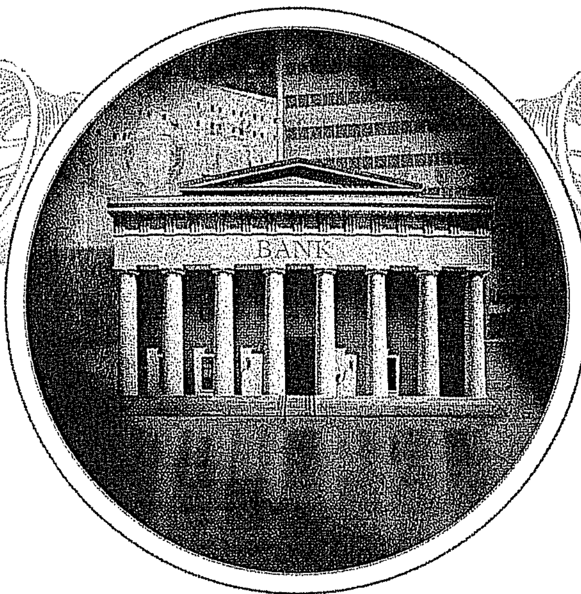
ATONEMENT

COMPANIES IN ALL INDUSTRIES ARE PAYING FOR THE TRANSGRESSIONS OF THE BANKING SECTOR.



UNTIL RECENTLY, the health of banks hasn't been a pressing issue for finance executives. After all, it's been almost two decades since the last swell of commercial bank failures, 10 years since a financial crisis of any consequence, and 7 years since the credit cycle took a big dip. Along the way, the earnings of commercial banks quadrupled.

But thanks to the subprime crisis, banks are back on CFOs' radar. While few finance chiefs expect bank failures of any magnitude, the discovery of modern banking's soft underbelly has created unease. And the ripple effects are hitting corporations from many directions.

Now that the gaping holes in their risk management have been revealed, banks are trying to restore faith. In "Missing Pieces" (page 50), we examine whether giants such as Merrill Lynch and Citigroup are really changing their risk structures or simply throwing new C-suite executives at the problem. One important question: How involved will bank CFOs be in monitoring exposures in financial markets?

Even as banks work out their risk quandaries, they are already demonstrating far less appetite for corporate loans. In "Pedaling As Fast As They Can" (page 61), we explore how companies are sweating to find capital for new investment—and paying more for it.

The clots in the arteries of financial markets are also bad news for companies that grant trade credit to their customers. The National Association of Credit Management's Credit Manager's Index, an indicator of trade-credit trends and receivables' performance, has dropped for six straight months. In "No Uncertain Terms" (page 67), we examine how to handle nonpayment risk in this environment.

Companies could be paying for the mistakes of banks for years. But in times of crisis, much can be learned. The credit crunch of 2007 will make CFOs more inquisitive of their financial institutions' business practices and balance sheets. That may do more to strengthen the foundations of banking than the previous 20 years of prosperity.

