Commentaries on the Financial Crisis

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Moral Hazard: A Necessary Price to Pay for Stakeholder Responsibility

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The current liquidity crisis centered in the American financial system but which has extended its cancerous tentacles as well out to global financial institutions has led to knowledgeable commentators reflecting on the problem of "moral hazard".

Is it wise, some ask, to provide relief from the consequences of their actions for those who created too much risk?

Recently, the case of Bear Sterns, the New York investment bank at the center of the sub-prime/CDO bubble – brought concerns for creating "moral hazard" to the fore.

To prevent the bankruptcy of Bear Sterns and defaults on its many borrowings and guarantees, which would have spread losses to many other financial institutions, the US Federal Reserve System with support from the US Treasury arranged easy terms for Bear Sterns to be purchased by another concern so that Bear Sterns' business and obligations could go forward in some form of a going concern basis.

The Federal Reserve System – the American lender of last resort – took bad assets from Bear Sterns in exchange for a loan to buy the firm. If the Bear assets prove to be worth something in the future, the cost to the public for this intervention will not be so much.

The owners of Bear Sterns were paid at first US$2 and then US$10 per share for equity worth $80 per share in book value. They were so forced to absorb great capital loss as a result of their company's imprudent business activities.

Nonetheless, the reformatting of Bear Sterns' business set a precedent that, in the future, incautious investment banking practices will again be coddled by the government and not given a market death sentence as was the case with Enron. This act of public interference with market discipline, it is said, creates "moral hazard" – the hazard that business decision-making will be more "immoral" or irresponsible than otherwise because the decision-makers will have less fear of the consequences of their actions.

Creating moral hazard implies that businesses will be careless about the risks they create or assume.

Coming as part of the sub-prime mortgage meltdown where the mortgage loans of many sub-prime borrowers will be foreclosed and the borrowers will lose their homes, the government's financial support for the well-to-do on Wall Street while providing no help for the poor was not well-received in many parts of society. The financial elite was indulged with tolerance of moral hazard while the poor were left to bear all on their own the consequences of their imprudent borrowing.

Market discipline is good enough for some but too tough for others it appears.

Under Treasury Secretary Paulsen's proposal for revised regulation of American financial markets, investment banks will be invited to use the lending capacity of the Federal Reserve System. This will give the originators of the most sophisticated and most sought-after financial instruments deep pocket support in times of crisis – crises no doubt brought about by the very practices of creating investment vehicles now to be given a kind of fiscal insurance by the government.

Why should the government, that is the people, reward mistakes in judgment with indulgence and protection against extreme outcomes? This will only encourage weak character in senior business leaders who will be more likely as a result to let their greed take the reins of business strategy, to lower quality standards, and to become more childishly naïve about risk. Moral hazard promotes infantile fixation on the short term where adult maturity should have pride of place in decision-making.

The free market, with its powers of creative destruction, its weeding out of the weak, the overly greedy, the stupid, and the careless, has its own high standards of morality. Failure is punished harshly and there are few second acts for companies that can't make the grade. Why not let the market dish out the consequences in all cases? All should get to sleep in the beds they make.

The justification for indulging in moral hazard is to eliminate contagion in financial systems. Financial systems turn on trust; credit is a gossamer thing, easily broken and lost. The so-called real economy of production and distribution is more tangible, with hard assets to support restructuring of ownership and creditor interests when things go badly. With financial services, however, protecting the intangible assets of trust and confidence keeps liquidity flowing so that industry and commerce can have their necessary flows of credit and cash on a daily basis.

Contagion in the financial system is a danger to all in a way that is not implicated so much when an individual home owner defaults on a mortgage or when an Enron or a WorldCom goes bankrupt.

The logic at work here in justifying indulgence in moral hazard is stakeholder thinking, akin to the ethical rational for corporate social responsibility.

When stakeholder interests are taken into account, good decision-making moves beyond pure market rationality narrowly defined in only micro-economic terms. When stakeholders are included in business decision-making, assets of a more intangible nature are added on to tangible ones in the calculation of risk and return.

Adding stakeholder considerations to the decision-making matrix moves more towards a system theory understanding of the economy, where tangible and intangible feed-back loops intertwine and crisscross one with another.

Thus, it would be very appropriate in the case of a Bear Sterns market failure to worry about contagion – the impact of one firm's demise on many who have interests in the play of market forces.

It is only another example of the problem of externalities – who should pay the cost of consequences that are external to the firm's profit and loss statement and its balance sheet?

In most cases, it is society that pays in one way or another – for environmental damage, for health problems of consumers or employees, for unemployment compensation when companies close down, etc.

So it would seem consistent with wider practices to have society, in the form of the Federal Reserve System that passes its costs on to all in the economy, step up and attempt to minimize the harm flowing from bad decisions on Wall Street.

The problem of moral hazard arises whenever we insure against the negative consequences of our conduct. When we spread the cost of our externalities widely through insurance policies, we create moral hazard by reducing the full measure of punishment on those whose actions produce the loss or harm.

By removing the onus of paying the "last full measure" of careful consideration from their shoulders, we encourage people through insurance programs to feel that they are less at risk themselves, So they may conveniently take greater risk with respect to the lives and fortunes of others.

Insurance, externalities, and moral hazard combine to form a rather intricate puzzle for optimizing market outcomes.

To reduce negative externalities, we want to bring the consequences of actions back on the actors. But they may not be in a position to make good on the harm they have created, so we need insurance to protect the interests of stakeholders who have no say in the decisions that affect them. But with such insurance, we open the doors to moral hazard.

In any case, society seems consistently to take the stakeholder perspective into account through its laws and regulatory practices and so runs the risk of allowing too much moral hazard.

The point would seem to be that markets turn on more than the stand-alone profit and loss accounts of firms and individuals, but are forced willy-nilly by the powers that create and sustain them to take account of intangible stakeholder concerns even at the cost of indulging in moral hazard.

The Pursuit of Money and Corporate Social Responsibility

Stephen B. Young
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The cynical and sad musical *Cabaret* has it that “money makes the world go round.” If so, then money must bear an awful responsibility for all the wrongdoing and misfortune that overtake humanity again and again.

On the other hand, St Paul wrote that “love of money is the root of all evil”, implicating not money but ourselves as the proper cause of wrongfulness in the world.

On the other hand, Adam Smith proposed that seeking to make money need not be sheer malevolence when he said: “Man is never so innocently engaged as when he is making money.”

Advocates for more corporate social responsibility, however, often point to profit – acquiring cash money – as the driving force behind business negligence, abuse of market power, and willful omission to correct harmful externalities. Greed, it is more often inferred than said outright, biases judgment and greed, it is also widely thought, is energized and encouraged towards its unrighteous ends by the ready availability of money to be made.

Non monetized societies, as a rule however, do not enjoy much in the way of business activity or capitalism. At the same time, they are more prone to poverty than wealth with all the conceptual opportunity costs that come with living in poverty. Not having money also comes with a cost.

If we want the fruits of wealth, which are many, but we fear the effects of greed and avarice, what role should we give to money? Can we ever reach a positive moral assessment of those who strive for money?

Powerful ideas for thinking about money were given by Georg Simmel in his book *The Philosophy of Money*, written in 1900.

His first proposition is to accept the subjective theory of value. According to this understanding of human dispositions towards reality, the value of a thing is entirely determined by what we make of it. Value arises from our emotions and thoughts. Value, like beauty, is in the eye of the beholder, not in the flower or the painting. From this perspective, there are no absolute values to be imposed on us, only the partial and relative values that we impose on ourselves and, may from time to time, attempt to impose on others.

Consciousness, said Simmel, endows objects with significance, not the other way around. No object has intrinsic significance.

Accordingly, it is our natural right to value or not value money just as we may or may not value a cowrie shell, an emu, or The Rollling Stones.

When two or more minds converge on a single evaluation, then we have a common value. What has been subjective now becomes more objective in that it has acquired a post-individualistic meaning with social characteristics and implications. Any such valuation in common takes on tangible form and public appearance, gains resilience in the presence of time and space, and acquires an aura of respect, even prestige.

Simmel pointed out that a primary function of money is to facilitate the process whereby people can reach common valuations. When they agree on a monetary amount to fix on an object, or a promise, they have achieved something social, something more objective than their individual preferences. When many people with different subjective concerns all come to agreement on a monetary price, then a market price enters social reality and conditions subsequent behaviors. Money helps us live in community and mutuality.

Without money, it is more difficult to find easily expressed and sustainable equivalences. With money, agreements can be more easily reached, kept and memorialized and transactions can be undertaken with far greater confidence in their having real advantages. The philosophical role of money, therefore, is to convert the intangible and the merely subjective biases and prejudices of the individual into social truth. Money gives us more objective certainty, which is a goal of philosophy.

Money, which through exchange can bring us into conditions of social objectivity, can also be conducive to the removal of the personal element from relationships. In this way money can contribute to our distancing ourselves from others and in so doing to protect ourselves from them. Money is indifferent and objective; with it we can be aloof from the desires and manipulations of others. Money can bring about reassuring feelings of inner independence and individual self-sufficiency.

Money has the amazing capacity to make possible relationships between people but at the same time leaves them personally undisturbed. It balances out respect for different dimensions of human dignity by leaving people alone in their own subjective majesty while permitting them to respond to the values and preferences of others.

But to probe further into the dark side of human dynamics around money, we need to consider the complex mental process of valuation.

Abraham Maslow proposed a hierarchy of human needs where prior and more immediate needs associated with preservation of the self – responding to fears and threats, seeking food and shelter, etc. - are first attended to. Only after such necessities, as it were, were fully and satisfactorily addressed, would a person be likely to appreciate more abstract goals such as friendships, art, religious insight.

