The spirit of the letter of the law … to avoid a “Graccident”

Raul Sampognaro and Xavier Timbeau

The noose, in the words of Alexis Tsipras, is getting tighter and tighter around the Greek government. The last tranche of the aid program (7.2 billion euros) has still not been released as the Brussels Group (the ex-Troika) has not accepted the conditions on the aid plan. The Greek state is therefore on the brink of default. It might be thought that this is simply one more episode in the drama that Greece has been acting out with its creditors and that, once again, at the last moment the money needed will be found. But if Greece has managed to meet its deadlines up to now, it has been at the price of expedients that it is not at all certain can be used again.

While tax revenues since the start of the year have been almost one billion euros behind the anticipated targets, the expenses for wages and pensions still have to be paid each month. This time the wall is getting closer, and an agreement is needed if the game is to continue. In June, Greece must pay 1.6 billion euros to the IMF in four tranches (5, 12, 16 and 19 June). On 28 May an IMF spokesperson confirmed the existence of a rule that would make it possible to group these payments on the last day of the month (a rule last used by Zambia in the 1980s). Since it would then take six weeks for the IMF to consider Greece in default, the country could still gain a few days after 30 June before the deadline with the ECB (with 2 tranches for a total 3.5 billion euros by 20 July 2015).

Historically very few countries have failed to honour their payments to the IMF (currently only Somalia, Sudan and Zimbabwe are in arrears to the IMF, for a few hundred million dollars). As the IMF is the last resort in case of a crisis in liquidity or the balance of payments, it has, as such, the status of preferred creditor, so defaulting on its debt may trigger cross defaults on other securities, in particular, in the Greek case, those held by the European Financial Stability Facility (EFSF). This could make them due immediately. A Greek default with the IMF could well jeopardize Greece's entire public debt and force the ECB to reject Greek bonds as collateral in the Emergency Liquidity Assistance (ELA) operations, the only firewall remaining against the collapse of the Greek banking system.

The legal consequences of such a default are difficult to grasp (which says a lot about the modern financial system). An article published by the Bank for International Settlements, dated July 2013, whose author, Antonio Sainz de Vicuña, was then Director General of ECB Legal Services, is very informative about this issue in the context of the Monetary Union.

In presenting the legal framework, Sainz de Vicuña focuses on Article 123 of the Treaty on the Functioning of the European Union (TFEU), a pillar of the Monetary Union, which prohibits the ECB or the national central banks from financing government[1]. In a footnote, the author concedes that there are two exceptions to this rule:

– "Credit institutions controlled by the public sector, which may obtain central bank liquidity on terms identical to private credit institutions." This exception appears explicitly in paragraph 2 of Article 123 of the TFEU[2].

– "The financing of state obligations vis-à-vis the IMF."

This second aspect has attracted our attention because it is little known to the general public, it does not appear explicitly in the Treaty and it could be a solution, at least in the short term, to avoid Greece being put in default by the IMF .

In searching the corpus of European law, this exception is defined more precisely in Council Regulation no. 3603/93, which clarifies the terms of Article 123 of the TFEU, which it is authorized to do under paragraph 2 of Article 125 of the TFEU[3]. More specifically, in Article 7:

*The financing by the European Central Bank or the national central banks of obligations falling upon the public sector vis-à-vis the International Monetary Fund or resulting from the implementation of the medium-term financial assistance facility set up by Regulation (EEC) No 1969/88 (4) shall not be regarded as a credit facility within the meaning of Article 104 of the Treaty****[4]****.*

The justification for this article is that: during quota increases in the IMF, the financing by the central bank was accepted because It had as a counterpart an asset comparable to international reserves. In the spirit of the law, financing Greek borrowing from the IMF by a credit from the central bank (the ECB or the Bank of Greece) should not be permitted. The obligations falling upon the Greek state probably only concern, according to the spirit of the text, the contribution to the IMF quotas. Nevertheless, the spirit of the law is not the law, and the proper interpretation of the phrase “obligations falling upon the public sector *vis-à-vis* the International Monetary Fund” could open another door for Greece. Given the consequences of a default with the IMF – in particular the continuity of the ELA – invoking this could be justified as preserving the functioning of the Greek payment system, a role falling within the mission of the ECB.

Beyond the legal possibility of a central bank financing

Greece's debt to the IMF, which would certainly be challenged by some governments, this action would open up a political conflict. A MemberState could be accused of violating (the spirit of) the Treaties, even though that is not a reason to exclude it (according to the ECB's Legal Services). But is this really an obstacle in view of the importance a default on Greece's debt would have for the sustainability of the single currency?