—VINCENT RYAN

Stephen Webster

missing pieces

HOW POOR RISK-MANAGEMENT TECHNIQUES CONTRIBUTED TO THE SUBPRIME MESS.
BY AVITAL LOURIA HAHN

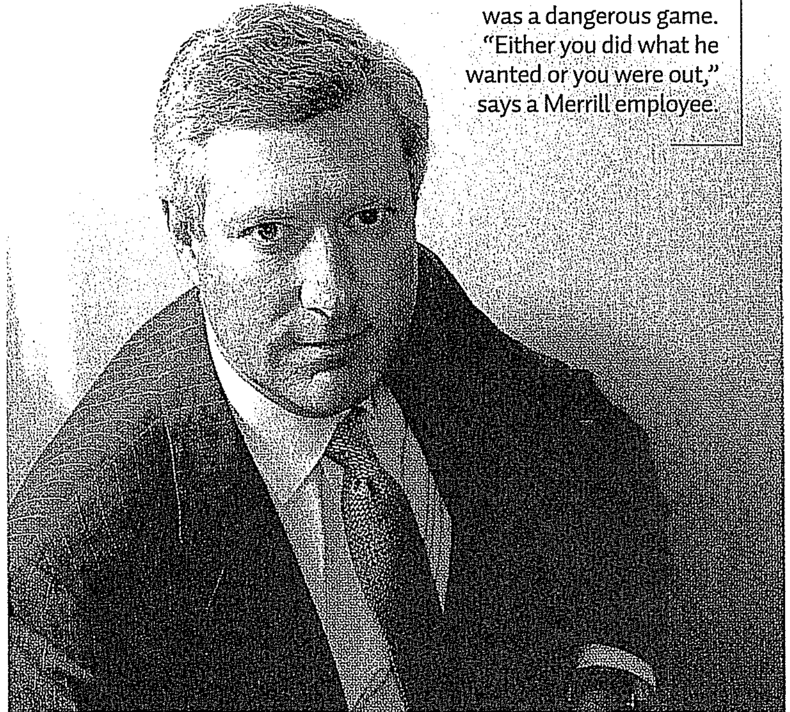
IN EARLY 2007, BELIEVING THAT TROUBLES IN THE subprime-mortgage industry would worsen, Morgan Stanley's fixed-income traders built a $2 billion short position on the sector. As protection, they bought $14 billion worth of triple-A mortgage-backed securities. Although there were troubling signs that the credit malaise was spreading to the higher-grade securities, the traders considered the triple-A's an adequate hedge. ¶ But by December, a perfect storm had gathered: with the credit markets in free fall, investors fled all forms of mortgage-backed securities, including investment-grade. Morgan Stanley's hedge collapsed, triggering a >>

$9.6 billion fourth-quarter write-down—nearly triple the $3.7 billion that Colm Kelleher, Morgan Stanley's newly appointed CFO, had forecast a month earlier.

In many ways, Morgan Stanley's predicament mirrors that of other banks caught in the subprime mess. Errors in judgment, the inability to properly manage risk, and the failure of stress tests have so far resulted in global bank losses of $265 billion. With a few notable exceptions, even bank CFOs seemed willfully ignorant of snowballing risk. "Everyone involved was caught unprepared, given the speed at which liquidity dried up," says Jess Varughese, managing partner of Milestone Advisory Services.

The question now is how an industry so splendidly adept at making a buck out of risk could get it so wrong, and whether the ritual executive bloodbaths and subsequent reshufflings will help forestall the next meltdown.

One thing is clear: the hardest hit banks, from Merrill Lynch to Citigroup, shared a siloed approach to risk, with insufficient communication among risk, finance, and operations. Unlike other businesses, where the CFO is typically the ultimate risk manager, banks tend to view risk as an advisory role.



People close to Merrill Lynch say that even if then-CFO Jeffrey Edwards (pictured) saw the risk, contradicting then-CEO Stan O'Neal was a dangerous game. "Either you did what he wanted or you were out," says a Merrill employee.

Bill Cramer

But as this crisis demonstrates, such separation is logical only up to a point. Among those banks that have, so far, dodged the bullet, such as Goldman Sachs, Lehman Brothers, and Deutsche Bank, risk has a high profile and the CFO, if not directly in charge, is still closely involved in monitoring and managing risk.

Attaching a high profile to risk management, of course, has not been the trend. Instead of managing risk, banks have been shedding it for years, passing it on to investors through securitizations and syndications. Former Federal Reserve chairman Alan Greenspan praised the resulting dispersion of risk. He claimed it bolstered the safety and soundness of his banking charges. In fact, it may have made them more careless.

> **Bankers bet with their bank's capital, not their own. If the bet goes right, they get a huge bonus; if it misfires, that's the shareholders' problem."**
>
> SEBASTIAN MALLABY, COUNCIL ON FOREIGN RELATIONS

After all, bankers are only human. Even when they are not playing with investor money, individuals in large banks don't have much skin in the game. "Bankers bet with their bank's capital, not their own," wrote Council on Foreign Relations scholar Sebastian Mallaby, in a *Washington Post* editorial. "If the bet goes right, they get a huge bonus; if it misfires, that's the shareholders' problem." It's no surprise, says Mallaby, "that rational bank employees take as much risk as they can."

