

LEHMAN BROTHERS AND BEAR STEARNS: RISK ASSESSMENT AND CORPORATE GOVERNANCE DIFFERENCES?

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Abstract

In mid-March, 2008, with substantial government support, JP Morgan Chase agreed to acquire Bear Stearns for \$10 per share. Because Bear's shares traded at \$170 a year earlier, the market cap destruction of 94% was devastating to the once venerable investment bank and its investors. The Financial Crisis Inquiry Commission had also cited as failure the inconsistent treatment by the federal government in helping to bail out Bear Stearns in March, 2008 but letting Lehman Brothers go into bankruptcy in September, 2008. This paper investigates such inconsistencies by comparing and assessing the risk management and corporate governance practices of Bear Stearns and Lehman Brothers in their March-September, 2008.

Keywords: Financial Crisis, Governance, Risk Assessment, Bailout, Bankruptcy

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1. Introduction

At the end of January, 2011, the Commission finished its report and concluded: "the greatest tragedy would be to accept the refrain that no one could have seen this coming and thus find nothing could have been done. If we accept this notion, it will happen again." The Commission also concluded that the financial crisis was an "avoidable" disaster caused by widespread failures in government regulation, corporate mismanagement and heedless risk-taking by Wall Street. It found that the Securities and Exchange Commission (SEC) had failed to require big banks to hold more capital to cushion potential losses and to halt risky practices and that the U.S. Federal Reserve Bank "neglected its mission by failing to stem the tide of toxic mortgages" (Chan 2011). The Financial Crisis Inquiry Commission (Commission) was a ten-member commission appointed by the U.S. government with the goal of investigating the causes of the financial crisis of 2007-2010.

Citing dramatic breakdowns in corporate governance including taking on too much risk, the Commission portrayed incompetence with the following examples. Citigroup executive conceded that they paid little attention to mortgage-related risks. Executives at American International Group were blind to its \$79 billion exposure to credit-default swaps. Merrill Lynch managers were surprised when seemingly secure mortgage investments suddenly

suffered huge losses. The banks hid their excessive leverage with derivatives, off-balance-sheet entities and other accounting tricks. Their speculations were aided by a giant "shadow banking system" in which banks relied heavily on short-term debt. The Commission concluded: "when the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans and the risky assets all came home to roost" (Chan 2011).

Also, the Commission had cited another avoidable failure, the inconsistent treatment by the U.S. federal government in helping to bail out Bear Stearns in March, 2008 but letting Lehman Brothers go into bankruptcy in September, 2008. Thus, the focus of this paper is to assess the risk management and corporate governance of both banks to see if this inconsistent treatment by the federal government was justified.

2. Risk Management Assessment

The last annual financial statements ever reported both for Bear Stearns and Lehman Brothers were as of November 30, 2007, due to Bear Stearns' acquisition by JP Morgan Chase in March, 2008 and Lehman Brothers' bankruptcy in September, 2008. Both firms' stock prices had declined in the past year from \$170 to \$10 for Bear Stearns and from \$70 to \$60 for Lehman Brothers as of November 30, 2007.

To help assess the risk management of both firms, their condensed balance sheets were compiled and analyzed in Tables A and B for 2003 and 2007. A major problem was the traditional lack of classified balance sheets for banks. No current and long-term categories of assets and liabilities are typically provided by banks. For guidance, the following comments of a Lehman Brothers' Atlanta office manager, who retired early at age 55, may be considered. In an interview, he said that over the years, the firm's culture had shifted from managing money for clients to proprietary trading for itself. A permissive management style increasingly favored short-term investment gains and unrealized profits through mark-to-market accounting over the

sustainability of the company. He said: "*the firm traded at the expense of the customers in some cases and on the trading desk, there was almost disdain for the customer*" (Lewis 2011). This strategy was reinforced by Lehman Brothers' change in its balance sheet terminology for its investments from "Securities" in 2003 (as a brokerage firm for its customers) to "Financial Instruments" in 2007 (as a trading firm for its own shareholders and management). Thus, such investments were classified as short-term assets in 2003 and as long-term assets in 2007 for both firms to summarize this strategic shift in investment banking over this period in Tables A and B.

Table A
Bear Stearns Balance Sheets
Risk Management Red Flags?

