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Corporate Governance in the Knowledge Economy

Lessons from Case Studies in the Finance Sector

Paul David Richard Griffiths

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To the wonderful women who have contributed to shape who I am

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CHAPTER 1

Introduction

With the transition from the Industrial Economy into the Knowledge Economy a formidable series of new challenges come to the corporate governance space. Although this transition has been happening gradually for close to five decades, there was an abrupt inflexion point in 2007–2008 that revealed to us how outdated many of our methods in management and governance are. Until then, the old Industrial Economy methods developed over 200 years and fine-tuned as part of the new world order that was established after the Second World War worked reasonably well.

Three key global phenomena happened in the 2007–2008 moment in history, each of which individually would have accelerated the transition but would not have caused a step change—it was that they happened simultaneously that made us change gear from evolution to revolution, particularly so in the financial services sector. The three phenomena are, first, the advent of the Great Recession with the devastating effect it had on the reputation of the financial sector that spilled over to the rest of business. The second is the technological revolution that came with the coming of age of cloud computing and the advent of the first i-phone and the other smartphones that followed. This led to the creation of social networks and their unplanned side-effect of uncontrolled growth in data that we understatedly called *Big Data*. Finally, at approximately the same

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time we had the Millennium generation or Generation Y with the cultural change they bring, having reached adulthood and making their footprint felt in the workplace and consumer markets.

The conjunction of these three phenomena revealed the preeminence of intangible assets over physical ones, for which our accounting and reporting systems are not prepared. As will be seen in Sect. 2.3.1 in 1975, 83 percent of assets in the Standard & Poor 500 companies were tangible, and only 17 percent were intangible. By 2015 the relationship at the S&P 500 flipped to only 13 percent tangible assets and 87 percent intangible ones, the majority of which are in the form of intellectual capital. How can we govern organisations with reporting systems that give us granular visibility of only 13 percent of assets? Even more important than this from a governance perspective is the fact that intangible assets being shareable radically changed the competitive landscape. While in the industrial era success depended to a great extent on taking control of physical raw materials and other resources and thus confrontational competition, in the knowledge economy no organisation creates value on its own but requires collaboration with multiple other organisations. This requires a radical change in the approach to governance and gives way to the following point.

The occurrence of the three phenomena reinforced a trend that was already happening, that is that the financial sector like the rest of the business needs to become sustainable, by which we mean that businesses need to integrate socially in their community and physically in their environment. As a result of this companies, especially in the Anglo-Saxon financial systems, could not focus only on the interests of shareholders but had to prioritise the interests of a multitude of other stakeholder groups many of which have opposing interests. Managing the priorities between stakeholder groups is a whole new challenge for governance.

Some of the regulatory changes that came after the 2007–2008 crisis such as Open Banking made incumbent banks lose power and become vulnerable to Fintech. This was reinforced by regulatory changes demanding banks increase their reserve capital, which derived in banks letting go their riskier young clients (none other than Gen-Y!) who quickly adopted the Fintech alternative. As a result of this the traditional standards for the governance of the financial sector, based on a relatively small number of licenced and highly regulated financial institutions, whose activities were circumscribed to the borders of a nation state, were no longer adapted to the new reality of a sector with a far

greater number and diversity of players operating under varying degrees of regulation and many of whom operate cross-borders.

Returning to the happening of the three simultaneous phenomena, through push of the Fintechs and pull of their Gen-Y customers, was triggered the need for financial services to become far more digital in a world of data tsunami where risks in cybersecurity are a reality. Cybersecurity, thus, created a series of new demands on corporate governance.

Although the issue of globalisation has been deeply researched in the strategy and operations domains, its impact on corporate governance is far less so. Organisations involved in the international business face a specific set of challenges arising from the clash between their governance standards and values defined at the corporate centre, and the societal culture of the host countries where they have subsidiaries or do business. This is particularly relevant in countries where formal institutions are weak and the voids they leave are filled by informal institutions. This has many implications and challenges from the corporate governance perspective that have not been tackled in the literature.