Sidelining caution in favor of potential profit is not particularly difficult in a culture built on producer worship. Traders looking for capital often get their business-unit head to intervene on their behalf. In many of today's large banks, risk officers and CFOs are cost centers. Morgan Stanley's new chief risk officer (CRO) is only now answerable to the CFO instead of the co-president. At Citigroup, risk reported to the chief administrative officer before its new CEO Vikram Pandit changed the structure to report to him.

Contrast these examples with Goldman Sachs, where risk reports to the CFO. Or with Lehman and Deutsche, where risk is an independent function that reports to the CEO. At those banks, risk management is vigilant, with frequent communication among business groups. Indeed, though we have not yet felt the full effect of this crisis, examples of how to manage risk (think Goldman) and how not to (Merrill, Citi) are already emerging.

Merrill's Peril

On paper, at least, Merrill's risk oversight was robust. According to the firm's 2006 annual report, the then-CFO, Jeffrey Edwards, headed the risk-oversight committee and was charged with establishing risk-tolerance levels, authorizing changes in the firm's risk profile, and putting in place proper

"DURING MY STAY IN TOKYO, THE HOTEL ROOM WAS IDENTICAL TO ANY AMERICAN-STYLE HOTEL I'VE STAYED IN, BUT THE TOILET WAS DIFFERENT. I'D NEVER SEEN A TOILET WITH A BUILT-IN CONTROL PANEL AND RETRACTABLE BIDET. IT CAME WITH INSTRUCTIONS AND A WARNING LABEL. I WAS **LITERALLY SCARED OF THE TOILET IN MY HOTEL ROOM.** IT COULD SENSE MY PRESENCE WHEN I WALKED IN THE BATHROOM. THEN IT WOULD SLOWLY RAISE ITS LID, AND A LOW SINISTER HUMMING WOULD BEGIN. THAT WAS THE SOUND OF THE BIDET'S WATER PUMP MOTOR WARMING UP. A LIGHT WOULD COME ON FROM WITHIN THE TOILET BOWL, AND THERE IT WOULD BE, GLOWING IN THE DARK, HUMMING OMINOUSLY, WAITING FOR ME. WAITING TO GET ME." *Julie P. Houston*

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risk-management processes. But in reality, the risk structure had problems. Risk was not integrated but split between a credit risk officer and a market risk officer, both of whom reported to the CFO, who then reported to the CEO.

That may work at a place like Goldman, where decisions are made collectively among executives. But at a firm with a strong-willed CEO, like Merrill, it can backfire.

People close to Merrill say that even if Edwards saw the risk, contradicting then-CEO Stan O'Neal was a dangerous game. "Either you did what he wanted or you were out," says a Merrill employee. Ironically, it was O'Neal, a former Merrill CFO, who drove the firm to take more risk with its own capital. Relieved of his job in October, shortly before Edwards (who remains with Merrill as part of the Executive Client Coverage Group), O'Neal also had overseen the $1.2 billion acquisition of subprime-mortgage originator First Franklin in late 2006 as the sector was deteriorating.

Merrill may have also become addicted to the enormous fees it collected from underwriting collateralized debt obligations (CDOs), which reached nearly $1 billion in 2006 and 2007 combined. Because CDO investors demanded the lower-credit, higher-yielding slices of the securities, Merrill did not have enough of a market for the investment-grade tranches and began keeping them on its books. Its pre-crisis holdings peaked at an only partly hedged $41 billion. As with Morgan Stanley, Merrill apparently felt those tranches were reasonably safe. And that may have made Merrill reluctant to pay the high cost of such insurance, says Tanya Azarchs, banking analyst at Standard & Poor's. "But by the time people realized what was happening, it was too late to do anything," she says.

