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Center for Financial Institutions Policy



## The Failure of Bank Board Governance

Research Note

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# THE FAILURE OF BANK BOARD GOVERNANCE

*Raj Date and Holly Scott Atallah<sup>1</sup>*

## 1.0 Introduction

The Cambridge Winter Center for Financial Institutions Policy is pleased to present this research note in conjunction with its ongoing research program on banks' regulation and governance.<sup>2</sup>

Over the course of the last several months, global financial regulators have signaled their intent to reduce systemic risk by limiting individual banks' discretion. For example, regulators in both the U.S. and abroad have focused on the need for higher capital requirements, and for more disciplined executive compensation schemes.<sup>3</sup> In general, these new constraints would necessarily reduce the level of free-market discretion traditionally afforded to private sector banks' boards of directors.

At the same time, two large banks that received significant taxpayer assistance -- Citigroup and Bank of America -- have, presumably through some manner of regulatory encouragement, undertaken a profound re-shaping of their boards of directors.

This research note is meant to inform debate on the need for such new constraints on board discretion and composition, by examining more closely the putative failure of bank board governance. In particular, it focuses on (a) evaluating the performance of banks' boards of directors during the build-up to the financial crisis; (b) identifying the likely causes of that performance; and (c) highlighting implications for policymakers.

## 2.0 Executive Summary

In practically any light -- even the most forgiving -- the performance of bank boards of directors during the credit bubble was astonishingly poor.

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<sup>1</sup> Raj Date is the Chairman and Executive Director of the Cambridge Winter Center for Financial Institutions Policy. He is a former McKinsey & Company consultant, bank senior executive, and Wall Street managing director. Holly Scott Atallah is a Cambridge Winter senior contributor. She is a financial consultant for a number of middle-market mid-Atlantic firms, and a former investment banker and hedge fund analyst.

<sup>2</sup> The Cambridge Winter Center is a non-profit, non-partisan think tank focused on fostering a rational, fact-based dialogue on U.S. financial institutions policy. Cambridge Winter does not engage in lobbying activities, nor does it accept fees or other compensation for its services, including the publication of this report. The firm is pursuing three research programs over the course of 2009-10: (1) Sleeping Watchdogs -- Bank Governance and Regulation Before the Fall; (2) Out of the Shadows -- Industry Structure as a Determinant of Financial Services Stability; and (3) Consumer Finance 3.0 -- Crisis, Reform, and the Next Decade of Consumer Lending. This research note is published under the program entitled "Sleeping Watchdogs".

<sup>3</sup> See U.S. Department of the Treasury, Statement by Secretary Geithner at the G-20 Meeting of Finance Ministers and Central Bank Governors, press release TG-277 (September 5, 2009) (focusing especially on capital requirements and compensation reform).

Much recent commentary has focused on the pernicious impact of moral hazard in explaining that poor performance -- that is, that boards made too risky decisions principally because they were maximizing their own bank equity holders' potential upside interests, at the expense of greater systemic downside risk.

Analysis of bank decisions during the credit bubble and the ensuing crisis, though, suggests that bank boards' failures were actually rather more simple, and more profound. Even on decisions relatively unaffected by moral hazard (like decisions regarding banks' own retained loan portfolios), and on decisions taken *after* the magnitude of the real estate asset bubble was clear (like decisions regarding dividend policy during 2007 and 2008), bank boards made systematically bad choices.

In other words, even adjusting for lenses clouded by moral hazard, and even without the benefit of hindsight, bank boards of directors still appear to have made extraordinarily unwise decisions on behalf of the shareholders whose interests they were meant to safeguard.

The problem with bank boards (especially for large banks), it would seem, has been less a problem of "will", and more a problem of "skill". It is true that moral hazard, on the margin, might dampen boards' incentives (that is, their *will*) to make good and tough-minded decisions. But the primary problem during the credit bubble was that bank boards lacked the capabilities, experience, and structural clout (that is, the *skill*) to divine what good and tough-

minded decisions might be in the first place.

Specifically, bank directors are too numerous (so accountability is diffuse, and interactive debate is difficult); too remote from the industry (so its complexity can be beyond their comprehension); too reliant on management (so an independent view on strategic risk is all but impossible); and (surprisingly) too poorly paid (so the prestige of continued bank board membership swamps any financial risk or reward).

An effective reform program could, conceivably, involve changes to positive (compensation) and negative (liability) incentives for bank directors. But, realistically, policy-makers should not expect such changes to solve banks' fundamental governance problem. Even the most perfectly crafted incentives will not change the unfortunate reality that bank directors -- particularly for large banks -- are simply not up to the task of providing a meaningful substantive check on management.

Although the SEC's proposal to ease shareholder nomination of directors might help, a more straightforward approach would be for federal bank regulators to set out more explicit and stringent minimum standards for board composition and capabilities.

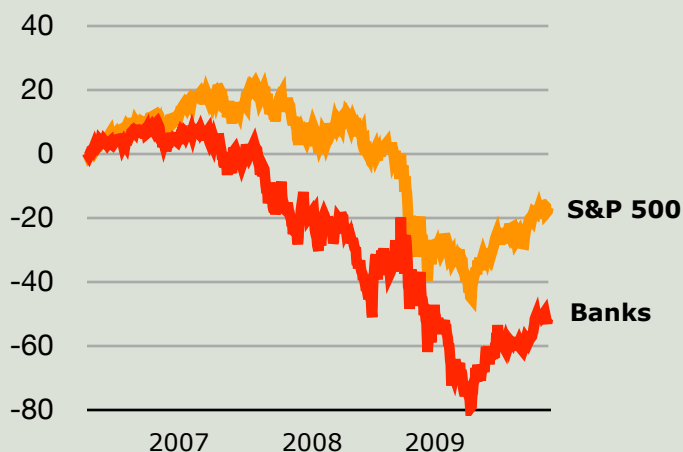
### 3.0 Bank Board Performance

The questions of whether, and how, to reform or constrain bank board governance should, presumably, begin with a threshold inquiry on how bank board governance has functioned under its current structure.

