Pegasus

A newsletter for the Caux Round Table Network
looking at business above the clutter and confetti

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Moral Capitalism At Work

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Pegasus

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INTRODUCTION

In this short issue of Pegasus we are sending you copies of the briefing papers to be presented to participants at the Caux Round Table's 27th Global Dialogue, to be held at Mountain House in Caux, Switzerland on the 30th and 31st of this month. We want readers of Pegasus to be 'in the loop', as they often say, on the issues and points of view that seem to invoke the spirit and guidance of the CRT ethical principles for advancing better prospects for our world. A vision of human flourishing implies a moral or ethical dimension to well-being that suffuses material satisfaction with more far-sighted understandings of the good.

The CRT's Global Governing Board chose 4 topics for discussion, each considered to be central to improving outcomes of the global economy through the interaction of business, governments, and civil society.

The *first* topic is to assert that sovereign governments have a responsibility to provide the public good of a robust but responsible system of financial intermediation. Recent events indicate that, if left solely to private players, financial intermediation will fall short of stewardship for the real economy and become dysfunctional, thereby causing widespread losses. The *second* topic puts on the table the issue of more fundamentally repositioning finance and banking from a business to a profession. The *third* topic for consideration at this year's Global Dialogue is the need for new approaches to valuation of financial instruments to reduce volatility in market pricing, prevent asset bubbles from forming, and minimize the losses that come from stupid projections of future earnings. The *fourth* topic is more academic: what theory of human nature should drive our mathematics of financial analysis? An understanding that market participants are condemned to short-sighted selfishness that maximizes immediacy and devalues the future or an understanding that we can have higher standards of conduct in private market transactions?

These topics, if not at the center of needed reform of global capitalism, at least establish an agenda of meaningful reform.

Stephen B. Young
Global Executive Director

SOVEREIGN RESPONSIBLITY FOR SOUND FINANCIAL INTERMEDIATION

Prepared by **Stephen B. Young**
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3 July 2012

KEY ISSUE | Sovereign states have a responsibility to promote economic growth. They are trustees for those under their authority. Economic growth is not, strictly speaking, a matter for the private sector alone. Market failures, especially in financial intermediation and in public/private rent extraction through cronyism and corruption, occur all too frequently.

Whether the country is Greece or Nigeria, Egypt or Laos, sovereign power has obligations under international law to promote sound structures for financing economic growth.

BACKGROUND AND CONTENT | Lives of full human dignity are not possible in conditions of poverty. Therefore, the obligation to respect human dignity calls forth systemic efforts to provide individuals with the material conditions which will permit them to exercise and enjoy their moral autonomy.

Financial markets, if left to their own, slide toward mispricing of financial assets. They are markets for legal claims on future payments; they are not markets for goods or services. The present value of such legal claims has no intrinsic benchmarks; such present values float with market opinion, which is subject to misperceptions and herd instincts. Market opinion also does not see until it is too late the arrival of "Black Sheep" or "fat tail" phenomena. Use of statistical averages from past behavior is not fully reliable for prediction of future events that drive the prices of financial instruments. Recent expansion of "marked-to-market" accounting for financial claims has added to the volatility of financial assets.

Mispricing in financial markets occurs most easily in financial markets when liquidity is plentiful. The marginal costs of borrowing and the marginal costs of creating additional legal claims – issuance of shares, bonds, mortgages, CDOs, CDSs, etc. – are very low and pose no barrier to issuance of claims on future income greatly disproportional to the capacity of the real economy to deliver such income.

For example, it is worthy of consideration that current global GDP is some US$63 trillion while total global financial claims from currency through derivatives are some US$900 trillion.

As John Maynard Keynes famously pointed out in 1936, financial markets have a close kinship with casinos. In a casino, present value is wagered on the outcome of future contingencies. The wager is more or less a legal claim to payment if the conditions precedent to payment should come to pass.

Economic growth demands steady and reliable pricing and access to liquidity. If financial markets cannot provide this, they need supplementation with government regulation to reduce volatility and to promote fairness in distribution of profits across sectors.

With the evolution of financial markets shifting away from traditional banking functions towards proprietary trading in speculative contracts (derivatives), the financial sector has taken a higher share of private income generated in the global economy.

The responsibility of governments to provide reliable financial markets is now a recognized part of sovereign duties. Financial markets are not to be left underdeveloped nor open to elite exploitation.

This responsibility of states was acknowledged by governments subscribing to the Millennium Declaration of 2000 which says:

2. *We recognize that*, in addition to our separate responsibilities to our individual societies, we have a collective responsibility to uphold the principles of human dignity, equality and equity at the global level. As leaders we have a duty therefore to all the world's people, especially the most vulnerable and, in particular, the children of the world, to whom the future belongs.

12. *We resolve therefore* to create an environment – at the national and global levels alike – which is conducive to development and to the elimination of poverty.

It was further noted by states signatory to the 2002 Monterrey Consensus that:

1. *We the heads of State and Government*, gathered in Monterrey, Mexico, on 21 and 22 March 2002, have resolved to address the challenges of financing for development around the world, particularly in developing countries. Our goal is to eradicate poverty, achieve sustained economic growth and promote sustainable development as we advance to a fully inclusive and equitable global economic system.

3. *Mobilizing and increasing* the effective use of financial resources and achieving the national and international economic conditions needed to fulfill internationally agreed development goals, including those contained in the Millennium Declaration, to eliminate poverty, improve social conditions and raise living standards, and protect our environment, will be our first step to ensuring that the twenty-first century becomes the century of development for all.

4. *Achieving the internationally agreed* development goals, including those contained in the Millennium Declaration, demands a new partnership between developed and developing countries. We commit ourselves to sound policies, good governance at all levels and the rule of law. We also commit ourselves to mobilizing domestic resources, attracting international flows, promoting international trade as an engine for development, increasing international financial and technical cooperation for development, sustainable debt financing and external debt relief, and enhancing the coherence and consistency of the international monetary, financial and trading systems.

6. *Each country* has primary responsibility for its own economic and social development, and the role of national policies and development strategies cannot be overemphasized. At the same time, domestic economies are now interwoven with the global economic system and, inter alia, the effective use of trade and investment opportunities can help countries to fight poverty. National development efforts need to be supported by an enabling international economic environment.

