

Corporations in Society

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Introduction

There is much debate about the nature of companies in the 21st century and their role in society. This address discusses these challenges and, in particular the role of stakeholders, in addition to shareholders, and the issue of corporate social responsibility.

Corporate sustainability

The fact of the matter is, that the three main challenges facing companies today are:

- Staying alive
- Producing value for shareholders, and
- Building an enterprise that will not only survive, but also succeed over the longer term.

Why do I say this?

Of the top 20 companies in Australia by market capitalisation in 1980, only 5 are on that list today. (I am pleased to say ANZ is one of them.) That means only 25% of those who started the race were sustainable in that form. In New Zealand it is only 3 companies, or 15%.

This is not just an Australian phenomenon.

In the United Kingdom, the FSTE 100 index of leading British companies started in 1984. When the index celebrated its 20th anniversary last year, only 23 of the original 100 remained – a 23% sustainability level – similar to Australia's experience.

In the United States, the S&P 500 index began in 1957. 45 years later, just 74 of the original 500 companies remained in the top 500 or 15%. The world is an even tougher place to make money.

The reality is that few corporations survive as thriving entities over the medium term. They become less important, collapse, or end up as part of another entity.

Some view this as the strength of the market economy operating naturally, where the strong survive and grow and eat the weak or discard their carcasses. Companies stuck in their ways decline, and new hungry, innovative and vibrant companies take their place.

There is nothing fundamentally wrong about eating or being eaten, providing it was an enjoyable meal.

For those being eaten, if it was because they were failing, they did not deserve to survive. That's a cheap meal. If it was because they were tasty and worth significantly more to someone else than themselves, then fair enough. That's an expensive meal, rich and more difficult to digest.

For those doing the eating, the question is what happens afterwards. In most cases expensive meals prove to be difficult to digest and fail to deliver value. The conventional wisdom is that over 80% of acquisitions or mergers fail to deliver value and would have been better left undone.

Although the world has grown substantially over the past 50 years, fundamentally survival is generally tougher in the developed world than it was then.

Economic growth in the OECD has declined from 5.1% in the 1960s to 2.5% in the 1990s – a decline of well over half a percent each decade.

This means that companies have to fight harder for each dollar of profit, and the pressures on management have never been greater.

This has contributed to the current pre-occupation of the share markets with short-term performance, where investors prefer the certainty of results today, than the prospect of higher but possibly riskier results tomorrow.

The institutionalisation of money together with regular fund performance benchmarking has refocused shareholders towards shorter-term returns. Annual guidance is now almost a given. The consequences of short-term under performance are material.

This is in sharp contrast with the purpose of companies, which is essentially to produce acceptable returns for shareholders over the medium term.

This current pressure causes companies to strive for superior short-term results, with the consequence that, instead of focusing on investing for tomorrow, they focus on harvesting today.

In ANZ's case, given our track record of performing, the market actually expects us to outperform rather than meet their expectations otherwise they are disappointed. In life, you shouldn't be disappointed with something you didn't expect.

An illustration of this is recent market comment about our decision to employ an additional 3000 people over the past 18 months, to take advantage of a situation

where many of our competitors are cutting back. Many investors have become more concerned about a potential decline in short-term productivity rather than an opportunity to invest in customer service and expansion into growth areas.

It all serves to highlight that to be sustainable long-term, the bias of our focus cannot be on today, but instead it must be on the longer-term.

It implies that the winners, over time, will not be those who maximise short-term results but those who invest wisely to produce superior returns tomorrow.

It also implies though, that in order to survive until tomorrow companies nevertheless need to produce reasonable results today, while they pursue their longer run ambitions.

Making this shift radically changes the agenda of companies because the things that contribute to today's results are not necessarily those that will build the long-term competitive advantage of the company necessary for long-term success.

Shareholder value

Here it is worth pausing to consider more deeply the concept of shareholder value, and how we achieve it.