Year	Current Assets	Long-Term Assets	Total Assets	Current Liabilities	Long-Term Liabilities	Total Liabilities	Total St. Equity & St. Eq.	Total Liab St. Equity & St. Eq.
2007	\$87,818	\$307,544	<u>\$395,362</u>	\$315,031	\$68,538	\$383,569	\$11,793	<u>\$395,362</u>
Balance Sheet Percentages	0.22	0.78	<u>1.00</u>	0.80	0.17		0.03	<u>1.00</u>
Current Ratio = Current Assets / Current Liabilities = (Liquidity)				\$87,818	\$315,031	<u>0.28</u>		
Liabilities to Equity = Total Liab. / Total St. Equity = (Leverage)				\$383,569	\$11,793	<u>32.53</u>		
Mismatching of Financing: By 2007, 78% of long-term (toxic) assets were funded by 80% short-term debt versus only 64% of long-term assets in 2003. Bear Stearns hid an estimated \$25 billion of short-term debt off its books with REPO 105 transactions each quarter (about 1/2 the Lehman Brothers \$50 billion) which would have increased its liabilities to equity ratio to 34.6 in 2007.								
2003	\$75,460	\$136,708	<u>\$212,168</u>	\$174,705	\$29,993	\$204,698	\$7,470	<u>\$212,168</u>
Balance Sheet Percentages	0.36	0.64	<u>1.00</u>	0.82	0.14		0.04	<u>1.00</u>
Current Ratio = Current Assets / Current Liabilities = (Liquidity)				\$75,460	\$174,705	<u>0.43</u>		
Liabilities to Equity = Total Liab. / Total St. Equity = (Leverage)				\$204,698	\$7,470	<u>27.40</u>		

Note: Bears Stearns did not change its Balance Sheet terminology for its investments or "Securities" from 2003 (as a brokerage firm) to "Financial Instruments" in 2007 (as a trading firm for its own shareholders) as Lehman Brothers did. Both firms never presented classified balance sheets showing either short-term or long-term assets or liabilities over this period.

Year	Current Assets	Long-Term Assets	Total Assets	Current Liabilities	Long-Term Liabilities	Total Liabilities	Total St. Equity & St. Eq.	Total Liab St. Equity & St. Eq.
2007	\$87,818	\$307,544	<u>\$395,362</u>	\$315,031	\$68,538	\$383,569	\$11,793	<u>\$395,362</u>
Possible Bankruptcy:			<u>(\$11,793)</u>					<u>(\$11,793)</u>
2007	\$63,306	\$295,751	<u>\$359,057</u>	\$545,423	\$123,150	\$668,573	\$0	<u>\$668,573</u>
		<u>-0.038</u>	<u>Write-down</u>					

Note: Only a 3.8% write-down of long-term (toxic) assets shows a possible bankruptcy at Bear Stearns! The U.S. Financial Crisis Inquiry Commission reported similar percentages for major U.S. banks in 2008. The European Parliament, the SEC, and the FASB in the U.S. have all "carved out" (eliminated) mark-to-market accounting for such asset investments of all public banks in the European Union and the United States. Such "carve outs" may be a threat to the widespread use of International Financial Reporting Standards.

Comments: Bear Stearns only had 3% capital at the time of its bankruptcy rescue. The Basel III agreement recommended at least 7%. The Swiss National Bank recommends 20%. The European Community is considering 15% to 20%. The Dodd-Frank Act recommends "adequate" capital. The old Glass Steagall Act stipulated 10% capital. At the time of the financial crisis in the U.S., the largest 19 U.S. banks averaged 3%. Why were there no "going concern" audit opinions when less than 1 year later, the TARP program provided \$700 billion in bailout funds to these largest U.S. banks? Also, if Lehman Brothers had been Lehman Sisters, its bankruptcy never would have happened!

Table B
Lehman Brothers Balance Sheets
Risk Management Red Flags?

Year	Current Assets	Long-Term Assets	Total Assets	Current Liabilities	Long-Term Liabilities	Total Liabilities	Total St. Equity	Total Liab & St. Eq.
2007	\$63,306	\$627,757	<u>\$691,063</u>	\$545,423	\$123,150	\$668,573	\$22,490	<u>\$691,063</u>
Balance Sheet Percentag	0.09	0.91	<u>1.00</u>	0.79	0.18		0.03	<u>1.00</u>
Current Ratio = Current Assets / Current Liabilities = (Liquidity)				\$63,306	\$545,423	<u>0.12</u>		
Liabilities to Equity = Total Liab. / Total St. Equity = (Leverage)				\$668,573	\$22,490	<u>29.73</u>		

Mismatching of Financing: By 2007, 91% of long-term (toxic) assets were funded by 79% short-term debt versus only 48% of long-term assets in 2003. Lehman Brothers hid approximately \$50 billion of short-term debt off its books with REPO 105 transactions each quarter which would have increased its liabilities to equity ratio to 33 in 2007.

2003	\$163,372	\$148,689	<u>\$312,061</u>	\$255,358	\$43,529	\$298,887	\$13,174	<u>\$312,061</u>
Balance Sheet Percentag	0.52	0.48	<u>1.00</u>	0.82	0.14		0.04	<u>1.00</u>
Current Ratio = Current Assets / Current Liabilities = (Liquidity)				\$163,372	\$255,358	<u>0.64</u>		
Liabilities to Equity = Total Liab. / Total St. Equity = (Leverage)				\$298,887	\$13,174	<u>22.69</u>		

Note: Lehman Brothers changed its Balance Sheet terminology for its investments from "Securities" in 2003 (as a brokerage firm) to "Financial Instruments" in 2007 (as a trading firm for its own shareholders). It never presented a classified balance sheet showing either short-term or long-term assets or liabilities over this period.

