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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INTRODUCTION

This issue of Pegasus brings you what in my opinion is an important conceptual breakthrough in providing markets with relevant information on the sustainability of firms and governments when they issue securities. Simon Hu points out the relevance of going concern opinions traditionally given by auditors on the prospects for a firm to the issues that have raised concerns about ratings of debt securities given by ratings firms. His proposal addresses two systemic issues with ratings: gaining more market participants to have more competition in providing information about the future prospects of payment on legal claims and the methodology used to assess risk.

Second, our colleague Bruce Piasecki of AHC has circulated a vision statement about sustainable companies. He presents a new vocabulary to make the case simply and compellingly for a more responsible free market capitalism, one that acknowledges its responsibilities for externalities.

Third, I thought it germane to our network to note that Christine Lagarde, Managing Director of the International Monetary Fund, at the recent annual meeting of the Fund, has set forth a reform agenda quite along the lines recommended by the CRT since the collapse of financial markets in 2008. On the one hand, I am pleased that our ideas continue to be seconded by leading authorities, but, on the other hand, a depressing fact to note is that so little real progress has been made with respect to these improvements in our global financial systems.

Stephen B. Young
Global Executive Director

GOING CONCERN RATING AND ECONOMIC ANALYSIS OF INSOLVENCY RISK

SIMON HU

Simon Hu prepared this comment for the Global Association of Risk Professionals, who graciously permitted us to distribute Simon's thoughts in edited form. Simon importantly takes an existing practice – providing going concern opinions – and shows its important in the field of rating securities. This kind of thought leadership is very special in the work of the Caux Round Table and we are very pleased to share it with you. Simon was introduced to me by Alexandra Lajoux, a notable thought leader with the US National Association of Corporate Directors. Simon spent the last 15 years in the global credit rating industry, most recently with Fitch Ratings as a senior director and before that managing director and general manager for A.M. Best Asia-Pacifi c. He holds a bachelor degree in electrical engineering from Rutgers University and an MBA degree from Golden Gate University. Mr. Hu is currently on academic sabbatical for his research on alternative credit worthiness standards.

- Stephen B. Young

In the good old days, the bond market was undisputed king of capital markets and senior creditors were protected subjects of the kingdom. Their inalienable rights were written into bond indentures and enforced by an army of lawyers. There were different classes of creditors whose rights were further defined by what is called subordination or the priority ranking for distribution of liquidation value in case of bankruptcy.

Credit rating agencies, aided by privileged access to non-public information of debt issuers, equalized "information asymmetry" between the issuers and investors via letter ratings and, at the same time, translated complex legal language of subordination into "rating notches" that represent the relative differentials in distribution of liquidation value among different classes of creditors.

Together, lawyers and credit rating analysts were in full control of risk creation and risk reporting in the kingdom of the bond market. Lawyers used legal language (such as "waterfall" and "credit enhancement") to define what credit risks were, and rating analysts translated the risks of noncompliance of legal obligations into easily understood letter ratings, with each rating scale representing a certain probability of default risk.

Simultaneously, accountants remained quietly at a distance from the disciplined, regulated activities inside the kingdom of bond market. Their turf was the rambunctious jungle of stock market. In most circumstances, audit opinions were simply rubber-stamp approval of listed companies' financial statements that few investors cared to read.

Once in a while, when a going concern opinion was issued to a listed company, the auditor was often accused of fabricating a "self-fulfilling prophecy"; however, when the listed company filed for bankruptcy, the auditor would most likely be taken to court swiftly for its failure to warn investors of the impending financial distress. It is the dichotomy of the binary audit reporting model that produces only two opinions: going concern or gone concern, with no choices in between for the auditors to use to inform investors.

While credit rating analysts felt lucky that they did not have to deal with such dichotomy issues in their credit rating analysis, auditors never felt comfortable about the notion of using a rating scale for financial audits. Therefore, each was happy with their respective roles in credit risk reporting and financial reporting, and the two practices had remained apart since the birth of the credit rating practice. Then, on one fateful day in late 2008, their world changed.

The Uncertain Roles of Auditors and Credit Rating Analysts in a New World

When fair value accounting was officially implemented for financial reporting in 2008, the parallel worlds of credit rating analysts and auditors collided, because risks were brought into financial reporting via valuation uncertainty. Shareholders and creditors suddenly found themselves exposed to non-contractual credit risk. In addition, certain numbers that used to be definitive in financial statements suddenly had probabilities attached, and thus became "uncertain."

When marked to market, credit risk is no longer created only by lawyers but also by the fickleness of capital markets. Credit Value Adjustment (CVA) volatility loss, for example, is "accounting" credit risk; asset migration from level II to level III due to market illiquidity creates "modeling" credit risk; and there are other factors, such as the risk of debt-to-equity conversion for contingent capital securities and the reversal of creditor seniority in a resolution for systemically important financial institutions (SIFIs).

