Why MBAs should not sign the Harvard Business School oath

Harvard MBAs have proposed that all MBA students sign an oath. The oath can be found on http://mbaoath.org/take-the-oath. It pledges, among other things, to "contribute to the well-being of society" and to "create sustainable economic, social and environmental prosperity worldwide."

I don't believe that this is a good idea, for three reasons. First, some parts of the pledge are inconsistent with fiduciary duties and ethical standards. Second the oath is a misplaced response to the financial crisis. Third, I don't believe in pledges as an instrument to guide people's behaviour.

The oath invites violation of fiduciary duties and ethical standards

In many countries, board members and, as a consequence, managers have a fiduciary duty to maximise the wealth of shareholders. Even in countries where the corporate governance code is promoting maximising stakeholder value, none of these codes would accept that managers promote "social and environmental prosperity worldwide" as the HBS oath does. Externalities such as the consequences of business decisions for the environment have to be dealt with by the government, unless, of course, a business case can be made that shareholder value is increased by taking care of these externalities. For example, if I install equipment to reduce pollution and, as a result of my "socially responsible behaviour," my customers buy more of my products, my workers accept lower salaries and the government lowers my taxes, my investment may well have a positive net present value. But then the oath should simply state that you pledge to maximise net present value.

Moreover, the oath may well promote unethical behaviour. (See Vermaelen, Theo : 'Maximizing shareholder value : an ethical responsibility?' in *Mainstreaming Corporate Social Responsibility : Text and Cases*. Wiley, June 2009.) I believe it is unethical to raise money from shareholders without telling them in advance that you are going to pursue causes that are destroying shareholder value. If you want to pursue other objectives, then you should tell them in advance, so that investors can incorporate these goals into stock prices, or simply refuse to buy the company stock. For example, a non-profit organisation can make it clear that the objective is to leave the shareholders with nothing, and this is of course ethical. So, if you want to promote "global environmental prosperity" you should set up your own company and attract shareholders and other stakeholders who share this objective. For example, I noticed that in 2009 almost every US-listed ethanol company went bankrupt. I don't know what was communicated to investors when these companies went public, but if they were told: "This is not about making money but about doing good to promote global environmental prosperity" then the management did not behave unethically, even if they were fully aware that their policies were expected to generate zero returns for their shareholders.

The oath is a misplaced response to the financial crisis

The oath assumes that the financial crisis was caused by unethical MBAs. For example, in a recent working paper, "The Ethical Roots of The Financial Crisis," Wharton Professor Thomas Donaldson argues that the financial crisis was caused by bad ethics, by bankers who were gambling with other people's money. This accusation ignores the facts.

First, Rene Stulz and Rudiger Fahlenbrach ("Bank CEO Incentives and the Credit Crisis" working paper, Ohio State University, 2009) show that banks where the CEO held a lot of stock were also the banks with the biggest losses. So they were not losing other people's money, they lost their own money. They apparently believed in their strategy.

Second, Viral Acharya and Matthew Richardson ("Causes of the Financial Crisis," Critical Review Foundation, May 2009) report that 81 per cent of the mortgage-backed securities purchased by bankers for their own personal accounts were AAA rated. These securities turned out, ex post, to be the most mispriced securities: they produced lower returns than the lower-rated tranches.

Finally, my INSEAD colleague, Harald Hau, and his co-author Marcel Thum show in a widely-publicised paper ("Subprime Crisis and Board (In-)Competence: Private versus Public Banks in Germany", Public Policy, forthcoming) that the largest bank losses in German banks were experienced by banks with board members who were least educated in finance.

So the evidence is that bankers have made mistakes and board members may have been ignorant, but they are not crooks. They believed rating agencies, which in turn made their forecasts of financial distress based on extrapolating historical data. Rating agencies behaved no differently than climate change scientists who base their doomsday forecasts of man-made global warming on extrapolation of historical data. If, for example, it turns out that 30 years from now we enter a period of global cooling, will we then accuse climate change activists of greed and unethical behaviour? Will we accuse them of deliberately misleading the public in order to get research grants, consulting contracts and government subsidies? Presumably not. Forecasting and modelling is a tricky business. So the solution is not more ethics or pledges, but more finance education and better forecasting and risk management models.

People are not driven by pledges, but they are driven by incentives

The donkey does not walk because he pledges to walk, but because of the carrot and the stick. The idea that the next crisis will be avoided simply because we sign an oath, seems excessively naïve. Signing the oath doesn't cost anything and therefore not a credible commitment. Even if Bernie Madoff had signed the HBS oath, he would not have acted any differently. Rather than focusing on pledges, businesses should make sure that managers comply with their fiduciary and ethical responsibility to maximise the wealth of the people who pay their salaries, i.e. the shareholders. The current debate should focus on how to improve corporate governance and how to design compensation contracts that are maximising shareholder value, rather than profits, earnings per share, return on equity or other non risk-adjusted short-term measures of performance.

The HBS school oath aims to achieve exactly the opposite. It pushes the stakeholder value maximisation idea to its extreme by including the whole world as a stakeholder. If this oath indeed would be implemented, then the resulting erosion of shareholder property rights would prevent the development of capital markets (see La Porta, Lopez-de-Silanes, Shleifer and Vishny: "Law and Finance", *Journal of Political Economy*, 1998) and undermine economic growth. As I interpret the oath as a commitment to bad corporate governance, companies which employ those who sign the oath as top executives should disclose this on the first page of their website. In this way investors are warned that investing in these companies can be "dangerous to your wealth."

If MBA students insist on taking an oath that promotes shareholder-friendly corporate governance, I would propose the following:

"I pledge to maximise the wealth of the people who pay my salary, i.e. the shareholders, unless the shareholders tell me in advance that they want me to do something else. I will do my best to learn how to do this by taking the relevant courses"

Theo Vermaelen and Craig Smith took part in a debate at INSEAD's Europe campus in Fontainebleau which was organised by the student club, INDEVOR, and sponsored by Actis.

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