Commentary by Professor Peter Urwin

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The document, *A Long-Term Focus for Corporate Britain*, tackles a number of issues that are highly politically charged and the main message here is one of caution. There is still argument over what caused the Great Depression of the 1930s and two years into the present crisis debate is needed, rather than knee-jerk reaction. This document attempts to set out some clarity on the present situation in the highly-politically charged areas which the document details and then provides comment on the specific questions posed.

Whilst it is well-trodden ground, there are a number of factors that created the present economic situation which are worth re-iterating as the easy credit that they created fuelled many of the behaviours that are the subject of discussion in the BIS document.

- Fiscal and monetary stances in the UK remained expansionary and helped fuel a credit boom; whilst regulatory bodies were 'captured' by the institutions they were supposed to be monitoring.
- This was re-enforced in the wider international economy by high savings rates in the emerging economies (with the bodies holding these savings chasing returns internationally); coupled with an expansionary monetary stance in the US and the importing of such (because of pegged exchange rate regimes) into many developing markets.
- Demographics in the developed economies have also been working in a way that has increased the flows of finance into equity and other capital markets, as the baby boomers have neared retirement.
- A wider deregulation of financial services, particularly in the US and UK, further expanded the amount of credit available to all economic agents.

The extent to which these were related, or not, is debatable and now irrelevant. The world was awash with easy finance and this created a credit boom, particularly in the UK where no attempt was made to prick various asset bubbles. This is a very basic statement of events, but there are implications of this for each one of the areas that the discussion document covers:

Capital Markets and Financial Institutions

In a situation where interest rates are held artificially low and finance is freely available, capital markets are not able to allocate resources efficiently. This is a problem of itself and would result in some eventual need for re-adjustment but what also seems to happen is that in such an environment, the pressure to secure returns either results in/or is accompanied by the acceptance of questionable practices and a lack of incentives to consider the long-term.

For instance, for the past 15 to 20 years financial institutions have been using mathematical and econometric models for the pricing of risk which did not take a long enough time horizon and did not therefore incorporate 'exceptional' circumstances; this was an approach that some commentators questioned (for instance Nassim Nicholas Taleb), but the practice continued.

This was 'short-termist', but not in the way that the discussion document suggests, and even with hindsight, it was not irrational for financial actors to adopt this approach in a booming market. The collective experiences of the finance sector and the capital markets they operate in suggest that, ultimately, their 'bets' have been under-written by the taxpayer and during the long boom of the 1990s and up to 2007 it was therefore rational to assume that there would be a bail-out if such extreme events were to take place. There was no incentive to write in extreme events to models, as such extreme events trigger government intervention. The implicit under-writing of the bulk of risks in large financial institutions provides little incentive to create models that predict events that will be the subject of large government bail-outs.

Furthermore, in finance the existence of credit externalities[1] fuels booms and make busts more likely. Together with the moral hazard implicit in the taxpayer under-writing of risk in modern finance there are potential market failures, but recognition that these factors are at the root of any short-termism is something that the discussion document does not seem to recognise.

Equity markets and corporate leverage

The question is, how do these incentives then translate into equity markets and the corporate environment? There is short-termism here, but again it is not of the form suggested in the discussion document. With the world awash with finance chasing returns, the criteria for lending and judgment of the financial viability of borrowers became more lax – again this is something that seems to accompany financial bubbles as there is a desperation to lend, in order to secure returns. For instance,

- At the level of individual consumers, the ability to secure large amounts of debt (for instance in housing finance) with little or no evidence of ability to pay became increasingly common. This was fuelled by the ability of lenders to package up this debt and pass it on to others – removing the incentive for initial lenders to carry out due diligence on borrowers' ability to repay.
- Similarly, ratings agencies, non-executive directors and private equity investors became enthralled by the possibilities of leverage. All of these supposedly well informed agents systematically under-valued the risks of excessive borrowing and leverage.

However, during a time when the level of interest rates is artificially low and credit is widely available, expansion and acquisition through leverage is a sensible corporate strategy. The excessive amounts of finance flowing into equity markets meant that companies were more likely to have the finance (on paper) to justify such expansionary plans.

There is a corporate short-termism here, but it is one that is analogous to the short-termism implicit in the risk-pricing models employed by financial institutions and, again, it is one that is completely understandable in the environment that preceded the bust. The experts (financial institutions) were willing to facilitate extensive corporate acquisition sprees and nobody asked what would happen if (i) interest rates increased or (ii) they were not able to roll over short term loans. Why would they, the problems arising over the last 2 to 3 years have not occurred on such a scale in the lifetime of most corporate operators.