These non-contractual credit risks are inherent in financial reporting, but are not captured in credit risk reporting. While auditors may see the risks in financial statement audits, the current binary audit model does not allow them to convey this incremental risk information to investors (other than "going concern" and "gone concern"), which creates a huge distortion in going concern valuation because of the draconian choice between going concern value and liquidation value.

At the same time, such non-contractual credit risks cannot be included in fundamental credit analysis, because they do not constitute default events, unless lawyers write them into bond indenture and make them contractual credit risk. To debt investors, however, credit losses are credit losses, and they see little distinction between contractual and non-contractual credit losses. Likewise, equity investors are now exposed to non-contractual credit risk, and they want more incremental risk information as a result.

Apparently, both auditors and credit rating analysts are confined by the scopes of their respective roles in capital markets. The role of auditors is to verify reporting entities' compliance with accounting standards and principles, while credit rating analysts' role is to perform fundamental credit analysis that largely focuses on contractual default risk. This is causing anxieties among auditors and credit rating analysts, because deviation from their stated missions in order to capture non-contractual credit risks would turn statutory audit into an analytical practice and credit rating into a credit valuation practice, which may create a host of problems, ranging from regulatory to liability issues.

Therefore, in the new world of fair value accounting reporting, a different breed of largely unmonitored risk has emerged – the quick-off- the-mark gradation of going concern risk. As the 2008 financial crisis vividly demonstrated, this type of risk is capable of pushing otherwise financially sound companies (like Lehman and AIG) over the insolvency cliff in a matter of just a few days during volatile economic conditions.

Going Concern Risk

Insolvency is the economic consequence of three financial scenarios: (1) assets are less than liabilities; (2) inadequate cash flow to cover due obligations; and (3) significant losses of capital. Bankruptcy is the legal consequence of insolvency.

Going concern risk is defined as uncertainty in going concern valuation, which is a discounted cash flow (DCF) valuation exercise. When a firm's residual going concern value falls below zero – i.e., when going concern value - liquidation value < zero – the firm is said to have become insolvent. Therefore, going concern risk is insolvency risk. However, going concern risk analysis would simultaneously involve all three definitions of insolvency (solvency, liquidity and capital), and thus is a multidimensional analysis of insolvency risk.. However, what constitutes the proper definition for going concern has been debated for decades in the accounting profession, and continues to be the subject of disagreement today.

Consolidated Risk Measurement vs. Unconsolidated Risk Measurement

Traditional risk analytical approaches typically include identification of individual risks, such as credit risk, interest rate risk, market risk and operational risk; the risk capital is then calculated by adding the risks together with various statistical adjustments for correlation, covariance, concentration, etc.

Basel I focused on credit risk only, while Basel II added market risk and operational risk, and Basel III added liquidity risk. With each new Basel accord, the calculation of risk capital became more complex and convoluted, and less intuitive.

The false sense of completeness of the VaR measures in the Basel accords is just a typical feature of such a traditional, "unconsolidated" risk measurement approach. Under this type of approach, if any individual risk is missed, the tail risk would be much closer than what VaR models suggest. And what a risk they missed in late 2008 when most VaR models did not capture the rapid gradation of going concern risk!

Can a "consolidated" risk measurement system be developed? If we take the view that the final resting place of all individual risks is in a firm's going concern value, then going concern risk is, in fact, a "consolidated" risk. As going concern risk is defined as uncertainty in a firm's going concern valuation, going concern risk and cash flow volatility is intuitively considered correlated, because going concern valuation is basically a DCF valuation exercise.

In a December 2005 white paper titled Earning Volatility, Cash Flow Volatility and Firm Value, Allayannis, Rountree and Weston observed (using a large sample of non-financial firms) that 1 standard deviation increase in cash flow volatility is associated with a 30%-37% decrease in firm value. In an updated version from March 2008, the same authors found that a 1% increase in cash flow volatility would result in approximately 0.15% decrease in firm value. Therefore, it can be assumed that going concern risk and cash flow volatility are causally correlated.

When insolvency risk is measured against cash flow and its volatility, implied probability of insolvency can be derived by observing the volatility and uncertainty in going concern valuation. Consequently, economic analysis of insolvency risk is essentially consolidated risk analysis, which combines considerations for both solvency and liquidity in assessing uncertainty of going concern valuation.

Notching between Insolvency Risk and Credit Risk

Unlike credit rating notching, which is defined by the contractual relationship among different classes of creditors that is static, notching of insolvency risk and credit risk is governed by the basic rule that cash flow allocation to all stakeholders cannot exceed 100% of a firm's economic cash flow; as such, this notching is dynamic. Therefore, the relative differentials in cash flow allocation among different classes of stakeholders would determine the notching relationship among them.