10. *In our common pursuit of growth*, poverty eradication and sustainable development, a critical challenge is to ensure the necessary internal conditions for mobilizing domestic savings, both public and private, sustaining adequate levels of productive investment and increasing human capacity. A crucial task is to enhance the efficacy, coherence and consistency of macroeconomic policies. An en-

abling domestic environment is vital for mobilizing domestic resources, increasing productivity, reducing capital flight, encouraging the private sector, and attracting and making effective use of international investment and assistance. Efforts to create such an environment should be supported by the international community.

11. *Good governance is essential* for sustainable development. Sound economic policies, solid democratic institutions responsive to the needs of the people and improved infrastructure are the basis for sustained economic growth, poverty eradication and employment creation. Freedom, peace and security, domestic stability, respect for human rights, including the right to development, and the rule of law, gender equality, market-oriented policies, and an overall commitment to just and democratic societies are also essential and mutually reinforcing.

12. *We will pursuit appropriate policy* and regulatory frameworks at our respective national levels and in a manner consistent with national laws to encourage public and private initiatives, including at the local level, and foster a dynamic and well functioning business sector, while improving income growth and distribution, raising productivity, empowering women and protecting labour rights and the environment. We recognize that the appropriate role of government in market-oriented economies will vary from country to country.

The Preamble to the Charter of the United Nations recognizes that nations should "promote social progress and better standards of life in larger freedom" and "employ international machinery for the promotion of the economic and social advancement of all peoples".

The UN Charter further states that, among the Purposes of the United Nations are:

1. *To achieve* international co-operation in solving international problems of an economic, social, cultural, or humanitarian character, and in promoting and encouraging respect for human rights and for fundamental freedoms for all without distinction as to race, sex, language, or religion; and

2. *To be a centre* for harmonizing the actions of nations in the attainment of these common ends.

A provision of the UN Charter relevant to the responsibility of sovereign authorities for the promotion of economic growth is:

ARTICLE 55. With a view to the creation of conditions of stability and well-being which are necessary for peaceful and friendly relations among nations based on respect for the principle of equal rights and self-determination of peoples, the United Nations shall promote:

Higher standards of living, full employment, and conditions of economic and social progress and development;

The Universal Declaration of Human Rights provides further directive guidance to sovereign states as to their obligations and responsibilities to individuals:

PREAMBLE. Whereas the peoples of the United Nations have in the Charter reaffirmed their faith in fundamental human rights, in the dignity and worth of the human person and in the equal rights of men and women and have determined to promote social progress and better standards of life in larger freedom,

ARTICLE 17.

(1) Everyone has the right to own property alone as well as in association with others.

(2) No one shall be arbitrarily deprived of his property.

ARTICLE 22.

Everyone, as a member of society, has the right to social security and is entitled to realization, through national effort and international co-operation and in accordance with the organization and resources of each State, of the economic, social and cultural rights indispensable for his dignity and the free development of his personality.

ARTICLE 25.

Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control.

ARTICLE 27.

(1) Everyone has the right freely to participate in the cultural life of the community, to enjoy the arts and to share in scientific advancement and its benefits.

(2) Everyone has the right to the protection of the moral and material interests resulting from any scientific, literary or artistic production of which he is the author.

The International Commission on Intervention and State Sovereignty proposed that sovereignty is the exercise of authority for protective purposes, arguing that:

2.14 The Charter of the UN is itself an example of an international obligation voluntarily accepted by member states. On the one hand, in granting membership of the UN, the international community welcomes the signatory state as a responsible member of the community of nations. On the other hand, the state itself, in signing the Charter, accepts the responsibilities of membership flowing from that signature. There is no transfer or dilution of state sovereignty. But there is a necessary re-characterization involved: from sovereignty as control to sovereignty as responsibility in both internal functions and external duties.

2.15 Thinking of sovereignty as responsibility, in a way that is being increasingly recognized in state practice, has a threefold significance. First, it implies that the state authorities are responsible for the functions of protecting the safety and lives of citizens and promotion of their welfare. Secondly, it suggests that the national political authorities are responsible to the citizens internally and to the international community through the UN. And thirdly, it means that the agents of state are responsible for their actions; that is to say, they are accountable for their acts of commission and omission. The case for thinking of sovereignty in these terms is strengthened by the ever-increasing impact of international human rights norms, and the increasing impact in international discourse of the concept of human security.

REFORMS AND REFORM PROPOSALS

Financial intermediation as a sovereign responsibility

The foundation of economic growth in today's global economy is financial intermediation. The access to spendable liquidity either in the form of equity investment or repayable debt permits the commencement of business ventures and sustains operating businesses of all sizes and varieties. Where access to such liquidity is limited, economic growth stagnates; where excessive liquidity is made available, asset prices become distorted, unsustainable price bubbles emerge, and financial collapse occurs damaging to economic activity and lowering living standards.

Thus, the sovereign responsibility to promote economic growth calls forth a subordinate responsibility to provide optimum conditions for private sector financial intermediation. Institutions of financial intermediation consist of banks, securities underwriters, insurance and reinsurance companies, brokers/dealers, financial advisers, investment banks, accountants, legal counsel.

Sovereign responsibilities

The first requirement of sovereign management of financial intermediation is to keep asset values – both public and private - within a range of prudent expectations.

Such public assets include both fiat currencies is-

sued by sovereigns and backed by their full faith and credit and the net present value of the state as a percentage of capitalized national income. The net present value of the state is a multiple of its budget expenditures wherein the higher the budget, the higher its net present value. (Completely self-funded state enterprises are not included within the state's budget.) In addition, sovereign debt should not exceed a prudential multiple of the sovereign's GDP.

The Financial Stability Board has issued standards which provide for transparency of the monetary and financial policies of sovereign states. The Financial Stability Board (FSB) emerged from the Financial Stability Forum (FSF), a group of finance ministries, central bankers, and international financial bodies. The FSF was founded in 1999 to promote international financial stability, after discussions among Finance Ministers and Central Bank Governors of the G7 countries, and a study which they commissioned. The FSF facilitated discussion and co-operation on supervision and surveillance of financial institutions, transactions and events. FSF was managed by a small secretariat housed at the Bank for International Settlements in Basel, Switzerland. The FSF membership included about a dozen nations who participate through their central banks, financial ministries and departments, and securities regulators, including: the United States, Japan, Germany, the United Kingdom, France, Italy, Canada, Australia, the Netherlands and several other industrialized economies as well as several international economic organizations. At the G20 summit on November 15, 2008, it was agreed that the membership of the FSF will be expanded to include emerging economies, such as China. The 2009 G-20 London summit decided to establish a successor to the FSF, the Financial Stability Board. The FSB includes members of the G20 who were not members of FSF.

