Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis

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Thank you for the invitation to participate in the Third East Asian Law & Society Conference at the KoGuan Law School of the Shanghai Jiao Tong University. In my paper today I would like to discuss lessons from the financial crisis in the United States. This paper focuses on the critical element for decisionmaking that I call “constructive dialogue.” Constructive dialogue includes (1) processes for eliciting risk-related information that flows across and to the top of the organization where it can be addressed in decisionmaking, and (2) full, candid, and respectful discussions of risk-reward tradeoffs. The financial crisis demonstrated how constructive dialogue was essential to promote sound decisionmaking at a time when the housing and credit bubbles had lulled many financial firms into complacency.

These lessons of the financial crisis can also be generalized to decisionmaking at nonfinancial firms and U.S. government agencies. I would welcome any examples that others may have that can shed light on issues of constructive dialogue as a means of promoting higher quality decisions in other organizations and contexts as well.¹

In the financial crisis in the United States millions of people lost their homes to foreclosure, the jobless rate doubled, and households lost trillions of dollars of wealth.² But it could have been even worse – much worse. Many policymakers believe that, except for the unprecedented reaction by the Federal Reserve Board, Treasury Department, and other federal agencies, the


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country and world might have gone into a “Depression 2.0,” as Federal Reserve Chairman Ben Bernanke put it. ³

The single most important factor in determining whether a company could successfully navigate the crisis was the posture of the CEO, and by extension, whether firms possessed cultures and processes that encouraged sound decisions at a time of uncertainty. Top managers at successful firms solicited feedback continuously; by contrast leaders of failed firms disregarded or discouraged input from their boards of directors, management teams, risk officers, and regulators. Review of other major company failures, such as the BP Gulf oil spill or fatalities caused by explosions at U.S. energy company facilities, reveals a similar pattern of weak oversight and CEOs impervious to feedback.

While their approaches differed, successful firms combined significant qualities: (1) discipline and a longer-term perspective, (2) strong communications and information systems to ensure that top management had access to information needed both to manage the firm and to understand enterprise-wide risks, (3) sensitivity to early warning signs and the capacity to respond quickly and effectively, and (4) a process of constructive dialogue between business units and risk managers.

As a staff member of the U.S. Financial Crisis Inquiry Commission (FCIC) I had the opportunity to interview CEOs, risk officers, traders, bankers, regulators, and policymakers to try to understand the difference between financial firms that successfully navigated the crisis and those that did not. FCIC interviews took place in 2010 while people, still in shock at the destruction caused by failures of financial firms and their regulators, were generally eager to tell their sides of the story. The FCIC also had access to many thousands of internal documents that helped to inform our questions and establish patterns of prudent or imprudent decisionmaking at various firms and regulators. ⁴

When the FCIC published its final report, ⁵ I built on its work and wrote a book, Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis (Oxford University Press, 2012). The book examines a dozen large financial firms, four which navigated the crisis successfully and eight which failed, in the sense that they went out of business, were acquired on disadvantageous terms, or required government aid to stay afloat. The book asks a simple question: what were key differences in governance and management (including risk management) that distinguish the two groups of firms?

⁴ The FCIC placed numerous interview records and documents on the public record. They are available at the FCIC permanent website, http://fcic.law.stanford.edu/resource.

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Constructive Dialogue: the Essential Difference between Firms that Navigated the Crisis and Those that Failed

One single factor distinguishes the two groups: firms that successfully navigated the crisis built a process of constructive dialogue into their decisionmaking: When making major decisions, successful companies brought together proponents in the firm who favored a revenue-generating activity and those such as risk officers who worried about its possible disadvantages and downsides. The CEO or another senior manager encouraged a respectful exchange of views between these perspectives to gain a better understanding of the risk-reward tradeoffs of the activity. These were the firms that successfully avoided exposure to unacceptable volumes of subprime mortgages and other risky products before the crisis or that shed or mitigated their exposures in a timely manner before taking major losses.