Since shareholders are the bearers of insolvency risk and creditors are the bearers of credit risk (and since these are the two major stakeholder groups for corporate issuers), their relative differentials in cash flow allocation would best approximate the notching differentials between insolvency risk and credit risk (or equity-debt notching).

For public sector issuers, such as sovereign or municipal issuers, economic analysis of insolvency risk would obviously involve different groups, because there are no shareholders. A conjectural economic analysis of sovereign insolvency risk may include stakeholders such as creditors, pensioners and voters (as beneficiaries of public services), as well as recipients of budget allocations such as education, healthcare and defense. The notching relationship between these stakeholder groups would still be defined by the basic rule that cash flow allocation to all stakeholders cannot exceed 100% of the sovereign issuer's annual budget.

Lehman Brothers filed the largest bankruptcy in U.S. history on September 15, 2008

Given that most governments in the world have deficit spending, creditors are naturally a major stakeholder group, but their notching relationship with other stakeholder groups could potentially be more dynamic than a simple analysis of traditional credit risk exposure, especially with the voter stakeholder group. Sovereign cash flow is often exposed to significant uncertainties, including natural disasters, national politics, social unrest and changing demography. These notching factors tend to collide more intensively during uncertain, volatile economic conditions.

For example, popular referendums or bloodshed in social unrest can often change government policies for cash flow allocation among stakeholder groups. As a result, voters in representative democracies tend to have stronger standing in sovereign cash flow allocation than citizens of less democratic regimes, who either have less interest in claiming cash flow allocation or are completely unrepresented. Any relative increase in cash flow allocation to the voter group during fiscal austerity periods would likely come at the expenses of other stakeholder groups, including creditors.

Endgame of Rated Risk

In any rating and notching schemes, the endgame of rated risks must be established and all major classes of stakeholders must be exclusively identified. Endgame analysis would involve calculating how the remaining value is distributed among stakeholder groups and how the notching relationship is derived from that process. If the endgame changes or if a new claimant suddenly emerged with pari passu or more senior priority than that of existing stakeholders for the distribution of the remaining value, the original notching order would be disrupted and lose its analytical meaning.

When a large SIFI bank is said to be too large to fail, it means its endgame has changed from bankruptcy to resolution. But would bankruptcy-centric credit rating notching practices still be applicable to the SIFI bank? When the SIFI bank is financially distressed and taken over by the FDIC for orderly resolution, its endgame is to redistribute going concern value equitably among shareholder and creditors instead of distributing liquidation value among creditors according to bankruptcy priority ranking. Clearly, the credit rating and its notching practice would not make analytical sense for SIFI resolutions, because there is no direct causal relationship between default risk and the resolution endgame, which may not be a default event.

What is the endgame of a sovereign debt issuer from a rating perspective? This is less obvious and intuitive than the corporate endgame. From a credit rating perspective, the endgame is obviously bankruptcy. However, no sovereign nations have been dissolved and liquidated by creditors in modern history. They are perpetual going concerns. Clearly, economic analyses of sovereign insolvency risk, or assigning going concern ratings to sovereign issuers, would require a different endgame.

What is the business of government? The principle role of government is to maintain social justice by providing public services to every citizen in the country, so that they can maintain respectable, decent livelihoods. To achieve that objective, a government would have to manage various competing interests, from legal obligations (legal contracts) to social obligations (social contract), and would also need to maintain equitable allocation of cash flow among all stakeholder groups.

Any departure from that mission would disrupt the equitable allocation of cash flow, benefitting certain stakeholders at the expenses of others and potentially creating political risks. Therefore, in a situation in which a government is incapable of maintaining a positive balance between evolving obligations and a shrinking budget, a potential endgame of a sovereign issuer (from a rating perspective) could be the forced redistribution (in potentially politically harmful ways) of the budget cash flow allocation between the government's legal contracts and its social contract.

Going Concern Ratings and Credit Ratings for Public and Corporate Issuers

Going concern rating is a hybrid rating-audit practice that measures the implied probability of insolvency by observing the level of reporting uncertainty in going concern valuation. Given that one understands the concept of notching of insolvency risk and credit risk, as well as the definition for the endgame, assigning going concern ratings and credit ratings to issuers on the same rating scale becomes analytically possible.

As going concern rating measures the level of uncertainty in going concern valuation, the purpose of notched insolvency risk-credit risk analysis (or going concern rating-credit rating notching analysis) is to reveal competitive relationships among all stakeholder groups for the allocation of cash flow and going concern value, especially when companies are experiencing financial distresses or approaching insolvency.