Essentially the role of a chief executive is to grow the value of the firm, which is essentially a function of two things:

The amount of capital invested today, plus

The present value of future excess returns from investing this capital

One can think of the future value as the area under the curve of future excess returns, which is essentially a function of 5 variables:

The future amounts invested in the form of capital and expense, which initially lower returns but prospectively add value.

The level of return - the higher the return on capital, the greater the height of the curve.

How fast it takes to produce the returns – the faster the growth the greater the slope of the curve.

The volatility of the returns - the more certain the returns, the lower the cost of capital employed, which increases the value of returns - the more uncertain or volatile the returns, the higher the cost of capital, which, in turn, subdues its value.

Finally, all returns eventually fade to the norm through the erosion of a company's competitive advantage by more effective competitors. The stronger the competitive advantage and the longer it takes before fade sets

in, the more sustainable the returns. Therefore, the ability of a company to survive and succeed over time is a function of the strength of its proposition and its ability to renew itself.

This raises some interesting observations regarding the balance between short and long-term returns.

We cannot produce growth and return unless we invest in the capacity to produce that return. It is inevitable therefore that we must dilute current profits if we desire future prosperity.

Since the future is uncertain, investment in the future must involve the taking of risk, and the risk taking requires capital.

Risk means the returns may vary from expectations - the riskier the investment, the greater the potential variance from expectations, and the more capital required.

Investing capital also inevitably lowers current returns.

To renew ourselves and offset the erosion of advantage, we need to invest in those things that extend our competitive advantage and the sustainability of returns. Competitive advantage is about longer-term uniqueness – about being different and more capable than our competitors.

Building our competitive advantage demands investment, which also dilutes our short-term returns.

Accordingly, a focus on maximising short-term returns cannot be a solid philosophy for managing our companies. Doing so would inevitably subdue investment, and would accelerate the long-term demise of the company.

The right balance is to focus on producing longer-term shareholder value while satisfying the short-term desires of the market by producing reasonable short-term returns.

Beyond shareholders

We don't need to look back more than a few years to see examples of companies that have not found this balance.

In Australia we have seen James Hardie, which in recent years was one of Australia's best-regarded companies, suffer reputational damage, product boycotts and a loss of shareholder value as a result of its handling of asbestos issues. This is a situation where the wrong actions in the eyes of the community and government led to a dislocation of the company.

In the US, we have seen market darlings like Enron fail for false accounting, and overstatement of profits.

One of the Big Four accounting firms Arthur Anderson failed because of poor governance and only this week we have learned of KPMG's issues in the US.

These serve to highlight the importance of intangibles as well as hard advantages and on meeting the expectations of the government and the community, not simply the short-term needs of shareholders.

It also highlights the fallacy of linking executive remuneration too much on short-term results and stock prices, as this distorts management focus towards personal financial gain, rather than the long-term sustainability of the company.

Accordingly, for a company to be successful and stand the test of time, they must have a responsibility beyond that to shareholders.

Corporate responsibility

This raises the subject of the broader responsibilities of corporations to stakeholders - customers, staff, community, government, as well as shareholders.

In fact, I would argue that such broader focus is not inconsistent with sustainable long-term results for shareholders, as it requires directors and management to focus on the right things for the long run.

To this end some years ago, we reset the mission of ANZ and our agenda around stakeholders, setting ourselves on the journey of humanising ANZ internally and externally, and creating a clear mission for each of our stakeholders:

The Bank with a Human Face

Put our customers first

Earn the trust of the community

Lead and inspire each other

Breakout, be bold and have the courage to be different

Perform and grow to create value for our shareholders

Customers

It is well understood that those who provide superior service and added value to customers generally become the most successful.

It is also conventional wisdom that companies with market leadership generally produce the highest long-term shareholder returns.

There is therefore real merit in the philosophy of “putting our customers first” and putting this into practice requires real commitment to this agenda.

In the case of ANZ it included:

Announcing a customer charter with 12 specific commitments to customers that are audited and reported on each year.

Opening rather than closing branches. We have a moratorium on closing branches and this year alone we have opened 15 branches in Australia, 3 in New Zealand and plans to open an additional 65.

