

Financial Leaders Go AWOL in the Meltdown: Ben W. Heineman Jr.

Commentary by **Ben W. Heineman Jr.**

Nov. 4 (Bloomberg) -- Government leaders around the globe have dominated the economic and business news as they struggle with the credit, solvency and housing crises.

Where are the chief executive officers, top management and corporate directors of the world's financial institutions? Their failures, that familiar litany of excess leverage, indecipherable financial instruments, poor risk management and woeful compensation systems, are the main catalyst for these unprecedented problems.

There has been a stunning silence on private-sector causes and private-sector cures from the private sector itself. This is unconscionable, because their lapses raise profound political and economic questions about the balance between government regulation and corporate self-determination.

What's happening is a crisis of capitalism, though not because there is a debate about the ultimate virtues of capitalism over socialism -- that argument is long over. Rather, the failure of business leadership on an almost cataclysmic scale has brought front and center the issue of how government should rein in business. Governments around the globe that are addressing the impact of failed corporate decision-making also must deal with what caused it.

Even [Alan Greenspan](#), a staunch advocate of free markets and no fan of regulation, acknowledged the problem: "I've been extraordinarily distressed by how badly the most sophisticated people in business handled risk management."

Unfortunately, Greenspan offered no suggestions about how companies should be managed in the future to avoid a repeat of the breakdown that, he said, caused him "shock and disbelief."

Facing Failures

In all good business organizations, facing failures honestly, looking at root causes, disciplining individuals and implementing systemic change to prevent recurrences is as important as planning for new products, markets or technologies.

Yet a voracious reader of economic and business reports would have a hard time finding a financial-industry statesman talking candidly about the errors and flawed judgment among managers or directors. Nor will you find a hint about how these private institutions should govern themselves in the future to avoid a recurrence of such widespread devastation.

Instead, the chairman of a failed investment bank testifies on Capitol Hill that he is responsible -- then blames everyone else. Financial CEOs at a session organized by the New York Stock Exchange call for more Wall Street tax breaks, repeal of the Sarbanes-Oxley Act and limits on class-action lawsuits.

To be sure, many actors have some responsibility for the current crises: policy makers, regulators, accountants, rating companies, imprudent consumers, quick-buck investors and the business-news media.

Performance With Integrity

But can there be any question that the root cause was the failure of financial-industry leaders to provide the balance between risk-taking and risk management needed for sound, sustainable growth? In short, there was a failure to fuse high performance with high integrity.

No one made these companies pile on leverage, create incomprehensible financial instruments, sideline robust risk assessment, fail to stress-test portfolios, assume housing values would only go up and award gargantuan compensation for churning paper.

Why did CEOs and business leaders so abjectly fail? Why did good corporate governance, which at its core is about checks and balances, fall short in financial services?

Obviously, public and government trust in industry decision-making has eroded. Now corporate leaders must honestly discuss their mistakes and propose how checks and balances can work before the slow process of rebuilding trust can begin.

Credibility Shredded

Some will say that this would mean admitting liability in a litigious society. But retired leaders or sitting CEOs in institutions singed by the crisis can surely find a way to discuss these issues without putting their heads in a noose.

Candor and realism about governance must be an essential part of the public debate about what limitations to impose on corporate decision-making. That debate will range from structural changes inside financial firms to procedural changes on issues such as disclosing off-balance-sheet liabilities to oversight of executive compensation.

In the immediate response to the financial and economic crises, issues left in the past to corporations are being addressed in a hurried, piecemeal way by government.

Business leaders' efforts to avoid regulatory change -- resorting to cries of "trust us" and "trust markets as they were" -- won't work. Too much credibility has been shredded for that, and the impact has been too severe.

Start Showing Up

The future of healthy, sustainable capitalism still turns on corporations' ability to govern themselves properly. This means balancing wealth creation and risk to drive performance with integrity, to have compensation systems that reward balanced growth rather than kowtow to greed, to respect customers and investors and to provide fairness and transparency.

