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TRUST, MARKETS AND GOVERNANCE

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Recently, the Business Roundtable hosted a visit by the American writer and academic Francis Fukuyama, who has made major contributions to the understanding of modern trends towards democratic government and market economies.

I want to organise my remarks today around the theme of his 1995 book *Trust*, which carries the sub-title 'The Social Virtues and the Creation of Prosperity'. The issue of trust in commerce is highly topical, as prominent cases of business misconduct have been in the headlines around the world. It is also central to the philosophy of the credit union movement.

Trust requires distinguishing between those who just talk the talk and those who walk the walk. Here is a quotation from a company's corporate responsibility report:

> "Since establishing our corporate responsibility function", it reads, "we have focused on strengthening internal awareness and governance of social and environmental issues facing our business …
>
> "We will … integrate human health, social and environmental considerations into our internal management and value system …"
>
> [In addition, we have] "enhanced our efforts to engage external stakeholders on human rights, biodiversity, indigenous rights, transparency and performance measurement."

Which company was that? You guessed it: Enron, just a couple of years ago. Enron was America's triple bottom line company par excellence.

But it wasn't the only one. WorldCom was ranked in the top 50 companies in the world for corporate responsibility in the FTSE4Good Index. The Swedish firm ABB preached the same gospel but was the subject of a scandal this year when two of its officers walked away with US$136 million of retirement benefits between them. They ended up giving half of it back, but not before the company's reputation was in tatters and its share price trashed.

It pays to be sceptical about companies that parade their virtues. Too often their motives are self-serving. For years I have had a simple investment rule. If a company starts proclaiming how socially responsible it is or buys a corporate jet, I sell my shares. Judge Corporation did both. I haven't lost money yet by following that rule.

Of course businesses have social responsibilities, which include making money for their owners, treating all stakeholders fairly and being environmentally responsible. They may want to report publicly on their plans and performance under these headings. But does it make sense to talk of a firm having a 'triple bottom line'? That might be reasonable if there were objective, measurable standards for social and environmental reporting comparable with those for financial reporting, whereby company officers could be charged for fraud and officers and auditors could be sued for negligence. But of course there aren't. We should discuss each role in its own terms, not in slogans. With multiple goals, managers cannot be held accountable for their primary duty to deliver maximum shareholder benefit – they always have the excuse that they were pursuing other goals. And why stop at three bottom lines? Companies should certainly have an ethical bottom line and a bottom line for corporate governance, to name just two more. Enron obviously came up several bottom lines short.

The Enron affair and other corporate scandals have triggered an avalanche of proposals for new regulations and changes to corporate governance. Debates on both aspects are healthy, but there is a serious risk of overkill. Some basic perspectives need to be kept in mind.

The first, and in some ways the most important, is to remember how the wrongdoing was discovered and punished. It wasn't the work of regulators. The Enron scandal was revealed when a private investor found oddities in Enron's reported accounts. And the market didn't wait for a trial and conviction to send the company packing – the death penalty was immediate. Not only that, but the accounting firm Andersen, then one of the world's 'big five', went down with Enron because of its role in helping to cook the books. The share prices of other companies that came under suspicion were quickly marked down.

The point here is that trustworthiness and reputation are priceless assets in business – without them, firms put their very existence at risk. The market's capacity for self-correction was demonstrated long before regulators or politicians appeared on the scene. It acted with a terrible, swift sword. As Fukuyama observed in a comment on the scandals, far from reducing trust, the ability of American capitalism – unlike crony capitalism in Asia or Russia – to expose misconduct and hold people accountable provided the basis to rebuild trust.

Another point made by Fukuyama relates to the greedy behaviour of some corporate executives. Greed, he pointed out, is an unattractive aspect of human nature which exists in all societies, regardless of their economic systems. Greed has to be constrained by institutions, laws and informal norms. Commentators have suggested that two changes in constraints in the United States made the problem worse. First, moves since the 1980s to make takeover regulation more restrictive made it more difficult to punish corporate incompetence and extravagance, and in the absence of this discipline too much emphasis was placed on remuneration incentives to align the interests of shareholders and company officers. Secondly, a 1993 law required annual bonuses greater than US$1 million to be tied to the company's performance or the bonus would not be tax-deductible. This created incentives for company executives to inflate reported earnings. Not for the first time did a government intervention have unintended and perverse consequences.