Adding 3000 mostly customer-facing staff while others have been reducing staff numbers.

Committing to keep our customer contact centre staff here rather than offshoring to a lower cost location, on the basis that customers prefer it that way.

The result of these and other actions has been that ANZ is now the best-regarded major bank with retail customers, an area that has never been a traditional strength of ours.

People

Turning to staff stakeholders; this is the area that I am most proud of and where I believe ANZ has distinguished itself globally.

I have always detested the term “human resources” on the basis the term lacks humanity. People are investments, not resources to be allocated.

That is why the mission of ANZ is to be “the bank with a human face”, and to add humanity into banking and business.

Many forget that it is people who serve customers, create new ideas and who make companies great.

Arguably our people invest more in the company than shareholders. They invest themselves, not just their money. They put their futures in our hands and spend their lives making us successful.

If we fail, our people lose their livelihoods as well as their money. Our obligations to them in turn are enormous.

How people feel about working in the organisation and how passionate and engaged they are in its agenda, is what makes the difference between good and great companies. Our people innovate and produce results, and we in turn provide them with opportunity and development.

People don't just want a job they want a life. At work they don't just want to be an employee, they want to be a person, bringing their whole self to work, not simply what the typical boss wants them to be, defined and boxed, instead they want to be free and creative. People are searching for fulfillment, and meaning. Since our staff members spend most of their waking lives with us, if we as employers can't or won't help them on this journey this journey they will find it on their own, or with those companies who will.

To this end, ANZ is now probably the largest private sector recruiter of graduates in Australia and the largest investor in the cultural development of our people and enlightened people practices and values.

As a result of our philosophy on people and the actions that support it, ANZ has 87% staff satisfaction across its 32,000 people, together with the highest staff engagement of all major companies in Australia.

Investing in leadership and management is also fundamental, as superior leadership is the scarcest resource in business today.

As leaders, our main responsibility is to enhance the capacity of our people to reinvent a new future for the organisation. This requires us to create an environment of opportunity and challenge for our people, enhancing their capacity to produce and create, and to stimulate, release and focus the incredible energy that normally remains latent.

There is no doubt in my mind that how we manage our people agenda is the key factor that will reshape our destiny and become the bedrock of our sustainability going forward.

Government

Turning to government and regulatory stakeholders, we only need to look at HIH, Enron, Arthur Anderson or James Hardie to understand why we need to operate on a sound fiduciary basis.

When companies get this wrong, they become consumed in fixing shortfalls in governance and compliance, at the expense of almost everything else as their permission to operate and the future of directors and management are all at stake.

Of course, this is a two-way street with governments having a parallel responsibility to provide the right political, social and economic environment for companies to grow and succeed, to advance education so that there is enough talent to fuel our future, and to govern and regulate effectively without imposing an unreasonable burden on companies.

In this latter respect, things have now gotten out of balance globally with new regulation in the form of Sarbanes-Oxley, International Financial Reporting Standards, and CLERP 9; and additionally in banking the Basel 2 capital accord, the Financial Services Reform Act and the Reserve Bank of New Zealand's new financial stability regulations.

At the business level, we experience it daily - media and investor scrutiny, increased disclosure and transparency requirements, and an attitude that more regulation is the solution to issues that arise.

Just because some companies get into trouble with regulators, it doesn't mean everyone else is likely to do so. Just because some companies go bust, it doesn't mean the system is broken. The failure of weak companies is a normal part of the market operating effectively but unfortunately the response tends to be overreaction and proscriptive, and it is time to lighten up and focus on the rules that really matter.

Let me give you an example:

In 1990 ANZ's Annual Report contained 33 pages whereas our 2004 Annual Report covered two volumes and was 238 pages.

This year the compensation report will dwarf the summary report itself. Whilst well intended and designed to limit excess, we have seen the opposite effect. Rather than containing excessive remuneration, increased disclosure has caused an upward shift in compensation as executives' pressure for comparative remuneration, and directors respond as a defensive measure to avoid losing them to competitors.

Community

Let me now turn to the final stakeholder group - the community and the issue of corporate social responsibility.

