

**Too big to fail – too big to manage**

**By**

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## TOO BIG TO FAIL – TOO BIG TO MANAGE

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In the wake of the financial crisis of 2007 many questions have been left unanswered until now. Of particular concern to the general public and the authorities is the problem how to avoid in future the need to spend huge public funds to support failing banks.

One proposal is to prevent banks from becoming so large that their failure would inevitably lead to a crisis of such dimensions as to force the authorities to rescue them. Discussions about this topic, generally under the heading *Too big To Fail*, appear to be ongoing. Possibly, they are still at an early stage, because no one seems to know how to define exactly a banking organization that is too big to fail. What does 'big' mean in this context? And what context is relevant? Obviously an important bank in a large country must be bigger to serve its economy than a bank in a smaller country. Does this mean that banks from smaller countries must remain smaller, and if so, how small?

I wonder whether other criteria might be more relevant to address the fundamental problems of public support for failing banks. In particular, one question should be given more thought: Have banks, or some banks, become too big to manage? What are the consequences of the structures of the global banks of today for their managements, their boards, their regulators, and their investors? Some light has been shed on these aspects lately. In particular, investigations carried out by a committee of the US senate have led to some astonishing revelations.

This paper intends to deal further with the question why some financial institutions may be '*Too Big to Manage*'. It also tries to sketch out a few ideas about possible remedies for some of the weaknesses in the governance of banks that have played a part in the history of the banking crisis.

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### Changes brought by Globalization and Information Technology to Global Banking ....

Managing a bank has always been a demanding job. Banks are dealing in money, which in truth is a little understood commodity, even though it is always under the limelight of the concerns of both the public and the authorities. Banks require staff that on average must have higher qualifications than most other businesses that deal with a large segment of the population. The banking business is even more exposed to the vagaries of the markets than most other businesses.

In contrast to the long gone days when commercial banking – due to central bank control of interest rates – was a de-facto cartel, banking has become highly competitive, forcing banks to optimize their structures, just like indus-

trial companies, not least through mergers and acquisitions. When the hurdles limiting competition from foreign banks were lowered in many countries, competition inexorably increased further.

Globalization since the 1990s marked a further dramatic step up of these trends. The major banks of today aim to be present in all major national markets. Their preference is to establish primarily their own organizations; only when necessitated by special circumstances, will they contemplate minority investments in local financial institutions.

Competition and the adoption of the European concept of universal banks in the US (leading to the abolition of the Glass Steagall Act) and in many other countries led to an expansion of the range of services provided by banks that had been unimaginable even in the early 1990s. Even more importantly, once modern information technology and the Internet became available, the volume and speed of trading financial products and commodities increased to levels that had been unthinkable and unmanageable earlier.

Once again, competitive pressures forced the leading banks to respond to the challenge and to broaden their activities into many fields, from consumer banking to corporate finance, securities underwriting, asset management, including investment funds, insurance and many more. Trading became major profit centres. In addition to the traditional trading in securities, money and foreign currencies, new financial products were developed that could be traded on and off regulated exchanges; finally commodities and commodity derivatives were also added. Significantly, hidden behind the euphemistically named trading activities, banks took substantial positions for their own account in financial products and derivatives, financing these assets largely through the short-term money and repo markets

In order to cope with the regulatory and legal problems posed in their various jurisdictions, most banks had to create a network of legal structures that often differed from one country to another. To the outside, global banks prefer to appear as a single unit, but in reality they consist of a plethora of legal entities, acting as counterparties for various services and as product providers.

In addition, many banks created 'innovative structures' outside the sphere of their consolidated balance sheets simply for the purpose of holding certain investments outside their reportable activities. These methods have come to light in the aftermath of the banking crisis. Is there a question of business ethics, if such structures are hidden from the view of investors?

