

Can SRI Help Corporate Governance?

“You will be confronted with questions everyday that test your morals. Think carefully and, for your sake, do the right thing, not the easy thing,” said TYCO International CEO Dennis Kozlowski, in a commencement speech at Saint Anselm College. He was indicted for tax evasion 17 days later. Unfortunately, this is only one example of the many business scandals that has shaken Corporate America in 2002. Incommensurate compensations and unethical behaviours have stirred up a huge debate on corporate governance. People have realized that bad corporate governance led to bad results.¹ Nevertheless, corporate governance is more complex than just finding the right compensation policy or hiring ethical CEOs. The factors that influence corporate governance are manifold, and the current crisis may be rooted in the unbalance among these factors. Currently, governments and public regulators are trying to influence new corporate governance practices. Perhaps less in the limelight, institutional investors, convinced that well governed companies will do better in the longer term, are also pushing for better corporate governance practices. In this article, we will first explain in simple terms our view of the factors that influence corporate governance; from there, we will focus our attention on how Social Responsible Investment (SRI), a growing investment philosophy promoted largely by institutional investors, can help improve corporate governance practices.

Corporate Governance Definition

With the recent uncovering of egregious business practices in the US, our society has started to wonder how business corporations are and should be governed. Given the globalisation of the economy, the debate itself has become global. What is corporate governance? According to the OECD,

*Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation...and spells out the rules and procedure for making decisions on corporate affairs. By doing this, it provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.*²

Mary O'Sullivan, associate professor of strategy and management at INSEAD, defines corporate governance as the answer to the three main following questions: Who exercises control over corporate activity? What do they do with their power? Who benefits from the way they exercise their power? Thus, corporate governance is influenced by a series of factors (law, economy, society, politics, history...), and hence, the search for good practices is complex. Corporate governance practices vary not only from company to company but also from country to country, and even from continent to continent.