Figure 1

### Total Returns to Shareholders, 9/06-9/09

Percent



Note: Banks is SNL Bank and Thrift Index  
Source: SNL

### 3.1 Shareholder Value Destruction

At first glance, that question appears trivial: on the whole, bank boards have performed quite badly.

Bank directors, like corporate directors more broadly, are meant to govern a bank's activities in ways that, subject to legal and regulatory constraints, maximize shareholders' interests.<sup>4</sup> High-minded aspirations about banks' role in society aside, bank boards' loyalty lies, in the first instance, to shareholders. Definitionally, it is not the job of a bank director to protect the global economy, and it is not his job to

promote employment rates; it is his job to maximize value for bank shareholders.

Through that straightforward lens, bank directors, as a group, have failed quite miserably. Even including the value of dividends, the value of bank stock has been cut in half over the past three years. That performance is some three times as bad as the stock market more broadly. (See Figure 1).

### 3.2 Separating Bad Outcomes from Bad Decisions

Financial underperformance of that magnitude implies that a great many strategic and financial

decisions made by banks during the credit boom ended poorly.

In fairness, though, not every analytically grounded, prudent business decision works out well. All business decisions carry some level of risk, and, at some level, weighing financial risk and return is precisely the purpose of the banking system, and of individual banks. Moreover, because of the oft-cited problem of moral hazard, bank shareholders should actually *prefer* a level of risk-taking that is greater than an unbiased decision-maker, because the adverse impacts of catastrophic outcomes are dispro-

<sup>4</sup> See Office of the Comptroller of the Currency, *The Director's Book: The Role of a National Bank Director* (March 1997) ("OCC Director's Book"), available at <http://www.occ.treas.gov/director.pdf>, accessed October 1, 2009, pages 1-3.

portionately borne by other stakeholders (namely, creditors and the FDIC). Moral hazard of this kind exists in most companies, but it is with banks that moral hazard is most pronounced. Put simply, bank shareholders (more so than, say, manufacturing company shareholders) should quite rationally prefer exaggerated risk levels, because banks are, definitionally, functioning with more borrowed money than are manufacturers.<sup>5</sup>

To understand the quality of board governance during the credit bubble, these two distortions -- the impact of hindsight, and the impact of moral hazard -- must be minimized. A practical way to mute these distortions is to focus on board decisions that (a) impacted banks' own balance sheets (as opposed to, say, decisions that impacted banks' creditors or capital market investors, that therefore would have been muddled by moral hazard); and (b) were made towards the tail end of the credit cycle (that is, at a point it was clear, even at the time, that the credit cycle was clearly turning).

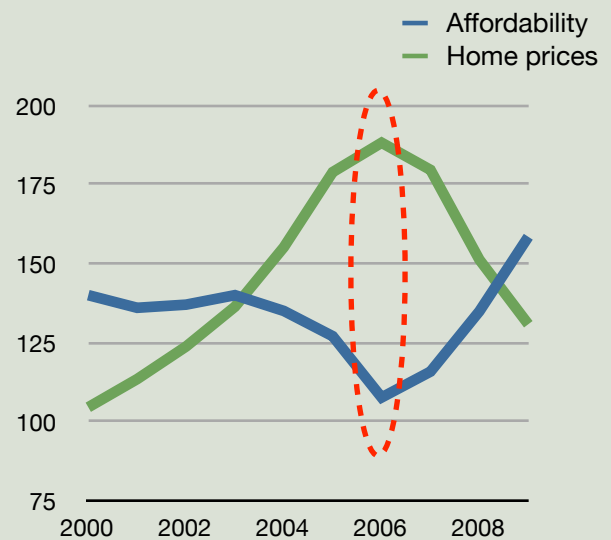
Given the centrality of real estate lending to the the credit crisis, the empirical nadir of housing affordability, in 2006, seems the appropriate point in time on

which to focus. Through 2003, 2004, and even 2005, boards of directors might arguably have missed the symptoms of the real estate asset bubble that was already inflating. But by 2006, and certainly by 2007, even the most inherently optimistic of market observers -- the National Association of Realtors<sup>6</sup> -- had noticed that U.S. home prices had become dramatically less affordable. (See Figure 2).

Figure 2

### Home Price and Affordability Indices

S&P/Case Shiller Index, NAR Home Affordability Index



Source: S&P; National Association of Realtors; Cambridge Winter

<sup>5</sup> See generally Lucian A. Bebchuk, Testimony Before the Committee on Financial Services of the U.S. House of Representatives, Hearing on Compensation Structure and Systemic Risk (June 11, 2009), available at [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/bebchuk.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/bebchuk.pdf).

<sup>6</sup> A variety of metrics have been devised to measure both relative home prices and affordability. Using the National Association of Realtors' metric seems the most conservative (that is, the most deferential to bank boards) in this context, given that the NAR is the largest trade association focused on real estate professionals. See National Association of REALTORS, NAR Fact Sheet, available at [www.realtor.org/press\\_room/public\\_affairs/narfactsheet](http://www.realtor.org/press_room/public_affairs/narfactsheet), accessed September 14, 2009. If anything, given its membership's interests, the NAR would have had an inherent bias to overstate affordability, not understate it, during 2006.

This does not necessarily imply, of course, that any particular bank board of directors did or could know precisely when the credit cycle would turn, or the speed with which conditions would deteriorate. But market data widely available during 2006 strongly suggested that a significant asset price correction was likely, so it would have been fair to expect boards to begin making at least some visible preparation for that eventuality. At minimum, any soundly performing bank board would presumably have begun fortifying its balance sheet -- by reducing credit exposure, and by building up capital.

The question of bank board performance during the bubble, then, can be narrowed to a relatively discrete inquiry: in light of the widely available evidence of a major real estate bubble by 2006, how did bank boards reduce their credit exposures and bolster their capital positions?

### 3.3 Credit Strategy

Examining banks' decisions through that prism, both in aggregate and in specific cases, yields startling results. Perhaps most clearly, bank boards' credit risk tolerance in 2006 appears to have been

bizarrely detached from the on-the-ground realities of the real estate market.

