CAUX ROUND TABLE

Moral Capitalism *at Work*

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2016 Global Dialogue

2016: An Inflection Point in History?

Historic events of 2016, so far, include a decision by a small majority of voters in the United Kingdom to withdraw their nation from the European Union, the rise of Donald Trump as a presidential candidate in the United States, the decision of an international arbitration panel that China has no claim to the ocean waters of South East Asia, a continuing series of killings in the name of one religion's God, the growth of global debt to 3 times annual global GDP, and a realization that the governments of the world have no way to end "secular stagnation" in the global economy.

Are we in a hiccup of history only, or have long-term trends taken a turn for the worse?

During the Caux Round Table's Global Dialogue in New York City on July 14-16, CRT members discussed a variety of issues that underlie efforts to bend history towards better outcomes: our current finance industry; the UN's Sustainable Development Goals; how to value and to nurture intangible assets; and the abiding role of governance.

The core message of participants was "start with first principles" to look high, not low, for better ways forward.

The vision/mission of CRT is for business, by embracing moral capitalism, to contribute to greater prosperity, sustainability, and fairness. From what was discussed during the dialogue, CRT can best further its mission, at this time of change and challenge, by pursuing four broad goals: (1) create all-important intangible capital by engendering purpose-driven businesses with engaged employees; (2) improve governance in both government and business; (3) embrace and encourage partnerships to achieve the Sustainable Development Goals; and (4) reform our finance industry so that, by creating jobs and putting hard assets to work, investments create sustainable value.

1. <u>Create intangible assets though purpose driven companies with engaged employees</u>.

The new business ideal is a purpose-driven business with purpose-driven employees. The corporate ethos needs to evolve – to get people in corporations, starting at the top, to think about their purpose in new ways. They need to embrace Environmental Social Governance (ESG) values. CRT can help return corporations to these first principles. CRT should go to the policy makers and help them re-design the system. Being an International NGO, CRT can point out that the Swedish word for business translates as "doing social good." Through chambers of commerce, podcasts and NPR (a segment for Marketplace), CRT can address values issues in practical ways, to discuss how first principles can be applied in practice. CRT should then work with others to create and promulgate better ESG metrics, because "what gets measured, gets managed."

Developing countries need to develop and to value intangible assets. Following its independence, Singapore developed the rule of law, avoided corruption, and educated its work force. To be ready for the knowledge economy, Singapore developed the KISE capitals: (1) Knowledge capital; (2) Imagination capital, (3) Social capital, and (4) Emotional capital.

Capital equals kinetic energy, and intangible assets equal potential energy. When locating a business, one should look for certain intangible assets. How good is the local human capital? Within a community, how strong is the rule of law? Prof. Tobin's observation (Tobin's Q) on the ratio of market value to book value reveals how intangible capital adds value to tangible capital.

We can now measure employee engagement, and employee engagement is highly predictive of an enterprise's performance. Yet such measurements are underused (Gallup offers the service). Moreover, stimulating employee engagement when it is lacking remains a challenge. We know that growth comes from unleashing the human capital. We need to learn how to unleash such capital.

<u>Synergy vs. Trust</u>. With respect to enhancing potential energy within a firm, centralizing generally creates synergies. For instance, put two or three purchasing departments together, and you get synergy. Synergy is not just the whole is greater than the sum of the parts; rather, the whole is unpredictably greater. But synergy usually comes at the cost of motivation. Motivated people are happier, and they are more fun for others. We know how to engender motivation. Managers must show that they care for, respect, and trust their employees. If managers want trust in return, they need to let their employees question them. When managers show that they care for employees, then, when

the business has a difficult time, the manager will have the employees' trust. If employees feel that they have been listened to, they can accept decisions that they had opposed.

One model to preserve both trust and creativity calls for companies to spin off operations once they reach 50 employees. That way, the theory goes, the employees always feel ownership.

U.S. military management successes and tool for improvement. The U.S. military has done the best job of racial integration, in part because it has a high level of trust. This trust is helped by the fact that the military has a clear and focused mission and consensus. Being mission driven, the military has an explicit need to change when conditions change. The Quadrennial review facilitates/requires such changes.

2. Improve Governance in both Government and Business.

Governance is a highly valuable form of social capital, which supports wealth creation, community peace and security, and social justice.