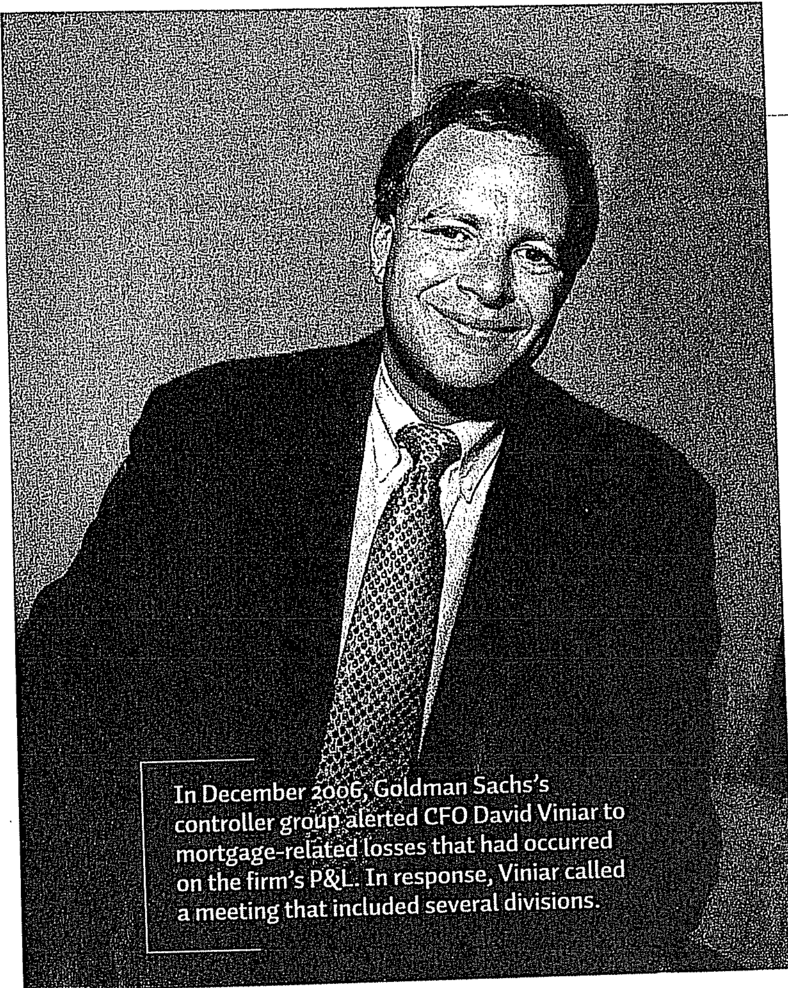
In December, Merrill appointed former Goldman president and NYSE head John Thain as CEO. He has since hired CFO Nelson Chai, also a former NYSE executive, and integrated market and credit risk under two co-CROs—former Goldman global risk officer Noel B. Donohoe and Edmond N. Moriarty, formerly Merrill's chief credit officer. Both report to Thain. In addition, Thain has instituted weekly risk meetings and changed the compensation structure from one that encouraged risky bets to one that reflects "firm results first," according to a January presentation.

How Bad Is It?

The disconnect between initial and final assessments of subprime fallout.

THE BANKS	THE CFOs	WHAT THEY INITIALLY SAID	THE REAL DAMAGE*
Merrill Lynch	**Jeffrey Edwards** (replaced by Nelson Chai, 12/10/07)	**"...Proactive, aggressive risk management has put us in an exceptionally good position."** (7/17/07)	Net write-downs of **$7.9 billion in Q3** and another **$11.5 billion in Q4**
Citigroup	**Gary Crittenden**	**"...There is no specific number that we're targeting. It depends on what the market conditions actually are during the time period."** (7/20/07)	Net write-downs of **$5.9 billion in Q3** and another **$18.1 billion in Q4**
Morgan Stanley	**David Sidwell** (retired; replaced by Colm Kelleher, 12/01/07)	**"Ultimately, what we believe is important in terms of what hits our balance sheet is making sure that we understand the credit and maintain very high credit standards."** (6/20/07)	Net write-downs of **$9.4 billion in Q4**
Bear Stearns	**Sam Molinaro**	**"We feel like we have those situations reasonably well in hand and well hedged."** (6/14/07)	**Q4 loss of $859 million**—nearly triple the forecast, and a **$1.9 billion write-down**
Lehman Brothers	**Chris O'Meara** (replaced by Erin Callan, 9/20/07; O'Meara is now chief risk officer)	**"The mortgage business is in a very challenging situation and really that's it."** (6/12/07)	Net write-downs of **$700 million in Q3** and **$830 million in Q4**
UBS	**Clive Standish** (retired; replaced by Marco Suter, 10/1/07)	**"Our first order of priority is, wherever possible, to get a marking that is completely transparent...."** (8/14/07)	Net write-downs of **$3.4 billion in Q3** and **$10 billion in Q4**
Goldman Sachs	**David Viniar**	**"...While I cannot predict the short term, we remain bullish on the prospects for Goldman Sachs."** (12/12/06)	Posted a **Q4 gain of 2.2%, to $3.2 billion,** beating analysts' forecasts and boosting earnings for the yr. by **21%, to $11.4 billion.**

*As of December 2007


In December 2006, Goldman Sachs's controller group alerted CFO David Viniar to mortgage-related losses that had occurred on the firm's P&L. In response, Viniar called a meeting that included several divisions.

