INSEAD
The Business School for the World®
Corporate Governance Centre

What place for humanity in Business 4.0?

by

Jaap Winter,
Professor at the University of Amsterdam and Vrije Universiteit Amsterdam
and Distinguished Visiting Professor of Corporate Governance at INSEAD,

&

Pr. Ludo Van der Heyden,
Chaired Professor of Corporate Governance at INSEAD
and Academic Director of INSEAD Corporate Governance Centre (ICGC).

Concept paper written on the occasion of INSEAD Directors' Network (IDN) Meeting, *Re-humanizing the Corporation,* held in Amsterdam at Randstad offices on 19 April 2018.
Based on Jaap Winter's presentation, *Re-humanising the Corporation,* held at the INSEAD Directors' Forum (IDF) in Fontainebleau on 14 October 2017.

Acknowledgements:
We thank Fennemiek Gommer for helpful comments on earlier versions of this paper.

Contacts:
jaap.winter@insead.edu
ludo.van-der-heyden@insead.edu

Date of this version:
14 April 2018.

Introduction

"The purpose of an organization is to enable ordinary human beings to do extraordinary things."[1]

Peter Drucker is known for many inspiring quotes. He also stated that the second purpose of an organization was to have customers or to create some.

The questions we would like to introduce here are the ones that will be debated and expanded upon in our forthcoming IDN Directors' Meeting, on 19 April 2018. These concern the question of humanity in the modern enterprise.

The combination of excessive focus on shareholder value, the forces of capital markets, organizational efficiency, regulation and compliance, single-minded remuneration systems in a context of increased digitization of work and business presents, in our view and also that of other experts, risks for the human face of enterprise that are unprecedented.

Of course, this is a big statement and needs to be qualified. Making the company a less attractive and motivating place to work for people will reduce its capability to attract talent, which is a company's most valuable resource. Hence, if such a trend were to persevere, the loss of human appeal and force would lead to that company's under-performance. The value of competitive markets is that, if some companies present failures, those that do not take away the prize. Hence, the first qualification would be of an economic nature, which markets would tend to self-correct.

In our forthcoming meeting, we will hear corporate leaders who indeed have been able to craft very human-centred strategies – identified as value-based strategies that provide value to their customers, stakeholders, and employees. That will prove the possibility for companies even in today's very turbulent world to remain human-centric, or to rebalance relations towards more human-centric practices. However, a few examples do not allow us to predict the overall trend.

The second point we wish to make here is to understand the tremendous changes the world is witnessing, with very different impacts in the advanced western economies as compared to the emerging economies. One of the goals of the UN Global Compact and of the World Bank is to eradicate extreme poverty by the year 2030. In the year 2013, 114 million individuals have dropped out of extreme poverty. Since 1990, 1,075 million people have left this horrific condition. All regions of the world

[1] *Management*, by P. Drucker, Routledge, 2012, p.361

receded, except for Sub-Saharan Africa where the number unfortunately grew.[2] Therefore, progress is manifest and ubiquitous, although in different relative trends.[3]

The human question remains whether enough is being done, and whether progress is fast enough. One interesting comment here came from the Dutch representative at the World Bank, Frank Heemskerk, who stated clearly that world poverty reduction is the result of targeted investments in pursuit of these goals, and that no one in the bank still believes in “trickle-down economics”.[4]

The third point we wish to make pertains as well to the state of today’s rapidly changing world: the result of globalization has resulted in a huge loss of traditional manufacturing jobs to emerging economies, principally China, which has truly emerged as a formidable competitive country result. Modern information and communication technologies are disrupting old markets and seriously threaten the continued existence of companies in many industries, including education and health care. Robotisation and Artificial Intelligence even pose the question to what extent human effort, labor and insights will still be needed in the near future. The ongoing pressure to move towards a fossil-free energy sector may threaten the continued existence of most of the current dominant players in the energy markets.