Good governance is a form of insurance for society, to protect us against harm and loss.

Government. Governments need to regain public trust. Back in the 1930s, people liked government, now they distrust government. Both the World Bank and the OECD argue that governments can win back the trust of their people if they get rid of corruption and provide basic services like health care well.

To bring back trust, governments should engage in small, short projects that: (1) address problems that are the most pressing, and (2) provide long term, sustainable solutions. In the US, such projects could be the areas of financial regulation and government procurement (which cries out for professionalization in an area that no one understands).

Too often employees within government systems are not sufficiently trained or otherwise qualified to serve the needs of either the government or the public. This is especially true in U.S. federal procurement programs. Vendors and government officials both acknowledge that government procurement employees do not have skills and competencies to do the job. Academia should work together with government to determine what skill sets and competencies are necessary.

Academia has an important role to play in assisting government to improve its performance. Public policy graduate schools should provide both trained and talented graduates to go into government service. Those schools should also devise creative and effective solutions to public policy issues. But most graduate schools will acknowledge that they have fallen short. Now, instead of taking on those challenges, the schools just produce graduates. Worse, those graduates are less and less inclined to take positions with the federal government.

More broadly, government managers complain that they don't have access to qualified people to hire or to train. In the United States, demeaning the role and effectiveness of government for 30 years has no doubt hurt recruitment. Nevertheless, public policy schools should research and define the necessary skills and competencies for a good government worker, and those schools should be figuring out how to teach those skills and competencies effectively. For their part, senior government managers would like to be more involved in teaching. CRT could help the schools and government to work more closely together in line with the CRT ethical principles for government .

It is hard to keep good people in government. The risk/reward ratio is out of balance, and that imbalance is the single biggest reason for government employee unhappiness. Bureaucrats are also hampered by legislation that lets both sides declare victory but that is unworkable.

Scoring country risk (for businesses within a country): (1) can you believe the company's reports; (2) are property rights protected -- your rights and the company's rights heard in an open and fair system; and (3) transparency of operations. Lower risk discount -- more money flows in, more development occurs, and the development is more just. For scoring risk in Islamic countries, they have created an Islamic version of finance and governance.

In Singapore, ministers are compensated by the performance of their departments. In 1965, when Singapore became independent, it focused on attracting investment. Per capital GDP was then $250, now it is $56,000. They created a social compact between government and the people whereby government, the privet sector, and the people come together to agree on planning – for instance, skills training, skills conversion, immigration, and talent attraction policies. They now have a truly international workforce. In 2011, voting resulted in a change of various government policies; voting in 2015 showed agreement with new policies.

<u>Business</u>. In the U.S., corporate boards owe fiduciary duty to the company shareholders as the fundamental norm of corporate governance. But Dr. Echols at Harvard Business School looked at laws in 20 countries and found no legal support for an exclusive primacy of shareholder interests over the

interests of other stakeholders in the company's success – customers, employees, suppliers, communities, and the environment. Boards therefore owe a practical duty to the company to promote its success (which includes all stakeholders). If a company takes care of its customers, its employees and its community, the interests of the shareholder will take care of themselves.

New corporate models. The best model that persuades companies to move companies is the German code, which created three categories of corporate obligations: musts, shoulds and coulds. While from the start the companies comply with the musts (by following the law), every year some of them adopt some shoulds and coulds. This model gives the companies leeway to move and improve their CSR performance over the years.

Public benefit corporations are another relatively recent model in the U.S. to promote companies with strong CSR motivation and orientation. The purpose of public benefit corporations is to reimagine the corporation from the ground up, to see if we can create some market incentives for people to collaborate for business purposes without being beholden to special interests. Now at least 30 states, having enacted bi-partisan legislation, have adopted public benefit corporations.

Employee owned enterprises also offer an ownership model more conducive to the production of shared value between the business entity and stakeholders.

Co-ops (in agriculture and consumer products) also offer flexible ways to operate businesses for broader goals -- shared profit and shared value. The mutual company structure also promotes other goals.

Employee owned companies and benefit corporations do not work with current finance structures, which promote trading of financial contracts over investment in productive growth. They prosper the old fashioned way by putting real value into a company. Diverting liquidity away from trading to such new and/or alternative forms of business ownership would stimulate global economic growth.