When corporate profitability is growing, shareholders are the main beneficiaries of the upside potential, because they can use their voting rights to claim more cash flow allocation. On the other hand, creditors tend to get more cash flow allocation than shareholders during periods of financial distress, because of contractual protection by way of covenants. In severe scenarios, creditors' contingent claims on cash flow allocation, such as accelerated collateral posting, can drive companies to implosion.

Since going concern rating essentially measures "reporting uncertainty" and probability of insolvency, the higher the going concern rating, the lower the uncertainty (or potential volatility), and vice versa. So a higher credit rating with a lower going concern rating would mean part of shareholders' cash flow and going concern value allocation is likely to be reallocated to creditors, because of their contractual protection. If negative market performance is anticipated, investors may want to consider selling equity and buying credit default swaps (CDS); if positive market performance is expected, investors should instead consider buying equity and selling CDS. A lower credit rating with a higher going concern rating simply means that the equity upside of the company is bigger than its credit risk downside. This article was originally published in GARP's November 2012 Risk News & Resources newsletter.

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SOCIAL RESPONSE CAPITALISM TODAY AND TOMORROW

BRUCE PIASECKI

The world of this new century, so swift and severe, needs superior leadership.

Like in the two prior centuries, competing on price and quality remain critical and necessary. But today, these two fountain heads of capitalism are providing insufficient criteria for success in a carbon and capital constrained world. What else is needed?

I believe we need something no less than a new kind of leader. Most social commentators today, from Sarah Palin to Barack Obama, note that we need leaders we can trust, leaders who can compete on price, quality and social needs—from avian and swine flu, to new forms of energy, and better cars, computers and homes. We need to combine the best that MBAs get with what Masters of Public Administration know and experience. How is this possible? And where will they work?

This essay explores what I mean by **Social Response Capitalism**—sometime quite necessary but still missed by Fox News and the Heritage Foundation as well as by most of the liberal leaning members of our thought establishment. Is this a new form of capitalism? Is it a deviant form of socialism? Or, is it simply a new way to compete in a smaller, more integrated and globalized world?

Defining Social Response Capitalism

Our definition of this burgeoning form of advanced capitalism is not without complexity and consequences. Before we can enjoy the definition, I know that many corporate leaders need to be persuaded to suspend their normal prejudices about planning and certainty. For it is all right for us to operate out of panic and resolve, okay for our firms to compete on social needs.

Here are some of the tenets of Social Response Capitalism, which we provide to clients and affiliates alike:

1. Companies restructure their operations to actively accommodate consumer demand by creating new products that bridge the gap between traditional expectations of performance and price and social impact on the larger world.
2. This gap has been ignored in the past because it wasn't considered good business to worry about such "externalities."
3. However, today, these externalities are impinging upon the long-term viability of entire product lines that have served as the basis for our industrial economy.

4. While past efforts at becoming a good corporate citizen often focused on streamlining production techniques and efficiency, the latest twist is making better products— products that respond to legitimate, emerging social pressures and needs.
5. Examples of these new social pressures include a drive to eliminate toxic chemicals in products of everyday use, a new corporate emphasis on the reusability and endurance of products, and some early examples of pure product innovation in advance response to pressures on clean air and climate change.

Altruism, Capitalism, and Social Response

I now believe this force for good in select capitalists is like altruism, but better. Altruism requires evidence of selfless good; Social Response simply requires not shooting those on your side. It means you create a web of support within your firm, industry, and the regulatory community, and basically recreate the rules on what determines a "good" product—addressing public expectations in a sensible and reliable business fashion—thus insuring that you are able to compete on price, technical quality, and social needs.

This is especially true for firms providing security, sensors, energy, cars, and computers. In the 21st century, three key elements will challenge businesses. I call it the "S Frontier," and it is comprised of: the **swiftness** of information, the **severity** of global problems, and the need for business leaders to become "social response capitalists." This S Frontier touches all firms, from large responsible companies such as Electrolux and Whirlpool to small firms looking for their niche and barriers against competition. Once you know to look for it, the trained eye sees it almost everywhere, and realizes that the day of the cheap, shoddy product is coming to an end. Nike sees this, as do Starbucks and IBM. It is about building to a new, higher peak from which to compete on price, technical quality, and Social Response. These corporations are seeing that more and more people are refusing to buy goods that don't meet a certain standard, even if they are cheaper.

Management scholars like W. Edwards Deming and Joseph Juran spent several decades after World War II making sure that quality processes entered the plans of corporate strategy, supplementing the classical concerns of price, technical reliability, and distribution matters. This revolution in quality, efficient manufacturing established the dual corporate emphasis on price and the technical quality of products and organizations. Firms like GE, Honeywell, Lockheed Martin, and ConocoPhillips are now famous for employing this dual emphasis on price and technical quality to bring better products into the world.