The Financial Stability Board's standards for sovereign governments by which to measure their responsibilities for prudent management of public assets - currencies, fiscal expenditures and sovereign debts - are a Code of Good Practices on Transparency in Monetary and Financial Policies and a Code of Good Practices on Fiscal Transparency recommended by the IMF along with a Special Data Dissemination Standard / General Data Dissemination System, also recommended by the IMF.

The standards are supplemented by the Caux Round Table's recommended ethical principles for government.

The Financial Stability Board has also issued standards which permit assessment of the responsibility exercised by sovereign authorities in their management of key components of private sector financial intermediation. For private sector financial intermediation to gain the trust and confidence needed by investors and necessary for agreement to financial transactions, rules and practices that promote such conditions of reliance and justified expectations are needed with respect to security of returns. These standards are:

FINANCIAL REGULATION AND SUPERVISION

Banking supervision:
Core Principles for Effective Banking Supervision

Securities regulation:
Objectives and Principles of Securities Regulation

Insurance supervision:
Insurance Core Principles

INSTITUTIONAL AND MARKET INFRASTRUCTURE

Crisis resolution and deposit insurance:
Core Principles for Effective Deposit Insurance Systems

Insolvency:
Insolvency and Creditor Rights

Corporate governance:
Principles of Corporate Governance

Accounting and Auditing:
International Financial Reporting Standards and International Standards on Auditing

Payment, clearing and settlement:
Core Principles for Systemically Important Payment Systems and Recommendations for Securities Settlement Systems and Recommendations for Central Counterparties

Additional standards such as the Code of Investors Rights as promulgated by the Convention of Independent Financial Advisers and the Caux Round Table Code of Conduct for Banks supplement the standards recommended by the Financial Stability Board.

RECOMMENDATIONS

First, the General Assembly of the United Nations should adopt a charter of Responsible Practices for Sovereign Nations incorporating the standards recommended by the Financial Stability Board with respect to financial intermediation to promote sound and sustained global economic growth.

Second, in addition to this general recommendation, each sovereign government has the duty to:

- Use anti-trust laws so that no financial house is too big to fail
- Separate provision of credit and liquidity from speculation and proprietary trading
- No bail outs for trading losses
- Insurance funds to enhance access to credit by SMEs and individuals
- Create social purpose corporations to use private capital for social and cultural purposes
- Clearing for all derivatives to ensure ability to pay
- Government takeover of businesses that support the economy when they become insolvent
- Government purchase of temporarily toxic assets due to marked-to-market requirements to buy time for prices to recover from market disruptions
- Permit banks to hold assets at higher than marked-to-market value to avoid taking losses and undermining capital reserves

Third, sovereign governments have the duty to apply the applicable reforms noted in Caux Round Table Global Dialogue Briefing Paper on Repositioning Finance and Banking

DISCUSSION POINTS

- Are financial markets reliable?
- Why do asset bubbles occur regularly?
- Why has government regulation been ineffective in preventing asset bubbles?
- Has deregulation contributed to instability in financial markets?
- Is there too much concentration of power in financial markets?
- Can governments be trusted to infuse financial markets with checks and balances without stifling economic growth?
- Can governments be held to ethical standards of conduct?

REFORMING THE **GLOBAL FINANCE AND BANKING SYSTEM**

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20 June 2012

KEY ISSUE | The global financial crisis has exposed severe flaws in the global financial system. Banking and financial intermediation has produced an unsustainable imbalance between 'paper' financial claims and real earnings and assets; regulation has been shown to be seriously inadequate; incentive systems have been seriously misaligned, fuelling naked greed; and society has been poorly served as a result.

Fundamental reform is urgently needed to: rebuild the robustness of the global financial system; to restore its fragile network of trust; and to get the finance sector to again make a positive economic and social contribution. But policy makers seem hapless, regulators are making only slow progress, and the industry itself is showing little leadership in driving needed change.

BACKGROUND AND CONTEXT

A failed system

Today's global financial problems are probably as severe as any time in history. The shock waves from the Global Financial Crisis (GFC), which firmly took hold in 2008, continue to reverberate around the globe, but particularly across the USA and Europe.

Central to the ongoing crisis is the fact that most of the world's ten biggest banks, each with at least $2 trillion of assets on their balance sheets, are either in or are yet to fully emerge from deep trouble. And they are all so entangled with the rest of the global financial system that none of them can be allowed to fail. Not surprisingly, the governments of the countries hosting these 'systemic' institutions have been doing all they can to save them with large bailouts, but this has further exacerbated the public debt crisis across Europe and the US.

There is almost universal agreement that the fundamental cause of the crisis was the combination of: an uncontrolled credit boom, driven by cheap money, culminating in high leverage and a housing bubble which was sustainable only under conditions of ever increasing asset prices; incentive driven risk taking; extremely poor governance and inadequate regulatory oversight; uncontrolled liquidity creation due in part to large global current

account imbalances; rapid growth of the largely unregulated 'shadow banking' sector; and the explosion of complex financial instruments which spread poorly understood risk throughout the global financial sector and created significant systemic interdependencies.

In the run up to the US sub-prime crisis, mortgages were granted to people with little ability to pay them back and lenders were allowed to keep little 'skin-in-the-game'. The lenders sold the risky mortgages into supposedly 'safe' but highly opaque structured products, constructed by investment banks and rubber stamped AAA by the credit rating agencies. But rather than properly lay-off the risks they were taking on-board, the large investment banks then arbitraged lax regulation and housed the collaterised paper and credit derivatives in special-purpose investment vehicles and conduits. These special vehicles were essentially 'banks without capital' and were funded by asset-backed commercial paper that was guaranteed, often fully, by the sponsoring investment banks themselves. This lack of real risk transfer exploded the actual leverage in these banks and was the ultimate reason for triggering the crisis in the global financial system.

When the 'house of cards' started to fall, the price of the collaterised paper and related credit derivatives collapsed and credit markets froze up. This in turn triggered the severe economic crisis that continues today, in one form or another, across Europe, the UK and the US.

