

In July, I gave a public lecture in St Kitts under the auspices of the University of the West Indies Open Campus and the St Kitts-Nevis-Anguilla National Bank. I had participated earlier in the annual compliance conference organized by the National banking group, and I have already posted how impressed I am with the National's executive management team. For the public lecture I chose as my topic, "Management and Responsibility: Redefining Accountability for the Contemporary Commonwealth Caribbean Corporation." In the public lecture, I was trying to extend the discussion I had begun the previous week in the compliance seminar.



A recurrent theme of many of the discussions I have had with persons, both from and outside of the Federation, attending the St Kitts-Nevis-Anguilla National Bank Corporate Compliance Seminar last week is that we are now operating in difficult times; but this is by no means new. We seem to be going through recurring cycles of business crises, one after the other, originating outside our region but whose adverse consequences are acutely felt here. The most recent is the Global Financial Crisis of the late 2000s which has had such an enormous impact on credit and we may still be feeling the effect that credit crunch in our part of the world. I am quite sure that our bankers and financial services executives here know this, and are more intimately acquainted with these developments than I am.

But as fundamentally debilitating as the recent Global Financial Crisis has been, and it may very well be the worst we have had in three generations, it is merely the latest crisis that has challenged our faith not only in the financial system in particular but also in the quality of our business management methods in general. Some see our series of business failures as systemic. Others attribute these failures to greedy, unethical or irresponsible management. I also share the view that much of the critical business failures can be attributable to irresponsible business management practices, but I intend to argue that this irresponsibility is, in fact, also systemic and may be traced to the systems we have established for rewarding our business executives.

One of the critical responsibilities facing a board of directors is determining the appropriate rewards for its executives. Thirty five years ago, two financial economists, one at Harvard University and the other at the University of Rochester, offered us what appeared to rational

basis to do so. Their proposal was based on a number of assumptions about the agency relationship that, over the years, we have identified as 'agency cost theory.'

Agency cost theory may be summarised as follows: The corporation is based on a number of agency relationships; that there are costs resulting from an agent performing services for a principal; that the costs arise because there are divergent employee and shareholder objectives; that these costs are impossible to avoid because of the information asymmetry between principals and agents; that the information asymmetry that exists between shareholders and the Chief Executive Officer is generally considered to be a classic example of a principal-agent problem; that the agents (the managers) are working on behalf of the principals (the shareholders), who do not observe and cannot always observe the actions of the agent; that this information asymmetry causes the agency problems of adverse selection and the moral hazard of the agent not taking responsibility and the full consequences of his actions. This may be a great over-simplification but I think it suffices for our discussion.

For our purposes, also, we can focus on just two of those assumptions of agency cost theory. The first assumption is that there is a necessary conflict of interests between the executives, whom we may call the agents, and the shareholders, whom we may call the principals of the firm. Put simply, the agents and the principals pursue different and conflicting utilities. The second assumption is that we can reduce that conflict by giving the agents a greater share in the enterprise, in effect making them more like principals and less like agents.

## Executives and Risk

I had always thought that the agency cost approach was rational one. Moreover, I thought that these objectives were not only rational but also achievable. I cannot be the only one that thought so. Notwithstanding that Agency cost theory was once considered innovative, even radical, it has certainly become one of the principal bases for rewarding executives, especially in North America, over the last twenty years.



However, there have been criticisms of the agency cost approach. Perhaps the most popular criticism, and perhaps the least defensible criticism in purely economic terms, is that it over-rewards executives in relation to more junior employees. Another view, which became popular in academic circles over the last several years, is that much of the spectacular failures in contemporary corporate governance may be attributed to the increasing popularity of theories, such as agency cost and its approach to pricing and rewarding corporate executives

and other managers. In fact, Samantra Goshal went further to argue that business schools indoctrinate business students in those theories, which suggest that executives are expected to be selfish and self-serving. In this way, Business Schools are developing a cadre of managers who are devoid of any sense of moral responsibility and convinced that they should behave in a selfish and self-serving manner.

