Banks and corporate accountability: The challenges of shareholder primacy and rise of social accounting

By Calvin Benedict | January 2014

1. Introduction

"[The] divorce between accountability and power strikes at the heart of any notion of democratic governance. [It] is not just economic. It is also constitutional" (January 14, 2014) – Martin Wolf, chief economics commentator at the Financial Times.

Beyond the requirements of the law, beyond compliance there is an ongoing debate as to whether banks have a greater external moral and social obligation. These obligations typically fall under the dynamic and extensive literature on corporate social responsibility (CSR). Several definitions of CSR currently exist. However, in essence, CSR examines the role of corporations in society beyond their respective regulatory requirements and the positive societal outcomes of their operations. Post the Global Financial Crisis (GFC), there have been echoing calls across the public and political spectrum for banks to sacrifice profits derived from "socially useless" exotic financial products that have little, if any, broader social benefit. These calls have triggered a powerful contemporary phenomenon termed by the author as the 'socialization of financial markets'. The phenomenon shines a light on the rising popularity of the belief that banks must account for broader social welfare in their financial and business decisions. This phenomenon implicitly dictates that it is no longer possible for banks to assess their activities and decision-making within the solitary confines of profitability. However, against this backdrop, bank management are faced with a fiduciary duty to act in the best interests of in the corporation, which – as this paper argues – has insofar become *wrongfully* synonymous with maximizing shareholder wealth. The doctrine that corporations have a single, exclusive purpose of focusing on shareholders' interest by maximizing their wealth is known as 'shareholder primacy'.

The information asymmetry concern of how do we measure and assess the CSR of banks is one that this paper seeks to discuss. At present, corporate accountability disparities exist between what banks are doing and what they are reporting. The disparities to some extent emanate from the observation that there is very little market transparency, despite the vast amount of available information. Therein lies the paradox observed by Professor McCormick:

"The difficulty arises when one tries to analyse the large amount of material made available, separate the hard facts from the statements of opinion, acknowledgements of room for improvement (which tend to be scarce) from self-acclaim (which tends to be plentiful) and find any kind of data that enables one bank to be compared with another".

As such, this paper surveys (i) how shareholder primacy is shaped by the socialization of financial markets and (ii) the efficacy of the integrated reporting initiative being undertaken in the evolutionary field of corporate accountability. To give a sense of concreteness to the relationship between CSR and corporate accountability it is useful to envision the following two-part scenario:

1. If the board of a retail bank discovers that a financial product sold by a commission-driven sales team is earning them substantial profit margins – do they commend the sales team for their successes and increase sales targets, or do they ask searching social responsibility questions to ascertain whether the product is truly in the consumer's best interest, and whether there are sufficient controls in place to offset any dangers posed by moral hazard ?
2. If the bank is later approached by regulators, who have verifiable evidence of the toxic nature of the said financial product, and subsequently agree to enter into a settlement (with no admission of guilt and criminal charges, of course) – how and to what extent does this bank disclose their corporate [ir]responsibility to shareholders and stakeholders alike?

2. Shareholder primacy and the socialization of financial markets

The debate on the social and moral obligations of public corporations garnered considerable publicity and prominence in 1932 when the *Harvard Law Review* published opposing articles by two leading academics. On the one hand, Adolf Berle argued for shareholder primacy – viz. "all powers granted to a corporation or to the management of a corporation, or to any group within the corporation... are necessarily and at all times exercisable only for the [rateable] benefit of all the shareholders as their interest appears". On the other hand, the view that corporations existed primarily to maximize shareholder wealth was resoundingly rejected by Merrick Dodd. Dodd asserted that a corporation must offer a social service as well as a for-profit function. Predicated on this argument, Dodd opined that the purpose of a corporation and its management transcended shareholder wealth maximization and included its contribution to broader social welfare. The prevailing market sentiment favoured Berle's shareholder primacy tenet as evident in 1970 when Nobel laureate Milton Friedman, a champion of free-market economics, famously articulated:

"There is one and only one social responsibility of business – to use it 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".

