a suite of technical electives in risk management, succession planning, and living wills, for example, for those Directors who want to go deeper.

As a result of the FIDE program, there will be a roster of qualified people who are not just "fit and proper" to be Directors of bank Boards, but who actually have the required skills and training to be able to ask the right questions of management and understand what the answers mean. This will allow them to exercise judgment in challenging CEOs and, as a result, help CEOs avoid mistakes they might otherwise make. As is the case with all professions, this will be supported by a continuous education curriculum for alumni whose topics will be decided by representatives of industry and the central bank to maximize the value of training to industry on the one hand, and to ensure that regulatory objectives are satisfied on the other. Bank Directors will be expected, as are accountants or lawyers, to go through a certain number of hours

each year in classroom environments, supplemented by approved seminars and workshops to maintain their qualification to remain a Director of a bank.

The UK Banking Standards Commission's Report *Changing Banking For Good* adopts a similar approach and recommends the professionalization of banking Directors with an appropriate continuous professional development to deal with the complexities they face as Board members.[41]

Boards are going to have to be better qualified, if they are to evaluate effectively the strategies (and their attendant risks) being put before them and discount the personal ambitions of dynamic, charismatic CEOs with past track records of success. They are going to have to master the complexities of risk management and structured products if they are to have a chance of avoiding "black swan" events, and appreciate the fallibility of human judgment, when dealing with randomness, because of the biases we all have.

Boards are going to have to get more involved in ensuring that ethical standards are being maintained, recognizing that ethics are situational and that what seems obviously wrong to a Director may not seem to so obviously wrong to someone lower down the organization because of the pressure not to snitch. This will mean that they will need to pay much greater attention to the integrity of the people that are hired, not just at the top of the bank, but throughout the bank. This in turn will mean that as far as adherence to codes of conduct and values is concerned, they will have to inspect rather than just expect, and that they may have to insist on a "no broken windows" approach to ethics. Equally, Directors will have to have a good understanding of the impact of the reward and recognition systems on behavior, not just at the top of the bank, but throughout, and in particular among the client-facing staff, lest mis-selling of the kind seen in the UK over PPI reappears.

At the same time, Boards will have to be able to reconcile the needs of leaders to have freedom to act, often under pressure, in uncertain conditions, with imperfect information, since risk taking lies at the heart of successful banking. The skill will be to find a way to reconcile the dynamism of leadership, the tolerance of ambiguity that all great leaders have, with the need to ensure leaders remain humble, capable of recognizing that they may be wrong this time, even though they have been right each time before. Only if this can be achieved will leaders be protected from their natural fallibility, while at the same time avoiding being neutered by excessive interference and micro-management.

Need to Reimpose Effective Regulatory Discipline

Regulatory discipline remains essential to make good the shortcomings in self-discipline and the failures of market discipline. A number of actions can be taken to reimpose effective regulatory discipline.

First, perhaps the simplest and most radical solution would be to reinstitute Glass-Steagall and separate the pure banking function from investment banking and securities trading. This would be a return to the regime imposed after the 1929 crash. There are two reasons why this might be sensible:

1. It would recognize the difficulties banks have had in creating a compatible culture in the merged entities, something that both Sandy Weill and John Reed, the architects of the demise of Glass Steagall, appear subsequently to have appreciated.
2. It might reduce the risk of contagion from non-banking financial institutions into the banking function. After all, in 1990, when Drexel Burnham Lambert went bankrupt, the reaction was, in the words of Ira Lee Sorkin of the law firm Squadron, Ellenoff, Plesent & Lehrer: "There's no moral message here; it's business. If (Drexel) goes out, they follow a long line of very fine institutions that have gone out of business over the last 50 years."[42] In other words, investment banks have gone bankrupt before and they will do so again. The reason for this reaction was that the failure of Drexel did not threaten the primary role of banking, which is that "it connects savers and borrowers, investors and users of funds, it allocates capital, it provides payment services, it insures against risk."[43] Had Drexel gone bust after the repeal of Glass-Steagall, the reaction would, I suspect, have been quite different.

Second, the FDIC and the Bank of England are now proposing a joint approach to resolving (winding down) globally significant financial institutions (GSIFIs) to prevent a repeat of the Lehman Brothers debacle.[44] At least, eight common elements of the way forward have been agreed to as follows:[45]

1. The new standards set by Basel III and their increased liquidity requirements.
2. Work is now being done to ensure that banks can be resolved and debt that can be bailed in will be a central part of the resolution process.
3. The reconfigured UK regulators (following in the footsteps of their Canadian and Australian counterparts who had a good crisis, and the Asian regulators who learned the hard way in the Asian financial crisis) have changed their approach to focusing on the essentials of leverage, capital and its quality, and liquidity.

