



Moral Capitalism at Work

LESSONS FROM THE GLOBAL FINANCIAL CRISIS

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The global financial crisis has brutally thrust the future of free-market economic fundamentalism – something called brute capitalism - onto centre stage.

The one thing that became increasingly clear - as the world was cast headlong into the financial crisis - was that the efficient market hypothesis, that free and unfettered markets will find stable equilibriums, is simply wrong.

Financial markets, left to their own means, are clearly not perfectly well behaved and they do not self-correct.

The then Australian Prime Minister, Kevin Rudd, summed it up when he said in the lead up to the April 2009 G20 Leaders Summit “unfettered free markets became worshipped as a god and we know now that god was false”¹.

The fallout from the crisis has been widespread, frightening and ongoing. Across the US and Europe we’ve seen massive levels of public and private indebtedness, growing income inequality, high levels of unemployment, and the flow on into chronic near-term under investment in education, public health, and other infrastructure.

It is pretty clear something will have to change or it will be just a matter of time before the next financial crisis is triggered – and that one may well take us over the precipice.

In considering the lessons from the crisis and how to reshape brute capitalism, it is helpful to firstly reflect briefly on how the seeds of the global financial crisis, and the ultimate collapse in trust and confidence in the system, were sown.

¹ The Australian, April 01, 2009

The experience of the earlier “new economy” dot-com stock market boom and bust in 2000 should have taught regulators, investors and others that ongoing returns, several times the underlying economic growth rate, are not sustainably possible.

Certainly, the so called financial masters of the universe in the investment banks should have understood the illusion of risk-free speculative finance.

But instead, spurred on by obscenely large financial incentives, bankers and others enthusiastically developed and promoted innovative financial products and investments promising above normal returns at apparently low risks – many coming with the so called comfort of AAA ratings. In reality, the risks were anything but low.

As this irrational exuberance storm gathered, transparency and concern for the underlying risks quickly went out the door.

Rational value and risk signals simply got ignored as the exuberant led the blind in a climate of greed and excess.

And to make matters worse, the originators themselves, let alone the regulators and investors, often didn't fully understand the risks sitting inside the complex and opaque structures. As a result, the unsustainable but promised high returns proved to be just that – unsustainable.

The risks ultimately mattered, and the prices of these so called high yield investments – CDOs and other mortgage backed securities – ultimately collapsed. And with it, trust and confidence in the market nose-dived.

To put it bluntly, the hoped for safety valve of market discipline failed to kick in and control the speculation. It failed to stamp out the greed and the narrow self-interest. And it failed to stamp out blinkered ignorance of two key investment fundamentals; namely that returns on capital have to be appropriately in line with real economic growth rates, and that asset prices have to correctly reflect the underlying risks.

Added to this, households across the G20 countries were on a debt binge and feeding their excessive levels of consumption through significant increases in borrowings. Combined with systemic failures in consumer protection, many were left with obligations they simply didn't understand nor could afford.

But the key trigger that really threw fuel on the fire was dysfunctional and short-sighted executive remuneration systems. Built principally around ever increasing short-term rewards, typically linked to increased risk taking, executive incentives have become largely decoupled from long-term stakeholder wealth creation. And if that was not concern enough, their structure in effect often shields executives from appropriate liability for their decisions.

Driven by such dysfunctional incentives, greed and narrow self-interest have thrived. And when rivers of narrow self-interest and executive greed are allowed to go on unchecked, they ultimately became fertile seas for long term value destruction.

The roots of this modern brutish capitalism of course go back to the rise of 'laissez faire' economics in the early 19th century. While the popularity of this libertarian driven economic philosophy - where governments give way to the power of markets - dipped somewhat with the socially

unpleasant consequences of the Great Depression and the world wars it made a resounding recovery in the West in the last few decades.

This free market fundamentalism, in fact, had drawn a good deal of its thinking from Social Darwinism a philosophy whose essence is that human societies work best when the principle of 'survival of the fittest' is exercised with the minimum constraint.

But as the global financial crisis showed again, when Social Darwinism gets applied to the capitalist system greed and narrow self-interest get elevated to the status of core values.

The one positive that we can take out of all this is that surely it has finally shattered the naïve belief that 'unfettered' financial liberalization in a market, driven by such core values, can be a path to securing sustainable economic prosperity and social progress.

Little surprise then that reforming the system, restoring confidence and rebuilding trust have been at the top of the priorities for the G-20 leaders as they have struggled to deal with what they have described as "the greatest challenge to the world economy in modern times".

To date, however, political and regulatory action has focused, by necessity, on 'putting out the fires'. But dealing with just the symptoms can only take us so far. Fundamental reforms are urgently needed to repair the free-market's immune system and get it back onto a sustainable basis.

The starting point for this must be to recognise that the problem has both an economic and an ethical dimension. The fact is that free-market fundamentalism has simply lost its moral moorings.

Adam Smith, the so called founder of capitalism, understood the importance of moral footings and he believed the economy could not function properly without ethical foundations.

At last year's Global Dialogue, Lord Skidelsky from the United Kingdom in fact drew attention to the two key ethical shortfalls of brute capitalism. First, it promotes bad behaviour as it is driven by the motivating forces of greed and selfishness. Second, brute capitalism sets no limit on wealth accumulation. Its only goal, he argued, was to make people richer and richer – at least in financial terms.

Clearly, we urgently need to get the 'free' market working again in a way that fulfils of Adam Smith's promise that individual gain can lead to collective gain.

Smith in fact described an economic system based on 'enlightened self interest' and he underpinned his system with the virtues of justice, fairness and honesty. Smith saw neither selfishness nor greed as virtues and he regarded the spheres of human conduct - economic, social, moral, and political - as interwoven and mutually dependent.

