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INTERVIEW with Anat Admati

Financial Governance:

Efficacy of Aligning Interests of Corporations with Interests of Society

HCER *staff members Laura Espinoza and Jimmy Lin conducted an interview with Anat Admati, the George G.C. Parker Professor of Finance and Economics at Stanford University Graduate School of Business, Director of the GSB Corporations and Society Initiative, and a senior fellow at Stanford Institute for Economic Policy Research. The following features the interview.*

In your paper "A Skeptical View of Financialized Corporate Governance," you criticize financial governance—the practice of using financial measures like stock price and profits to evaluate corporate success—for not always being the best way of aligning the interests of corporations with the interests of society. Can you elaborate on this idea and how the practice of financial governance came to prominence?

Corporations have lots of people impacted by what they do—most directly, their employees, suppliers, customers, creditors, and then, of course, corporations may impact other people in the economy and in the government. The view that the corporation should focus on shareholders came because of the assumption that the interest of every other stakeholder is protected by market competition and by contracts and laws.

Operationally, maximizing "shareholder value" became a quest for maximizing stock price. As a finance professor, I had been teaching this material for 25 years. The standard idea is that corporation managers must focus on that objective should not worry about other considerations as long as they obey the law.

The assumption is that such behavior contributes to economic activity. The corporation then "maximizes profits" the way we describe firms in Econ 1. It's a beautiful and alluring story. But it's misleading because it is based on assumptions that are often simply false. It is rarely the case that contracts and laws protect stakeholders in all circumstances, that markets for labor, products, etc. are perfectly competitive, and that enforcement of contracts or laws is seamless, especially in a corporate context. In fact, it is sadly not always true that governments act on behalf of the broad public interest, however attractive this deal appears on paper.

So the law and economics literature has spilled a lot of ink on the relationship between managers and dispersed shareholders under the assumption that managers will do their job for shareholders, and the corporation will do its best for society, if they maximize the stock price.

I wrote a few papers on shareholder activism that belong to this literature, but I became skeptical that this potential conflict is where the true challenge of corporate governance is after looking into banking. The problem in banking is much less about a conflict between managers and shareholders, but that in the process of trying to maximize the stock price, managers end up harming most of society (including many of their small shareholders, in fact), and that in the politics of banking they can get away with it. As I got more into this problem, I saw the combination of confusion and politics that has led to this dangerous situation.

It is interesting to go to the history of corporations. At the start, you needed a special charter to incorporate; it was a privilege. People organized corporations for building infrastructure, like bridges or tunnels, that governments were not doing. In that case, the shareholders were the customers and they did not want to charge monopoly fees. The notion that the many stakeholders of large corporations are distinct individuals is flawed. The small shareholders may well be customers, employees, and all are citizens and part of the public.

In banking, for example, taxpayers subsidize the sector in ways that perversely encourage recklessness when banks act to maximize their stock prices. And what about the opioid-related corporations that have contributed so much to drug addiction and deaths by overdose? Clearly, maximizing their stock price causes enormous harm. Even as a shareholder, my utility function includes the health of my family and community, not just the stock price of a company in my pension fund. Yet what we teach in finance is that shareholders want a high stock price. It also creates confusion about competition. You do want competition as a customer but you don't want competition as a shareholder—so what do you want?

It turns out that in economics, we have remarkably little to say about corporate purpose, except in ideal conditions that don't hold in reality. Even when we take contracting seriously, we make assumptions about "final period" and what can and cannot be in the contract, and we typically take enforcement for granted. In the real world, contracting is more complicated. New contracts are made on top of previous contracts, everybody's got to monitor and see where they are in these contracting environments, and at times, many people are covered by the same contract, and they need coordination and are subject to free-riding problems in monitoring and enforcement.

We create shortcuts in economic models, and sometimes these shortcuts overlook critical forces such as the political economy. By now, both capitalism and democracy appear to be in trouble. Research and teaching in economics has increasingly documented inequality and some policy failures, but the focus of the literature on corporate governance has not changed much to reflect the missing parts.

I think part of the problem is disciplinary silos. Economists rarely confront a situation in which it is no longer clear who has more power in the world, corporations—especially multinational corporations—or governments. Governments may be more fragile than corporations, and that is a large concern if corporations have very narrow objectives that harm society. I have become concerned about this problem, and I would like to encourage economists to question their assumptions and to use their tools to analyze and help address the political economy issues that often are key to economic outcomes.