We can infer from Maslow’s notion of a hierarchy that money easily associates itself with goods on the lower levels of the hierarchy. Food, shelter etc. are quite easily obtained

with money. For most of us they are market goods which must be purchased from others. From Maslow's perspective, then, money would be less easily be associated with the more lofty, intangible desires and perceptions at the top of the hierarchy, giving money something of a debased quality.

Sigmund Freud associated money with his conception of an anal personality – someone fixated on retention and holding in. Anal personalities tend to be tight with money and stingy. They are also more comfortable as controlling personalities in their relationships with other people. Money for Freud took on a bad connotation of assisting anal personalities in their search for dominance over others.

Freud did not elaborate on the point at all but there is indeed an easily observed very strong link between money and having power. Since others need money to meet their own needs, we can use money to win their submission on a transaction basis. If we give them access to what they want - money, we can demand and receive in return some "price" paid by them for the goods or services we have at hand. That "price" could be money, but it could also be submission, labor, respect and public praise, help on a project, intimacy or some form of friendship.

Power offers another form of assurance as well; power provides means for risk reduction. Since many of us are risk averse – some of us all of the time and all of us some of the time – having power in our hands, under our sole control, brings emotional relief when thinking about what could go wrong or who could hurt us. Power leads us getting that which offsets life's contingencies . Having a stock of money readily at hand puts us in the driver's seat so to speak.

If our goal is indeed power, seeking money is a reasonable means to that end. What drives us, however, is not the money but the need for power. The need for power leads to the love of money.

And a need for power can be insatiable. When power is sought to make up for inadequacies, to fill a spiritual void of low self-confidence, to hold off fears of the infinite and the unknown, to make up for feelings of personal sinfulness and guilt or shame, then we can never enjoy enough power.

Correspondingly, such needy people can never have too much money. They are always on the hunt for what will make them feel more secure and less threatened.

At times, their approach to business can be to "cry havoc and let slip the dogs of war". It is dominance that they seek and power that they need at almost any cost. The premises of Social Darwinism, Herbert Spencer's theory of life and private freedom as constant rivalry and competition, fits comfortably with their understanding of who they are and what they need. Such strivers press for unconstrained competition and glory in making short term profits that they can appropriate personally not because they need the money, but because they would feel victimized without having the power that money can bring.

Avarice, as opposed to simple greed, is the will to power expressed through money where the power represented by money is experienced as the absolutely satisfying value.

Psychologists have studied motivations by using the "Ultimatum Game" where one player divides a pot of money between himself and another. The second player then gets to whether to accept the division or not. If the second player rejects the division, neither player gets any money. In this game, a stingy offer by player one to player two will usually be rejected – even though it will give player two some money. (The offers that get rejected are usually offer player two less than ¼ of the total pot.) Thus, game results imply that money in and of itself is not always a goal for human interaction. Other considerations come into play as well. The further implication is that people strive for relative, not absolute, prosperity, believing that it's not the money but the share that counts.

In one series of Ultimatum Games played among men only, men with high levels of testosterone were more likely to reject offers with low proceeds for themselves.

Higher up on Maslow's hierarchy of needs is having status in the eyes of others. Such status too confers a form of social protection, so it meets one's need for power. But it has, apparently, other attractions as well.

Adam Smith noticed this quite some years ago. In his 1759 book on human moral capacities, *The Theory of the Moral Sentiments*, Smith wrote: "… yet we cannot live long in the world without perceiving that the respect of our equals, our credit and our rank in the society we live in, depend very much upon the degree in which we possess, or are supposed to possess, 'the advantages of external fortune'. The desire of becoming the proper objects of this respect, of deserving and obtaining this credit and rank among our equals, is, perhaps, the strongest of all our desires, and our anxiety to obtain the advantages of fortune is accordingly much more excited and irritated by this desire, than by that of supplying all the necessities and "conveniences' of the body, which are always easily supplied." (p. 213)

In another recent experiment, volunteers were asked to take sips of what they were told were five different wines priced between US$5 and US$90 per bottle. But actually only three wines were used; two of them were served twice. Volunteers were monitored for brain functions. As they drank what they thought were more expensive wines, activity in their medial orbitofrontal cortices increased in tandem. What were thought to be more expensive wines triggered more engaged mental activity.

What costs more money is, pro-forma, most likely to be more exclusive, more rare, and more prestigious. Fewer people will have access to it. Participation in exclusivity generates perceptions of the value associated with being special, favored, above the rest; exclusivity is the reward that comes to wealth and status and most of us like it.

A dynamic money culture can indeed spawn cynicism and a blasé attitude in the face of tragedy and human need. This results, says Simmel, when the concrete values of life are

reduced by our choices to the mediating value of money. What should be highly valued on moral or aesthetic grounds, is reduced to the lowest instrumental value, one completely relative at that.

Money is a servant of our desires. If the abusive desires motivating others have our concern, we might be wiser to tackle the problem directly by confronting the source of those desires rather than indirectly by reducing the means (money) used to temporarily assuage what will remain as an active command center in our psyches.

We are come to an ancient point of view: tranquilization of the passions should be uppermost in our minds. Character to govern desire removes the "love" that would and does turn money from a boon into an evil. Aristotle taught this as did Cicero and Marcus Aurelius and Confucius. In our time, an eloquent teacher of this perspective on business is the Dalai Lama.

Money in and of itself enters the world as a useful good. It is we who abuse it, as we abuse many other things in the physical world. It is a useful tool; it is an institution through which the individual concentrates his or her activity and possessions in order to attain goals that he or she could not attain directly says Simmel. Like any tool money is inert; it has no purpose of its own and functions impartially to all humanity.

Money is demonstrative of the truth that humans are the "tool-making animal", which infers, of course, that they are "purposive" animals with goals and desires. The tool incorporates into its use the aspirations of the human will.

Money reveals its indifferent and empty character, says Simmel, very clearly where the valuation process putting it to work is exclusively upon consumption. When desires are superficial, money facilitates the triumph of superficiality.

Simmel wrote that "the psychological structure of demand is such that in most cases it is focused upon the satisfaction itself and the object becomes a matter of indifference so long as it satisfies the need." If what we seek are status and power, and money is not available, will we not find other means to achieve our ends? And, the alternatives may be even more cruel or vindictive than making money.

Simmel notes perceptively that exchange – the transactions facilitated by money – are the highest form of interactions between people in that they are win – win, or non-zero. In a true exchange, which is voluntary and non-coerced by power or excessive need – each party is offered more than what he or she had before. So, the social work of exchanges is to increase the sum of value that is tangible.

As Adam Smith said in *The Wealth of Nations*, the butcher and the baker look to their subjective needs to supply us with meat and bread for our dinner and we look to our needs to supply them with money, which they value as a means to meet their needs. Their values and our values are both vindicated- simultaneously and separately. It is an alchemy that turns selfish reflections into social good.

Exchange presumes the scarcity of goods – that the goods available are not public goods made freely accessible to all upon use or demand. Exchange takes place through subjective valuations of that which is limited and so responds constructively to scarcity and fair exchange generates positive social enhancement enjoyed by the parties to the exchange.

Furthermore in making an exchange and paying for it with money, one is subordinated to an objective norm. We are socialized in the process and become less the wild beast or the imperious tyrant. Theft of what we desire – instead of purchase - stands distinctly apart from socialization and moral conduct.

Where there is pure subjectivity in the transfer and no exchange, we might have either robbery and theft, on the one side, or unilateral compassion and gift on the other.

Simmel warns that exchange with money reconciles opposites: relativism and society. Money perpetuates a relativistic world view where each can live with his or her own subjectivities. But at the same time through exchange, money permits individual relative things, as valued by individuals, to become something of social consequence and so to enter into history as objective phenomena.

Money as the expression of a concept of objective economic value brings forth, says Simmel, an interpretation of existence. Money can be a direct source of philosophic meaning as well as a means of exchange.

Money is no more than way stations in an endless series of cognitions. Cognition – valuation – is a free-floating process where elements determine their positions reciprocally and relative to one another. Truth here is relative like weight or price. Truth is an aesthetic more than a command. It works through induction far more surely than with deduction. Money thus tends to engender a cognitive culture of flux and change. Money has no respect for any eternal verities other that the process by which it is assigned to prices reflecting our values. As Simmel wrote, money corresponds to the "many-sidedness of our being and the onesidedness of any conceptual expression."

The ultimate principles of such a culture proposed Simmel become realized not in the form of mutual exclusion (I-It over I-Thou to borrow from Martin Buber) but in the form of mutual dependence, mutual evocation, and mutual complementation – just like in an exchange. The philosophical significance of money, then for Simmel, is that it is the clearest embodiment of the formula of all being, according to which things receive their meaning through each other, and have their being determined by their mutual relations.

Money interweaves all singularities and so creates reality among its users. Money could, Simmel affirms, thus play the role of God for a weak minded humanity. If we let it.

The Survival of Capitalism -

Supporting Communities to Stare Down

National and Global Threats

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With communities and businesses alike being confronted with sustainability challenges on multiple fronts, the imperative of communities being in control, and the critical role of business in this, needs urgent attention.

The evidence is clear. If we don't change our ways, the future of our society remains increasingly uncertain, and not just from human triggered climate change.

At the same time, with public trust in the actions and intent of big business at an all time a low, the future of capitalism as we know is under question.

But it is not all bad news. The world has been getting better economically and socially, not worse, as the anti-globalisation movement would have us believe. While the extremes are widening, global incomes are becoming more equal and a bulging middle class is emerging. More importantly, the proportion of the global population living in extreme poverty (on less than $1 per day) has dropped from 28% in 1990 to less than 20% just a decade later. There has also been an overall expansion in political and civil freedoms.