[1] Bianchi, J. (2010), "Credit Externalities: Macroeconomic Effects and Policy Implications", American Economic Review, Vol. 100, No. 2; pp 398-402.

Appointing the CEO and Remuneration

In the environment described to this point, let us imagine the incentives facing prospective CEOs who wish to secure a new post. They have no incentive (and would not secure appointment) if they were to suggest in interviews that they are 'a safe pair of hands'; that the company should retain cash reserves and reduce leverage. In such a booming environment corporations appoint those who are risk-taking.

But this does not explain why their remuneration should continue to rise– we would expect a focus on appointment of 'risk-taking' CEOs to have both an up- and down-side, with some cancelling-out in the aggregate. More risks should mean more CEOs winning (and their remuneration growing) but also an offsetting fall in remuneration for those who lose their corporate bets. However, in an environment where consumers, governments and corporations are taking on excessive debt with little apparent fall in their credit rating, the balance of wins starts to outweigh the balance of losses. As we have just described, up until 2007 there was clearly a massive misallocation of capital in investments that were not sustainable (i.e. they were losses), but they were not uncovered until the bust. Corporations (and the CEOs who run them) were making bad bets, but these were seen as good bets in an environment where risk was under-priced.

Are we that surprised that in an environment where the owners of capital (shareholders) continue to make a return on very poor investments, simply because interest rates are low, that the managers of those investments see their remuneration packages rise substantially? A little reality check is needed here. Anybody who purchased a house 10 years ago will have made 10s, maybe 100s of thousands of pounds (even given recent reversals). Is this justified by their incisive investment acumen? No, they were simply operating in an environment where the possibility of losing a bet was substantially reduced and the possibility of winning was almost assured – even bad purchasing decisions made a profit.

Again, as with the situation in the financial markets, such a situation would eventually lead to re-adjustments and reversals (preferably when interest rates rise as a result of deflationary monetary policy). However, during the period of boom, the pressure to secure every-more phenomenal returns and the need to secure the services of the (apparently) charmed CEO who has won all of their corporate 'bets' for the last 15 years results in corporate laxity. The appointment of non-executive directors becomes window dressing, rather than a serious position of oversight; ratings agencies fail to take a long term view of risk; accountancy firms start to secure large 'consultancy' contracts with firms that they are supposed to be 'independently' auditing and regulatory bodies become increasingly toothless.

So why has this not now changed? Clearly many of these corporate bets have been uncovered as 'losses' and we are now expecting to see remuneration packages tumble as a result. However, as with the wages of lesser mortals, the wages of corporate high flyers are 'sticky' downwards (lest we forget the fundamental premise of Keynesianism). Again there are many reasons for this, but the suggestion that it is a result of corporate short-termism would seem misplaced. Recent evidence on the pay of those running various government quangos shows just how extensive the 'misallocations' can be during a protracted boom.

Summary and tackling the questions asked in the commentary

The main message from the discussion above is to show how misplaced the questions in the BIS document are.

Question 1: Do UK boards have a long-term focus – if not, why not?

In an environment where a boom creates what is essentially 'Ponzi finance', no board has an incentive to adopt a long-term approach. In the present environment, forecasts of most economic variables are subject to wide margins of error – do we expect boards to be able to adopt a long-term focus now?

Question 2: Does the legal framework sufficiently allow the boards of listed companies to access full and up-to-date information on the beneficial ownership of company shares?

'Beneficial' is a highly subjective term and is a worryingly lax use of terminology for the department tasked with securing our corporate futures.

Question 3: What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?

If anything, the greater concentration in a smaller group of professional investors should boost shareholder power (as one would expect shareholder groups to become less disparate and better informed). However, what matters is not who owns the shares, but the incentives they face. As the prior discussion suggests, in the peak years of a boom there is very little incentive for either side of this principal-agent relationship to take a long-term cautious view.

Question 4: What are the most effective forms of engagement? Question 5: Is there sufficient dialogue within investment firms between managers with different functions (i.e. corporate governance and investment teams)? Question 6: How important is voting as a form of engagement? What are the benefits and costs of institutional shareholders and fund managers disclosing publically how they have voted?

