Australia
Executives & Boards

Returns, Reputation, or Both?

What to do when the regulator calls

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Amrop

Leaders For What's Next

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In Brief

Short-term profit maximization for shareholders, or longer-term value optimization for stakeholders? Returns, reputation, or both? In a recent Amrop article, 'Cash or Continuity?', we revisited assumptions of 'shareholder primacy' and the link with fiduciary duty. We found that sustainable performance is increasingly important not only for organisations, but for all stakeholders. Here we take a closer look at the Australian context.

In the past years, some of the world's most famous multinationals have been hit by reputational crises - VW, Siemens, Wells Fargo, Facebook - to name just a few. Now in Australia, a Royal Commission Report[1] is causing upheaval in the financial industry. Even ASIC, the regulator, has met criticism for failing to effectively enforce the law.

The "returns versus reputation" debate to which these events give rise is rooted in a conflict of interest between stakeholder and shareholder value. In other words, the emphasis placed by top executives and boards on optimizing stock ownership at all costs, at all times. Unethical behaviour may result from this emphasis, versus a broader perspective, one which adopts a stakeholder, or even stewardship, approach.

There is a Core Dilemma

How should boards react to a reputational crisis such as the one faced today by AMP and other major Australian banks? The discussion boils down to two perspectives: *short-term profit maximization for shareholders, versus longer-term value optimization for the organisation* (where blockholding shareholders and crucial stakeholders, such as employees, play an important role). Surely, many argue, any top executive should above all else enrich the owners of the company? Isn't this what fiduciary duty should be all about?

The answer, we argue, is *No* if this duty only concerns short term stockholders and their serving executives. Moreover, the misguided behavior within AMP (and other financial services providers) outlined in the Royal Commission Report has taken the scalps of the CEO, the Chair, and half of the directors on the board, as well as the general council of AMP[2]. Do other financial institutions face a similar fate?

The Throne of shareholder supremacy Is Wobbling

Over forty years the concept of 'fiduciary duty' by executives and boards has fallen prey to a series of misinterpretations, to the point that it is now widely taken to mean 'shareholder primacy'. The idea that shareholders should ultimately dictate the functioning of a company creates a robust platform for short-term shareholder activism. It is also facing some serious counter-arguments.

3 flaws in the shareholder primacy argument:

1. Ignoring key stakeholders can create an existential threat. Without an engaged, proficient workforce, or loyal customer base, a company will underperform - also financially. And acting in a socially or environmentally responsible way is an increasingly important factor in how people choose where to work or what to buy.
2. Shareholders are not a single 'entity'. Different shareholders have different motivations and time perspectives for investing.

3 Many shareholders are essentially risk-takers. They are providing capital to enhance the short-term [quarterly or annual] financial performance of the organisation, and their own portfolios. Top executives *allegedly* need to serve these risk-takers at all costs. But risk-taking does not need to be at the expense of sustainable performance.

It's Time to Re-Frame 'Fiduciary Duty'

Executives are not 'agents' of shareholders, whose job is to 'serve' their interests as the organisation's 'owners'. Their duty should be seen as *loyalty to the organisation and its sustainable or long-term value*. And that duty needs to extend beyond organisational walls: to customers, employees, lenders and other critical stakeholders. Without clients there is no return, and without dedicated professionals, no quality products or services. If shareholders could be seen as *first among equals*, they are certainly not the only major player a responsible organisation needs to consider.

Have your sights on Trust and Reputation: ESG

If potential suitors must demonstrate care for the long-term interests of organisations, so too must target organisations. Research indicates that a majority of investors (up to 82% in one study) now use ESG data because it is financially material to investment performance. Many do so due to growing client demand or formal mandates. Even Larry Fink, the CEO of BlackRock – one of the biggest global investment funds with $6.3 trillion assets under management – recently advised CEOs to act more responsibly. So it is increasingly acknowledged that modern businesses are part of a broader societal framework. Profit at any cost will no longer secure a "license to operate" or genuine legitimacy. The Australian financial industry is fast (and painfully) finding this out.

In Conclusion

The time has come to uncouple 'fiduciary duty' from 'shareholder primacy' and reinstate its true definition: *loyalty and care to the organisation, restoring trust and reputation to the core of its business.* And intangibles such as responsible ethical behavior, sound investments and proper governance, measured by ESG criteria, are increasingly part of loyalty and care. For organisations, executives and investors.