An honest reckoning is a critical step in developing new regulations that advance the safety and soundness of our financial system. For that to happen, corporate leaders need to show up soon to talk credibly about the failings of the past and how to achieve the right internal balance in the future.

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Viewpoint: Ben W. Heineman Jr.



Boards Fail -- Again

Directors are ultimately responsible for the decline of their companies. At teetering financial institutions, they have a lot to answer for

by [Ben W. Heineman Jr.](#)
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The battlefield of the credit crisis—indeed, the crisis of capitalism—is strewn with the dead and wounded.

One casualty is the role of directors at a broad range of dead and maimed financial institutions. These board failures represent, in turn, a signal failure of the broad governance movement that gained momentum at the beginning of this decade.

This issue is of profound importance because the board of directors stands between government regulation and corporate freedom. The board's duty is to provide a balance among wealth creation, financial discipline, and risk management; to make the fusion of high performance with high integrity the firm's foundation; and to choose and reward a CEO who has the vision, motivation, and skills to affect that essential balance and critical fusion. When boards don't succeed but fail, as so many have, the terms of debate shift from how companies can best govern themselves to how regulators should govern them.

A Board's Responsibility

Since the Enron scandal, regulators, academics, commentators, and the media have all focused on the importance of an independent board in providing meaningful checks and balances on chief executives and top management. Centers have been established by nonprofits and professional schools; conferences are held every week somewhere around the nation; enough earnest papers have been written to fill a library.

Yet, despite the enormous time, energy, and focus generally devoted to governance in the past decade, the boards of directors at Bear Stearns, Merrill ([MER](#)), Citi ([C](#)), Countrywide, Fannie Mae, Freddie Mac, Lehman Brothers, and Washington Mutual ([WM](#)) are ultimately responsible for the sharp decline or disappearance of their companies. Although the sad sagas of institutions will vary due to their cultures, the personalities involved, and their particular mistakes, I believe it is

safe to say that the boards at all adversely affected financial service companies have failed in their most basic tasks.

Properly defined, a corporation's strategy is not just its business plan but also the major short-, medium-, and long-term opportunities and risks it faces: commercial, societal, reputational, and legal/ethical. Oversight of these risks and opportunities is a fundamental board function. A clear process for identifying these priority issues and addressing them in detail at the board level (and perhaps at more than one meeting) is the essence of board oversight. The board must assure itself that the process for making and implementing decisions, as well as the decisions themselves, are carefully considered and reasonable.

Paying Attention to Risks

Sadly, it is clear that the boards of our major financial institutions did not understand the risks the entities were taking. It may be that the CEOs and top management didn't understand, either, but it is the board's job to press management. The board should ensure that the risk function report directly to the board as a whole or to the audit committee. The board should cut through complexity and require that the reasons for committing capital are explained in plain English. Directors must assure that risks are sufficiently spread so no one activity can threaten the enterprise. As experienced individuals, it is board members' duty to ask hard questions when things are going extremely well as well as when they are going badly.

Boards cannot, and should not, review all risks. But surely they should identify and review risks with potentially disabling, even catastrophic, consequences. Look at what resulted from huge investments based on huge borrowing that assumed unending growth in asset values. Broad common sense, skepticism, and judgment may be more important in board members than narrow expertise. Are the dangers of leverage, the importance of understanding investments, and the need to spread risk so esoteric?

The most important checks and balances in a company—the balance between innovation and discipline, the fusion of performance with integrity—must come from the CEO and top business leadership. In my recent book, *High Performance with High Integrity*, I have argued that the real governance of the corporation occurs from the CEO down into the company. If the board's most important job is choosing the CEO, the board must make sure that that the "spec" for that top job—and for development of top leadership—goes beyond a business vision. It must put pride of place on the CEO's visceral understanding of and commitment to assessing risk, balancing entrepreneurship with financial discipline, and integrating performance with integrity.

Selecting the CEO

Without conducting an autopsy on each institution that has failed or fallen, the boards of financial institutions did not choose CEOs wisely in recent years. The institutions pursued profits with overleveraged and ill-understood strategies and banished tough risk assessment from the center of decision-making. Unlike the accounting scandals, where top leadership manipulated the company's systems with fraudulent schemes, it appears that in this crisis, all systems in a number of institutions have failed. The responsibility for that systemic failure—and leadership's failure to understand and mitigate the risks—falls squarely on the CEOs and the boards that chose them.