Notably, this appetite for credit risk did not merely translate into more permissive underwriting on loans that were sold into the capital markets. By 2006, it is true that most large banks were participants in the subprime or non-traditional (e.g. stated income, interest-only, option-ARM) mortgage markets. For those most dubious of loans, it was perhaps understandable, or at least predictable, that bank boards would be somewhat cavalier about credit quality. To the extent such loans were sold, in their entirety, through Wall Street investment banks to private-label MBS and CDO investors, then those loans' ultimate credit quality was quite literally someone else's problem.<sup>7</sup>

Far more troubling, from the point of view of bank shareholders, is how bank boards permitted on-balance asset allocation strategies that seemed to ignore the mounting evidence of the asset bubble. As real estate valuations rose well past their historical moorings with fundamental drivers (like, say, household income, or rental prices) during 2004-2006, banks responded

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<sup>7</sup> From a systemic perspective, it is not clear that this was a healthy attitude. Indeed, the Administration and various observers have proposed that originators should hold a continuing economic interest (that is, "skin in the game") in loans that are originated for the securitization markets. See U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation* ("Treasury White Paper"), available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf), accessed September 14, 2009, pages 44-45.

by intentionally *increasing* their exposure to the riskiest of real estate loans: home equity, and construction and development.<sup>8</sup> This dynamic was remarkably consistent across the bank sector, although it manifested itself differently across firms of different sizes.

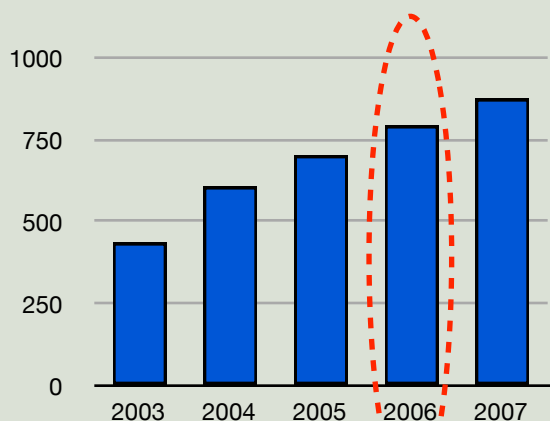
In aggregate, banks nearly doubled their balance sheet exposure to home equity and junior lien residential loans over the course of the credit bubble, and continued to accelerate that risk-taking even into 2006 and 2007. (See Figure 3).

In smaller firms, bank boards permitted strikingly high construction loan concentrations to accumulate. In the years before the crisis, banks with between \$1 and 10 billion in assets (roughly 600 banks in total) doubled their exposure to the construction and development business -- continuing to double down on the asset class despite the clear empirical signs of an residential real estate bubble. (See Figure 4).

Notably, large banks, despite their presumably superior access to market analytics and more expensive talent, made the same types of mistakes, and often in more dramatic fashion. For example, Regions Financial (the very large Alabama-based regional bank) in 2003 held as little as 16%

Figure 3

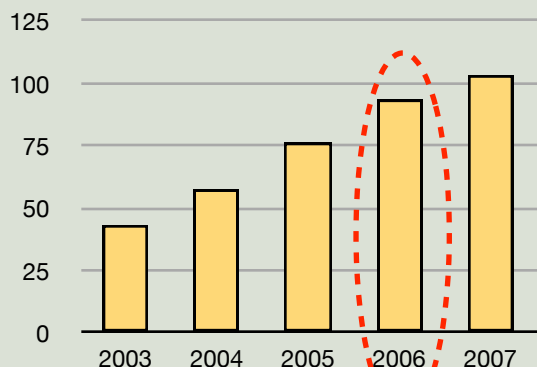
### Bank Home Equity & Junior Lien Loans \$ Billions



Source: FDIC; Cambridge Winter

Figure 4

### Mid-Size Bank Construction & Development Loan Concentration Percent (Loans / Total Risk-Based Capital)



Note: Mid-sized banks are \$1-10 billion in assets  
Source: FDIC; Cambridge Winter

<sup>8</sup> Home equity loans, because they are secured by junior liens to underlying collateral, and construction & development loans, because they are secured by commercial real estate properties that are not yet income-producing, tend to deteriorate quickly in a real estate downturn. Some other real estate-secured assets suffered as much or more during the crisis, but those loans (e.g. subprime mortgages, Alt-A mortgages, option-ARMs) typically found their way from bank or non-bank originators into the capital markets, rather than to bank balance sheets. Home equity loans and construction loans, by contrast, typically were held on bank balance sheets, not securitized.

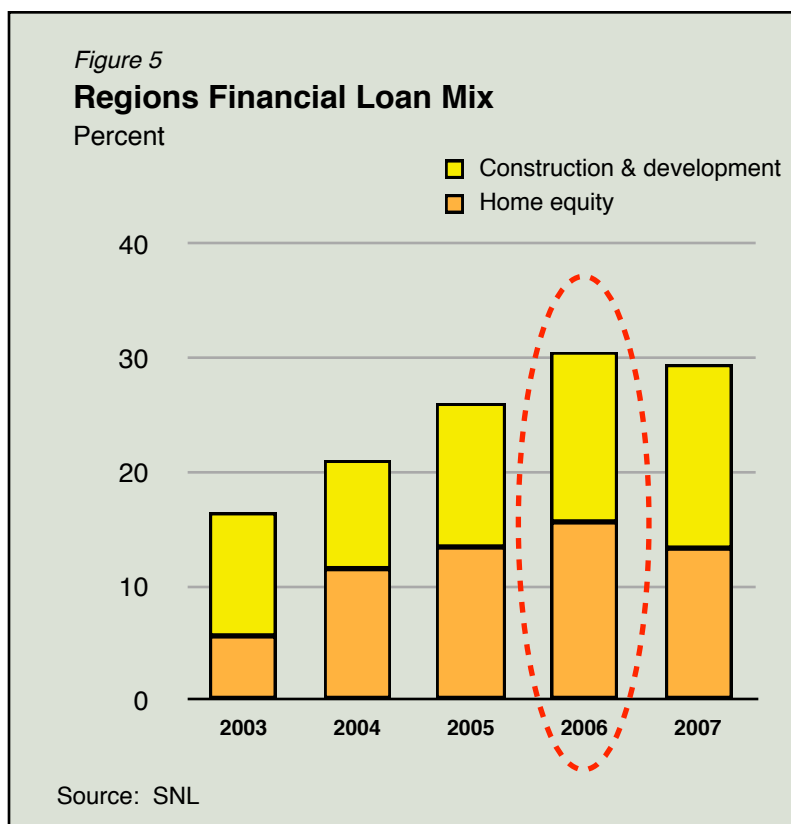
of its loans in home equity and construction and development loans.

