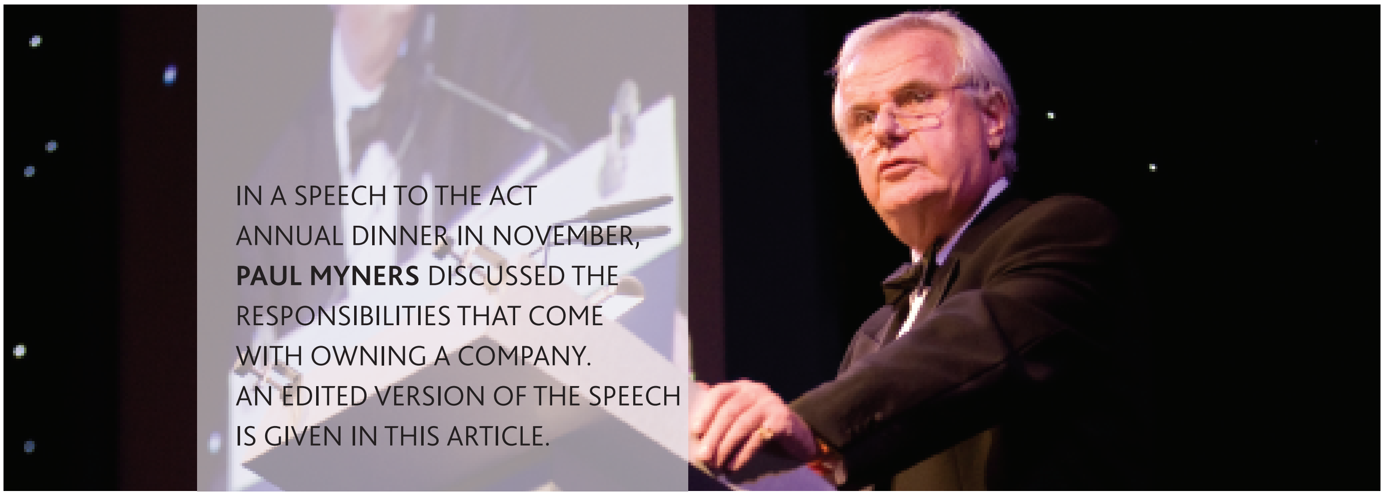
The idea of moral hazard



IN A SPEECH TO THE ACT ANNUAL DINNER IN NOVEMBER, **PAUL MYNERS** DISCUSSED THE RESPONSIBILITIES THAT COME WITH OWNING A COMPANY. AN EDITED VERSION OF THE SPEECH IS GIVEN IN THIS ARTICLE.

I would like to speak about the responsibilities that come with owning a company. The topic calls on philosophy, economic theory and business practice – an unpromising combination.

Let me start with a philosophical question. What does it mean to own anything – a shirt, a car, a house? I think most of us would answer with something like: "If I own something, I can do what I want with it. That's what my property is – my stuff to mess around with."

Suppose I get angry while talking to a particularly frustrating corporate treasurer. I tear the shirt off my back and use it to strangle him. My claim of despotic dominion over the shirt is not likely to impress the judge. It also isn't likely to impress modern philosophers, who often consider property a concept that is so hard to define in a consistent way that it is, in their language, "essentially contested". In other words, property can mean almost anything.

The law steps in where philosophers fear to tread. It gives rights to property owners, but those rights come with limits and responsibilities. As the property gets more complicated, the responsibilities increase. When it comes to a company, the plcs that we work for, the property responsibilities are very broad. That is as it should be, since corporations are just about the most complicated thing around. So shareholders, the legal owners, are correctly bound in by very complex rules of good behaviour.

Economists pay close attention to companies – known to them as "economic actors" – so they should be able to tell us what the owners (the shareholders) can and can't, should and shouldn't, do.