Nevertheless, the current times remains particularly challenging for the future of communities and for business.

In the suburbs and the regions, people are feeling the stresses and strains, and they're feeling a real sense of powerlessness and a loss of control.

Understandably, there is a growing desire within communities to get greater control of their own destinies again.

Yet inside the corporate walls, it feels like another world, another reality. A world where, too often, these community concerns and sustainability challenges are simply viewed as someone else's problem – a distraction from the business of business.

Broader societal concerns struggle to penetrate the corporate veils, often shunted aside and ignored in favour of short term profit and shareholder wealth maximisation.

Many, too many, companies seem to operate on the premise that *'the business of business is business - and only business'.* The externalities of business activities are simply left for someone else's care.

But if communities are to be in control, and they need to be, then the social goods necessary for a functioning and sustaining society must be cared for and nurtured. And when the economic power of corporations is growing ever larger, and that of government ever weaker, we simply can't afford to have a large part of the corporate world detached from or seemingly at odds with this need. No-one should be too surprised that the role of business in society is now firmly in the spotlight and that the concerns of citizens, which have been largely frozen out, are finding new voice.

Attention is again being focused on the central question – the central question that has been on the table ever since the father of capitalism Adam Smith wrote his *Wealth of Nations* in 1776. Is it possible for corporations to deliver on their fiduciary responsibilities to shareholders and at the same time serve the public interest in contributing to human, social and environmental capital?

Or to put it more bluntly, will the unfettered pursuit of corporate profit, without adequate attention to the public good, ultimately set crippling and unnecessary limits on capitalism and our society, making it less creative, less equitable, less dynamic, and less sustainable?

What is not widely understood is that Adam Smith in fact described a system based on 'enlightened self interest' and not one based on personal advantage at the ultimate expense of the common good. In his earlier work, *The Theory of Moral Sentiments* in 1759, Smith underpinned his 'capitalist' system with the virtues of justice, fairness and honesty. Smith saw neither selfishness nor greed as virtues and regarded the spheres of human conduct - economic, social, moral, and political - as interwoven and mutually dependent. Societies function best, Smith argued, when economic and ethical interests coalesce.

So how did so much of today's corporate behaviour end up being at odds with that envisaged by the father of capitalism?

At least part of the answer can be traced back to the early influence of Social Darwinism – a philosophy whose essence is that human societies function best when the principle of 'survival of the fittest' is exercised to the maximum extent. Following this philosophy, a 'laissez faire' form of capitalism soon dominated built on the belief that the market works best if unfettered by regulation or externally imposed obligations. While its popularity dipped somewhat with the socially

unpleasant consequences of depression and war, it has made a resounding recovery in the last few decades.

The latter day Social Darwinists now unite behind the 'shareholder primacy principle' to reject ideas of corporate responsibilities extending to civic, common good or other stakeholder responsibilities.

At the same time, they actively seek even greater autonomy in decision making despite what has already been a major shift in power from the true owners, the shareholders. At the extreme, they argue that fiduciary responsibilities and the law actually prevent them from considering the interests of stakeholders beyond shareholders.

But the corporations' law contains no such legal constraint nor does it contain any legal obligation to maximise profits or shareholder wealth - and certainly not in the short term at the expense of longer term interests.

The legal obligation on directors, in fact, is to manage the company *'in good faith'* and *'in the best interests of the corporation'*. And their common law fiduciary responsibility is to act '*in the interests of the company as a whole'.*
But the latter day Social Darwinists typically misrepresent these duties as an obligation to act in the best interests of shareholders alone, thereby excluding the interests of other stakeholders such as employees, customers and the broader community.

The problems with this rather narrow and brutish form capitalism are several. First, the so called agency problem arises whereby the growing gap between the interests of the owners and the managers creates a vacuum of real ownership and the inevitable governance problems. And second, narrow self-interest and personal advantage inevitably get elevated to the status of core values.

Little wonder that stories of corporate scandals, frauds, accounting deceptions, sub-prime crises, and so on, continue to unfold. All of these powered by outlandish greed and lack of ethics and such stunning disregard for the public interest. One might wonder if those involved even recognise that such a thing as the public interest existed.

The unfortunate thing is that all business tends to get tared with the same brush, and hence the widely held public view that all big business is naturally opposed to the public good. But this is a position that certainly does not accord with the actual practices of a great number of companies. And it is a position that is not sustainable.

The confusing and often misunderstood language of corporate responsibility has also not been helpful. Implying something foreign to the normal course of business – something of an optional extra – it has provided a convenient escape

hatch for those not wanting to be held accountable for the social and environmental blowbacks from their corporate activities.

At its core, however, corporate responsibility is all about enlightened self interest. Enlightened in the sense that the interests of all stakeholders are considered and responsibility for the externalities of business activities accepted. It involves an understanding that business, and its interests, can't be separated from the society in which it operates and on which it depends.

Confusing and misunderstood it might be, the recent emergence of corporate responsibility - or what is better described as responsible capitalism – does stand in stark contrast to this somewhat harsh and unbridled form of capitalism that has increasingly prevailed over recent decades.

Having arrived at this confronting and worrying crossroad for business and society, which path will business take?

Will the corporate world opt for a more responsible, dynamic, creative and sustainable form of capitalism? A form where corporate leaders willingly lead beyond their institutional walls. A form where corporations readily accept accountability for the impacts of their business activities that affect the public interest and where they actively contribute to building community and hence the common good.

Or are new corporate laws and regulations the only way to ensure that the public goods required for social justice and for a prosperous society are nurtured, as Robert Reich argued in his book *Supercapitalism*. Do governments need to get beyond the rhetoric and play a stronger, more active role in dictating responsible business behaviour by intervening in the market place whenever a societal case can be made?

The problem with laws and regulations, however, is that they can be clumsy and blunt, typically targeting the lowest common denominator, and often seeking to close the barn door after the horses have bolted.

Or will community led activism be necessary to ultimately drive the needed step changes and action in corporate responsibility and sustainability?

The warnings are clear. Doing nothing is not an option – at least not an option if business wants a prosperous and sustainable future.

The great management thinker Peter Drucker didn't mince words when he said that unless the common good is adequately looked after – and corporations must be a big part of this – our society ultimately risks destroying itself, just as all earlier pluralist societies destroyed themselves.

But fortunately - standing at this challenging business and society crossroad - we can also see positive and helpful signposts. A growing number of companies have shifted or are shifting their mindsets and rediscovering the true role of business in society.

Progressive companies are out there raising the bar through new coalitions, groupings and initiatives. Initiatives such as the Extractive Industry Transparency Initiative, the Equator Principles, the Forestry Stewardship Council, the Principles for Responsible Investment, the Ethical Trading Initiative, and the Australian Business Roundtable on Climate Change, to name a few.

Companies that have voluntarily driven such initiatives see the societal and business threats and the paradigm shifts underway and they want to be ahead of the game.

Even the folk hero turned corporate monolith, Wal-Mart has come on board. On the back of the aftermath of Hurricane Katrina, Lee Scott, the CEO of Wal-Mart, spelt out a new leadership for Wal-Mart in the 21st century. Environmental impact, community involvement, workforce practices and responsible sourcing were the new gateways for Wal-Mart becoming the most competitive and innovative company in the world. It was a major change in stance.

A further signal of the growing revolution in business thinking was found in the July 2006 issue of *Fortune* magazine. The magazine ran a piece titled *The New Rules* claiming a dramatic rethinking was underway about the fundamental drivers that had defined corporate success over the past few decades. Fortune's new rules are more about being agile, finding niches, looking out not in, and the premise that the customer is king – and not the shareholder - although of course shareholder interests remain fundamental.

Nothing captured the shift more than new rule 7. The old rule was *Admire my Might*; the new rule is *Admire my Soul*. Having a '*soul*' Fortune stated is all about "*defining a company's vision in a sustainable, long-term way - and to hell with what the hedge funds or other pay-me-now investors say*".

The sustainability of capitalism in its current guise was already coming under scrutiny from surprising quarters. Bill Emmott, the then editor of the *Economist* magazine, summed up the growing concerns when he declared that whether *"capitalism will survive"* was one of the most crucial questions for the 21st century. Emmott identified four flaws threatening its survival; namely that capitalism in its current form was "unpopular," "unstable," "unequal" and "unclean". It was not a great scorecard.

Boards certainly should have started listening when the Economist magazine itself featured an article titled *'Pigs, pay and power'* claiming that executive pay lay at the heart of capitalism's troubles.

As we have come to know it, however, modern capitalism makes no claim to providing an equitable distribution of income and wealth. Nor, of itself, does it care much for the environment - its basic impulse is ‘creative destruction.’

But when pushed or threatened, people care mightily about equity and fairness – and the environment – and they are prepared to trade economic efficiency for it.

This matters to business because in any functioning democracy, the community ‘licence to operate’ is up for continual renewal. And ultimately the community’s voice gets heard. This means corporations need to demonstrate that in accepting the massive transfer of power from the public to the private sector they successfully fought for over the past 25 years or so, they also accept the additional responsibility that comes with it.

Specifically, corporations need to show they will use that power responsibly with due regards for the interests of the entire community who grant their social licence to operate. Community trust that they will do so has clearly not yet been won.

So where to from here? How do corporations fully restore community trust and how do they successfully play their part with local communities in staring down these sustainability challenges?

For a start, a more moral form of capitalism needs to be widely adopted – one where the interests of the firm are reconciled with the public interest. A form where, in the pursuit of the corporate interests, the public interest is not lost, and neither are the principles of right and wrong.