Misaligned incentives

The incentive system driving the behaviour of bankers and insurers provided the fuel for the fire. The bankers were incentivized to take unacceptable (and as it turns out, often misunderstood) risks as they greedily chased the enormous cash bonuses on offer. The ultimate risk and profitability of the positions created was ignored and the generous short-term cash bonuses were simply dealt out in each period based on the volumes written and marked-to-market profits. The liquidity and other risks embedded in the structured products and positions created were typically ignored.

Inadequate regulation

The approach of financial regulators proved to have serious flaws; precisely because they have principally focused (albeit inadequately) on the individual risks of financial institutions as opposed to systemic risk. In key markets, regulators left major cracks in the regulatory architecture for bankers to climb through and arbitrage capital and leverage requirements.

All of this was compounded by 'too-big-to-fail' guarantees and lack of appropriate risk pricing of deposit insurance which resulted in excessive aggregate systemic risks.

The key challenge for regulators is how to redesign the regulatory overlay to make the global financial system more robust without crippling its ability to innovate and spur economic growth.

Financial instability

The current global monetary and financial system has delivered large and not sustainable imbalances and hasn't maintained financial stability as well as the Bretton Woods system. China, for example, runs trillion-dollar surpluses while the US and the EU run trillion-dollar deficits.

This reflects the dominant pursuit of individual country interests over global or regional interests. But when this breaks down, big problems follow as seen with Europe's debt crisis. Now in its third year, the spectre of the euro area breaking up continues to imperil global growth and undermine financial markets. Even massive rescue funds, bond purchases and cheap bank loans from the European Central Bank have failed to placate investors.

Sustaining global economic activity

If these challenges were not enough, the need to re-build and sustain global economic activity must also be addressed. The challenge is particularly large given the availability of traditional bank credit will remain constrained under the new Basel III framework and as the leverage in the financial system is necessarily decreased. Additionally, public sector expenditure in the

US, EU and UK will remain squeezed for years to come, and unlikely to adequately take up the slack.

Adding to the global fiscal and credit stains is the ballooning growth of aged citizens who are more and more reliant on pension plans and hence on the long term performance of securities and investment markets.

Logically, ways to increase market based financing of the global economy will have to be found if global economic activity is to be rebuilt and sustained.

REFORMS AND REFORM PROPOSALS

The repair of the global financial system is far from complete despite the global attempt at harmonized regulatory responses as overseen by the G20. Arguably, much of the activity has been in the right direction, but it has generally lacked a rigorous compass or consistent view of how global financial markets should operate. The elongated time-lines for much of the proposed new regulations also provides scope for watering-down, through private lobbying by institutions and others with vested interests, of both economically and socially warranted reforms.

The key point of the reform agenda has been to avoid future financial crises. But it is not at all clear that the complex array of reforms involved will deliver a financial system that: is rigorously monitored and well governed; efficiently and effectively allocates capital; diversifies and manages risk; mobilizes and safely invests savings; and facilitates investment and trading and the exchange of goods and services.

Perhaps the starting point for the required reform is to recognise that the pre-GFC dominant paradigm - one based on the optimality of free markets, checked by only minimal regulation to counter market inefficiencies arising from externalities and imperfect information - has failed. One thing becomes abundantly clear with the GFC; the efficient market hypothesis - that free and largely unfettered markets will find stable equilibriums - is simply wrong in practice. The financial markets, left largely to their own devices, proved to be anything but well behaved and they showed little ability to self-correct.

Post-GFC, there is now at least a sense that regulation needs to be founded on a different (but not yet well developed) paradigm to deal with the inherent instabilities of financial markets and firms and their compatibility with financial stability. At the core of this new paradigm must be a more interventionist approach involving greater regulatory oversight and prudential controls, combined with more responsible and ethical market behaviour which better reconciles the interests of financial institutions with the public interest.

Current regulatory responses at the international (and national) levels are, arguably, picking and choosing from both paradigms and have included reforms directed towards:

- Strengthening bank capital and liquidity requirements, limiting leverage, narrowing the definition of qualifying capital, limiting counterparty risk, and raising standards for risk management through the Basel III Accord;

- Addressing risks posed by Systemically Important Financial Institutions (SIFIs) and improving resolution regimes (including strengthening deposit insurance and core financial infrastructure);

- Improving regulation and transparency of OTC derivatives markets;

- Strengthening accounting standards;

- Strengthening adherence to international supervisory and regulatory standards;

- Reforming compensation practices to support financial stability;

- Developing macro-prudential frameworks and tools to reduce the likelihood and costs of systemic crises; and

- Expanding and refining the regulatory perimeter and reach.

For example, the US Dodd–Frank Wall Street Reform and Consumer Protection Act was signed into law in July 2010 "*to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end*

'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." It contained a series of regulatory reforms to address consumer protection, executive pay, capital requirements, the regulation of the shadow banking system and derivatives, and to enhance mechanisms to safely wind-down systemically important institutions, among others.

Another important reform is the "Volcker Rule," a measure named for Paul A. Volcker, the former Federal Reserve chairman who proposed it, which would restrict the ability of banks whose deposits are federally insured from trading for their own benefit. The Volcker rule would allow banks to continue risk hedging activities, as well as to serve as market-makers to facilitate client orders but it would prohibit proprietary trading.

While much has been done in terms of regulatory change, there is much still in progress and much that still needs to be done. In particular, additional reforms are needed to:

• Further develop macro-prudential frameworks to deal with volatile capital flows;

• Address regulatory issues for emerging market and developing economies;

• Better regulate the area of shadow banking, particularly money market funds, securitisation and non-bank systemic financial institutions;

• Improve market integrity and efficiency; and

• Enhance consumer finance protection.

The principles and approaches to consumer protection in financial markets particularly have had relatively limited attention at the national level, relative to other issues. And incentive arrangements within national regulatory agencies and the appropriate structuring and allocation of responsibilities needs additional attention in several key markets.

A range of related specific reforms have been floated but are yet to be adopted or fully acted upon, including:

• Reining in incentives systems for executives, lenders and traders at large financial institutions and holding bonuses in escrow (not immediately vesting) and reducing retroactively (clawing-back) in cases of any future related losses.

• Directly charging institutions for the provision of deposit insurance, loan guarantees and any other 'too big to fail' protections, with the charges risk priced.

• Requiring centralised clearing and regulatory oversight of all 'over the counter' (OTC) derivatives and ensure greater transparency.

• Strictly separate investment banking from retail and commercial banking (i.e., from managing the payments system, taking deposits and providing credit to households and businesses).