4. There is a realization that even in the wholesale market's past regulatory reliance on *caveat emptor* needs to be adjusted.
5. Recognition that macro-prudential policies must be in place to counteract the pro-cyclicality of the unintended consequences of the global capital and reserving standards adopted in Basel II.
6. The introduction of higher capital buffers, tighter controls on the use of leverage, and the setting aside of much higher capital against proprietary trading, combined with the reduction in the scope to do proprietary trading (as a result of the Volcker rule in the United States, and the Vickers and Liikanen[46] recommendations to ring-fence commercial bank deposits in the United Kingdom and the European Union respectively) will "reduce the scope for malpractice in complex wholesale finance, simply as a by-product of limiting the potential for unnecessary and risky activity overall."[47]
7. Recognition that if banks are going to reduce the riskiness of their business models as a result of regulatory pressure to hold more capital, the only way ROE can be preserved is by tackling the problem of excessively high staff costs. Staff costs will need to fall, either as a result of reduced head count or as a result of changes in the way people are paid.[48]
8. The ring-fencing solutions being proposed will increase the range of resolution options open to regulators when things go wrong. This has three potential benefits:
   a. Authorities will be able to save the ring-fenced entity and let the rest of the bank fail. This will strengthen market discipline by removing the "too big fail" assumptions that allowed banks like Citi to require government intervention time and again to bail them out.[49] This will in turn simplify the structures that have proliferated, making such banks too big to manage.
   b. It may protect lending to SMEs if the majority of the loans are within the ring-fenced part of the bank. This could help preserve economic activity in a downswing because the damaging deleveraging would take place in the non-ring-fenced part of the bank.
   c. By splitting the banks into separate operations it will allow management to focus better on providing service excellence to the retail public and thus help with rebuilding trust.

However, for these suggestions to work as intended, two essential ingredients are:

1. Better communication between regulators accompanied by heightened surveillance and cross-border cooperation.
2. A realization that financial crises and the increased complexity of finance cannot be addressed by making regulation more complex as well, a point made so eloquently by Andrew Haldane at Jackson Hole.[50]

CONCLUSION

To rebuild and maintain our trust in banks, we must have leadership with governance. However, this will require a number of changes in the way the three disciplines of good governance are applied.

Changes in Self-Discipline

At the individual level, the following changes will be needed:

- People who join banks will have to believe that their institutions have a valid social purpose and that they are not just disconnected institutions designed to make money from synthetic structured products that have little or no relevance to the real economy. This may help them become less narcissistic and self-centered.
- Bankers must once again believe that they succeed when their clients succeed rather than trying to make money at their clients' expense.
- Senior bankers and traders will have to recognize that it is no longer socially and politically acceptable to work on the assumption that banks can privatize profits and socialize losses.
  "Too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibility. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making."[51] This allowed them to hide behind what the UK Banking Standards Commission called "The Murder on the Orient Express Defense." As a result, the Commission specifically recommends that a "Senior Persons Regime" replace the Approved Persons Regime to: *"ensure that the key responsibilities within banks are assigned to specific individuals, who are made fully and unambiguously aware of those responsibilities and made to understand that they will be held to account for how they carry them out."*[52]

  At the organizational level, Boards will need to:

- Revisit the basic purpose of their banks to ensure they have an ethical foundation, based on a values-driven purpose that is socially acceptable.
  - They will have to answer questions about why the bank exists: who its beneficiaries are, what difference it makes in their lives, and the returns that can be expected by making that difference.
  - They will have to establish clear and compelling missions, visions, and values that provide motivating lines of sight between individual jobs and the bank's overall purpose.

- Ensure the right processes are in place and verify that they are adhered to, so that:
  - The "tone at the top" is right.
  - It reinforces and is reinforced by the "tone in the middle."
  - The reward and recognition systems promote responsible risk taking and protect the bank's reputation.
- Ensure that the dynamics of power in the bank do not make it impossible for the escalation of failures of compliance.
- Recognize that the staffing strategy of the bank must pay serious attention to the personal values and motives of key employees, as opposed to just focusing on their technical competence and business development or rain-making skills.

To do all the preceding, Directors will have to:

- Have a granular understanding of the business model assumptions, associated risks, and aggregated risks.
- Be able to challenge the assumptions underlying the strategies being proposed.
- Master the complexities of risk management and the impact of structured products on both the bank itself and the customers it has sold them to.
- Be able to reconcile the need for CEOs to be free to take responsible risks while at the same helping to protect them from their human fallibility.
- Become professional Directors who are properly trained to sit on bank Boards as the technical skill and time-related demands made by the four listed responsibilities make the days of the talented amateur numbered.