Even Michael Jensen himself, one of the original proponents and current principal standard bearer for agency cost theory, has added his word of caution. Most recent criticisms have just focused on the fact that the principal objectives of the agency cost approach, shareholder value maximization, have not been met. Even Jensen has now to some degree retreated from the approach of transferring shares in the corporation to the executives as reward for services. He now argues:



*I have long supported increased managerial holdings of equity to reduce the conflicts of interest between stockholders and their agent managers. However, the vast increase in the use of standard options in managerial compensation plans in the last decade does not suffice to identify managers' interests with their stockholders and with society. My purpose here is to call attention to the fact that typical executive stock options are not structured properly and as a result reward managers for taking actions that destroy value. And because standard executive stock options are flawed I recommend that companies not use them.*

We may well be indicting agency cost theory for what it fails to achieve, but perhaps we should be indicting it for what it has actually achieved. {16} We now know that while agency cost theory promotes and rewards executives for their successes, it does not really punish them for their failures. It may well be that agency cost promotes risk taking, and risky behaviour of the part of senior executive and this is what is accountable for not only the most recent financial crisis, but also for the several crises we have had in modern times. Even the largest and most profitable corporations occasionally fail and we have learned that the failure of large corporations are likely to have a far more debilitating effect on economies than even many small ones. Indeed, in recent years we have been introduced to a new term in economics: 'Too big to fail!'

## Corporate Failure

This is not only an international phenomenon by any means, as we can point to many examples of corporations in the Commonwealth Caribbean region, especially in financial services, which were once shining examples of great success that have now disappeared, or are struggling to

maintain their existence. CLICO may just be our most recent example, and the effects of that meltdown is been felt elsewhere in the OECS even if it may not be of significant concern here in the Federation.



My former colleague at the University of the West Indies, Wilberne Persaud, who was himself a former director of FINSAC, the financial apparatus set up to assist Jamaica's recovery from the spectacular failure of its financial services industry several years ago, is a columnist on financial matters with the Gleaner newspaper. In his most recent contribution on the subject, he asked if the meltdowns in Jamaica, Wall Street and CLICO were similar. Persaud concludes—

*CL Financial is entirely similar, a clear parallel to the groups of indigenous financial-services firms in Jamaica that suffered meltdown in mid-1996. The first move is to create a group or stable of financial-services firms. Solicit funds for legitimate financial instruments such as mutual funds and unit trusts, insurance products that are in effect, fixed deposits with no withholding tax. Use these funds to acquire or develop businesses in completely separate fields. Pay principals of the group enormous sums in actual money, property holdings and/or other assets, regardless of the value of their inputs and obviously with no regard to fiduciary responsibility. The CL Financial business model, should one take the latitude of so describing this procedure, was one of offering high fixed interest deposits attached to insurance or annuities defined and accepted by the authorities in Trinidad and Tobago as insurance products.*

Persaud's article came on the heels of the announcement that the Central Bank of Trinidad and Tobago and CLICO itself had sued former CL Financial chairman, another of its senior executives and three associated companies. The substance of their claim is that CLICO was used by its executives to provide funds, security and guarantees for other entities within the group, businesses in which CLICO had no interest or insufficient interest to justify its level of financial input.

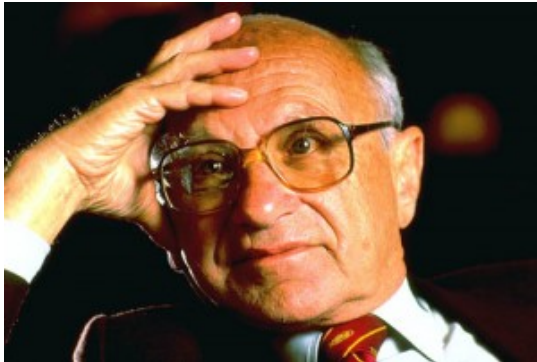
An important characteristic of all these failures, whether it is in Jamaica, on Wall Street, or of CLICO, is that we do attribute them and the consequences that follow from them to inept or dishonest executives. Arguably, we should also attribute such failure of our executives, and their consequences, to lax oversight of the board of directors. After all, one of the generally agreed roles of the board of directors is to provide oversight of the executives and officers of the corporation. Attributing responsibility for corporate failure to directors and executives is probably quite appropriate. Considering that directors and executives readily accept responsibility for the successes of the corporation, so should they be accountable when the corporation fails.

I have argued above that, over the last twenty or thirty years, we have developed matured ideas and coherent schemes of how to reward successes at the executive level. {20} Indeed, we could well argue that we have developed coherent schemes for pricing and rewarding employees at all levels of the organization, even if you do not accept my preferred agency cost approach. I doubt very much that if today you were to establish a new post in the St Kitts, Nevis and Anguilla National Bank and sought someone to fill it, that your human resources managers would have great difficulty determining the appropriate wage or salary for that post in the labour market of the Federation or the OECS. And, increasingly, we are agreeing that some form of gain-sharing is appropriate in the reward package for all levels of employees. On the other hand, what we have not achieved with a similar degree of success is the development of a process for treating with the employee when she fails, and more especially when her own actions leads to the catastrophic failure of the corporation.