Finally, if one takes the generally accepted Governance triangle of shareholders, Board of Directors and CEO/senior management team, there is significant knowledge on the relationship between the shareholders and the Board of Directors, and on the relationship between the Board of Directors and the CEO/management team. However, there is a third critical relationship in corporate governance which is that between the CEO/management team and the rank & file of the organisation. This relationship is extremely important to develop an ethical corporate culture and one that protects and enhances the intellectual capital of the organisation.

So, the objectives of this book are (a) to shed needed light on the new challenges for corporate governance that derive from the transition to the knowledge economy as described above, and (b) to fill the gaps in the literature on corporate governance in an international context and on the 'CEO vs rank & file' governance relationship.

To focus on the issues, this book addresses the following question: *What changes need to be incorporated into corporate governance to cope with the challenges posed by the transition to a knowledge economy?*

To facilitate its response, that question is broken down into the following sub-questions:

- *How can corporate governance deal with the advent of the predominance of intangible assets such as intellectual capital?*
- *How does corporate governance need to be adapted to deal with the reality of multiple stakeholder groups many of which have opposing interests?*
- *How does corporate governance need to be adapted to cope with the challenges of digitalisation in the era of Big Data and risks of cybersecurity?*
- *How can multinationals deal with the tension between the headquarters and the subsidiary due to the need to combine the corporation's ethical culture and corporate governance values with the institutional forces of the subsidiaries' host market?*
- *What is the role of the 'CEO vs rank & file' relationship in achieving effective corporate governance in the knowledge economy?*

These questions are tackled in the context of financial services, in the new banking and Fintech landscape that has resulted from the phenomena described above that took place in 2007–2008. The method followed is to develop a series of case studies around four challenges in governance: the hidden cost of poor governance, the adaptation of multinational strategy to local markets, the risks of corruption and the adoption of the Principles of Responsible Banking. The findings of each case study will be mapped onto extant theory in corporate governance and a cross case analysis within each of these themes is performed in search of new insights. Finally, these insights are combined to propose new theoretical conjectures and a series of scenarios of possible developments in corporate governance are produced.

Many of the case studies come from personal experience working as a consultant for blue-chip companies in over 15 countries—such are the cases of Glamorgan FS, Orica, Wells Fargo, MW CPG and the four bribe situations described under corruption. Other cases were developed throughout my academic career either as personal research cases (i.e., Santander Chile, HSBC Mexico, Danske Bank and those on the Principles of Responsible Banking) or by my doctoral research students (i.e., IBM Argentina and BAT Argentina).

The rest of the book is organised as follows. Chapter 2 presents the current status of relevant theory on corporate governance and the knowledge economy. Chapter 3 presents the four case studies and discussion on the hidden costs that result from having poor corporate governance

in place. Chapter 4 presents the three cases on strategy adaptation to local markets and contrasts the outcomes of good and not so good governance practises to extract lessons on how to bridge across different societal cultures. Chapter 5 goes deep into the issue of corruption with four real-life situations on bribing and two cases on money laundering, to emphasise the need to build a corporate culture of performance with integrity. Chapter 6 uses the recently adopted Principles of Responsible Banking to present some thirty years of history of banks working for environmental sustainability and some interesting insights are extracted from comparing three large banks that have enrolled on the principles with another three that have not done so. Chapter 7 synthesises the prior chapters into theoretical conjectures on corporate governance in the financial sector, and develops twelve possible scenarios of corporate governance going forward in a horizon of some fifteen or twenty years. Finally, Chapter 8 presents the conclusions.

It is recommended that the reader goes through the book in the order presented, but it is pointed out that after having read Chapter 2 the reader could alter the order in which Chapters 3–6 are read as they are self-contained. However, all chapters need to be read before moving onto Chapter 7 and Chapter 8.

