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On Leadership



LEGAL SCHOLAR

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THE QUESTION

Building Better Wall Street Leaders?

A major cause of the year-old financial crisis was a failure of leadership in a financial sector that had become focused on its own short-term profits rather than the long-term health of the economy. What does Wall Street have to change to produce better leaders, a different culture and a more long-term focus?

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Channeling the 'Animal Spirit'

We can describe what *should* happen inside financial institutions---but the real question is *how* to confront the powerful forces that drive a short-term culture focused heavily on remuneration and which are resistant to change.

Four fundamental, interrelated governance actions inside corporations are essential to create real economic value (not the paper chase that brought the sector low), to enhance accountability, to increase the confidence of investors and other stakeholders and, in this era importantly, to ensure that the public trust and public mission of finance is honored.

- Boards of directors must redefine the role of the CEO--and then choose a leader who meets the new spec. The CEO's first foundational task is to achieve a core balance between taking economic risk and creating economic value (promoting creativity and innovation) and managing economic risk (within a systemic framework of financial discipline) over a sustained period of time. The second foundational CEO task is to fuse this high performance with high integrity---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 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, at early stages in 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 should be a talent-management imperative as individuals rise within the corporation and face greater challenges in all dimensions.

- Boards must completely redesign compensation systems to reward these redefined foundational CEO and top leadership behaviors. Measurements for durable, sustainable economic performance, sound risk management and high integrity embedded in daily business operations must be developed. They must form the basis for compensation paid out not just annually but systematically over time, with good or bad results on those new measurements yielding more or less compensation. The huge naked annual cash payout and stock-option grant based only on stock price increases should become extinct.

- Board "oversight of strategy" should focus on the highest priority risks and opportunities along these three dimensions of the redefined CEO role and redesigned compensation --- economic performance, risk management and integrity---with reviews both of this year's efforts and also of results over a longer-time horizon. These issues 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 suggests that they are not. Within the financial sector itself, few leaders have been heard to criticize the short-termism, lack of risk management, improper compensation incentives, failure to act with integrity in the public interest, despite the failures of the sector that nearly drove the world economy into a depressions.

The harsh reality is that business organizations must be designed---by boards at a conceptual level and 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.

The necessary changes inside financial institutions may be stymied by some fundamental forces:

- The labor market for executive and financial talent drives companies to short-term behavior that may lead to a selfish culture with excessive risk-taking. Unless the company can develop a strong culture of loyalty which promotes other values, then individuals who want only to maximize their income will defect to non-regulated companies, if public policy seeks to address this problem in a certain class of financial institutions, or to other jurisdictions with weaker rules (regulatory arbitrage).

- The short-termism of today's stock market puts pressure on companies which seek to act in the longer term and to reward executives and money-makers for accomplishments on economic performance, firm enterprise risk and strong integrity over time.

- Calling for more shareholder involvement in company leadership may be letting the fox in the chicken-coop. There is no such thing as a "shareholder" but instead a menagerie, with an

increasingly number focused only on the short-term and on beating bench-marks with little interest in the long-term economic growth of the companies whose stock they own.

- It is difficult to define the right-sized role of the board (see basics above), and even more difficult to find experienced, broad-gauged and tough-minded people who can define, select and support a new type of CEO, maneuver through the shoals of the labor market and resist short-termism. For example, boards need to find new compensation experts--not individuals who know how to manipulate different compensation mechanics and how much the person next door took home but a real business expert who can understand what metrics for performance, risk and integrity are appropriate and how to assess those over time to link with proper compensation.

The core truth is that without strong boards selecting strong business leadership with a more balanced mission and the ability to create a strong culture, there is a high likelihood that we will return to the excesses of the past. With respect to internal leadership of institutions, regulations can point in the right direction and impose some process requirements, but they will not accomplish the task .

The innovation, wealth creation, integrity, safety and soundness of financial institutions turns, as it always has, on its top leaders. The basic question is whether the sad past of business leadership, as we move through the crisis and green sprouts become trees that obscure the forest, is unfortunate prologue.

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