• Phase out crisis-driven government guarantees and support measures through financial stability contributions from industry participants.

• Tax financial transactions (at a rate of at least 0.05%) on all classes of financial assets.

• Split 'too-big-to-fail' financial institutions into smaller institutions so the failure of any one will not require taxpayer bailouts nor pose systemic risk.

• Penalise and/or prohibit speculative trading, starting with short selling.

• Tightly regulate and restrict speculative traders such as Hedge Funds.

• Enhance regulatory supervision of complex financial products and market activities such as credit default swaps and high frequency trading.

• Impose stronger capital requirements, increase regulatory oversight and make structural changes to money-market funds, including:

liquidity minimums, average maturity limits, tighter credit quality standards, shortening the maturities of fund invest ments, and increased disclosure;

a capital buffer requirement and a 30-day hold-back on redemption requests by investors; and

disclosure of a floating net asset value to help curb investor complacency over the stable '$1-per-share' value that funds currently quote.

• Supervise and manage global capital flows to prevent huge global money imbalances such as through:

implementing "equilibrium exchange rates" and trading bans that would still allow mar kets to help determine currency levels;

an international authority to authorize and supervise aggressive intervention by trading partners to promote consistency;

stronger surveillance by the International Monetary Fund including possible use of financial penalties and incentives; and

establishing a multiple-currency reserve system.

Beyond regulatory and market reforms to cultural change

Clearly, global financial system reform remains huge and urgent. But to be successful it will require even stronger political determination and the collective wisdom of banking and securities regulators, leading market professionals and academics from all over the world, plus enlightened banking and finance industry leadership.

Most of all, reforming global banking and finance will not be successful unless the culture that has pervaded banking, finance, and investment globally changes. Apart from limited reforms that impact incentives and remuneration, little has been done or proposed in this critical area.

Achieving the needed cultural changes is an enormous task, because it is all about people, power and politics. And it is at the heart of the decline of the West that we are living through – the central drivers of which are over indulgence and narrow self-interest. Two key channels of over indulgence across the West are central to this task and need to be addressed.

First, is the need to reverse the past indulgence of politicians, regulators and investment bankers of the ideology of the 'efficient' free market and its supposedly magical ability to reach a stable equilibrium. Captured by this, the investment bankers created new and ultimately mysterious ways of profiteering from the steady flow of cheap money from the central banks, particularly in the US and Europe; and they rewarded the faith of the politicians with generous political donations. And when it all went wrong the politicians had to bail out the banks, adding to the increasingly unsustainable public debt levels.

Second, is the need for central banks and politicians to finally learn that indulging the banks, markets and people with rivers of cheap money simply pushes up asset prices to unsustainable levels where ultimately the bubbles burst.

To prevent the political and regulatory capture by bankers, the necessary first steps would be to implement stronger regulation including prohibiting the financing of political parties (through donations or otherwise) by financial institutions and placing restriction on the direct appointment of senior finance sector executives into key policy or regulatory roles to avoid the 'poacher turned gatekeeper' conflicts.

But perhaps the key to addressing the current ills pervading global banking and finance is to counter its key ethical shortfalls, namely:

• The free market tends to promote behaviours driven by the motivating forces of selfishness and greed;

• The key goal of modern banking and finance is to make the owners and managers of capital richer and richer – at least in financial terms – without limits on wealth accumulation; yet

• The negative externalities when things go wrong, such as with the GFC, are typically socialised.

Countering these ethical shortfalls will involve a

shift to a more responsible and ethical banking and finance culture - one where the interests of the financial institutions and their executives are better reconciled with the public interest. This means that the current global banking and finance paradigm needs to be reframed in a way that: emphasizes the benefits of co-operative or collective solutions; counters the dangers of excessive greed and narrow self-interest; and blends the primary and legal obligation of bankers to operate profitably with the creation of societal value and a genuine concern for the common good. More specifically, the new paradigm involves aligning the strategic interests of the owners and managers of the capital with those of the relevant stakeholders on which the ongoing viability of global banking and finance actually depends.

DISCUSSION POINTS

• Are global banking and finance markets and their regulatory frameworks ready to step up to the plate and deliver first class, convergent regulation that can build investor confidence and widen the supply of finance and investment capital at the right price?

• Are the current reform initiatives enough to address the structural and behavioural flaws in the global financial system? What other reforms need to be prioritised and implemented?

• Are corporate cultures and governance regimes adequate to rebuild the robustness of the global financial system and to restore its fragile network of trust? If not, what needs to change?

• Should ongoing ethics, governance and stewardship training be a requirement for key banking and finance executives?

• How adequate are the current reforms impacting remuneration in the banking and finance sectors and what more needs to be done to fix the underlying problem of misaligned and excessive incentives?

• Are market surveillance and enforcement regimes sufficiently deterrent and convergent to avoid global regulatory arbitrage and prevent another build-up of dangerous systemic risk?

REGULATING AND REFORMING **CREDIT RATINGS AGENCIES**

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Global Governing Board
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KEY ISSUE | The credit rating agencies (CRAs) have captured the market when it comes to issuing the verdict on their credit-worthiness of countries and corporations. In the process, they had become one of the most powerful organisational groups in global finance. But this almost total reliance and dependence of the global finance and investment markets on the verdicts of the CRAs, their ratings proved to be spectacularly wrong in the run up to the global financial crisis (GFC) and collapse of credit markets.

Widespread calls for reform were triggered as a result – particularly relating to the way credit ratings conduct their business, the oligopolistic nature of the ratings market, and the lack of accountability of the CRAs for the performance of their ratings. While some reforms have resulted, the power and influence of CRAs remain. As a consequence, the risk to global financial stability from conflicted and inaccurate ratings has yet to be adequately addressed.

BACKGROUND AND CONTEXT | From the 1980s onwards, the then US based CRAs became increasing hard wired into the whole global financial system as financial markets became more deregulated and companies started borrowing more and more from the globalising debt markets. Debt issuers and investors alike willingly went along with the rise of the CRAs and effectively outsourced their credit worthiness risk assessment to the verdicts of the CRAs.

This has remained the case to date, for all material debt and bond issues, despite the fact that the ratings have often proved to be totally inaccurate and, as a result, have had destabilising impacts on financial markets. Notably, the CRAs still rated Enron, WorldCom, Lehman Brothers and AIG debt, to name a few, as relatively safe just days before they went bust, and in the run-up to 2008, a staggering proportion of mortgage-based debts were rated AAA, when in fact they were junk. If that was not bad enough, in 2009 Moody's issued a report titled "Investor fears over Greek government liquidity misplaced", just six months before the country was seeking a multi-billion dollar bailout. And S&P's sovereign debt team somehow managed to miscalculate US debt by as much as $2tn when it downgraded America's credit rating in 2011.

