Belfer Center
for Science and International Affairs
John F. Kennedy School of Government • Harvard University
July 2009

Policy Memo Series: Economics and Global Affairs

# The Governance Crisis: First, Let's Redefine the CEO Role

## RECOMMENDATIONS

- Boards of directors must redefine the role of the CEO—and then choose a leader who meets the new spec. Under this recast role, the CEO's first foundational task is to achieve a core balance between taking economic risk (promoting creativity and innovation) and managing economic risk (within a systemic framework of financial discipline). The second task is to fuse this high performance with high integrity.
- Boards and business leaders must institute new management development processes for corporate P&L and functional leaders that, throughout their careers, put strong emphasis not just on achieving commercial goals but on developing the experience and skills to do this through balanced risk-management and performance with integrity.
- Boards must completely redesign compensation systems to measure and reward these redefined foundational CEO and top leadership behaviors.
- Board "oversight of strategy" should focus on the highest priority issues along these three dimensions of the redefined CEO role and redesigned compensation metrics—economic performance, risk management and integrity in the near, middle and longer term.
- One place to start in redesigning compensation plans: Look closely at the real performance of the corporation (immunized as much as possible from book-keeping manipulation, and stock price fluctuations): for example, focus on cash flow, return on assets, return on invested capital and economic value added over years, not just annually.
- Elevate the risk management function so that it reports at the top of the company to the CEO and Board.
- Compensation must be built on company, division and individual results, not on individual contributions alone.

*By Ben W. Heineman, Jr., Senior Fellow, Belfer Center, Harvard Kennedy School*

The witch's brew of high leverage, poor risk management, creation of toxic assets and poor business judgments—all made more poisonous by excessive short-term executive pay—are unprecedented failures of financial sector directors and CEOs. The result: credibility has eroded, trust has dissolved and financial re-regulation seems inevitable.

For financial services, indeed all, corporations, the admonition—physician heal thyself—is imperative. As Lloyd Blankfein, Goldman Sachs CEO, said recently in a speech to the Council of Institutional Investors: "… the past year has been deeply humbling for my industry

… the loss of public confidence … will take years to rebuild … decisions on compensation … look self-serving and greedy in hindsight. Financial institutions have an obligation to the broader financial system … . Meaningful change and effective reform are vital and should naturally emanate from the lessons learned."

Four fundamental, interrelated governance changes inside corporations are essential for enhancing accountability and increasing shareholder confidence.

- Boards of directors must redefine the role of the CEO—and then choose a leader who meets the new spec. Under this recast role, the CEO's first foundational task is to achieve a core balance between taking economic risk (promoting creativity and innovation) and managing economic risk (within a systemic framework of financial discipline) over a sustained period of time. The second recast, foundational CEO task is to fuse this high performance with high integrity. That means tenacious adherence to the spirit and letter of formal rules, voluntary adoption of ethical standards that bind the company and its employees, and employee commitment to core values of honesty, candor, fairness, reliability and trustworthiness—which together are in the enlightened self-interest of the company, are embedded in business operations and address legal, ethical, reputational and public policy risk.

- Boards and business leaders must institute new management development processes for corporate P&L and functional leaders that, throughout their careers, put strong emphasis not just on achieving commercial goals but on developing the experience and skills to do this through balanced risk-management and performance with integrity. This is vital as individuals rise within the corporation and face greater challenges in all dimensions.

- Boards must completely redesign compensation systems to measure and reward these redefined foundational CEO and top leadership behaviors.

- Board "oversight of strategy" should focus on the highest priority issues along these three dimensions of the redefined CEO role and redesigned compensation metrics—economic performance, risk management and integrity in the near, middle and longer term. These risks and opportunities should be core agenda items for the boards of a growing, sustainable and durable companies.

Although corporate rhetoric might suggest that these fundamentals are recognized, corporate reality is, generally, that they are not. For example, within the financial sector itself, voices like Blankfein's are increasingly heard, if in muted tones, to criticize short-termism, lack of risk management, improper compensation incentives, failure to act with integrity in the public interest.

The harsh reality is that business organizations must be designed—by boards at a conceptual level and by business leaders at both a conceptual and operational level—to check greed, stupidity and corruption and to channel capitalism's "animal spirits" into sustained, durable creation of real economic value within a framework of financial discipline, law, ethics and values.

## A SHIFT TO NEW FUNDAMENTALS: WHAT TO MEASURE

In a shift to these new fundamentals, one key question is what to measure. Here are some general, suggestive (hardly detailed, exhaustive) thoughts which have been highlighted by the many reports and commentaries since the credit meltdown, the sharp economic downturn and the governance crisis broke upon us.

With respect to economic performance, looking closely at the real performance of the corporation (immunized as much as possible from book-keeping manipulation, and stock price fluctuations) is a place to start: for example, focusing on cash flow, return on assets, return

on invested capital and economic value added over years, not just annually.

Appropriate management of financial risk management involves elevating the function so that it reports at the top of the company to the CEO and Board and is treated as an equal to business generators in status (if not precisely in pay). It then entails evaluating both business processes and real results in the core tasks of assessing, spreading and controlling risk. It should focus on fundamental issues of capital adequacy, leverage and liquidity—integrating off-balance sheet activities in assessments of these risk issues and using early warning systems to catch idiosyncratic or unforeseen risks.