A New Trinity of Social and Corporate Beliefs

We now live in a time of a new corporate trinity, a set of beliefs that puts social concerns on par with price and performance. This new approach to business strategy is designed to promote "sustained value creation." It produces families of products that can stand up to social scrutiny over time. To the ever-present pursuit of lowering price while improving technical quality, Social Response Product Development introduces a new decision model. As a result, companies are taking on unfamiliar, new roles that can build the long-term value of their business and fundamentally change the quality of our everyday lives. If price and technical quality are the "father" and the "son" of this corporate creed, then this third variable is the "holy ghost" of many companies.

To date, this third part of the trinity has been largely invisible. But the truth is that the social mission of a firm is becoming more firmly embedded in everything they do as consumers and competitors keep raising the bar on socially responsible products. And that is why writers such as Scott Bedbury, the creator of the earthy yet sassy feel of corporate brands like Nike and Starbucks, have so much fun talking about the "soul" of an organization. When a firm asks questions about how the future needs of society will reshape their organization, then you begin to feel their soul.

Give Them What They Need, Not Just What They Want

Social Response Capitalism is rapidly growing in importance in all corners of the global marketplace. It is grabbing center stage in select corporate boardrooms throughout the world. My experience with firms like HP and DuPont dictates that this is not a passing fad. The CEOs may leave, but this kind of culture will remain. It is constantly updated and modified, but permanent. The need to compete on price, technical quality, and Social Response have historical underpinning and economic success tied to them now.

What's Surprising and What's New About Social Leadership

The development of, and call for, social responsibility is quite new. This phenomenon is so new, in fact, that you really can't blame Deming and Juran for not noticing this emerging trend in their time. In fact, most of the well-published management gurus of today (from Warren Bennis to Jim Collins) are still so preoccupied with the duality of price and quality that their very good work suffers from the lack of this promising third variable to success. However, a few pioneering corporations are trailblazing ahead, changing faster than the ideas being espoused in traditional circles of scholarship and theory-building on good business management practices. Starbucks, Nike, Shell, and BP have spent millions on advertising to promote their "social brands."

In a similar manner to what Deming and Juran did for corporate strategy after World War II, many new social forces began to alter the standard decision models of corporate strategy after the tragic accidents of Bhopal and the Valdez oil spill. After working for Mario Cuomo and expanding my definition of the legitimate roles of government, I chronicled this trend in my 1995 book *Corporate Environmental Strategy: The Avalanche of Change since Bhopal*.

I was thankful when Andy Hoffman, within two years, wrote a book called *Competitive Environmental Strategy* that echoed many of the same themes in a larger organizational dynamic context.

Last but not least, Elsevier Science soon began publishing a quarterly journal entitled *The Journal of Corporate Environmental Strategy*. But, what I failed to notice in all of these developments at the time was the speed and magnitude of these changes.

Social Response Capitalism is much larger than an end-of-the-century curiosity, and I've spent much of the last two decades proving to clients why it goes well beyond environmental and energy concerns. It resides in consumer product selection, corporate strategy, investment appeal, and public brand. We sum it up as "balancing" the competing social needs of corporate strategy, energy, and environmental leadership with the classical management of financial risk and opportunity. But it involves this entire search for superior products to secure a better world.

A far broader range of topics is being discussed by the world's major companies, which is both the result of Social Response Capitalism (the demand by consumers for better, safer products) and just the beginning of it (as better products are developed and become successful, more and more companies will begin to follow suit). The issues being addressed range from the labor conditions in the factories located throughout Asia that produce many of the clothes and electronics products sold in the U.S.—a real concern of companies like Nike and The Gap—to public health concerns such as AIDS. After the recent spate of hurricanes, fundamental life-saving services—such as a clean and adequate water supply—are considered in this mix, along with modernizing the power grid. As governments across the globe retreat on these issues, companies are expected to fill the void.

Shaping Social Response Capitalism

This history, in a sense, has only begun. The world now collectively faces some of the most serious threats to our normative sense of life, liberty, and freedom than ever before. The interconnections between global economic development, terrorism, resource tension over oil and water, population growth, uncertainty over climate change, and political unrest are all converging. These catalysts are shaping the promising new developments in our global equity culture. The best social capitalists see the opportunity beneath these serious social challenges.

Consider some of the following challenges to our current lifestyles in the coming decade. In sizing up a potential client to gauge how well we may be able to help him or her, we look at the following inescapable global facts that must be considered in any corporate strategy of consequence:

1. The world's population currently exceeds six billion people, placing large constraints on the capacity of the earth to provide for everyone.
2. The majority of the world's population remains hungry, illiterate, and poor.
3. Butting up against constrained markets, many companies are extending their social responsibility reach into the poorest regions of the world in hopes of helping them and one day creating a market for their products where one did not previously exist.