While there have been calls for the credit rating agencies to therefore shoulder a significant part of the blame for the global financial crisis and the current European debt crisis, they have largely escaped unscathed. As a result, reforms are clearly needed to address the industry's key shortcomings and to hold the CRAs adequately accountable for their ratings.

But despite the seriousness of the issue and the clear link to global financial stability, reform efforts have been slow and inadequate to date. Basically, CRAs have simply been told to bolster ratings integrity, especially in structured finance, and to reduce conflicts of interest. And the regulators have been told to tighten oversight. Jonathan Macey, deputy dean of Yale Law School, summed up the widely held views of the effectiveness of the recent new regulatory efforts: "the overall impact of existing and proposed regulatory changes on rating agencies is extraordinarily easy to summarize: They reward abject failure."

The European Commission and Parliament have been slightly more aggressive in proposing new regulations to address issues with CRAs and their ratings outlooks. The focus has been on regulating sovereign ratings, reducing investor reliance on ratings, and restricting the scope for conflicts of interest. However, much of the initially proposed reforms have now been watered down. For example, current proposals approved by the European Parliament Economic and Monetary Committee in June 2012 would now only require ratings agencies to be rotated or switched every five years and only for very specific types of credit.

The new European rules, which have yet to become law, would also require each CRA to prepare and publish an annual timetable of dates for publishing its sovereign ratings, so as to give states time to prepare for them. Also over-reliance on ratings are to be reduced by requiring all regulated financial institutions to develop, over time, their own rating capacities and risk assessments and thus not rely entirely on CRAs. Under the approved proposal, the CRAs would also be held liable for their ratings in civil law.

KEY SHORTCOMINGS OF RATINGS AND AREAS FOR REFORM

Independence of CRAs and conflicts of interest

The current 'issuer-paid' business model involves the CRAs being paid by the debt issuers who need ratings for the securities they are issuing. This model creates an unmanageable conflict of interest and a clear incentive for CRAs to assign higher ratings so as to secure the future lucrative ratings business on offer from the issuers. The long tenure of the same CRAs rating the same debt issuers is evidence of this and the lack of competition in the ratings market.

While it is frequently claimed that the agencies do not deal robustly enough with the companies who pay them, it is also said that they are too aggressive with the companies who don't sign up to a paid rating. When Hannover Re failed to sign up to paid ratings, Moody's started issuing unsolicited ratings. In 2004, Moody's downgraded Hannover Re's debt to junk status and because of the 'respect' paid to Moody's valuations, shareholders panicked, sold their stock, and Hannover Re lost $175m of market capitalisation in an afternoon.

A range of possible reforms have been suggested to address this so called lack of independence and conflicts of interest arising from the 'issuer-pays' model. These include:

• Eliminating the 'issuer-paid' model and returning the rating agencies to their roots as investor-paid businesses.

> It is argued this reform would create room for a larger number of rating agencies, re store incentives for quality and accuracy, and encourage more prudent decision-mak ing by investors, regulators, and financial institutions.
>
> An 'investor-paid' model appears to be a viable business model – for example, one-third of Moody's revenues during 2008-9 came from subscription fees for research, data, analytics, and risk management soft ware, with healthy margins in excess of 40%.

• Creating private not-for-profit credit rating foundations to provide investors with independent ratings.

> The suggestion is that by having several stakeholders with different interests, conflicts could be minimised.

• Creating publicly funded independent ratings providers.

• Requiring mandatory rotation of CRAs under the 'issuer-pays' model.

> Comparisons with the audit industry are obvious where mandatory rotation is required.
>
> However, it is also argued that this may fur ther weaken ratings due to the lack of high quality CRAs to rotate to.

• Paying CRAs with the securities they rate, instead of paying a cash fee.

> This would clearly align the compensation of CRAs with performance of their ratings, as suming they would also have to hold those bonds to maturity.

Reverse legislative and regulatory requirements to use external credit ratings

The requirement to use credit ratings from the CRAs have become incorporated into regulations covering securities, pensions, banks, insurance companies, and broker dealers. Also some institutional investors can only invest in securities with investment-grade ratings, while others are protected from lawsuits if they stick to AAA-rated securities.

With so many decisions requiring credit ratings under law, the CRAs have become a source of enormous leverage in the financial system and this overreliance on external credit ratings, it is argued, leads to procyclicality and "cliff" effects in capital markets.

To correct this problem, possible reforms include:

• Systematically deleting all references to external credit ratings from existing legislation, regulations, directives or guidelines; and

• Requiring fund managers to remove all references to credit ratings from their internal rules so that they do not rely solely or mechanistically on external credit ratings.

Address high barriers to entry

High concentration in the credit rating market combined with the high barriers to entry into the market and a lack of comparability of ratings has resulted in limited choice and lack of competition in the market. The big 3 (Moody's, Standard & Poors, and Fitch) account for close to 95% of issued ratings. This oligopolistic structure of the credit rating market, despite the existence of strong regional or specialist players, highlights the need to increase competition and to encourage more players in the market.

The high barriers to entry are evident, for example, in the US *Rating Agency Reform Act of 2006* which requires that a 'rating' agency has to have been in business for three years and have at least 20 issuer subscribers before applying for registration as a Nationally Recognized Statistical Rating Organization (NRSRO). Currently there are only 9 registered NRSROs.

Some transparency requirements also have unfortunately deterred potential entrants given their reluctance to publicly reveal details of their proprietary ratings technology and models for fear they will be copied. Also the cost of compliance for any NRSRO is very material and acts as a disincentive to entering the ratings business. Added to this, the so-called '10 percent rule' in the *2006 Reform Act* requires that no one client should represent 10 percent or more of a NRSRO's total annual revenue. For a smaller NRSRO, one large client could easily put it over the 10 percent threshold. Yet these compliance requirements have done little to ensure integrity and accuracy.

Possible reforms that have been floated include:

• Realigning and or removing current regulatory requirements that create unnecessary barriers to entry.

• Requiring increased flow and transparency of relevant company and securities data to assist potential entrants to provide new ratings into the market; and

• Stimulating more competition by promoting comparability of the performance of ratings issued by CRAs.