Or to use corporate-speak a form where the concept of corporate value reconciles the needs of the owners of the capital with those of the relevant stakeholders on which the ongoing viability of the business depends, including the broader community.

This is very doable and progressive companies are actively demonstrating that recognising and embracing concerns for the impacts of their corporate activities on the public welfare does not compromise their profitability.

In accepting accountability for the externalities of their business activities these companies are finding that they are taking risk out of their business, enhancing their ‘social licence to operate’, and thereby adding to shareholder value.

To put it another way, these companies have managed to find that wonderful point of equilibrium that successfully blends their corporate self-interest with principles and values that accord with broader stakeholder interest.

As Adam Smith would have put it, they have managed to put '*self-interest considered upon the whole'* into true practice.

Were all firms to recognise this and make the necessary effort, capitalism would be a more sustainable system; if anything, a more efficient one and certainly one more uniformly admired.

Encouragingly, there is now a growing view in equity and investment markets that this is the right strategy. The message is becoming increasingly clear: the pursuit of excellence in business does not require companies to forget their moral sense and the related risks. Companies can do good and do well at the same time.

The smart and progressive companies have realised that they can't sustainably prosper in societies that are failing. And they have realised that to have prosperous and thriving high streets, you also have to have prosperous and thriving back streets. They go hand in hand.

Or to put it another way, they have realised that they need more than strong financial capital. They also need strong human, social and environmental capital. They realise that they cannot expect to sustainably increase their profitability if the so called intangible value drivers of employee commitment, innovation, brand reputation, customer satisfaction, and environmental management, to name only a few, are not properly managed.

Unfortunately, accounting conventions do not readily embrace such non-financial value drivers. Too often, managers simply overlook or undervalue them as a result. So the second thing needed for responsible capitalism is for the concept of corporate value, and the related accounting conventions, to better embrace the full spectrum of both financial and non-financial capital.

Thirdly, in order for the global business community to operate more ethically and morally there needs to be commonly accepted principles and standards.

A decade ago, the Caux Round Table codified a set of principles and guidelines for activating a moral sense in business. The Caux Round Table's *Principles for Business* initiative was followed in 1999 by the United Nations' *Global Compact* – ten principles defining responsible corporate citizenship covering the areas of human rights, labour, the environment and anti-corruption.

Today, around 4,000 corporations have signed up to such principles. But many more have yet to publicly embrace these standards of behaviour and ethics that are so fundamental to social inclusion, strong communities and sustainable prosperity.

Fourthly, if we are to sustain the prosperity of our companies and our society, more of our business leaders are going to have to move beyond the walls of their institutions and truly learn to create community.

Adam Smith was right when he implied via his *'invisible hand'* that the intention of free and autonomous individuals would lead regularly and reliably to socially beneficial results. But strong leadership from both business and political leaders is needed to create the conditions for free and autonomous individuals within business and within society.

What is also not as widely understood as it should be is that economic activity is co-operative activity. The best capitalism consequently involves cooperative activities, ethical principles and values that respect stakeholder interests.

All of this will require innovation in corporate thinking including around community partnerships, so that the vital goal of strong communities and sustainable prosperity can be secured.

The Westpac story over the past decade provides a compelling example of how this all plays out. It provides an example of how social concern, environmental sensitivity and innovation can lift a brand beyond the conventions of an industry and deliver more sustainable returns and improved public outcomes.

In the early 1990s, Westpac was waking up to the growing realities of an ageing population, the inevitable war for talent, the increasing stresses of two income households, and the related challenges for their employees in balancing work, home and carer responsibilities.

The inherent workplace and employment risks to Westpac were clear, as were the broader societal issues. After all, workplace practices can play a big role in contributing to or detracting from social capital across the community.

Seizing the opportunity to take leadership in implementing workplace reforms, Westpac introduced paid maternity leave in 1995. This was followed by paid adoption leave in 1997 and then paid paternity leave in 1998. Extensive workplace child care and other child care support initiatives were also implemented.

Not only did these initiatives materially lift employee moral, commitment and retention they also delivered material community benefits in contributing to social capital. In fact, without them one can argue Westpac would not be as well positioned as it is today.

They were very positive for Westpac's bottom line. In the early 90s, Westpac's return to work rate for women following pregnancy was around 30%, adding to a relatively high employee turnover rate across the company. The return to work

rate is now consistently in the high 80s to 90% and Westpac's employee turnover rate is consistently around two percentage points below the industry average.

When you consider that it costs Westpac conservatively an average of $50,000 or more to recruit and train a new staff member, not to mention costs from the loss of experience and so on, the business case was obvious. Savings, or avoided costs, in excess of some $50 million per year resulted.

A more current example has been Westpac's actions on climate change. In April 2006, together with the five other companies and the Australian Conservation Foundation, Westpac released the Australian Business Roundtable on Climate Change report. The report called for urgent action to deliver large emission reductions including the introduction of a market-based carbon pricing mechanism.

Being prepared to stand up against the prevailing government and business views at the time was a pretty lonely space. But supported by others willing to speak out, other reports supporting the case for urgent action, and the undeniable science, by June 2007 this had become bipartisan policy. It demonstrated that business can do all sorts of things when it leads.

A further important aspect has been Westpac's community contributions initiatives. The global best practice aspiration of investing 1% of pre-tax profits in community based initiatives has been well-established for some time and several Australian companies, including Westpac meet this standard. Last year in fact, Westpac's community contributions in Australia totalled some $52 million, or 1.3% of its Australian pre tax profits.

Assisted with paid time off to volunteer, in excess of two thirds of Westpac's employees regularly volunteer in the community. Last year, employees also personally donated in excess of $ 1 million to Australian charities which was dollar matched by Westpac. Since Westpac's Matching Gifts program was started in the late 1990s, some $15 million has now gone out to 1,100 charities through the individual efforts of Westpac's employees.

A key part of Westpac's community contribution is in the form of community partnerships across the community and welfare sectors, indigenous enterprise, and rescue services and so on.

Westpac's Community Partnership program is based on the premise that a bigger impact on society can be made by working closely with key community groups over the long term, and by using Westpac's network resources and the skills and expertise of its people.

The Westpac example demonstrates the sort of leadership that builds community and encourages faith in the capacity of business to play a leading role in strengthening communities and caring for the common good.

The clear message from the Westpac story and from the many others that could have been used is that the pursuit of excellence in business does not require capitalism to forget its moral sense.

After all, the links between stakeholder-responsive practices and shareholder value are pretty obvious and are particularly evident through: improved reputation capital, with both employees and customers; enhanced social licence to operate; reduced regulatory and other operational risk; greater operational efficiency; and more rapid responsiveness to changing societal trends. All of which go to enhancing shareholder value both today and into the future.

It is no surprise that corporations in the top decile of the Dow Jones Sustainability Index, such as Westpac, deliver on average over 50% greater return on invested capital than companies in the bottom decile of the index.

The evidence is there that corporations that outperform in managing environmental, social and governance risks, and that actively contribute to human, social and environmental capital, also typically perform strongly financially. In any event, corporations will ultimately have little choice but to adopt a more responsible form of capitalism.

It is clearly in corporations' intelligent self-interest to act. To appreciate why, one needs to look no further than the regulators' response to the business world's ostrich-like reaction to earlier corporate excesses and governance failures. Community outrage at corporate inaction was inevitably followed by highly prescriptive governance and costly disclosure requirements.

Surely business will be clever enough to regulate itself this time around, and clever enough, one would hope, to see the upsides not just for itself but also in ensuring strong communities.

Just as readily, business can be a big part of the solution to national and global threats, rather than simply being just a big part of the problem.

The path forward from the current crossroad for business and society is clear. Business must show the innovation and foresight to take responsible and moral capitalism from the fringes of the business model and firmly entrench it in the heart of everything it does, as Adam Smith the founder of capitalism intended.

STATEMENT
CAUX ROUND TABLE SCHOLARS' RETREAT
MOUNTAIN HOUSE
CAUX, SWITZERLAND
9 JULY 2008

After discussion, we would like to suggest the following propositions:

(1) the better meaning of CSR is one that links the justification of business enterprise to the deepest, sustaining sources of human well-being in addition to the creation of material wealth and the satisfaction of consumer wants; in a profound and necessary way, business enterprise provides sustenance for human dignity and moral achievement and this function of business needs to be recognized in theories of the firm and of free market institutions; this deeper meaning of responsibility should not be restricted to business enterprises; a concern for the common good, including global perspectives, provides such a link;

(2) such concern requires the acceptance of responsibility; we feel that such responsibility must be asserted at the levels of individuals, companies, other organizations, regions, nations, and globally; at the individual level, personal responsibility requires an obligation to take action and is encouraged by habits of personal reflection and discernment; at all levels, responsibility correlates with governance;

(3) it is the obligation of actors always to consider the effects of their acts and omissions over a relevantly practicable scope of time and space; human actions embed themselves in history, forming conditions for the future which, on the one hand, may become disturbing realities or, on the other, the basis for social cooperation based on mutual respect and trust. Because they are setting such destinies in motion, actors should be prudent in their initiatives out of regard for others yet to come on the scene.