4. The world's oil reserves are dwindling and some experts expect them to be depleted within fifty to one hundred years.
5. Energy is at the crux of sustainability. More and more new technologies, policies, and investments are shaping the energy industry—fuel cells, biofuels, wind power generation, thin-film photovoltaic power supplies, and bridge technologies like hybrid-electric engines. These technologies represent our growing awareness of finite resources.
6. The availability of clean and fresh water is limited. Some experts believe the global conflicts of the future will be "resource wars" related to gaining access to fresh water, fertile soil, and other natural resources.
7. Economic growth in China is expected to continue exponentially for the next ten to twenty years, potentially making them the second largest GDP worldwide by 2020 or 2030. China is attempting to develop its economy with sustainability in mind.

In 2003 and 2004, China adopted guidelines for automobile emissions and renewable energy technologies that, in some cases, go beyond the requirements in other developed countries.

Most good MBA and junior executives' minds start to wander after you share the first three of these global realities, and this is what separates the leader from the manager—the ability to cope and respond to new pressure.

The Boundary Conditions That Gave Birth to Social Response Capitalists

» Here, again, are the boundary conditions whereby this set of forces reshaping capitalism took hold in society, policy and the general public:

» Fifty-one of the one hundred biggest economies in the world are now corporations, only forty-nine are governments.

» The one hundred largest multinational corporations (MNCs) now control about 20 percent of global foreign assets.

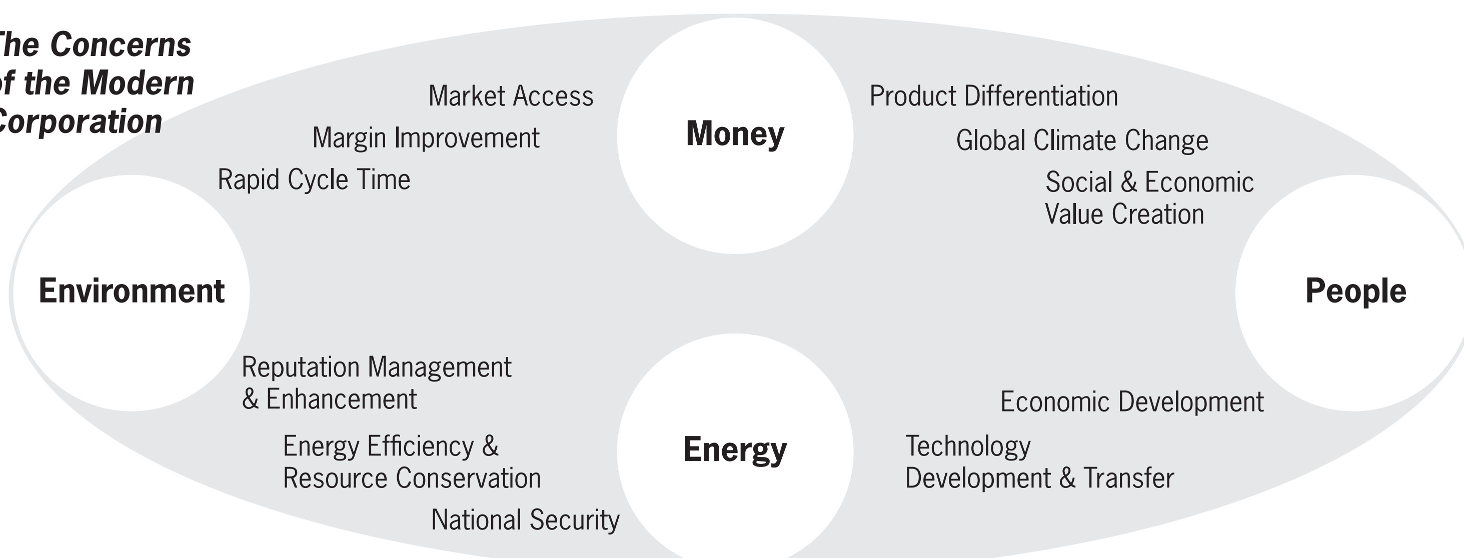
» As much as 40 percent of world trade now occurs within MNCs.

» The annual sales revenues of each of the six largest multinational corporations are now exceeded by the GDPs of only twenty-one countries in the world.

These higher facts and rapid global corporate growth have now collided to form our new global equity culture. This collision offers both opportunity and hope, as seen in the figure below.

The figure shows that when rapid money transfers and corporate global demand on the price and availability of oil (for example) collide, it has repercussions that revolutionize how people and profits interact. You see this most vividly in the ways energy and environmental decisions impact the economy—such as national security. The left bottom corner of this chart shows the growing interactions between energy choices and environmental impacts, while the right bottom shows how these impact people.