If we add it all up, apart from times of war and similar physical destruction in society, there may never have been a time of more fundamental directional uncertainty for most industries. The resulting change implications and pressures on western economies are tremendous, as change always takes a human toll. Many known European companies (such as Alcatel-Lucent, British Steel, Hoogovens Fortis…) have disappeared altogether or have been swallowed-up by new conglomerates, while UK banking has become largely nationalized. New giants have appeared (Alibaba, Huawei, Facebook, Google…), great disruptors like Uber and Facebook are confronted with limits of what societies find acceptable, while Tesla may have huge potential, but because of lack of profit-generation is announced to be heading for bankruptcy in 4 months. Some argue that when one looks for survival there is no time for niceties such as “human touch.”

These fundamental changes go hand in hand with geo-political changes: the Chinese are taking over from the Americans as being the new global capitalists, the UK has voted to exit the EU, putting the European construction further at risk (although so far it seems only to have strengthened the joint resolve of the remaining Member States),

[2] SDG Atlas 2017 on the *datatopics.worldbank.org* website

[3] For an extensive treatment of progress, see Steven Pinker, *Enlightenment Now, the Case for Reason, Science, Humanism and Progress,* Viking 2018. People are living longer, healthier, are richer, live more in peace and safety, are freer, more knowledgeable, literate and smarter. On all scores that we tend to value as humans, we are much better off than any generation before us.

[4] FD.nl Week-end, “De Wereldbank denkt niet langer dat groei mensen vanzelf uit de armoede tilt”, April 7, 2018.

wars are continuing in the Middle East (and elsewhere). The earth is moving to a boiling point: a new US President is playing “reality TV” from the White House, while his Chinese alter ego has assumed power “without term”; his Russian counterpart is de facto doing the same while aiming to be known as a rather nasty disruptor; similar (semi)-autocratic leadership in Turkey, Hungary and Poland threaten the liberal, democratic societies as we know them. These faces of leadership are very human, but in a most troubling manner. These changes will affect economic and investment flows, as well as market performance and country risk, two major regulators in world affairs that may lead to some self-correction over time. Change is everywhere around us and appears to be accelerating in multiple dimensions, economic for sure, but also political, social and even threatening the survival of our planet – where the score on bio-diversity is frighteningly negative. All this is well documented in the media, even though far from clear, particularly in its repercussions.

In this short paper, we wish to prepare our debate by illustrating the tremendous tensions business and business stakeholders are under in today’s world, with a particular focus on West European businesses and their leaders. The discussion at our upcoming meeting will further explore the question by examining, possibly counter to our intuition, whether this tremendously changing and pressured context cannot in fact become a catalyst or background for very positive changes in business, resolutely pushing businesses to have an eye for people and planet, as a condition for sustainable profit, to a much greater extent than has been the case in the recent past.

To prepare for this discussion, this paper discusses the following questions in sequence:

1. What forces are dehumanizing corporations?
2. Is technology helping our humanity?
3. Is regulation the answer to paying greater care for people?
4. Can we rely on shareholders?

These questions do not, we believe, have conclusive answers. Our exchange will try to bring to light some of the answers and conclusions that are emerging (mostly in the Netherlands). Some of our statements will be motivated by hope and will indeed hopefully stimulate and bring hope.

As a friend mountain climber states (and yes, survival and moving to a more positive world appears much more complex than mountain climbing) “on Everest, hope is not a plan; a good plan just needs to be executed and does not need hope.” So beyond hope, our second aim is to consider whether better plans might be formulated than those that are on the table today.

That is our wish then for the debate, we look forward to listening to and contributing to on 19 April 2018 in Amsterdam.

1. What forces are dehumanizing corporations?

In his IDF presentation of 14 October 2017, Jaap Winter pointed out five factors that in a mutually re-enforcing loop threaten to de-humanize corporations and beyond threaten to dehumanize our societies by weakening, for example, our health care and higher education institutions. These five factors are:

a) Theory of the firm,
b) Capital markets and investment,
c) Organizational efficiency,
d) Remuneration,
e) Regulation.