Year	Current Assets	Long-Term Assets	Total Assets	Current Liabilities	Long-Term Liabilities	Total Liabilities	Total St. Equity	Total Liab. & St. Eq.
2007	\$63,306	\$627,757	<u>\$691,063</u>	\$545,423	\$123,150	\$668,573	\$22,490	<u>\$691,063</u>
Possible Bankruptcy:		<u>(\$22,490)</u>					<u>(\$22,490)</u>	
2007	\$63,306	\$605,267	<u>\$668,573</u>	\$545,423	\$123,150	\$668,573	\$0	<u>\$668,573</u>
		<u>-0.036</u>	Write-down					

Note: Only a 3.6% write-down of long-term (toxic) assets shows a possible bankruptcy at Lehman Brothers! The U.S. Financial Crisis Inquiry Commission reported similar percentages for major U.S. banks in 2008. The European Parliament, the SEC, and the FASB in the U.S. have all "carved out" (eliminated) mark-to-market accounting for such asset investments of all public banks in the European Union and the United States. Such "carve outs" may be a threat to the widespread use of International Financial Reporting Standards.

Comments: Lehman Brothers only had 3% capital at the time of its bankruptcy. The Basel III agreement recommended at least 7%. The Swiss National Bank recommends 20%. The European Community is considering 15% to 20%. The old Glass Seagal Act stipulated 10% capital. At the time of the financial crisis in the U.S., the largest 19 U.S. banks averaged 3%. Why were there no "going concern" audit opinions when less than 1 year later, the TARP program provided \$700 billion in bailout funds to these largest U.S. banks? Also, if Lehman Brothers had been Lehman Sisters, its bankruptcy never would have happened!

A simple balance sheet percentage calculation shows the switch from brokerage services for clients in 2003 to trading accounts for shareholders and management compensation in 2007 for both firms. Lehman Brothers changed its balance sheet terminology for its investment inventories from "Securities" in 2003 as a brokerage firm to "Financial Instruments" in 2007 as a trading firm. However, Bear Stearns just kept the same terminology for both 2003 and 2007 although it had made the same switch in strategic operations. There was also a mismatching of financing terms for both firms (Finance 101 concepts). By 2007, 78% of Bear Stearns' long-term

(toxic) assets were funded by 80% short-term debt versus only 64% of long-term assets in 2003. By 2007, 91% of Lehman Brothers' long-term (toxic) assets were funded by 79% short-term debt versus only 48% of long-term assets in 2003.

The current ratios of both firms fell significantly from 2003 to 2007: 0.64 to 0.12 for Lehman Brothers and 0.43 to 0.28 for Bear Stearns. Leverage (total liabilities to equity) also increased significantly from 2003 to 2007: 22.69 to 29.73 for Lehman Brothers and 27.40 to 32.53 for Bear Stearns. To "window-dress" its balance sheet, Lehman Brothers hid approximately \$50 billion of short-term debt off its

books with REPO 105 transactions each quarter which would have increased its liabilities to equity ratio from 29.7 to 33 in 2007. Such window dressing reduced reported leverage by 10.56% in the fourth quarter of 2007, 12.34% in the first quarter of 2008, and 14.89% in the second quarter of 2008 (Dutta et al., 2010). Although not disclosed by Bear Stearns, REPO 105 transactions can be estimated as \$25 billion since it was one-half Lehman Brothers' size.

Both firms were under-capitalized in both 2007 at 4% each and in 2007 at 3% each. The Basel III agreement recommended at least 7%. The Swiss National Bank recommends 20% and the European Community is considering 15% to 20%. The Glass Seagal Act, which was overturned in 1999, stipulated a 10% capital requirement. At the time of the 2008 financial crisis in the U.S., the largest 19 banks had only 3% capital. Afterwards, the capital percentage went up close to 10% but has now fallen back to about 6%. Note that only a 3.6% write-down of mortgage-backed or other toxic investments would eliminate all the capital of Lehman Brothers as would a 3.8% write-down for Bear Stearns. The Commission reported similar percentages for major U.S. banks in 2008. The European Parliament, the SEC, and the FASB have all "carved out" (eliminated) mark-to-market accounting for such asset investments of all public banks in the European Union and the United States. Such "carve-outs" may be a threat to the widespread use of the International Financial Reporting Standards. In summary, both firms had very similar balance sheet percentages and ratios in 2003 and 2007. Recently, the Obama administration made the decision to let big banks recapitalize as the economy recovered along with dividend increases and high bonus payouts. "As the recovery stalls, this strategy looks increasingly dubious because the banks' equity capital levels are now probably too low to buffer the shock of another down leg (Johnson 2011).