### ...and their Impact on Management Structures and Responsibilities

The impact of these developments on the management structure of global banks has been far reaching. Modern banks are organized by a matrix system of responsibilities along product and regional lines. The inevitable conflicts between regional and product responsibilities are a common concern in large organizations. Generally the final say rests with the product heads of the large divisions into which banks are organized. As in industrial companies, each division has its own management focusing exclusively on its own

divisional business. On the surface, there is nothing new with this structure, because divisional structures have always been the norm. However, given the size of the modern divisions and their reach into many countries and continents, they can no longer be run by just *one* divisional executive vice-president, as in the past. Today, divisions require an extensive management team with their own support services, such as personnel and legal departments that in former times were centralized. Below the contemporary divisional managements there are the large hierarchies necessary for the management of worldwide operations.

Some of the complexities of such a system have been quite vividly demonstrated recently when top executives of Citibank appeared before a Committee of the US Senate. The bankers clearly baffled the Committee members when they seemed to suggest they were not personally responsible for the bad risks in their balance sheet, as this responsibility had been delegated to a highly capable executive on a lower level.

A critical result of these developments appears to have been hardly noticed so far: The fact that the executive boards of the parent company of such 'banking conglomerates' no longer control day-to-day operations.

This description may be somewhat exaggerated, but even if it is only partly true, there are two consequences: The traditional two-tier structure of the executive and the non-executive boards has been superseded by a three-tier structure: Beneath the traditional structure a third level has been established consisting of the division/product heads who are responsible for the various operating units. It follows that the boards of directors of such an organization are no longer supervising the executives in the traditional way, because they are mainly dealing with the executives of the second tier whose primary role is to supervise the executives on the third level who in reality manage the bank.

### The Role of the Executive Directors

Of course, the executives on the second level are not idle. As their global organizations operate 24 hours a day, they must be constantly available to deal with special matters, urgent decisions, and internal conflicts. They must keep in touch with the government authorities in the countries where they operate, maintain relations with important clients and investors, and act in their legal capacity as directors. They have to set strategy and targets, allocate capital to divisions, and establish policies for matters like remuneration and compliance. Jointly with the board, they have to determine the financial policy of the firm and an adequate strategy to monitor and limit the risks in their loan, security and other portfolios. They also have to ensure that a succession plan for the top management and board positions is in place.

Looking at the developments in recent years, one can point out banks where the top executives have been involved, during periods stretching over many months, with the preparation and execution of mergers and takeovers between their bank and other financial institutions. In fact, top management in these instances has been running a merger rather than its institution.

There is one paramount task for the top management of every well-run institution: Ensuring that the ethical standards are maintained throughout their organisations. This task is often delicate: There are border-line cases that need to be recognized, and it requires experience and thorough understanding not only of the business aspects, but also of the political and social environment, to draw the line and decide when not to pursue promising deals. The Goldman hearings have highlighted the problems of dealing in financial products, but they did not really address the specific question whether a bank acting as issuing house should have a higher responsibility than when it acts as broker or market maker only.

The question is whether the modern structures allow top managements both enough insight into their operations to be aware of such problems in good time, and sufficient influence to ensure both that rules are followed and adapted to market changes.

Traditionally, well-run banks attached great importance to the fostering of staff loyalty and the development of a company culture. In the modern structures, the loyalty of middle managements is necessarily focused on their division, or even on their departmental profit centre. Where bonuses form a large part of the compensation, it is inevitable that people will look to those who are able to determine their compensation, rather than to a distant top management.

The new system makes it also more difficult to groom people who know their organizations well. Traditionally, young promising executives were moved to various positions in a bank, being monitored by top members of the executive. In today's organizations the divisionalization makes this difficult.

Acquisitions of large other banks and/or hiring large teams of product specialists, salesmen and traders are often necessary for business reasons. Boards and top managements must be mindful of the risk that a uniform company culture may be impaired by the invasion of too many outsiders.

A great problem lies in the collaboration of the many back offices of a bank with a large international network. Many banks have only belatedly realized that they not only require specialists for their front offices, but equally competent people in their back offices that must loyally cooperate with their colleagues across their global organizations. There are many examples of severe problems caused by administrative mistakes due to the fact that there was no culture of mutual support within the firm.

### The Role of the Non-executive (outside) Directors

The tasks and responsibilities of the non-executive (outside) directors are generally reflected in the committee structure that boards normally establish to deal with their main responsibilities such as Audit, Governance, Nominations, Compensation, and Risk Policy.

