

Bill George: Where Were the Boards?

By BILL GEORGE

As the financial crisis continues to whipsaw the markets, the question we need to ask is: "Where were the boards of directors of Lehman, AIG, Bear Stearns, Countrywide Financial, Wachovia, Washington Mutual, Fannie Mae and Freddie Mac?"

The first job of the board of directors is to ensure the viability – indeed, the survivability – of the firm. By this criterion, these boards failed miserably.

About the Author

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Were they lulled into complacency by their CEOs? Or did they lack the insight to see that their firms had placed themselves in great peril if there were major disruptions in financial markets? Or were they looking at computer models rather than applying the judgments they were selected to make?

Regardless of the reasons, the boards of directors of these firms are directly responsible to their shareholders for the firm's viability and survivability, and they should be held accountable for their failures. Yet no one is focusing on how these boards failed to exercise the fiduciary duties they assumed when elected by the shareholders.

If history teaches us anything, it is that financial markets can and will gyrate wildly from time to time. Of all corporations, financial institutions must keep their balance sheets and cash balances in line to weather the kind of storms we are currently experiencing. The bursting of the housing bubble was predicted back in 2006 and the excessive debt consumers were holding was also evident. Yet, the directors of these firms kept approving higher and higher levels of leverage as the storm clouds grew ever darker on the horizon.

Even the early signs that the housing bubble had burst in early 2007 were ignored. Didn't anyone notice the filing for bankruptcy protection of mortgage lender New Century Financial? By taking on the same kind of mortgages, wasn't it obvious that Countrywide Financial would be next – forced to sell itself to Bank of America after its stock declined 85% -- and would drag down the banks that were repackaging these mortgages as AAA securities?

My Harvard colleague Ben Heineman, former general counsel of General Electric, writes, "It is clear that the boards of our major financial institutions did not understand the risks the entities were taking." He further asserts, "The boards of financial institutions did not choose CEOs wisely in recent years. The institutions pursued profits with overleveraged and ill-understood strategies and banished tough risk assessment from the center of decision-making." Sad, but true.

Confirming Heineman's thesis, a year ago a former colleague of mine joined the board of one of the world's largest banks. At his first audit committee meeting he asked to see management's assessment of the firm's cumulative risks. He was told bluntly by the audit chair, "This bank is far too large to look at cumulative risks, as risk management is delegated to all our units." In the following six months, the bank was forced to write off over \$20 billion in losses, and the CEO had to resign.

In response to the Enron and WorldCom crises, the Sarbanes-Oxley legislation of 2002, with its intended improvements in board governance, was rushed through Congress in just thirty-one days. Since then, we have witnessed the growing power of shareholder advisory firms like ISS that aim to improve board governance. Apparently, neither these firms nor Sarbanes-Oxley caused the boards of these failed institutions to step up their oversight of management and the risks it was taking.



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Where were the board audit committees when management was rationalizing that their computer models gave the best indication of the value of their holdings, instead of marking them to market as required by "fair value accounting"? Some financial firms and politicians are now arguing that mark-to-market accounting caused the problem and should be abandoned. To the contrary, marking to market is the only way to force managers and boards to face reality and provide shareholders and debt holders with an accurate valuation of the firm's assets.

If the government accepts this flawed line of reasoning and abandons mark-to-market accounting, we will not have learned anything from this debacle. As a consequence, we will have yet another crisis in a few years. The innovative financial instruments will be new, but the root cause will be the same: a focus on short-term gains enabled by the under-pricing of risk and inaccurate accounting. Doesn't anyone recall the Nobel Prize-winning economists who brought us the Long-Term Capital Management fiasco in 1998?

In their failure, these boards of directors forced the Federal Reserve and the Treasury Department to step in and take over their responsibilities. As a result, it seems almost certain that the U.S. government will have to impose greater regulations on all financial institutions, and thereby assume some of the fiduciary responsibilities previously held by their boards of directors.

As capitalists, this is certainly not the outcome that any of us would have intended. But it is the logical consequence of what happens when boards fail in their responsibilities. The solution is not to diminish the responsibilities of directors, but rather to hold them accountable to fulfill their fiduciary duties and to enforce negative consequences when they fail to do so.