Unfortunately, the bank seemed to abandon its conservative stance at precisely the wrong time. By the end of 2006, through a combination of organic and inorganic<sup>9</sup> growth, those two asset classes accounted for some 31% of Regions' loan portfolio. In other words, despite obviously frothy Southeast real estate values, the bank's board allowed the firm to double its exposure to those of its businesses most in the cross-hairs of an eventual real estate correction. (See Figure 5).

### 3.4 Capital Strategy

Bank boards' decisions with respect to capital strategy were, if anything, even more troubling than their decisions on credit risk tolerance.

As discussed above, bank boards of directors (as custodians of shareholders' interests) have a rational bias towards maximizing leverage during most points in the cycle. Shareholders capture the upside of investing borrowed funds at positive spreads, while the downside of catastrophic performance is borne by disproportionately by creditors. This asymmetry is accentuated by the availability of FDIC deposit in-



sure, which enables banks to gather artificially cheap liabilities, despite aggregate leverage that considerably exceeds that of non-financial firms.<sup>10</sup>

During most points in a credit cycle, then, bank boards logically should tend to maximize leverage, subject to the constraints imposed upon them by regulators and rating agencies, which, in theory, should check that unfettered leverage given their roles as stewards of taxpayer and debt investors' interests.

<sup>9</sup> Among other transactions, Regions merged with Memphis-based Union Planters in 2004, and with Birmingham rival AmSouth Bank in 2006. Regions Financial Corp., *Regions History*, available at [http://www.regions.com/about\\_regions/regions\\_history.rf](http://www.regions.com/about_regions/regions_history.rf), accessed October 1, 2009.

<sup>10</sup> Tax-related distortions (namely, the deductibility of debt and deposit interest expense) and implicit government support for non-deposit funding (the "too big to fail" phenomenon) also fuel the bias towards higher leverage. See Douglas J. Elliott, Pew Financial Reform Project, *Briefing Paper #7: Quantifying the Effects on Lending of Increased Capital Requirements* (September 24, 2009), available at [http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic\\_Mobility/Elliott-Capital-final.pdf](http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/Elliott-Capital-final.pdf), accessed October 1, 2009, pages 4-6.

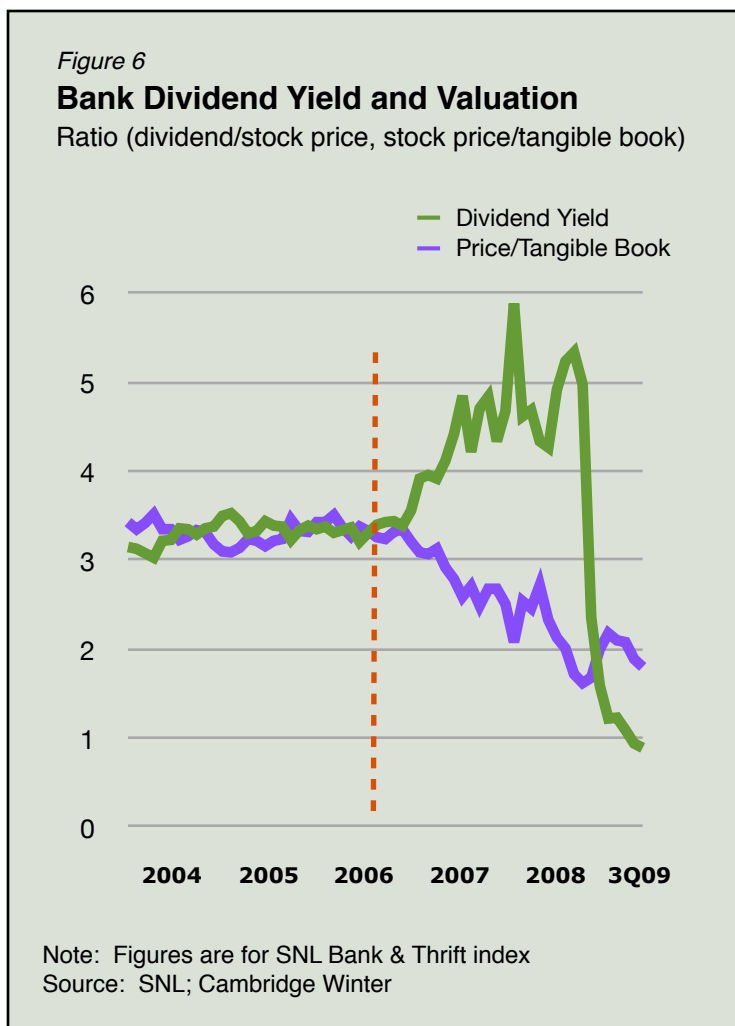
However, that problem of moral hazard among bank boards, which pushes banks towards ever-higher leverage, is mitigated at the tail end of a credit cycle. Because deteriorating credit performance arithmetically must pressure capital ratios, a rational board of directors for a high-leverage bank

should carefully husband capital as the cycle begins to turn. If it did not, then the bank would risk being forced to raise capital (by regulators or rating agencies awakened by suddenly lower capital ratios) *after* the bank's stock has already declined. Such capital-raising, at low stock prices, would be painfully dilutive to existing shareholders.

So to maximize shareholder interests, bank boards should have begun to bolster capital positions when, in 2006, it became clear that asset valuations had reached untenable peaks.

Analysis of banks' capital strategies during 2006, and even 2007, however, suggest that bank boards did almost precisely the opposite: They continued to intentionally erode their own capital positions despite the mounting evidence of a major credit downturn.

