Vince Cable: Cadbury Lecture 2016:

Socially Responsible Business and Corporate Governance Reform

Introduction

The Cadbury tradition is being celebrated here and I vividly recall that on my last outing with the Lunar Society Sir Adrian was on the front row. I would like to pay tribute to his work and his considerable legacy.

My own appreciation of that tradition started rather earlier with Bournville cocoa and Cadbury Milk Tray though I confess to divided loyalties. One of my earliest recollections is of the deliciously sweet smell of chocolate manufactured in Terry's 200 yards from my first childhood home. My mother worked on the production line when she left school at 15; my father started his working life on the shop floor, across the city in Rowntrees; and my uncle, who broke through the glass ceiling into management, ran the box making plant. My diet was generously supplemented by chocolate 'waste' and my spiritual diet was greatly improved when I went as a teenager to the Quaker Meeting House, where there was also an ample supply of attractive young women as well as a lot of Rowntrees.

That world has gone, not just because I have grown up and grown away but because the great Quaker companies, which specialised in ethical business, have largely disappeared. Terry's was acquired by Kraft which closed my mother's old production line and moved it to Poland. Rowntrees has been acquired by Nestle. Cadbury was subject to a hostile takeover from Kraft, an episode which still reverberates. A few of those Quaker companies survive, notably Clarke's Shoes. But others surrendered their ownership and values and have seen their reputation trashed. Barclays, for example, enjoyed a period of notoriety during and after the financial crisis from which it has barely recovered.

The question we face is whether the values which these companies represented- profitable, well-run, businesses combined with integrity and long term commitment to the work force and communities- are simply incompatible with the current Anglo-Saxon model of shareholder capitalism. This lecture series is a good place to explore that question.

There is undoubtedly an appetite for 'responsible business' – though that rather bland phrase can mean very different things. The financial crisis in 2008/09 produced a wave of revulsion not just against greed and excess but the impact of these on society when market panic and financial collapse lead to serious damage to the real economy.

But there is a wider malaise in which the boundaries of legal business are stretched close to breaking point or beyond, and enforcement sanctions are seen to be weak and ineffectual. In my term of office, we had the saga of enquiries into the conduct of RBS and Lloyds/HBOS directors none of whom have been sanctioned (though a small number of lower level operatives have gone to jail following the Libor scandal and there is a trial at present on the Reading /HBOS case). There was the investigation into the so called 'gang of four' at Longbridge which led to no meaningful penalties. And more recently there has been the Comet closure with a similar result.

There is, moreover, apparently legal business behaviour which is cynical and anti-social; the most recent examples being that of Sir Philip Green and the companies exposed as engaged in large-scale, systematic, tax avoidance. And, then, there is behaviour which is perfectly legal and may be incentivised by markets and regulatory systems but is potentially harmful if we consider the long- term effects and not just the immediate. I would put a lot of M&A activity in that box including recent take-overs, as with ARM.

Yet there is little consensus of how to proceed. I recall, in my first few months as Business Secretary, attacking 'irresponsible capitalism' in banking in particular and acquiring the epithets 'Communist' and 'anti-business Business Secretary' in some newspapers. Ed Miliband went down the same path though it did him little good. Now Theresa May has adopted similar rhetoric especially on executive pay. The issue she faces, as I did, is how to translate an instinct for reform into concrete measures which work but do not undermine the wealth creating capacity of business.

I will address three questions in particular: can we further reform cooperate governance particularly in the emotive and politically sensitive area of executive pay? Are we doing enough to encourage new models of business organisation – in the social sector or based on best practice in other countries – which appear to work better? And can we further reform capital and equity markets, and particularly the market for corporate control, in a way that encourages long term decision making in business?

Corporate Governance Reform

In response to past abuse there has been a succession of reforms under different governments: new insolvency legislation, Companies Act reform redefining directors' duties (which, under the 2005 Act, are far more wide-ranging than many directors or the public appear to realise), the Cadbury Code on corporate governance and Greenbury (then Walker) on executive pay. Recent and proposed changes to strengthen the system centre on three areas: transparency and information; shareholder responsibility for executive pay; and employee representation.

On the first, I oversaw: improvements in narrative reporting; the requirement to publish a simple number to summarise complex remuneration packages; disclosure of top salaries in banks; and disclosure of information which is of interest not just to shareholders but a wider group of stake holders. The last of these included introducing an open register of beneficial ownership, payments to governments of oil and other resource rich states and transactions within supply chains where 'modern slavery' may be involved.

The Prime Minster now wishes to increase transparency specifically in respect of executive pay by publishing pay ratios between top and median pay. I have drawn attention to a problem which emerged when my officials considered the idea: that it might embarrass the wrong people. Investment banks like Goldman Sachs and companies which outsource labour intensive work overseas look much more responsible than widely admired retailers like John Lewis which have a lot of relatively low paid workers because of the sector in which they operate.