You mentioned that when corporations seek to increase their share value, their actions can actually conflict with the actual interests of shareholders, for example by encouraging managers to misrepresent accounting data or engage in other fraud and deception that later leads to fines and loss of reputation with harmful impact on the corporation, shareholders, and long term economic growth. Can you speak to these ideas?

First, let me observe that fraud can happen in public corporations with numerous shareholders or in private corporations with only few. A recent example of fraud in a private company is Theranos, where executives ultimately acted against the interests of investors as well as customers, employees, and regulators. But if you look closely, there is so much more and so much that we don't see. One case I bring to students in my Finance and Society MBA class involves a risk manager with math PhD who uncovered accounting fraud in Deutsche Bank back in 2011 and was fired for whistleblowing. Very few people understand the details here. In this case and many others, the justice system doesn't appear to work well in a corporate context. In the example of Deutsche Bank, it took major efforts to get any action, and the ultimate result was a small fine paid by shareholders, who were among the victims together with the rest of society, not by the managers who actually engaged in the fraud.

"The assumption that 'free markets' work is simply wrong here."

Excessive endangerment can be more subtle. We have strict laws about physical health and safety, so restaurants will clearly get into big trouble if they cause customers to get sick, and their reputation can get harmed. We recall contaminated food. But when it's abstract harms like financial harm, or your data being stolen, or data breaches, or excessive borrowing by banks, we tolerate too much endangerment. When GM endangered drivers with faulty ignition, it took someone from the outside to find the problem as well.

I am most concerned when policymakers don't do their job. The organization Transparency International defines corruption as "abuse of trusted power," and I have come to realize that the problem goes beyond illegal bribery. I expect those in the private sector to act in their own interest and do what benefits them if they get away with it, including some ethically questionable actions, but when the same forces apply in the government sector, which is supposed to act in the public interest and set and enforce fair and just rules for everyone, then something is seriously wrong. I have seen many examples, certainly in the financial sector, where the rules and enforcement work poorly. Short-termism is a word people throw around a lot, but we teach in finance that the long term is the short term when it comes to valuation, which often makes sense. If a nuclear waste dump will be built near your house in five years, that fact would be reflected in the price of your house today.

But sometimes when risk is taken with other people's money, the Wall Street expression IBGYBG—"I'll be gone, you'll be gone"—applies in the sense that the downside risk bites later while the risk-taker gets a bonus earlier and does not bear the full consequences of the downside. The same can be true for policymakers—they may want bankers to take risks that benefit both bankers and policymakers in the short run but endanger taxpayers in the long run. It will be difficult to find the direct link to them if things don't work out. In that case, everyone offers narratives that deflect their own responsibility. If people don't have to step back and learn lessons, it's hard to improve the situation.

Of course, corporations and all of us must take reasonable risks to innovate, but when the downside falls disproportionately on others, we can get distortions, and this is more common than we may want to believe. I have a friend whose toddler died from a defective portable crib that had caused previous deaths and had been recalled, but few knew it. A dangerous product remained in use, and the manufacturer chose not to invest in taking out ads to try to recall more units. The assumption that "free markets" work is simply wrong here. Those with more information and power may have different incentives and benefit even as others are endangered and harmed.

I imagine that your policy perspectives inspired your class, Finance and Society, but also the creation of the Corporations and Society Initiative. Can you talk a little bit about that initiative within the business school?

Because I'm a finance professor and had been teaching corporate finance, my interest in governance and policy started with looking into the financial sector after the financial crisis. My observations there led me to question my previous assumptions more broadly.

When I looked into banking, I had a fairly simple policy proposal, and I've spent lot of time in the last decade lobbying for it. I wrote numerous op-eds, chapters, policy comments, and a book to explain the issues; I talked with many people within the system and outside. What I experienced in this advocacy effort led me to step out of my academic silo because understanding the issues involved other disciplines as well.

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The Corporations and Society Initiative I initiated and direct at Stanford started with the effort to break academic silos, to try to make colleagues engage across disciplines—such as economists engaging more with political scientists, law academics, sociologists, and psychologists, and even bridge the gap with engineering— to understand better what was going on, which can be difficult to do from one silo. Even just within the business school, we have accounting, marketing, finance, etc. with seminars, Ph.D, programs, and research that are often totally disjointed.