Improve right of redress for ratings users

Currently, CRAs are not rewarded based on accuracy of their ratings and hence there is little to no direct incentive for them to do a good job.

Added to this, investors who relied on CRA ratings have had little recourse to the CRAs for damages as the ratings proved to be inaccurate and even at times possibly negligent. As a result, there have been widespread calls for more stringent liability for CRAs, similar to that for the audit industry.

Concerns relating to the role of the CRAs in the lead up to the GFC resulted in the US SEC in 2009 proposing to reclassify credit rating agencies as experts under the Securities Act, thereby removing their exemption from the expert consent and liability provisions. This reform was implemented by Congress in 2010 when it passed the Dodd-Frank Wall Street Reform and Consumer Protection Act which eliminated past protections under the Securities Act for any credit ratings issued by a NRSRO.

The European Commission and Parliament is also moving to make CRAs liable under civil law for the ratings they issue. And the Australian Securities and Investments Commission has also made CRAs accountable and liable for their ratings by requiring the CRAs to consent to the use of their credit ratings in prospectuses and product disclosure documents.

Possible other reforms that have been floated include:

• Developing a consistent liability system for rating agencies based on an agreed upon set of regulated standards that spells out the ratings approach for the different areas of debt finance, including the conduct of due diligence and surveillance; and

• Applying a standard of gross negligence or intent.

Improve credit rating methodologies and processes

A number of concerns have been raised relating to credit rating methodologies and processes. In particular, it is argued that the valuation and risk assessment process has lacked investment, innovation and reform. As a result, the traditional criteria are limited and narrow; mostly involving data based on accounting conventions and historic financial performance and occurrences which only report present consequences of past actions. Consequently, the CRAs are largely basing their assumptions on the past, whereas investors need to make assumptions about the future.

Current credit rating methodologies also provide little professional insight into the future contingencies that drive the real ability to meet existing debt obligations. In particular, little account is taken of the quality of ongoing relationships with stakeholders despite the fact that they have a material impact on the ability to meet existing debt obligations.

In addition, the current letter-based ratings system has come in for criticism as it is seen to represent not just an opinion but a verdict. As a result, the ratings overly influence, by themselves, financial markets and economic decisions.

Possible reforms that have been floated include:

• Incorporating stakeholder, governance and stewardship dimensions into ratings methodologies to adequately bring into present consideration future potentials and risks;

• Replacing the current letter-based ratings system with a simple number expressing the assessed probability of default, backed by a narrative explanatory text;

• Introducing a harmonised ratings scale across CRAs.

Reduce investor dependency on credit ratings

How investors use ratings also needs to change, with investors only using ratings from CRAs as part of their analysis, and not as a proxy for proper credit work. This will require investors to be better educated about the nature of ratings, what they purport to measure, their limitations and how they should be used.
Indeed, part of the legislation coming out of the US and the EU seeks to encourage more independent credit work on the part of investors and financial institutions. The challenge is how to wean the financial markets off their dependence on the rating agencies and promote other ways of analysing credit risk.

Sovereign debt ratings

Serious concerns have been voiced over the quality of and impact of some sovereign debt ratings issued by the large CRAs. Concrete examples cited include the recent European downgrades where the CRAs appeared to fail to take account, or assess in a consistent manner, all relevant information such as support initiatives and other factors. Such ratings issued by the CRAs have been variously described as 'not logical', 'questionable', 'disruptive' and 'not credible'.

Reforms being considered and suggested include:

• Creating a not-for-profit ratings agency to rate sovereign debt which appropriately incorporates forward looking indicators such as in the blueprint for INCRA (an International Non-Profit Credit Rating Agency) as developed by the Bertelsmann Foundation (http://www.bfna.org/).

• Subjecting sovereign ratings to specific regulations such as requiring such ratings to be issued at prescribed times with adequate notice to nation states, as currently under consideration by the European Parliament.

• Increasing transparency via publication of full reports including the explanation and justification behind any sovereign rating changes, including detail on the staff involved and the time devoted to the rating; and

• Banning sovereign debt ratings by CRAs altogether.

Are CRAs needed?

Stock markets are efficient public security markets that operate completely devoid of CRA ratings. Investors are supported by private equity research firms, broker research and other analysts who examine stocks and publish their analyses, including guidance about whether the stocks in their opinion are a buy, hold or sell, etc.

This raises the question as to whether the bond and debt securities markets could function effectively if CRA ratings were simply no longer required.

DISCUSSION POSTS

• Can the conflict of interest issues with 'issuer-paid' ratings be adequately controlled?

• What alternative ratings business models could be used instead of 'issuer-paid' external credit ratings?

• How best can new players be encouraged to enter the credit rating agency sector?

• Should alternative measures of credit risk and enhanced risk management models be developed?

• Should credit rating agencies be held civilly or otherwise liable if they infringe negligently or intentionally basic code of conduct principles or regulatory requirements? If so, and how?

• Do the specificities and sensitivities of sovereign debt ratings justify enhanced requirements for sovereign debt ratings compared to other rating classes?

FIXING THE FLAW IN ECONOMIC ANALYSIS

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KEY ISSUE | Modern micro and macro economic analysis depends on mathematics for its analysis and its predictions. But use of mathematics, in turn, favors assumptions about human nature that are too simplistic and not in line with emerging anthropological and neurological understandings. New assumptions are necessary to better align economic understanding with human realities.

BACKGROUND AND CONTEXT | At the level of fundamental assumptions, modern economics and financial theory, including the conventional theory of the business firm, derive largely from a special Western philosophical tradition. In the background is duality of utilitarian thinking where only pleasure and pain are considered as relevant goals for human motivation and activity. In the utilitarian calculus, we seek to avoid pain and acquire that which gives pleasure. Translated into market dynamics, this simplicity implies that we will always take a lower price (pleasure) over a higher price (pain) and therefore act as rational maximizers under all conditions.

While moral philosophers have furiously debated the relative merits of deontological moral reasoning from first principles versus calculations of utility, another point of view has gained great influence. Herbert Spencer in his 1851 book *Social Statics* argued that human energies are spent in a struggle to survive, and that the most fit tend to survive in better conditions and for longer time spans. Spencer dismissed arguments that a moral nature is fundamental to the human condition (Adam Smith's position for example) with the retort that human are extensions of the animal kingdom, evolved from animals and retaining animal drives and instincts to compete and kill. Spencer's arguments against the Nanny State and government regulation of individual behavior shaped convictions that *laissez faire* economic was the ideal as it aligned best with natural law. The outcomes of competition were presumed by Spencer to be the best of possibilities – as social justice – as they represented the values and desires of the winners.

