HEC PARIS | In the UK

FROM HEC UK GOVERNANCE CLUB

The current pandemic amounts to a very large, unplanned, and extremely disruptive experiment on the structure of the global economy. It is an opportune moment for many businesses to look to a fresh start. Whilst corporate governance varies across regions, companies are, globally, considering more and more the role they play in society, and the expectations placed on directors who oversee these companies have never been greater. ESG factors are getting more and more traction across the globe, and in many regions, regulators and policy makers are looking at ways to better embed sustainability into the corporate governance framework. In his 2021 letter to CEOs, Larry Fink, the CEO of BlackRock, the world's largest asset manager, set expectations for companies to disclose how their business plans incorporate commitments to carbon net zero by 2050 and how these plans are reviewed by the board. As the recent changes on the board of Danone, France's first listed "entreprise a mission", illustrate, combining sustainable business practices with shareholder value creation remains a balancing act for boards, which is not without challenge.

For our first publication, we would like to share with you a paper by Eric Bourdais de Charbonniere (HEC 1963), founder of the HEC Gouvernance club in Paris, who reflects on his long career as a company director and draws from his experience a possible path *"Towards a New Corporate Governance".*

For any question or comment relating to this communication or the activities of the HEC UK Governance club, please contact Nathalie Romang (Nathalie.romang@mailhec.com) or Alexis Grabar (alexisgrabar@mailhec.com)

PANDEMIC EXIT: TOWARDS A NEW CORPORATE GOVERNANCE?

The re-confinement of this sad end of 2020 is once again an opportunity to reflect calmly on what could happen in the aftermath of this never-ending crisis. Where are we going? What do we want? Return to yesterday's world or rebuild it differently?

The year 2020 will be the worst year experienced by our generations who, having known neither war nor deep misery, were not really prepared for this pandemic. We don't know how we're going to get out of it and get back on the path to growth.

It would be a big mistake to hope that the post-crisis world would allow us to do without financial discipline and where the demand for profitability and value creation would take a back seat. On the other hand, we must expect an acceleration of yesterday's trends: teleworking, digitization, the questioning of existing supply and distribution chains ... and corporate governance which opens more of a role to all the stakeholders who will be needed to turn around the economy.

In the wake of the pandemic, we will find ourselves in the midst of a sea of debt, bankruptcies and social problems. In addition, I fear that the health crisis will further accelerate criticism of an economic system that we are unable to control and regulate. We also know that it is the extremist and populist parties that will take advantage of the situation to force the return of authoritarian regimes and protectionism.

To better define the right path for tomorrow and offer the right solutions, we must understand the origin and nature of the abuses that will have to be corrected to get out of the crisis. I therefore went back in time to my experience of nearly fifty years in industrial and financial companies on both sides of the Atlantic and I was able to easily find the proofs of the progressive influence exerted by the financial sphere on business in an increasingly unbridled global economy.

During my 25 years at JP Morgan, I was involved from New York in the evolution of the bank's strategy, which for more than a century has focused on financing the global economy. 20th century capitalism was largely based on an alliance between bankers and industrialists. The latter operate on slow cycles: between the preliminary studies, the exit of the production lines and expected profits, several years pass. This is the reason why JP Morgan required its young recruits to undergo six months prior training in New York for a "credit course", the purpose of which was to prepare us for the job of bankers in charge of a group of corporate clients. The success of JP Morgan, the leading market capitalization in its sector on Wall Street, was largely based on the quality of this long-term relationship between the bank and its client. This period ended in the aftermath of the “thirty glorious years” and the two oil crises of the 1970s.

The dismantling of the Glass Steagall Act, the liberalization of financial markets, the disintermediation of banks and the development of collective fund management sounded the death knell for the traditional banker and the long term relationship with the client. It opened the door to a new generation of creative bankers and fund managers with a strong technical background.

As corporate financing was no longer profitable enough, JP Morgan chose, starting from the end of the 1980’s, the investment banking model. After the dismantling of the Glass Steagall Act, we therefore moved from financing healthy growth, concerned about the long term and the sustainability of corporate clients, to a search for immediate profit-- ignoring the disastrous consequences on the social and environmental level.

Like a good soldier, I switched to my new uniform of "investment banker" and JP Morgan Paris, which I had headed since 1981, adapted a multitude of financial products created on Wall Street to the French market. Subordinated debts, securitizations, swaps and other derivative products made our fortune with the encouragement of socialist finance ministers converted to the liberalization of financial markets!

When JP Morgan London became the strategic centre of these new activities, I left my position as CEO of JP Morgan in Paris for that, more austere, of Chief Financial Officer of Michelin in Clermont Ferrand.

During my 23 years at Michelin, I witnessed de-industrialisation in Europe and the United States and I participated in the necessary restructuring of our industrial tool which has partly relocated, mainly to Asia.

During my three terms as Chairman of Michelin, I have had the good fortune to be a director of over a dozen companies and banks in Europe and North America. When Michelin had big financial problems and I was responsible for its finances, I could measure the greed of certain financiers when they offered me operations whose objective was obviously juicy commissions without any consideration for the interests of the company. I could list them: it would be a long list ...

It was the time when I realized the growing importance of large investment funds which were the "new masters of the world".

They are also the ones who imposed a new governance on all the major players in the world economy. The financial logic that underlies this governance has imposed common standards and references on companies calling on the financial markets to develop in a rapidly expanding global economy. This financial logic has contributed to the emergence of rules of transparency and austerity which have been imposed on everyone and have undoubtedly contributed to the development of the world economy. I haven't forgotten the big American funds that helped me save Michelin when we were on the brink of bankruptcy.

