Part 6: Trust and the Social Contract: Expectations, Collaborations and Responsibilities
Thursday 23rd July 2020 at 1600 hours, BST

There has never been more interest in the role of companies in society and how companies and societies intersect. Well-governed companies will be better placed to deal with the myriad of challenges they face at this difficult time. These will be companies which have embraced relationships with all of their stakeholders, be they shareholders, employees, suppliers, contractors, customers and who have focused on both their impact on the environment in which they operate and their reputational capital. ICGN advocates the pursuit of a long-term view on social responsibility, fairness and sustainable value creation and for companies to publicly define a social purpose. This webinar explored the role of trust and how the social contract that companies have is a privilege, which also brings significant responsibilities. In addition, the financial system is under much scrutiny, and trust in that system remains elusive. The pandemic has emphasised these issues to threshold levels of tolerance. How can rebuilding trust play a part in rebuilding economies for a more sustainable and equal future?

ICGN is grateful to our Speakers as follows:

- Alex Edmans, Professor of Finance & Academic Director, London Business School & Centre for Corporate Governance
- Marianne Harper-Gow, Governance & Sustainability Specialist, Baillie Gifford
- Leo Strine, Of Counsel, Wachtell, Lipton, Rosen & Katz & Penn & Harvard law Schools
- Robert Walker, ICGN Chair & Principal, LVC Strategies

Introduction

Throughout the webinar series on the evolving social contract, it has been fascinating to understand how the issues debated - executive pay, corporate reporting, human capital, systemic risks such as pandemics, climate change and inequalities and accountability mechanisms in the age of stakeholder capitalism - intertwine under the overarching theme of the social licence to operate of both companies and investors. This brings the debate to trust, a much-used term but one upon which so much relies. Trust is the core idea that is at the centre of so much that is positive and negative about how companies engage with their stakeholders and exist within society.

According to the Edelman Trust barometer released every year, financial services remains the least trusted sector and has remained so for at least the last 8 years. This presents a huge challenge to the finance community in how it rebuilds trust. But it also presents a real opportunity and there is an important role for both forceful, transparent investor stewardship and company engagement with stakeholders in rebuilding trust and in the process of rebuilding economies for a more sustainable and equal future.
The debate on trust is framed in three ways:

- Before the Covid-19 pandemic, the debate about the role of the corporation in society was in play in markets around the world. Capitalism has been called into question. Trust in business and in finance is low.
- The pandemic has heightened the debate about the role of the corporation in society in the context of both the pandemic and building back better. Inequalities have been harshly exposed, be they income, gender or racial. All are plainly in view for the world to see and clearly action must be taken.
- Trust is critical to a functioning economy and value creation for a company. As noted by Andrew Haldane from the Bank of England: ‘there is a now a strong body of evidence, looking across a large range of countries and over long periods of time, that high levels of trust and co-operation are associated with higher economic growth’. More immediately, evidence suggests that trust is critical to an effective response to Covid-19.

Trust as foundational to a functioning economy

The concept of trust comes from a very ancient, 12th Century idea, from the time of the Crusades under the jurisdiction of the King of England. Trust law concerns the creation and protection of asset funds, which are usually held by one party for another’s benefit. So this idea of trust is closely aligned with investment stewardship. What does society look like without trust?

The concept of trust is very complex and varies between countries and markets. In the UK, there is a “principles based” governance system with comply and explain at its heart, which has an element of trust baked into it. This is quite different to the US “rules based” system where the potential for interpretation has been removed and it appears there is no room for discretion. However, the US system does have flexibility. For example, the SEC Chair’s work on human capital allows companies to some freedom in how they report and some labour oriented funds are pushing for objective comparable information so that comparisons can be made on a company-by-company basis.

Social contract and trust

The link between social contract and trust has always existed. Companies are inextricably linked to society: they create wealth, they employ people, they deliver new technology and pay taxes. Employees pay taxes to support social welfare, education and public transport etc. More recently, companies are also viewed as perpetrators of inequalities, economic risk, mistrust and environmental degradation. The Covid-19 crisis has significantly increased an awareness and understanding of social contract. This link to society means companies need to be in tune with the issues and concerns of society now but also anticipate evolving views over time. A current example is the welfare of society’s lowest earners, which is rising up the social agenda as a result of Covid-19.

Looking back in history, the British people rallied in their reaction to World War I and World War II. Even at times when the working class were hurting, they were very patriotic, rallied to the cause and were self-sacrificing despite their deep scepticism.

