

A conflict of interests? Reconciling the interests of shareholders and stakeholders

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Good afternoon ladies and gentlemen, and thank you to RiskMetrics for the invitation to speak to you today.

The advert you have just seen is one of HSBC's most recent TV ads, part of a long-running campaign that we call "your point of view". What the campaign is trying to say is that we understand that there are many, contradictory points of view in the world on a massive range of issues. We think it is possible, indeed important, to recognise and value those different points of view, even where they may be at odds with our individual sympathies.

These ads were not, of course, intended as a metaphor for our approach to our corporate responsibilities but I think they echo some of the dilemmas that businesses face as they seek to define and meet their responsibilities *vis a vis* their shareholders and other stakeholders.

The debate about the extent of company responsibilities is as old as companies are themselves. At one end of the spectrum, you have a very narrow, short-term and limited definition of those responsibilities – to maximise profits for the business' owners, its shareholders. At the other end of the spectrum is a much more diffuse concept of what those responsibilities are, and to whom they are owed.

In shorthand, these are often referred to as the shareholder versus the stakeholder ideal, with the former model the more overtly capitalist of the two, and rooted in the US. While the stakeholder ideal has a long history in continental Europe, with its spiritual home in Germany, where the famous principle of co-determination still governs much corporate decision making.

Of course, like all stereotypes, these are only partly true. The history of corporations going back the last 150 years provides numerous examples of companies assuming responsibilities unprompted –the Lever Brothers and the Cadbury family in the UK setting up the model villages of Port Sunlight and Bournville to provide decent living conditions for their workers; the landmark \$5 wage that Henry Ford offered his workers; the health and education infrastructure built in America by some of the so-called robber-barons.

However, it is certainly true that if it were ever enough for a company to declare that its aim was solely to maximise profits for shareholders, that is clearly not the case today.

The interests of a wide range of other stakeholders – customers, employees, suppliers, NGOs and the wider public, to name a few – all stake a claim on corporate decision-making. And those decisions are made, and

debated, in the full glare of 24-hour media and public opinion.

The number of companies that has to face this reality is growing. Until recently, the private equity market was able to keep its business just that, private. But that was when it was backing mainly small and mid-market businesses.

Today, with 8% of UK private sector employees now employed by private-equity backed businesses, the industry faces some of the same scrutiny as listed companies. Indeed, the UK industry association's chairman recently acknowledged that private equity "needs to engage with its audiences and explain its role in society". Effectively, the distinction is getting a little blurred and private equity is learning what major companies have been discovering – that businesses today need to articulate a 'social contract' with the societies in which they operate.

Defining that social contract, i.e., defining the extent of a company's responsibilities, and reconciling the interests of the various stakeholders in a business is an undertaking that has become a much larger and more visible part of the management task of any large company in the last few years.

In the past this contract has been largely unwritten. Now it has become a statutory duty for Directors of UK-domiciled companies. The UK Companies Act 2006, which codified Directors' duties, included a responsibility to "promote the success of the company" taking into consideration the interests of employees, suppliers, customers and the company's reputation.

The UK's minister for industry, Margaret Hodge, described these new statutory duties as "articulating the connection between what is good for a company and what is good for society at large".

And what is that connection? It is that the first contribution a business makes to society is through supplying goods and services that consumers want; creating employment; paying taxes and creating wealth. The full effect of these can be hard to quantify, but a detailed study by the charity Oxfam and Unilever of the latter's economic impact in Indonesia four years ago produced striking results. It found that Unilever's business, which employed 5,000 people, actually supported the equivalent of 300,000 jobs along its value chain.

The company's contribution to Indonesia's economy was estimated at US\$630 million and Unilever paid US\$130 million in Indonesian taxes.

defining a social contract

We haven't done this analysis for HSBC – it's a major piece of work – but the impact of our operations will be similarly broad. Last year, we paid some US\$8 billion to our shareholders. But this sum was dwarfed by the US\$14 billion we pay in salaries; the US\$10 billion we spend on our premises and procurement; and the US\$5.7 billion we pay governments in one way or another. And of course we provide financial services to over 100 million customers, including some 2.8 million businesses.

As the *Economist* newspaper, perennially sceptical on the subject of corporate responsibility, noted in a survey at earlier this year:

“The welfare [companies] create in the form of jobs, products and innovation dwarfs anything [they] are likely to do explicitly in the name of CSR.” Or as Rex Tillerson, the plain-speaking Chairman and CEO of ExxonMobil, told shareholders at this year's annual meeting that Exxon had “a corporate social responsibility to ensure the world continues to receive the energy it needs”. The most important corporate social responsibility is to do business well.

When I think about ‘promoting the success of the company’, I'm inevitably drawn to the conclusion that long-term success is fundamentally about sustainable business models. Sustainability begins not with a social or environmental agenda, but in the business model itself. We have to put a sustainable business model at the heart of our strategy.

