Ethics and Finance: a contractual approach

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Is Business Ethics incompatible with shareholder value maximization?

Shareholder value maximization encourages **unethical behaviour** (*Smith and Van Wassenhove*, Business Week 2010)
### Forecast - Income Statement/Balance Sheet/Cash Flows

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<tr>
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<th>Explicit Forecast Period</th>
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Rethinking Business Ethics

• Traditionally ethics is about values

• Values are either very general or internally inconsistent

  “professionalism, integrity, respect, sustainability”

• Or, when specific, highly subjective (based on religion / politics)
Religion: Leonardo Lessius (1554 - 1623)

“high interest rates are unethical”
Politics: Algirdas Semeta (1972 - ):
“aggressive tax avoidance is immoral”
Religion/politics: Socially Responsible funds

Exclude investing in “unethical activities”

Gambling
Alcohol
Pornography

Democrat fund managers invest more in SRI than Republicans (Hong, Harrison and Kostovetsky (2012))
Redefining Business Ethics

Ethical behavior in business should enhance economic sustainability through better governance
Business Ethics: a contractual approach

• Relationships between stakeholders are governed by explicit and implicit contracts

• Writing complete explicit contracts is costly/impossible or shows a lack of trust

• Hence respecting implicit contracts is an efficient way to improve corporate governance
Explicit contracts can be unromantic

• “Love Contracts that make requirements on sex, weight, cheating are increasingly common, experts say. One agreement specified that the future mother-in-law won’t be joining them on long trips, the groom will not watch more than a specific time in front of TV and the bride agreed not to replace her pet when it passes on”

New York Daily News, June 2013
Corporate governance and contracts

- Corporate governance deals with design and management of the *explicit* and *implicit* contracts between various stakeholders in the firm so that firm value is maximized.
Explicit features of business contracts

- Board
  - Compensation
  - Severance payment
  - Performance targets
  - Duration
- CEO
  - Employees
  - Compensation
  - Severance payment
  - Performance targets
  - Duration
- CEO
  - Customers
  - Warranties
  - Duration
- CEO
  - Bondholders
  - Interest rate
  - Principal
  - Seniority
  - Covenants
  - Duration
- CEO
  - Suppliers
  - Payment
  - Interest rate
  - Duration
Contracts of shareholders

• Shareholders have voting rights and can appoint the board
• Fiduciary responsibility of board members to maximize “firm value”
• However, Board members are at an informational/skill disadvantage to judge whether a decision creates “firm value”
• Moreover, private benefits from control means that minority (small) shareholders and controlling shareholders interest may diverge
• Minority shareholders have basically pure implicit contracts
Business ethics as respecting implicit contracts

• **Explicit contracts** have been the focus of economists and regulators (bonus caps)

• However not all conflicts can be resolved by explicit contracts at reasonable costs

• Hence respecting implicit contracts should be an *ethical responsibility*

• While people may differ on religion and politics, they should agree that respecting implicit contracts is the right thing to do

• This requires, of course, making clear in advance what the implicit contract is
Examples of implicit contracts

• Maximize shareholder value

• Maximize shareholder value with constraints (Google)

• Non profit : minimize shareholder value

• Maximize stakeholder value ?
Stakeholder value versus shareholder value: an illustration (1)

• “An employee calls in sick. Should team members take over his/her tasks?”

• Shareholder value maximization: yes

• Stakeholder value maximization: trading off cost to team members against benefits to shareholders
Stakeholder value versus shareholder value: an illustration (2)

• “A client defaults on his mortgage. Should the banker who arranged the mortgage be allowed to bid for the house?”

• Shareholder value maximization: no (potential reputation costs)

• Stakeholder value maximization: trading off benefit to banker against expected loss to shareholders
Critique on the world of finance

1. Lack of concern for **CSR**

2. Selling products that are **bad for clients but good for bonuses**

3. Manipulating spreadsheets to get success fees in acquisitions

4. Conflicts of interest in **IPOs**
Conflict between CSR, ethics and shareholder value

According to the WSJ (April 15, 2010)

“Ethics teaching should not just be about refraining from cheating and corruption, but recognizing that a company has responsibility beyond its shareholders wallets to employees, community, customers and the environment”
Shareholder value maximization: inconsistent with CSR?

Shareholder value maximization may well be consistent with CSR and concern about an externality (e.g. global warming) if:

- Revenues will increase because consumers care
- Workers accept lower salaries/work harder because they care
- Taxes fall because you get tax credits
- Shareholders will require lower rates of return because they “like” the policy: lower cost of equity (discount rate)
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Evidence that CSR is positive for shareholder value

• From 1996 to 2002 Nuon (Dutch energy company) sold energy from wind and sun at a 60 euro premium with the promise to invest the money in alternative energy.

• This promise was made in an explicit contract.

• Would you buy this expensive alternative energy?
Evidence that CSR is positive for shareholder value

• 217,000 individuals and 500 firms signed up

• However, from 2003 on the company kept charging the 60 euros without investing but also without signing explicit contract

• Scandal revealed in 2013 led to lawsuits

• Maybe not illegal (no explicit contract) but surely unethical breach of implicit contract!
Takeaways

• Business ethics should be about respecting implicit contracts in the organisation to enhance firm value
• To the extent that investors who buy shares are led to believe that the implicit contract is to maximize shareholder value, doing otherwise is unethical
• Important is to specify and communicate what these implicit contracts are in advance
• Whenever possible, explicit contracts should dominate
• Avoid conflicts between explicit contracts (bonus based on profits) and implicit contracts (maximize shareholder value)