Changes in Market Discipline

The market will have to come to terms with the fact that banks will no longer be able to make the high apparent ROEs of the past. Investors will need to have more realistic expectations of what profits deposit-taking banks can make and recognize that the high returns they look for are the province of proprietary traders.

The market will also have to change the way it rewards individuals and must find a satisfactory way to link performance to the long-term risk and reputation impact of decisions taken. To deal with the problems created by remuneration, the UK Banking Standards Commission proposed a radical reshaping where *"the main features of the redesign were:*

1. *Much more remuneration to be deferred and, in many cases, for much longer periods of up to 10 years;*

2. *More of that deferred remuneration to be in forms which favour the long-term performance and soundness of the firm, such as bail-in bonds;*
3. *The avoidance of reliance on narrow measures of bank profitability in calculating remuneration, with particular scepticism reserved for return on equity;*
4. *Individual claims on outstanding deferred remuneration to be subject to cancellation in the light of individual or wider misconduct or a downturn in the performance of the bank or a business area;*
5. *Powers to enable deferred remuneration to Senior Persons and licensed individuals, as well as any unvested pension rights and entitlements associated with loss of office, to be cancelled in any case in which a bank requires direct taxpayer support."*[53]

Most important, the market will have to come to terms with the fact that the regulatory agenda has changed and will continue to change as new banking scandals come to light. Light-touch regulation and self-regulation have been discredited in most jurisdictions.

Changes in Regulatory Discipline

From a regulatory perspective the agenda is enormous. Broadly speaking, however, the changes that are required come under three headings:

1. Reinstitute Glass-Steagall or its equivalent to separate deposit taking from securities trading.
2. Develop cross-border resolution regimes to avoid the problems created by the liquidation of Lehman Brothers.
3. Recognize that the market cannot be left to self-regulate and appreciate the role of regulation in allowing markets to function.

In addition, the UK Banking Standards Commission has proposed new and more severe sanctions against Senior Persons:

1. In a case of failure leading to successful enforcement action against a firm, relevant Senior Persons will have to prove that they took all reasonable steps to prevent or mitigate the effects of a specified failing. Failure to do so would lead to possible individual enforcement action, switching the burden of proof away from the regulators;
2. A criminal offense would be established applying to Senior Persons carrying out their professional responsibilities in a reckless manner, which may carry a prison sentence. If convicted, the remuneration received by an individual during the period of reckless behavior should be recoverable through separate civil proceedings.[54]

Reconciling Leadership with Governance

Reconciling leadership with governance is even more important in banking than in other industries for two reasons:

1. Leverage allows banks to grow much faster than other organizations, and deleveraging makes them contract much faster too, exaggerating the impact of errors of judgment because of the sheer speed with which a bank can unravel.
2. When a bank goes bust, it has a systemic impact that a failing razor blade manufacturer or even a General Motors does not have, because of the importance and fragility of bank counterparty confidence.

If we are to rebuild trust in banks, we must have leaders who can articulate the moral and social purpose of banks and demonstrate their relevance in creating a better future for all of us, not just those employed by banks. We must have leaders who have integrity, are capable of setting the right "tone at the top" and reinforcing the "tone in the middle," can provide a line of sight between the bank's mission and the job of every employee, and can be believed when they say that certain forms of behavior will not be tolerated under any circumstances because they violate the bank's values. We have to have leaders who recognize the difficulty of growth through acquisition because of the conflicts of cultures and values that will occur.

We also need Boards who can challenge the assumptions of these leaders to help them make better informed decisions, along the lines of Alfred Sloan, making it clear that both the Board and the CEO are on the same side, in the same boat, and that the failure of the CEO is the failure of the Board. In short, we need the Board to provide the counterpoise, the counterbalance to the dynamism, vision and energy of the CEO to ensure that a "great good leader" does not become a "great bad leader." As we learned in the Global Financial Crisis (GFC), it was not the leaders who failed; it was their governance, which failed to protect them from their own human fallibility.

If we are to trust our banks once more, we need to be sure the new generation of bank leaders have learned the lessons of the GFC:

- They understand they must rediscover a moral purpose for banks.
- They appreciate the fact that the days of privatized profit and socialized losses are over.
- They articulate and emphasize values-based business development.
- They put long-term metrics of sustainable value creation ahead of short-term profit maximization.
- They are able to work with their Boards, instead of marginalizing them, to ensure that proper systems of governance are in place.

- They are exemplars of self-discipline.
- They enforce organizational self-discipline as well.

Only if these conditions are met will we be able to trust banks once more. Otherwise, we will have to resort yet again to heavy and intrusive regulation to make good the failures of self-discipline and the volatility of market discipline.

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