The real job of boards

Widely seen as the key for ensuring quality in corporate governance, the board of directors has been a particular focal point for reform. Harry Korine, Marcus Alexander and Pierre-Yves Gomez believe that more leadership at board level could avert many corporate crises in the future.

Comments

Over the last decade, great efforts have been made to improve the corporate governance of publicly quoted corporations in the UK and US as well as those in France, Germany, Switzerland and elsewhere. Nonetheless, as the financial crisis has shown (at least in the case of banks and insurance companies), adequate corporate governance is not yet assured. Boards are still not working as they should. Why is it that less than 10 years after Enron, Worldcom and Parmalat, we are again mulling over corporate governance failures as significant as Lehman Brothers, RBS and UBS? The recent corporate governance failures in the finance industry follow precisely the same pattern as their predecessors earlier in the decade: in practically every major case of corporate governance failure of the last 10 years, the corporation’s survival was put at stake in the unreserved pursuit of strategic fashion.

 Broadly speaking, the past decade provided three transformative opportunities for growth: globalisation (throughout the period), the Internet (especially to 2000) and exceptionally cheap and easy credit (from 2002 to 2006). Each of these opportunities for industry transformation also engendered its own strategic fashion: go global or go bust, the Internet changes everything, or play the leverage game. Globalisation, the Internet and easy credit were truly transformative opportunities, but they were not good business for all of the corporations that boarded the respective bandwagons. Rather than insisting on the essential question of how their corporation should respond to the transformative opportunity, directors of Ahold, Worldcom, UBS and others got caught up in the hype, the promises of quick riches and the need to keep up with their industry peers. They became victims of strategic fashion.

After a fashion

Policy makers and legal experts are currently working overtime to come up with new mechanisms for preventing governance failure. We worry that the regulatory push for more detailed compliance manuals or better-articulated codes of conduct will not help boards of directors prevent the next wave of corporate governance failures. Rather than putting the accent on the exercise of prudence, boards are being primed to zero in on questions of financial and legal detail that reveal the signs of trouble only post hoc — after the pursuit of strategic fashion has gone bad.

The real job of the board consists of acting up front to protect the corporation against strategic fashions. Not only should boards discuss long-term strategy, they should specifically focus on formulating appropriate responses to transformative opportunities. Understanding the difference between strategic fashion and a transformative opportunity is critical to the success of any board.

A transformative opportunity for growth represents radically different conditions for doing business that have the potential to change the rules of competition in multiple industries. For example, the onset of globalisation — with the whole world involved in a global marketplace and most previously protected industries opened — posed profound questions for the management of a value chain. For almost everybody, globalisation raised the spectre of global competition in what were previously national or regional businesses.

Transformative opportunities for growth invariably produce winners and losers. Both the highly successful Renault-Nissan alliance and the greatly disappointing Daimler-Chrysler merger can be seen as responses to globalisation. Both the stellar performance of eBay-PayPal and the implosion of Vivendi-Universal are outcomes of the Internet transformation. And JPMorgan Chase and Citibank, in their very different respective current states, are the result of easy credit. In the face of such transformative opportunities, a corporation has to act, and the board of directors cannot stay inactive and silent.

However, a truly transformative opportunity is so large and so apparently obvious that it engenders strategic fashions.

Strategic fashions are perversions of the transformative opportunity. Under the hold of a strategic fashion, reasoned debate and careful choice go out the window. All that is heard is some variation of a mantra about joining the corporate bandwagon: “Everyone is doing it; we’ll get killed or downgraded if we don’t!” Consider, for example, how bank after bank moved into speculative buying and selling of mortgage bundles that lacked actual, valuable real estate as underpinning for their risk taking.

The publicly quoted corporation is especially prone to strategic fashions. None of the larger family-owned or family dominated corporations went global with such a vengeance or took to the Internet with as much abandon as their publicly owned competitors. And none of the former went bust in the process. Similarly, family-owned banks such as Pictet were more sceptical of the various manifestations of easy credit than their publicly owned rivals, and many have actually benefited from the ensuing financial crisis by attracting thousands of new clients in search of a safe haven.
Whereas family-owned corporations can decide for themselves without concern for shareholders, there is always pressure on the management and the board of the publicly quoted corporation to adhere to a strategic path that all the different stakeholders can easily agree upon. It is in this context that shareholders in the guise of fund managers and analysts demand that management take an active stand on the latest strategic fashion. The news media want to know what management is doing to be ‘with it.’ And even regulators may put pressure on the corporation to act (particularly situations in which the state is still an important shareholder, such as in the former telecom, post and energy monopolies). For their part, executives interested in making a mark and building a reputation during their generally limited time in office will have great difficulty resisting the temptation to roll the dice. When there is broad stakeholder agreement on what should be done, it is very hard to stand out from the crowd; the corporation is put in precisely the situation in which Keynes said that it is “better for reputation to fail conventionally than to succeed unconventionally” (The General Theory of Employment, Interest and Money, 1936).