Going forward, boards and executives will need to carefully weigh up and balance the interests of share- and stakeholders (beyond organisational walls) when considering sources of capital, or their response to tempting short-term windfalls. The question boils down to instant gratification (short-term shareholder profitability) versus the longer-term creation of organisational value, where stakeholders' interests are taken seriously, and the 'no-harm' adage prevails. The Australian public and investors are rightfully outraged at the unethical behavior of boards, executives and managers, as well as that of financial services stockbrokers.

Leading Questions

1 Do you trust your banker, financial advisor, or the boards of these organisations? Are your own board and top executives role models?

2 What kind of an organisation does your board envision? At what moral level should it operate?

3 How important are non-financial objectives in your organisation? What value do individual board members attribute to sustainability, and ESG criteria? To what extent are ESG criteria embedded in corporate reporting?

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Revolt by AMP shareholders

Headquartered in Sydney, AMP is Australia's largest retail and corporate pension provider, and the country's largest life risk business. One of its subsidiaries, AMP Capital, is the aligned wealth manager with over AUD 150 billion in assets under management. This makes it one of the largest in the Asia Pacific region. When the company recently became embroiled in the fallout of unethical behavior by its executives, managers, and allied brokers, the board did not step in or diligently govern the consequences. AMP's share price plunged about 29% in a matter of weeks - to its lowest level in more than five years - wiping out nearly AUD 3 billion in market value.

As a result of their unconvincing performance as highlighted by a Royal Commission report, AMP's board received the largest shareholder protest vote for a major company in Australian corporate history, and was bluntly rebuffed by 61% of the votes at their annual shareholder meeting in May 2018. The protest vote was initiated by the Australian Shareholders' Association, which directed its proxies against the executive pay structure. Their argument? AMP's over-generous remuneration policies, which apparently did not carry accountability, had been responsible for much of the unethical behavior raised at the Commission. Some voted against those generous remuneration packages (hardly aligned with the company's lackluster financial performance – a cornerstone in any corporate governance charter[3]). Others blamed senior management for the ethical misdemeanors that came to light at the Royal Commission. Others still issued a general protest vote against a board which had failed to properly govern or lead the company in the right direction.

AMP's most senior executives have been felled since the Commission raised the prospect of criminal charges for alleged breaches of both the corporation's and ASIC (the law enforcement agency) rules. The CEO, chair and chief legal counsel were all forced out over allegations that they interfered with the writing of an independent report to ASIC. And two other directors up for re-election withdrew amidst the ongoing protest against the board. With a 30% value destruction (May 2018) since the March 2018 high point of AMP's stock price, Mike Wilkins, the interim Chair of AMP, openly apologized at the shareholders meeting, admitting that AMP had let down their customers.

The level of misconduct at AMP and other financial institutions has angered shareholders and stakeholders alike. And with good reason.

It's fair to state that this kind of unethical behavior - and the subsequent attempts to cover it up - will not be tolerated by any sensible investor.

Why such a strong expression of distrust? Such an "outpouring of venom towards a board" is seldom seen in a major company, let alone a major pillar of Australia's financial system. It is rare for important institutional shareholders to turn on all the governors of a company in which they invest. The level of misconduct at AMP and other financial institutions has angered shareholders and stakeholders alike. And with good reason.

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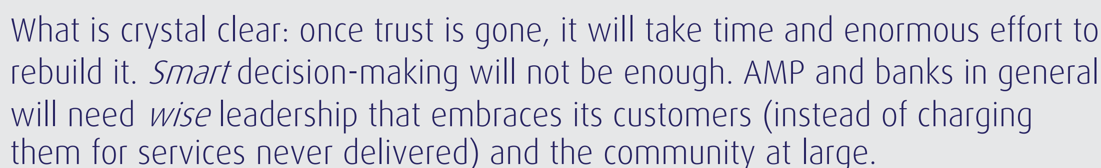

What is crystal clear: once trust is gone, it will take time and enormous effort to rebuild it. *Smart* decision-making will not be enough. AMP and banks in general will need *wise* leadership that embraces its customers (instead of charging them for services never delivered) and the community at large.