Greece's cash flow problems are not new. Since January, the government has been financing its expenditure through accounting transactions that allowed it to offset tax losses. In particular, on 12 May, the Greek government was able to repay an IMF loan tranche by drawing on an emergency fund that was essentially international reserves. The Eurosystem was able to use this exception to give Greece extra time in order to continue the negotiations and avoid the accident.

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[1] Paragraph 1 of the article stipulates that, "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."

[2] Which stipulates that, "Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions."

[3] Which stipulates that, "The Council, on a proposal from

the Commission and after consulting the European Parliament, may, as required, specify definitions for the application of the prohibitions referred to in Articles 123 and 124 and in this Article."

[4] Article 104 became Article 123 in the TFEU.

On the search to "recapture the industrial spirit of capitalism": From patient shareholders to shared governance

By Jean-Luc Gaffard and Maurizio Iacopetta

The government, buoyed by the law to recapture the real economy, the Florange act, which establishes the possibility of double voting for patient shareholders (who have held their shares at least two years), has just taken two significant decisions by temporarily increasing its holdings in the capital of Renault and Air France in order to ensure that in a general shareholders meeting the double voting option is not rejected by the qualified majority authorized under the law. The objective spelled out by France's Minister of the Economy in *Le Monde* is to help "recapture the industrial spirit of capitalism" by favouring long-term commitments in order to promote investment that will foster solid growth.

Under the impulse of the Florange law, that has recently introduced the institute of the double voting for 'patient' shareholders (shareholders who have held their company's shares for at least two years), the government has taken the important decision of increasing temporarily its equity shares into two major French companies: Renault and Air France.

The increased government's stake into the two companies aims at preventing attempts of the shareholders general assembly to block the adoption of the double voting institute, which would require the approval of a qualified majority. The France's Minister of the Economy explained in Le Monde that the government's action is intended to help "revive the industrial spirit of capitalism" by favouring long-term commitments that promote investments and foster robust growth.

This initiative has led to renewed discussions about the governance of joint-stock companies and corporations (Pollin, 2004, 2006), to consider the problems that afflict them, possible remedies, and what one could expect from the government.

Because corporations have the ability to attract abundant savings and because of their power in choosing where to direct these savings, they are undeniably at the heart of the investment process. They can be governed in various ways, depending on the institutional contexts, which are related in turn to significant differences in productivity and growth (Bloom and Van Reenen, 2010 ; De Nicolo', Laeven and Ueda, 2008 ; La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2000). So the question arises as to which governance model is best able to promote entrepreneurial activity and innovation, and thus ultimately to ensure growth (OECD 2012).

There is evidence that the big corporations do not suffer from a lack of long-term financing. The development of the stock and bond markets since the 1980s has allowed corporations to reduce their dependence on bank financing and its cyclical character. Investment problems thus mainly reflect major breakdowns in the governance of companies, whether large, medium or small, as well as in the governance of financial institutions (Giovannini *et al.*, 2015).

Traditionally, the focus has been on the ways controlling shareholders' choose managers, *i.e.* the conditions under which the capital owners get the yield on their investment that is justified by their special position as residual claimant (Shleifer and Vishny, 1997). But this ignores that other company stakeholders (creditors, employees, suppliers or even customers) also incur risk, and that the long-term performance of the company depends on the conditions in which the shareholders' engagement controls the commitment of the other stakeholders (Mayer, 2013). It is not certain, in this regard, that the distribution of voting rights between different classes of shareholders is decisive.

Control and engagement

The central issue is how capital owners affect management's decision-making. Thus, the goals and values of family businesses reflect the interests and inclinations of the family owners, which can become inconsistent with productive efficiency, especially with the rise of rentier capitalism, when it is no longer the founders who are at the head of the company but their heirs or, more surreptitiously, a self-perpetuating caste (Philippon, 2007). While there is a positive relationship between the wealth of self-made millionaires and GDP and growth, the relationship to GDP turns negative when this concerns the wealth of millionaire heirs (Morck, Stangeland, and Yeung 2000). Faced with this potential problem, the existence of dispersed ownership would seem to be beneficial in so far as it replaces special interests with what can be likened to a collective interest.