The same was true of the American people. The post-war era brought the New Deal vision of trying to make an economy work for all. This forged a middle way of a market-based economy with personal freedom and where the totalitarian models of fascism and communism were defeated. Trust levels grew, although the stain of racism remains in the US as there was a large exclusion of black people, which the US still suffers from. But there was a huge amount of shared prosperity and, coming out of the war, there was greater trust because of this shared sacrifice. This characterised the business community’s approach to society because they had served alongside others. Clement Attlee’s reforms in the UK and reforms in Europe were largely inspired by the New Deal.

In the pandemic, the same sections of society are suffering again. The working class in the US make less than the average American worker, they have been taking more of the risk and they are more likely to be Black. To establish and rebuild trust, the standard setting conversation is a very important one. This starts with:

- an acknowledgement that if corporate America had shared the gains equitably, there would be less inequality
- asset managers admitting that they had pressured companies to lever up which left companies without adequate reserves
- an acknowledgement of those who have dedicated themselves to public health services during the pandemic
- metrics and reporting expectations that all companies have to adhere to.

Is it just about trust?

A contrarian view is that trust might not be the only indicator of responsible business. Consider two stories about Vodafone Group plc:

- In 2007, Vodafone launched M-Pesa, a mobile money service in Africa that transformed the lives of business owners by making accounting easier. A recent study from MIT indicates that 2,000 households were lifted out of poverty because of M-Pesa. In addition, many of these households were led by women and M-Pesa allowed them to move from agriculture to business and retail. Therefore, M-Pesa also improved on gender parity.
- In 2012, Vodafone became the first telecoms company in the global telecoms industry to publish a tax transparency report showing how much tax they were paying to Governments worldwide. This was really important, not least because in the telecoms industry, companies can locate their licences in low tax regimes.

This leads to two questions:

1) Which of these decisions created most value for society?
2) Which of these decisions, if not taken, would have led to the greatest loss of trust in Vodafone?
The first example created the most value for society: by launching M-Pesa, Vodafone lifted 2,000 households out of poverty and contributed to gender parity. But what would have been the loss of trust if they had not launched M-Pesa? Probably nothing as companies do not lose trust for not doing something that was ever expected of them. However, the loss of trust if companies are not transparent on tax can be very material. This is especially true given it was uncovered, 10 years ago, that Vodafone had, legally (but not morally, some people argued) avoided £6 billion in tax. At the same time, the then UK Chancellor unveiled £6 billion in spending cuts as the era of austerity in the UK began. The implication was that the UK taxpayer was suffering austerity due to the actions of an “untrustworthy” company that had breached its social contract to pay fair tax and this loss of trust led to boycotts of Vodafone etc.

The pie of social value

A pie metaphor is helpful in explaining the value a company creates, which can be split between investors and stakeholders. A trustworthy company is one which splits the pie fairly and makes sure investors do not take too much. A company with trust is one that actively grows the pie in creating social value. A different perspective of trust is where the company uses the resources it has to proactively solve social problems. Trust becomes not simply fulfilling contractual duties, whether explicit or implicit, but going beyond even implicit contractual agreements to thinking about how a company can use its resources to actively create value and solve social problems.

In the pie metaphor, the pie is not financial wealth. The pie is social value, including natural capital and human capital. In that definition, the pie has not grown if the way that people have got richer is through depleting the environment and not providing meaningful work for employees. Professor Edmans’ own research in this area indicates that treating workers better is not just splitting the pie and helping employees at the expense of investors. If companies go above and beyond how they treat their workers, they deliver stock returns that beat their peers by 89% - 184% in the long term. By treating employees well as “humans” and not as human capital and not as resources, ultimately those workers become more productive and more efficient and therefore investors can benefit in the long-term and there is alignment between investors and employees. The evidence of long-term incentive schemes shows that they do have a positive impact on communities but the most beneficial effect on stakeholders is the impact on employees.

How has trust been eroded over time?

Trust has been eroded by an elite attack on the foundations of society in three key areas:

1. Governments and institutions: leaders like Margaret Thatcher and Ronald Reagan targeted the institutions of society. This continues in some nations today.
2. **Sharing the pie**: The problem is not that the pie has not grown enough. The pie has grown quite substantially. Over the last 40 years, the huge loss of trust in the private sector has been caused by:

- the power of the stock market soaring upwards
- the power of the working people and communities within the economy in OECD nations soaring downwards.

It is the share of the pie taken by a certain part of the population ('The Haves') and it has particularly grown in the US. The percentage of corporate profits that goes to workers in the form of pay raises compared to the 1960s, 1970s, 1980s has markedly declined. It has declined much faster in the US where the power of labour has shrunk even more than in the EU and in the UK. If the share for workers had remained the same, we would have far less inequality in the OECD nations. In the US, inequality has grown much faster because ‘The Haves’ are eating more of the pie.

