

Reactions

Opinion - Restoring trust in the financial markets

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In the wake of the subprime crisis, the public's faith in financial markets has been massively shaken. The disastrous global ramifications of what started as a regional mortgage crisis have brought about the most severe economic calamity since 80 years. What went wrong? And what needs to be done to minimize the likelihood of such a cataclysm repeating?

Against this backdrop, we have interviewed a number of senior corporate and non-corporate finance experts, including prominent insurance figures such as Stine Bosse, CEO of TrygVesta, a leading Scandinavian insurer; George Stansfield, the group general counsel of AXA; and Patrick Liedtke, secretary general and managing director of The Geneva Association. In addition, we have spoken to Peter Voser, group CEO of Shell; Bill Emmott, former chief editor, The Economist; Klaus Wellershoff, former chief economist of UBS; and professor Ernst Fehr, a renowned academic from the University of Zurich.

The findings from these interviews will enter the discussions at the 10th International Sustainability Leadership Symposium, to be held in Rueschlikon/Zurich on September 10-11, 2009 (<http://www.sustainability-zurich.org/en/p67000279.html>).

What went wrong?

Severely flawed risk management practices

The financial crisis has exposed serious flaws of corporate risk management. Stress testing was not properly implemented, particularly in banking.

Further, more often than not, quantitative models were allowed to supersede managerial judgment, experience and intuition, says George Stansfield, group general counsel of AXA. The inability of traditional risk models such as Value-at-Risk to anticipate extreme scenarios turned out to be one of the biggest flaws, he adds.

Patrick Liedtke, secretary general and managing director of The Geneva Association feels that the insurance industry has done relatively well, based on its long-standing familiarity with scenarios and a good understanding of model limitations.

Risk grossly mispriced

Risk has been grossly mispriced by markets. In the absence of effective risk management tools, market participants were complacent about risk and fooled by securitisation and its promise to disperse risk, says Bill Emmott, former chief editor, The Economist.

Stansfield adds that securitisation has caused a severe misalignment between risk origination and absorption. The originators often had no or far too little skin in the game, he says. The consequences: reckless behaviour, very poor underwriting of risk, and perverse economic incentives in many cases.

Peter Voser, group CEO of Shell, points out that flawed risk models and ratings contributed to a severe mispricing of the structured securities created through the originate-and-distribute model. He also emphasises the disastrous effects of the complexities of the securitisation process. End investors in the structured securities were faced with major information asymmetries. This led to a financial panic and illiquidity of whole asset classes that destroyed much more financial value than the underlying losses in the US housing market.

Klaus Wellershoff, former chief economist of UBS, suggests that the current crisis is the result of collective

exuberance and exaggeration as consumers, companies and policymakers were lured to believe that high growth combined with low inflation would be a stable and sustainable paradigm for the future. This belief ultimately led to a monetary policy which has proven to be excessively aggressive and lax.

Corporate business models went astray

Stansfield believes that excessive leverage was primarily driven by financial markets' seemingly unlimited appetite for securitised products coupled with the exponential growth of other non-bank sources of credit over the past years.

Emmott goes one step back and highlights the profitability problems in retail banking and insurance due to commoditisation. To address this long-standing issue, he says, banks and insurers did accelerate financial innovation, took on increased risk and, ultimately, deviated from their traditional business model. Liedtke is sceptical about putting the blame on business models and corporate strategies as such. In his view, market participants were simply exploiting the opportunities of cheap financing, changes in regulation and financial innovation, whilst ignoring tail risk, a notion well known in the insurance industry but grossly neglected in banking.

Deficient corporate governance practices

Voser believes that the crisis was triggered by a systemic failure of checks and balances and a collective, single-minded focus on short-term success. Stansfield at Axa adds that in certain cases, boards were simply too close to their CEOs. He also considers the concept of independent directors as being ill-defined in certain cases and feels that the independence criteria are, in many cases, overly technical and have the perverse effect of disqualifying people with deep industry experience who are often best placed to assess risks in complex institutions and protect shareholder interests. Liedtke concurs and stresses the importance of a decent level of "insider know-how", understood as familiarity with the business, for any board member to perform his or her role.