3. Corporate Governance Assessment

For potential use as corporate governance risk management tools, the New York Stock Exchange (NYSE) recently sponsored a Commission on Corporate Governance⁴⁸ which issued the following key corporate governance principles (2010):

- The Board of Directors' fundamental objective should be to build long-term sustainable growth in shareholder value. Thus, policies that

promote excessive risk-taking for short-term stock price increases, and compensation policies that do not encourage long-term value creation, are inconsistent with good corporate practices.

- Management has the primary responsibility for creating a culture of performance with integrity. Management's role in corporate governance includes establishing risk management processes and proper internal controls, insisting on high ethical standards, ensuring open internal communications about potential problems, and providing accurate information both to the Board and to shareholders.
- Good corporate governance should be integrated as a core element of a company's business strategy and not be simply viewed as a compliance obligation with a "check the box" mentality for mandates and best practices.
- Transparency in disclosures is an essential element of corporate governance.
- Independence and objectivity are necessary attributes of a Board of Directors. However, subject to the NYSE's requirement for a majority of independent directors, there should be a sufficient number of non-independent directors so that there is an appropriate range and mix of expertise, diversity and knowledge on the Board.
- Shareholders have the right, a responsibility and a long-term economic interest to vote their shares in a thoughtful manner. Institutional investors should disclose their corporate governance guidelines and general voting policies (and any potential conflicts of interests, such as managing a company's retirement plans).

Various empirical studies have investigated impacts of corporate governance upon banks' risk taking (stock market based measures) and financial performance (return on assets, non-performing assets, etc.). The following corporate governance variables have been found to have a significant, negative impact on risk taking and financial performance (Allemand et. al. 2011, Grove et. al. 2011, Victoravich et. al. 2011):

- CEO duality (the CEO is also the Chairman of the Board of Directors)
- Board of Directors and CEO entrenchment (only staggered re-elections of the Board versus all Board members re-elected every year and CEOs being in the job for more than a decade)
- Older Directors (over 60 years of age)
- Short-term compensation mix (cash bonuses and stock options versus long-term stock awards and restricted stock)
- Non-independent and affiliated Directors (larger percentages of such directors versus independent directors)

⁴⁸ With a press release on September 1, 2009 NYSE announced the establishment of a Commission on Corporate Governance which is "an independent advisory commission to examine U.S. corporate governance and the overall proxy process. This advisory commission will take a comprehensive look at strengthening U.S. best practices for corporate governance and the proxy process".

- Ineffective risk management committees (few or no meetings)

Also, high leverage (debt to equity) levels were associated with high levels of banks' risk taking and poor financial performance in these studies. When implementing the \$700 billion bailout of major U.S. banks, the U.S. Treasury did not replace any existing bank Board members but added new Directors to represent taxpayer interests. Many of these original Directors oversaw the big banks and brokerage firms when they were taking huge risks during the real estate boom. A corporate government specialist concluded: *"these boards had no idea about the risks these firms were taking on and relied on management to tell them"* (Barr 2008). A senior corporate governance analyst said: *"this financial crisis is a direct result of the compensation practices at these Wall Street firms"* (Lohr 2008). Board of Director profiles and other corporate governance information for both Bear Stearns and Lehman Brothers are included in Appendix A.

Corporate governance for risk management and company oversight was very weak at both banks as shown by the following red flags which were cited in the empirical research on corporate governance in banks:

- CEO Duality: At Bear Stearns, the CEO, James Cayne, had also been the Chairmen of the Board (COB) for the last seven years. At Lehman Brothers, the CEO, Richard Fudd, had also been the COB for the last seventeen years.
- Board Entrenchment: At both banks, there were no staggered board elections as all members were re-elected annually. However, both CEOs had been in their jobs for more than a decade: 26 years for the Bear Stearns CEO and 17 years for the Lehman Brothers CEO. Also, there were a majority of older and long-serving Directors as noted below.
- Older Directors: For Bear Stearns and Lehman Brothers, respectively, the majority of the Directors were over age 60: 85% and 91%, over age 70: 23% and 55%, and over age 80: 15% and 18%. Also, 54% of the Bear Stearns Directors were retired or just "private investors" or in academia. 91% of the Lehman Brothers Directors were retired or "private investors."
- Short-term Compensation Mix: Both companies had large portions of their compensation packages for their top executives in short-term cash (bonus) and stock options.
- Non-independent, affiliated, and diverse directors: Long-serving Directors may lose or reduce their independent perspective. For Bear Stearns and Lehman Brothers, respectively, the number of Directors serving since the 1980's were 38% and 9% and since the 1990's were 31% and 55% for totals from the 1980's and 1990's of 69% and 64%. Also, there were only one woman and one minority on Lehman Brothers' Board and none on Bear Stearns Board.
- Ineffective Risk Management Committee: Bear Stearns' risk committee only started in January 2007 just 14 months before JP Morgan Chase bailed out the company by taking it over in March 2008. Three of the four members were in 64 and the other was 60. Lehman Brothers' risk committee had only two meetings in 2006 and 2007 before it went bankrupt in 2008. The chairman of the risk management committee was 80 and a retired Salomon Brothers investment banker. The other members were 73 (retired chairman of IBM), 77 ("private investor" and retired Broadway producer), 60 (retired rear admiral of the Navy), and 50 (former CEO of a Spanish language TV station).
- Opaque Disclosures: Per the SEC chairman and SEC chief accountant, there was a direct line from the implosion of Enron to the fall of Lehman Brothers which was an inability for investors to get sound financial information necessary for making sound investment decisions. This meant resisting any calls to repeal the current mark-to-market standards and also meant expanding the requirement to disclose the securities positions and loan commitments of all financial institutions. There was no fair value reporting at either bank which would have provided the information investors needed to make informed decisions, and bring much needed transparency to the market.