The legality of shareholder primacy is a contentious topic. Corporate directors, as part of their fiduciary duties, are typically required to act in the best interest of the corporations, but there is debate surrounding whether 'best interests' only includes shareholders or a wider array of stakeholders. This author supports the view of *Reinhardt et al.* that although the judicial record is somewhat supportive of maximizing shareholder wealth, there is an unequivocal legal freedom on an international level for corporations to sacrifice profits for the benefit of greater social welfare.

From a retrospective viewpoint the GFC was a self-fulfilling manifestation of Berle's shareholder primacy tenet, whereby banks disregarded broader social welfare in favour personal financial enrichment for themselves and shareholders. Exuberant financial innovations in the scale and complexity of derivatives and securitization, spurred by light touch regulation, generated unprecedented short-term financial returns for shareholders. When the bubble burst, though, and shareholders came to terms with the bleak reality, one truism became abundantly clear: the underestimated social problems – including stringent austerity measures, mass unemployment, and an explosion in bankruptcies and property foreclosures – caused by the interconnectedness and opacity of 'too-systemically-important-to-fail' financial institutions and the solution thereof in the form of taxpayer-funded government bailouts. A recent article in *The Guardian* on the ascendancy of the financial sector concisely summed up the latter:

"Consider, for instance, the policies to confront the crisis. First, public funds were injected into banks to boost capital. Second, public liquidity was made available to banks to sustain their operations. Third, public interest rates were driven to zero to enable banks to make secure profits by lending to their own customers at higher rates. This extraordinary public largesse towards private banks was matched by austerity and wage reductions for workers and households".

The public view of banks and their social obligations forever changed when taxpayer funds were used to bail them out for risks that they failed to internalize. Moreover, a political and media storm ensued when it was discovered that bailout money was used to pay for remuneration bonuses. For sure, it is very difficult to justify that the bailout money was well spent. Banks subsequently returned to enviable profitability, the almost universal acceptance of the neoliberalism ideology that the 'market knows best' became largely debunked and along came a more intrusive regulatory regime. However, the moment when banks received the bailout funds, was also the moment they ventured into unchartered territory of higher public accountability and, whether they agreed to not, took a wider societal role. The socialization of financial markets had begun. Since then, banks have assumed the (seemingly uneasy) role of being a for-profit enterprise and yet still being accountable to the public domain. After all, it could easily be contended that many of these banks are only still in business thanks to us, the all too trusting taxpayer. Questions, however, remain as to whether this heightened corporate accountability in the financial sector has hitherto amounted to empty, meaningless rhetoric.

3. Corporate accountability

Conceptually, corporate accountability reporting is much broader than corporate accounting in that 'accountability' reporting in contrast to accounting, can serve as a driver for corporations to disclose externalities that are not typically captured by conventional accounting definitions of revenues and expenses. The resulting externalities can be classified as 'positive' (e.g., community development programs) or 'negative' (e.g., regulatory capture and the destruction of ecosystems). Once banks are assessed in this manner, we can examine their behaviour, not only as just market players, but more generally within a societal context. Corporate accountability thus necessitates that a greater emphasis is placed on a holistic view of performance by focusing on disclosures surrounding environmental, social and governance (ESG) issues. Following international momentum in examining the traditional domain of corporate accounting practices KPMG, one of the 'Big Four' auditors, has openly stated that:

"The mismatch between current corporate reporting and business value has become increasingly apparent in the volatile business environment of the last five years. The focus on current year performance may go some way towards helping readers understand 'business as usual' but it is not enough to provide a complete picture of long-term value".