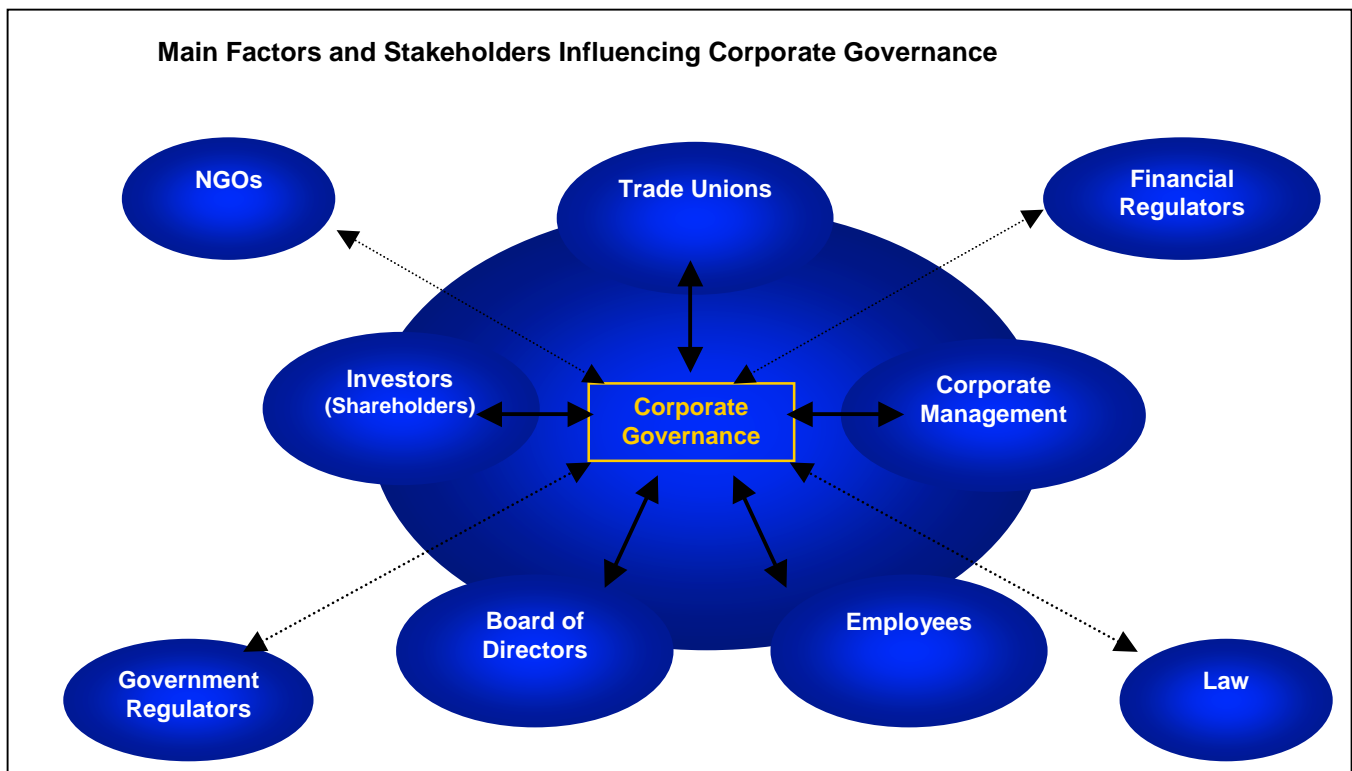
Corporate Governance Principles

O'Sullivan considers that there are three main perspectives on corporate governance: First, the notion that shareholders are principal people for whom the corporation is run (i.e. shareholder view); second, the principle that the corporation should be run for the benefit of other interest groups (i.e. stakeholder view); and third, the

¹ <http://www.thecorporatelibrary.com>

² Corporate Governance in Europe, KPMG survey 2001/2002

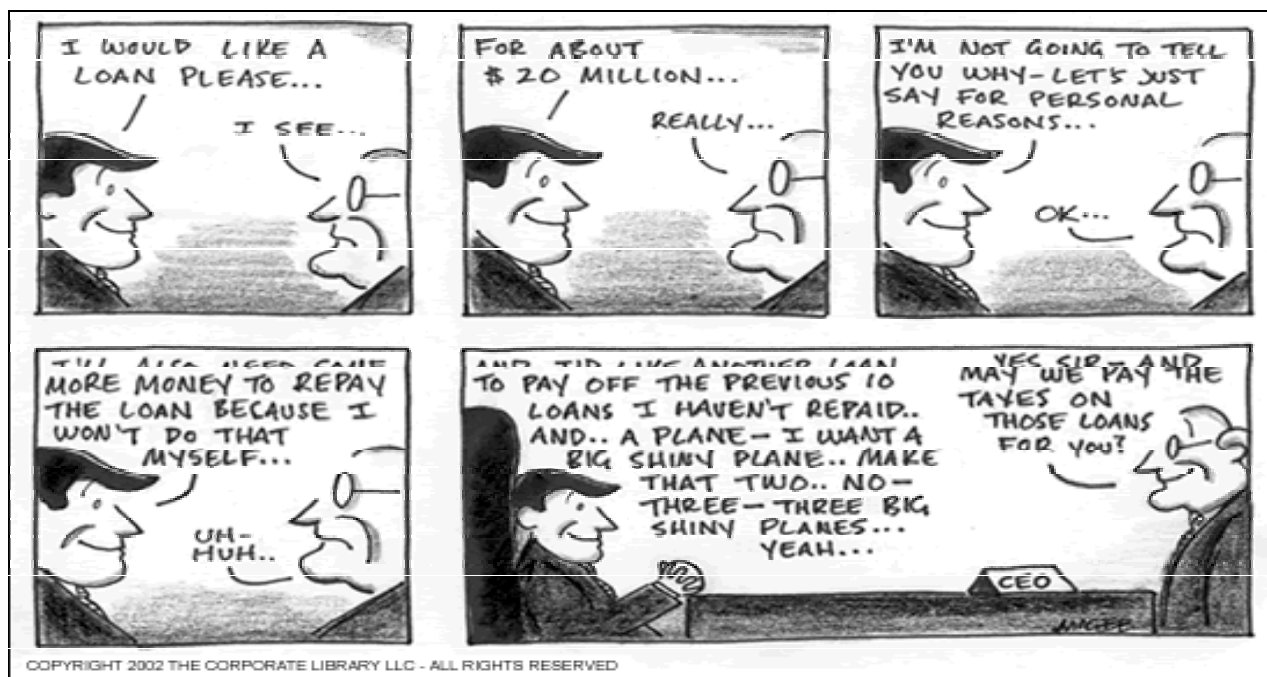
managerial perspective which advocates management autonomy.³ So far, the shareholder view has been the most prevalent. However, with the burst of social and environmental sustainability requirements and with the corporate governance crisis, the stakeholder perspective is gaining rapid ground. This view considers that the corporation should be governed in accordance with the key company stakeholders. In doing so, the company would take into account long-term social and environmental factors, these factors being represented by a number of different groups (unions, NGOs, regulators...). Yet, even if the stakeholder perspective is growing, it is not without challenge. The factors and stakeholders that influence corporate governance are numerous (see chart below). Which stakeholders should the company take into account? How can it incorporate the requirements of such diverse groups? How can decisions be made? These are just some of the questions.