It's fair to state that unethical behavior - and subsequent attempts to cover it up - will not be tolerated by any sensible investor. The conduct seen here indicates a lack of wisdom and possibly incompetence. Not exactly the ingredients one expects from a major international finance company with a long (and laudable) history of managing the pensions of many Australians. The incoming AMP Chair, David Murray, has reluctantly accepted one of the most difficult corporate jobs - to turn this financial juggernaut around.

Nor are the four main Australian banks (CBA, WP, NAB, ANZ) without fault. Their dubious behavior – or moral blindness[4] - was clearly reported in the Royal Commission report. For instance, more than half of Australia's home loans are organized by mortgage brokers. This begs the question: are these brokers working for the client, the bank or themselves? Commissioner Kenneth Hayne – presiding over his Royal Commission into banking misconduct – has been relentless in his pursuit for an answer.

Surely, banks are well aware that credit loans or mortgages are better handled by computer algorithms than by credit officers or mortgage brokers[5]? Considering that these human agents are incentivized by the bank to bring in loans at any cost, you hardly need to be a rocket scientist to conjecture that such a remuneration recipe is prone to a variety of unethical and unsustainable behaviors.

Moreover, ASIC seems to shy away from strict enforcement, and has therefore failed in its fiduciary duty too. As always, there are different perspectives and versions of this unravelling story. What is crystal clear: once trust is gone, it will take time and enormous effort to rebuild it. *Smart* decision-making will not be enough. AMP and banks in general will need *wise* leadership that embraces its customers (instead of charging them for services never delivered) and the community at large.

Why good managers make bad decisions

The board and its top executives should take full responsibility for failures to properly guide, govern and manage an organisation in line with the fiduciary duty of loyalty and care to the organisation, (not just shareholders).

Entrenched or lazy boards may be failing to properly curate the interests even of shareholders, whether day-traders, short-term, or block holder. In that sense, shareholder activists may serve a useful purpose - questioning the legitimacy of CEO bonuses or ruffling the feathers of a sleeping board. The problem is that most activists tend to focus on short-term financials, often temporarily raising the stock price. But they do not necessarily contribute to long-term strategy.

The best boards take a balanced view when dealing with stakeholder activism, reconciling short term interests, and sustainability[6]. When boards focus on shareholder value maximization at all costs, misguided, unethical or unsustainable behaviour can bloom, starting at the board and spreading down to subordinate managers and employees. A recent global Amrop study[7] finds that business leaders are missing a host of opportunities to drive more sustainable business performance, (even though it also reveals that senior executives tend to have good intentions, placing a high premium on ethics).

So why do good managers make bad decisions? Meeting the board's demand to focus on maximizing quarterly or annual profitability and stock price only is definitely one of the main culprits of unethical behaviour. And focusing on outcomes alone, instead of a responsible decision-making process, or closing eyes to questionable behaviours that contribute to incredible revenues streams, are other examples that could easily degrade into questionable and irresponsible behaviour - jeopardizing the reputation of leaders and entire organisations[8].

Digging deeper in our research, we find that organisational pressures are often preventing corporate leaders from acting in accordance with their own personal ethical values[9]. We also see a mismatch between what corporate leaders say is important, versus their choices when presented with career choices or potential bonuses. These disconnects can result in flawed decision-making, potentially putting organisations at risk.

There is no contradiction between short-term return and gaining a reputation to create consistent return on investment over a longer period - without harming people or society.

The core dilemma

Essentially, the discussion boils down to two different perspectives, *short-term profit maximization* versus *longer-term optimization of earnings,* in other words, short-termist shareholder primacy, versus a more long-term perspective. One where stakeholders are taken seriously and validated[10].

Particularly when it is not the regulators who are calling, but investors, the response to their approach will depend on the potential investor's orientation: short-term-focused and playing/trading stock on the capital markets, or seeking to secure ROI over a longer period, caring for the stakeholders that make or break the company (employees, customers and even the wider community).

But surely any top executive, under all circumstances, should undertake all endeavors to enrich the owners of the company he/she is leading (as fiduciary duty seems to claim)? Not really: good management and governance can perfectly well result in short-term profitability, while preparing for sustainable organisational value creation.

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In fact, the idea of a single shareholder value is intellectually incoherent."

The wobbling throne of shareholder supremacy

Over the past forty years, the concept of 'fiduciary duty' has fallen prey to a series of eloquent misinterpretations, to the point that it is now widely understood as meaning 'shareholder primacy'.

