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[Deepak Moorjani](#)

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## [Deutsche Bank: A Letter to Shareholders](#)

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When speaking about the banking sector, many people mention a "subprime crisis" or a "financial crisis" as if recent write-downs and losses are caused by external events. Where some see coincidence, I see consequence. At Deutsche Bank, I consider our poor results to be a "management debacle," a natural outcome of unfettered risk-taking, poor incentive structures and the lack of a system of checks-and-balances. In my opinion, we took too much risk, failed to manage this risk, and broke too many laws and regulations.

For more than two years, I have been working internally to improve the inadequate governance structures and lax internal controls within Deutsche Bank AG. I joined the firm in 2006 in one of its foreign subsidiaries, and my due diligence revealed management failures and also inconsistencies between our internal actions and our external statements.

Beginning in late 2006, my conclusions were disseminated internally on a number of occasions, and while not always eloquently stated, my concerns were honest. Unfortunately, raising concerns internally is like trying to clap with one hand. The firm retaliated, and this raises the question: Is it possible to question management's performance without being marginalized, even when this marginalization might be a violation of law? Two years later, our mounting losses are gaining attention, and I offer my experiences and my thoughts in the hopes of contributing to the shareholder and public policy debate.

### Background

Born and raised in Toledo, Ohio, I was infused with Midwestern values of hard work, individual responsibility, honesty, quiet integrity and fiscal prudence. After careers in New York City and Menlo Park, I moved to Tokyo in 2005 to pursue investments in corporate restructurings and distressed assets. At the time, the Japanese market offered unique opportunities.

I joined Deutsche Bank in 2006 to build an investment business within its commercial real estate lending operation, and I was generally surprised by the aggressive sales culture within our firm. While many people consider the banking sector's problems to be caused by residential lending, I witnessed multi-billion dollar loan proposals for commercial property. With funds provided at more than 90% loan-to-value, these loans were "priced to perfection" and assumed that property prices and rental rates would continue to rise. For perspective, a single billion-dollar commercial real estate loan is equivalent to 2,000 residential loans of \$500,000.

In general, my colleagues are hard-working, decent people, but the system of incentives encourages people to take risks. I have seen honest, high-integrity people lose themselves in this cowboy culture, because more risk-taking generally means better pay. Bizarrely, this risk comes with virtually no liability, and this system of OPM (Other People's Money) insures that the firm absorbs any losses from bad trades.

As these losses have grown, taxpayers are being forced to absorb these losses. As an example, my firm recently received nearly \$12 billion from AIG (which has effectively been nationalized with \$180 billion in taxpayer funds). Essentially, every American household sent my firm a check for \$105. The reason for this payment: my firm bought credit default swaps from AIG. In plain-speak, we bought unregulated "insurance" from AIG to cover losses from bad trades. What did taxpayers get in return? Nothing. Taxpayers simply paid an IOU triggered by our gambling losses. (Note: This \$12 billion payment was more than 50% of our market capitalization at the time of its disclosure).

### Solution

While shareholders (and taxpayers) are becoming angry, I think they should be furious. Our management has eviscerated the concept of moral hazard by systematically adopting pay schemes that reward excessive risk-taking despite its long-term implications. If governments have decided to socialize our losses, governments are implicitly saying that the banking industry is fundamentally sound. In effect, governments would be voting in favor of the status quo. In my opinion, the status quo does not work, and we need to address the core issues of structure and compensation. Capping executive compensation is a first step, but as a solution, it is insufficient.

While I am on the "inside" at Deutsche Bank, much of my career has been within partnership structures, and I continue to advocate a partnership-like structure for our firm. With collective liability, partnerships provide a proper alignment of incentives between management and its stakeholders. In a

partnership, bonuses are paid from profits, not revenues. Losses are shared, and these losses introduce an appropriate penalty for excessive risk-taking. If profits are overstated in one-year, the already-paid bonuses are clawed-back (returned to the partnership).

#### Conclusion

Our asymmetric incentive structure is fundamental to our problems. The question remains: Do we maintain the status quo and naively hope for better results, or do we begin to implement structural reforms in order to align the incentives? If taxpayers are forced to pay for the losses from bad trades, this socialization of risk adds to the moral hazard problem. This socialization of risk actually encourages more aggressive behavior in the future.

Maintaining the status quo is not a good bet, and we cannot afford to ignore the fundamental issues of structure and compensation. We need to introduce personal responsibility into the system, because accountability is glaringly absent from the status quo. The collective liability aspect of partnerships achieves this goal; collective liability is the most powerful way to align incentives and encourage rational risk-taking.

As an employee and as a shareholder, I am doing my part to build a better firm. Unfortunately, the political landscape within our firm finds it difficult to assimilate any criticism of management's leadership. To my fellow employees, I ask that you resist the incentives that reward groupthink. To my fellow shareholders, I ask that you implement the changes needed to address our asymmetric incentive structures.

 

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