If boards need to find "balanced" CEOs, then they also need to pay them for that balance—for exerting financial discipline and driving integrity into business operations, and not just for the "performance" of making the numbers. Many commentators have already criticized current compensation in financial service firms for its emphasis on annual bonuses, its preoccupation with short-term revenues that may hide long-term toxicity, and the failure to reward the essentials of risk assessment, financial discipline, and integrity. Unless boards design compensation to

reward a set of balanced behaviors, the greed that has brought their institutions low will only be fueled.

I believe that an integrity component of compensation can easily be constructed by evaluating integrity principles, practices, culture, annual goals, and peer-company comparisons. Perhaps there were suggestions about deferring bonus and annual compensation to reward sound decisions—to ensure that a deal actually works, or that loans perform, or that the exotic instrument doesn't bloom in Year One and die in Year Three. But if there were such suggestions, clearly they weren't acted upon. On the question of balanced executive compensation to reward balanced behavior, the boards, once again, have defaulted on a central director obligation.

As with the accounting scandals at the beginning of this decade, many other actors inside and outside financial institutions have contributed to the current credit crisis: regulators, accountants, analysts, and media as well as those involved in virtually all corporate functions, such as operations, finance, legal, and risk. But now, as then, subpar performance by the boards of directors is central.

Need for Soul-Searching

For the moment, the nation needs to find the right governmental response to stabilize the markets and to help the financial institutions clear up their balance sheets so lending can begin again. Once this has occurred, the question of effective governance of great for-profit institutions will become front and center.

Beyond understanding the failures of particular institutions, regulators, corporate leaders and the governance movement need to do some soul-searching about why there was such a widespread default of fundamental director (and CEO) responsibilities in financial services—why the much discussed checks and balances of the governance movement couldn't constrain the commercial pressures and greed that led to such unbalanced behavior and ultimately to devastation.

We are at a hinge of history, where deregulation has been discredited and a new "mixed economy" balance between regulatory oversight and corporate self-direction will, without doubt, be established. Corporate self-determination and sensible risk-taking is still essential, and the boards still have essential core tasks, but how will we get to the right balance in the future when the credibility of corporate advocates has been so eroded by the board (and other corporate) failures of today.

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Principles for Reforming Executive Pay

Reining in excessive management compensation will be high on the "to-do" list of the 111th Congress

By [Ben W. Heineman Jr.](#)

The rocket fuel that sent the [financial sector](#) soaring into the stratosphere (where it ultimately exploded) was excessive [executive compensation](#), which rewarded the churning of paper and risk-taking rather than the creation of sustained economic value and risk management.

The day of regulatory reckoning on the causes of the financial meltdown will soon be upon us, even as governments struggle with the severe effects and the world waits for a "mega-stimulus" proposal from President-elect Barack Obama. Reforming executive pay will likely be high on the financial [reregulation](#) "to do" list for the 111th Congress as anger at executives remains white-hot.

To be sure, partial ad hoc measures are popping up, both in the U.S. and abroad, from a flat cap on executive pay at German companies receiving bailout funds to active oversight of payouts by the British government in its varying roles as shareholder, director, and regulator of troubled companies. Under the Troubled Assets Relief Program (TARP), Congress last fall hastily imposed executive compensation limits on senior leaders in financial sector entities, including limiting tax-deductibility on exec comp over \$500,000; providing new clawback rules for material mistakes; capping or eliminating golden parachutes; and requiring board assessments of the relationship between compensation and risk-taking.

Striking a Balance

As more thoughtful, comprehensive approaches evolve, agreeing on principles will be key to effecting any real change. Here are three principles that I believe should be the foundation of any substantive change.

First, executive pay should promote a fundamental balance between taking risk and managing risk as the core of high performance. Executives must be rewarded both for stimulating value-creating innovation and for disciplines that assess, spread, and manage risk. There can be little doubt that compensation in the financial sector was not based on personal ownership and understanding by top leaders of risk assessment and management.