The shareholder-centric view of the corporation has been based on the concepts of risk-bearing, promises[11] and fiduciary duty. The idea that shareholders should be compensated for taking risks since they have no fixed legal claimants, but legal vulnerability to *risk*,resulted in an interpretation that they should control the organisation through voting rights[12].

In addition, shareholder primacy relies on a *promise* argument - although logically speaking it only should be legally enforced if explicitly determined in the corporation's Charter. Furthermore the *legal duty of loyalty, prudence and care* stipulates that in "making a business decision, the directors of a firm need to act on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the company." Maybe the organisation should compensate shareholders for specific risks they are intentionally willing to take,[13] although it may be difficult to quantify exactly what that individual level should be, making it hard to implement.

A recent 2017 Harvard Business Review article: "The Error at the Heart of Corporate Leadership"[14] is just one example of a number of convincing arguments that are gradually dismantling the notion of shareholder primacy - and reinstating the true meaning of fiduciary duty. Lynn Stout offers another. An expert in corporate governance, financial regulation and moral behaviour, her publications include the award-winning book "The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations and the Public[15]." In a 2013 article, "The Myth of Shareholder Value"[16], she explores the crisis of confidence undermining the shareholder primacy concept, an idea most easily traced back to a New York Times article published in 1970, by the late American economist Milton Friedman.

His article was uncompromisingly titled: "The Social Responsibility of Business Is to Increase Its Profits", and is considered the basis of the shareholder primacy theorem. Professor Stout is dismissive of shareholder primacy, describing it as "an abstract economic theory that lacks support form history, law, or the empirical evidence. In fact, the idea of a single shareholder value is intellectually incoherent."

Shareholder primacy – 3 counter-arguments

Here are just three flaws in the notion that shareholders should dictate the functioning of a company.

1 Failing to take account of key stakeholders can create an existential threat

Without an engaged and proficient workforce, or loyal customer base, a company is doomed to underperform in every sense, including financial.

Acting in a socially or environmentally responsible way is becoming critical in the way people decide where to work or what to buy. If (particularly millennial) employees or clients don't feel a company is responsible, it will have a hard time attracting or retaining talent or convincing customers who want 'untainted' products. And as ROI suffers, so will shareholders.

2 Shareholders cannot be viewed as a single 'entity'

Different shareholders have different motivations and time perspectives – short, medium and long-term.

Different shareholders have different motivations for investing, and different time perspectives – short, medium and long-term. If it is the organisation's mission to provide great products and services that do not harm people or the environment, then providers of capital should be fairly remunerated. The equity holder's vulnerability to risk should be more specifically determined (from short to longer term risk). Shareholders who align with that mission and are willing to hold onto their stock for a certain period (beyond seconds, minutes or days, mere short term speculation or investment without care or loyalty) deserve to be treated well. But even that does not justify making them sovereigns, or obeying the dictates of shareholder supremacy at the expense of other crucial stakeholders.

3 Many shareholders are essentially risk-takers

This is particularly the case for activist or hedge fund shareholders

Many secondary shareholders – in contrast to reference or initial entrepreneurial investors or family members - are providing capital to enhance short-term performance, and their own portfolios. Being rewarded for taking risk does not necessarily equal full and unconditional primacy over others, as interpreted today. A more balanced view is suggested: creating long term sustainable value while also performing well in the short-term, meeting or exceeding the expectations of pressing stock holders and traders on the Stock Exchange.

It's time to re-frame the concept of fiduciary duty

Far from being Milton Friedman's 'agent' of shareholders, whose job is to serve their interests in their capacity of the organisation's 'owners', we can argue that executives' duty of loyalty should be literally interpreted as loyalty to *the organisation and its sustainable or long term value*.

And that duty needs to extend beyond organisational walls. An organisation should take care of its customers, its employees, (who may well have higher stakes than investors), and its lenders. So whilst shareholders could be seen as *first among equals*, they are certainly not the only major player a responsible organisation needs to consider.

Furthermore, a significant shift is underway in the mindset of some of the world's most influential investors. Not only do *suitors* need to be able to demonstrate that they have the long-term interests of organisations firmly in their sights, so, too, do *target* organisations.