Alas, economists give an answer that is perfectly correct but worthless. Economists usually say corporate ownership is a simple matter: all owners need to worry about is maximising profit and value. Or to use the more technical vocabulary of the Nobel Prize-winning economist Milton Friedman: "to make as much money as possible".

But that answer is really useless. Friedman recognised that owners need to be responsible. In his words, they have to conform "to the basic rules of the society, both those embodied in law and those embodied in ethical custom". Unfortunately, he left it at that. He didn't explain how to identify or balance those customs, or how to balance today's profits and tomorrow's possible laws and rules.

So how exactly are we supposed to run companies responsibly? In the new Companies Act, the UK government has fundamentally redefined the responsibility of the board of directors, who represent the owners. The board is now required to consider what is known as enlightened shareholder value.

The idea is simple. Unenlightened shareholders want as much money as soon as possible. But enlightened shareholders, who care about what the government calls "long-term sustainable success", will want, in the government's words, "to have regard to wider factors such as the interests of employees and the environment".

Many board members are unhappy with this. In a practical sense, I have some sympathy. It is easy to imagine a crop of lawsuits.

PROPERTY AND JUSTICE But morally speaking, the concept of enlightened shareholder value makes sense. It is simply wrong for company owners to do something that serves their short-term self-interest but which is unfair or irresponsible. The philosopher David Hume's comment on property relations is pertinent: they are "not natural, but moral, and founded on justice". That applies with special force to corporations, which are so far from anything natural and which can contribute so much to making our society just.

Economists make up for the simplicity of Friedman's views with the more complex idea of moral hazard – that is, the temptation of shareholders to take advantage of others. You could say that moral hazard is the pursuit of unenlightened shareholder value, or that it is a variety of the vice traditionally known as greed.

I would like to give four examples – two general and two more topical – of the responsibilities and complexities that come with corporate ownership.

The first general issue is tax policy. When owners or directors instruct finance managers, they often say something like: "We want to maximise the value of our shares, so go and reduce the tax rate, exploit transfer pricing, create equity that looks like debt, and maximise after-tax earnings and the valuation of the enterprise."

What should finance managers do? I'm not going to discuss that question in legal or accounting terms: how far can things be squeezed and stretched? I want to stick with the question of enlightened shareholder value. What should an enlightened, responsible finance manager do about what is fondly called tax optimisation.

For shareholders, the gain from pushing the tax rate down as far as possible is certain and immediate. But owners and managers should balance current gain against possible future losses. They should worry that the government will eventually retaliate with a higher, possibly punitive, tax rate, or hold a tax-minimisation policy against a company in a later regulatory dispute. There is also the social balance. Someone has to pay taxes to keep government services flowing. A company sets a bad example in trying to pay less than a fair share. A third of the UK's 700 biggest businesses paid no corporation tax in 2005/06 and another third paid less than £10m each. This adds to the already high burden of corporate tax borne by smaller companies and asks questions of equity and fairness. The tax management of some large companies may have overstepped the boundary of justice.

ENLIGHTENED SELF-INTEREST Shareholders may say: "Why bother with the distant future? Why should we try to set a good example? Our task is just to make as much money for ourselves as soon as we can." But unenlightened shareholder self-interest is ultimately self-defeating. As treasurers, you should include a moral imperative – to educate your companies' owners to think of their self-interest in an enlightened way. Without a moral compass, they – and you – will be lost.

The second general example I have in mind is the role of institutional investors. Let me be frank. From my perspective most traditional institutional investors have ceased (if they ever did) to behave like responsible owners of businesses. They and their clients have become so frightened of producing returns that deviate from the major equity indices that they no longer create portfolios with meaningful tracking-error. They forsake conviction for comfort. They regard equities as an asset class rather than an instrument of enlightened and benign ownership. They care little for the longer term or for those whose lives are critically affected by corporate development. Portfolio managers abdicate the responsibilities of governance to the open-toed regiment of so-called governance experts, who pleasure themselves on the minutiae of audit fees and the like, consistently missing the big picture.

