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Risk-Taking, Discipline—and Regulation

Balancing the three is critical for company health—and the health of the economy

by Ben W. Heineman Jr.

At the core of capitalism is a fundamental tension between risk-taking and discipline.

The huge failure of many of our major financial institutions—as evidenced by billions in write-offs from complex instruments, including subprime mortgages—is just the latest example of the catastrophic effects of "risk-taking and greed" trumping "discipline."

To be sure, entrepreneurship, creativity, and innovation are necessary to stimulate growth in revenues, profits, and market value. But, so too, internal checks and balances are needed to constrain greed, avoid commercial and legal collapses, and ensure integrity and quality deep inside the corporation.

Risk-taking unchecked by discipline invariably causes greed to ascend and the company to fall. And discipline without sound risk-taking inevitably cramps innovation and leads to slow growth at best, and stagnation at worst.

Plunging Forward Blindly

The current credit crisis is not a traditional business case of taking a risk, understanding the downside, and suffering a limited loss when the ship doesn't come in. Rather, top business leaders in many major institutions didn't appear to understand the risk at all as they plunged forward with subprime and other mortgage exotica—and off the cliff.

The mid-April report from UBS to its shareholders—after $37 billion in write-offs—is a searing litany of internal failures: a fragmented staff risk function that didn't look across the whole company; business leaders not listening to risk warnings; internal conflicts of interests taking the place of real checks and balances; failure of senior managers to ask hard questions; improper pay incentives that over-rewarded revenue creation; and, ultimately, an unbalanced culture that valued gains over discipline.

The UBS report also drily notes that many of its problems were "similar" to those of "other financial institutions with exposure to the U.S. subprime market." Indeed,

systemic, internal failures in the credit collapse may be even deeper and more extensive than the fraudulent accounting and backdating problems at the core of this decade's earlier scandals when internal systems and processes were the supine Maginot Line defenses breached first by manipulative senior leaders (although external gatekeepers failed, too).

It is thus vital that the affected financial institutions understand and explain how all the key functions and constituencies failed: finance, legal, controllership, risk, P&L management, the CEO/senior execs and the board.

Dramatic Failure of Discipline

When internal discipline fails so dramatically and with such broad impact—when stress on Bear Stearns threatened extensive damage to the economy—then the calls for new regulation grow louder and louder, both in the U.S. and across the globe: The reflexive response from the affected institutions—"we will do a better job of self-regulating and reporting in the future"—is viewed as too hypocritical and too little, too late.

Some regulation is likely to occur (with heated debates over such initiatives as increased capital requirements, closing of the gap between regulated and unregulated institutions, dealing with "off-balance-sheet" items, consolidation of regulatory authorities). But there are two fundamental questions that both regulators and companies should answer first: What were the internal failures? And how, with real world pressures, can companies exercise greater internal discipline in the future?

Such understanding and explanation is important, of course, in designing regulation that can properly address the need for financial institutions to attain a new, appropriate balance between risk-taking and discipline. But regulation doesn't work unless companies drive systems and processes deep into business operations that balance risk-taking and discipline—and fuse high performance with high integrity. Indeed, the challenge for boards and CEOs is to effect such fusion in a way that goes beyond regulation, rather than working to undermine the next set of rules, to ensure the long-term health of the organization—and the economy. This is their job—regulators can't do it.

But it is naive to think that such a challenge will be met:

•Unless the board explicitly charges the CEO with developing the balance in its job specification, making clear that business leaders, not staff leaders, are responsible and will be held accountable;

•Unless the CEO and senior executives are paid not just for performance but for performance with integrity and discipline;

•Unless the CEO develops management systems and processes, including real checks and balances, that surface hard decisions and honestly discuss the risks of "innovative" revenue enhancement;

•Unless these processes are supported by a robust culture in which key people understand, indeed embrace, the necessary balance between risk-taking and discipline; and

•Unless all these changes are credible to the outside world.

The CEOs of our financial institutions are preoccupied with the business issues raised by the credit meltdown and billions in write-offs. But just digging out of the deep financial hole is not enough. They must also firmly, realistically, and publicly address the broad questions of how they govern their companies in the future—if regulation and company practices are to be meshed constructively to promote both innovation and rigor.

I believe the most fundamental task for business leadership is to find the right organizational and cultural balance between risk-taking and discipline. These should be seen as complementary, not conflicting, imperatives.

If CEOs don't do this in a credible, systematic way, then the investor and public trust their companies have forfeited will be reposed heavily in regulators, not regained by them.

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