Draft

Global Prosperity at Risk

The Current Crisis and the Responsible Way Forward

Imprudent decisions on the part of US and European investment banks, banks, mortgage brokers, insurance companies, and consumers - all seeking profitable advantage - have brought the global financial network that sustains global capitalism to crisis. It is the greatest crisis of capitalism since the great depression of the 1930's.

Great American financial houses – even Lehman Brothers that survived the Great Depression of the 1930s - are no more; banks in America and Europe have been propped up by governments - even to the extent of deposit guarantees; and massive amounts of liquidity have been injected into the financial system by the US Federal Reserve System and other central banks.

This is not business as usual. Trillions of dollars in private wealth has been destroyed in a matter of weeks, some of it never to be regained. And governments have been forced to step in to protect the economically vulnerable where markets have failed.

Yet, ironically, inadequate regulation and government policies also contributed in various ways to risks being negligently addressed by financial markets, thereby paving the way for the current crisis.

Beyond dealing with the immediate crisis, the critical task will be to address the underlying causes through reforms to restore trust and confidence in financial markets. Functioning and sound financial institutions, despite their current failure to meet their fundamental responsibilities, remains of first importance for supporting a successful free market economy. Credit is now scarce and capitalism cannot properly function without it.

The triggers to this crisis were centered on a lack of: prudence in the extension of credit; rigor in valuations; and of transparency in management. For example, major banks extended credit and assumed obligations on contracts that were inherently over-valued. When the over-valuation became apparent, bank capital was inadequate to support the corresponding liabilities. This was compounded by the mispricing of risk via the bundling and sale of debt through collaterised debt securities and via complex derivative based credit default swaps. These failures reflected profound shortcomings in private sector governance both as prescribed and as applied. In short, risk was not appropriately managed; it was not even properly understood both by those creating it and by those bound to mitigate it.

Driving this lack of prudent management was a dysfunctional and shortsighted system of incentives and personal remuneration.

Compensation of senior executives, traders and fund managers was built on greed and self interest and was decoupled from long-term wealth creation. Compensation based on fees earned and other incentive-based benchmarks blinded otherwise intelligent managers to the long-term dire consequences of their decisions. Rewards rose with excessive risk taking and was provided in ways that has largely shielded senior corporate officers and fund managers from liability for their decisions.

As a result, the best interests of customers, owners, employees and communities have been systematically overlooked. Decision-makers, driven by short-term interests, paid too little to no attention to managing risk accumulation.

Short-term speculation dominated, with part of the market enriching itself by betting on and contributing to the destruction of wealth via short-selling. Not only did the regulators fail to halt the growth in systemic risk, some of the contributing market activity and behavior was allowed to remain unregulated.

This global financial crisis has further exacerbated the very low levels of trust which the global community places in business. The fact that the profits were in effect privatized to those who created the crisis through excessive rewards, and the losses are now being socialized to taxpayers has further outraged the community. Though justly perhaps, the shareholders of the ‘failed’ financial institutions responsible for the crisis have lost most of their ownership wealth.

This is not the first time that market capitalism has so failed. Less than a decade ago, global markets lived through the bust of the dot-com and telecom bubble in equities and the accounting scandals of Enron and World-Com. Before that, world financial markets were upset by currency collapses in Thailand, Malaysia, Indonesia and Russia. And before that, the United States lived through the savings and loan/junk bond bubble and bust.

More fundamentally, the current crisis represents the latest, albeit the most severe, fallout from the systemic erosion within the corporate world of the importance of ethics and responsibility in business decision-making. Ideological commitments to laissez-faire free market fundamentalism, social darwinism philosophies, and shareholder primacy at the expense of other stakeholders, have divorced business leadership from standards of good faith, wise stewardship and care for the public interest.

As a result, capitalism’s immune system of market discipline fails every so often and the cancer of “irrational exuberance”, greed and narrow self interest metastasizes. The object of reform, obviously, should be either to eliminate this deep cancer within capitalism once and for all or to boost society’s market immune system of accurate pricing, risk management and valuation transparency in order to keep the cancer in long-term remission.

At the core of all these market shortcomings were the boards of directors of the corporations involved. They were not sufficiently encased in an environment of accountability and transparency and ultimate accountability. The market failure, therefore, was ultimately a failure of governance.

With respect to the current crisis in financial markets, there are no clear remedies on the table. Business leaders are largely silent; academics have little to say beyond the immediate; and politicians, regulators and central banks are putting out fires. No one is focused on designing a sustainable future that removes once and for all the underlying problem.

Interestingly, the recent movement promoting corporate social responsibility via CSR standards, monitoring, reporting and ratings, has not proved adequate in preventing these failures of capitalism. It is now apparent that much of the CSR movement remains on the fringes and too removed from core of business risk management and strategy. Compounding the problem, business education has been lacking with a general absence of teachings in responsible and ethical business practices.

Uniquely, the Caux Round Table (CRT) Principles for Business provide strategic ethical guidance which, had it been followed, would have kept those institutions that have triggered the crisis more faithful to their obligations of stewardship, good governance and stakeholder risk management. The CRT Principles go to the heart of constructive and ethical behaviors that enhance risk assessment and stakeholder management, boosting bottom-line valuations of business success and sustaining responsible long-term wealth creation for society.

The way forward to free markets that are consistently reliable in their capacity for robust wealth creation is through the imposition of higher standards of good governance and transparency. Lack of good governance and transparency, again and again, leads market capitalism down wrong roads. Such opacity and lack of accountability has long been a fundamental flaw in institutions of private enterprise.

The following remedial steps to take responsible capitalism from the fringes of the business model and firmly entrench it in the heart of corporate strategy deserve priority attention:

- First, the principle of *"enlightened shareholder value"* should be codified in company law via non-prescriptive minimum standards for responsible decision-making and good governance. (The UK Companies Act 2006 provides an example of such legislation.)

    - Directors should be required to document and defend their stewardship over company affairs via specific disclosure of:

        - the principle risks and uncertainties likely to affect the future development, performance and position of the company's business; and
        - material risks and impacts relating to environmental matters, employees, customers, suppliers and social and community issues.

- Second, members of corporate boards should be trained corporate governance including Board oversight of the full spectrum of financial, social and business risks.

    - Business is not without consequence for society and should, therefore, be attentive to the demands for responsible execution of its private office of trust and profit.

    - The CRT risk assessment process of Arcturus provides an example of what can be required of companies in regard to stakeholder, social and environmental risks.

- Third, corporate boards should establish a dedicated committee responsible for strategic risk consideration across the full range of stakeholder, responsibility and sustainability issues.

    - The environmental, social and governance risk assessment processes and outcomes, should be subject to third party assurance.

    - Boards should make annual disclosures of the material financial, environmental, social and governance risks assessment in easily understood prose that is meaningful to stakeholders.

- Fourth, executive compensation must be reformed to ensure incentives are aligned to the achievement of long-term wealth creation and reward prudent risk management rather than excessive risk taking.

- Fifth, equity and capital market regulation and taxation should be reformed to incentivize sustainable value creation and to penalize / ban market manipulation, short-selling and other value destruction.

- Sixth, derivative markets need to be regulated, including the introduction of a fully regulated exchange for credit derivatives.

- Seventh, opportunities for companies and individuals to illegally hide income by utilizing tax havens and secrecy jurisdictions should be eliminated.

These reforms will not only address the causes of the current crisis, they will have a salutary effect on a broader and longer basis. Such reforms to eliminate the underlying, systemic flaws in the system should have as an objective promotion of global social responsibility on the part of all companies.

For the Caux Round Table

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