We briefly discuss these pressures and their effects below.

a. <u>Theory of the firm</u>

Milton Friedman's statement that the only social responsibility of business is to increase its profits (for shareholders) landed him the Nobel Prize in 1976. This work has had a fundamental impact on what the purpose of the company ought to be, both in theory and in practice. Before the insights of Friedman became dominant thinking, business leaders, also in the US, repeatedly stated that it was their job to balance the needs of everyone affected by the corporation, namely its stakeholders including the public at large.[5]

Changes in globalization and liberalization have pushed for more efficiencies for consumers and investors. The focus became for companies to produce shareholder value as their sole purpose. Theories such as the principal-agent theory developed by Michael Jensen and William Meckling took Friedman as a starting point and suggested that managers act as rationally self-interested agents pursuing their own objectives rather than to produce value for the shareholders as their principals. Shareholders, as principals, incur so-called agency costs when they seek to curtail and control managers, or when managers do not act in the interest of the principal.[6]

The single-minded focus on generating shareholder value formed the basis for measurable indicators that suggested stronger directional grip for managers. Tools such as hostile takeover bids, variable pay in remuneration schemes and shareholder activism were developed to further strengthen the company's management's focus on creating shareholder value with a strong myopic bias. Where previously the generation of value for shareholders in terms of dividends and share price increase were seen as outcomes signaling successful performance, they

[5] See Rober B. Reich, *Supercapitalism*, Alfred A. Knopf 2007, p. 45.
[6] Michael C. Jensen, William H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics*, October 1976, Vol. 3, No. 4. P. 305-360.

became targets that needed to be achieved and as a result were no longer an objective measurement of success.

The theory and new belief also ignored that shareholders are not the sole principals of the corporation and that shareholders would not necessarily agree amongst themselves and be homogenous. It was unable to resist the pressure of not pricing external costs such as costs to the environment by the corporation's production as costs that should reduce corporate value (to shareholders). Any notion of the corporation's ulterior purpose in society, the reason why society should value the corporation's contribution, disappeared since its mission had been defined as the generation of financial value for shareholders.

b. Capital markets and institutional investment

Following this fundamental shift in the theory of the firm, capital markets and their key participants, the institutional investors, started to diminish their view of corporations. They no longer saw corporations as organisations or institutions that form a nexus of relationships with a variety of parties involved connecting them with society at large, but merely as a bundle of assets and liabilities that could in theory and practice become subject to specific transactions valued and priced separately. Corporations in the capital markets are no longer seen as integrated organisations on which many parties rely, but as being balance sheets with assets and liabilities that can be transactioned separately if monetary profits can be made by doing so. The financial value of such individual transactions justify the transaction in assets and/or liabilities. The consequence is the disintegration of the corporation as an organization it its own right.

One factor that has furthered this, is that financial instruments developed in the capital market remove investors in those instruments further and further away from the reality of the corporation, as an organization in which real people work and to which many other parties relate. Investors are only interested in the chunk of financial value that is visible to them through their derivative instrument, a trend which is deeply rooted in the development of financial capitalism.[7] Institutional investors solely focus on generating this financial value and actually have lost sight of the corporations in which they invest.

Excessive diversification into portfolios of thousands of equity investments, searching for mathematically calculated absolute and relative returns on their portfolios also triggers a constant focus on liquidity, an ability to trade individual stocks at every instant in order not to lose a better opportunity for gains elsewhere. The process of intermediation, in which institutional investors such as pension funds and insurance companies, employ a host of different asset managers who actually make individual investment decisions, has exacerbated this and moves individual corporations almost

[7] Paul Mason, *Postcapitalism, a Guide to our Future*, Allen Lane, 2015.

completely out of sight of institutional investors. For the largest parts of their portfolios, they invest in markets and market trends and movements, not in individual corporations.[8] Colin Mayer in his book *Firm Commitment* states: “shareholder value focus delivers corporations into the hands of uncommitted and irresponsible capital”.[9] Transactionality and (immediate) financial value dominance pushed by capital markets and institutional investors erode the integrity of business organisations and their societal value.

