Part I Corporate crisis, leadership and governance

1 Financial crisis: a leadership crisis?

1. An accelerated race to the top

On 15 April 2009, Oswald Grübel, UBS's chief executive, unveiled a financial loss of SFr2bn (€1.3bn) for the Swiss bank in the first quarter of 2009. With this figure, UBS's total writedowns, dating back to the beginning of the financial crisis in August 2007, reached around €37.8bn. After the technology bubble burst in early 2000, UBS had launched an impressive global expansion process, becoming one of the darlings of the investment banking industry. Its growth was phenomenal, its profitability was very high and its business model was admired by many competitors. At a time when other major investment banks, such as Morgan Stanley and Merrill Lynch, were experiencing severe problems, UBS seemed to have developed the capabilities to overtake them. The incredible trading floor of the recently built UBS regional headquarters in Stamford, Connecticut, was a symbol of the bank's new power in the United States: it was considered the largest trading room in the world. It aptly reflected UBS's ambitions to become one of the world's top investment banks by the end of the decade.

Unfortunately, in June 2007 UBS was being closely watched not for its ambitions, but for some hints that a deep crisis was brewing. The sudden replacement of Peter Wuffli, UBS's chief executive, with Marcel Rohner, came as a big surprise inside the bank. Wuffli had been the architect behind UBS's expansion; he had developed a business model that combined the investment banking and wealth management teams in a new, more efficient way. Nevertheless, the news that UBS's investment banking division had accumulated around $76bn exposure to toxic assets related to the troubled US housing market made investors very uneasy. When the markets for those assets collapsed in mid-2007, UBS was unable to sell them; this failure sent shockwaves internally and around the world, raising an alarm about the bank's financial position. Since this was a bank that had grown very quickly over the past few years, had escaped the technology bubble relatively unscathed and had a reputation for being managed well, the news came as a big shock to everybody.

This marked the beginning of the unravelling of UBS's investment banking division. The roots of its problems were complex and interrelated. UBS started to take more aggressive risks in 2005, when its top managers decided to run an internal hedge fund to take advantage of the growth opportunities in alternative investments. The decision seemed to put UBS in the same league as other top investment banks, which had already been developing their own internal hedge funds; it could help UBS close the gap with its peers in the fixed-income division. However, executing the decision was complex. In order to attract top people for that division, UBS had to design a special compensation system, with a more generous pay mechanism for senior employees who could generate new business with higher margins – by taking more risks. At the same time, UBS had to fund the new division. Since it was unable to raise all the required capital externally, UBS had to put up about $3bn to fund the new business. The goal was to run a unit that could operate at about twenty times its capital, with leverage up to $70bn.

The newly created hedge fund and the traditional fixed-income division accelerated UBS's activity by piling up mortgages and slicing and packaging them into specialized credit securities. As the housing and credit bubbles gained momentum, UBS's traders started to accumulate higher risks. For a bank known for its risk management control systems and the prudence of its lending operations, the crisis that had developed in less than two years was truly embarrassing. By June 2007, UBS held more than $20bn of different CDO (collateralized debt obligations) tranches. A few weeks earlier, the bank had tried to sell CDOs to determine the price that potential buyers would give those assets. In one day, the bank lost $50m. In October

2007, UBS revealed its first losses of $4.4bn. It was truly disappointing news.

In twelve months, UBS's reputation was severely damaged. Once one of the fastest-growing investment banks in the world, with the credibility of an innovative business model, it now represented every unwise strategy investment banks had adopted: extreme risk taking, dysfunctional compensation systems, excessive leverage, poor risk management systems and the concentration of investments in low-quality sub-prime CDOs. Furthermore, the top management team was taking too many risks without providing detailed information to the board of directors; and the board of directors was not fully aware of the bank's increasing financial leverage and risk.

It is true that UBS's quick expansion occurred in the context of a growing world economy that showed important financial imbalances in the United States and other key countries: a huge credit bubble in many countries; external imbalances (both surpluses and deficits) that were driving savings away from China, Japan and Germany into voracious spenders like the United States and Britain; and an increasingly deregulated financial system. But it would be ludicrous to say that the financial crisis that began in 2007 was unleashed by some of the factors that dominated the world economy after the technology bubble in the late 1990s and the sudden reversal of expectations. As we see in UBS's fall, recent corporate crises have their origins in strategic mistakes, reckless decision investments, mediocre risk management, dysfunctional control systems and too much leverage, a powerful cocktail that became even stronger when adulterated with destructive drops of greed. From a leadership perspective, we can observe in this and other corporate crises senior business leaders' negligence in making decisions without fully informing their boards, boards of directors forgetful of their duties and responsibilities, and the focus on short-term profits.