CHAPTER 2

Conceptual Framework: Corporate Responsibility, Governance, Business Ethics, Culture and the Knowledge Economy

2.1 Corporate Responsibility (CR) as a Framework for Corporate Governance

2.1.1 Adopting a Sustainable Business Strategy

Legitimacy is a prerequisite for private sector business if it is to contribute to society and thus maintain a licence to operate. Unfortunately, over the last two or so decades trust in business has seriously deteriorated in even the most pro-market economies. Departing from the negative aura that emanated from what are perceived as failed privatisations of the 1990s in many regions, through the e-bust and accounting scandals such as the Enron incident of the early days of this century; the role of the financial sector in the Great Recession of 2007–2008; the outrageous 'diesel-gate' scam of 2015 at car manufacturer VW; highly visible money laundering cases at HSBC Mexico and Danske Bank; the cross-selling and false customer account openings that emerged at Wells Fargo in 2016, to the still unravelling accounting (again) case of Wirecard. Businesses are now under pressure to gain legitimacy: the main route they are following is the adoption of corporate responsibility (CR) principles and making promises of commitment to sustainability (Kusnetsov et al., 2007).

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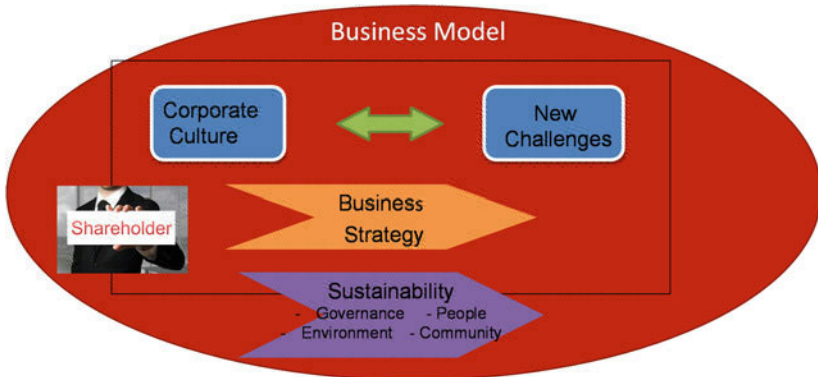

Fig. 2.1 Elements of a sustainable business model of the transition to the knowledge economy (*Source* Author)

In this context, adopting a sustainable business strategy is becoming ever more imperative, and this requires thinking on who are the stakeholders of the organisation, what are their expectations and, above all, recognising that different stakeholder groups often have conflicting interests. Sceptical analysts will be watching out for signs of greenwashing, window-dressing and smoke-screening. Overcoming this requires moving sustainability away from a standalone programme to incorporating the principles of CR into shaping the business model, into building the culture of the organisation, into the setting of new challenges and into the formulation of corporate strategy, as is represented in Fig. 2.1.

The following sections will develop the concepts required to formulate and implement a sustainable business strategy.

2.1.2 Corporate Responsibility: A Framework

Corporate responsibility comprises a series of management principles that enable and facilitate an organisation to fit harmoniously into its social and physical contexts (Capriotti & Garrido, 2006; Griffiths, 2006). Perera's (2003) framework on corporate social responsibility proposes managing and monitoring corporate citizenship behaviour along four dimensions:

a. Corporate governance and ethics;
b. People;
c. Environment; and
d. Contribution to Development.

To take these in turn, Corporate Governance and Ethics in the realm of CR refers to the processes of adopting and maintaining corporate values and objectives, of ensuring transparency, of accepting accountability and of confronting corruption. The need for aligning core business investments with social responsibility requires that the evaluation of fit with corporate values be part of the investment evaluation methodology (Griffiths, 2006, 2007).

Under the dimension of People come issues such as the safety of products and working conditions, labour standards, human rights of its staff and equal opportunities. It has been said (Handy, 2002) that people should be treated as assets (to be nurtured and helped to grow) and not as costs (which are there to be reduced). Key within this dimension of CR is giving staff opportunities for professional development taking into account that the organisation cannot ensure long-term employment, but it should enable the future employability of its staff.

The environmental dimension of social responsibility requires actions and investments in preserving the local and global environment, on cleaner production processes, on eco-efficiency and on environmental technologies. Paramount here is the migration towards non-fossil sources of energy, pursuing a neutral carbon footprint, reducing its water footprint. In other words, the organisation needs to internalise all its environmental costs and not transfer them to society.

