Shareholder and stakeholder thinking at banks, insurance companies and pension funds

(Banking Review, February 2003)

Building on recent accounting scandals, Charles Handy wonders in the Harvard Business Review what a business is for really. In other words: what is the purpose of a corporation? In this article I conclude that other interests than those of the shareholders alone will become more important in corporations. Also I highlight some consequences for financial services companies.

Corporate purpose and financial capital

The answer to the question 'what is the purpose of a company' has far reaching consequences and is more complex then it would seem at first sight. The first thought that comes to mind is probably: "make profit". If so, you have a traditionally American vision towards the term 'corporation'. This vision has rapidly gained terrain internationally in the last decennium of the 20th century.
However due to recent accounting scandals and increased uncertainty on the economy the question can be asked whether this company model still holds. Some people even say that the focus on the interest of the shareholders is decreasing.

A great virtue of capitalism is that it offers a way to use public or corporate money savings for the creation of wealth via exchanges. However the value of this virtue has decreased due to the loss of trust and faith of investors in the markets.

Investors feel that companies have misused their trust to ensure the capital markets that the profits were still in line with expectations. And 'trust is fragile and resembles a piece of china and, once cracked it is never quite the same' as Handy so beautifully puts it.

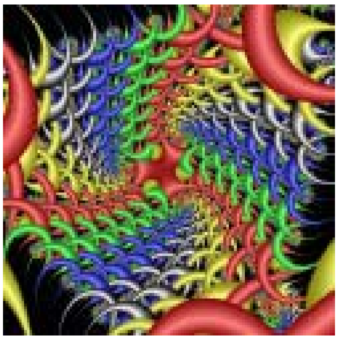
Shareholder value philosophy

How could things run so out of hand? A few high positioned people have probably misbehaved, but this is rather a symptom than the cause of the current situation. In order to find the deeper cause we must look firstly to the way success is measured in the originally American model for managing companies that we call 'shareholder value'. This shareholder value model has been increasing in importance in the last 10 years and was entering Western Europe via Great Britain rapidly. The American enthusiasm and entrepreneurial spirit was attractive as a remedy to the sometimes bureaucratic company cultures in Europe.

Shareholder value can be achieved and measured in a number of ways. Cutting costs and postponing expenditures are popular ways to make short-term profits grow. And, as a result, also grow shareholder value. Also the buying and selling of (parts of) companies is very popular, although it is widely known that most if not all mergers and takeovers on the longer run decrease corporate value. So it can be concluded that shareholder value thinking and short-term horizons of corporate management go hand in hand at the cost of long term value creation.

Stabilizing by financial institutions

Very important here is an economic function of banks, insurance companies and pension funds. Financial services companies and institutions can to some extent compensate for short term thinking provided they own a substantial amount of shares or can in another way have a stabilizing effect on markets and corporations.



The extent to which financial initiations can do this is different per region and country. In Europe the potential for this stabilization or dampening effect on short term corporate and investors thinking is bigger then in the United States, but smaller than in Japan.

The dampening effect of financial institutions has not been sufficient to prevent the poor worldwide economic situation from occurring. What measures must be taken now? Hardy says about this that the fundamental capitalism may have lost its sheen. Better and tougher regulation, clearer separation of auditing from consulting and better corporate governance seem to be necessary certainly, but we also must dare to ask the deeper question once again: what is the purpose of a corporation. It would be attractive if we could keep the strong aspects of shareholder thinking (entrepreneurial spirit and market dynamics) and combine that with something new to compensate for its shortcomings or less strong characteristics?

Intellectual capital

Shareholder value thinking has certainly not become obsolete. Investments of shareholders will continue to be very important and even necessary for almost any company. But what is necessary is not automatically the purpose and is certainly not the only purpose. (We need to breathe to live, but we don't live to breathe).
For people other things are important than only breathing, likewise for corporations other things are important than only financial value. Human knowledge and experience, innovation capabilities, customer relations and efficiency and flexibility of corporate processes have become important sources of value in most companies nowadays.

Real options

A less well-known and often underestimated source of value is the extent to which a corporation is able to adapt quickly and in the right direction towards uncertainty and change through creating and developing so called 'real options'. The value of these kind of strategic options increases like normal financial call or put options if the exercise period is longer (and as a consequence potentially contains more changes) and the amount of risk taken is bigger (and as a consequence potentially contains more uncertainty). In current uncertain economic conditions and bearing in mind how fast technology and customer needs are changing nowadays, investors, corporate management and decision makers should explore and develop this component of value.

Durability and social capital

The employees in corporations form an economically important group. Well-educated, motivated and innovative employees have nowadays become a very important source of value (human capital), particularly for services-oriented companies like banks and insurance companies. As a result they can to some extent also claim the right to involve their own desires and values into those of the corporation. When you agree on this, aspects such as durability and social capital start playing an increasingly important role on how and why a corporation should be run and measured.

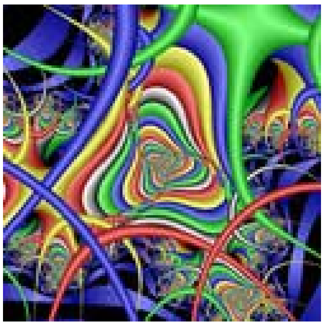
Indeed, completely ignoring the natural environment or pushing the stress level of employees to rise above certain acceptable limits can turn against the corporation and can inevitably lead to lower corporate value. Whether also the opposite is true (more corporate democracy and better corporate behavior will lead to higher corporate value) is something still to be further investigated but seems likely.
Another special form of durability for financial services corporations is the already mentioned stabilizing effect they can have on stock and option exchanges.
Most above-mentioned value carriers can be further broken down into other value carriers. At solvingcomplexityinfinance.com you can find an overview formula of the most important value drivers, the Universal Valuation Framework©.

Value Based Management implementation

What forms of value must be used to what extent when we shape the vision, mission, strategy, culture, organization and information systems of a corporation? In other words how can we make the new value thinking concrete?
The answer here is not simple and is different per individual corporation and industry sector. Also the vision one has regarding the future plays an important role. For example: is knowledge just the last hype of management writers or are we dealing here with a fundamentally different economy? Will fast changes be the only constant from now on, or will things quiet down eventually in the world economy? A meticulous consideration of all trends, interests and values is certainly advisable and necessary.
Corporations where intellectual capital forms a relatively large part of the total added value or corporations that have a big impact on society, such as banking and insurance services companies should consider keeping substantial distance from the shareholder value model.

Conclusion

Recent accounting scandals, changing circumstances and increasing economic uncertainty are causing renewed interest in the paradox of profitability and responsibility, resulting in a shift towards non-financial values and purposes.
The immediate cause for this has been the recent accounting crisis. That does not mean the shift in the paradox is only temporary. Investors trust can not be restored quickly nor easily and deeper causes such as the fast changes of our knowledge economy and increased uncertainty about our economy and society will stimulate companies to more seriously strive for non-financial values besides financial values. Those corporations that implement this most quickly and most successfully in their mission and strategy will add more value than those who don't. There are chances here for Dutch and Continental-European companies that already have a stakeholder tradition and changes for Anglo-American companies to catch up…



As soon as more companies start to deal with the above mentioned developments, also investors trust can be restored, because companies will no longer be seen as pure profit machines for themselves, their managers and investors, but also as responsible coalitions and communities that serve the interests of all stakeholders in a balanced way.

JAAP DE JONGE
J.H.M. de Jonge is Value Based Management consultant in Bilthoven, the Netherlands.
To request more information via Email click here.