BusinessWeek

Viewpoint: Ben W. Heineman Jr.
April 16, 2009, 12:01AM EST

Redefining the CEO Role

How fundamental governance changes within corporations can enhance accountability and increase investor confidence

By Ben W. Heineman Jr.

Like the companies they run and oversee, CEOs and boards of directors in the financial sector have been battered by the credit meltdown. The witch's brew of high leverage, poor risk management, creation of toxic assets, and faulty business judgments—made more poisonous by excessive short-term executive pay—are seen as failures of an unprecedented magnitude. The result: Credibility has eroded, trust has dissolved, and financial re-regulation seems inevitable.

As Lloyd Blankfein, CEO of Goldman Sachs (GS), said recently in a speech to the Council of Institutional Investors: "…[T]he past year has been deeply humbling for my industry…the loss of public confidence…will take years to rebuild…effective reform(s) are vital and should naturally emanate from the lessons learned."

To this end, I believe there are four fundamental, interrelated governance changes inside corporations that are essential for enhancing accountability and increasing stakeholder confidence:

• Boards of directors must redefine the role of the CEO—and then choose leaders who meet the new specs.

Under this recast role, the CEO's first foundational task is to achieve a 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 redefined foundational CEO task is to fuse this high performance with high integrity. That means adhering 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 corporation and reduce legal, ethical, and reputational risk.

• Boards and business leaders must institute new management-development processes for corporate profit-and-loss and functional leaders at early stages in their careers. These processes would put strong emphasis not just on achieving commercial goals but on developing the experience and skills to do so through balanced risk management and performance with integrity as individuals rise within the corporation.

• Boards must completely redesign compensation systems to reward these redefined fundamental business leader behaviors. Measurements for durable, sustainable economic performance, sound risk management, and high integrity embedded in daily business operations must be developed and form the basis for short-, medium-, and long-term compensation.

• Board oversight of strategy should focus on the highest priority issues along the performance, risk, and integrity dimensions of the redefined CEO role, which should, in turn, be reflected in redesigned compensation metrics. Thus issues addressed in strategy reviews flow seamlessly from proper specs for business leaders and appropriate standards for executive compensation—with focus both on this year's efforts and also on results over a longer time horizon.

Although corporate rhetoric might suggest that these fundamentals are already recognized, corporate reality is, generally, that they are not. Business organizations must be designed—by boards at the conceptual level and business leaders at both the conceptual and operational levels—to check greed, stupidity, and corruption and to channel capitalism's "animal spirits" into sustained, durable creation of real economic value. And it must be done within a framework of financial discipline, law, ethics, and values.

In a shift to these new fundamentals, one key question is what to measure.

With respect to economic performance, looking closely at the real performance of the corporation (immunized as much as possible from bookkeeping manipulation and stock-price fluctuations) is a place to start: for example, focusing on cash flow, return on assets, return on invested capital, or economic value added over years, not just annually.

Appropriate management of financial risk 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 in status (if not precisely in pay) to business generators. 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 into assessments of these risk issues and using early warning systems to spot unforeseen risks.

Integrity metrics should focus on key principles (consistency and commitment of leaders, embedding integrity issues in business operations), the implementation of key 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 hard problems are handled, how key people are hired).

A second important question, after deciding what to measure, is how to translate those metrics into compensation design. A broad consensus is beginning to emerge on key concepts.

Dealing with Compensation

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 as objectives in those 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 that 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 awarded in Year One should be paid out in increments, with a portion paid in Year One but a significant portion held back. A performance or integrity miss in subsequent years means that the held-back amounts will not be paid. This redesign should be the death knell of the huge annual cash bonuses that reward the risky, short-term upward spike.

Variable equity should vest over a period of several years after the grant. The amount awarded in the first year should be increased, stay the same, or be reduced at vesting depending on relative comparisons with peers both for total shareholder return and economic performance. Like variable cash, variable equity can be held back for significant misses in the areas of absolute performance, risk, or integrity.

This approach should be the death knell of naked stock options or restricted stock based only on share price as a dominant form of compensation (without comparison to peers or reference to other measurements of performance). The cataclysmic events of the past year have severely undermined the long-dominant theory that share price reflects efficient, rational markets.

Answering Important Questions

It should be obvious even from this brief discussion that redefining the CEO role and making the other suggested changes will require substantial effort because each business and each industry will have its own particulars. Moreover, important recurring questions must be answered. Will boards, which have failed, face up to this basic responsibility, perhaps aided by a new breed of compensation consultants with expertise in company operations rather than knowledge of how execs are paid at other companies? Can shareholders—a diverse lot with conflicting agendas—develop a constructive say on pay but also accept a longer-term view of corporate performance? Will industries, not just individual companies, embrace change so new terms of competition for executive talent are not eroded by a return to the profligate past?

It should also be obvious, however, that this is why public regulation of core governance and of executive compensation is so prone to oversimplification and unintended consequences, especially when emotions are running high and politics is trumping policy.

Given the forfeiture of basic trust, however, re-regulation is coming to address the causes of the worst financial meltdown since the Depression, as well as the effects. Broad structural reforms will be debated: including systemic risk regulation,

countercyclical capital requirements, leverage ratios, liquidity protections, credit-rating agency reform, and special oversight for large complex financial institutions.

But re-regulation in the governance area would be greatly informed if corporations would articulate a new vision of the CEO role—and of developing executive talent, promoting it, paying it, and overseeing it according to this redefinition—rather than sparking firestorms with unexplained (and inexplicable) bonuses.

Such a vision won't—and shouldn't—stop regulation, but it might (conditional emphasized) help find the best balance between public and private decision-making in resolving the governance crisis.

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