esm blog

European Stability Mechanism

Looking beyond profits to secure financial stability

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29/08/2024

Profitable businesses are often considered successful enterprises. However, that notion is increasingly challenged by active stakeholders, who demand more value and also look beyond companies' financial information.

As often attributed to Albert Einstein: "Not everything that can be counted counts, and not everything that counts can be counted." In this blog we examine whether a business's success should also be measured by other metrics such as the ability to manage risks, adapt to changes, or navigate turbulent markets. Such essential qualities determine the trust stakeholders have in an entity, and therefore the value they assign to it. Companies' reliability, especially during times of high uncertainty, impacts financial stability, the very thing the European Stability Mechanism (ESM) is here to safeguard.

How does value materialise?

Value should not be gauged solely in terms of the short-term viability of an enterprise. One should also look farther afield at its resilience to unexpected shocks and its long-term sustainability.

Essential value beyond profit is therefore measured by various factors that stakeholders can judge by digging into companies' public information. Such factors can also often be gleaned from third-party analysts' reports. In this blogpost, we organise these factors into three areas (strong risk management and effective governance; preparedness and adaptability; and credible, transparent reporting) and point to past instances when companies' profits did not protect them from the risk of collapse when other fundamentals were lacking. We also underscore the importance of respecting all aspects that contribute to value.

1. Strong risk management and effective governance

As elaborated in an ESM blog post on lessons from last year's banking turmoil, investment strategies and weak risk management were among the reasons for the banking turmoil that unfolded in the United States (US) and Switzerland in early 2023.

The US Government Accountability Office cited that "risky business strategies along with weak liquidity and risk management contributed to the recent failures of Silicon Valley Bank and Signature Bank. For both banks, rapid growth was an indicator of risk".[1] Similar findings were raised by the Federal Reserve.[2]

Before 2023, these deficiencies did not appear to threaten these banks' stability. In fact, the value of sound risk management is most evident in business cycle downturns. Claudia Buch, Chair of the European Central Bank's Supervisory Board, stated that "the main lesson is that crises often happen when banks' poor risk management is exposed by external shocks."[3]

Unfortunately, this is not new. Major corporate failures in history often came from failures in risk management, not from lack of profits.[4] In 2008, the collapse of US bank Lehman Brothers made history less than a year after reporting record profits. Risky strategies mostly explain that case too.[5]

2. Preparedness and adaptability

In today's ever-evolving world, the ability to adapt and rapidly steer an organisation's direction is a necessary condition for success.

The failure of the giant British tour operator Thomas Cook in 2019 is just one of the many cases that underscores the importance of adaptability. After almost two centuries of commerce, the company found itself unprepared[6] for the huge competition coming from digital platforms and low-cost airlines that rapidly made traditional tour operators obsolete.

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[1] U.S. Government Accountability Office (2023) Bank Regulation: Preliminary Review of Agency Actions Related to March 2023 Bank Failures.
[2] The Federal Reserve (2023) Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank - April 2023
[3] The European Central Bank (2023) Annual Report on supervisory activities 2023 (europa.eu)
[4] See, for example, U.S. Securities and Exchange Commission (2008) Risk Management Lessons from the Global Banking Crisis of 2008 (sec.gov).
[5] Harvard Business Review (2009) Lehman's Three Big Mistakes (hbr.org)
[6] New York Times (2019) How Could Travel Giant Thomas Cook Fail? - The New York Times (nytimes.com)

The ability to adapt and transform is also a tool for growth. The famous sports car maker Lamborghini started as a tractor manufacturer, Amazon began as an online bookstore, and Samsung was founded as a grocery trading company.

Companies should strive for a balance between scenario planning and strategy planning and seek to use profits to invest in more productive efficiency and flexibility tools to best position themselves for success. This has become even more relevant in the current fast-changing environment.

3. Credible and transparent reporting

Assessing the credibility of an entity's reporting can be difficult because it is vulnerable to fraud. For example, in March 2003, Parmalat announced growing profits to its shareholders only to suffer one of the most painful corporate collapses in European history a few months later. Fictitious liquidity was shown in the company's balance sheet.[7]

Another recent reporting scandal is that of Wirecard in 2020. The lack of transparency and accuracy in financial reporting, among other issues, emerged as the main elements that triggered its demise.[8]

Going one step further, transparency also brings many benefits in addition to warding off negative effects. It can foster market discipline and attract fresh capital to the best investment opportunities, which in turn helps the economy grow. Not by accident, transparency is also an important element of the European Union's (EU) Green Deal Initiative. This was explored in an ESM blog post about reforms that could help Europe finance its fightback against climate change.

The ESM's experience

We recognise the differences between private and public sectors of the economy. Public entities' top priority is public value in line with their mandates, which makes the three above-described factors more crucial than profit. That applies at the ESM, which has allocated all profits to its reserves to maintain robustness and preparedness. Indeed, our statute requires it.

ESM Managing Director Pierre Gramegna pointed to these important factors in his personal message in the 2023 ESM Annual Report saying, "it is imperative to remain vigilant, adaptable, and cooperative in pursuit of a more robust and prosperous future."

Adaptability is a priority for the organisation. In 2020, before the introduction of the 'Next Generation EU' package by the European Commission, the ESM promptly created a new instrument for sovereigns in the form of the Pandemic Crisis Support credit line, set up to support ESM Members in financing healthcare costs related to the Covid-19 crisis.

For its risk-management framework, the ESM follows the widely used three-lines of defence model, originally developed in the military sector and adapted for use in organisations with financial operations. In accordance with the Basel Committee on Banking Supervision,[9] this model covers the organisation's business units (first line), an independent risk management

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[7] Financial Times (2008) The saga of Parmalat's collapse (ft.com)
[8] European Parliament (2020) EU Parliament study on the Wirecard case and its implications
[9] See Bank for International Settlements (2021) Revisions to the Principles for the Sound Management of Operational Risk (bis.org).

function (second line), and internal audit function (third line). This multi-layer approach ensures the desired level of robustness and transparency, which are essential values for stakeholders.

The ESM follows strong governance standards with a regular flow of information provided to the Board of Directors, as well as Board of Governors, the highest decision-making body of the ESM. Sub-committees of the Board of Directors examine more closely the developments on budget and on risk management.

The ESM is just one example of how the three uncountable value factors described in this blog are applied in the public sector. In general, we are convinced that all these factors contribute to real value and success in both the private and public sectors, and ultimately to financial stability.

Acknowledgements

The authors would like to thank Christophe Frankel, Pilar Castrillo, Nicoletta Mascher, George Matlock, Thomas Pies, and Mario Prodi for their contributions to this blog post, and Raquel Calero for editorial review.

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