BusinessWeek

CORPORATE GOVERNANCE September 26, 2008, 12:01AM EST

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.

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 balancd 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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