4. Conclusions: Risk Management, Corporate Governance, and Other Observations

Our analyses show that both companies had weak risk management and corporate governance practices. They seemed to be in similar, very weak financial positions. Bear Stearns bailout may have been helped by Wall Street connections, like Henry Paulsen, the U.S. Treasury Secretary and former CEO of Goldman Sachs. However, possibly the federal government later thought that Lehman Brothers was "too big to save" since it was twice the size of Bear Stearns. Then, after the Lehman Brothers bankruptcy ignited the world financial crisis, the federal government reversed its thinking and bailed out the largest 19 U.S. banks since they were now "too big to fail." This bailout occurred despite the fact that all these banks had received unqualified audit opinions on their financial statements and internal controls in their last annual reports before the bailout. No "going concern" qualified audit opinions were issued for possible bankruptcies in these banks and audit opinions appear not to be a tool for assessing the risk management of such banks. Thus, it appeared that there was inconsistent and unjustified treatment by the U.S.

federal government in helping bail out Bear Stearns but letting Lehman Brothers go into bankruptcy.

Concerning the lack of disclosure transparency by these banks in not using fair value reporting for their assets, Arthur Levitt and Lynn Turner, former SEC chairman and former SEC chief accountant, respectively, observed (Levitt and Turner 2008):

“There is a direct line from the implosion of Enron to the fall of Lehman Brothers—and that’s an inability for investors to get sound financial information necessary for making sound investment decisions. The only way we can bring sanity back to the credit and stock markets is by restoring public trust. And to do that, we must improve the quality, accuracy, and relevance of our financial reporting. This means resisting any calls to repeal the current mark-to-market standards. And it also means expanding the requirement to disclose the securities positions and loan commitments of all financial institutions. Fair value reporting, when properly complied with and enforced, will simplify the information investors need to make informed decisions, and bring much needed transparency to the market. By reporting assets at what they are worth, not what someone wishes they were worth, investors and regulators can tell how management is performing. This knowledge in turn is fundamental to determining whether or not an institution has sufficient capital and liquidity to justify receiving loans and capital. We should be pointing fingers at those at Lehman Brothers, AIG, Fannie Mae, Freddie Mac, and other institutions who made poor investment and strategic decisions and took on dangerous risks.”

At a 2011 Town Hall discussion, entitled Does Wall Street Really Run the World?, Lynn Turner, the former SEC Chief Accountant, made the following comments. “There was greater attention to risk management when Wall Street firms were partnerships with individual partner liability twenty years ago versus today as corporations (similar to the evolution of Big 4 Accounting firms). Wall Street firms changed from raising money for corporations and being investment brokerage firms to a new emphasis on trading for its own sake and their own shareholders. An eleven trillion market cap destruction occurred from the economic crisis of 2008. These firms were not really creating value but were selling toxic investments such that a Rolling Stone reporter nicknamed Goldman Sachs the Vampire Squid. Paul Volcker has commented that the last real innovation of Wall Street banks was the ATM thirty years ago, actually by a Nebraska bank.” Also, the chairman of the International Accounting Standards Board had commented that the fraudulent financial reporting problems of this century were

really failures in corporate governance (Tweedie 2007). There may have been audit problems as well since both companies received unqualified or “clean” opinions on their 2007 financial statements and internal controls even though both companies had solvency issues since Bear Stearns was bailed out and Lehman Brothers went bankrupt.