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Boards and executives should have their sights on regaining trust and reputation (via ESG criteria)

The Harvard Business Review, in its annual review: The Best-Performing CEOs in the World[17] spotlights top executives such as the CEOs of NovoNordisk (2016) and Zara/Inditex (2017) who, together with their boards, take stakeholders seriously. Based on their performance so far, it's fair to assume that these pilots would never deliberately mislead their customers or mistreat their employees.

Bringing ESG criteria into the fore – criteria that embrace a more stakeholder-oriented, or steward-like approach - seems to result in superior performance (combining financial and non-financial criteria). Yet there is a fine balance between shareholder value optimization and serving stakeholders. And this is a balance that increasing numbers of organisations are trying to strike. Corporate Shared Value[18] has become a goal for a number of the world's best-performing corporations. According to this, the firm, its shareholders, and society at large, benefit from sustainable value creation and this subsequently enhances corporate reputation. Furthermore, long term profitability is strengthened by consistent – including short-term – ROI.

Assessing the motivations of investors or shareholders to consider ESG data, 82% of boards use it because it is "financially material to investment performance," according to one survey [19]. A significant percentage do so due to a growth in client demand, or formal client mandates. They face barriers, however. The biggest is the lack of comparability of reporting across firms, with a lack of reporting standards as a major inhibitor[20]. The costs of gathering and analyzing ESG data are also problematic, as is quantifying ESG information[21].

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Paving the way back to trust

There is increasing evidence in favor of ESG guidelines and reporting. Larry Fink, the CEO of BlackRock, one of the world's biggest fund managers, recently publicly announced that any investor should take ESG seriously to create corporate shared value, and avoid endangering their own existence long term.

Trust is the glue of any interaction in business – or any relationship for that matter. Australian banking and financial services executives might well take note of how Kevin Johnson, the CEO of Starbucks, faced a recent crisis related to race discrimination by an employee at one of the company's US outlets. He took an ethical approach, rectifying the action to preserve Starbucks' reputation and trust This, in contrast to Mark Zuckerberg's recent meek reaction to the 50-80 million data breach of private information on Facebook by Cambridge Analytics, or how Uber's founder became embroiled in #DeleteUberCampaign that ultimately forced him to resign as CEO.

Recent psychology research seems to indicate a correlation between unethical behaviour and creativity[22], (a general attitude that "the rules don't apply to us", paired with a narrow focus on outcomes alone – such as maximizing shareholder value at any cost). And this creates fertile ground for an imminent ethical, and thus reputational, crisis[23]. When key stakeholders perceive that a good rule based on common sense has been violated, they get rightfully upset and will find ways to retaliate. Managers and executives who overstep rules and norms will (occasionally) find out that this carries real costs. *In short, you will have to pay for what you break.*

A crisis such as the one the Australian financial industry is currently navigating will require leaders to transform themselves as well as the organisations they lead and govern. They will need to come up with a compelling narrative for their stakeholders to believe in, one built on collective and not just individual leadership capabilities. Leaders who are not just smart, but wise, will install disciplined processes to drive innovation and growth, based on metrics and reward systems aligned with corporate values and organisational norms. And they will build vibrant talent factories, where ethical creativity and innovation become the standard. Such leadership skill sets assume the mastery of dualities and ambiguities. Navigating an unforgiving, grey and complex business context requires a specific mind set that embraces both urgency and patience, collective leadership and individual accountability, functioning as a development coach whilst pushing for relentless performance, fostering continuous learning and acting as an inspiring teacher. And finally, being a humble servant or steward who simultaneously functions as a bold change catalyst[24].

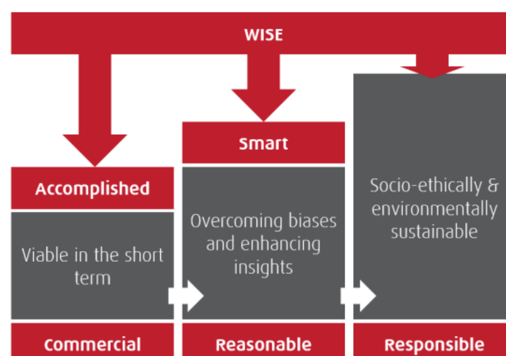
Dealing with a [reputational] crisis calls for adherence to a particular process[25]. First of all, CEOs and boards should face reality and address the issue without excuses or justifications (such as the AMP General Counsel attempted, by stating that he did not do anything illegal). Subsequently, the board should function as a coherent team where all members and top executives are on the same page. Furthermore, once a problem is publicly acknowledged (instead of being denied or downplayed) the board and executive team need to dig deep for the root causes, and prepare an action plan for the long haul, instead of succumbing to short term profitability yardsticks.