The Concerns of the Modern Corporation



The chart displays how things of global consequence are actually linked regionally and in our lives. It is a very difficult image to convey to those unwilling to hear more than what directly impacts their bottom line—the four-sided nature of the chart shows that some of the impacts and collisions are indirect, second-order relationships, but can have just as much of an impact on a business' success. Social Response Capitalists hear them loud and clear.

Herein lies the hope: to profit in a sustained way you must leverage your money, corporate resources, energy, and people in a fashion that answers mounting social needs. I founded the AHC Group twenty-five years ago on this motto: "Answering Public Expectations." We use this motto to remind ourselves how small we are in the larger turbulence of global social needs. It is not about short-term markets only, but increasingly about long-term societal needs and expectations. We are still responding to these elements above—in fact, they reshape us monthly.

Six Recurrent Benefits Enjoyed by Social Response Capitalists

For Social Response Capitalists, product stewardship and the management of their product families directly embody new forces within capitalism. One good idea is often quickly and creatively applied to as many products as is suitable. In less than three years, Toyota transferred its basic innovation of consequence—fuel efficiency—to ten models of their products, from the Highlander SUV, the Camry and the Lexus to some emerging high-efficiency trucks. HP does the same as it patterns innovations across product families—the liquid crystal display is one well-known case in point. The post-Maytag Whirlpool will have to begin this process to compete with Electrolux properly. And, according to the well-financed and often-read pages of Fortune and Forbes, GE and Wal-Mart are after this kind of innovation as well. Wired and Fast Company fill frequent pages with midsize and smaller companies hoping to do the same, as do Inc. and CFO magazine.

From 1999 to 2001, many of the key meetings we were invited to attend at Toyota had to do with this rigorous alignment of product families. As soon as the Prius reached 3 percent of the firm's global market share in 2005, Toyota let the New York Times print a piece about the ten-model implementa- tion strategy we had conceived in 1999. At last, my confidentiality constraints could be lifted and the logic of these Social Response Product Development benefits could be generalized to benefit some of the other companies I worked with. For a decade now, I have been advising clients that Social Response Product Development offers six recurrent benefits that compound like interest in a bank.

As you read these, measure them in reference to a decade, not a quarterly report:

1. **Margin improvement** — seeking cost savings at every stage of the product life cycle through more efficient use of labor, energy, and material resources. Toyota is world famous for such lean manufacture.
2. **Rapid cycle time** — reducing the time it takes to get a product to market by considering environmental issues as part of the concurrent engineering process during the early stages of design. Intel, HP, GE, and Honeywell benchmark these advances frequently.
3. **Global market access** — developing global products that are environmentally preferable and meet international eco-labeling standards in Europe, Japan, and other important trade regions. In 2006, after a significant new Goldman Sachs report itemized market access constraints in oil and gas, this strategic factor grew in importance at all global manufacturers. Toyota was there by 1999. Think of the benefit.
4. **Product differentiation** — introducing distinctive environmental benefits such as energy efficiency or ease of disassembly to your products that may sway a purchase decision. Toyota out-competes all the auto giants in this category year after year.
5. **Social bundling of value in products** — positioning a company's product line in a fashion whereby it becomes clear to consumers and investors that this firm thinks of their products as social expressions, as a compromise and a hybrid between addressing a social need and making some money.
6. **The sixth and last benefit of Social Response Product Development involves reducing the risk premium of the firm.** By selecting products that have Social Response built into them, the overall risk profile of the firm is reduced.

In short, Social Response Product Development is a blend of classical product development tools with this new set of "social" elements. Up until this new century, elements of yield improvement and market positioning across industries were constrained within the realms of engineering performance specs and production criteria. But lately, this has been reaching the upper levels of the corporate mansion, from the head of marketing and sales (as in the Toyota case) to the heads of law, IT, energy procurement, and the like.

Mounting Social Pressures Begat More Capitalists Who Think This Way

Writing World Inc—and watching it surface into eight foreign editions—taught me that I had hit a raw nerve in industrial society. Social Response Capitalism is about to become much more prominent than it currently is.

That's why it matters now to investors, managers, executives, supply chain strategists, the banks, and our entire global equity culture. To some extent, it doesn't really matter as much as I had thought it did if the consumer even sees this holy ghost of "Social Response."

This is where the work of John Elkington, Joel Makower, and the other advocates of the green consumer fall short. When Social Response Capitalism works best, it is embedded in the price of the product—and becomes the invisible hand closing the purchase. I believe Patricia Aburdene's books started noting this new reality about ten years ago, as did the works of Stu Hart and others.

In an important way, all the literature from 1972 to present on the need for "green consumers" misses this grounding point. Social Response Capitalists have created these larger expectations that make it more difficult for their competitors to jump through the same hoops. This enlightened self-interest is what fuels the global equity culture that I have come to celebrate in my latest book,

The Surprising Solution: Creating Possibility in a Swift and Severe World. I now see this each day in newspapers, wherever I am working. I see it from the search for fuel cells, bio-fuels, new ways to package, and new ways to power our economy, transportation, and computing infrastructure. It is the way of the world that business first seeks to sustain and further itself, but this revolution has the side benefit of being good for us all.