c. Organizational Efficiency

The world of modern management is characterized by a constant search for efficiency increase and cost reduction, in order to deliver maximum value to shareholders. Employees from this perspective are primarily a cost factor and every laying off of staff is value added to shareholders. The movie *The Company Men* (2010) offers a revealing example. The movie’s main character Ben Affleck is laid off in one of the series of lay-offs and needs to find new employment. At some point, the person who is responsible for the lay-off programmes himself is dismissed and challenges the CEO, who simply tells him that this is what is expected of him by the capital markets. And for doing that job he has a large office and private jet. The human cost of constant reorganisations and lay-offs is not featured in in the decision-making process.

At the same time management practices relating to those who stay employed are constantly diminishing human judgement and discretion in order to achieve maximum efficiency. KPI’s, control systems, targets, reporting, compliance e-tools and finally matrix systems are employed to make sure employees do the things as planned. Most of these management tools conceptually view employees as instruments that need to be productive and efficient and therefore need to be directed, controlled and constrained. They do not see employees as humans with judgement and discretion. Former INSEAD Professor Sumantra Goshal in his brilliant Smell of the Place speech at the World Economic Forum characterized such organizations as organizations of Control, Constraint, Compliance and Contracts compared them with Downtown Calcutta, an environment that seeps all energy and inspiration out of people.[10] As Laloux observes in his *Re-inventing Organisations*: “When year after year things boil down to targets and numbers, milestones and deadlines, and yet another change program and cross-functional initiative, some people can’t help but wonder about the meaning of it all and yearn for something more.”[11]

---

[8] Jaap Winter, *Shareholder Engagement and Stewardship : the Realities and Illusions of Institutional Share Ownership*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1867564.
[9] Colin Mayer, *Firm Commitment: Why the corporation is failing us and how to restore trust in it*, Oxford University Press 2013.
[10] Sumantra Goshal, *The Smell of the Place*, https://www.youtube.com/watch?v=YgrD7yJwxAM.
[11] *Re-inventing Organisations* , Frédérique Laloux, reinventingorganizations.com, 2014.

d. Remuneration

Modern executive remuneration schemes, based on substantial short term and long-term incentives, are crowding-out human intrinsic motivation for the sake of extrinsic financial outcomes. We have seen an explosion in the level of pay executives now extract from their companies, all based on two assumptions. The first is that by providing executives with incentives based on targets that are in the interests of shareholders we substantially reduce the agency problem. This assumption proves false in light of the ongoing cases in which executives were willing to cheat with the target setting, measurement or even became party to destructive business behaviour in order to be seen as having reached the targets. As Michael Jensen has observed: budgeting and target setting is paying people to lie twice.[12]

Behavioural research now clearly shows that we cannot handle substantial performance-based pay.[13] Not only do they crowd-out our intrinsic motivation and trigger ubiquitous cheating, but cognitive performance actually deteriorates if substantial variable pay can be received. "More and more incentives destroy our moral will" as Barry Schwartz says.[14] The substantive remuneration schemes that have been designed over the last two and a half decades have replaced the human inspiration of our business leaders with only an interest in their personal financial outcome.

e. Regulation

In broad realms of our society, including financial industry, health care and education, a constant increase in regulation is determining what organizations can, cannot and must do. The fallacy in politics that society's course can be successfully directed by designed rules and processes goes hand in hand with a growing incapability in society to accept setbacks and failures. Every instant of failure must either have a culprit that can be charged, or must have been triggered by some systemic failure or absence of rules that must be corrected by new rules and processes.

A possibly alarming trend in this development is that governments and legislators tend to set up more and more regulatory or supervisory authorities that independently from government exercise authority over organizations in certain domains to ensure compliance with particular rules and in the hope of reducing the likelihood of failures. The financial industry, health care and education are examples of legislation combined

[12] Michael C. Jensen, *Paying People to Lie : the Truth about the Budgeting Process, European Financial Management*, Vol. 9, Issue 3, 2003.
[13] Jaap Winter, *Corporate Governance Going Astray: Executive Remuneration Built to Fail*, Festschrift Klaus Hopt Walter de Gruyter 2010, p. 1521-1535, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1652137.
[14] Barry Schwartz, *Our loss of Wisdom*, see https://www.ted.com/talks/barry_schwartz_on_our_loss_of_wisdom?language=nl.

with intensifying public or semi-public supervision by authorities imposing massive compliance bureaucracies on organisations in these domains.