3.1 The rise and legitimacy of social accounting

Equally apposite to this discussion, is the global adoption of social accounting practices – whether voluntary or driven by market forces – which can be seen as arising to address the need for banks to assume a higher level of corporate accountability. By definition, social accounting as its name indicates is a process whereby corporations report on their social, environmental and economic ('triple bottom line') performance and impact. Social

accounting and sustainability has become inextricably linked in the minds of many. In this light, social accounting is a means to an end, not an end in itself as it encourages the integration of sustainable business practices into core business strategy.
For the purpose of this paper, the legitimacy of social accounting and corporate accountability can be distilled into one question: should banks conduct themselves in a manner that factors in wider social welfare or, as Berle and Friedman suggest, merely chase after profits (ideally to the extent that this complies with the law)? Ultimately, the answer to this question should determine what financial and non-financial information they must disclose. As touched upon earlier, there is a rising convergence in civil society and politically post-GFC for banks to adopt Dodd's view by operating on a sometimes conflicting paradigm – that is, to deliver social welfare and still be profitable. JP Morgan's 2012 Corporate Responsibility Report corroborates this view:

"[Today] doing business as usual is not sufficient. Rather, we believe we have an affirmative responsibility to play an even bigger role in helping solve the economic, social and environmental challenges of the day".

Indeed, these words could be perceived as just a PR ploy since over the past year JP Morgan has paid in settlements almost $20 billion to regulators. Nevertheless the statement signifies that there is a general recognition of the vitally important role that banks play towards achieving the realization of public policy objectives such as financial stability and sustainability. More importantly, where on the continuum between societal welfare and profitability should banks consider as the 'silver bullet' for them to operate? Logically, if banks are to continue business in the foreseeable future they must have a relatively strong bias towards profitability as a result of the increasing competitive pressures they face. The nature of for-profit enterprise is therefore fundamentally important but the trouble comes when we take a purist market view by seeing revenues, expenses, assets, liabilities and cash flows as the *sole and only* barometers for performance and success. We must now bridge the gap between traditional corporate reporting and social accounting to provide a more complete perspective of performance and value.

As a peripheral note, there are certainly instances when profitability and social welfare go hand in hand. For example, providing credit facilities to impoverished communities via microfinance allows banks to earn fees and stimulates entrepreneurial activities in these communities. To differentiate themselves from competitors, some banks have even embraced environmental reforms along the lines of advertising themselves as 'carbon neutral'. The benefits in these instances are twofold. Specifically, banks gain positive reputational externalities accompanied by a rise in profitability and shareholder value.

By contrast, ethical as well as managerial dilemmas under the hegemony of shareholder primacy tend to arise when profitability and social welfare conflict. Subsumed in the notion of profitability is risk-taking; for without risk-taking it is next to impossible to consistently yield large returns if we choose to accept that there is no 'free lunch'. The risk taken by banks may not necessarily contribute to social welfare. A simple example, non-banking of this occurs in the environmental sector: firms, on the basis of profitability, are sometimes encouraged to exceed carbon emission quotas and pay for their legal risk instead of actually lowering their carbon footprint. Accordingly, due consideration must be allocated to the external forces that shape corporate accountability and social accounting.

The role of the law suffices as a meaningful starting point for discussion. The relationship between social accounting and the law is, admittedly, rather opaque. Recent advancements in social accounting, in the form of industry-led ESG codes and standards, tend to lack the enforcement mechanisms provided by regulatory regimes. The law is making some headway as evident by the "apply or explain basis" that companies listed on the Johannesburg Stock Exchange publish an integrated report in place of their annual financial report and sustainability report. That said, normative inquiries have surfaced in relation to whether advancements of this nature should in fact be regulated.

To this end, it is counter-argued that if social accounting is regulation-led, as opposed to market-led, then disclosures become more boiler-plate and compliance orientated. By all appearances, for a market-led initiative to be of value, it must be relevant to the firm engaging in it. The author sympathizes with the views of many CFOs, who already argue that there is too much corporate reporting. Where social accounting results in highly esoteric, compliance-driven disclosures that really only serves the purpose of regulators there is almost no real social utility in such an endeavour. However, where social accounting results in readily understandable and verifiable disclosures that promotes an enlightened sense of stewardship and accountability there are obvious broader social benefits. This paper limits the discussion of social accounting initiatives to work being carried out under the rubric of 'integrated reporting'.