Specifically, bank boards authorized three kinds of capital-diminishing strategies. First, banks reduced their aggregate capital ratios (through a combination of stock buy-backs and asset growth). Second, they shifted their mix of capital towards lower-quality forms of capital, and away from common equity.<sup>11</sup> And, third and most surprisingly, banks continued to pay dividends well after the credit crisis was manifest to



<sup>11</sup> Common equity is the highest quality form of capital, because it maximizes all three dimensions of what makes a capital cushion attractive for a creditor or depositor: (1) it is, definitionally, subordinated to all other claims; (2) it is permanent, and therefore does not diminish as conditions deteriorate; and (3) it is not necessarily entitled to any distribution of cash or earnings, so it does not weaken a firm in adverse circumstances. Perhaps belatedly, policy-makers appear to have embraced the uniquely high-quality nature of common equity. See U.S. Department of the Treasury, *Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms* (September 3, 2009). As discussed below, however, irrational dividend policies can severely impair the loss-absorption provided by common equity.

the debt markets, the equity markets, regulators, legislators, and the public at large. As the extent of the residential real estate bubble became obvious in 2006, predictably, bank stock valuation began a steady decline. Nevertheless, bank boards chose to, in aggregate, continue paying dividends all the way until early 2009, driving dividend yields to double their historic levels. Foreclosure trends spiked, Bear Stearns collapsed, Fannie and Freddie were nationalized, Lehman declared bankruptcy -- and, amazingly, banks continued paying dividends. (See Figure 6).

This failure to bolster capital, predictably, worked to the detriment of shareholders. It was not until 2008 and 2009 that bank boards, in general, finally acknowledged the need to raise capital ratios (and, even then, often only at the behest of federal regulators). But by that point, bank share prices had already been severely punished, so the resultant dilutive impact to existing shareholders was far more profound than if boards had exercised better judgment in 2006 and 2007. In effect, bank boards decided to undertake a curious trading strategy with their own stock: buy high, sell low. (See Figure 7).

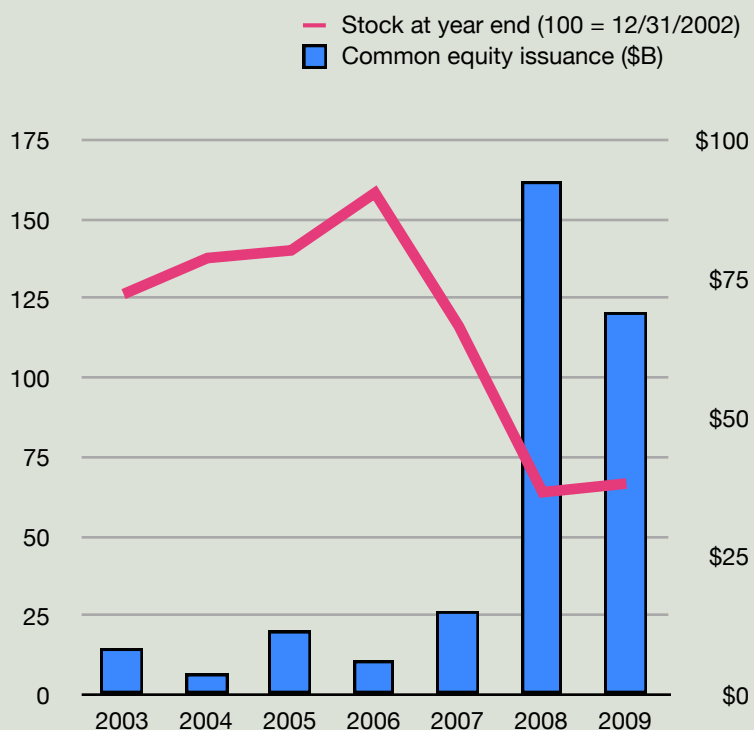
#### 4.0 Causes of Boards' Failures

Targeted analysis of bank credit and capital strategies in 2006 and 2007, then, allows a

Figure 7

### Bank Stock Prices and Equity Issuance

Index, left (stock prices); \$ Billions, right (issuance)



Note: Figures are for SNL Bank & Thrift index  
Source: SNL; Deutsche Bank FIG ECM; Cambridge Winter

perspective on the substantive quality of board governance that is relatively free from the distortions of hindsight and moral hazard.

And that perspective is clear: in aggregate, bank boards made unwise decisions, and the poor quality of those decisions cannot solely be attributed to skewed incentives. If skewed incentives were the only problem, then decisions should have become considerably better in cases where banks were making decisions that primarily im-

pacted shareholders themselves, as opposed to other constituents, like depositors or creditors. But they did not.

Where the incentives -- the "will" -- to make prudent decisions, therefore, is not wholly to blame, then the "skill" required to make good decisions must be a factor. Closer evaluation of bank boards' skills reveals a clear problem: bank boards face governance challenges that are greater than the challenges faced by non-banks; but bank boards typically have capabilities that are no better than non-banks, and quite frequently seem worse.

#### 4.1 The Challenge for Bank Boards

The job of bank boards of directors is not an easy one. Indeed, in three distinct ways, bank boards have a more difficult set


of challenges than their non-financial counterparts.

First, bank directors owe duties not just to shareholders, but also have explicit obligations with respect to regulators and the community. On the margin, this creates additional burdens in terms of interaction costs, as compared to non-banks.<sup>12</sup> It is important not to overstate this point, though; non-banks have a wide variety of non-shareholder constituents as well.

Second, because banks, almost definitionally, operate with considerably higher leverage than non-financials, the possibility that strategic or operational errors result in catastrophic harm is correspondingly higher. Leverage enhances returns to equity holders in benign environments, but

Figure 8

### Bank Board Challenges and Potential Governance Mitigation

CHALLENGE	PROCESS MITIGATION	STRUCTURAL MITIGATION
<b>External constituents</b>	<ul style="list-style-type: none"> <li>Direct Board access to regulators</li> </ul>	
<b>Higher leverage &amp; risk</b>	<ul style="list-style-type: none"> <li>Periodic stress testing on capital, credit, and liquidity</li> <li>Board reporting on risk management</li> </ul>	 <ul style="list-style-type: none"> <li>Directors with financial services expertise</li> <li>Smaller Boards, to encourage debate and point accountability</li> <li>Directors with meaningful financial incentives</li> </ul>
<b>Management capture</b>	<ul style="list-style-type: none"> <li>Direct Board access to line management</li> <li>Direct Board access to audit and risk functions</li> </ul>	

Source: Cambridge Winter

<sup>12</sup> See, e.g., OCC Director's Book, *supra* note 4, pages 43-44 (discussing CRA obligations on national bank boards).

creates less room for error in adverse environments.