ESG ratings. CRT could promote an ESG ratings system that would rank (and therefore incentivize) all companies. The value of an ESG focus is that it identifies material risks to companies that are not on the balance sheet. In other words, a business's ESG rating would reflect material issues and risks within the community in which the business operates. From an investor standpoint, ESG ratings make sense because: (1) they positively screen (instead of negatively); (2) if a company has a good G score, it usually does well with E and S; and (3) any effort to improve performance of its ESG will improve a company's profit. A high ESG rating by a company should lower its cost of capital.

Company employees are pushing back hard because they want to do the right thing. We should inspire and support enterprises to make the effort to embrace principles from within the organization. We need to give those in business a license to go to first principles. Then they can put important values in their Key Performance Indicators. If they can't think it or say it, then they can't do it.

Professional business oaths to use commerce to serve the greater good. Traditionally, the oath of a professional in business covers the entire range of business responsibilities, including, *inter alia*, finance, operations, customers, and the environment. The oath project at Harvard Business School succeeded in getting all members of the class signed such an oath. Bill George was behind it. All graduates signed it. By 2016, all had forgotten it.

3. Sustainable Development Goals (SDGs)

The UNGA adopted the SDG's on September 25, 2015. In July 2016, the High Level Political Forum, under the auspices of ECOSOC, reviewed progress on the Sustainable Development Goals (only 6 months after they became effective). The theme for that review, "Leaving no one behind," is appropriate because: (1) amidst widespread economic uncertainty, inequality is rising, and the wealth gap is widening; (2) terrorism and the proliferation of refugees increase instability and the likelihood that people will be left behind; and (3) climate change is, among other things, putting whole Pacific island states at risk of disappearing.

CRT's position is that the SDGs reflect the ethics of a global "moral capitalism" and that the SDGs ratify the ideals of the CRT and its supporters. The expected cost of the SDGs is $53 trillion (over 15 years), based on no cost to implement them and 100% success. The cost is to be paid by governments and the private sector (business, philanthropic and non-profit communities). So the question for CRT is how to get the business community to support the SDGs and to create partnerships with governments and civil society to implement (and pay for) the SDGs.

Pledges. One approach is to ask business leaders to take a pledge, such as the Business Leaders' Sustainable Development (BLSD) pledge, to engage with SDGs. But pledges have proved to be problematic – no one wants to be the first to sign ("I'll do it when everybody else does it"). Furthermore, companies do not want outsiders holding them to obligations under the pledge. Worse, an unmet pledge can become the basis for litigation.

CRT should encourage shareholders of family-owned companies to embrace the BLSD pledge and, in turn, persuade the company CEO to sign it. With such shareholder support, closely-held businesses are less vulnerable to shareholder lawsuits.

UN Global Compact. The UN Global Compact has re-designed its entire website around the SDGs -- a sustainability compass. All of the indicators (several hundred) show how to measure success. The Global Compact Leaders Summit has embraced all of the SDGs and has held 20 round tables in capital cities around the world to discuss how businesses can collaborate to achieve the SDGs. Within companies, however, the discussion about the SDGs often gets too removed from the board, and responsibility for company alignment with the SDGs gets delegated too far down the corporate ladder. As a result, there is not a lot of knowledge of the SDGs.

When the Global Compact started, few U.S. companies signed on. Signatory companies had to report on their adherence to Compact principles. That would make them subject to class actions whenever there was a perceived gap between corporate behavior and the language of the Compact. Even if the lawsuits were without merit, they still added costs of time and money to resolve. Litigation sensitive companies declined to sign up. Hence, of the 8,500 organization members, only about 800 are from the U.S.

Open the hidden economies. In July 2015, the Addis Ababa Action Agenda called for governments, businesses, and philanthropists in every country to contribute to funding the SDGs. But the AAAA also noted that, in developing countries, 40% to 50% of GDP is locked out the economy. In order to bring the underground economies into the open, we need to get serious about finance, titling, technology transfer, and other means of enabling underground economies to mature and participate in the open.

The Tschida experiment in Tanzania shows that underground economy will become visible only if the market mechanisms have taken hold. Countries should not try to force underground commerce to close. Rather, each country should respect its hidden economy but, at the same time, encourage its hidden economy to become part of its open economy.