As majority shareholders of many large French groups, these investment funds do not have representatives on the board of directors because they would then be considered "insiders" and could not intervene in the stock of the companies in which they are shareholders. They are therefore very distant from the board's debates on the company's strategy and forced to vote at general shareholders meetings for directors presented by the company and whose objectives and priorities are often very different from theirs. Worse, they often delegate their voting power to third parties, the “proxy advisors”, which distances them even further from the company of which they are nevertheless the main shareholders.

Under these conditions, we should not be surprised at the short-lived and speculative behaviour resulting from this situation. Listed companies are aware of this and their managers are eager to meet them and seek their loyalty. During these "road shows", the leaders, in this search for adherence on the part of those whom they consider to be their true masters, may sometimes lead them to indulge into insider trading situations which most often go unpunished.

A solution must absolutely be found to this lack of coordination between the majority institutional shareholders in the capital of large French listed groups and the boards of directors.

This is all the more necessary as the prevailing short-termism has favoured the emergence of a new species of financial predators on the markets and a multiplication of the drifts resulting from the growing financialisation of the economy: de-industrialisation and growing social inequalities, of which the lower middle classes of developed countries are more particularly the victims.

During my three terms as Chairman of the Michelin Board, I had the good fortune to become a director of a dozen companies and banks on both sides of the Atlantic. Thanks to this experience as a director, I have devoted the past few years to teaching corporate governance (ScPo, ESSEC, HEC Alumni, etc.) and more particularly board of director’s specific governance. I should emphasize that, overwhelmingly, short-termism is designated as the most harmful tendency by the executives of large companies.

Should we therefore resign ourselves, accept the world as it was before and face a growing challenge that will remove all hope of returning to the happy globalization that we were promised?
Or should we take advantage of the crisis to rebuild on new foundations and put the market economy back on the right track?

Ideally, the establishment of rules and controls in the global market should be preceded by political will at the highest level between Europe and North America. It would be the founding act that would facilitate the implementation of a new governance. But the wait may be long ...

Realistically, the change will more likely come from the changing behaviour of the main players in the global economy.

A new governance has been established for a few years now and leaves more room for all those who participate in the value creation. Like family companies, it is this search for balance that guides a growing number of heads of family-owned companies.

CSR (Corporate Social Responsibility) requires companies to take into account the social and environmental issues of their activity and to report on them.

ESG is aimed at investors and encourages them to incorporate Environmental, Social and Governance factors into their decisions.

SRI (Socially Responsible Investment) consists of directing investment towards companies selected for their financial performance and with the best ESG scores.

The requirement for profitability remains inescapable, but there is an awareness that the company's strategy cannot be limited to the sole satisfaction of shareholders' requirements. It must therefore include employees, customers, suppliers, local authorities ... and the search for synergies that exist between these different participants.

The fruit of this new governance will be a better sharing of the creation of value in favour of sustainable development.

This search for synergies for the benefit of all is already practiced by major players in the economy and by certain investors who make it their priorities in their choice of investments, which often perform above average. They have understood that beyond the essential search for profit and growth, it was also necessary to seek a positive impact for all stakeholders.

This search for its raison d'être and the governance that underlies it is gaining ground, but the game is far from won.

Large investment funds and the cohort of new financial players around them must accept a paradigm shift and the sharing of the strategic decision with the other stakeholders of the company which can be a source of synergies for the benefit of all. What may appear to some to be a constraint can be a strategic opportunity.

The search for this new corporate governance is desirable, but is it possible at the global level? Realistically, it will be difficult to make a synthesis between an Anglo-American governance which gives power to the shareholders (UK) or to the CEO (North America) and the « pluralist model » of Europe which has opened up to varying degrees the doors of the board of directors to employees.

It is this "pluralist model » that gives us the best chance of success for achieving the right balance of power. The right balance is probably found between the “co-determination” of the

German model (50-50 between shareholders and employees) and the model more widespread in southern Europe which, like France, reserves for employees of the company a limited number of seats on the board of directors.

In the aftermath of the health crisis, it will be necessary to manage both a weakened economy, companies in difficulty (bankruptcies, restructuring, change of model, etc.) and social problems.

Companies should not be satisfied with expected aid from the states, they will also have to seek the participation of all stakeholders in the necessary effort: shareholders, employees, customers, suppliers, local and societal actors ...

The pluralist European model has more flexibility in this regard: business leaders and boards of directors will have to offer the right mix between short-term investments to get out of the crisis and long-term investments to ensure the future and sustainability of the company. Unlike the Anglo-American mono-power model, our pluralist model should make it more natural to move towards governance in search of synergies between the various stakeholders and constituents of the company. To achieve this, managers, directors and employee representatives will have to prioritize the interests of the company over all other considerations.

I was able to easily trace through my industrial and financial experience the different stages that led us to abuses resulting from the excessive influence of finance on our economies. Today we have no choice: we must quickly put in place all the means to correct these abuses in order to regain healthy growth, concerned with sustainable development and the long term.

I am well aware that this will not solve all the problems that will arise after the crisis of 2020 and that there is no credible alternative to capitalism and the market economy today.

However, we can fear that this model, which has enabled extraordinary economic growth for our generations, will sign its death warrant if it does not quickly correct its shortcomings.

Eric Bourdais de la Charbonniere, December 2020