But what does a sustainable business model mean? I would define sustainability in four senses.

First, and crucially, a company must achieve sustainable profit growth for its owners. Success has to be about profitability. Profits allow a company to reward its shareholders for trusting their capital to it and to invest in the business for future growth. And profits are fundamentally and over the long term the best and only way of measuring the extent to which a company is satisfying its customers, engaging its employees and fulfilling a valued role in society.

So, as Directors and managers, we must never forget that our primary duty lies in the careful stewardship of the capital that the owners of the business have entrusted to us. It is our duty to ensure that that capital works hard for its owners – that it is invested in the business so that it will provide the owners with a decent return over the long-term; and that it is invested prudently, so that its value is protected. Achieving good returns for our shareholders sustainably is our first aim.

The next question is, of course, what makes for sustainable profits? And surely the answer is that achieving sustainable profits for shareholders will only be possible if a company has sustainable customer relationships. And sustainability here clearly depends on a reputation for fair dealing and on trust. To put it crudely, if we go for the quick buck, then eventually customers will vote with their feet.

The third way in which companies need to be sustainable is in their approach to their people. It is surely impossible for any company – large or small – to be

successful in the end without high quality, committed staff. At HSBC, I have 330,000 colleagues around the world, and their understanding of HSBC's strategy, their perception of our brand and reputation, and their opinions of their day-to-day working environment ... employee engagement, in the new catchphrase ... all of these factors affect their attitude and will be crucial to performance.

This is why, last year, we started to measure that engagement with a no-holds barred annual people survey. And it's why we have set ourselves targets for increasing employee engagement, benchmarking our results against other organisations.

We are just getting the results from our second survey that 315,000 – or 93 per cent – of my colleagues completed. And we are delighted that engagement has increased significantly over the last year. But we are not complacent – we still have some way to go to be best in class. What we do know is that without the support of committed employees, no management team, however talented, will be able to be successful in the long-term – because it is your employees who, ultimately deliver the corporate strategy.

Underpinning and interwoven with each of these three aspects of sustainability is a fourth component – a company's commitment to society ... its social and environmental impact. This has become a much more central focus of attention for companies recently. Investors, employees, customers and regulators are all providing the momentum for this,

because they share an interest in the sustainability – in the broadest sense – of a company's activities. We are witnessing a growing intensity of governance and SRI dialogue with all our stakeholders.

The rise of sustainable and responsible investment – in the US, more than 10 per cent of investments that are professionally managed involves SRI – reflects investor appetite for sustainably-managed companies, ones whose goal is long-term profits combined with ethical values.

You certainly see it amongst colleagues. We know from our own people survey that our sustainability a major factor for my colleagues. Employees want to work for an organisation that is respected and of which they can be proud.

And any graduate recruiter will tell you that a sustainable business model – including our direct environmental impact – is a major factor today in a company's ability to recruit top quality graduates.

You see it among consumers now, too. Consumers put sustainability issues – specifically climate change, poverty, food and water shortages – high on the agenda of their concerns in a PricewaterhouseCoopers survey published earlier this year. No wonder then, that coverage of sustainability issues in the media has increased 10-fold in the last decade.

You see it too among regulators and other supervisory authorities. As I travel around the world and meet with the authorities in different markets, one of the issues they raise most frequently is the importance they place on banks making a contribution to economic development,

**sustainability,
success and profits**

particularly through support for the SME sector that is so important in creating jobs and prosperity.

So you need to be sensitive to this. You need to be seen to be ‘making a contribution’ to society as a whole. It is not good enough to simply demand access under commitments a country makes to WTO.

So what is it reasonable to expect of ourselves? A recent academic paper published by the Harvard Business Review noted that: “Corporations are not responsible for all the world’s problems, nor do they have the resources to solve them all. Each company can identify the particular set of societal problems that it is best equipped to help resolve and from which it can gain the greatest competitive benefit.” The key, the authors believe, is about creating “shared value – that is, a meaningful benefit for society that is also valuable to the business.”

The interesting thing is that – lo and behold! – finding that shared value takes you back to the fundamentals of your business and your competitive advantage. The shared value that companies can create lies in using their competitive strengths to help address societal challenges.

These strengths will vary from company to company. For banks, it means looks at how we use our expertise in financial markets to create new business opportunities. At HSBC, for example, that means we are financing renewable energy; creating SRI funds; backing microfinance initiatives.

One specific example in our case is the creation of rural banks in China, which we are the first (and currently only) foreign institution to do. The creation of these banks is helping meet Chinese policy objectives; they will be profitable in the long term – although the numbers may not be big; and they will support the development of a sustainable rural economy. And this is not coming out of the philanthropic budget. Nor is it incompatible with sustainable overall profitability – in fact, quite the opposite, we believe it is essential to it.

