



ENHANCING RELATIONS BETWEEN THE BOARD OF DIRECTORS AND THE CEO

Hot topic of discussion

By Professor Paul Strebelt - June, 2008

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The hottest topic of discussion at the recent IMD program on High Performance Boards (HPB) was how to manage the relationship between the Board and the CEO more effectively. An IMD on-line survey of board members reinforced the importance of this challenge. It rated the CEO and management as having the biggest influence on the Board's decision-making freedom.

This is not surprising, because the Board of Directors has to fulfill two major roles that are constantly under tension: controlling the conduct of the business in the interests of the shareholders, or the owner; and supporting the economic performance of the business. The first role encourages a more adversarial relationship, the second a more cooperative one. This article lists some of the best practice discussed during the recent HPB program and related research on how to make the relationship more effective.

1. Avoid concentration of power at the top

According to a 2007 Booz Allen Hamilton survey, "Independent Chairmen are best. Globally, investors enjoyed the highest returns relative to a broad market average when the Chairman was independent of the CEO, compared to when the CEO also held the title of Chairman, or when the the person was the prior CEO. In 2006, all under-performing CEOs in North America with long tenures had either held the additional title of Chairman or served under a Chairman who was the former CEO."

This research was confirmed during the recent subprime banking crisis. The investment banks with the biggest write-downs all had dominant CEO/Chairmen or a dominant Executive Chairman: Citigroup, UBS, and Merrill Lynch had write-downs of more than \$30 billion each, more than double those of their closest rivals. The latter had more recent changes at the top and correspondingly less dominant CEOs or Chairmen.

2. Balance diversity with expertise

Asking the right big questions about strategy and risk is ultimately the responsibility of top management and the Board. A meaningful discussion at the top pre-supposes not only diversity on the Board, but also directors with sufficient industry expertise to influence the Board's agenda. Directors must have the credibility to challenge management about the critical issues facing the firm. It is unreasonable to expect Board members, no matter how eminent they are in their field but without industry expertise, to raise the red flag on, say, looming industry risks, such as triple-A subprime assets in the banking industry.

Indeed, there was a striking contrast in the composition of bank Boards, between those banks with the biggest write-downs and credit losses in 2007/8 and those with much lower losses. On the Boards of the former, there were no directors with financial services expertise who could challenge the CEO/Chairman (as a result, warnings about subprime from outside were rejected). Those with more limited losses typically had much more financial expertise on the Board (they began reacting to the subprime threat in mid-2006).

3. Expose top management to the Board of Directors

At an IMD meeting in Amsterdam earlier this year for Board members from diverse companies, those present cited access to timely and relevant information as the biggest challenge facing Boards of Directors. Ensuring that executives meet with Board Directors on a regular basis is one of the best ways of meeting this challenge. To complement the information from management, Board Directors should ensure that they have access to independent sources of industry and competitive information.

Access to top management is also key for Board Directors to assess the quality of the CEO succession pipeline. This is especially important both for informational and succession purposes in the two-tier governance system in Northern Europe, where often no executives sit on the Supervisory Board.

4. Increase the transparency of the compensation system

During the recent HPB program, one strong view was that compensation systems for the Chief Executive have become so multi-dimensional and complex that it is virtually impossible for the Board to monitor the link between compensation and performance. Academic research suggests that complex compensation systems and hidden remuneration in the form of perks, pet projects, pensions, etc., make it look like top managers rather than the Board are setting their own pay.

This creates the impression that top managers have “captured” the Board of Directors, that they are acting together to set one another’s compensation and to protect themselves from external criticism. As a counter, the Board has to take control of compensation away from the compensation consultants and insist on a clear transparent link between pay and executive performance.

5. Put tensions on the table earlier rather than later

A highlight of the HPB program was the session on how to manage and improve the psychological relationship between the Board and the CEO, to avoid misunderstandings building up to the point where neither the Chairman nor the CEO can back down without badly damaging their egos. This is easier said than done, however, owing to the ritualistic nature of Board proceedings. Raising the red flag during a Board meeting disrupts the proceedings, so members are hesitant to do so, especially if it's about a "soft" issue that is difficult to describe objectively. Yet, not raising psychologically sensitive issues makes it progressively less and less possible for the Board to support the CEO and management in their central task of creating long-term economic value.

To create the psychological space for the Board to help the CEO, the conduct of the business must be under control. The best practice described above can help the Board enhance control, thereby creating space to help the CEO shape the long-term strategy of the company and assist at critical points in its execution.

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