Big Isn't Always Better

For Citigroup, the subprime crisis simply accelerated a downward slide. With investors calling for the bank's breakup long before the crisis, Citigroup's $20 billion subprime-related losses and its battered structured investment vehicles (SIVs) further exposed the difficulties of managing this complex institution. In fact, in addition to taking onto its balance sheet as much as $43 billion in CDOs, Citi had close to $100 billion in SIVs.

Internally, the finance function has been in flux for some time. Two consecutive CFOs—Todd Thomson and Sallie Krawcheck—were replaced in short order. It wasn't until last March that the bank hired what one corporate-governance scholar calls a "professional CFO," American Express's Gary Crittenden, but by then it was too late. Indeed, in an analyst call in October, Crittenden conceded that Citigroup's massive CDO losses had to do with failure to properly monitor the value of the bank's CDO holdings until it was too late to hedge or sell them. Collaboration "between the credit-risk team and the market-risk team was not as strong as it needed to be," he said. "We have to have more integration between the way those teams operate."

Like Merrill's, Citi's CDO losses were disclosed gradually. (Ironically, Thomson had been in charge of risk as CFO, but that structure was dismantled during Citi's struggles to overcome a series of crises over reputation risk.) A $5.9 billion third-quarter hit predicted in November mushroomed to $11 billion in December. CEO Charles Prince, who in the summer said that Citi would "keep dancing" as long as the music played, resigned. The bank named Pandit as CEO in December and split the role of CEO and chairman. But those and other corrective steps did not prevent a fall in the bank's capital ratio to 7.3 percent from its 7.5 percent target, triggering a downgrade from Moody's Investors Service.

Overall, the risk function at Citi lacked visibility or direct lines to the top. Former CRO David Bushnell reported to Citi vice chairman Lewis Kaden, who had been a chief administrative officer, an ineffective organizational structure, according to corporate-governance gurus. Just prior to his retirement in November, Bushnell served as both risk officer and chief administrative officer, reporting to Prince. In November, the bank named Citigroup risk veteran Jorge A. Bermudez as CRO, reporting directly to acting CEO Sir Win Bischoff. Citi also formed an advisory committee of senior leaders from across the company that will provide input on ways to strengthen risk-management processes. The group meets weekly, with the CEO often present.

Crittenden, meanwhile, has said he would centralize the treasury functions to "facilitate the allocation of capital to our highest growth and return opportunities." He is also in charge of

> Developing a risk function is a cultural change, and it takes time to see if these are committed actions or just a form of window dressing."
>
> PRODYOT SAMANTA OF STANDARD & POOR'S

Internal Controls: The Invisible Link

CFOs MAY NOT BE IN CHARGE OF RISK MANAGEMENT at some Wall Street banks. However, management is responsible for certifying a company's internal control over financial reporting in accordance with Section 404 of Sarbanes-Oxley.

"As CFO, you are signing off that internal control over financial reporting is effective," says Joseph Atkinson, U.S. advisory operations leader for governance, risk, and compliance at PricewaterhouseCoopers. But while internal controls over financial reporting are designed to provide reasonable assurances, he says, "they don't provide absolute assurance." The subprime crisis, he adds, involved **"instruments that were complex to value and impacted by market events. While you can definitely see large changes in values, that does not necessarily mean there was a failure in internal control over financial reporting."**

Still, the ultimate authority for raising risk questions lies with the board's audit committee, according to Section 303A of the NYSE Listed Company Manual. Of course, it stands to reason that most audit committees would turn to one of their main liaisons—the CFO—for advice in that area. And if that happens at most public companies, why not banks? —A.L.H.