This vision of the corporation nevertheless faces an objection formulated by Berle and Means (1932), who view the separation between ownership and control as a source of inefficiency. It creates problems of agency, meaning that the managers are likely to act in their own interests rather than in those of the shareholders, just like families or owning castes. Empirically, the Tobin’s Q (the ratio of capital’s market value to its replacement cost) increases, then decreases before increasing again as the power of the managers grows (Morck *et al.*, 1988). It is then possible that shareholders have less incentive to subscribe new shares or keep the ones they hold, resulting in lower share prices and less access by companies to external financing. The provisions that make it possible to protect large enterprises can have the effect of hindering the market entry of new businesses and introducing significant distortions into the investment decision-making of established firms (Iacopetta, Minetti and Peretto, 2015).

Solving these problems requires creating institutional arrangements to ensure that shareholders become active in corporate management.

These arrangements have involved improving the quality of audits, of risk management and of communications between the company and its shareholders. They have led to greater transparency in executive compensation policy and linking pay to performance. This process has spurred the development of “markets for corporate control” and for shareholder activism, and indeed of a particular class of shareholders consisting of investment funds, including pension funds, whose management methods (the delegation of investment decisions to fund managers) emphasizes the immediate performance of their portfolios.

In the light of the financial crisis, these arrangements seem questionable to say the least (Giovannini et al., 2015). Financial institutions, although subject to the “best” governance rules ensuring genuine shareholder control, have been scenes of conflict between shareholders who have benefited from upside positive performance and creditors (and taxpayers) who have had to bear any losses. What was true of the financial institutions also held true for manufacturing companies, which have been arenas of conflict between shareholders and the other stakeholders (creditors, employees, suppliers and customers).

The real problem is that the while arrangements that were designed to solve agency problems have strengthened the control exercised by shareholders over company management, they have also reduced the shareholders’ level of engagement (Mayer, 2013).

Notwithstanding their particular interests, family owners can ensure a stability and long-term engagement vis-à-vis other stakeholders that is not guaranteed by dispersed shareholding. The same is true of managers with delegated authority who have acquired sufficient independence vis-à-vis the shareholders to be open not only to their own interests but also to the interests of the employees (and sub-contractors). After all, the constitution of industrial empires is far from a bad thing so long as they are economically viable and do not violate the rules of competition. But the advantages conferred on managers are being offset by the development of markets for corporate control and shareholder activism, which has led to judging managerial effectiveness on the grounds of current performance. There is indeed a trade-off between the requirements of control and engagement. The problem is perhaps not so much to align the interests of managers with those of shareholders as to make shareholders responsible for what happens in the long run to the companies in which they invest.

The measure of engagement

The degree of commitment of financiers, lenders and shareholders is critical since it determines that of the other stakeholders in the company. It is reflected in the attitude chosen in response to fluctuations in performance, and more specifically in the degree of tolerance of poor business results. A low tolerance is a sign of a low degree of engagement, and usually a sign of hostile takeovers and pension fund activism.

It is also necessary to agree on the meaning of poor results. This could be the result of bad management, in which case investors’ power to provide financing conditioned on management’s ability to make the changes they require does not necessarily indicate a lesser degree of engagement. It may even prevent the financial crises that could result from serious agency problems – at least if consistent performance is the norm. But this is exactly not the case when the relevant industrial activities have a cyclical dimension. Companies can deal with this by offsetting the results of several activities against each other provided that their cycles are different. But the attitude of investment funds is to emphasize the diversification of their portfolio on the valuation of the diversification of their activities by the companies themselves, prompting the latter to refocus on what is sometimes described as their core business. A series of dismantling operations, in particular, in the cases of Alstom, Alcatel and Thomson, constituted one of the reasons for the deindustrialization seen in France (Beffa, 2012).

Nor does the consistency of performance prevail when companies choose to innovate by introducing new products or new production techniques and exploring new markets. Because firms incur the costs long before increased in revenue, these are irrevocable costs, that is to say, whose recovery is contingent on the success of the decision to innovate (“sunk costs”). Any form of governance that would have the effect of favouring immediate results and eliminating tolerance of a temporarily poor performance would then only hold back innovation by penalizing long-term investment. But this is exactly where the possibility of hostile takeovers and the activism of investment funds are leading.

The institutional prescriptions

The debate has thus been opened on the ins and outs of the conflict between different classes of shareholders established in relation to the volume of securities held and the length they are held (Samama and Bolton, 2012). Many companies have adopted mechanisms that financially reward shareholders' loyalty or that grant them additional voting rights in return for this loyalty. Some countries (France and Italy in particular) have legislated in this regard. It is difficult to assess the results. In theory, the principle of "one share – one vote" does not rule out the existence of several classes of shares involving different voting rights. It does of course reduce the agency problems involving the holders of blocs of shares, but it also reduces the beneficial effects of the stability that these blocs provide (Burkart and Lee, 2008). Moreover, empirical studies reach mixed conclusions, further indicating the complexity of the problem (Adams and Ferreira, 2008).