Successful firms had cultures that welcomed input from those concerned about risk. In the felicitous phrase of American organizational development specialist Jack Rosenblum, they recognized that “Feedback is a gift.” By encouraging constructive dialogue between those seeking increased profits and those concerned about risks, company leaders elicited information and obtained a more robust understanding of the contours of decisions than they otherwise would have had. Perhaps my favorite example comes from an official of a successful firm who told me, "The CEO often asks my opinion on major issues," and then added, "But he asks 200 other people their opinions too." When he made a decision, that CEO had a strong sense of the risks and rewards that it entailed.

When there was still time before the financial crisis finally broke in 2008, information flow and constructive dialogue were essential to allow a firm to avoid, shed, or hedge its exposure to toxic assets, i.e., those that looked to be safe but in fact contained major embedded risk. Classic toxic assets were AAA-rated private-label mortgage securities that appeared to give financial firms both safety and higher yield than usual safe assets. While toxic assets were risky investments for any firm, they proved fatal for highly leveraged firms that lacked the balance-sheet strength to absorb the losses.6

Successful Firms: JP Morgan Chase, Goldman Sachs, Wells Fargo, and Toronto Dominion Bank

My book identifies four firms that successfully navigated the crisis: JP Morgan Chase, Goldman Sachs, Wells Fargo, and Toronto Dominion Bank (TD Bank). Each distinguished itself in operational competence and intelligent discipline, but with different approaches. JP Morgan

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6 The financial crisis broke in two waves. First, firms started taking losses on assets that they had considered to be safe (especially “AAA”-rated private label mortgage securities). Second, when firms realized they didn’t understand the assets on their balance sheets or, by extension, on the balance sheets of their counterparties, the market panicked and withdrew liquidity from counterparties they considered potentially troubled because of too many toxic assets on the counterparties’ books. It was the panic that allowed a relatively small volume of toxic assets to precipitate the financial crisis and its consequences. See, Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis, chapter 2 “Dynamics of the Financial Crisis.”
Chase’s story is of preparing the company to be strong enough to take advantage of long-term opportunities. Goldman’s is of firm-wide systems and capacity to react quickly to changes in the environment. Wells is a company with a strong culture of customer focus and restraint. And TD Bank provides the simple lesson: if you don’t understand it, don’t invest in it. A fifth firm that successfully navigated the crisis, Deutsche Bank, which will not be covered here, also reflects the theme of this paper. Deutsche Bank built risk management into the culture of its business units, including processes of constructive dialogue with risk managers, which allowed the firm to reduce its exposure to risky assets in a timely way before the crisis took its toll.7

Constructive dialogue was built into the cultures of these firms. The first important element was an emphasis on ensuring that information flowed to parts of the organization that needed it. As one JPMorgan Chase executive put it, “Jamie [CEO Jamie Dimon] and I like to get the bad news out to where everybody can see it… to get the dead cat on the table.”8 Goldman Sachs maintained a "culture of over-communication; multiple formal and informal forums for risk discussions coupled with a constant flow of risk reports.”9 Dan Sparks, formerly head of the Goldman mortgage desk, told FCIC staff that he reported bad news to the firm’s top management because, "Part of my job was to be sure people I reported to knew what they needed to know."10 The Wells Fargo Vision and Values Statement emphasizes risk awareness as a part of the company’s culture:

“We want compliance and risk management to be part of our culture, an extension of our code of ethics. Everyone shapes the risk culture of our company. We encourage all team members to identify and bring risk forward. We should thank them for doing so, not penalize them. Ben Franklin was right: An ounce of prevention is worth a pound of cure.”11

TD Bank’s CEO Edmund Clark wanted to hear negative news fast:

I'm constantly saying to people: ‘Bring forward the bad news, the good news will surface soon enough. What I want to hear about is what's going wrong. Let's deal with it.’ … It's about no surprises. Any number of problems we've had to deal with could have been solved if the person had only let us know early on… In fact

10 FCIC interview with Dan Sparks, Goldman Sachs, June 16, 2010.
[employees] joke that I'm only happy when the world's falling apart and that I'm a total pain when everything is going well."^12

The second important part of effective constructive dialogue is that managers need to have a forum where they can conduct open and respectful but possibly intense debate about what the information actually means. This part of constructive dialogue has been a feature of well-run banks for a long time. Banks use a credit committee to deliberate whether to make particular loans or not. Loan officers bring information about a proposed large loan to the committee. There, under the watchful eye of a senior executive, the loan officer presents the case to make the loan, followed by the underwriting department’s presentation about risks that the loan involves. If the dialogue goes well, the result might be a synthesis between the two views. Instead of simply making a yes-or-no decision, the credit committee might decide to ask for more protection, such as an added guarantee or a shorter term, or more collateral, as a way to allow the transaction to go forward. The final result often can be a higher-quality decision than either the loan officer or the underwriter would make by themselves.