Despite the resistance of business, the landscape has already changed dramatically with widespread socialization of the veins of the western economies via the bail-out or guarantee of banks.

As Martin Luther King said - when times get hard we get "socialism for the rich and rugged free market capitalism for the poor". How right he was with this crisis.

As one would expect, politicians and regulators are seeking to enact regulation aimed at preventing the types of excessive behaviours that

precipitated the global financial crisis. But regulation, in itself, cannot fully repair the market's immune system and make it resilient to future attack.

At the end of the day, you cannot regulate good behaviour. And businesses and markets can't comply themselves to greatness. What is needed is for markets and governments to re-engage with each other in a reciprocal and systemic balance that fosters responsible stewardship and trust. Markets need to be adequately constrained by governments, and governments need to be disciplined by market realities and aspirations.

What is clear is that 'free' markets can't be sustained without responsible stewardship and trust. But responsible stewardship and trust are first and foremost ethical and behavioural issues.

This is why the first step in repairing the market's immune system must be to get government and business leaders to embrace and enact ethical principles consistent with responsible stewardship and citizenship, enlightened governance, and sound risk management.

The Caux Round Table's (CRT) Principles for Responsible Business² and for Government go to the heart of constructive and ethical business behaviours. By embracing and living such principles, free-markets can flourish and sustainable and responsible prosperity can become the foundation for a fair, free and transparent global society. But widespread voluntary adoption of such ethical behaviours and practices will require a new leadership ethos for those in government and business.

The great business thinker Peter Drucker summed up the challenge. If society is to survive and prosper, he said *"the leaders of all institutions will have to learn to be leaders beyond the walls . . . it is not enough for them to lead their own institutions, though that is the first requirement."*

² The CRT *Principles for Responsible Business* can be accessed at <http://www.cauxroundtable.org>

They will also have to learn to become leaders in the community. In fact, they have to learn to create community.”

Beyond embracing ethical principles, the needed accumulation of responsible stewardship capital will require additional reform measures covering corporate governance, executive remuneration, financial and banking regulation, and the functioning of multilateral institutions, if we are to rebuild a resilient market system.

Reforming our dysfunctional and short-sighted systems of executive incentives and remuneration is most critical. Put bluntly, the way incentives for senior banking executives, traders and fund managers are structured simply provides them with greater incentive to do the wrong thing than to do the right thing.

In the chase to secure the enormous short term performance bonuses on offer, nothing much got in the way of self-interest. The bonus culture sowed the seeds of the sub-prime crisis and the long term interests of shareholders and other stakeholders didn't get a look in.

Boards and regulators therefore need to urgently correct the inherent conflicts and systemic misalignment of incentives. For example, when compensation derives from the issuance or sale of risk based financial products, the key executives involved should be required to personally provide a legally binding annual statement on their assessment of the risks and responsibilities involved.

If such statements had been provided on sub-prime mortgages and related mortgage securities, the market would have been informed on borrowers' capacity to repay, particularly when loans reset; the sustainability of the boom in housing demand; whether the rate of house

price appreciation was sustainable; and so on. If such disclosures had existed, it is unlikely that the sub-prime crisis would have eventuated in the first place.

Accurate and reliable investment analysis and valuation also has to be a part of the market reforms. This will require adequate and timely public disclosure of all material information. When all relevant material facts are in intellectual play, valuation analysis has a high probability of getting the price right. But opacity of risk, combined with greed and narrow self interest in a rising market, has been a toxic mix for serious mischief.

Equity markets must also be reformed as they have largely become decoupled from long-term value creation. They look and function more and more like casinos with a material part of the market more interested in betting on stocks losing value than focusing on investing for growth. Even the horse racing industry, which is not well known for its ethical practices, bans punters from betting on horses to lose!

In line with these widespread concerns and in the lead up to the G-20 Summit in April 2009, the Caux Round Table laid out a seven point reform plan in mid-2009 to restore a more responsible and moral free-market system. The proposed reforms directly address the key underlying causes of the global financial crisis and the critical need to restore the soundness of financial institutions which remains of first importance for a successful market economy.

In summary, the CRT's proposals are that:

1. Board directors should be required to consider interests beyond shareholders, which may affect the company's success, by codifying the principle of "*enlightened shareholder value*" in company law.

2. Minimum standards of corporate governance knowledge and expertise should be required for corporate board directors.
3. Corporate boards be required to have a dedicated board committee responsible for risk oversight across the full spectrum of risks - financial, governance, social, and environmental.
4. Executive remuneration structures must be regulated to ensure that they are consistent with prudent risk management, align with long-term shareholder wealth creation, and do not reward poor performance.
5. Stronger and globally co-ordinated financial and banking regulatory reforms should be implemented to prevent systemic risk build-up or market manipulation.
6. All financial markets instruments and investment activities, which materially impact on financial system stability and on superannuation and pension system viability, need to adequately regulated.
7. The IMF and other multilateral institutions should be reformed and adequately resourced to ensure that they are effective forces for economic and social justice globally

Detailed reforms are proposed within each of the above seven reform areas and full details can be found at www.cauxroundtable.org.

This reform plan represents the path to building a resilient free-market immune system of strong ethics, responsible stewardship, enlightened corporate governance and sound risk management. If fully implemented, the deep cancer of irrational exuberance, greed and narrow self-interest within brute capitalism would be eliminated.

In conclusion, the key lesson from the global financial crisis is that if the free-market capitalist economy is to sustain itself for global prosperity, it needs to be both responsible and moral. The business of business cannot simply be business – and certainly not business divorced from good stewardship and accountability for its impacts on society.

Put simply, the lesson is that business needs an ethical compass in addition to its practical reliance on measures of profit and loss. And the interests of business must be balanced with the aspirations of society for mutual and sustainable prosperity.

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