The executive pay issue has become increasingly toxic not just because top pay has risen while real wages have stagnated or fallen but because there is a serious mismatch between pay and corporate performance. Remuneration committees appear motivated (and perhaps are pressured by CEO's) to put CEO's in the top quartile regardless of their record. I introduced binding shareholder votes on company pay policy. This, and earlier moves to introduce non-binding votes on existing pay packages, has led to growing numbers of challenges but the number of cases where pay packages have been revised as a result is small. Theresa May wants to make the backward looking votes binding too. I sympathise but the obvious problem is what happens when the binding shareholder vote contradicts a legal contract.

A deeper problem is that responsibility for policing executive pay has been placed in the hands of institutional shareholders like pension funds and insurance companies. These institutions vary enormously in their degree of engagement with the companies in which they have a stake. They may have little interest in the problem of executive pay (CEO pay may be a small element in the costs of companies they, partly, own). Their executives may not share the concern of politicians and the public if they are very well paid themselves. They may be based overseas and have no stake in UK society.

These shareholders are, moreover, being required or asked by government to monitor a wide variety of performance indicators unrelated to their own chosen metrics (to encourage diversity, achieve short term rather than long term results and aspire to social responsibility in general). These work best where there is hard evidence of commercial gain. One of my more successful campaigns in office was getting the FTSE 100 (and 350) companies to put more women on boards and to get them to run a stretching target (which was met). Research shows that more diverse boards are associated with better corporate performance and this was a factor in engaging investors as well as management. Market failures in executive pay have not been sufficiently obvious for investors to immerse themselves in the issue.

Some people, moreover, question whether a model based on shareholder activism can possibly work. They argue that other stakeholders, notably workers, should be involved in issues like executive pay by sitting on boards, or specifically on remuneration committees, or by being given a say through better consultation mechanisms. Mrs May has advocated workers on boards. In my first introduction to my department in government, in 1979 as John Smith's special adviser, I oversaw the preparation of legislation to implement the Bullock Report with far reaching commitments to worker engagement-until it was blown away in the 'winter of discontent'. So I am very sympathetic to Theresa May and wish, in the Coalition, I had been able to persuade business groups and colleagues to embrace the idea.

There are however genuine practical problems: many of the largest FTSE companies are international companies – in oil and mining in particular – with a relatively small UK workforce; many others have outsourced much of their labour intensive work; most are non-unionised and have no mechanism for worker election. Another route would be to make it obligatory to consult the workforce – taking more seriously EU directives on worker consultation. As Secretary of State I made it a requirement that companies report on whether they have consulted their workforce on executive pay; that could be strengthened by making consultation, in some form, obligatory.

These incremental steps may however merely be attempts to breathe artificial life into a system of accountability which cannot work well because shareholders have neither the incentive nor the ability to make it work. If the aim is to produce more socially responsibility maybe we need a different model, to encourage more enterprises which are directly accountable to their workers, their consumers or trustees with a social purpose.

Alternative Forms of Ownership

Before getting into the various forms of social enterprise it is worth noting that there are other ways of organising business than the public limited company and, specifically, PLC's which offer shares to the public. One of the advantages of the UK being a relatively open economy in respect of ownership is that many of our largest companies are foreign owned. We therefore have experience of different business cultures albeit through subsidiaries or branches: German, Dutch, French, Swedish, Japanese, Indian, Spanish, Mexican, Korean. These are of course different: very different, though almost all operate on longer time horizons than UK and US companies because they are not subject to the same short term market pressures to generate high shareholder returns. Moreover, we rarely hear of scandalously over paid chief executives in Nissan or Jaguar Land Rover or Unilever or Samsung or BMW -though perhaps there is more noise in the country of ultimate ownership.

We do not, however, need to go abroad to discover business models which have the same long term stability. Private companies, and among them family companies, committed to long term organic growth, do the same. But as we have seen with the Quaker companies there is a constant tension between capital raising and equity dilution on the one hand and the core purpose of the firm. Although it has had a bad press, private equity often provides a far more stable, long term, financing platform than recourse to banks for credit or stock markets for equity. But, even here, time horizons rarely extend much beyond five years and expected rates of return can be very high – that is, after all, why yield-seeking investors place their cash in private equity. Socialists in particular would add publicly owned enterprise and stand-alone models have been created, like Network Rail, which have substantial autonomy within the public sector. But here there is a constant problem of escaping from the iron grip of the Treasury and its control over borrowing: the decisive factor in driving the Royal Mail, for example, into the private sector. The regulated private utility has been a near-universal response to this problem in the UK.

Of more interest are enterprises which build a social programme into their business model. The social purpose family of companies includes Coops, consumer owned mutuals, worker owned companies like John Lewis and social enterprises which range from charities, which do some commercial trading, to commercial enterprises which donate their surpluses to charity.

Experience of these alternative forms of ownership is very varied. The cooperative sector is substantial but in the UK has, until recently, seen its retail market share shrivel and its banking arm succumb to the abuses associated with mainstream banking. Mutual building societies almost disappeared as their dispersed membership pocketed the current value of the company and mutual insurers went the same way. But new mutuals – providers of social care, childcare, nurseries and open source software – are proliferating. The worker owned enterprise model of John Lewis, Arup and the Bader Partnership is, rightly, lauded but the legal and time complexities have proved a deterrent to large-scale emulation. The partnership model works for professional service companies and is used too in investment banking though without any obvious social purpose.