**JPMorgan Chase**

At JPMorgan Chase constructive dialogue at the top management level helped protect the company from taking major losses in the financial crisis. The 15-member operating committee was a diverse group “of longtime loyalists, J.P. Morgan veterans, and outside hires.” They met monthly for intense debate about developments in the company and in the markets it serves.

“"The group is generally loud and unsubtle…. the atmosphere is variously described by the participants as "Italian family dinners" or "the Roman forum - all that's missing is the togas." [CEO Jamie] Dimon will throw out a comment like "Who had that dumb idea?" and be greeted with a chorus of "That was your dumb idea, Jamie!" "At my first meeting, I was shocked," says Bill Daley, 60, the head of corporate responsibility and a former Secretary of Commerce. "People were challenging Jamie, debating him, telling him he was wrong. It was like nothing I'd seen in a Bill Clinton cabinet meeting, or anything I'd ever seen in business."^13

A similar atmosphere prevailed at monthly meetings of top management of each of JPMorgan Chase’s major operating units:

“To make it on Dimon's team you must be able to withstand the boss's withering interrogations and defend your positions just as vigorously. And you have to live with a

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^13 Shawn Tully, “Jamie Dimon's swat team: How J.P. Morgan's CEO and his crew are helping the big bank beat the credit crunch,” *Fortune*, September 2, 2008.

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free-form management style in which Dimon often ignores the formal chain of command and calls managers up and down the line to gather information.” 14

As one participant told Fortune in 2008, Mr. Dimon was tough but open to feedback. "He understands the details completely, he loves to debate and disagree, yet he'll let you do it…As long as you know what's in Appendix 3 of your report as well as he does."

In October 2006 at one of the monthly reviews the part of JPMorgan Chase’s retail operations that serviced mortgages reported a significant increase in delinquencies by subprime mortgage borrowers. Data confirmed that the trend was widespread in the subprime market and that competitors’ subprime holdings were performing even worse. Other parts of the company also reported indicators that mortgage securities were increasingly troubled. Putting all of this together, Mr. Dimon issued an order to all parts of the company to shed its exposure to subprime mortgages. JPMorgan Chase took losses that were modest compared to its major competitors.

As Northwestern University Professor Russell Walker concludes:

“In the case of JPMorgan, it was the retail banking division that shared data with the investment bank on the escalations in mortgage delinquencies. This sharing of data across business lines allowed Mr Dimon and his corporate team to change strategy on the investment side. For many organisations, sharing information that challenges accepted norms or questions conventional wisdom is not welcomed. Other banks could have done the same as JPMorgan, but the practice of communicating risks and data across business lines was absent. The lesson, of course, is that an enterprise must be willing to communicate about risk, especially when things are going well and the risk has yet to be realised.” 15

Goldman Sachs

Goldman Sachs has built constructive dialogue into the firm’s daily processes. The firm uses mark-to-market accounting to assess the value of each trader’s position. The firm maintains a parallel structure so that a controller supervises each trader’s position and marks it to market each evening. This information helps manage trading positions through devices such as internal pricing to ensure that assets do not remain on the balance sheet for too long. The information from each position is rolled up through the organization to the CFO, who obtains a timely firm-wide view of positions and exposures. Goldman CFO David Viniar told the FCIC that there may be disagreements between a controller and a trader, and in such cases the controller’s view is likely to prevail.

