Market insight: Goldman offers example of governance

By John Plender

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Financial institutions are notorious for responding to market shocks in a herd. They are driven to this behaviour by complex but flawed risk-management models that assume little interaction between the individual institution and other players in the market. Yet in spite of this impulse to conformity, the risk-management performance of banks in this credit market turmoil is anything but herd-like. What is striking is the sheer variability of outcomes.

At one end of the spectrum Goldman Sachs sails sublimely on, churning out ever-improving earnings figures while offsetting losses on its exposure to the subprime market with vast profits on short positions in mortgages. At the other end, Merrill Lynch and Citigroup write off billions and shed their chief executive officers. How is this disparity to be explained?

Much of it is down to culture. Until recently, Goldman was a partnership, which is one of the best risk-control mechanisms invented. The culture of partnership, which entails a high degree of mutual surveillance in the common interest, still survives in spite of Goldman's status as a listed company. That is clear from remarks made at a Wharton finance conference in New York last month by Lloyd Blankfein, Goldman's chairman and chief executive.

Apart from the discipline of marking to market, he explained, the firm put great emphasis on ensuring that risk concerns were constantly communicated to higher levels of management, "getting more fingerprints" on potential problem risks and challenging the notion that a business group leader ought to make independent decisions on risks that affected the entire firm. There was intense accountability through a host of management committees that evaluated all aspects of risk.

Most importantly, Goldman ascribes as much status, prestige and pay to people engaged in control functions as to those running businesses. It constantly rotates human capital back and forth between risk control and business operations.

Compare and contrast with any large bank, where risk management too often degenerates into mere compliance. In such a culture, traders will always find ways around the rules. And if those in charge of the bank are rewarded with bonuses and other incentives where the award is not deferred for long enough, you have a roller-coaster cycle of escalating returns invariably followed by heavy losses.

The structure of boards is also relevant. In the US governance model, the chairman and CEO roles tend not to be split, while the boards are dominated by non-executives who too often lack expertise in risk. Over the recent credit cycle, these non-executive directors permitted a huge escalation of risk across the banking system. They also sanctioned pay deals for CEOs, complete with rewards for failure, that encouraged risk escalation.

Pete Hahn, a former Citigroup executive who is now a fellow at the Cass Business School in London, argues bank boards too often resemble retirement clubs. And he has a point. Apart from CEO Stan O'Neal, only three of the 12 directors of Merrill at the end of last year were under 60. Distinguished though Merrill's board was, it was hardly chock-a-block with expertise on banking and risk.

In contrast, Mr Blankfein is accompanied on the board by two other executive directors, together with Stephen Friedman, a former senior partner of the firm. So there is a core group on the board steeped in the disciplines of risk. And Goldman's managing directors include Gerald Corrigan, a former head of the Federal Reserve Bank of New York, who is regarded as the pre-eminent expert on financial plumbing.

It would be foolish to assume the firm will be necessarily immune from upsets in a deepening credit squeeze. It has had problems with its in-house hedge funds. But it does offer a marked contrast to the "big bank" model now under attack from shareholder activists such as Knight Vinke. Within a predominantly wholesale operation its activities are diverse. Yet they offer genuine synergies, albeit with potential conflicts of interest.

It is clear that bank governance badly needs a rethink. With its distinctive model, Goldman offers interesting food for thought.

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