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Editorial: Reflections at a stockholders' meeting

A few weeks ago, lured by the prospect of an epic showdown between incumbent directors and a dissident stockholder, I attended the shareholders' meeting of one of our three largest banks. And between one vote count and the other, I found myself wondering about corporate governance.

In the weeks preceding the meeting, the media were in a frenzy debating optimal board size. In various interviews, the dissident stockholder argued that a board with more than twenty people is unlikely to be effective. Some articles even circulated the notion of an optimal size of seven. The beleaguered chairman of the board (COB) countered that the board of the bank in question is actually organized in three vertical layers of diminishing size for the very purpose of guaranteeing effectiveness. For all the fuss the media made, it quickly became apparent that many things were left unsaid.

I was puzzled by the issue the dissident stockholder picked. I doubt he was primarily concerned about board size per se. Doing away, in principle, with the bottom layer of the bank's board would not save much money. The dissident stockholder was probably trying, rather, to establish his credibility and reputation as an active stockholder - i.e., someone able not only to identify relevant issues but also to mobilize fellow stockholders. If he could demonstrate that credibility, future engagements would become much cheaper and more effective. The threat of taking a given issue to a vote would convince even recalcitrant COBs and chief executive officers. Obviously, he could have chosen any number of subjects to prove his authority, from esoteric derivative products matters to the size of the annual bonus. But he needed success and therefore a cause that anyone could easily form an opinion about. What better issue than that of a board of pachydermic proportions?

And as far as the COB is concerned, his stance reflects, at least in part, the fact that large banks are struggling with political acceptability. Being a major player in the housing market and a major supplier of funds to thousands of enterprises, they are thrashed by critics when loan and mortgage rates rise. And they are the ones blamed when the rates paid on savings deposits fall. No wonder then, that large banks see their boards as an opportunity to demonstrate integrity and political correctness - it isn't a coincidence that the bank in question was trying to add two women to its board. And it should not shock anyone either if they resist board-size reductions.

That is not to say the issue of board efficiency is irrelevant. I would dare to argue, however, that the problem of board efficiency is a question of incentives rather than mere size. The challenge is making sure the board does its job of choosing good managers, paying them appropriately, and monitoring their decisions. The question boils down to setting benefits and penalties for directors in such a way as to: (1) attract the right candidates for the job, and (2)

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induce whomever does take the job to work hard at making the firm prosper.

One could, for instance, promise handsome compensation for success and impose significant costs for failure. Since success ultimately means value creation, and value for shareholders means market value of equity, it has been argued that the personal wealth of directors or their compensation should be tied to share prices. This is not the place for an elaborate discussion of the most effective way to establish that tie. There is a whole literature on that issue. One frequently mentioned possibility is to require directors to hold a minimum equity stake in the firm. Another is to give directors long-term options, possibly written on the difference between firm performance and industry performance.

Some people claim that forcing directors to hold stock in their firms seriously shortens their planning horizon. Accordingly, if they own stock, all they end up caring about is a quick profit, to the detriment of the firm's long-term well-being. Research and development activities will be drastically curtailed and other investments with a long-term payoff will be slashed. The trouble with the argument is that it rests on the notion of stock market myopia, a notion by and large rejected by the available evidence. How else can one explain the fact that the value of the next five dividend payments represents only about 20-30% of current stock prices? Or the fact that firms with large research and development expenditures do not seem to sell at a discount to other firms?

A limitation of stock-based compensation is that stock prices (assuming there are any) reflect expectations about future performance and react only to unexpected performance. Alternative compensation schemes without this problem pay a bonus based on the income generated each period by the firm.[1] To establish a link to value creation, income is calculated net of a charge for the capital invested (including equity capital). Moreover, the potential bonus is unlimited in both directions and partly deferred (full payout is contingent upon continued successful performance).

Regardless of its specific incarnation, incentive compensation should vary significantly with performance. That's what makes it effective: generous rewards for above-average performance and harsh penalties for subpar performance. But this is also the political weakness of successful performance schemes. Above-average performance can lead to sizable payoffs, which the popular press is quick to label obscene. Unfortunately, it's not possible to have it both ways. One cannot ask for performance-related pay and then demand that firms renege on compensation contracts when performance is extreme - stiff penalties for abnormal performance are as controversial as high rewards for stellar performance.

Establishing the proper incentives is the key to solving many problems that are said to afflict boards. Excessive size could be one of them. Another is that several directors appear to be so overworked that they cannot possibly perform effectively: they hold top jobs in other firms, simultaneously serve on other boards, or take part in other time-consuming activities. Moreover, in some cases boards interlock and raise questions about conflicts of interests: executives of firm A sit on the board of firm B, and executives of firm B sit on the board of firm A. Interestingly, many of these problems are taken care of automatically if directors are given the proper incentives to care about firm value creation. Take the problem of directors with multiple seats. If the incentives are appropriately set, there is no need for explicit prohibitions against accepting other jobs. Directors will be able to judge for themselves. If multiple jobs jeopardize good performance, the directors in question will pay the consequences, and this should discourage them from assuming multiple jobs in the first place.