The City has shown a profound disinterest in the fate of companies and their stakeholders. Like the British guns in Singapore in the Second World War, the takeover code is silent on protecting the interests of the purchaser and refrains from any moral responsibility in respect of employees and stakeholders. No one in the City speaks up for the lives of those affected. I see little here that could possibly be described as enlightened or with a moral aspect to the responsibilities of corporate ownership.

The first of the two topical examples is Northern Rock. For many years the bank's owners gained from a risky strategy of increasing the loan book much faster than the secure deposit book. More recently, the owners have also taken some of the pain when the strategy failed. The share price is down sharply, but the shareholders haven't taken all of the pain, or even most of it. However low the share price, Northern Rock's risks-gone-wrong predicament has done more damage to the British financial system and society than to its shareholders. Northern Rock's problems have helped push up interest rates and severely damaged the reputations of institutions and individuals. Taxpayers have been placed at considerable risk, for uncertain amounts, and an undetermined period, and the risk can only be reduced over time and with a significant recapitalisation by new investment. This is moral hazard: the owner's big gains, the owner's relatively modest pain, and someone else's great big grief. I endorse without reservation the line taken by Mervyn King, the Governor of the Bank of England. Public interest protection required an appropriate deterrent to moral hazard.

MOST TRADITIONAL INSTITUTIONAL INVESTORS AND THEIR CLIENTS ARE SO FRIGHTENED OF PRODUCING RETURNS THAT DEVIATE FROM THE MAJOR EQUITY INDICES THAT THEY NO LONGER CREATE PORTFOLIOS WITH MEANINGFUL TRACKING-ERROR.

So were Northern Rock's shareholders wrong to take these risks, or to authorise the managers to take them on their behalf? Not legally, to be sure. The bank was in good nick with the law and the regulators. And not in the court of current opinion when the risks were being taken. Only a few specialists were complaining then.

But it's still hard to feel that the bank's owners took an enlightened view of shareholder value. To speak plainly, it looks like they did not behave responsibly. Why was government so willing to guarantee depositors at Northern Rock while turning its back on customers of Farepack or First Solution Money Transfer in the Bengali community in Brick Lane? Could it be because the customers were silent, poor, disorganised and disenfranchised? And will the Treasury find it as easy to step in with public funds to support a bank that fails because of reckless dealing by highly paid traders? And where is the taxpayer's reward for silently underwriting banks and their executives? There are moral issues here that deserve to be debated.

The second and final topical example is the highly geared capital structures favoured by some private equity groups. The unenlightened argument for shareholder value is clear. If the company does only reasonably well, the owners do extremely well. If it does badly, there will be other investments to compensate in the portfolio.

THEIR GAIN, EVERYONE ELSE'S LOSS From an enlightened perspective, the value of highly leveraged balance sheets is doubtful. The gains of the owners should be set against the losses of the workers, who generally have undiversified job portfolios. If a company fails, many of them could end up unemployed and on benefit – a cost to be borne by others. Then there is the loss that profit-greedy owners cause the national economy – definitely from the low taxes that go along with high interest payments, possibly from underinvestment in R&D, and maybe from painful reorganisations if things go wrong.

Enlightened ownership exercises restraint in leverage but this is at odds with greed-driven cultures in some private equity houses and inadequately checked by their bankers who used to constrain excess but no longer do so under the source, package and distribute model.

The apotheosis of this was the statement in July from Chuck Prince, Chairman and CEO of Citigroup, when he said, in connection with leveraged buyouts: "As long as the music is playing, you have got to get up and dance. And we are still dancing." Four months later Citigroup has announced losses of over $11bn, investors have lost multiples of this amount and Prince has retired on a reported annual pension of $6m and a departure package of $40m. Where is the morality in that? Where are the inducements to responsible management? Where are the impediments to moral hazard or accountability to injured parties?

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