Risk management at the major U.S. (bailout) banks was very poor and contributed significantly to the U.S. financial crisis which started with the bankruptcy of Lehman Brothers in September 2008. In March 2010, the SEC started requiring all publicly traded companies in the U.S. to provide disclosures that describe the Board’s role in risk oversight. Such disclosures were required in the annual proxy statements of these firms. In July 2010, the Federal Financial Reform (Dodd-Frank) Act was signed into law. It mandates risk committees for Boards of financial institutions and other entities that the Federal Reserve Bank oversees.

The following interview with Satyajit Das, an international respected expert on finance with over 30 years of working experience in the industry, provides comments on risk management and corporate governance in the banking industry:

“As banks expanded you exhausted the pool of people who you could lend to and then moved onto the others—until you came to people who couldn’t ever really pay you back. So the trick was to hide or get rid of the risk of non-payment--it became a case of NMP (not my problem) or risk transfer. So you made loans that you shouldn’t and then transferred them to people who probably didn’t quite grasp the risk fully or were incentivised to look the other way. It was a culture of fraud and self-delusion.

It’s amazing how much money you can make just shuffling paper backwards and forwards. Paul Volcker, the former chairman of the Federal Reserve Bank, argued: ‘I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth---one shred of evidence.’

Management and directors of financial institutions cannot really understand what is going on---it’s simply not practical. They cannot be across all the products. Non-executives are even further removed. Upon joining the Salomon Brothers Board, Henry Kaufman found that most no-executive directors had little experience or understanding of banking. They relied on Board reports that were neither comprehensive nor detailed enough about the diversity and complexity of our operations. They were reliant on the veracity and competency of senior managers, who in turn were beholden to the veracity of middle

managers, who are themselves motivated to take risks through a variety of profits compensation formulas.” Such poor risk management at banks has recently occurred again as UBS lost over \$2 billion through the manipulations of a UBS rogue trader, just like the Barings Bank episode several years ago which bankrupted that bank. Un-hedged trades by this rogue trader had been going on since the 2008 financial crisis, despite the clean opinions given by a Big 4 auditor on the internal controls of UBS (Craig et al., 2011)

“Henry Kaufman later joined the Board of Lehman Brothers. At that time, nine out of ten members of the Lehman Board were retired, four were 75 years or more in age, only two had banking experience but in a different era. The octogenarian Kaufman sat on the Lehman Risk Committee with a Broadway producer, a former Navy admiral, a former CEO of a Spanish-language TV station and the former chairman of IBM. The Committee had only two meetings in 2006 and 2007. AIG’s Board included several heavyweight diplomats and admirals; even though Richard Breeden, former head of the SEC told a reporter: “AIG, as far as I know, didn’t own any aircraft carriers and didn’t have a seat in the United Nations.”

It’s silly to think that everybody in finance is evil or engaged in fraud. Most people involved are very smart, diligent, hard-working and passionate about what they do. It’s groupthink. They have ways of thinking about the world. They think it’s the right way so they keep trying it again and again. At least until there is a horrendous disruption and then they go: “Oh dear? There’s a problem.” Take Alan Greenspan. He thought deregulated markets were the solution. He thought that any problem could be fixed by flooding the system with money. He was wrong, but even today he doesn’t really see that his world view is erroneous. They are very good at rationalization and don’t tolerate dissent. As for responsibility, they are doing what is accepted practice---they think they are doing the best for their stakeholders. As long as you follow convention, you are unlikely to be successfully prosecuted or made liable. Ultimately that’s the only purpose of corporate governance---to ensure that by following a set of accepted practices, you make yourself and your organization litigation proof.”

Few bank officers and Directors from the financial crisis have yet been found liable under either state or federal law. The Lehman Brothers’ CEO and top executives did owe \$90 million in fines which were covered by insurance. Also, many directors

from Bear Stearns (six), Lehman Brothers (six), and Enron (seven) continue to serve on other Boards. The “old boy” network is emphasized here as is the decline in importance of reputation on Wall Street. Prior bad conduct simply is not viewed as a problem (Davidoff, 2011).

In response to an email about this issue of why Bear Stearns was saved and Lehman Brothers let go into bankruptcy, Lynn Turner replied: “Both were highly risky with very, very arrogant CEOs and chairmen. Neither had a great board but Bear Stearns may have had better connections on their board and in this instance, Lehman Brothers being second was fatal. Both depended way too much on very short term financing, including overnight commercial paper or repo’s---a very ill advised and highly risky strategy for any company let alone one with very little capital.”

Similarly, when asked in an October 2008 interview about Rabobank’s role in the Bear Stearns crisis when it refused to renew \$2.5 billion in short-term loans coming due in two weeks, Bert Heemskerk, Rabobank’s chairman, said: “It is not true that Rabobank helped to bring down Bear Stearns. No, Bear Stearns had set up their balance sheet totally the wrong way.” Asked if he understood that when one bank stops refinancing, others will follow, Mr. Heemskerk responded: “And rightly so.”