³ Whose bottom line is it anyway?, Mary O'Sullivan, INSEAD Quarterly 2001-2

Current Corporate Governance Crisis

Over the past 20 years, many believe that as the power of multinationals has increased, the ability of corporate management to influence corporate governance has grown too strong. Why is management so strong today? The answer is not that it has become greedy! Actually, it is more about the changing power levels of corporate stakeholders. In fact, some people argue that corporate leadership has been empowered by a reduction in strength in three areas: unions, shareholders and independent board members. Unions, because individuals have become more empowered and want “control over of their destiny” rather than advancement through a collective, and sometimes rigid, bargaining process.⁴ Shareholders, because as equity ownership has become more dispersed, direct involvement in company affairs has been reduced to a portfolio assessment rather than potentially a broader, deeper role.⁵ Finally, the independence of board members has been increasingly questioned over the recent scandals as it becomes apparent that “Friends and family” of senior management have often found themselves on the board.⁶ Thus, corporate executives have arguably been in a stronger position in recent years when it comes to influencing corporate governance. Jack Welch’s 2000 total compensation was 80% higher than in 1999. In the mean time, the value of GE stock declined by 6%.⁷ The Corporate Library, a US think tank on corporate governance, discovered that over a third of the largest companies, as measured by market capitalization, loaned cash to executives. The average size of such loans is \$10.7 million, with a total amount of indebtedness for the whole sample of \$4.5 billion.⁸ In response to the crisis and in order to invent a new type of governance, societal reactions and new business practices have emerged.



⁴ Corporate Values, Enterprise Risk and the Board, Michael J Philips, August 2002

⁵ Interview with Wharton Professor Bruce Kogut, December 13, 2002 at INSEAD

⁶ Corporate Values, Enterprise Risk and the Board, Michael J Philips, August 2002

⁷ www.paywatch.org

⁸ Exec reap benefits of cushy loans, *USA Today*, 12/23/2002

⁹ Corporate Values, Enterprise Risk and the Board, Michael J Philips, August 2002

New Laws and Regulations

One of the early responses has come through the legal channel. The corporate crisis in the US was so acute this past year that the public authorities had to intervene. The strongest government reaction was from President George W. Bush himself. On July 9, 2002, George W. Bush called for a “new era of integrity in corporate America” in the wake of the “abuses and excesses” brought to light by recent US corporate scandals.

¹⁰ Immediately after, President Bush signed the Sarbanes-Oxley Act of 2002 into law on July 30, 2002, the most sweeping legislation affecting accounting, disclosure and corporate governance in a generation. ¹¹ It is not clear yet how these new regulations will be implemented. Professor Bruce Kogut, Felix Zandman Professor of International Management at Wharton and INSEAD visiting professor, declares that if the law is implemented and enforced by the financial regulators, then there is a good chance that there will be sustainable changes--new market practices have much more chance to be sustainable if they are backed up by regulations. ¹²

In Search of a New Generation of Board Members

In any case, the way board members are selected and retained will have to change. In some countries, there is too little diversity in the board structure, which nurtures all sorts of “cosy agreements”... In 1993, 50% of the CEOs of the 200 largest French companies graduated from either Polytechnique (‘X’) or ENA. There is also a need for board members to be better prepared and in some cases, more professional. But asking for more liability and accountability from board members may be an obstacle to risk-taking and innovation. It could become detrimental to the company. Again, Professor Kogut stresses that we may be asking board members “too much”. It is quite possible that a response in this domain will be to initially put more pressure on board members and then scale back over time if the pendulum swings too far. ¹³

The Shareholder Factor

Legal and corporate board revision have been heavily discussed in the media, yet the steady growth of Social Responsible Investment (SRI) as a tool for investors to use to influence corporate governance has perhaps been under-emphasised. In the restoration of trust and integrity in global corporations, institutional shareholders, because of their size and long-term commitment, can play a pivotal role ¹⁵. Institutional investors hold about 50% of all listed corporate stock in the US (about 60% in the largest 1,000 corporation). Standard Life Investment, one of Britain’s biggest fund managers, which manages about 70 billion pounds, has recently urged other institutional shareholders to join forces with them to exercise greater discipline over boards of companies. Why are they doing this? First, they believe that a badly governed company brings bad results. Second, they believe that a company taking into account social and environmental factors will outperform others in the longer term. Social Responsible Investment (SRI) funds, which are targeting companies that integrate the social and environmental factors with financial analysis, are promoting a new type of corporate governance. In this context, SRI has the potential to become a powerful lever to help change corporate governance practices.