(4) it is the obligation of all actors to invest in the forms of social and human capital that foster societal cooperation for mutual advantage;

(5) those who create, possess, or use wealth must realize that the right to property carries responsibility;

(6) numerous actors contribute to the capital value of an enterprise and, therefore, those who own or manage this wealth must take into account the interests of these stakeholders in their decision making; this realization makes adoption of this more deeply grounded understanding of CSR more important;

(7) the current need for this new understanding of CSR is intensified by a number of serious challenges to the common good of humanity, such as (a) the recent increase in the cost of energy; (b) the current dysfunctional financial intermediation; (c) the increasing cost of food; (d) national imbalances in the cost and availability of labor; (e) imbalances in availability of resources, e.g., water, energy, and food; (f) unyielding poverty with negative environmental consequences and immigration issues; (g) the erosion of middle-class prosperity in the industrialized world; (h) climate change in combination with

resistance to energy conservation and more efficient energy usage; (i) increasing concern for insecurity in the global community due to intolerance, terrorism, criminal activity, and other forms of aggressive violence;

(8) a new level of disengagement, resignation, and discouragement due to perceptions of disempowerment in the face of a highly complex and intellectually fragmented globalized world; this trend is particularly disturbing because it prevents the emergence of those shared conceptions that inspire us to act for the common good; this trend has been amplified by "short-termism" and opportunism on the part of political and business leaders; however, greed and selfishness on the part of individuals contributes seriously to this avoidance of responsibility for the common good;

(9) overcoming the aforementioned global challenges is also frustrated by (a) corruption and defective governance in public institutions; (b) defective governance in private institutions that leads to fraud, scandal, violations of fiduciary duty, market manipulations, and other illegal or morally dubious behaviors; (c) market failures; and, finally;

(10) the above propositions raise serious questions that deserve immediate and thoughtful responses from leaders in government, business, and academe; we are convinced that one appropriate response is application of this deeper conception of CSR; likewise, there needs to be courageous leadership.

We recognize that, under all circumstances, financial institutions, in particular, will play a necessary role in funding solutions and in avoiding aggravation of our difficulties.

Therefore, we must ask whether there is sufficient transparency and CSR in global financial transactions. One initial question is, even though a market economy makes fundamentally constructive contributions to the common good, whether untrammeled free-market operations will provide an adequate response to the challenges noted in paragraph 7 above. That is, under what conditions will such free markets foster dysfunctional short-termism or, on the contrary, enhancement of societal cooperation for general benefit?

A second important question is whether or not we have in place adequate global institutions to provide a framework that creates conditions conducive to solve the aforementioned challenges. Subordinate to this question is the related one of what responsibility multinational corporations have to advance appropriate international rules and standards for the globalized economy.

Both questions should trouble the minds and activate the consciences of world leaders in government, business, and civil society.

Heribert Schmitz, Lester Myers, Jose Luis Fernandez Fernandez, Yves Fassin, Andreas Suchanek, Paul Jankowitsch, Jean-Pierre Diserens, Stephen B. Young

“Renting” Stocks

Stephen B. Young
July 16, 2008

A fascinating set of issues, most germane to business ethics and corporate social responsibility, hovers around the proper role of highly liquid markets for equity securities (“Wall Street”) with in an optimal structure of capitalist incentives.

Some – largely the efficiency conscious free market libertarians – would put Wall Street’s needs as the distinctive measure of a good capitalism. Others – like Warren Buffet - are not so sure about making Wall Street’s values a priority. They prefer to make a distinction between speculation and short-term profit taking, on the one hand, and fundamental company valuation on the other.

Many others from the standpoint of ethics and social responsibility object to the value set – not much more than greed and profit they say – dangled before us by stock market trading dynamics.

I had lunch recently with a very successful manager of equities who put this set of concerns in a very fruitful context. He runs his own investment firm in Minneapolis and now has nearly $2 billion in client funds under management. Like Warren Buffet, he makes a distinction between Wall Street values and the “real” values supporting a company’s growth prospects.

His telling remark to me over lunch was about those in Wall Street who “rent” stocks for a time just to make a quick profit in trading or other short term activity.

“Renting” a stock as opposed to “owning” a stock – I thought that was a very helpful distinction for certain purposes.

Of course, a long-term “renter” often comes to act like an owner in terms of investment thoughtfulness, concern for the effects of depreciation, commitment to renewal and remediation, and using strategic foresight. Owners commit capital; renters pay current expenses. Owners take bigger risks associated with longer term time horizons.

Renters more typically are in and out of the property; exploiting it for a more narrow set of goals and moving on to the next opportunity.

In trading markets, like those for equity securities, the bright conceptual line between owning and renting gets dim. Owning a stock is subject to the temptations of just being a renter – paying a fee in order to play in a game of chance. We “buy” stocks it is said; and we commit our “capital” to the market. Yet even if we buy stocks to own, but things don’t go our way, we just sell – turning ourselves retrospectively into renters of the security.

But what if this use of language – “owning shares in a company” - is out of date, created back in a time when stock holding was not a mass phenomenon and individuals were truly old fashioned, long-term owners in the style of today’s Warren Buffet or in control of a family company. Now with so many shares in the market moving in and out of great funds on the command of computerized trading algorithms, what reality is left to the notion of share ownership?

Using the word “rent” to describe what is going on in Wall Street has another advantage than being perhaps closer to an economic reality. It points to a certain system of economic relations that is not fully in line with the requirements of a good capitalism.

“Rent seeking” for economists is not sound capital investment bringing new factors of production into the economy. In classical economics, it was long ago pointed out that paying rent for land does not bring the land into being; it is only a charge paid to the title holder to gain access to that asset. Opening up uncultivated land, on the other hand, really is an entrepreneurial activity that increases society’s underlying capital assets.

Renting land is like buying someone’s already existing property: it moves money around and it sets up new legal rights to use the property. Humanity has been renting and buying and selling property rights for millennia in every part of the world long before modern industrial capitalism arose in Europe.

Rent is what an owner can charge for use of existing property. It is often non-free market in origin, made possible by rules of law or prerogatives of power. So, the premium available to monopolies and cartels over and above selling at marginal cost is often considered to be a rent premium and the practice of gaining monopoly market power to be one of rent seeking.

For example, when the City of New York limits by law the number of taxicabs, a price arises to “rent” the opportunity to make money by having permission to use one of those licenses. The most recent “rental” fee for a taxi medallion in New York City was $600,000, a nice price to pay for a legalism.

Rent seeking is the heart and soul of crony capitalism. It encourages irresponsibility, abuse of the power that is rented out for cash, having only limited time horizons for earning a return, taking risks with power or property while leaving the long-term consequences of rash behavior for others to bear, and minimizing reciprocally beneficial conduct.

“Renting” stocks for short-term exploitation of their legal powers gave rise to green mail pressures of yesterday and to the hedge fund pressures of today.

Having only such a “rentier” mentality was the focus of social criticism of classical landed aristocracies. Landlords then often prefered to rack rents and their tenants become more like indentured servants.

The incentives around renting for both lesser and lessee tend to cut off rights from corresponding responsibilities whereas ownership tends to bind property rights to responsibilities with its incentives to profit over time.

Renting can more easily become a license to be cavalier with money and property while enduring ownership is more likely to be a burden of care and concern.

Renting property is not, therefore, inherent in or essential for capitalism.

Renting stocks on Wall Street, therefore, is not necessarily a fundamental component of modern capitalism I would add.

Liquid equity markets for corporate control and a share of profits do have their justified place in modern capitalism. Better stock markets in developing countries indeed would contribute much to the economic growth of those countries.

The desirable functions of "Wall Street" financial institutions are: to permit companies to raise money, either to expand a business or to allow founders to realize the wealth they have created for society; two, to help retain staff with stock ownership and options as incentive to stay and build the company for future earnings; three, reputation assurance for customers, suppliers, creditors, and potential employees; and, four, pricing signals for the efficient investment of financial capital in one company or another, or one industry or another.

These functions are most associated with encouragement of ownership rights. That is their social office. These functions promote industry, thrift, and responsible management of corporate assets and opportunities.

Less constructive functions of "Wall Street" financial institutions, it seems to me, are those that encourage speculation, short-term – devil-take-the-hindmost – profit seeking, and illusory, unsustainable valuations of enterprise. These are more associated with "renting" stocks for a limited time and purpose.

Benjamin Franklin once noted that "The general foible of mankind is in the pursuit of wealth to no end."

This aspect of "Wall Street" set up the scandals of Enron and WorldCom. Playing to those who only "rent" stocks encourages earnings management and quarterly reporting of earnings. In high turnover trading activity around short-selling and options trading, money spent on "renting" shares in order to go short or to write a put options contract doesn't go to any company to help improve its balance sheet.

If today's Wall Street is more appropriately analogized to "renting" than to "owning" stocks, perhaps regulatory policy should take this into account in imposing costs, hurdles and consequences on those who are in the markets only to take from others and not to give of themselves.

Asset Pricing and Asset Bubbles

Stephen B. Young
August 3, 2008

A habit of mine to turn hours spent in an airplane flying great distances into something more educational than just watching movies is to read something I would not otherwise have time for - like the *Memoirs* of the Duc de Saint Simon for example.

As with Boswell's *Life of Johnson*, Cervantes' *Don Quixote*, or Lady Murasaki's *Tale of Genji*, the Duc de Saint Simon's *Memoirs* were long ago recommended to me as part of the foundational reading of well-educated men and women. Just recently, I saw a reference to the Duc de Saint Simon in the *New York Review of Books* and so, before leaving for a long flight to Cape Town, South Africa, I went to a nearby college library to borrow a volume of his memoirs to read on the trip.

On the flight, I got through volume 3 of his *Memoirs*. I can recommend it to anyone interested in a lively, insider's view of the dysfunctions of French royalty in the early decades of the 18th century.

But the work contained a surprise – insights into the financial mismanagement that from time to time, on a regular basis, overtakes market capitalism with unseemly greed followed by panic sell-offs.

We have just come through two such episodes in the United States: first the stock-market bubble of the late 1990's centered on dot.com and telecom companies which was busted by the Enron/WorldCom/et. al. scandals, followed, second and rather quickly, by the virulent bust of the subprime mortgage market and the related market for CDO s, a financial collapse that has yet to run its course.