As the adage goes, *one should never waste a good crisis*: the board and its team should take the opportunity to review the incentive system and how top executives are measured and paid. Since you are in the spotlight, you had better take real action in your organisation and address the causes of unethical behaviour, instead of waiting for the regulator to impose stringent boundaries on your organisation. And finally, the board and CEO should not merely react to the situation but take assertive action, showing who is command and assuring all stakeholders that the organisation will "do the right thing". Only such a chain of action will lead to wise decision-making, allowing trust to be regained.

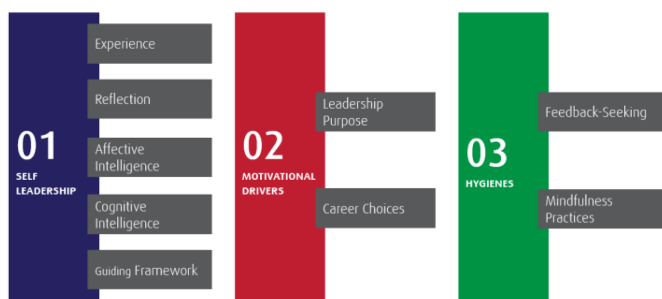
The steps from smart to wise

A recent Amrop study: "Wise Decision-Making: Stepping Up to Sustainable Business Performance" argues that accomplished, or smart decision-making, (defined as commercial and reasonable), whilst essential, will no longer earn organisations the legitimacy to operate. But what steps can leaders take?

Going forward, leaders will not only need to be accomplished or smart, but wise: making decisions in a way that is socio-ethically and environmentally sustainable. In short, not just reasonable, but responsible. Smart leaders become wise when they address the dilemmas of modern business in a more holistic way. Not only do wise leaders create and capture vital economic value, they also build more sustainable – and legitimate organisations. Wise leaders are able to embrace the grey areas in which business operates.



3 Pillars of Wise Decision Making



The study assesses individual leadership characteristics, factors within the scope of leaders' control. It is organized along three pillars. *Self Leadership* (how leaders exercise self-governance and exercise wisdom), *Motivational Drivers* (what drivers influence leaders' choices) and *Hygienes* (how leaders nourish their decision-making 'health').

It reveals that whilst leaders are on the path from smart to wise, they are missing vital steps and opportunities: for example, stopping a decision in the face of counter-evidence, or involving diverse, qualified (and especially confrontational) stakeholders in decisions. As such they are at risk of group think and commitment bias. And if the moral guiding light is in sight, with leaders placing a high emphasis on wise decision-making (82% believe business should operate at the highest moral level) it is often lost in the clouds. 71% report facing ethical blockages during the past 3 years, mainly due to profit imperatives, local business culture and practices, and the demands of other leaders in the organisation.

Wise decision-making, then, is about taking ecologically and socio-ethically sound decisions. Doing so in a pragmatic way that acknowledges difficulties, dilemmas and grey areas. Wise leaders are able to overcome ethical barriers and take enlightened decisions. These feel responsible and give due respect to all stakeholders involved in creating value for the organisation. Just as one should expect from anyone who takes the duty of loyalty and care seriously. In the case of a crisis, we can add resilience to the basket of qualities - the strength and speed of a leader's response to adversity[26]. The leaders of AMP and the Australian banks would do well to go back to the essence of what their organisations stand for, and build creative teams who are self-organizing and willing to be accountable for their activities.

The study concludes with a set of leading questions for boards, concerning organisational strategy. To be ready for when the doorbell rings, following are just some of them:

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Leading Questions

Supposing your organisation faces a reputational crisis[27], how should it be dealt with? And how well-equipped is it to do the right thing in the first place?