Second, compensation must clearly reward a foundational fusion of high economic performance with high integrity. That means a tenacious adherence to the spirit and letter of formal rules, legal and financial; voluntary adoption of uniform ethical standards that bind the company and its employees to act in its enlightened self-interest; and employee commitment to the core values of honesty, candor, fairness, reliability, and trustworthiness.

Promoting a Culture of Integrity

Third, to reward that balance—and that fusion—the annual compensation of top financial-sector executives and key "risk-takers" should be redirected away from short-term cash toward longer-

term payouts. Affirmative performance goals, which measure the creation of real value and the implementation of a culture of integrity, should guide the amount. But a significant portion of a year's compensation should be withheld; to be paid out over time if value is sustained and cancelled if adverse events occur.

Such adverse events could include: financial results that exceed established risk parameters; outsize, unpredictable financial losses; significant financial restatements due to accounting failures; and major legal or ethical lapses for which the pay recipient is responsible in whole or in part. The withheld compensation may be either cash (held in escrow) or equity instruments (subject to cancellation).

Such reform would encourage a focus on creating real economic value and discourage baleful "short-termism." It would also retain control of payouts, rather than requiring boards to go through a cumbersome clawback process to recover monies already paid to culpable executives. And it would make it more difficult for employees to leave after bonus season.

Rewarding Durable Success

An example of such program is the "bonus/malus" system UBS announced in a report late last year on its new compensation model. This interesting report, which received little public notice, is one of the first systematic responses to a company's recognition that prior payouts failed to assess large risks or evaluate "the quality or sustainability" of earnings. A similar approach has been announced by Morgan Stanley.

This stretch-out of annual compensation can, of course, also be combined with other longer-term bonus/malus plans—awards based on total performance over five years, as well even longer-term equity grants that pay out (after 10 years or at retirement) only if the corporation has durable success and if the executive remains with the company due to sustained personal performance.

Putting the balance of risk-taking and risk management and the fusion of high performance with high integrity at the center of executive compensation systems will require significant thought and redesign based on knowledge of the industry and the particular corporation. This redesign would, customarily, be the task of the board and senior management. But the striking failures in the financial sector have quite rightly made people question whether industry leaders are capable of creating a new culture and implement needed compensation change.

Putting It Out in Proxies

But government regulation in this complex area—either as policy-maker or shareholder—also has problems: bright-line pay caps or limits on deductions can be ham-handed and counterproductive; detailed substantive rules are difficult to administer; given the complexities of pay, more disclosure may just mean more obfuscation; and, per TARP, imposing "procedural" requirements on board compensation committees to ensure that executive comp doesn't lead to "unnecessary and excessive risks" can end up as a box-checking exercise. Most importantly, ill-conceived rules may stifle the calibrated risk-taking and creativity that are so central to capitalism and could adversely affect the labor market for corporate leadership.

Finding the appropriate balance between government autonomy and corporate responsibility on executive compensation is an extraordinarily challenging and complex task. The best course for the next three or four months is for corporations to follow the UBS and Morgan Stanley examples and rethink, redesign, and put out for public scrutiny and debate reformed systems of executive compensation in anticipation of, or as part of, the 2009 proxy season. Such a public discussion should also include thoughtful questions about the hastily assembled reforms enacted in TARP. Such reassessments—if they came from numerous companies, reflecting different perspectives

and circumstances—would greatly inform the inevitable regulatory debate that will soon start in earnest.

Continuing corporate silence on this seminal issue will constitute an unconscionable private-sector default to the political process. The public debates on executive compensation are going to among the most difficult in financial reregulation. Corporate abdication on new pay systems will dramatically compound that difficulty.

A Call to Arms

HSBC Chairman Stephen Green recently said, "There is clearly urgent work to be done to ensure that compensation structures...do not encourage short-termism and excessive risk-taking. Any responsible bank will be looking hard at this issue."

Let's hope they do that—and then speak out. Soon.

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