14 Ibid.

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The firm reported that, “…Dan Sparks, then head of the mortgage department, [told] senior members of the firm in an email on December 5, 2006, that the ‘Subprime market [was] getting hit hard… At this point we are down $20mm today.’ For senior management, the emergence of a pattern of losses, even relatively modest losses, in a business of the firm will typically raise a red flag.”16

The immediate result, Mr. Sparks explained to the FCIC, was that he suddenly received visits from senior Goldman officials who before had never bothered to learn the details of his operations. Chief Financial Officer David Viniar convened a meeting to try to understand what was happening. Goldman’s senior management decided, in Mr. Viniar’s phrasing, “To get closer to home” with respect to the mortgage market. In other words, in its combination of long and short positions, the firm would begin taking a more cautious and more neutral stance. It would reduce its holdings of mortgages and mortgage-related securities and buy expensive insurance protection against further losses, even at the cost of profits foregone on what had looked like an attractive position in mortgages.17

In January and February 2007 Goldman hedged its exposure to the mortgage market. The firm then closed down mortgage warehouse facilities, moved its mortgage inventory more quickly, and reduced its exposure yet further by taking on more hedges and laying off its mortgage positions. The end result was that Goldman avoided taking the substantial losses it would have suffered if it had not reacted so promptly to signs of problems.

In one area, Goldman was slow to recognize emerging risk: this concerned the firm’s reputation. When FCIC staff asked a Goldman risk officer who was responsible for reputational risk, the answer came back that everyone was responsible; the company had not organized to deal with reputational risk. In early 2011 the firm published a response to its problems with reputational risk, including a new committee structure for reporting potential conflicts and a code of conduct. Goldman stated that this would be integrated not only into processes of the firm, but also into its culture:

The firm’s culture has been the cornerstone of our performance for decades…We must renew our commitment to our Business Principles – and above all, to client service and a constant focus on the reputational consequences of every action we take. In particular, our approach must be: not just “can we” undertake a given business activity, but “should we.”18

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In 2011, Goldman separated its reporting of business segments to distinguish investing on behalf of clients from the firm’s proprietary trading on its own account, an area of public controversy that had been subject to some reputational risk in the aftermath of the financial crisis.

Wells Fargo

Wells Fargo protected itself in the financial crisis because of a strong company culture with several important elements: (1) a general conservatism that precluded simply following the market with new products and services, or even acquisitions, until these had been tested within the firm for consistency with the company’s culture and values, (2) an emphasis on developing relationships with customers rather than simply viewing sales of products and services as transactions, and (3) a decentralized structure that made heads of business units responsible for the risks of their activities.

These cultural attributes helped Wells to weather the crisis more successfully than many of its peers. The focus on the customer meant that Wells refrained from offering the most risky mortgage products. Richard Kovacevich, then Chairman of the Wells board and past-CEO, told the Stanford Graduate School of Business in 2009 that Wells “did not offer any no-doc option, negative-amortization loans, to subprime borrowers. These exotic, subprime mortgage loans were not only economically unsound, they were not appropriate for many borrowers. We lost 4% market share in our mortgage business for three years between 2005 and 2007, $160 billion in originations in 2006 alone.”

Wells supported this customer-centric approach with its core business strategy, which was to be able to cross-sell financial products to its existing customers. Again Mr. Kovacevich:

“Consistent, organic, revenue growth through cross-selling is probably Wells Fargo's most distinctive skill. Our average retail household has 5.9 products and over one in four has over eight products. These are, by far, the highest cross-sell ratios in the industry and about twice the industry average.”

The logic was that if customers lost money on a risky financial product then they would not turn to Wells for the many other financial products and services they would purchase from a trusted source.

Wells also had a management style that sought to promote constructive dialogue. Mr. Kovacevich rejected hierarchical control as an effective means to promote performance. Instead, as CEO he saw his job as:

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“to select the best people to run [individual Wells business lines] and … groups, let them do it, coach them so they learn even faster, and assure we have a strong internal check-and-balance audit process that verifies that they are adhering to the principles and the policies that we've agreed upon.

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“People at the top should, above all, be leaders…At Wells Fargo, we believe personal leadership is the key to success. We believe the answer to every problem, issue, or opportunity in our company is already known by some person or team in the company. The leader only has to find that person, listen, and help effect the change. By the way, the people with the best answers are not always the people with the most stripes. True leaders do not demand loyalty, they create it. They use conflict among diverse points of view to enable the team to reach new insights. They exert influence by reinforcing values….”

(emphasis added).

