

FIXING CORPORATE GOVERNANCE

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Turning points in the economy have revealed poor corporate governance design, not just recently but in almost every episode over the past five decades. Near the top of economic expansions, share prices often soar at rates two to four times faster than expected. When the economy contracts, they often collapse, revealing shortcomings in corporate governance and a fundamental misunderstanding of the way markets function. Journalists, politicians – including the new US President – assure us that we are witnessing market failure almost everywhere. In fact, markets are revealing important information and providing guidance about the need to cleanse governance practices.

The really big surprise is that these problems are repetitive. When share prices soar, management receives unexpected gains from share options, which they typically exercise out of fear the gains will evaporate just as quickly. When share prices erode under other economic conditions, we learn about the need to reset the exercise price on options. After all, if share prices fall well below the exercise price, for all practical purposes motivation is lost.

In my 40-year career, beginning at Chase Manhattan Bank, I have realized just how difficult corporate governance is for boards of directors. In the mid-1960s, I was invited to attend loan committee meetings. To my dismay, it became clear that both incentives and promotions to higher levels of responsibility were tied to loan volume and market share, rather than loan repayment. I watched as credit quality to South American clients withered, and as real estate loans in the US and advances to smokestack industry everywhere deteriorated with hardly a whimper. It appeared to me that both boards and management were waiting to be bailed out by the next economic upturn, and time and again that is precisely what happened. The result was no change in corporate governance practices.

Then there was the quadrupling of oil prices in 1973-74, accompanied by an involuntary wealth transfer to OPEC, a sharp drop in GDP growth and an enormous expansion in government regulation. Inflation increased unexpectedly to 12 per cent, the prime interest rate to 20 per cent and 30-year government bonds yielded 15 per cent – all of which cut the price-to-earnings ratio on shares to only 4 from a level of 15-18. In 1981-82, the US experienced its deepest recession in 50 years, with unemployment reaching 10 per cent - 16 per cent in the industrial heartland. Shares saw no net gain in almost nine years and executive compensation appeared broken. Once again, this was due to poor design and wrong measures, with critical lessons yet to be learned. However, all of this bad news was quickly forgotten with the Reagan Revolution that helped propel share prices up again. Stability in the 1990s under President Bill Clinton, accompanied

by shares soaring at 2½ times the normal rate, led to inevitable criticism of executive compensation.

In upswings, managements are simply lucky, but CEOs are criticized in downturns as if the gains had all been planned. This despite three market crashes: 35 per cent in 1987, 40 per cent in 2000-01, and 40 per cent yet again in 2008. Each instance has been associated with loud criticism of corporate governance. How much is legitimate? Have boards abdicated their responsibilities? What is “fair” executive compensation? Is greed the cause of it all?

What is needed is a conceptually sound approach to corporate governance that can be employed in both good and bad times, even when shares are in a long-term funk. Boards should change the way they measure managerial performance, allocate capital and view incentives: not as bonuses, but rather as a participation in the creation of discretionary value. The same approach needs to be used to allocate and prioritize capital expenditure, especially acquisition candidates, so that the board will know when to drop out of a bidding contest. The goal is not sales growth or earnings growth, but rather sustainable growth in value. In addition, corporate governance needs to deal with the role and responsibility of employees. The objective should be to have no employees at all, but rather partners in the creation of value. Employees at all levels should be able to earn variable compensation so that they feel a part of the process of building long-term value. Until now, employees have been viewed as corporate overhead. No wonder there is an adversarial relationship between hourly workers and management.

My main proposition is that the fundamental problem, which has existed for decades, lies in the way boards of directors measure management’s performance. Boards focus on the accounting framework, especially bottom-line profit, net profit after tax (NPAT), or earnings before interest, taxes, depreciation and amortization (EBITDA). Critically, there is evidence that the “lead steer” investors, who dominate the price-setting mechanism on stock markets, do not focus blindly on the accounting framework; rather, they make important adjustments to accounting results to convert these measures into economic reality.

Failure to make this adjustment leads management to undertake investments where the expected rate of return will often be less than the rate required for risk taking- the weighted average cost of debt and equity capital. If NPAT is the principal objective, all management must do to increase NPAT is to earn returns on capital that are greater than the after-tax borrowing rate. Even worse, setting EBITDA as the objective only requires returns on capital to be greater than zero. Using NPAT or EBITDA encourages management and boards of directors to uncapped reasonable levels of debt-to-equity on the balance sheet because, with thin margins above the borrowing rate, management can

only achieve significant growth in NPAT or EBITDA if the ratio of debt-to-equity is astronomical.

This is the cause of the meltdown in housing, subprime mortgages and even in securitized collateralized mortgage obligations. Lenders aggressively made mortgage loans with no equity deposit required by the borrower. In my 40-year career, I had never witnessed such irresponsibility. Of course, this was largely caused by the House Banking & Currency Committee and the Senate Finance Committee, encouraging both Fannie Mae and Freddie Mac to relax borrowing standards so that people who otherwise would not qualify became prime borrowers, a truly preposterous situation. Push markets to their limits and beyond and the result is not market failure, but rather market meltdown. The players in that game paid dearly - as did their shareholders.

Further, the idea that Americans exported these preposterous ideas to the rest of the world, as has been claimed by journalists and economists outside the US, is disingenuous, to say the least. Banks that were considered the very best in the world, such as Royal Bank of Scotland, are now basket cases because of their excesses. Nobody forced them to do it.