My view about the importance of the community in business decision-making not only reflects the reality of today's society but a strong element of enlightened self-interest.

Companies are not islands that exist separate from the communities within which they operate.

This is not a new idea - the nature of business and its place in society has been a topic of debate for centuries. But in the last 20-30 years the growth in the size and power of business has changed the centre of gravity for the debate.

Today, based on country GDPs and the value added of large corporations it has been claimed that in 2000, 51 of the world's 100 largest economic entities were corporations, not counties.

In this environment, while some celebrate the process of "creative destruction" whereby old companies – complacent and stuck in their ways – decline, and new companies hungrier and more innovative – take their place, others argue that companies are now a living part of the community. When companies falter or disappear there are significant social consequences.

In advancing the interests of the community, I am not contending that this dilutes the company's primary responsibility to its shareholders. On the contrary, I am contending that one of the reasons for a company's long-term success is continued success is the skill with which it engages with and invests in the community.

I say this because how the community feels about you really matters. Reputation takes years to build but only seconds to destroy.

It matters because when the community speaks, governments listen and this can not only affect the amount of regulation and the cost of compliance, but can also ultimately lead to the demise of the firm, as in the case of Arthur Anderson.

It also matters because the community is our current and future customer base.

Now there are of course boundaries on the extent to which we should invest in the community. As the owners of public companies, shareholders have a legitimate right to ensure their money is being invested properly in their interests. Money spent on the community is an investment and all investments are with the purpose of generating a future revenue stream.

In order to justify such investment, it means we need to ensure some congruity between our social responsibilities and our shareholders interests. If we stretch the link too far, it is natural for shareholders to voice their concern. If we don't invest at all, we are likely to damage our future sustainability. We need to find the sweet spot, in reaching a balance that satisfies the potentially conflicting needs of stakeholders.

Accordingly, for example, it is easier for us to justify community spending in areas that are natural to the nature of our business and where there is proximity to our core business. It becomes difficult to justify spending where there is no discernable link.

For example one can easily understand a media or entertainment company investing in theatre or the arts, or for a pharmaceutical company in community health matters.

For a bank, we deal with the investing of customers' deposits, in lending to customers and in handling customers' transactions. Therefore it is easier for our shareholders to understand our social investments where they are concerned with financial issues in the community such as financial understanding, money management, saving or debt relief.

Conclusion

I have taken us through a journey that has navigated shareholder value, particularly on the need to focus on long-term growth and sustainability and avoid the pressure to overproduce today at the expense of tomorrow.

I have argued there is fundamentally no inconsistency between the pursuit of this and our responsibility to our broader stakeholders, as there sits part of our long-term competitive advantage.

I would though conclude by going beyond this, by posturing that a company is not simply a financial construction, of land, labour and capital. It is much more than this. A vibrant company is more than the sum of its pieces. It is a synergistic space where one plus one equals much more than two.

What is clear is that the way we have managed and led our companies in the past is not the right way, given the lack of sustainability and humanity of our companies.

Going forward, we need a new and more radical way forward, a paradigm shift in our conception of what a company is.

All of us here either deal with companies or work in them. We can sense when a company is working and when it isn't when we interact with it. We can tell if it is engaged with us or not. We can sense whether it is interested in us or in itself. We can also sense when a company lacks the vital ingredients for success.

If we can sense these things, a company must be more than its property, its people, its products and its capital. What we sense is it's true essence, and how alive, energetic and purposeful the company is.

My own attitude is that a company is a community that is interdependent with other communities. It takes on the characteristics of those it engages with and, in turn, influences them.

So in taking our corporations forward, we need to think of advancing not a company but a community. This means a very different agenda for companies going forward.

People are searching for meaning in their lives. I believe we are now firmly in a new age where spirituality, humanity and community will matter much more. In such a world, enriching the vital spark, or soul of the company becomes the real agenda for our future leaders, together with masterminding the engagement with our communities with the wider community.

This is a new and very different way of thinking about our role as business leaders, and it will tantalise and challenge us as leaders in the decades to come.