Some industries are more prone to strategic fashion than others. As both makers and takers of strategic fashion, the publicly quoted universal banks have been particularly hard hit by the last 10 years of transformative opportunities turned to strategic fashions. On the one hand, globalisation, the Internet and cheap credit are all apposite to the banking business; banks had to take a stand on every one of these opportunities. On the other hand, banks were also directly involved, through lending and loan agreements, with client firms that followed every one of the three strategic fashions of the decade. Citibank, for example, not only failed to profit from its own efforts at globalisation and the Internet and lost untold sums in the credit derivative markets but was also an important creditor to Parmalat, Worldcom and AIG. Banks, more than any other industry, except perhaps insurance (similarly exposed, as providers of capital), should be especially mindful of strategic fashions. In finance, strategic fashions almost always have double-whammy potential.

It is worth noting that pressure to pursue strategic fashions can also arise at a more local level, even in industries that are not exposed to transformative opportunities of the type described above. The pharmaceutical industry is a case in point — even though this is an industry in which globalisation has been gradual and of long standing. The Internet has had little effect on the business model, and cheap credit has not fundamentally altered the equation. The big drug makers also had their flogging at following each other down a questionable strategic path these last 10 years. Thus, there are many examples of forward integration through large-scale acquisition that were ill-considered and eventually had to be unwound at a loss. Fortunately for the companies concerned, the ostensible opportunity was not big enough to prompt a betting of the house and risk outright failure of the corporation. The amount of money lost was manageable. Still, even the pursuit of local, industry-level strategic fashion raises governance questions. Did the boards of Big Pharma companies acquiesce to questionable logic? Were they presented with an actionable alternative or did they simply yield to the influence of the crowd?

Leaders and followers

In theory, independent, non-executive directors are in an ideal position to assess transformative opportunities for growth. First of all, by virtue of the distance from the day-to-day running of the business, they are better able to keep big-picture, strategic questions in perspective. Second, they are less likely to be entrenched in the history and culture of the organisation and can therefore challenge accepted thinking. Third, their external networks and outside experience allow them to see trends that cut across sectors or countries, as against the sometimes more parochial view of insiders. Fourth, their focus on the long-term health of the organisation enables them to resist the pressure for short-term gains that might compromise the longer-term existence and growth of the organisation.

In practice, however, the advantages associated with independent directors may actually contribute to pushing boards towards adopting strategic fashions. Focus on big picture trends and lack of detailed operational understanding strongly support high-level pattern recognition that ignores granular difference; lack of fear for history and culture soon leads to overambitious change initiatives; external networks can reinforce the essence of ‘fashion’, by lending credibility to the fashion’s apparent ubiquity; an aim to promote long-term organisational health can turn into a burning desire not to let the organisation slip behind the pack (especially ‘on my watch’); or lose its growth drive or become yesterday’s news, leading to strategic fashion obsession.

The role of the board

Standing up to a strategic fashion requires intellectual investment and personal fortitude. Already overloaded, board members will find it much easier in practice to acquiesce. Give the board too much to do, and nothing will be done well. If preserving the long-term health of the corporation is the primary responsibility of the board, then prudence in the face of transformative opportunity and the attendant strategic fashions is its most important job.

If the board of directors were to focus on responding to transformative opportunity and strategic fashion, what questions should it be asking? The first and most critical question a board should ask concerns the existence of a credible alternative. In our experience, boards are often presented with proposals and rather than questions. Thus, at Vivendi, in 1999, board attention was concentrated entirely on the extremely easy value available through expansion in the Internet or entertainment space. The board members of a company that had the financial resources to have gone in almost any direction were offered no real choice. Without a choice between credible alternatives, however, one cannot speak of the board having real decision-making authority. Posing strategy in yes or no terms does not offer the scope for wise judgement.

By contrast, the insistence on a credible alternative focuses board and management attention on the competences needed in order to capitalise on the transformative opportunity for growth at hand. It is natural for boards in which outsiders and part-timers play important roles to put more weight on the opportunities and threats side of the strengths-weaknesses-opportunities threats (SWOT) analysis; after all, the critical examination of strengths and weaknesses requires inside knowledge and takes a considerable amount of time. In most of the cases of corporate governance failure we have studied, however, it is precisely the competence side of the analysis that did not hold up to the aggressive pursuit of a transformative opportunity for growth.