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Appendix A Corporate Governance Information And Board of Directors Profiles

Both Bear Stearns' and Lehman Brothers' Compensation Committees had approved mixes of cash bonus compensation, stock options and stock awards which appeared to favor and reward short-term performance. Their Audit Committees never required full disclosures of the fair values of all their asset investments. Their Nominating Committees did require annual elections of all Board members, instead of staggered elections. Bear Stearns established its Finance and Risk Committee on January 10, 2007 just 14 months before it was bailed out by JP Morgan Chase in March 2008. The five members were Nickell, Novelty (Chairman), Salerno, and Tese. No information on the number of meetings was provided. Lehman Brothers' Finance and Risk Committee met two times a year in both 2006 and 2007. The five members were Akers, Berlind, Evans, Hernandez, and Kaufman (Chairman),

Bear Stearns Board of Directors

Henry Bienen, age 68, has been President of Northwestern University for more than the past five years. He has served as a Director of the Company since 2004 and is a member of the Audit and Legal Compliance Committees. He is not on the board of directors of any other public company.

James Cayne, age 73, has been Chairman of the Board and Chief Executive Officer (CEO) of the Company and Bear Stearns for the past seven years. He has been the CEO for the past 26 years, has served as a Director of the Company since 1985, and is a member of the Executive Committee. He is not on the board of directors of any other public company.

Carl Glickman, age 81, has been a private investor for more than the past five years. He has served as a Director of the Company since 1985 and is a member of the Audit and Legal Compliance Committees and is Chairman of the Compensation Committee. He is also the Presiding Trustee and Chairman of the Executive Committee of the Lexington Corporate Properties trust.

Michael Goldstein, age 68, was the Chairman and CEO of Toys "R" Us, Inc. until his retirement in 2001. He was appointed to the Board of Directors and the Audit Committee on January 10, 2007. He is on the boards of

the following additional public companies: 4Kids Entertainment, Inc., Martha Stewart Living Omnimedia, Inc., Medco Health Solutions, Inc. Pacific Sunwear of California, Inc. and United Retail Group, Inc.

Alan Greenberg, age 80, has been Chairman of the Executive Committee of the Company for the past 20 years and has served as a Director of the Company since 1985. He is on the board of one additional public company, Viacom Inc.

Donald Harrington, age 62, has been the President of St. Johns University for more than the past five years. He has served as a Director of the Company since 1993 and is a member of the Compensation Committee. He is not on the board of directors of any other public company.

Frank Nickell, age 60, has been President and CEO of Kelso & Company, a privately held merchant banking firm, for more than the past five years and Chairman of the Kelso board for the last two years. He has served as a Director of the Company since 1993 and is a member of the Compensation, Nominating, and Finance/Risk Committees. He is not on the board of directors of any other public company.

Paul Novelly, age 64, has been Chairman of the Board and CEO of Apex Oil Company, Inc., a privately held company engaged in wholesale marketing, storage and distribution of petroleum products, for more than the past five years. He has served as a Director of the Company since 2002 and is a member of the Audit, Nominating and Legal Compliance Committees and is the Chairman of the Finance/Risk Committee. He is on the board of one additional public company, Boss Holdings Inc.

Federic Salerno, age 64, was the Vice Chairman and CFO of Verizon Communications Inc. until his retirement in September 2002. He was the Vice Chairman of the Board of NYNEX for more than five years and has served as a Director of the Company since 1992. He is a member of the Audit, Finance/Risk and Legal Compliance Committees and is the Chairman of the Nominating Committee. He is on the boards of the following additional public companies: Popular Inc., Viacom Inc. Consolidated Edison Inc, Akamai Technologies Inc. and Intercontinental Exchange Inc.

Alan Schwartz, age 57, has been the President and Co-Chief Operating Officer of the Company and Bear Stearns for more than the past five years. He has served as a Director of the Company from 1987 until 1996 and from 1999 until present and he is a member of the Executive Committee.

Warren Spector, age 50, has been the President and CO-Chief Operating Officer of the Company and Bear Stearns for more than the past five years. He has served as a Director of the Company from 1987 until 1996 and from 1999 until present and he is a member of the Executive Committee.

Vincent Tese, age 64, has been the Chairman of Wireless Cable International for more than the past five years. He has served as a Director of the Company since 1994 and is a member of the Compensation, Nominating and Finance/Risk Committees and is the Chairman of the Audit Committee and the Legal Compliance Committee. He is on the boards of following additional public companies: Bowne & Co. Inc, Cablevision Systems Corporation, Mack-Cali Realty Corporation, Intercontinental Exchange Group and GAMCO Investors Inc.

Wesley Williams, age 65, had been a partner in the law firm of Covington & Burling LLP for more than the last five years prior to his retirement in 2005. He has been President and Chief Operating Officer of Lockhart Companies Incorporated, a conglomerate of real estate, insurance and consumer finance companies operating in the Caribbean. He had also been member of the board of directors of the Federal Reserve Bank of Richmond for more than five years. He has served as a Director of the Company since 2004 and is a member of the Audit and Legal Compliance Committees.