The asset bubble and ensuing bust swirling around the Duc de Saint Simon in 1719 and 1720 arose from selling shares in the Mississippi Company. The project was the brainchild of a Scotsman, John Law, who proposed his scheme to the Regent of France as a way to earn money for the government. Sales of the stock were very successful; share prices rose to absurd heights; millions were made by those who bought early and sold early; losses, when they came with the collapse of the company, withered the entire economy of France, coming to roost most heavily on those who could least afford the cost.

Saint Simon, a landed aristocrat, never bought shares even when pressured by his friend the Regent to take up thousands for the cash equivalent of a pretty song. Saint Simon didn't believe in the inherent value of paper assets.

He wrote in his diary:

One day M. le Duc d'Orleans (the Regent of France during the minority of Louis XV) made an appointment to meet me at Saint-Cloud, so as to take the air after he had been working there, and we both sat on the balustrade before the Orangery, looking down the slope of the woods towards Les Goulottes (fountains). He spoke again of the Mississippi Bank, urging me to accept stock from Law. I refused once more, but he continued to press me, producing one argument after another, until at last he grew angry, saying that it was mere vanity to refuse what the King offered (all was done in his name), when so many other persons of my rank and condition urgently desired it. I said that such a refusal would be stupid and impertinent, as well as conceited, and was not my way. Therefore, as he was so pressing, I would explain my true reasons. Not since the reign of King Midas had I heard of anyone who turn all he touched into gold, and I did not think that even Law had this talent. All his ability was, I believed, no more than clever trickery, a brilliant exhibition of juggling, a robbing of Peter to pay Paul, by which some people became rich at the expense of others. Sooner or later, I declared, it would be seen for what it was; enormous numbers would be made bankrupt, and then how, and to whom, would restitution be made? I added that I abhorred the idea of touching other people's money, and that nothing on earth could persuade me to do so now, not even at second hand.

M. le Duc d'Orleans was at a loss how to answer.

At a later point in his *Memoirs* as the Mississippi Company was desperately writhing in its death spiral, the Duc de Saint Simon commented:

It had become necessary to substitute something real for the mirage of the Mississippi, converting to a new trading company the Indies Bank, capable of guaranteeing the exchange of 600 million in banknotes and have profits of tobacco monopoly and numerous other vast sources of revenues, but even so it was still unable to meet the demand for payments of its notes and this despite all the measures taken to lower their value which, incidentally, had ruined great numbers of the people by reduction of their savings.

All this known as of 1719 and still we have to suffer globally from the unsustainable issuances of subprime mortgages and CDOs derived therefrom.

Why can't this great reoccurring flaw in capital markets be permanently corrected?

Is it all because of a greed that lies forever chained to the beating heart of capitalism and, from time to time, makes financial fools of us all?

Or, as I am coming to think, is it more a question of systematic distortion of pricing under certain conditions, leading to mis-pricing that opens the door of markets to “irrational exuberance” and supporting avarice for immediate cash profits.

My argument is the following:

First, when asset bubbles occur, the strategic good sense normally encouraged by micro-economic supply and demand curves does not operate. Under conventional supply and demand interactions, the marginal utility of additional amounts of supply is worth less and less. At some point it therefore becomes unprofitable to produce more of the good or service and so supply contracts and a market equilibrium at a sustainable value is reached between demand and supply. No asset bubble occurs. There is no “irrational exuberance” driving prices ever higher and higher.

Under these circumstances, the price/supply curve slopes downward to the right on the graph where supply is the horizontal axis and price is the vertical axis.

But when asset bubbles build up, the supply curve slopes very differently. It slopes upward to the right.

As price increases, so does supply, without any deterrent effect set in motion by declining marginal utility of additional units of the asset brought to market. This supply curve accurately represents the “irrational’ belief of buyers that more of the good or service deserves higher and higher prices. There is no diminishing demand curve to intersect with the supply curve at a point of sustainable equilibrium. Demand grows; supply responds; and prices keep going up. Each increment of the good or the service seems to have added value attached to it, at least in the eyes of potential buyers.

Everybody is happy; the nominal price value of the asset class keeps growing higher and higher as more and more assets are brought to market to enjoy higher and higher returns – like shares in the Mississippi Company or, in the subprime mortgage bubble, new houses built to take advantage of easy credit. There is no regulation of self-interest by price that cautions producers to keep more product off the market. There is no automatic governor on the engine to keep it from spinning out of control.

Markets for contract rights – shares, loans, mortgages, CDOs – are especially susceptible to such upward sloping supply curves. As prices paid by willing investors rise, more opportunities to buy the contracts are brought to market by creative sellers. Each additional opportunity to invest in these promises for future returns continues to have the same (or greater) utility to buyers than the previous opportunity. The marginal cost of bringing more contracts to the market is almost zero –mostly payment for secretarial formalisms. It was thus very easy for John Law and his Mississippi Company to issue more shares; very easy for Enron to create more special purpose entities with which to manage reported earnings, and very easy for banks to issue both more sub-prime mortgages and CDOs.

But rising prices for assets can only be supported by rising supplies of money with which to buy them. Here is where the price of credit seems to become dysfunctional. In a bubble, as the price of the asset rises, the supply of credit expands as well. Another supply curve sloping upward to the right. Under conditions of "irrational exuberance" official bank interest rates do not rise with the amount of credit being made available as you would think. More and more credit is made available to buyers when bubbles are growing. The buyers, using mostly borrowed money, pass the resulting cash on to sellers.

The dynamic expanding the supply of credit for subprime mortgages was the proliferation of CDO sales. Global capital markets bought up CDOs and the cash from those sales was passed back to the originators of subprime mortgages, who then lent the money out on more subprime mortgages, which kept buyers in the market for houses at ever rising prices.

In the dot.com/telecom bubble, stock prices had been kept high by the arrival of day-traders in the market, using their equity plus borrowed funds to take advantage of rising prices for stocks.

As the risk/return tradeoff inherent in the extension of credit would have it, you would think, that as more and more credit is extended, the most reliable debtors would be taken care of first, so that later extensions of credit should carry more risk, and therefore be harder to sell. One might say that the marginal utility of additional credit carries higher and higher risk for the usefulness of the money lent.

The market for credit should stabilize at the point where investors providing new credits at the margins where new lending is offered and accepted begin to question if the returns and the security they are promised will support the risks they are to undertake. At that point of decreasing returns to credit, lending investors will demand so much for use of their money, that providers of the underlying assets will balk at the price demanded for credit and the market will slowly stabilize around sustainable prices of assets.

But in bubble environments, pricing does not reliably lead to sustainable asset valuations. Rising prices bring on speculation and then growing speculation brings on yet higher prices until buyer's remorse finally sets in at the margin, new supply is not taken up, and the market suddenly collapses.

Normally as the supply of credit expands, the price charged for increments of credit rises. The normal curve here is one sloping upward to the right. But when an asset bubble is underway, the curve is more flat; as the supply of credit expands, the price for credit does not rise substantially. Credit becomes, relatively speaking, cheaper than it should be. The gap between the thoughtful price for credit (high) and the actual price for credit (low) exposes the market to risk of future collapse.

One reason for this odd pricing of credit is the financial security seemingly provided by rising asset prices. The nominal higher and higher values of the asset offered for sale by

the bubble market provide a vision of security protecting the money borrowed to own the asset. The owner/borrower feels confident that he or she can sell the asset at a moment's notice to repay the debt and the investor/lender feels confident that the asset can be acquired from the owner and sold if necessary to repay the debt.

But when the market collapses, asset values collapse and the credit appears in truth as having been essentially unsecured. It has long been said prudentially that lending too much money to an enterprise makes one take the risks of an equity investor – in for a dollar of risk as well as for the actual dime lent on security.

As asset bubbles expand, another gap in prices emerges to undermine the sustainability of nominal asset values. Under thoughtful analysis, the value of an asset should stay reasonably steady or decline some as more and more assets are brought to market. The value/supply curve is then largely level or sloping downward to the right. This assessment of value is largely sustainable.

But, in a bubble, the value of the asset rises and rises ever higher as more and more assets come to market. The value/supply curve slopes upward to the right. The growing divergence between the thoughtful curve and the "irrationally exuberant" curve is the gap between sustainability (thoughtful valuations) and collapse (irrational valuations). At some point, the gap between the two valuations becomes so large that it can't be ignored. Upon the discovery that "irrational" valuations are at risk, nominal asset prices start to drop towards the level of sustainability and the market collapses.

Mis-pricing drives financial markets first to excess and then to collapse. Greed may sustain the mis-pricing and its resulting bubble, but mis-pricing gives to greed its sometime power to trump thoughtful analysis of risk and sound valuations.

Discouraging mis-pricing of both assets and credit would seem to be essential to improving the level of economic justice provided by free capital markets to all participants, but especially to the less well capitalized ones.

If we could better understand the mechanics of how mis-pricing begins in any cycle of excessive accumulation of assets, especially the contract right assets favored by financial markets, we might be able to better eliminate such erroneous pricing signals. Better pricing would tip the odds away from speculators towards genuine value investors.

Two factors, it seems to me, contribute to the onset and the maintenance of mis-pricing.

First is the fact that most providers of contract rights (equity securities, debt obligations, derivatives, etc.) take a fee out of the deal on the sale of the right and leave town so to speak. They have no incentive to price accurately for the sustainable long run. They price to sell in the market at the time. They feed speculation and they feed off of speculation.

Second, and related to the way in which originators of contract rights get paid, is the fact that those who originate contracts rights to sell in financial markets very frequently

assume no long-term ownership risk for sustaining the value of the asset. These originators do not retain an interest either in the tradable contract right sold to investors or in the underlying asset, if there is one, which supports the right to future income that is sold to the investor via the contract.