There are critics, however, who assert that no performance pay is necessary. The new corporate law has extended the personal liability of directors to a point where, so the argument goes, bad performance is strongly discouraged. Alas, simply preventing financial disaster or legal wrongdoing does not suffice. Watching out, for instance, that the firm makes its mandatory social security contributions is not the same as making sure that managers avoid squandering firm value and work hard at boosting

it.
Of course, money isn't directors' only motivation. Other variables such as honor, pride, public recognition, and a sense of duty determine the behavior of directors, and they could in fact be the dominating consideration. But these other variables are hard to fine-tune. How can you instill more sense of duty in anyone? How can you raise his/her pride? If we knew the answer, education would be a piece of cake - and managers would work for nothing. You could try with persuasion, but there is little evidence it works. Pay, in contrast, can be fine-tuned: it can be increased or it can be decreased. And, at the margin, it appears almost always to work.
And if money does not suffice, stockholders can step in directly. They can simply withdraw their support from boards that don't do their job. This solution, however, can work only if management is given clear targets to achieve, and if stockholders know these targets. There are many possible targets (a certain growth in net cash flow over a given horizon, for instance), but they should be simple and their achievement should be observable, at least by the firm's auditors. Clear targets help distinguish successful from unsuccessful performance and make both management and the board accountable. With clearly defined targets, the board has a standard to gauge management's performance, reasons to ask for justification in the case of significant deviations, arguments to insist on corrective measures, and grounds to replace underperforming executives. When targets are not met, shareholders will also have grounds to demand explanations from the board, along with an illustration of the corrective measures. If all this does not satisfy shareholders, they can refuse to renew the board when the time comes.
Managerial targets in general is the last subject I pondered during that memorable afternoon. What are managers supposed to maximize? Since top executives are technically hired by the board of directors, and since the board of directors is appointed by shareholders, the answer would seem to be obvious: shareholder wealth. By expanding their consumption opportunities, higher stock prices can only make shareholders better off. This reasoning has far-reaching implications for the organization of production in the corporate world, because it implies that stockholders do not have to worry about managing the firms they invest in. They can delegate that function to specialists. And these specialists, managers, don't have to concern themselves with the identity of their shareholders, since there is only one thing these people want: higher stock prices.
Yet, what happens when shareholders own different portfolios of assets? What happens, for instance, when some shareholders of Ciba-Geigy also own shares (but in a different amount) in competitor Sandoz? Will shareholders unanimously back decisions that increase the profits of Ciba-Geigy at the expense of Sandoz? What should Ciba-Geigy's managers do in that situation?[2]
Or, what happens when not everything is for sale and stockholders are therefore willing to sacrifice wealth for things like a cleaner environment, a safer world, or more social justice, whatever these terms mean? Then, since it is unlikely that shareholders share the same tastes, their unanimity of interests is compromised. There was ample evidence at the meeting that some shareholders pursue objectives other than wealth. It would be wrong, however, to conclude that because of these problems, managers stagger around with no clear objectives. There are forces that push managers toward firm value maximization.
If markets are truly open and competitive, firms whose managers do not maximize value will have little chance of long-run survival. They will either become profitable takeover targets or be swept away by the competition of low-cost producers. Consequently, over the long run, managers do not really have a choice other than to reduce costs and produce goods and services that fetch a lower price than they cost - or, in other words, to create firm value. The more competitive an economy, the stronger the pressure on management. Unfortunately, in some instances, the long run may be too far away to matter. For some firms, competitive forces may have a serious impact only when it is too late to turn things around.[3]

The competitive forces that push managers toward firm value creation make it difficult for the firm to pursue nonmonetary objectives. There simply isn't room in the long run for these objectives in a competitive market. It follows that, since investment policies that are friendlier to the environment than mandated by the law cannot compete with policies that simply comply with the law, it would not make much sense to expect firms to voluntarily follow stricter environmental standards than required. Pressuring firms to do otherwise would hardly lead to a cleaner environment and more certainly would cause some firms to go out of business.

Shareholders concerned about environmental issues are better off convincing consumers to change their habits and support producers of goods and services that meet the desired environmental and political standards. Alternatively, they can pursue their goals in the political arena. There will be benefits for everyone from this separation of business and politics. One major benefit is that it leaves managers' accountability clearly defined and not muddled in a maze of contradictory interests - whose interests are they supposed to look after if they have to heed various political agendas? To avoid all these problems, let managers be managers, therefore, and compete by providing goods and services at the lowest prices. And if we don't like the outcome, let's change the rules of the business game by changing the laws or consumers' habits, as opposed to trying to change managers' minds or the nature of their incentives.

Footnotes

[1] See, for instance, STEWART (1990). These schemes were developed for the compensation of managers, but there is no reason why they should not be applicable to directors as well.

[2] In a world of differential taxes and heterogeneous information, payout policy is conceivably also an area of substantial disagreement among shareholders. I focus here on the investment side of operations.

[3] See JENSEN (1993).

References

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