John Stumpf, Mr. Kovacevich’s successor as CEO of Wells Fargo, told the FCIC that “We believe at the company that risk is best managed as close to the customer as possible with strong oversight from independent bodies within the company” Part of the process of checks-and-balances was what Michael Loughlin, the Wells CRO, called “[providing] effective challenge.” He offered the FCIC several examples how oversight from his office helped detect risk shortcomings in major business units and led to remediation, and in some cases, changes in business unit management.

The result of the Wells culture and processes was that the company refrained from taking major losses and came through the financial crisis with greater strength than before. Wells doubled in size and, through its acquisition of Wachovia, a firm that failed in the crisis, became a national company.

Toronto Dominion Bank (TD Bank)

Toronto Dominion Bank (TD Bank) provides a useful lesson about the need to surface anomalous facts, investigate them, and make a disciplined decision. While the FCIC did not interview people from TD Bank, the company’s annual reports and other public information tell the story. In the early 2000s, Toronto Dominion Bank had had an active international business in structured products. Then with little explanation CEO Edmund Clark announced in the company’s 2005 annual report that, “We…made the difficult business decision to exit our global structured products business…While the short-term economic cost to the Bank is regrettable, I am pleased that we have taken the steps we have and that we can continue to focus on growing

20 Ibid.
22 FCIC interview with Michael Loughlin, Chief Risk Officer, Wells Fargo, November 23, 2010.
our businesses for the future to deliver long-term shareholder value.” The company reported taking significant losses as it unwound its positions in 2005 and 2006.

How did Mr. Clark make the decision both to avoid exposure to the U.S. subprime market and to shed the firm’s exposure to structured mortgage products and derivatives? "I'm an old-school banker," Clark told a reporter in May 2008. "I don't think you should do something you don't understand, hoping there's somebody at the bottom of the organization who does."

Clark said he spent several hours a week meeting with experts to understand the financial products being traded by the bank’s Wholesale Banking unit. "The whole thing didn't make common sense to me," Clark said. "You're going to get all your money back, or you're going to get none of your money back. I said, 'wow!' if this ever went against us, we could take some serious losses here."

Mr. Clark recalled that stock analysts at the time wrote that he was an “idiot” for the taking his long-term perspective. Yet, as the crisis hit, the company could report that it held no exposure to U.S. subprime mortgages, no direct exposure to third-party asset-backed commercial paper except for exposure of its mutual funds and asset management group, and no direct lending exposure to hedge funds, with only nominal trading exposure. Because TD Bank came through the crisis intact it was able to begin systematic expansion from its Canadian base into the U.S. market. By 2013, through a series of acquisitions TD Bank had become one of the ten largest US banks with branches extending along the East Coast from Maine to Florida.

Firms That Failed to Navigate the Crisis

By contrast to these examples of financial firms that successfully navigated the crisis, firms that failed lacked constructive dialogue in their cultures. I met with one CRO who explained her dilemma: if she kept raising concerns with management, she would become a pain in management’s neck; but if she didn’t raise concerns she would be known as the CRO at an institution that blew itself up. She left the firm in 2006 and the firm failed in 2008.

A distinguishing characteristic of unsuccessful firms was their pursuit of short-term growth without appropriate regard for the risks involved. In 2005-2007 both Fannie Mae and Freddie Mac decided to take more risk and increase exposure to the subprime mortgage market just as

25 Ibid.
home prices were peaking. Other firms decided similarly around the same time, including Lehman, WaMu, and Countrywide.

Many of the firms that took excessive risk at the wrong time did have chief risk officers (CROs). Sometimes, the chief risk officer reported to the head of a business unit rather than to a committee of the board of directors or even the CEO. This muted their ability to assess risk or make recommendations that top management would hear. Some of the firms that failed either fired the CRO (Freddie Mac) or moved the CRO to a less important position at the company (Lehman) or layered the CRO far down in the company and ignored his input (Countrywide). In one major case, the corporate CRO simply lacked access to information at a part of the firm that was taking excessive risk (AIG). At many firms, enterprise risk management specialist Stephen Hiemstra explains, risk management was a compliance exercise rather than a rigorous undertaking.28