¹⁰ Bush seeks new business ethic, *CNN/Money*, July 9, 2002

¹¹ The Sarbanes-Oxley Act of 2002, Stanley Keller

¹² Interview with Wharton Professor Bruce Kogut, December 13, 2002 at INSEAD

¹³ Ibid

¹⁴ Doing the right thing, Henri-Claude de Bettignies, INSEAD Quarterly 2001-2

¹⁵ SLI urges joint action to keep board true, www.socialinvest.org, 2003

What is SRI?

SRI is an investment philosophy that considers social, ethical and environmental performance as well as financial performance. There exist various means to incorporate SRI, such as positive and negative screening, and/or engagement to encourage companies to improve their environmental and social performance. Briefly, there are two main reasons why SRI is of growing significance when making investment decisions. Firstly, an individual or institutional investor may want to take account of their personal or organisational values as well as their financial requirements. This approach is more common in the church and charity investments and by individuals. Statistics collected by the SIRI group show the number of European retail SRI funds grew 58% in the 18 months to June 2001, and recent Lipper research revealed SRI to be one of the few areas still experiencing growth since the market slump. Secondly, investors may adopt SRI policies because they believe it makes financial sense. In a world where shareholder value is increasingly dependent on intangibles like brand and management quality, it may make more sense to look at social, environmental and ethical performance indicators as well as traditional indicators. This approach includes assessing the corporate governance of corporations as part of an investment decision.

Growing Support for SRI

Financially motivated SRI is increasingly becoming part of mainstream financial analysis. Furthermore, the European Commission has recognised the potential for SRI in their July 2002 communication on Corporate Social Responsibility (CSR) and through support for the European Sustainable and Responsible Investment Forum (Eurosif). The interests of institutional investors, NGOs and the European Commission drove Eurosif's creation in 2001. Eurosif aims to aid the integration of social, environmental and ethical issues into European financial services and to provide a multi-stakeholder network to share best practices on SRI. Recent Eurosif activities include calling for the inclusion of a disclosure measure in the draft Directive for Institutions for Occupational Retirement Provision (IORP Directive), developing pan-European transparency guidelines for retail SRI funds and calling for investor representation at the EC's Multi-stakeholder Forum on CSR. Later in the year, Eurosif will be drafting the first European report of the SRI institutional market, an effort that will make clearer the growing influence of the sector as a tool for influencing corporate governance.

Conclusion

The balance of power among corporate stakeholders has shifted. In the past few years, corporate management has gained enormous power, generating abuses and excesses. Legal and corporate board factors have received initial attention as levers that need to be adjusted for improved corporate governance. SRI, an investment philosophy that intends to promote a "stakeholder" based corporate governance for the development of more social and environmental corporations, is also becoming an interesting market driver to advance good corporate governance. Yet, perhaps as Bruce Kogut suggests, the best response to change corporate governance practices could be through improved business education.¹⁶ Through education, people will have a more complete understanding of how various factors influence corporate governance. Some people have

¹⁶ Interview with Wharton Professor Bruce Kogut, December 13, 2002 at INSEAD

already started to prepare the future generation of business executives and “future board members” to act in a responsible and ethical way. At INSEAD, Professor Henri-Claude de Bettignies leads these initiatives. His conviction is that those driving the globalisation process must internalise a sense of responsibility and caring.¹⁷ It is quite possible that this type of transformation will bring the market economy to a higher level of maturity.

Matt Christensen (Wharton MBA, 1997) is Executive Director of the European Sustainable and Responsible Investment Forum (Eurosif). Eurosif is the pan-European multi-stakeholder network for promoting and developing sustainable and responsible investment.

Sylvain Guyoton (INSEAD MBA, December 2002) focuses on business ethics, corporate social responsibility and SRI. As a member of Indevor, Sylvain initiated the first INSEAD “graduation pledge”.

¹⁷ Doing the right thing, Henri-Claude de Bettignies, INSEAD Quarterly 2001-2