4. Integrated Reporting: A Panacea?

The International Integrated Reporting Council (IIRC) was formed in August 2010 with the remit of creating a globally accepted integrated reporting framework for accounting that combines "financial, environmental, social and governance information in a clear, concise, consistent and comparable format – put briefly, in an 'integrated' format"'. Integrated reporting enables the assessment over time of how a corporation creates value and includes a description of: a corporation's current and intended future use of capitals, its value drivers, and the implications on and trade-offs between those capitals over time. Six capitals are considered in the framework that corporations are said to use to create value: financial, manufactured, intellectual, human, social and relationship, and natural. The framework is principles-based and future-orientated, thereby allowing for flexibility, and a detailed discussion of each capital is not required in a corporation's integrated report. Anecdotal evidence suggests that if management incorporate 'integrated thinking' through linking the effects of different capitals in their decision-making, this should be reflected in the corporation's integrated reporting.

The advantages of integrated reporting can fall under the auspices of three classes. First and foremost, there are "internal benefits" that allow for enhanced internal resource allocation decisions, more rigorous engagement with shareholders and other stakeholders, and lower reputational risk. Second, there are "external market benefits", including the provision of ESG reporting for interested mainstream investors and financial analysts. Finally, the third advantage relates to the management and mitigation of "regulatory risk". This advantage acknowledges the increasing wave of global reforms in corporate accountability, and the consequential benefits of participating in the development of frameworks and standards.

The most recent undertaking of the IIRC is its Pilot Programme, an industry-led initiative designed to develop and test the principles, content and practical applications of integrated reporting. The IIRC will run the programme until September 2014, following the publication of the "International Framework" in December 2013, to allow participants to test the effectiveness of the framework during their reporting cycle. The financial sector has a strong presence in the Pilot Programme. According to a published, non-exhaustive list of the 103 participants, 16 can be categorized as part of the financial arena, including:

Name of Corporation	Country	Classification
AEGON NV	Netherlands	Financial services
bankmecu Limited	Australia	Banks
BBVA	Spain	Banks
BNDES	Brazil	Banks
DBS Bank	Singapore	Banks
Deutsche Bank	Germany	Banks
Deutsche Börse Group	Germany	Financial provider
HSBC Holdings plc	United Kingdom	Banks
Itau Unibanco	Brazil	Banks
LeasePlan Corporation N.V.	Netherlands	Financial services
National Australia Bank Limited	Australia	Banks
Prudential Financial, Inc.	United States of America	Financial services
STRATE	South Africa	Financial services
Turkiye Garanti Bankasi Anonim Sirketi	Turkey	Banks
Uralsib	Russian Federation	Financial Services
Vancity	Canada	Banks

A November 2013 report by the Financial Stability Board provides for the latest list of global systemically important banks (G-SIBs). The list names 29 banks and of that list HSBC Holdings plc, Deutsche Bank and BBVA are the only banks that have adopted the Pilot Programme. This amounts to just over a 10% uptake among the G-SIBS, which highlights just part of the picture of the challenges levied on the industry-led initiative. As an organisation the IIRC has made commendable progress in bringing integrated reporting closer to being embedded within mainstream business practice and should be applauded for their efforts. But, as this is a market-led initiative, there is only so much they can achieve alone and a number of challenges remain to be addressed in the future:

1. **Inconsistency:** There is no globally accepted framework or organizational consistency specifying what type of information should be presented in integrated reports. As a result, no cohesion exists on what metrics should be used as key performance indicators for corporate accountability. It is hoped that specific sector guidance can be agreed upon to accommodate the idiosyncratic reporting requirements of different industries. For example, when banks say that they are committed to 'sustainability' we need to ask ourselves two questions. Firstly, what does 'sustainability' actually mean in a banking context and is there a common consensus around this meaning? Second, what standard set of criteria should we test this representation against? Clearly, this is an exercise with considerable complication.