3. **Tax**: One of the primary ways to express shared compassion and belief that vulnerable people should live in dignity is by paying taxes to the common wheel. Governments support healthcare, incomes and provisions for the disabled. In the US, CEOs lecture the public school system for not being good enough but the share of school taxes paid by corporate America over the last 40 years has shrunk. They have systemically exempted themselves from paying those taxes.

On a foundational level of trust, the first test of a societally powerful institution from the general public is: *does the institution do what I am expected to do?* Paying your fair share of the taxes that support the fire service, the military, the education system and the healthcare system is the starting point. The business community, in many ways, has tried to exempt itself from that requirement. Trust will not be rebuilt unless we can determine: who is living up to their obligations to meet the expectations of being a citizen and who is going further to create value?

**The role of the community**

Social value includes all stakeholders: customers, employees, communities, the environment, taxpayers. The people who are closest to the communities affected by a company are the ones who work in it. Some industrial workers have suffered as they get relatively high wages but very bad health conditions. In Europe, USA and Canada we have worked hard to eliminate that trade off. Workers should have safe working conditions, good wages and safe drinking water. Globalisation has led to companies with employees all over the world. Respecting workers rights and respecting the people in the community around them is a common interest we all have.

**The role of investors and asset managers**

Self-awareness by investors is important. Asset managers need to take responsibility for soaring executive compensation. In the US, they pushed to tie executive pay to total stock returns and thus companies were encouraged to change the gain sharing away from workers. 99% of American people owe most of their wealth to their job and
owe what they can save to their job. There is now an acknowledgement from asset managers that their investors have long time horizons and save for 30-40 years, for college and for retirement. The asset managers have not acted that way. They are starting to but they are not really walking the walk. One of the ways we build trust is an acknowledgement of responsibility. Did asset managers play a role in this huge increase in the immediate power of the marginal traders over companies? Have any of the asset managers said ‘Yes we did’? Have any of them bemoaned some of their own behaviour? This is not that evident.

In the UK, despite having a vote on remuneration for 20 years, pay has continued to increase. One of the challenges of transparency in pay is knowledge about what everyone else gets paid, which has been a contributory factor to the increase. In addition, the Board’s Nominations Committee will never acknowledge that their CEO is below median.

**Baillie Gifford’s approach to investing and engagement**

Baillie Gifford’s relationships with clients and investee companies are based on trust. They are investing for the long term (for 10+years) and investing in management teams, in their visions and their operational expertise so, as an investor, Baillie Gifford needs to trust these management teams. At the beginning of a relationship, engagement can be quite transactional and is different to those of more long-term trustful relationships where the discussion can be much more challenging, robust and wide-ranging because, over time, relationships have been built and trust is gained.

There is a paradox in Baillie Gifford’s corporate structure as they remain a private partnership (which is no accident) but they are telling listed companies how they would like them to behave. They consider that being private is the best way for them to be able to take a long-term perspective and to align their interests with those of their clients. Baillie Gifford look to invest in a small number of good companies and run active, concentrated funds so they are looking to invest in those companies that can shield themselves from the short-term challenges of the market and that behave as if they have a private mindset. In that context, dual class structures and inside ownership are not considered ‘bad’ as it allows companies to have a long-term view and shield themselves from the worst pressures of the market.

**What can we do to rebuild trust, rewrite the social contract and build back better? What changes are needed from capital market participants, either individually or institutionally? How do we frame the debate going forward?**

All parties need to work together: regulators, companies, asset owners and asset managers as they are all inter-linked as an eco-system. It is not helpful for any to undermine each other in the long run. All represent different stakeholder groups. Should a reframing be less about business and more about society? Or is the issue that finance encourages some businesses to act in a way that runs counter to the interests of society? Finance needs to be on the side of business done well rather than where there is too much to gain in the short term of cutting costs and exploiting stakeholders at the expense of the long-term opportunity. Stakeholders need to rise up the agenda now and for the long term. All parties need to do what they say they are doing. Investors need to be able to trust that companies will apply the policies they present. Investors need to recognise that greenwashing adds no value or benefit in the
long run. Honesty, integrity and accountability are needed in all investor actions and the reporting of such actions to promote trust and develop social contract.

**Time horizons**

The issue that binds all of this together is time frames, which are critical. The end beneficiary is thinking of the next 30 years whereas an executive team is thinking about the next quarter earnings; trustees and portfolio managers are somewhere in between. The UK’s 2012 Kay Review also focused on this. The further out into the future, the more alignment there is due to a convergence of shareholder and stakeholder interests, which should add value to each other over time.

Back to remuneration: when a company tries to implement long-term incentive pay, profits fall but only in the short term. They rise in the long term. If measures beyond shareholder measures are considered such as measures of social value (i.e. the measures of the value that a company delivers to society, communities, employees) then those measures increase. This suggests that the better way to serve wider society is: rather than cutting the CEO’s salary and redistributing that, the CEO should have a slide of the pie where the pie is broadly defined as social value and then the CEO will start to invest in these other forms of stakeholder capital knowing she is free from the short term financial targets. Time horizons also matters in terms of reporting and asset owner mandates.