Third, bank boards are more subject to the risk of management capture than non-financial boards. Bank balance sheets are notoriously opaque to outside inquiry, because the relative quality of financial assets and liabilities (particularly whole loans and demand deposits) can vary greatly based on highly technical or arcane factors known only to management.<sup>13</sup> As a result, bank boards are almost totally dependent on management to understand the risk-reward tradeoffs inherent in their own balance sheets. At the same time, the greater leverage within banks helps encourage more pronounced moral hazard among management.<sup>14</sup>

The combination of these challenges suggests that, compared to other corporates, bank board governance should be designed to provide a substantively grounded, independent check upon management decisions. In turn, that goal suggests both process-related, and structure-related governance considerations. (See Figure 8).

From an external viewpoint, it is not especially practical to gauge how well specific processes are undertaken by various banks. If anything, though, it would seem banks in general are recognized as having considerably more extensive and formal risk-related processes than non-financial corporates.<sup>15</sup>

It is practical, though, even from an outside perspective, to evaluate how well banks

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<sup>13</sup> For example, consider two banks' credit card portfolios with identical distributions of credit scores, balances, credit lines, and current delinquency rates. The first portfolio was built in large measure through repeated offers of credit line increases in exchange for up-front fees; the second portfolio was not. The first portfolio would be considerably riskier, particularly in a credit downturn, than the second portfolio, because of "adverse selection". Nonetheless, on the face of GAAP accounting and market-standard disclosure, to an outsider, the portfolios appear identical.

<sup>14</sup> There is arguably a fourth, more nuanced, special challenge faced by bank boards. Banks lack two forms of market-based discipline that exist for non-banks: at-risk debt investors (because so much of banks' funding comes through FDIC-insured deposits), and activist equity investors (because the Bank Holding Company Act severely restricts control investments by typical hedge funds or private equity firms). Certainly, in the abstract, the absence of such tension enables bank boards more freedom to aggressively pursue shareholder interests. But, in reality, the absence of those market-based checks can enable very large strategic blunders by bank boards -- in a peculiar way, bank boards are operating without a net. Of course, regulators provide a constraint on bank board decisions -- but regulators are not a market-based force, and they are necessarily constrained in both analytical bandwidth and the vagaries of budgetary resources.

<sup>15</sup> See Andre Brodeur and Gunnar Pritsch, *Making Risk Management a Value-Adding Function in the Boardroom*, McKinsey & Company (September 2008).

have adopted structural risk mitigation features that relate to board governance -- that is, whether (1) bank boards include outside directors with pre-existing financial services expertise; (2) bank boards are small enough to enable robust dialogue and point accountability; and (3) director compensation is sufficient to warrant credible substantive engagement.

## 4.2 Financial Services Expertise

The first structural attribute -- outside directors with financial services expertise -- would seem a relatively straightforward way to reduce the probability that biased (or even simply incompetent) management teams would lead a bank towards imprudently great leverage, liquidity risk, or credit risk.

Given the consolidation in the U.S. banking market, analyzing the composition of the largest banks' boards provides a reasonable perspective on how well this structural safeguard has been employed. In any event, given that smaller banks' business models tend to be rather simpler than

<sup>16</sup> Smaller banks tend to be significantly more concentrated in traditional spread-generating lending businesses, as opposed to fee-generating asset management, capital markets or processing businesses. See FDIC, *Quarterly Banking Profile Graph Book* (2Q09), pages 10-11.

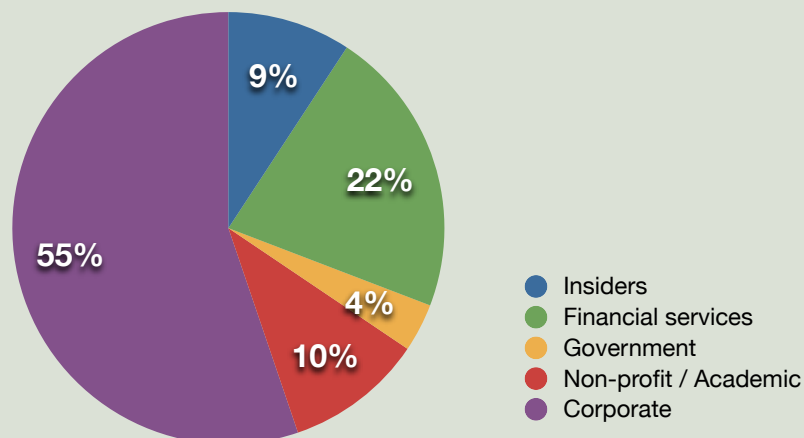
<sup>17</sup> The sample is the same as the 19 banks selected for federal banking regulators' "stress tests" on capital positions, but without MetLife (because it is principally an insurance company) and GMAC (because of its tangled ownership structure): AXP, BAC, BBT, BK, C, COF, FITB, GS, JPM, KEY, MS, PNC, RF, STI, STT, USB, and WFC.

Figure 9

### Average Large Bank Board Composition

Percent, Number of Directors

100% = 237 Directors



Note: Includes AXP, BAC, BBT, BK, C, COF, FITB, GS, JPM, KEY, MS, PNC, RF, STI, STT, USB, WFC

Source: SEC filings; Cambridge Winter

those of larger firms<sup>16</sup>, the need for small bank directors to have pre-existing technical expertise is, arguably, less pronounced.

Surprisingly, the boards of the largest banks -- the 17 largest bank holding companies<sup>17</sup> -- consist, on average, of only 22% outside directors with financial services experience. Indeed, even including insiders, less than a third of large bank directors, on average, have any meaningful financial services experience away from their roles as directors. (See Figure 9).

Given the seemingly obvious benefits of financial services expertise for a bank board of directors, it is worthwhile to reflect on what causes such facially suboptimal board composition among large banks.