These lessons should be remembered when considering proposals for new regulatory controls. One popular idea is to require share options granted to employees to be treated as current expenses in financial reports. This probably has some merit, but not too much should be hoped of it: changes in accounting treatment don't alter share prices so long as information is disclosed; difficult issues of accounting are involved; and it is easy to foresee claims that alternative treatments are misleading. Similarly, requiring chief executives and chief financial officers to certify the accuracy of reports seems attractive, but it is questionable how far that would change existing practice – it is already the case in New Zealand that two directors, one of whom is usually the managing director, are required to sign financial statements. Pushing this requirement further may drive up executive salaries and liability insurance to compensate for additional risk; it could lead people to believe in the impossible –

indisputable accounting; and to play safe, executives could shun risk taking that would benefit shareholders and promote economic growth.

Similar problems are posed by other fashionable ideas, such as prohibiting accounting firms from offering audit and non-audit services to the same client, requiring rotation of auditors, and regulating accounting standards. The basic issue is not whether some of these ideas have merit but whether decisions about them should be made by firms or regulators. Telecom, for example, has already announced that it will expense options when an accounting standard has been drawn up, and some accounting firms have moved to set up their consulting arms as separate entities. These are voluntary, market solutions to deal with problems as perceived by individual market participants. They differ from regulatory solutions which impose one-size-fits-all requirements on the whole market. A rush to legislative judgment would be foolish; as one commentator put it in the American context, "Congress does not help investor confidence by lurching around like demented bovines stomping on a complex financial and entrepreneurial ecosystem."

New Zealand and other countries have been down this path many times before. Experience suggests new laws are as likely to make things worse as to make them better. We established a Securities Commission in the late 1970s in response to corporate scandals of the time. Commerce had operated largely on the basis of the common law and without the benefit of a Securities Commission for over a hundred years in New Zealand. During that time we became one of the richest countries in the world. Since 1978 tens of millions of dollars have been spent on the Commission and on complying with its rules. Are we better off as a result? I don't know the answer to that question, but it is not self-evident.

New Zealand has a chronic habit of passing more laws rather than enforcing laws we already have. There are endless calls, for example, for new legislation on insider trading – a problem, incidentally, of minor significance in our markets. Yet there is a law against insider trading on the statute books, and although it was a botched piece of work by the Securities Commission, at least it provides remedies for shareholders. Frustrated by the absence of initiatives to enforce it following a clear-cut breach by a

former chairman of Fletcher Challenge, I joined with another shareholder in a successful action. We have set up a trust to help others take similar cases.

But mention of Fletcher Challenge brings to mind a far more important issue of corporate governance that is relevant to this discussion. The insider trading case was not the worst of its kind, and the board acted with commendable swiftness to insist that its chairman stand down. The much more egregious aspect of Fletcher Challenge's performance was the billions of dollars of shareholder value that was destroyed in the period when Hugh Fletcher ran the company. Those losses may have been the largest in New Zealand's business history. They were aided by failures of corporate governance, including an employee share scheme that served as an anti-takeover device, the adoption of restrictive listing rules that also inhibited takeovers, and effective management control of the board via the presence of several executive directors.

It is also worth noting that the problems of Enron and WorldCom arose in the first instance from bad business decisions. The accounting irregularities were an attempt to cover them up. Better audits might have warned investors a little sooner about the insolvency of those companies, but they would still have gone bankrupt.

It follows that any discussion of corporate governance in the wake of recent scandals must keep firmly in mind the main role of the corporation – to benefit shareholders and the wider community. This requires entrepreneurial initiative and risk taking. It is impossible to earn profit without an element of risk. If we criminalise risk taking we will simply get less of it.

Generally speaking, corporate governance in New Zealand is in line with international best practice. Typically, New Zealand boards have a relatively small number of directors, an independent chair, a substantial majority of non-executive directors, and audit committees independent of management. Accounting practice and information disclosure are also generally of a high standard. While there is always room for improvement, the last thing we need is company boards populated by lawyers to ensure compliance with rules; liability exposures that deter talented people from accepting board appointments; and a regulatory environment that is so

utopian in its drive to eliminate wrongdoing that it stifles wealth creation and makes the New Zealand market and economy uncompetitive.

For, in the final analysis, our market system depends on trust and integrity. Not even the most primitive exchanges can take place if one party cannot trust the other to deliver on their side of the bargain. Laws and institutions can encourage ethical behaviour and check excesses, but they can only take us so far. You can't legislate for honesty. The attitudes and actions of CEOs to a very large extent determine corporate conduct. As President Bush put it recently:

> … ultimately, the ethics of American business depend on the conscience of America's business leaders. We need men and women of character who know the difference between ambition and destructive greed, between justified risks and irresponsibility, between enterprise and fraud. Our schools of business must be principled teachers of right and wrong, and not surrender to moral confusion and relativism.