Integrity metrics should focus on key principles (consistency and commitment of leaders, embedding integrity issues in business operations), key implementing practices (legal and ethical risk assessment and risk mitigation), culture (employee surveys, 360 reviews), comparisons to peers (both across internal divisions and with outside companies) and annual goals and objectives (how are hard problems handled, key people hired).

## TRANSLATING METRICS INTO COMPENSATION DESIGN

A second key question, after deciding what to measure, is how to translate those metrics into compensation design. Again, a consensus is beginning to emerge on key concepts. The key economic performance, risk management and integrity measurements must be the lodestone for variable cash and variable equity compensation that is paid out or held back over time as objectives in these three dimensions are met, exceeded or missed.

Similarly, compensation plans must risk assess jobs below the top business leaders (e.g. traders), and apply a new compensation approach, beyond top officers to individuals with the ability to commit resources which will produce significant gains or losses over the long term. And, at all levels, compensation must be built on company, division and individual results, not on individual contributions alone. Variable cash compensation paid in Year 1 should be paid out in increments, with a portion in that first year but a significant portion held pay (say to Years 3 and 5). A performance or integrity miss in subsequent years means that held-back amounts will not be paid. This redesign should be the death knell of the huge annual cash bonuses which incentivizes bad behavior.

Variable equity should vest in the years after the grant. The amount awarded in Year 1 should be increased, stay the same or be reduced at vesting in outyears depending on comparisons with peers both for total shareholder return but also for economic performance. So, too, it can be held back for significant performance, risk or integrity misses This approach should be the death knell of the naked stock option or RSU based only on share price as a dominant form of compensation (without comparison to peers or reference to other measures of performance). One salient reason: the cataclysmic events of the past year have severely undermined the long-dominant theory that share price reflects efficient, rational markets.

## OVERCOMING OBSTACLES TO CHANGE IN COMPENSATION PRACTICES

A third key question is how to overcome the obstacles to the significant rethink suggested above. Here are some basic ones.

- Given past, stark failures, can boards of directors, as an institution, engage in such a sophisticated, fine grained assessment of a corporation in the context of its business sector? One answer is that they need a new kind of compensation expert reporting only to them (although obviously working with the CEO and the company). Such individuals' expertise would be less on pay trends and pay packages and more on how companies operate. They would be capable of addressing the fundamental questions flowing from the redefinition of the CEO in

operational metrics that flow from real results and that that minimize incentives to "game" the system.

- Can individual corporations who redefine the business leader role and redirect and stretch out executive compensation compete in the labor market for leadership talent with those who just want to throw cash and options at top leaders and performers? This may not be an issue for companies receiving TARP funds today, but could will re-emerge, as the economy and financial institutions resume growth, in the future. One approach, beyond individual firm initiative and well short of comprehensive public regulation, is for firms in the financial sector to develop a code of compensation principles (without raising any antitrust concerns) to which they commit themselves and which will be reported in Proxy Statements or other reports. In such an approach, public officials might have a "convening" and "dialogue" role, given the legitimate interest in the safety and soundness of the financial sector, rather than a "rule-making" role.

- Most difficult of these difficult issues is how do firms resist the short-termism of the stock market which create pressures for behaviors which are not in the interest of a sustainable, durable institution focused on creation of real economic value and which, indeed, can injure the company (corruption, ill-considered risk-taking, unproductive short-term decision-making). Certainly, making the changes describe above is a start. And nothing that I have said takes away from a corporation's primary mission: to have strong, sustained growth based on superior, high quality goods and services which provides durable benefits to shareholders and other stakeholders. Securing buy-in for real creation of shareholder value from institutional investors is one approach to this recurring, vexing problem. But the "short-termism" of important shareholders is not likely to be extinguished by the current crisis.

## CONCLUSION

It should be obvious even from this brief discussion that redefining the CEO role, changing management development, redesigning executive compensation and recalibrating priority board oversight, even if undertaken according to new principles, will require substantial, granular effort because each business and each industry will have its own particulars. It should also be obvious that this necessary granularity is why public regulation of core governance and of executive compensation is so prone to over-simplification and unintended consequences, especially when emotions are running high and when politics is trumping policy.' Given the forfeiture of basic trust, however, post-TARP re-regulation is coming to address the causes of the worst financial melt-down since the Depression, as well as the effects. Broad structural issues will be debated: systemic risk regulation, counter-cyclical capital requirements, leverage ratios, liquidity protections, revised accounting standards, credit rating agency reform, special oversight for large complex financial institutions (LCFIs).

But any re-regulation in the governance area would be greatly informed if boards of directors and CEOs, rather than giving out bonuses without explanation and sparking firestorms of criticism, would articulate a new vision of the CEO's role—and its seamless connection to developing executive talent, promoting it, paying it and overseeing it. Such a vision stop won't stop regulation, but it might (conditional emphasized) help find the best balance between public and private decision-making in resolving the governance crisis.

*The content of this policy memo was first published by Business Week.*

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## RELATED RESOURCES

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