The long boom and cheapness of credit resulted in an unprecedented misallocation of resources. Furthermore, for a number of actors (financial and corporate) the incentives were further skewed because of the implicit assurances provided by the public sector. In such environments, short-termism; inflated corporate remuneration and asset price bubbles are to be expected. These fundamentals have not changed and, whilst they are unfortunately the most challenging issues, they are also the ones that this document does not tackle. All the mechanisms for the next bubble remain in place, in this respect.

In contrast, Questions 4 to 6 focus on the the nitty-gritty of corporate rules and regulations – specific relations between investment managers, shareholders, the corporations they own and the people who manage them on a day-to-day basis. As the discussion above suggests, the long boom was accompanied by questionable practices, but these seem on the whole to have been a symptom, rather than a root cause. Furthermore, these are unlikely to be areas where government is able to make an informed and sensible contribution – the internal workings of firms and the relations in dynamic internationally-focused financial markets. In contrast, they should be tackling the environment that created incentives for those working in the sector to adopt inefficient practices.

<u>Question 7</u>: Is short-termism in equity markets a problem and, if so, how should it be addressed?

Yes, but it arose from poor management of the economy by governments around the world, providing incentives for economic actors to focus only on the short-term

Question 8: What action, if any, should be taken to encourage a long-term focus in UK equity investment decisions? What are the benefits and costs of possible actions to encourage longer holding periods?

Managing the economy at a macro-level will better assure a long-term approach to finance, and an interventionist approach is rarely appropriate – even if it was ever appropriate it is now too late. More and detailed rules will not secure the future of corporate Britain. Rules can be bent and circumvented. Rather, what is needed is political will to pull the plug on the party when it is in full swing.

The key is having structures in place which provides a group of policymakers with an incentive to call a halt to the party. The problem is that across government, corporate boards and financial institutions there is simply no incentive to turn off the stereo and stop the party when there are no complaints from the neighbours – at an individual level it is simply a no-win situation. Nobody could prove that they had turned the stereo off and avoided the police coming round – the incentive is to party until the police arrive and then hope you will be able to make your escape.

Furthermore, imposing rules now related to the previous downturn, risks creating an armoury of measures that are needed for battles which only arise every 70 years.

Question 9: Are there agency problems in the investment chain and, if so, how should they be addressed?

There are always problems of agency, but citing some of the discussion from my IEA colleague, Professor Len Shackleton, "the Turner Review… found that, 'while inappropriate remuneration structures played a role, they were considerably less important than other factors….(such as) inadequate approaches to capital, accounting and liquidity.'

<u>Question 10</u>: What would be the benefits and costs of more transparency in the role of fund managers, their mandates and their pay?

Probably very little benefit (other than politically) and some cost.

Question 11: What are the main reasons for the increase in directors' remuneration? Are these appropriate? Question 12: What would be the effect of widening the membership of the remuneration committee on directors' remuneration? Question 13: Are shareholders effective in holding companies to account over pay? Are there further areas of pay, e.g. golden parachutes, it would be beneficial to subject to shareholder approval? Also question 14, 15 and 16)..

From the discussions above it is hopefully clear that the remuneration of directors was not appropriate and nor were many of the acquisitions and takeovers that took place in the boom years. However, this is symptomatic of a wider misallocation of resources (and a long period of securing returns to such misallocations) which pervaded most economies that experienced a boom in credit –

rather than a failure of corporate institutions (which may have been complicit, but not instrumental).

Additional comments:

As an economist I would suggest an approach to the consideration of corporations which is based on the sectors in which they operate. Banks and other financial institutions do benefit from (I) an implicit financial guarantee by the taxpayer to underwrite any losses and (ii) the (capital) markets they operate in are subject to a number of market failures (not least credit externalities). There may be a role for government here, but the lack of depth of the discussions in the existing document does not raise ones hopes that this would be tackled with a 'considered' approach (see the 1933, Glass-Steagal Act).

The document suggests that some commentators have identified potential problems arising from a focus on short-termism – the three citations given do not suggest that these views are either current or widely held.

It is still not clear which aspects of the concerns raised in the document - short-termism, the nature of capital markets and the remuneration/behaviours of managers – are due to one-off events related to the recent bubble in financial assets and which are more fundamental issues that need to be tackled for the future of UK corporatism. More specifically, booms and busts are a characteristic of economies and, seemingly, once every 50 to 100 years we experience a world-wide event which brings us close to a Depression. This may seem fatalistic, but acceptance of facts is a first step in creating a realistic environment for policymaking. We need to be careful that policy at this point in time is not designed to ward off an event that may not be due for another 70 years and which may actually be unavoidable.