Moreover, this disjunction of rewarding the executives for the successes of the organization while not punishing them for its failures, promotes in the organization a tolerance for risk. The new economic formula is, "Heads I win; tails I do not lose." This approach is undesirable in any organization, but it most especially so for an organization in the financial services industry. If recent history is prologue, then this approach should be completely intolerable for large financial institutions since the consequences of their failure are so dire.

## **Risk and Theories of the Firm**

How then do we deliver ourselves from this oppressive prophecy; how can we effectively attribute responsibility and accountability for both successes and failures? It may not really depend on how we see the corporation. There are many theories of the firm, but even if we take two extreme examples, the threats remain the same. Whether we see the corporation as a simple instrument of agency representing the interest of the shareholders, on the one hand, or as an independent economic person, pursuing its own objectives and representing a host of conflicting stakeholders, on the other, we are still faced with the problem of risky behaviour by the executives.



If we accept the first interpretation, that the corporation is simply an agent of its shareholders, then we can readily accept Milton Friedman's injunction that managers should have no objectives other than to increase shareholders' value. You may recall Friedman's prescription:

*There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud. (p. 60)*

Under this theory of the corporation, managers should pursue no objectives independent of their shareholders. In this case, the duty of the executive and the board is to ensure that, first, the corporation is profitable; second, that the corporation's profits increase its value; and third, that the value is returned to the shareholders. The latter point was critical to Friedman's thinking and may well be inconsistent to how many managers now see their role as agents; that is, to create value but not necessarily to distribute it. Friedman was adamant that any profit made by the corporation should be passed on to the shareholders to be applied as they wish, and not kept in the corporation for its use. If we accept Friedman's view, then we should note that there is a necessary subtext to it. If the objectives of the executives and directors are to increase shareholders' value, then in implicit in that must be the responsibility not to destroy shareholders' value. Executives and directors should not engage in activities that put shareholders' values unnecessarily at risk, but that is precisely what happens, and precisely what we have to worry about, even if we accept Friedman's view of the firm.

On the other hand, we can pursue the concept that the corporation is something sui generis; something organic; something with an independent personality and independent objectives. In this case, the corporation's principal responsibility is to survive and to grow, as any organic thing. As such, the executives and directors need to negotiate with the corporation's suppliers and providers of goods, services and other rights, those contracts and licences that it needs to survive and to thrive. From this perspective, the shareholders are just one set of many

stakeholders that managers of the corporation must satisfy; and from one point of view they may not even be the most important. We are now invited to see stake holding and corporate social responsibility in much broader terms. {27} Thus, from Michael E Porter and Mark R Kramer's perspective, community outreach such as yours, to sports, education, culture and youth development, for example, take on a necessary and utilitarian value that is essential for the success and wellbeing of the corporation.

I must confess that, intuitively, I find this approach disturbing but I cannot disabuse myself of the realization that there is something plausible, even if it is at the same time intuitively unacceptable, in viewing the corporation as a sui generis independent agency. However, even if this approach is accepted, we are still faced with the problem of ensuring that our executives remain accountable. Indeed, one may argue that this view of the firm makes the executive even more unaccountable than Friedman's view, and thus more prone to risky behaviour.

## Accountability

Whatever is our view of the firm, whether we see the enterprise simply as a proxy for its shareholders or we see the firm in more complex economic terms as something independent of the shareholders, we must recognise that, at the very least, a principal responsibility of the executives in all cases must be the preservation of the company's assets. A second consideration must be that the executives should seek to enhance the value of the enterprise.

A certain tolerance for risk is necessary in any case. How high that tolerance will depend on a host of factors, including in part on the industry in which the enterprise is engaged. In principle, we can incentivise our executives to preserve the assets or to achieve growth. In the real world, however, we are faced with something like the Parable of the Ten Talents: No investor wishes to incentivise a manager of an asset simply to maintain what he is given. Certainly, one measure, perhaps the principal measure, of the success of the St Kitts, Nevis and Anguilla National Bank is the extent to which the directors and executives have increased the assets of the organization. Thus, our managers are expected to increase what they are given; and, if they expect to attract more investments in the enterprise that they are charged to manage, they must provide greater returns. This, of course, means that our managers have an incentive to take greater risk. The critical question is whether our managers can be incentivised to achieve both growth of the organization as well as the preservation of the assets.

So we are confounded with this question of finding the right balance between incentivising for increasing the value in the enterprise, yet avoiding unnecessary risk. It may well be that in the St Kitts-Nevis-Anguilla National Bank group you have an institution that could provide us with

the answer. In your group is the National Caribbean Insurance Company Limited. {31} The business of insurance is risk, and insurers have long realised that one way of reducing risky behaviour of the insured to remove the moral hazard of that behaviour. The insured are therefore required to take the consequences of their actions. In short, in different ways, insured persons share in the consequences of the risk.