Large banks in the U.S., in general, have been cobbled together through years of M&A-driven consolidation. Absent any exogenous force, then, it would be reasonable to expect that large bank boards would not look especially different than small bank boards. Given the inertia that generally characterizes director nominations, shareholders themselves virtually never create such an exogenous force for change.<sup>18</sup>

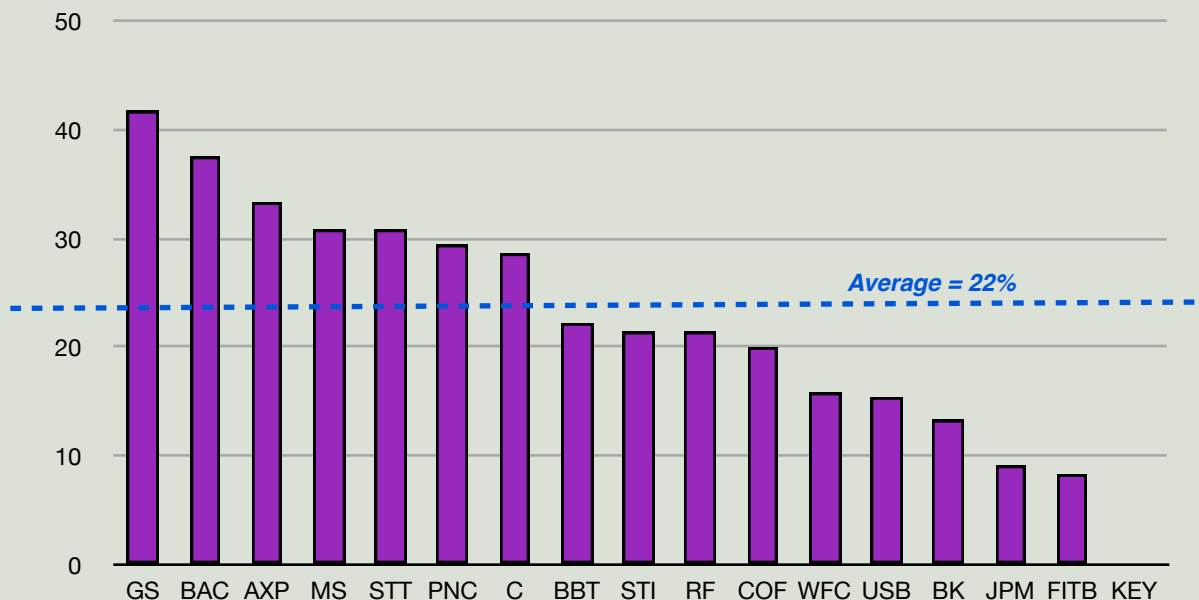
The result of this inertia is striking: large banks, despite the breadth and complexity of their business models, still retain boards of directors that are mostly amateurs in financial services.

Of course, averages can be deceiving, and it is in fact true that there is variance among large banks in the degree to which they rely on directors without financial services backgrounds. Lessons can be learned from both ends of that range. (See *Figure 10*).

Figure 10

### Outside Directors with Financial Services Expertise

Percent of Board



Source: SEC filings; Cambridge Winter

<sup>18</sup> See SEC, Proposed Rule on Facilitating Shareholder Director Nominations, Rel. No. 33-9046 (June 10, 2009), available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>, pages 7-14 (discussing need for more permissive approach to shareholder nominations).

One end of the spectrum, KeyCorp, the large Cleveland-based bank, has no outside directors from financial services at all.

Consistent with the explanation above, Key's corporate lineage has been marked by a long series of small bank acquisitions, as well as the 1994 merger of Key Bank of Albany and Society Bank of Cleveland.

On the other end of the spectrum is Goldman Sachs, the preeminent Wall Street investment bank. There, more than 40% of the board are outsiders with financial serv-

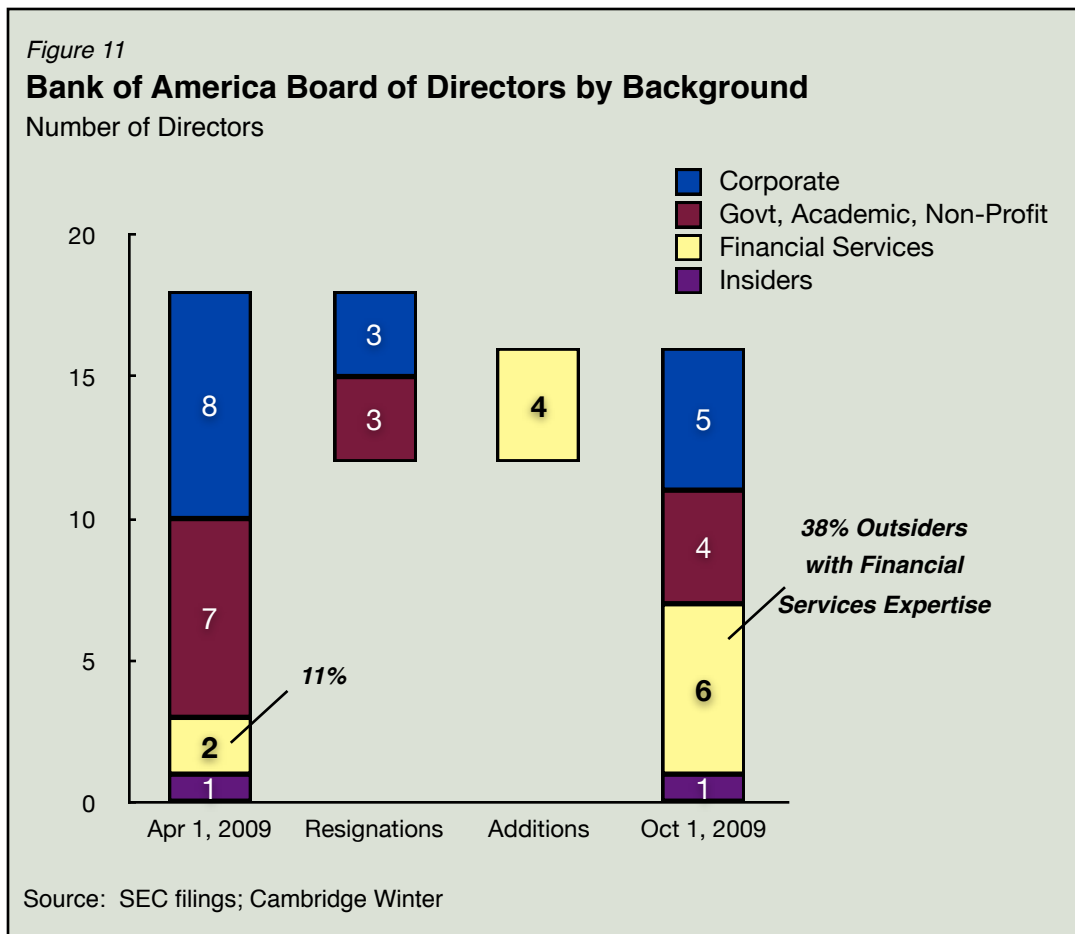
ices experience. Counting insiders, well more than half of Goldman's board hail from the financial services industry.<sup>19</sup>