All of this generates a false sense of control: the more we regulate and impose control and compliance on organization the less can go wrong. But this is a fallacy indeed.[15] The paradoxical consequences of piling rules upon compliance and control mechanisms is that the sense of responsibility towards others that people as societal beings have is reduced to only a sense of having to comply with the rules. In addition, the more rules we need to comply with, the less we need to make any judgements ourselves about what behaviour is acceptable and what is not. We no longer train our moral muscle. As Barry Schwarz says: "More and more rules destroy our moral skills."[16]

At some point, the same happens as with financial incentives: we no longer seem to behave because of some intrinsic motivation to do good or at least not harm others, but only because the rules tells us so: regulatory crowding-out. Finally, constantly adding rules and compliance and control measures will generate ever more breaches of these rules and measures, causing defensive and distracted behaviour in the boardroom.[17] People no longer dare to rely on their own sense of morality but seek comfort in rule-following, compliant behaviour. The essential human capacity of making moral judgements is effectively destroyed by rules and supervision.

Marja van Dieijen-Visser, during the forthcoming IDN meeting, will discuss how a large medical center such as the Maastricht University Medical Centre is dealing with all the compliance requirements and at the same time deliver quality of care to the patients.

In light of all these pressures, we would advocate not only, as Laloux argues, for the reinvention of the corporation, but that it is time to replace humans squarely in the middle of the organizations. Organizations are supposed to serve men and not the other way around.

What we wished to illustrate here is that there are a great number of forces that might need to be countered to meet this goal. Or perhaps milder, there are too many logics that exist on their own that may be combining into an unintended but real consequence: "the squeezing of the imperfect, volatile, complex, questioning human out of the perfect organizational, market or investment design"*.* The corporation, in particular the corporation subject to the pressures of capital markets, is becoming more and more

[15] See extensively Jaap Winter, "A Behavioral Perspective on Corporate Law and Corporate Governance", in *The Oxford Handbook on Corporate Law and Corporate Governance*, Oxford University Press, 2018.
[16] See note 15 above.
[17] Jaap Winter, "When others pass judgement. The real liability risk for executive and non-executive directors", in Dutch version in : *Aansprakelijkheid van bestuurders en commissarissen*, No. 140 VHI, Wolter Kluwer 2017, p. 41-54.

a de-humanized entity, disconnected from society. Unintended perhaps, but very real in its consequences.

2. Is technology (further) dehumanizing us?

In our time, a crucial question is whether the rise of modern information and communication technology, combined with the revolution we can expect from digitization, robotisation and artificial intelligence, will even further remove the human quality from the corporation or perhaps will be able to offer a counterbalance. To start us directly on the question we only need to cite Gerd Leonhard's latest book title: *Technology vs Humanity.*[18] Leonhard is a well-travelled and studied futurist who provides his readers with "one of the last moral maps as humanity enters the Jurassic Park of Big Tech." The warning is clear and ominous.

The conclusions of Leonhard are welcomed by humanists, yet also scary: technology development, according to Leonhard, is not so much about the what, but about the how, which needs to be guided by good governance and investment processes, themselves guided by human meaning and purpose. The question that he presents us all is whether humanity will raise to that challenge. Max Tegmark takes up the challence by inviting us to think about scenarios that we as humans would want to unfold in the age of artificial intelligence.[19]