**The importance of employees as a stakeholder group**

With this notion of stakeholder capitalism, the challenge is balancing the interests of competing stakeholders. Should companies be required to report more clearly about how they balance the interests of competing stakeholders, including money paid to employees and contractors versus distributions to shareholders? How do board directors make that balance to ensure they are providing a rate of return to all stakeholders?

In terms of social responsibility and being a good business, if companies don't treat their workers well, they are not socially responsible. If a company cannot treat its employees well, given employees are the most responsible for producing value, a company is very unlikely to treat more abstract interests well. ESG has employees buried in the ‘S’ of social issues. In the sustainability movement, there has been a tendency to think abstractly about these issues and not about the human element. These are not at odds. Most human investors are diversified – as air breathers and taxpayers, every time a company externalises its costs or harms the environment, that is not a gain to investment portfolios.

Constructively the following actions need to be taken:

- Large private companies and all public companies should report on ESG metrics. It should not just apply to public companies, because we have to eliminate the distortions of only public companies reporting on these issues. There should be a standard setting agenda to make the reporting comparable. If all companies are not expected to report, we will not know if they treat their
workers and their supply chains well or whether they exploit externalities to take unfair advantage of their competitors.

- Asset managers need to do symmetrical reporting on how they are taking ESG issues into consideration in their voting requirements and their investing requirements.
- Index funds need to have voting and investment policies that reflect the unique and long-term nature of that type of investing.
- In the US, a move towards a “Benefit Corporation” model in Delaware with stakeholder governance underpinning it where there is a ‘shall’ duty towards stakeholders.

Calling the system we have by a different name is not progress. It is just delusion. Power and purpose go together. In the US, traders in the stock market hold immense power. There are US states where there is a ‘may’ duty to constituents and it is putatively stakeholder based. There is no difference in outcomes because the power of the market over these companies has not been moved in any meaningful way. Moving to a form of governance where there is some sort of insulation from the market would be useful.

Internationally:

- Restoring the basic idea of the New Deal and European social democracy which has been eroded by regulatory arbitrage
- Strengthening the importance of labour and environmental standards
- Working towards an OECD wide approach to carbon taxes and financial trading taxes and patient capital approaches to taxation that would reward asset managers for holding for the long term and would discourage speculation.
- Reinvigorate our support of labour unions and working people and have sensibly adjusted geographic approaches to living wages that put rising pressure on the wages for working people in all segments of the world.

**We have been here before ..........**

It is important to recognise that we have had opportunities before to make change and to think about how we want the future to look. A 1975 survey called “The Future of British Business” has an illustrative quote: “Perhaps the biggest failure by employers - and one of the greatest importance – is the failure to demonstrate to workers the identity of interests between management and employees.” There was also hope for change after the financial crisis. But we have not seen much change and so we need to think about what we need to do to build back better. Otherwise we will still be having these same conversations for many years to come.

**There is some good news.....**

If we want to reform capitalism for the better, we need to look at the evidence of what works:

- Investors are the solution rather than the problem. Some investors extract value at the expense of society, are engaging for the short term or not engaging at all. But there is some evidence that the right type of investor engagement
(eg. collective engagement) can hold companies to account for not just creating financial value but also creating social value and creating value for communities and other stakeholders.

- Long-term asset owner mandates: the company CEO is accountable to asset managers who are accountable to asset owners. That is one part of the puzzle.

Identifying what the problems are is also important:

- Is it the conversation structures of the asset managers themselves?
- Do we need asset managers to take large stakes in companies so that they have the incentives to understand these intangible factors?
- Do we want investors to work collectively?

**All eyes on the US in November**

The US presidential election in November is incredibly important. The US has not reinvested to recover its strengths since the financial crisis; instead the economy has been managed on fumes. The President of the United States has historically been an individual who cared very much about working people and the US’ relationships with the world and who very much respects institutions. At the forefront of the Biden agenda is investing in working people, in promoting more equality in the US economy across all lines, avoiding dividing the working class across racial lines and giving working people more of a fair share as this will reduce racial tensions.

A President focused on climate change, and related investments, is also vital. There can be wonderful synergies if the OECD nations come together around that agenda with a “worker first” approach to addressing climate change in the recovery. There is a real chance, with a Biden administration, to move towards some form of stakeholder governance in the US, to look at fair gain sharing with workers and to try to align the interests of investment managers’ ultimate beneficiaries – the ‘human investors’ - with interests of companies for sustainable growth.