I started by inviting people for visits of one to two weeks who can cut across disciplines and engage mostly with the faculty and Ph.D. students. They did meet with the MBAs and visited some classes, as well. Some came from disciplines that we don't have in the business school like law or from government bodies. I collaborated with other centers and departments at Stanford, depending on the visitor.

But I also thought there is much more that needs to be done on the issues, and the visitors program I had did not seem to be making a sufficient difference. Then, last year, I started engaging with MBA students who cared a lot about business and society and understood that there must be more conversations on the issues. I was then able to get a little more support from my school to hire a staff director and expand the activities.

Everybody talks about corporate social responsibility, and we have a Center for Social Innovation, but the focus of these trends and this center is on the private sector doing good voluntarily within for-profit or non-profit organizations. In a business school context, there is no effort directed at policy and government institutions. We leave it for others and focus on the private sector. But my experience showed that such a focus can cause harm in reality. The staff director we hired has law education and experience in policy, and we have worked with student leaders to experiment with new activities, but it is hard to know where the new initiative is going after just a few months.

"...there is no such thing as "free market" without governments setting rules..."

Your ideas probably aren't the most popular with everyone who works in finance. Have you faced any pushback for this effort?

I do challenge some people from various crowds, including academics. Some of them do not react well, which is not so much fun, but some do engage. Ultimately, I care about doing the right thing and have to decide what is useful to do. I get most disappointed when people do not engage on issues that matter for society.

What are fundamental policy proposals that you think would address the issues surrounding financialized governance?

One of my concrete proposals deals with the tendency of policymakers to use and subsidize, explicitly and implicitly, private debt to accomplish policy goals. My academic research shows that corporate borrowing gets addictive, and it is particularly heavy and inefficient in banking, yet governments fail to counter the distorted incentives and bring about better outcomes. We also subsidize debt for housing and for higher education when there are alternative ways to achieve whatever policy goals we have.

More broadly, we must focus on accountability of those whose decisions affect others. I like to point to aviation safety as an example where the incentives are generally aligned and accountability works. In this area, we get remarkably safe flying and collaboration across countries. In the financial sector, it's the opposite. If the financial sector were an airplane, the cockpit has people who benefit when they act recklessly and endanger the passengers and have their own parachutes out of the plane. If the system fails and there is a crisis or a scandal, it seems to be nobody's fault, and we are told the system is as good as it can be and that changing it would be somehow harmful. Those who control this system get away with their actions, as well as with misleading narratives. The observations describe many other sectors where the issues get confusing, governance and policy fail, and there is insufficient accountability for those who are responsible. We need to examine these issues not only in finance. Healthcare and the internet also present serious and related problems.

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What do you see as the future of financial education in terms of teaching people about the financial system and its integration with society? What do you maybe see the future of how people see capitalism as a system that we belong to?

Ultimately, if the problem is one of collective action, people first need to understand the issues. In finance, being savvier and understanding the basics can help given that the economy is so financialized. I teach a Finance and Society course for undergraduates at Stanford which is aimed at creating savvier consumers of finance and better educated citizens who can sort the issues out in a political debate.

In the discussion of corporations and capitalism, there's a false distinction some make between markets and government. Milton Friedman and libertarians tend to hate governments and follow market fundamentalists. What James Kwak calls "Economism" is the blind belief that the perfect world of Econ 101 describes the real world without understanding that there is no such thing as "free market" without governments setting rules and ensuring basic rights, competition, and the enforcement of contracts.

The real question is what activities are best done by the private sector and, to the extent that essential sectors operate in private markets, that these markets actually produce efficient outcomes. The healthcare sector is one example where markets fail, and if governments do not act properly, inefficiencies follow as we see in the U.S.

Instead of criticizing governments, we must figure out how to ensure that governments do a good job. That's how we can save capitalism as well as democracy. Governments need expertise and resources to know what to do. Otherwise, they let lobbies with often narrow interests write the rules and the dispersed public may lose out. The problem with capitalism is intertwined with the democratic failures.

Ken Arrow, the greatest economist of the 20th century, developed general equilibrium under perfect markets, but he also has a so-called "impossibility theorem" that articulates how difficult it is to aggregate the preferences of many into a social "utility function" if we don't want dictatorships. We don't start with that result when teaching economics, maybe because it would be difficult to know how to continue. Instead, we start with a perfect world, and some people get stuck there. ■