Technology has always presented us with its dual faces: for the better and also for the worst. Fire heats and also kills, as Icarus found out. History is abundant in showing us a great number of Icarus-like situations: automobiles both save people and kill them (including through gas emissions); nuclear energy was mastered first for ending the war against Japan, and then one was dropped on Nagasaki without warning, which is where the debate on the ethics of nuclear clearly starts (the first one is a more difficult discussion, the second is much easier). More fundamentally perhaps, technology has always had the tendency to reduce people to standing reserves, to resources in the most literal sense of the word, as Heidegger explains.[20] Translated to the age of artificial intelligence, are humans just another algorithm that could be replaced by superior algorithms? This is the key question of Harari's book *Home Deus.*

However, let us also contemplate the positive. The advantage of the internet is the very visual and transparent way, as well as the speed, with which it is able to connect humanity, or at least major parts of it. Thanks to this remarkably new feature - and the Gates Foundation - every African (and elsewhere too of course) village can have access to a computer, and through it be connected with the world, including with its major universities. Nobel prizes are now reaching the savannah, leading us with the happy thought that "the desert of ignorance is no longer."

Distance and isolation have largely receded thanks to digital technology. Australia now delivers many of its health services to far-away populations digitally, a major

[18] *Technology vs Humanity*, Gerd Leonhard, techvshuman.com
[19] Max Tegmark, *Life 3.0, Being human in the age of Artifical Intelligence*, Allen Lane, 2017.
[20] Martin Heidegger, *Die Frage nach der Technik*, 1954.

improvement over being left out altogether. The Brent Spar and Gulf of Mexico Macondo incidents – though presenting very different circumstances and implications – will remain in people's memories for a long time to come.

In fact, the internet is now acting as the world's knowledge management and memory system, and surely provides substantially greater incentive for corporations and individuals to act properly. It is a formidable stick and the fear of "internet name and shame" is becoming a powerful social control mechanism that is inducing both greater adherence to human standards, while at the same time providing much greater sanction than in our previous "local villages," where negative news would not necessarily leak out. In that aspect, US Supreme Court Judge Louis Brandeis' statement that "sunlight is said to be the best of disinfectants; electric light the most efficient policeman" has now achieved a different meaning where virtual light is shining on the global world, with ensuing compliance to more proper behaviours.

The Harvey Weinstein affair is an excellent illustration of this new light or this new virtual policeman. It is amazing that it took a Harvey and social media to put light on the pervasive and vicious biases women have been facing all these years, if not centuries, and kept under cover. It took the dissemination of a less than empathic conversation by Uber's CEO with one of the Uber drivers to expose Uber's shady tactics in dealing with law enforcement, as well as a corporate culture of sexual harassment. Travis Kalancik, the world's great disruptor, was disrupted… and forced to resign!

The duality between good and bad is today again at the centre of digital technology. Surely, all is far from solved, and abuses of technology will continue. At the same time, one senses a world increasingly calling if not shouting for responsibility and its dual sister, transparency, which is the big positive news of the day. No doubt, the internet is making our societies more democratic by squarely increasing the level of transparency. It is interesting that Amazon, Facebook, Google, and Uber are all being called to respond to people's questions about the legitimacy of aspects of their operations. However, talk is not action, and given the recency of all this, it is too early to tell whether we have turned the corner. We need to explore, experiment and review.

The questions that people generally ask on these companies is how they do business, and what businesses these companies are in (bringing value to consumers… or using consumer knowledge to bring value to other parties, much more objectionable, particularly if done in a non-transparent way). In democratic societies, these are good questions to ask. For let us not forget that people pay for it all… People's voices can now be heard, much more so than in any previous time, save perhaps for the Greeks arguing on the agoras of their cities.

The "paper trail" required by the Sarbanes-Oxley Act (consequence of ENRON and Arthur Andersen misbehaviour) has become a digital reality, allowing shady deals to be traced back and increasingly revealing the true actors hiding behind most shady screens (financial, legal, country,…).

The debate on digital technology has moved forward to two other domains: information manipulation in the political domain, and the emerging AI society in the business domain. Robots are capturing people's work and – this is Leonhard's point - possibly increasingly taking over their own governance from humans. Technology interferes with normal human democracy, in ways that most would approve. Yet it happens increasingly and the extent, to which we, the people, are subjected to regular revelations of how we are manipulated, is scary.