Closest to the Goldman board's composition, in this regard, is the recently overhauled Bank of America board of directors. Notably, Bank of America would seem one of the only case examples of what could happen to an underperforming bank's board of directors if a large, sophisticated shareholder (in this case, the Treasury) were able to exert meaningful influence. Six

months ago, only 11% of the bank's board were outside directors with financial services experience; today, that figure is 38%. (See Figure 11).

### 4.3 Bank Board Size and Compensation

As discussed above, bank shareholders (as opposed to shareholders of non-banks) would uniquely benefit from boards with the ability and inclination to engage and challenge management teams on substantive issues.



<sup>19</sup> It is likely not completely coincidental that Goldman's stock price performance over the past 10 years has been, by far, the best of the 17 large banks analyzed (up 203%). Key's has been the second worst (behind only Citigroup), down 76%.

Even if bank boards had an adequate background in financial services, their absolute size would make such active, substantive engagement difficult. There is nothing particularly different about boards of directors than other forms of joint human undertakings. The ability to forge a robust, interactive discussion, on frequently complicated topics, is very difficult as groups become large.

Ideally, then, one would expect that banks would have, on the margin, smaller boards of directors than non-banks.

Comparing the largest banks to the largest non-banks, however, shows this is not the case: large bank boards average 14 members; non-banks average 12.

Indeed, it is striking that the basic characteristics of bank boards are so similar to non-bank boards, despite the demonstrably unique challenges faced by banks. (See *Figure 12*).

In fact, the only marked difference in basic characteristics is in compensation. Surprisingly, for such a famously well compensated industry, large banks actually pay their directors one-third less than large

*Figure 12*

### Board of Director Characteristics

Average of each attribute

	Large Banks	Large Non-Banks
<b>Number of Directors</b>	14	12
<b>Age</b>	61	61
<b>Percent Insiders</b>	9.2	11.3
<b>Other Board Commitments</b>	1.7	1.7
<b>Tenure (years)</b>	7	8
<b>Total compensation (\$ thousands)</b>	209	311

Note: Large banks are AXP, BAC, BBT, BK, C, COF, FITB, GS, JPM, KEY, MS, PNC, RF, STI, STT, USB, WFC; Large non-banks are AAPL, GE, GOOG, IBM, JNJ, MSFT, PG, T, WMT, XOM

Source: SEC filings; Cambridge Winter

non-banks. Granted, \$209 thousand likely seems, to most observers, more than adequate pay for what is, after all, a part-time job. But, ironically, it may well be too low for the job that bank shareholders actually need directors to do -- providing an active, grounded substantive check on management.<sup>20</sup>

## 5.0 Implications

Banks' boards of directors performed miserably in the run-up to, and during, the financial crisis. Bank shareholders have paid a dramatic price for that poor performance, but so has the financial system and the real economy more broadly.

<sup>20</sup> As an example, consider SunTrust, the large Atlanta-based regional bank. Given that two-thirds of its directors come from non-financial corporates, and most of those are the CEOs of significant enterprises, the roughly \$130 thousand in average annual compensation from SunTrust is quite unlikely to matter to most of its directors. As a result, the more significant implicit driver of directors' choices should, quite rationally, be the psychic satisfaction associated with continued board membership (SunTrust is, in Atlanta, an important and highly prestigious institution). Those are not circumstances likely to encourage vocal skepticism regarding management risk-taking.

Policy-makers will, no doubt, be tempted to react to this poor performance by strengthening one or more of the existing modes of board discipline: (a) creating mandatory oversight processes and sign-offs (as Sarbanes-Oxley did for internal financial controls) ; (b) constraining the structure of director compensation (as has been proposed more broadly for bank executives); or (c) increasing directors' personal liability.

On the margin, these three familiar items in the policy-making toolkit would likely have some impact -- but not much. Each is predicated on the notion that banks' boards of directors would have made better decisions during the credit bubble and crisis, if only they had been armed with the right information (because of better reporting, processes, and sign-offs), or if they had better positive (compensation) and negative (threat of liability) incentives.

But that narrative, as a factual matter, does not explain why bank boards failed as profoundly as they did.

Although faulty incentives certainly affected how bank directors made decisions, that bias is insufficient to explain banks' most egregious decisions. In reality, the explanation is far simpler: bank directors, especially those of the largest banks, simply lack the capabilities to make sound decisions in what is, after all, a high-risk, complicated business executed by management teams who are themselves influenced by moral hazard.

Although process- and incentive-related changes to board governance may, on the margin, enable better results, the most

pressing problems are structural. Bank boards are too large to facilitate active, substantive engagement, and they are dramatically underweight financial services experience.

Although reform to shareholder nomination rules might help fix these structural flaws, policy-makers should instead consider more direct remediation. Specifically, federal bank regulators could impose strict caps on bank board sizes, and strict floors on the fraction of directors that are independent and have pre-existing financial services expertise. Ironically, the shifting mix of directors at a poorly performing firm, Bank of America, may well be a beacon for the sector more broadly.