We were all a little uncomfortable last week at the St Kitts-Nevis-Anguilla National Bank Corporate Compliance Seminar when Mr Gerald Mendez, the insurance executive from ICWI, reminded us of that fact. The implication of our joint response to his presentation is that all of us, not just business executives, are gamblers. But in requiring us to have an insurable interest before issuing a policy of insurance, in not paying the full value of the loss when we under-insure, in not paying in excess of the loss when we over-insure, and in requiring us all to share the first part of the loss even when we are adequately insured, remove from us the moral hazard of risky and irresponsible behaviour. The lesson from the insurance industry is reasonably clear, and it adds a new dimension to agency cost theory: Sharing the risk of the loss reduces that moral hazard of risky behaviour. There is no reason in principle we should not adopt a similar approach to pricing and rewarding executive action.

If we now accept that gain-sharing is an appropriate method of rewarding executives, and that executives should now receive a share of the value they create for the firm, why should they not also share in the loss that their risky behaviour generates? Especially when we also know that if people are rewarded for taking risk but are not exposed to the adverse consequences that flow from risk taking, then they will always take unnecessary risk. In other words, without removing the moral hazard, executives will always gamble with the assets they are charged to steward. There is no reason in principle then we should not adopt a similar approach to moral hazard in pricing and rewarding executive action.

Another approach to avoid the moral hazard associated with executive risk-taking is to promote transparency inside the corporation, perhaps in the form of whistleblowing procedures. The thesis is that all employees, as well as the executives, are less likely to pursue undesirable conduct if that conduct is open to scrutiny. Although the evidence is not conclusive, whistleblowing procedures in an organization might help.

Whistle-blower legislation is not yet a common feature of the Commonwealth Caribbean landscape, and there as yet is no equivalent in the region of the UK Public Interest Disclosure Act 1998, although it has been on the political agenda for many years. Bills on the subject have been brought to the legislature in some jurisdictions. Neither is this need being met by private sector initiatives or any public-private partnerships. There is nothing in the region such as the



British Standards Code of Practice on Whistle Blowing, and thus, for this reason, the need for state intervention may be even more pressing. The need for legislative reform is especially demanding, as the existing law is so inadequate. As Davis Lewis explains, the existing duty of fidelity under the common law can be used to prevent disclosure of information by members of staff of improper acts of the executive:

*The common law has never given workers a general right to disclose information about their employment. Even the revelation of non-confidential material could be regarded as undermining the implied duty of trust and give rise to an action for breach of contract. In relation to confidential information obtained in the course of employment, the common law again provides protection against disclosure through both express and implied terms.*

The argument that is being advanced here is that to reduce executive risk-taking and to make our executives more responsible requires reducing or eliminating moral hazard for risk-taking. Reducing moral hazard requires greater oversight and accountability. Oversight and accountability can in part be achieved through greater transparency. However, this is just an argument. Whether this will work is a challenge for us to address in the future. Indira Carr cautions us that 'There are no available comparative statistics relating to number of complaints about malpractices involving whistle-blowers to assess the success of the legislation.' {37} However, once we accept the hypothesis that transparency and accountability reduces moral hazard in the principal-agency relationship and thus reduce risk-taking, then it should be generally accepted that transparency in general, and whistle-blower protection in particular, will advance the moral hazard or irresponsible conduct.

## Conclusion

I had intended in this lecture to be a little provocative; to invite you to consider solutions that are not traditionally put on the agenda. The emerging discourse is that management behaviour, and in particular executive risk-taking, is a significant contributor to constantly recurring business crises we have had over the last two or three decades. {38} My principal thesis is that we have got in the practice of incentivising risk-taking among our executives, while doing nothing to remove the moral hazard of that behaviour. It is almost inevitable, therefore, that some executives, and perhaps too many, will behave irresponsibly. To remove that moral hazard, we should invite our executives to share both the risk of success and risk of failure and expose their conduct inside the organization to greater scrutiny and transparency. That is a very tall order.

It may be difficult to promote this type of shared responsibility and transparency in the modern

corporation, but it not impossible if we are willing to think outside the box. Indeed, the solution may necessarily require that we think outside the box. It is what is necessary to remove the moral hazard of risky behaviour.

I had asked the question earlier whether it is possible to incentivise the executive to pursue growth, which means taking risks, while at the same time seeking to preserve the assets of the corporation, which means avoiding risk. The obvious answer must be no. We cannot optimise in two opposite directions at the same time. {39} We are in effect seeking compromise; an appropriate balance between risky behaviour and preservation behaviour. I can think of no better way to achieve this than to ask the executives to share both sides of the equations with the shareholders, the rewards as well as the loss.