AI forces people into work that is particularly human and difficult for machines to do, mainly innovation and the exercise of judgement and responsibility (as exercised by boards of directors and executives). The world is not short of running out of issues to solve, let us concentrate humans on what humans are good at: the exercise of humanity! A lot of repetitive work is coming to an end, with even blue-collar workers soon requiring substantial education and training. The robots are telling us to focus our energies on exercising our humanity!

But, as in every issue, there is the other side, very aptly described by James Julius Wilson, in his leading book called *When Work Disappears: The World of the New Urban Poor.*[21] Wilson shows the effect on inner-city ghetto's in the US of work disappearing and the impact on social and cultural life. The main issue is that chronic job loss prohibits the work force from acquiring skills that are necessary to obtain and keep jobs. His call is for a Depression-style intervention aimed at bringing back these people into the modern world. One can only think what difference it would have been if the US corporate tax break (which US CEO's were not asking for), would have been associated with public private partnerships aimed at saving the urban poor! That is the new thinking that is needed: not just profit, but people first, and profit as a consequence.

Randstad is seeking to create a balance between becoming fully digital and remaining human for the candidates it works for, and for its employees. CEO Jacques van de Broek will discuss Randstad's Tech and Touch strategy and its challenges in the forthcoming IDN meeting.

[21] *When Work Disappears : The World of the New Urban Poor,* by William Julius Wilson, Knopf, 1996.

3. Can shareholders become a force for change?

The US myth – propagated by business schools and finance teachers – is that "market discipline" is the best governance instrument, indeed making US financial markets perhaps very efficient, but certainly not always effective in terms of warning shareholders of impending disaster (as shown by the 2008 US financial crisis). The increasingly dominant framing over the 20 years preceding the economic crisis was that of shareholder value as the simplest measure of purpose and value creation, and the paradigm of the principal-agent model. They have done good and provided some clarity; the mistake in our view has been the excessive reliance if not ideological dominance of these views. And business schools have their share to blame by not studying and presenting the limits of these models sufficiently explicitly as opposed to becoming advocates of theories that are not easily mapped on true organizations.

European regulators today are proclaiming a different mantra, namely one of improving governance not solely by market discipline, but by holding boards of directors more responsible and enforcing board competence. And by considering the adoption of the former UK merchant shipping rule: stock market allows investors in long-run projects, short-run trading being there for liquidity (but not control) reasons (i.e. to "cash in"). It would appear that allowing longer-term investors greater voice and control would restore us closer to the original intent of UK stock markets and reduce a lot of short-term stock movements, motivated by arbitrage, a necessary price correction mechanism, but not one that should remain second order to longer term value creation. The spirit of UK merchant shipping investment seems the right one, but it looks like that spirit has disappeared… as today's markets increasingly where being run by algorithms in search of mispricing and stock market effectiveness increasingly questioned. Investors and their suppliers appear to have become convinced of the fact, as the number of stock-listed companies in western countries is dwindling. A kind of melt-down that mimics that of the icebergs… and we are well advised to care about both.

All this discussion is gradually returning us to call for greater human presence in governance and in financial markets, and return to the iron law of finance, namely that greater return should be associated with greater risk taking, and to the means and ends debate on stock markets, that they are a means to an end, and that the end is human progress (not financial scoring). Black Rock's CEO wrote a letter in January 2018 to the CEO's of publicly listed US companies to embrace purpose, improved governance and to take leadership roles in contributing to society. Black Rock is – with its $6 Trillion the biggest investor in the world, and must be taken seriously. It is interesting notwithstanding that Black Rock's CEO is also Chairman of the Board and that the letter was written to CEO's and not to Chairs, as one might argue that a company's purpose is set by the Board, and not by the CEO, even though she might provide key input. This connotes another truth of US Wall Street Capitalism: boards are run by the CEOs and the executives, not by the Board members and their Chairs.