This brings me back to Fukuyama, trust, and the role of civil society – of which businesses such as credit unions are a part. Fukuyama points out that if the government intervenes too much to structure social relationships, it runs the risk of supplanting the ability of civil society to spontaneously organise. Civil society, he says, is:

> … a complex welter of intermediate institutions, including businesses, voluntary associations, educational institutions, clubs, unions, media, charities, and churches. [It] builds, in turn, on the family, the primary instrument by which people are socialized into their culture and given the skills that allow them to live in the broader society and through which the values and knowledge of that society are transmitted across the generations.

As the Maxim Institute noted recently, the essential qualities of trust, reliability and accountability that are vital to successful business are learned primarily in the functioning family. We need families to teach children that stealing is wrong if we want business people to understand that fraud and deception are thefts of property. We need schools to teach values, not just engage in 'values clarification'. Without shared social norms, values and ethical standards that go beyond laws, the transactions costs and risks of doing business become prohibitive, as the experience

of Russia demonstrates. The United States is a highly successful economy in part because – as the response to the events of September 11 reminded us – it is a high-trust, group-oriented society, despite its individualistic traditions.

Institutions of civil society such as friendly societies and credit unions were damaged as the state assumed responsibilities for welfare and mutual aid that they once discharged. Credit unions are now under some threat from the establishment of Kiwibank – particularly if it fails to succeed commercially, gets propped up by the government and creates unfair conditions of competition with other financial service providers. This is all the more reason why credit unions should have the chance to operate on a level playing field without handicaps. I think you have a legitimate complaint that many of the current statutory rules applying to credit unions, such as those relating to capital raising and to the setting of fees and charges, are unduly restrictive.

I believe the government should be looking to establish rules based on sound principles that apply generally with fewer special regimes that apply narrowly. The general direction of policy relating to saving and investing over most of the past century was to regulate more heavily with the aim of protecting investors from losses. While this may have protected some people, such regulations involve costs. Losses from fraud, incompetence and market factors will not be avoided. More regulation is particularly hard on smaller organisations, because costs usually fall disproportionately on them. We would do better to put more reliance on general protections against dishonesty, on the principle of caveat emptor, and on competition.

Similarly, I would argue that the tax treatment of credit unions should be neutral relative to other entities. I would not favour special tax concessions, but the mutual principle that a mutual association cannot derive a taxable profit by trading within its circle of membership, and the principle that organisations that are not-for-profit should be exempt from income tax, should apply.

Finally, there should be no outside pressure to change your mutual form of organisation. Mutuals, cooperatives, partnerships, corporations and other forms of business organisation all have a role to play in commerce. In a competitive

environment without special privileges, it is the business of their owners to decide whether any changes in organisational form are warranted. But high standards of corporate governance are as important in mutuals as in any other businesses. Those running credit unions should be properly accountable for delivering maximum benefits to your members, and exposure to competition should spur you to do that.

Let me sum up. All of us in the business community are thinking about the lessons of Enron and other scandals for market rules and corporate governance. Public indignation over the abuses is fully justified. It would be good to see the fraudsters put behind bars. They have hurt the reputations of honest companies, shaken trust, damaged the sharemarket and affected millions of people who depend on the integrity of business for their livelihood and their retirement.

In the wake of these events, the same mistakes won't be repeated in hurry – as least for a time, people will be on their guard and financial probity will be valued. Enron won't be the last corporate scandal, but the changes in market transparency and corporate governance that are occurring will make future Enrons less likely. The self-correcting properties of markets are one of their strengths. There are some things that need to be fixed. Corporates and professional firms in New Zealand are changing some of their practices, the Stock Exchange is reviewing some of its listing rules, and the Institute of Chartered Accountants has put out a useful discussion paper on corporate transparency. These things have happened without government prompting.

Because New Zealand avoided the worst of the recent excesses, the corporate hero-worship and the mindless enthusiasm for the so-called 'new economy', the fallout here has been less severe. But over the years we have not been immune from corporate misconduct and, especially, failures in corporate performance that have destroyed large amounts of shareholder wealth. The weaknesses that have been revealed in corporate governance need to be remedied but, as Fukuyama notes:

> You would not want corporate governance to simply be a matter of draconian punishment or the micro-management of the accounting process because a lot of that *does* have to rely on values.

Business is an honourable vocation. The vast majority of New Zealanders work in business. Most of them are honest people. There are abuses in business but governments are even more prone to cooking the books. These things happen because men and women are not angels and their tendencies to opportunism need to be constrained by institutions, laws and shared values. Failures in business occur in large and small firms alike, and the remedies are much the same – there are no great differences between the needs and interests of large and small businesses. It is incumbent on all of us in business to reflect on the lessons of recent events, strive for high standards, earn the community's trust, resist ill-considered reactions that would do more harm than good, and remember above all else that if we want faster growth and higher incomes for all, we must have an environment that encourages rather than stifles business enterprise.