Firms that came to grief in the crisis lacked both (1) a proper flow of information from inside the organization to the top and (2) forums for constructive dialogue, so that sound decisions could include consideration of risks as well as potential rewards. Classic was the experience of a Fannie Mae official who told the FCIC that his unit produced pricing models showing that Fannie Mae was not appropriately pricing risk of the mortgages that it purchased. The official recounted that the Executive Vice President to whom he reported, asked, "Can you show me why you think you’re right and everyone else is wrong?"29

Citigroup CEO Charles Prince, only partly in jest, characterized Citigroup as not having one good culture but five or six good cultures. Mr. Prince told the FCIC about his frustration at the inability of Citigroup’s business lines to communicate with one another. In an e-mail in October 2007, he wrote about Citi’s “Incredible lack of coordination. We really need to break down the silos!”30 Inability to communicate effectively across organizational lines meant that a firm lacked an enterprise-wide view of risks. A 2008 UBS report to shareholders on the firm’s losses similarly notes the absence of strategic coordination at that institution. While the various risk functions, relating to market risk, credit risk, and finance, came together to assess individual transactions, "[i]t does not appear that these functions sought systematically to operate in a strategically connected manner."31

30 Financial Crisis Inquiry Commission, Interview of Charles O. Prince, Transcript, March 17, 2010, pp. 37, and 41, respectively, available on the FCIC permanent website.

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The CEOs of both Citigroup and AIG told the FCIC that until sometime in 2007 they were completely unaware of the financial products that almost took their firms down.\(^{32}\) In part this resulted from the immense size and organizational complexity of these firms. Citigroup had 350,000 employees and nearly 2,500 subsidiaries, and AIG, much smaller than other large complex financial institutions,\(^{33}\) consisted of 223 companies that operated in 130 countries with a total of 116,000 employees.\(^{34}\)

Another problem was the CEO or other powerful top manager who simply refused to take feedback. The FCIC heard repeated statements that pressure from chief officers to increase market share was a problem, for example at Moody’s Investors Services, which came under pressure to please issuers with its ratings, and numerous financial institutions including AIG Financial Products, Lehman, Countrywide, and WaMu. As a European supervisor told staff in an interview, “The best guys in the banks are often the arrogant ones.”

The financial crisis was not the first time that executives followed success with serious lapses in judgment. Some years before the crisis, Dartmouth Business School Professor Sydney Finkelstein pointed to a pattern:

"Want to know one of the best generic warning signs you can look for? How about success, lots of it! .... Few companies evaluate why business is working (often defaulting the credit to "the CEO is a genius"). But without really understanding why success is happening, it's difficult to see why it might not. You have to be able to identify when things need adjustments. Otherwise you wake up one morning, and it looks like everything went bad overnight. But it didn't – it's a slow process that can often be seen if you look."\(^{35}\)

This observation helps to relate the credit bubble to governance and risk management: in years when house prices were appreciating and the economy displayed apparent moderation, financial firms grew and reaped generous returns, regardless whether they had the people and systems and


\(^{33}\) Herring, Richard and Carmassi, Jacopo (2009), “The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety & Soundness,” Chapter 8 in Allen N. Berger, Phillip Molyneux and John Wilson, editors, The Oxford Handbook of Banking, write that “Among the 16 international financial conglomerates identified by regulators as large, complex financial institutions (LCFIs), each has several hundred majority-owned subsidiaries and 8 have more than 1,000 subsidiaries.”

On the other hand, Commission staff learned in interviews with federal regulators that many of these subsidiaries and affiliates were small institutions, acquired in a process of accretion, which had little financial significance.


processes in place to ensure effective risk management. The problem was exacerbated as financial firms consolidated and became larger and more complex. CEOs of firms that made substantial profits during the credit bubble too frequently came to believe in their ability to make infallible decisions without soliciting constructive dialogue to inform themselves.

**JPMorgan Chase after the Crisis: The Perils of Hubris**

The problem of too much success also beset JPMorgan Chase, despite (or perhaps because of) its emergence from the financial crisis as a successful financial institution with $2.3 trillion in assets. In 2012, JPMorgan Chase unexpectedly lost $6.2 billion on operations of its London office. When news accounts broke, CEO Dimon dismissed them on an analysts’ call as “a tempest in a teapot.” Two weeks later losses accelerated significantly and only then did top management request an independent review of positions of the London office.