Finally, the ‘Contribution to Development’ dimension of corporate responsibility is about showing contributions to education and healthcare, to the development of local small and medium enterprise (SME) suppliers, to closing the digital gap, to promoting community development and other similar initiatives. Peinado-Vera (2006) cites Prahalad (2005) when he talks of the ‘Base of the Pyramid Model’ that ‘combines profits with improving poor peoples’ lives’.

So, what is the relationship between CR and sustainability? Sustainability is the operationalisation of the CR principles into a sustainable business model. As such, it is about actions and behaviours, not principles. A sustainable business model balances financial returns with the principles of CR. This balance is achieved when management performance

is measured, monitored and assessed based on indicators that represent at least some of the four dimensions of CR. This leads to the definition of sustainability as:

> *Business behaviour that creates the trust and commitment of stakeholders, both now and in the future.*[1]

This is a powerful statement with strong words such as 'behaviour', 'trust', 'commitment', 'stakeholders', 'now' and 'future'.

The MacMillan SPIRIT Model (where SPIRIT is an acronym for Stakeholder Performance Indicator and Relationship Improvement Tool) assists in formulating a sustainability model focussed on the stakeholders. The model is applied to define the organisation's sustainability priorities in terms of stakeholder interests, and in designing how to incorporate those priorities into the business strategy.

The application of SPIRIT departs by understanding the external pressures on the organisation and does so by focussing on issues and stakeholders. The external issues vary significantly over time. Over the last forty years there have been tectonic movements that have required organisations to adapt vigorously or succumb. Some of these have been:

- Deregulation and privatisations in the 1980s
- Advent of Total Quality Management at the end of the same decade
- Globalisation and consolidation in the 1990s and onwards
- Industrialisation of emerging economies in the 1990s and 2000s
- Relocation of manufacturing to the newly industrialised world
- Global population growth, with great disparity across regions
- Reduction of extreme poverty but growth of wealth inequality
- Consciousness for the climate crisis as from the 2000s
- Awareness of and unacceptability towards pollution
- Terrorism at an unheard-of scale since 9/11
- Unstoppable migration waves at great volume, especially in the 2010s
- Advent of mobile technologies, social networks and Big Data with its impact on cyber-security
- Threat of Water-wars in several parts of the world

[1] This definition was proposed by the late Prof MacMillan at the Institute of Reputation, Henley Business School.

- Pending US—China commercial war
- Pandemics such as the current Covid-19.

These trends did not come alone. They have been accompanied by significant changes in laws and regulations; new demands on companies by investment funds; voluntary but morally obliging codes particularly in the environmental space; the proliferation of increasingly assertive third sector organisations such as NGOs, consumer protection and community groups.

So, these are the external issues that need to be dealt with in applying the SPIRIT model, but these issues must be related to the different stakeholder groups as is developed in the next section.

2.1.3 Stakeholders and Conflict of Interest

As will be seen later in this chapter, in the Knowledge Economy where assets are mainly intangible and no organisation creates value on its own but collaborating with others, companies are expected to integrate into their physical and social context. This is the essence of corporate responsibility: development of relationships with key stakeholders in order to simultaneously create social and financial value (Marquis & Velez Villa, 2012). It follows that stakeholder management cannot be left aside from a key decision as is stated in the SPIRIT model.

Stakeholders are defined as 'any group or individual who can affect or is affected by the achievement of an organizational purpose' (Freeman, 2010) or that contribute, voluntarily or involuntarily, to the value creation process of the company and are either 'beneficiaries or risk bearers' of its activities (Post et al., 2002).

CR in the SPIRIT vision calls for a stakeholder-centred approach to management which does not mean that stakeholders make the decisions. It does not mean, either, that the organisation needs to bend backward to satisfy all stakeholder groups. In fact, it is quite the contrary. It means that the organisation is sensitive to the impact of its activities on the different stakeholder groups and uses that as input for defining its priorities. One of the interesting things about CR, and possibly the reason why the issue does not go away as a resolved problem or as a passing management fad, is that stakeholder groups have opposing interests.