Overwhelmed regulators and policy-makers

Emmott believes that regulation is a constant battle between regulators and financial innovators. For example, banks responded to tighter capital requirements by resorting to huge and intransparent off-balance-sheet vehicles which masked their true risk exposure. This, plus securitisation, meant that nobody knew where the risk went, he says. The level of ignorance was compounded by the fact that a number of truly global institutions were still regulated largely on a national basis and, therefore, inadequately, adds Stansfield.

The future of finance: Towards a sustainable paradigm

Transparency and disclosure need to be enhanced

Emmott believes that improvements in transparency are of key importance to making market participants act more sustainably and rendering markets less vulnerable to shocks and dislocations. In his view, enhancing disclosure has both a qualitative (e.g. in respect of complex structured products) and a quantitative dimension (e.g. in respect of derivatives traded "Over-the-Counter" (OTC)).

Ernst Fehr, an academic from the University of Zurich, disagrees: Excessive risk taking must be constrained, he says, pointing to the pharmaceutical industry where entrepreneurial freedom is curtailed due to human health considerations – without choking the market mechanism as such or stifling innovation.

Stine Bosse, CEO of TrygVesta, a leading Scandinavian insurer, also feels that even though the financial markets generally work well and, over time, excesses in either direction are corrected, the lessons from the years of easy finance (2002-2007) suggest a tighter regulation.

Stansfield at Axa sees a specific need for regulatory action in the area of securitisation where the interests of originators and risk takers need to be more properly aligned in order to avoid excesses such as in US subprime lending. On the topic of accounting standards Liedtke at the Geneva Association warns that an unreflected application of fair value accounting rules for long-term businesses could create the sort of short-term incentives which have proven to be pernicious in the run up to and during the crisis by fuelling the boom and exacerbating the downturn, respectively. From an insurance perspective, Stansfield argues that the notion of marking assets to market is somewhat hard to reconcile with the long-term character of insurance liabilities, a mismatch which can cause major distortions to the insurance industry's financial reporting.

Heavy-handed intervention in business models needs to be avoided

Voser says that, as a businessman, he still has faith in the free market's ability to serve society. In his view, a good regulatory framework sets clear rules and offers credible, effective mechanisms to enforce these rules, while at the

same time enabling the market to unleash its value-creation and innovation potential.

Bosse warns that the risk of overregulation needs to be carefully managed. In her view, excessive regulation will reduce innovation and the motivation for growth and this could in the longer term work against an effective asset allocation and market expansion for the financial markets.

Wellershoff expects that customers will have the most significant influence on future business models in finance. They want simpler and more transparent products. Financial services companies will respond accordingly, he believes. Liedtke also suggests that markets and their sanctions are the most effective regulator of business models. He forcefully calls for entrepreneurial freedom to be maintained. But this comes with the obligation for management to exercise judgment rather than allowing models to take over thinking, he stresses.

Emmott believes that we are witnessing a 'back-to-basics' movement, with simplification combined with enhanced transparency and disclosure being the name of the game, adding that this development is largely driven by shareholders and customers, not by governments.

Corporate governance regulations must be stepped up

Fehr calls for increased public intervention in corporate governance. The fundamental economic case rests on the free rider problem associated with corporate governance: An individual shareholder may have no incentive to press for specific improvements in corporate governance (e.g. the protection of minority shareholders and constraints on compensation schemes) as the benefits would accrue to all shareholders – irrespective of their individual efforts and respective expenses incurred.

In Emmott's view the main challenge in the area of corporate governance is to make Boards of Directors less "clubby and cosy" to promote dissenting behaviour. Liedtke warns against establishing a legalistic compliance culture supplanting individual values. Not everything that is done according to the rules is necessarily right, he says. Stansfield puts forward a specific proposal to strengthen corporate governance: The establishment of a risk committee of the board of directors to focus specifically on enterprise risk management, separate and apart from the audit committee.

Regulation must reflect the realities of globalisation

Liedtke believes that the crisis suggests two main regulatory lessons: First, the introduction of a truly global approach to regulating institutions which span the world and second, the establishment of a systemic risk regulator. Bosse also advocates new regulatory frameworks where risk and risk management are given a higher priority and where globalization dynamics are properly taken into account by regulators and supervisor. Stansfield agrees. He also calls for more regulators with a private sector experience in order to cope with the dynamics of product innovation and complexity.

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