In this chapter, we shall explore some of the problems that have plagued companies in recent years and that have contributed to a deterioration of corporate reputation. We will map out the symptoms and diseases and argue for the need to rethink the notion of the firm, the role of CEOs and senior managers, and the concept of corporate governance.

2. The changing social perception of companies

In the late 1980s, a wave of deregulation and privatization swept the European economies. It was propelled by a similar wave unleashed in the United States in the early 1980s; this wave's influence extended beyond North America and Western Europe and shaped policies in Latin America, Asia and even Africa. State-owned companies were privatized, markets were deregulated, government intervention was pulling out from many industries, and faith in market economies and private enterprise seemed limitless. Corporate growth and share price maximization became popular, and globalization sparked international business expansion. Moreover, the fall of communism reinforced these trends. It looked like the market economy was unstoppable and that the business world was heading toward unlimited growth.

Two decades later, the business outlook was strikingly different. By mid-2009, the global economy was tanking, the huge credit bubble that developed in the early and mid-2000s had burst, corporate growth had disappeared, profits were sinking, powerful US investment banks had collapsed or gone bankrupt, and confidence in the business world and senior executives was quickly diminishing. In the 1990s and in most of the current decade, corporate growth and empire building were the fads that dominated the business world. Now, the current economic downturn is pressuring companies to perform for survival; but it is also forcing business leaders, scholars and regulators to rethink the role of companies, markets and governments and to reconsider the roles of senior leaders in companies and society.

The boom of the 1990s helped generate new management practices and saw the emergence of the charismatic CEO, unafraid of breaking the rules. For some years, strong economic growth seemed to prove those policies right. Nevertheless, the violation of basic management principles brought many companies to their knees, seriously harming their reputations. Many corporate crises were attributable to a disregard for sound financial management, speculation around IPOs, excessive leverage, senior executives' rule breaking and the lack of an effective system of corporate governance. In fact, many failing companies offered good products and services, and the new financial landscape gave them almost immediate access to capital markets. And yet, at the heart of the crisis was the role played by CEOs.[1] Corporate growth was the driving engine of decision making, regardless of whether it made sense or not. Governance was poor. Many companies lacked a sensible balance of power between the CEO and the board of directors. CEOs became celebrities on a par with top athletes or movie stars. Investment banks were the paradigm of this collective behaviour: aggressive risk-taking policies, excess investment, rashness, empire building, ballooning executive compensation and conflicts between the board and the CEO.

The purpose of this book is to reflect on the roots of the deterioration of corporate reputation over the past decade, the role of senior executives and board members in this process, and what needs to be done to rebuild respected companies. The underlying thesis is that the current notion of the firm as an economic organization whose purpose is to maximize its market value in the short term – and to be achieved by giving senior executives some economic incentives linked with performance – is an oversimplification that has opened the door to a game of incentives with adverse effects for the firm in the long term. Too often, this game has allowed strategies based on opportunism, self-interest and a lack of integrity. Confidence in

[1] Khurana (2002) offers a fascinating account of this transformation.

corporations will return if we rethink the notion of the firm, what society expects from companies, and how board members and senior leaders become stewards in this very important social institution. Unless there is a new sense of what companies are for, what they should achieve, and how their contribution to society should be defined, we may survive the current crisis, but we will be sowing the seeds of a new one.

The role of CEOs and senior business leaders in corporations and their wider impact on society is this book's second major topic. We will explore the transition from the shareholder-dominated governance system that prevailed in the West from the second half of the nineteenth century to the system dominated by CEOs, which began in the United States after World War I and in Western Europe a little later. The historian Alfred Chandler (1977) described this as a transition from investor capitalism to managerial capitalism. It is not only that CEOs accumulated a lot of power in the 1980s and 1990s, when many became empire builders and boards of directors were not particularly active; but in a period of strong economic growth, the sometimes reckless actions of many CEOs passed unnoticed. Not until the technology bubble burst in the early 2000s were some disastrous business decisions revealed. At the same time, with capital markets deregulation in the USA and Europe in the late 1980s and 1990s, financial markets started to get the upper hand in the way investors looked at companies and their decisions. Unfortunately, investment banks and other advisory firms started to get a stronger influence on boards of directors' decisions, sometimes bypassing or sidelining the interests of shareholders in the long term. CEOs became more powerful, but as far as they could please financial markets.[2] Unfortunately, the current financial crisis has revealed the weaknesses of this model of corporate leadership.