Nevertheless, numerous empirical studies do confirm that companies that have a more stable ownership structure and meet performance indicators that do not refer merely to financial capital have better outcomes in the long run (Clark et al., 2014). The existence of stable shareholder blocs or of restrictions on voting rights may be mechanisms that are likely to ensure this sustainability and strengthen the degree of commitment made by the capital providers, thereby justifying that other stakeholders – employees, suppliers and customers – do likewise in turn.

The difficulty with mechanisms for restricting voting rights is that they do not allow shareholders to indicate the length of time that they want to keep their shares and to indicate their level of engagement (Mayer, 2013). In fact, those who intend to hold their shares only briefly (possibly milliseconds in case of high-frequency trading) have the same influence on managers' decisions as those who intend to keep their shares for many years. The first bear the consequences of their votes only momentarily, unlike the latter, but both have the same influence on current decision-making, which may affect the company’s performance for a long time to come. Basically, establishing different classes of shares does not necessarily substitute for the constitution of a stable bloc of shareholders that is able to deal with hostile takeovers motivated by the quest for short-term capital gains.

Things may be different when past loyalty is rewarded financially by an increase in the dividends paid, since in this case selling the shares leads to losing the financial advantage acquired. There is therefore an incentive to hold the shares even longer. Nevertheless, the payment of dividends is never equivalent to the retention of profits. The proceeds from new issues are under the control of the shareholders, whereas undistributed profits are still under the control of the managers. The higher the dividends, the more companies are dependent on their ability to draw on the stock market. There is still an issue of too much dependence vis-à-vis impatient shareholders, pulling companies towards short-term investments.

Accordingly, one potential relevant mechanism might be to establish voting rights based not on the time the shares have been held, but on the future period to which the shareholders are committed (Mayer, 2013). Under this proposal, shareholders would be able to register the period for which they intend to hold their shares and to be paid in the form of votes that are set according to the length of time remaining before they are able to dispose of them. At the moment, “loyalty and the double vote of the shares remunerate shareholders for the period the shares have been held and, consequently, fail to make them more responsible for the future consequences of their decisions. Really, since shareholders who have held their shares a long time are more likely to sell them, this potentially rewards a lack of commitment” (Mayer, 2013, pp. 208-9). It is clear, however, that it would be difficult to implement this institutional arrangement in practice, not least due to its credibility, and it would be preferable to explore other forms of governance that involve other stakeholders in the decision-making process.

On the expectations of government

In light of the analysis above, the question arises of what the government can expect from its decision to impose double voting rights. The answer is that this could be mainly to reduce, even if in a limited way, the public debt, without losing its influence in the companies in which it holds shares. The intention to revive industrial capitalism by this measure, laudable as this may be, is unlikely to have any real impact. This is true in particular because there is nothing to suggest that in the future the State would behave differently from any other shareholder, despite double voting rights, and could impose or contribute to imposing management decisions that are not necessarily in the long-term interest of the companies and their stakeholders.

Also, without wishing to neglect what the existence of several classes of action could mean for making decisions about business strategy, including possibly introducing protection against hostile takeovers, it seems a more fundamental measure would be to revise the business model as a whole.

The degree of engagement of the capital providers commands the commitment of the other stakeholders. Intermediated financing is the primary source of funds for owners who want to keep control of their business. It enables companies to innovate and grow without the need to dilute ownership. But it is necessary for such financing to exist, i.e. for banks to commit over a long term to these companies. Yet banks too are afflicted with problems of governance, leading to a conflict between the two main types of investors, shareholders and creditors (Giovannini et al., 2015). If institutional progress is to take place, it should therefore concern the financial system and be based on a return of intermediation (Pollin 2006). And if action is to be taken on the conditions of governance of the corporations themselves, this should be based on the proposals by Mayer (2013): perhaps, subject to feasibility, by instituting voting rights in proportion to the time for which shares are held in the future, but especially by establishing “boards of trustees” that set broad guidelines, acting as the guardians of values common to the various stakeholders (shareholders, creditors, employees and even suppliers and customers) instead of acting merely as representatives of the shareholders. These common values do nothing more than express the recognition of the strategic complementarities that exist between all the actors who are the source of value creation.

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