Spencer's views were adopted most fully in the United States after its Civil War when they became the core beliefs of the Republican Party. They reemerged in American politics under Barry Goldwater and Ronald Reagan and now once again drive

the passions of most Republican voters, Ron Paul's libertarian followers, and the Tea Party stalwarts.

Spencer's libertarianism with autonomous individuals always in competition for power and resources was reflected in the game theory. Game theory models assumed a narrow basis for human rationality in order to predict competitive outcomes. That narrow basis was a self-interest in securing advantage and avoiding loss. No moral sense was presumed.

Game theory subsequently spawned pricing models for micro economic behaviors on firm maximization of profit and so gave conceptual power to financial theory and the conventional curriculum of business schools.

In the 1970's a variant of Spencer's libertarianism emerged under the name of "agency theory". This was a presentation of cooperation and collaboration in free markets among free individuals that was designed to resolve the "agency problem". Simply put, the "agency problem" is that people are inherently bad and faithless agents. They cannot be relied upon to be supportive and considerate of others, including those who hire them or who depend on them.

Agency theory presumes that people in finance and business are only self-interested and self-seeking; that they will not cooperate willingly and with dedication to seek a common goal; that they need to be incented to do so with money and power. Agency theory places mis-trust and aggressive competition at the heart of business enterprise. It rejects any need to be socially responsible or to act as a fiduciary or to offer servant leadership. Agency theory favors the present over the future as the agent can't reliably expect to benefit from future contingencies to the same extent as from current opportunities. Agency theory promotes compensation schemes and business practices of "take the money and run".

Agency theory permeated all the practices that led to the collapse of credit markets in 2008, from clients being converted into "counterparties" or, as at Goldman Sachs, referred to as "muppets" to the negligence of rating agencies, the sale of naked CDSs, and the rigging of LIBOR interest rates.

As Justin Fox wrote in his book "The Myth of the Rational Market", the 2008 collapse of credit markets exposed the conceptual failure of the agency theory. Such a theory leads not to superior market performance, but to massive losses. The current agency theory is a formula for unsustainable and immoral capitalism. It needs to be replaced.

The premise of Herbert Spencer and Agency Theory that people have no moral sense is wrong. It flies in the face both of traditional wisdom teachings and modern research. In recent years, new studies of human evolution have pointed to the capacity of the species for cooperation as the means of survival and improving living conditions; and for culture and language and division of labor as critical, post-animalist means of living well on the planet. Individualism is contextualized with social requirements if one is to survive.

As Francis Fukuyama has argued, trust is the critical determinant of success in human undertakings. Where there is no trust, there are more shortcomings and failures.

Furthermore, neuro-science is demonstrating through observation of brain functions and chemistry that people do better when they use their prefrontal cortexes to make decisions, mental operations that invoke social and moral considerations. And, successful interactions and trusting relationships trigger oxytocin, a chemical in the brain which brings a sense of satisfaction and security so that such behaviors come to be favored in the future.

REFORMS AND REFORM PROPOSALS

Contemporary Agency Theory should be replaced by a theory of human behavior that will more fully support a moral and sustainable global capitalism.

Such an improved theory of agency can be taken from the Common Law of England, which supports most modern requirements for corporate governance. The core proposition of Common Law Agency is that an agent is a fiduciary.
The Common Law thus presumes that people can be held to standards of ethical and responsible stewardship; that they are not merely self-seeking beasts, "red in tooth and claw" and caught up following the law of the jungle beyond the bounds of human civilizations.

Common Law agency theory holds that where one has power, one needs to be responsible and consider the effect of that power on the others who come under its sway. This is an extension of the more normal requirement to avoid negligent use of our individualism that brings foreseeable harm to others. The core concept is that of office, a status burdened with duties as Cicero asserted was true for all people in his essay *De Officis*.

In the case of *Heaven v. Pender* (1883), Master of the Rolls Brett held that "whenever one person is by circumstances placed in such a position with regard to another that every one of ordinary sense who did think would at once recognize that if he did not use ordinary care and skill in his own conduct with regard to those circumstances he would cause danger of injury to the person or property of another, a duty arises to use ordinary care and skill to avoid such danger."

The Common Law was not naïve. Judges were well aware of the tendency of people to fall short of prudent and other-regarding conduct. The court cases accumulated over the centuries contain story after story of abuse and selfishness.

Thus, where direct agency responsibilities are involved – employees (a category which includes CEOs and other senior corporate officers), partners, joint-venturers, trustees, corporate directors – the courts applied special rules to encourage better stewardship. These are now called fiduciary duties. They form restraints that attempt to wall off the moral sense from temptation and fear as a protection against crude self-assertion. The lesson of the Common Law is that ethical conduct is a battleground between Spencerian survival of the fittest and what Abraham Lincoln called "the better angels of our nature". If better outcomes for all are to be achieved, market incentives, rules and regulations should be designed to "tip' outcomes in favor of fiduciary rectitude and so towards social responsibility.

Stewardship standards are most likely universal as all religious traditions seek to pull us away from the most base of motivations and actions. The Qur'an enjoins all people to act as "Khalifa", or custodians of what God has created for them. This is a fiduciary standard. Confucius and Mencius are quite explicit about living up to responsibilities – the name and the duties – which come with any position – father, mother, son, daughter, king, minister, etc. The Buddhist admonition that right thinking, right speech, right actions, etc. will lead to transcendence in this life provides a template for mindfulness appropriate to stewardship responsibilities.

RECOMMENDATIONS

• MBA schools adopt a required course in fiduciary obligations and the moral sense.

• Members of boards of directors should be certified in the law and best practices of fiduciary stewardship.

• CEO compensation should be tied to demonstrated loyalty to company and high standards in use of due care with respect to goodwill value of business franchise.

• Required reporting of annual assessments of stakeholder relationships for firms.

DISCUSSION POINTS

• How well does Agency Theory describe business ethics?

• Can companies compete effectively if they assume too much responsibility?

• How can we account financially for fiduciary conduct?

• Do current compensation schemes adequately reward and encourage fiduciary behaviors?

• What role should business schools play in revising Agency Theory?