2. **Assurance:** Assuming the problem of inconsistency was solved, an external assurance process for integrated reporting still needs to be developed. The use of external, independent reviews should theoretically increase the robustness, accuracy and trustworthiness of disclosures. The difficulty of providing assurance to integrated reporting must not be underestimated given the volume of qualitative and quantitative data which has never historically been subject to a formal reporting process. Therefore, even if external assurance is provided, there are realistic apprehensions that it will not be done to the same degree of rigour as the audit of traditional corporate reports. Auditors will have to grapple with how to provide a concrete level of assurance on forward-looking reporting that is outside the conventionally accepted price system, say, underlying data on social and relationship capital. This level of assurance must also be balanced with the legal risks that auditors may incur if they are accused on not providing a 'true and fair view' of the underlying data.
3. **Institutionalized practice:** How do we make integrated reporting an institutionalized industry practice? Proponents of integrated reporting tend to claim that if an industry leader adopts the initiative, its competitors (perhaps by virtue of external social pressures) may follow suit. Along the same vein, in the financial sector it could be further asserted that the 10% of G-SIBs who signed up for the Pilot Programme may be rewarded for their willingness to innovate and gain what some call a 'first-mover advantage' that may, in turn, propel the others into action. Whether or not such a trend eventuates is left to be seen, but if the events of the past and ever-converging global desire to seek positive ESG changes, particularly in the behaviour of banks, do not elicit the breaking down of dogmatic corporate reporting silos, one wonders what will.
4. **Ad hoc reporting:** Aside from external assurance, it is crucial that management strive to attain congruency between what is stated in their integrated reports and how this aligns with their business operations. The very purpose of this initiative is lost, if management opt to 'fix' a report on an *ad hoc* basis rather than addressing the underlying deficiencies in activities and processes.
5. **Reporting burden:** Oscar Wilde said of cynics that they knew the price of everything and the value of nothing. His remark mirrors the concerns of those who have aversions to integrated reporting for the reason that it may increase the reporting burden on corporations and still result in no tangible benefits. If anything, the legislative 'more is better' response to the GFC adds greater credence to this concern and so as integrated reporting evolves close attention must be paid to this.
6. **Commercially sensitive argument:** In the past corporations have relied, often overly so, on the 'commercially sensitive' argument, which they claim over-rides the need for full and transparent reporting. However, this argument lacks credibility if the competitors of these corporations adopt integrated reporting. In the case of banks, we can add another dimension to this analysis. The author believes that the socialization of financial markets may affect the legal and commercial basis extending to when banks can withhold information on the grounds that it will prejudice their commercial position.

5. Conclusion

Quite simply, these challenges must be addressed quickly. It could easily be stated that the current status quo of corporate reporting is untenable especially given the grim climate change predictions, partly stemming from a paucity of corporate accountability – however, our cause for concern is much more encompassing than this. The globalization of finance, aided by a defective belief in shareholder primacy and traditional corporate reporting, have created growing societal inequalities but none, arguably, more so than the 'Lost Generation' of unemployed youth affected by the Eurozone Crisis. In this respect, the latest research figures put youth unemployment as high as 57.7% in Spain and across the Eurozone region it remains steady at 24.2% (which amounts to 3.5 million people under the age of 25). The gravity of the situation cannot be exaggerated. In a public lecture in December 2013, Nobel laureate Christopher Pissarides affirmed that this high youth unemployment has persisted for 6 years and negligible economic growth in the Eurozone will do nothing to tackle the scale of the problem; let alone lubricate the process by which younger generations enter the job market. We are constantly bombarded with talk about a migration towards a more sustainable society and greater corporate accountability, and yet the 'Lost Generation' is already a by-product of our inability to achieve this. Do we wait for the onset of another financial crisis, an environmental catastrophe or higher youth unemployment levels before we feel impelled to act?

The future trajectory of social accounting and the pace at which it will evolve is uncertain, and largely dependent on the future engagement of corporations. Further, the socialization of financial markets has provided a platform to reinforce the adoption of social accounting initiatives like integrated reporting by banks. We, as a society, ought to be in favour of transparency for an avowed aim – to emphasize the interconnectivity between CSR, corporate accountability, social accounting and banks. In conclusion, and as food for thought, it is fitting to pay tribute to the words of T.S. Eliot: "where is the wisdom we have lost in knowledge? Where is the knowledge we have lost in information"?

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