If the fees charged for selling contract rights became less and less profitable as the market for such securities grew, or if ownership responsibilities became more and more unavoidable as the risk of market collapse accumulates, then market-wise, enlightened self-interest would find ways to dampen speculation and to protect asset values.

Merrill Lynch, Lehman Brothers, AIG – What might it all mean?

Stephen B. Young
September 2008

Markets are unforgiving; they expose truth and drive out chaff. As the Tao Te Ching says of Heaven itself, markets "treat all things as straw dogs". They have no emotions, shedding no tears for losers and taking no pride in winners, for today's winner may be tomorrow's loser. And, markets refuse to subsidize idealisms.

Over time, free markets reject fraud, abandon products that have no sound purpose or accommodating price, and undermine false or misleading valuations.

That Bear Sterns with balance sheet assets worth $80 pre share was sold for $2 and then for $10 per share, that Lehman Brothers with billions in assets nonetheless went bankrupt, wiping out owner's equity, and that Enron as an enterprise was gone within months of revelation regarding its true debt obligations and real income flows, testify to the cruel discipline of markets at work.

True, markets create liquidity and asset bubbles; but then they turn and destroy them if they are bubbles. Bubbles can't last forever. Only well-supported valuations are sustainable.

It is better, I think, to say that market makers create bubbles and also that market makers break bubbles. Perhaps market makers are more irresponsible in making than in breaking bubbles for the breaking can only occur if bubbles have been created. And, the breaking gets us back closer to the reality of sustainable values, a salutary step towards truth.

But, in the breaking of bubbles, people get hurt as we see happen all around us in the continued destruction of wealth and value flowing from the sub-prime mortgage/CDO/credit default swap bubble and bust of the past 5 years.

The teaching of market makers when they lose faith in valuations and so refuse to buy more at that price, or sell to unload risk, or suddenly refuse to extend credit or guarantee an obligation, is that the valuations at play in the market have become unreliable. Prices will thereafter drop until valuations become more acceptable.

The bubble stretches credulity about valuations ("irrational exuberance" some call it) until confidence is lost and the search for "quality" and security begins.

So, in some sense the current crisis of American financial institutions is necessary and just. It is correcting a past injustice. Only, the pain of correction does not fall fairly on those who made the mistakes in the first place. They have most likely taken the money and run.

Prices go down, wealth is un-created, and the economy contracts. People lose jobs; families suffer.

The lesson of this current financial retraction is perhaps keener still. It may be telling us that the share of global cash flows appropriated by the financial services industry in general was excessive and unsustainable.

The value of mortgage brokers, investment banks, and insurance companies like AIG, depended on their making hay while the cash was flowing. High fees, charges for all kinds of intermediation, huge bonuses, were converted into capital values. But such substantial and systematic extraction of commissions from the economy could not last if the financial intermediaries collectively were not providing real value-added to investors and players in the real economy.

And, perhaps the failed Wall Street intermediaries were not contributing enough to justify their returns. So, losing them – in the long run – is just treating them like “straw dogs” - useless playthings that will burn and disappear.

Some coldness is required to let companies and their fortunes decline and fade away as casualties of poor risk management and imprudent forethought.

Over time, market makers turn to second thoughts about values, then to third thoughts, and then to an endless series of different thoughts. It takes real worth to survive all these market-maker changes of attitude and desire more or less intact as Goldman Sachs and Morgan Stanley seemed to have done. Though they too were shopping themselves to avoid liquidation and loss of equity for their owners.

But the un-creation of value is not what we want from free markets and capitalism. We should hold the system and its leaders to the powerful capitalist standard of wealth creation on a grand scale so that the positive synergies of investment and production will flow throughout the economy improving lives for all.

The first Principle of the Caux Round Table Principles for Business sets this standard: the purpose of a business is to create wealth, not destroy it. Other CRT Principles and stakeholder considerations add ethical obligations to the manner in which such wealth is to be created and its benefits distributed.

I would assert that the titans of financial intermediation which took the lead in building the investment bubble in sub-prime mortgages and subordinate contracts did not live up to this CRT ethical principle. Had they done so, the bubble would have been smaller and so its bursting would have caused less harm to society and far fewer financial losses to investors and owners.

If the CRT Principles for Business are to be assiduously implemented, there should be no bubbles at all – not ever - just a sustainable rise in valuations as a rising tide floats all

boats. Such a sustainable rise would rest on sound, real value-adding, business activities of tangible, non-illusory benefit to stakeholders.

Momento Mori: on Wall Street's Death by Negligence

Stephen B. Young
September 28, 2008

What we have known as "Wall Street" is now stunningly no more.

Manhattan's great investment banks are gone. The last two – Goldman Sachs and Morgan Stanley – are converting into banks, submitting to more intrusive government regulation in return for more secure sources of capital.

Communism couldn't kill this Wall Street; capitalism, however, did. Adam Smith won out over Karl Marx.

This "Wall Street" died at its own hands in a form of negligent suicide. It lived by the sword of extreme market capitalism and died by that same sword. It overdosed on toxic behaviors as did John Beluchi, Jimi Hendrix, Janis Joplin, and Jim Morrison.

The epitaph, I suppose, for "Wall Street's" mighty rise and astonishing fall should be "Sic Transit Gloria Mundi" – "thus passeth worldly glory".

Street talk for what killed Wall Street's investment bank titans is that it was "greed" that did them in. As in a Greek tragedy, excess and hubris worked through a cycle of boom and bust to humble even the best and the brightest. It's an old story, really, new in its techniques of subprime mortgages, CDOs, and credit default swaps, but very old in its moral fundamentals.

But I don't think it was greed precisely that was the cause of the losses and bankruptcies.

Greed – understood as seeking a profit, as pursuing one's interest in business transactions – has not always been so terribly dysfunctional and hurtful to the common good. Indeed most of our modern life was devised, produced, distributed and sold by capitalist behaviors and motivations. There was a baby in Wall Street's bathwater to be sure.

Goldman Sachs, Morgan Stanley, Merrill Lynch, Bear Sterns and their predecessors brought companies to life by raising capital for them. America's growth and resulting economic well-being rested on robust capital markets. Without them there would have been no railroads, steel mills, General Motors, Ford, Boeing, Microsoft, or all the other Fortune 1,000 and smaller companies that ever sold stock or debt securities to finance their businesses.

So what went wrong? When did this "Wall Street" of once sound investment banking houses start walking on the wild side towards perdition?

The short answer is too much leverage – too much debt. Lehman Brothers, as an example, was leveraged 30 to 1 when it failed. When its chickens came home to roost in questions

about how it was going to pay off its debt as the market turned sour, Lehman had insufficient capital of its own to be credibly self-reliant in down markets.

This answer raises a further question: why the need for so much leverage?

The answer to this question gets us closer to the culprit. Lehman wanted to buy securities and other tradable assets to resell them for a profit. It borrowed money to buy assets. It was not raising capital for other companies and taking a fee for the service. That was the traditional role for investment banks. No, Lehman had become a big trader on its own account as well. Lehman and the other investment banks were buying and selling any number of assets – short sales, currencies, options, puts and calls, stocks, bonds, many sorts of derivatives – to speculate on price movements.

When done well, such trading earned huge returns and permitted lavish bonuses and life styles on the part of its owners and employees.

The point to note is that trading is not real investing. It is playing in the space left open by other buyers and sellers. Trading is short term; it is not designed to hold rights to the income or the capital appreciation of companies over the long haul. The time frame for trading is “right now”.

Trading is not a special, distinct part of capitalism with its genius for engineering modern economic growth. Trading has been with us since the dawn of time. Markets predate capitalism by millennia. Capitalism is a recent evolution in human social practices, substantially starting in Holland and England only in the 1600’s.

In the ancient Chinese state of Qi before the time of Confucius, there was a famous Prime Minister, Quan Zi. His lord, Duke Huan, loved purple cloth but grew annoyed when the price for such beautiful cloth rose too high even for him. A shrewd judge of human nature, Quan Zi advised his Duke as follows: since the dye used to make the cloth purple left a smell, the next time someone approached the Duke wearing purple clothes, the Duke should hold his nose as if the smell was repugnant to him. The Duke did so and all the courtiers, suddenly fearful of offending the Duke by wearing purple, sold all their purple clothes. The price of purple cloth in the markets of Qi immediately dropped. Quan Zi bought up all the purple cloth for a song and gave it to his now very happy Lord.

Such trading in markets has a long history throughout human history. But capitalism seeks patient capital to invest over the long haul in companies that need the cash for working capital, wages, raw materials, plant, equipment, etc. For capitalism to succeed, the right kind of investment capital markets is very necessary. But it must be a market that attracts investment, not speculation. A market in speculation is a casino.

From the beginning of capitalism, old trading habits were brought over to finance and trade the new possibilities created by the new, emerging economic system. But trading habits loosed inside capitalism have been disruptive.

The first boom and bust irrational exuberance in capitalism was the tulip mania in Holland in the early 1600's. That mania for buying tulip bulbs was not systematically different in its origins, dynamics or eventual losses from our current boom/bust cycle in buying certain financial products.

Trading and investing thrive on different and inconsistent incentives. Traders like to take a fee from every trade; investors look to dividends and the sale of appreciated ownership shares as a company becomes successful in its business for their returns.

Trading is akin to speculation: you pay money for a chance to win. You don't always win so your winnings over time need to compensate for your losses and the risks associated with the gambles taken. Trading and speculation are inherently short term and limited in their consideration of consequences. Their spirit is at odds with the motivations and perseverance needed to grow a business.

