Trends in Corporate Governance

Goldman Swaps, Greece, Toyota and Cost of Lies

Why In this new face of the normal, transparency is your best weapon?

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One by one all our icons are falling from grace. Greek crisis has exposed how Goldman Sachs pays billions in bonuses. How it screwed Greek government $500 billion for massaging its debt. Fresh reports reveal that Ben Bernanke , chairman Federal Reserve is looking into Goldman Sachs's role in arranging contentious derivatives trades for Greece which helped the country to massage its public finances. "We are looking into a number of questions relating to Goldman Sachs and other companies and their derivatives arrangements with Greece," Mr Bernanke said,referring to Greek currency transactions structured by Goldman. Germany's chancellor Angela Merkel said, "It is scandal if it turned out that the same banks that brought us to the brink of the abyss helped to fake the statistics."

Surrealism of Goldman and Greek Tragicomic

The surrealism of the Greek tragicomic around Goldman Sachs abounds. After all the damage that the Greek debt management agency has done to erode not just the public confidence in Greece but ruin the green shoots of recovery , it was under pressure to replace its head. That replacement has now been effected, lo and behold, by whom - none other than Petros Christodoulou, who till then was head of Private Banking and Group Treasury at the National Bank of Greece (reporting directly to the CEO of the National Bank of Greece). So what is odd? Mr. Christodoulou worked not only as head of derivatives at JP Morgan but also held comparable posts at Credit Suisse, and… wait for it, Goldman Sachs… Uh, say what? Here is the cv courtesy Forbes:

Petros Christodoulou, born 1960, is the General Manager of Treasury, Global Markets and Private Banking. Before joining the Bank in 1998, he worked in various positions in Global Markets for Credit Suisse First Boston and for Goldman Sachs. Additionally, at JPMorgan he led the derivatives desk, followed by the short-term interest-rate trading and emerging markets division in London as Managing Director. He is a member of the Investment Committee of EH and the Foundation for Economic and Industrial Research. He holds a BSc from the Athens School of Commerce and Economics and an MBA in International Financial Markets from Columbia University.

From Wall Street to Crawl Street

In its first issue of Corporate Governance Journal last year the lead story titled "From Wall Street to Crawl Street" showed how the explosion of credit default swaps – at one stage valued at $64 trillion by the International Swaps and Derivatives Association, aggressively offered by Wall Street investment bankers such as Goldman Sachs led to the global economic downturn never witnessed since the great depression. Despite the severity of the global meltdown as a direct consequence of these resulting in millions of job losses and hundreds of thousands of homes being repossessed, no lessons seem to be have been learnt. That the history repeats , not just rhyme, is now evident from the revelations of Goldman Sachs involvement in Greek maelstrom. They made a killing by first arranging these swaps back in 2001 and then shorting them.

Goldman Sachs arranged swaps that effectively allowed Greece to borrow 1 billion euros without adding to its official public debt. While it arranged the swaps, Goldman also sought to buy insurance on Greek debt and engage in other trades to protect itself against the risk of a default on those swaps. Eventually, Goldman sold the swaps to the National Bank of Greece.

CDS – an insurance contract

A credit default swap is, essentially, an insurance contract between a protection buyer and a protection seller covering a corporation's or sovereign's specific bond or loan. A protection buyer pays an upfront amount and yearly premiums to the protection seller to cover any loss on the face amount of the referenced bond or loan. Fundamentally, this kind of derivative serves a real purpose-as a hedging device. The actual holders, or creditors, of outstanding corporate or sovereign loans and bonds might seek insurance to guarantee that the debts they are owed are repaid.

The terms of the swap meant that Goldman essentially made an upfront payment to Greece in exchange for a revenue stream later. If Greece defaulted on its obligation to keep that revenue stream flowing, Goldman stood to lose money. Goldman also sought to buy insurance on a Greek debt and engaged in other trades to protect itself against the risk of default on those swaps. These swaps were eventually sold to the National Bank of Greece. Despite its role in creating swaps that allowed Greek government to mask it growing debt Goldman has no net exposure to a default on Greek debt. It will be recalled that many Americans, both democrats and republicans, believe that the TARP was primarily designed to benefit Goldman Sachs. In fact the bailing out of Bear Sterns and the tranche of $65 billion in the rescue package of AIG was designed to benefit Goldman Sachs.

Goldman first put the Greek swaps in place in 2001. It immediately sought to hedge its risk to the Greek obligations by making side deals with other parties and eventually sold the entire swap to the National Bank of Greece. Later it tried to entice Greek government t about a similar deal that would delay their debt obligations.