Social enterprise is the least explained and most diverse part of this family but there is much interest in it. As it happens I have recently been appointed Chair of one of Britain's largest social enterprises (a bus company, HCT, with turnover around £50 million employing just under 1000 workers) which ploughs back its surpluses beyond reinvestment into helping improve mobility amongst the disabled. And I am helping establish another, a community bank based on German Sparkassen principles, whose surpluses beyond reinvestment will go back into social purposes in local communities.

We have come to learn that there are two generic problems with all these organisational forms. One is the problem of raising capital to sustain rapid growth. Either the company becomes overleveraged through excessive borrowing, given the level of risk. Or it seeks to expand its equity base but at the risk of dilution and loss of control. Small but ambitious building societies which cut corners to grow ran into trouble, like the Dunfermline. Others like West Bromwich, have taken the risk of losing their mutual purpose by inviting in market equity. My own social enterprise, HCT, which is expanding rapidly, has been able to do so by tapping into bond finance from a special purpose bank (the Big Issue Bank set up by the government using capital from unclaimed bank deposits) or creating innovative special purpose vehicles to draw finance from social impact investors. This is a growing community of social impact investors but they are collectively small in relation to financial markets as a whole.

The other danger is that the patient accumulation of value over years, and perhaps generations, offers a tempting honeypot to the current batch of mutual, worker or coop owners, if they can unlock the capital. The financial mutuals were almost destroyed by the short term greed of 'carpet baggers' who acquired membership accounts with the sole purpose of forcing a sell off. Secure lock-ins are essential if socially oriented businesses are to survive. The two I am associated with are ultimately owned by a charity and subject to the regulatory framework of charity law. Another model is the Community Interest Company but it is new and relatively untried.

Today's social enterprises face the same challenge as yesterday's Quaker owners: how to maintain their social purpose in a market for corporate control, and for raising equity and debt capital, which does not undermine social responsibility.

Capital and Equity Markets

I encountered this problem, and sought to pursue reform in two areas: takeovers and the problem of "short termism". In many respects the Kraft-Cadbury takeover was a wakeup call. It illustrated the ease with which hostile takeovers could be pushed through, provided the offer price was sufficiently tempting to enough shareholders including hedge funds who had bought heavily into the company during the takeover process. My predecessor was unable to stop the deal despite making hostile noises and undertakings about jobs proved largely worthless (Kraft would argue however that they then invested heavily in R&D in the UK – here in Birmingham – but haven't yet been credited with it).

I was left with demands to tighten the rules around takeovers. I was urged in particular to prevent hedge funds and other recent investors from voting. I was persuaded by advice that creating a new, inferior, class of investors based on length of share ownership would be legally problematic and counterproductive if the investors were a 'white knight'. Instead, I persuaded the Takeover Panel to change its rules: to create strong 'put up or shut up' provisions and shorten bidding periods to prevent additional hostile bids; to require proper consultation with the various stakeholders; and to require long term value to be generated in a successful bid.

The Takeover Panel has however limited powers and the powers of government to block bids are severely circumscribed by the 2003 Enterprise Act and the European Union law (for the moment). These limitations were exposed by the Pfizer bid for Astra Zeneca. In the event I signalled strongly that the bid was unwelcome to government because of its impact on the science base and Astra Zeneca successfully resisted the bid. Pfizer backed off but had they persisted with a higher bid it would have been difficult to block it, and even the suggestion of legally binding conditions under the takeover code would have been difficult to enforce. I concluded that the national interest test needed to be strengthened to include a test of long term national scientific capability – and the (uncontested) takeover ARM reinforced my view.

The other major governance issue concerns 'long termism' in capital markets. I commissioned Professor John Kay to review this problem. He acknowledged that there was a serious mismatch between, on the one hand, the demand for long term, patient, capital in many companies as well as the demand for long term savings vehicles by personal and institutional investors and, on the other hand, the short term market churn generated by intermediaries. He concluded that the problem was serious but did not allow easy solutions short of cultural change. His remedies for voluntary cultural change are attracting genuine interest in the investor community but we have yet to see the results..

I was however able to take several specific initiatives to embed long-term thinking in decision making. A ruling was obtained from the Law Commission on the fiduciary duty of investors which shifts the balance towards long termism. We incorporated a requirement for long-term value to be incorporated in the terms of reference of the Competition and Markets Authority as well as the Takeover Panel. We established new financial institutions with a remit to provide long term, patient, equity capital (the Business Growth Fund – which is privately financed) and the Green Investment Bank. Most important, we established an Industrial Strategy specifically designed to create greater long term certainty about public procurement, innovation strategy and training in industries which requires it: automobiles, pharmaceuticals, aerospace, energy supply chains, railway manufacturing, chemicals among them.

I am pleased to see that the new Prime Minister shares my enthusiasm for this approach and for corporate governance reform more generally. It remains to be seen whether the commitment will be sustained as the government is gradually overwhelmed by the complexities and difficulties of Brexit.