Capital markets exist to accommodate traders and trading in financial instruments. Investment capital is raised by selling equity and debt contracts. We can't, as far as I can tell, eliminate trading from capitalism. Providers of capital and companies need the liquidity which the ability to sell into a robust market of buyers permits; trading sets prices, which give vital information on values and trends, successes and failures.

But the goose that lays the golden eggs is not one that lives on trading alone. Firms need patient capital – investors, not speculators renting stock for a while in order to profit from market movements. Speculators can easily divert management's attention away from long term strategies to short term manipulations of stock prices.

The most important role of financial intermediaries is to provide capital; therefore, short term trading in capital contracts should be subordinate to the mission of finding ways to raise money for companies so that they can create jobs, products and services – and, in consequence, the precious commodity of real economic growth.

From here on out, I suggest, that financial markets be so structured that trading beyond a certain band is burdened with responsibilities that will reduce the appeal of more and more speculative trading and so bring incentives in financial markets back to the provision of patient capital.

We need a trading regime that performs useful services without spinning out of control and throwing us into spasms of wasteful excess.

We might want to consider having different kinds of markets – one for trading and one for investing, or pricing arrangements that add to the purchase price of the trade as the risk associated with each new, incremental trade gets bigger and bigger. If risk were properly priced, the demand for financial instruments would contract as risk conditions change adversely given the growth of excessive supply. Too much supply financed with debt leads to a boom, which sets us up for the ensuing bust.

But, this strategy would require taking into account up front all the external consequences – both positive and negative – for consumers, society, workers, lenders, investors, suppliers, government – that will flow from the activities funded by the extension of credit.

The Caux Round Table Principles for Business and the Crisis

Stephen B. Young
October 1, 2008

The best test of a principle, perhaps, lies in its effects, not always in its aspirations. Does it lead to constructive action? Can it influence and shape behaviors for the better, especially dysfunctional behaviors?

On the one hand we can judge the quality of a principle according to a moral calculus of abstract standards of right and wrong. But, on the other hand, we can also assess the practical worth of a principle by its power to achieve ethics in the field. This might be considered the inherent potential of a principle to obtain compliance with its preferences for better outcomes. As Karl Marx said in his Theses on Fuerbach, "Up to now philosophers have only interpreted the world. The point, however, is to change it."

This seems especially relevant in the arena of corporate responsibility and business ethics. Overcoming the functionality of greed and short-term self-interest is the goal of those who promote responsible decision-making in business. And a daunting task they have. The Caux Round Table published a set of ethical principles for business in 1994, the first such set of principles for guidance of global business and the only set of such principles yet designed by experienced business leaders.

The current massive disruption of financial markets initially brought on by the collapse of the sub-prime mortgage market in the United States provides an opportunity to assess the relevance of the CRT Principles for Business.

If they had been followed, are there reasonable grounds to believe that the crisis could have been avoided, or at least mitigated in scope and intensity?

I think the answer is, yes, the CRT Principles might have made a difference had they been infused in strategic and tactical decisions on the part of those financial institutions which contributed to the current crisis.

First, let us consider the implications of the first CRT Principle for Business:

"The value of a business to society is the wealth and employment it creates and the marketable products and services it provides to consumers at a reasonable price commensurate with quality. To create such value, a business must maintain its own economic health and viability …"

Since the crisis is about the failure of major financial houses and banks such as Bear Sterns and Lehman Brothers, the sale of others such as Merrill Lynch and Washington Mutual, and the government rescue of Freddie Mac, Fannie Mae, AIG, Fortis, and others, we can quite quickly conclude that these companies failed to meet the ethical requirement of maintaining their own economic health and viability.

Their decision-making was wrong-headed in the accumulation of too much debt and in setting imprudent values on certain financial assets such as sub-prime home mortgages and CDOs. In their collapse, these firms caused a contraction of markets, thus erasing wealth and employment in violation of what the CRT advocates as the primary obligation of business firms.

Second, the current crisis was caused by a failure to provide quality products at a price commensurate with their inherent worth.

Sub-prime mortgages were priced inappropriately for many borrowers. Excessive and imprudent borrowings were offered to home owners. In the many cases where credit standards were waived or overlooked lenders and mortgage brokers knew or should have known as professionals that the borrowers were highly likely to default if economic conditions changed.

Borrowers were effectively sold defective financial products. Such mortgages were also sold in excessive quantities, creating an asset bubble that gave rise to perverse incentives on the part of home buyers to assume unreasonable risks of future default and foreclosure.

Similarly, the terms of many CDOs sold were not of the value that was represented to buyers. They carried more risk than was reasonable for the investment goals of those who purchased them. They were also issued in excessive amounts that undermined their long-term value.

This requirement to serve customers with respect for their needs is reinforced in Section 3 of the CRT Principles for Business with the requirement that businesses *"provide their customers with the highest quality products and services consistent with their requirements."*

The first CRT Principle also holds that:

"Businesses have a role to play in improving the lives of all their customers, employees, and shareholders by sharing with them the wealth they have created."

Here has been the greatest harm done by those who create the unsustainable markets in sub-prime mortgages and CDOs – they destroyed wealth and made worse the lives of many customers, employees, owners, creditors and communities.

Principle No. Three of the CRT Principles holds that:

"… businesses should recognize that sincerity, candor, truthfulness, the keeping of promises, and transparency contribute not only to their own credibility and stability but also to the smoothness and efficiency of business transactions, particularly on the international level."

The current crisis in financial markets was caused by a lack of sufficient transparency in CDOs valuations which eventually undermined the smoothness and efficiency of international markets for credit and liquidity.

Principle No. Four of the CRT Principles holds that:

"[Businesses] should recognize that some behavior, though legal, may still have adverse consequences."

It appears that in general, the provision of the financial products that gave rise to the crisis was legal. No laws were violated in lending to sub-prime borrowers or securitizing those mortgages and selling off interests in them through CDOs and in providing guarantees of payment through credit default swaps. Individuals here and there are being investigated for fraud in the sale of such products, but the products themselves were legitimate in concept. What went wrong was selling them to excess on unsustainable terms. That behavior, though legal, had adverse consequences that should have been foreseen and avoided.

With respect to their owners, those responsible for the credit crisis failed to meet other responsibilities set forth in the CRT Principles for Business. For example, they failed to "apply professional and diligent management" and to "conserve, protect and increase the owner's/investors assets". These failures lay at the heart of the dynamic that caused the crisis. There was strategically poor judgment exercised in the development of these markets. Risk was exacerbated to the point of destabilization; it was not properly foreseen or managed.

And, finally, those who caused this crisis failed to meet the CRT standard of enhancing community environments and standards of living. Where homes go into default when mortgages can't be paid, communities suffer disinvestment and even blight as home prices fall and homes are abandoned to the lenders.

Had the boards of directors and senior managers of Bear Sterns, Lehman Brothers, Merrill Lynch, Citibank, Morgan Stanley, Goldman Sachs, Washington Mutual, Freddie Mac, Fannie Mae, and others who thrived for a while off the issuance of sub-prime mortgages and CDOs taken their CRT responsibilities more seriously – and insisted on products and sales strategies consistent with those practices – there would have been less risk injected into the global financial system and less provision of unsustainable financial products.

As I wrote a few years ago in Moral Capitalism, "Directors and corporate officers are hired to be agents not just for their fidelity but also for their skill. Their responsibility is to guard against high risk and imprudent courses of action."

In that book, I also pointed to the intertwining of interdependencies and the need for trust in transactions. Capitalism breeds interdependencies through the specialization of function and the division of labor. Reliance and trust are essential for capitalism to thrive.

Destruction of either leads to trouble in markets. People lose confidence and withhold their ideas, labor, and capital from productive exchange. The economy then contracts. That is what is happening now. The current crisis is really only a crisis of confidence; trust has been lost.

But how do you restore trust when it has been abused?

I wrote in *Moral Capitalism* that "where mistrust prevails, people fear entering into dependency relationships. Mistrust always raises the risks of enterprise. Who would invest where risks are excessive and returns uncertain?"

This dynamic explains the collapse of value in Bear Sterns, Lehman Brothers and Washington Mutual – they had billions of dollars of assets on their books but no one wanted to buy their shares. The value of Bear Sterns was $80 per share on the books, but only $2 per share in the market. Lehman Brothers went bankrupt and its owners could not realize the value of the company's book assets as no one wanted to buy those assets encumbered as they were by debt and uncertainty.

I also noted in *Moral Capitalism* the sometimes negative effect of desire for money. "The interest of owners and investors in making money introduces a challenge to moral capitalism. Money is easily idolized, provoking heresy by turning us away from the things of God to the things of Mammon. There are times when we may sell our souls to gain what money promises in way of power and license. This is especially true in today's culture of consumerism, where we have sanctified appetite over character."

How much did this dynamic contribute to the current crisis?

I close these thoughts with a quote from an ancient Chinese text, the Annals of Lu Bu Wei, who wrote about 250 BCE

"In making judgments, the early kings were perfect, because they made moral principles the starting point of all their undertakings and the root of every thing that was beneficial. This principle, however, is something that persons of mediocre intellect never grasp. Not grasping it, they lack awareness, and lacking awareness, they pursue profit. But while they pursue profit, it is absolutely impossible for them to be certain of attaining it."

Global Prosperity at Risk

The Current Crisis and the Responsible Way Forward

Draft Statement by The Caux Round Table

October 1, 2008

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- First, the principle of *"enlightened shareholder value"* should be codified in company law via non-prescriptive minimum standards for responsible decision-making and good governance. (The UK Companies Act 2006 provides an example of such legislation.)
    - Directors should be required to document and defend their stewardship over company affairs via specific disclosure of:

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

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

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

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

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

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

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

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

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

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

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

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