In early 2013 the company published findings of the internal task force investigating the losses. Of relevance here, the task force found that the company failed to allow negative messages to rise to top management and failed to engage in timely constructive dialogue to understand the contours of the problem:

1. “A number of…employees…became aware of concerns about aspects of the trading strategies at various points throughout the first quarter. However, those concerns failed to be properly considered or escalated, and as a result, opportunities to more closely examine the flawed trading strategies and risks…were missed.…

2. “These concerns were not fully explored. At best, insufficient inquiry was made into them and, at worst, certain of them were deliberately obscured from or not disclosed to [London] management or senior Firm management. Although in some instances, limited steps were taken to raise these issues, as noted above, no one pressed to ensure that the concerns were fully considered and satisfactorily resolved.…

3. “[The London office’s] Risk Management lacked the personnel and structure necessary to properly risk-manage the Synthetic Credit Portfolio, and as a result, it failed to serve as a meaningful check on the activities of the [office’s] management and traders. This occurred through failures of risk managers (and others) both within and outside of [the office]….  

4. “As Chief Executive Officer, Mr. Dimon could appropriately rely upon senior managers who directly reported to him to escalate significant issues and concerns. However, he could have better tested his reliance on what he was told. This Report demonstrates that more should have been done regarding the risks, risk controls and personnel associated with [the London office’s] activities, and Mr. Dimon bears some responsibility for that.”

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The JPMorgan Chase board of directors issued its own report, emphasizing that it could not make sound decisions without access to good information:

“The ability of the Board or its committees to perform their oversight responsibilities depends to a substantial extent on the relevant information being provided to them on a timely basis...Because the risks posed by the positions in the [London office] were not timely elevated to the Risk Policy Committee as they should have been or to the Board, the Board and the Risk Policy Committee were not provided the opportunity to directly address them.”

The company responded to these losses in a way that would seem to banish current hubris from its risk management and decisionmaking processes. Top management accepted resignations from several high-ranking officers including the firm’s Chief Investment Officer to whom the London office reported and the firm-wide Chief Risk Officer, and terminated or accepted resignations from a number of employees of the London office. The board of directors, while expressing confidence in how he ultimately responded to the crisis, cut Mr. Dimon’s 2012 compensation by 50%.

Constructive Dialogue and Nonfinancial Organizations

This pattern also applies to companies and government agencies more generally. Dartmouth Professor Sydney Finkelstein has analyzed public and private organizations and their decisions. He and his colleagues found that decision makers may be hampered by misleading experiences in their backgrounds (fighting the last war), misleading prejudgments, inappropriate self-interest, or inappropriate attachments, all of which can lead to flawed decisions. Finkelstein and his colleagues point to two factors that must be present for an organization to make a major mistake: (1) an influential decisionmaker makes a flawed decision, for any of a number of reasons, and (2) the decision process lacks capacity to provide feedback to expose errors and correct the decision.

The remedy, they found, lies with improved decision processes. First, design the decision process to enlist additional experiences and data relevant to major decisions. This can help to offset tendencies towards group-think. Second, encourage group debate and challenge to ensure that opposing points of view have been heard and understood. Third, possibly separate decision-making authority bodies, with one group submitting the proposed decision to a higher “governance” group for approval. Professor Finkelstein reports, with respect to US corporate governance, that he has become a strong supporter of the idea of separating the role of CEO from

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that of board chair. Dividing the roles allows the board to exercise more independent judgment than may be possible if the CEO also exercises authority as the board chair. Finally, implementation of a decision should be carefully monitored to ensure that each major decision is yielding the promised results.

My book assesses decisionmaking and costly mistakes such as the BP Gulf oil spill, fatalities at the Massey Mining Company, and hospital medical errors. Failures at nonfinancial firms show the same patterns of overbearing or distracted CEOs or others (e.g., doctors) who make poor decisions without obtaining feedback, cultures that emphasize production without adequate consideration of risk, and weak regulators.

Take the BP Oil Spill in the Gulf of Mexico, for example. On April 20, 2010, a BP exploratory deep sea rig blew up, killing 11 people, injuring 17 others, and releasing almost five million barrels of oil, about 206 million gallons, into the Gulf of Mexico from BP’s Macondo well. When BP finally capped the leak two months later, the company had spent about $6 billion on cleanup and pledged another $20 billion to a fund for restitution to people and businesses harmed by the spill. The BP oil spill was the worst environmental disaster in U.S. history.