CDS gives incentive to burn down your house

It is this kind of swaps that prompted Franklin Keyes, a prominent Wall Street lawyer to say in 1902: "Wall Street speculation fosters aring of idle gamblers, parasites upon society, who prey upon the fortunes of the honest and industrious; such people are a menace to the legitimate business interests of the country and an element of danger to the republic.".

As James Richards, Director of Omnes and former General Council of long term capital management says, "For over 250 years insurance markets have required buyers to have an insurable interest; another name for skin in the game. Your neighbor cannot buy insurance on your house because they have no insurable interest. Such insurance considered unhealthy because it would cause the neighbor to want your house to burn down and may be even light the match. When the CDS market started in 1990s the whiz-kid investor have neglected the concept of insurable interest. Anyone could bet on anything creating a perverse wish for the failure of companies in countries by those holding side bets but having no interest in the underlined bonds of enterprises. We have given wall street huge incentives to burn down your house."

In the aftermath of one of history's worst meltdowns, the governments specially in the western world have emptied their chests bailing out businesses. Britain itself has the third worst deficit in the world after Iceland and Greece. Faced with large scale unemployment these countries are naturally reluctant to take drastic measures to put their house in order. It is here that CDS's become the proverbial weapons of mass destruction and need to be regulated lest they seriously impinge on the sovereignty and stability of countries under debt.

Does Goldman Sachs Rule the Fed?

It is important to realize that the investors are getting increasingly wary of the shenanigans of bankers. The arrogance of Goldman Sachs stems from its strong connections. In the financial industry it is difficult to find someone with sufficient experience of finance and banking who has not been worked for Goldman Sachs. There was a general perception before Tim Geithner took over as Treasury Secretary that Goldman Sachs ruled the Fed. After he took over there are insinuations that Goldman Sachs rules the White House.

During the nomination of Tim Geithner last year in January when it was discovered Mr Geithner had not accounted his taxes properly there was huge congressional outcry against his nomination. Commenting on the issue Christopher Whalen, Managing Director and Co-founder of Institutional risk analytics had said “I am not just sure Tim Geithner is the guy we should have driving the bus”. It was found that Tim Geithner had not only been shy of his tax dues but also asked AIG to remain silent about the rescue package that it received from the government.

Volcker’s Rule shifts the power away from Tim Geithner

All this has controversy has been put to rest by the Volcker Rule that takes the power away from Tim Geithner. The spectacle of a beaming Volcker standing at Obama's right as the president endorsed his proposal and branded it the "Volcker Rule” with Geithner standing somewhat at a distance showed that the two had exchanged places.

The moment was the product of Volcker's persistence and a desire by the White House to impose sharper checks on the financial industry than Geithner had been advocating, according to some government sources and political analysts. It was Obama's most visible break yet from the reform philosophy that Geithner and his allies had been promoting earlier.

Volcker had been arguing that banks, which are sheltered by the government because lending is important to the economy, should be prevented from taking advantage of that safety net to make speculative investments.

To make his case, he met with lawmakers on Capitol Hill and gave numerous speeches on the subject, travelling to at least nine cities on several continents to warn that banks had developed "unmanageable conflicts of interest" as they made investments for clients and themselves simultaneously.

Advocates of Volcker's ideas were delighted. Obama officials were growing concerned that government guarantees designed to spur lending by letting banks borrow cheaply were instead funding banks' speculative investments and fuelling soaring profits.

"This is a complete change of policy that was announced today. It's a fundamental shift," said Simon Johnson, a professor at MIT's Sloan School of Management. "This is coming from the political side. There are classic signs of major policy changes under pressure . . . but in a new and much more sensible direction."

Solving Conflict of Interest – The Obama way

One of the issues that has constantly bedeviled corporate governance is the conflict of interest. Tim Geithner has long been criticized as a Goldman fink in the White House. As New York Fed President, Mr Geithner worked closely with ex-Goldman CEO "Hank" Paulson and Fed Chief Bernanke on the bailout of AIG which benefitted mostly Goldman. Mr Geithner's Chief of Staff at Treasury is Mark Patterson - a former lobbyist for Goldman Sachs. President Obama has clearly checkmated the bankers and hopefully removed this conflict of interest with Volcker’s Rule.

Toyota's fall from grace

None would have imagined that Toyota, a car known for its iconic reliability, will have its reputation shattered in a matter of days and its chief executive Akio Toyoda will be mauled by the Congress in a way that has been reminiscent of war criminals. The Committee chairman, Henry Waxman wrote to the company:

"Our preliminary assessment is that Toyota resisted the possibility that electronic defects could cause safety concerns, relied on a flawed engineering report, and made misleading public statements concerning the adequacy of recent recalls to address the risk of sudden, unintended acceleration." The Committee accused Toyota of:

- failing to investigate reports of unintended acceleration dating back to 2000
- rushing out the results of a flawed investigation into the problem of unintended acceleration this month, after testing just six cars
- telling the public that "sticky" pedals were to blame for most of the incidents of It has had to recall millions of cars because of their sudden unintended acceleration.