A similar phenomenon occurred more recently when the global economic growth recovered strength by 2004, although that

[2] For a historical description of the increasing role of financial markets and their impact on business leadership, see Davis (2009).

time the reckless behaviour was concentrated in financial institutions – more particularly, investment banks. CEOs and senior executives embarked on a remarkable spree of trading in dubious assets and reckless lending that was clearly lacking in prudence and good judgement. The temptation of generating rapid business growth and high short-term results was irresistible, but it was at the expense of long-term growth and survival. Moreover, the sense of mission that those senior executives had was not clear, beyond their own self-interest. The outcome is that by the end of 2008 the leading US investment banks had disappeared or, in the case of Goldman Sachs and Morgan Stanley, had chosen to be transformed into bank holding companies. Moreover, the subsequent financial meltdown had pushed the global economy to the brink of collapse.

The survival of the company as a respected social institution requires a redefinition of the role of the CEO and senior leaders in organizations; what their functions are; and what shareholders, employees and society at large should expect from them. All in all, we have to transform management into a more respected profession (Noria and Khurana 2008) whose appeal transcends the ability to make money.

The role of the board of directors and, in general, the notion of corporate governance must also be rethought. Corporate governance can never be a perfect substitute for entrepreneurial initiative or personal integrity, but it can bring some balance to the decision-making process and help CEOs avoid making imprudent judgements or rash decisions about specific business situations. Moreover, good governance can help improve corporate reputation.

Corporate governance is sometimes described as a balance of power among shareholders and CEOs or directors, as a means of managing conflicts of interest. There have been attempts to improve corporate governance by reforming board regulations or changing board structure and composition. These factors must be considered, but they are not as decisive as policies and initiatives to ensure that the board of directors works as a team, or that the CEO and top managers lead by example. The widespread adoption of governance codes has helped solve some problems by setting down in writing the best ways to structure the functions and powers of a company's governing bodies. This is an important step, but, as we shall see, it is not the essence of governance.

Good business leadership and governance have a very important effect: they help build respected companies. In a business world that seems focused on financial engineering and deal making, the value of institutions and people who can be trusted is priceless. Excellent corporate governance and business leadership must go beyond simply fulfilling legal requirements and move toward fostering long-term success and respect among all stakeholders.

3. CORPORATE CRISIS: SOME DRIVERS

We will begin the discussion by exploring certain dimensions and characteristics that we can observe in corporate crises in recent years (see Table 1.1). Although each crisis is different, they all highlight problems of corporate leadership and governance.

3.1 The explosion of corporate scandals

The general trend in the world economy during the 1990s – aside from regional setbacks, such as the Russian and Southeast Asian crises – was one of growth. The United States, in particular, experienced a spectacular economic expansion, driven by investment in information technology (IT).

Encouraged by the overall health of the world economy and the supposedly unstoppable power of IT to generate new industries and markets or redefine existing ones, both traditional and new-economy companies started to plan for growth. The so-called new economy – 'new' in the sense that it was founded on a more efficient use of information and enhanced connectivity between companies and customers – created a new market: the market for corporate growth. Senior executives began drawing up overly optimistic business plans. Consultants mined the rich seam they had discovered

Table 1.1. *Business leadership and governance: some challenges*

- Explosion of corporate scandals
- Emergence of the charismatic CEO
- Boards and CEOs
- CEOs' compensation
- Institutional investors

in executives' fixation on growth at any price. Investment banks, already swimming in cash, leapt at the enormous business opportunities these growth plans offered. And the media started to treat corporate CEOs as if they were Hollywood celebrities. The bubble expanded rapidly, thanks to a combination of mutually reinforcing factors.

Against the background of strong growth and the race to satisfy capital markets whose expectations were rising, many companies lost their sense of proportion. Some of the best-known corporate crises, such as Enron, AIG, Lehman Brothers and General Motors in the United States, or RBS, Vivendi, Fortis and Ahold in Europe, are multidimensional. Before disaster struck, some of the executives involved, such as Ken Lay or Jeff Skilling of Enron, Bernie Ebbers of MCI, Fred Goodwin of RBS or Hank Greenberg of AIG, were considered extremely talented business leaders.

The financial crisis afflicting today's global economy has its roots in the monetary flood that followed the bursting of the technology bubble, when central banks fought to avoid a recession. Interest rates were brought down, and liquidity injections made credit easily available. This financial context paved the way for a booming real estate industry; banks and other financial intermediaries encouraged people to buy homes by providing highly attractive conditions. Quick securitization of these sub-prime mortgages followed, banks' earnings ballooned, and the seeds of the current crisis took root. In 2008, Lehman Brothers and Bear Stearns collapsed; Merrill Lynch was acquired by Bank of America, bringing huge new problems for