In short, sustainability is about bringing relevant issues together into your own business model; creating shared value for the company, and for society as a whole. For these are the factors which, together, create a company’s reputation and brand. And the brand embodies the long-term **value and values** of a company, highlighting the commonality of interest between different stakeholders. These stakeholders – shareholders, employees, customers and society are all important – but their interests are not always identical. This means that there will inevitably be a number of difficult trade-offs and for the last few minutes, I’d like to talk to you about some real world issues that we and many others face.

My first example is about stewardship of capital – one of the most fundamental duties we owe our shareholders.

In the current economic turmoil, it’s hard to remember that one of the recurring criticisms HSBC faced 18 months ago was that we were over-capitalised. For a sustained period of time, we were under considerable pressure from analysts to reduce our capital ratios, return capital to shareholders and/or increase our gearing. It seems a long time ago now!

But financial strength – and this means not only capital strength, but liquidity strength and the discipline of requiring subsidiaries to raise deposits locally – financial strength has always been an article of faith at HSBC. For the industry as a whole, robust capital and balance sheet strength are now very much back in focus.

Or to take another illustration of the same basic point.

I was asked at one investor meeting why we didn’t sell off our Chinese investments, release the capital and hand it back to investors. Essentially, to close the door on the world’s largest nation as it re-emerges on the global stage. It’s hard to imagine a more blatantly short-termist attitude than that. An attitude that perhaps reflects the fact that the average share on the London market now is now only held for less than a year. But the job of the Board and management must be to maximise the long-term value of the company.

Clearly, it is the responsibility of the Board to constantly assess the business model for continuing viability. There are plenty of examples companies that have failed to do so – and failed. As Keynes said: “In the long run, we are all dead.” But there is an obligation to avoid being whipsawed by the market into short-termism. While the market often puts its finger on a weakness; equally often it’s following a herd instinct. The Board has a duty of care to know which is which.

When the ownership of companies is widely dispersed as it is today managers need to “behave as if there is a single absentee owner, whose long-term interest [we] should try to further in all proper ways”. You don’t manage for the quick buck. So said Warren Buffett – so it must be right!

My second example relates to our employees in the UK. This is a live issue we are trying to resolve – the funding of our pension schemes, especially the final salary part of the scheme. The final salary scheme was closed to new members over a decade ago and newer employees are on a defined contribution scheme.

What are the issues? First, that the final salary scheme is an open-ended liability, whose economics need to be managed toughly. Second, that newer colleagues are disadvantaged financially by comparison with those on the final salary scheme and this risks creating internal tensions. Thirdly, that colleagues on the final salary scheme are necessarily long-serving employees who have devoted a large part of their career to the bank and deserve to be treated fairly.

Addressing these conflicting issues is not easy. We are trying to balance the interests of two sets of employees and of shareholders – and, of course, many staff are shareholders as well as employees. We’re in the midst of this. A set of proposals has been sent to affected colleagues for their comments. Realistically, I think it will be impossible to entirely satisfy everyone but we have a duty and interest to try and find a fair resolution.

Third: customers and environmental policy.

Over the last few years, we have had to put in place a number of policies that guide how we do our business in environmentally sensitive sectors such as mining, water,

creating shared value

forestry, and chemicals. We have also signed up to the Equator Principles governing project finance.

On occasion, these policies have brought us into conflict with customers whose activities do not meet the minimum standards set out in our policies – for instance, customers undertaking logging in south-east Asia, which in the past has been an important business. The dilemma here is that customers are operating legally but they are not operating sustainably. To what extent do we have the right, unilaterally, to make that judgement? The answer, of course, is that we are paid to make those judgements – there are a number of businesses that we simply do not finance, weaponry, for example, or operations in UNESCO World Heritage Sites.

When we do find a customer and our policies in conflict, our first approach is always engagement – through interaction and dialogue we try to work with customers to improve their sustainability. And in many cases we are able to resolve the issues and continue our relationship. This is a win-win – improved sustainability meets profitable business. But inevitably, there will be some cases where the differences cannot be resolved and,

regrettably, we have had to withdraw from the relationship. In the end, we have to do what we believe to be the right thing for the long-term.

Where do you draw the line? There are no easy answers to this. But you can no longer treat the question as irrelevant.

The general point is that reconciling these conflicts must be done with a view to the long-term interest of the company, and with regard to the differing interests of the organisation's various stakeholders. Balancing these responsibilities, and managing sometimes conflicting interests, is inevitably a matter of judgement. Some decisions will not win you the popularity stakes, especially in the short-term. But ultimately, managing the business for the long-term is about balancing our responsibilities to all those who have an interest in the business' long-term success.

And the fundamental principle – an optimistic one – is clear: with that long-term strategic focus, the responsibilities are **not** incompatible, they come together as the surest basis for sustainable profit performance, and for an enduringly valuable brand.