In general, pursuing a transformative opportunity for growth either requires considerable development of existing competences or acquisition of entirely new competences. Faced with the transformative opportunity of globalisation, for example, none of the previously nationalised telecoms, energy-water
utilities and posts had the deal-making prowess, the international business experience or the complex organisational management skills required to make a success out of such a business. As a relatively new technology, the question whether to engage the Internet opportunity also put those traditional manufacturing and service companies that wished to pursue it before the question of how to obtain and master the new skills required to leverage it.

Similarly, only very few of the banks and insurance companies heavily involved in playing the leverage game had the needed derivative trading and risk management skills that should have been in place to handle such risk. Had the boards of Kelda, Vivendi-Universal or Swiss Re been offered valid, credible alternatives to going global, embracing the Internet or playing the leverage game, they would have been forced to weigh the import of the competence investments involved in following these strategic fashions and to estimate the ultimate cost if things went wrong.

The acquisition, by whatever means, of new competences that are mission-critical can put the future of the corporation at stake. Successful fashion leaders as well as successful fashion followers tend to exploit a transformative opportunity by either building on existing competences or gradually and systematically developing the new competences required. Whether fashion leader or fashion follower, the risk of collapse is particularly great if pursuing the transformative opportunity means destroying existing competences or making such a large investment in new competences that the corporation cannot continue if the new business does not pan out. The former is what happened to corporations like Marconi and Vivendi-Universal that bet the shop in trying to become premier Internet players. The latter scenario is playing out today for many traditional banks around the world.

If the board does decide to go down the path indicated by the transformative opportunity, it needs to be sensitive to the fragility of the strategy chosen. The board should be particularly alert to large-scale efforts to change the face of the corporation in a short time. Many of the best known cases of corporate governance failure of the last 10 years share the symptom of competence acquisitions carried out at breakneck pace that were intended to change the identity of the corporation. The pursuit of a strategic fashion should be accompanied by unusual vigilance by asking key questions such as: How robust is the strategy to changes in macroeconomic assumptions (that is, availability of easy credit)? At the industry level, to what extent are competitors narrowing the field by copying each other? Have we scrutinised internal figures with an eye for overheating? If the composition of revenues and profits has changed dramatically in a short time, do these numbers demand special study? If a significant proportion of profits is due to the effort of a disproportionately small group of people and this situation is new, should we be worried? Strategic fashions typically have the side effect of causing certain indicators to balloon.

Part of the board’s duty of prudence is to watch these indicators with great care — practically and in real time — for they are vulnerable to reversal.

There is always an alternative to following strategic fashion, but it takes a clear head and the courage to stand alone against the mania of the moment. If the board does insist on resisting the pressures to go for it, or just decide to go slow, it also has to be able to stand tall and explain why. In the past, boards have preferred to stay in the background, operating outside of public view and scrutiny.

In fact, boards are particularly well placed to explain to the financial markets and to the public at large why it may not be in the long-term interests of the corporation to take up on a strategic fashion. Boards are supposed to function as impartial arbiters, with only the best interests of the corporation at heart. In today’s world of increasing pressure for conformity on all dimensions, including the strategic, only the board has the independence to act differently and the unique and primary credibility to convince the different stakeholders of the wisdom of such a stance. In the future, boards need to put their independence and credibility to better use in protecting the future of the corporation in the public arena.

The best defence

The board of directors of the publicly quoted corporation, as it currently functions, is not likely to be good defence against the corporations falling victim to strategic fashion. Recent reforms in board practice, although intrinsically commendable, are unlikely to alleviate the problem. New reporting requirements and a new emphasis on oversight have meant that, in practice, a great deal of valuable board time is spent on financial and legal detail, to the detriment of strategic debate. In many corporations, an adversarial spirit has replaced the old chumminess, with boards seeing themselves as ‘the police’, and thus management tempted to only tell boards what they want to hear. Even more perniciously, perhaps, board reform has provided a false sense of comfort — to board members and shareholders alike. With all their administrative and committee duties, board members can work really hard and feel they are doing their best, even if they have given the key questions of transformative opportunity and strategic fashion only short shrift.

Corporate governance failure linked to the unreserved pursuit of strategic fashion represents a failure of the board of directors to preserve the long-term viability of the corporation. In the special context of the transformative opportunity for growth, only the board can stand between the corporation and its various stakeholders and defend the case for prudence. In *Nicomachean Ethics*, Aristotle famously praised the virtue of practical wisdom in the direction of public affairs. Practical wisdom may be what boards now need most.