BP had a long history of safety-related problems. In 2005 a fire and explosion at a BP refinery in Texas City killed 15 workers and injured 180 others. This was the worst US industrial accident since 1990. In its review, the Chemical Safety Board, a federal agency, found that, “Many of the safety problems that led to the March 23, 2005, disaster were recurring problems that had been previously identified in audits and investigations,” and concluded that, “The disaster at Texas City had organizational causes, which extended beyond the [directly affected] unit, embedded in the BP refinery’s history and culture.”

BP is a case study in the lessons of my book. The company failed to respond effectively to feedback, even from repeated disasters. The regulator was weak. Lower level employees working for Transocean, BP’s contractor, feared reprisals if they reported safety violations, and, as the Independent Panel found after the 2005 Texas City explosion, the company lacked constructive dialogue between process safety and the company’s production goals.

Lessons of governance and risk management apply to governmental organizations in the United States as well as private firms. While the legal framework and organizational imperatives of government agencies differ from those of private companies, higher level lessons such as the need to build constructive dialogue into decision making and the risks of not doing so, apply to all organizations, and not merely private firms. This was apparent from the NASA experience.

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with both the Challenger\textsuperscript{40} and the Columbia space shuttle disasters. In both cases, top management faced pressure to produce, in NASA’s case, to launch shuttles on a demanding and unrealistic schedule, while front line engineers expressed concern about the potential for a mishap. Concerns of these front-line people were neither clearly heard nor responded to from decisionmakers at the top of the organization.\textsuperscript{41} Besides the regulatory failures seen in the financial sector and in other contexts, government has seen emergence of expensive events, including the weak response to Hurricane Katrina, the massive 2010 Gulf oil spill, homeland security events such as September 11, and the Great Recession that resulted from the financial crisis. All of these and many less dramatic but expensive occurrences took place within a single decade. Not only the private sector, but also US federal agencies need to encourage constructive dialogue to enhance the quality of their decisionmaking.\textsuperscript{42}

\textit{Conclusion: Constructive Dialogue Should be Part of a Company’s Culture}

The JPMorgan Chase example is instructive. Past success doesn’t always predict success in the future. Not only is constructive dialogue an essential part of an organization’s culture, but it also must be continually nurtured by top management to ensure that it endures. If it is not embedded in the company’s culture, constructive dialogue tends to be displaced by the drive for revenues, profits, market share, and the substantial personal remuneration that these bring for top officials of large complex financial institutions and their most profitable units.

This leads to one final conclusion with respect to large complex financial institutions, or other large complex firms that require high quality decisionmaking to protect the public from major harm: better decisionmaking is essential in today’s increasingly complicated world. Ultimately, if constructive dialogue is not part of a company’s culture, then the company’s regulators will need to insist on it. The crisis and its immense costs suggest that many companies need to change their approach and try to listen to their government supervisors and consider the merits of supervisory feedback. While regulators may not have the depth of expertise or access to detailed information available to managers in a large financial institution, feedback from supervisors can help to improve decisions sometimes merely by posing the right questions and pursuing the answers. In the end, constructive dialogue from a regulator may be the only way for overbearing

\textsuperscript{40} For an illustrative example of dissonance and impeded information flows from front-line officials to senior levels of a government agency, see, e.g., Richard Feynman’s account of his experiences interviewing politically attuned officials at NASA compared to what he learned from engineers. Feynman, Richard P. \textit{What do You Care What Other People Think?} Part 2, “Mr. Feynman Goes to Washington: Investigating the Space Shuttle Challenger Disaster,” 1988.


\textsuperscript{42} For a public sector agenda to try to monitor and anticipate the impact of major adverse events, see, e.g., Stanton, Thomas H. “Improving Managerial Capacity of the Federal Government: A Public Administration Agenda for the Next President,” \textit{Public Administration Review}, November/December 2008, pp. 1027-1036
top company managers to receive the feedback that they need to make better decisions and protect the public’s health, safety and economic well-being.43

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