Another big change is the question as to whom is running the corporation: the CEO, the Board, or the shareholder? Of course, the phrasing of this question itself is increasingly questioned as it leaves out too many parties, the so-called stakeholders. A good aspect of the financial crisis is that it is increasingly clear that shareholders are only one of the stakeholders in establishing the corporation. European banks today operate under tight supervision of their regulators – and this is revolutionizing banking governance, with terms such as risk-adjusted capital complementing previous terms such as Economic Value Added. But one myth that is gradually being undone is that shareholders pay for everything and that one ought to live and die for shareholders!

The truth of course is that this is a power play by (public) shareholders, trying to subject the other stakeholders to their (private) interests. Economists have proposed that shareholders as residual claimants, who only receive returns after others with contractual claims have been satisfied), are best suited to determine the future direction of the company. Certainly with listed companies in which no individual shareholder takes such a large position that it can directly determine the outcome of key decision-making by shareholders, another sort of balance is required, not based on the false assumption that shareholders are the owners of a listed company. They own shares with specific entitlements to financial outcomes (dividends and payments at dissolution after all creditors have been satisfied), and that makes them an important stakeholder.

The truth that needs to be resurfaced is that it is another stakeholder group, the customers, which provide the funds needed to pay for salaries, suppliers (including of finance), taxes, as well as bonuses and dividends! It is only in the start-up or crisis phase that shareholders need to put in finance to get the company started or to get it out of distress. Shareholders buy “tickets” that are rights for “shares” of future dividends; in other words, most shareholders take money out of the company, which is why executives prefer to keep that money in by proposing to their boards growth plans ensuring even more money. Another way of stating this is that except for the start and for conditions of distress, most companies grow from retained earnings, and that shareholders essentially take money out of the company. Their residual position makes them an important stakeholder but not per se the dominant stakeholder.

De Volksbank is attempting to create a new balance between the various stakeholders. The bank, nationalized by the Dutch government in 2013 and seeking a return to the stock market in the years to come, has formulated a new strategy of Share Value and is developing a governance framework that seeks to include other stakeholders like customers and employees in the key decision-making by the bank. CEO Maurice Oostendorp will discuss these developments during the forthcoming IDN meeting.

4. Concluding: restoring humanity of the corporation is a key role for the board

The current European debate has shifted its focus to the fiduciary role of boards as being in charge of all stakeholders, and not just or primarily shareholders. The Dutch 2016 Corporate Governance Code explicitly requires boards to focus on long-term value creation. Similarly, the consultation on amendments to the UK Corporate Governance Code suggests it is the board's responsibility to consider the needs and views of a wider range of stakeholders, suggesting specific changes to the board composition to ensure such a wider approach is taken.

All stakeholders tend to be biased by their own private interests. This is human too, as business often is fuelled by dreams (and delusions). This means that a stronger, and in some countries renewed emphasis on longer-term stakeholder orientation is in need of boards who can judge how to strike the right balance. Boards are there first to ensure that the business project remains fair, is part of a fair deal for all stakeholders, that no class of stakeholder profits excessively from the others. That is the basis for sustainable business and business relationships, and is the primary role of the board.

There is a real effort in all European countries of restoring the central responsibility for corporations at board level. Because corporations are an essential human and collaborative exercises including a number of stakeholders this appears entirely natural. It is to be noted that Europe is leading in this effort, if we compare with the US or with Asia. This is by no means an easy decision or wish to implement for governance is subtle, complex and systemic. To us that seems right, and for our debate, we would argue that not only the question of the ulterior purpose of the corporation and its relations to all its stakeholders, but also the essential question of the humanity of the corporation should then squarely fall on the shoulders of the board members.

That means these questions of humanity will in the end be answered by the members of the Board in conversations with their stakeholders. If this materializes, these boards will move miles away from only discussing the financials of the past year, the resulting dividends and bonuses. That to us appears a necessary and vital change in today's environment.

It is to support this change that we have organized the debate and we will be looking forward to what the speakers and audience will state in terms of the pertinence of the concerns expressed here, and foremost the concrete actions that are taken at board level.