For decades, auto executives from around the world made the pilgrimage to Toyota's factories to learn its methods of lean production and continuous improvement. The famed quality guru W Edwards Deming helped Toyota set up its manufacturing methods after being spurned by complacent US auto makers. Detroit thought its dominance could never be challenged, and certainly not by the Japanese with their fleets of small, cheap compacts. Since then, a generation of business school students has studied Toyota's management and manufacturing techniques. Now its safety woes are certain to find their way into business school case studies on how to ruin a company's reputation.

While Toyota's public fall from grace came suddenly, it was years in the making. A memo from 2007 portrayed executives boasting of saving $100m by negotiating a limited recall of floor mats related to the acceleration problem. (The cost to the company's reputation and sales will almost certainly be much greater.) Toyota's dismissive attitude of the acceleration problem brings to mind the sorry example of Ford's handling of the Pinto's exploding gas tanks in the 1970s. Nothing erodes confidence in a company's reputation so much as internal documents subordinating safety concerns to the bottom line.

For years, MBA students have compared Ford's mismanagement of the Pinto gas tank problem to Johnson & Johnson's handling of the Tylenol tampering case in 1982. It has taken years, if not decades for Ford to recover, while the Johnson & Johnson credo has been held up as the model of corporate responsibility for a generation, even in the face of further product recalls. The lesson that good ethics can be good business was forgotten by Toyota.

Toyota executives have said they lost their focus on quality as they strove for market share. It wasn't too long ago that Toyota surpassed GM as the leader in sales. But in doing so, executives lost their focus on quality, and saw the acceleration problem as an impediment to meeting their sales targets, rather than a warning that the company was getting sloppy. Toyota is finding that it's hard to maintain market share when 60% of its vehicles have been pulled from dealer lots for safety concerns.

When Toyota, after years of fudging, finally acknowledged the problem, it went into full apology mode. Toyota president and chief executive officer Akio Toyoda told a congressional committee that he takes "full responsibility" for the auto maker's problem, and pointed out that his name was on the cars the company sells. It can be fairly concluded that Toyota's problem stem not so much from their

poor record of safety but secretiveness and a culture of cosiness. Lot of what has been reported in the US media including the Congress witch hunt has political overtones. What cannot be denied is they picked up a seriously bad time to fudge on their integrity and reliability.

How to build a war chest - Lessons from Germany

In times when bailouts have dried government coffers all around , Germany is having a boom in back payments of taxes since it threatened to buy a disk containing details of Germans who have stashed their wealth in Swiss banks. Of course, it has not made the Germans the most popular immigrants in Switzerland. There are images of Angela Merkel and her Finance Minister appearing on 'wanted' posters in Switzerland. Swiss sensibility is so badly hurt that Germans are out of bounds from bars. Swiss are still sulking from the public ignominy of having their bankers put on Interpol charged by US authorities for opening accounts of US citizens in violation of the US laws. Swiss had to eat a humble pie when they had to share the information about their clients with US federal government.

There is a fear that the worst is yet to come when other cash-strapped governments realise the potential windfall in getting tough with tax evaders, chasing their citizens in Switzerland and other offshore havens . The punishment of two tennis icons, Boris Becker and Steffi Graff for tax evasion should be a reminder that soon there will be no place to hide the ill-gotten money.

Thou shalt be found out

We are aware how Bank of America assisted by John Thain's Merrill Lynch duped investors in 2008. In a move unthinkable elsewhere a new civil fraud suit has been filed by the New York Attorney General Andrew Cuomo against Bank of America and its former Chief Executive Ken Lewis and former CFO Joe Price. It accuses the two of duping shareholders about mounting losses at Merrill Lynch and manipulating Washington into handing over $20 billion to help finance the merger in 2008. This is despite the fact that US's Securities and Exchange Commission had already reached a settlement with BOFA.

Transparency - your strongest weapon

We are living in hard times. Writing in his book "Chaotics" Philip Kotler says, this oscillating Age of Turbulence is not an aberration but new face of the normal. The above examples bring home a common theme – a zero tolerance for the culture of cosiness, conceit and concealment that has afflicted business as usual and fostered corruption. Corporate governance has to focus on delivering much greater accountability and transparency. This is not good news for the independent directors holding multiple directorships. They would need to spend much more time with companies and get their teeth into committees as suggested by Sir David Walker. In doing so they will find transparency their strongest weapon.