Often there is confusion between CR and philanthropy, but it must be stated clearly that these two concepts are radically different. In

fact, philanthropy with corporate funds is corporate irresponsibility. A stakeholder-centred management approach is based on that maintaining appropriate relationships with stakeholders is to the long-term benefit of the organisation; that is why organisations increase social benefits or mitigate social problems to groups external to the company. Companies invest in CR because they expect that will lead to company-favouring responses from their stakeholders (Bhattacharya et al., 2009; Marquis and Velez Villa, 2012). Philanthropy is virtuous but it should be done from the agents own wallet, not that of the shareholders.

Marquis and Velez Villa (2012, p. 20, exhibit 1) classifies stakeholders into employees, customers, governments, investors, community and civil society and suppliers. There is a lot lumped together under some of those categories, but this classification will work for the sake of analysing stakeholders at this stage.

There is evidence to support that CR and involvement of staff on the organisation's CR activities generates organisational identification that in turn is highly correlated with improved job performance. The logic behind this is that organisational identification leads to higher commitment to the company's mission and to higher motivation. It connects the employees' values and identity to the values of the organisation (Ashforth & Mael, 1989; Dutton & Dukerich, 1991; Jones, 2007).

There is overwhelming evidence to support that the adoption of clear CR values operationalized into a sustainable business model will help attract high calibre professionals, from MBAs to Gen Y graduates, and that they will select a CR company over a non-CR one at equal pay, and in fact may even accept a lower pay to become part of a more responsible organisation (Bhattacharya et al., 2008; Greening & Turban, 2000; Sen et al., 2006; Turban & Greening, 1997). It is sometimes lost of sight that by 2025 Gen Y will comprise 75 percent of the workforce, and it is little known that 70 percent of them see themselves working independently at some point, so if firms do not make a significant effort to retain them they will suffer from a lack of staff. This situation is even more alarming in emerging markets where 82 percent see themselves as independents at some stage (Deloitte, 2014; Islam et al., 2011).

The second stakeholder group is that of customers. Customers are increasingly inquisitive into the CR standards of the companies they do business with. It is too early to say what the effect of the current Covid-19 crisis will trigger in terms of customers' buying habits but it may be surprising when data becomes available—in the 2007–2008 financial

crisis in the UK the demand for sustainable products actually increased, surprising the analysts who anticipated that in a crisis consumers would be more focussed on price. The importance of customers as a stakeholder group depends to a significant extent on the value discipline of the organisation. When the value proposition to clients is based on customer intimacy and best total solution, the customer will rank very high up on the stakeholder group hierarchy; if the value discipline is of operational excellence and the value proposition of best total cost, maybe customers will rank further down. If, on the other hand, the value discipline is of product leadership and the promise to clients is of the best product, ensuring that the product incorporates sustainability throughout seems a must.

The third stakeholder group mentioned above is that of government. Governments are a particularly sensitive stakeholder group in highly regulated industries such as financial services and robust sustainability standards are essential in maintaining a productive relationship with this stakeholder group, particularly in times when the government is under pressure of scrutiny by a disgruntled population. Under these conditions governments are highly sensitive to flares in sustainability that will contribute further to population unrest, so it is key to keep this front under control for a smooth relationship.

With respect to CR and its connection to investors, there is much literature. The literature is mixed in that there is evidence that CR reduces company risks and increases its reputation, both of which translate into a positive outcome for shareholders; but there are other studies that arrive at that the impact of CR on shareholder value is not so clear; and yet some other studies that have arrived at that in companies with low innovativeness capability CR actually reduces customer satisfaction levels which in turn harms market value. An increasing number of investors are sensitive to social value creation, and many others are positive towards CR as long as it is demonstrated that it does not detract from shareholder value. What everyone agrees with is that investors do value transparency and expect that management in the companies they invest in are vigilant in keeping costs under control (Bhattacharya et al., 2009; Dowell et al., 2000; Luo & Bhattacharya, 2006).

Community and Civil Society engulfs a multitude of organisations such as environmental groups, charities of different natures, local NGOs and international NGOs, consumer defence groups, the traditional media and, highly relevant these days, social media groups. These stakeholder groups