Lehman Brothers Board of Directors

Michael Ainslie, age 64, and director since 1996 is a private investor and former President and CEO of Sotheby's Holdings. He was formerly the Chief Operating Officer of N-Ren Corp., a Cincinnati-based chemical manufacturer, and formerly the President of Palmas Del Mar, a real estate development company. He serves on the Audit Committee.

John Akers, age 73, and director since 1996 is a private investor and the retired Chairman of the Board and CEO of IBM. He is a Director of W.R. Grace and Co. and serves as the Chairman of the Compensation Committee and as a member of the Finance and Risk Committee.

Roger Berlind, age 77, and director since 1985 is a private investor and has been a theatrical producer and principal of Berlind Production since 1981. He is also a Governor of the Broadway League and served as a Trustee of the Eugene O'Neill Theater Center and the American Academy of Dramatic Arts. He serves as a member of the Audit and Finance/Risk Committees.

Thomas Cruikshank, age 76 and director since 1996 was both Chairman and CEO of Halliburton Company, a major petroleum industry service company, from 1989 to 1995 and CEO from 1983 to 1989. He joined Halliburton in 1969 and served in various accounting and finance positions before being named CEO. He serves as the Chairman of the Audit Committee and as a member of the Nominating Committee.

Marsha Evans, age 60 and director since 2004 is a retired Rear Admiral, U.S. Navy after being a career officer in the U.S. Navy. She served as President and CEO of the American Red Cross from 2002 through 2005 and as National Executive Director of Girl Scouts from 1998 to 2002. She is a director of Weight Watchers International Inc, Huntsman Corporation, and Office Depot Inc. She serves as the Chairman of the Nominating Committee and as a member of the Compensation and Finance/Risk Committees.

Richard Fuld, age 61 and director since 1990 has been Chairman of the Board of Directors since 1994 and CEO of the Company since 1993 and serves as Chairman of the Executive Committee. He was Co-CEO from 1990 to 1993 and Vice-Chairman from 1984 to 1990. He joined Lehman Brothers in 1969. He serves on the Board of Directors of the Federal Reserve Bank of New York and is a member of the International Business Council of the World Economic Forum and The Business Council.

Christopher Gent, age 60 and director since 2003 has been Non-Executive Chairman of GlaxoSmithKline plc since 2004. Prior to his retirement in 2003, he had been a member of the board of directors of Vodafone Limited, a mobile phone service company, since 1985 and its CEO since 1997. He is a director of Ferrari SpA, and a senior advisor to Bain & Company Inc. He serves as a member of the Audit and Compensation Committees.

Jerry Grundhofer, age 63 and elected as a director in 2008 is the Chairman Emeritus and Retired CEO of U.S. Bancorp. He served as Chairman of U.S. Bancorp from 2002 to 2007 and CEO from 2001 to 2006. From 1993 to 2001 he served as Chairman, President, and CEO of U.S. Bancorp predecessors Firststar Corporation and Star Banc Corporation. He is a director of Ecolab, Inc. and The Midland Company, Inc.

Roland Hernandez, age 50 and director since 2005 is the Retired Chairman and CEO of Telemundo Group Inc., a Spanish-language television station company. He served as Chairman and CEO from 1998 to 2000 and as CEO from 1995 to 1998. Prior to that position, he was founder and President of Interspan Communications, a Spanish-language media company. He is also a director of MGM Mirage, The Ryland Group Inc., Vail Resorts Inc. and Wal-Mart Stores Inc. He serves as a member of the Finance and Risk Committee.

Henry Kaufman, age 80 and director since 1995 has been President of Henry Kaufman & Company Inc., an investment management and economic and financial consulting firm since 1988. For the previous 26 years, he was with Salomon Brothers Inc. where he was a Managing Director, Member of the Executive Committee, and in charge of Salomon's four research departments. Before joining Salomon Brothers, he was in commercial banking and served as an economist at the Federal Reserve Bank of New York where he is now a Member of its International Advisory Committee. He is also a Member of the Advisory Committee of the Investment Committee of the International Monetary Fund Staff Retirement Plan. He serves as the Chairman of the Finance and Risk Committee.

John Macomber, age 80 and director since 1994 has been a Principal of JDM Investment Group, a private investment firm, since 1992. He was Chairman and President of the Export-Import Bank of the United States from 1989 to 1992, Chairman and CEO of Celanese Corporation from 1973 to 1986 and a Senior Partner at McKinsey & Company from 1954 to 1973. He is a Director of Collexis Holdings Inc. and Stewart & Stevenson LLC. He serves as a member of the Compensation, Executive, and Nominating Committees.