1 Shareholder primacy versus the Stakeholder perspective:

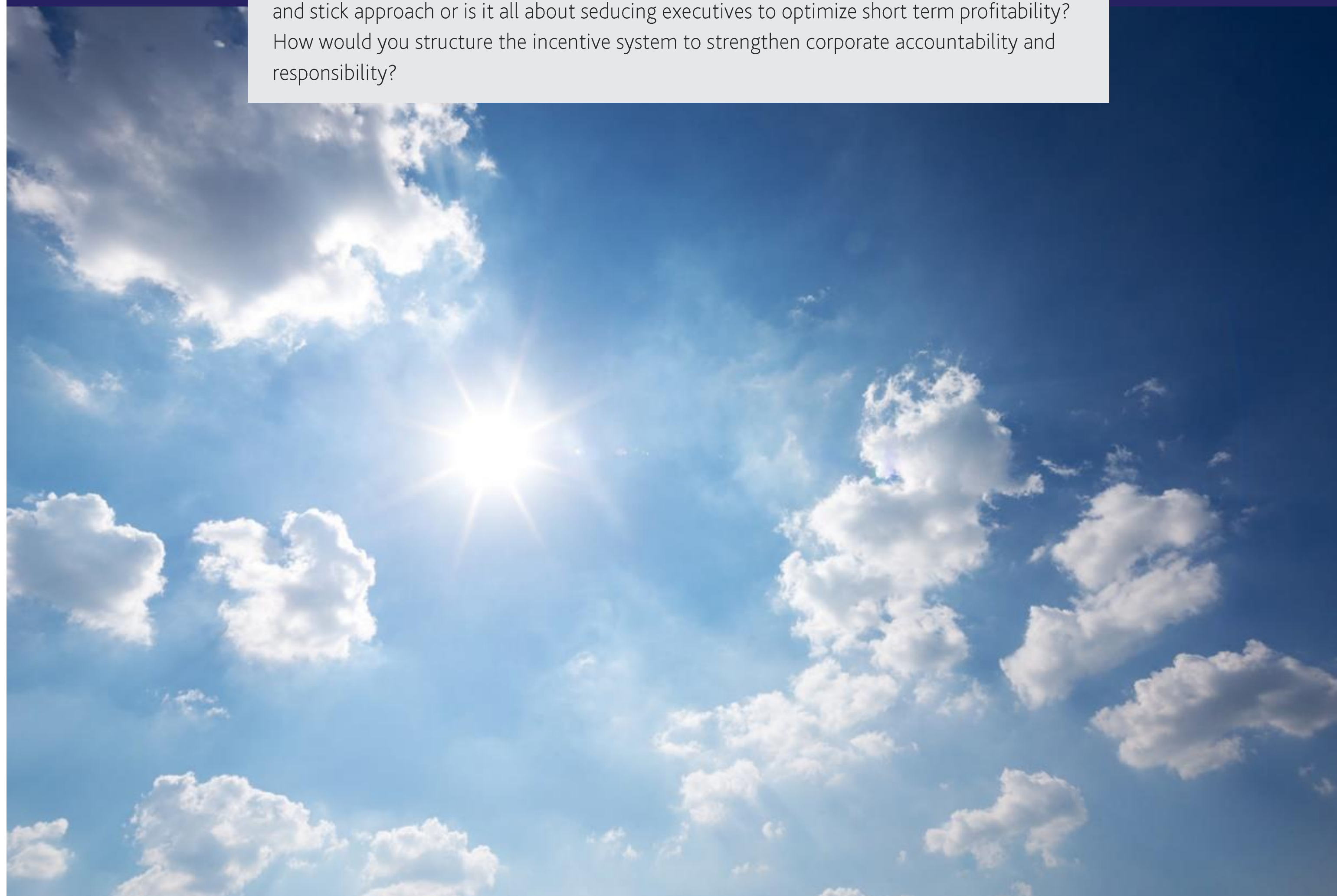
How likely would your organisation follow the shareholder primacy argument? How is the board and the CEO expected to react and to communicate with their shareholders and the public at large? How does your organisation address the balance between the shareholder and stakeholder perspectives? And in the case of a crisis, how do you think a board and top executives should act to regain trust? How does that apply to your own organisation?

2 ESG Reporting

To what extent are ESG criteria embedded in corporate reporting and with what level of detail? How do you think is ESG related to trustbuilding – and thus reputation - in the organisation?

3 Corporate Culture and Incentive Systems

How do the board and CEO determine the values and the corporate culture at your firm? To what extent are bonuses dependent on applying those criteria? Does the board use a carrot and stick approach or is it all about seducing executives to optimize short term profitability? How would you structure the incentive system to strengthen corporate accountability and responsibility?



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