It is in this act of making better products for a better world that Social Response Capitalists develop leaders who we can trust.

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THE ROAD AHEAD
A CHANGING GLOBAL ECONOMY, A CHANGING IMF

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FRIDAY, OCTOBER 12, 2012

In her recent address to the annual meeting of the International Monetary Fund, IMF Managing Director Christine Lagarde included the following remarks. They parallel two of the recommendations made by CRT participants in our recent Global Dialogue, recommendations which were distributed in the last two issues of Pegasus.

- Stephen B. Young

This morning, I would like to share some sense of what that future might look like—for the global economy, the IMF, and all of us.

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Navigating the Road Ahead

This brings to me to my second point—how do we successfully navigate that road? How do we manage this change?

I see three milestones:

» Putting the crisis behind us;

» Completing reform of the financial sector; and

» Addressing inequality and building inclusive growth.

Putting the crisis behind us

The first priority, clearly, is to get beyond the crisis and restore growth—especially to end the scourge of unemployment.

We know the package of policies that can get us there: accommodative monetary policy; the right pace of fiscal adjustment, mindful of not undercutting growth but with solid and realistic plans to bring debt down over the medium term; finishing the banking sector clean-up; and structural reforms to boost productivity and growth. All of this should be complemented by a rebalancing of global demand toward the dynamic emerging markets.

Let us not delude ourselves: without growth, the future of the global economy is in jeopardy.

Perhaps the greatest roadblock will be the huge legacy of public debt, which now averages almost 110 percent of GDP for the advanced economies—the highest level since World War II. This leaves governments highly exposed to subtle shifts in confidence. It also ties their hands, especially as they seek to build the infrastructure of the 21th century while respecting social promises. The needs of rapidly aging populations will add to these pressures.

One lesson is clear from history—reducing public debt is incredibly difficult without growth. High debt, in turn, makes it harder to get growth.

The road ahead of us is narrow and long.

The key now is to move from deliberation to action on the policies we know are needed, and to move together and on all fronts. We are multiple players, but it is a single game—a game of increasing complexity that can be a positive-sum game.

A better financial system

My second milestone is a better financial system. We know that it is crucial to the modern global economy.

But we need to move beyond the system that gave us the crisis—a financial sector where some, as the ancient Greeks might say, toyed with hubris and unleashed nemesis.

Christine Lagarde speaks in Tokyo, stresing change. Photo credit: Financial Times

Today, despite some progress, the system is not yet much safer than at the time of Lehman. It is still too complex; activities are still too concentrated in large institutions; and the specter of too-important-to fail still haunts the sector. Continuing excesses and scandals show that the culture has not really changed.

So, as a matter of urgent priority, we must complete the agenda of financial sector reform: better regulation, better supervision, better resolution of cross-border entities, sensible incentives in financial institutions, and a level playing field for the sector.

We are making progress, especially on the Basel III agenda for better capital and liquidity buffers. But I fear that we are losing momentum, both on implementing the agreed reforms and on making more progress in areas like derivatives, shadow banking, and too-important-to-fail institutions.

Many in the industry are concerned about the costs of new regulations. Are these concerns valid? A recent IMF study shows that better regulation will nudge bank lending rates up, but by relatively little. We also found that increasing capital buffers to appropriate levels helps growth, not hurts it. Reforming financial sector taxation can also help reduce excessive risk-taking and leverage.

The bottom line is that the costs of reform are affordable. The costs of complacency are not. We have been there.

One further point: the financial system can help ease the transition to more balanced global growth. Right now, emerging Asia accounts for about a third of world savings. Developing local financial markets can redirect more of these savings into emerging Asia's own backyard—to the people on the edge of prosperity who need it most.

Inequality and inclusive growth

This brings me to my third milestone: inequality and the quality of growth in our future world. Really, this is about the human dimension of policymaking.

Growth is essential for the future global economy, but it must be a different kind of growth. A growth that is not simply the fallout from unfettered globalization. A growth that is inclusive.

Recent IMF research tells us that less inequality is associated with greater macroeconomic stability and more sustainable growth. This has profound policy implications.

It means focusing on efficiency but also keeping equity in mind when setting fiscal policy. It means fairness in sharing the burden of adjustment, and protecting the weak and vulnerable. It means better financial inclusion, so that all have access to credit and financial markets. It means better transparency and governance, so that the doors of opportunity are open to all—and if they close, one knows why.

So again, three points on which our future global economy will turn: getting beyond the crisis, improving the financial system, building a new kind of growth.