Traditionally, banks like to invite chairmen or chief executives of important client companies to sit on their boards. With major operations in foreign countries, it makes sense to have an outstanding business or public figure from

one or several such countries on the board to gain a top-level insight into the circumstances in such countries.

On the other hand, there are generally few or no bankers among the typical non-executive directors of banks, the reason being that the executive directors are the bankers and provide all the necessary know-how to the board.

However, outside directors are busy people in their primary functions and the amount of time they can devote to such board positions is limited. The question is not so much what directors are doing to fulfil their legal tasks, but, given the developments described above, what they should be doing to gain sufficient insight into their banks' operations and risks.

The banking crisis has demonstrated that many banks relied far too much on short-term repo- and money market financing. Did the non-executive directors sufficiently appreciate the hazards of such policy? Did they at least enquire into the practical efforts their institutions were making to build and maintain a solid standing in the money markets around the world? Leverage in Bank balance sheets increased to an unimaginable extent in the years after 2000. Were the non-executive directors sufficiently aware of the causes and risks of these developments? Did they know of pressures exerted on bank managements by institutional investors who pleaded for higher bank profits, and did they realize that many former principles of sound banking were jettisoned in the pursuit of these targets? What did they know about special purpose vehicles and similar structures which were used to keep assets (and liabilities) outside the published accounts?

Obviously, main board outside directors will never discuss concrete transactions between the bank and its clients, and it follows that the modern products that carried substantial unknown risks were probably not analyzed on the highest level of the banks.

The US Senate hearings have forcefully raised the point of a company's responsibility when it transacts large deals that have or may have a considerable impact on the economic situation of a country. There were also the problems with financial products that aim to obfuscate the financial situation of a country as in the case of Greece. Boards may well have to address such matters in future in far greater detail than in the past.

Looking at the mega- mergers and acquisitions in the banking world, there is a further area where directors have a huge responsibility for extremely complex transactions with many unknown risks not least for the company's shareholders. When such deals have to be done in a short time, it is obvious that the degree of involvement of the full board must be limited.

### Conclusions

A number of institutions have recognized the dangers resulting from the modern structures. Some have taken steps to counter these trends by establishing new central functions that can override the decisions of the division managements. One example is risk management. However, in order to be suc-

successful such corporate divisions need highly qualified staff that can act as sparring partners for the operating departments and fully understand the complex business activities that constitute modern banking and the various financial products. Not every bank will be able to introduce such structures successfully.

Little appears to have been said about efforts to review the role and functions of the non-executive directors. At the very least, more qualified bankers should act as non-executive directors. While this sounds like a proposal easy to implement, not many qualified candidates may be available. Such directors should not normally be former executives of their bank, nor should they be retired people who are no longer in regular contact with market developments. Appointing bankers from other institutions to this function might be delicate in view of the competition between banks.

Other ideas would go further. Should there be a special board committee of a few non-executive directors who would be given direct access to internal data of the institution that would be provided without the normal filtering by the executive directors? This might be a way for the main board to exercise some oversight over the third tier-level of the product and country heads.

Or should there be directors that are given special functions to assist the regulatory authorities in their supervisory functions? This would obviously represent a far-reaching move, but it might be justified by the evident limitations of the reach of the regulators into the complex contemporary banking structures.

It would seem to me that further study is required to protect the present global banking system from the risk that it, or at least many of its components, have grown so much in their size, diversification and complexity that they have become too big to manage.

Paramount in these reflections should be the imperative of ensuring that ethics are preserved in the structure and activities of modern banks. In all well run banks this has always been one of the key responsibilities of top management and the full board. Concern for the institution's ethics should include the topic of fostering the loyalty of the staff, in particular, middle and senior management, to the company and its long-term prosperity. There seem to be too many cases that came to light in recent times when the focus of key people in a bank was basically short-term only. Bonuses also played a role, as they often neglected to include consideration of the long-term allegiance by the recipients to the success of the company.

It was Keynes who said it many years ago: 'Capitalism cannot survive without ethics.'