Schumpeter

Corporate constitutions

The world knows less about what makes for good corporate governance than it likes to think

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“REVOLUTIONS” can take place in surprising places. The past decade has seen nothing less than a revolution in the command centres of capitalism: corporate boardrooms. The *ancien régime* of club ties and long lunches has been swept aside, and replaced by a new order based on transparency and accountability.

The new order has its roots in the work of *sans-culottes* such as Sir Adrian Cadbury in the 1990s. But it was given a powerful shove in 2001-02 by debacles at Enron and WorldCom, and the subsequent Sarbanes-Oxley legislation. Reformers in America and elsewhere argued that checks and balances were just as important in the corporate realm as they are in politics. Companies needed to have powerful shareholders and independent directors to keep a watchful eye on managers. In 2009 both the New York Stock Exchange and the NASDAQ demanded that companies should have a majority of independent directors.

Booz & Company’s annual survey of the world’s biggest public companies shows how far-reaching this revolution has been. Firms now routinely separate the jobs of chairman and chief executive: in 2009 less than 12% of incoming CEOs were also made chairmen, compared with 48% in 2002. CEOs are held accountable for their performance—and turfed out if they fail to perform, with the average length of tenure dropping from 8.1 years in 2000 to 6.3 years today. Companies have turned to a new class of professional directors, and would-be directors sign up for bespoke courses at business schools because Sarbanes-Oxley makes them personally liable for the accounts that they sign.

This model is quickly becoming the norm around the world. But is it quite as robust as the reformers claim? The financial crisis of 2007-08 provided the toughest possible test. Some firms weathered it much better than others: America’s Citigroup and Switzerland’s UBS experienced severe losses whereas JPMorgan Chase and Credit Suisse (also in America and Switzerland respectively) suffered far less damage.

Corporate reformers immediately seized on the crisis as yet more proof of their arguments. Banks had always been badly managed, they argued. And banking CEOs were past masters at bamboozling shareholders and directors. Nell Minow, one of the most industrious of the reformers, flatly declared that “the recent volatility” proved that the “need for better corporate governance has never been clearer or more pressing.”

But sceptics could point to counter-examples. Some banks which performed best during the crisis flouted the rules of good corporate governance: Santander had a familial culture and a powerful executive chairman. And some banks which did worse were paragons of good governance: Citigroup and Lehman Brothers employed powerful outside directors (including, in Lehman’s case, an economist known as “Dr Doom”). Royal Bank of Scotland received enthusiastic encouragement from its institutional shareholders for its acquisition of bits of ABN AMRO.

New research by David Erkens, Mingyi Hung and Pedro Matos, of the University of Southern California, powerfully reinforces the sceptics’ case. The authors conducted a comprehensive study of the performance in 2007-08 of 296 financial institutions with assets of more than $10 billion. They found that none of the tenets of good corporate governance stood up to close examination. Directors who were well informed about finance performed no better than know-nothings. Companies that separated CEOs and chairmen did no better. Far from helping companies to weather the crisis, powerful institutional shareholders and independent directors did worse in terms of shareholder value. Indeed, the proportion of independent directors on the boards was inversely related to companies’ stock returns.

Why was this? The authors argue that in the run-up to the crisis powerful institutional owners pushed firms to take more risks to boost shareholder returns. This suggests, they argue, that outside shareholders may be inherently more risk-hungry than managers who have their livelihoods tied up with their companies. They also argue that independent directors were much more likely to press firms into raising more equity capital even when the company’s share price was tanking. One possible reason for this is that independent board members are worried that their value in the market for directorships will plummet if they have overseen companies that have filed for bankruptcy or debated restructuring.

The oddball banks

What do these striking results tell us about corporate governance? Certainly not that companies should turn conventional wisdom upside down and re-embrace the old order. Admirably sceptical about their own scepticism, the authors point out that the evidence from Asia since its 1997-98 financial crisis suggests that greater external monitoring has produced better performance. Banks are odd creatures; there is no sign that external monitoring has produced the same perverse results for other companies. And behaviour during a crisis may be no guide to behaviour in more normal times.

But the study does at least suggest that one should not expect too much from corporate governance. Good corporate governance on its own will not protect companies from taking excessive risks. They need to tackle the problem directly, by setting up better risk control, rather than indirectly by ticking various corporate-governance boxes. Good corporate governance on its own cannot make up for a toxic corporate culture. Reformers should continue to experiment with systems of checks and balances. But they would also profit from spending less time drawing up ideal constitutions and more time thinking about intangible things such as firms’ values and traditions.

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