4. Reforming our Finance Industry

Finance should be seen as a public utility that serves the needs of public systems and large institutions, as well as the interests of private individuals. The reform of our global financial system should flow from its purpose, its first principle. Our system now creates a lot of money, but not enough “value.” Our leaders don’t want to move out of their comfort zones.

Finance has been taken over by traders with short term interest. Worse, the world of finance has become taken over by derivatives – investment plays that create no new jobs, create no new businesses, and spawn no new inventions, cures, or technologies. The rise of derivatives contributed to the economic meltdown of 2008.

Finance turns on valuation of investment opportunities. But good valuation should measure the effectiveness of achieving that which is valued. What do we value? What should we value? Intuitively, are short term results really that valuable? Or are they only nominal, subject to fluctuation and therefore misleading in the immediate term? Value should flow from purpose and mission – that which justifies our lives.

Currently we are in a period of severe secular stagnation -- no growth, with negative yields, for a prolonged period. Modern capitalism has never seen such an environment . There is no consensus on the causes of this stagnation, but there is a growing awareness that both business and finance have no tools to bring it to an end with a new phase of robust economic growth. In the aftermath of the 2008 crash, we have made many reforms, but fundamental misalignments remain. For instance, not touched by the post-crash reforms is a section of the U.S. Bankruptcy Code that still gives special treatment to short term funders. The provision, which could be easily removed, drives holders of securities as collateral to sell them in a panic mode when market prices start to drop. Such selling triggers a deeper panic in financial markets which, in turn, imposes losses across the real economy.

Similarly, Collateralized Debt Obligations (CDOs), the very asset class that was at the heart of the crisis, remain protected. A safe harbor had been put into law, for financial stability reasons, to cover treasury notes/bonds and CDs. Then in 2005 the protection was extended to include MBS (Mortgage Backed Securities) CDOs as well. And today the United States' Security and Exchange Commission, in its Regulation AB II, still carves out for protection the private placement market where CDOs are made and sold. CDOs are now cheaper than equity and long term debt. Financial institutions are still addicted to CDOs. Indeed, today the world has $700 trillion in derivative investments, which is more than 8 times the world's GDP. Our system is also largely addicted to debt. We need to wean ourselves off it and embrace equity. But debt is incentivized by the deductibility of interest.

Muslim banks are designed to serve the real economy, not the finance economy. Banks are seen as being in service to the economy. Generally, there are no derivatives in Muslim economies.

While the Federal Reserve's post-crisis regulatory response incentivizes big banks to get smaller, our tax policy incentivizes them to get larger. Regulatory structure in the U.S. is the result, not of design, of political compromises. Simplicity is harder to get to than complexity. A better model was shown when President Reagan and Speaker O'Neill agreed to have experts recommend reform for Social Security and then have Congress make an up or down vote.

By the time regulators have found and corrected one loophole, the market players have long since moved on to find and exploit a new one. Similarly, the ability of the finance industry to create new forms of derivative instruments greatly outstrips the ability of regulators to comprehend them.

We're beginning to measure the impact of derivatives. A derivative-laden system misallocates resources, including economic capital and HR talent, and it systematically creates inequality. Derivatives divert funds away from start-ups and investments that create jobs. Indeed, regulation reform has kept banks out of funding new start-ups. Similarly, since 2008, all trend lines about getting capital to small towns and companies are down. Traditional start-ups and IPOs, which together have been a traditional source for jobs in small towns and communities, are way down. That is another unintended consequence of the reforms to our macro-economic system.

Our current financial system cyclically creates huge life disasters (like the 2008 crash), from which some people and families never recover. It corrodes a sense of purpose within society, creating large groups of disaffected people. For instance, despite warnings, working class Britons voted for Brexit. In the U.S., Occupy Wall Street lives on in both the Trump and the (now concluded) Bernie Sanders campaign. Millennials don't see a society that will take care of them. They now distrust the free market. Young people are drawn to large companies because there are fewer start-ups and fewer organic corporations.

Conclusion:

This is an unsettled time – good governance seeks to foster the art of finding solutions to today's problems and going forward. Our world needs courage and creativity. We should open-mindedly take the best of the results and apply them widely. We should seek a meritocracy of ideas. What works, should win our allegiance.